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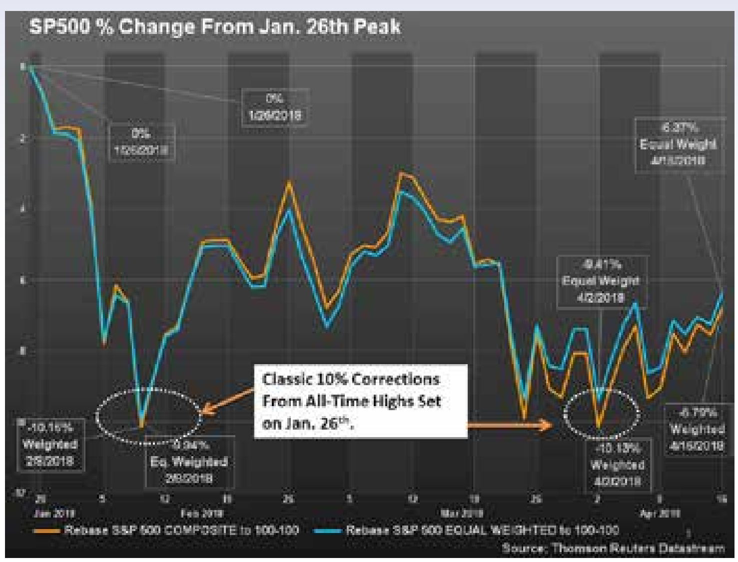
BULL MARKETS & ECONOMIC CYCLES: LIFE EXPECTANCY

In last month's publication we emphasized that, from an investment perspective, it is very important to stay grounded in the fundamentals of the economy and markets during times of extreme volatility. As you can see in Chart #1 the S&P500 weighted and equally weighted indices twice experienced a classic 10% correction from their all-time highs of January 26th of this year while also experiencing high levels of volatility not seen in nearly two years, Chart #2.

1



CHARTS 2-3

Our view at the time, based on our reading of the fundamentals, was that the correction and volatility were primarily technical in nature. The market had advanced very quickly in January and the volatility indicator, the VIX, had remained nearly dormant for almost two years. To some extent a reversion to the mean process should have been expected but, in addition, there was evidence that too many bets had been placed on continued low volatility and that they needed to be quickly unwound. This unwinding process merely served to amplify volatility and incite fears of systemic financial problems.

There are many indicators that helped us to stay grounded during this turmoil of which one is the St. Louis Federal Reserve's Financial Stress index, shown on the bottom of Chart #2. It certainly indicated some increases in financial stress during this time but there are two important readings of this index that helped us to understand that a crisis wasn't imminent. First, whenever the index value is below zero, which it currently is, it is an indication that financial conditions remain easy, i.e., not under duress. Also you'll notice that the index didn't rise to its prior peak in early 2016 when volatility was not as high.

Another factor which supported our optimistic outlook during this time was the growing confidence in the market's earnings. This has been driven by the recently passed tax reform and the ongoing global, synchronous, economic growth. Chart #3 clearly illustrates the rise in earnings, the gold line, and the adjustment of the market's forward multiple due to the increase in earnings and the correction of the index.

2

3

CHARTS 4-5

Now that we have passed through this correction phase of the market it is interesting to note that the US economy is entering into a seldom seen phase when monetary policy is tightening at the same time that fiscal policy is easing! In Chart #4 the yellow line represents the rate of change in the Federal deficit as a percentage of GDP. Whenever that line exceeds zero it indicates that policy is stimulative. As shown by the dashed arrow this is the condition that we'll be in by the end of 2018. At the same time the Federal Reserve will be raising interest rates, the blue line. Since the end of World War II this has happened only seven times and the average return of the market has been a little over 16% and lasted an average of 12 months! This bull market may become one of the longest on record. A good indication of this is the fact that this is the longest that the yield curve has not inverted in over 50 years, Chart #5. You will note that whenever the curve falls below zero, i.e., inverts, it precedes a recession and that we are currently well above zero. The vast majority of all bear markets are caused by recessions but now the question remains as to when the next recession and thus bear market will occur. Fortunately there are a few indicators that give us confidence that we are not yet at the end of this economic cycle.

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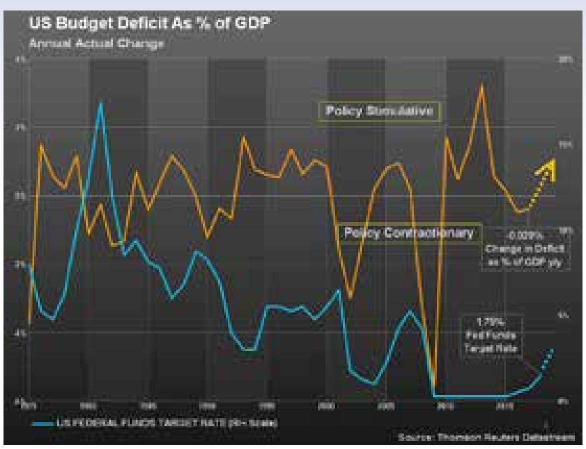

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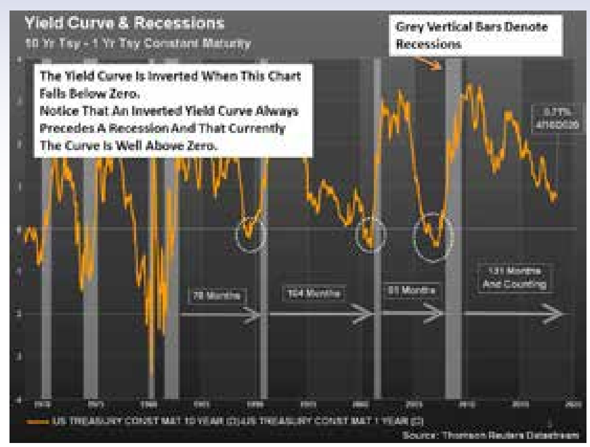

CHARTS 6-7

Chart #6 provides an illustration of the relationship between peaks in the US Conference Board's Leading Economic Indicator and subsequent recessions represented by the gray bar. You'll see on this chart that whenever the Leading Economic Indicator surpasses the peak of the prior economic cycle a recession will follow, on average, in about six years. If this holds true during this cycle then we shouldn't expect a recession until June of 2023. Since bull markets and strong economic growth don't die of old age but, rather, are killed by the Fed's monetary policies it is instructive to see how things currently stand in relationship to past cycles. In Chart #7 we have plotted the real effective Fed Funds rate by subtracting both core and headline PCE inflation. Once again you can see that whenever this rate exceeds inflation it acts like a brake on the economy and eventually leads to recession. You can see that, much like the like the length of time that the yield curve has remain positive as shown in Chart #5, the effective Fed Funds rate has remained negative for a record period of time and, if it soon becomes positive, we would still be several years away from a recession.

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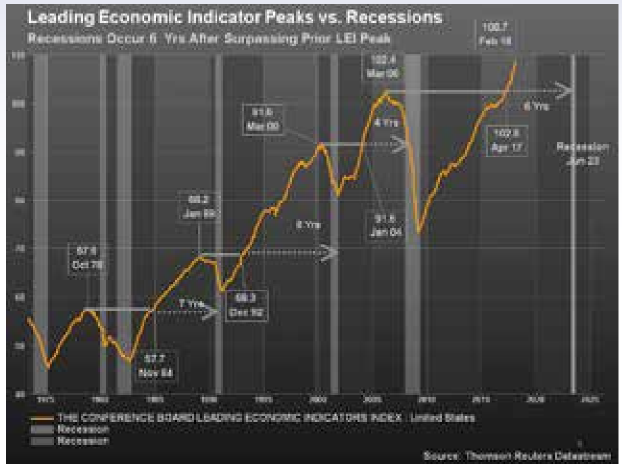

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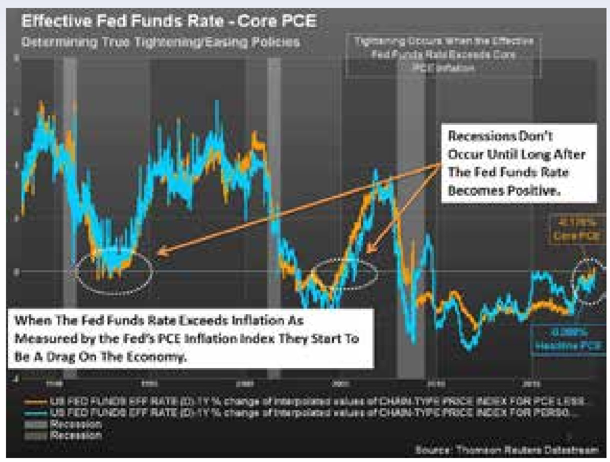

CHART 8

During the past few months the market has been subject to the buffeting winds of a potential trade war; political turmoil in Washington; growing geo-political tensions with China and Russia; and, increased middle-east tensions. The market, however, appears to have absorbed these blows and, based on our valuation metrics shown in chart #8, remains reasonably valued if not somewhat inexpensive. So long as earnings growth remains strong, inflation rises only modestly and interest rates don't unexpectedly spike up then the equity markets will very likely continue to perform well.

Please speak with your advisor if you would like to discuss this report relative to your investment profile and portfolio.

8