December 21st, 2015

First rate hike in almost ten years, now what?...

Entering 2015, consensus expectations were that the first Fed rate hike since June 2006 would commence in March. That forecast was upended by an unexpected slowing in Q1 GDP (initially reported as a modest increase of 0.2%, later revised to a decline of 0.7% before the final estimate settled in at a decline of 0.2%) which caused the Fed to delay the initial volley in normalizing interest rates. Leading up to each subsequent FOMC meeting, market prognosticators – in conjunction with the Fed's dot plot –

overestimated the strength of the U.S. economic expansion by penciling in expectations that June… no August… definitely September… maybe October… would be when the Fed hiked rates for the first time in almost ten years.

As the year progressed there always seemed to be an exogenous event that provided the Fed with cover to push out hiking: in the Spring it was the threat of Greece exiting the Eurozone, in mid-May renewed carnage in the commodity markets emerged – namely in energy – which further dampened inflationary forces, then in the Fall the persistent sluggish growth in China (the world's second largest economy) boiled over and was punctuated by a surprise one-time devaluation of the Yuan, and finally as Fall was nearing an end the mounting signs of an industrial recession in the U.S. became a reality as the ISM manufacturing index dipped below 50...

All of these events as they were playing out in real time seemed monumental and worthy of concern, with volatility in the capital markets elevating considerably as these events reached their crescendo. However, in time, many of these events were resolved – some with Band-Aid solutions, some were punted until a later date, and some just became old news as attention shifted to the next big story.

Last week, at the FOMC's final meeting of 2015 Chair Yellen and the other brass heading up the Fed decided now was the right time to hike rates for the first time since June 2006 – ending the zero-interest-rate-policy that started seven years to the day of their hike on Wednesday. The decision offered few surprises to investors as it was viewed as a “dovish hike” with both the statement and Chair Yellen’s comments at the press conference underscoring a gradual pace of hikes ahead. The one item the construed a subtly different message was the Fed’s ‘dot plot’ which indicates that the Fed expects to hike by 100bps next year, which is much slower than history, but a divisive contrast to market expectations with the fed funds futures market pricing in only two hikes next year.

In my opinion, Chair Yellen went into this meeting with a losing hand and had to walk a very fine line between acknowledging the improvement that’s been made at meeting the labor side of the Fed’s dual mandate while eschewing confidence that inflation will progress towards their 2% objective over the medium term. On this front she did just that, stating “the Committee judges that there has been **considerable improvement** in the labor market this year, and it is **reasonably confident** that inflation will rise to its 2% objective" (emphasis mine). Furthermore, Chair Yellen went on to provide context for this initial rate hike and what will guide additional steps in the future:

> "I think it's important not to overblow the significance of this first move. It's only 25 basis points. If monetary policy remains accommodative, we've indicated that we will be watching what happens very carefully in the economy in terms of our actual, and forecast, our projected conditions relative to our employment and inflation goals."

Undoubtedly, a 25bps hike with unemployment down to 5% from its peak of 10% and inflation showing signs of bottoming – perhaps sometime in Q1 of 2016 as year-over-year comps in commodity prices begin to lap pernicious declines – should come as a surprise to no one. The current economic backdrop does not justify zero-interest-rate-policy, and one of the main reasons the Fed has held rates this low for this long was because we were coming out of a significant credit induced recessionary period that required time to allow for the necessary deleveraging to run its course.

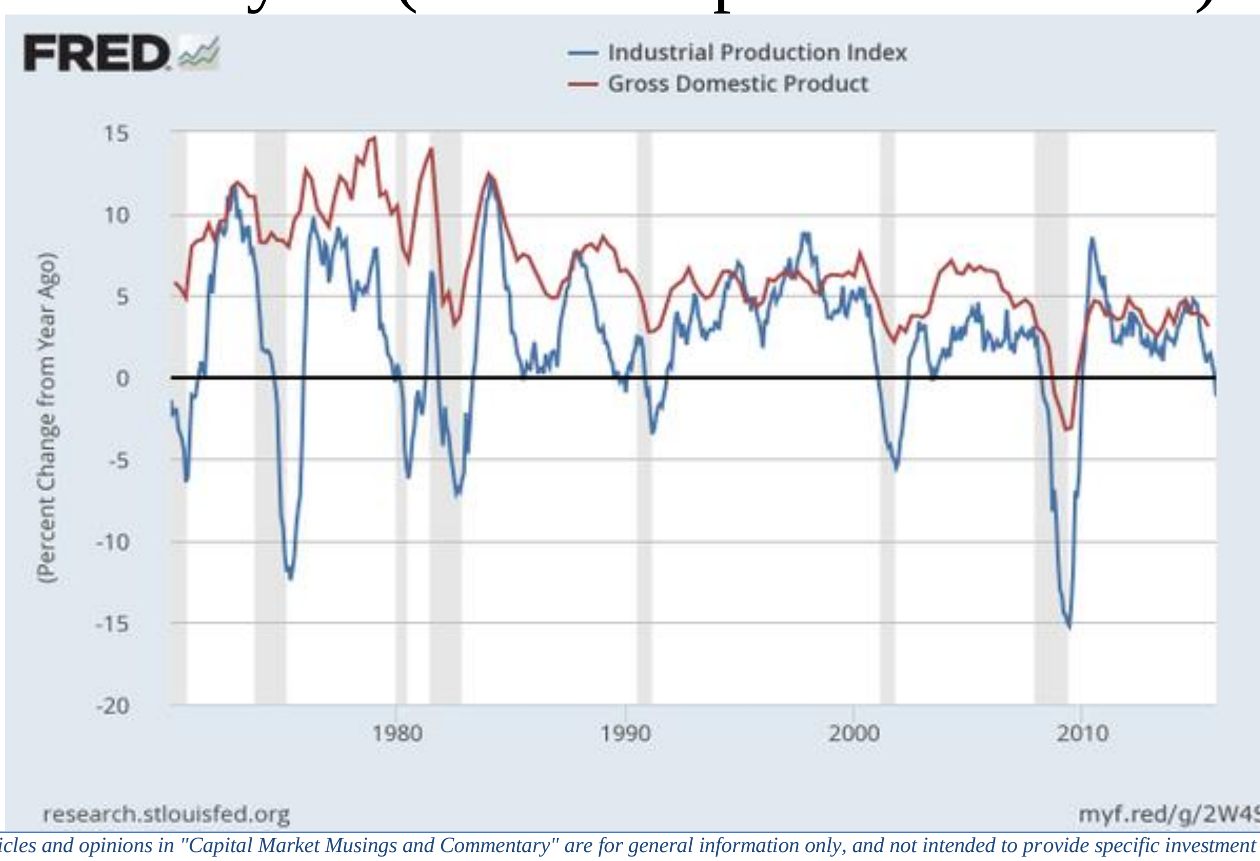
Unfortunately, time is one variable that does not stand still, and time, in my opinion, represents one of the most significant variables working against the Fed going forward. While I readily admit that I'm not even in the same stratosphere as Chair Yellen when it comes to economic acumen, I do disagree with her comment relating to the time variable in the business cycle, to wit:

> "I think it's a myth that expansions die of old age. I do not think that they die of old age. So, the fact that this has been quite a long expansion doesn't lead me to believe that it's one that has – its days are numbered."

Time is a variable in virtually every financial model ever created – if time wasn't material and relevant then what scale would virtually every measurement metric be referenced to? Take GDP for example, it quantifies the output of the U.S. economy and measures the growth of output 'over time', so that the Fed, the government, citizens, investors… can gauge its progress relative to the past as well as relative to other economies. Earnings is another example: whether measured for workers or corporations, earnings are a gauge of the income that can be used for consumption and investment both today and in the future (today and in the future are both references to time). I can go on, but I think you get the picture.

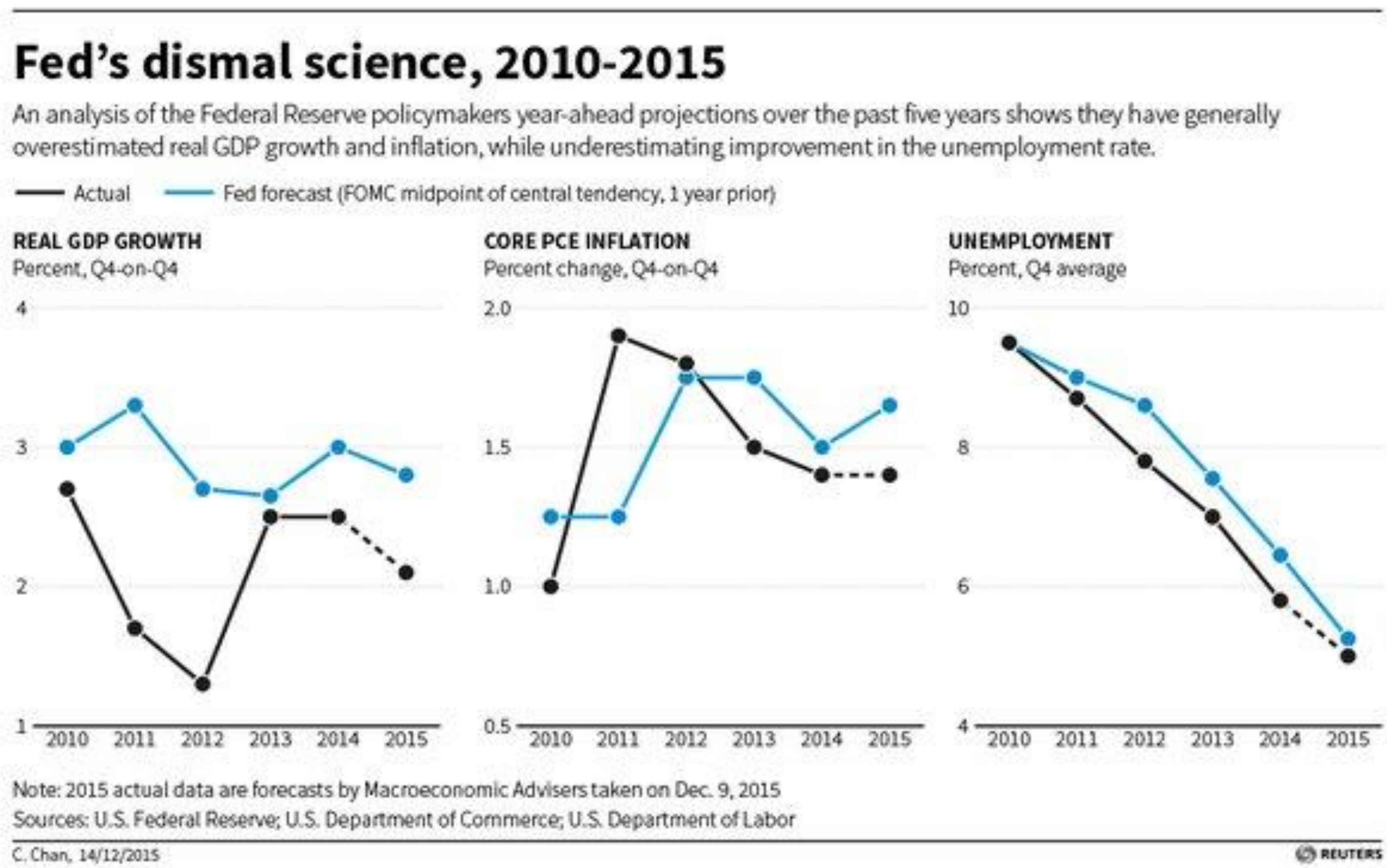
My point however, is that expansions and contractions – a.k.a. the business cycle – are a function of time. If they weren't, then we wouldn't have a business cycle and we wouldn't have to worry about remedial facts, like the fact that the average length of an economic expansion over the last century is 59 months. We could be readily dismissive of the fact that we are now in month 80 of this expansion and ignore the warning signs, such as: the profit cycle peaking in Q2 of this year, the rate of change in employment growth peaking in Q1 of this year, M&A activity (both on a deal count and deal value basis) eclipsing the peaks at the top of the 2007 business cycle, credit growth surpassing profit growth over the last 18 months (a notorious late cycle indicator), and indications that the service sector is softening with the latest Markit Flash Services PMI declining to 53.7 for December (its lowest level in 12 months) from 56.1.

Furthermore, take a look at the below chart which plots the very close relationship between Industrial Production (IP) and GDP growth, where just last week we received the latest IP results showing a contraction of 1.2% year-over-year (the worst print since 2009).



My advice to investors is to respect, appreciate, and always pay attention to the Fed, as they are a very significant variable in any analysis relating to capital markets and investing, but don't take everything they say as gospel. The Fed has never forecasted an economic recession, yet the U.S. economy has experienced 18 recessions since the Fed was created in 1913 and 11 recessions in the post WWII era. Part of the Fed's role beyond its dual mandate is to be a voice of confidence, to try and perpetuate expansionary cycles and provide social stability through monetary policy when the economy does turn down. But, by no means are they able to stop economic gravity from playing out. Bend it for a little while, yes, but eliminate it, no way.

The following chart from Reuters details the inaccuracy of the Fed's forecast just over the last four years. Please, don't interpret my comments as a lack of respect for the difficult responsibility these individuals bear, but as a steward of other people's capital it is a variable that must be heavily scrutinized, just like many others. As these forecasts, if they continue to prove to be off the mark, pose one of the most significant risks to investors.



The Fed hiking rates by 25bps for the first time in nine years is of very little concern to me, but what is of concern to me is the Fed starting a rate hiking cycle this late into a business cycle. And, this is what I think the market has been sniffing out for months now and why we saw the action we did last week in the two days following the Fed's decision. The 10-year Treasury bond rallied on the week with the yield dropping from 2.28% to 2.19%, while the yield on the 30-year Treasury bond declined 11bps from 3.01% to 2.90%. This is an indication that the bond market is concerned about long-term economic growth which is what drives long-term bond yields.

The initial reaction in stocks after hearing the Fed decision was to rally, pushing the S&P 500 to a high of 2075 Wednesday afternoon. However, investors fell subject to buyer's remorse on Thursday and Friday with the S&P and Dow giving back 70 and 670 points respectively over the last two trading days of the week. Oil prices continued their downward spiral closing below $35 per barrel. Interestingly, the latest rig count data from Baker Hughes showed oil rigs increased by 17 last week to 541 – the first jump in five weeks. The 541 rigs still represents a considerable decline from the October 2014 high of 1,609 when oil prices were near $95/barrel.

The Energy sector was by far the worst performing sector last week declining 2.75% with Utilities registering the best gains, up 1.72%. For the month of December the S&P 500 is down 3.6% with all sectors in the red, but the defensive sectors of Consumer Staples, Utilities, and Healthcare faring the best by considerable margins, down 0.16%, 0.72%, 0.87%, respectively.

As for the broader stock market, the S&P 500 ended the week at 2005, smack dab in the middle of its calendar year high of 2134 (reached in May) and its calendar year low of 1862 (reached in August). The S&P 500 remains only 6% below its all-time high, but looking below the surface indicates that the pain in the overall stock market is much worse than what is depicted by the absolute index level, as approximately 45% of the S&P 500 constituents are down more than 20% from their highs.

What's more, the internals of the stock market and other ancillary metrics we follow continue to suggest to me that we are in a topping process:

- Junk bonds peaked in June 2014
- MSCI EAFE index peaked in July 2014
- MSCI Emerging Markets peaked in September 2014

- Dow Jones Transports peaked in December 2014
- German DAX peaked in April 2015
- NYSE All Issues Daily A/D Line peaked in April 2015
- Dow Jones Industrial Average, S&P 500, and NYSE Composite Index peaked in May 2015
- Shanghai Composite, Russell 2000, and S&P MidCap 400 peaked in June 2015
- Japan's Nikkei 225 peaked in June 2015
- NASDAQ Composite peaked in July 2015

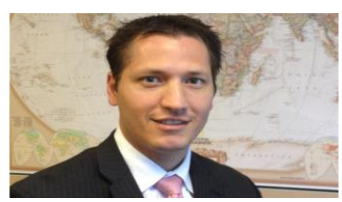
None of these items are indications that this market is healthy or on the forefront of taking off to the upside. This is the reality of today, where the path of least resistance for risk assets is no longer higher. Trust me, I very much want to be constructive and optimistic on this economy and the stock market (bull markets are much more fun than bear markets), but with my interpretation of the tea leaves I continue to believe it is more prudent for investors to execute caution and skepticism at this time.

When the facts change, I reserve the right to change my mind and I will be sure to make that known in these weekly musings.

In closing, I'd like to wish all the readers a very Merry Christmas and Happy Holiday Season. I will not be penning a commentary next week, as I will be traveling over the holiday, so I will take this opportunity to wish you a Happy New Year as well.

Corey Casilio
Partner, Portfolio Manager

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



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