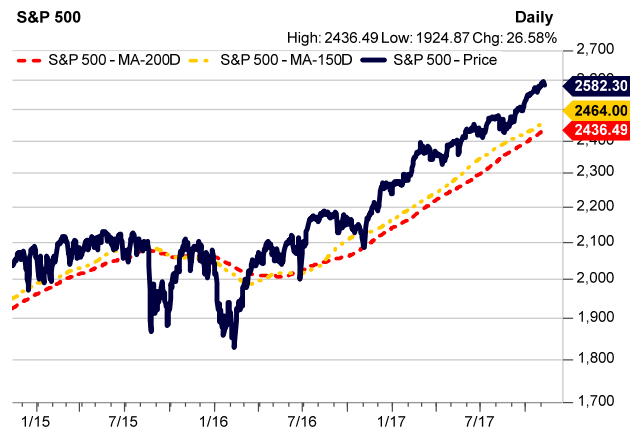


# Observation Deck

Views from the Investment Policy Committee



4<sup>th</sup> Quarter 2017

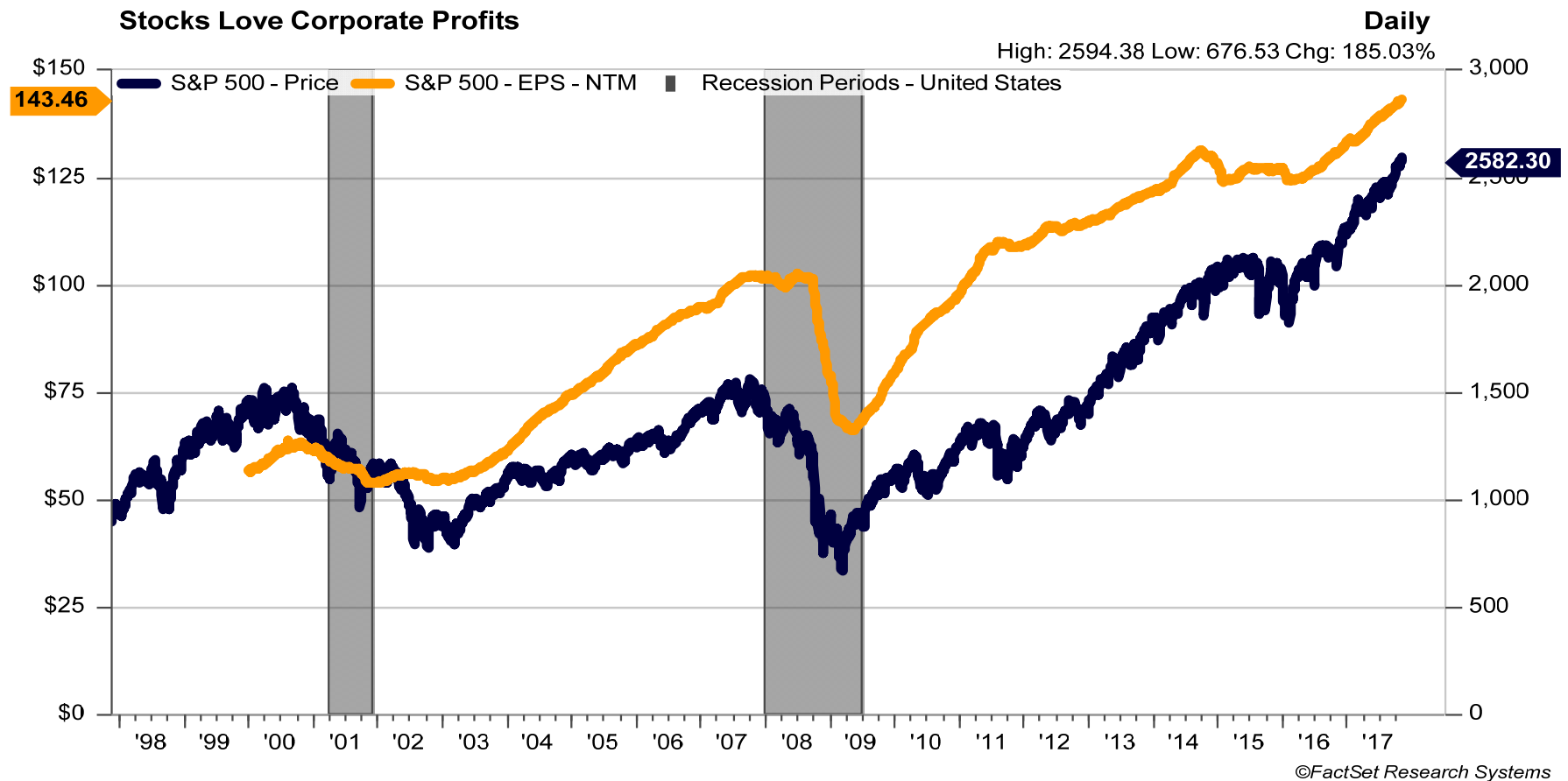
# Purpose

- The Observation Deck is a series of pictures designed to communicate points of view and to generate discussion and debate, it is NOT a set of recommendations
- Our commentary is not the result of any single data point or graphic, it is a reflection of the weekly conversations within the Investment Policy Committee and a set of perspectives that are derived from many observations accumulated over varying time frames
- Slides that are included in the Observation Deck are a subset of the scores of data points and graphics that the Investment Policy Committee views each week in assessing the status of the business cycle and the health of financial markets
- We hope that you enjoy the Observation Deck and recognize that the views and opinions expressed are capturing a moment in time and are subject to change without notice

# Observation #1

## Stocks Love Corporate Profits

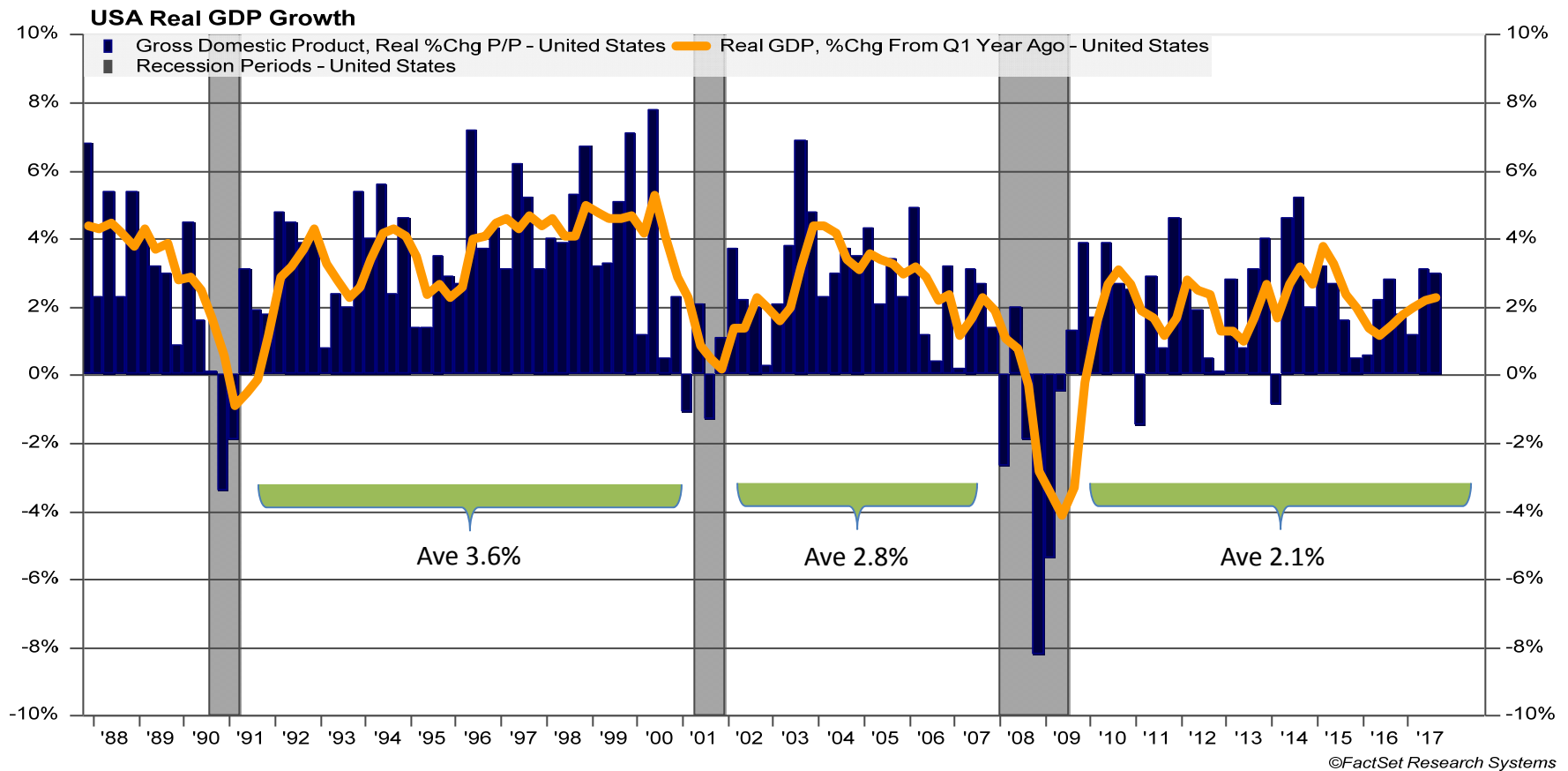
- Financial markets digest a lot of noise every day from a plentitude of sources, but what stocks (blue line) ultimately care about is the path of corporate profits (gold line)
- The profit cycle has been quite strong since recovering from the “Great Recession”



## Observation #2

# Profit Cycles Come from Business Cycles

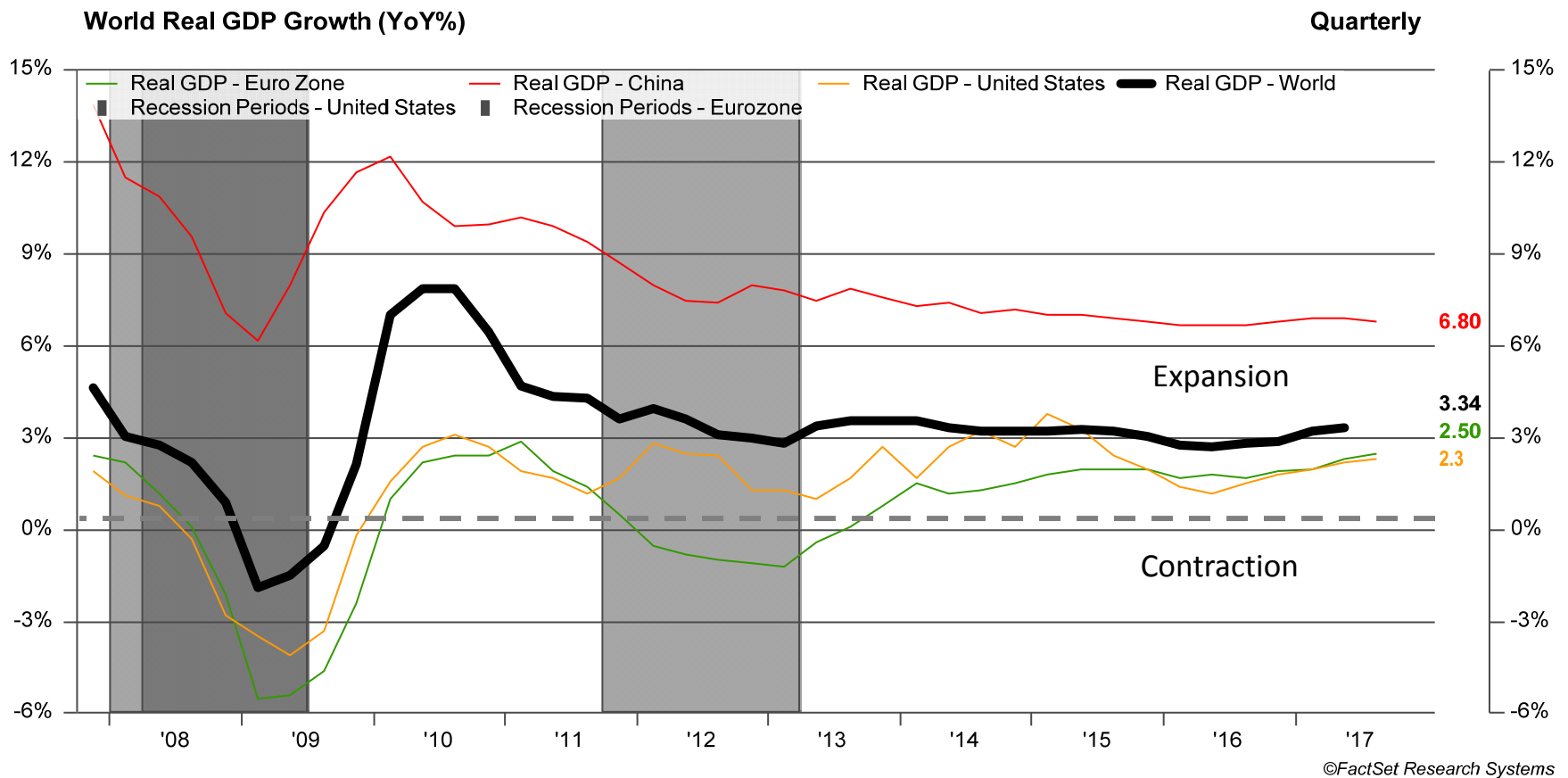
- Economic expansions are of varying length and strength and are interrupted by periods of recession (gray bars)
- What the current US business cycle has lacked in pace it has made up for in duration
- Nominal GDP in the USA has grown from \$14,340b in Q2 2009 to \$19,495b in Q3 2017, a 36% increase despite slower than historical annualized growth



# Observation #2

## Profit Cycles Come from Business Cycles

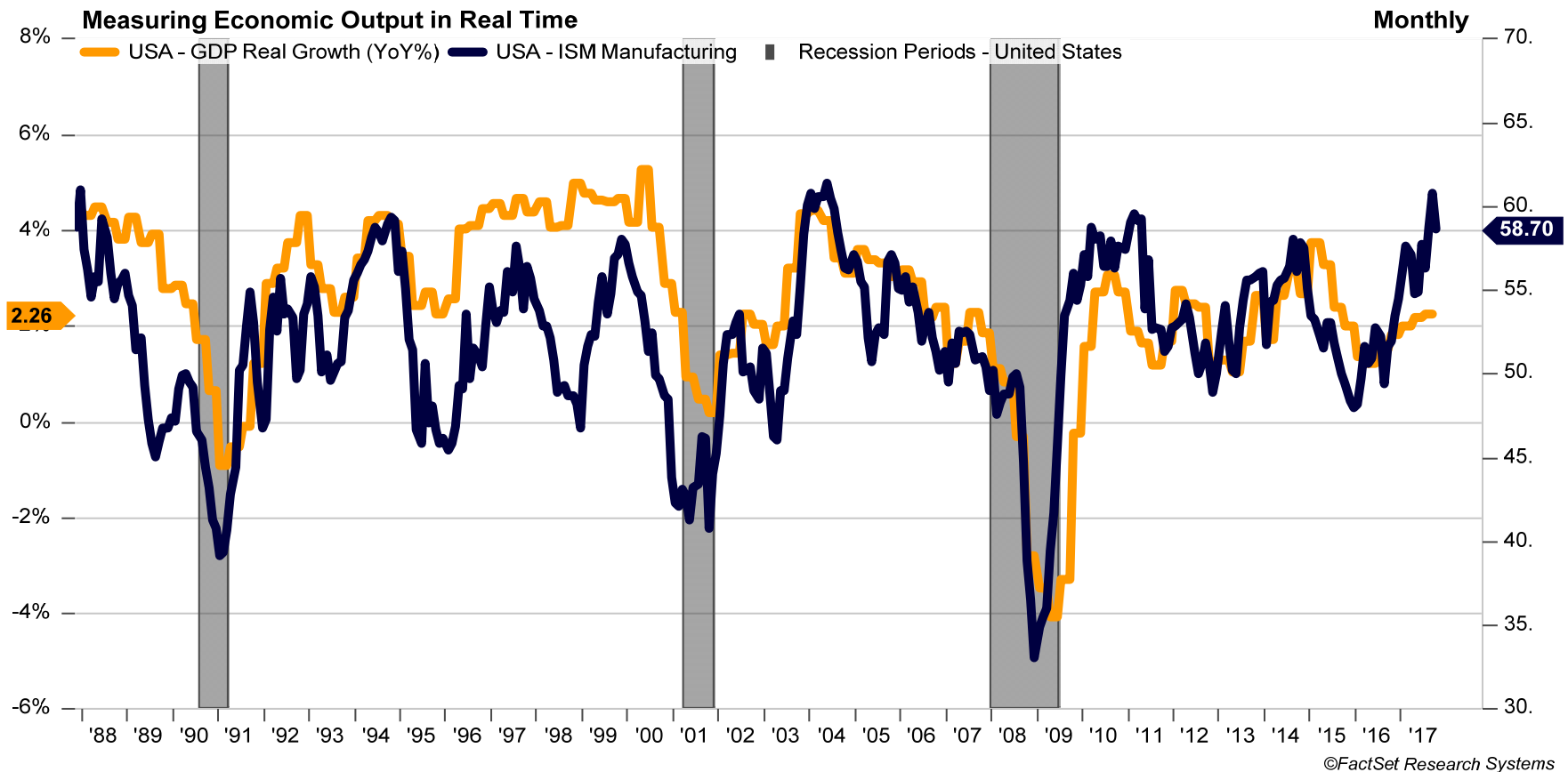
- Globalization means that companies compete for profits around the world, deriving them from the growth in sales that aligns with economic expansion
- While USA real GDP growth (yellow line) has been moderate relative to historical standards, World real GDP (black line) has been bolstered by faster rates of growth from emerging economies like China (red line)



# Observation #3

## Manufacturing Surveys = Leading Indicators

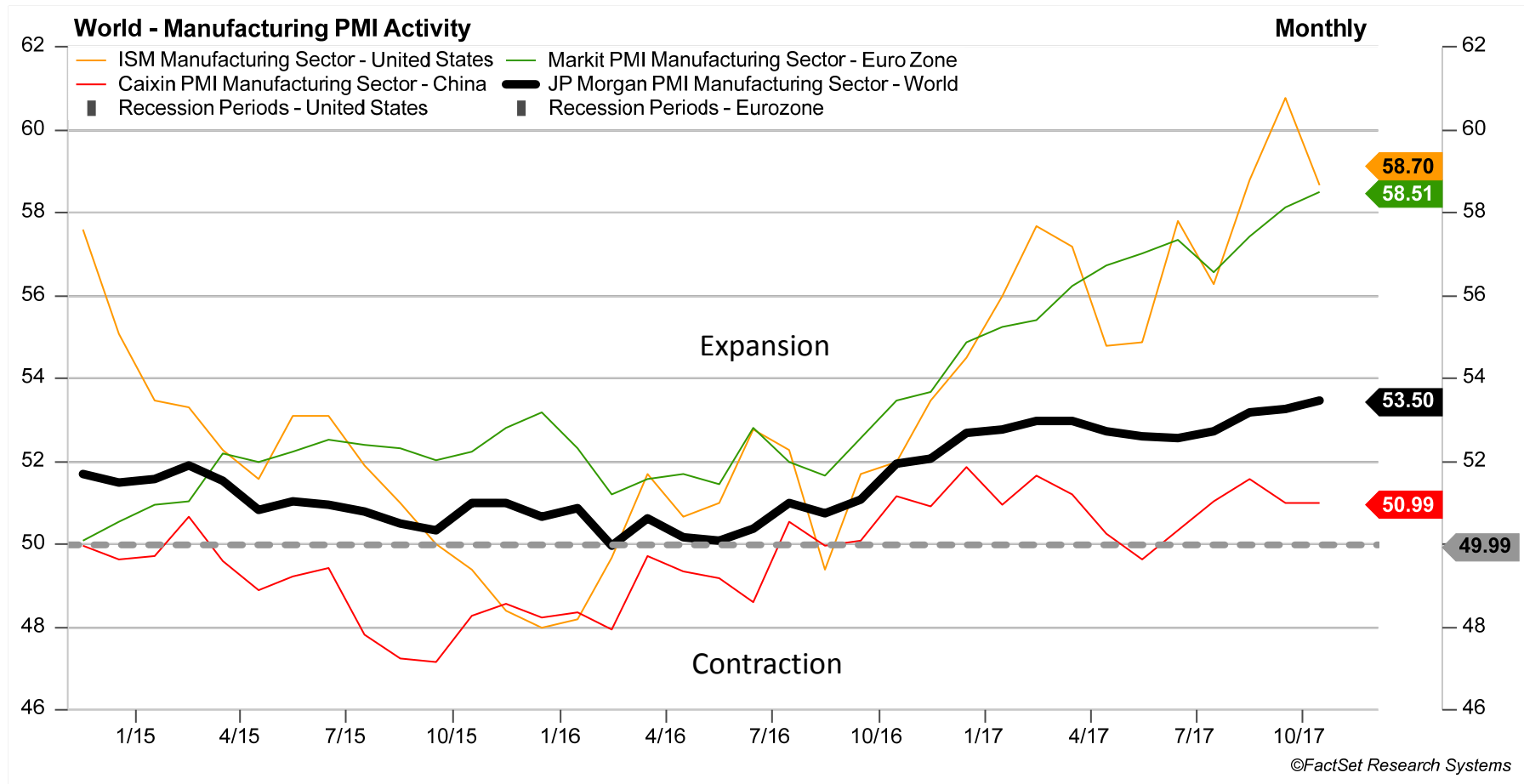
- For investors, waiting for real GDP data (gold line) is akin to driving using the rear view mirror, it is looking backward at the business cycle
- Manufacturing surveys (blue line) move in-sync with real GDP, but investors receive the data in real time, making them considerably more valuable in assessing the business cycle and in making investment decisions



# Observation #3

## Manufacturing Surveys = Leading Indicators

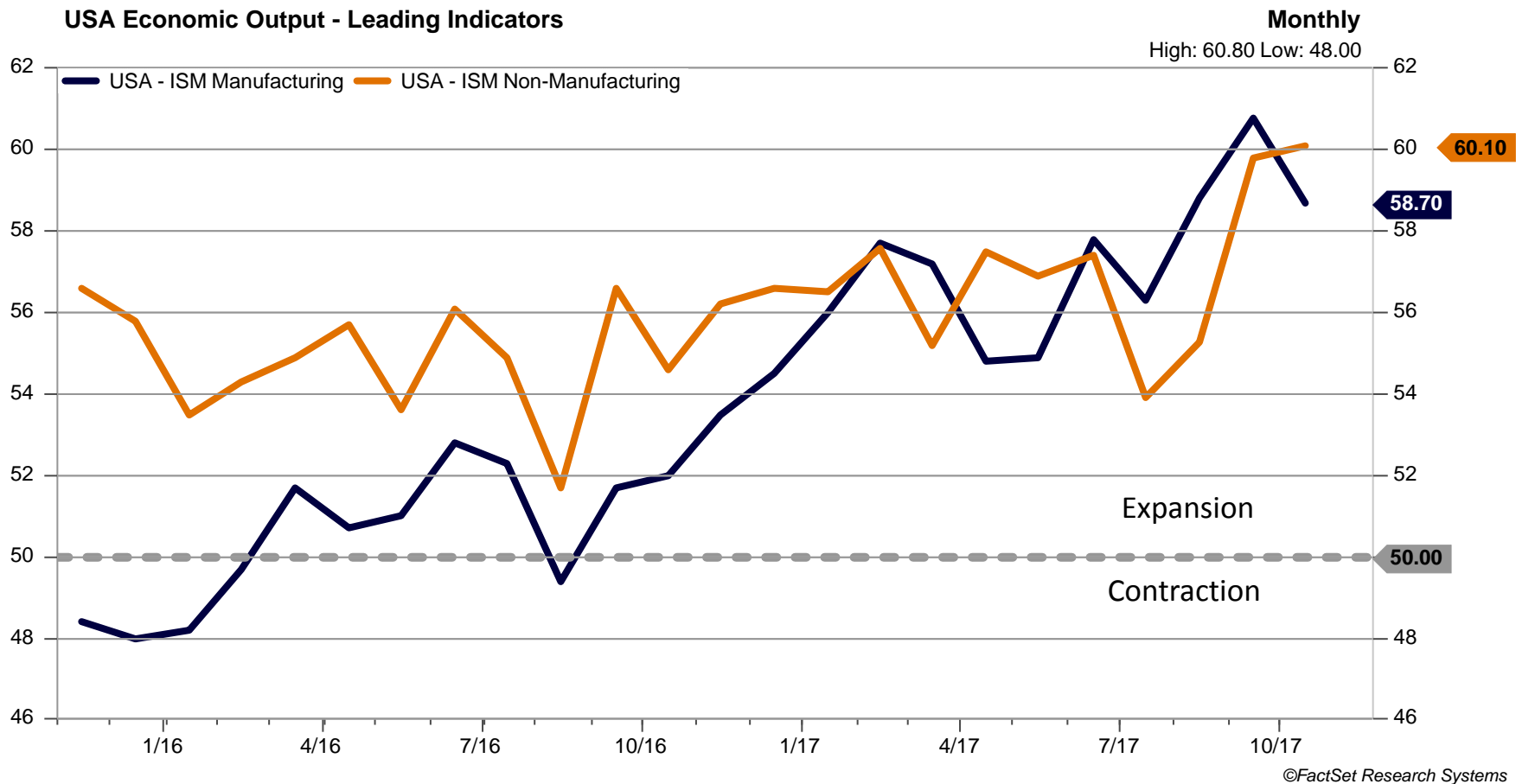
- The pace of manufacturing activity (black line) has been increasing over the past 18 months with the broadest geographic participation since the “Great Recession”
- Together, the US, Eurozone, China & Japan represent greater than 60% of global GDP



# Observation #3

## Manufacturing Surveys = Leading Indicators

- Leading indicators of USA economic activity have been very constructive over the past 18 months
- Faster economic expansion is expected to translate to higher corporate profits

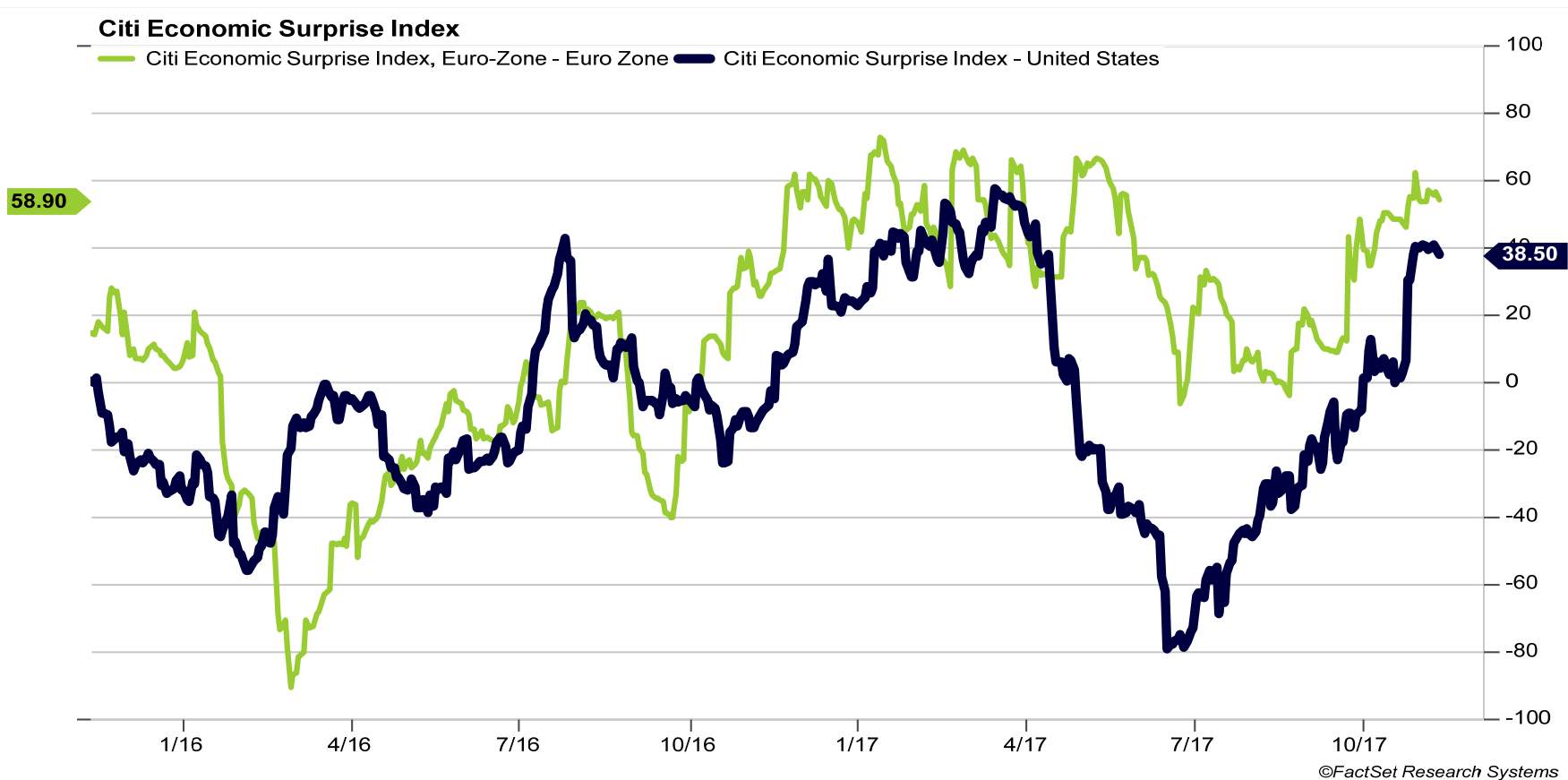




# Observation #4

## Economic Strength Exceeds Expectations

- Economic data points used to assess the status and strength of the business cycle are digested by financial markets every day around the world
- Over the past 18 months, economic data points in the Eurozone (green line) and the United States (blue line) have exceeded expectations more often than not

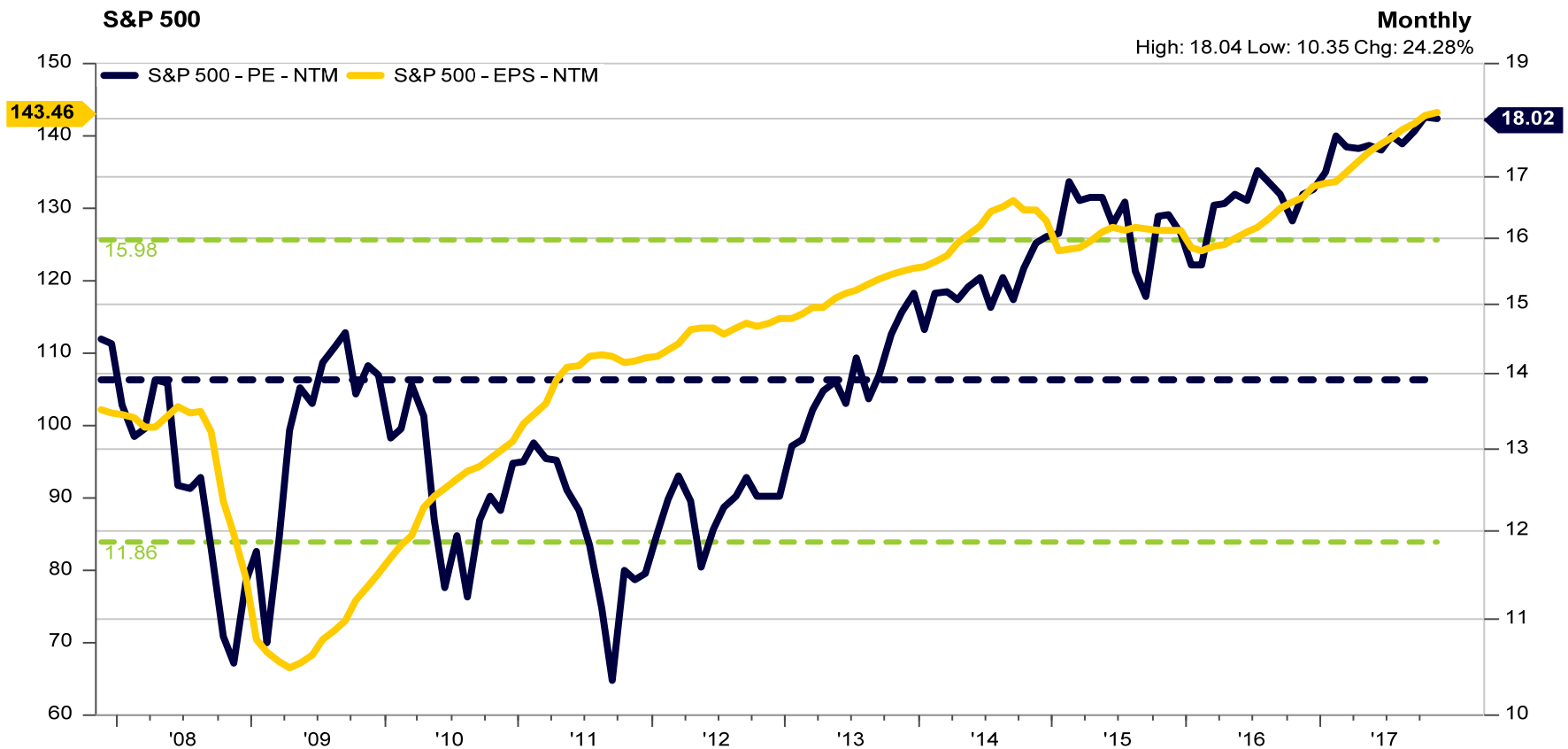


# Observation #5

## Stock Prices Reflect Optimism

10 Year

- Economic expansions lead to rising earnings per share outlooks (yellow line) and higher Price/Earnings ratios (blue line) that investors are willing to pay for stock ownership
- Investors expect earnings to grow near 8% during the forward 12 month period



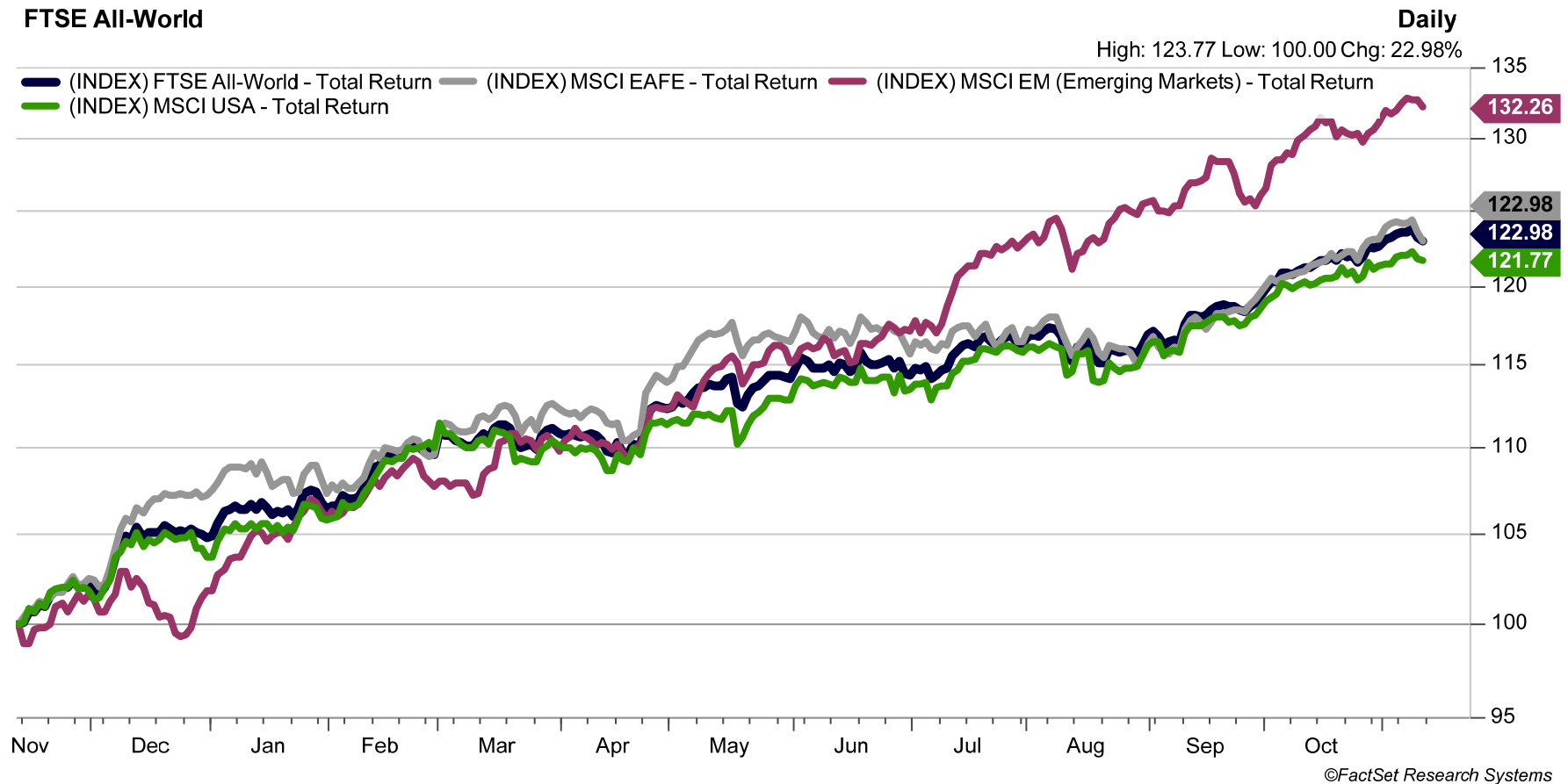
# Observation #5

## Stock Prices Reflect Optimism

1 Year

- The Global economic growth story has fueled stock prices higher across many geographies
- The trailing 12 month gains have been extraordinary, led by stocks in emerging market economies and supported by strength from developed economy stock markets as well

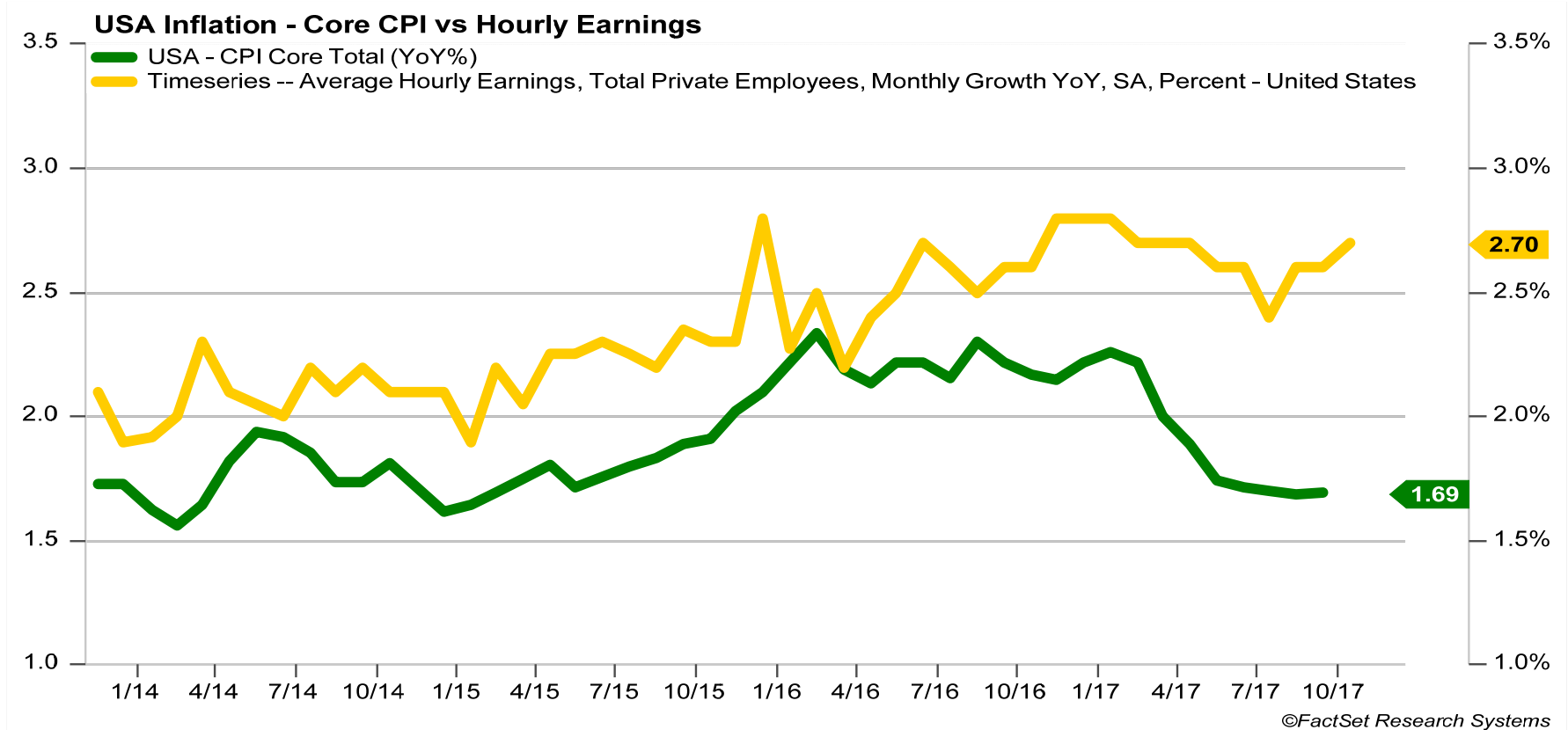
### FTSE All-World



# Observation #6

## Inflation likely to Accelerate

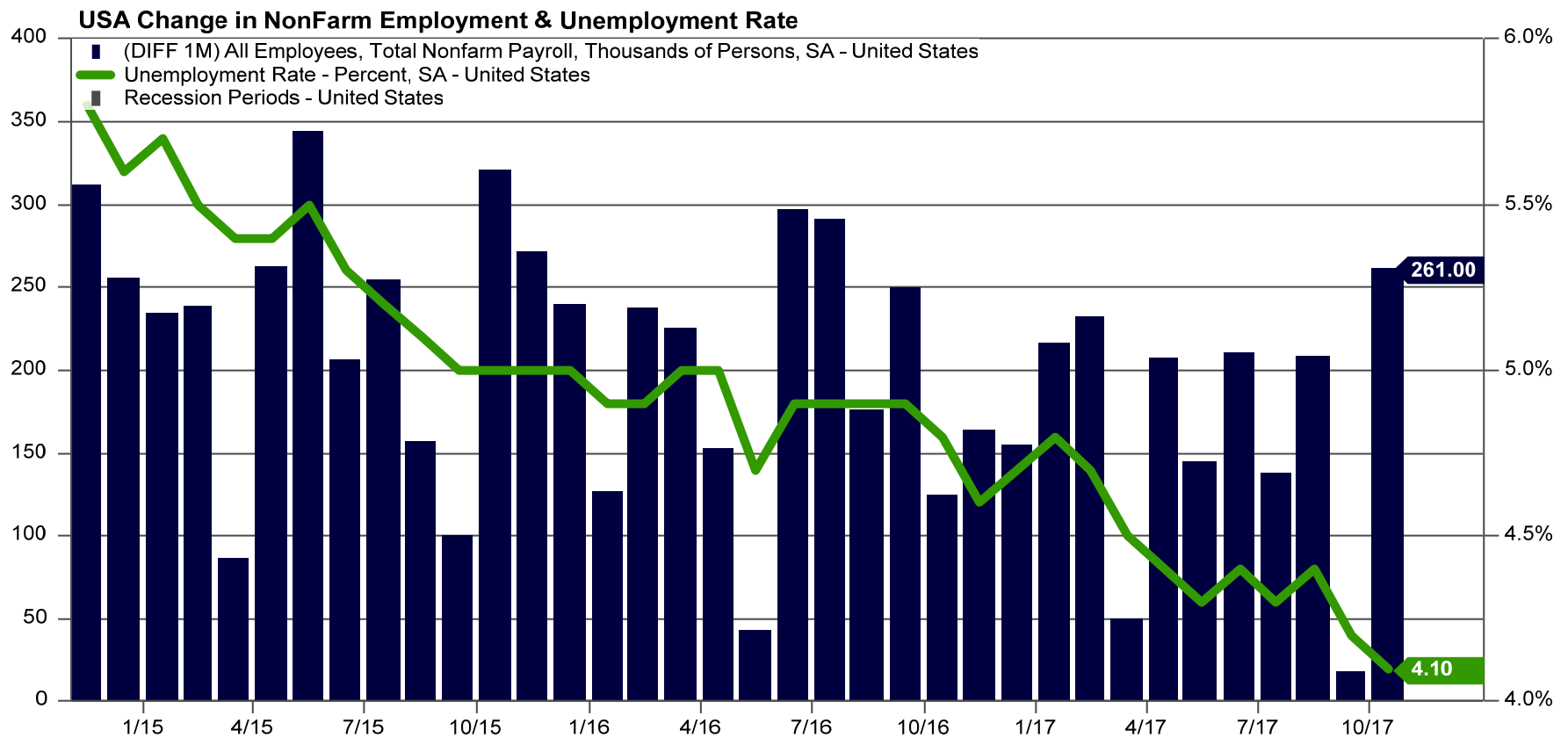
- Monetary policy considers the strength of economic conditions and will raise interest rates if inflationary pressures begin to counter the benefits of faster economic growth
- The structure of the global economy and the pace of growth have not generated inflationary trends that would alarm policy makers (Green Line)
- Hourly earnings can be a leading indicator of looming inflationary pressures (Yellow Line)



# Observation #6

## Inflation likely to Accelerate

- While segments of the employed population continue to face challenging headwinds, the strength in employment data has become significantly broader over the past two years
- Global supply of workers, a lower penetration of organized labor, and technological advancements, all place a downward pressure on wage growth, but as labor markets tighten wages are likely to accelerate

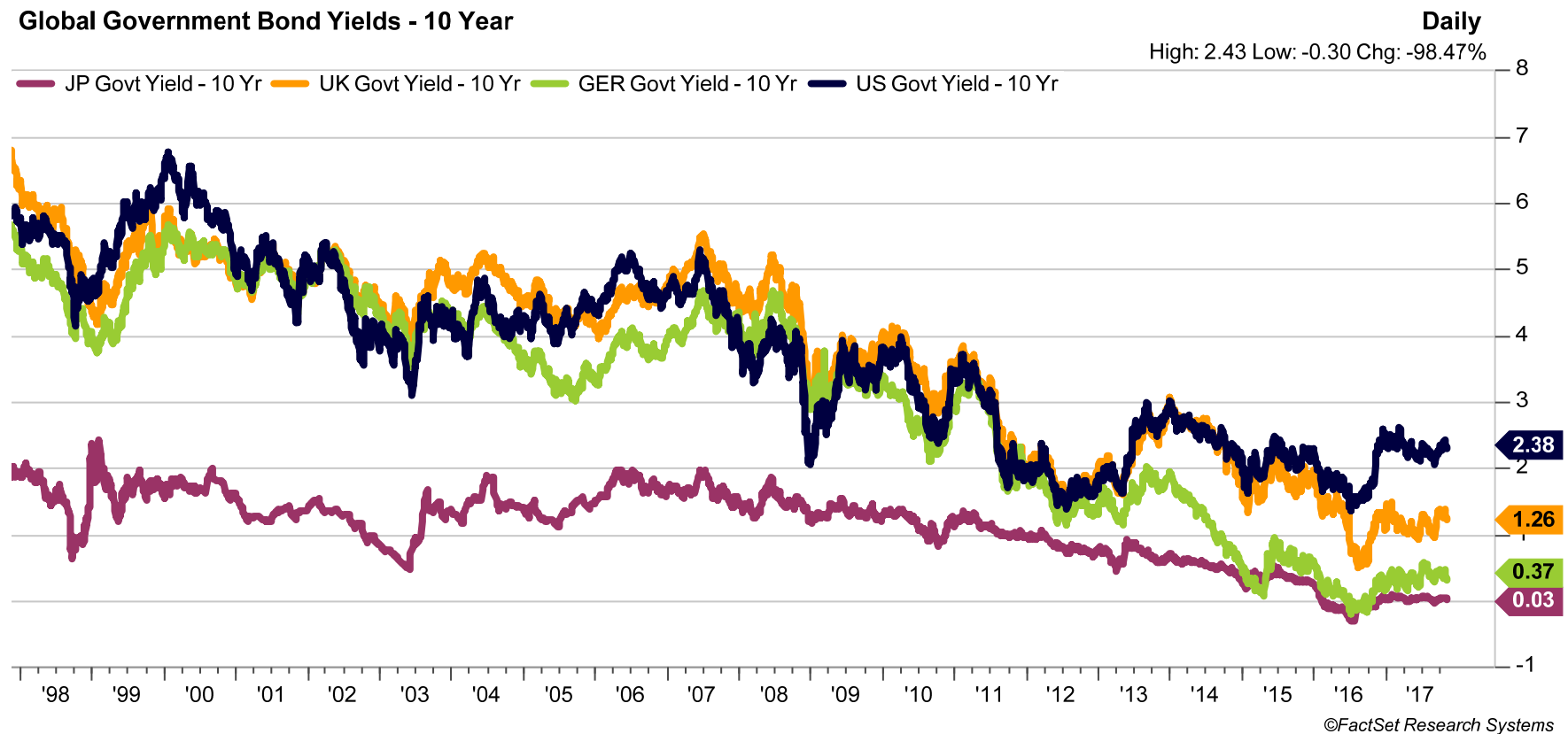


# Observation #7

## Yield Curves don't see Inflation

- The yield on Government Bonds across mature, relatively stable, geographies have experienced a multi decade slide toward near zero, suggesting that inflation is near absent and will remain so into the future
- But Quantitative Easing programs have been utilized by Central Banks over the past decade and may have exhibited outsized influence on yield curves that may reverse as QE programs fade

Global Government Bond Yields - 10 Year



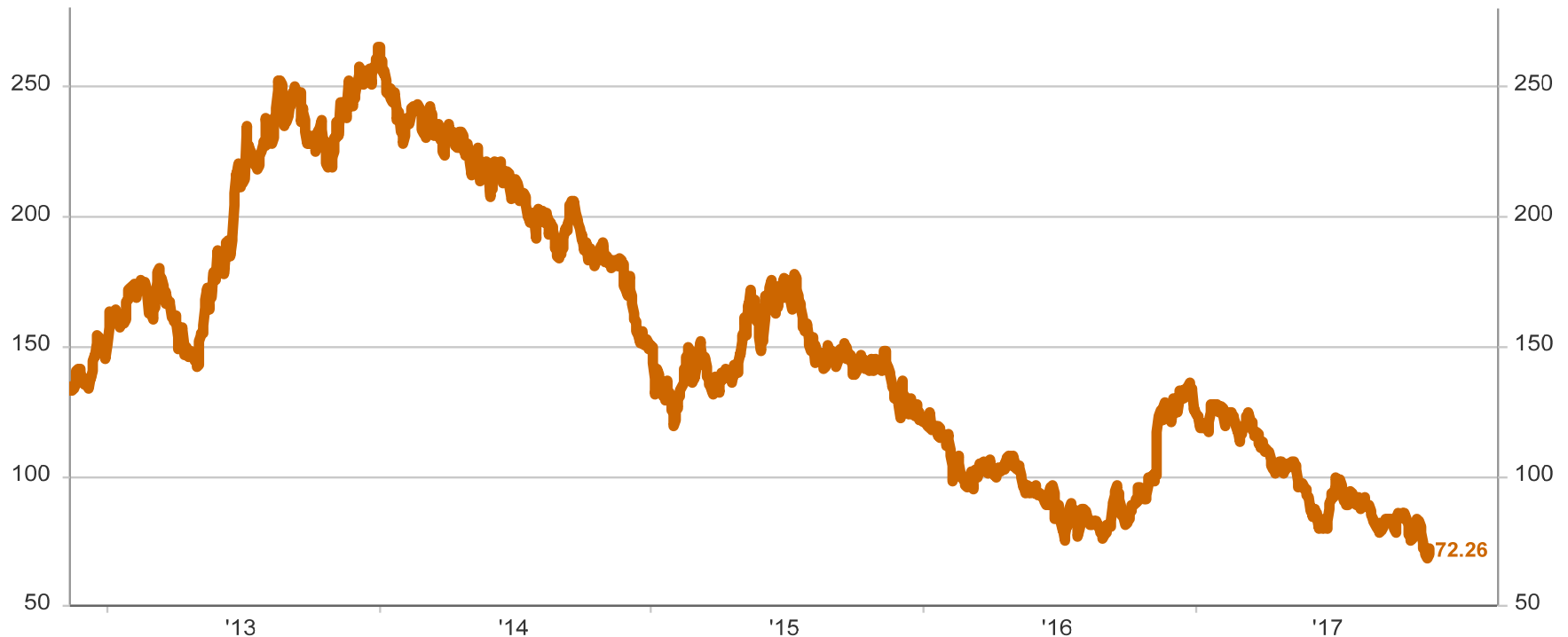
## Observation #7

# Yield Curves don't see Inflation

- As the Federal Reserve slowly pushes short term yields higher, the yields on longer term maturities have remained stubbornly low, causing the spread between short and long maturities to narrow considerably
- The 10Y/2Y spread has a tremendous record of predicting recessions when it “inverts” ..... good reason to observe this relationship

10Y / 2Y US Treasury Spread

Basis Points

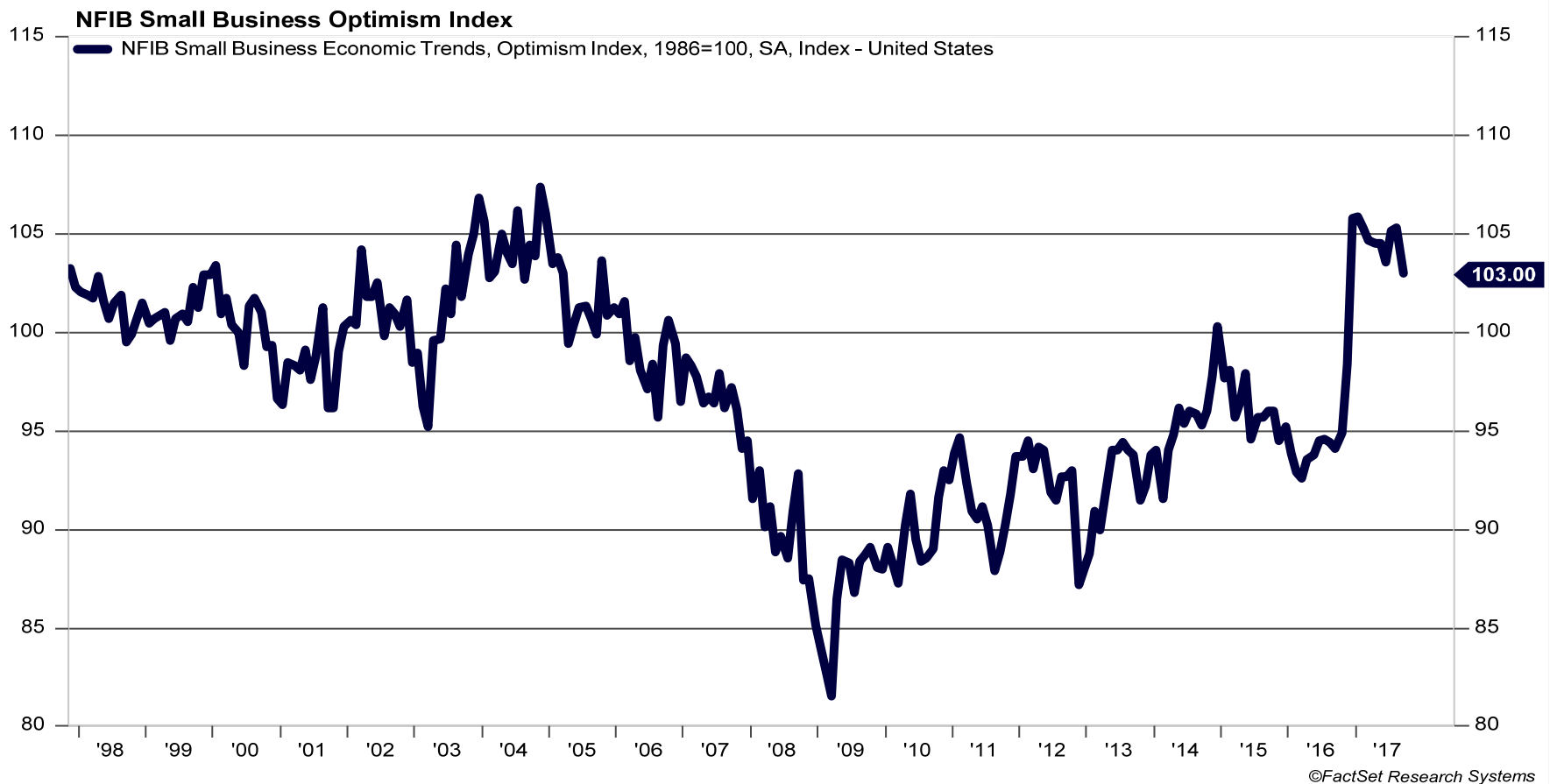


©FactSet Research Systems

# Observation #8

## Confidence is High

- Small business optimism has surged and many of the key components of optimism are rising
- The US economy is extremely dependent on the health and optimism of small business for increasing the opportunities for labor and new capital spending

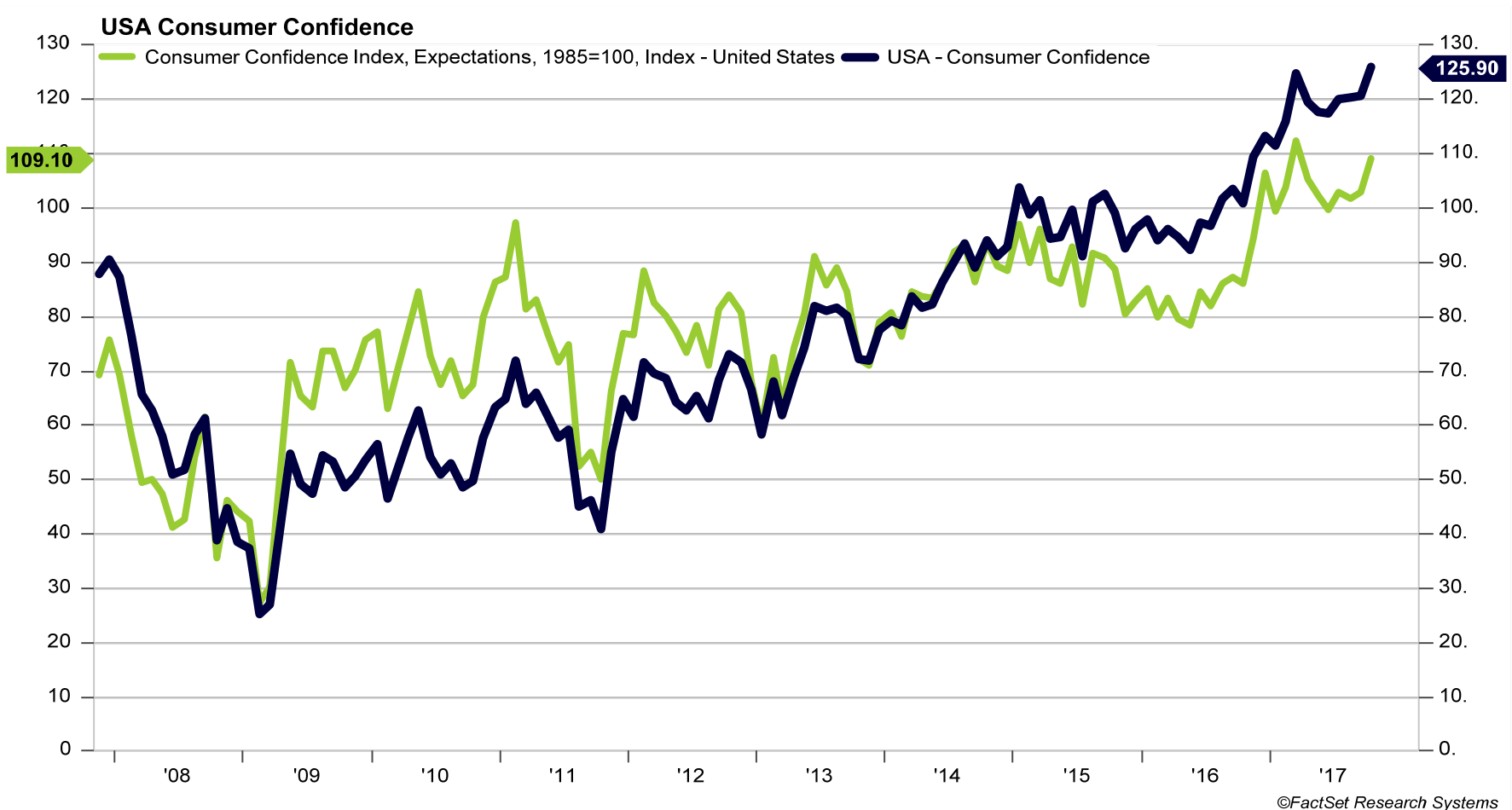




# Observation #8

## Confidence is High

- Consumer Confidence is near the 10 year high, which historically would translate to stronger consumer spending and lead to greater business expenditure toward inventory stocking and capital investment

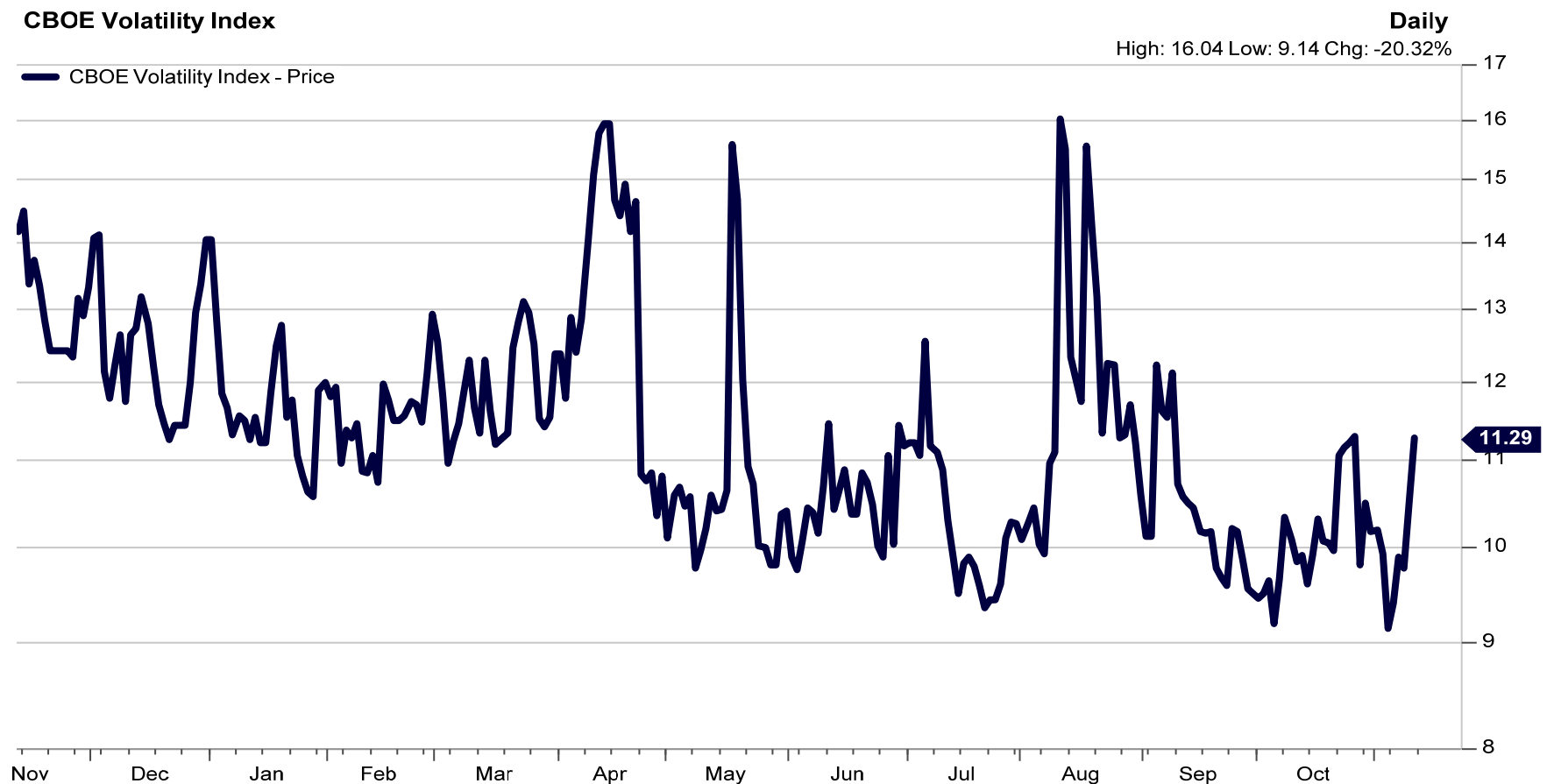


# Observation #9

## Investor Complacency is Low

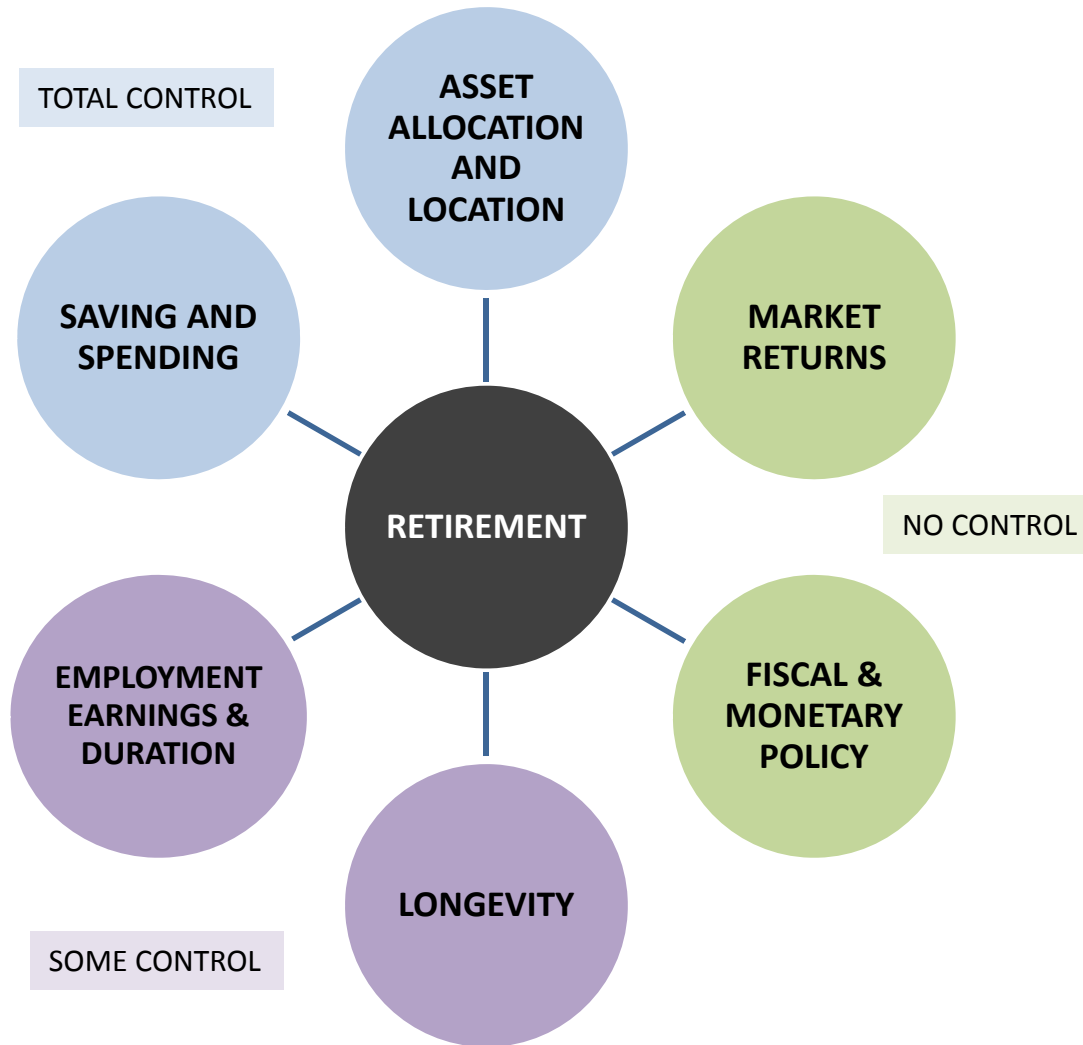
1 Year

- Investor confidence about the future has led to higher stock prices and a dangerous level of complacency
- Volatility levels this low are usually a precursor to retreating stock prices, at least temporarily



# Observation #10

## The Most Important Decision - Asset Allocation



### A SOUND RETIREMENT PLAN

Make the most of the things that you can control but be sure to evaluate factors that are somewhat or completely out of your control

Charles Schwab Retirement Solutions

# Disclosure

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