Winslow, Evans & Crocker, Inc.[SM]

DECEMBER 2019 GLOBAL ECONOMICS & CAPITAL MARKET COMMENTARY

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GOING WITH THE FLOW INTO 2020

Why bother fighting the Fed? In the December Federal Open Market Committee meeting, the targeted Fed Funds rate was kept at 1.50%-1.75%, an outcome that was widely anticipated. Chairman Powell's comments, however, helped to crystalize the Fed's economic observations and goals for 2020. From our earlier report you may recall that nearly all recessions are begun by the Fed when it gets behind the curve with inflation and must aggressively tighten monetary policy to catch up. These periods always lead to declining earnings and bear markets. At this time, however, the Fed is worried that the expectations for inflation are too low and that the greater risk is a disinflation spiral. On Chart #1 you can see that current inflation expectations are well below the Fed's target of 2.0% and that, in order to achieve hit it, inflation expectations should be in the 2.3%-2.5% range. Therefore the Fed will likely stay on hold for the balance of 2020.

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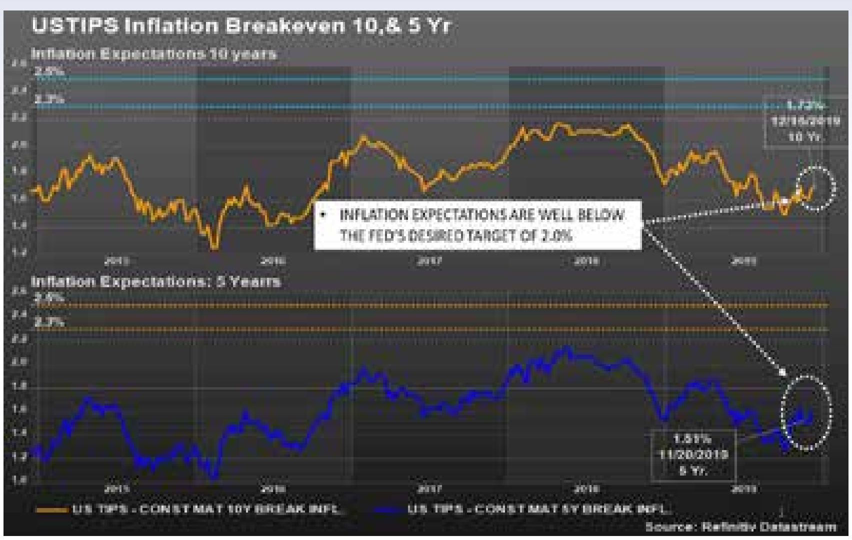

CHARTS 2-3

What was more interesting in Powell's commentary was his observation that there is a greater amount of slack in the labor market than would be assumed when the unemployment rate is at a fifty-year low of 3.5%. This is his answer to the conundrum that average hourly earnings have not been accelerating at a faster clip. Chart #2 shows the annual growth rate of average annual earnings alongside the Fed Funds target rate. You can see that average hourly earnings are growing at a healthy rate of 3.65% year/year. Normally this would be cause to be concerned about inflation, but the economy is showing little of it. What is telling about this chart is that during prior cycles when the Fed observed that earnings were accelerating to the upside they raised the Fed Funds rate, indicated by the blue line. This time, however, they have lowered the rate, a clear signal that the Fed is willing to let the economy overheat before turning off the monetary spigot. In fact, as illustrated in Chart #3, there is little evidence in some of the lead indicators that there is any threat of accelerating inflation on the horizon. The regional and national surveys of economic activity have been experiencing a steady decline in prices paid since mid-2018 and the core PCE, the Fed's favored measure of inflation, is well below its target of 2.0% at 1.59%.

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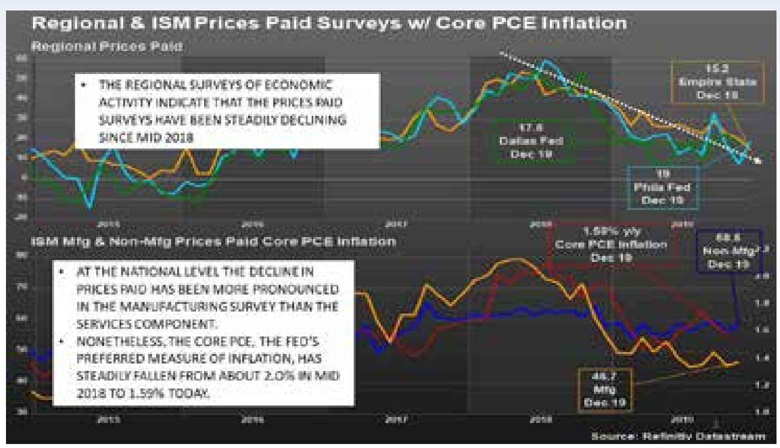

CHARTS 4-6

The strength of this labor market is illustrated in Charts #4 and #5. Chart #4 shows that the unemployment level, U3, is at a 50-year low while the underemployed level is near an all-time low at 6.9%. Chart #5 is evidence of the durability of the employment situation. The top of the graph is the number of job openings, the JOLTS data. This is well above the peaks of the prior two economic cycles and is very near an all-time high. The bottom of the graph is a measure of the quit rate and is a strong indication of the high level of employee confidence in the jobs market. With such a strong labor market and with household balance sheets in superb shape, Chart #6, it is clear that personal consumption, which is 70% of US GDP, has a solid foundation on which to continue growing.

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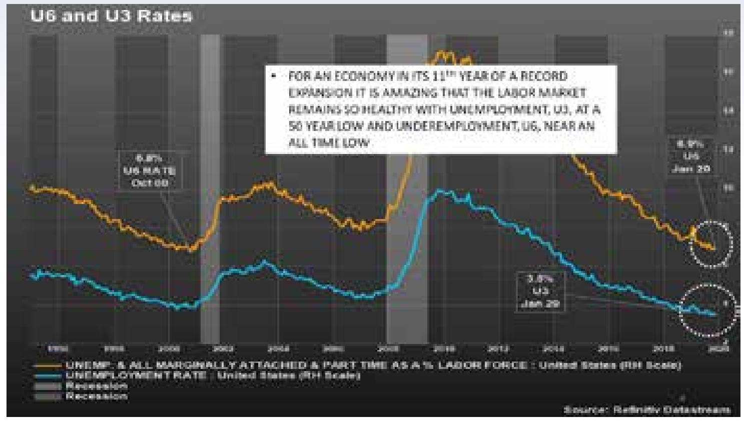

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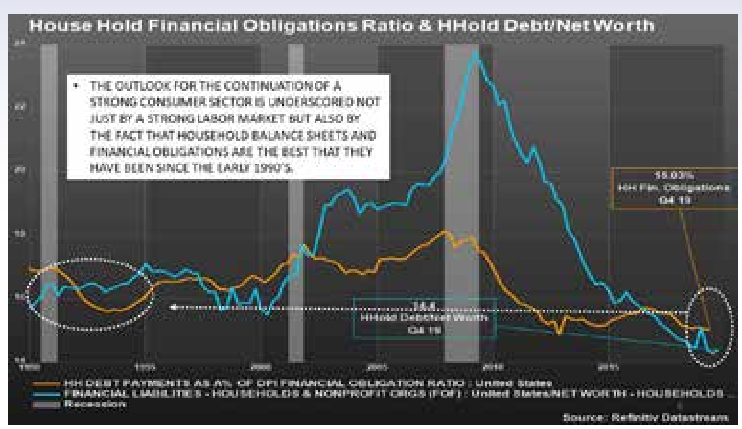

CHARTS 7-8

Chairman Powell, in his commentary, observed that there is probably greater slack in the labor market than one would expect in this environment of such a low rate of unemployment. Thus, the modest wage growth and weak inflationary pressures. Statistical evidence that is support for his observation is in Chart #7. In this chart we have divided the underemployed rate, U6, by the unemployment rate, U3, and compared this time series with the annual growth rate of the Employment Cost Index (ECI), a broader measure of labor costs than the Average Hourly Earnings numbers. There are two observations from this chart that support Chairman Powell's thesis. First, the U6/U3 ratio is well above the peaks of past economic cycles. This implies that the number of underemployed for a labor market this strong remains too elevated and is thus a relatively large pool of labor from which to draw. The effect on the ECI, the blue line, is equally clear in that it remains well below the levels of the last two cycles. This high U6/U3 ratio is not the only plausible explanation for modest wage growth. Another could be that productivity has been growing steadily over the past four years, Chart #8, and that it may be getting under reported by the government as the benefits from the early adoption of the Cloud, Hyperconnectivity, AI/ML, 5G and the Internet of Things is boosting productivity in ways that official statistics have not captured.

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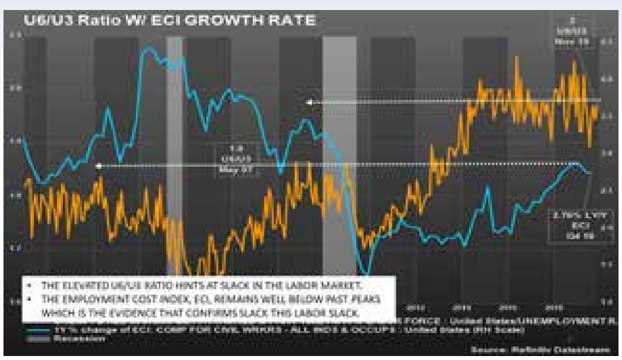

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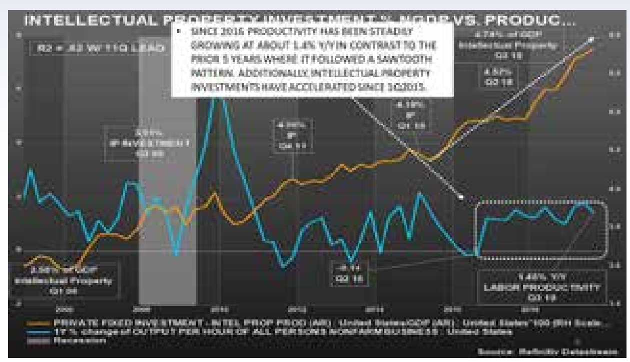

CHARTS 9-10

The position of the US Federal Reserve has pivoted dramatically from a year ago to one of maintaining a neutral stance for at least the balance of 2020. In combination with a very healthy consumer sector and labor market the outlook for both the economy and equity markets for 2020 is very positive. The S&P500 has clearly been on a tear for 2019. This performance raises the question as to whether or not it is overvalued. For the past several years we have been consistent in using a valuation model that compares the forward earnings and dividend yield of the S&P500 to the risk free rate of return, for which we use the 10 year US Treasury bond yield. In Chart #9 we can see that the market's yield spread over the 10 year Treasury yield is remains above its 20-year average. Although this yield spread is not nearly as wide as it was during and just after the 2008 financial crisis it is still relatively attractive. Looking at the past two economic cycles, you can see that, by comparison to those periods, the S&P500 remains even more attractive. It is interesting to note that just before the 2000 bear market the yield on the risk free 10 year Treasury bond was higher than the yield from the market…a clear sign of a market bubble. Today we are not at all close to those risky conditions. To verify that the market is not in a bubble we approach the valuation from a different perspective by discounting the National Income Profits Account (NIPA) by the yield on the 10 year treasury and compare the results to prior recessions, Chart #10. This chart clearly shows how the valuation of the S&P500 had become excessive prior to the last two bear markets and recessions but currently remains reasonable. These two valuation models are dependent on future earnings and the current interest rate environment. The former is expected to pick up in 2020 and 2021 over a poor 2019,

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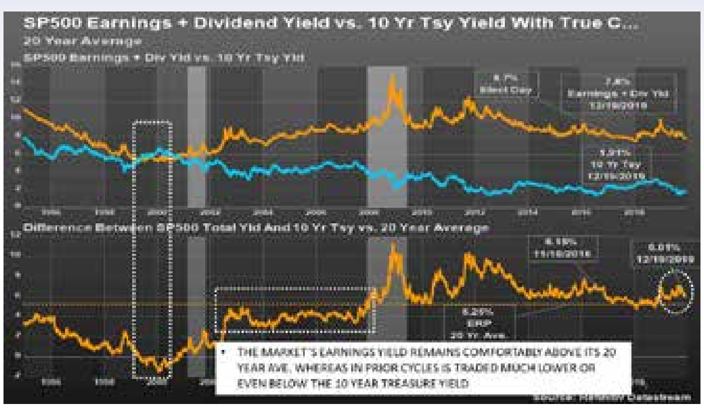

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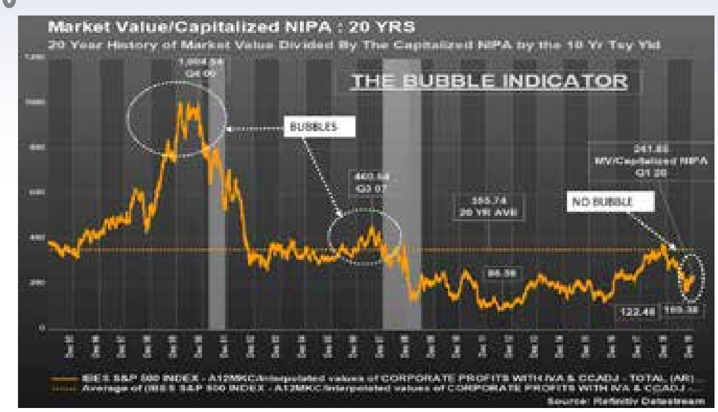

CHARTS 11-13

Chart #11. Interest rates should also modestly increase as the economy improves and inflation remains tame. In fact, interest rates have been in a long term, secular decline since the early 1980's, Chart #12 and, unless a severe bout of inflation should occur , they will likely remain modest for the balance of 2020 and possibly into 2021.

As a final note, we are seeing that the global economic indicators, which had been in decline for the past two years, are finally beginning to trend back up. Chart #13 gives a clear picture of this. Because the central banks in the other major global economies have been aggressively pursuing relaxed monetary policies for the past few years there is a strong potential that global growth will strengthen in 2020 and 2021. This will benefit not only the US economy but should be a tailwind for foreign equities.

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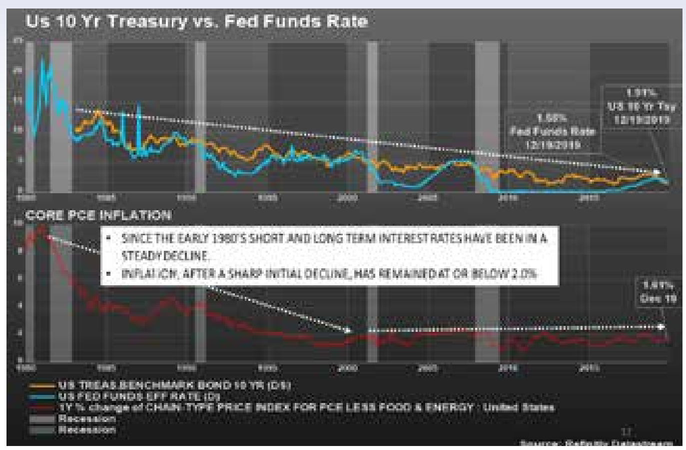

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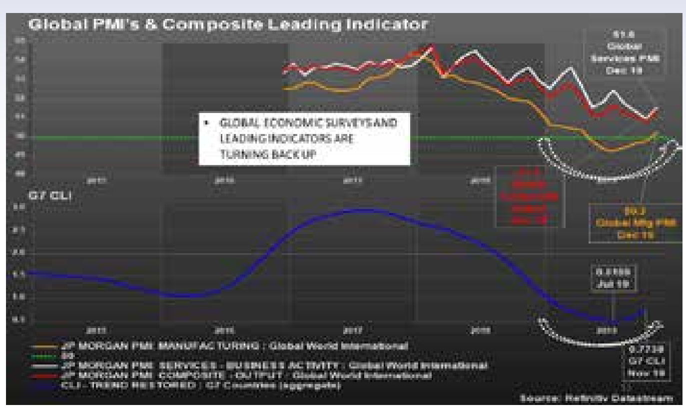

CHARTS 14-15

Chart #14 illustrates relative global interest rates and Chart #15 the relative valuations between global equities and the S&P500. A strengthening of global economic growth will make global equities appear attractive relative to the S&P500 especially since they are operating in a lower interest rate environment.

We have painted an optimistic picture for the markets and the economy for 2020 but there are some risks worth watching. First, the markets have had a fast run up and so could be vulnerable to a short-term correction, which, if it does occur, will not be the start of a bear market. Secondly, issues around trade and politics will create uncertainty and inject jitters into the market but, again, they will be corrections within a bull market. Finally, any major global geo-political event that severely disrupts global trade would be the kind of scenario that could trigger a recession and bear market but, at this stage, we see this as a low probability.

As always, please review these comments with your investment advisor should you have any questions or concerns.

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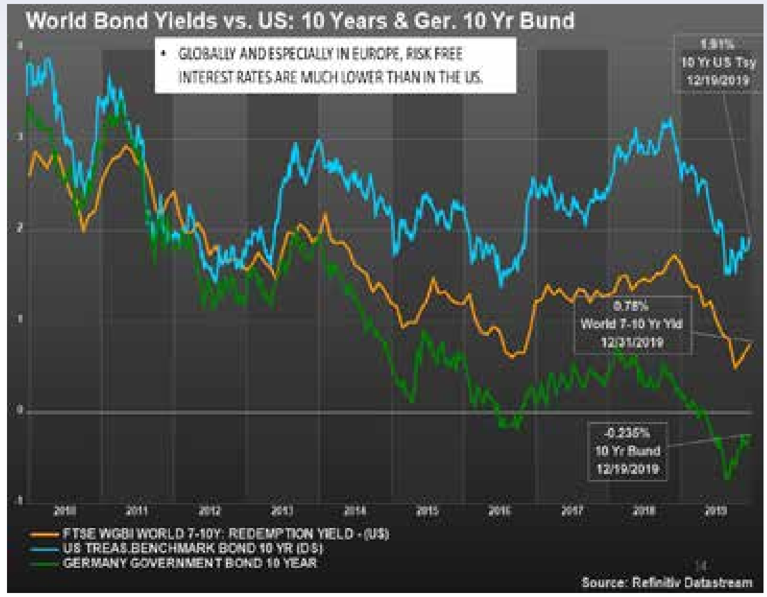

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