Winslow, Evans & Crocker, Inc.℠

DEC. 2016 GLOBAL ECONOMICS & CAPITAL MARKET COMMENTARY

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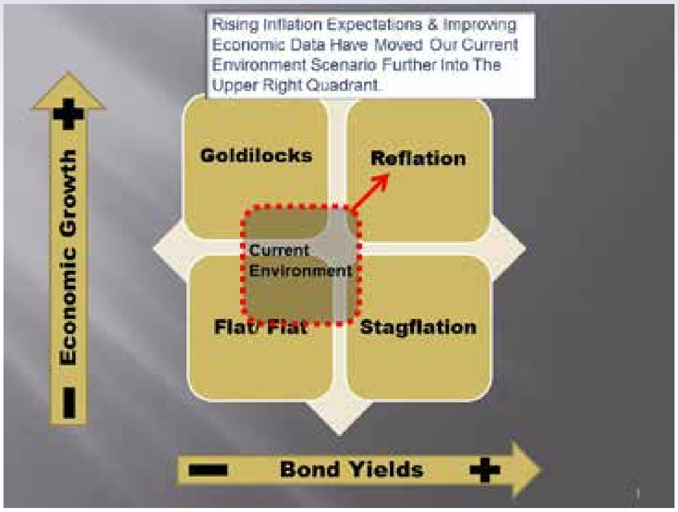
Overview

In our November monthly publication we introduced a four quadrant matrix framework to develop a better understanding of how various scenarios for economic growth and interest rate levels would impact the equities market. Our conclusion at that time is that we were trending towards the upper right quadrant of "Reflation" as shown on Chart #1. Since that publication we have had a surprise presidential election outcome which appears to have accelerated this reflation trend.

1



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CHARTS 2-3

In Chart #2 we have graphed interest rates and inflation expectations since November 8th, election day. It is readily apparent that both of these have accelerated to the upside with rates increasing from 1.86% to 2.45% and inflation expectations from 1.57% to 1.77%. This is the highest level in over two years for both! As we highlighted in last month's publication, the equity sectors that will be most adversely impacted by rising interest rates are Utilities, Telecommunications and Consumer Staples. These companies typically pay high dividend yields and therefore act as bond substitutes so that as interest rates increase their prices decline. In Chart #3 we show the Consumer Staples sector, the blue line, falling as interest rates, the gold line, began increasing around the July time period.

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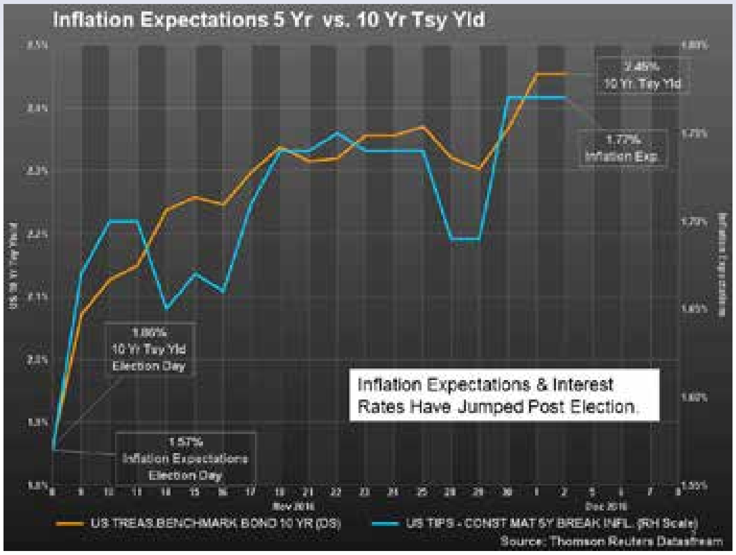

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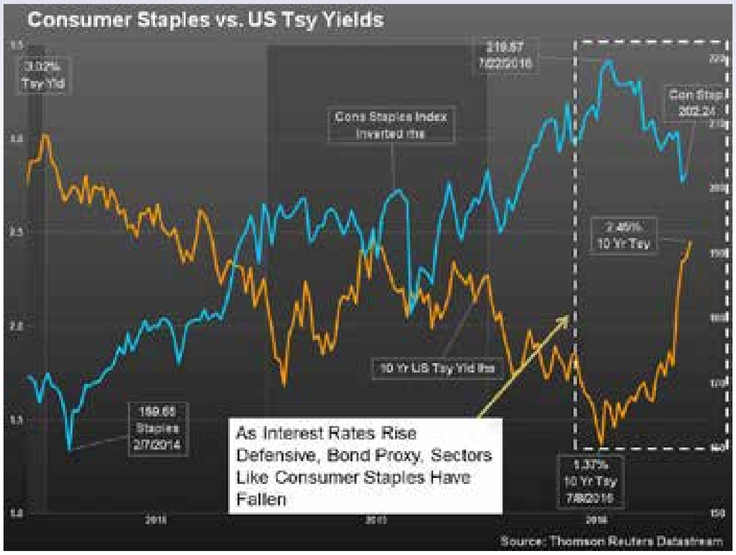

CHART 4

In contrast to a defensive sector like Consumer Staples, cyclical stocks have been outperforming the market since the July time period as shown in Chart #4. Note how the outperformance of the Cyclical Index and the underperformance of Consumer Staples accelerated in conjunction with the post-election jump in interest rates. As we mentioned last month, any movement into the reflation quadrant would be to the detriment to defensive sectors and beneficial to cyclical stocks. Within the cyclical group banks and industrials have been especially strong beneficiaries of this trend.

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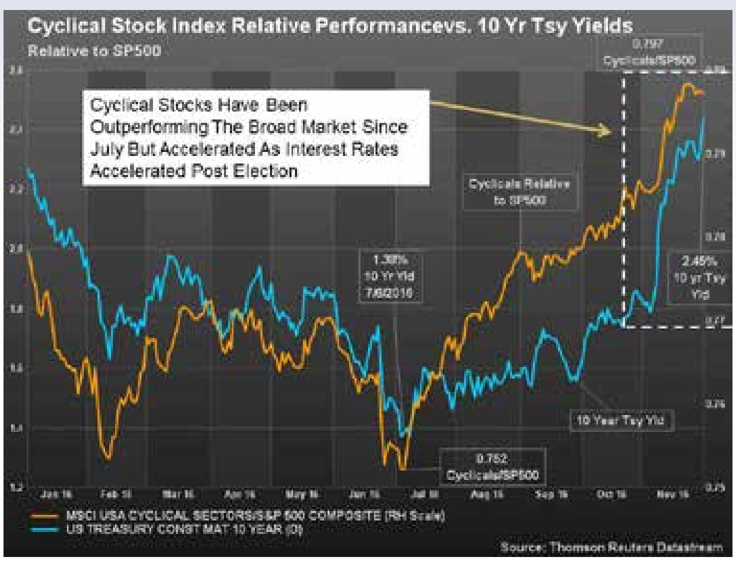

CHARTS 5-7

The sharp rebound in the equity markets alongside the jump in inflation expectations and interest rates post-election is likely due a few fundamental reasons. First, there was probably a good amount of short covering by investors who bought insurance against a Trump win. Second, investors probably drew comparisons to the post Brexit vote and decided it was a good time to jump in. Third, and probably most important, is that there may be some legitimate reasons why a Trump presidency may be good for stocks and bad for bonds. In addition to the prospect of lower corporate tax rates and fiscal stimulus, a Trump administration is likely to go soft on regulation which is good news for banks and energy companies.

It is important to remember, however, that the rotation into cyclical sectors and out of defensive sectors began before the election, around mid-year, and occurred primarily because many of the leading domestic and global economic indicators had bottomed out in early 2016. On Chart #5 you can clearly see how the ISM Manufacturers Survey and the Industrial Production index for the US both bottomed out around the end of 2015. The same holds true for global economic indicators which bottomed out in early 2016, Charts #6 and #7.

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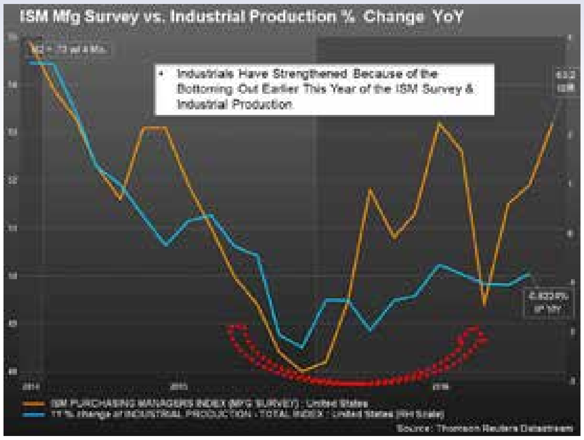

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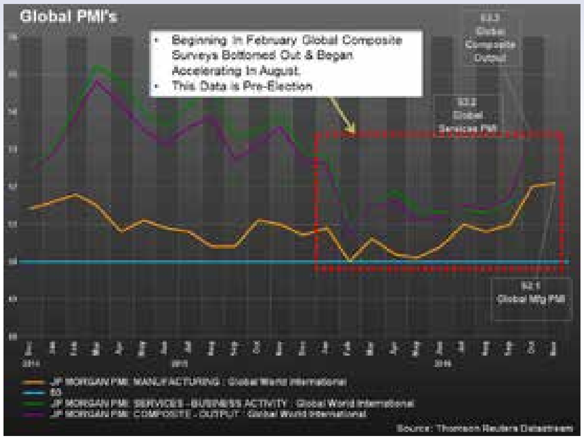

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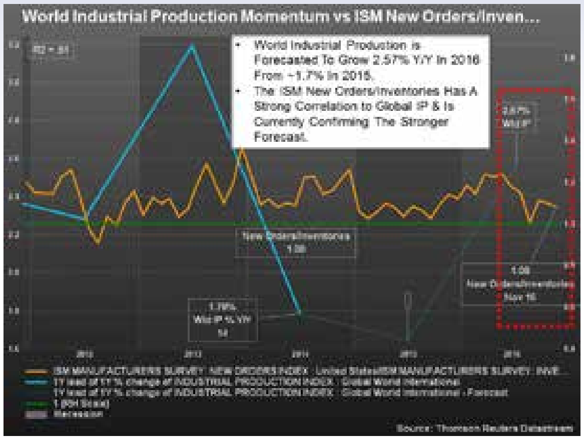

CHARTS 8-9

So, along with a strengthening jobs market, the Trump presidency will begin with a strong economic tailwind. The market sees this and anticipates that his policies will drive corporate profits and inflation higher. Although it is likely that a Trump administration, because of Republican control of both legislative branches, will get a good portion of his stated platform passed we tend to view the market as having gotten ahead of itself.

As we pointed out in Chart #2 both inflation expectations and bond yields have had a post-election jump but, upon closer examination, it is clear that bond yields have jumped much faster than inflation expectations. Some of Trump's trade and immigration policies, if implemented, will clearly be inflationary but the current angst over inflation is being driven by a tightening labor market. This is where we believe that there is still slack even though the unemployment rate is now around 4.6%. In Chart #8 we show the jobs openings, known as the JOLTS data, as the gold line alongside the annual growth rate of the ECI, or employment cost index. Note that the jobs openings level is near an all-time high and yet the growth in the Employment Cost Index remains near one of its lowest levels in 30 years! One explanation for this, we believe, resides in the fact that the U6 level of unemployed plus partially employed remains near peak levels of the past two economic cycles. In Chart #9 we have compared the U6/U3 ratio to the annual growth rate in Average Hourly Earnings (AHE). This ratio remains well above the peaks of the past two economic cycles and helps explain why the growth in AHE (blue line) remains well below past cycle peaks. Thus we think that interest rates may pause for more policy clarity before continuing their ascent.

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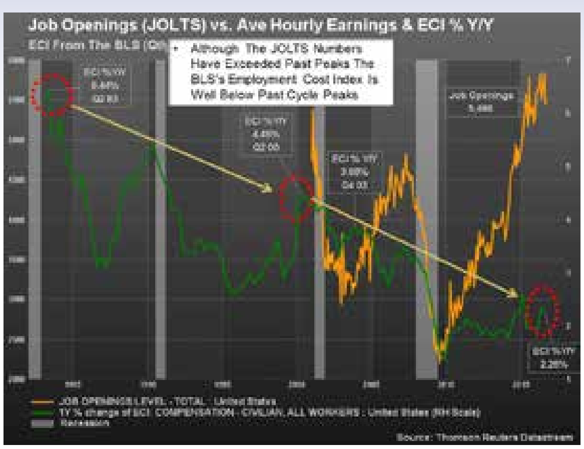

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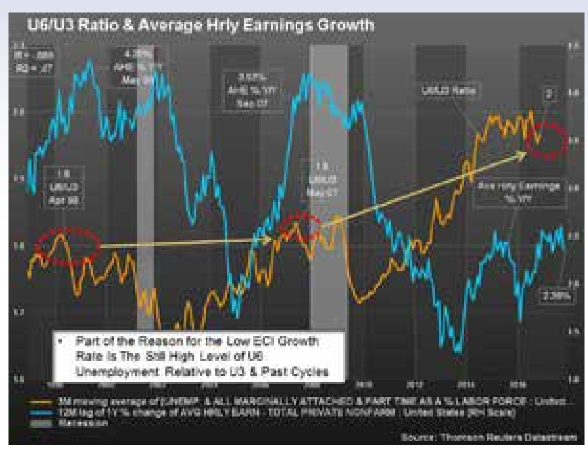

CHART 10

Our observation about the equity markets is similar in that they are no longer as undervalued as they were prior to the election. In Chart #10 we show the S&P500's Earnings Yield differential over the 10 Year Treasury yield as the gold line. This excess yield, or Equity Risk Premium, had been consistently one standard deviation above its 20 year mean since 2009. Since the election, however, it has quickly fallen from 4.33% to 3.52% and is now below one standard deviation. Although we do not yet view the markets as overvalued they have clearly "brought forward" future expected returns and may also trade sideways until further policy clarity.

Clarity, or lack of it, in how the new administration's economic policy will unfold is the wildcard for how bond yields and equity valuations will proceed from here. The public is probably accustomed to political flip-flopping on the campaign trail but the president elect will probably prove to be, as one wag has recently observed, the first "Quantum" president … able to occupy two opposite positions simultaneously!

Please consult with your advisor if you would like to further discuss any of the topics mentioned in this report.

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