Winslow, Evans & Crocker, Inc.[SM]

MARCH 2018 GLOBAL ECONOMICS & CAPITAL MARKET COMMENTARY

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STAYING GROUNDED

In last month's publication we emphasized how the unusually well synchronized global growth environment in combination with relatively easy monetary and fiscal policies around the world was the driving force behind the rise in equity markets. Also, until recently, the volatility of the US equity market had been uncharacteristically low. Since that publication the market went into an official correction by falling about 10% from its peak in conjunction with a spike up in volatility, Chart #1.

1

CHARTS 2-4

The cause of the correction was precipitated by several factors. The primary ones in our view were simply technical in nature. The markets had advanced too far, too quickly and with very low volatility. Chart #2 shows the level of volatility over the past few years and it is clear how quickly and dramatically it jumped during the correction.

In Chart #3 we illustrate the level of the VIX, the measure of volatility, relative to the daily percentage change in the S&P500. You can see that it jumped by over four times the level that one would expect from the change in the market. Some have argued that the unwinding of a very large number of investment positions that were betting on continued low volatility were the actual cause of the market correction! Also, it was very clear at that time that the market was indeed very overbought after its sharp run up in January, Chart #4.

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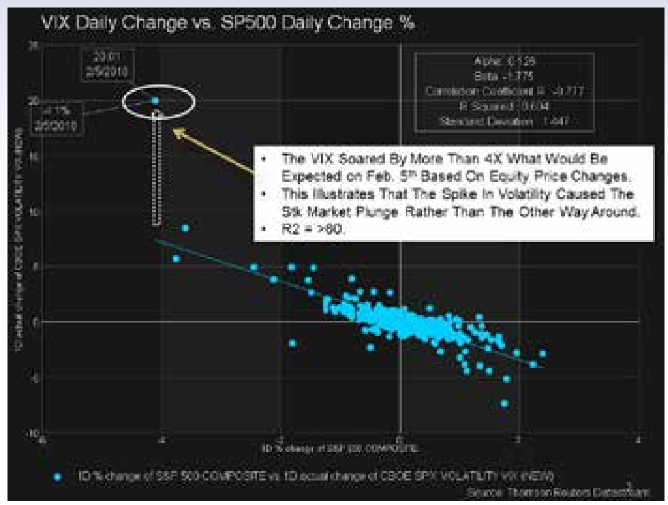

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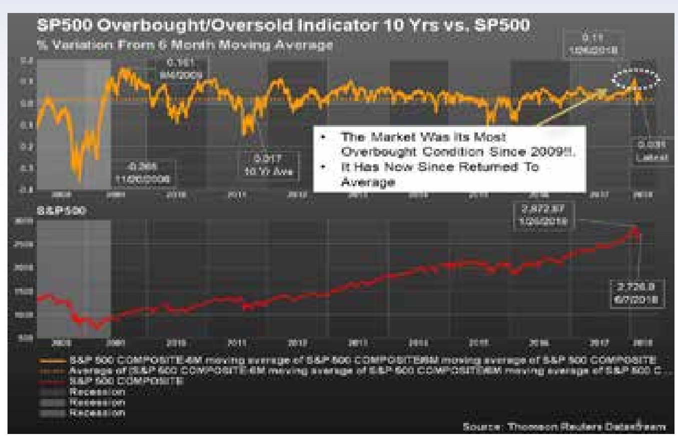

CHARTS 5

The key to determining whether such a sharp pullback in stocks is just a correction or the beginning of a bear market is to look for other financial indicators that would give us a better understanding of the underlying dynamics taking place. There are many that we follow but one that I think tells the most dramatic story is the performance relationship between high yields and the 20 Year US Treasury bond. In Chart #5 we divide the high yield ETF by the 20 Year US Treasury ETF as illustrated by the gold line. Remarkably the high yield ETF is outperforming (going up) while the stock market is going through a sharp 10% correction (green line). This tells us that there was no “flight to safety” occurring throughout the financial system and, indeed, the market’s pullback was just a correction from an overbought condition.

Another important area to examine is the fundamentals of the market and the economy. We’ll review a few here but, in general, they remain very strong and continue to validate the synchronous global growth thesis that we highlighted in last month’s publication.

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CHARTS 6-7

Chart #6 illustrates the dramatic increase in the 12 month forward earnings estimates of the S&P500, the gold line, and the current 12 month forward price to earnings ratio of the market. The sharp jump in earnings estimates was due largely to the new tax law. The increase in earnings in combination with the market correction caused the market's price earnings to fall to around 17x from over 18.5x in early January! This brings valuations back to levels last seen in late 2016. The question then becomes one of whether the optimistic earnings forecast represented by the yellow line are supported by any of our leading economic indicators. One consistently accurate indicator is the US Institute for Supply Management (ISM) monthly surveys. This survey hit a ten year high last month and the New Orders sub-component which is a very good leading indicator for earnings also hit a cycle high, Chart #7.

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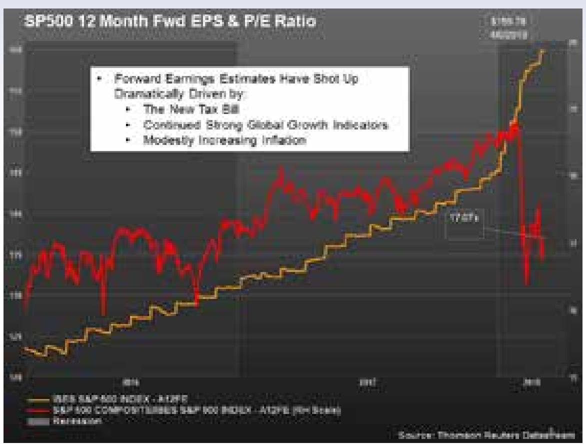

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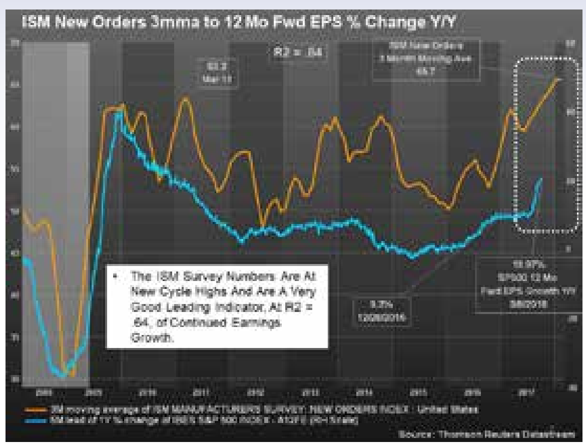

CHARTS 8-10

Based on these earnings growth forecasts and ISM readings along with many other indicators that we watch we still view the market's valuation as attractive. In Chart #8 we calculate the market's forward earnings yield plus the current dividend yield, the red line, and compare it to the yield of the 10 Year US Treasury bond, the yellow line. The bottom half of the graph plots the difference over the past 30 years and it is interesting to note that there have been many prolonged periods when the market has traded below this average.

Globally, surveys of economic activity along with leading economic indicators remain strong and in an upward trend, Chart #9. Additionally, global inflation remains tame, Chart #10. This supports the theme of a synchronous global economic expansion without extreme inflation…the "Goldilocks Scenario".

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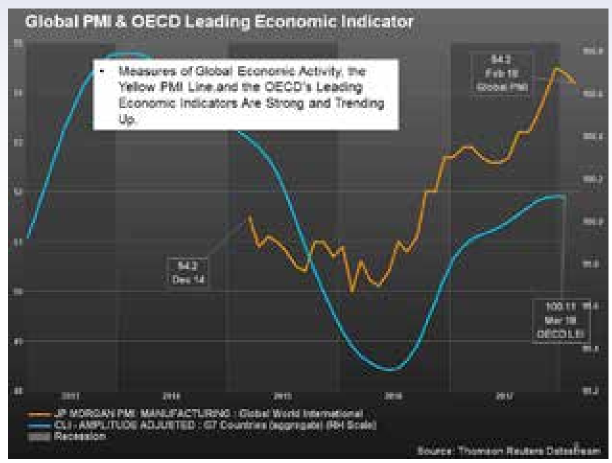

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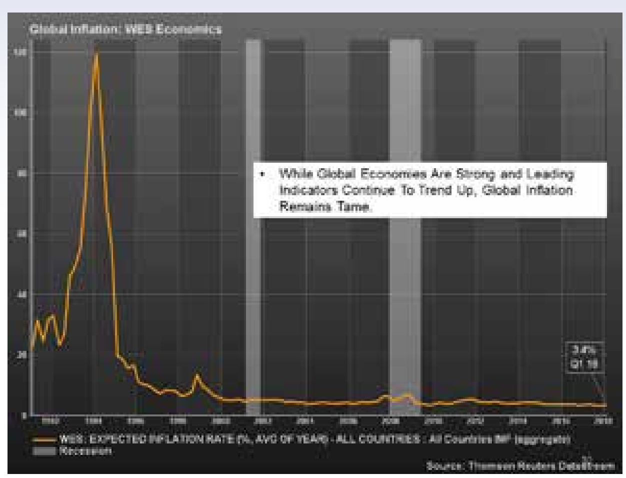

CHARTS 11

The most likely cause of the next bear market will come from a recession which, because of tax and regulatory reform, we don't see occurring until 2020 or later. It is interesting to note that since the 1970's the occurrence of the next recession, i.e. the end of an economic cycle, would happen on average six years after the Leading Economic Indicator surpassed the peak of that of the prior economic cycle. If this holds true then, as shown in Chart #11, the next recession may not occur until 2023!

In conclusion, there are many positive data indicators providing a tail wind to the equity markets as briefly outlined above but there are some risk clouds on the horizon. Most immediately is the risk of the beginning of a trade war precipitated by the Trump administration's imposition of duties on the import of steel and aluminum. This could cause inflation to spike higher than expectations thus forcing the US Federal Reserve to tighten monetary policy more severely than is now being anticipated. Additionally, corporate balance sheets are very highly leveraged from years of borrowing during years of low interest rates. This would cause a risk were rates to suddenly rise. Finally, China is in the midst of restructuring their economy which is also highly leveraged and, should they err in their efforts, could cause a down-turn in global economic activity. At the current time we don't judge these risks to be very high and thus remain bullish with risk assets and somewhat bearish for fixed income.

Please speak with your advisor if you would like to further discuss the above comments in reference to your portfolio.

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