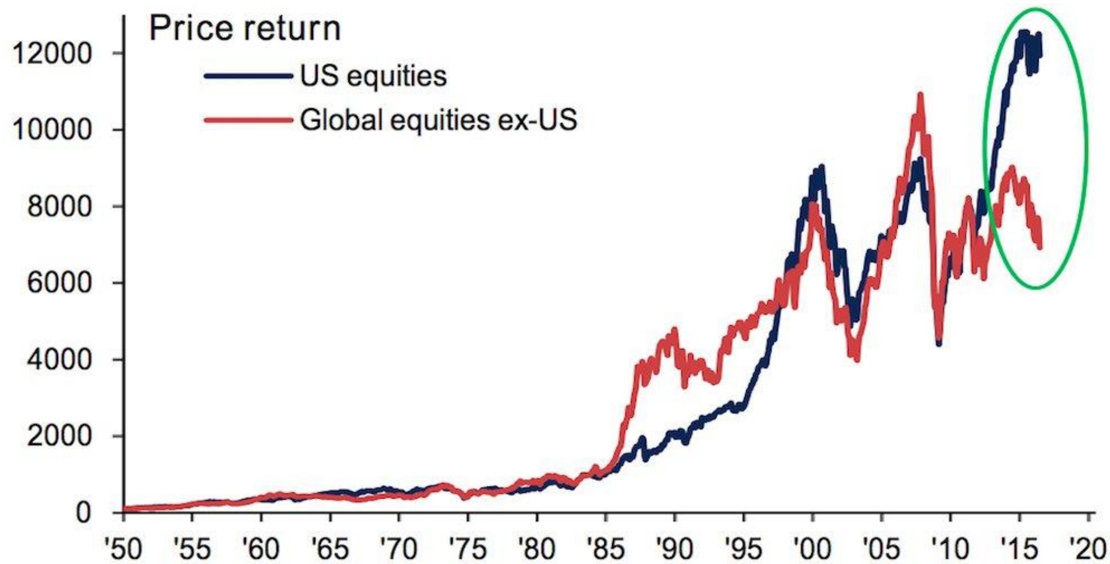
August 1st, 2016

The Greater Fool…
After a volatile end to June in which the UK vote to leave the EU shocked investors, global equity markets rallied back sharply in July as U.S. equites posted their second best monthly gain of the year. The performance scoreboard for July shows broad based gains across the globe: German DAX +7%, Japan's Nikkei +6% (despite the BoJ disappointing market expectations for more monetary stimulus), S&P 500 +4%, and the UK's FTSE 100 rose +3%. As of last week (nearly five weeks post-Brexit) the majority of global equity markets are either back to or above pre-Brexit levels – one of the few exceptions is European banks, where Italian banks and general profitability concerns have been at the forefront. While the STOXX Banks index gained +6% in July and was one of the best performing market segments, it still remains in negative territory since Brexit (-12%).

Much of the rebound in virtually all asset classes can be attributed to a calming in Brexit catastrophe fallout prognostications (rightly so, as this process is sure to play out over a period of years – not months) and renewed hopes of central bank policy remaining accommodative. In the case of the BoE and ECB, expectations are high for further easing despite remaining on the sidelines in July and instead waiting for the post-Brexit data to see if this is having an impact on activity. As for the Fed, they concluded their July policy meeting last week noting that near-term risks to the economic outlook have diminished, even though they are continuing to monitor global economic and financial developments. Even with their more upbeat assessment, capital markets continue to price in a low probability that the Fed will hike rates anytime soon with Fed Fund Futures pricing in only an 18% chance of a hike in September and less than one in three odds of them hiking by year end.

Investing is a mosaic of many things, and one of those elements in that mosaic is evaluating an asset, economy, valuation, central bank policy … relative to something else. Having said that, the U.S. (both the economy and capital markets) have held a favorable view in investor's eyes over the last twelve months relative to other regions in the world. Call it the best house on a bad block or the cleanest shirt in a dirty laundry pile, but investors have taken comfort with the view that their capital would be best served in U.S. assets. As a result, a significant gap has opened up between the price returns in U.S. equity markets versus global equities. You can see from the below chart that the historical correlation between U.S. equities and global equities (ex-U.S.) is fairly high (they track each other pretty closely throughout time) which raises several questions: 1) Is this decoupling sustainable? 2) If not, which way does it mean revert? (Do U.S. stocks fall to meet global equities or do global equities rise to catch up with U.S. equities?).

The articles and opinions in "Capital Market Musings and Commentary" are for general information only, and not intended to provide specific investment advice. Performance, dividends and other figures have been obtained from sources believed reliable but have not been audited and cannot be guaranteed. Past performance does not ensure future results. Investing inherently contains risk including loss of principle. Corey Casilio is a founding partner of Casilio Leitch Investments, a legal business entity. Advisory services offered through Casilio Leitch Investments, a CA State registered investment advisor.



Second quarter earnings season is in full swing with last week seeing the busiest week of the entire reporting period. According to Factset, 63% of S&P 500 companies have reported results with earnings coming in 4.4% above expectations and sales 1.2% above estimates. The better than expected results has brought confidence to the consensus view that Q1 represented the trough in the earnings recession that stems back to Q2 of 2015. However, it doesn't remove the stain on yet another quarter of overall falling profits with expectations for earnings to decline -3.8% on the quarter and sales growth coming in at a whopping 0.1% (this would represent the first year-over-year increase in sales since Q4 2014).

Another quarter of earnings decline accompanied by a general rise in U.S. stock prices has done little to temper rich valuations, with the S&P 500 trading at a trailing P/E of 22 and a forward P/E of 18.5. Yes Virginia, I too hear the masses extolling the virtues of low interest rates and accommodative central bank policy and how this tonic blend justifies above average valuations. Just to play devil's advocate, if equity valuations were to revert back to their historical average we would have to see earnings grow 25% over the next twelve months. A 25% spurt in EPS growth over a twelve month period hasn't happened since 2010 and that was coming off trough recessionary earnings from 2009. Just to make sure this point is given proper perspective, a 25% pop in earnings over a twelve month interval is a 1 in 20 event – possible but improbable especially this deep into what has become a very mature economic expansion. The other way we could mean revert to a historical average P/E multiple is for the S&P 500 to decline 20% from today's value of 2,175 to 1,775.

The resilience in risk assets has been impressive given it's occurring in the midst of so-so corporate earnings, sluggish economic data, and renewed weakness in the commodity sector (namely oil prices). The price of WTI crude slid -14% in July which brought the cumulative decline to more than -20% since the early June peak north of $50/bbl. Undermining a sustained recovery in the oil sector is continued imbalances on both the supply and demand front. The latest inventory data show historically high stockpiles of both crude and gasoline while global production volume continues to run full tilt (OPEC production increased by 264k barrels in June to average 32.86 million barrels).

Since oil prices started their decline from north of $100/bbl in mid-2014 through the recent trough near $26/bbl in February, it has been a significant weight on economic growth, investor risk appetite, and capital markets. Over the past two years each time there has been a material leg down in the price of crude the S&P 500 was not far behind. Which begs the question of the growing disconnect displayed in the following chart?

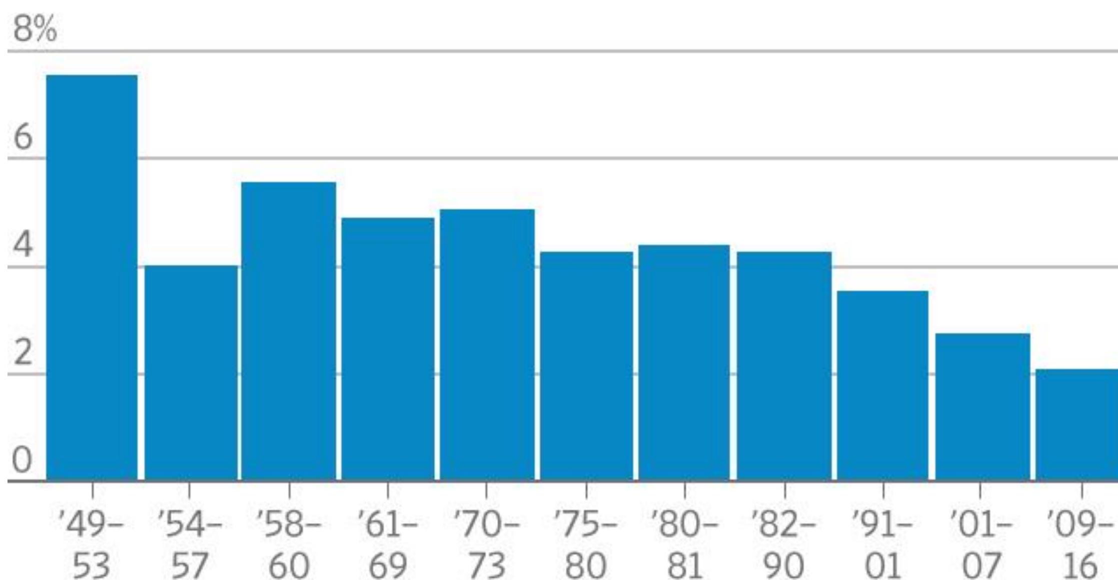
The articles and opinions in "Capital Market Musings and Commentary" are for general information only, and not intended to provide specific investment advice. Performance, dividends and other figures have been obtained from sources believed reliable but have not been audited and cannot be guaranteed. Past performance does not ensure future results. Investing inherently contains risk including loss of principle. Corey Casilio is a founding partner of Casilio Leitch Investments, a legal business entity. Advisory services offered through Casilio Leitch Investments, a CA State registered investment advisor.

It's become a widely held view that the supply / demand imbalance in the oil market will correct itself in the second half of this year and become completely balanced in 2017 – if so, then there is no need to worry about the dichotomy depicted in the above chart. However, I always like to have at least one alternative thesis and perhaps the renewed plunge in oil prices is an indication of weaker global growth – if so, the hoped for balancing of supply / demand will be pushed much further out on the time scale.

Speaking of weaker economic growth, the first release of Q2 GDP came out on Friday showing the U.S. economy expanded at only 1.2% (well below consensus expectations for 2.5%). Like much of the economic data over the last six months this report had some meat for both the bulls and the bears. The consumer was the one relative bright spot as spending increased 4.2% in Q2, and this was pretty much the sole component that contributed to growth over the quarter. Given that 2/3rds of our economic output is derived from consumption and spending, it's a welcome sign to see the strength emanating from this component. However, jubilant enthusiasm should be tempered when gaining some perspective on the trend in consumption relative to the entirety of this cycle. Over the last four quarters consumption has averaged 2.7%, which on an absolute basis is a solid number. This level of consumption is on par with the 2.7% growth rate over the four quarters ending Q2 2014. Why I point this out is that since Q2 2014 we've seen energy prices decline by more than 60% and more than five million jobs created – yet the overall trend in consumer spending has not improved. This is a worrisome signal in what has become a very mature economic expansion.

The Wall St. Journal put out an insightful graphic comparing the growth rate of this expansion relative to prior expansions going back to 1949. Whereby, this expansion is the weakest on record when compared to the last ten on an annualized growth rate basis.

The articles and opinions in "Capital Market Musings and Commentary" are for general information only, and not intended to provide specific investment advice. Performance, dividends and other figures have been obtained from sources believed reliable but have not been audited and cannot be guaranteed. Past performance does not ensure future results. Investing inherently contains risk including loss of principle. Corey Casilio is a founding partner of Casilio Leitch Investments, a legal business entity. Advisory services offered through Casilio Leitch Investments, a CA State registered investment advisor.

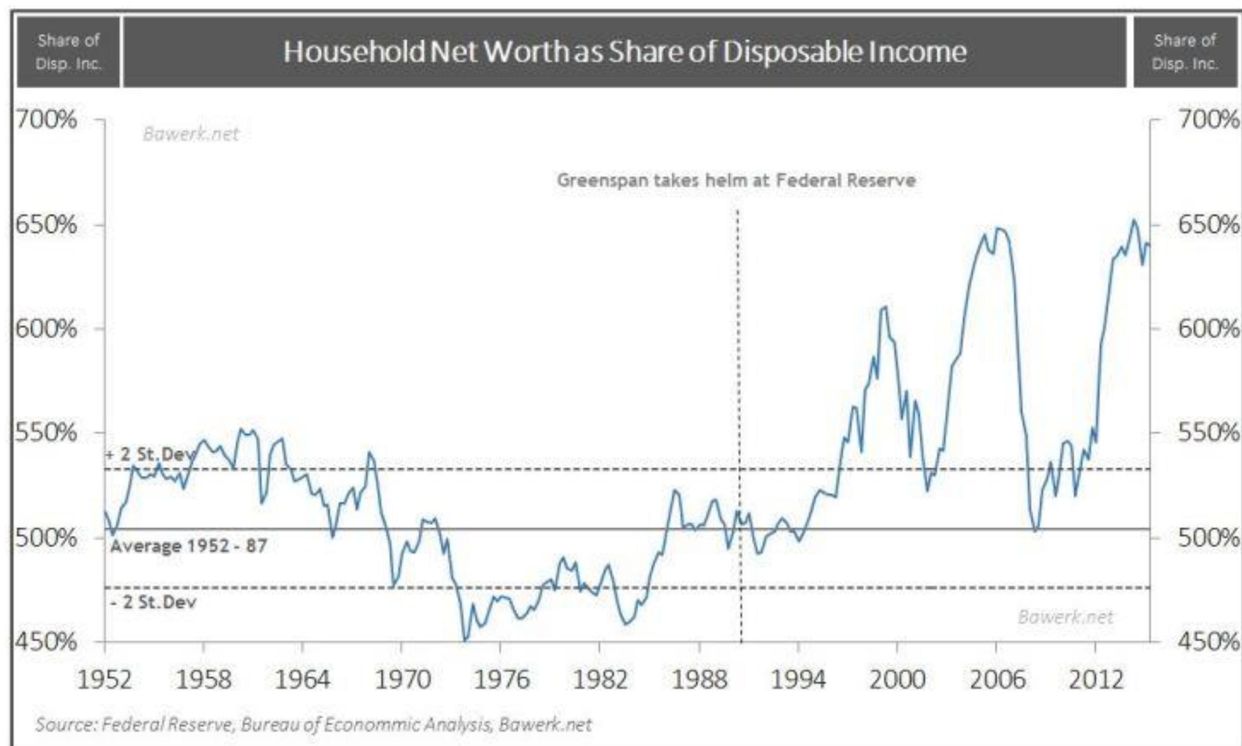


What's more is that this 1.2% print follows a downwardly revised 0.8% GDP growth rate in Q1, and 1.2% in Q4 – this trend suggests a material slowdown in the U.S. economy is at hand. The year-over-year growth rate of nominal GDP fell to just 2.4% and is the lowest growth rate since Q1 2010 (2.1%). Keep in mind the four quarters ending Q1 2010 includes the last quarter of the recession which ended in the second quarter of 2009. This is a rather ominous sign for corporate profits and a stark contrast to an equity market that is trading at all-time highs as if a robust reacceleration is right around the corner.

I'm not saying that a recession is imminent – that's a difficult proclamation to square with real final sales to private domestic purchasers growing at a 2.7% clip last quarter (a marked improvement from 1.8% in Q4 2015 and 1.1% in Q1 2016) – but it is becoming more and more obvious that this economic expansion is well past peak and thoroughly engulfed in its contractionary stage. The only element that has clouded this phase transition is the fact that the Fed recognizes it and this is why after one 25bps token rate hike in December they are unable and unwilling to tighten any further because they know it could well be the death-nail to push the U.S. into a recession.

The Fed deserves credit for this restraint, but their inaction is manifesting itself in other places, in particular by distorting and inflating asset prices to levels that are stretched on a variety of fundamental metrics. Let me put it in its simplest and most logical form: A household's balance sheet – which is comprised of both assets and liabilities – is a function of the amount of income generated by the household. With that being said, asset prices today – be it stocks, bonds, and/or real estate – are at or near their all-time highs, yet the median income in the U.S. is no higher today than it was in 2000. The following chart is a measure of Household Net Worth as a share of disposable income.

The articles and opinions in "Capital Market Musings and Commentary" are for general information only, and not intended to provide specific investment advice. Performance, dividends and other figures have been obtained from sources believed reliable but have not been audited and cannot be guaranteed. Past performance does not ensure future results. Investing inherently contains risk including loss of principle. Corey Casilio is a founding partner of Casilio Leitch Investments, a legal business entity. Advisory services offered through Casilio Leitch Investments, a CA State registered investment advisor.



If asset prices of all kinds are above levels that preceded the Dotcom bubble in 2000 and the Global Financial Crisis in 2007 and median incomes are no higher today than they were at either of these peaks – what would cause anyone to conclude that current asset price levels are any more sustainable today?

This is a question that I don't have the answer to, because I am hard-pressed to come up with a justifiable rationalization that adheres to the definition of prudence and responsibility when it pertains to investing. The most frequent response I hear from some highly respected and very intelligent investors is that central banks continue to remain accommodative and interest rates remain low. I concede this view and very much understand this narrative for explaining why asset prices of all stripes are higher, but this explanation does not come close to meeting the definition of prudence. No, to me it more closely aligns with the "Greater Fool" theory – which postulates that the price of an object is determined not by its intrinsic value, but rather by irrational beliefs and expectations of market participants (a la the belief that another party is willing to pay an even higher price for an asset – 'the greater fool').

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.

The articles and opinions in "Capital Market Musings and Commentary" are for general information only, and not intended to provide specific investment advice. Performance, dividends and other figures have been obtained from sources believed reliable but have not been audited and cannot be guaranteed. Past performance does not ensure future results. Investing inherently contains risk including loss of principle. Corey Casilio is a founding partner of Casilio Leitch Investments, a legal business entity. Advisory services offered through Casilio Leitch Investments, a CA State registered investment advisor.