Winslow, Evans & Crocker, Inc.℠

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GLOBAL ECONOMICS & CAPITAL MARKET COMMENTARY

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Markets, Interest Rates, Inflation & Recessions

The weeks of October 1st and 8th experienced some of the worst market sell-offs of the year with the S&P500 weighted index losing 6.9% followed by the Russell 1000 index losing 7.1% from their respective all-time highs, Chart #1. Although the markets have been fretting for most of the year about trade and tariff issues with China; the uncertainty in the Eurozone over Italy and Brexit; and, the fiscal problems facing emerging markets it was the sudden rise in the yield of the US 10 year Treasury bond that appears to have been the catalyst for the correction.

1

CHARTS 2-3

As can be seen in Chart #2 the yield rose quickly from 2.83% on 08/24/18 to 3.15% on 10/15/18. This was an 11.3% increase in interest rates in just six weeks! This rapid rise in interest rates was, in our view, an excuse for the markets to initiate an overdue correction. We see the US economy as being in mid-cycle with solid fundamentals that will continue to support equity markets. In fact, it is interesting to observe the sharp divergence between the global economic policy uncertainty indices with that of the US since the beginning of 2018, Chart #3.

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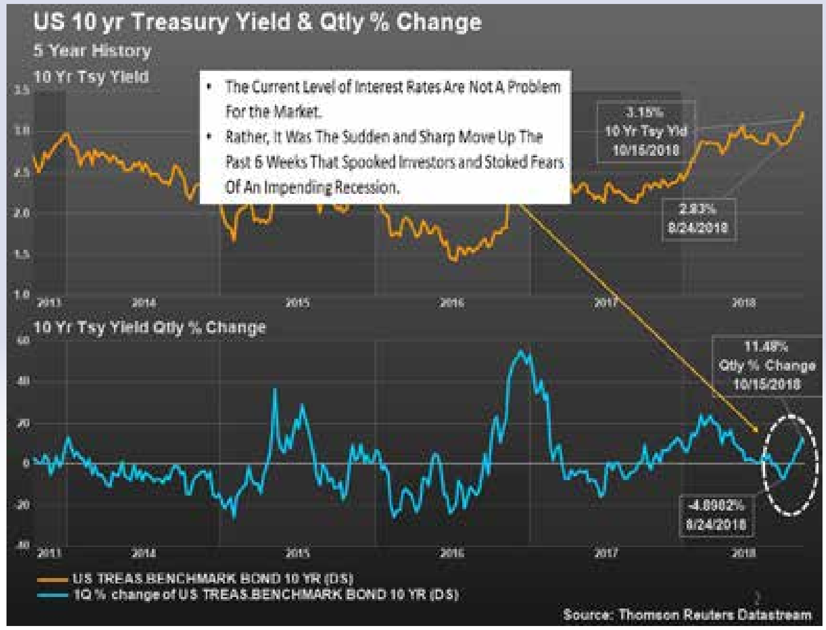

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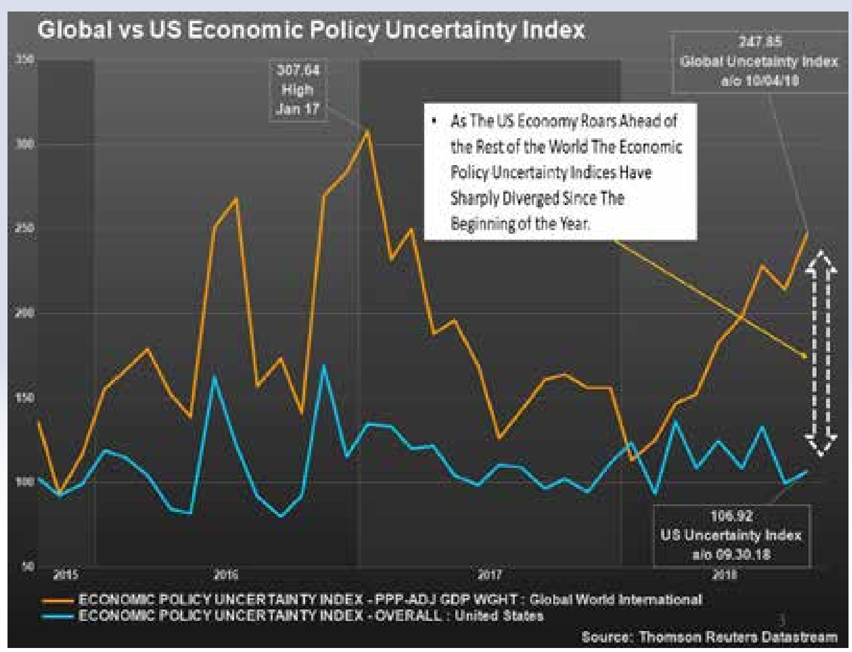

CHART 4

Our stance on the US equity markets has been bullish for several years and remains so today and, as we have published in the past, is based on the forward earnings and dividend yield of the S&P500 relative to the yield on the 10 year US Treasury bond. As can be seen in Chart #4 the market remains slightly inexpensive on a relative basis but not nearly as inexpensive as it was earlier in this economic cycle. There are three critical variables that determine the valuation measurements as seen in Chart #4: 1) forward earnings estimates; 2) the forward price to earnings ratio; and, 3) interest rates and, by inference, inflation.

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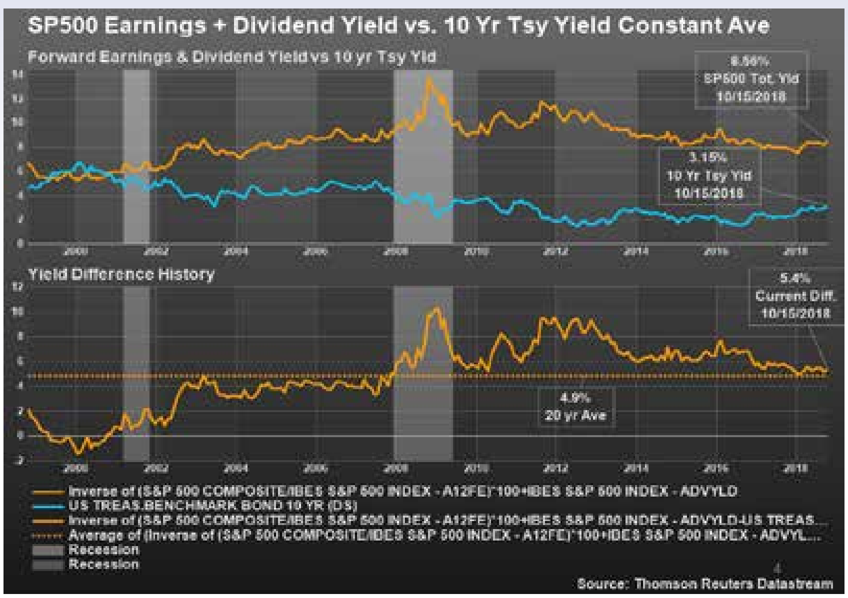

CHARTS 5-6

Historically company earnings grow during economic expansions so it is critical to look for signs of a recession which would cause earnings to decline and thus precipitate a bear market in equities. All of the indicators that we watch are indicating that we are still in the middle of this economic cycle and that a probability of a recession is at least a few years out. For example in Chart #5 it can be seen that recessions typically occur an average of six years after the leading economic indicators surpass the peak of the prior recession. This would imply no recession until around 2023. In Chart #6 we look at the six month rate of change in leading economic indicators where it is clear that they need to be negative before the beginning of the recession. At our current level we are well into positive territory thus providing further evidence that a recession is not imminent.

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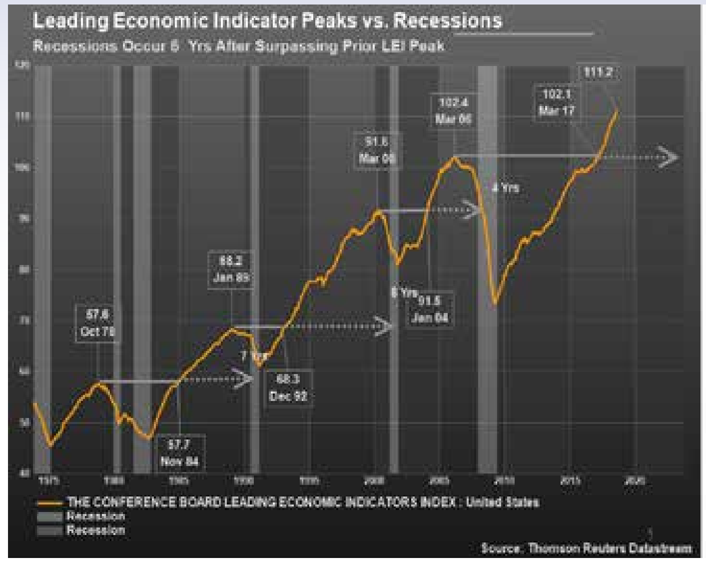

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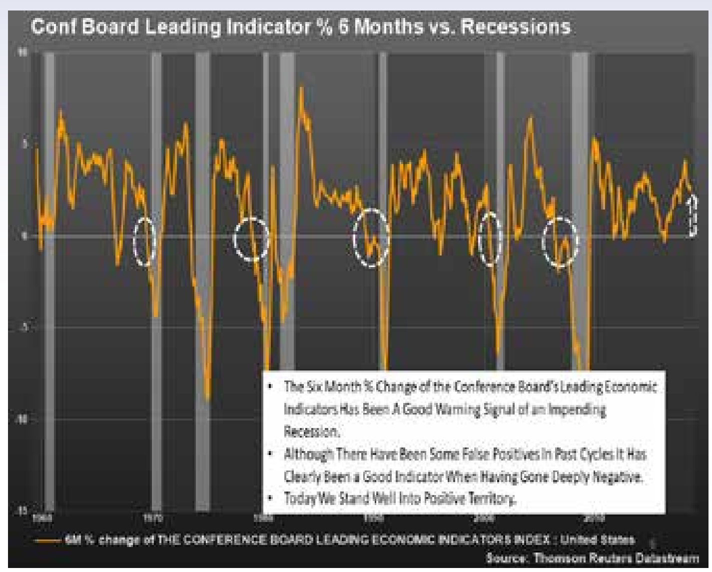

CHART 7-8

The level and rate of increase in interest rates are another critical factor for valuing equities. As mentioned above the current level of interest rates are not a negative factor for the equity markets because of the strong economic backdrop that is driving the growth in corporate earnings. It is therefore critical to watch for signs that interest rates might accelerate to higher, more troublesome levels. Because the relationship between interest rates such as the 10 year US Treasury bond and inflation has historically been very tight we are constantly on the lookout for indications that inflation will accelerate. In Chart #7 we show the ten year history of inflation as measured by the headline CPI to the 10 year Treasury yield. The yield currently resides just above its average. There are several indicators that we watch for the threat of potentially higher inflation. The vast majority of them are not currently flashing any warning signs. For example, in Chart #8, we show the inflation gauges put out by the NY and St.Louis Federal Reserves and it is clear from these measures that inflation pressures have been easing for the past several months.

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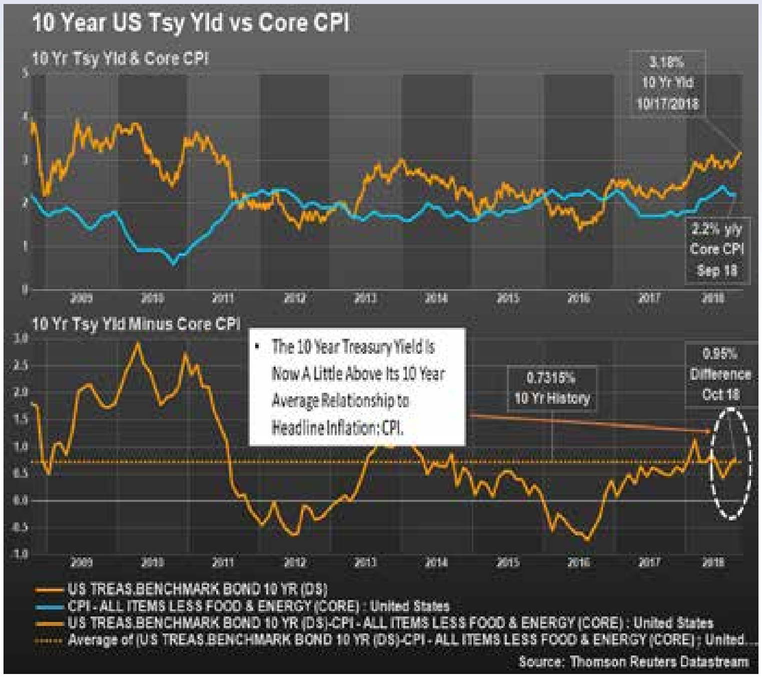

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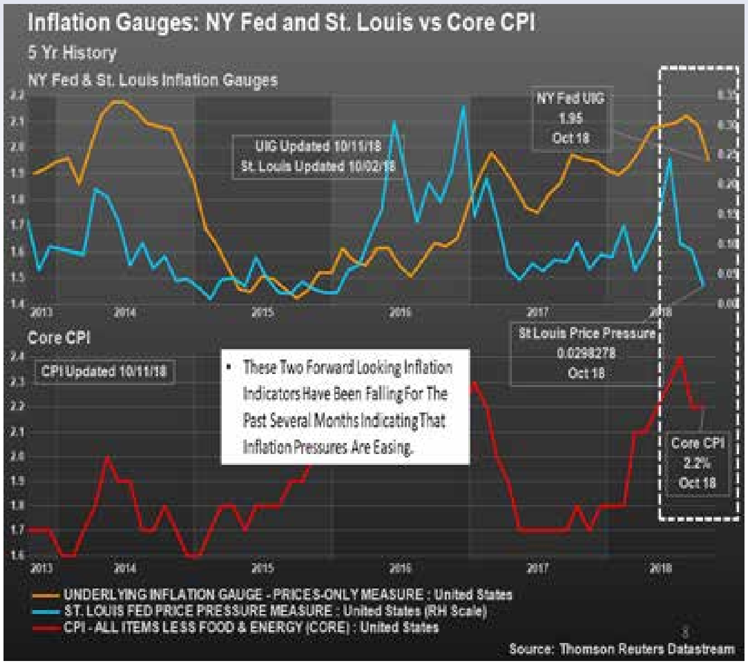

CHARTS 9-10

One factor that will tend to push up inflation is the increase in labor costs caused by a historically tight labor market. In Chart #9 you can see that the number of job openings is well into record high territory and far surpasses the peaks of the past two economic cycles. The quarterly Employment Cost Index is growing at its highest level of this economic cycle but remains well below the peak levels of the prior two cycles. Additionally, for the past several months there have been more job openings than the number of persons unemployed, Chart #10! The US economy is clearly very strong and is several years away from the onset of another recession. This is positive for corporate earnings. Inflation and interest rates are rising in response to this growth but are doing so at a modest pace. Although the earnings and dividend yield provided by the US equity markets are not nearly as attractive as they were just after the end of the recession they still remain modestly inexpensive. Because the equity market valuation is near its twenty-year average it will be much more sensitive to unexpected changes in such macro factors as trade, international problems and in modifications of the US Federal Reserve's outlook. This, in turn, will tend to heighten volatility and uncertainty.

Despite the likelihood of greater volatility going forward our view remains modestly bullish on equities because of a strong and durable economy and modestly increasing inflation.

Please speak with your investment advisor about how any of the above referenced topics might impact your portfolio.

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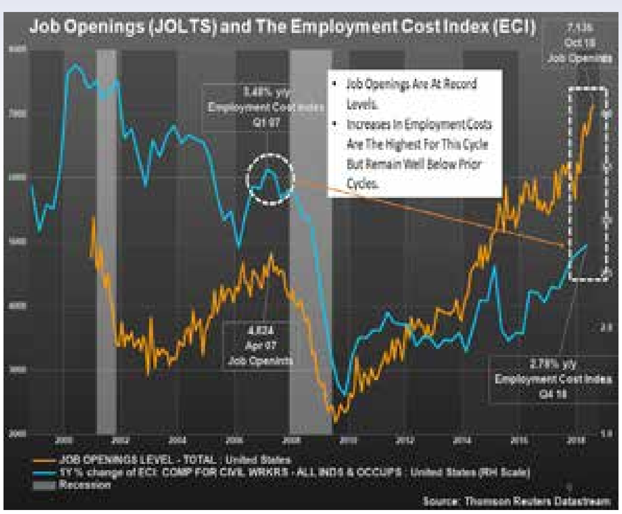

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