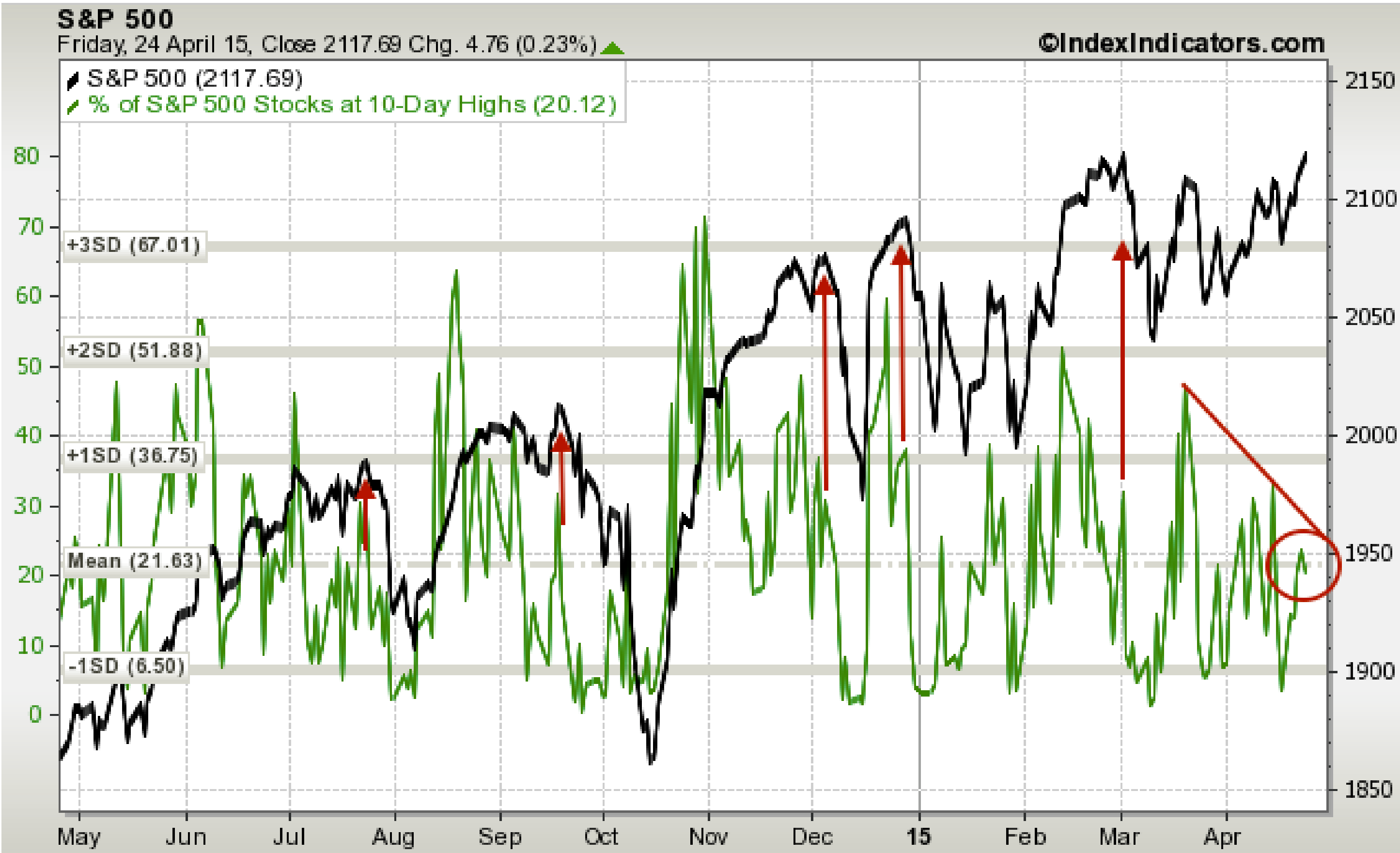
April 27th, 2015

"Time in the market, not timing the market"…

If I had to describe the U.S. equity market in a single word, that word would be 'resilient'. In the face of continued sluggish economic data and so-so corporate earnings reports (overall earnings numbers are coming in above expectations, but this is off a bar that has been dramatically reduced), the S&P 500 and tech-heavy Nasdaq closed out Friday's trading at new all-time highs. It was almost 14 ½ years ago (December 31st, 1999) when the S&P 500 and Nasdaq collectively closed at record highs, with the latter reclaiming this level with a much more reasonable valuation – trading at a trailing P/E of 30x today versus a trailing P/E of 175x at its previous peak.

While it usually feels good when stocks traverse new all-time highs, the real proof will come when/if this momentum can be sustained. This may prove to be easier said than done in the near-term with the market internals showing very little conviction, as Friday's breakout to new all-time highs came on the lowest level of volume since December 26th. Furthermore, breadth was rather muted with a pedestrian 20% of stocks trading at a 10-day high – implying that this most recent rally has been very selective with fewer companies leading the charge – compared to previous peaks in this bull-market cycle where 50-60% of stocks were at a 10-day high (see chart below, where the green line representing the % of S&P 500 stocks at 10-day highs leads the black line which represents the price action in the S&P 500).



The market cap of the U.S. equity market comprises roughly 48% of the overall market cap of the global equity market, hence why it is not difficult to imagine how a U.S. based investor ends up with a significant home country bias in their portfolio allocation. However this leaves about 52% of the equity market universe as a potential investment opportunity set for investors to profit on, and those that have dipped their toes into these waters this year have by and large been rewarded with returns that have bested the 2.9% gain in the S&P 500 year-to-date.

From Shanghai to Tokyo, stock markets in the Asia Pacific region are hitting new milestones this year, where last week the Nikkei Stock Average closed above 20,000 for the first time since 2000 and Taiwan's Taiex broke through to a 15 year high. Within the last month Hong Kong's Hang Seng Index closed above 28,000 for the first time in more than seven years, and the Shanghai Composite broke above 4,000 for the first time since March 2008. Australia's S&P ASX 200 is up 11% this year and within 20 points of taking the 6,000 level which would mark its highest close since January 2008. In

Korea, the Kospi, currently at 2,157.54, is just 3.3% off its record 2,228.96 set in May 2011.

A similar theme has taken shape across the collective group of European equity markets and this is happening despite the ongoing travails in Greece. As for Greece, the situation is intensifying as creditors remain steadfast in not offering Greek leadership any more wiggle room or ability to kick this can any further down the road. Prime Minister Tsiparas is raiding the coffers of any source he can to meet Greece's obligations to lenders, civil servants and pensioners. As I've said before, this issue is coming to a head sooner-rather-than-later, but the action in capital markets indicates that the risk of a severe impact on the European financial system is rather low. Why else would the euro be trading at $1.08 to the dollar and interest rates in Spain and Italy hovering in the arena of 1.4%?

Undoubtedly, one variable buoying foreign equity markets relative to U.S. equity markets is ongoing or initiated asset purchase programs on the part of central banks. The BOJ (Bank of Japan) QE program tallies some ¥80 trillion of assets per annum (equivalent to $56 billion per month). The QE program initiated in March by the ECB totals €60 billion worth of assets per month (roughly $65 billion). And now we have the PBOC (Peoples Bank of China) becoming more aggressive in its efforts to provide support to its economic growth by implementing the most aggressive cut (100 basis points) to its reserve ratio since November 2008.

Add it all up and this makes the loss of $85 billion per month in the Fed's QE program pale in comparison. Like it or not, agree with it or disagree, but accommodative policy on the part of central banks has become a variable that must be accounted for when evaluating and implementing investment decisions. This will be true until it is not, and is one of the variables that caused us to increase portfolio allocations overseas earlier this year (see Broaden your scope…) as the tailwinds of stimulative monetary policy and currency depreciation are very powerful.

One quick note on China – without question its economy faces its fair share of challenges (over-indebted private sector, potential property bubble, excess capacity, and growing demographic gap), but continuous calls for its demise since the credit crisis have yet to materialize. Why is that? One big reason is that China remains the second largest economy in the world, and its 7% GDP growth rate last year adds more to global GDP growth than its 14% pace did back in 2007. How is that for some perspective?

As for the U.S., the performance of the equity market is quite impressive considering that there hasn't been much of a spring thaw in the latest batch of economic indicators. The winter's ice patch is looking more and more like the spring's soft patch – all the more reason to expect a Fed rate hike gets not only pushed out to later in the year, but also that rate hikes for 2015 might be either a one-and-done or none-and-done event. Consider the following:

- The Chicago National Activity Index (one of the broadest measures of monthly economic activity) came in with a negative reading for the third month in a row at -0.42 in March. We haven't witnessed a negative trend of this length since October 2012, but the three-month index which smoothes out the volatility in the series was a little better than the headline coming in at -0.27 in March (down from a -0.12 reading in February).

- Four of the five Fed districts that release monthly manufacturing activity indicators have shown a weakening trend for April (New York, Richmond, Kansas City, and Dallas) with Philadelphia the lone district showing a firming in activity. This doesn't look to be a good omen when the ISM-manufacturing index is released for April given how strong the relationship is between the regional indices and national index.

- The headline print on durable goods orders (+4.0% month-over-month) came in above expectations for a +0.6% print, but the more closely followed core capital goods data (which feeds directly into GDP tracking as a measure of capex spending) fell 0.4% month-over-month (consensus expected a decline of 0.3%). This was the seventh straight month of decline in this metric and suggests that business investment will be weak in the coming months.

Additionally, the trade data around the globe has been somewhat puzzling, in particular the export data. In an open market, Economics 101 (keeping all else constant) would suggest that currency values redistribute growth across the globe making one region's tradable goods more competitive relative to another. However, recent export data from around the world is leaving many economists scratching their heads:

- U.S. exports are weak and weakening on a stronger dollar; April export sales dropped for the first time since November 2014
- Japan exports are rising in the 5% range year-over-year (in units) but new export

orders are increasing at a slower rate in spite of a very weak Yen

- China exports are also rising slowly with slowing new export orders
- German manufacturers reported a slight increase in foreign orders in April in spite of a weak Euro
- France's manufacturers' new export orders fell at the sharpest rate in six months in April

Given the appreciation in the trade weighted dollar relative to other currencies, it would be expected for U.S. exports to take a hit, but the lackluster export data out of regions with much weaker currencies calls into question the strength of worldwide demand.

One place where the dollar strength has been on full display is in Q1 earnings results from large-cap multinational companies where IBM, Johnson & Johnson, General Motors, Amazon, and Proctor & Gamble all referenced sales that were negatively impacted by more than $1 billion as a result of the appreciation in the dollar. However, this negative currency impact will likely moderate as we get into the second half of the year and the comps become easier. Additionally, it looks as though the dollar rally is running out of steam with the greenback having declined for two consecutive weeks; as of Friday is at a seven week low, and off 3.3% from the 12 year high it reached on March 13th.

According to data from Factset, 201 companies representing 54% of the S&P 500 earnings have reported for the first quarter with 73% coming in above earnings estimates. In aggregate, EPS growth for Q1 is tracking a decline of 2.8% which compares to a 4.6% decline expected by analysts as of March 31st. So better than expectations, but if the EPS contraction continues through the end of the reporting period it would represent the first year-over-year earnings decline since the third quarter of 2012.

Perhaps even more concerning than the decline we're seeing in EPS growth is the weak showing in revenue growth. Thus far only 47% of companies reporting have beat on the top-line with the sales growth for the quarter tracking a decline of 3.5% compared to estimates of a decline of 2.6% coming into the quarter.

When analyzing large samples of data it's always imperative to look for outliers or pieces of data that could be skewing the end result. The Q1 earnings results include two such outliers which cloud the overall message. One of these is Bank of America's (BAC) first quarter report – as a result of a litigation charge recognized in Q1 2014 which caused their earnings to contract by $0.05, BAC's Q1 2015 earnings results of $0.27 represents the largest contribution to EPS growth for an S&P 500 company in Q1. Now this is a one-time non-recurring item (although it could be argued the litigation will always be a part of the banking business going forward) which if excluded from the overall results for S&P 500 companies, the EPS growth rate would drop from -2.8% to -4.1%. This suggests that much of the improvement in EPS growth relative to expectations has come at the hands of one company's results.

Dissecting the EPS results even more indicates that the bulk of the decline we are experiencing in earnings for Q1 is the result of a roughly 60% decline in energy prices. So, if the energy sector is excluded, the estimated earnings growth rate for the S&P 500 would jump to 5.6% from -2.8%. I know it's confusing, so let me summarize. Overall EPS growth for the S&P 500 is tracking -2.8%: if you exclude BAC it's -4.1%, if you exclude Energy it's +5.6%, and if you exclude both BAC and the Energy sector, it's +4.2%.

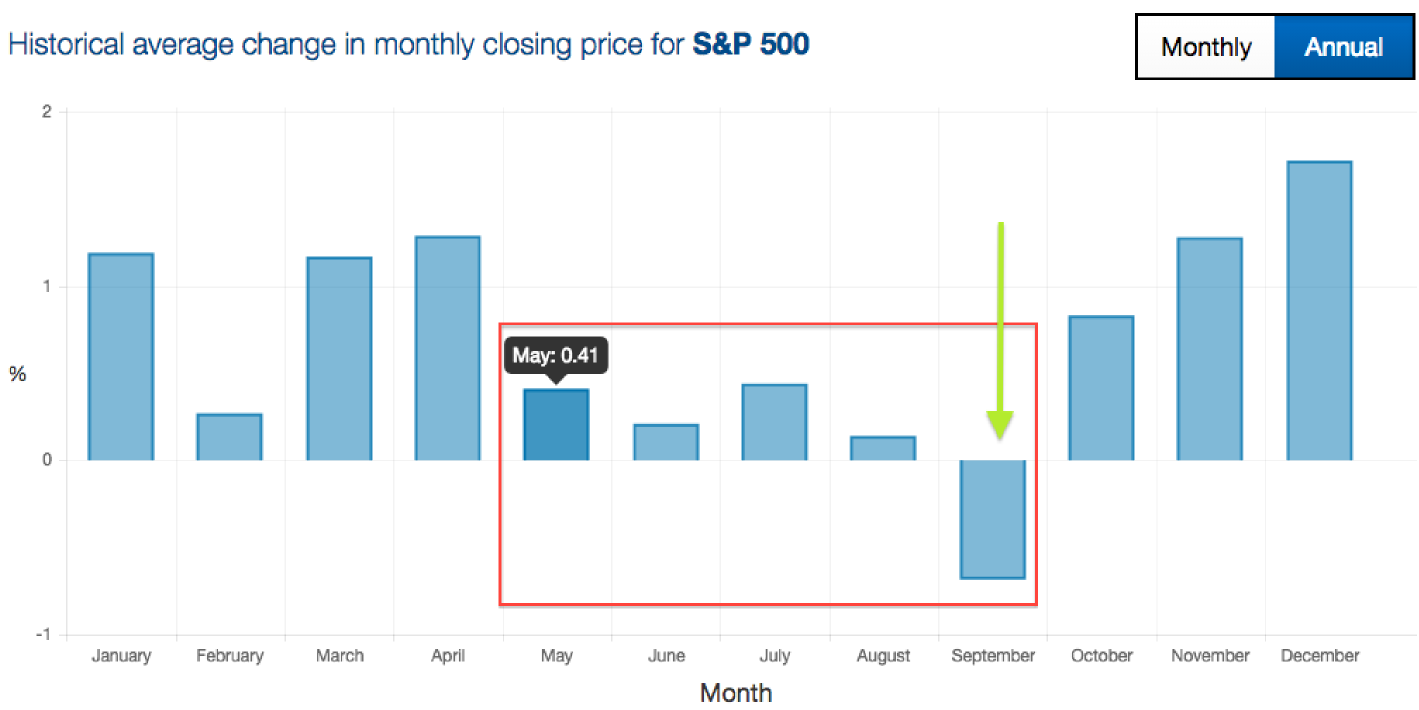
Using +4.2% as a normalized growth for non-energy equities compares fairly well with the +6.4% results from Q4 2014. Given that revenues are growing by 2.6% (excluding energy) it suggest that corporate America continues to be able to wring out profit growth with increased focus on productivity, efficiency, and cost controls which shows through with profit margins continuing to hover near all-time highs.

So the overall fundamental backdrop remains in a steady state where the data is not dire enough to compel investors to head for the hills nor is it rosy enough to be the catalyst that ignites another leg higher. This isn't a bad thing; a sideways market checking time while allowing the data to play catch up to fully valued asset prices is much preferred to the alternative where a material correction takes hold bringing valuations back to a level that intrigues buyers.

Furthermore, the sluggish data continues to keep the Fed at bay and staves off the initiation of a Fed rate hiking cycle. But I will continue to stress that investors should not get overly complacent in the current environment as risk has a way of happening much quicker than most investors anticipate.

We are now moving into what has historically been a seasonally weak period for stocks where the "sell in May and go away" philosophy will surely catch some headlines over the next couple of weeks. This was a question posed in a meeting with a potential client last week who was evaluating the timing of putting some capital to work – I hope this provides them with some additional context to the discussion we had.

The below chart covers the monthly returns of the S&P 500 from 1970 through 2014 where the data indicates there is some validity to the notion that returns from May – September have generated lackluster results relative to the rest of the calendar.



Likely complicating the weak seasonal pattern is the laser-like focus investors will be paying to the Fed regarding the much anticipated normalization of interest rates after 6-plus years of zero-interest-rate-policy. The key to success throughout the duration of this economic and bull-market cycle will be for investors to position themselves in a manner that affords them the comfort necessary to remain fully invested going forward as volatility is sure to intensify. This implies allocating a portfolio across a diverse blend of asset classes including non-correlated absolute return strategies that have the characteristics of moderating a portfolio's overall volatility while potentially providing the ability to profit from such an environment.

After all, success in investing is in large part due to "time in the market" not "timing the market" – as the latter has more often than not been a recipe for sub-par long-term returns. I'll close this week's missive with one more piece of advice from famed investor Peter Lynch: "far more money has been lost preparing for corrections, or trying to anticipate corrections, than has been lost in corrections themselves."

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.