Winslow, Evans & Crocker, Inc.℠

MAY 2017 GLOBAL ECONOMICS & CAPITAL MARKET COMMENTARY

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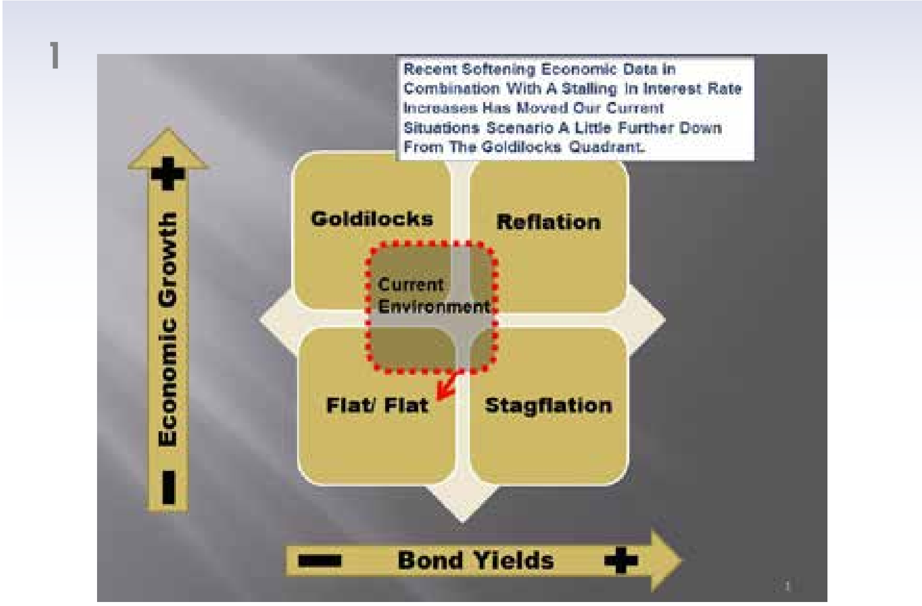
Overview

US Equities: Are They Primed For An Upward Breakout To New Generational Highs?

In our last report we highlighted some of the many domestic and international data points that underpin our positive outlook for the equities market through the balance of the year. Over the past month, however, some of the domestic economic data has disappointed. As shown in our stylized depiction of the current economic/interest rate environment, this softer data has dropped our current conditions indicator a little below last month's level, Chart #1.



CHARTS 2-3

In Chart #2 you can see that the Economic Surprise Indicator for the US has quickly fallen into negative territory. Also note that this has not been the case for other major world economies. Yet despite the latest string of economic disappointments the S&P500 rose over 1% for the month of April as investors appear to have shrugged off the weak data. Individual and business optimism, the so-called soft data, remain near record highs while the hard data indicators have struggled, Chart #3. The optimism surveys typically are a leading indicator for hard data which implies that this current divergence should eventually be resolved with stronger economic data. Much of the optimism has been driven by a rising stock market, rising home prices, falling unemployment and rising wages.
The sharp fall in first quarter Real GDP to an annualized growth rate of just 0.7%, although disappointing, appears to have largely been anticipated by the markets. For the past ten years the first quarter RGDP has averaged -0.1% while the second quarter RGDP has averaged 2.0%. This pattern is prompting the Bureau of Economic Analysis to examine the accuracy of the seasonality adjustments made for that period.

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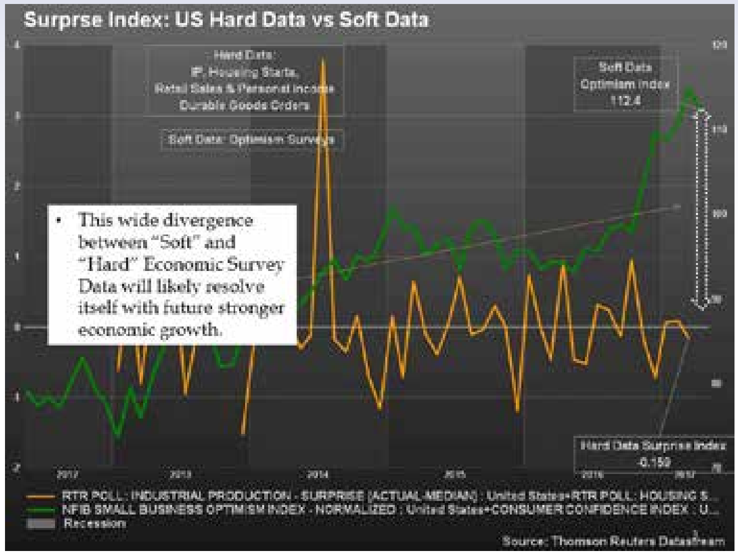

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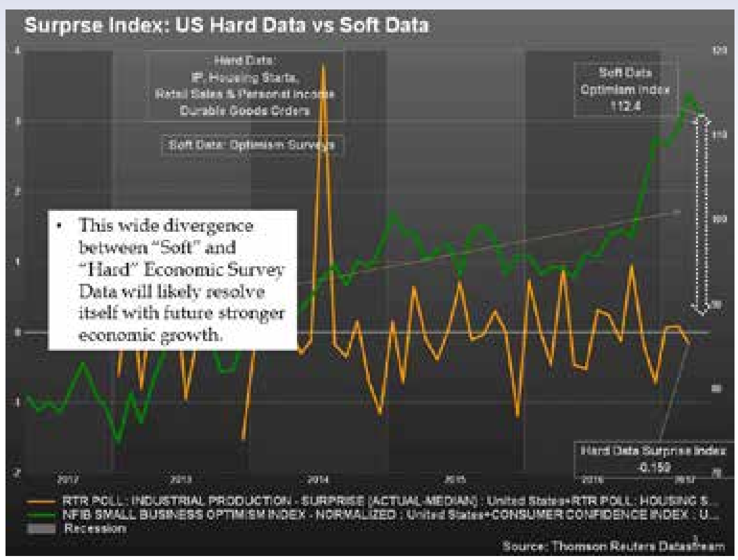

CHARTS 4-5

In Chart #4 you can see the actual GDP number as the blue bar and the continuous GDP estimates put out by the Atlanta Federal Reserve, the orange line. What is notable is that their first estimate for the second quarter has jumped to 3.6% which is well above their highest estimate for the first quarter. This estimate will change as this quarter's economic data begins coming in but this does give credence to the observation that second quarter growth is typically much stronger than that of the first quarter.

Risk assets are likely to continue to trend higher. While much of the weak US economic data in the first quarter has been linked to technical factors, the other major economies remain strong and have very accommodative monetary policies. Additionally, the easing of European political risk and the introduction of a tax plan by the Trump administration have helped to push the US stock market close to new highs. In Chart #5 you can see that the US Economic Policy Uncertainty Index had moved up sharply after the presidential elections but has since begun easing as the Trump administration's economic policies begin to come into better focus.

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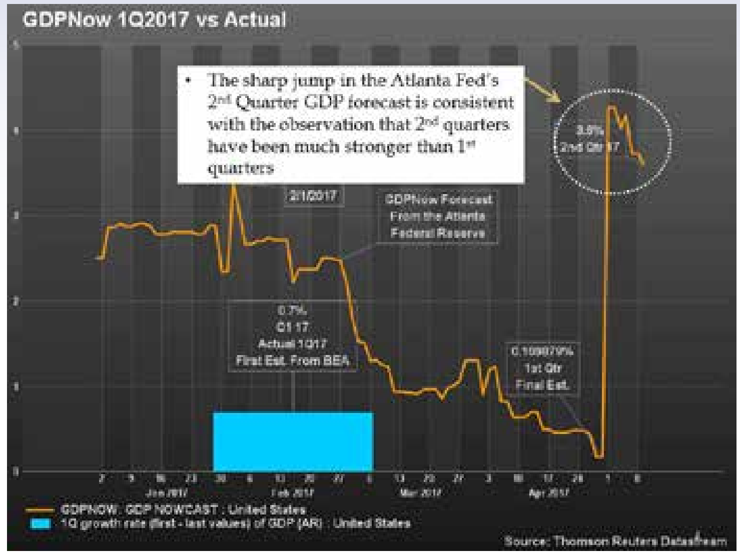

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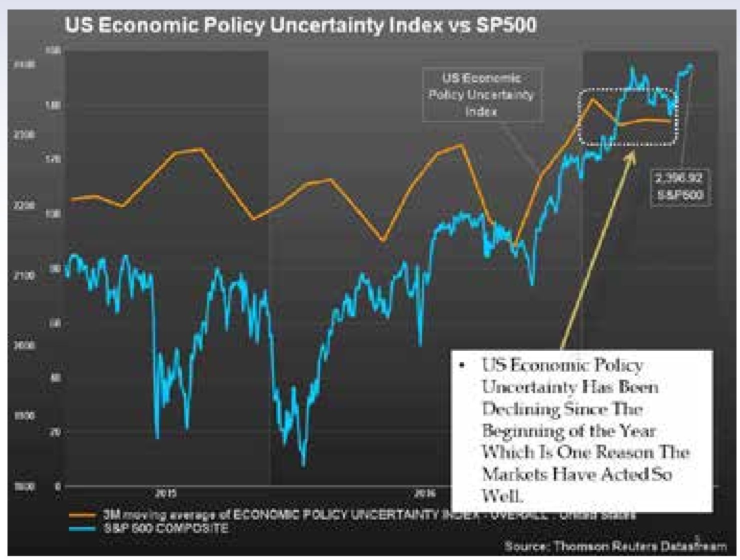

CHARTS 6-7

The factors which have supported the market in the face of soft economic data are:

1) robust corporate profitability;
2) strong forward earnings guidance;
3) reasonable valuations;
4) tame monetary conditions.

As shown in Chart #6 the twelve month forward earnings and sales growth forecast for the equity markets are at their highest level in five years. Furthermore, one of the better leading indicators of future earnings growth is the Institute for Supply Management New Orders survey and, as shown on Chart #7, it is pointing to a continuation in earnings growth. With the evidence in hand for earnings growth the question now becomes one of valuation. The market is now trading at nearly 18x its forward twelve months earnings which is high by historical standards. Our approach to this issue is to look at the market's earnings yield relative to the yield on the 10-year US Treasury bond.

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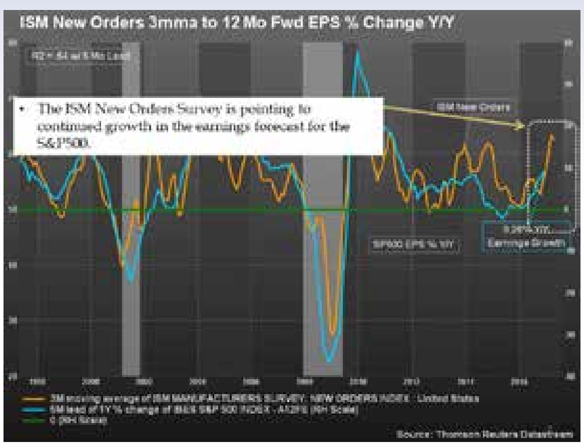

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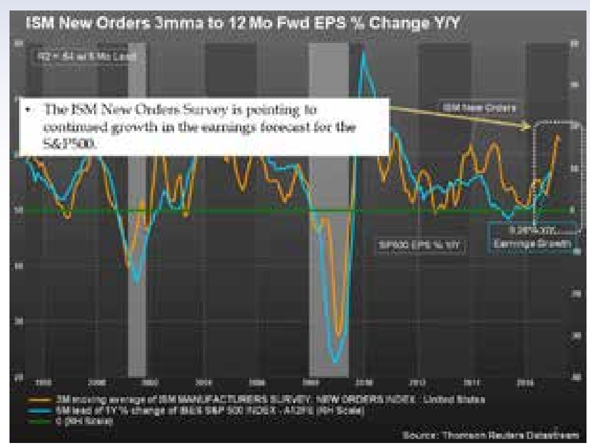

CHARTS 8-9

As shown on Chart #8 the market is currently offering an earnings yield over the US Treasury bond that is above its twenty year average. From our perspective this actually indicates that the market is modestly cheap on a relative basis. This, of course, would change if Treasury yields were to sharply increase and/or corporate earnings were to collapse…two scenarios that we don't envision occurring in the near to intermediate term.

As important as earnings and valuation are for structuring a successful portfolio it is also critical that equity positions be allocated to those economic sectors which will benefit from the current economic environment. Chart #9 shows the year to date returns for most sectors and you'll notice that only three sectors have outperformed the S&P500 thus far: Technology, Consumer Discretionary and Health Care. It is our view that, as the current headwinds of disappointing economic data begin to fade and earnings growth continues on its current path, the market should make new highs by the end of 2017.

Please contact your advisor if you would like to discuss how the viewpoints expressed in this report could impact your portfolio.

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