



## NOV. 2016

## GLOBAL ECONOMICS & CAPITAL MARKET COMMENTARY

### GLOBAL ECONOMICS

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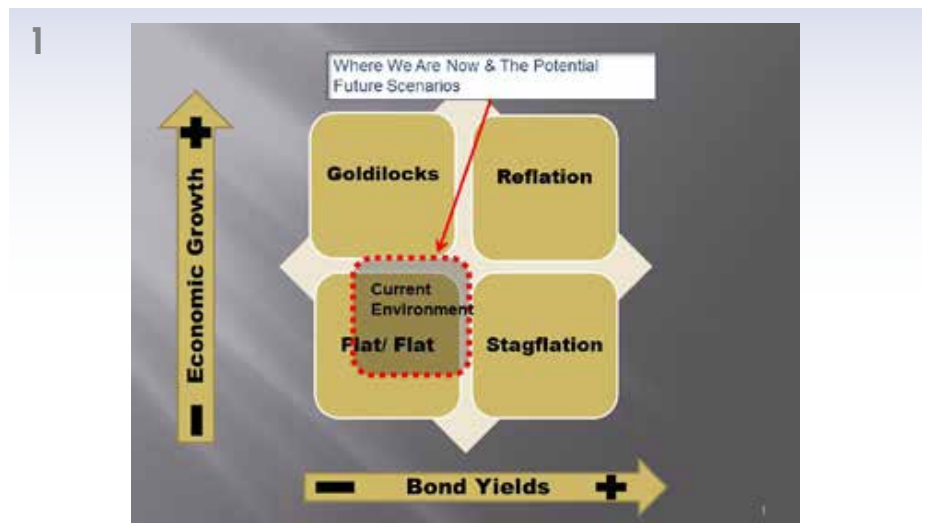
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### Overview

#### Scanning The Environment: Four Potential Scenarios

Much of the recent financial headlines and talk shows have been dominated by speculation about the next move of the US Federal Reserve, the shape of the economy under the next president and the outcome of the third quarter earnings season. All of these are important issues but we thought that it would be important to step back and examine what scenarios could potentially unfold and how to best position your portfolios for each one.

Looking forward we believe that there are four fundamental outcomes for different interest rate and growth scenarios as illustrated in Chart #1. The red outlined area is where we believe we are currently situated. The vertical axis represents the path of economic growth and the horizontal axis the path of interest rates. As you can see, we view our current situation to be primarily in the low interest rate, low economic growth box but the critical question, of course, is where we will be in the next year.





### CHARTS 2-5

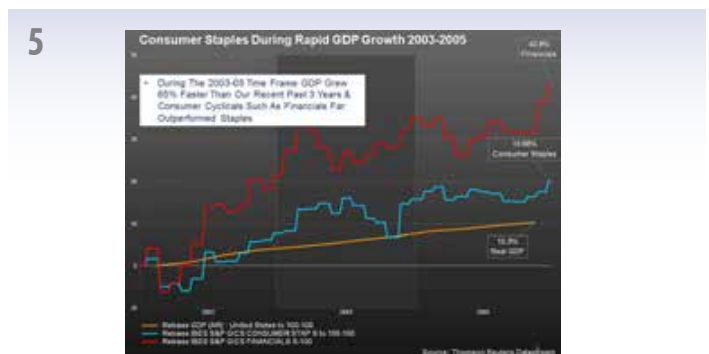
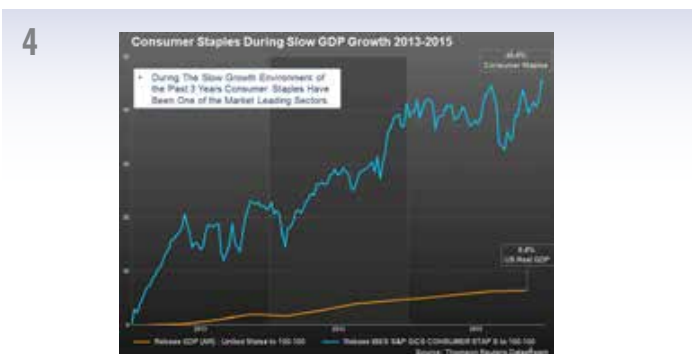
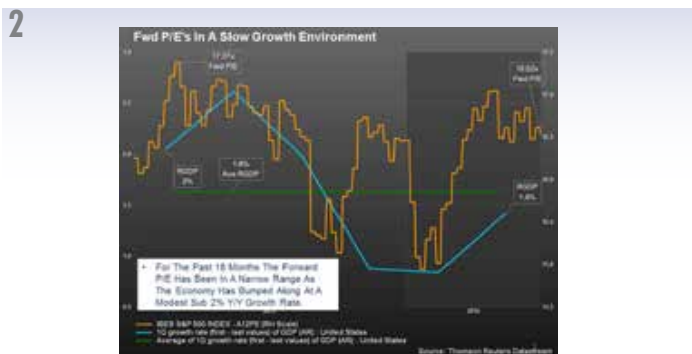
**I. Flat/Flat:** This is, in our view, our current environment. Interest rates are rising modestly but remain low and economic growth has, for the most part, been modest. In this environment we have been experiencing the typical characteristics of:

**a.** Equity valuations remaining range bound. Chart #2 illustrates how P/E's have averaged around 16.5x forward earnings for the past 18 months while the economy has bumped along at a modest sub-two percent y/y growth rate.

**b.** In this environment we would expect equities to continue to move higher driven by modest but uneven profit growth coupled with cash returned to investors through dividends and share buybacks.

**c.** Equities will outperform bonds primarily because investors do not like the alternative. Stable, defensive and low volatility growth companies will usually outperform. Active portfolio management is critical.

Chart #3 illustrates how the strongest dividend paying stocks, the so-called Dividend Aristocrats, have outperformed the S&P over the past 18 months. In Chart #4 you can see that consumer staples, a defensive sector, has performed well over the past three years while the economy has grown a mere 6%. By contrast, back to the 2002 time period, Chart #5, when the economy grew by 10% over a three year time frame consumer staples did ok but the financial sector was the stronger performer.





### CHARTS 6-9

**II. Goldilocks:** You can see from Chart #1 that in the Goldilocks environment economic growth is strengthening and yet interest rates are remaining low.

**a.** Our current situation is starting to slowly move in this direction. In Chart #6 we show that the monthly ISM Purchasing Manager's Survey is very closely correlated with Industrial Production and usually leads by four months. This is currently indicating that Industrial Production annual growth should soon be turning positive. Additionally, the earnings slump which began in mid-2015 appears to have bottomed and is now positive and growing, Chart #7.

**b.** Low interest rates are another characteristic of the Goldilocks scenario. We currently find ourselves in an environment where inflation expectations and interest rates are both rising in anticipation of stronger domestic and international growth, Chart #8. You can see in this chart that interest rates, although rising, remain at the low end of their five year range. If they rise too rapidly and too high, however, we could enter the reflation environment shown in Chart #1.

**c.** In the Goldilocks scenario cyclical stocks typically outperform the S&P500 and, as you can see in Chart #9, this has indeed been the case since the June/July time frame (blue line). This was also about the time that inflation expectations (yellow line) had begun rising in anticipation of an improving economic landscape.





### CHARTS 6-8

**III. Reflation Scenario:** In this scenario we would experience strong economic growth in combination with much higher interest rates as wage inflation rises, the economic output gap closes and fiscal policy gives a boost to monetary policy. Cyclical stocks will benefit but defensives (bond proxies) will underperform.

**a.** In Chart #10 you can see that the job openings/application ratio is at an all-time high and is helping to pull up the growth in average hourly earnings (blue line). Although the wage growth rate remains well below the past cycle its direction could signal a problem for corporate margins, Chart #11.

**b.** In an environment of rising interest rates defensive stocks typically underperform. In Chart #12 the blue line is the Consumer Staples Index inverted so that as the line goes down the index is rising (right hand scale). The gold line is the yield on the 10 year US Treasury bond. It is clear that as the bond yield declined the defensive stocks appreciated in large part because they often behave as a bond substitute. Notice, however, in the lower right hand corner that as bond yields have started rising the Consumer Staples Index is falling.

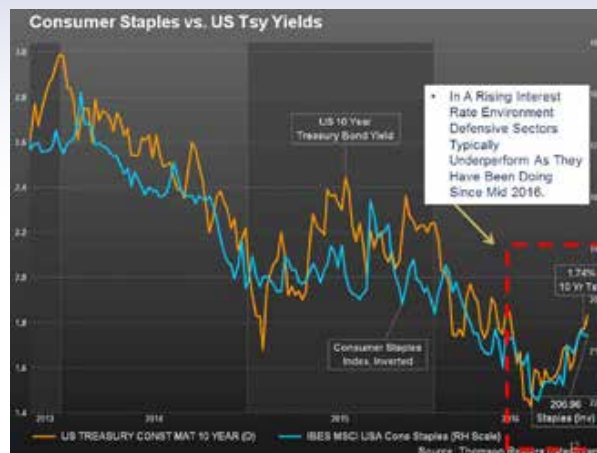
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### CHART 13

**IV: Stagflation Scenario:** This is the most bearish of the four scenarios when growth fails to materialize but inflation and interest rates keep rising. Fiscal and monetary policy has failed while rising wages squeeze corporate margins and force price increases.

Cyclical stocks typically underperform in this environment while defensive issues such as Consumer Staples outperform. Chart #13 shows the historical relationship between core CPI and wages. Of the four scenarios outlined we think that this is for now the least likely to occur.

Our current view is that we are slowly moving upwards and to the right in our four quadrant scenario model. As highlighted above this tends to be more favorable for companies in cyclical sectors rather than those in the traditional defensive sectors. The degree to the outperformance gap will largely be determined by the pace and level of change in the economic and interest environments.

Please consult with your advisor to discuss how any of the issues referenced above could impact your investment goals and profile.

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