April 20th, 2015

Mind the noise, rely on the plan…

Equity markets ended last week on a sour note with a Friday sell-off that drove stocks down 1.13% as traders fled to safe-haven U.S. Treasuries, driving the yield on the 30-year down 6 basis points. Investors interested in a possible explanation for the sudden spike in volatility can point to a re-emergence of default risk in Greece on the back of delays in reaching an agreement on a path forward with creditors. While this Greek drama (which has now spanned more than three years) is running on borrowed time, it likely still has a couple acts left before finally coming to a conclusion.

Investors are anticipating that an agreement will not be reached between Greece and the official creditors at the next Eurogroup meeting on April 24th. However, an agreement is urgently needed as without new loans Greece will likely be unable to make required payments to the IMF in May and ultimately (after the grace period) an official default in June. A potential Grexit (Greece exiting the Eurozone) is a real possibility and if such an event becomes a reality it will undoubtedly create a stir across the capital market landscape. But I believe any panic will be short-lived as virtually all of Greece's debt obligations have been moved from bank balance sheets to the European Commission, ECB, and IMF – so a systemic financial event should not be of concern.

Also adding fuel to the sell-off on Friday was a move by China's securities regulators to tighten margin lending as they look to curb some of the euphoria that has gripped its equity market, which has doubled over the last 12 months and is up 70% to start the year. Then, over the weekend, in yet another act of central bank action which has dominated the globe since the ’08 financial crisis, China’s central bank cut the reserve requirement ratio for all banks by 100 basis points to 18.5% in an effort to combat slowing growth. Moderating economic growth is not the only concern for the world’s second largest economy as Chinese house prices declined in 69 of 70 cities in March compared to a year ago – the 6.1% year-over-year decline is the biggest drop in the history of Chinese house price data.

Don’t look now, but oil has staged a huge rally over the last month, up more than 30% from the $42.25 level it reached on March 18th (WTI ended last week just under $56 per barrel). So much focus has been placed on the supply backdrop with the rig count having now declined by 50% (according to the latest Baker Hughes rig count data) and news last week that Saud Arabia produced 10.3 million barrels per day in March (its highest level of production in three decades), but what perhaps has been overlooked is that the demand backdrop is continuing to grow. Consumers are back to their gas-guzzling ways with SUV's and truck sales reaching their highest levels in over a decade and the IEA is predicting global oil demand will jump from 92.66 million barrels per day in the second quarter to 94.67 million barrels per day in the fourth quarter.

Since 2008, the consensus view on the price of crude has been increasingly framed by OPEC's apparent defense of oil trading at $100 per barrel, but with recent events undermining the belief that the OPEC cartel can uniformly dictate the price of crude and the explosion in

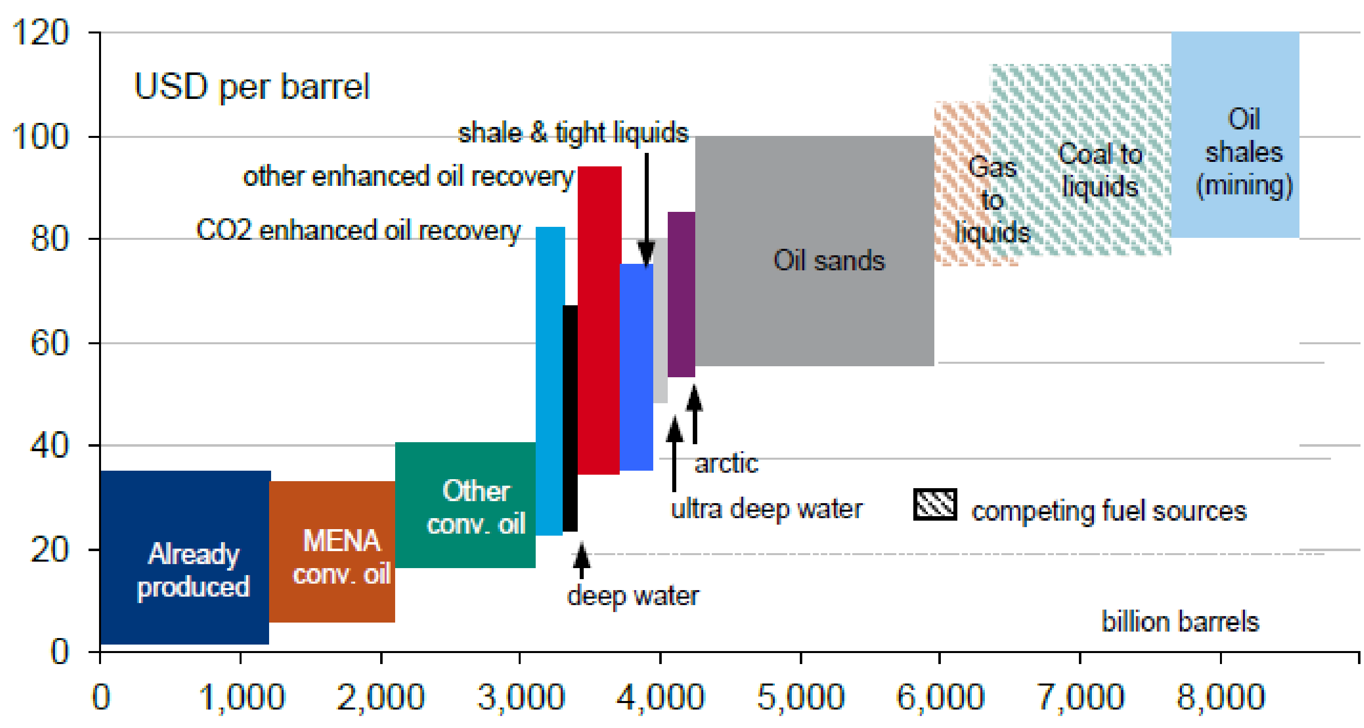
U.S. shale production, capital markets are being forced to rethink the long term price outlook for the commodity. Ultimately supply/demand dynamics and the marginal cost of production will dictate where the long-term fundamental price of crude goes.

Breaking down the supply front requires separating OPEC production from Non-OPEC production and it is the latter that is easier to assess – given it is more highly scrutinized and dependent on the merits of financial profit and loss. Said another way, most Non-OPEC production is at the hands of for-profit companies (most of them large publicly traded companies) which have to answer to shareholders and/or creditors for their success and/or failures – with bankruptcy being the ultimate downside from an unsuccessful endeavor.

The roughly 57 million barrels per day of Non-OPEC production is where investors should anticipate the biggest changes to take shape as this new price level for crude is eventually established. Some trends are already beginning to take hold and fall within the conceptual framework of what financial theory would suggest, where entities that possess available free cash take advantage of the short-term market displacement by strengthening their position within the marketplace as they take market share from those running cash deficits. Companies have focused on shelving high cost capital intensive projects that are no longer feasible at current price levels in favor of short-cycle lower cost production to maintain returns.

This form of production can only continue for so long before causing a possible adverse shock in the opposite direction as a result of a sustained period of underinvestment, which causes supply to fall materially below demand. The reality is that producing oil is an expensive, capital intensive business that requires substantial capital outlays and this is where the rubber meets the road. The below chart from BofA Merrill Lynch Global Commodity Research summarizes the incremental cost of supply which shows that the marginal cost for production is on the rise.

Chart 1: Incremental cost of supply



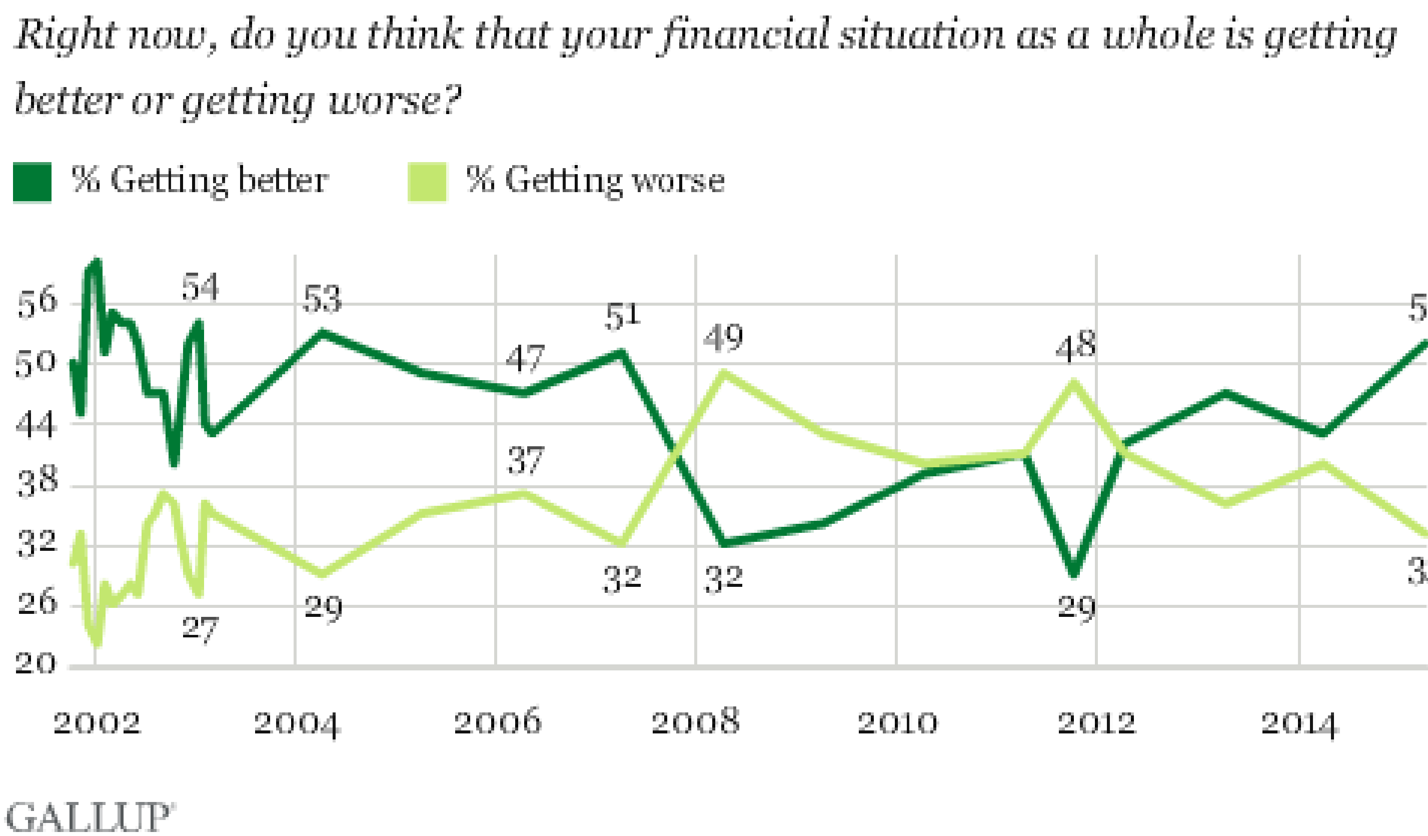
Source: BofA Merrill Lynch Global Commodity Research

What I'm getting at here is that it looks as if the lows have been put in for the price of oil and a recovery is underway. Ultimately the supply/demand dynamics and the marginal cost of production will dictate where the new range for crude gravitates to over the long-term, which I suspect is higher than where we are today but below the $100 per barrel level that prevailed (outside of the credit crisis) for the last several years.

And this seems to be the message implied by the price action in energy stocks. Even with a 30% rally in oil prices over the last month, oil is still down more than 40% from June of last year. Yet, energy stocks as measured by the XLE (energy sector ETF) are back to trading near the levels they traded at in May of 2013 (when oil prices were still north of $100/barrel). So, investors just now looking to get back into the energy space have missed a good bit of the rally – not to suggest that it has completely run its course, but the biggest opportunity was back in mid-January when crude prices were in a tailspin and everyone was heading for the hills.

As we matriculate through the early part of Q2, the economic data appears to be getting a little better, but so far it is a bit more sluggish than the snapback most economists have been expecting following the squishy soft Q1. Last week's data that came in on the positive side of the ledger was a better than expected Philly Fed Index (7.5 versus expectations of 6.0), another sub 300k reading in initial jobless claims, and a rebound in retail sales which increased 0.9% month-over-month following three consecutive monthly declines. However, the retail sales report came in below consensus expectations for a stronger rebound of 1.1% and control group sales (excluding autos, gas, building materials and food) also disappointed –

increasing 0.3% versus expectations for a print of 0.5%. Homebuilder and consumer sentiment increased in April versus March as the improvement in sentiment is confirmed by the below Gallup poll, reaching its best level since 2004 as 52% of respondents acknowledged that their financial situation is getting better vs. 33% believing it is getting worse (lowest reading since 2007).



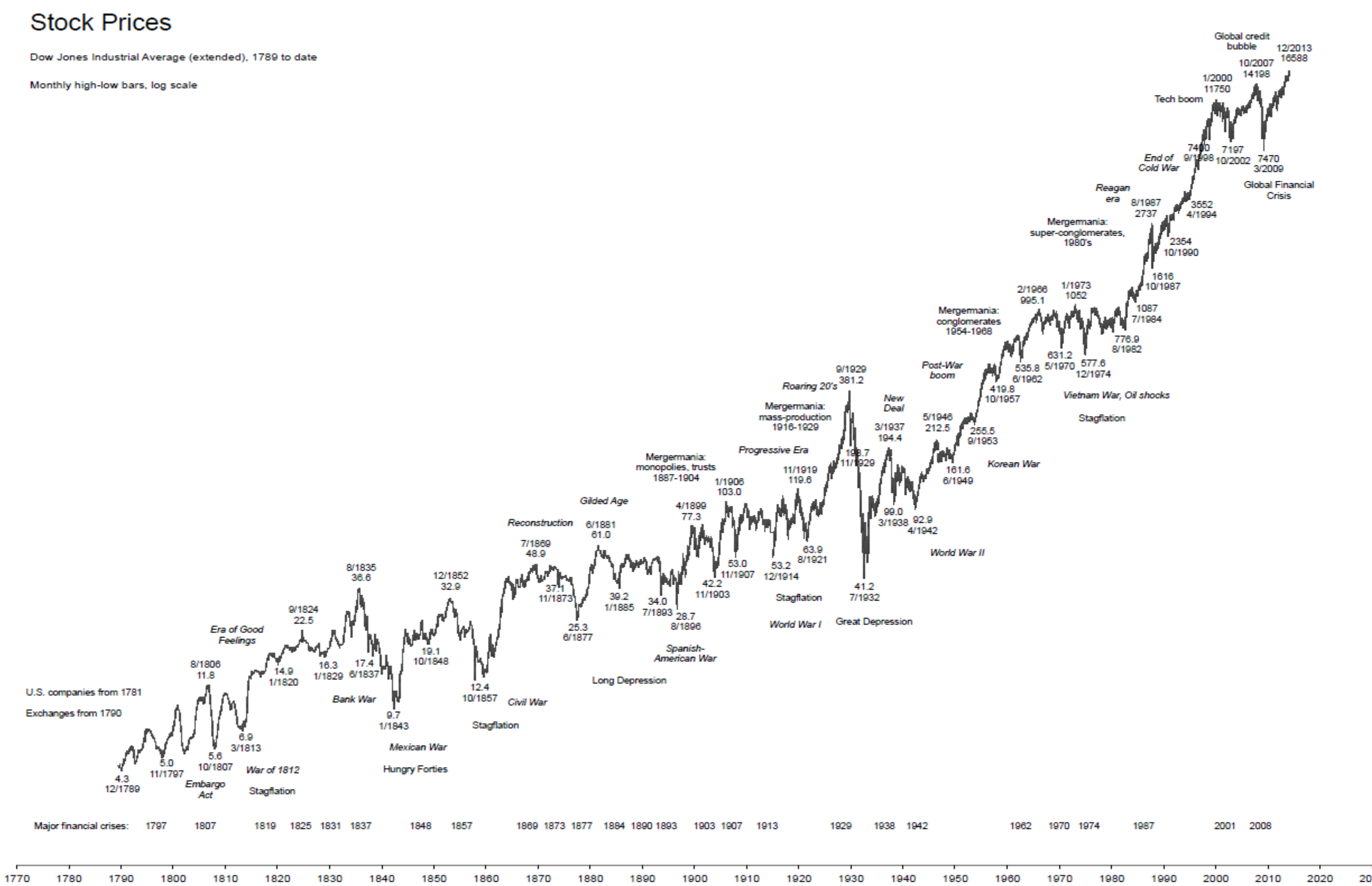
Inflation also showed some signs of life with both headline and core CPI increasing 0.2%

month-over-month in March, the former coming in a tenth below expectations and the latter matching. The year-over-year growth in the headline CPI reading inched lower to -0.1% from 0.0% (largely driven by the slide in oil prices from year ago levels), while core inflation edged higher by a tenth to 1.8%. The acceleration in core CPI growth suggest some stabilization and will give some confidence that inflation is moving towards its 2.0% target, but it is too early to tell if we will see further gradual upward drift.

On the weak side of the ledger was a disappointing housing start report (926k saar vs. expectations for 1,040k), worse than expected industrial production which fell 0.6% month-over-month versus a consensus looking for a more modest 0.3% decline, and a fall in the NFIB small business optimism index to

95.2 in March (lowest reading since June 2014) from 98.0 in February.

Once again investors are finding themselves in the crosshairs of a difficult to interpret capital market backdrop with a Fed that is itching to moderate monetary policy, but unable to do so without corroboration from the economic data. Add to this tonic blend increased probabilities of Greece exiting the Eurozone (call it a coin-flip, not a foregone conclusion at this point), an expected Q1 contraction in profits (negative EPS growth in Q2 is also a possibility), elevated valuations in stocks, and continued ultra-low interest rates on sovereign debt that offers an unacceptable risk/reward for investment. This adds up to an environment with no shortage of things to be worried about, but this is not the first time investors have confronted such a wall of worry. Investors have been enduring through these battles as far back as the late 1700’s – where investors who executed discipline, patience, and prudence have navigated the contours pretty well.



Just take the last 60 years and you have to appreciate the circumstances and events investors have had to navigate through:

- The 1950's – Three economic recessions, Korean War, aftershocks of WWII, but overall U.S. GDP growth was 6.7% and inflation hovered near 2.2%.
- The 1960's – GDP growth was once again strong, averaging 6.9% for the decade with inflation remaining low, but a dangerous inflationary spiral began in 1965. Federal deficits ran rampant to finance the Vietnam War and social dissent escalated precipitously.
- The 1970's – Watergate, the gold standard gets dropped, significant monetary instability, inflation spikes causing wage and price controls, and a decade of "stagflation" takes hold with GDP averaging 10.1% and inflation of 7.4%.

- The 1980's – A decade that began with an oil price shock and Latin American debt crisis and ended with the savings and loan crisis. In between those events bookending the decade we had the fall of the Berlin Wall, an asset bubble in Japan, and Black Monday. Debt to GDP during the Reagan years almost doubled the largess experienced in this cycle under the Obama Administration. GDP growth averaged 7.9% and an era of disinflation began with inflation declining sharply relative to the 70's to average 5.1% over the decade.
- The 1990's – The Japan asset bubble bursts, the signing of the Maastricht Treaty and NAFTA, balanced Federal budgets, Asian Financial Crisis, the introduction of the Euro, and the dotcom bubble. GDP growth averaged a healthy 5.5% and inflation was a low and stable 2.9%.

- The 2000's – The bursting of the Tech bubble, 9/11 terrorist attacks, a housing and credit bubble causes a massive global financial crisis. GDP growth averaged 4.1% (the weakest rate of growth since the 1930's), and inflation declined further, averaging 2.5% (CPI actually turned negative in 2009).

And today we have this cycle of unprecedented monetary policy on the part of central banks around the globe, which has worked wonders in propping up financial assets and masking the warts and scars of debt-laden economies and vulnerable financial markets. The point of this history lesson is twofold: whatever unintended consequences result from the current cycle will be what they are, and it's virtually impossible to identify in advance, much less time them appropriately if you are able to identify them. Secondly, as has been the case through the almost 240 years of U.S. history – we will survive, endure, and figure it out to get through whatever short term setback ails us. Why believe that after 240 years of this being true that this is the time that it will be different?

The readers who have been following this commentary over time know that my concern regarding where we are in this cycle has started to become elevated. Furthermore, that my skepticism about the deterioration in the fundamental underpinnings supporting this recovery is increasing. But, I don't believe it is prudent to allow those short-term cyclical views (which are subject to bias) to overwhelm a much longer history of proven results. Those results suggest that betting on the demise of capitalism, growth, and prosperity has been a loser. Hence, why having a plan and employing the discipline to adhere to it is of paramount importance to long-term investment success – this will keep you from caving to emotional and irrational reactions to what ultimately ends up being nothing more than temporary noise.

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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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