Growth Conditions Update

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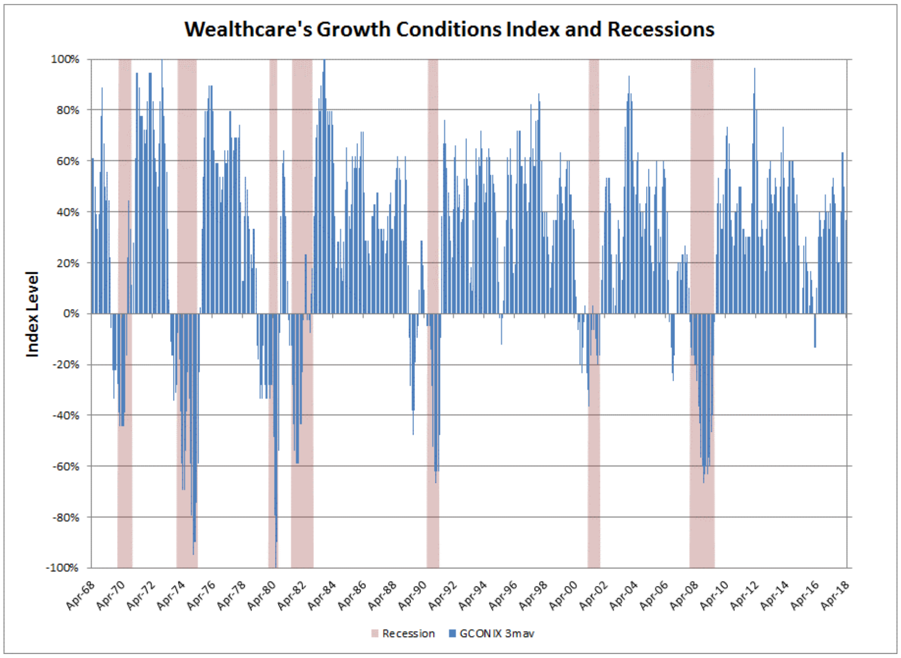
Over the first quarter, growth conditions deteriorated versus the prior quarter, but remain favorable. Our Growth Conditions Index (GCONIX[1]) fell from 63% favorable at the end of last year to 37% favorable as of the end of March. Three of the four sub-indexes fell, with Macro Policy falling the most. Consumption & Employment rose by 11%.

Growth Conditions Index (GCONIX) Update				
Sub-Index	Weight	Dec-17	Mar-18	Change
Business Activity	35%	62%	33%	-29%
Consumption & Employment	30%	56%	67%	11%
Housing & Construction	20%	67%	50%	-17%
Macro Policy	15%	78%	-33%	-111%
Summary	100%	63%	**37**%	-27%

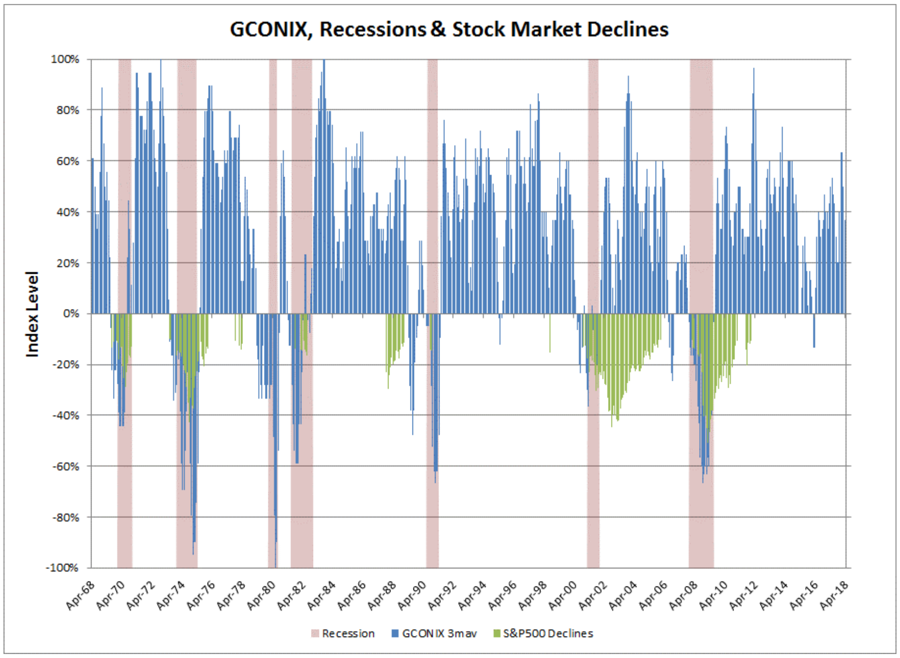
The macro policy sub-index seeks to measure the economic impact of monetary and fiscal policy. Continued tightening by the Fed has caused monetary indicators to turn negative. Fiscal policy remains a positive driver given the passage of the new tax law and associated stimulative deficit spending. On balance, while the macro policy sub-index is now negative, growth conditions, as measured by the current 37% overall positive reading on GCONIX, remain supportive to equities and continued economic growth.



[1] For reference, a summary of how GCONIX is constructed is provided at the end of this article.

As you can see from the above chart, recessions occur when GCONIX sustains readings below -20%. Absent a catalyst such as excessive Fed tightening or an actual, rather than threatened, trade war, a recession is not currently on the horizon.

The chart overlay below plots GCONIX with declines in the S&P 500 Index. GCONIX has captured every stock market decline of 20% or more except for Black Monday – the October 19, 1987, one-day, 22.6% crash.



While there are a number of explanations for Black Monday's 22.6% decline in 1987, impending recession was not one of them, as the next recession was more than two and half years away. Reasons given included program trading, portfolio insurance ("downside protection" trading strategy that attempted to mimic options and required the strategy to sell more as prices fell), and Middle East tensions (Iran had fired silkworm missiles at US-flagged commercial ships). Portfolio insurance was a favored scapegoat, the strategy was abandoned, and circuit breakers became policy.

So, a bear market can occur without a recession, but ultimately fundamentals prevail. The 22.6% decline on October 19th, 1987 was followed by the S&P 500 returning more than 57% over the next two years.

What was happening with the fundamentals prior to the crash of October 19th, 1987?

1. The S&P 500 Index rose by 32.9% in the first nine months of 1987. Based on historical earnings valuation measures, it was more than 40% overvalued. Historical earnings based valuation measures like historical P/E ratio are often mentioned in the financial press. When valuation measures are adjusted to trend levels of earnings, the degree of overvaluation was modest – 7.5% or less depending on the model used.

2. CPI headline inflation rose from 1.1% at the end of 1986 to 4.4 % by September of 1987, an increase of 3.3%.

3. The Fed had raised the Funds rate by 1.25%, lagging the rise in inflation.

4. The 10-year Treasury yield was up by 2.9%, nearly keeping pace with inflation and putting pressure on equity market valuations.

What was happening to the fundamentals prior to Monday, February 5th, 2018, the day of the "largest one-day point loss ever" in the Dow?

1. The S&P 500 index was up more than 21% over the prior year. Using an average of our most effective valuation measures on a trend-adjusted basis, the S&P500 was more than 8% above fair value.

2. CPI headline inflation was up just 0.5% from its low point over the prior year.

3. The Fed had raised the Funds rate by 0.75%, staying ahead of the rise in inflation.

4. The 10-year Treasury yield was up just 0.80% from its lowest point over the prior year, keeping pace with the rise in Fed Funds.

So, the pattern of the two Mondays is the same – favorable growth conditions as measured by GCONIX, rising inflation, rising interest rates, and modest overvaluation - with a contentious geopolitical environment. The difference is in the magnitude. The inflation and interest rate increases were modest in the run-up to the 4.2% decline on February 5th of this year as compared to the inflation and interest rate increases in the run-up to the 22.6% drop on Black Monday.

If the pattern holds, and we have a bear market without a recession this year, the decline will present a buying opportunity. Of course, no one knows what will happen for the rest of this year, but here are two key recession risk factors to watch:

1. Contentious trade negotiating tactics developing into an actual global trade war

2. The Fed being overly concerned with inflation rising above 2% and tightening too aggressively

Simply put, a significant trade war will cause a decrease in output and a rise in prices - this is bad for jobs, bad for the consumer, and bad for stocks. Conventional wisdom is that President Trump is using the threat of tariffs as a negotiating tactic.

In a recent Forbes[2] article, according to the Organization for Economic Development and Cooperation (OECD), "If Trump's negotiating position is a 10% across the board tariff on most things entering the U.S., instead of the average level of 2%, then global trade volumes would drop by 6% and global real GDP would drop by 1.4%." The article goes to reference Goldman Sachs prediction of a 20% drop in equities if Trump slapped 10% tariffs on everything.

Our base case is that neither President Trump nor other world leaders will let tough trade talk deteriorate into a significant trade war, similar to the way tough military talk yielded to the upcoming direct talks between the U.S. and North Korea. If our base case plays out, then overaggressive tightening by the Fed is the main recession risk factor.

An inverted yield curve, caused by the Fed raising short-term interest rates above long-term bond yields, has preceded every recession over the past 50 years. The following chart illustrates using the 10-year Treasury yield versus the overnight Federal Funds rate. The red portion on the chart shows when the yield curve is inverted – when the Fed Funds rate is above the 10-year Treasury yield.

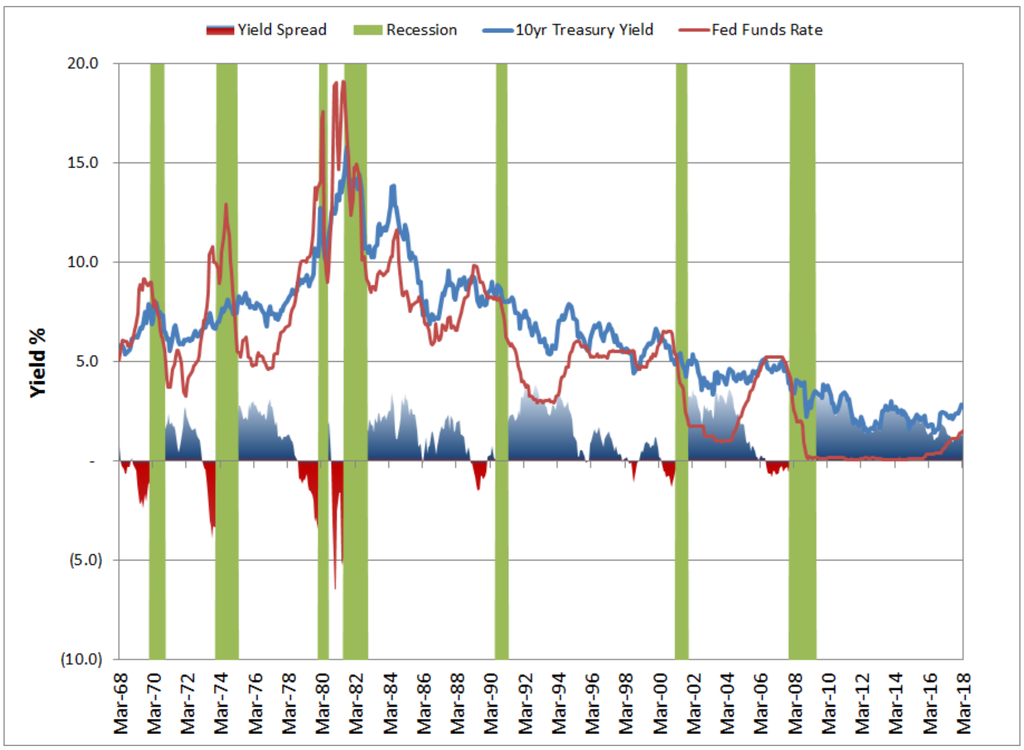
[2] https://www.forbes.com/sites/kenrapoza/2018/03/27/is-trumps-tough-tariff-talk-his-art-of-the-trade-deal/#54bcd88f60ce

The Fed Funds rate is currently 108 basis points below the 10-year yield, so the Fed has room to tighten further before causing a yield curve inversion and risking recession.

We will continue to monitor growth conditions and the yield curve, but for now we conclude that the fundamentals remain supportive of stocks and the risks to the market and the economy are political.

The Yield Curve and Recessions

Last 50 Years



GCONIX: Wealthcare's Growth Conditions Index

The Wealthcare Growth Conditions Index, "GCONIX" for short, is a composite of 20 key economic indicators that have had a tendency to lead or coincide with changes in economic activity. The components of GCONIX are published no less frequently than monthly. It is intended to measure the breadth of economic strength/weakness, not the level of growth. As such, the selected indicators span the major elements of economic activity and actors (e.g. the Federal Reserve) that influence it. Below is a list of the indicators (source in parenthesis):

Business Activity and Production

1. New Orders (National Association of Purchasing Managers Survey)
2. Backlog Orders (NAPM)
3. Business Activity (NAPM)
4. Industrial Production (Federal Reserve)
5. Manufacturers' New Orders (U.S. Census Bureau)
6. Durable Goods New Orders (U.S. Census Bureau)
7. Capital Goods Orders (U.S. Census Bureau)

Consumer/Worker and External Demand

8. Personal Income (Bureau of Economic Analysis)
9. Personal Consumption Expenditures (BEA)
10. Retail Sales (U.S. Census Bureau)
11. Initial Jobless Claims (Department of Labor)
12. Average Work Week (Conference Board)
13. Exports (U.S. Census Bureau)

Housing and Construction

14. Home Builders Market Activity (National Association of Home Builders)
15. Housing Starts (U.S. Census Bureau)
16. Building Permits (U.S. Census Bureau)
17. Construction Spending (Census Bureau)

Monetary and Fiscal Stimulus

18. Government Debt (U.S. Treasury)
19. M2 Money Supply (Federal Reserve)
20. The Monetary Base (Federal Reserve)

The business activity indicators focus on orders as they lead production activity. Likewise, Housing and Construction have downstream impacts on economic activity – buy a new home and you also buy appliances, employ construction workers, painters, etc. The Consumer/Worker indicators assess the state of this important component of the economy. Consumer Spending represents about two-thirds of GDP. Jobless Claims and the average work week tend to lead consumer spending. The Monetary and Fiscal indicators provide a measure of policy support for economic activity.

Of note, there is no financial market data used in GCONIX. The raw Index can range from 100% positive to 100% negative based on whether each component of the Index is rising or falling in real terms. Data is smoothed to reduce noise. If 10 of the GCONIX components are rising and 10 are falling, the Index has a reading of zero, which is a neutral reading meaning neither positive nor

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