



September 12th, 2016

It's still all about the Fed...

Like it or not, but you can't deny it – in the land of capital markets it's all about the central banks. Across the board capital markets threw a hissy fit last week on the heels of what was perceived to be an incremental tightening of global monetary policy accommodation. European Central Bank President Mario Draghi got the ball rolling on Thursday when he refrained from committing to market expectations that additional rounds of policy easing were right around the corner. This set off an initial move higher in yields across the globe which

accelerated in Friday's market action on the heels of some hawkish comments by Boston Fed President Eric Rosengren, who has long been viewed as one of the most dovish FOMC members.

Couple this with a continuous flow of stories running all week about escalating dissension within the Bank of Japan over the efficacy of any further actions on the monetary policy front. And why shouldn't the BoJ be reevaluating its policy toolkit, when they now find themselves in a situation where they are buying all of the Japanese government bonds being issued and then some, which has pushed their bond market to a point where there is no private market for JGB's to speak of and a yield curve that has become completely flat. Maybe this has something to do with – 30yr JGBs jumping from 0.05% to 0.50% over the last four weeks – doesn't look like much of an

absolute move in yields, but this caused a -15% decline in price.

Interest rates across the globe have shot up with the German 10-year bund yield moving back into positive territory (0.04%) and the U.S. 10yr Treasury increasing to 1.7% as it broke out of its longstanding range between 1.4 - 1.6%. This move in the yield on the U.S. 10yr T-note broke its 100-day moving average (1.63%) and sets up a test of the 200-day at 1.80% with a worst case scenario sending it up to its Fibonacci retracement level around 1.90%.

This is where we're at in the investing world, where fundamental analysis has taken a back seat to wordsmithing every speaking engagement by a central bank representative. Prior to Friday's sell-off equity markets were in the midst of one of the lowest volatility

periods in market history, where the S&P 500 had not moved more than +/- 1% in the prior 44 trading days. With potential changes afoot either in central bank policies (ECB, BoJ, Fed) or investor confidence in such policies – this era of calm may be coming to an end.

Whether Fridays -2.5% selloff in the S&P 500 (a similar level of declines were experienced in most other major indices) and a comparable -2% selloff in the long-end of the Treasury curve is just a preamble for what's to come or a one-time market adjustment of investor positioning is yet to be determined. On a short-term basis the equity markets have some ground to make-up, but overall the selling pressure abated at some pretty text-book technical levels:

- The Dow Jones Industrial Average closed at its 100-day moving average of 18,085

- The S&P 500 (while registering its biggest weekly drop since early February) closed just above its 100-day moving average of 2,120
- The Russell 2000 index closed at its 50-day moving average of 1,217
- However, both the Nasdaq and Dow Jones Transport indices both closed below their 50-day moving averages

The follow-through this week from Friday's weakness will be more telling than a one-day (perhaps one-off) spasm on the part of investors. As of mid-day on Monday markets are already back to their expected Pavlovian conditional response, bidding up all the assets they sold on Friday (not to the same levels – yet...) following dovish comments from voting Fed member Lael Brainard, where she struck a cautionary tone against hiking rates too early. Following her remarks, asset prices

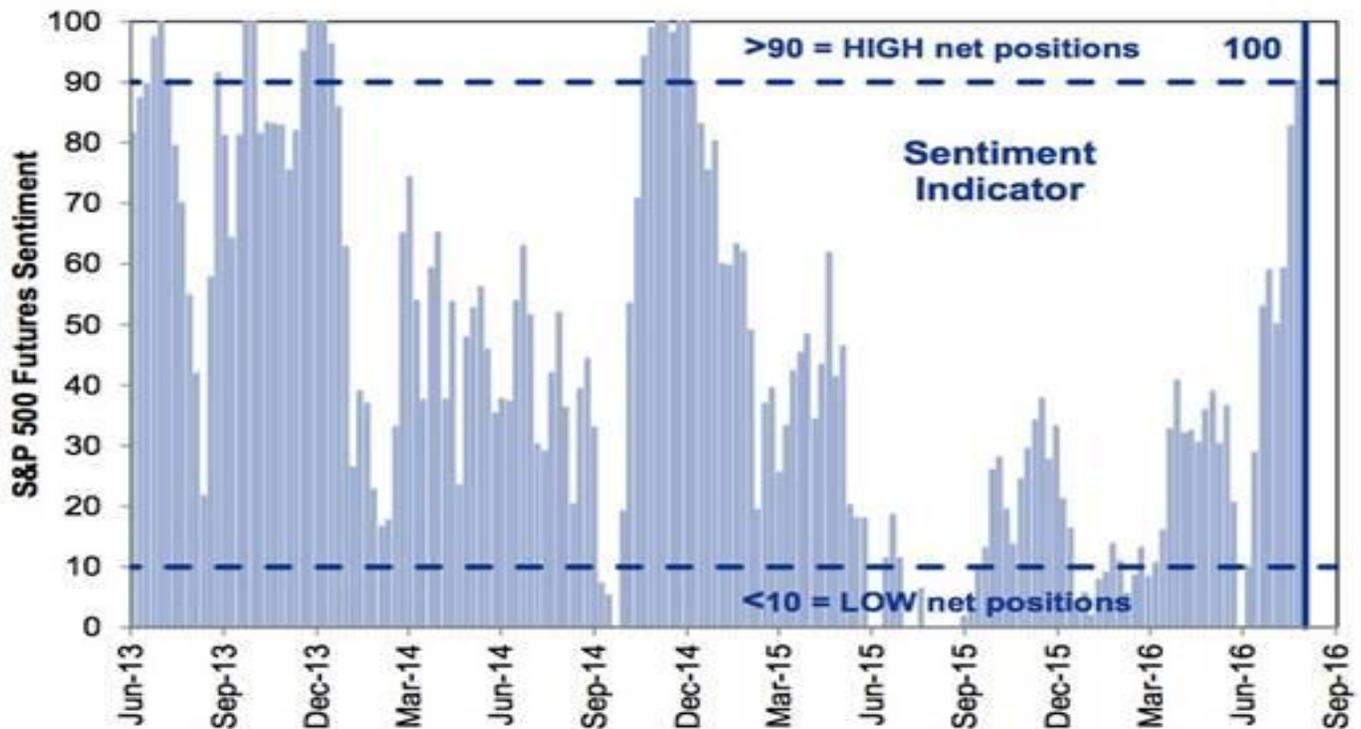
ripped and Fed Fund Futures plunged to just a 15% probability of the Fed hiking rates at the conclusion of their September meeting next Wednesday (down from 30% on Friday).

What is and has been obvious for some time now is just how embedded the “central bank’s got your back” investment strategy has become in asset prices across the board. To me this is the greatest near-term risk facing investors today – the increasing positive correlation among asset classes that have long been viewed as portfolio diversifiers, which in the past represented a foundation for asset allocation to act as a prudent risk management strategy.

As a result, a bull market in complacency is coinciding with a bear market in volatility, as can be seen in the following sentiment chart from Goldman Sachs research team, where

investor positioning is at its most aggressive (risk-oriented) level since 2014.

Sentiment Indicator stands at 100 (maximum)



Note: Sentiment Indicator ranks net futures positioning versus the past 12 months. Readings below 10 or above 90 indicate extreme positions that are significant in predicting future returns.

Two things that appear to be pretty clear when observing central bank policy throughout this cycle are 1) it is an effective tool at raising asset prices, and 2) it is an ineffective tool

when it comes to dealing with structural issues.

Regarding the latter, I just find it a bit surprising when I read statements by Fed officials like John Williams of the San Francisco Fed saying that the U.S. economy is “in good shape and headed in the right direction”. I guess ‘good shape’ is a relative term depending on one’s interpretation, but flat real gross domestic income in Q2 and an annual trend that has downshifted to 1.2% YoY (a level that in the past was more closely aligned with recession than expansion) is not exactly consistent with that description.

Nor is industrial production declining on a YoY basis for eleven consecutive months, negative capex growth over the last three quarters, and/or six straight quarters of declining corporate profits. An ISM

manufacturing index back below the 50 growth/contraction break-even level, ISM non-manufacturing falling to its lowest level since February 2010 (back when this economic expansion was just getting going), and growth in single family housing starts has flat-lined over the last six months.

Well, the labor market is booming...Is it? Since this expansion started back in 2009 the U.S. economy has added a little more than 12 million jobs, which is no small feat, yet the U.S. population has grown by 18 million. The employment to population ratio south of 60% is far from a sign of a strong labor market when compared to the average level of 61.7% since 1990 and readings consistently north of 63% prior to the global financial crisis.

Other than that, how was the play Mrs. Lincoln?

All sarcasm aside, if this is at all representative of a strong economic foundation then I'd love to see what their definition of a weak economy looks like. Whether the Fed is serious about removing policy accommodation at this time is yet to be determined (and I must say that I'm just as much in the guessing game as everyone else on this front), it does set up the potential for a two-way street being reopened in capital markets – you know, the one where asset prices can go both up and down. It's worth acknowledging the following statement (which to this point has been overlooked) from the most recent FOMC minutes:

“Several expressed concern that an extended period of low interest rates risked intensifying incentives for investors to reach for yield and could lead to the

misallocation of capital and mispricing of risk, with possible adverse consequences for financial stability”.

Maybe this is just lip service by the Fed or their way of saying ‘don’t say we didn’t warn you’ as financial stability concerns become a more pressing issue. After all, it was an easy scapegoat to look back after the fact at the 2008 credit crisis and blame the Fed for keeping interest rates too low for too long as housing morphed into a bubble.

Couldn’t the same argument be made today, with debt levels globally at all-time highs? Two companies in Europe issued debt last week with negative yields, PIK toggle loans are back in vogue (where bond issuers pay coupon payments with additional debt – really, we’re back to this?), and household debt as of the end of Q2 is only 3% below

2008 peak levels. Legendary junk-bond guru Marty Fridson was in this weekend's Barron's Current Yield column where he had this to say about high yield debt: *“the gap between the present spread and fair value is almost twice the cut-off for what I consider extreme overvaluation. It's extreme, extreme (for double emphasis)”*. This is a guy who is highly respected in this space, knows his stuff, and when he talks investors should listen.

Looking ahead, not much has changed and I think it's premature to draw any definitive conclusions on recent market moves other than continued confirmation that risk assets remain highly addicted, dependent, and correlated to Fed accommodation. This is a trend that will remain firmly entrenched until a change in the status quo emerges, and it doesn't look as though the Fed has the gumption to violate this relationship.

It has been my view since the beginning of the year that it is the economic data and the business cycle that will be the catalyst to snatch control away from complacent and stale monetary policy. To me, the second half of this year has always set up to be a very challenging environment when it comes to measuring the strength and health of the U.S. economy. It's the risk of an already weak and fragile growth profile getting weaker from here to year end that presents the biggest risk to rich equity valuations and complacent investor positioning. On this front the last two weeks of economic data has been the weakest readings in the last five months and the momentum going into October looks to be waning.

It's the porous fundamental underpinnings that have prevented me from capitulating to the

“this time is different” camp and buying into the notion that global central banks will forever be able to suspend and smooth economic gravity. Over the last year they’ve been able to trump weakening fundamentals and slowing global economic growth, but their biggest test lies ahead.



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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