December 7th, 2015

What we're watching…

A casual observer of the equity market could have opened up the weekend paper to see how stocks did last week and shrugged their shoulders as they learned the Dow Jones Industrial Average and the S&P 500 closed a mere 49 points (0.28%) and 2 points (0.08%), respectively, above the previous Friday's close. However, while this conclusion would be accurate, it overlooks the rollercoaster ride that occurred throughout the trading week which saw the Dow Jones trade in a 440 point range and the S&P 500 oscillate more than 60 points peak to trough.

And this volatility wasn't relegated to just the equity market as the bond market also experienced wild swings (long-term Treasuries traded down almost 3% at their lows during the week, while ending the week down a modest 0.32%), the dollar index got smashed to the tune of almost 3% on Thursday alone (keep in mind we are talking about the world's reserve currency moving as much in a day as you would normally see over the course of a year) and a similar script played out in the commodities market with WTI crude prices trading in an 8.5% range (closing near its lows to end the week), gold traded in a range of 3.5%, and copper's range was a little over 5% (the red metal with a PhD in economics is still off almost 30% from its calendar high).

As a whole, the ebb and flow of the equity market remains unsettling with the S&P 500 having risen in only 8 of the last 22 trading days going back to November 4th (the last time it was above the 2100 level). However, this indecisive behavior is not a new development for a stock market that is virtually flat on the year with a couple pockets of upside and downside volatility sprinkled in – the S&P 500 was up as much as 3.6% at its high of the year in May and down as much as 9.3% at its August low.

While there are many variables market prognosticators could point to in an effort to explain what has transpired, among them would almost certainly be central bank policy. This was front and center last week with Fed Chair Yellen presenting at two different speaking engagements and ECB President Mario Draghi (arguably the two most powerful central bank officials in the world) concluding an ECB policy meeting on Thursday and speaking at the Economic Club of New York on Friday.

Capital market expectations were for Janet Yellen to hold firm on the view that the Fed is going to raise rates for the first time in seven years come next week's FOMC policy meeting (which she did). The surprise came from Draghi as it was widely expected that he would aggressively up the ECB's monetary spigot in the wake of weak inflation and growth data. The ECB did re-up its policy stimulus, but the 10 basis point cut to the deposit rate (markets were looking for 15 basis points) to negative 0.30% and an accompanying six month extension from Sept. 2016 to March 2017 of the current €60 billion per month asset purchase program

The articles and opinions in "Capital Market Musings and Commentary" are for general information only, and not intended to provide specific investment advice. Performance, dividends and other figures have been obtained from sources believed reliable but have not been audited and cannot be guaranteed. Past performance does not ensure future results. Investing inherently contains risk including loss of principle. Corey Casilio is a founding partner of Casilio Leitch Investments, a legal business entity. Advisory services offered through Casilio Leitch Investments, a CA State registered investment advisor.

represented a much less significant turn of the liquidity spigot than anticipated (markets were expecting an increase of €5 to €15 billion per month).

The lack of more aggressive action by Draghi sent capital markets into a tizzy on Thursday with the gambit of yields across Europe spiking higher (10-year German bund +20 basis points, Italy +25 basis points, Spain +24 basis points…), the Euro surged 3% against the dollar, the STOXX 600 fell 3% while the German DAX and France's CAC both plunged -3.6%. A similar sequence played out in U.S. based assets with Treasury yields rising (10-year T-note rose 15 basis points) and equities selling off. However, much of this destruction was reversed on Friday following a solid U.S. employment report and comments from Draghi that the ECB continues to stand at the ready should additional stimulus be necessary. What is becoming a growing schism for investors to monitor is the mounting divergence in central bank policy, namely the beginning of an interest rate normalization cycle in the U.S. juxtaposed against stable or increasing stimulus out of Europe, Japan, and China (to name a few).

How about that November employment report, which showed the economy added 211k jobs while the prior two months were revised up by 35k, pushing average monthly job creation to 218k over the last three months, 213k over the last six months and the monthly average for all of 2015 stands at 209k. Furthermore, the private sector diffusion index increased to 60.5% from 59.1% which suggests that this report was as impressive in terms of breadth as it was in magnitude. All-in-all the November jobs report was solid, solidifying the case for a rate hike at the conclusion of the December 15th – 16th Fed meeting.

The unemployment rate held steady at 5.0% (5.046% from 5.036% in October), as household jobs increased 244k, offsetting the rise in the labor force participation rate to 62.5%. Over the past 12 months, the unemployment rate and the number of unemployed persons are down by 0.8% and 1.1 million, respectively. That said, the broader measure of the unemployment rate – the U6 rate – increased to 9.9% from 9.8% while wage growth slowed to 2.3% year-over-year from 2.5% YoY. The "quit rate" (share of unemployed who quit their job voluntarily in search of greener pastures) rose to a four-month high of 10.0% from 9.9% in October, and 9.8% in September.

Let's provide some context for the big-picture view underpinning the make-up of this jobs data. The most recent estimate from the Census Bureau pegs the total U.S. population at roughly 320 million people. In November, according to the Labor Department's Bureau of Labor Statistics, the nation's civilian non-institutional population, consisting of all people age16 or older who were not in the military or an institution, reached 251.75 million, of which 157.3 million are participating in the labor force by either holding a job or actively seeking one and 94.45 million civilians are not in the labor force. Of the 157.3 million in the labor force, 149.36 million are currently employed (of which 6.1 million of these people are working part-time for economic reasons) leaving the total unemployed at 7.94 million.

One of many takeaways from this data is the level of slack that remains in the labor market. At the peak of the last economic cycle back in 2007 the total level of employment was a little more than 146 million workers compared to a little more that 149 million at present. So we have 3 million more people working today than was the case at the height of the last expansion, but what can't and shouldn't be overlooked is the increase in the working population from 231.9 million in '07 to 251.75 million at present. This is an increase of almost 20 million in the potential pool of labor over the last eight years with only an additional 3 million jobs to show for it.

This speaks to the challenges facing not only the Fed but also government officials as they put forth policies to promote sustainable economic growth – policies that should be focused on closing the gap that has been created due to the skills mismatch that has become prevalent in our economy today, in part as a result of

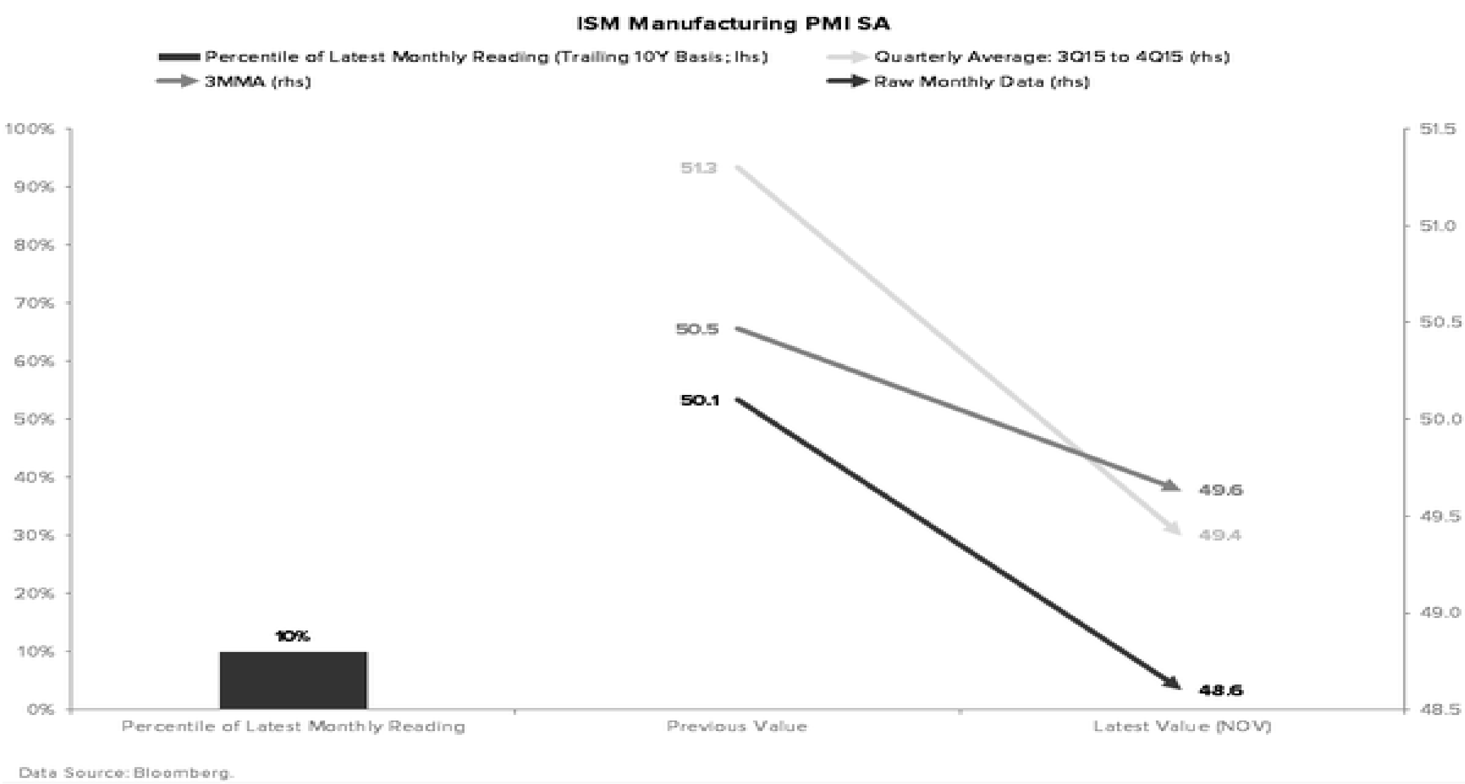
The articles and opinions in "Capital Market Musings and Commentary" are for general information only, and not intended to provide specific investment advice. Performance, dividends and other figures have been obtained from sources believed reliable but have not been audited and cannot be guaranteed. Past performance does not ensure future results. Investing inherently contains risk including loss of principle. Corey Casilio is a founding partner of Casilio Leitch Investments, a legal business entity. Advisory services offered through Casilio Leitch Investments, a CA State registered investment advisor.

what has been viewed as a shortfall driven by cyclical events, but looks to have morphed into a more significant and difficult to combat secular change.

We also received economic data last week from the ISM via its manufacturing and non-manufacturing surveys. First with the manufacturing side of the economy, which has been under pressure for some time due in part to the strong dollar and weak economic growth around the world. The ISM Manufacturing report for the month of November was a big disappointment as not only did the headline number miss expectations (48.6 act. vs. 50.5 est.), but it also dropped below 50 (the dividing line between expansion and contraction) and fell to its lowest level since June 2009. While it should surprise no one that the manufacturing sector in the U.S. has been struggling and is no longer the behemoth that it once was in the U.S. economy, when you start having to go back to the last recession to find times when any economic indicator was as bad as the current reading, it raises concerns.

The internals of the report were as weak as the headline suggested with just four components increasing relative to October (Backlog Orders, Supplier Deliveries, Employment, and Imports). On the downside, the biggest declines this month were in New Orders and Production which both dropped to their lowest levels since August 2012. As discouraging as the month-over-month readings were, the year-over-year readings were even more negative. Of the ten subcomponents, nine declined including more than ten point declines in Production (-13.4), New Orders (-13.2), and Backlog Orders (-12.0).

The following chart from Hedgeye shows that last month's 48.6 level is in the 10th percentile of readings over the last 10 years (just for reference the lower the number the worse it is in relation to other readings it's measured against) and also indicates that the deterioration in this index has accelerated over the last quarter.

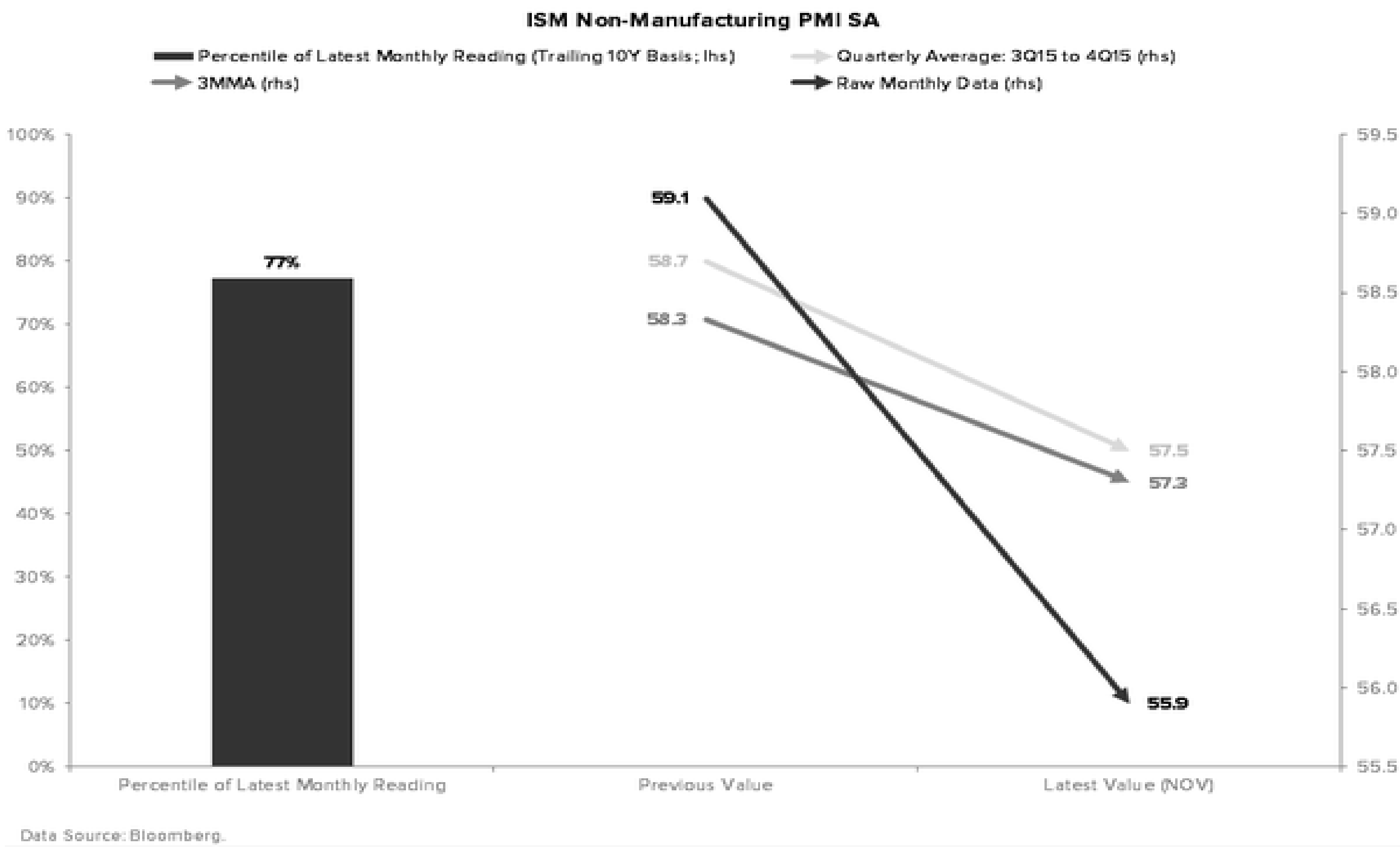


I've heard numerous decrees from market prognosticators to not get too caught up in the deterioration in the manufacturing side of the U.S. economy given it represents less than 15% of GDP at the current time and is a far cry from the importance it used to have some 30-40 years ago. I'll concede that view, but I'm not nearly

The articles and opinions in "Capital Market Musings and Commentary" are for general information only, and not intended to provide specific investment advice. Performance, dividends and other figures have been obtained from sources believed reliable but have not been audited and cannot be guaranteed. Past performance does not ensure future results. Investing inherently contains risk including loss of principle. Corey Casilio is a founding partner of Casilio Leitch Investments, a legal business entity. Advisory services offered through Casilio Leitch Investments, a CA State registered investment advisor.

as dismissive or eager to overlook its weakness given its strong historical relationship in tracking the contours of the business cycle. Additionally, market fodder is quick to point out the strength in the services side of the economy and the fact this segment represents more than 70% of the U.S. economy. Once again I'll concede to agreeing with this view, but my concern stems from the notion that the manufacturing side tends to be more of leading indicator than a lagging indicator. If this relationship holds true for this cycle as it has in past cycles, could this breakdown into recessionary levels (sub 50) in the manufacturing sector be foretelling as to what may lie ahead for the services sector?

Last week's ISM non-manufacturing report continued to show the expansion in the service sector is ongoing with it coming in at 55.9 for November – well below market expectations of 58.0, and off considerably from October's print of 59.1. At a level of 55.9, November's decline was the largest one-month decline in the headline index since November 2008. The combined reading from both the ISM manufacturing and non-manufacturing index fell three points from 58 to 55, which is the lowest reading since March 2014 (November 2008 was also the last time we've seen this combined index fall by three points month-over-month). Similar to the manufacturing index, the internals of this report were weak as well, with just four of the ten components increasing on the month. On a year-over-year basis the breadth was even weaker as only one component (inventory sentiment) was higher than a year ago.



At the current time the U.S. economic expansion that started in the summer of 2009 remains intact, but my view of the data suggests that the rate of change is slowing and in some segments, outright contracting. This doesn't mean that the economy or the stock market is set to roll-over tomorrow as this trend change tends to take some time to play out, and the lags from more restrictive monetary policy also take time.

If an investor were to solely scope their view of the overall global capital markets from what was occurring in the major U.S. equity market averages, they would likely conclude that all is well in the world – the Dow

The articles and opinions in "Capital Market Musings and Commentary" are for general information only, and not intended to provide specific investment advice. Performance, dividends and other figures have been obtained from sources believed reliable but have not been audited and cannot be guaranteed. Past performance does not ensure future results. Investing inherently contains risk including loss of principle. Corey Casilio is a founding partner of Casilio Leitch Investments, a legal business entity. Advisory services offered through Casilio Leitch Investments, a CA State registered investment advisor.

Jones Industrial Average is less than 500 points or 3% from its all-time high and the S&P 500 is within 43 points or 2% of its all-time high – but this would be a gross oversight of material destruction that is taking shape in other parts of the capital markets:

- The broad commodity index is off 25% YTD, oil is down more than 30%, copper is down almost 25%, and iron ore just went below $40/ton (its lowest price since May 2009).
- Emerging Markets are down 15% year-to-date.
- Junk bonds are near cycle lows (more on this later).
- Stock market technicals remain unflattering with the number of stocks hitting new 52 week lows outnumbering new 52 week highs by a ratio of 5:1 (426 to 84).
- Over the last four weeks, defensive sectors have emerged as the best performing sectors in the market: Consumer Staples (2.56%) and Utilities (0.52%) while Energy (-7.31%), Telecomm (-1.67%), Industrials (-0.55%) and Consumer Discretionary (-0.25%) have lagged. This is a significant shift from the year-to-date leaderboard: Consumer Discretionary (12.10%), Technology (7.25%), and Healthcare (4.39%).

Bulleted below are, in my opinion, economic or market signals that I'm monitoring which are flashing amber at the current time and could spell trouble ahead. I'm sorry but I'm more focused on the negative than the positive at the current time, not because I'm a pessimist as I firmly believe being an optimist is much more fruitful in investing and in life over the long-term, but because I believe the current backdrop demands a higher level of attention to risk management than return achievement.

- Trouble looks to be brewing in the junk bond market with the Standard & Poor's "distress ratio" for bonds reaching 20.1% at the end of November, up from 19.1% in October, and at its highest level since 2009. Furthermore, the default rate, which lags the distress ratio by about eight to nine months, has been on a steady increase hitting 2.8% in November, up from 2.7% in October, 2.5% in September, and 1.4% in July 2014.

  S&P has cut its ratings on more than $1 trillion of U.S. bonds in the first 11 months of the year, a 72% increase from all of 2014 which is a major contributing factor to the yield on the Merrill Lynch high yield U.S. Bond index moving above 8% from 5.5% eighteen months ago. Yields on the lowest of the junk bond market, bonds rated CCC and below, have hit their highest levels in six years.

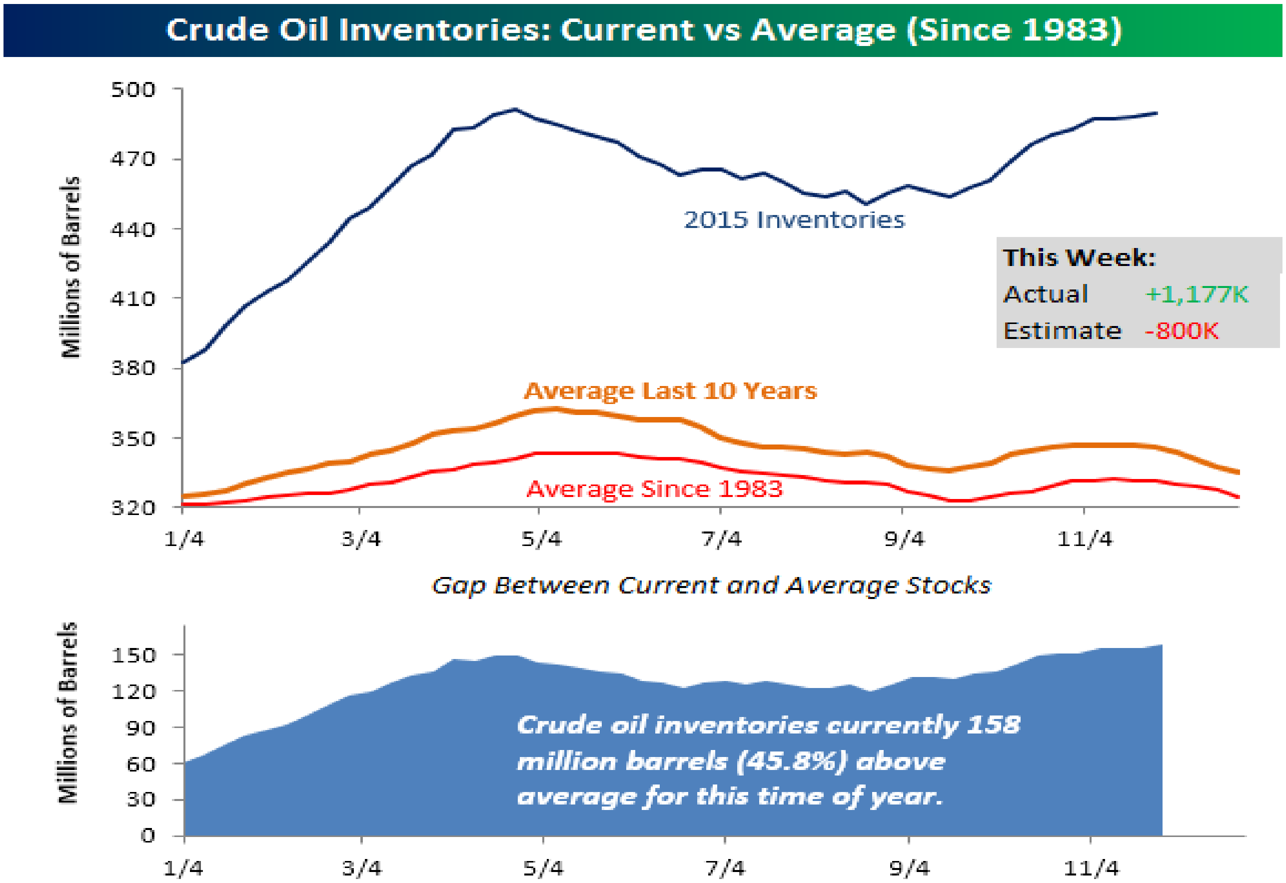
  Keep in mind that the credit markets typically lead the equity market and in last Friday's huge ramp higher in stocks, which saw the Dow climb almost 370 points, the junk bond market closed down on the day.

- Oil prices closing below the $40/barrel level spells trouble for all producers, especially for those that are bloated with debt loads based on a price curve at much higher levels. The OPEC meeting that concluded last week added even more confusion to the supply backdrop as there was not a cut to the production cap and many OPEC followers even question whether any explicit (or implicit) cap was agreed on. The target heading into the meeting was for a 30 million barrel per day cap with rumors swirling that it is closer to 31.5 million b/d which would be consistent with estimates that OPEC nations produced 31.77 million b/d in November, up from 31.64 million b/d in October.

  With little to no constraint on production, the scale to balance supply and demand ultimately will be left to price. What continues to leave many scratching their head on this front is that oil prices are down 60% from their peak, yet U.S. production is only off 3% and Saudi Arabia continues its focus on retaining market share rather than taking on the "swing producer" role that it has in the past to

The articles and opinions in "Capital Market Musings and Commentary" are for general information only, and not intended to provide specific investment advice. Performance, dividends and other figures have been obtained from sources believed reliable but have not been audited and cannot be guaranteed. Past performance does not ensure future results. Investing inherently contains risk including loss of principle. Corey Casilio is a founding partner of Casilio Leitch Investments, a legal business entity. Advisory services offered through Casilio Leitch Investments, a CA State registered investment advisor.

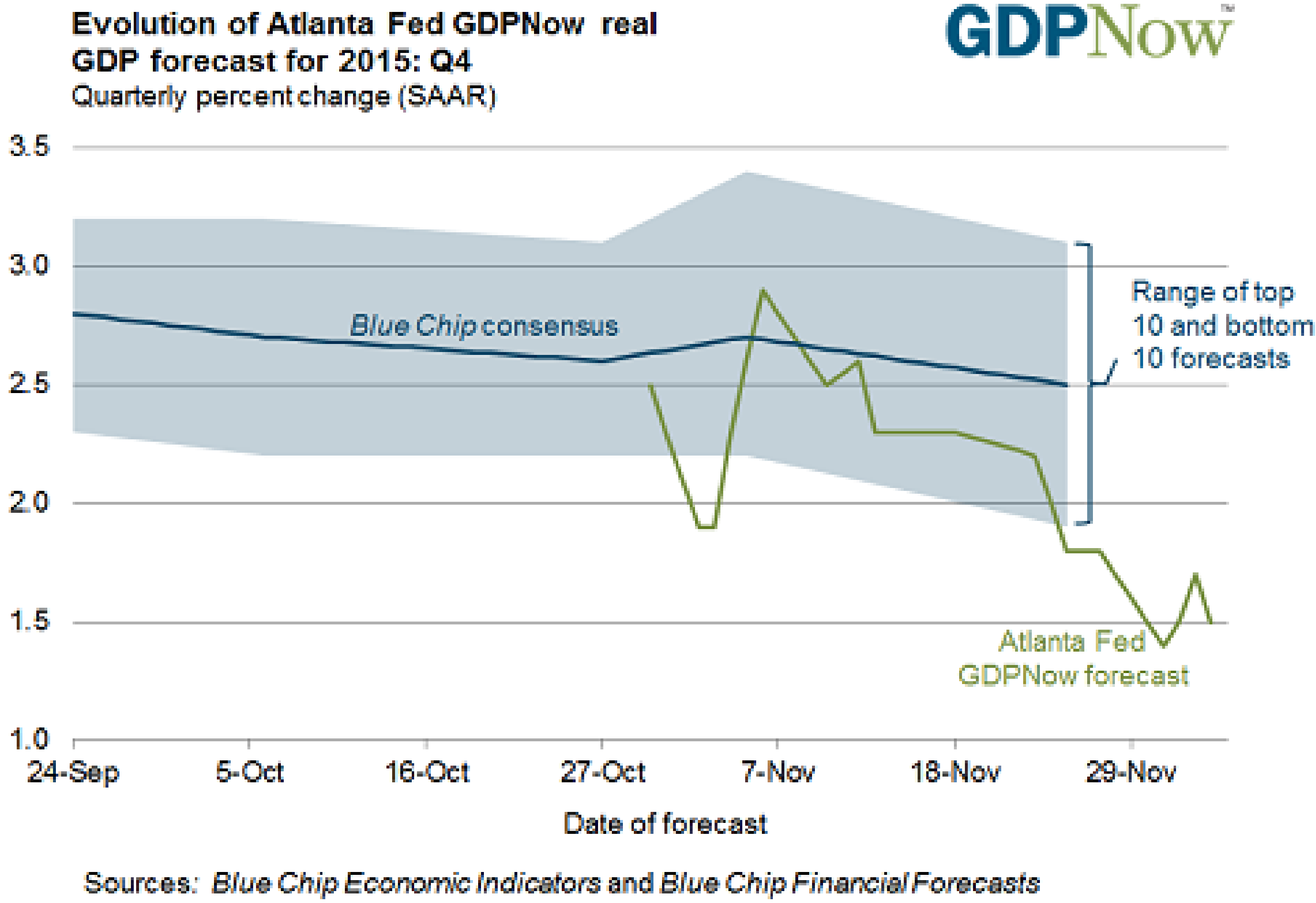
balance the market. This combination of no one willing to give in and the advancement in technology making U.S. oil production cheaper on a breakeven basis is why crude supply and stockpiles remain near their highs. The chart below from Bespoke showcases current U.S. inventory levels which are nearly 46% above their historical average for this time of year going back to 1983 and 42% above that average compared to the last ten years.



- Economic growth around the globe continues to remain constrained by an array of headwinds, so watching incoming economic data from around the globe will be paramount to gauge whether we are at an inflection point or a pause that refreshes (my view continues to be the former rather than the latter). On this front we were on the receiving end of some poor data last Tuesday (the same day the ISM manufacturing index dipped into contractionary territory at a sub 50 reading) we learned that South Korean exports fell 4.7% in November from a year earlier. Economists often focus on Korean exports as a canary in the coal mine because they are a significant manufacturer of a broad array of traded goods, such as automobiles, petrochemicals, electronics (PC's and mobile devices), cosmetics, appliances… and these exports are the worlds imports given the breadth of their trading partners. The actual decline in exports would have been closer to -8.9% if not for a significant shipping vessel delivery which skewed the data upward. Exports to China fell 2.6%, even as exports were bolstered by China's record Singles Day shopping event, with exports to the U.S. soft as well, declining 9.2%.

  Also, last week the Atlanta Fed cut its Q4 U.S. GDP estimate to 1.5%, down from its 2.2% forecast just two weeks ago. It's tough to square the Fed continuing to ratchet down its growth and inflation forecasts while using these same variables as talking points to support their rationale to start the interest rate normalization cycle in December.

The articles and opinions in "Capital Market Musings and Commentary" are for general information only, and not intended to provide specific investment advice. Performance, dividends and other figures have been obtained from sources believed reliable but have not been audited and cannot be guaranteed. Past performance does not ensure future results. Investing inherently contains risk including loss of principle. Corey Casilio is a founding partner of Casilio Leitch Investments, a legal business entity. Advisory services offered through Casilio Leitch Investments, a CA State registered investment advisor.



- For what we know, at the current time it looks as though the profits cycle peaked in Q1 of this year and expectations are for it to reaccelerate in 2016 once we lap (Q1 and Q2) the tougher comps from the strong dollar and steep fall in oil prices, but the near-term setup going into this expected outcome is not improving. The three-month earnings estimate revision ratio (ERR) declined for the fourth consecutive month in November, to 0.55 from 0.67 – an eight-month low. This is below the long-term average of 0.84 and suggests nearly twice as many downgrades vs. upgrades to estimates.

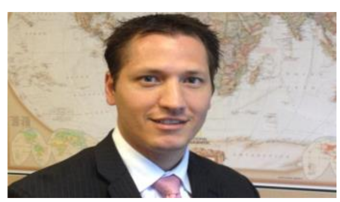
  All sectors except Health Care have seen more downward than upward earnings estimate revisions over the last three months. But the pace of upgrades within Health Care has been slowing and last month we saw the biggest deterioration in its three-month ERR of all 10 sectors. Materials has the worst ERR, with 9x as many cuts vs. increases to estimates over the last three months – the worst since March '09. Also of note, Financials' three-month ERR fell to its lowest level in four years. Meanwhile, Energy saw the biggest improvement in its 3m ERR, as analysts slowed their pace of estimate cuts for the first time since July. Staples also saw its ERR improve. The three-month ERR continued to fall for both multinationals and pure domestics within the S&P 500 and, outside the US, analysts have accelerated their pace of cuts across regions.

  The sales forecast revision ratio also fell for the fourth consecutive month, to 0.41 from 0.45. This is well below the long-term average of 1.0, and the lowest since April 2009. All sectors have seen more downward than upward revisions to sales over the last three months, led by Energy (whose ratio is at an all-time low) and Materials (whose ratio remains at its lowest level since early 2009). The more volatile one-month sales forecast revision ratio improved to 0.47 from 0.34 last month.

The articles and opinions in "Capital Market Musings and Commentary" are for general information only, and not intended to provide specific investment advice. Performance, dividends and other figures have been obtained from sources believed reliable but have not been audited and cannot be guaranteed. Past performance does not ensure future results. Investing inherently contains risk including loss of principle. Corey Casilio is a founding partner of Casilio Leitch Investments, a legal business entity. Advisory services offered through Casilio Leitch Investments, a CA State registered investment advisor.

Moreover, during the first two months of the fourth quarter, analysts have lowered earnings estimates for companies in the S&P 500 for Q4 by 3.4% (to $29.61 from $30.65). Now to be fair this is a typical Wall St. ritual as this rate of decline is consistent with the historical averages, but it hasn't helped the above average valuation levels at all. So far in Q4 the S&P 500 has increased by about 8.5% while earnings estimates have declined – not the recipe you're looking for as a fundamental investor.

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.

The articles and opinions in "Capital Market Musings and Commentary" are for general information only, and not intended to provide specific investment advice. Performance, dividends and other figures have been obtained from sources believed reliable but have not been audited and cannot be guaranteed. Past performance does not ensure future results. Investing inherently contains risk including loss of principle. Corey Casilio is a founding partner of Casilio Leitch Investments, a legal business entity. Advisory services offered through Casilio Leitch Investments, a CA State registered investment advisor.