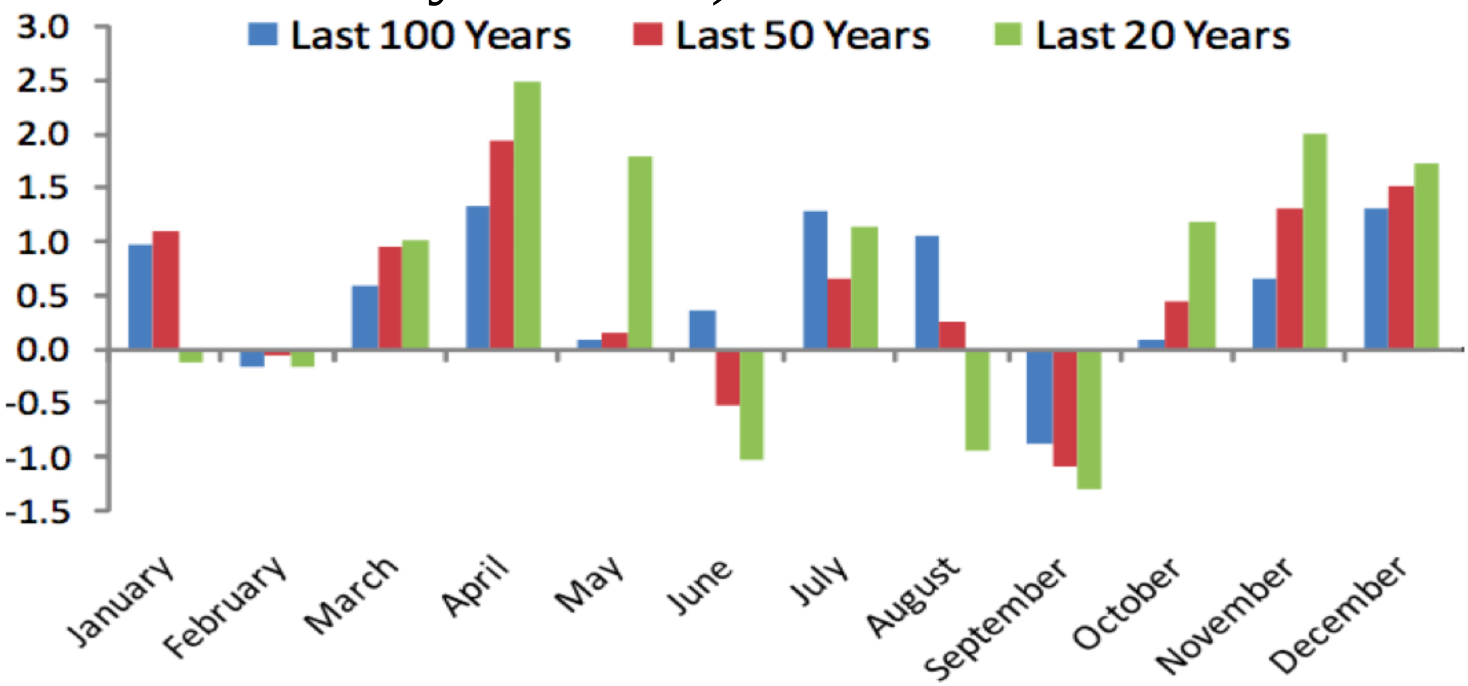
March 30th, 2015

A tough earnings season awaits…

Equity markets around the world retreated last week with the Dow Jones Industrial Average, S&P 500, and Russell 2000 all giving back 2%. The tech-heavy Nasdaq was the biggest loser, declining 3%, while Europe traded lower by 2% and Emerging Markets lost 1.5%. As the end of the first quarter nears, U.S. equities continue to oscillate around the flat-line for the year with a tight range of +/- 3% becoming well established.

It's been a roller coaster ride of sorts for investors so far in 2015 where January brought weakness in equities, a strengthening dollar against all currencies, continued decline in oil prices, and a big rally in bonds. Then, like the flip of a switch, all of these trends reversed course in February. With March quickly coming to an end we have a similar about-face confronting investors, with the yield on the 10-year Treasury note falling about 30 basis points from the 2.3% yield it reached following February's strong payroll report, the dollar rally has been stopped in its tracks following a more dovish tone from the Fed, and the S&P 500 has registered a decline in 4 of the last 5 weeks (the S&P 500 has actually declined in 7 of this year's 12 trading weeks).

What will cause equities to break out of its trading range in one direction or the other is up for debate, but perhaps the calendar rolling over into April will provide a little fodder for the bulls as April has historically been one of the strongest months of the years for stocks (the below chart from Bespoke Group shows the average monthly returns for stocks over the last 100, 50, and 20 years with April stacking up well over every interval).



Source: Bespoke Group Blog

It's far from a stretch to suggest that the complexion of the capital markets has become more erratic, but much of this has to do with some rather substantial cross-currents that investors have to wade through: excessive valuation levels in stocks, a more than 20% rally in the greenback in less than 12 months, declining earnings estimates, another soggy economic growth profile to kick off a calendar year, a tug-of-war between deflationary forces and above trend job growth clouding the Fed's ability to achieve success in the pursuit of its dual mandate, and interest rates in 90% of the world's GDP at sub 2% levels.

All the while we have a Federal Reserve that is itching to get off the zero interest rate floor, but continues to be restrained from doing so because of a lack of economic growth. A point eloquently made in a recent blog post by former Fed Chair Ben Bernanke (emphasis added is mine):

> *"If the Fed wants to see full employment of capital and labor resources (which, of course, it does), then its task amounts to using its influence over market interest rates to push those rates toward levels consistent*

with the equilibrium rate, or—more realistically—its best estimate of the equilibrium rate, which is not directly observable. If the Fed were to try to keep market rates persistently too high, relative to the equilibrium rate, the economy would slow (perhaps falling into recession), because capital investments (and other long-lived purchases, like consumer durables) are unattractive when the cost of borrowing set by the Fed exceeds the potential return on those investments. Similarly, if the Fed were to push market rates too low, below the levels consistent with the equilibrium rate, the economy would eventually overheat, leading to inflation—also an unsustainable and undesirable situation. The bottom line is that the state of the economy, not the Fed, ultimately determines the real rate of return attainable by savers and investors. The Fed influences market rates but not in an *unconstrained way; if it seeks a healthy economy, then it must try to push market rates toward levels consistent with the underlying equilibrium rate."*

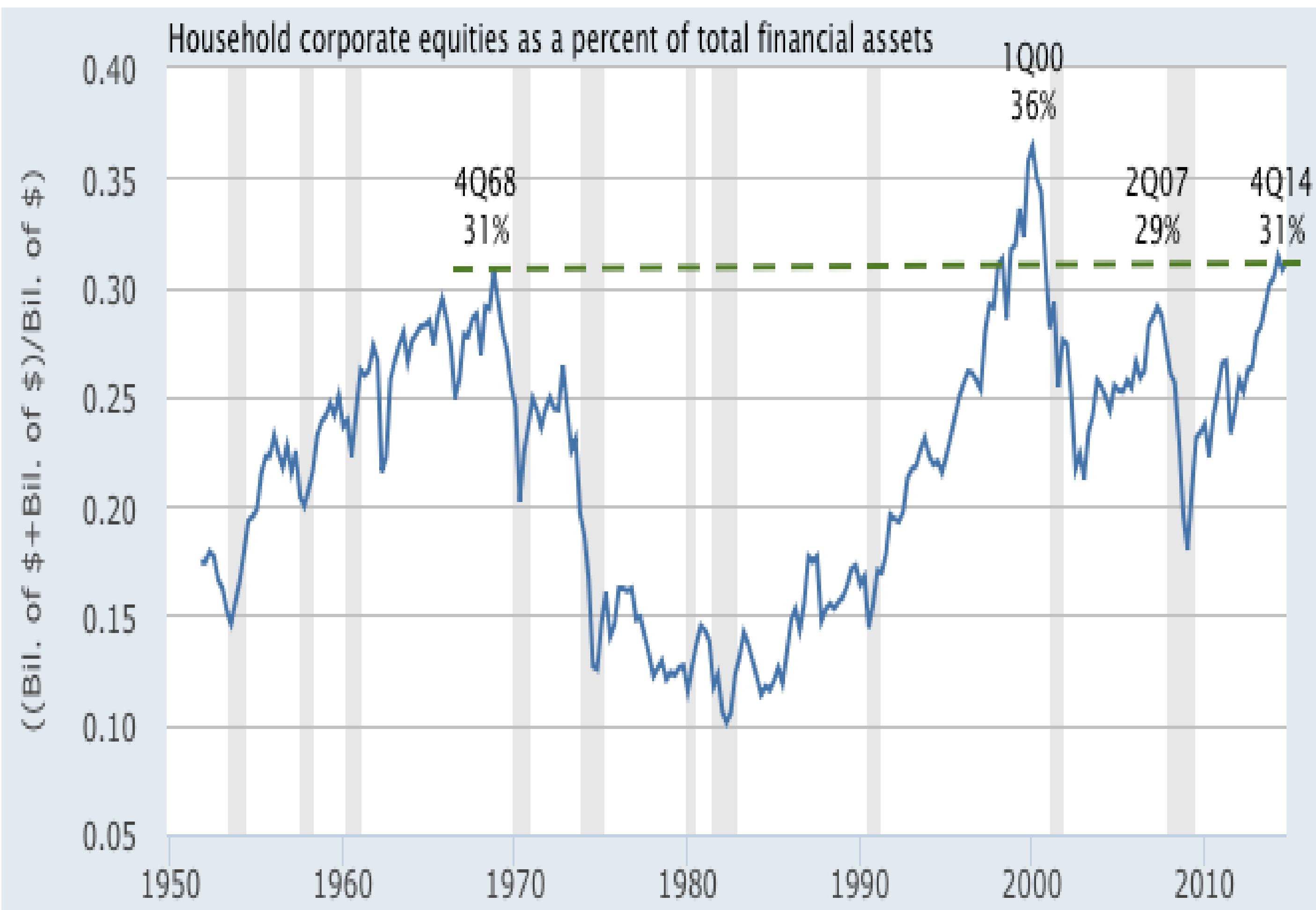
"…<u>The state of the economy, not the Fed, is the ultimate determinant of the sustainable level of real returns. This helps explain why real interest rates are low throughout the industrialized world, not just in the United States."</u>

The idea that we are now in year six of this economic recovery and that the state of the economy remains too weak to digest even a modest increase in short-term interest rates is a bit unnerving from an investing standpoint. This isn't to question the policy that the Fed has employed since the depths of the credit crisis, but more to the excesses that are potentially being built up in parts of the capital markets. In times of stability (like we're in today) these potential pockets of weakness are commonly overlooked and explained away. But, after six years of ZIRP with investors being forced out on the risk curve to areas that do not match their risk tolerance I wonder how the eventual unwind of this investor positioning will unfold (especially in times of instability – like a recession).

For example, the regulatory reform (The Dodd-Frank Wall Street Reform and Consumer Protection Act) coming out of the credit crisis has focused on shoring up the balance sheets of large banks with the goal that never again can one institution (or several) bring the financial markets to the brink of destruction. As a result, the dealer market which in the past was a profitable business for many large banks and investment banks, would leverage the size of their balance sheets to facilitate the transacting of much of the trading in fixed income securities, but as a result of the reform the number of dealers has been cut in half since the credit crisis. This shrinkage in dealers coincides with a time when investor's exposure to mutual funds and ETF's focused on investing in fixed income securities has exploded to more than four times the size it was prior to the credit crisis.

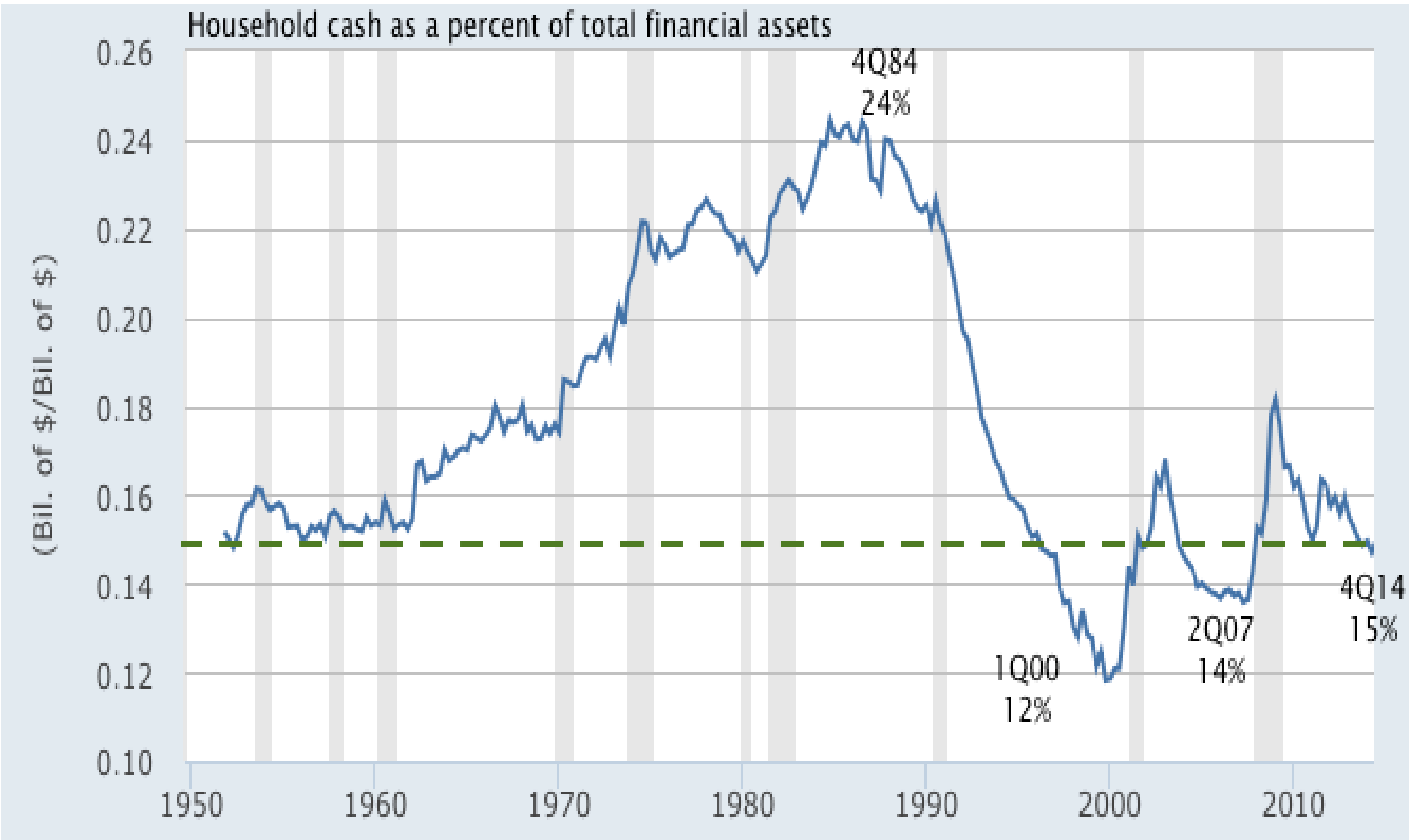
While I'm of the view that the Fed should be taken at face value and that rate hikes will be gradual, the question facing investors has shifted from 'if' the Fed will hike to 'when' will they hike as the futures market price in a high probability of sometime in the second half of 2015. With that being said, it has been almost nine years since the Fed last hiked rates and I fear that many weak handed investors may not know how to respond to eventually seeing negative signs show up in front of their fixed income investments. If investors who have found refuge in liquid bond mutual funds and ETF's decide they all want to head to the exit together, I'm more than curious to see how this effects a market where the infrastructure doesn't appear to be equipped to handle a mass exodus – my guess is that price discovery will get pretty interesting and quickly. This isn't a current worry for capital markets, but something to keep in mind as the interest rate normalization process evolves.

Beyond the high valuations that are likely impeding further appreciation in the broad stock market averages this year is the fact that household positioning in stocks is at its highest levels since the late 1990's tech bubble. The most recent Federal Reserve Flow of Funds report shows that the strong price gains in stocks over the last two years coincided with households and investment funds increasing their asset allocation to equities at the most robust pace since this bull market started in ’09. The below chart shows household corporate equities as a percent of total financial assets having troughed this cycle at 18% in early 2009 compared to a current weighting of 31% as of the end of 2014.



The current weighting of equities on household balance sheets is greater than the 29% weighting reached prior to the bull market peak in 2007, but still below the 36% high hit at the peak of the tech bubble in March 2000.

To fund this increased exposure to equities, households have been shedding exposure to Treasury, corporate, and municipal bonds which currently comprise about 20% of household financial assets – fixed income ownership is nearing the 18% weighting level it reached at the height of the ’00 tech bubble (outside of the tech bubble, today’s 20% allocation is near a 35 year low). Households have also reduced their holdings in checking and savings deposits as well as money market funds which currently comprise 15% of household financial assets – nearing the 14% level it fell to in mid-2007, but a little ways off the extreme low of 12% reached in March 2000.



With cash and fixed income allocations on household balance sheets pared back and equity exposure nearing levels seen in previous bull market peaks – it begs the question of where the incremental buyer of stocks will come from? Corporate buybacks have been a driver through this entire bull market and that isn't likely to change – perhaps a pick-up in M&A will withdraw some supply of stock for ownership out of the market and help propel the next leg of this bull-run?

This week marks the first week of a new month which brings with it a new slate of data to gauge the heath of the economy. Economists have been busy over the last couple weeks taking a knife to Q1 GDP growth estimates with weather, port strikes, inventory builds, lack of consumer spending, and the strong dollar acting as the key variables driving lowered expectations. The big report of the week will be the BLS employment data released on Good Friday with expectations for another monthly gain of 200k in payrolls – capital markets will have to wait until Monday to react to how the data comes in relative to expectations given both equity and debt markets are closed in observation of the Easter holiday.

Beyond the economic data, corporate earnings season is set to kick off in a couple of weeks and analysts have already been busy cutting numbers coming into Q1 reporting season. The one-month earnings revision ratio for the S&P 500 has come down to 0.47 for February from 0.49 in January (implying downgrades are outnumbering upgrades by a two to one margin). This is the lowest one-month revision ratio since September 2011 (the last time the S&P 500 endured a correction of any significance).

The less volatile three-month EPS revision ratio has now declined for seven consecutive months to 0.56x in February and is a long way from the 1.11x level it reached last July. According to John Butters of Factset earnings growth for the first quarter is projected to decline 4.6% (the first contraction in EPS growth since Q3 of 2012). At the start of the year analysts' expectations were for Q1 EPS to grow 4.2% – so you can see that the hatchet has already come down.

This begs the question of whether the bar has already been lowered enough for positive surprises to provide some much needed ammunition to get this bull market reignited. However, there are some big differences between the fundamental backdrop today and the one that prevailed the last time we saw earnings cuts of this magnitude back in the fall of 2011. Back then the S&P 500 was trading at a P/E multiple of just over 13x trailing earnings and almost 12x forward earnings. Today we have an earnings backdrop that is deteriorating when the S&P 500 is trading at an 18.5x trailing multiple and 17.5x forward multiple.

Furthermore, back then we had a Fed that was just getting started on another round of QE compared to a Fed today that is on the doorstep of an interest rate hiking cycle.

What will be important to monitor through the earnings reporting season is the extent to which companies kitchen sink (throw in any negative reporting item they can – write-downs, pension adjustments, impairment charges, restructurings…) an already subpar performance quarter and blame the miss on currency effects, bad weather, or port strikes. How the equity markets handle this news will be telling for future quarters as Q2 EPS estimates are for negative growth as well. As I have indicated in past missives the margin of safety in equities with valuations trading at current levels (irrespective of low interest rates) has become razor thin – rendering sector positioning, security selection, discipline and asset allocation paramount to a successful investment strategy going forward.

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.