Winslow, Evans & Crocker, Inc.[SM]

JANUARY 2019

GLOBAL ECONOMICS & CAPITAL MARKET COMMENTARY

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MARKET CORRECTIONS AND RECESSIONS

As illustrated in Chart #1 the S&P500 managed to fall 20% from its peak in September to its trough on the 24th of December, temporarily entering bear market territory. Truly a lump of coal for Christmas.

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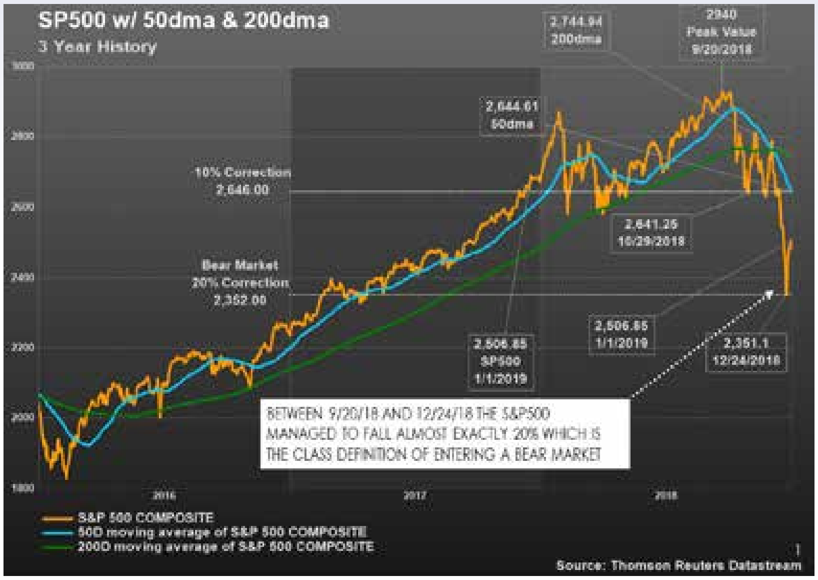

CHARTS 2-3

Additionally, the forward price to earnings ratio collapsed nearly 28% during that same time-period returning to levels last seen in June of 2013 as illustrated on Chart #2. Also shown on Chart #2 is the growth of the forward earnings estimates, in yellow, over that same time period to be +79%. Clearly the US equity market had become very oversold as fears grew of an imminent recession or, at the very least, a much slower economy for 2019. These fears were not without some reasonable cause as trade tensions increased between the US and China; US financial conditions tightened; the government shutdown continues; oil prices were rapidly falling again; and, global economic conditions and leading indicators have been declining. Several of these concerns such as trade tensions and the government shutdown are difficult to quantify but there is no doubt that indications of global growth have been fading as shown on Chart #3. Because the beginning of this fade was around the time that the Trump administration began to aggressively pursue their trade agenda it is very likely that there is some causality present. There are, however, other underlying forces at play which have as much if not more explanatory power. For example, there are the Brexit issues; Italy's deficit problems; the inability of France's Macron to implement needed economic structural reforms; and, China's reticence to move away from a state dominated, centrally planned economy a la the old Soviet Union.

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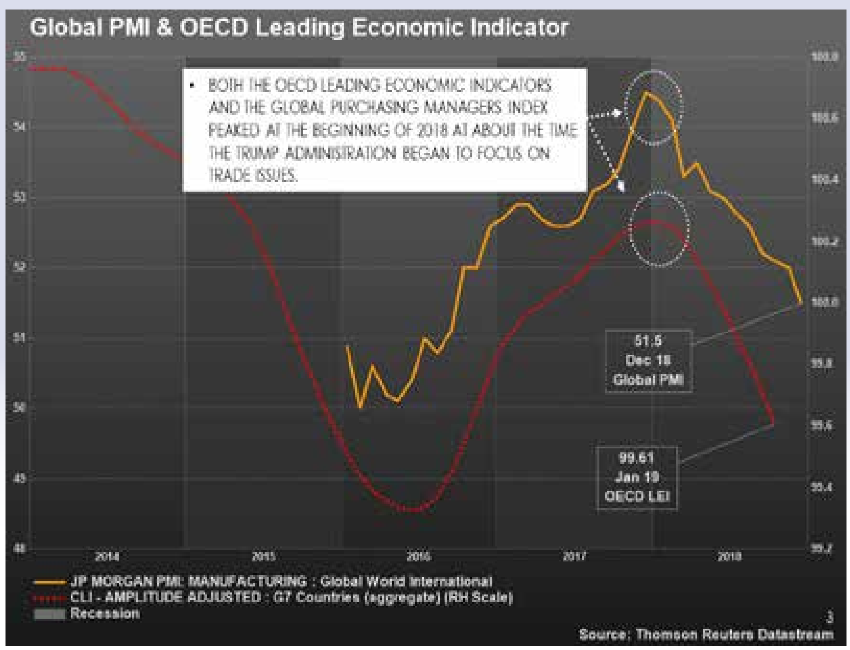

CHARTS 4-6

Reinforcing these concerns are the recent weaker manufacturing numbers from China and the surprisingly weaker US ISM Manufacturing Survey for December. It is becoming clear that some of the weakness in global economic growth is leaking into the US economy. This, however, does not mean that the US economy is entering a recession as was implied by last year's market fall. Recessions, as shown in Chart #4, are drivers of a fall in corporate earnings but a correction in markets does not mean that a recession is imminent. Our view that we are not about to experience a recession, and thus a bear market, is based on a number of economic and financial leading indicators. Charts # 5 and #6 represent two good economic indicators that support our view. Chart #5 shows the monthly ISM Manufacturing Survey for the past five economic cycles. Whenever the ISM number is above 50 it indicates an expanding economy and below 50 a contracting economy. Historically the number has had to decline to 45 to signify an imminent recession. Although the most recent reading of 54.1 is well below its cycle peak in August of 61.3 it remains comfortably above 50 indicating that the manufacturing sector is still expanding. The recent sharp drop may have been precipitated by trade tariffs along with the slowdown in global economic growth. Note, however, that this survey is very cyclical, displaying a sine wave pattern, and that it has fallen below 50 in past cycles without then also being followed by a recession. Chart #6 shows the six month change in the Conference Board's US leading economic indicators for the past seven economic cycles. Unlike the ISM survey, this indicator has been a more accurate forecaster of impending recessions. As the chart clearly shows the indicator must go deeply negative prior to the onset of a recession and, although currently trending down, it remains well above zero.

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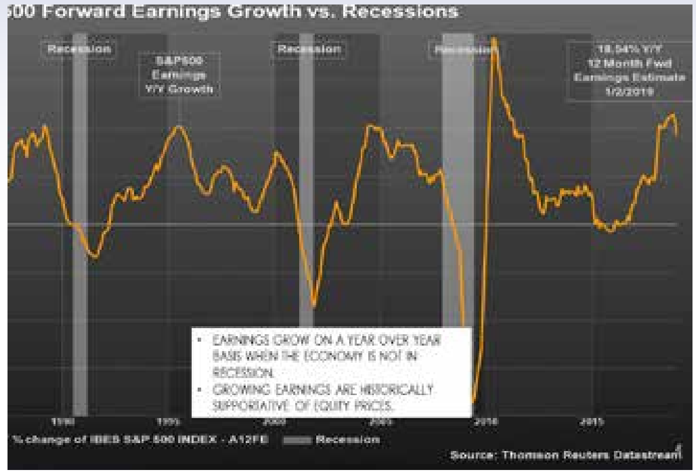

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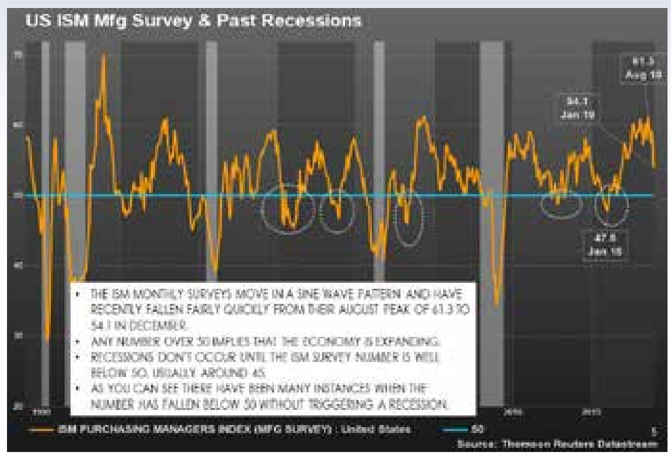

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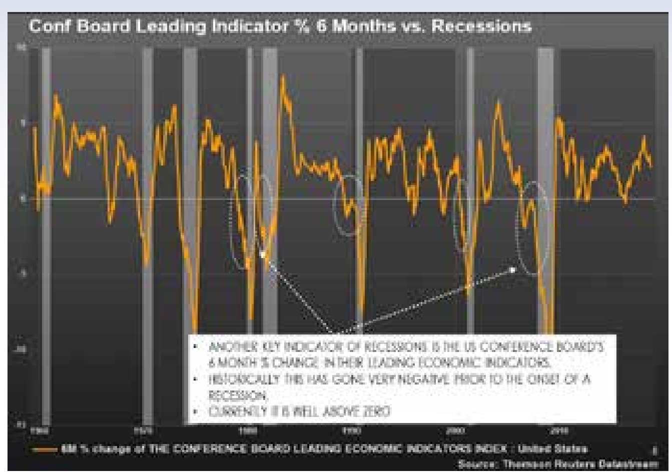

CHART 7-9

The next three charts, numbers six through eight, represent leading financial indicators that also support our view that a recession is not imminent. Chart #7 shows that credit spreads for high yield debt have widened and, in the bottom half, that financial stress indices have increased. Although this indicates that financial conditions have tightened they are both well below the cycle peaks of 2016. Additionally, the financial stress indices on the lower half of the chart remain below zero which means that financial conditions in the economy remain "easy". Chart #8 illustrates how the yield curve has been sharply flattening over the past several months. It has historically been a harbinger of a recession whenever it inverts which, in this chart, would be a negative number. This flattening process is probably caused by the Federal Government financing the deficit by issuing short term debt thus driving short term rates higher and by the modest inflation in the economy which would help to hold down interest rates on longer dated debt. As an aside, the trends shown in the above two charts may dissuade the Federal Reserve from raising the Fed Funds rate in 2019. Chart #9 illustrates the level of the Fed Funds rate over the past three economic cycles and its influence on recessions. It is clear that the current level is well below rates that precipitated the last recessions.

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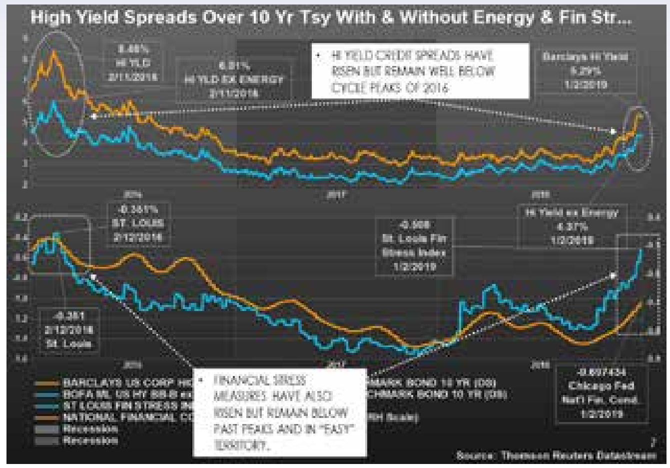

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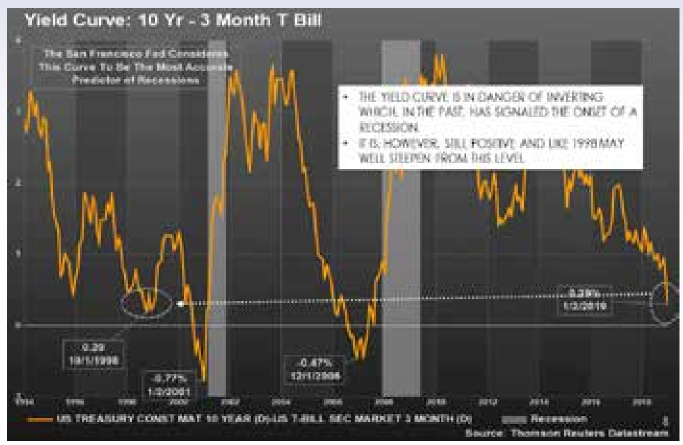

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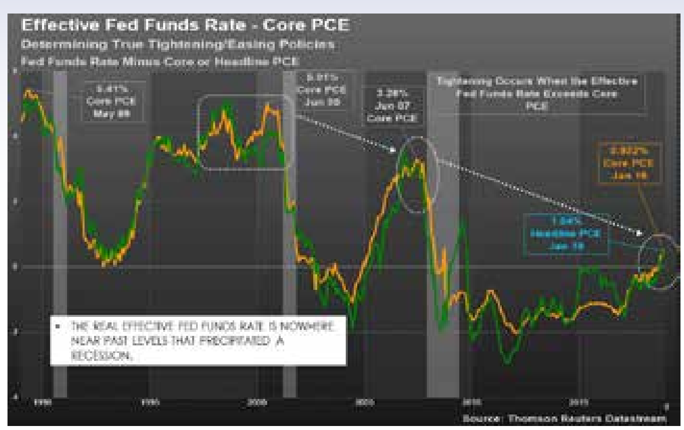

CHART 10-11

Since 1987 there have been four market corrections, including the one we're in, that have not been associated with a recession. Chart #10 illustrates the 1987 decline of 34% and how it was associated with a tightening of financial conditions initiated by the increase of the Fed Funds rate. After the S&P500 bottomed in 1987 real GDP increased for 11 quarters before a recession finally hit in 1990. Chart #11 shows the 13% fall in the S&P500 from November 2015 to March 2016 and the associated action in oil prices and the US$. That correction was associated with a collapse in oil prices, a surge in the US$ and a slowing Chinese economy. Also, at the beginning of the correction, the Fed Funds had been hiked by .5% despite the fact that financial stresses in the economy had already been rising. In addition, GDP slowed that year to just 1.3% and yet since then the US economy has increased for 10 quarters and still hasn't had a recession.

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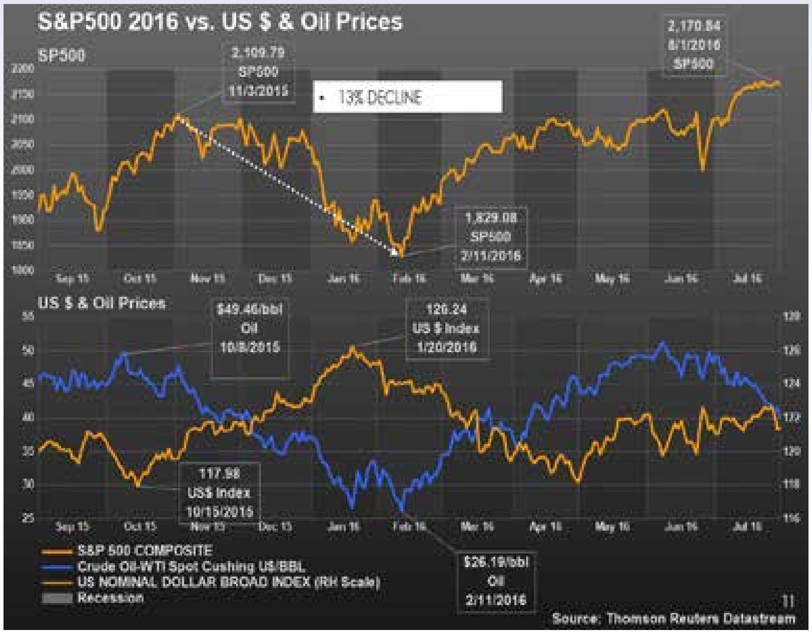

CHART 12-13

The global and domestic uncertainties described above means that market volatility for 2019 will remain elevated. Although we don't see a recession it is clear that corporate earnings growth will moderate from its torrid pace of 2018. Forward earnings growth estimates have fallen from about 23% to around 18% as shown in Chart #12. This growth rate will likely continue to moderate if the ISM New Orders Survey continues to soften.

In order to see through the clutter caused by the myriad of uncertainties outlined above we like to examine the market's forward earnings and dividend yield relative the yield on the 10 year US Treasury bond. In Chart #13 you can clearly see that the market's spread over the bond yield is at its highest since the last correction in 2016. Unless there is a complete collapse in corporate earnings, which we don't forecast, the market valuation remains attractive.

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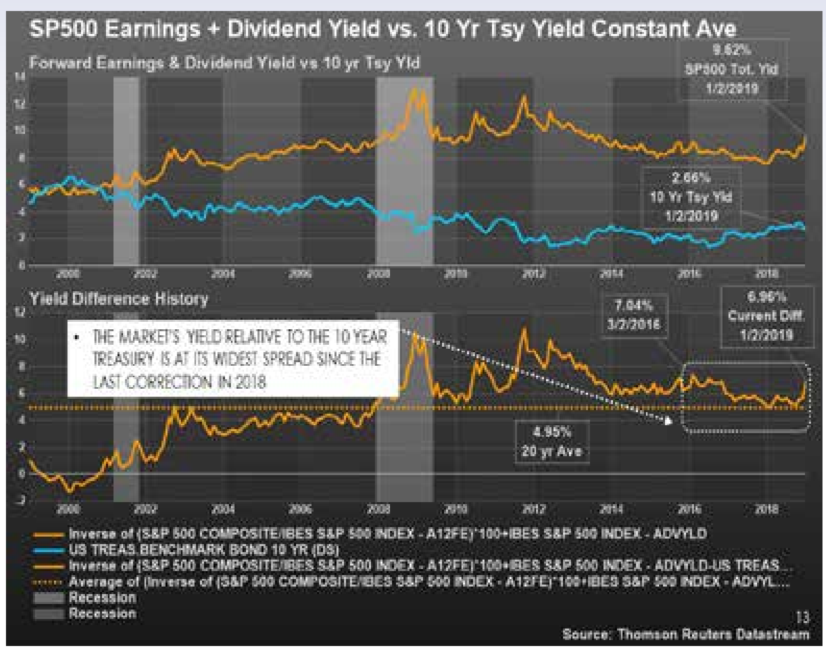

In conclusion, our economic and financial indicators are not showing us the threat of an imminent recession. We believe that we are in a market correction similar to the ones in 1987, 1998 and 2015 and, as shown in Charts #13 & #14, that the US equity markets are modestly undervalued but very oversold.

Please contact your investment advisor if you would like to discuss the commentary in this report.

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