JANUARY 2018 GLOBAL ECONOMICS & CAPITAL MARKET COMMENTARY

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Synchronicity

The strong returns in the domestic and global equity markets in 2017 reflect the rare occurrence of a synchronous economic recovery in all of the major global economies. Chart #1 shows the 2017 returns for the Emerging Markets (33.93%), the World Market Index (24.74%), the S&P500 (19.42%) and the Eurozone (11.49%). These are very impressive returns which, as of this writing, are continuing into the early weeks of 2018.

CHART 1

1

CHARTS 2-3

Chart #2 shows the US and Global Purchasing Manager's Index (PMI). Whenever this index is above 50 it indicates that economic activity is expanding and, as can be seen in this chart, both the US and Global PMI's are well above 50 and on an upward trend. The remarkable breadth of this synchronous economic momentum is further demonstrated in Chart #3 where you can see that all major economies with the exception of Brazil have PMI's above 50.

The duration of this market strength and economic expansion is a question foremost on the minds of our clients and the Winslow, Evans & Crocker investment policy committee. There are several indicators that we monitor for any hint of an impending recession and/or a potential bear market. These indicators, some we discuss below, are keeping us, for the time being, bullish through 2018 as a minimum.

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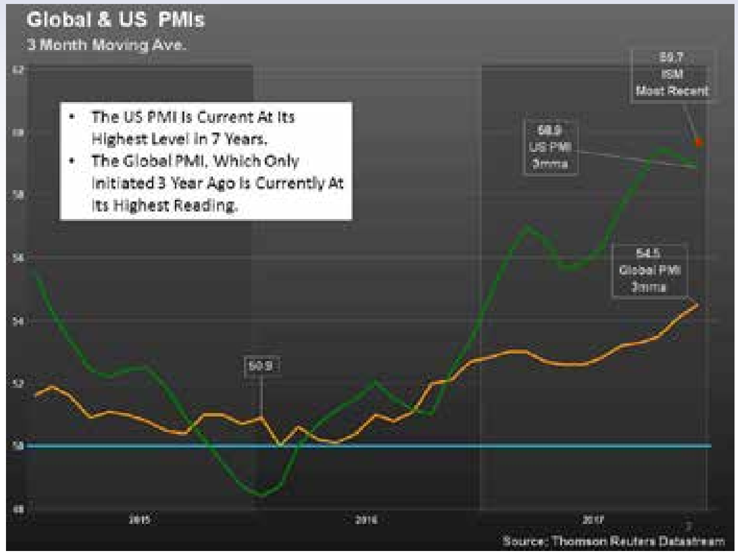

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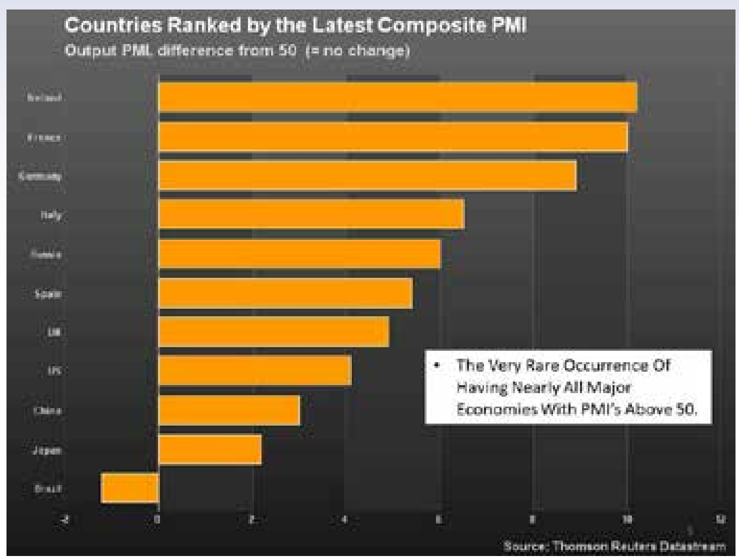

CHARTS 4-5

Chart #4 shows the US ISM new orders to inventory ratio. This correlates very well with domestic and global industrial production. This ratio is at its best level since 2008 and provides confirmation of continued synchronous economic strength for the balance of 2018. Another measure that we find useful is the impulse, or slope, of the growth of the US Economic Council's Leading Economic Indicator divided by the Coincident Economic Indicator as shown on Chart #5. When this ratio exceeds one it is an indication that the economy is expanding. This ratio also tends to lead the Chicago Federal Reserve's measure of US economic activity which is at one of its best levels of this cycle and is also a good indicator for strong GDP growth. Another very important indicator for the US economy and corporate profits is the Chicago Federal Reserve's National Financial Conditions Index. This index provides an in-depth and sophisticated insight into the workings of the financial markets and is another important indicator for future economic activity.

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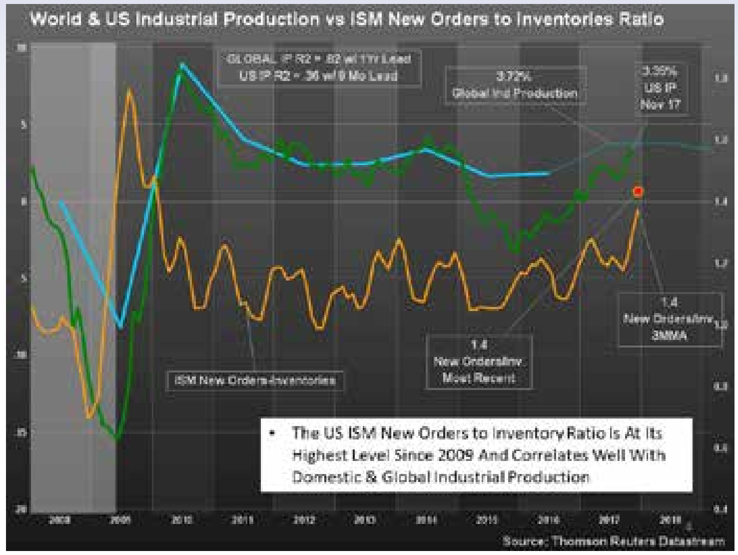

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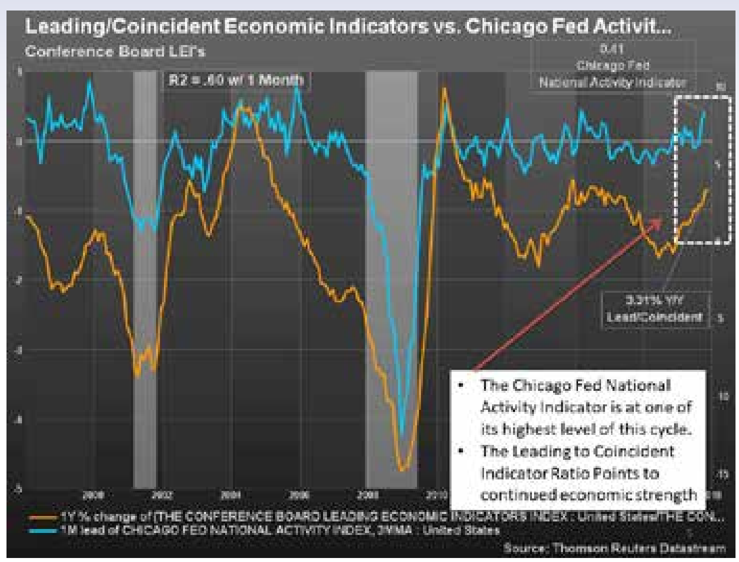

CHARTS 6-7

This index is represented by the yellow line in Chart #6 and is currently at its best level since 1993. This is very important because it is a good predictor for overall corporate profits as measured by the National Income Profits Account (NIPA) represented by the blue line on the same chart.

This once in a generation synchronous global economic growth in combination with the strongly positive leading indicators referenced above is an important foundation for the strength of the US equity markets. As can be seen in Chart #7 the primary driver of the S&P500 has been the tremendously strong growth in the twelve month forward earnings estimates as represented by the gold line. Within the past week these estimates have risen sharply in response to the passage of the tax bill.

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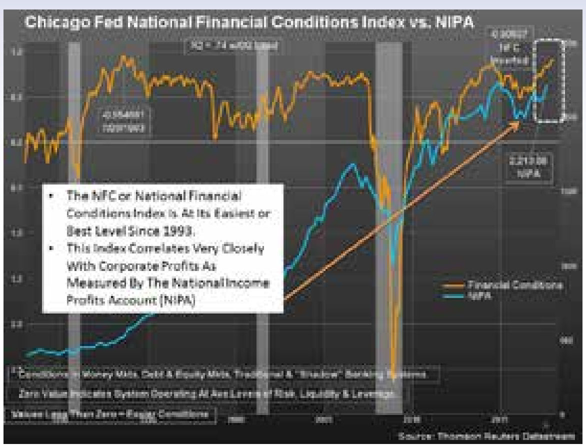

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CHARTS 8-9

In addition to the above referenced leading economic indicators we also examine the relationship between ISM Manufacturing New Orders and the growth rate of future corporate earnings and, as can be seen in Chart #8, this indicator also confirms our bullish outlook for equities. Notice how the three month moving average of New Orders is at its highest level since 2004. This will tend to pull up the S&P500 earnings growth rate, the blue line, well into 2018.

One of the major concerns about the US equity markets is one of excess valuation. At about 18.5x forward earnings it is certainly at the higher end of its historical range and appears expensive but, as is the case with all valuation metrics, it needs to be viewed against alternative investment choices. In Chart #9 we have calculated the market's forward earnings yield, the e/p ratio; added the dividend yield and subtracted inflation as represented by the headline Consumer Price Index. This results in a real, inflation adjusted return from the market of 5.59% (the gold line). An alternative investment would be the risk free 2 year US Treasury note which, as you can see on the blue line is a negative -0.55%. Looking back at this relationship over thirty years shows that it is currently at one its widest spreads for that time period. This implies that, on a relative basis, the US equity markets are not yet expensive.

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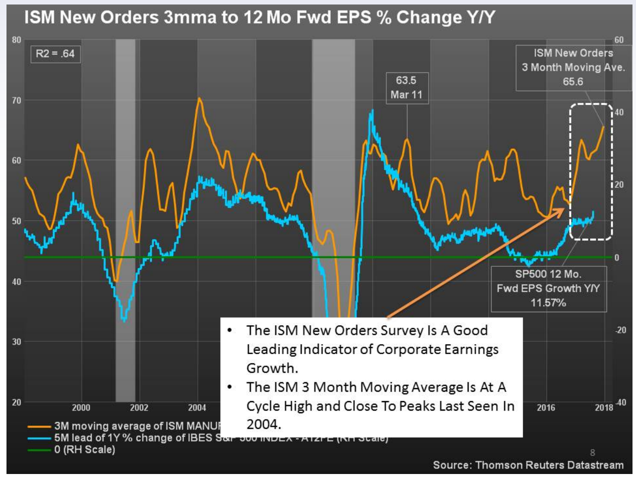

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CHARTS 10-11

One major cloud on the horizon which may alter our above stated optimistic views would be the occurrence of a sudden spike in inflation, a factor that so far has not been an issue. As you can see on Chart #10 the core Consumer Price Index (CPI) and the core price index for Personal Consumption Expenditures (PCE) are both well below their peaks of this and the past economic cycles. This is even more surprising given the fact that real GDP, the green line, has far exceeded the peak of the last cycle.

10

There are, however, some leading indicators that point to an increase over the next few years and which could alter the equity to bond valuation relationship by causing interest rates to rise and bond values to fall. In Chart #11 you can see that the core Producers Price Index (PPI) has been on an uptrend since early 2016 and is near a five year high. Similarly the ISM prices paid index has recently begun to trend up. Both of these indicators usually signal an eventual increase in the Consumer Price Index. The only missing component for greater inflation is an increase in labor costs.

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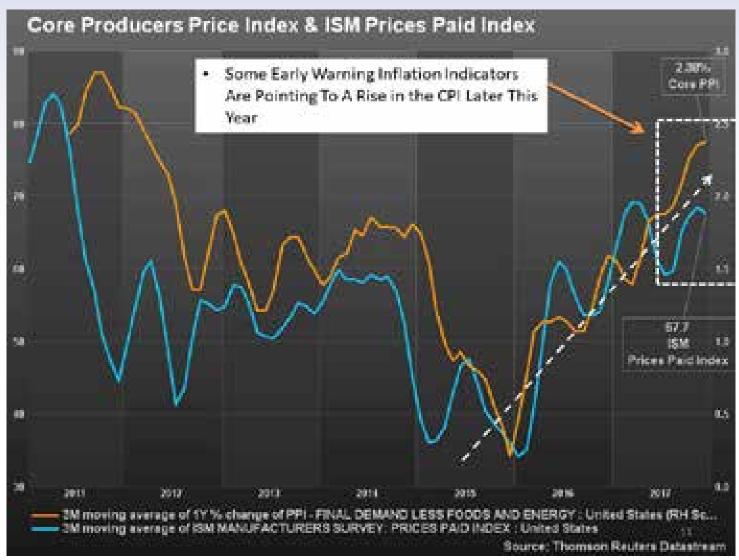

CHARTS 12-13

In Chart #12 it is clear that the Employment Cost Index (ECI), the green line, which is published quarterly by the Bureau of Labor Statistics, is well below levels achieved during the prior two economic cycles. This is especially puzzling given that the number of job openings, the gold line in the chart, is well above the peaks achieved during these past two cycles. This apparent divergence will most likely be resolved by increasing wages. This reality is just now being reflected by increases in inflation expectations and a rise in the 10 year Treasury Bond yield as shown on Chart #13.

In conclusion the US economy is enjoying a “Goldilocks” scenario with good economic growth, very moderate inflation and a synchronous global expansion not seen in generations. As referenced above we may begin to see inflation increase later this year but if it is gradual and is accompanied by economic growth we will continue with our stance of being overweight equities and short duration.

Please speak with your Investment Advisor if you would like to discuss how any of these ideas may impact your portfolio.

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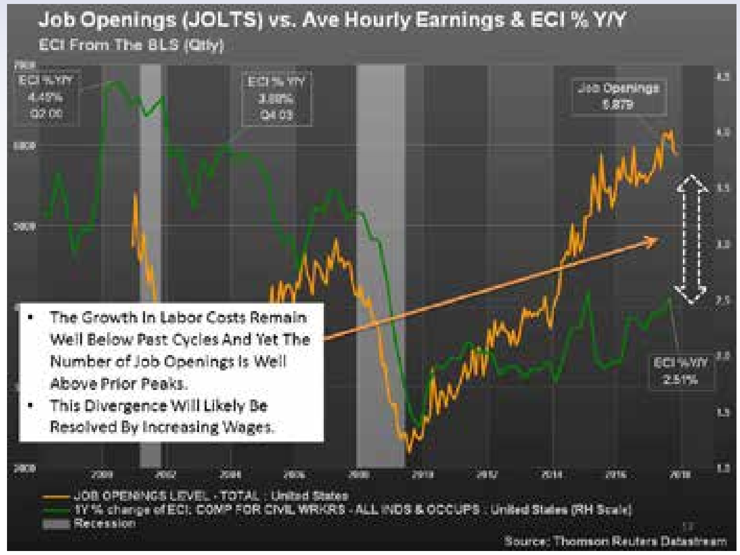

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