July 25th, 2016

Too much complacency…

Welcome to the 'dog days of summer' which was on clear display last week in the capital markets as both stocks and bonds were open for trading, but very little trading occurred in what was the lowest volume week of the year. All of the major U.S. equity indices finished higher on the week with the Dow Jones Industrial Average's win streak of nine consecutive positive closes coming to an end on Thursday (who knew stocks could trade down?) but by Friday's close both the Dow and S&P 500 closed virtually at their all-time high levels.

Since the Brexit vote the U.S. dollar has been on a bit of a stealth rally (+4.7%) in yet another example of something that mattered in the past (strong dollar) not mattering in the present. Same goes for oil which peeked its head above $50/bbl in early June, but has since stair stepped lower as it dipped below $44 last week. The decline in the price of oil (-5.3% over the last week and -11.2% in the last month) is occurring on the back of some legitimate headwinds: seasonally high inventory levels, OPEC continuing to play the 'market share retention' game, and rig counts having risen in each of the last four weeks. However, if it's any consolation the executives of both Halliburton and Schlumberger insinuated on their earnings calls that they see indications that the trough in the oil cycle is in. Here's to hoping they're right as they would know better than almost anyone, but they also have every incentive for this to be the case.

Both a rising dollar and falling oil prices had markets on their heels this time last year, but what's different this year and why it doesn't matter to investors as much at this point is that we know where the ceiling and the floor are for both these prices at the current time. You see, capital markets (technicians in particular) are much more at ease when they can identify a price range for a financial asset – it's when an asset breaks out of a range to one side or the other that uncertainty takes over and things get pushed to extremes.

This is something that is playing out in a U.S. stock market that continues to make new highs almost daily. The FOMO (Fear Of Missing Out) trade is clearly on and no one knows how far it will get bid up on what is an almost 185 point (+9%) move in the S&P 500 over the nineteen trading days since the Brexit lows. While the anxiety may be rising for anyone who is sitting on the sidelines watching this rally, it's likely best to stay the course at this point and not jump in and chase what looks like a move that is reaching its exhaustive phase.

Giving me confidence in the view that stocks are too far out over their skis at the current moment are the following data points:

- The latest CFTC Commitment of Traders report which details the net long or short positioning of Non-Commercial participants (think speculators) show that as of last week the net long positioning in the S&P 500 is at its most extreme net long exposure (+154k contracts) in the last 18 months. On a one year Z-score basis the current net long exposure is equivalent to a 1 in 20 event (or about 5% of the time). This data should be viewed as a contrarian indicator and the current extremely bullish positioning stands in stark contrast to the net short exposure of -280k contracts in the S&P 500 during the week of the February lows.

- The broad array of industry sentiment surveys have all shifted materially towards bullish optimism (sentiment data should also be viewed with a contrarian mind frame). The Market Vane Bullish Consensus Stock Index has moved to its highest level of the year at 64% (history indicates that the best times to buy stocks is when this metric is near the 40% level), the latest American Association of Individual Investors (AAII) Sentiment poll numbers show the bull share rising to 35.4% (up significantly from the year-to-date low of 17.7% reached at the end of May) with the bear share melting away to 26.7% (down from 29.4% at the end of May), the Bull/Bear spread (Bull camp 54.4% vs. Bear camp 23.3%) in the Investors Intelligence poll has expanded to its widest level since global equity markets peaked last July, and the CNN Money 'Fear and Greed Index' reached 90 last week which triggered an 'Extreme Greed' reading (given the range of this index is 0 to 100, with 0 representing 'Extreme Pessimism' and 100 representing 'Extreme Greed').
- The Chicago Board Options Volatility Index (VIX) ended the week at 12 and is at its lowest level since mid-August 2015 – for those of you who don't recall by the end of August the VIX had spiked to almost 30 (this came on the back of an unexpected one-time devaluation of the Yuan by the Chinese). This decline in the VIX over the last four weeks is the largest decline over any four week period in history.

It's been outright impressive how investors have been able to brush aside any semblance of bad news since the stock market lows in February. I guess this is what is meant by the old adage 'markets climb a wall of worry', and this wall of worry seems to have only gotten higher over the last four months: Q1 GDP on its initial print had all the makings of an economy slipping into contraction, then there was the lowly 11k print in the May payroll report, the Brexit vote shocking everyone by becoming a reality, a failed coup in Turkey (one of the 20 largest economies by GDP in the world), solvency scares across the European Banking industry, terrorist actions around the world almost on a daily basis, and an extremely contentious U.S. election campaign. Yeah, I guess there is nothing to see here and the fact that market positioning is nearing its most complacent state in the last year makes complete sense (yes, the sarcasm is very much intended).

There's no denying that the incoming economic data in Q2 has pleasantly surprised to the upside, rendering the recessionary scare in Q1 a relic, but investors should not get too carried away here as this pick-up in the data thus far is merely just a bounce to lower highs in most data series. However, should this bounce gain momentum throughout Q3, then we'll have something to talk about and a firmer foundation to support what are becoming quite lofty equity valuations (more on this in a moment).

Keep in mind that this bounce came on the back of some material shifts in policy and stimulus that likely are not repeatable and carry a decaying shelf life. For instance, the about face in the Fed's rate hiking cycle that shifted from a tightening bias (guiding markets to expect four hikes this year) to a more accommodative stance. This had the effect of moving the Fed Funds futures market to not price in one 25 basis point hike until February of next year. Then there were similar moves by the Bank of Japan which took rates into negative territory and the ECB (which was already implementing NIRP) expanded upon its QE program by extending its asset purchase program to include corporate bonds. In a world where the efficacy of each incremental move towards more monetary policy accommodation has diminished – it begs the question of what these central bankers can do for an encore.

Helicopter money? Yes, this along with a massive fiscal stimulus package are being considered in Japan as Abe and Kuroda start to scrape the bottom of the barrel of policy initiatives they can employ to jump start an economy stuck in neutral.

In addition to central banks going all in earlier this year we had the Chinese extend nearly $1 trillion of credit to its economy in a four week period starting in late February. This injection had the effect of China printing a GDP growth rate of 6.7% – a measly one tenth of a percent above consensus expectations – which makes you wonder what that number would have been without the massive extension of credit. Don't get me wrong, I'm not calling for the imminent demise of China as I think they have both the ability and capacity to stretch this debt implosion out over the span of years, if not decades. But when a global economy that is extremely desperate for growth sees income growth slow in the first six months of the year to 6.5% (from 7.6% in 2015) in the second largest economy of the world, on top of investment slowing to a 16-year low, and job prospects hitting a four year low – it should surprise no one when headlines hit that the IMF is trimming its world growth forecast to 3.1% from 3.2%.

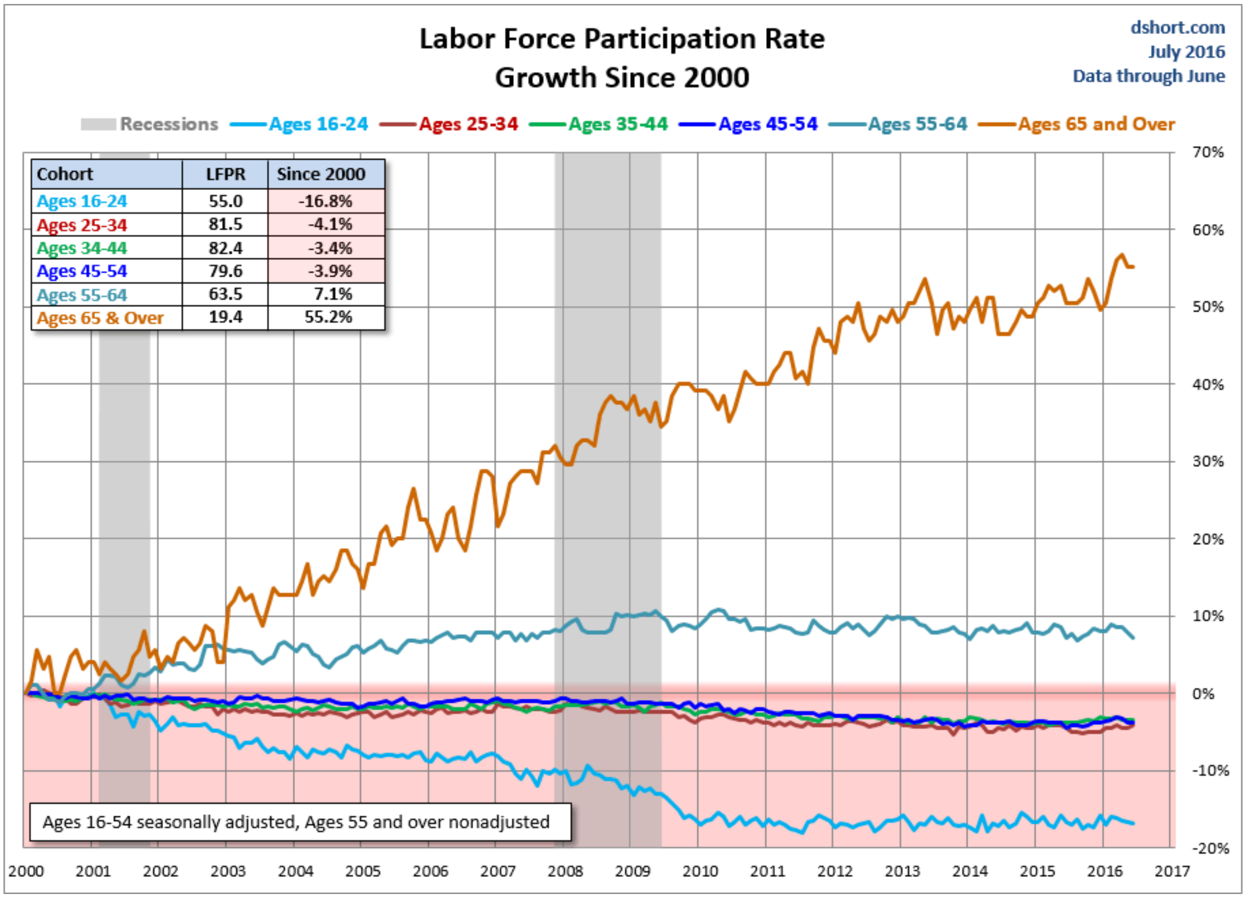
Sorry, but I just can't coble together the same level of excitement and enthusiasm as other investors at the all-time highs in the U.S. stock market. Stocks have been resilient, for sure, but they are also becoming quite expensive where for the first time since last November the cyclically adjusted P/E (CAPE) multiple inched above 26. True, they have been at or above this 26 level before – historically less than 10% of the time with those other times occurring prior to or during the Great Depression, the Tech Bubble, and Global Financial Crisis. This is not a forecast, but rather an observation and more than anything stresses for investors to tread cautiously. No question, valuation is a notoriously poor market timing metric, but it has been very accurate at forecasting the path of potential future returns – which are not favorable at current valuation levels.

I know, I know – interest rates are so low and as a result rich valuation levels are justified. Give me a giant break – is it possible that interest rates are artificially low or that low interest rates are accounting for the elevated level of uncertainty permeating an environment investors have never experienced before? It's this type of environment that I believe Howard Marks was referencing when he said, "It's dangerous when the market's at record levels to reach for a positive rationalization that has never held true in the past".

Speaking of interest rates, this 1.6% yield seems to be the new ceiling on the 10-year Treasury which is a considerable reduction from what was a 2.3% ceiling over the last twelve months. It's not difficult to imagine this being the case with more than $10 trillion of global government bonds carrying a negative yield and another $15 trillion yielding between 0% and 1%. Negative yields are no longer unique to just sovereign debt with nearly $390 billion investment grade corporate debt now able to lay claim to this distinction. As of last week 621 companies (General Electric, Unilever, Siemens, & Roche) dawned a negative yield which is a steep increase from the 59 companies carrying a negative yield at the start of the year.

This is just what the 80 million person cohort known as the Baby Boomers need at a time when the most senior of this demographic are turning age 70 this year (median hitting 60 years of age). Chalk it up to one of the unintended consequences of this ongoing global monetary policy experiment where just as this pool of people reach the stage of life where they are in most need of secure and stable income it's been annexed from the investment universe.

Know too, that the mortality tables show there is a better than 50/50 chance that those who are reaching age 70 will be alive for their 90th birthday. For sure, this isn't a bad thing, but also know that the statistics show the majority of this population set do not have enough saved to maintain the standard of living they are accustomed to over this extended duration of time. Now these boomers – who have been a secular force over the last three decades in driving almost everything in the U.S. from consumption, to politics, to economics, and comprise a significant proportion of overall wealth – are no dummies. They realize this potential shortfall and have made the decision to continue to work or re-enter the labor force in search of work in order to close this gap. Just have a look at the following chart showing that the 55 and older age group is the only place that we've seen an increase in the Labor Force Participation Rate since 2000 (all other age groups have experienced negative growth rates).



Undoubtedly there are numerous forces at work to breakdown and explain this data set so don't sensationalize this one graphic, but it does speak to a demographic that is closing in on their golden years and realizing that they are not in a secure enough financial position to make the transition.

One more point on this soap box is that this is a demographic that has been through two recessions inside of the last 15 years where in each case the stock market was cut in half. So to say that this group is apprehensive about subjecting its capital base to another one of these episodes (not a forecast, just an observation) is likely a gross understatement.

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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