November 21st, 2016

Long-term optimism tempered by near-term hurdles…

The post-election jostling in capital markets continued to unfold last week with U.S. equities garnering all the attention as the S&P 500 closed on Friday within a whisker of all-time highs. The action within the stock market has been very discriminating between the winners and losers with leadership coming from the Financials, Industrials, Energy, and Materials sectors while the sectors viewed as more defensive and yield oriented have lagged (Utilities, Consumer Staples, and Telecom). Interestingly, the Technology sector has also been a laggard in this rally and not because of its growth characteristics, but more so because of its ties to global trade which will come under pressure if the protectionist policies under President-elect Trump come to fruition.

Viewed as one of the biggest beneficiaries of deregulation, infrastructure spending, and protectionist policies are small-cap stocks which have surged +10% since the election. This move has far outpaced the +2% post-election advance in the S&P 500 which, according to analyst Howard Silverblatt, if not for the nearly +11% move in the Financial sector, the S&P 500 would be up just 0.62% since the election. What's more is that nearly 35% of the gain in the S&P 500 following the election has come from five companies: Wells Fargo, Bank of America, JP Morgan, Berkshire Hathaway, and Citigroup. If you've owned them, great. If not then you've had a very different post-election experience.

Bond investors are having a tough go at it, with the yield on the 10-year Treasury-note jumping more than 40bps since the election and having spiked nearly 100bps from the post Brexit low of 1.35% to as high as 2.35% last week. This surge in yields has wiped out more than $1 trillion of value from the global bond market which has spurred a reaction from investors who yanked $18.1 billion from global bond funds last week (the second largest weekly outflow on record).

International equities (Emerging Markets in particular) have been another post-election causality as they have declined nearly -8% on the back of higher interest rates and the U.S. dollar index rising to its highest level since 2003. The run up in the U.S. dollar index to above 100 is equivalent to a quarter-point rate hike by the Fed, and an actual hike is expected just around the corner in mid-December.

The recent moves in interest rates and the dollar have spurred a meaningful tightening in financial conditions that, if they persist (let alone continue further), will have negative implications on some key economic data releases in the next couple months. In terms of the Industrial economy that voted lock, stock, and barrel for Donald Trump hoping to improve conditions in the manufacturing side of the economy, well we learned last week that industrial activity contracted on a year-over-year basis for the 14th consecutive month and the recent move in the dollar actually erodes competitiveness in this space, not improves it. Add to this the move higher in interest rates which has already caused the yield on a 30-year mortgage to spike north of 4%

(first time since July 2015) which has resulted in mortgage applications plunging at more than a 70% annual rate over the last eight weeks.

So the indications we have been seeing over the last couple months in two parts of the economy (manufacturing and housing) that were gaining momentum are looking as though they will reverse if the current strength in the dollar and higher interest rates persist.

It's fascinating to see how quickly and aggressively sentiment has shifted within markets as shown by the recent release of the AAII Sentiment Survey, where bullish sentiment jumped 7.8 points on the week to 46.7% (historical average is 38.5%) while bearish sentiment fell 2.8 points to 26.6% (historical average is 30.5%). A little perspective here is necessary, especially when you see the bullish sentiment gauge ramp 23 points over the last two weeks to its highest level since February 2015.

If nothing else, this is an indication that a lot of hope and expectations are priced in to a policy agenda that only 14% of business economists in the aggregate favored ahead of the election. Of course, these prognostications have been retrofitted over the last two weeks to comply with the bullish repricing in equity markets.

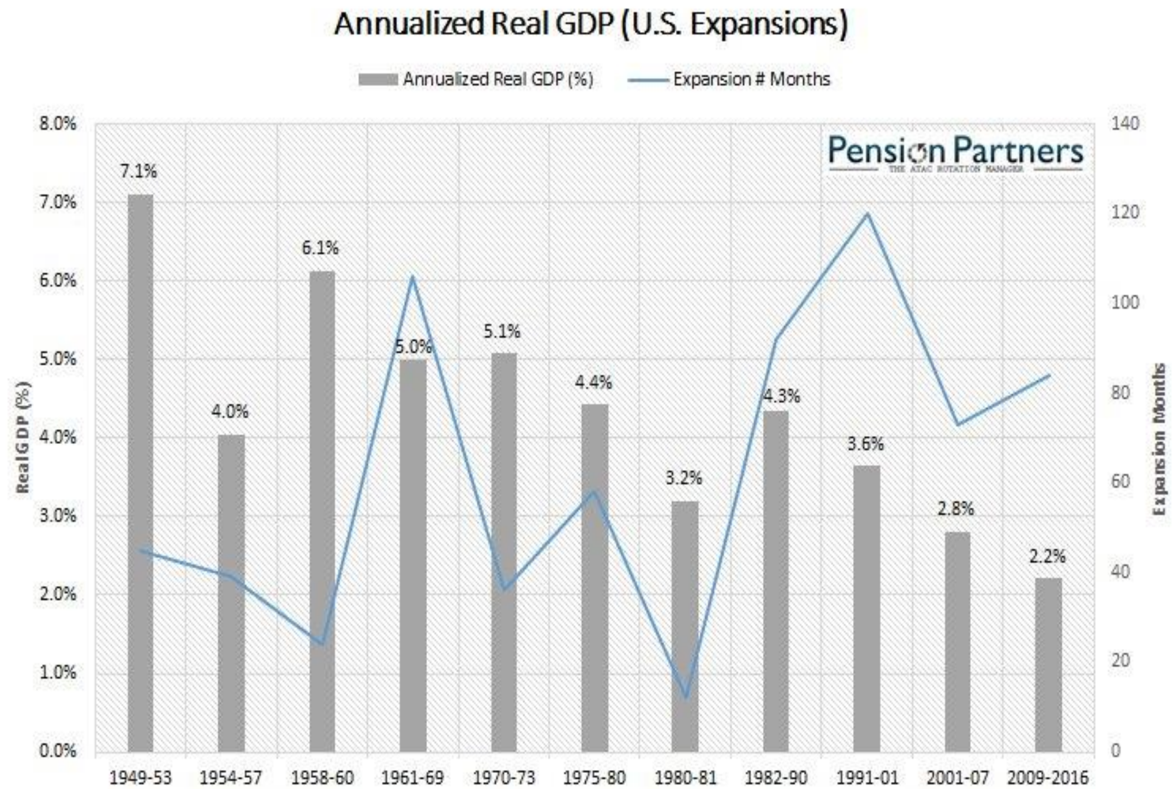
Given all the hype and hysteria over the potential for a pro-growth / pro-business policy agenda out of D.C., one would think that the U.S. just discovered the economic equivalent to a break-through in cold fusion. This is hardly the case, but the only thing concerning equity investors at the moment is that one hundred percent of the good policies under a Trump administration will be implemented and none of the bad policies.

Forgive me for reserving judgement and understand that for the first time in the last 18 months I can see the potential for optimism for long-term investors. However, that long-term optimism is still tempered by some rather significant near-term hurdles, and unfortunately I don't think these near-term hurdles get cleared without investor's first experiencing some pain.

1. **Hurdle #1: The Business Cycle**
   In the annals of history there has never been a presidential cycle that proved to be more powerful than the business cycle, and while no business cycle has an expiration date attached to it, come January when President-elect Trump takes office this expansion will be in its 91st month – making it the fourth longest dating back to 1929 and closing in on double the median 50 months of past expansions.

   What's more is that 100% of the time (dating back to 1910) when a two-term President leaves office, the U.S. economy is either in or is entering a recession within twelve months of the new administration. Many forces and factors likely drive this relationship with the degrees and significance of each varying depending on the character of the business cycle at that time, but one constant is likely the change in policy and priorities of the voters from one regime to the next.

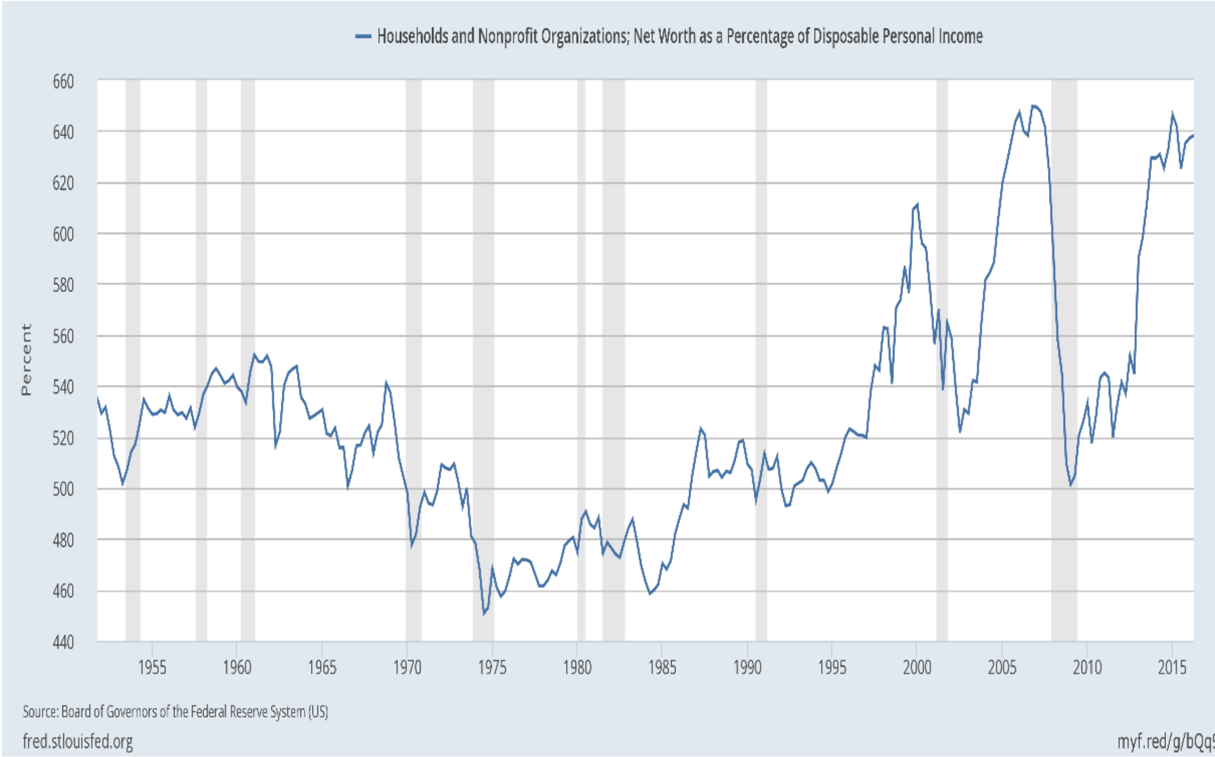
   Keep in mind that during the debates Trump pulled no punches in labeling the current macro backdrop as a "fake" economy being held up by low interest rates and an overly accommodative Federal Reserve. While his comments are blunt and come off as shrewd, they are not lacking of context given that this is the weakest economic expansion in the post-WWII era.



And while the economic data has improved from the beginning of the year, where at that time it looked as though a recession was imminent, the improvement is more akin to a stabilization at a level that minimally reduces the output gap (difference between potential economic growth and actual economic growth). The decelerating growth in employment, industrial production, capex spending, and consumer spending is ongoing, but while none of these indicators have broken to the downside in a material way they all confirm that the overall economy remains in a vulnerable state.

2. **Hurdle # 2: Asset Price Valuations**
   In regards to the stock market, investors are looking at an S&P 500 index that is trading at a trailing price-to-earnings multiple of 20x which is quite the premium to the 14x it was trading at when this bull market was in its infancy almost seven years ago. Yes, it looks like the five-quarter-earnings-recession ended in Q3 with S&P earnings growth coming in at +3% YoY, but aggregate earnings still remain 11% below their 2014 cycle high and I suspect if the dollar and interest rates continue to move higher we will be seeing a renewed set of estimate cuts to the lofty double digit EPS growth rates being penciled in for 2017.

   Keep in mind Trump was also outspoken about the stock market during his campaign, characterizing stocks as being "in a big, fat, ugly bubble". It's likely his tone will change now that he is set to become President, but the below chart showing household net worth as a percentage of disposable income near all-time highs doesn't leave a whole lot of room for improvement. Unless of course, this time is different and the U.S. economy never again experiences a recession or bear market in the stock, bond, or real estate markets (all of which were at or near all-time highs within the last 5 months).



As an aside, investors need be aware of the potential sea change afoot where the initial stages are underway to reverse the order that has dictated the direction of capital markets throughout this cycle, where ultra-accommodative monetary policy led to low interest rates and excess liquidity, globalization led businesses to seek out low cost labor pools allowing for the labor share of income to be depressed relative to the capital share of income (this was good for corporate profits), and volatility in asset classes remained suppressed given the expectation of telegraphed and gradual change. Thus far, the early stages of the unwinding of capital in these themes has been calm and controlled with the most visible immediate shift being a rotation by investors out of stocks and into bonds, but investors should be mindful that this orderly transition could become disorderly very quickly.

3. **Hurdle #3: Globalization and Protectionism**
The global economy has been streamlining its policies to be more integrated and specialized with increased attention focused on these initiatives over the last three decades. In all the hoopla of this honeymoon reaction to the Trump agenda (and in particular to the protectionist bent with the focus on preserving and rebuilding U.S. manufacturing) it should be noted that the rest of the world is already responding.

What's at risk for the U.S. economy is only $2.2 trillion of U.S. exports – more than just a drop in the bucket in terms of an $18 trillion economy (sarcasm intended). Already we are seeing countries taking action as they cobble together a regional trade agreement that will exclude the U.S., but does include China (which the TPP excluded) and 15 other Asian nations. Now this agreement has been in the works since 2012, so it's not a direct consequence of a Trump victory, but the RCEP (Regional Comprehensive Economic Partnership) as it's called covers one-third of global GDP and nearly half of the world's population – a rather considerable part of the world if you ask me and one that is growing at a much faster clip than the U.S. So, what the U.S. may ultimately see is other countries trading more among themselves than with the U.S. – see the Wall St. Journal article "China Picks up the U.S. Trade Fumble".

4. **Hurdle #4: Fiscal Policy**
Of all the items on the agenda for a Republican led ticket, fiscal policy appears to be the one driving the most optimism. I get it, who doesn't want lower taxes? As a business owner, who wouldn't opt in for less regulation and government oversight? Who doesn't want better infrastructure? The problem isn't with these policies, it's with the math behind implementing them. Take the Trump tax cuts: the math works out to where they are extremely regressive in that the people getting the biggest benefit are the wealthy individuals that need it the least. I'm not playing class warfare here, but the financially well off have a higher propensity to save the benefit rather than spend, which thereby mitigates the stimulative aspect of the tax cut. The folks at the lower end of the income curve who are most apt to spend the tax cut are estimated to get less than a 4% cut in their tax bill.

   As for infrastructure spending, it sounds great and on the surface it makes all the sense in the world, even if it's financed with debt given interest rates are still at historically low levels. However, a couple of things come to mind and in particular it relates to the $830 billion stimulus package (American Recovery and Reinvestment Act) put in place by President Obama from 2009 – 2019. Yeah, I bet you didn't realize that it is still ongoing and yet we still have this feeble economic recovery. Keep in mind that back when this was signed into law in February 2009 the unemployment rate was 8.3% and on its way to 10% by October 2009, and back then debt-to-GDP was 65% versus 105% today.

   All I'm getting at is that fiscal stimulus and infrastructure spending is not something new and is not a panacea. Janet Yellen is aware of the cost / benefits of an ill-timed and/or poorly crafted package which is what she was stressing last week during her economic update to congress.

Taking it all together, the good and the bad (the business cycle, interest rates, regime change, valuations…), I understand the optimism being unleashed in equity markets. Add to this the performance chase by professional investors as we move into year-end and you have yourself quite the tonic blend to push stock prices to all-time highs. How high and how far is anyone's guess, but embrace and enjoy it while it's here. However, don't abandon prudence, discipline, and keep a pulse on responsible risk management as the last time the S&P 500, Dow, Nasdaq Composite, and Russell 2000 all closed at record highs was December 31, 1999. Another time when caution was thrown to the wind with equity investors unknowingly at the time nearing the cliff of a sizeable multi-year decline – not a forecast, just an observation.

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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