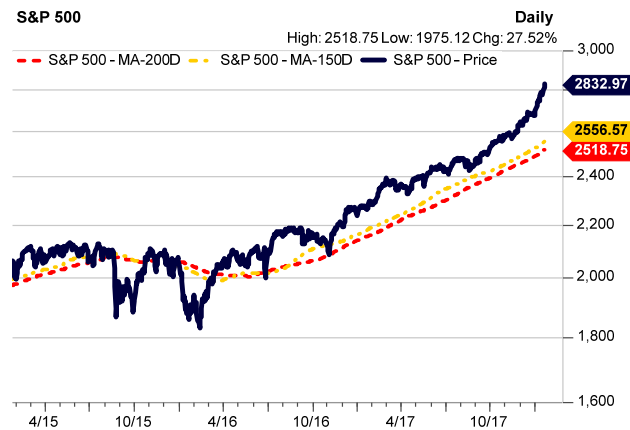


# Observation Deck

Views from the Investment Policy Committee



1<sup>st</sup> Quarter 2018

# 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

# Macro TIP Chart

Tactical Investment Positioning

1<sup>st</sup> Quarter 2018

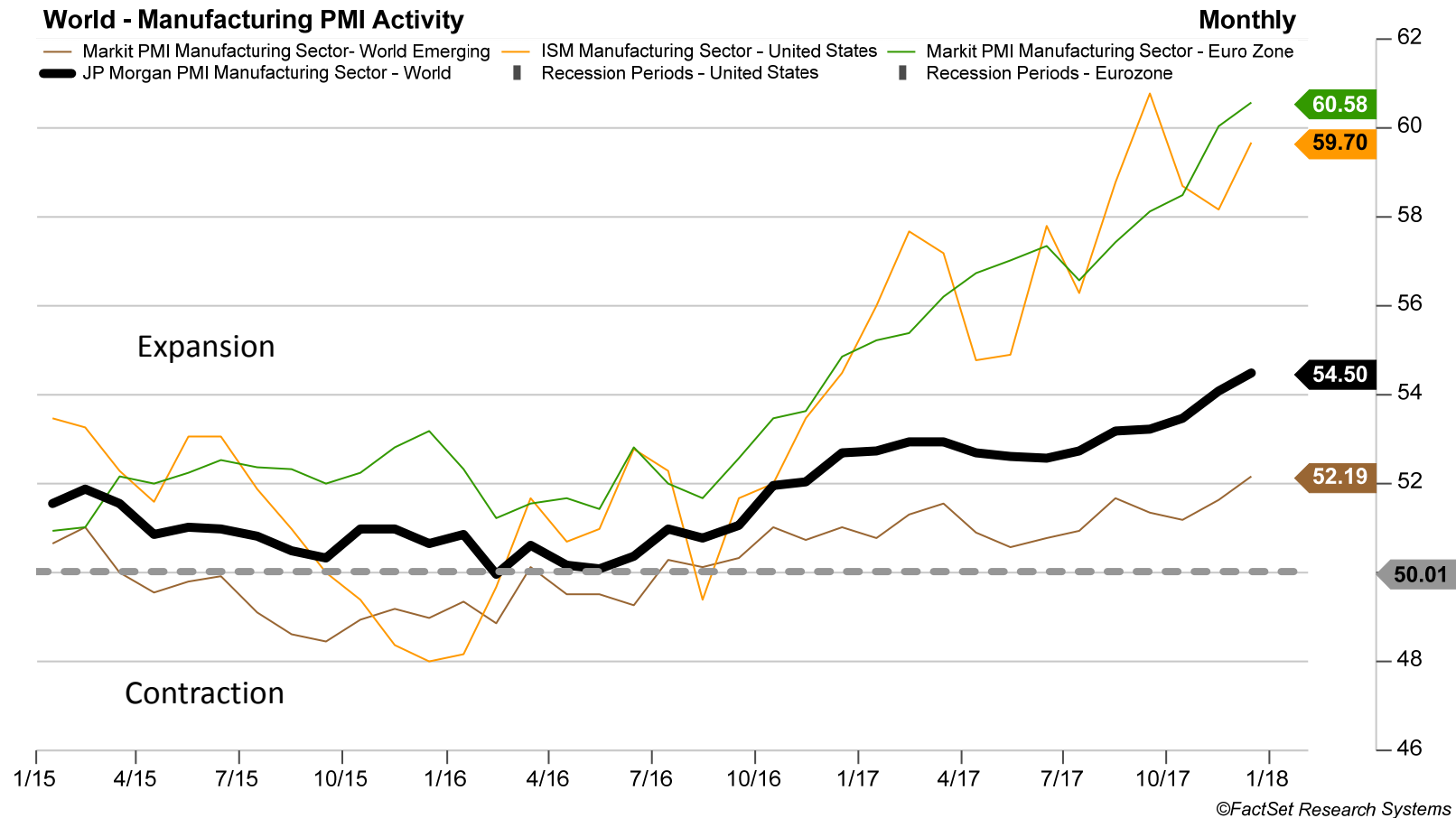
Strength of Conviction	Chg	Negative	Neutral	Positive	Rationale
Business Cycle					Synchronized Global Growth; strength in PMI Surveys, high confidence & sentiment levels, strong job growth
Financial Conditions					Monetary policy changing but still accommodative. Fiscal policy adding near term stimulus with tax reform.
Relative Preference	Chg	Neutral			Rationale
Asset Class		Bonds		Stocks	Strong profit growth is positive for stocks. Bond yields remain extremely low relative to GDP growth.
Economic Sensitivity		Defensive		Cyclical	Profit cycle is good for economically sensitive stocks. Higher bond yields are headwind to defensive stock sectors.
Credit Quality	←	Sovereign		Credit	Profit cycle is good for credit fundamentals. However, spreads are very narrow and suggest valuations are full.
Duration Profile		Short Maturity		Long Maturity	Bond investors responding to faster pace of economic activity and expectations for rising inflation
Commodities	→	Below Weight		Above Weight	Global GDP strength increases demand for natural resources while supply is held steady.
Cash		Below Weight		Above Weight	Rising cash yields offer competition to financial assets for the first time in over a decade.

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# Observation #1

## Manufacturing Activity has Accelerated

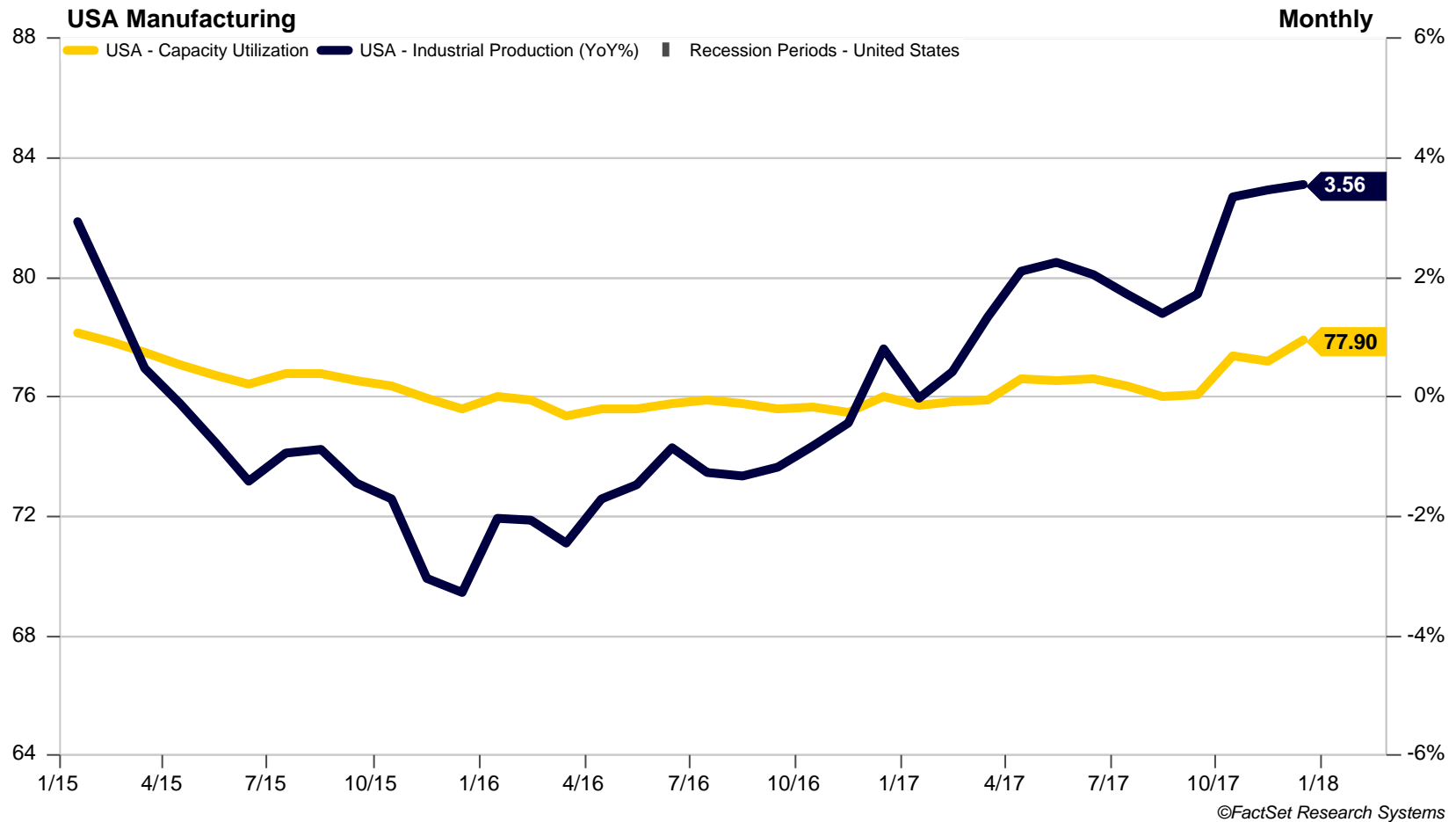
- The pace of manufacturing activity (black line) has been accelerating worldwide over the past 18 months, with the most diverse geographic participation since the “Great Recession”
- Developed market activity levels are exhibiting broad based strength not seen since the mid 1990’s



# Observation #1

## Manufacturing Activity has Accelerated

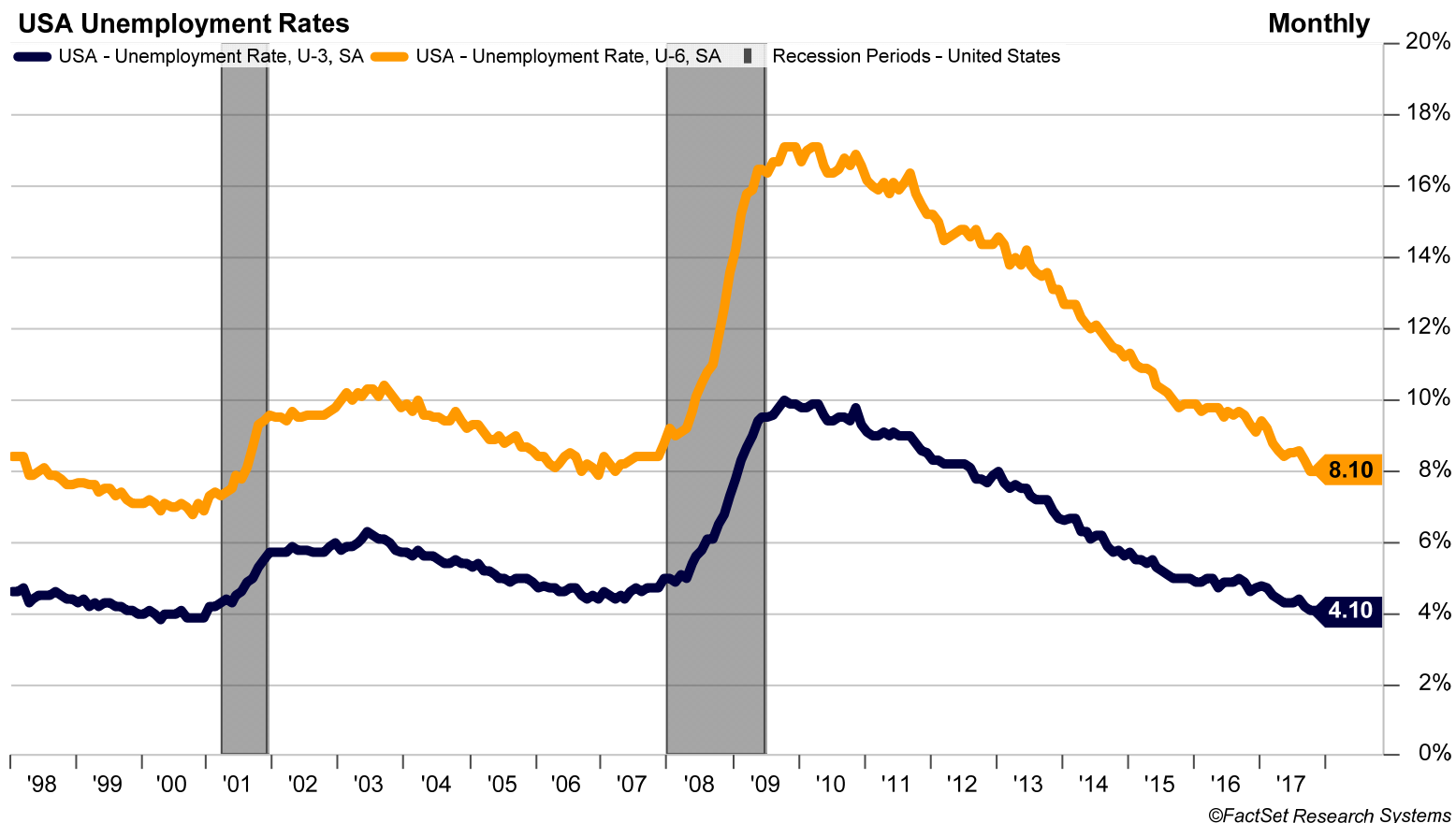
- Industrial production has accelerated in the USA (blue line) and capacity utilization is on the rise (yellow line)
- Expanding activity levels are being witnessed across a broad set of industries



## Observation #2

### Labor Markets are Tight

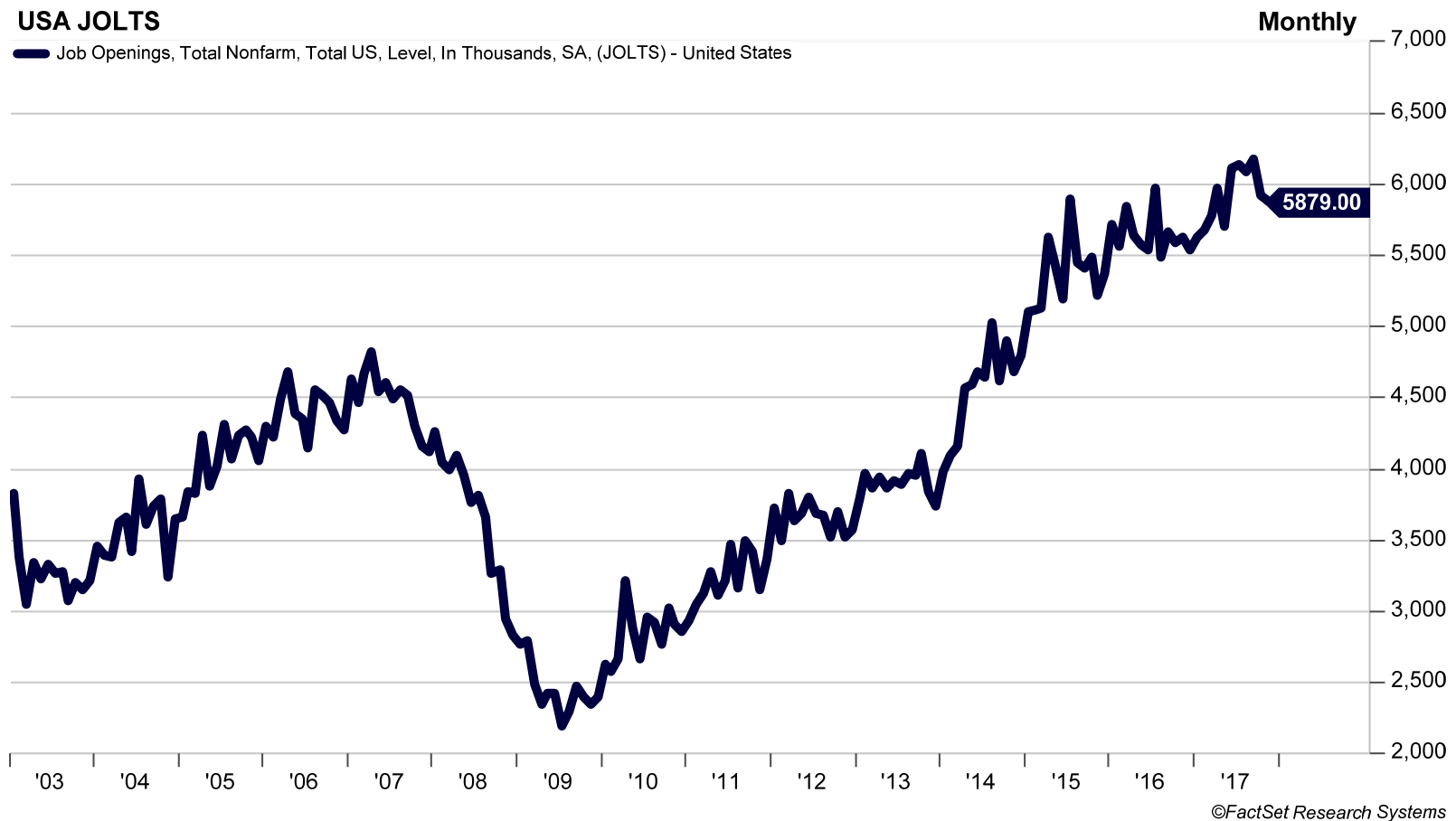
- Strength of the business cycle has led to a healthy pace of monthly job creation and a significant reduction in the full time unemployment rate (blue line) and the underemployed rate (gold line)
- While segments of the employed population continue to face challenging headwinds, the strength in employment data has become significantly broader over the past two years



## Observation #2

### Labor Markets are Tight

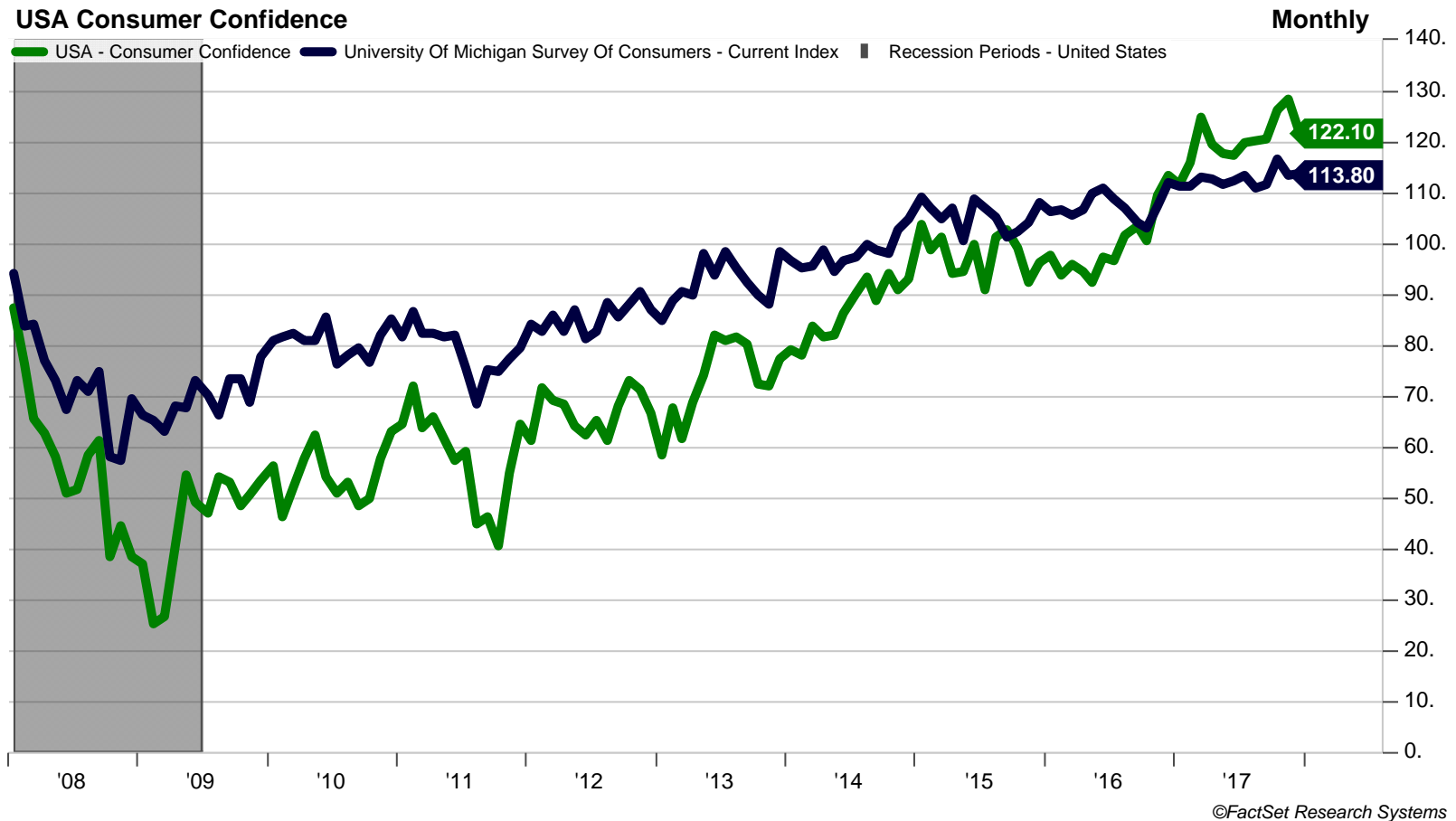
- The number of job openings (blue line) is near an all-time high and employers are finding it increasingly difficult to match the skill sets of labor with the needs of today's economy



# Observation #3

## Confidence & Sentiment Indicators are High

- More consumers collecting paychecks is a strong catalyst for rising consumer confidence
- Consumer confidence is near the 10 year high, which historically would translate to robust spending on a diverse set of goods & services; traditional retail, autos, housing, travel & entertainment

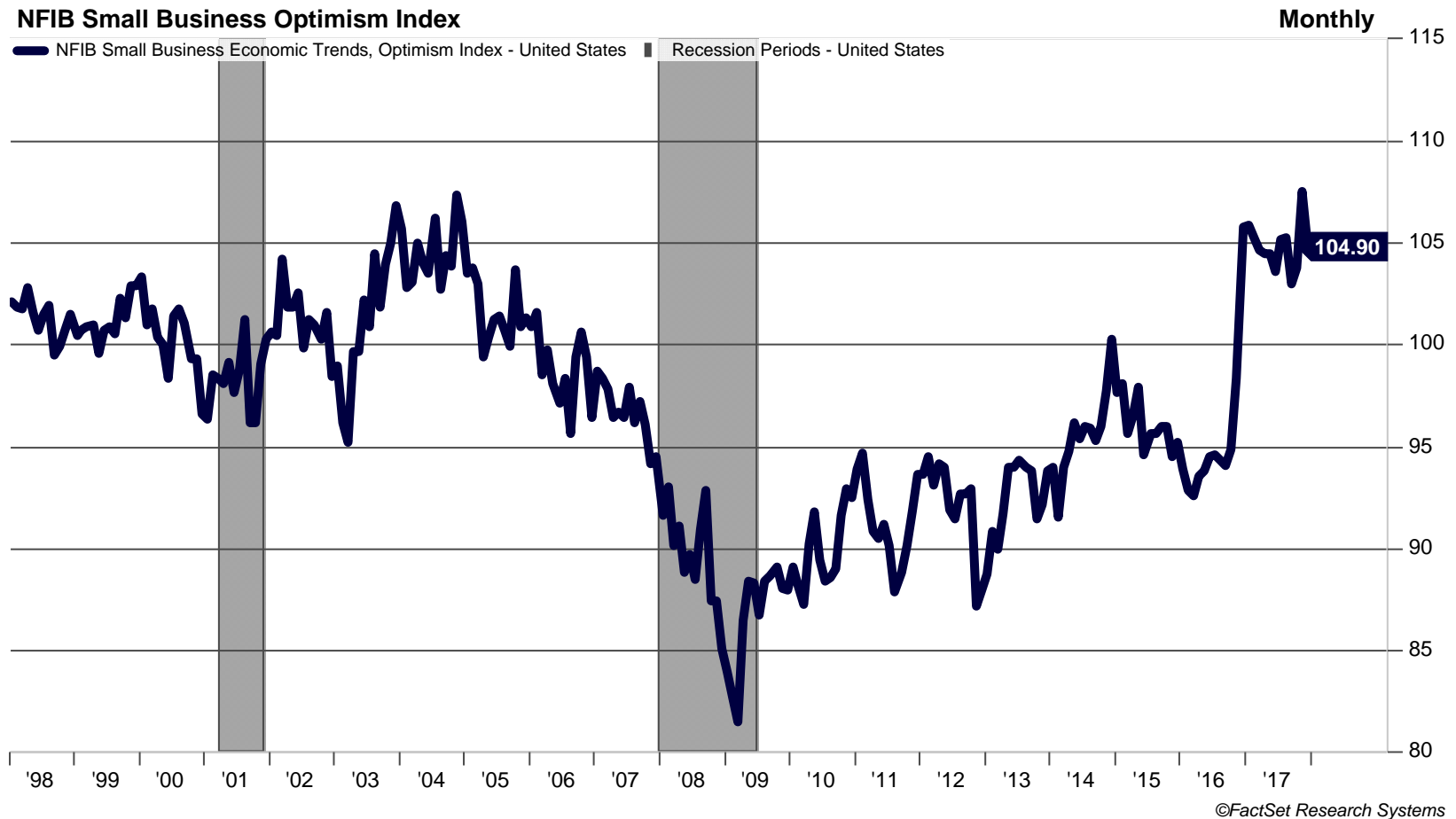




# Observation #3

## Confidence & Sentiment Indicators are High

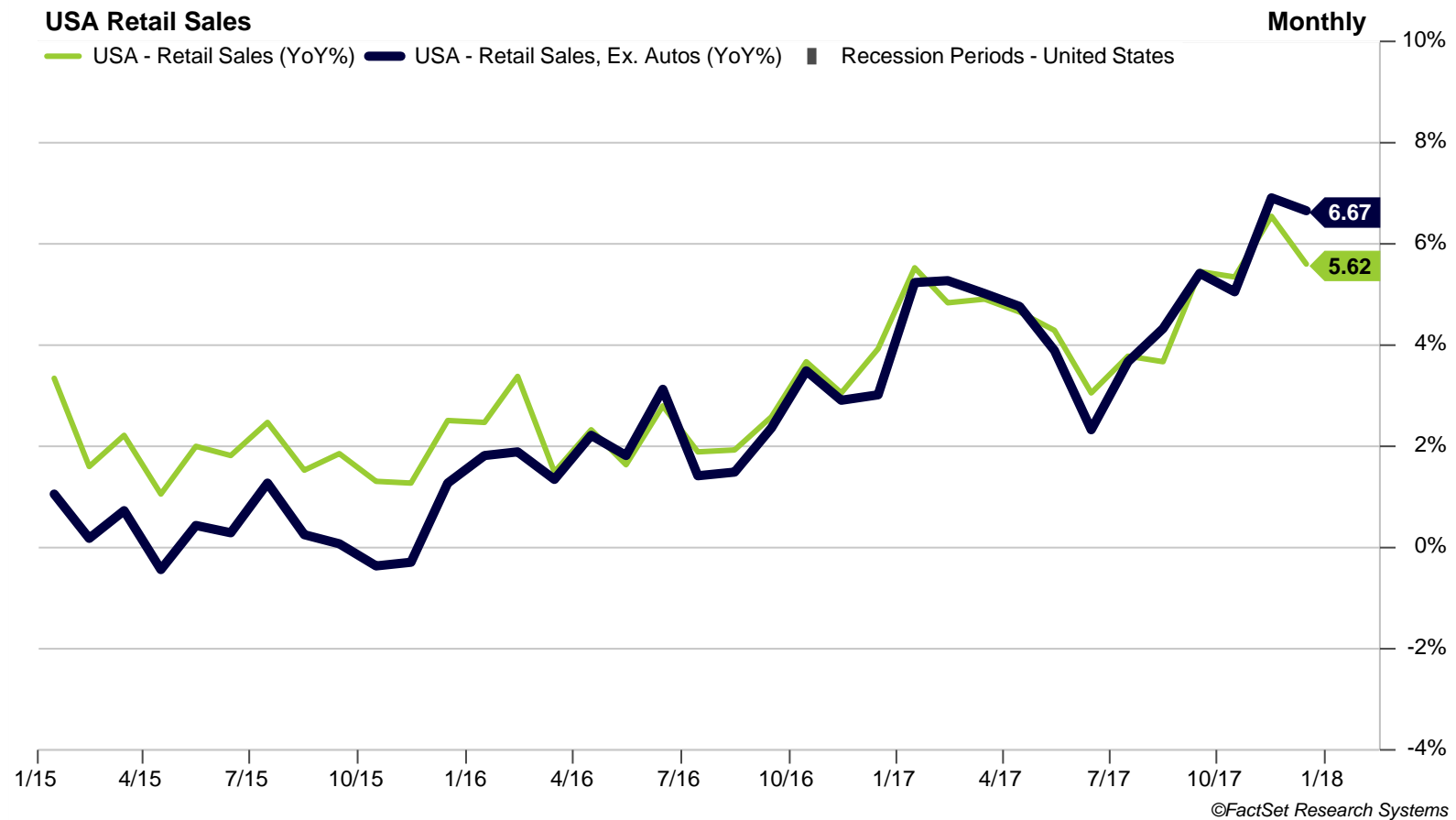
- Small business optimism has surged and many of the key components of optimism are rising
- The US economy is extremely dependent on the health and optimism of small business for increasing the opportunities for labor and new capital spending



# Observation #4

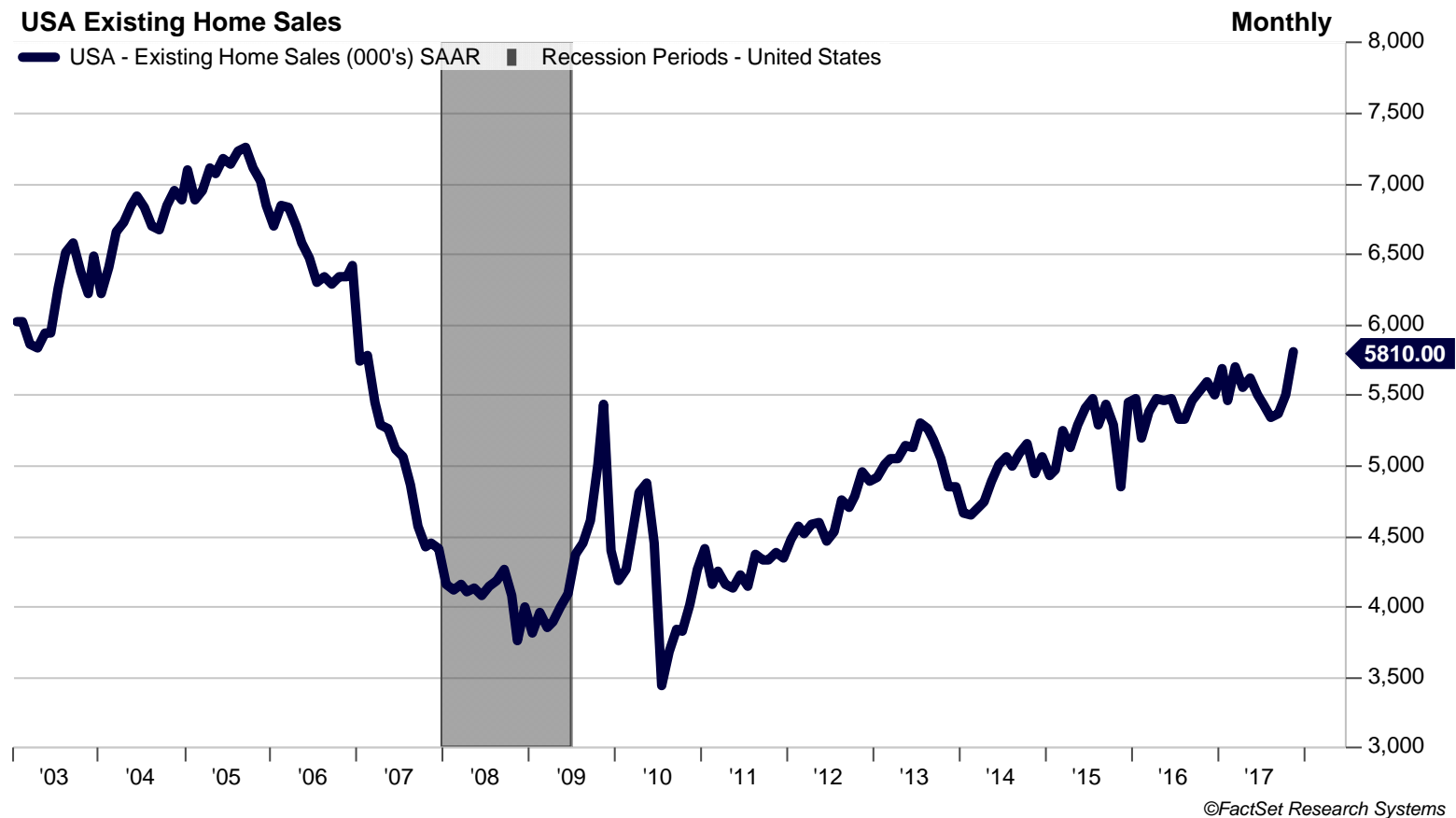
## Consumer Spending is Strong

- Retail Sales growth has been accelerating on the heels of very high consumer confidence levels
- Growth in retail sales, at this level and for this duration, often induces companies to invest in inventory replenishment and new productive capacity



## Observation #5 Housing Markets are Robust

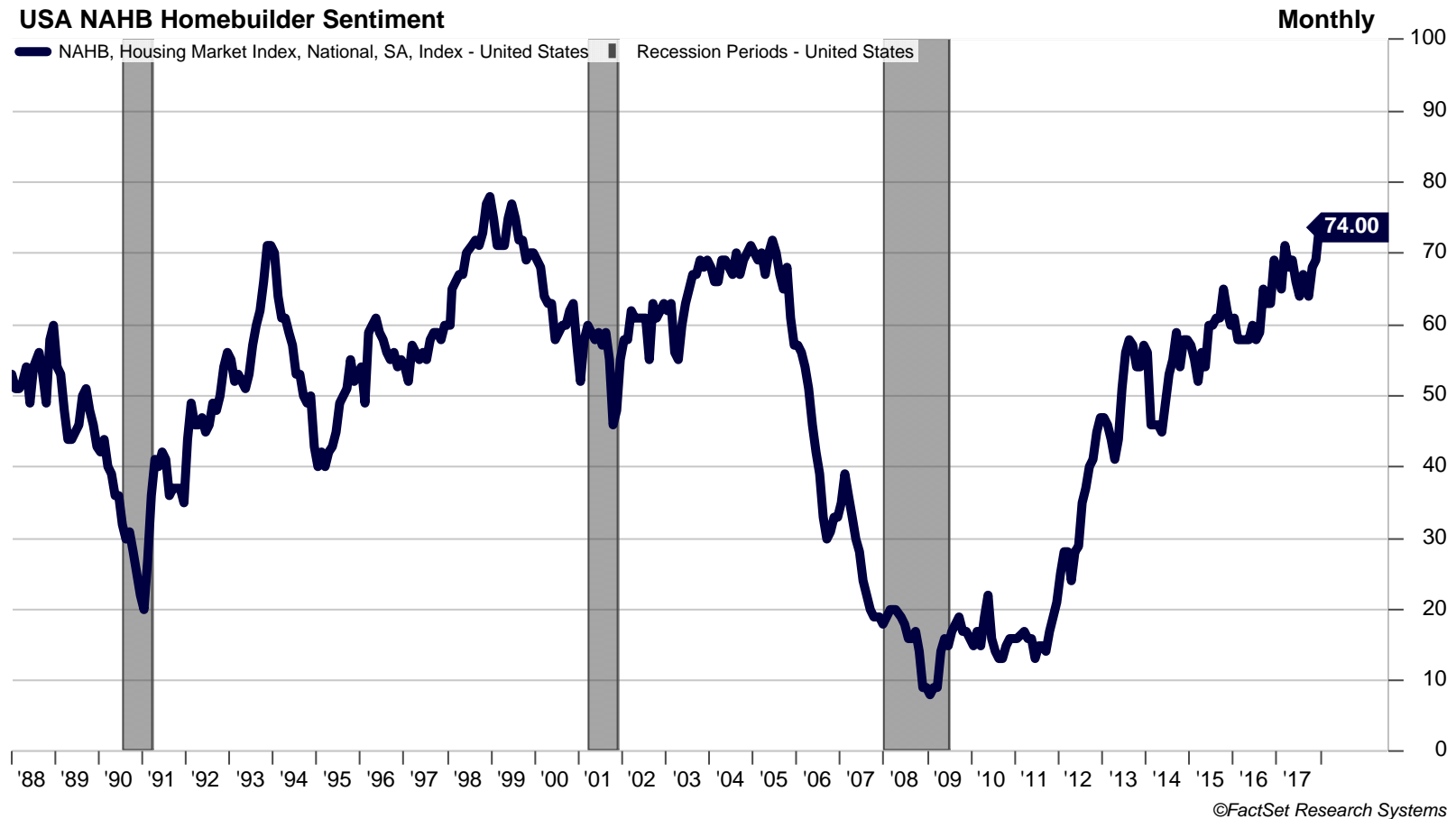
- High levels of consumer confidence also lead to stronger housing markets
- Sales of existing homes (blue line) and new homes, against a backdrop of short supply, are causing home prices to rise in many markets. The S&P Case-Shiller Index of home prices increased 6.2% YoY as of December 2017



# Observation #5

## Housing Markets are Robust

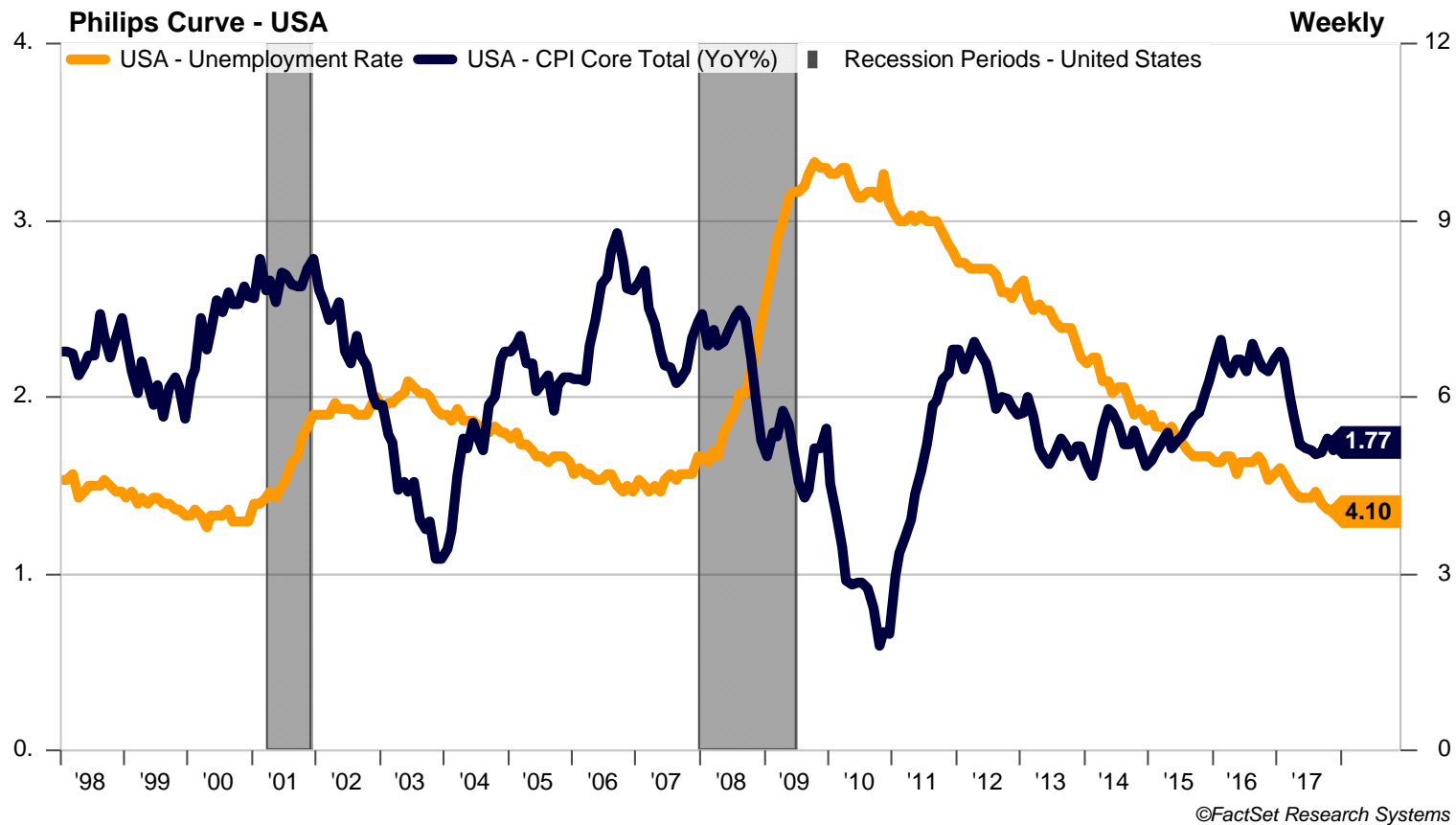
- Homebuilder sentiment (blue line) is being influenced by the short supply of existing homes for sale and the increasing rate of family formations



# Observation #6

## Inflation Should Emerge

- When unemployment rates (gold line) reach levels indicative of tight labor markets, the demand for additional workers is often a catalyst for rising wages and higher inflation (blue line)
- As the number of paychecks increases, so does consumer consumption, placing upward pressure on the prices of goods & services that consumers desire



## Observation #6 Inflation Should Emerge

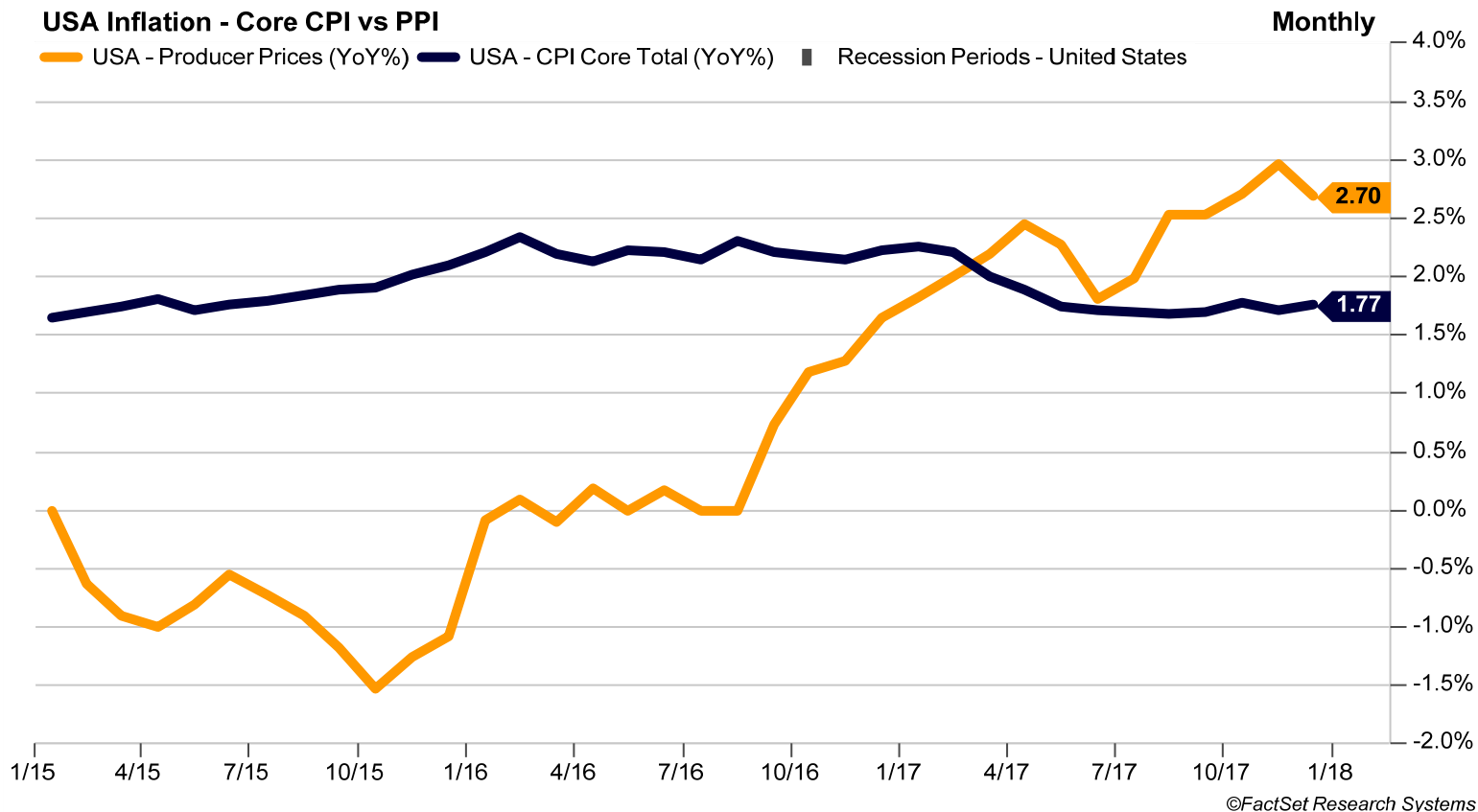
- The input costs for a producer of goods and services are heavily influenced by commodity prices (bronze line)
- Energy prices carry a lot of weight within the commodity basket, but demand on industrial metals and wood products have pushed prices on these economically sensitive commodities significantly higher



# Observation #6

## Inflation Should Emerge

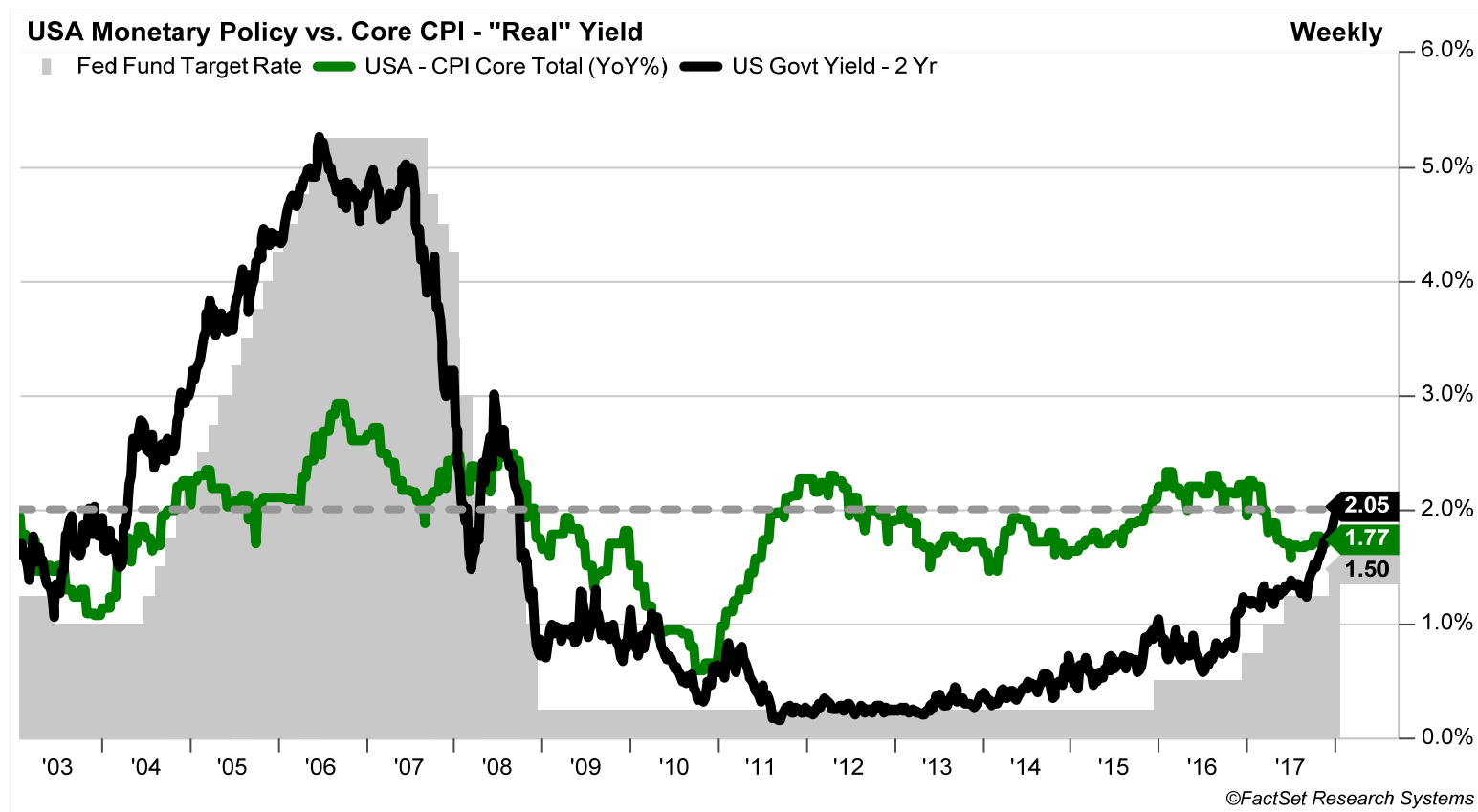
- Rising demand for labor and raw materials, associated with global economic strength, are causing producer prices (gold line) to accelerate higher
- Higher producer prices will either be passed through to end consumers as rising inflation (blue line) or will be absorbed by producers at the expense of corporate profit margins



# Observation #7

## Yields Are On The Move

- Central Banks implemented emergency measures, including a zero interest rate policy (gray backdrop), to help rescue the economy from the depths of the “Great Recession”
- Zero Interest Rate Policy pulled yields on many bonds below the rate of inflation (green line) causing negative real returns for bond investors as illustrated by the 2Yr US Treasury Note (blue line)
- The pace of yield reversal has been accelerating in recent months

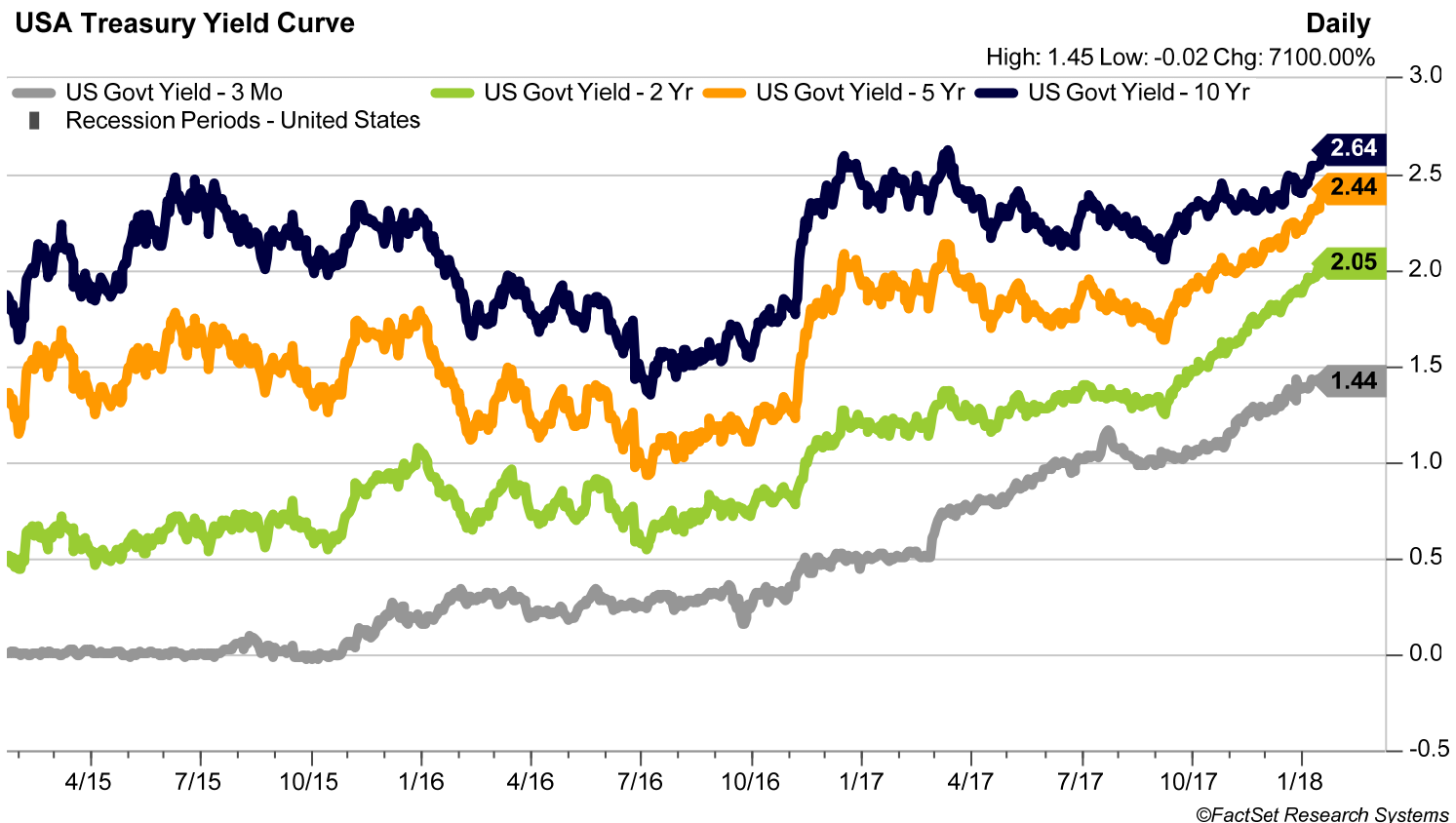




# Observation #7

## Yields Are On The Move

- Quantitative Easing programs utilized by Central Banks over the past decade may have exerted outsized influence on yield curves that pushed them to extreme lows
- As QE programs now begin to fade, the removal of the largest bond buyers in recent years (Central Banks) is allowing yields to rise toward “normal” with very uncertain outcome



# Observation #8

## Stocks Remain in Favor

- 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

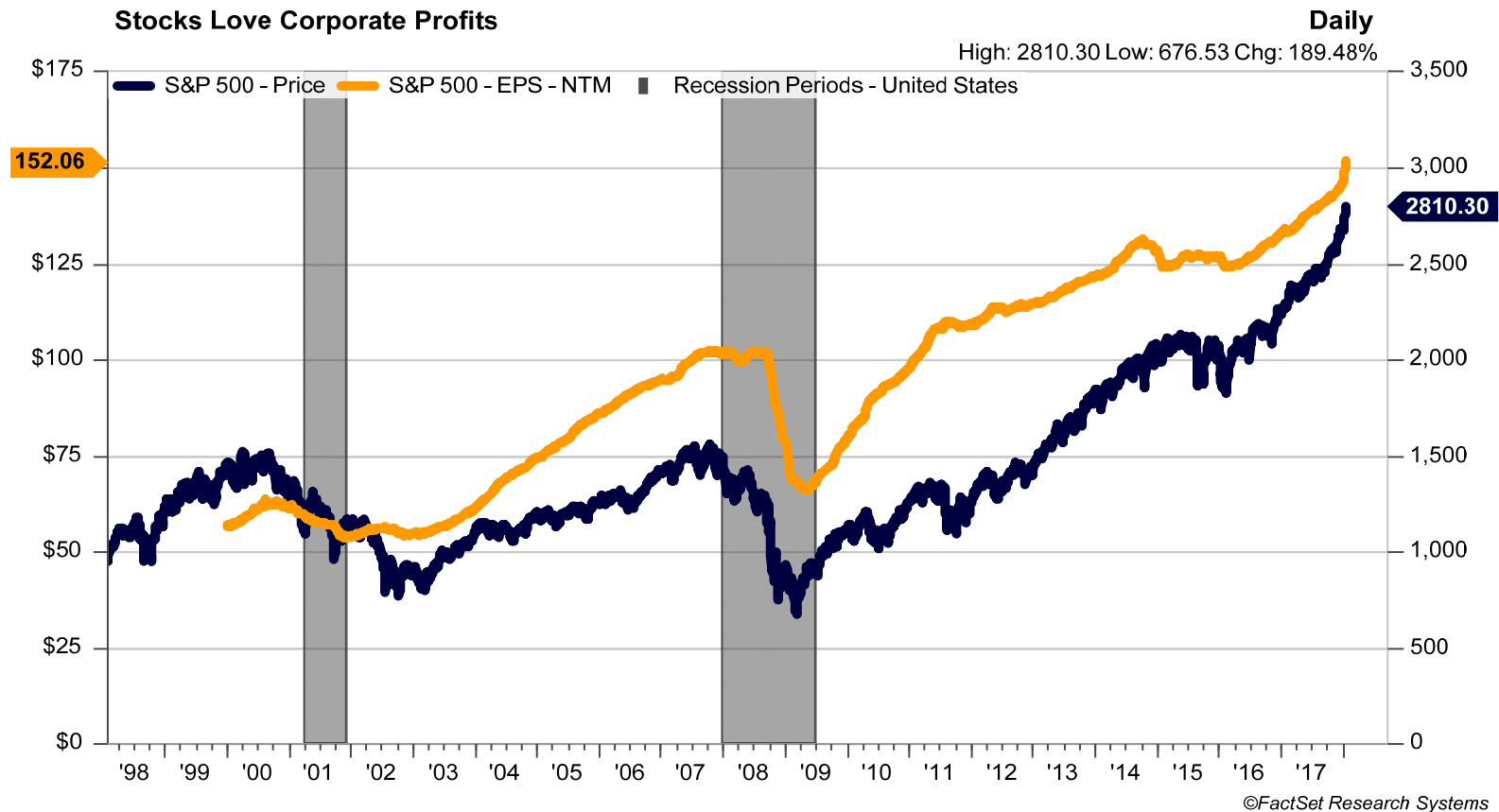
**MSCI World Index**



# Observation #8

## Stocks Remain in Favor

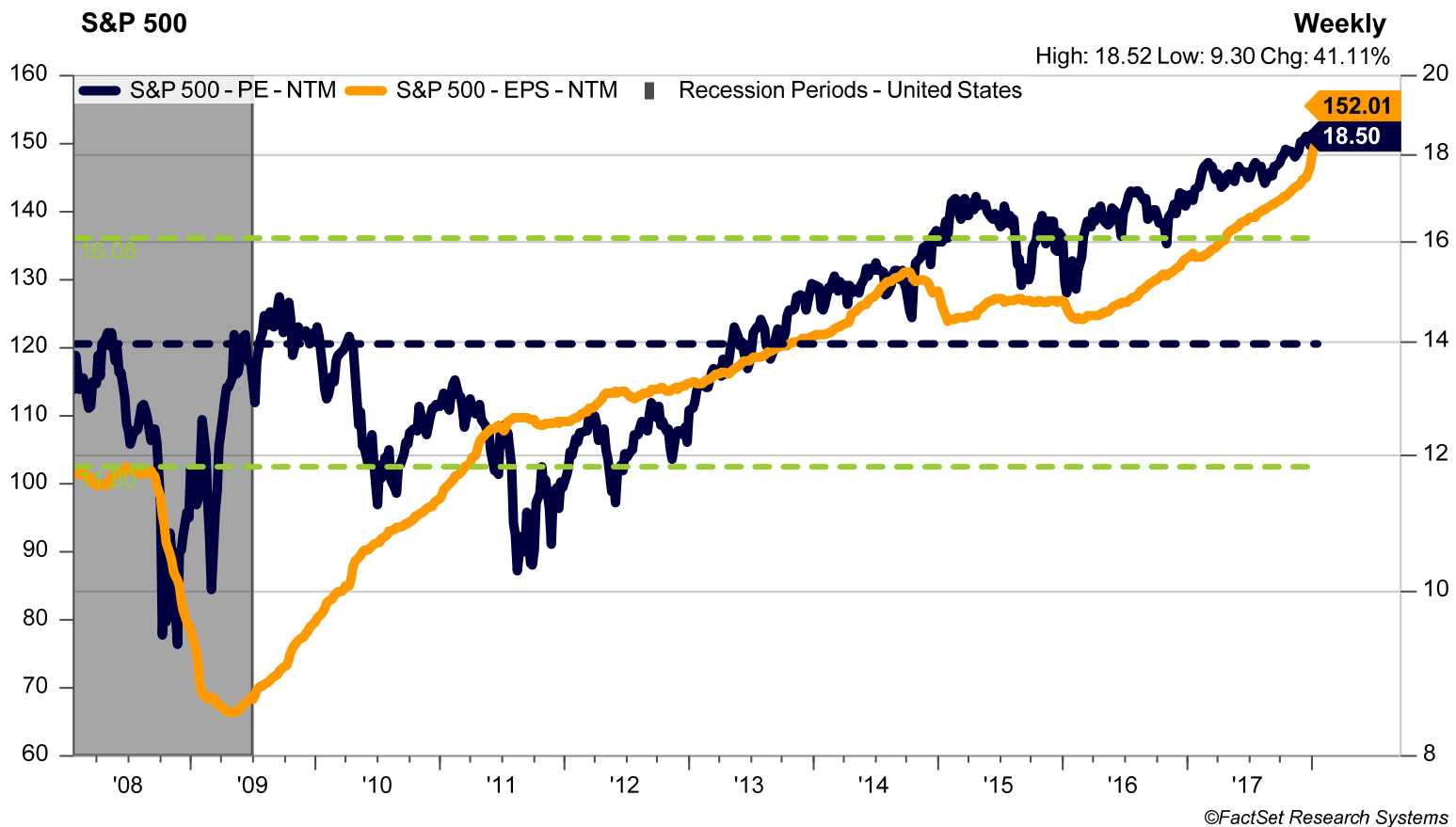
- Financial markets digest a lot of noise every day from a plentitude of sources, but what stocks (blue line) ultimately care about is the path of corporate profits (gold line)
- The profit cycle has been accelerating as the pace of global growth has improved
- Recent tax legislation, specifically the reduction of the corporate tax rate, will further boost the profit outlook



# Observation #9

## Trees Don't Grow to the Sky

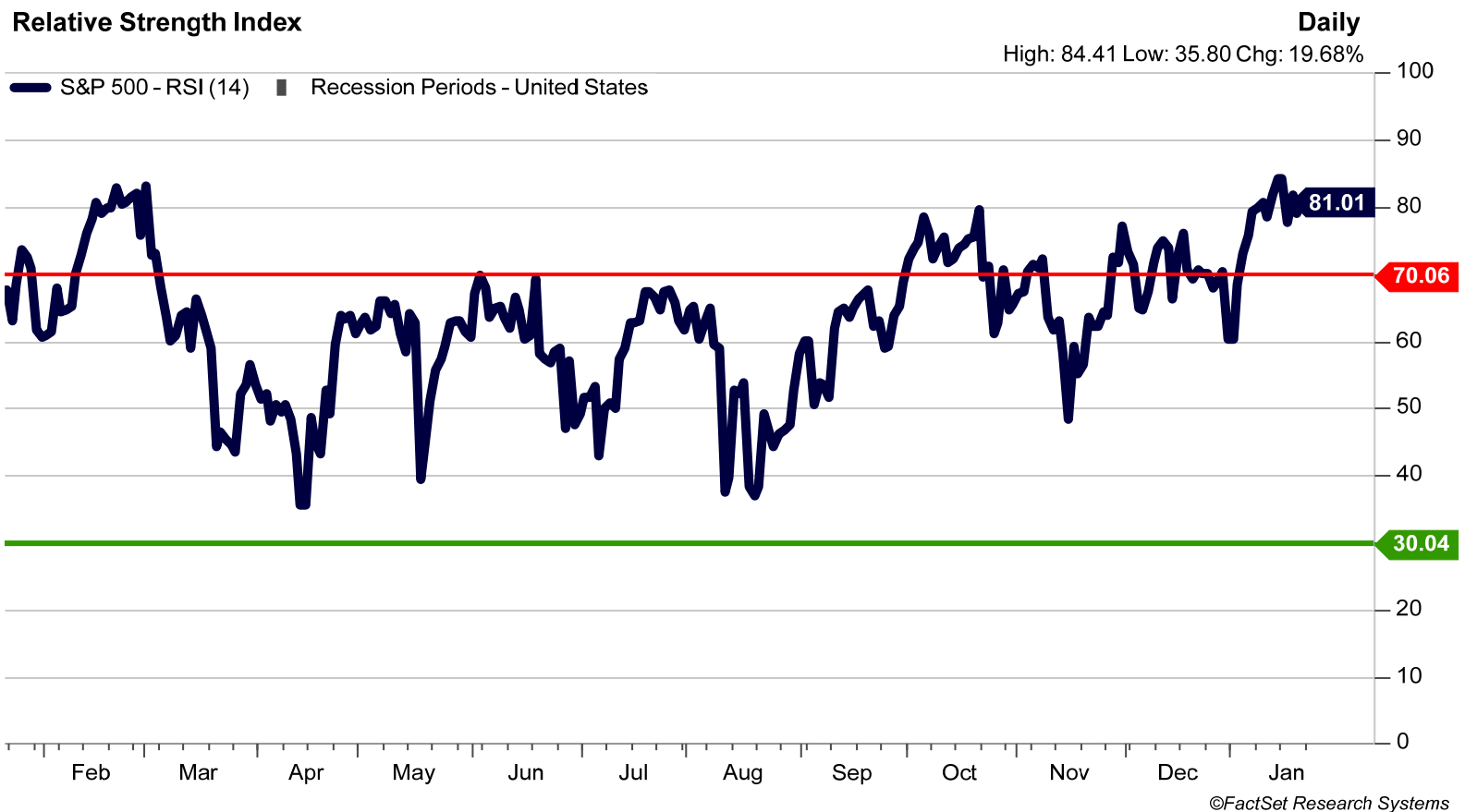
- Economic expansions lead to rising earnings per share outlooks (gold line) and higher Price/Earnings ratios (blue line) that investors are willing to pay for stock ownership
- Investors now expect earnings to grow near 18% during the forward 12 month period



# Observation #9

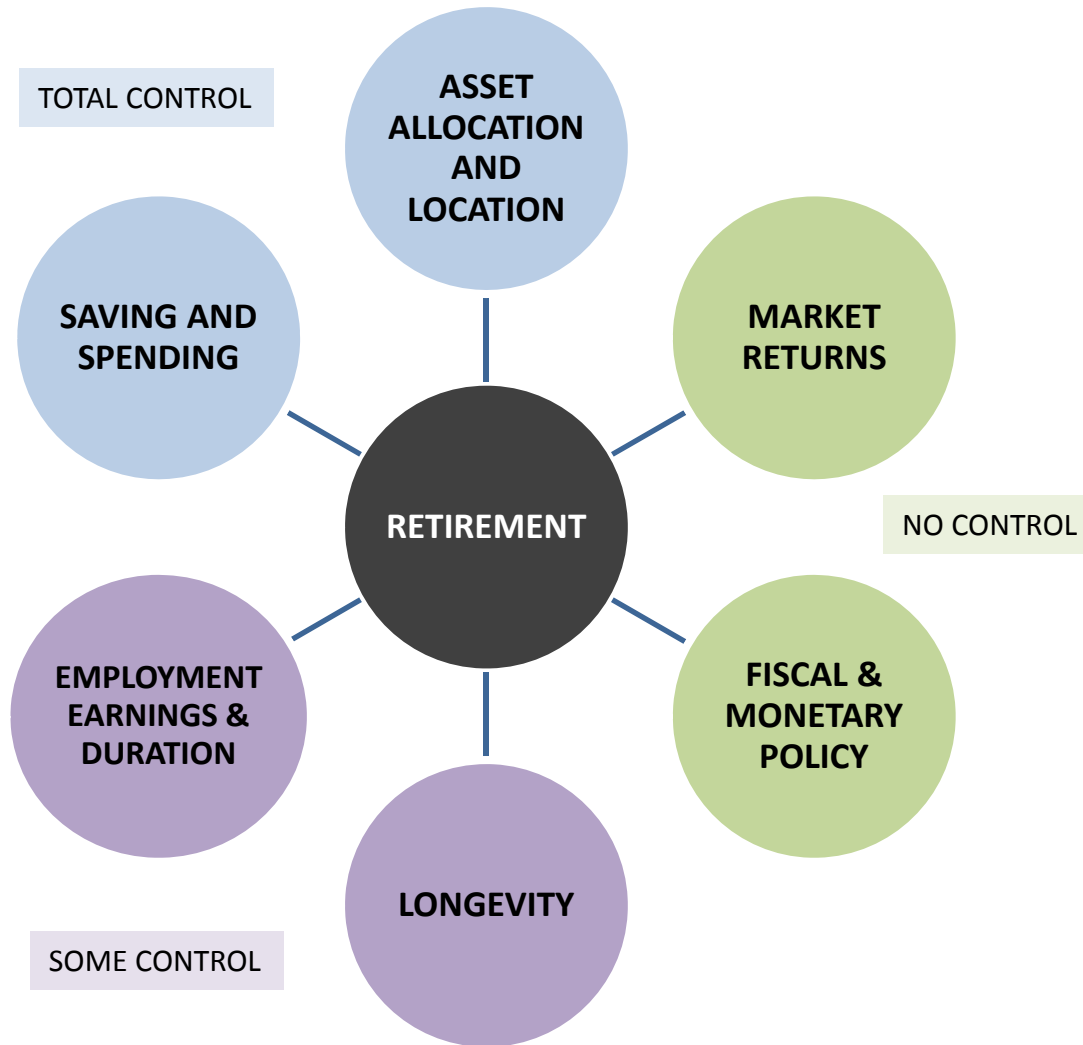
## Trees Don't Grow to the Sky

- The Relative Strength measure of a market index is often used as a technical indicator for near-term oversold conditions (green line below 30) and near-term overbought conditions (red line above 70)
- Many stock markets are flashing near-term overbought conditions, but they should not be mistaken as indicating the end of a market cycle



# 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

# Disclosure

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