January 12th, 2015

Buckle Up…

Capital markets have had a bumpy ride over the past twelve months, that is, for anyone following anything other than the S&P 500. In 2014 the S&P 500 increased by a little more than 11%, handily bettering its mid and small cap counterparts which gained 9.8% and 4.89%, respectively. Interest rate sensitive asset classes such as REIT's and Long-term Treasury bonds performed handsomely with the fall in interest rates, gaining 34.5% and 27.5% respectively. International equity markets lagged considerably with the MSCI World Index ex U.S. losing 4.3%, Europe down 6.2%, Emerging Markets declining 2.2%, as commodities took it on the chin for a third straight year down 33%.

So far 2015 is getting off to a choppy start with last week's price action in the equity market illustrating how the many crosscurrents across the globe are causing some indecision on the part of investors as the Dow Jones Industrial Average traded lower by 331 points on Monday, gave up another 130 points on Tuesday, rallied by 212 points on Wednesday, surged higher by 323 points on Thursday, before declining by 170 points to close out trading on Friday. The litany of candidates causing heightened volatility in the capital markets range from the tragic shooting in Paris, further deterioration in the economic fundamentals coming out of Europe (not to mention the resurfacing scuttlebutt of Greece exiting the Eurozone), a continued slide in oil prices, worse than expected (albeit still solid) numbers from U.S. economic data reports, and signs that global deflationary forces are not abating.

A popular Wall St. adage is “as January goes, so goes the rest of the year”. Based on S&P 500 data going back to 1928, when January is positive, the year is up 80% of the time with an average return of 13.0%. When January is down, the year is up only 44% of the time and the S&P 500 has an average decline of 1.9%. Putting the January barometer into context is the non-trivial fact that since 1928 on a calendar year time increment the S&P 500 generates a positive rate of return 67% of the time with an average annual return of 7.5%. FYI, the S&P 500 declined in January of last year, but that didn’t stop the S&P 500 from appreciating by 11% (let this be a lesson that stats are useful metrics to help inform ones decision, but they should not be interpreted in a vacuum).

Taking this ‘playing with numbers’ game a step further we can look at the first five trading days of January as a gauge for the year as another January Barometer. Once again using S&P 500 data going back to 1928, above average returns occur when the first 5-days are up (the year is up 74% of the time with an average return of 10.4%) and below average returns occur when the first 5-days are down (the year is down 52% - a coin toss – of the time with an average return of 1.8%).

Last week’s economic data releases can best be characterized as solid, but not great as the ISM non-manufacturing index followed the lead of the previous week’s worse than expected ISM manufacturing index, coming in at a healthy 56.2 for December – but below expectations for a reading of 58.0. Also following the script of solid but not great data releases was initial jobless claims improving to 294k from 298k the previous week but higher than the 290k expected. Auto sales rose 6.4% year-over-year to a seasonally annual adjusted rate of 16.8mn (consensus was for 16.9mn SAAR) – this brought the full year 2014 unit sales tally to 16.4mn, up 5.8% yoy from 15.5mn sold in 2013.

But the big report of the week was the December employment report which capped off the best year of job growth in 15 years and pushed the unemployment rate to a post-recession low.   All-in-all this was a solid report in almost every respect with nonfarm payrolls increasing by 252k with upward revisions to the prior two months totaling a non-trivial 50k. Job gains were broad based with the private payroll diffusion index holding above 60% for the ninth consecutive month. Job growth averaged a solid 246k in 2014 which saw the economy add a total of 2.95mn jobs in its best year of job creation since the Dotcom days of 1999. The unemployment rate declined to 5.6% from 5.8% - over the course of 2014 the unemployment rate sank an impressive 1.1% (6.7% to 5.6%) in its second sharpest decline for any year since 1983.

The lone sore spot in the report was the fact that wage inflation continues to run at stubbornly low levels. Average hourly earnings unexpectedly declined 0.2% month-over-month while the November data was revised to show a gain of only 0.2% versus the prior estimate of 0.4%. Wages ended 2014 up 1.7% yoy, down from the 1.9% pace at the end of 2013 and barely ahead of inflation.

This puts FOMC officials at the Fed in a bit of a conundrum as wage rates and inflation continue to sputter while on many metrics the labor market continues to tighten, and tighten fast. All the while the U.S. economy closed out 2014 with growth running at its hottest pace in 11 years and Q4 GDP looks to have expanded at a better than 3% clip which would make it 5 of the last 6 quarters that this has happened.

The fed funds futures contracts are now pricing in almost 70% odds that the Fed hikes rates at its September meeting, but yields on the long end of the Treasury curve continue to decline with the 10-year yield falling back to levels that prevailed prior to the 2013 “taper tantrum” at sub 2.0%. This begs the question as to what the yield curve is forecasting: a reflection of diminishing inflation and global growth prospects? Or a powerful case of supply/demand mismatch in the Treasury markets as foreigners pour money into U.S. markets due to the dearth of yield around the globe and a strengthening dollar at a time when Treasury issuance has fallen to multi-year lows as our fiscal deficit craters?

How the Fed interprets this dilemma has important ramifications for how the Fed will progress with normalizing monetary policy. This is a topic that New York President William Dudley spoke about at length in a speech he made in December. He argued the Fed had the wrong reaction to lower long-term rates in the 2000s, a mistake that might have contributed to the housing boom that ended disastrously.

> *"During the 2004-07 period, the (Fed) tightened monetary policy nearly continuously, raising the federal funds rate from 1 percent to 5.25 percent in 17 steps. However, during this period, 10-year Treasury note yields did not rise much, credit spreads generally narrowed and U.S.*

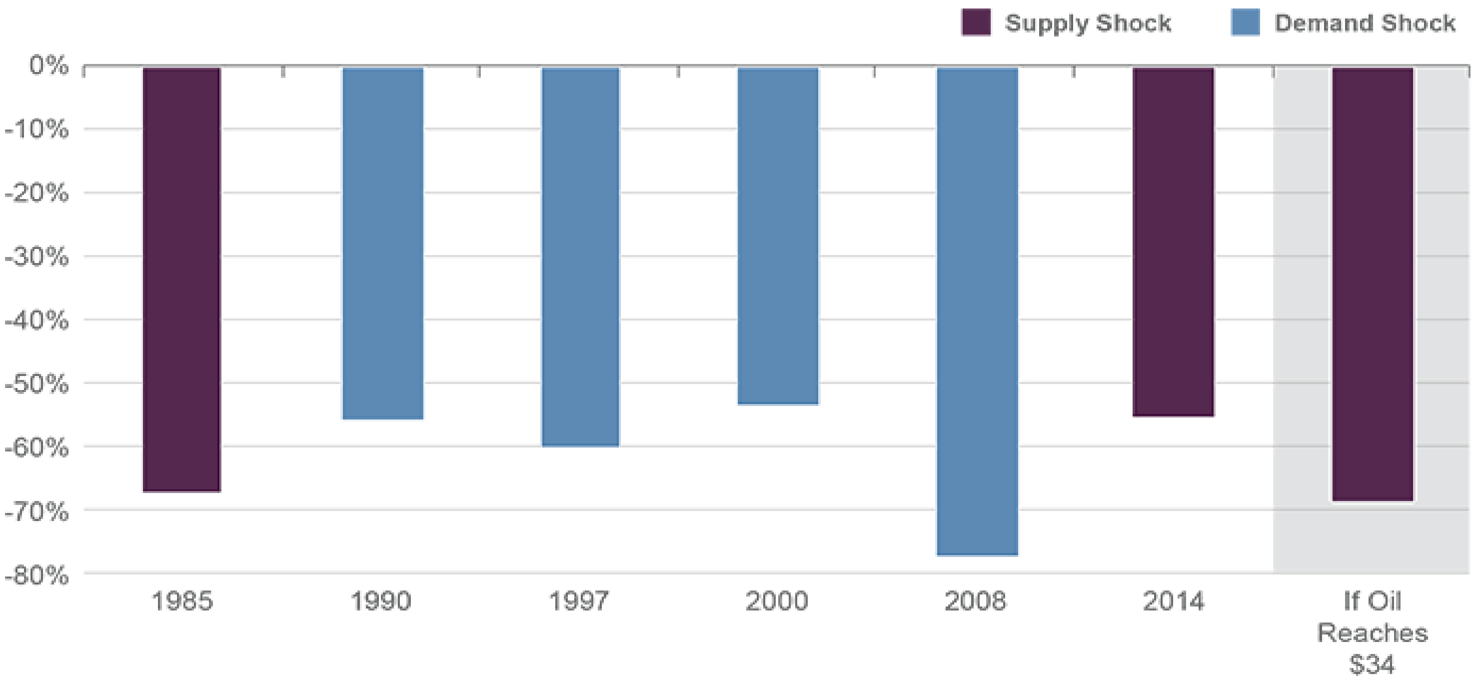
equity price indices moved higher. Moreover, the availability of mortgage credit eased, rather than tightened. As a result, financial market conditions did not tighten. As a result, financial conditions remained quite loose, despite the large increase in the federal funds rate. With the benefit of hindsight, it seems that either monetary policy should have been tightened more aggressively or macroprudential measures should have been implemented in order to tighten credit conditions in the overheated housing sector.

Mr. Dudley's conclusion was that the pace of the Fed's short-term interest rate moves this time around ought to be dictated in part by whether the rest of the financial system is moving with or against the Fed's intentions when it decides it ought to start restraining credit creation:

"When lift-off occurs, the pace of monetary policy normalization will depend, in part, on how financial market conditions react to the initial and subsequent tightening moves. If the reaction is relatively large—think of the response of financial market conditions during the so-called "taper tantrum" during the spring and summer of 2013—then this would likely prompt a slower and more cautious approach. In contrast, if the reaction were relatively small or even in the wrong direction, with financial market conditions easing—think of the response of long-term bond yields and the equity market as the asset purchase program was gradually phased out over the past year—then this would imply a more aggressive approach."

The Fed's next policy meeting is three weeks away and it is clear officials will spend a considerable time debating the correct response to a perplexing combination of economic undertows.

The bursting of the oil price bubble (and yes, this is what a bubble bursting looks like when you see its price cut in half over a 6 month time frame) continues to make the front page news as both WTI and Brent crude prices traded below $50/barrel last week. The below chart from Guggenheim Investments details a chart of the six major declines in oil prices (defined as a greater than 50% cumulative decline) over the last 30 years. All but the 1985-86 oil price bear markets came as a result of a demand shock (most coinciding with an economic recession (except the 1997/98 Asian Contagion). With oil breaking below the $50 level this week their technical models indicate prices could ultimately reach $34 – time will tell whether this proves to be true – but it's better to run stress tests on this possibility in advance of it happening and know what the outcomes are than to never do the work at all.



Interpreting the current oil price decline and its potential tertiary implications down the road are what is key for investors – not handicapping (guessing) at what price level it bottoms – as no one truly has an inside track on knowing where the ultimate floor will be. The heart of the debate centers around the question of how much of the price decline is supply related and how much is demand related. My belief is that it is both, with it being three parts supply induced and one part demand.

Without question demand growth has subsided (it's still growing, just at a lower rate) and it's not hard to see why this is the case: the U.S. economic expansion has now moved into its 6th year as auto sales reach their highs of the cycle, total employment is at a new all-time high, new home construction continues to recover, and the manufacturing sector is gaining share from competing international geographies – all of which increase the demand for energy consumption. However, the advances in technology, energy efficiency, and regulatory focus on reducing carbon emissions over the last two decades has proven to be a respected adversary in moderating demand growth.

Furthermore, economic growth in Emerging Markets is weak (many of these regions are oil producers), the Eurozone has been teetering on recession for the last six years, the Japanese economy has been sputtering for the last 25 years, and China has been slowing for more than four years now. None of this is new news. What is new is the fact that outside of the 2001 and 2008-9 recessions, oil prices have been rising for 15 years. Whereby, oil supplies have finally caught up to, and surpassed, demand to the tune of a sustainable one-million barrel per day oversupply. Additionally U.S. oil production is at its highest level in 25 years, OPEC is no longer willing to be the swing producer to stabilize prices, and fracking technology has made previously difficult to access or cost prohibitive oil supplies viable to explore and extract.

As a result of the precipitous decline in crude prices there are winners and losers. Over the last twelve months the U.S. has run a trade deficit in oil of roughly $200 billion, so we still consume more than we produce and that on net is a gain for the economy as the oil price declines. Those who are tied to production bear the brunt of the pain (a small fracture of the overall economy) and the 2/3rds of the economy that is consumption have a little more money in their pocket.

So for me the rationale for lower oil prices is more of a supply story than a demand story. If it were truly flashing warning signals that global economic growth was set to fall hard and fast then why aren't other commodity prices crashing as well? Yes, other commodity prices have declined as a result of slower global growth and a stronger dollar, but copper prices are at levels that in the past coincided with $75/barrel on WTI, the price of lead is consistent with oil trading at $85/barrel in the past, and the price of tin is where it was when oil was at $100/barrel. None of these metals, which are very sensitive to the economic cycle, are trading anywhere near spring 2009 prices, which is where oil is at today.

The price of crude will ultimately find a floor, at what level, I'm not sure, but as "high prices are a cure for high prices", "low prices will be a cure for low prices". Not a day goes by where news doesn't hit the tape that production or spending by some producer on a new or even an existing project is being slashed. Additionally, the rig count continues to decline with each passing week. According to data from Baker Hughes – oil rigs in use fell by 61 last week to 1,421 (total oil rigs peaked at 1,609 in 2014) extending the five week decline to 154.

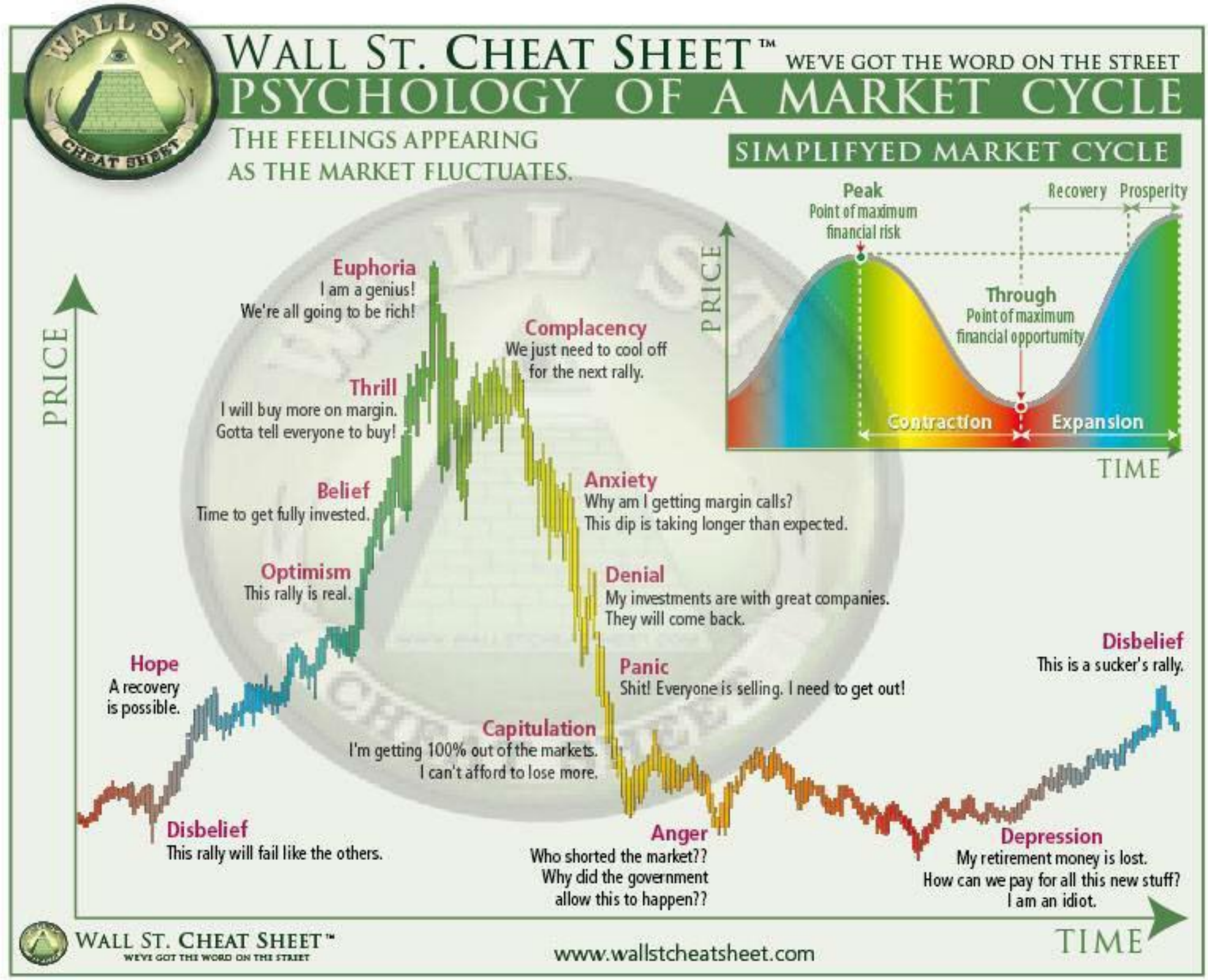
Ultimately we will find a new equilibrium for the price of oil at some point and when we get there it's likely we will remain in a new lower range for some time. As was the case with the bursting of previous bubbles: at the top of the Tech bubble the Nasdaq peaked in March of 2000, declined almost 80%, and still hasn't regained its all-time high (almost 15 years later).   Home prices, according to the S&P Case / Shiller 20-city index peaked in July 2006, declined 34%, and are still 16% below their all-time highs (almost 8 years later). Gold prices peaked in September 2011, declined 40%, and still remain more than 30% below their all-time high (almost 3 ½ years later).

As for the equity market we are now in the mature stages of this economic cycle and the current bull market is closing in on becoming the 3rd longest in history. Now to be sure, bull markets don't end of old age, but they do evolve throughout the cycle. This bull market started with P/E valuations below 10 at the

March ’09 bear market low and currently trade at a P/E of 17. The question for investors is what is the typical multiple during the mature stage of a bull market cycle? The answer, according to the archives of history suggests that it is two to three points higher than they are today. So, it’s safe to presume that the bulk of the multiple expansion for this bull market is in the rearview and what’s going to drive this stock market higher going forward is earnings growth.

Likely also supporting higher equity market multiples are the historically low interest rates around the globe. The coupon protection on a 10-year Treasury bond today is so minuscule that all it would take in the coming year is a 30 basis point increase in yields to make the total return on that instrument negative for the year. I don’t point this out to suggest that investors should have no exposure to or abandon fixed income as a viable form of insurance or stabilizer to a prudently diversified portfolio, but bonds are unlikely to make investors much money this year. So yes, given the TINA acronym (There Is No Alternative) a richly priced stock market can get even more expensive.

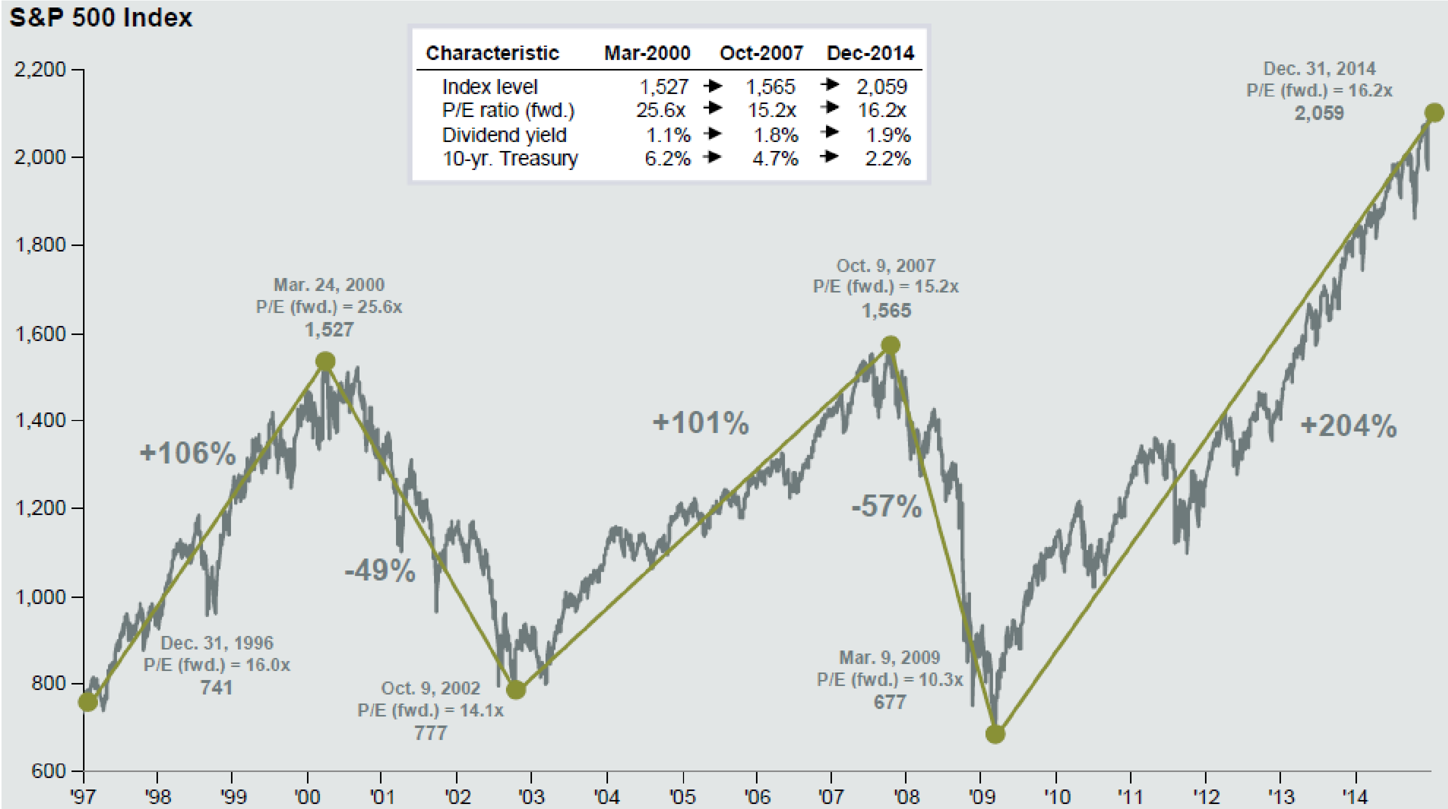
The level that the stock market trades at is a result of three variables: valuations, fundamentals, and sentiment. As was pointed out earlier, valuations are fair to a little rich, but not euphoric at this time. Fundamentals are strong with profit margins in corporate America hovering at all-time highs, balance sheets are strong and flush with cash, debt levels are low and manageable, and earnings continue to grow. The most difficult of these three variables to analyze is sentiment. The below chart is one of the better summaries I've come across on the psychology of investors throughout a market cycle.



There is no exact science to peg where we are in this chart in the current bull market cycle. Based on fund flows data, sentiment surveys, household net worth, and investor's portfolio weightings to equities, I would conclude we are handily in the optimism phase if not in the belief stage. There is no definitive data on the length of time any one of these stages lasts, so handicapping the duration to make informed timing decisions is difficult.

However, the one variable an investor (who can keep their emotions in check) always has control of is the risk they are willing to take in order to achieve their goals. The emotional tug-of-war between greed and fear almost always is dominated by fear in most investor's psyche. Given where we are in the economic and capital market cycle I would advise all investors to reevaluate where they stand in relation to their long-term goals and objectives, as it's likely that the returns in the stock market over the next six years won't be nearly as plentiful as the 26%, 15%, 2%, 16%, 32%, and 13% total returns over the last six years, and it's a good bet to expect that the volatility pick up we've been experiencing in the early part of this year will likely persist as new variables enter the fold – namely the Fed beginning the process of normalizing interest rates, plateauing valuations levels, and sentiment hovering at cycle highs.

The chart below illustrates just how strong this bull market has been relative to the previous two bull markets. Don't take this as an indication that it's time to get off the ride, but prudence and discipline should be heeded in rebalancing your portfolio back to an allocation that properly aligns with your risk tolerance and objectives – as the road ahead will require a seat belt.



Source: Standard & Poor's, First Call, Compustat, FactSet, J.P. Morgan Asset Management.

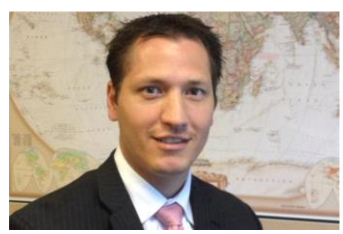
Dividend yield is calculated as the annualized dividend rate divided by price, as provided by Compustat. Forward Price to Earnings Ratio is a bottom-up calculation based on the most recent S&P 500 Index price, divided by consensus estimates for earnings in the next 12 months (NTM), and is provided by FactSet Market Aggregates. Returns are cumulative and based on S&P 500 Index price movement only, and do not include the reinvestment of dividends. Past performance is not indicative of future returns.

Guide to the Markets – U.S. Data are as of 12/31/14.

J.P.Morgan Asset Management

Corey Casilio
Partner, Portfolio Manager

101 Ygnacio Valley Road
Suite 211
Walnut Creek, CA 94596
corey.casilio@clpwm.com
925.448.2215



Casilio Leitch Investments is a private wealth management firm, focused on providing financial advisory and investment management services to individuals, families, and institutions. The firm was founded on the principles of Character, Integrity, and Trust and pledges to abide by these principles, dutifully focusing on our fiduciary responsibility to our clients throughout our financial advisory relationship.