



April 25<sup>th</sup>, 2016

### What goes around comes around...

It was a fairly quiet week in the capital markets last week with the majority of the main equity indices registering modest gains: the Dow Jones Industrial Average rose 106 points (0.59%), the S&P 500 added 11 points (0.52%), and the small cap Russell 2000 index jumped almost 16 points (1.39%). However, several key segments of the equity market experienced some relative weakness as the Nasdaq Composite struggled (declining -0.65% on the week) in the face of some disappointing earnings out of some key constituents (Google & Microsoft), the Consumer Discretionary sector registered a modest loss on the heels of good but not great results out of Starbucks, Visa, and McDonalds, and investors rung the register on some of the profits generated in the Utilities (down -3.5% last week, but still up more than 10% on the year) and Consumer Staples sector (lost -2.0% last week but up almost 3% ytd).

As for Q1 earnings season, so far 26% of S&P 500 companies have reported with 76% beating on the bottom line with overall S&P 500 EPS estimates tracking a year-over-year earnings decline of -8.9% in the first quarter (top line revenue is tracking a decline of -1.2%). Fully seven sectors are tracking a YoY decline in earnings while only three sectors (Consumer Discretionary, Healthcare, and Telecom) are reporting YoY growth in earnings. Now I've seen numerous mentions of the "if you exclude the energy sector" from the Q1 earnings picture then the earnings decline would improve to -3.6% from -8.9%. Yes, on the surface this is accurate, but what I don't see when these exclusions are made is what would happen to the 2.2% ytd gain in the S&P 500 Index if you took away the 11% ytd gain generated by the best performing sector (which is the energy sector) of the S&P 500. That's because it would almost eliminate all the gains for the year.

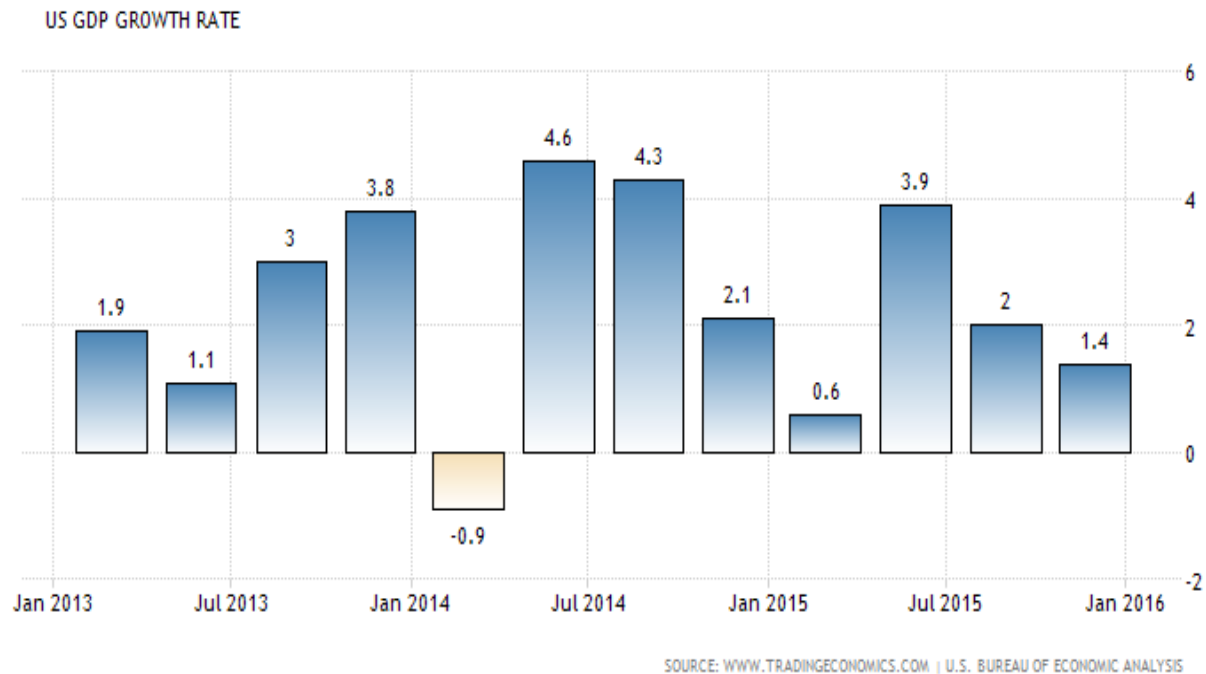
Digging a bit deeper into the earnings picture shows a similar tale to what has epitomized 2016 thus far – a fundamental picture that is weak, but resilient and not falling off a cliff. While the absolute earnings results show profits declining more than -8.0%, these same results are 4.0% better than analyst expectations with all 10 sectors besting the beaten down analysts estimates coming into the Q1 reporting season. This week represents the busiest week of the earnings season with nearly 1/3<sup>rd</sup> of the S&P 500 market cap reporting (some big players: Apple, Amazon, Facebook, Proctor & Gamble, Exxon Mobil, and Chevron...), but it appears at this point that the table is set and investors have accepted the narrative that Q1 will represent the trough of the earnings cycle with expectations that an earnings recovery is set to commence in the second half of this year. Time will be the ultimate arbitrator on this thesis, but with an S&P 500 back at the high end of its trading range at 2,100, it begs the question of how much of this 'hope strategy' is already reflected in prices (me thinks a lot of it).

This 15% rally in the S&P 500 off the February lows is indicative of investors not only pricing out a recession, but at the same time pricing in a "V-shaped" recovery. As I look out over the next several quarters I believe the current setup in the capital markets creates a rather ubiquitous mine field which renders

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itself extremely challenging to navigate. From a big picture view, the macro environment is anything but comforting when you consider that U.S. GDP growth has been persistently slowing to the point where it may be a stretch for Q1 growth to dawn a one-handle. The Atlanta Fed GDPNow is modeling Q1 GDP growth at 0.3% while the recently revealed New York Fed “Nowcast” of GDP growth is forecasting 0.8% for Q1 (we’ll get the first release of the official Q1 GDP data on Thursday). And I tell you what, according to some of the research we follow there is an elevated probability that Q2 will be even worse than Q1. Take a look at the following table tracking quarterly GDP since the beginning of 2013 (now envision Q1 and Q2 2016 estimates of less than 1%) and you be the judge on whether or not U.S. economic growth has peaked and started to rollover.



This trend implies growth over a three-quarter period has throttled back to an average pace of 1%. This isn't recessionary, but let's call a spade a spade as this represents a trend growth rate that is razor thin in the way of allowing for any margin of error, whereas even a mild exogenous tremor has the potential to create a rather large crater.

I would be remiss if I didn't call attention to the article in today's FT on page three highlighting China's debt surge as one of those potential exogenous shocks. The article points out that Beijing has boosted net borrowing by 50% on a year-over-year basis which is a meaningful crutch helping to put a floor under growth, but it's realistic to expect that this credit card is nearing its limit with total net debt at 237% of GDP (materially higher than the 148% of GDP this metric was at back in 2007). Highlighting how China's debt boom could become a growing concern for investors is a report from Bloomberg that in the past week China's noninvestment grade bond market posted its worst selloff in two years with over 90% of the country's bond funds experiencing a decline in their net asset values.

Back in the U.S., unfortunately the economic data over the last several weeks hasn't been all that constructive in fundamentally supporting the equity market multiples pushing up to cycle highs (more on this later). The results last week from the Philly Fed manufacturing index swinging back into negative terrain in April to -1.6 (consensus was expecting +9.0) from +12.4 in March was a big miss and the internals of the report are consistent with next week's national ISM index falling back below 50 for the month. On top of the disappointing Philly Fed Index we got the Chicago Fed's National Activity Index (NAI) – keep in mind

this is one of the most comprehensive metrics to assess overall economic activity – and it continues to go from bad to worse: from -0.07 in January to -0.12 in February, and to a five month low of -0.23 in March.

The three month trend in the NAI (which the board encourages followers to focus on, as it smooths out the noise in the monthly data) fell to -0.18 while all four major categories in the index were either flat or sub-zero. In summary, this report is consistent with what is showing through in the national GDP workup and that is increasing slack as growth remains below potential.

The last bit of disappointing economic data that I'll highlight (not to mention the disappointing retail sales and weakening trend in housing) was the Conference Board's Leading Economic Indicator (LEI) ticking up to 0.2% in March, but this was half of what consensus was expecting and the February reading was revised down to -0.1% from +0.1%. This index has been negative now in three of the last four months with the six-month diffusion index moderating to 55% and if one were to play the 'ex-game' (excluding the positive contributions from a rising stock market and the yield curve) the headline LEI would have declined for four consecutive months – this last happened at the depths of the recession from Feb-May 2009.

So, here we are with the S&P 500 within a whisker of its all-time highs, trading at close to a 19x P/E on trailing 12 months earnings (historical average is near 15.5x), and 17x multiple on forward earnings. This forward multiple is what is key to me, as markets tend to focus on what they see through the windshield rather than what's in the rear-view mirror. On this score, the horizon looks a bit foggy when you consider that the average forward P/E multiple since the early 1980's is around 14.5x and if one were to strip out the Tech-bubble in the late 90's this average falls to the mid-13's. The following chart from Ed Yardeni clearly encompasses the recently renewed divergent trend between the lofty P/E on the S&P 500 and weakening macro-economic data (captured by the Citi Group Economic Surprise Index), this is a similar setup to where we entered 2016 and we all know how that turned out (the worst decline in the stock market to start a year in history).



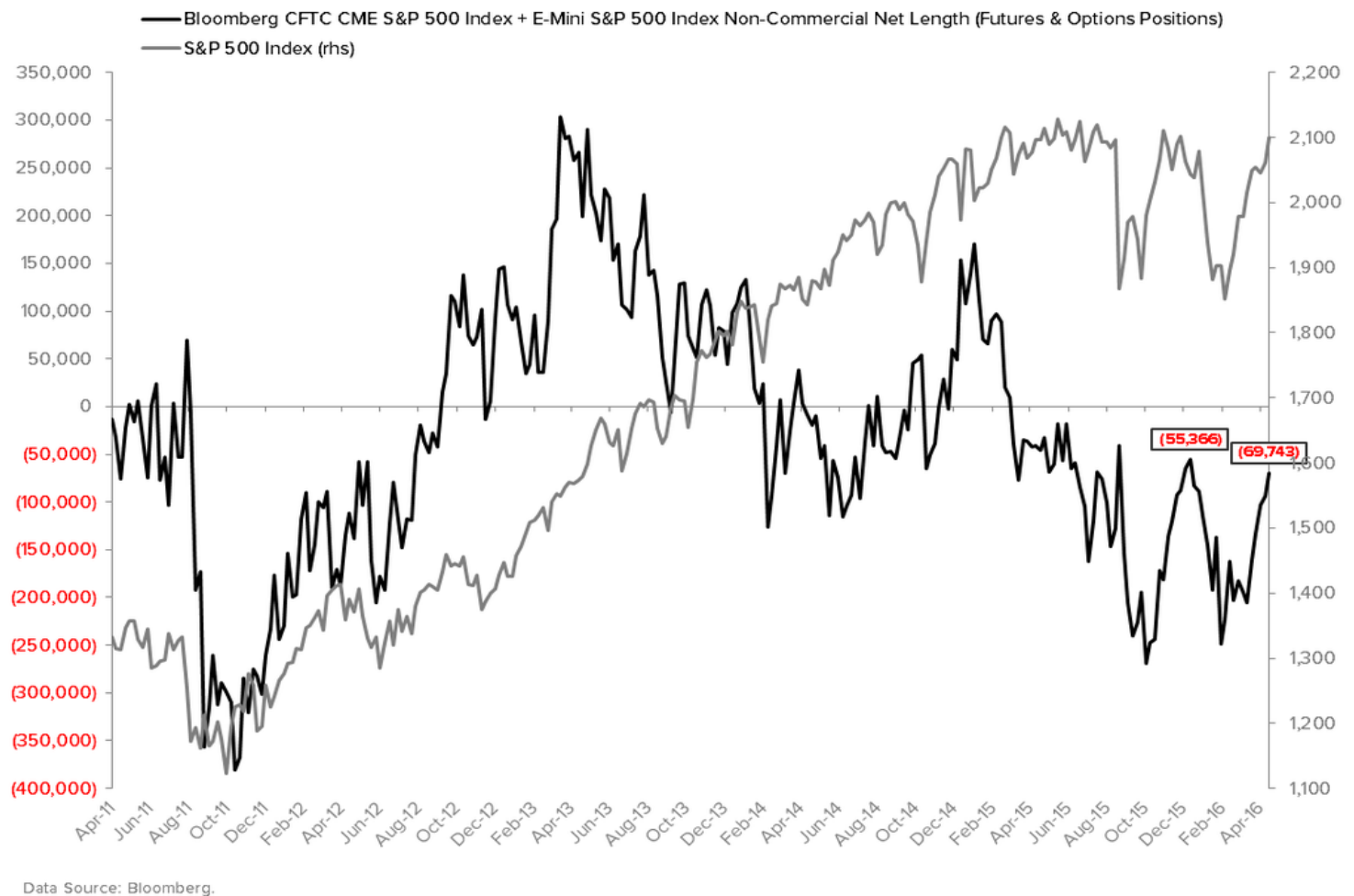
\* Average weekly price divided by 52-week forward consensus expected operating earnings per share.  
Source: Standard & Poor's, Thomson Reuters I/B/E/S, and Citigroup.



I'm not suggesting that equities are currently in bubble territory, but outside of a handful of euphoric periods in market history, rarely have stocks been as expensive as they are today. So, at current valuation levels stocks have either borrowed a material amount of gains from the future as they tread water waiting for fundamentals to catch up, or investors putting new capital to work at current levels risk a rather large air pocket if prices move down to meet soft fundamentals.

So valuation is a constraint, the economy is sputtering, and earnings are weak (with a forward outlook that is holding up for now), but what about sentiment and positioning? The VIX trading around 13-14 and a put/call ratio of 0.6x signifies a high level of complacency among market participants. Looking back over the last year, investors who bought stocks when the VIX was at current levels likely were not very happy with their results. However, investor sentiment as measured by the latest Investors Intelligence poll isn't crazy bullish – bulls up at 47.4% from 41.2% and the bear camp falling to 21.7% from 28.7%, which took the bear-bull spread to levels that persisted back in August 2015 (not all that comforting given what transpired in late August / early September).

As for positioning, the latest Commitment of Traders data out of the CFTC shows a lot of the short positioning in the S&P 500 futures has been worked off since the February lows. At the present time short bets (bets against the market moving higher) are at their lowest level since December – another one of those contrarian negative signals as it indicates that much of the pent up demand for further short-covering has virtually played out (see chart below).



There are also some bearish divergences that have started to show up in the relative strength (momentum indicator) on many indices that I think are too important to ignore as some of these indices were the first to call the positive turn at the market lows on January 20<sup>th</sup> and February 11<sup>th</sup>, but they are singing a different tune at the current time (hat tip to J.C. Parets and All Star Charts for sharing).

**S&P 500**



**Nasdaq Composite**



**Emerging Markets**



**Latin America**



**Semiconductors**



**Industrials**



This week is a light week on the data front in the U.S. with the key reports being March durable goods orders and Consumer Confidence on Tuesday, GDP on Thursday, and Personal Income and Spending as well as U. of Michigan Sentiment on Friday. What will garner the most attention will be the FOMC meeting on

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Wednesday and the Bank of Japan meeting on Thursday. Keep in mind that this Fed meeting will not include updates to Fed forecasts or a press conference, so a lot of attention will be paid to any perceived shift in tone from the interpretation of the press statement (gotta love this game – oy vey). Given the dovish shift at the March FOMC meeting and the reiteration of the Fed’s accommodative stance by Chair Yellen during her speech at the Economic Club of New York in late March, I believe the risk to asset prices is tilted towards the statement leaning hawkish – especially when considered in the context of a Fed Fund futures market that is only priced 20% of the way towards a June hike (16% last week and 40% before recent speeches by Yellen and Dudley).

If this year has taught investors anything it is that the driving forces behind significant market moves can change on a dime and with that so do market prices and investor’s reactions to those forces. Coming into the year and leading the charge to the equity market lows it was all about the strong dollar, collapsing oil prices, an earnings recession, faltering Chinese growth, and a tightening Fed. Since the lows, many of these headwinds have dissipated: the U.S. dollar is down -6% from the January highs, oil prices look to have put in a floor and while inventory levels remain high the falling output data and strengthening demand picture suggest this excess supply will gradually be chipped away, market perceptions are that the earnings recession is nearing its end (I remain suspicious of this view, but that’s what makes a market), Chinese economic data has stabilized, and the Fed interest rate normalization cycle has been put on hold.

In this business what goes around comes around, so just as it paid not to follow the herd mentality of extreme negativity at the lows it makes just as much sense to not get too caught up with all the hype at the highs. As J.P. Morgan famously said, *“I never became wealthy by buying at the lows or selling at the highs. I was there merely for the middle 60 percent”*. In my opinion, we’re well beyond the middle 60% of this bull market cycle and investors have an opportunity today with stocks near all-time highs to heed this advice and adjust accordingly.



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