January 30th, 2017

It's complicated…

The Dow Jones Industrial Average finally broke through the 20,000 level last week after flirting with this milestone for more than a month, and as a result you were hard pressed to find a daily periodical that didn't run with this historical achievement as one of its main headlines when they went to print last Wednesday night. Without question this is quite a feat for the stock market and brings some constructive attention to an industry that at times serves as an easy punching bag for the growing inequality problem festering in the United States.

Let me remind you though that the Dow Jones Industrial Average today is not the proxy for the market that it was several decades ago – for example only four of its current constituents are classified as industrials. Furthermore, without getting into the specific makeup and minutia of this price weighted index, just know that there is only 1 company of the 30 stocks in this Blue-Chip index that is still around today from the time it was created back in 1896.

One last thing of note on the Dow is its sensitivity to highly priced stocks within the index, whereby five stocks (Goldman Sachs, Boeing, IBM, United Health, and JP Morgan) account for half the gain in the index since Election Day.

As for the markets as a whole last week, stock gains were broad based with the S&P 500 rallying 1%, the Nasdaq jumping 1.9%, and the Small Cap Russell 2000 gaining nearly 1.4%. However, the power of the pen and President Trump with his rapid fire executive orders appear to be stirring some anxiety among investors as we start off the week – it looks as though the Dow 20k level and all of last week's gains could be given up by the end of today's trading.

It was a relatively quiet week in the bond market with yields rising across the curve, but it looks like 2.5% on the 10-year Treasury is proving to be a key resistance level for yields. Time will tell whether this level holds or if investors will push rates above their 2.6% post-election high, but they'll have plenty of catalysts to decipher this week with the calendar full of data. Speaking of the data, we will have more than 100 companies reporting this week with Q4 earnings thus far coming in a bit better than estimates (when don't they beat in this era of earnings management?). Earnings growth for Q4 2016 is tracking +4% year-over-year with sales growth coming in around +5.0% y/y. The more important question for investors is whether or not 2017 earnings will finally break-out from what has been a flat lining in S&P 500 earnings since 2014.

If there is a bull market in any asset class in this post-election world, it is in complacency. Last week the VIX index flirted with single digits and was trading at its lowest level since July 2014. The fact that the VIX is at these levels with an unpredictable and unproven leader in the White House, a market that is trading at a cycle high P/E of 21x on trailing earnings, a business cycle that is looking very mature, and a Federal Reserve that appears determined to move forward on its rate hiking cycle, is beyond a head scratcher to me. This complacency is sure to get tested this week with an upcoming slate of economic data including ISM manufacturing and non-manufacturing surveys, Federal Reserve meeting, and Friday's employment report.

In the commodity markets, oil continues to hold its ground around the $53/bbl price level which is impressive given the jump in the U.S. rig count over the last two weeks. Sure, I understand the OPEC production cut and all, and we won't know until February who's actually cheating on this deal and by how much, but one thing is for sure and that is that U.S. producers are not sitting around waiting. Oil rigs have nearly doubled from their lows last year and recent estimates suggest that U.S. shale production could breach 9.0 million bbl/day this year which would go a long way to making up more than 50% of the roughly 1.3 million bbl/day production cut out of OPEC – a real world example of free markets versus cartels.

Gold had a tough week as it broke below $1,200/oz, but is up 3.5% on the year and has outperformed U.S. equities year-to-date. Perhaps it's me, but I don't imagine I'm the only one that deems it prudent in the current environment of elevated uncertainty and profound change to seek out some form of portfolio hedges like gold, select fixed income, and cash.

One area of the investment landscape that I liked coming into this year and continue to think makes a lot of sense for long-term investors is overseas equity markets. Granted we're only a month into the New Year, but the MSCI All-cap world ex-U.S. equity index is up more than double the S&P 500's 2.5% return. The outperformance is even greater with Emerging Markets having regained all of their post-election weakness and an impressive 7% rally so far in 2017. Surely, these overseas markets carry their own warts and investing in them will carry a higher level of volatility, but many of these regions are at drastically different phases of their business cycle than the U.S. This isn't to suggest that they won't be highly correlated with the U.S. business cycle, but on a relative basis it's hard to be excited about investing in U.S. stocks with valuations on many metrics that have only been more expensive in 1929 and 2000, yet Emerging Market valuations are near two decade lows.

The initial move by investors following the election has been like a paint by numbers portrait where the prevailing view was that investors should buy the U.S. under the auspice that deregulation, lower taxes, and infrastructure spending were going to ignite the economic expansion that has been so shallow following the Global Financial Crisis. Time will tell whether this ends up being the case, but one has to wonder how much political currency is getting used up on Trump's cabinet getting confirmed and on his executive orders, which leaves less to get the good stuff like tax reform and infrastructure passed in a timely manner.

Last week's Q4 GDP report should serve as a bit of a reality check to those who have been viewing the fundamental landscape with nothing but rose colored glasses. You'd never know it from the one way street U.S. stocks have been on (and this jubilation is confirmed by the surge in virtually every sentiment survey), but this is still a rather fragile economic footprint we're dealing with according to what we've see out of the hard data.

U.S. economic growth slowed to a +1.9% annualized growth rate in Q4 which was a rather disappointing print relative to consensus expectations for GDP to expand closer to +2.5% to close out 2016. What's more is that the internals of the report were even weaker than the headline suggests with a massive inventory build adding nearly a full percent to headline growth and state and local government spending accounting for 0.3%. So, this implies that outside of these two segments the rest of the economy expanded by a grand total of 0.6% – in most circles this would be considered stall speed.

On a calendar year basis GDP grew by 1.6% in 2016 which is the weakest year of growth in this entire expansion (matching the 1.6% growth rate in 2011). Bulleted below are the quarterly (annualized) growth rates in real GDP since economic growth peaked this cycle in Q2 2015:

- Q3 2015: +2.0%
- Q4 2015: +0.9%
- Q1 2016: +0.8%
- Q2 2016: +1.4%
- Q3 2016: +3.5%
- Q4 2016: + 1.9%

It can be argued that what this expansion has lacked in verve it has been made up for in duration, with this now being the fourth longest economic expansion in U.S. history. But when you see that there have been 16 quarters (out of 30) during this expansion where economic growth came in below 2%, and this compares to only five sub-2% growth quarters in the '03-'07 expansion, then you can start to see why voters around the world are going the direction they are with their protectionist/mercantilist leanings.

Without a doubt the argument can be made that this is all backward looking data and in the new Trump administration this trend is sure to change with all the pro-growth / pro-business goodies. While I remain open minded to this potential outcome and I really want to join the optimists in their celebration, I continue to be mindful of this difficult variable to ignore known as history. What worries me is the hope that so many people are putting in the power of the government to effect change for the economic benefit of society.

When examining the data, history would suggest that the identity of the Oval office occupant has much less impact on GDP than the campaign rhetoric presumes. And I'm not referring to what happens or is the result of short-cycle economic impacts, like a President coming into office at the peak or trough of an economic cycle (think G. W. Bush for the former and Obama for the latter). I'm referring to the drivers of economic growth over an extended period of time where the empirical evidence is rather definitive on this front in suggesting that real GDP growth is a function of growth in the labor force (can be approximated by population growth) and productivity increases.

Among the many comparisons that have been made to the beginning of the Reagan era and the start of the Trump administration, where the fundamental set-up could hardly be more different, here is yet another headwind that the current reality presents relative to the early 1980's. The following table from Morgan Stanley provides a summary of the growth rate in these two variables today versus where they stood back then.

Growth rate of GDP determinants

	Population	Productivity
Reagan era	1.70%	1.70%
Now	0.75%	0.75%

Source: Morgan Stanley Investment Management

As you can see both population and productivity growth were running at 1.7% during the 80's which suggests that potential GDP growth in the Reagan era was 3.4%. Any guesses on what actual GDP growth was from 1981-1990? Answer: 3.4%. This isn't to say that the Tax Reform Act of 1986 wasn't beneficial or meaningful legislation for that period, but it just goes to show you that the most meaningful drivers of economic growth were already in place and provided a nice tailwind for whatever policy measures were coming down the pipe. Let me also point out that productivity growth in the decade leading up to Reagan's administration averaged 1.8% – this isn't to argue, but to show that it wasn't Reagan's policies that drove a material increase in productivity growth.

Today, population and productivity growth are running at a 0.7% clip which suggests that economic growth potential is around 1.5%. This isn't a knock against Trump or his administration, but just a heavy dose of reality to all the hopes that one man can wave a magic wand and make all of our challenges go away. He and his economic advisors can make all the promises they want about expectations for 3-4% growth, but keep in mind that it's highly probable that these are nothing more than hype and hope.

The irony is that one of the few levers that could be pulled to move the needle in a positive direction on the population growth side of the ledger would be to open up the floodgates on immigration – not exactly high up on the new administration's agenda. A development that could positively move the needle on the productivity side would be an unforeseen technological breakthrough that causes productivity to surge. You can't say that we're not witnessing innovation and advances with technology today when you look at the Amazon's and Uber's of the world, but these technologies are more destabilizing and disruptive to legacy businesses, whereby they are making existing industries more efficient and not advancing potential economic output to a higher utility function.

What I see transpiring at the current time is a growing divide between expectations and reality – where the economics community and fundamentals continue to grossly lag market prices and investor hopes. As is always the case, time will be the ultimate arbitrator, but someone is going to be right and someone is going to be wrong – the bigger risk for investors is if it's the equity markets that ultimately end up being wrong.

From my vantage point there is no better word to describe the prevailing investment landscape than to say its "complicated". The spreading mercantilist movement around the world is a profound change from what has been a concerted effort toward globalization over the last five decades. There is no deregulation or tax reform that can match the potential negative impacts of anti-trade measures. According to estimates from some very sharp economists that know the ins and outs of these changes better than I, global trade has added roughly 0.75% per year to global GDP. Yes, I said global GDP because last I checked the U.S. population accounts for less than 5% of world population, and as a result the gradual transformation of economic power was an inevitability. However, retrenching from our ability to guide and remain relevant in this transformation is worrisome to me.

If the pro-business / pro-growth Republican agenda is effective in moving the needle on increasing the return on invested capital in the U.S. economy, then there is much less to worry about as growth and profits will pick up and elevated valuation levels will take care of themselves.

However, if these policies prove to be ineffective and we are diagnosing the wrong problem which leads us to prescribe the wrong medication – then we should all become better versed with the 1930's. There is no easy answer for an investor today with U.S. equity markets at record highs, bonds just off record highs, and real estate assets at record highs. In hindsight, it makes sense that we are at this juncture with global central banks flooding the system with cheap money, but even this variable that has been there to keep the economy and asset prices from stumbling throughout this cycle seems to be at an inflection point.

Investing is all about taking intelligent risks and then managing those risks that you chose to take – please don't forget the second part of this equation.

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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