December 19th, 2016

Expectations outpacing reality…

The post-election rally in U.S. equities took a pause last week with the Dow Jones Industrial Average ticking higher by 0.4%, the S&P 500 basically flat (-0.06%), same for the Nasdaq Composite (-0.13%), while the Russell 2000 Small Cap index got a dose of reality declining -1.7% on the week in what otherwise has been a one way ticket higher since election night (+14%). While I remain somewhat befuddled with the speed in which the narrative has shifted from what the expected market reaction was for a Trump victory going into the election and where it stands today (a topic I'll get into a little deeper below), the move in the stock market is rather consistent with the history books.

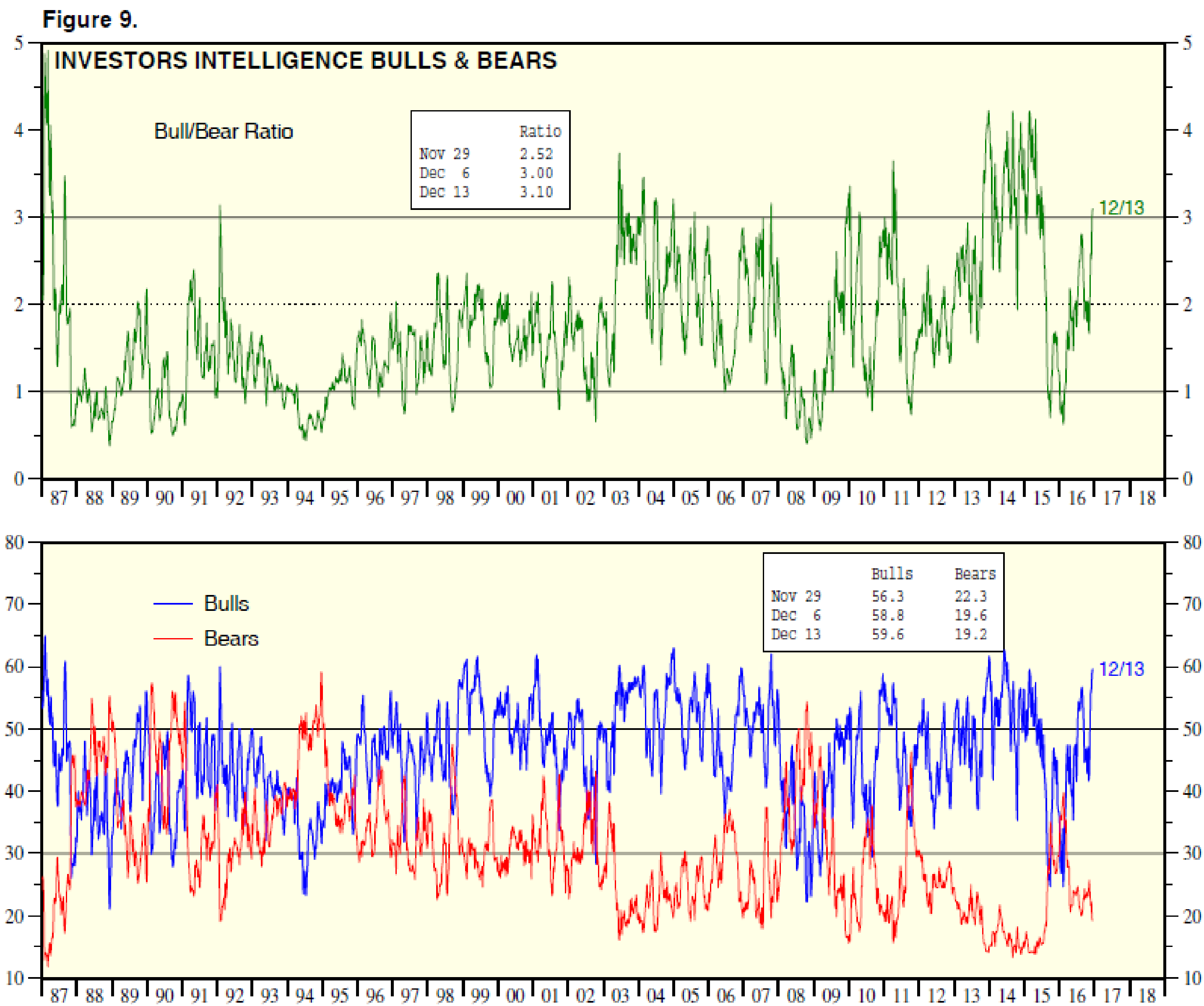
Using data from 1928 to present, from election-day to inauguration day the S&P 500 has rallied roughly 80% of the time with the average gain being a little more than +3%. Through last week the S&P 500 has enjoyed a +5% bump, so a bit better than the averages, but not that far out-of-sync with what has been typical.

That being said, this rally has many of the earmarks of emotion and euphoria trumping (pun intended) rational thought and fundamental prudence. The front cover of Barron's two weeks ago aptly sums it up: "Get Ready for Dow 20,000" – this is the type of hype that historically coincides with market tops. That was followed up with this weekend’s Barron’s edition summarizing 2017 capital market forecasts from 10 Wall Street Strategists, where all 10 see the stock market higher. It was only in September that these same 10 strategists’ views were polled with only four seeing the market going higher – everyone has a right to change their mind and when supported by sound analysis and tangible evidence, then that change of view should be applauded (it’s not an easy endeavor).

It’s amazing what a 5% rally in stocks can do to crystalize one’s view.

It’s not just the papers or bubblevision TV, but investor sentiment indicators are off the charts with the Market Vane Consensus Stock index at 60% bulls and fewer than 20% bears, the Investor’s Intelligence poll tells a similar tale with bullish sentiment up to 59.6% versus bearish sentiment falling to 19.2% (this 40.2% gap is the widest it's been since early 2015 – right before the market topped out for almost 18 months).

Investors Intelligence Sentiment



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.

Okay, so you don’t put a lot of stock in survey based sentiment indicators. You would rather take your cue from what investors are doing rather than what they are saying. The latest reports on market positioning indicate that we’ve seen a massive swing across asset classes (all in the direction of heightened risk appetite) as short interest on both the Nasdaq and NYSE collapsed nearly 4% in the second half of November, and the latest Commitment of Traders report from the CFTC showed net speculative long futures and options positions on the Dow Jones Industrial Average hit their second highest level on record while the Small Cap Russell 2000 net long spiked nearly 50,000 contracts to almost double its prior peak from four years ago.

Lastly, TrimTabs Investment Research was out with a report this morning highlighting that since Election Day through last Friday nearly $100 billion has flowed into U.S. equity exchange traded funds. For reference this flow total over the six weeks since the election is 1.5 times the size of the $61.5 billion that went into U.S. equity ETF's in all of 2015.

This epitomizes what is known in the industry as a year-end performance chase and the "fear of missing out trade" – you just have to plug your nose, close your eyes, and take the plunge by buying equities. The other part of this equation is we are in what has historically been a seasonally strong part of the calendar for equities, not to mention the lack of sellers given the potential carrot of lower tax rates in 2017.

One more thought on this "Trump Rally" and the equity market before moving on to some actual analysis and data. For those of you who caught this entire move, good on you and congratulations. For those that didn't, I would caution against chasing at this point – a market driven by emotions is bound to overshoot and that is what I think is going on now, which suggests that there is a fair chance we see a decent chunk (if not the entirety) of this move unwound over the course of the opening months of next year.

In these times of exuberance it's easy for investors to lose perspective on what the real risk is for them. It's not on "missing out" on a further rise in a stock market that is already up nearly 240% from its March 2009 trough and is now approaching the second longest in history. The biggest risk facing investors today is catching the bulk of the reversion that wipes out a chunk of these gains during the next recession. I know, to speak of a potential recession is heresy at this time, but just in case you've forgotten, during the last two that started in March 2000 and October 2007 the S&P 500 registered peak to trough declines of -49% and -57%, respectively.

To say this differently, an investor that was all-in on equities at the peak of the Tech bubble in March 2000 had to wait all the way until March 2013 before the S&P 500 traded above that high on a sustained basis (it did breach the March 2000 high in September '07, but peaked in October '07).

As for the economic data of late, it's been a mixed bag where anything survey based has spiked in tandem with the post-election optimism permeating through the air, but when it comes to hard data or tangible output, it's showing a continuation of the sluggish / stagnant state we've seen throughout the balance of the last year and a half. For example, the University of Michigan consumer sentiment index jumped to 98.0 in December from 93.8 in November, with the December reading representing the best level since January 2015 and the second best level of this entire cycle. However, within the report we see that spending intentions on both autos and housing actually fell a point.

A similar surge was seen in the NFIB small business sentiment index jumping from 94.9 in October to 98.4 in November (its best level since December 2014 – let me remind you that real GDP growth slowed to a mere 2% annual rate in the following quarter, so even back then the survey data wasn’t exactly lining up with the hard data) and the +3.5 point monthly gain is the best run up since April 2009. But, as with the University of Michigan index the real meat was buried in the report where intentions to boost capital spending in the next three to six months fell to a six month low of 24 from 27.

So basically in these two survey measures (one for the consumer and one for businesses) it's clear that people are feeling a lot better coming out of the election (for whatever reason, perhaps because the stock market is up and historically sentiment tracks the stock market…), but no, I don't intend to change my spending or capex investing plans because of it.

Call it a case of what people say differing from what people actually do, which was further evidenced by the miss in retail sales last week with the headline gain coming in at +0.1% versus consensus expectations for a +0.3% gain. The miss in the subcomponents was across the board as well with core sales (sales ex autos and gas) up +0.2% versus expectations for +0.4% while the control group (which feeds directly into GDP) nudged up just +0.1% compared to expectations of a +0.3% monthly increase.

To be fair, this report wasn't all bad with the weakness being confined largely to motor vehicles and parts while the breadth of the rest of report showed eight of the remaining eleven sectors posting increased sales in the month. Moreover, the soft November control sales tally combined with the downward revision to October's figure (down to +0.6% from +0.8%) computes to a not bad +3.6% at an annual rate Q4 build-in for GDP (mind you this is down from the +4.3% build-in prior to this report).

So as would be expected with this lower than expected retail sales data and the -0.4% decline in last week's Industrial Production report, Q4 GDP estimates have been ratcheted down closer to the 2.0% level from what were lofty expectations (in some cases north of 3%) at the start of the quarter. What's more is that we still haven't seen what the impact of a meaningful tightening in financial conditions via higher interest rates and a strengthening dollar will have on the economic data when it gets reported after the turn of the year.

So far this quarter we've seen the U.S. dollar appreciate 8%, the 10-year U.S. Treasury yield surge 1% (from 1.6% at the start of the quarter to 2.6% at present), the 30-yr fixed mortgage rate spike from 3.54% to 4.38% (that's a nearly 25% increase in less than three months), and national average gas prices are up to $2.24/gallon from $2.00 this time last year. We're also seeing a considerable deceleration in bank credit with the 13-week rate of change stalling to a tepid 2.6% pace (half the rate it was expanding at in mid-

October and the weakest it has been in three years).

A similar script is playing out in Commercial and Industrial business loan growth which has actually contracted at a 2.8% annualized rate over the past month – the weakness is broad-based with residential loans barely up more than 2% and commercial real estate credit growth has virtually ground to a halt in the past four weeks to a level we haven't seen since four years ago when the Fed was knee-deep in QE mode.

The extent of this broad based tightening hitting both the consumer (higher gas prices and more expensive credit) and business sectors (higher borrowing costs, contraction in credit, and reduced foreign earnings via the more expensive dollar) is likely to pull U.S. economic growth back down to the 1.0 – 1.5%

stagnation level it was running at through the twelve months ending in June, making the 3.2% Q3 growth rate look even more like an outlier.

With a Fed now on a clear rate hiking path, hinting at three more next year after last week's second hike of this cycle, commercial real estate peaking and rolling over, the auto sector looking like it peaked around this time last year, unemployment back to pre-crisis lows, delinquencies and default rates in the credit markets on the rise, and valuations across an array of asset classes at cycle highs – it all points to classic late cycle signals.

There continues to be widespread optimism about the Trump economy and the sea change in animal spirits it will cause in unlocking the shackles that have restrained this economic recovery, which at the current time goes down as the weakest post-WWII expansion in history. And while I too am excited about the long-term economic benefits of a less regulated business climate, lower taxes, and effective fiscal stimulus – I also remain much less enthusiastic than what markets are currently pricing in (that we get all of the good policies of the Trump campaign and none of the bad).

I think it is dangerous to be basing investment decisions on expectations of government policy with little more than a stencil sketch of what the actual policy is and when it will get done. Look, I'm not a pessimist and it's not easy swimming against the tide of sentiment nirvana oozing out of Wall St. group think right now, but consider me a little more than suspicious about the idea that a Trump / Republican agenda can overnight arrest the U.S (and global economy for that matter) from the structural forces that have frustrated it over the last three years. I'm talking about excessive debt, aging demographics, technological advances, and inequality.

With the rise of populism around the globe – first Brexit, then Trump, and most recently the failed Italian referendum – the one thing the world is in desperate need of at the current time is leadership, and America has always been looked to as a reliable source of direction. Leadership is not one of those qualities that leaves much open to interpretation – more than anything it is born out of other people's respect, admiration, faith, and trust in someone that inspires them. How these feelings are procured can vary, but once you have them it's a delicate balancing act to carry out and build upon the responsibility.

Considering the U.S. is as divided a nation as it's been since the Vietnam War, it will be imperative for a Trump administration to bring us together for the collective good.

I look back to when President Obama first came into office on his "hope and change" agenda, and this followed what at the time was viewed as a failed Presidency from the Bush administration. In actuality, the Obama agenda had more in common with the Trump agenda than many might have thought – he said we would renegotiate NAFTA, cut income taxes for low and middle income earners, curtail the power of lobby groups in Washington, and implement a shovel-ready infrastructure stimulus plan. Also recall that Obama had a majority in both the House and the Senate in his first two years in office.

Sound familiar?

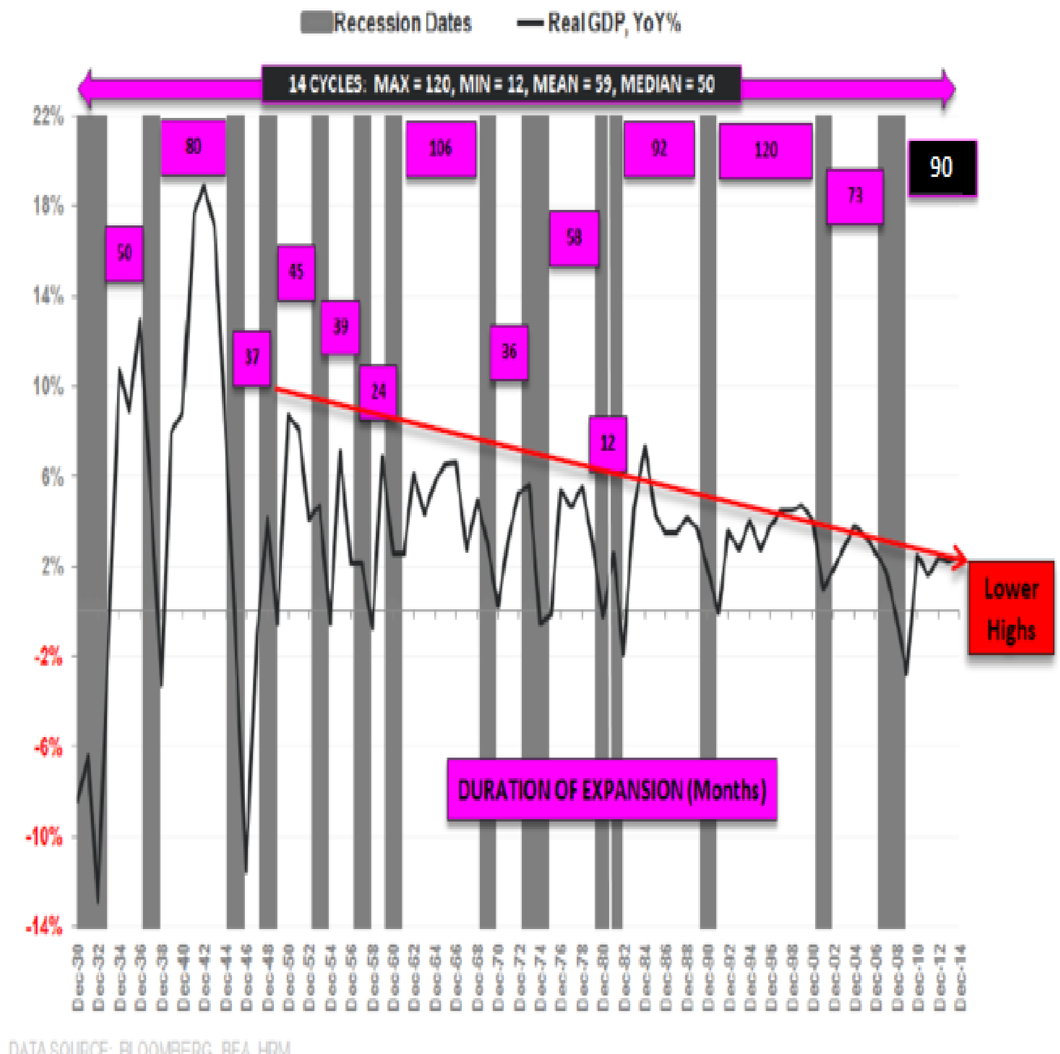
Reflecting on the Obama legacy you see that he did not fully live up to the promises made on the campaign trail. Even going back to the highly touted Regan administration, it's estimated that he fulfilled barely more than 50% of his campaign promises. You see where I'm going with this – according to data compiled by FiveThirtyEight, U.S. presidents historically keep little more than 60% of their promises. At last check Trump's campaign promise tally is up to 282 – when setting a goal, you might as well set the bar high.

Just so we're clear and to head-off a log jam of incoming emails from my GOP readers scorning me for not jumping on the Trump train, when it comes to politics – I am completely agnostic. I've voted both Democrat and Republican in my life and anything I pen in these missives is based strictly on my interpretation and analysis of how it feeds into a multifaceted view of the economy and capital markets. In my opinion, America is great and that's in the best interest of everyone – now whether some view it as in the process of becoming "Great Again", well then I'm all for that too and let's do it.

At the end of the day, I find myself still firmly in the wait and see camp in regards to how much Donald Trump ends up getting accomplished in the first 12 months of his presidency. What is most concerning to me about this view is how far markets have gone in pricing in all of the good potential policies as a virtual certainty. Yet these very same markets seem to be conveniently dismissing away any of his contractionary economic policies (such as anti-immigration and protectionism) and there is still this rather significant variable known as the business cycle which last I checked is pushing into its 91st month when the calendar flips to 2017. This is nearly a full two and a half years longer than the average 59 months of the fourteen expansions since 1930.

It's true that cycles don't just die of old age, but they do die nonetheless and this usually comes at the hands of a tightening Federal Reserve who have engineered 10 recessions in the post-WWII era but only three "soft landings" (mid-1960s, mid-1980s, and mid-1990s – all expansions that were in their third or fourth year at the time – not their eighth).

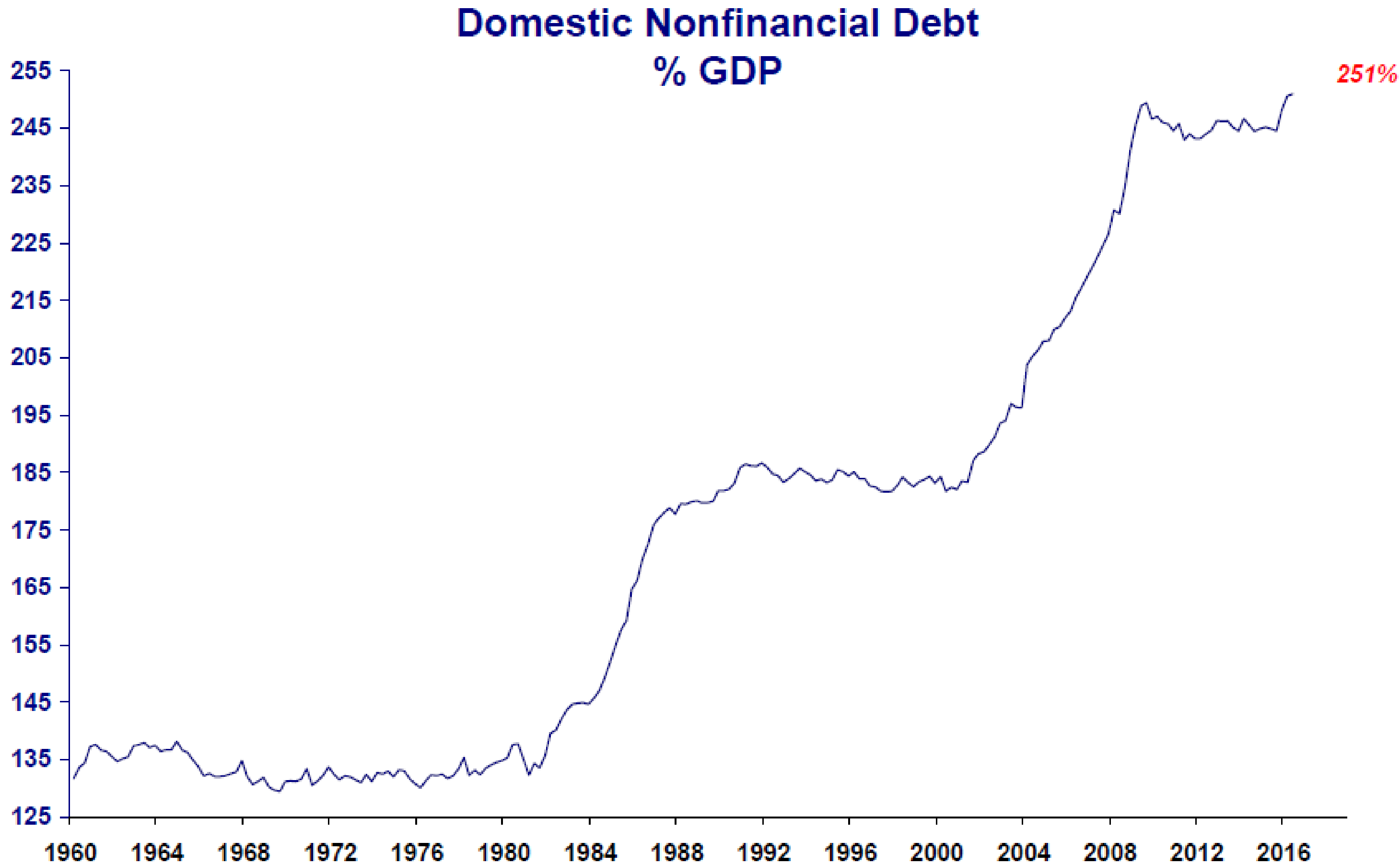
A CENTURY OF CYCLES



When you overlay the economic setup with equity market valuations, it's hard not to be even a little cautious given the S&P 500 is trading at a 20.5x P/E multiple on trailing earnings and a little over 18x on forward earnings – multiples we have not seen in 15 years and two standard deviations above the norm.

These high valuation levels complicate how one can envision transitioning from an economy that for the last eight years has become dependent on an overly accommodative monetary policy via high liquidity, low inflation, and cheap interest rates without skipping a beat. You see, the problem with this transition stems from the fact that America is carrying its highest debt burden in history, where Peter Boockvar (Chief Market Analyst at the Lindsey Group) estimated that a 100 basis point increase in rates causes interest rate charges on the Federal debt to soar $470 billion, or 2.5% of GDP.

And it's not just Federal debt, but household debt is expected to breach its 2008 high by the end of Q1 2017 and corporate debt has already breached its all-time high (see chart below).



So, while some items high up on the Trump administration agenda will likely be an incremental stimulant to economic growth (deregulation, individual tax reform, and corporate tax cuts financed in part from repatriated profits overseas), one of the big surprises to the market will be how limited the benefits of fiscal policy will be given a record debt ratio for a peace time economy. You wouldn't know it but we're still in the midst of President Obama's 10-year, $830 billion infrastructure plan – go figure.

This is an item Fed Chair Janet Yellen referenced during her press conference last week: "With the debt-to-GDP ratio around 77%, there's not a lot of fiscal space, should a shock to the economy occur, an adverse shock that did require fiscal stimulus." The bang for the buck from fiscal stimulus is much more powerful at low levels of government debt, which is why the FDR and Regan stimulus worked so well.

While U.S. equity markets look to be priced for perfection at the current time, investors may want to look more globally in terms of their equity weightings. The Japanese equity market has been on fire, much of it as a result of the weakening Yen, but the economic data has turned up for several months now, it trades at a P/E multiple just over 18x (compared to a historical average of 20x), and earnings estimate revisions have been on the rise for four consecutive months (rising to 0.89x in November to its highest level since April 2011 and up from 0.51x at the turn of the year).

Developed Europe is seeing earnings revision estimates move to the upside and nearing their best level since the winter of 2011. What's more is the valuation in the region is cheap on a relative basis with Germany's DAX trading at a P/E multiple just north of 13x and while France and Italy are a wreck economically, their stock markets reflect that (to a degree) trading at 15x forward multiples.

Then there are Emerging Markets which have been abandoned since the Trump victory, mostly on the auspice of the sharp move higher in the dollar and the impacts this will have on the nearly $10 trillion in outstanding dollar denominated debt. Yes, there is some risk here so any investment in this area (inclusive of Asia and the Pacific-Rim) has to be viewed within the context that a high level of volatility should be expected for these markets, but as a whole the EM index trades at a historically cheap 13x P/E multiple.

So while investors are jumping over themselves to buy U.S. assets, almost any region outside of Japan has been shunned and this just may set up to be the contrarian investment to own going into 2017 and in particular for investors with a time horizon that spans longer than the next twelve months.

Before signing off on this missive I'd like to wish you all Happy Holidays, and thank you for your readership and support throughout 2016.

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.