April 18th, 2016

Asymmetric risk / reward setup…

Better than expected earnings reports out of the banks and reassuring economic data out of China provided a lift to the major U.S. equity averages last week with the Dow Jones Industrial Average gaining 321 points (1.8%) to within almost 100 points of 18,000, the S&P 500 tacked on 33 points (1.6%), and the technology centric Nasdaq added 1.8% to close within 75 points of 5,000. Given where the major averages trade today I've definitely underestimated the rapaciousness to which stocks could levitate to and while valuations and earnings remain a concern, anyone with a defensive posture has to take notice of the broad based improvement.

- Equity market breadth has dramatically improved to the point that 90% of stocks are trading north of their 200 day moving averages – as a point of reference, market internals indicate broader participation in this current rally relative to the Q4 bounce that failed to make a new all-time high after the double digit August – September correction.

- The NYSE cumulative Advance-Decline line just broke above its cycle high.

- The U.S. dollar bull market that stirred deflationary worries around the world appears to be over and this along with structural adjustments in the energy sector has allowed oil to consolidate around the $40/bbl level.

- Financials are finally starting to participate and for the last two weeks have been leading the market as the banks posted better than expected results.

In the bond market, the yield on the 10yr Treasury-note continued to trade within its 1.60-2.00% range as it ended the week at 1.75%. It's quite interesting to see the 10yr yield down nearly 50bps from where it came into the year (2.27%), the 10s-2s spread hovering near cycle lows of 100bps, yet stocks have broken out to year-to-date highs.

Although, with central bank assets on their balance sheets comprising well over one-third of a share of their combined GDP's, perhaps the scarcity of safe yields in this environment makes complete sense and is the main force behind the stubbornly low U.S. yields. The reach for yield investment case has been pushed to such an acute level that street bond dealers were left with a record low share of last week's $12 billion 30-year Treasury bond sale with 22 primary dealers only able to walk away with 24% of the issue. You have to scour the archives of history to find a time when a 2.6% yield on long-duration paper seemed so juicy, but when it is stacked up against a 0.385% yield in Japan, 0.8% in Germany, or 1.4% in France it seems like a no brainer.

Don't get me wrong, a 30-year T-bond at 2.6% isn't the risk-free asset it has been in decades past as it is subject to experience severely volatile price swings should yields move merely 50bps (in either direction), but it blows my mind that Spanish 30-year sovereign debt also yields 2.6% – mind you Spain carries a credit rating of BBB compared to the U.S. AAA credit rating. For sure, much of this has to do with the confidence investors have in these European economies being able to tap into the ECB's pocket book when and if the need arises.

As for oil prices, all eyes were focused on the much anticipated gathering of OPEC members in Qatar this weekend where expectations were high that some level of production freeze would be agreed upon. It came as little surprise to learn yesterday afternoon that no deal could be reached with the ongoing tension between Iran and Saudi Arabia seeming to be front and center in hindering an agreement. The initial reaction in early futures trading saw oil plunge almost -7% (to $37.60), but into Monday's trading this loss has been more than cut in half with WTI rallying back to above $40/bbl. This rally in part (or in whole) is being assisted by news that workers in three refineries in Kuwait went on strike. Looking ahead the focus will shift to the regularly scheduled June 2nd OPEC meeting in Vienna where I'm sure headlines will continue to litter the wires speculating once again on a production freeze.

Keep in mind that the forward looking supply glut doesn't look nearly as daunting today as it did six months ago with estimates from the IEA indicating that non-OPEC supply will fall to 57 million barrels a day in 2016, down from a forecast of 57.8 million bbl/day last October. Additionally, the IEA expects the growth in oil stocks to slow from a 1.5million bbl/day pace in the first six months of this year to only 200k bbl/day in the second half of 2016 due to a drop in high cost production in places like the U.S. (oil rigs collapsing to 350 at last count from 640 at the end of 2015 and 1,550 at the end of 2014 would lead one to expect a decline in production).

Over the weekend investors were also keeping an eye on the impeachment vote in Brazil's lower house of Congress where a two thirds majority (342 votes out of the 513 deputies) was required to impeach President Dilma Rousseff – with the final yes count coming in at 367 votes. Brazil's Bovespa Index welcomed the news and continued to build on the huge gains (+22%) in this index year-to-date.

Staying on the international front, the numbers coming out of China last week were (on the margin) a mild disappointment with GDP coming in at 6.7% (a tenth better than expectations) to its slowest year-over-year growth rate in seven years, but these numbers were good enough to alleviate ‘hard landing’ fears. Furthermore, the monthly Bloomberg Tracker is indicating that overall GDP momentum was picking up steam as Q1 came to close, setting up the possibility that Q2 GDP growth could move up to 7%. However, it’s not all puppy dogs and rainbows in China as doubt continues to mount around the sustainability of this recent pick up in Chinese data as it is coming in tandem with a meaningful pick up in credit growth. As a share of GDP, China’s corporate debt load relative to GDP has skyrocketed to 160% today from 98% in 2008 (for context this ratio in the U.S. stands at 70%). This debt largesse continues to be brushed aside by Chinese leaders, which raises the question about how these maneuvers to buffer short-term gains will impact the long-term.

At the current time investors don’t seem to be too caught up the long-term impacts as the recent slate of stability out of China’s economic data (export data expanding in March, double digit rise in car sales, tame capital flows, and solid GDP print) has gone a long way in calming nerves.

On the U.S. data front it continues to be a mixed picture with the ongoing resiliency of the labor market seeming to outweigh soft data in other parts of the economy. Initial jobless claims plunged 13k to 253k last week after a 10k decline the prior week – marking the lowest reading in nearly 43 years for this series. This took the four week moving average to 265k which is a level that has historically coincided with monthly payroll gains of about 200k.

On the soft side of the economic data dump last week was March retail sales declining -0.3% month-over-month versus expectations for a gain of 0.1%. The control group (which excludes autos, gas, and building materials – economists focus on this figure as it factors into the estimates of consumer spending that feed into real GDP) increased only 0.1%, but the prior two months were revised modestly higher. All-in-all the trend in the retail sales data is indicative of a consumer that appears ho-hum about spending – after all how many trinkets and gizmos does someone really need?

The other major piece of economic data reported last week was Industrial Production declining -0.6% in March – its sixth decline in the last seven months. Manufacturing, which represents about 74% of the index, fell -0.3% as mining declined -2.9%. Never in the history of this data series has the U.S. economy skirted a recession when this metric was in negative territory on a rolling 12-month basis, as is the case today.

We also got releases on some lower-tier economic surveys which confirm the overall soft underbelly of economic growth. The NFIB small business optimism index crept down to 92.6 in March from 92.9 in February and continued its gradual decline from the peak of 100.3 in December 2014. The University of Michigan Sentiment index inched lower to 89.7 in the preliminary April print from 91.0 in March, but I would guess that this level will improve with the higher stock market when we get the final print. Latest was the March inflation data coming in mildly below expectations with headline and core CPI both rising by only 0.1%. This pullback came on the heels of two strong monthly gains, but just attests to the overall tame inflationary back-drop.

At this point the bulk of the data that would go into Q1 GDP growth estimates has been reported with forecasts gravitating to a flat to 1.0% growth level. This expansion will undoubtedly go down as the weakest in history with fully 40% of quarterly GDP prints coming in at a sub 1.5% reading. It should not be overlooked that we are currently in the 82nd month of this expansion (which far exceeds the average 59 months of the previous thirteen expansion since the Great Depression) where it’s highly probable that growth doesn’t accelerate from here – be it with unemployment at cycle lows, jobless claims at 43 year lows, both the corporate profit and credit cycles turning over, consumer spending slowing, and the manufacturing sector in contraction.

So the dichotomy between a strong labor market and a weak everything else continues unabated – just as the dichotomy between contracting corporate profits and higher stock prices stretches to uncomfortable levels. We are still early in Q1 earnings season with only 7% of S&P 500 companies reporting thus far with earnings growth expected to decline -9.3% (a slight deceleration from the -8.7% decline on March 31st). This has pushed the P/E multiple on forward 12-month earnings investors are willing to pay for stocks to a lofty 17.5x and a little over 19x on trailing 12-month earnings (both handsomely above historical averages).

The valuation gap, to me, remains the biggest constraint to future market returns and also represents the greatest risk to investor's capital. Time will ultimately tell whether this last push higher in the S&P 500 over the last three weeks is the result of all the shorts finally capitulating and covering (CFTC data would confirm this is occurring and reaching a point of near-term exhaustion) or a long-term commitment on the part of investors that believe the optimism being built into the recovery story in the second half of the year will come to fruition.

That is the juxtaposition between the bulls and bears today, where the former believe a second half reflation in risk assets is likely given the U.S. dollar has peaked, commodities have bottomed, corporate profits have troughed, manufacturing activity is set to reaccelerate, Chinese growth stabilizes, European bank credit risk is dormant, and central banks can thread the needle in pulling back accommodation. The latter camp (the bears) see an environment where global growth has decelerated to its weakest level since this expansion started, year-over-year growth in employment, consumer spending, and consumer confidence is decelerating, treasury yields are near their cycle lows, 90% of the worlds global bond market trades with less than a 2% yield, S&P 500 earnings growth is on track to decline for 4 consecutive quarters, sales growth has declined for 5 straight quarters, and equity market valuations are at cycle highs.

It’s a challenging and complicated setup with risks to either side, for which I don’t believe the risk/reward payoff is symmetrical for the two sides. For the bull case I believe the asymmetric payoff is tilted towards a modest return for an elevated level of risk if this thesis comes to fruition as current valuations reflect a heavy dose of optimism. As for the bear case, the payoff would be high (in a manner of speaking) as a defensively positioned investor would mitigate the downside impact on capital levels (marginal loss) as the risk of a steep decline is high if risk assets adjust downward to weak fundamentals.

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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