November 2nd, 2015

Quite a rally – what has changed? Not a whole lot…

After posting their worst quarter in four years, equity markets surged in October en route to their best month since 2011 (prior to that was March of 2000 – which also followed a serious corrective phase in the market, and marked the top of the tech bubble) as both the Dow Jones Industrial Average and the S&P 500 gained more than 8.0% for the month of October while the higher beta Nasdaq rose more than 9.0%. According to estimates from Wilshire Associates, U.S. stock investors saw their paper wealth expand by some $1.8

trillion on the month with investors flocking into U.S. equities via $10billion in ETF purchases on the month, far surpassing the $6billion in purchases for the year through September.

October's strong month extended overseas as well with the MSCI All Cap World Index (ex. U.S.) gaining almost 7%, China up 8%, South Korea +11%, Emerging Markets +6.5%, Europe rallying 7.3%, and Japan jumping more than 8%. The face ripping rally over the last thirty days has moved most major equity averages in the U.S. back near the flat-line on the year which corresponds well with the mixed economic and corporate profit picture that has transpired throughout 2015.

As strong as October's rally was, there remains some holes in the staying power of this advance with breadth and volume yet to confirm the move. At Friday's close of 2079.36 the S&P 500 is close to the mid-August highs and marginally below the May all-time high of 2134, however less than half the stocks (48%) in the S&P 500 have moved above their respective 200-day moving averages. This is not a particularly auspicious technical trend-line for the long-term health of the market's rebound. Looking at the ten sectors that make up the S&P 500 provides some validation of the lack of breadth underlying this rally with only two sectors – information technology and consumer staples – having more than 50% of the stocks in those respective sectors trading above their mid-August highs.

The lack of verve underpinning this rally is also visible when viewed through the prism of market-cap size with the S&P 100 index (the 100 largest companies in the S&P 500) appreciating 13% since the lows on August 25th, versus a 5% advance in the small cap Russell 2000 index. Moreover, in the rally that followed the last 10% correction in the S&P 500 back in 2011, the percentage of stocks above their 50-day moving average quickly shot through 90% compared to the 79% of S&P 500 constituents that are above this level as of the end of last week. Mind you, a lot of the heavy lifting has been done in the major averages to restore the damage that was done in the August-September correction, but for momentum to carry the whole market forward and take out the May highs, the average needs to move decisively above 90%.

Listen, my intent isn't to pour cold water over what has been a significant rally that has pushed the major averages back to within spitting distance of their all-time highs, but there is very little I can point to that has occurred over the last six weeks that vindicates a fundamental improvement has transpired to justify such a move in stock prices. Let's rundown a checklist of the positives and negatives being bandied about out there and you be the judge of which narrative you feel best about putting money behind.

The positives:

- The macro and market conditions in the Emerging Market space have stabilized with China's willingness to flex its monetary muscle to stem the tide in its languishing economic growth, which has been viewed by the markets as an indication that the worst may well be behind it in this regard. Furthermore, Chinese leaders announced following its Fifth Plenum that they would end their one-child policy for all families. In order to spur growth two children will now be permitted and their stated GDP growth target for 2016-2020 is 6.53% (only the Chinese can make forecasts out to the second decimal place and have confidence that it will come to fruition – sarcasm intended).

- The commodity markets appear to have found stability with the price of WTI crude oil holding the mid-$40/barrel price and Brent hanging in just shy of $50/barrel, which is significant given the expectation that Iran and Iraq are set to add to the supply glut to the tune of 500-600k barrels a day through the first six months of 2016. Expectations are for demand to grow by 1.7million barrels a day in 2016, compared to 1.9million barrels a day this year with U.S. production having declined by 500k barrels per day since June and OPEC production expected to decline by several hundred thousand barrels a day in 2016. All this speaks to a new equilibrium price level being reached – my guess is somewhere ultimately in the $45-$65/ barrel range – in the not too distant future which will provide some much needed clarity to major oil companies around the world to plan future capital budgeting and investing decisions.

- The Senate passed legislation (64-35) on Friday that boosts spending levels and lifts the debt ceiling for two years. So, fiscal policy (which has been a decisive drag on economic growth for the last several years) will actually become an incremental positive contributor – according to some economists' estimates this plan is expected to add 0.2-0.3% to GDP growth.
- Credit market spreads have compressed over the last couple of weeks and in particular in the High Yield space, with

spreads collapsing over 90 basis points to below 600 basis points – the tightest they have been since mid-September. However, the U.S. High Yield distress ratio – which is a good leading indicator for defaults and the overall profits cycle – has risen to its highest level since the double-dip recession scare back in 2011.

- Initial jobless claims (a leading indicator of economic activity) saw its four-week moving average dip again last week to a new cycle low of 259,250 and the lowest level on record since 1973. Clearly employers continue the trend of hoarding workers as layoffs have been few and far between. We'll see how this relates to the monthly jobs data set to be reported on Friday with expectations for the economy to add 185k new jobs.

Neutral:

- The headline number of 1.5% growth in the Q3 GDP report following Q2 growth of 3.9% would suggest that this metric should belong in the negative list, but that would be an injustice to how constructive the internals of the report were (hence, it falling in the neutral camp). The headline number would have come in close to 3.0% if not for the huge decline in inventories which, coupled with exports, subtracted 1.5% from growth in the quarter. The most constructive element of the report was private domestic spending checking in at a 3.2% annual rate with personal consumption expenditures acting as the main source of strength. As has been the case, the consumer story remains healthy and unlike the industrial side of the economy has shown very little sign of rolling over.

- When the Fed ultimately decides to initiate its rate normalization cycle remains one of the biggest clouds hovering over the market's head. Last week's Fed decision perhaps offered a subtle hint of clarity as they acknowledged that the U.S. data has lost some steam, but they offset this dovishness by removing the concerns over "recent global and financial developments" from abroad and the risks they posed to economic activity. The markets took notice by increasing the odds from 1 in 3 that the Fed may hike in December to a 50% probability. I maintain the view that a 25basis point hike in the fed funds rate will do little to impact economic growth, however I am less sanguine about how this will ripple through the capital markets which have revolted at each attempt by the Fed to transition from a backdrop of high liquidity / low growth to one of lower liquidity / higher growth.

The Negatives:

- This economic cycle is aging and mature on many accounts: 1) we are now entering month 78 of this expansion which far eclipses the median 59 months of the average expansion going back to 1930, 2) the manufacturing sector has been in decline since August of 2014 and is on the cusp of moving into contractionary territory with the latest ISM Manufacturing Index reading of 50.1, 3) monthly employment growth, while still positive, peaked in November of 2014 and the rate of growth has decelerated throughout 2015, 4) Consumer confidence peaked in February of this year and has been unable to move back to new highs, and 5) the corporate profits cycle looks to have peaked in Q1 2015.

- Corporate profits continue to underwhelm with 341 of S&P 500 companies having reported as of the end of last week. Yes, over 2/3rds of companies have beaten lowered EPS estimates but overall EPS growth looks like it will contract for a second consecutive quarter. What's more troubling is the deterioration in sales growth as it is tracking worse than the decline in EPS (see table below).

SECTOR	SALES GROWTH (% CHG)	EARNINGS GROWTH (% CHG)	#REPORTED
S&P 500 (Aggregate)	-5.5%	-3.9%	341 / 500
Energy	-34.7%	-53.5%	25 / 40
Materials	-16.9%	-20.1%	20 / 28
Industrials	-5.5%	0.7%	57 / 66
Consumer Discretionary	4.1%	16.7%	47 / 84
Consumer Staples	2.1%	0.2%	20 / 37
Healthcare	7.6%	11.5%	37 / 55
Financials	-1.3%	-4.6%	73 / 88
Information Technology	1.1%	2.3%	44 / 68
Telecom	12.3%	24.8%	3 / 5
Utilities	-1.9%	-1.6%	15 / 29

Source: BBG

Granted there are pockets of opportunities in select sectors (consumer discretionary, technology, and healthcare) which has filtered down to the performance of these sectors year-to-date, (12.22%, 5.56%, and 4.32% respectively) which has made this a year for stock-pickers as index investors have been plagued by the poor results from the energy (-14%), materials (-6.8%), and industrial (-4.08%) sectors dragging down the major averages. With earnings being the key driver to stock market returns it will be imperative for this trend to reverse in the next couple of quarters for this bull market to continue. However, this will not be an easy feat with the rate of change in economic growth decelerating, sales growth languishing, and cost pressures via labor markets beginning to crimp record profit margins.

- With the October rally in stocks, valuations have moved back up above historical averages on virtually every metric as well as approaching peak levels for this cycle.

What all of this means for the future path of debt and equity markets is unknown: is this a mid-cycle slowdown and a pause the refreshes, where the 33 year bull market in bonds finally ends and a secular bull market in equities that started in March of 2009 continues? Or, will the deterioration we are seeing in the industrial economy, the weak corporate profit backdrop, and years of unprecedented monetary policy experimenting lead us into the next recession?

I’ve listened to and read enough earnings conference calls and capital market presentations over the last two quarters to conclude that today’s backdrop is highly conflicting and extremely complex. As good as this recent rally in stocks feels I’m reticent to uncork the champagne bottle and declare the ‘all clear’ as I must admit that my skepticism remains elevated as other than a material shift in investor psychology, a performance chase into year-end by investors and money managers, and China avoiding a hard landing, not a lot has fundamentally changed.

At this point investors find themselves in an interesting position, as here we are back near the all-time highs reached in late May and they have to ask themselves if the outlook for the future has improved or worsened since then. In my opinion, we’ve dodged some bullets throughout 2015, but I can't say that I see a future that is any brighter than it was at the May highs. If anything, on net, I see a future that is a little more uncertain with the rolling over of some material economic data.

Don't get me wrong, I'm not calling a market top nor the end of this economic cycle, but I encourage investors to take this opportunity with this rally in stocks to reevaluate how their portfolio is positioned. You must be objective in investing and your analysis while not allowing your emotions or biases to cloud your decision making, and there remains ample evidence that caution should continue to be exhibited at this juncture.

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.
