September 14th, 2015

Investor indecision is becoming contagious…

Stocks may have turned in their best week since July, but truth be told what investors have on their hands is a directionless market that is not trading well at all. The "buy the dip" psychology that has been so profitable for investors throughout this bull market cycle is in retreat and, at least in the interim, has shifted to a "sell the rip" psychology. The evidence that this sea change in activity is afoot can be witnessed in the daily rallies that continue to lack natural buyers with any real conviction, and are more symptomatic of investors taking profits by covering their short positions as they retool to take advantage of the next phase of weakness.

The extent of indecision among investors is perhaps most aptly summarized by the fact that the S&P 500 has oscillated between gains and losses for 10 consecutive weeks. Yep, in case that didn't register, this is how that sequence looks: up (2.07%), down (-3.40%), up (0.91%), down (-5.77%), up (0.67%), down (-1.25%), up (1.16%), down (-2.21%), up (2.41%), and down (-0.01%).

The lack of conviction on the part of investors couldn't be any clearer based on the latest Investors Intelligence poll where the percentage of investors in the "bull" camp fell to 25.7% from 27.8% while the "bear" camp increased to 27.9% versus 26.8%, and those expecting a "correction" expanded to 46.4% from 45.4%. This represents the first time since October 2011 (the last time the S&P 500 experienced a correction, and came within a whisker of a bear market) that we have more bears than bulls in this survey. Those investors with a contrarian impulse are sure to take some comfort given that back in 2011 the S&P 500 went on to rip into year end with a 20% rally once these sentiment levels were hit.

Not sure that I believe we are in store for a repeat performance this time around, but it does appear as though a lot of bad news is priced in at this juncture and much of the speculative froth that was in the market is in the process of being worked off. The latest Investors Intelligence survey is not the only "contrarian signpost" suggesting we may be in for a short-term reprieve from the selling:

- The CBOE put/call ratio went into cardiac arrest during this latest correction surging to 1.69 at one point, which was higher than any print we saw during the '08 -'09 credit crisis.
- The share of bulls in the latest AAII individual investor poll shrunk to 21% – a level last seen at the lows in 2008.
- The net speculative short position in futures & options on the CME increased almost nine-fold from 2,716 S&P 500 contracts to 23,932 contracts as of September 2nd.
- In the most recent Conference Board consumer confidence survey, only 31% of respondents believe stock prices are headed higher – this is at the very low end of the range for this metric over the last three years.

The irony in this equity market correction is that it is coming at a time when the U.S. economic data is taking a turn for the better. All of the following data points have recently come in above expectations: autos, retail sales, bank lending, mortgage approvals, housing, durable goods, aggregate hours worked, and hiring plans. However, the question that's been top of mind for me since the beginning of this year is whether or not we are at the peak level of output growth for this expansion. Given many of these metrics are late-cycle or lagging indicators it would make sense for them to be peaking after the business cycle has already begun (ever so slightly I might add) to turn down. Perhaps others are coming around to this viewpoint at this time as well – given the rate of change in this economic expansion is decelerating.

One example of this disconnect in the economic transmission function is last week's JOLTS data (Job Openings & Labor Turnover Survey) where U.S. job openings soared 430k in July – this was the third increase in the last four months – and rose to an all-time high of 5.75 million. The increase was broad based, covering industries from leisure & hospitality (69k) to professional & business services (122k) and even manufacturing (32k). The problem is that the openings are not translating into new hires as the number of new hires declined by 199k to mark the sharpest drop since the turn of the year.

It is a bit perplexing to see a month where job openings spiked higher and yet the number of new hires literally collapsed – the demand for labor is there, yet the supply is another story. The conundrum appears to stem from a skills mismatch, whereby there are eight million unemployed people looking for work and another six million who are technically out of the labor market but would take a job if offered one. How this pool of 14 million potential employees can't fill some of the 5.75 million current job openings is surely a head scratcher for the top brass at the Fed.

The current whims of the capital markets are being driven by policy concerns and a rolling series of troubles in overseas markets. Early in the year it was Greece and Europe and at present it is the cascading slowdown in China and what effects this will have on other Asian economies. Forgive me, but I'm just not there yet in terms of the 'China bringing down the rest of the world' thesis. Yes, it is the second largest economy in the world and vitally significant for world GDP growth, but the number-crunching shows that for every percentage point shortfall in Chinese growth there is a 20 basis point hit to global GDP – not overly concerning when put into that perspective. As for the U.S., this magnitude of slowdown would exert an approximate 0.2% drag on growth – once again not all that material, even in a slow growth economy.

Here is some additional perspective as it relates to the impacts from the rest of the world on U.S. output:

- GDP for the U.S. as of the end of the second quarter totaled $17.9 trillion. U.S. exports of goods and services totals $2.25 trillion – no small chunk, but almost 8 times smaller than total GDP.
- National account profits derived from the U.S. tally some $1.67 trillion whereby approximately $390 billion in profits come from abroad – a ratio of almost 4:1.

I readily concede that we live in an interconnected globalized world today where capital markets are no longer bound by geographic property lines, but it will be important for investors going forward to differentiate between economic impacts that transcend borders and can materially upset the global economic climate and mere noise that jostles short-term volatility but lacks any long-standing impact.

This isn't to suggest that some of the concerns emanating from around the world should be easily dismissed as some of them could potentially fester into problems that cripple this global expansion. Couple this with the sprawling monetary policy experiment of excessive central bank liquidity used as a panacea to stimulate sluggish economic growth and unrelenting deflationary pressure and you have an expanding probability set of potential negative outcomes. This is why investors should continue to maintain discipline and prudence in how their capital is allocated at the current time.

This remains one of the longest economic expansions in history and even if we've seen the highs in the stock market for this bull market cycle this will still go down as the fourth strongest and longest in history. The S&P 500 is a little over 8.0% off its all-time highs and is down a little over 5.0% for the year, with perhaps the most significant variable driving this pricing adjustment being the onset of a Fed rate hiking cycle. Since QE was first introduced in November 2008 and then expanded in March of 2009 the equity market has become addicted to central bank liquidity. But we are at a juncture where the Fed would like to transition the economy from a high liquidity / low growth profile to one that is more balanced – preferably a low liquidity / high growth environment, but this is an unrealistic utopian state at the current time. That being said, the stock market is rebelling like a teenage child that isn't getting their way.

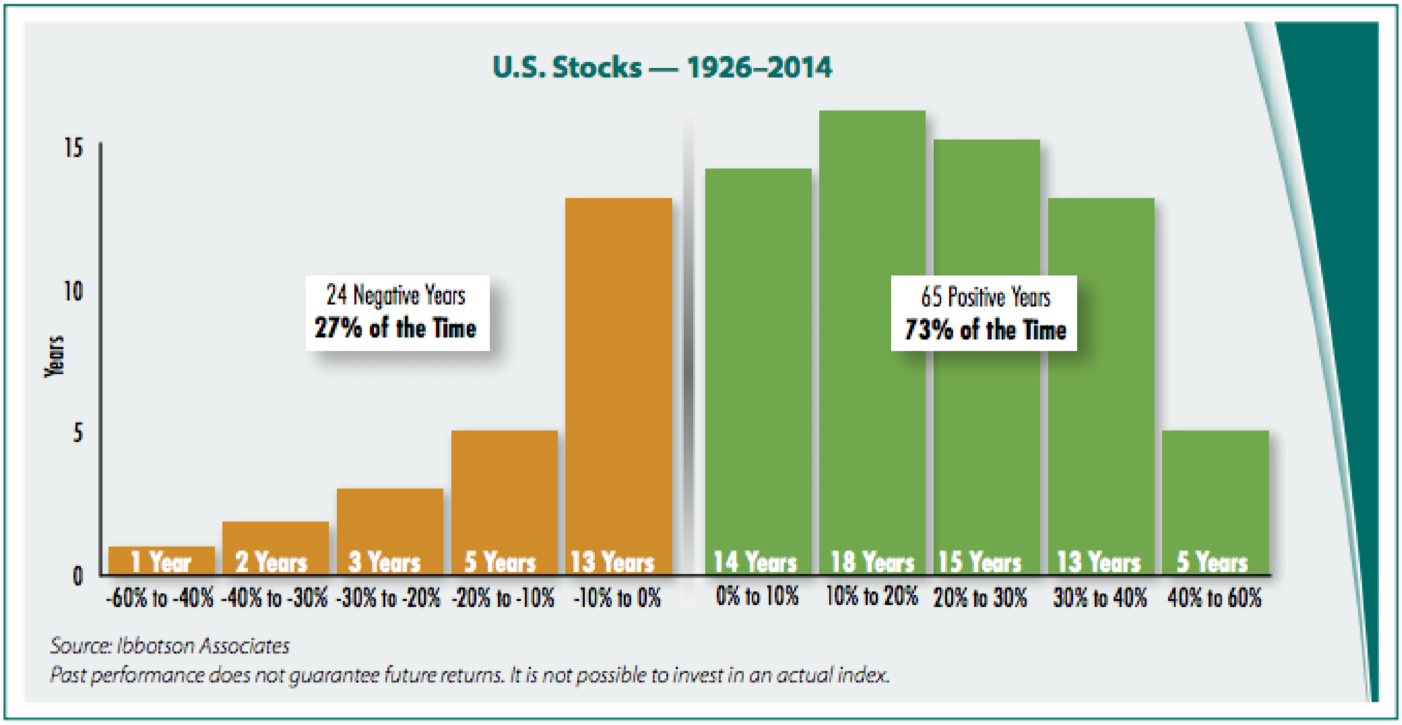
The FOMC will conclude its two day meeting on Thursday with investors decisively mixed on whether they will raise rates or not. While this is an event we will be paying attention to I don't have much to offer on what they may ultimately do – I can see the arguments for hiking or not at this meeting. What I prefer to analyze from this event is not the timing of the hike (as I believe it is inevitable and any meeting for the remainder of the year is a possibility), but how markets have reacted in the past to the Fed's first rate hike after an easing cycle. Looking at the last three hiking cycles can provide some perspective for what may lie ahead (they are never the exact same, but they do provide a roadmap for what to expect):

- In February 1994 the Fed hiked rates for the first time in five years with the S&P 500 trading at 469. By April the S&P 500 traded down to its low of 438 – an almost 7% decline within two months of the initial volley.
- In March 1997 the Fed hiked rates for the first time after two years of easing, with the S&P 500 trading at 789. Within two weeks of the initial volley the S&P 500 traded down almost 7% and marked a low at 737 before going on to make new highs later that year.
- June 30th, 2004 was the last time the Fed set off on an interest rate hiking cycle. The S&P 500 traded around 1,140 that day and went on to experience a mild correction of 5% as it declined to 1,084 by late July.

Whether an investor can use this as guide to perfectly time this Fed hiking cycle is yet to be determined, and my feeling has long been that it is extremely difficult to accurately time the market consistently. But it does indicate that a swoon is typical around the initial Fed hiking volley, so keeping some powder dry and having the courage to take advantage of a sell-off if/when it were to happen could be a profitable strategy.

On a bigger picture perspective for investors, my view is that both the debt and equity markets remain fairly valued. The recent correction in stocks has made valuations more reasonable, but they are not cheap. Earnings growth continues to be elusive and reasonable forecasts peg the S&P 500 earning roughly $122/share in 2016. At this earnings level the S&P is trading at roughly 16x forward earnings – two points above its historical average of 14x – with earnings growth in the mid-single digits. Yes, interest rates are low and that should justify paying a higher multiple for stocks, but in a low growth world with an elevated number of "known unknowns" a higher multiple may not be warranted.

My view remains consistent with where it's been since February of this year and that is that investors should be favoring a more balanced, defensive, and risk averse approach to their portfolios (see: **More often than not, the hardest thing to do is the right thing to do…** and **When did Noah build the ark?**). This by no means implies that investors should abandon equities altogether as the chart below from the Virginia Retirement System clearly demonstrates why investors should own stocks for their long-term financial needs and objectives.



This chart summarizes the 89 years of returns in U.S. stocks from 1926-2014 where stocks generated a positive return in 65 years (73% of the time) compared to experiencing a loss in 24 of those years (27% of the time). What is interesting is that the average return in the positive years was 21.47%, while the average loss during negative years has been 14.29%.

The thing about this summary data is that you never know when those big up or down years are coming. For example, it's believed that earnings and earnings growth are the most important metrics for stock ownership, given that when you own shares in a company you are part owner of the franchise and therefore a part owner of the earnings stream generated by that company. The S&P 500 is nothing more than a collection of publicly traded companies that experienced gains of 16%, 32%, and 13% in 2012, 2013, and 2014, respectively. However, earnings growth during these years for the S&P 500 was 0%, 11%, and 5%, respectively.

As you can see, the equity market doesn't always follow in lock-step with academic theory. The key to long-term investing success is "time in the market", not "timing the market".

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.
