Casilio Leitch Investments
A Private Wealth Management Company

Capital Market Musings & Commentary

March 21st, 2016

Amalgamating some thoughts…

The rally in the U.S. equity market marked its fifth straight week of gains last week with the latest boost coming amidst a more accommodative monetary posture from the Federal Reserve. On the week, the Dow Jones Industrial Average jumped nearly 400 points (2.26%) and the S&P 500 gained 1.35% while equity market volatility (as measured by the VIX index) plunged -15%, and the 10-year T-note yield fell 11 bps – pushing prices higher by almost 1%.

Fed Chair Janet Yellen and the FOMC committee followed in the footsteps of recent dovish policy moves out of the ECB and BOJ as they revised down their estimates for rate hikes this year to just two hikes from four (surprising market expectations for a much more hawkish tone). Fed funds futures reacted instantaneously, plunging to a 38% probability of a hike by June from a 52% probability just prior to the FOMC meeting, and to 69% for only one rate hike by December from 82%.

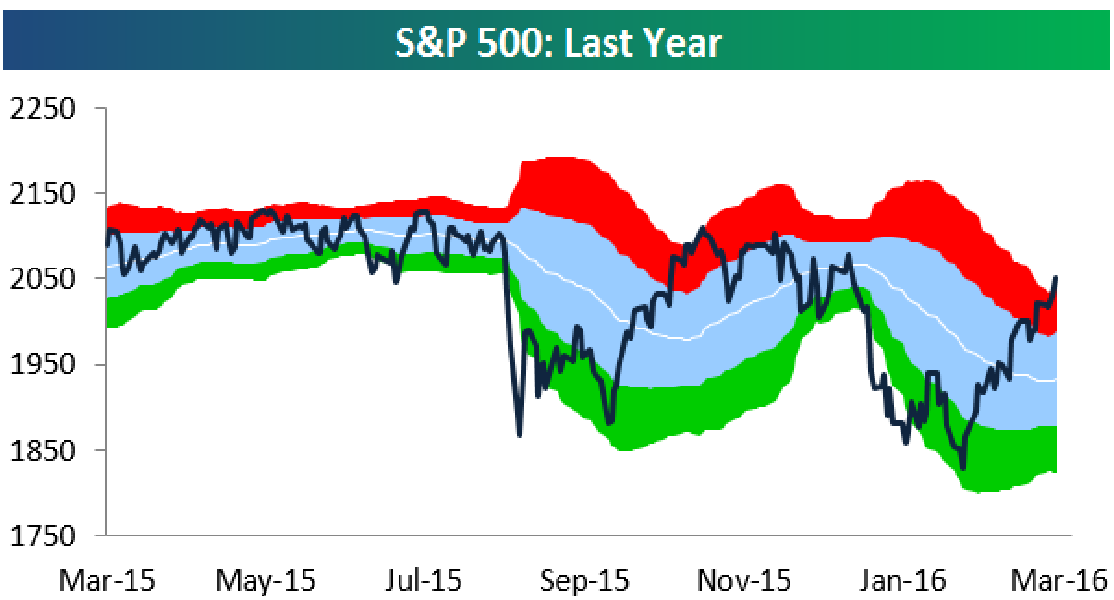
In summary, the Fed merely recalibrated its dot plot and forecasts more closely with where the capital markets have been for some time, but in doing so, it begs the question of whether the Fed is stirring market confusion or is the Fed itself confused? For example, for over a year the Fed has insisted that low inflationary readings were being driven by "transitory factors" – tough to convince savvy investors that a prolonged four year decline in commodity prices matches the definition of transitory (but, debating this topic is a fool's errand at this point). Yet, the most significant headwinds to higher inflationary readings (the unrelenting implosion of commodity prices and significant rise of the trade-weighted dollar) appear to have reversed and become tailwinds pushing recent inflation readings towards the Fed's 2% target. The Fed is finally getting what they asked for: core PCE inflation is running at 1.7% year-over-year (versus 1.3% only a few months ago), Core CPI rose at its fastest two month pace since 2006, and both the Cleveland and Atlanta Fed's inflation tracking indexes are running north of the 2% target level.

So here we have a Federal Reserve with a dual mandate targeting full employment and price stability, with the unemployment rate at a cycle low of 4.9% and core inflation near or above 2% (depending on the measure you choose) – for all intents and purposes the dual mandate is being met, and yet the Fed is nowhere near neutral. Go figure, my view is that at some point the Fed's affection for propping up asset prices is going to matter, but if and when that happens the pricing adjustment will be highly dependent upon the extent to which fundamentals have caught up to lofty valuations.

Be that as it may, the Fed (rightly) sees more downside risks than it did in December when it hiked interest rates for the first time in nine years – though back then oil prices were still in free-fall on their way to breaching the $30/bbl level to the downside, currency market volatility was unsettling with Chinese devaluation concerns front and center, and deflationary risks were all the rage. Fast forward a couple months and stock prices round-tripped a recessionary scare, commodity prices are firming, oil has popped above $40/bbl, the U.S. dollar has rolled over (down nearly 4% on the year), and U.S. economic data flow has shown a bit of a pulse.

One has to wonder if there was an unofficial agreement (a la Plaza Accord) reached at the recent G20 meeting deciding to take currency devaluation tactics off the table in an effort to stave off a potentially disruptive global currency war. Since that meeting ECB President Mario Draghi shot his bazooka, Chinese leaders have stepped in with numerous policies to slow its economic weakness (including actions to offset its burgeoning debt problem), the Bank of Japan stood pat while reassuring markets it could do more if needed, and finally we had a surprisingly dovish move by the Fed. The bottom line for investors is that central banks around the world continue to implement policies that feed into the wealth effect strategy of stimulating consumption which has been prosperous for asset prices throughout this cycle – albeit with what has been a diminishing marginal return at each incremental injection.

As for the stock market, the recent rally which has swept across the globe has restored nearly $8.5 trillion in global equity wealth since the February 11th lows. The S&P 500 is back into positive territory on the year, above its 200-day moving average, and a mere 4% below the all-time highs it reached last May. However, investors have to wonder if this move from egregiously oversold levels to egregiously overbought levels is a little too much too soon. According to work from Bespoke Investments the S&P 500 is currently at its most overbought level in the last twelve months – a full two standard deviations above its 50-dma which you can see from the chart below, a level that has in the past placed a cap on any further upside over the near-term.



It's amazing what a five week, 13% rally in stocks can do for investors psyche as the widespread negative sentiment that was so prevalent six weeks ago has dissipated considerably with the bears feeling as beaten up at the current time as the bulls did in mid-February.

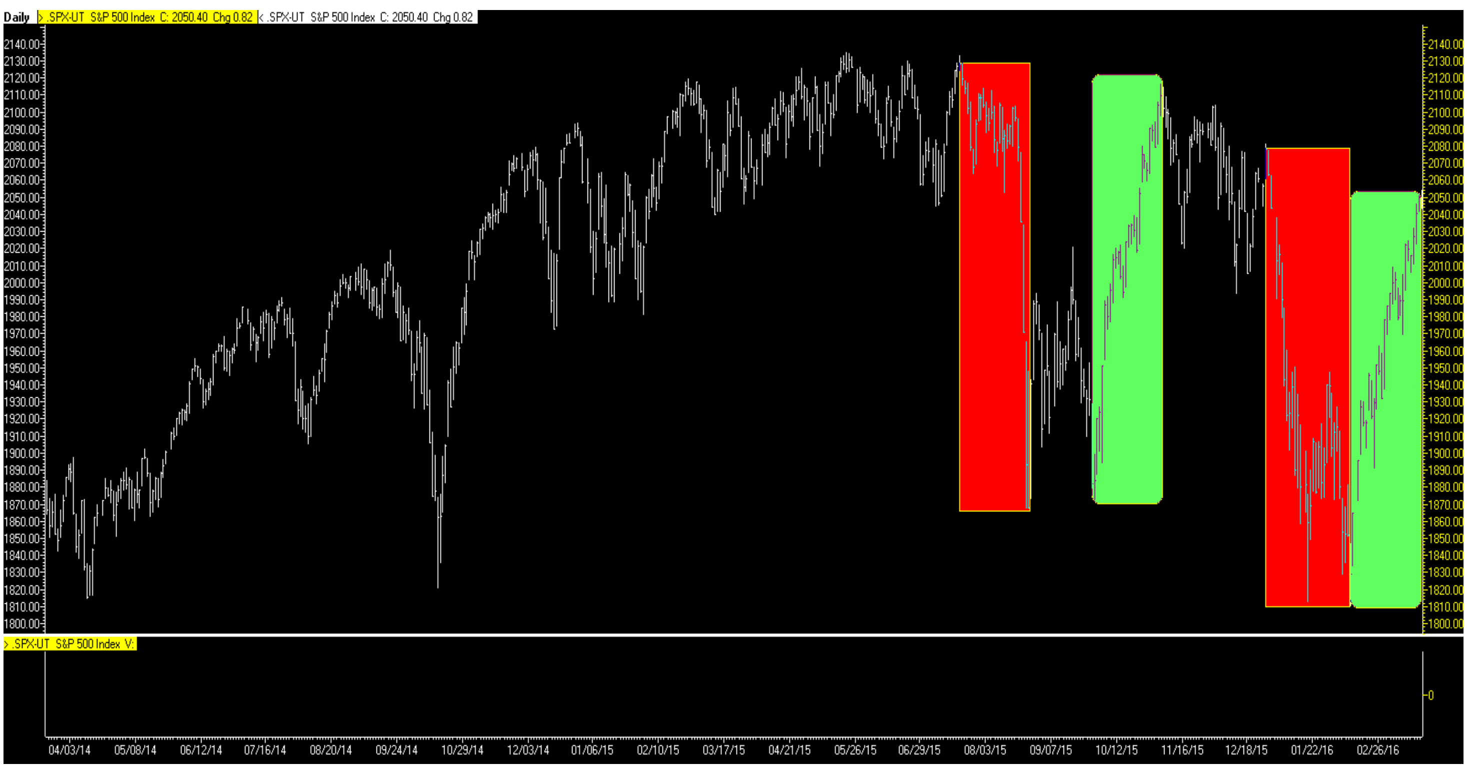
In addition to the sentiment readings flipping from a tailwind to a slight headwind, stock buybacks will be moving in the same direction over the near-term. This large source of equity demand is about to take a sabbatical with companies set to enter a quiet period (restricting their ability to execute share buybacks) in advance of Q1 earnings season starting in April. According to TrimTabs, companies bought back $95billion of stock in February which represented the third highest monthly level in history. These buyers will not return in full until late April early May so we'll see what the true investor appetite is for equities absent these systematic earnings management purchases.

Until proven otherwise, the stock market should be viewed through the prism that it remains in a topping process that began last July with the S&P 500 and Russell 2000 unable to push above cycle highs reached in May and June. Since peaking last year the S&P 500 has established a trading range of 1,800 on the low end and roughly 2,080 on the high end, with investors willing to take action at either one of these extremes being rewarded.

Here is how that trading pattern has played out: From July 21st last year through August 25th the S&P 500 experienced a -12.43% correction which lasted 27 trading days. It oscillated near the low end of this trading range for 23 trading days into late September before rallying +12.63% over the next 26 trading days. Once again treading water at the higher end of the range a new correction began with the S&P 500 dropping -13.84% over the duration of 33 trading days. Since then the S&P 500 has experienced a +13.4% rally over the last 26 trading days.

What is most concerning for the bulls who hold the view that this 20 month period of meandering stock prices is just a pause that refreshes and that the third longest bull market in U.S. history is not over, is the fact that the corresponding high to every rally since last July has been lower than the previous rally high:

- S&P 500 all-time high reached on May 20th, 2015 at **2,134.72.**
- July 20th the S&P 500 rises to **2,132.82**, but can't make a new all-time high.
- September 29th – November 3rd rally takes the S&P 500 up to a lower high of **2,116.48.**
- If the current rally (S&P 500 ending last week at **2,050**) that began on February 11th stalls out and fails, once again making a lower high, it would surely provide the bears with a lot of confidence and be a rather large blow to the bulls.
- All the while at each correction trough we have been making lower-lows – (lower highs and lower lows are not characteristic of a bull market).



Peeling back the onion a little further when comparing this current rally with the prior one is telling in a matter that suggests there is either some more healing that needs to be done or on the margin market prices reflect a view that things are modestly worse than they were at the rally high four months ago.

Comparing the Rallies

Data ▼	11/3/2015	3/18/2016
10-yr Treasury yield	2.22%	1.87%
Gain from recent low	12.10%	11.80%
Junk bond yield	7.43%	8.29%
S&P 500	2109	2044
S&P 500 Forward P/E	16.7x	16.6x
VIX	14.5	14.4
WTI crude oil	$47.90/barrel	$39.90/barrel

CNBC

The lower 10-yr Treasury yield suggests expectations for slower economic growth and tame inflation expectations. Junk bond yields failing to fully come down to where they were in November indicates a further weakening in corporate credit which is a function of oil prices (while having rallied 50% - also to lower highs) remaining stubbornly low and the anticipation that defaults will continue to pile up. Then we have the VIX index back near the 14 level which when this level was reached on prior occasions suggested that much of the risk aversion in equity markets has abated and complacency has resurfaced.

What this amounts to in my view is that the setup for investors continues to remain muddled with the wild and crazy gyrations over the last six months providing nothing in the way of clarity for those hoping to gain conviction in their view. We have an economic data flow that is progressing along a 'two steps backward one step forward path' with the latest batch of manufacturing data showing some signs of life at the same time that the larger consumer and services side of the economy is taking a leg down.

The valuation picture is even less constructive than it was six months ago with earnings growth expected to decline for a third consecutive quarter (notably with the slope of the decline picking up steam: Q315 earnings growth -1.6% YoY, Q415 earnings growth -3.3%, and estimates for Q116 earnings growth -8.2%). This has pushed the P/E multiple on the S&P 500 to a rather rich 17.5 at a time when profit margins continue to compress, top line revenue growth is decelerating, inventory/sales ratios are hitting cycle highs, and pricing power is non-existent.

The rally in oil prices will surely provide a bit of a reprieve to the earnings degradation and valuation premium as the outlook going forward appears to be better than at any other point since this decline started in 2014 that a bottom may be in. The U.S. just posted its first year-over-year decline in crude production in four years while the rest of the non-OPEC club has also seen production drop for the first time in three years. It appears that the rumors of an output freeze by OPEC members may well become a reality as an unscheduled April meeting seems likely. Moreover, the rig count in the U.S. has fallen by 70% and all those arguing that once oil prices reach a certain level a rush of supply will come back online from all those untapped wells should have a look at how tight the credit markets have gotten for energy producers. U.S. energy sector default rates rose to 10% this month from 8% in February and 0.9% this time last year when WTI was sitting around $48/bbl. Many of these producers that are on the brink of insolvency likely won't have access to the capital to get these untapped wells gushing again.

What is really catapulting up my list of things that 'keep me up at night' is the growing divisiveness and instability around the world. Call it what you will, but to me it amounts to a lack of confidence in global leaders. Here in the U.S. we are witnessing a primary season like nothing else we've ever seen before and its notoriety stems from the depths to which candidates will succumb to in order to look better than the other guy or gal. The two frontrunners – Hillary and Donald – have the highest unfavorable ratings of all the candidates in the field (you can't make this stuff up) – as Hillary gets forced further left by Sanders and Trump is completely unpredictable. Presiding President Obama has all but checked out and our legislative arm is in complete "kick the can" mode focused more on campaigning for the upcoming election than they are on governing.

Across the pond in the U.K. Prime Minister David Cameron is in a battle with this upcoming Brexit vote, German leader Angela Merkel is seeing her popularity wane more than at any point during her rein, secessionists forces are spreading through Spain, Prime Minister Francois Hollande is being forced to back off labor market reforms due to a weakening economy, and Italy is on the precipice of a banking crisis. Putin is dictating policy in the Middle East while stabilizing the Assad regime in Syria, Iran is back to testing missiles, Brazil is engulfed in fraud, China's leadership is fighting credibility issues, Abenomics in Japan is failing, and the Modi revolution in India has largely fizzled.

This isn't to imply that anarchy is about to explode as most of these issues have been ongoing for some time now, but it does lead one to surmise that the world is an unstable place. If global growth continues to decelerate this will only bring further pressure and stress to the most fragile regions – in a globalized and highly integrated world these adjustments, whether large or small, could be impactful. Ultimately, what it implies for investors is that risk premiums should remain elevated and valuation levels should compress.

I will be taking a brief respite from this missive next week in celebration of the Easter holiday and would like to wish all those partaking in the festivities a very happy holiday.

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.
