



May 2nd, 2016

U.S. growth nearing stall speed...

Global equity markets closed out April on a somber note with most of the major equity averages ending last week in the red: Dow Jones Industrial Average (-1.28%), S&P 500 (-1.25%), Nasdaq Composite (-2.67%), Russell 2000 (-1.38%). It's hard to imagine with all the talk about stocks nearing all-time highs, but this marked the fourth weekly decline in the last six for the S&P 500 and this waning momentum is coming at an inauspicious time as the calendar shifts to what has historically been the weakest seasonal period for stocks (that old 'sell in May and go away' market mantra). It's not in my nature to put a lot of stock into these spurious correlation relationships, as I believe the statistical relevance supporting this adage is very much driven by some aberrational one-offs that so happened to have occurred during the summer months.

Nevertheless, the data detailing this relationship going back to the 1960's and over the last 10 years is provided in the below chart which does confirm that the May to October time period is relatively weaker than the rest of the calendar year, but historically the S&P 500 has still averaged a positive rate of return during this presumably terrible period. So, perhaps a little more bark than bite when you peel back the onion and a reminder to investors to focus their attention on things that historically have a better track record of forecasting future market trends (such as: fundamentals, valuations, interest rates, inflation, positioning...) rather than betting their hard earned fortune on a clever catch phrase.



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The real market moving event(s) last week was the inaction by central banks in both the U.S. and the Bank of Japan. First on the latter, as it was widely expected that the BOJ would expand upon its existing quantitative easing program and take interest rates further into negative territory given the deteriorating economic picture and escalating deflationary pressure in Japan. But Governor Kuroda (in an eight to one vote) shocked investors with his decision to keep policy on hold, expressing his desire to sit back and assess the lagged impact of the stimulus already in place due to prior action.

Given investors' continued insatiable appetite for monetary largesse it's fair to presume that the Bank of Japan has moved ahead of the People's Bank of China as the central bank with the biggest credibility issue. Recall that Kuroda first shocked investors in late January when he adopted negative interest rates without any guidance, then he follows that effort up with a giant dud. The market reaction following that January meeting was the first indication of fraying in the central bank belief system as one of the BoJ's objectives in adopting a NIRP (negative interest rate policy) was to further weaken the Yen. However, the Yen has done anything but weaken since the adoption of NIRP and has appreciated 12% on the year as it sits at its highest level (¥106.5) since October 2014.

No doubt the ECB is taking notice of the market reaction to the BoJ's policies: shock the markets with more than expected stimulus at the end of January – the Yen rallies, then shock markets once again by doing nothing last week – the Yen rallies further – in what is morphing into one of those 'damned if you do and damned if you don't' situations. The last thing the ECB wants is to see the Euro trading back up to €1.15 (where it closed on Friday) with growth in the Eurozone limping along at a little over 1.0%.

What wasn't a surprise to markets was the Fed deciding to leave rates unchanged at the conclusion of its April FOMC meeting. The most important thing coming out of the meeting was the Fed's acknowledging the weakening growth trend in the U.S. economy, as the statement read "growth in economic activity appears to have slowed". While they attempted to temper this dreary view by highlighting "labor market conditions have improved", what we've learned over the last four quarters as GDP growth has declined from 3.9% (Q2 2015), to 2.0% (Q3 2015), to 1.4% (Q4 2015), to 0.5% (Q1 2016) is that more jobs are not healing what ails floundering economic growth.

All in all the Fed meeting closely mirrored market expectations with market based odds of a June hike slipping from 21% just prior to the release of the Fed statement to 15% shortly after. Another variable working against a potential June hike (meeting is held on June 14-15th) is the U.K 'Brexit' vote on June 24th where it is widely viewed that the Fed has little interest in adding additional volatility to an event that already carries heightened uncertainty (although this uncertainty is diminishing with the latest polls moving more in favor of the U.K. remaining in the European Union).

Over the last couple of years I've continued to warm to the view that when either the curtain gets pulled back or the music stops with this widespread experimental monetary policy, it will end badly. Perhaps the unexpected currency movements (or maybe this is what the central banks wanted and I'm the fool for thinking otherwise...) to the recent moves by the ECB and the BoJ are indications that central banks are reaching their limits to monetary policy effectiveness as the laws of diminishing marginal returns are setting in.

Though when one takes a step back and assesses what has transpired since the rumored 'Shanghai Accord' following the G20 meeting in late February, they must acknowledge the positive impacts. After all, the broad weakening in the U.S. dollar (down nearly -6% on the year) takes a lot of pressure off the beaten down manufacturing sector and removes a headwind for a large chunk of the S&P 500 that operate beyond the U.S. borders. This weaker dollar also helped put a floor under collapsing commodity prices which has provided a much needed jolt to stabilize deteriorating credit conditions in the Emerging Market space. Additionally, it

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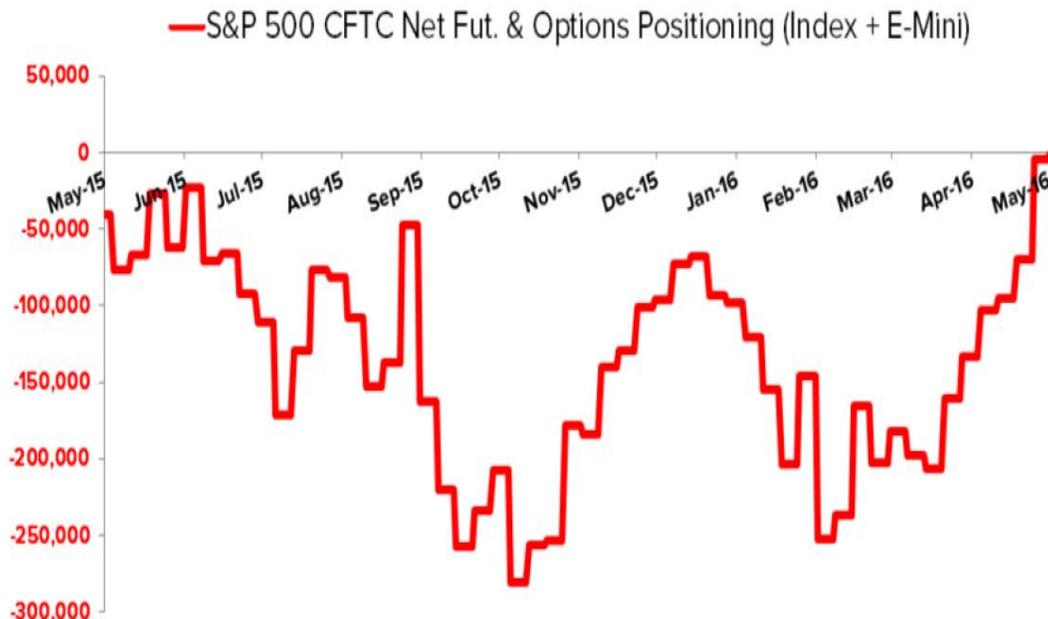
has taken cost pressure off a Chinese economy that is struggling with its transition from an export and infrastructure dependent economy to a more stable consumption driven model.

One variable that is theoretically viewed as having positive implications on economic growth is lower interest rates, yet I find myself apprehensive at the current time buying into this notion when I see negative yields out as far as 15 years in Switzerland, 10 years in Japan, 8 years in Germany, 5 years in France, and 2 years in Italy. So, let's just say the verdict is still out on this one as it will require more time to fully comprehend the ultimate implications – unprecedented monetary policy implemented for a much longer than anticipated time period which has pushed rates to historically low levels and global growth hovers around 3.0% (a level the IMF views as recessionary)...hmmm.

The data flow last week was mixed at best with consumer confidence continuing to falter, wage growth remaining subdued, and jobless claims rising slightly (while the absolute level remains near 40 year lows). The headline grabbing economic report on the week was Q1 GDP growth slowing to a puny 0.5%. The internals of the report didn't leave much to be desired as the consumer, non-residential construction, and net exports components all slowed with only government spending and residential construction showing a pick-up in growth.

The most cyclical components of U.S. real GDP are contracting at nearly a -4% annual rate in Q1 and the handoff to Q2 doesn't look that robust with early estimates tracking growth expanding at 1.5 – 2.0%. A pickup, yes, but anemic when compared to the typical 3.0%-plus rebound the following quarter in prior cycles when GDP dipped below 1.0% (for whatever reason). Considering the trend in growth from Q4 (1.4%) to Q1 (0.5%) anything below 2% in Q2 classifies as a miserable recovery in growth and materially challenges the view for a V-shaped earnings recovery in the second half of the year with a S&P 500 trading at a lofty forward P/E of 18x.

For sure, GDP is backward looking, but this is no time to be aggressively long when all that may be in the offering looking forward is a pathetic and muted bounce. Moving forward, but with caution looks to be the prudent approach at this point. Unfortunately this doesn't appear to be the approach many investors are taking considering the latest reading from the CFTC data showing that all of the net speculative short position on the S&P 500 has been taken out in this latest rally. In fact the below chart shows investor positioning at its most bullish level since the S&P 500 neared its all-time highs last July.



This move back near the all-time highs in the U.S. equity markets is coming at a time when S&P 500 earnings growth is traversing its weakest quarterly tally since this expansion began. Over 60% of S&P 500 companies have reported with earnings falling -8.95% as only four of ten sectors are reporting growth (Consumer Discretionary, Consumer Staples, Health Care, and Telecom). Sales growth is weak as well, but the saving grace is that on both metrics companies are meeting beaten down analysts' estimates.



One constructive fundamental underpinning that investors are hanging their hat on is the positive turn in Earnings Revision Ratio's (ERR). According to data from Merrill Lynch's Global Strategy Team the three-month ratio of positive vs. negative earnings revisions (ERR) ticked up in April for the second month (to 0.76 from 0.53), after falling since July. Analysts are still cutting more estimates than they are raising, but at a slower pace. The one-month ratio increased to 1.03 from 0.77 amid better-than-expected 1Q results, its third month of improvement and the first month of more positive than negative revisions since August. Sustained improvement in the ERR could suggest the earnings downgrade cycle has ended.

The three-month sales forecast revision ratio also ticked up for the second month in April, to 0.66 from 0.46 – its highest level in nine months. The ratio still remains below the long-term average of 1.0, suggesting more cuts than increases to sales forecasts, but at a slowing pace. The more volatile one-month sales forecast revision ratio improved for the third month in a row, to 0.95 from 0.75 – it's highest since mid-2014.

We'll see if this trend continues to hold and the optimistic expectations going into the second half of the year materialize, but at a minimum this improvement makes the current rich valuation more palatable.



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