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.

SETTLEMENT AND TRADING

OASYS: WUAW
DTC: 0725
Clearing: Raymond James & Associates, Inc.

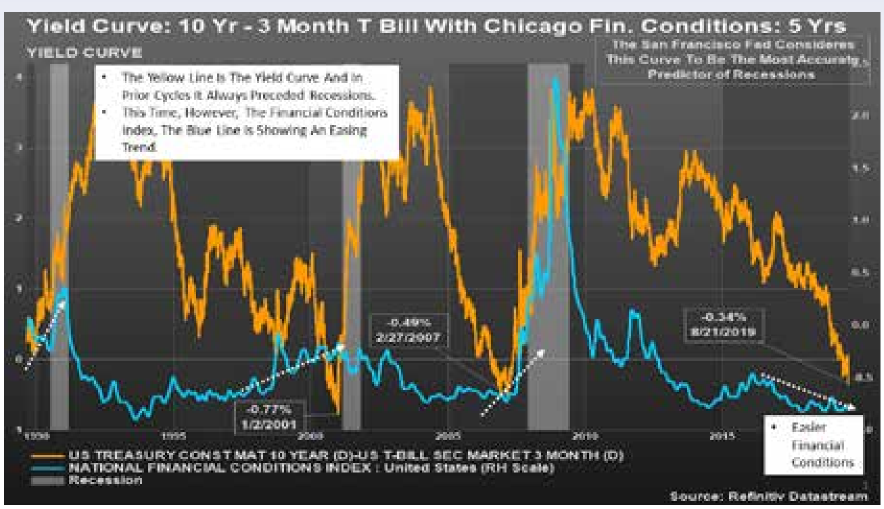
WINSLOW, EVANS & CROCKER

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

This Crazy Yield Curve & Its Diminished Recessionary Predictive Value

For nearly all economic cycles, prior to our current record long cycle, the inversion of the yield curve had always been a reliable forecaster of an impending recession. A yield curve inversion, you will recall, occurs when short-term rates are higher than long-term rates. Chart #1 illustrates the inversion of the 10 year US Treasury yield minus the 3 month US Treasury note yield to be about -0.34%. The blue line underneath is a measure of the overall financial stresses in the economy. A declining blue line indicates that financial conditions are getting easier and vice versa. You will notice that during all prior yield inversions the blue line was increasing, indicating rising financial stresses in the economy. This time, however, it is declining. We have highlighted this divergence in earlier publications to emphasize the point that the inversion of the yield curve during this cycle is driven by many structural issues that do not necessarily relate to an impending recession.

1

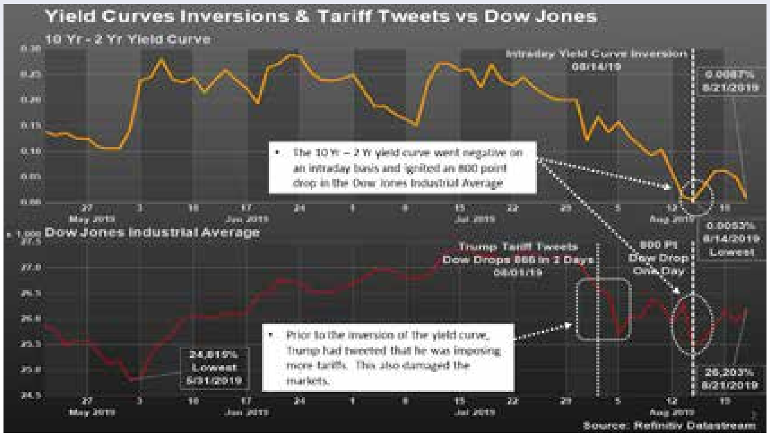


CHARTS 2-3

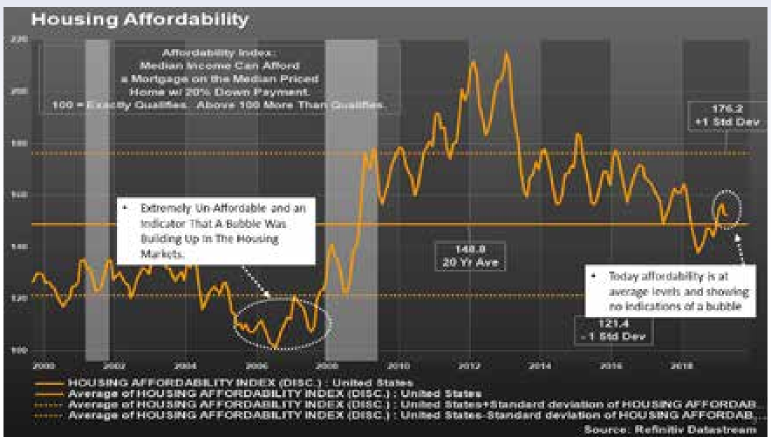
A look at Chart #2 helps to illustrate this point. On August 14th the 10 year minus the 2 year section of the yield curve inverted on an intra-day basis and ignited an 800 point sell-off in the Dow Jones Industrial Average. You should also note, however, that earlier in the month on August 1st, the President tweeted that he would be imposing more tariffs on China. This, too, set off a decline in the stock market. Therefore, prior to the temporary inversion on the 17th, the conditions had already been in place for an extreme negative market reaction to any further evidence that a recession might be imminent.

The bottom line is that, yes, the yield curve has inverted prior to the start of prior recessions but there were many other factors that were driving the economy toward a recession that just are not in place today. This time, however, we can find no excesses in the economy or capital markets that would tip the economy into negative growth. There is no housing bubble, as evidenced by the affordability indicators in Chart #3. You can clearly see that housing affordability is at about average levels today which is a sharp contrast to the extreme levels of unaffordability just prior to the housing bubble burst in 2007. Additionally, bank capital ratios are much healthier today than in 2007 thus providing a much greater cushion should a slowdown occur.

2



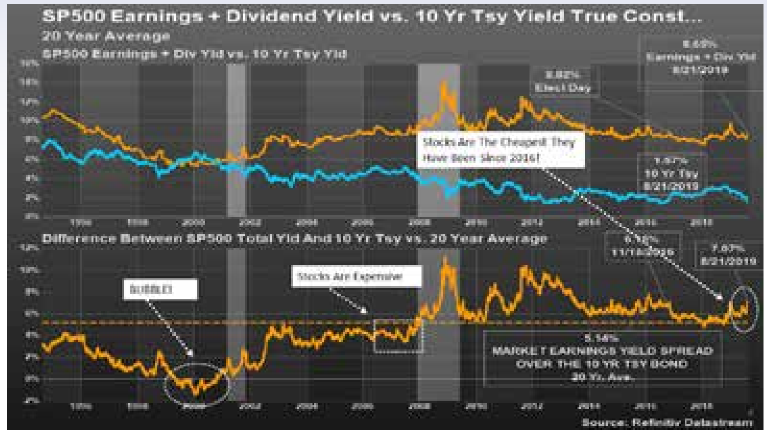
3



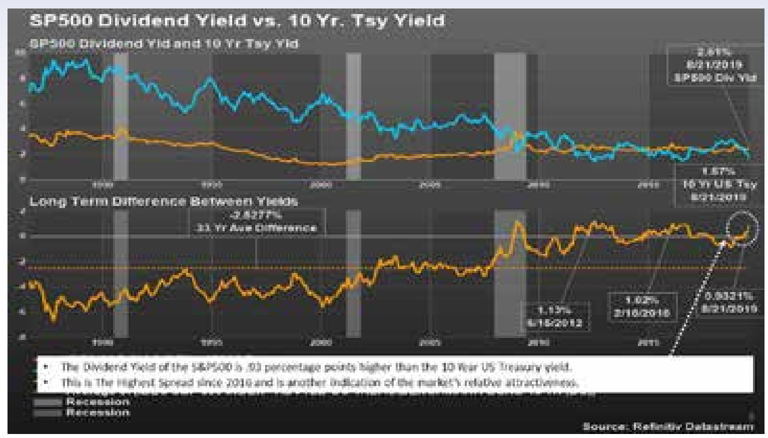
CHARTS 4-6

We also see no bubble in the stock market. Chart #4, which we have used in past publications, compares the forward earnings and dividend yield of the S&P500 to the yield on the US 10 year Treasury bond. At +7.07% spread over the Treasury yield the market is the cheapest it has been since 2016! Two other indicators point to the same conclusion: 1) the dividend yield on the S&P500 is greater than the 10 year Treasury yield, Chart #5; and, 2) the forward P/E ratio is only slightly above its 20 year history, Chart #6.

4



5



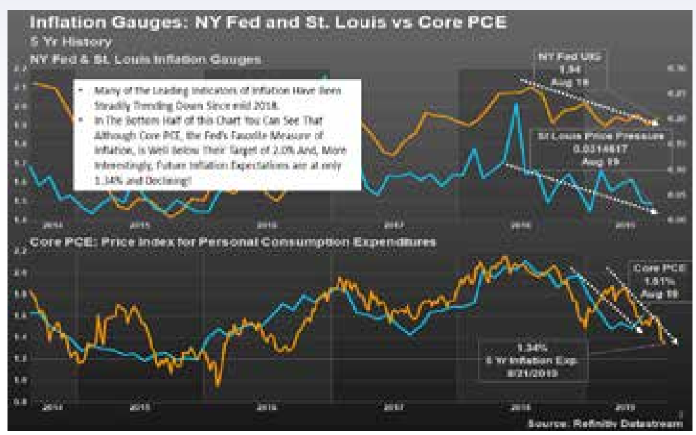
6

CHARTS 7-8

We pursued our observation of an undervalued market by examining, over a shorter time-period of five years, the peaks and troughs of the S&P500 against the market's earnings yield spread over the Treasury's yield. In Chart #7 it is clear that the current valuation, at a 7.07% spread, is indicating that the market is at a trough and could be getting ready for an upward increase similar to those that occurred after the prior troughs. This chart clearly shows that during the last three troughs in the stock market, highlighted by the vertical white lines, the market's spreads were very elevated. Another major factor that had been present in prior recessions is a flair-up in inflation. As the economy overheated and began to build up excesses during these past economic cycles the Federal Reserve has had to step in to cool down the resultant inflation. This inevitably let to inversions in the yield curve as the Fed increased short-term rates, increased economy-wide financial stresses and, eventually, precipitated a recession. This time around, however, the leading indicators of inflation are showing no hints that inflation will soon be erupting and thus forcing the Fed to tighten. In fact, as Chart #8 demonstrates, the leading indicators are signaling that inflation is remaining very tame.

7

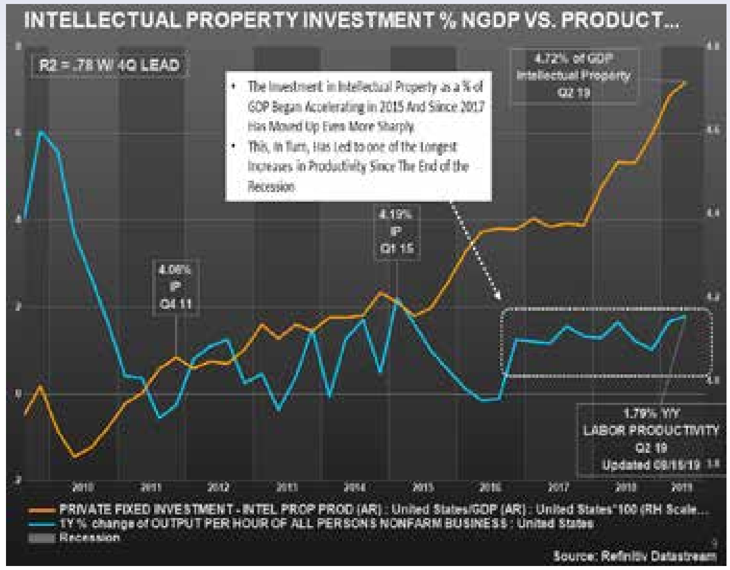
8



CHARTS 9-10

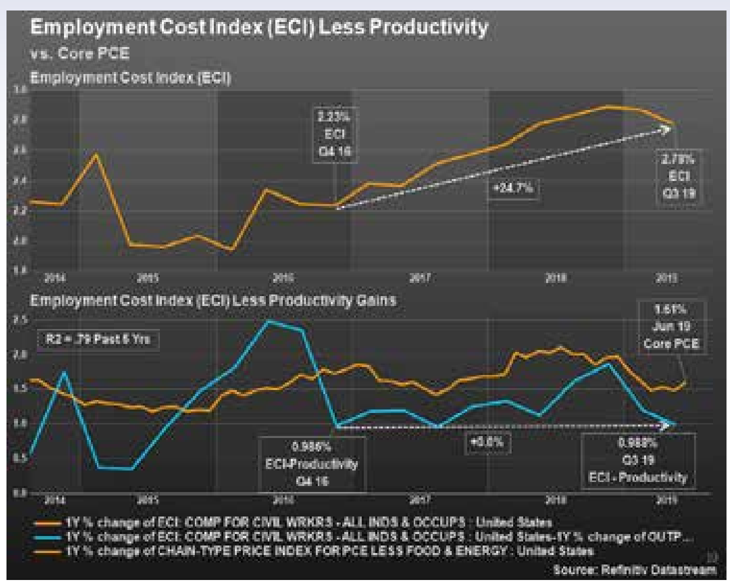
The fact that inflation has remained tame during a time when the US economy is strong and, for the first time in history, there are more job openings than unemployed workers has been a puzzle for economists. One factor that they seem to have overlooked is the steady increase, year over year, in productivity since 2016. This is the longest such period of this cycle, Chart #9. Also, note in this chart the sharp acceleration over the past few years in investment in Intellectual Property. This is a reflection of the information technology advances being made for the Cloud, Artificial Intelligence, the Internet of Things, Edge Computing, etc., and which is driving productivity higher.

9



To understand how productivity has helped to keep inflation at bay we calculated the increase in the Employment Cost Index, the most comprehensive measure of employee costs, since quarter 4 of 2016. As you can see on the top half of Chart #10, it had increased by nearly 25%. Then we factored in the increase in productivity over that same time-period and, as illustrated by the blue line in the bottom of the chart, the Employment Cost Index remained flat as did the core PCE, the orange line. Although there are many factors that influence the direction of inflation there is little doubt that the constant growth in productivity over the past three years has been a major and positive contributor.

10



In conclusion, we view the elevated angst over the inverted yield curve to be unwarranted and remain bullish on equities over the next 12 to 19 months. Please contact your investment advisor if you have any questions regarding this report.