Winslow, Evans & Crocker, Inc.℠

NOVEMBER 2017 GLOBAL ECONOMICS & CAPITAL MARKET COMMENTARY

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 Phillips Curve Has Been Dormant But Will Soon Awaken: Beware The Rise Of Inflation

Before delving into the reasons why we see a resurgence in inflation within the next eighteen months it is useful to review the current condition of the US equity markets and to examine some of the reasons to remain optimistic in the near term.

CHART 1

On Chart #1 you can clearly see how the S&P500 weighted index has, once again, broken out to new highs.

1

Member FINRA/IPC • Accounts are carried by Pershing LLC, Member FINRA/NYSE/SIPC
The information contained herein, including any expression of opinion, has been obtained from, or is based upon, sources believed to be reliable, but is not guaranteed as to accuracy or completeness. This is not intended to be an offer to buy or sell or a solicitation of an offer to buy or sell the securities, if any referred to herein.
Women Business Enterprise (WBE) certified through The Supplier Diversity Office FKA: SOMWBA

CHARTS 2-3

The chart for the equally weighted index, Chart #2, has not broken out, as of yet, to new highs and may be indicating that we could be in for a period of consolidation. Also, notice in Chart #3 that the market's breadth, the orange line, has turned down while the market's momentum, the blue line, has risen. This indicates that fewer and fewer stocks are driving up the market and is another reason to believe that we could be in for a period of consolidation before moving further up.

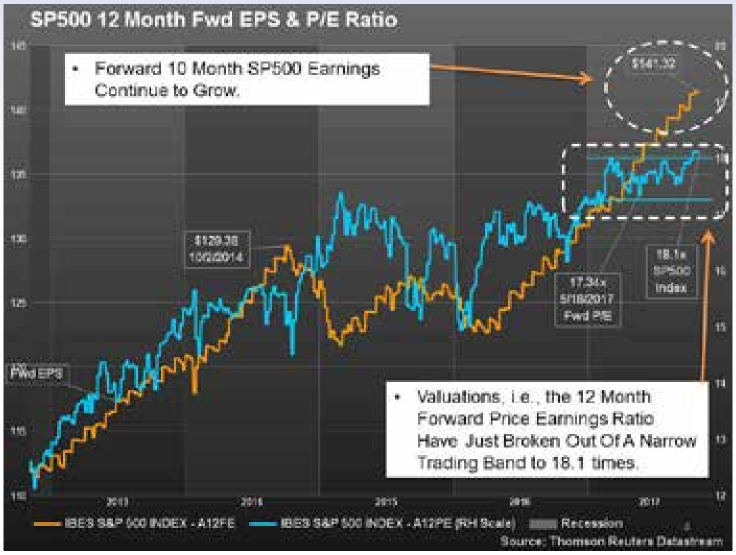
2

3

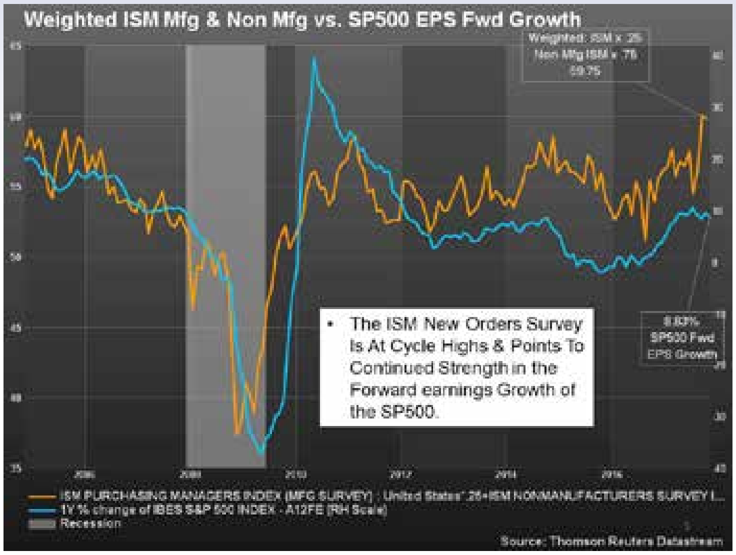
CHARTS 4-5

The reasons that we are optimistic about further market advances in the near term are that earnings have been strong, leading indicators point to continued strength in earnings and, finally, relative valuations don't look excessive. In Chart #4 you can see the steady climb in the twelve month forward earnings estimates for the S&P500, the orange line. Furthermore, the forward price to earnings ratio, the blue line, is just now breaking out of a narrow trading range to 18.1 times forward earnings. This combination of increasing earnings and a higher valuation is what has been driving this market higher. In order to answer the question as to whether or not the market's earnings are peaking we look at some leading indicators that have had a good history of telling us the direction that earnings will go. One such leading indicator is the New Orders component of the ISM Manufacturing and Non-Manufacturing monthly surveys. In Chart #5 we have plotted the New Orders survey, the orange line, against the twelve month forward S&P500 estimated earnings growth rate.

4



5



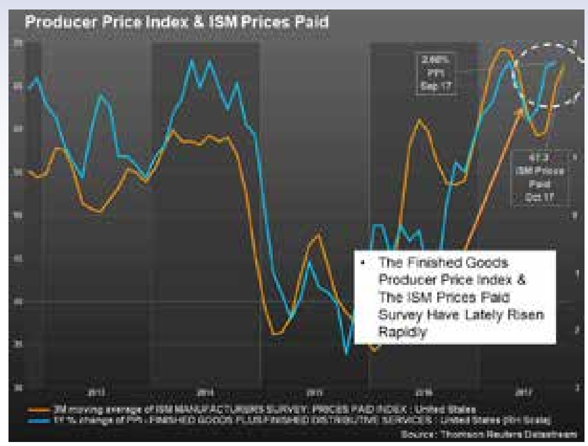
CHARTS 6-7

The correlation of R2 is .63 which is very strong. The level of this survey has risen sharply to post recession highs and is sending a very strong signal that earnings should continue to grow. Finally, there is the question of valuation. Many of the traditional market valuation metrics such as price to earnings, price to book value, enterprise value to sales, etc., all reside in the 88th percentile of their historic range. This certainly makes the market look expensive. However, if we compare the market's forward earnings yield to the yield of the 10 year US Treasury bond we observe that the market's valuation is actually below average, Chart #6. This is because earnings, as noted above, have been growing while interest rates have remained low. Should earnings collapse and/or interest rates rise then we would conclude that the market is expensive.

There are indications, however, that we could begin seeing a rise in inflation over the next 18 months which would lead to an increase in interest rates and, potentially, a downward rating of equities. Our leading indicators of inflation, some of which we have referenced in past publications, have recently begun increasing. In Chart #7 we can see that pricing pressure is building up in the economy because of the recent rapid increase in the Producer's Price Index (PPI) and the prices being paid by manufacturers as reflected in the ISM Prices Paid survey.

6

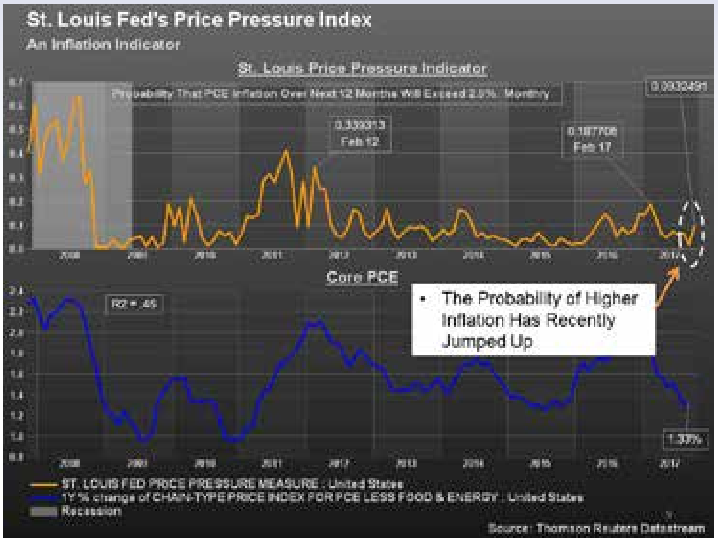
7



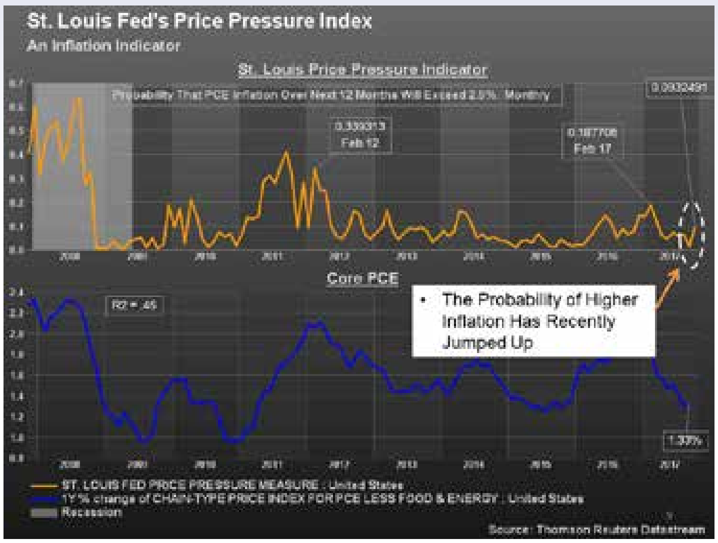
CHARTS 8-9

Inflation is also influenced by the rate at which money turns over in the economy. This is called the velocity of money, the orange line on Chart #8, and is a good leading indicator of core PCE inflation, the blue line. Finally, the St. Louis Federal Reserve calculates, on a monthly basis, a probability of inflation exceeding 2.50% over the next twelve months. As you can see in Chart #9 this has recently jumped up.

8



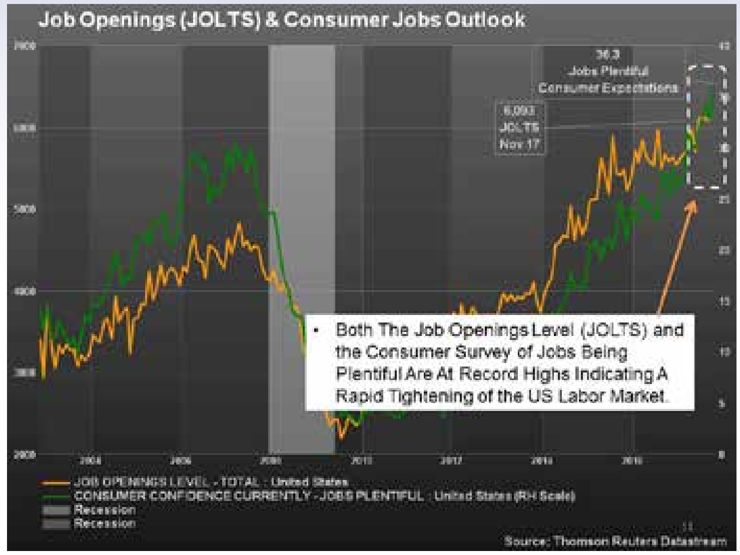
9



CHARTS 10-11

All of our leading indicators are pointing to the building up of pricing pressures in the economy that have yet to show up in the various measures of inflation. One of the primary reasons for this is that average hourly earnings have remained muted despite a rapidly falling rate of unemployment, chart #10. In this chart you can see that unemployment has been steadily falling to near all-time lows and yet the annual year over year growth in average hourly earnings, AHE, has remained in a narrow range of about 2.5%. This, in our view, is about to change as we believe that the labor market is becoming overheated as demonstrated by the number of jobs openings and the consumer survey of available jobs, Chart #11. Both of these indicators are at record highs.

10



11

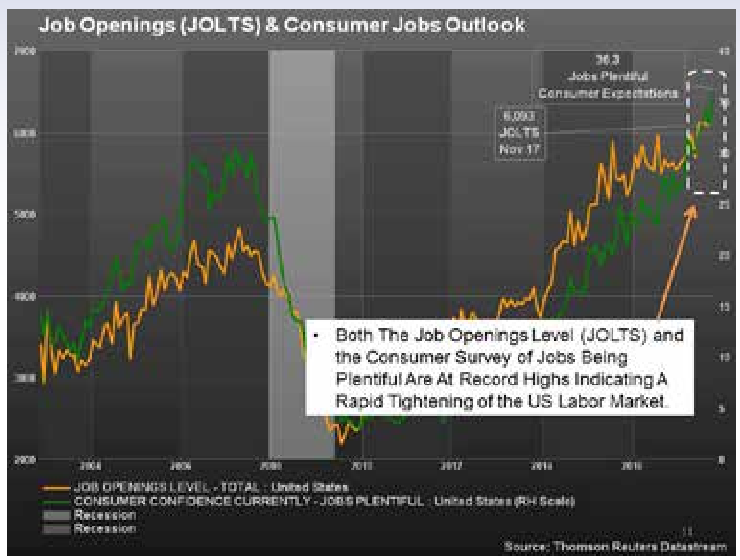


CHART 12

Finally, a better way of measuring the changes in labor costs is to examine the wage indicators put out by the Bureau of Labor Statistics and the Atlanta Federal Reserve. In Chart #12 we have averaged the growth of these two indicators along with the monthly average hourly earnings to develop our own wage growth index. As you can clearly see in this chart our index has recently turned up sharply and is now approaching the upward trend line begun in the fourth quarter of 2012. This is indicating to us that the missing link in inflation, increasing wages, will be coming into play over the next several quarters.

12

CHART 13

Chart #13 shows, in blue, the market's expectations for inflation in five years while the orange line is the current yield of the 10 year US Treasury. Both of these indicators have been declining since the beginning of the year. With increasing corporate earnings, muted inflation expectations and declining interest rates this has been a "Goldilocks" type of environment for equities…not too hot and not too cold. Our concern is that, with the resurgence in wage growth in what is clearly a tight labor market, the expectations for inflation will begin rising which in turn will push up interest rates. We don't expect this to become a problem until sometime in 2019. So long as the economy remains sold and earnings continue to grow, the raising of rates by the US Federal reserve should not be a problem. We remain bullish but ever diligent.

Please speak with your investment advisor if you have any questions for me or for your portfolio about the comments made in this month's report.

13