



February 22nd, 2016

Time to make a call...

In the midst of one of the worst starts to a year for equity investors, stocks showed they had a pulse last week as the S&P 500 registered its best weekly gains for the year, surging nearly 3%. The risk-on trade resonated around the globe as the German DAX ramped 4.7%, France's CAC jumped 5.7%, the Emerging Markets index raced higher by more than 3%, and the Asia-Pac index advanced 5.7% (best weekly gain in over four years). All in, the global stock market posted a nearly 4% rally last week and put a large dent in replenishing what had been a nearly \$6 trillion paper loss in global wealth at the nadir of this sell-off.

It is way too early to declare a winner in this tug of war between the opposing views of those investors that believe this is nothing more than a bear market rally or those of the view that the worst of this vicious downward spiral is now behind us. There remain data points that support both views at the current time, but those on the more skeptical side of the ledger (myself included) must respect the improvement that has taken place in market breadth, a more than 20% decline in the VIX index, and the lack of further declines in the stock market to what has been a continued flow negative news.

For example, last week the OECD cut its forecast for world GDP growth for 2016 to 3% from 3.3% (its slowest pace in five years), citing a litany of headwinds. They forecast 2.0% growth in the U.S., 2.1% in the UK, 0.8% in Japan, 6.5% in China, 7.3% in India, and Euro area growth to come in at 1.4% in 2016 (1.3% in Germany, 1.2% in France, and 1.0% in Italy). Not exactly the margin of safety (3.0% global growth) that one would like to have if we are in fact entering the late stage of an economic cycle (more on this later). There is an old Wall St. adage that a market that does not respond bearishly to bearish news is not bearish.

Another data point supporting the recent rally is the washout in investor sentiment with the latest Investors Intelligence survey showing 26.5% of respondents in the bullish camp while 39.5% lining up on the bearish side (recall this data series should be viewed with a contrarian mindset). The bear share right now is back to levels we had back in the Fall of 2011 when double-dip recession calls were on the tip of everyone's tongues. Back then all it really took was for the panic and fear to subside (helped in a major way by ECB President Mario Draghi pumping out his chest to backstop the cratering Eurozone economy) to set off an 8.5% rally in the S&P 500 into year end.

So, what has changed in the matter of seven trading days to calm investor nerves? In my opinion any one of a number of narratives can be scripted, so here is my stab at a few:

- The appearance of stability finding its way into oil prices with a definable near-term range on WTI between \$26-\$33/barrel. Rumors and announcements have been flying around erratically since news hit that the Saudis and Russians are in discussions about an output freeze. Other OPEC nations have

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also come to the floor supporting such innuendos, but keep in mind this freeze would be taking place with production levels running at or near all-time highs. So, is this really all it's cracked up to be? Not to mention, the Saudi's have made it pretty clear that they are no longer interested in acting as the swing producer to stabilize the oil price. This baton is being passed off to U.S. producers, and while the latest rig count data shows that oil rigs have declined nearly 70% from their 2014 highs, production has declined by less than 10%. This cut in production is being more than made up for by Iran reentering the fray and looking to take back some of the market share it lost over the last couple years as its production was curtailed by sanctions.

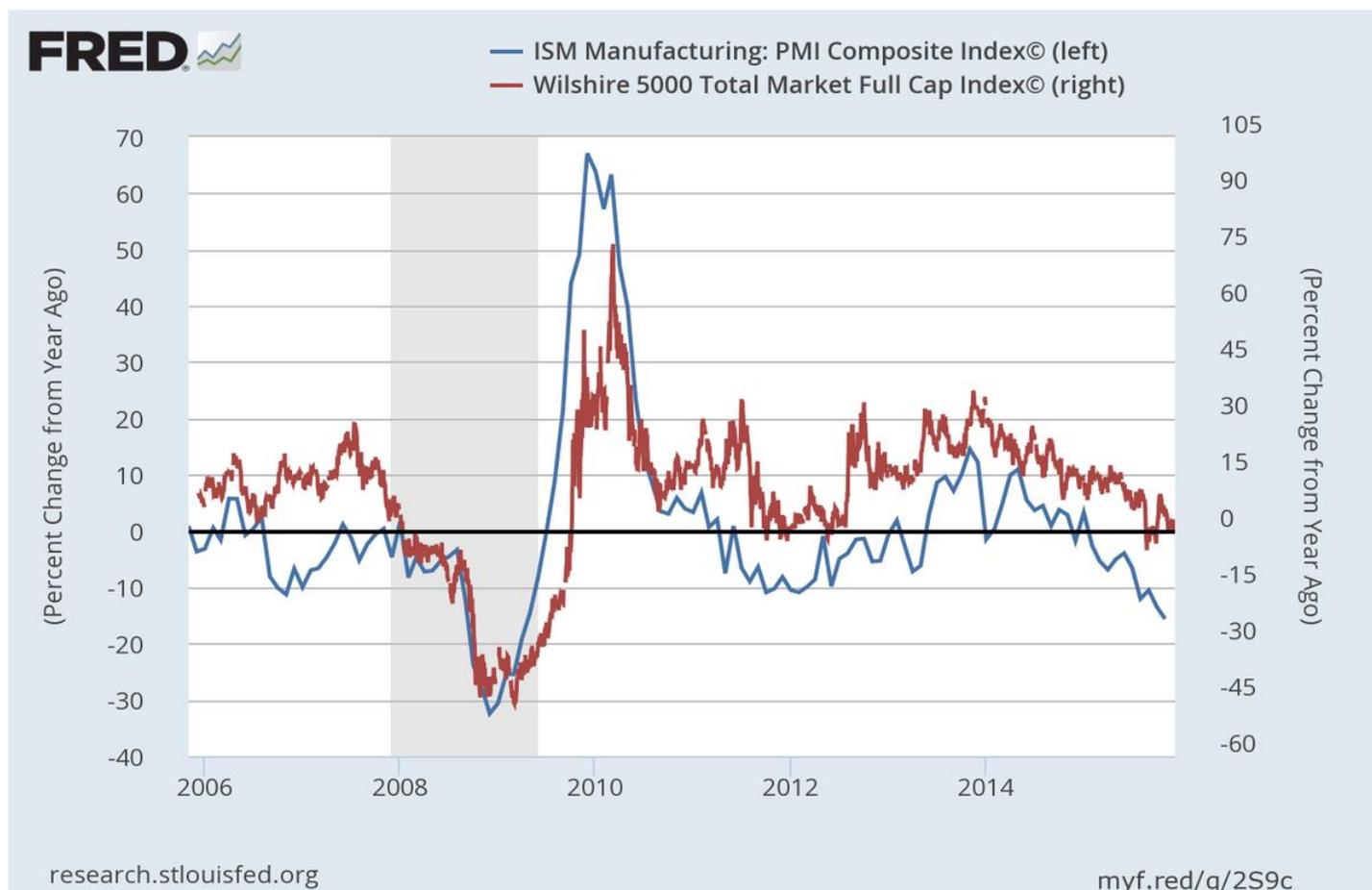
- The bull market in the U.S. dollar has lost its momentum with the DXY dollar index down nearly 2% on the year (this will remove one of the tourniquets undermining the weak corporate earnings landscape for multinational companies, U.S. manufacturing activity, and debt-servicing strains in the Emerging market space).
- Expectations for Q1 2016 real GDP growth rebounding back above 2.0% after gripping a zero handle in Q4 (0.7% at last estimate) – the Atlanta Fed's GDPNow model is forecasting 2.6% GDP growth in Q1.
- Increasing expectations that the Fed will remain on hold through the balance of 2016 – CME futures are pricing in less than a 50/50 chance that the Fed implements another 25bps hike this year. Additionally, last week's release of the minutes from the January FOMC meeting validated a lower for longer interest rate path as officials acknowledged that "uncertainty has increased and the majority see downside risks to the outlook".
- The Chinese Yuan has stabilized with rumors circulating that Beijing is planning more fiscal stimulus and adopting measures to stimulate bank lending. Reading through the tea leaves of whether this is ultimately a constructive sign is a tough call given it is well known that China's economy is slowing, has a huge debt overhang, and will experience banking sector losses. So, the question is: if everything is just fine in China then why do they need more stimulus?
- Shares of European bank stocks stopped collapsing, yet credit default swaps on Deutsche Bank's 5-year subordinated debt hit a new high of \$525,000 (for \$10 million of protection) within the last week and this is just shy of where Lehman traded back in September 2008 before it went belly up. Also helping to alleviate any near-term concern in the Eurozone economy was comments out of ECB head Mario Draghi, who testified in front of the European Parliament's economic and monetary policy affairs committee last week, where he stated that the ECB intends to step up its stimulative efforts in a major way (we'll have to wait for the March 10th ECB meeting whether this means an even deeper cut to negative interest rates or an increase to the current €20 billion monthly asset purchase program).

Those of you that have been reading this weekly missive are well aware that my view on the U.S. equity market has evolved from open minded skepticism at the beginning of 2015 (thinking that at some point the business cycle would be transitioning from the mature stage to the late stage, but the data at that time was not indicative that the transition was at hand), to caution and concern in mid-2015 (at that time enough economic and market data – given our interpretation and analysis of it – was indicative that this transition in the business cycle to the late stage had taken place), and by the end of 2015 I was (still am) of the view that the probability of a recession has risen to a level that investors need to take appropriate actions to account for it.

This wasn't a call (and the corresponding adjustments to client capital) that was made lightly, nor was it one that was made without a lot of conviction behind it. Given this view, very little of the downward price movement and increased volatility in risk assets that has transpired to kick off this year has taken us (me) by surprise. Hence, why I am currently of the view that the rally we are seeing in global equity markets over the last seven trading days is nothing more than a bear market rally. However, I was taught very early in my career that as an analyst "you marry your partner, not your forecast", and for that reason I am constantly surveying the landscape in an effort to stress test my thesis for where I could be wrong.

I could easily take the side of punching holes in the vigor of this rally – pointing out that the bulk of the gains have come from the most heavily shorted segments of the market (typical of a short-covering rally) or that volume is weak and doesn't show a substantial commitment from big money players with long-term staying power. But these are examples of items that are more representative of noise that can cause a significant short-term move in a market rather than long-term fundamental drivers of the next big sustained move. The next big sustained move in capital markets will come at the hands of what is transpiring in the business cycle, credit cycle, and corporate profits cycles – and in my opinion all three continue to point towards tougher times ahead.

1. **Business cycle** – signals of the plateauing and rolling over of the U.S. economy first began back in the Fall of 2014 when the ISM-manufacturing survey began to slowly decelerate, and this deceleration picked up steam throughout the balance of 2015 when this data series ultimately slipped into contractionary territory and has been there for the last four months. The below chart plots the correlation between the ISM-manufacturing index and the Wilshire 5000 Total Market Index which sums up why this economic variable (in tandem with an array of other data points that are confirming its breakdown) is so important to the equity market.



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So the cyclically sensitive manufacturing side of the economy was the first segment to deteriorate (and continues to as of the most recent data point) which was followed in Q1 of 2015 by the year-over-year rate of growth in monthly employment starting to decline. Then came the peak and corresponding rollover in corporate profits and the ISM-nonmanufacturing sector in Q2 2015 with the latter reaching 59.6 in July 2015 and subsequently falling to 53.5 as of the most recent January 2016 reading.

All of this is consistent with what is playing out in last week's release of the Conference Board's Leading Economic Indicator (LEI) slipping 0.2% in January (the second straight monthly decline following December's 0.3% falloff). This dropped the annual rate of increase to +2.2% year-over-year (the lowest rate of growth since May 2013) from +2.4% in December, and even further below the 6.2% YoY rate that prevailed last January. While it's worth noting that the main drivers of this decline were the result of two components (jobless claims and the stock market) that had weakened in January, but have since reversed course in February indicating that the overall report is not actually as weak as the headline. However, what's different today than May 2013 (the last time the LEI was at these levels) is that U.S. economic growth is decelerating today versus accelerating back then.

Furthermore, this data point needs to be evaluated with context as it does have a good track record of predicting the future direction of the economy (hence its name LEI). Historically, on average when we are within six months of a recession the year-over-year trend in the LEI falls below zero (we're currently at 2.2%), three months before a recession it falls to -1.0%, and by the time the recession hits the LEI is contracting 4.0% year-over-year. So, as you can see we're not there yet, but based on the trend that has been playing out since January 2015, it looks as though we are on our way.

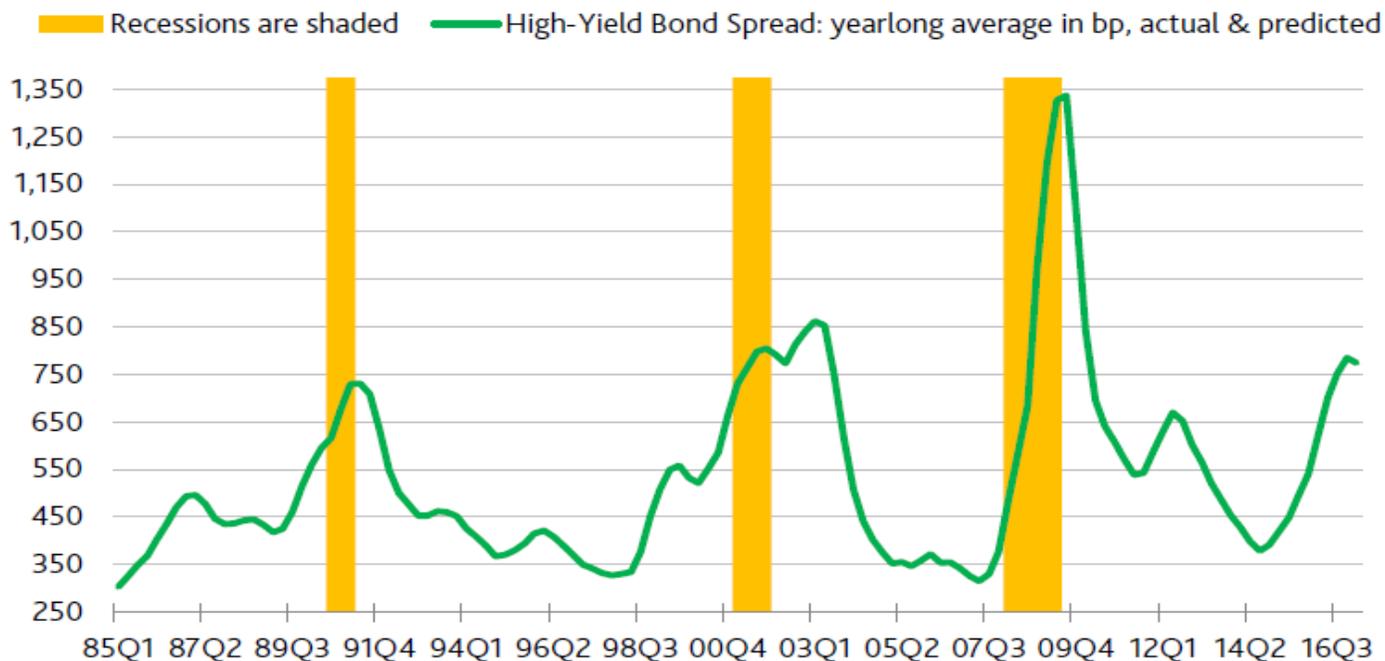
2. **Credit Cycle** – The global economy is awash with more debt of all stripes than at any point in history, as global debt ballooned from \$85 trillion in 2005 to \$225 trillion as of the end of 2015. When the economy is expanding and corporate profits are growing, debt and leverage are a great tool to capitalize on this backdrop, but when the cycle turns the unwind of this speculative excess is vicious. This unwind began in the commodities market with miners and oil producers and now is starting to broaden out to other parts of the global economy. Last week Moody's published a report about the deterioration playing out in the high-yield bond market where they highlighted that in only 8.6% of the time (32 of 373 months) since 1984 has the high-yield bond spread's month-long average been at least 800bps – the month long average so far through February is at 848bps.

Furthermore, they go on to state that when the month-long average first breaks above 800bps more than two years after a business cycle bottom the U.S. economy is already in or closely approaching a recession. Prior to the last three U.S. recessions this metric breached the 800bps level in August 2008, November 2000, and October 1990 – with only November 2000 being similar to February 2016 in that both months overlapped business cycle upturns. Note that the upturn that was ongoing in November 2000 quickly rolled over as a recession began in March 2001 and lasted through November 2001.

In addition to the warning implicit to a wider-than-800bps monthly spread, the now rising trend of the high-yield spread's moving 12-month average suggests that complacency is ill advised. Recessions were either present or less than a year away each time the high-yield bond spread's moving 12-month average topped 600bps two years after the cycle bottomed (see accompanying

chart). Thus, the nearness of a possible downturn deserves consideration in view of how the high-yield spread's latest year-long average is 573bps and rising.

Figure 1: As Derived from Consensus Outlook for Baa Yield Spread, High-Yield Bond Spread May Reach a Recession-Prone Range Later in 2016



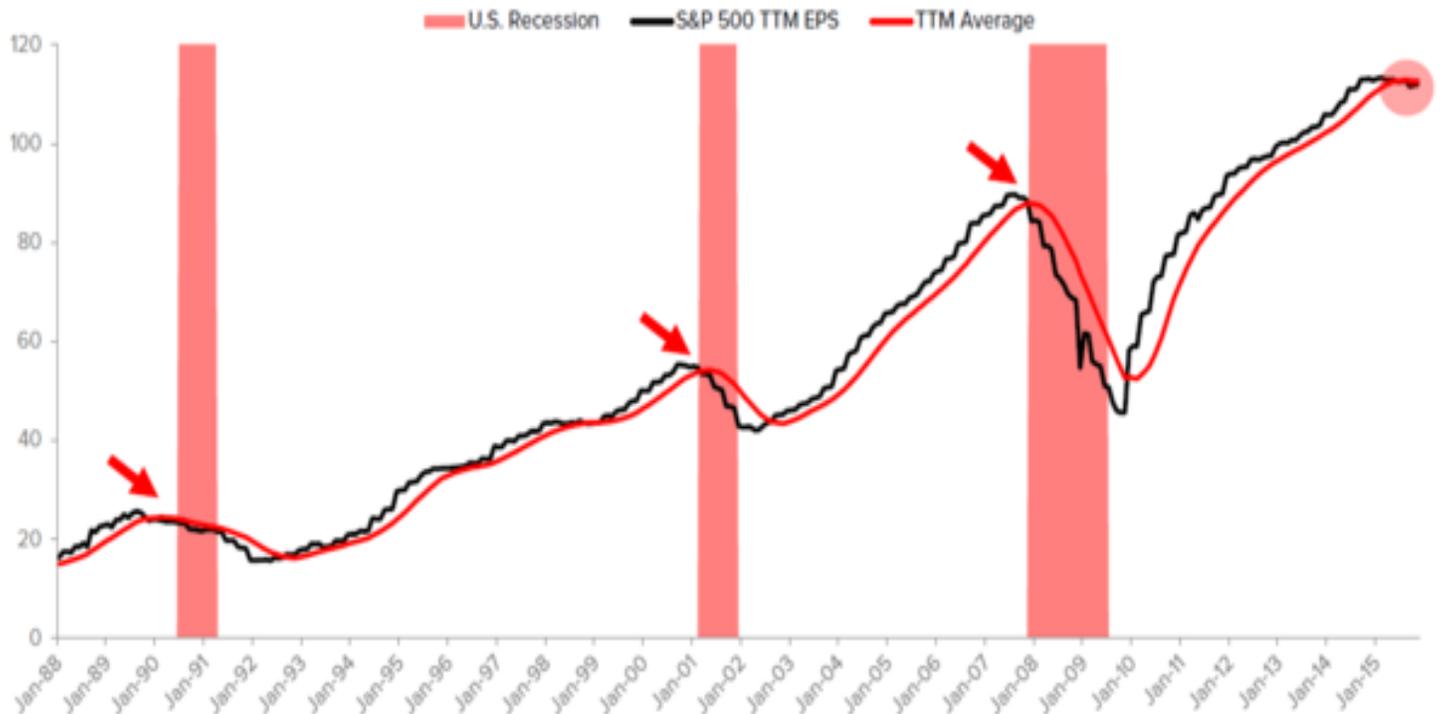
- Corporate Profits Cycle** – Fourth quarter earnings season is nearing an end with nearly 90% of S&P 500 constituents having reported with 68% beating bottom line estimates (in line with the historical beat rate) and less than half (46.8%) beating revenue estimates. The earnings beat rate looks good all things considered, but a growing divide that has been going on for several quarters and highlights the declining quality of earnings beats is the fact that only 37% of S&P 500 companies are beating “As Reported GAAP” rule based earnings estimates. Simply stated, this implies that the bean counters are having their fun with accounting shenanigans to meet low-balled Wall St. operating earnings estimates.

All told, Q4 EPS growth is set to decline almost -4% year-over-year and this represents the first time earnings will have declined for three consecutive quarters since Q1 2009 through Q3 2009. Ironically the S&P 500 is down close to -5% so far in 2016 which is almost in lock step with the decline in earnings which indicates that there really hasn't been much in the way of valuations getting cheaper for the overall equity market as both price and earnings in the P/E ratio are falling.

It's becoming more difficult to argue against the point that we are in fact in an earnings recession and looking back at the last three recessions, in each occurrence the trailing twelve month EPS level for the S&P 500 broke below its trailing twelve month average – this occurred in the second quarter of 2015.

EPS (E) INFLECTING, IN RATE OF CHANGE TERMS

THERE IS PERHAPS NO SUCH THING AS AN "EARNINGS RECESSION" WITHOUT AN ACTUAL RECESSION; THE LAST THREE RECESSIONS HAVE BEEN PRECEDED BY S&P 500 TTM EPS BREAKING DOWN BELOW ITS TTM AVERAGE – AN EVENT THAT OCCURRED IN 2Q15

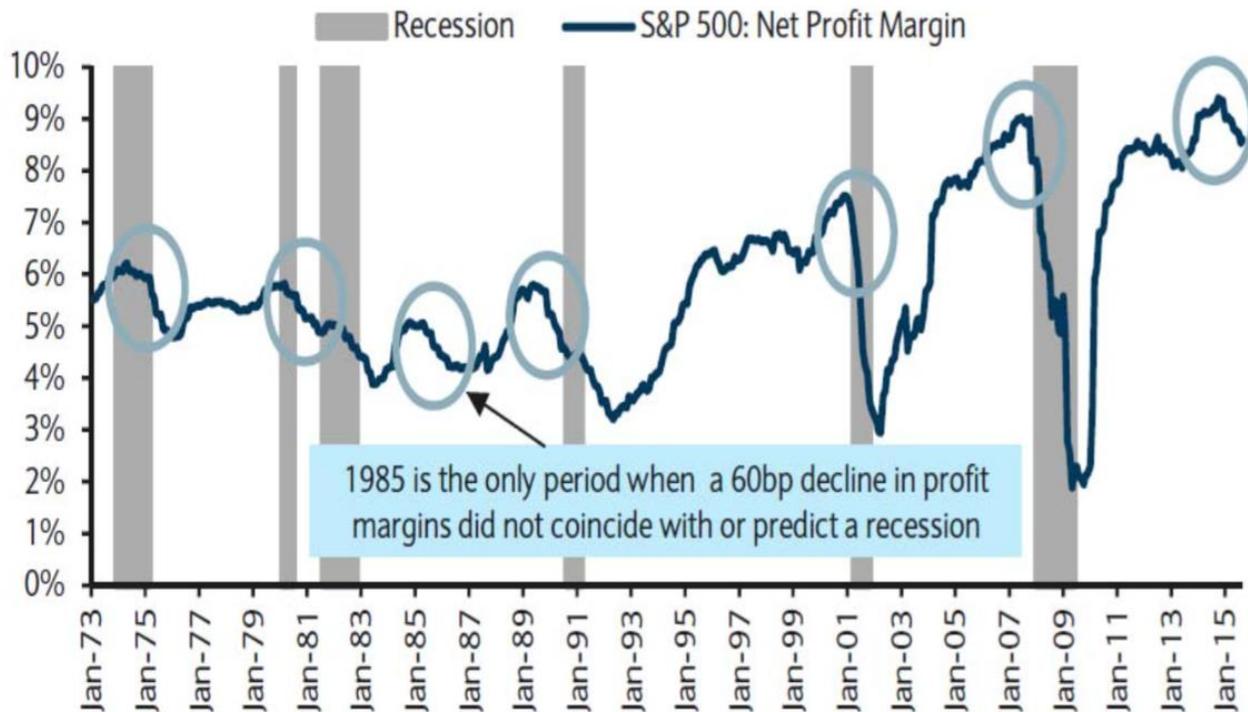


DATA SOURCE: BLOOMBERG

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A common refrain I am hearing from the talking heads on bubble vision is that the headwind from the collapse in oil prices and the rising dollar over the last 18 months is currently abating and this will turn into a tailwind going forward. I will concede that point and acknowledge how the math works as a positive going forward on a year-over-year comparison basis, but I find it misleading to highlight that caveat without referencing the continued deceleration in global growth. Furthermore, profit margins have been declining since the beginning of 2015 and will not be getting a reprieve going forward with wage growth increasing at its most robust pace of this cycle and labor share of corporate profits on a discernible uptrend. One additional point on this thought: the following chart highlighted by Jeff Gundlach (considered one of the brightest minds in the industry) in a recent presentation where he showed that only once in the last three decades have profit margins declined by 60bps or more and we didn't enter a recession.

S&P 500 Net Profit Margin



Source: Thomson Reuters, Barclays Research

Source: S&P 500 Index is designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries. You cannot invest directly in an index. 11-17-15 Asset Allocation Webcast 21

In closing, nothing has changed in the last two weeks that would alter the prevailing trends taking shape in these broad global market cycles. In my view, the rally that is underway in the equity market at this point is nothing more than a bear market rally in the midst of what continues to be a gradual deterioration in global economic and corporate fundamentals. Moreover, it's not until we get above the 1,960 level on the S&P 500 with confirmation from strong volume and leadership in the Financials and Cyclical that would indicate a breakout is underway and support a favorable technical setup.

I am well aware of the risks to this outlook and the merits of this thesis are being tested when we have a rally like the one that is currently underway. Keep in mind that I analyze and assess the capital markets through the prism of probabilities and not certainties (there are very few things in life, let alone this profession that I am certain of). With that said, I remain of the view that the probability of a recession commencing within the next twelve months remains elevated and the current rally off the February 11th 'lower lows' in the S&P 500 has done little to alter that view. While this investment thesis lacks certainty the analysis supporting such a view is not lacking of conviction or rigor. Furthermore, I believe the payoff structure from the array of scenarios that could payout is skewed to the downside if a recession does occur in the next 6-12 months with a material repricing of a wide swath of capital market assets awaiting investors positioned incorrectly.

A 1,000 point rally in the Dow in a matter of seven trading days isn't going to change what I think is going to be the next big discernible move in global capital markets. What hasn't confirmed this recent rally is the pricing in the credit markets with yield spreads compressing only marginally and the 10s/2s Treasury yield spread continuing to tighten as it recently moved inside of 100bps (its tightest level of this expansion).

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Beyond the price signals in the capital markets, there has not been any turn in the data flow that would be prescient at this point to consider actionable. On the margin the data continues to deteriorate outside of some one-off data points that create some short-term noise because it comes in better than expectations – the broader trend in global growth is slowing which is a recipe for lower prices for risk assets.

Keep in mind that bear market rallies are typically sharp, severe, and erratic as investors get whipped around as they try to make heads or tails of the confluence of conflicting data. Go back to the previous market peak in the S&P 500 at 1,576 in October 2007 when it proceeded to decline to 1,270 by January 2008 – a 306 point or -19% decline inside of four months. By May 2008 the S&P 500 ripped back up to 1,440 (adding 170 points or +13.4% - another four month interval) before crashing to 741 by November 2008 (a 699 point decline or -48.5% over the course of five months).

The point is that risk has a way of sneaking up on you and then you hit the edge of the waterfall and it's too late to jump out of the boat. All I'm suggesting is that investors do not become overly complacent with this recent rally and exhibit some discipline, humility, and prudence in their capital market outlook and their portfolio positioning. This is an exercise I am working through at the current time with my view. I know that if my risk-averse view turns out to be wrong that I can always put risk back into our client's portfolios.

In my opinion and in its simplest form, the risk to our client's capital for being wrong is twofold: 1) The missed opportunity from the potential upside to an equity market that is still trading near its historical average valuation levels and would have to go to above average valuation levels in a move higher and/or 2) The data turns for the better and suggests that the destruction in risk assets that has already occurred is behind us. In both cases I risk missing the initial move higher in asset prices from the turn (which may have just happened – I don't think so, but time will tell), but that is a risk I am willing to take given my belief that the downside risk in asset prices, if my view is right, is much larger. Whichever way this market pivots off this fulcrum, investors are currently in a position where they have to make a call in one direction or the other.



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