January 11th, 2016

Risk happens slowly, then all at once…

Flipping the calendar to a new year has done little to spell capital markets from global event risk, which prior to this past week most recently reared its head last August when China surprised global markets with a 3.5% devaluing of the yuan. Well, China is back at it, once again orchestrating a devaluation of its currency which precipitated a wave of selling on its local exchanges where circuit breakers – which were put in place to quell relentless selling pressure and provide a respite for order to be reestablished during the trading day – were triggered twice within a three day span, with the second episode halting trading for the day within only 29 minutes of the opening bell.

Investors looking at China perhaps are starting to connect the dots that it's not just about its stock market (the Shanghai Composite has declined 38% since last June), but about its deteriorating fundamentals. The economy is clearly slowing and has been for some time, but the true extent to which this slowing is occurring remains the big mystery, as it is already expected they will not meet their informal 6.5% growth goal. The ripple effect is what is truly concerning to the overall balance of global growth where economists' estimates suggest that if China's growth slumped to 4% this year (versus their forecast of 6.2%), it would slice half a percentage point off U.S. growth, 0.8% of a point off Europe's and 2.6% points off Japan's. Keep in mind these are all developed markets that can ill afford any more headwinds to an already challenging growth environment – this perhaps provides some context for why commodity prices have been so sensitive to Chinese developments.

China is in a tough spot and with it being the second largest economy in the world it is going to inflict global economic repercussions. In my mind, the biggest risk emanates from what materializes in the credit markets. Couple the slowdown in China and other emerging markets with an oil price which declined 30% last year – following a year where oil declined roughly 50% – and is already off 10% to start this year. This encapsulates a very large percentage of the global economy that is mired in some sort of economic malaise and this is coming at a time when global debt has ballooned from $86 trillion in 2005 to $227 trillion currently ($55 trillion of it is dollar denominated). Where I'm going with this is that there is a possibility of a global credit crisis playing out that makes 2008 look like a walk in the park.

Please don't extrapolate this risk too far at this point as at its current stage this is not a high probability outcome, but seeing the TED spread (difference between 3-month T-bills and 3-month LIBOR) double over the last month is an indication that global credit risk is elevating. Keep in mind we are still a far cry from the levels that prevailed back in the '08 credit crisis, but the rate of change over the last month does bare watching.

Other global events spurring last week's rout in the stock market was a claim from North Korea that they detonated their first hydrogen bomb at an underground test site not far from the Russian border (though this assertion has been disputed by weapons experts). On top of that we had heightened tensions in the conflict between Saudi Arabia and Iran which after first blush further undermined the trap door that has been opened under oil prices, with expectations that the price of crude is now being used as a financial weapon to target the solvency of some Gulf producing nations.

In an environment where financial hardship is creating pressure on regions that have a questionable track record of social stability, a portfolio strategy that includes some exposure to defense companies and perhaps some gold looks to be fairly appropriate. As an aside, new orders for U.S. defense goods have surged 44% from year ago levels and backlogs are clearly on the rise. As for gold, it looks like the yellow metal is one of the few areas in the commodity space that has found some footing this year, gaining more than 3% to start the year – don't overlook the possibility that gold could be catching a bid from investors fearing that a global currency war could become a reality.

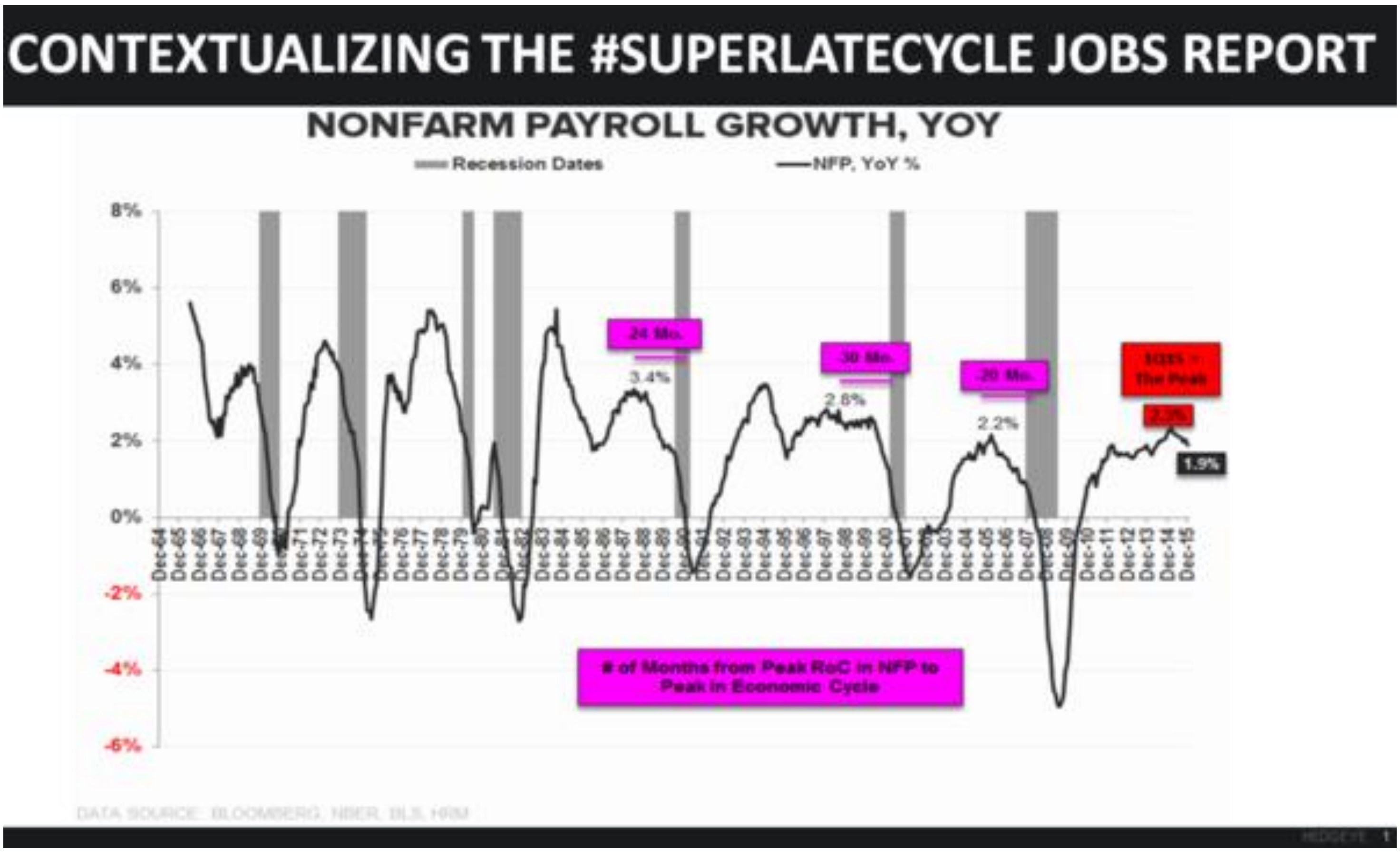
As for the capital markets, the Dow Jones Industrial Average lost 1,079 points (-6.2%) in the first week of 2016, while the broader S&P 500 fell 6%, sending it to its worst ever five-day start to a year. Bond markets have responded in their typical fashion to the risk-off sentiment with Treasuries rallying for seven consecutive days. The yield on the 10-year T-note finished the week at 2.12%, breaking below what has been a tough resistance level at its 50-day moving average of 2.2% (it also broke both the 100 and 200-day moving averages at 2.17% with a clear path to the 2.0% level in its sights).

We clearly have a broken stock market on our hands with very little technical support until we get down to the August 2015 lows around 1,867 on the S&P 500; if we don't hold these levels then it's anyone's guess for where buyers might come in (1,704 on the S&P would mark a 20% pullback and push the index into bear market territory). Bespoke Investment Group tallied some numbers on the carnage taking place in the equity market, where as of Friday's close they tabulate that the average decline from its 52-week high of large cap stocks in the S&P 1500 is -22.5%, -26.5% for mid-cap stocks, and -30% for small cap stocks.

I hear talking head after talking head commenting on CNBC or Bloomberg that this is yet just another run-of-the-mill pullback and that the economy remains on solid footing. I take issue with both of these views and in particular the latter referring to the economy being on solid footing. Today, yes the economic expansion remains intact, but that is looking at economic data points from an 'absolute' level standpoint and not a 'rate of change' dynamic.

Take last week's employment report for example. On the surface, 292k new jobs in December (consensus expectations were for around 200k) on top of 50k in upward revisions to the prior two months is very impressive. This pushed the 3-month trend in average monthly job growth to 284k to end 2015 and resulted in 2.65mn in total job gains for all of 2015 (the second best level since '99 – behind only the 3.12mn created in 2014). The unemployment rate held steady at 5.0% as household jobs surged 485k, keeping pace with the increase of 466k in the labor force. Wage growth was perhaps the lone disappointment in the entirety of the report as it grew 2.5% year-over-year on favorable base effects. The sluggishness in wage growth continues to cause head scratching among the economist community and suggests that we are further from full-employment than initially estimated.

However, when you start to peel back the onion on what was for the most part a stellar monthly jobs report, it helps to provide some context for why the market didn't have a more bullish reaction (i.e. stocks go up and bonds go down). First off, the year-over-year growth rate in monthly job creation continues to decline from its peak level of growth at 2.3% in Q1 2015 to 1.88% currently. Looking at the last three business cycles (see below chart from Hedgeye) when this rate of growth trend starts to turn down this late into a cycle, it historically has portended a bad omen that a recession was looming somewhere, on average in the next 28 months (according to this metric the clock is ticking and we are already almost 12 months beyond the peak rate of growth).



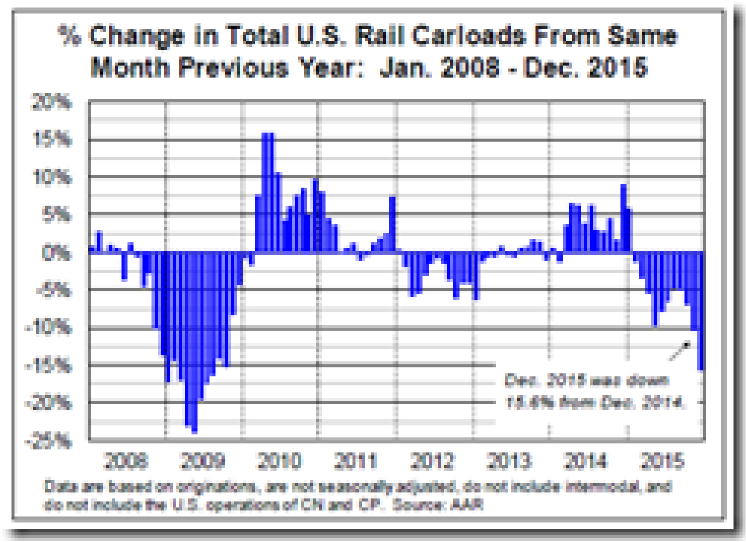
Beyond that, and perhaps even more perplexing, is the fact that the unemployment rate as of the end of December 2015 is 5.0%, the same level it was at in December 2007, yet according to the BLS data full time jobs total 122.8mn currently compared to 123.3mn in 2008. So we have less full-time jobs than at the peak of the last business cycle, but population growth over this seven year period has expanded by 15mn. Go figure, it is likely this is why productivity growth has been so poor.

Say what you will about the strength in the services sector (which is starting to show signs of rolling over, mind you), the record level of 17.5mn in auto sales for 2015, or the robust pace of job creation, but you can't dispute that all of these metrics are pro-cyclical and lagging economic variables. Meaning, these significant variables used to gauge the pulse of economic activity historically look the best after the economic cycle has already started to soften.

A similar pattern exists for corporate profits which started their decline in Q2 of last year, and with Q4 earnings set to start being reported this week, expectations are for this to mark the third consecutive quarter of EPS declines (consensus expectations are for earnings to fall 5.3% y/y). These data points are not indicative of a business cycle that is in its expansionary stage and this, in my opinion, is what many investors are at least starting to consider is taking shape.

The most interesting, yet striking, data point I reviewed last week (yes, beyond the Fed minutes, employment report, manufacturing and non-manufacturing surveys, and jobless claims) was the monthly rail traffic indicator published on Friday by The Association of American Railroads. This report (excerpts of report are bulleted below), in my mind, leaves little to no doubt that the U.S. manufacturing sector is in a serious recession and showing very little signs of improvement (emphasis is mine):

- December 2015 was a lousy month in a lousy quarter for U.S. rail carloads. U.S. railroads originated 1,219,443 carloads in December 2015, down 15.6% from December 2014. **That's the biggest year-over-year monthly percentage decline since August 2009**. December 2015 was the 11th straight year-over-year monthly decline.



- Weekly average carloads of 243,889 in December 2015 were the **lowest for any**

month since January 1988 when our data began.

- Weekly average carloads in the fourth quarter of 2015 were down 11.3% from the fourth quarter of 2014, the **biggest year-over-year quarterly percentage decline since the third quarter of 2009**. Average weekly carloads in 2015's fourth quarter — 260,424 — were the **second lowest for any quarter since 1988, behind only the second quarter of 2009**.

- Just four of the 20 carload commodity categories the AAR tracks were up in December 2015 over December 2014. That's the **fewest for any month since October 2009**.

- **Motor vehicles and parts were the biggest bright spot for U.S. carload**

traffic in 2015, with year-over-year gains in nine of the 12 months (including eight of the final nine months of 2015).

- For months, carloads of commodities related to steel have been hurting badly. That continued in December. Combined, carloads of four steel-related commodity groups were down 25.6% YoY in December 2015. **Here at RTI we don't claim to be experts on the steel industry, but we do know that the huge recent decline in the crude oil rig count has had a negative impact on steel production.** (According to Baker Hughes, the U.S. oil rig count totaled 698 for the week of December 31, 2015, down 1,113 rigs (or 61.5%) from the same period in 2014 and the lowest level since the second week of September 1999).

- Carloads of petroleum and petroleum products fell 20.5% in December 2015, probably mainly because of a decline in carloads of crude oil, which accounts for approximately half of this traffic category. Carloads peaked in the fall of 2014 and by the end of 2015 were approximately 25% below their peak. Carloads fell in nine of the 12 months of 2015, including the last seven.

- Excluding coal and grain, carloads were down 7.3% in December, also **their biggest decline since October 2009.**

U.S. RAIL CARLOADS EXCLUDING COAL AND GRAIN (weekly averages)

	Current Year	Previous Year	Change From Previous Year: Cars	Change From Previous Year: %
Sept. '15	158,363	166,354	-7,992	-4.8%
Oct. '15	158,374	167,162	-8,788	-5.3%
Nov. '15	146,666	156,255	-9,589	-6.1%
Dec. '15	141,153	152,259	-11,107	-7.3%
Q1 '15	150,575	149,155	1,420	1.0%
Q2 '15	159,243	163,650	-4,407	-2.7%
Q3 '15	159,456	166,216	-6,760	-4.1%
Q4 '15	148,148	158,074	-9,926	-6.3%

Data are originations, are not seasonally adjusted, do not include intermodal, and do not include the U.S. operations of CN and CP. Source: AAR

- Carloads of industrial products, an aggregation of a variety of rail commodities used in various manufacturing industries, were down 7.4% in December 2015 from December 2014, their tenth straight year-over-year monthly decline and their **biggest percentage decline since November 2009**. As we said last month when talking about disappointing November rail traffic data, December's rail data confirm, along with the PMI and manufacturing output, that manufacturing is going through a very rough patch right now, and it's not confined to energy- and steel-related sectors.

Without question, the litany of worries troubling investors continues to mount, leaving many uncertain about what to do, if anything. I for one can tell you that I myself don't have all the answers I'd like to have in hand when attempting to make informed investing decisions. But, I also know you will never have an all clear signal – in one direction or the other – when making decisions about what the future will hold.

Those of you that have been reading this missive for the last twelve months know that my enthusiasm for what lies ahead for the economy and the capital markets is not that constructive. However, it is my responsibility to find areas in the capital markets that I believe will perform best given our outlook and based upon our research. There are and will continue to be investment opportunities to take advantage of, but they just won't be as abundant.

My advice to anyone reading this would be the same things I say to myself, which at the current time is to use the action in the capital markets last week as something to learn from. Furthermore, allow yourself to take some selfreflection to gauge your emotional reaction to what was a severe and rather abrupt sell-off in global risk assets. This latter point is perhaps the most important because the last thing you want to do at the current time is panic.

Fortunately, other than the severity of the decline, the action in stocks last week was not a surprise to me. However, I must admit that I wasn't all that comfortable watching it unfold. We've spent the better part of the last year reducing our client's exposure to global equities and came into the year relatively well positioned for what materialized in the first week. This isn't to imply that we didn't see our portfolios decline in value – they did – but to an extent that I am comfortable with and to an extent that I would expect them to given the movement in various parts of the capital markets.

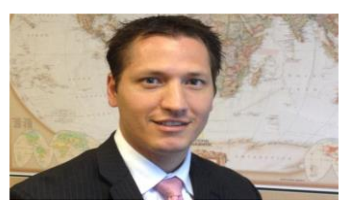
At this point I am of the view that last week could potentially be just a prelude of more to come – mind you I don't believe it's all going to happen over the course of a week, a month, or even a quarter. No, I think this part of the cycle will play out over an extended period of time that is unknown to me at this point. Meaning, all investors should take some time to assess how last week's action in the capital markets impacted their portfolio: Was the portfolio volatility acceptable? Can you stay the course with how you're positioned if last week's action persists for some time? Do you have an idea (you cannot know for sure) how your portfolio will hold up in a recessionary environment based upon prior cycles? These are all questions that I believe would be helpful for any investor to have an answer for or a frame of reference for understanding. After having answers to these (or similar questions) where changes are necessary, you need to go through the exercise of what changes can be made to get yourself into a more acceptable position.

Even a professional like myself can fall subject to irrational emotional behavior that some investors got caught up in during times like last week, where I consciously push back against any emotional impulse which is much easier to do knowing that we have a prudent long-term investment strategy in place. What I also did last week was identify some shortcomings we see in some of our holdings that we will monitor and look for better opportunities to make adjustments to. Furthermore, we identified some other investment opportunities that we may want to take advantage of or add to when we deem appropriate.

We are at a point in the business cycle that historically has proven to be very challenging for investors where risk happens fast and then all at once. You will be best equipped to contend with this environment if you are prepared, aware, and disciplined. The best thing I can tell you is don't panic and have a plan – if you don't have one, then make one (and do it quickly), but don't shoot from the hip by allowing your emotions to dictate the fate of your future.

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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