June 13th, 2016

Puts and takes…

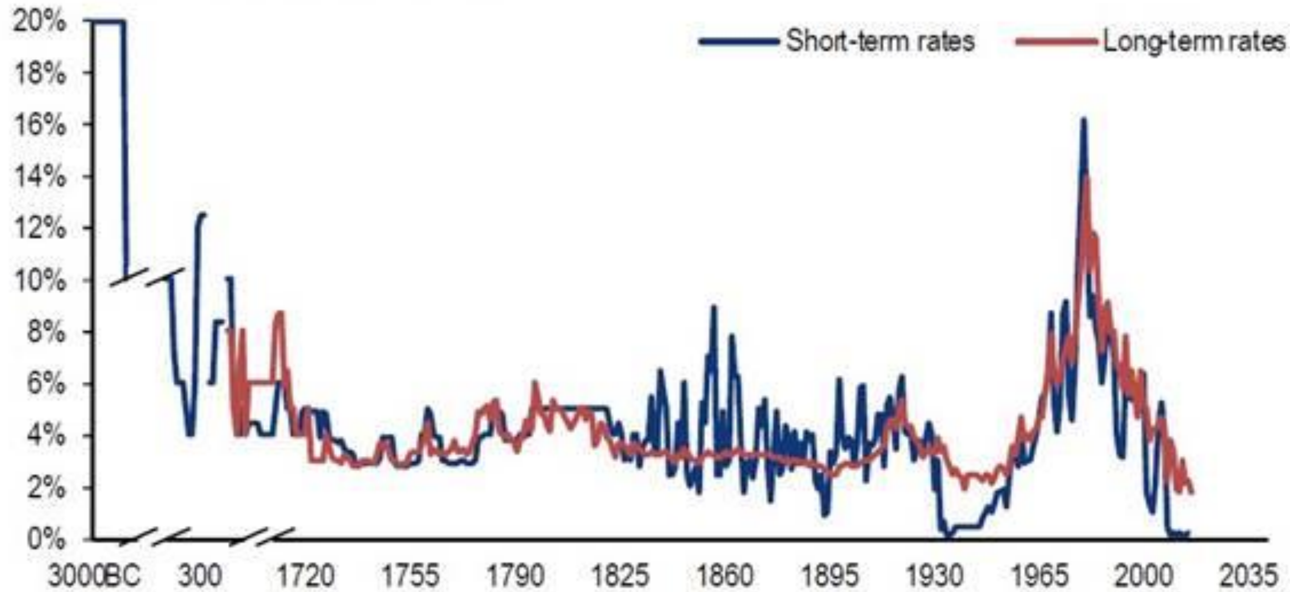
It was rather quiet on the economic data front last week, and investors solely focused on the major U.S. equity indices might conclude that last week's stock market action was deserving of a big yawn: The Dow Jones Industrial Average rose 58 points (+0.33%), the S&P 500 fell 3 points (-0.15%), the Russell 2000 (small cap stocks) ebbed lower by -0.02%, while the tech heavy Nasdaq bore the brunt of the punishment losing almost -1.0% on the week. However, I would argue that anyone who came to this conclusion is missing the forest for the trees.

Investor risk aversion picked up steam in the latter part of last week as new poll numbers surfaced out of the UK showing the “leave” camp overtook the “stay” camp leading up to next week’s referendum vote on Britain’s fate in the Eurozone. Questioning the accuracy and authenticity of the polls misses the point that matters to markets – what moves markets is certainty (or the lack thereof), and this event has become much too close to call for the markets liking. Hence why we saw the VIX (volatility index) spike by more than 26% last week and the major European equity markets selling off decisively (DAX -2.66%, CAC 40 -2.6%, and UK’s FTSE All-share index fell -1.44%).

What really grabbed my attention last week was the flat-lining of global interest rates. According to data from Fitch, the absolute level of global government bonds trading with a negative yield eclipsed $10 trillion for the first time ever (excuse me for pointing out the obvious, but ‘ever’ is a very long time). I plucked the below chart from a note put out by the Global Investment Strategy team at BofA Merrill Lynch which highlights just how far ‘ever’ goes back and just how low global interest rates are.

The Long View

Chart 2: The lowest interest rates in 5000 years



Source: BofA Merrill Lynch Global Investment Strategy, BoE, Global Financial Data, Homer and Sylla 'A History of Interest Rates'
Note: the intervals on the x-axis change through time up to 1700. From 1700 onwards they are annual intervals. Full methodology available upon request

As a result U.S. Treasury yields have slipped back to the lows they were at in mid-February – recall back then how dark and gloomy the outlook seemed with global recession warnings emanating from every corner of the world. This sets up an interesting dichotomy within the capital markets, where last week the yield on the 10-year T-note fell back down to 1.64% (its calendar year low) yet the S&P 500 traded up to its high of the calendar year at 2,120 (within 0.6% of its all-time high).

Something is amiss with this backdrop where history would suggest that the risk averse nature of investors who adhere to the wisdom of what Mr. Bond is telling them have had a much better track record of sidestepping trouble than those who followed Mr. Stock's lead. Furthermore, since the S&P 500 made a new all-time high back in May of 2015 it has closed above 2,100 on a mere 43 out of the

268 trading days (16% of the time) – just goes to show this 2,100 level has proven to be an extremely difficult level for investors to maintain conviction.

Puts and takes on things I read or heard last week:

- **TINA (There Is No Alternative)**
  This acronym has been making its rounds for the last couple of years and stems from the concept that global interest rates are so low that investors have no other choice than to put their money in the stock market.

  If only it were that simple!

  I can understand the simplicity of this concept and will concede that there was some validity to it, but that fundamental elements that justified this theory have (in my opinion) expired. The genesis of this theory harkens back to the initial stages of the Fed's experimental monetary policy whereby they implemented ZIRP (zero interest rate policy) coming out of the credit crisis in the hopes that it would create a wealth effect and stimulate the 2/3rds of the economy known as the consumer. What is becoming more evident by the day is that the aggressive monetary policy implemented by global central banks around the world has done a good job of increasing the wealth of those who own assets, but it has been rather ineffective at elevating economic growth onto a sustainably higher growth path.

Those who continue to make the case today that TINA is an actionable investment concept are naively and ignorantly (in my opinion) misjudging the profit and credit cycles. In the early stages of these respective cycles the math works to the benefit of investors willing to take risk as corporate profits are expanding, lending standards are loose, return on capital exceeds the cost of capital, and economic growth is gaining momentum. Couple this environment with a lower interest rate, which has the effect of lowering the discount rate in every 'time value of money' equation, and yeah – asset prices, valuation multiples, and present values should all increase.

However, when the corporate profits, credit, and business cycle rollover (as is currently the case), whereby corporate profits are declining, lending standards are tightening and the cost of capital exceeds return on capital, the value of asset prices and equity market multiples contract. Reason being (and while perhaps counterintuitive), discount rates tend to increase in this environment because risk premiums rise. While central banks can control yields at the short end of the Treasury curve, they have less control over what yield credit investors will demand on comparable maturity spread instruments.

This is an environment our research suggests we have reached today and why I think the TINA investment thesis is a rather reckless justification for owning risk assets.

- **U.S. Equities – leading or misleading?** If all an investor looked at was the year-to-date performance of the Dow Jones Industrial Average (+2.5% ytd) or the S&P 500 (+2.5% ytd) they would conclude (understandably) that all was fine in the world. However, an investor that expanded their view to include equity markets from around the world would likely come to a drastically different conclusion, given the following results:

    - The German DAX is down more than -10% year-to-date and more than -20% from its high last summer
    - Italian's FTSE MIB index is down -22% year-to-date and has plunged more than -30% since July of last year

- Japan’s Nikkei 225 Index is down nearly -16% year-to-date and down almost -24% from its high reached last July
- China’s Shanghai Index is down almost -20% year-to-date and has been crushed to the tune of almost -44% from its 52-week high

These are some of the most prominent and significant economies in the world and all of them are in a bear market (decline of -20% or more). It begs the question, in a world that is more highly correlated and interconnected than it has even been: do these markets rise to catch up to where the Dow and S&P 500 are currently, or does the Dow and S&P 500 recouple (at much lower price levels) with these markets? Me thinks the latter.

The sector leaderboard within the U.S. equity market should be causing a prudent investor to take a pause with defensive sectors (Utilities +16%, Telecom +15%, and Consumer Staples +7%) heading up the year-to-date performance results while cyclically sensitive sectors (Technology +0.54%, Consumer Discretionary +0.15%, and Financials -3.2%) bring up the rear.

Piggybacking on the TINA comments, those advocating that global equity markets are the only game in town need to double check their figures as bond markets have handily outperformed equities so far this year. Below is a brief run through of a smattering of broadly owned bond ETF's:

- Ishares U.S. Aggregate Bond (AGG): +3.35% ytd
- Ishares 7-10 year Treasury Bond (IEF): +5.74% ytd
- Ishares 20+ year Treasury Bond (TLT): +12.15% ytd
- Vanguard Ext. Duration Treasury (EDV): +18.32% ytd
- Ishares iBoxx Investment Grade Corp. Bond (LQD): +5.90% ytd
- SPDR Barclays High Yield Bond Fund (JNK): +3.60% ytd
- Ishares J.P. Morgan USD Emerging Mkts Bond (EMB): +6.27% ytd

You get the point – the relative results on an absolute basis are obvious. Now consider if you were to evaluate these results on a risk-adjusted basis – this folks is what you would call a 'no-contest'.

- **Corporate earnings and valuations** S&P 500 corporate profits registered their sharpest year-over-year decline in Q1 which marked the third consecutive quarter of negative earnings growth, all the while the S&P 500 closed last week within 35 points of its all-time high. Looking through the historical archives of S&P Senior Index Analyst Howard Silverblatt's earnings database, I see that S&P 500 earnings are at the same level they were back in 2011 when the S&P 500 was trading around 1,300. Without question this equity market is pricey with the S&P 500 trading at a P/E of 18x 2016 earnings estimates of $114.

  Keep in mind earnings estimates for Q2 are expected to decline to the tune of -4.0% which puts an awful lot of hope into the pick-up in EPS growth in the back half of 2016. A large part of the math driving this pick up in earnings growth is a more favorable currency comp to what was a significant rise in the dollar in Q3 and Q4 of 2015. Additionally, assuming oil prices maintain the roughly $50/bbl price level, the earnings profile for the energy sector will turn from a significant headwind to a tailwind for overall S&P 500 profits.

This all makes sense, but whether or not these estimates will accurately reflect what the global economic picture looks like in the second half of the year is a rather large unknown. Whether you're looking at the continued weakness in railcar volumes, slowing global auto sales, seventeen straight months of decline in South Korean export volume, a softening corporate profit picture in Japan and the Eurozone, or a slowing labor market in the U.S. – all of it suggests a challenging corporate profit environment is afoot. Clearly this is what the World Bank is seeing as it revised down its global growth estimate last week to 2.4% from the 2.9% pace they projected in January.

- **Interest rates and central banks**
  There have been subtle signs throughout this year that the belief system in central banks was beginning to break down, but the action and talk crossing the wires last week pushed these signals from subtle to blatant. Just look at what happened with yields in the bond market last week – the 10-year Japanese Government bond yield slid to -0.17%, the Swiss 10-year yield dropped to

-0.50%, U.K. Gilt yields fell to 1.2%, and 10-year German Bund yield plunged to a minuscule 0.01%.

The yield story in the Eurozone is driven in part by the ECB's further foray into the experimental monetary policy toolkit by buying corporate bonds as a part of the extension of its QE policy announced earlier this year. If you are a corporation, why not take advantage of free money, which is exactly what companies have been doing as last week Unilever issued €300 million of zero coupon bonds due in 2020. Barron's penciled an article over the weekend saying that since March some 30% of investment grade issuance has prices with a yield lower than 1%.

Call it what you will, but in my opinion interest rates today are artificially mispricing risk and the effects of such a prolonged and drastic mispricing of the cost of capital are starting fester. Two of Europe's largest banks took the ECB to task last week with public statements railing against the extremes to which this monetary policy experiment has extended. Commerzbank is considering storing cash in its own vaults to avoid paying for storage and in a colorful note penned by David Folkerts-Landau (Chief Economist for Deutsche Bank's banking arm), he quipped that, "the benefits from ever-looser policy are diminishing while the litany of distortions, perversions, and disincentives grows by the day".

As I’ve said before and I’ll say it again, I don’t know how or when this ends, but I fundamentally believe that it will end badly. The back bone of free capital markets is the idea that there are winners and losers, risk and reward, and a market determined price for the cost of capital. In the short run these metrics can be manipulated to achieve a predefined objective for the greater good, but the longer these distortions are perpetuated the further removed prices get from fundamental reality, and the closer capital markets get to a day of reckoning.

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.