Winslow, Evans & Crocker, Inc.SM

JUNE 2018 GLOBAL ECONOMICS & CAPITAL MARKET COMMENTARY

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Bear Markets and Recessions: Watching Signs of Change

In our process of exploring the forces that underline the moves in equity markets we find it best to keep it as elementary as possible and thus we reduce it to the simple product of two factors, earnings and the multiple investors are willing to pay for them. In arithmetic terms the equation is P = (P/E)xE where P = price, P/E = the forward P/E ratio, and E = forward four quarter earnings per share. This decomposes stock prices into two principle drivers: fundamentals as represented by E and emotion and psychology as represented by P/E. This equation renders the link between recessions and bear markets – earnings – crystal clear. Outside of recessions, earnings almost always grow, consistent with economic expansion as illustrated in Chart #1. Stocks have a propensity to rise if earnings are growing and only a multiple de-rating can affect an overall market decline. This is the motivation for our constant search for clues of an impending recession and/or anomalies that would alter investor psychology.

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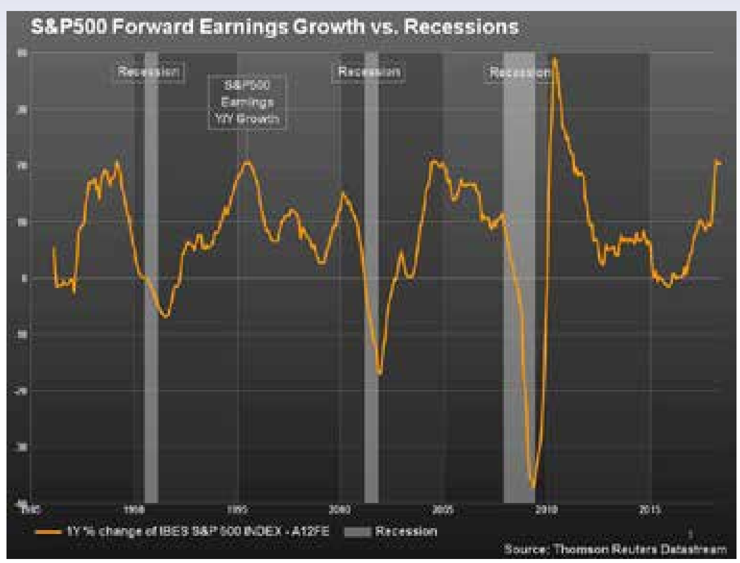

CHARTS 2-3

As highlighted in last month's publication the US economy is very clearly on a roll with the prospect of a recession at least two years away. In this report we will examine several additional indicators such as the yield curve, the output gap, corporate margins and wage growth that support our optimistic outlook. Also, we will examine two factors that have the potential to negatively modify our optimism: high corporate debt and the risk of a global trade war.

The shape of the yield curve is a good leading indicator for recessions. Whenever the curve turns negative, which occurs when short term interest rates exceed long term rates, a recession has always followed. The red circles on Chart #2 indicate a negative curve which invariably signaled the subsequent recessions over the last fifty years. The current curve is flattening but has yet to go negative. Also, this is its longest time on record that the curve has been in positive territory! Chart #3 illustrates a study done by the New York Federal Reserve that, based on the current shape of the yield curve, indicates a very low probability of a recession over the next twelve months.

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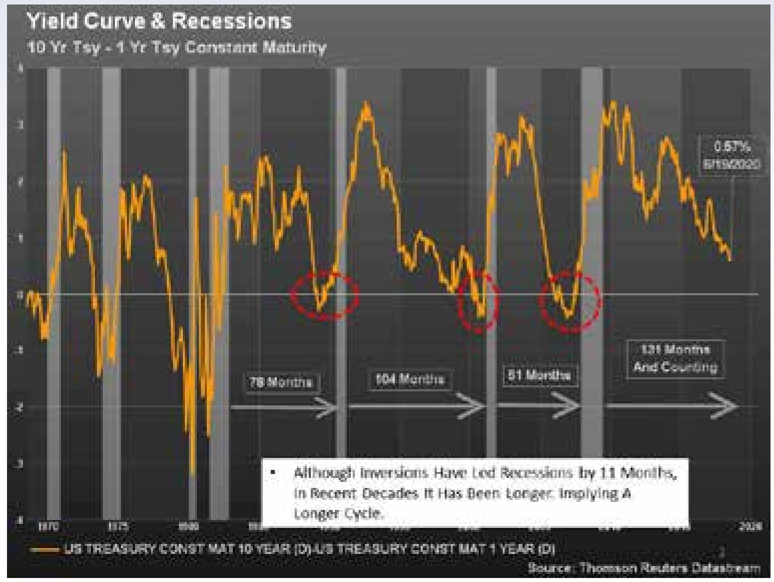

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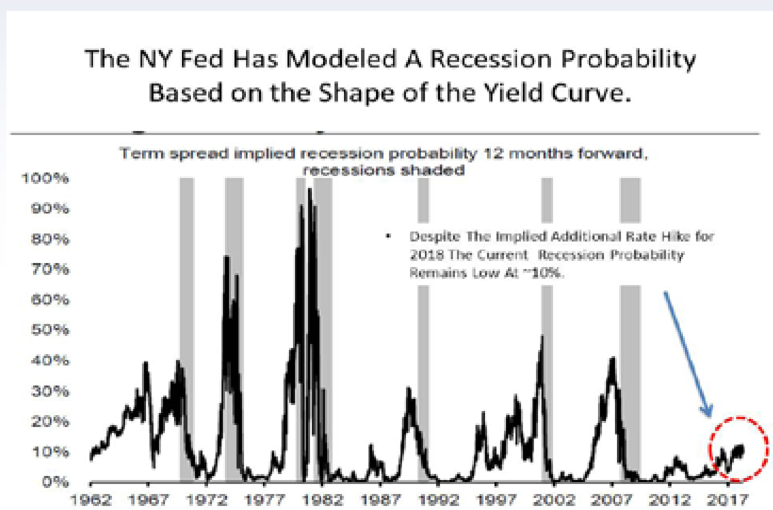

CHARTS 4-5

Another key indicator is the output gap of the US economy. Historically there is a recession about 2 ½ years after the output gap becomes positive. As illustrated on Chart #4 this output gap, as calculated by the OECD, has only just turned positive implying no recession until around 2021.

Corporate margins and the impact of rising wages are also important indicators of the market's health and of the potential of future, rapid increases in inflation. Chart #5 illustrates that corporate margins, the blue line, are once again at another high for this economic cycle and that the various measures of wages are only modestly increasing. In the past the Federal Reserve has viewed a 3.5% year over year increase in wages as a precursor of rapidly increasing inflation. As you can see in this chart we are currently well below that level as well as being well below the peaks of the last two economic cycles. This modest growth in wages at this stage of the cycle when unemployment is so low is puzzling to many economists.

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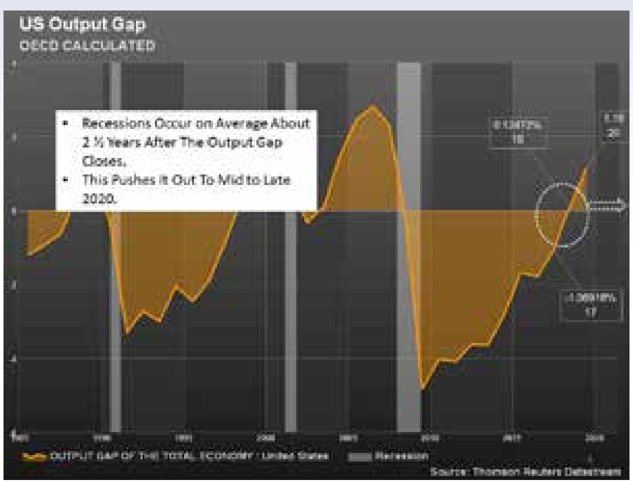

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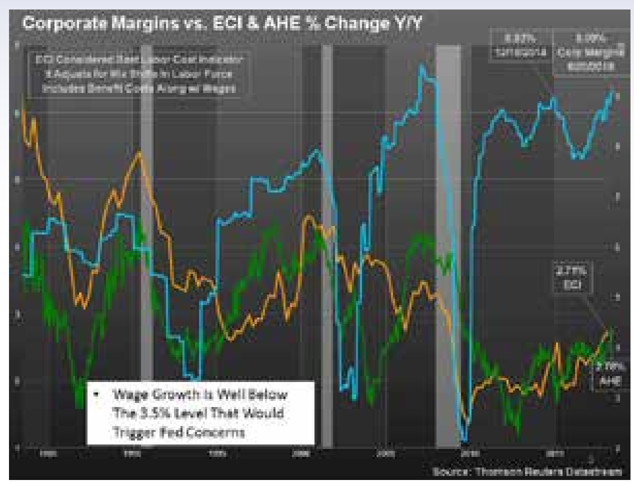

CHARTS 6-8

Chart #6 is a great illustration of the divergence between the demand for workers, as measured by the job openings or JOLTS data and the modest growth in wages. The number of job openings hit another new high this past month and yet the increase in wages has remained modest and doesn't currently pose a threat for accelerating inflation. The explanation for this divergence resides in a number of factors. The prime work force participation rate is lower than in the past two cycles thus implying more slack in the labor force than implied by the low unemployment rate; part time workers make up a larger part of the work force; and, technology allows for greater labor flexibility and efficiency and thus lower costs. One dark cloud that may be gathering on the horizon is the high level of corporate debt as a percentage of GDP as shown on Chart #7. It currently resides near an all-time high. Furthermore, as indicated on Chart #8 by the orange line, the ratio of corporate debt to EBITDA or earnings before interest, taxes, depreciation and amortization, has also risen to very high levels. The only positive that can be taken from this chart is the healthy growth of corporate free cash flow, represented by the green line. A rapid and large reduction in corporate debt would be deflationary and would cause a halt to corporate stock buybacks and dividend increases which, of course, would be negative for the equity markets. At the current time, however, corporations as a whole have enough cash flow to be net creditors. Historically recessions have occurred about two years after the corporate sector becomes a net debtor. Over the past year the performance of companies with low debt levels, such as technology companies, has been much better than those with high levels such as telecoms and consumer staples.

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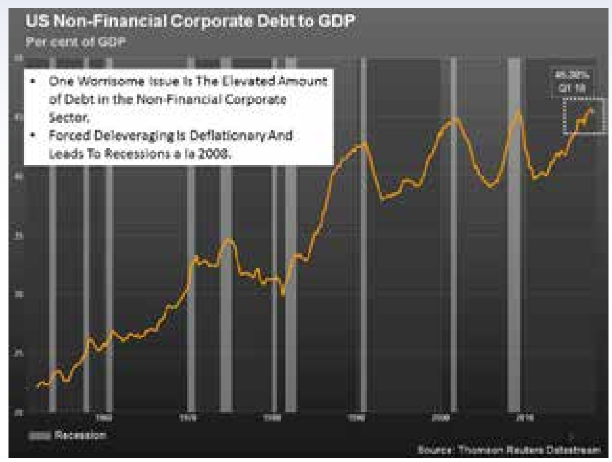

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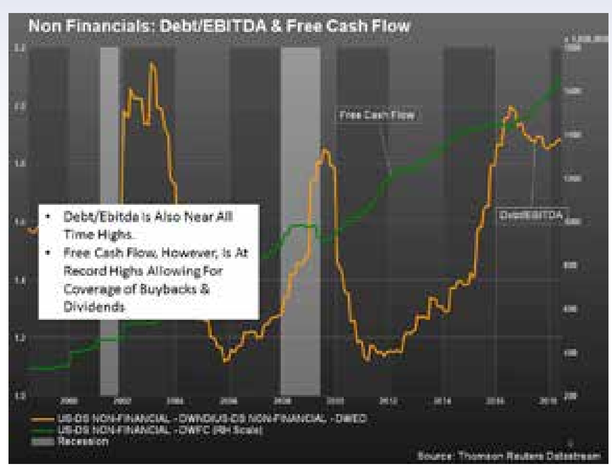

CHART 9

The last and perhaps most severe problem is the enormous uncertainty being caused by the president's trade positions and their potential to trigger a global trade war. This trade uncertainty is the type of special event that can impact the psychology of the market and cause P/E ratios to de-rate. Chart #9 shows the index of economic uncertainty for global trade and for the US. It is clear that global uncertainty has risen dramatically over the past few months while US uncertainty has barely budged. This is likely due to the fact that the US economy has a very much smaller exposure to trade than do the economies of Europe and Asia. Also, this survey was done in May and doesn't reflect the trade issue with China that worsened over the past few weeks. The next time this survey is done it will likely show increased uncertainty for both the US and the global economies.

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CHARTS 10-12

A study by Thomson Reuters that purports to quantify the impact on global trade under various Trump proposals is illustrated on Chart #10. If this analysis is at all accurate it is easy to understand the spike in the global economic uncertainty index. There are, however, other surveys that don't appear to reflect an elevated concern over the potential of a trade war. One such survey is the National Federation of Independent Business (NFIB) which is shown on Chart #11. As you can see the level and breadth of small business optimism is at an all-time high!

While the stock market psychology has been buffeted by trade war uncertainties the fundamentals remain strong and valuations are reasonable as demonstrated on Chart #12. Here we see that the market's forward earnings and dividend yield remains above its average relationship to the 10 year US Treasury yield. In the words of Benjamin Graham "The market is always making mountains out of molehills and exaggerating ordinary vicissitudes into major setbacks". We remain bullish on equities.

Please speak with you investment advisor if you have questions about this commentary.

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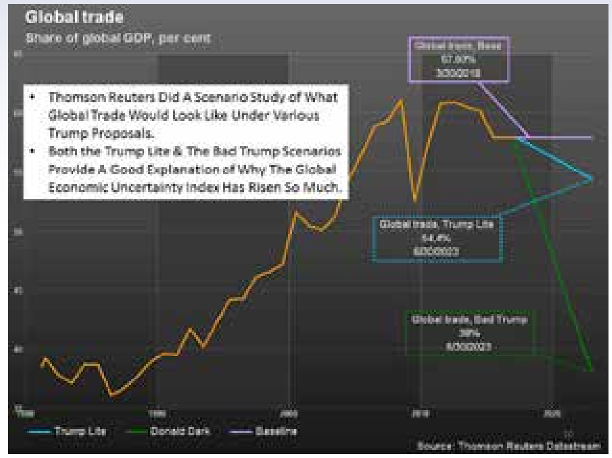

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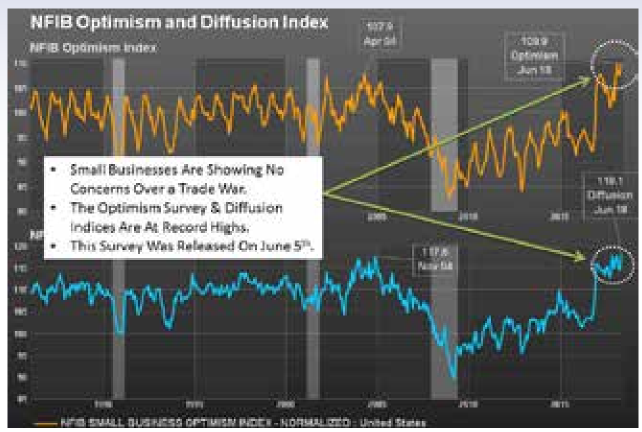

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