Winslow, Evans & Crocker, Inc.SM

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GLOBAL ECONOMICS

Douglas E. White, CFA
Chief Investment Officer
Executive Vice President
(617) 896-3518
dwhite@e-winslow.com

Rand Folta, CFA
Executive Vice President
(617) 896-3590
rfolta@e-winslow.com

INSTITUTIONAL TRADING

Fixed Income
Nomi Caperton
Managing Director
(617) 896-3526
ncaperton@e-winslow.com

David Strimaitis
Managing Director
(617) 896-3577
dstrimaitis@e-winslow.com

Equity
John Bridges
Managing Director
(617) 896-3524
jbridges@e-winslow.com

SETTLEMENT AND TRADING

OASYS: WYNS
MPID: WYNS
DTC: 0443
Clearing: Pershing, LLC.

WINSLOW, EVANS & CROCKER

175 Federal Street, 6th Floor
Boston, MA 02110
Phone: (617) 896-3500
Member: FINRA/SIPC

The Sleeping Dragon: Smoldering Inflation and Its Ramifications

In last month's publication we reviewed some of the economic indicators that we monitor for early warning signs of an imminent recession and a negative turn in the equity markets. As was pointed out at the time the growth in corporate earnings, a fundamental driver of the equity markets, is positive during economic expansions and negative during recessions, Chart #1.

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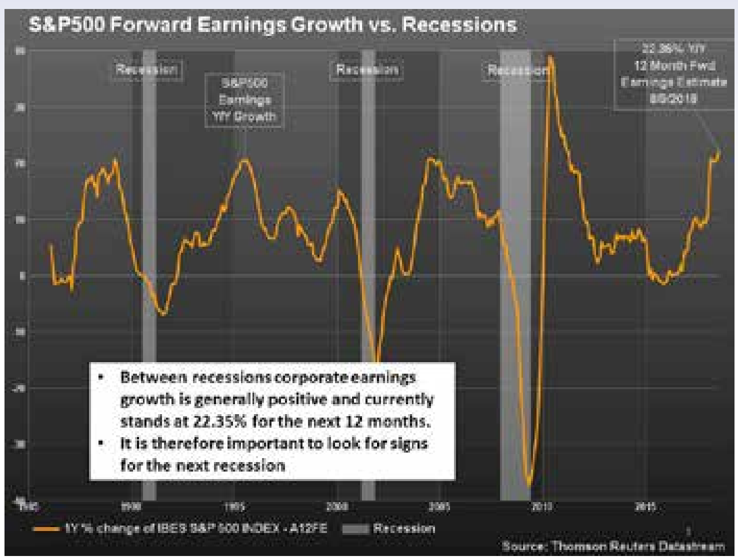

CHARTS 2-4

In Chart #2 you can clearly see that the forward twelve month projections in earnings is still climbing even after taking into consideration the boost provided by the tax reform act. These earnings are growing because the US economy remains strong and continues to grow. A good leading indicator for earnings and therefore the direction of the market comes from the monthly Institute For Supply (ISM) Manufacturing New Orders which, as can be seen on Chart #3, continues to remain elevated in the 60 range. Anything over 50 implies that orders are expanding. Chart #4 shows that the Conference Board's Leading Economic Indicator for the US continues to rise and, since 2016, the slope of that indicator has increased.

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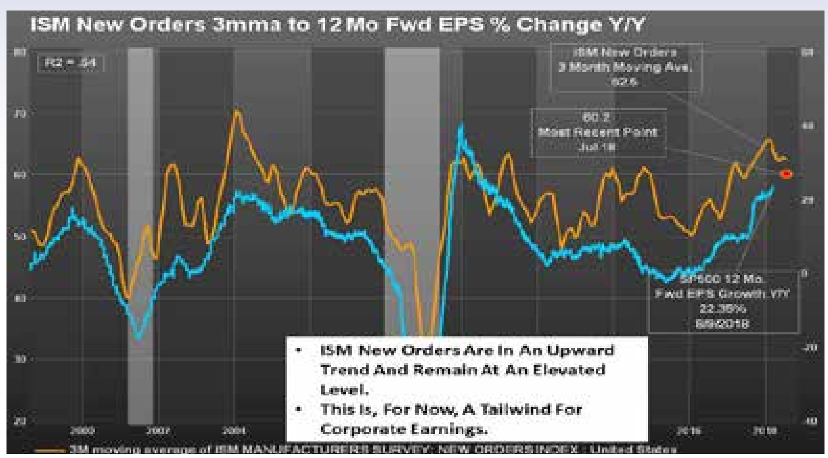

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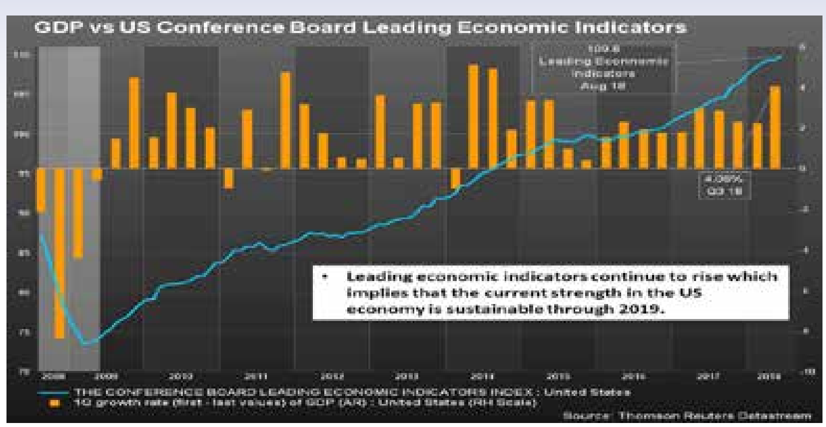

CHARTS 5-6

Also, as a confirming indicator, the OECD's leading indicator for the both the US and world shows that the US continues its upward trend while the rest of the world has been losing momentum, Chart #5. This means that non-US central banks will maintain their easy monetary policies while the US Fed will be going in the opposite direction by raising the Fed Funds rate and by reducing their balance sheet (Quantitative Tightening). Although domestic monetary policy is tightening the opposite actions taken by non-US central banks are helping to moderate the increase in US interest rates.

One of the major risks that we outlined in last month's publication is that of a trade war which, as can be seen on Chart #6, is generating greater uncertainty. The acceleration of trade uncertainty creates risks that are transmitted through delays in capital investment spending, business expansions and, the focus of this paper, inflation. All three of these elements could slow the momentum of the US economy and retard corporate earnings growth and market valuations. It is interesting to note, however, that the US Economic Policy Uncertainty Index, represented by the blue line, has barely budged. This divergence is likely due to several factors such as corporations making adjustments to mitigate the impact of tariffs on their sales or input costs or simply that the US economy is stronger and has more momentum than the rest of the world.

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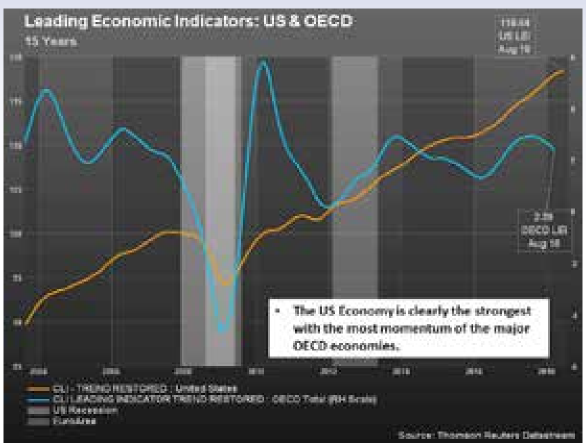

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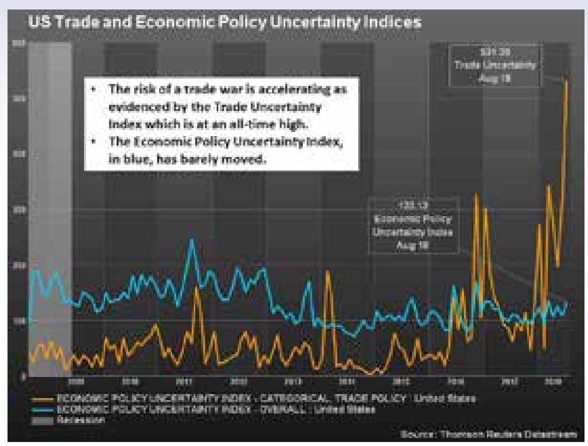

CHARTS 7-9

The three most commonly used measures of inflation have all been moving up since early 2017 as shown on Chart #7. The Producer Price Index (PPI) has had the longest run while the favorite measure used by the US Federal Reserve, the PCE, has been range bound between 1.25% and 2.00% since the end of the recession. These three measures give us a current picture of actual inflation but we want to find measures that will give us a hint of inflation to come. One approach is to use the Prices Paid component of the regional and national business surveys as shown in Chart #8. Here we see a gradual, upward moving trend in the regional surveys, top chart, and also in the national surveys shown in the bottom chart. One final place to look for early indicators of inflation is the increase in wages paid. Chart #9 shows that Average Hourly Earnings, the blue line, are currently growing at an annual rate of 2.67% which is the fastest rate for this economic cycle. When compared to past cycles and to the number of job openings, the gold line, this rate of increase seems less ominous. New job openings are at record highs and yet wage increases are well below the peaks of prior cycles. We are experiencing a “Goldilocks” like scenario wherein the early warning signs of inflation are not too hot or too cold.

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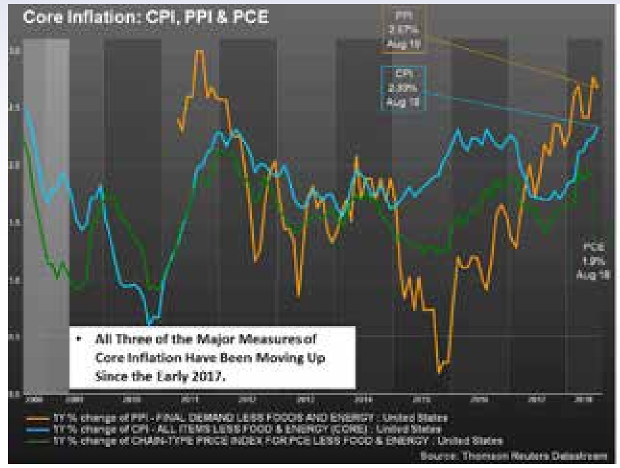

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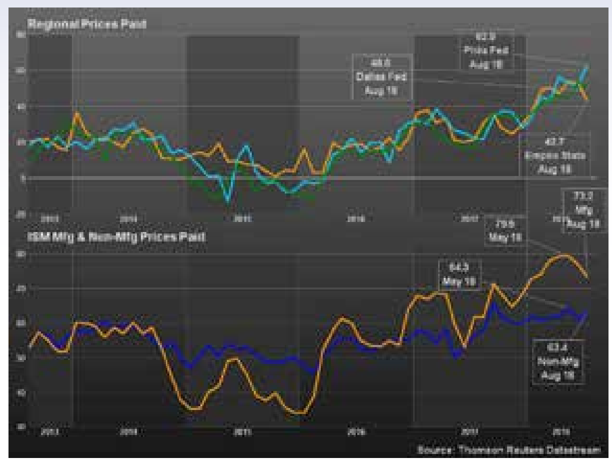

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CHART 10

The major risk to this mild scenario is the proposed increase in US Federal spending during a time when taxes have been cut and the economy is beginning to operate near full capacity as indicated by the output gap in Chart #10. This confluence of fiscal expansion during a period of a very strong economy is historically rare and could cause several unpleasant outcomes such as: 1.) accelerating inflation; 2.) shortages and higher costs for inputs such as labor and materials; and, 3) a more aggressive tightening of monetary policy by the Federal Reserve to slow the economy and fight inflation. As mentioned above a slowing of the economy followed by a recession would drive down both earnings and the equity markets.

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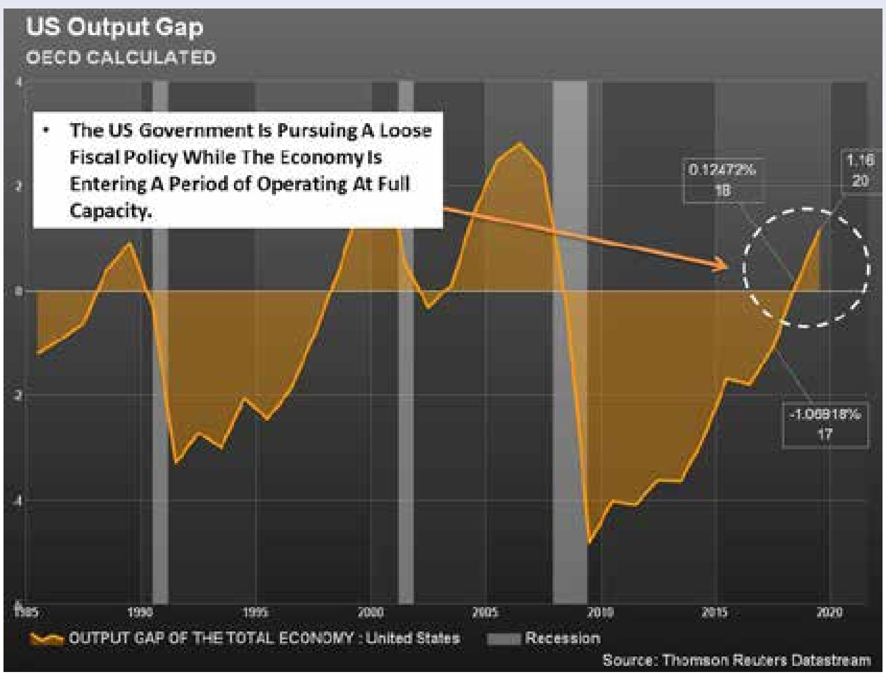

CHART 11

Chart #11 provides a good illustration of the risk to the equity market should inflation take a turn for the worst. The gold line in this chart represents the S&P500's earnings yield (E/P ratio) plus the current dividend yield reduced by the Consumer Price Index. The green line represents the yield of the 2 year US Treasury note also reduced by the CPI. At present the equity markets provide a handsome and near record real, after inflation return. If, however, inflation should suddenly increase it is very likely that the yield on the 2 year Treasury would increase and the S&P500's earnings yield would fall thus substantially narrowing the current gap and return premium. This is clearly a negative for equities.

Although our current position is that this worst case scenario is unlikely in the near term it is imperative to remain diligent for signs that the current Goldilocks environment will change. We remain moderately bullish for US equities and maintain a short duration for fixed income portfolios.

Please contact your investment advisor if you would like to discuss the content of this commentary and how it may impact your portfolio.

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