
**October 16th, 2017**

**The Central Bank Conundrum: Asset Prices versus Social Stability…**

The S&P 500 notched its fifth consecutive week of gains last week and while its double digit year-to-date return profile is impressive, it pales in comparison to the 22% YTD gain in the MSCI All Cap World Index (ex-US) or the 33% rise in the Emerging Markets Index. It's widely known at this point that the world is experiencing a level of synchronized growth that has been absent since the Global Financial Crisis and while this rightfully provides a fundamental element for the year-to-date gains in global equity markets, the major question lingering over investors' heads is how much credit is owed to the $2 trillion in financial asset purchases made by central banks so far this year? It looks as though investors aren't going to have to wait long to find out the answer to this question with the Federal Reserve already starting to reduce its balance sheet in Q3, the ECB floating trial balloons last week about cutting their asset purchase program in half from the current $60 billion per month they are buying, China's credit impulse having already peaked and started to turn down, and BOE President Mark Carney commenting that interest rate hikes were likely to commence sometime before year-end.

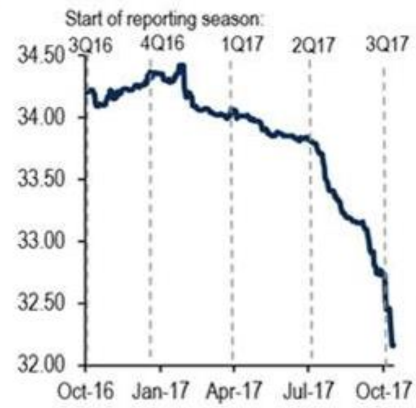
The important thing for investors to keep in mind is that monetary policy impacts economies and markets with a lag, whereby the goldilocks economic environment we are experiencing currently has a lot to do with global central banks taking decisive action in the Spring of 2016 to inject the highest level of liquidity into the financial system since the Global Financial Crisis. This looks to have peaked in Q3 and it's reasonable to surmise that here in the U.S. we have yet to fully experience the effects of the three rate hikes by the Fed since December 2016. One thing that stood out to me last week that provides some color on the impact this is having were the results out of the money center banks. On the surface the results looked fine with all the big money center banks beating expectations, but all of them increased loan loss reserve provisioning to offset weakness they were experiencing in their loan books. Wells Fargo, the poster child for the health of the U.S. consumer, reported total loans down 1% YoY and this marked the third straight quarter of total loan balance declines.

As for earnings season, it kicks into high gear this week with 10% of the S&P 500 reporting and we'll see if this earnings season sets up as a 'sell the news' type of event (similar to what transpired with the banks that reported last week, all of which sold off after reporting). What will be most important to watch is the revenue line and what companies provide in the way of forward guidance. Based upon the work from BofA's Quant Team it looks as though the Q3 earnings bar has been lowered going into reporting season (S&P 500 EPS estimates are down 1.4% since October 1st, down 4.5% since July 1st, and down 6.1% since the start of the year), but you'd never know it by the unrelenting bid higher in the market averages.

**Chart 2: Revisions to 3Q17 consensus earnings since the start of Oct.**

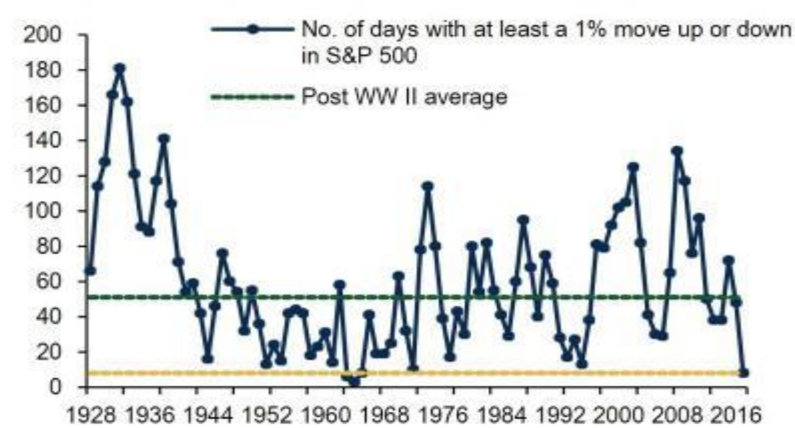

Source: FactSet, BofAML US Equity & US Quant Strategy

**Chart 1: Trend in S&P 500 3Q17 bottom-up consensus EPS**




All this has done is raised the valuation levels for the equity market to even loftier levels. I must admit with each passing day that I see increasing signs of euphoric investor behavior and market froth, but observing and acting upon these observations are two entirely different things. What I'm referring to is a market that has gone 11 months without so much as a 3% pullback – an event that has happened only one other time in the past. The only other occurrence was in 1996, when the U.S. economy was four years into one of the strongest and longest economic recoveries in history, which is almost the polar opposite of where we are now approaching year 9 of what is the weakest economic recovery in the post WWII era. What else makes the list of things that stand out as abnormal equity market activity? On only eight occasions this year has the daily equity market moved by greater than 1% in either direction – a precedent for which there are only three other occurrences of similar tranquility in the history of the stock market.

**Chart 3: Number of days with large equity moves**




Source: BofA Merrill Lynch Global Research, Bloomberg

Another example of investor confidence and overly complacent attitudes was front and center in last week's University of Michigan Surveys of Consumers where the bull/bear spread of those who say there is a 100% chance of stocks going up in the next year versus a 0% chance of them going up reached a record high. Surely, this is a contrary indicator from an investment standpoint, but it's not an indictment to other parts of the Survey that showed an increase in spending intentions for cars (75% from 66%), a house (74% from 68%), or other large household durable goods (83% from 78%) which if these intentions turn into reality it will move the economic needle.

One last place I'll highlight some market froth that I see evident is in the small cap segment of the equity market where investors today are buying the Russell 2000 Small Cap index at a trailing P/E multiple of 108x (and this is after they remove from the P/E calculation the roughly 1/3rd of the companies in the index that don't turn a profit…).

OTHER INDEXES

Friday, October 13, 2017

| | P/E RATIO | | | DIV YIELD | |
|---|---|---|---|---|---|
| | 10/13/2017† | Year ago† | Estimate^ | 10/13/2017† | Year ago† |
| Russell 2000 | **108.56** | nil | 20.22 | **1.33** | 1.60 |
| Nasdaq 100 | **26.19** | 24.15 | 21.15 | **1.10** | 1.22 |
| S&P 500 | **24.55** | 24.33 | 19.39 | **1.95** | 2.15 |

† Trailing 12 months

^ Forward 12 months from Birinyi Associates; updated weekly on Friday.

P/E data based on as-reported earnings; estimate data based on operating earnings.

Source: Birinyi Associates

Let me just say, any investor bidding up small cap stocks at this point on the hopes of tax cuts may want to revisit their thesis on the merits of the impact (should it happen) it will have on small cap companies relative to what is already priced in and their conviction level in tax cuts getting passed. On the latter point, last I checked the GOP has only a 52-48 majority with zero support from the Democrats for Trump's version of tax reform which leaves a very thin margin for any economically meaningful legislation to get passed into law. The President's choice to make public his feud with select GOP congressmen (such as Corker, McCain, and in the past Majority Leader McConnell) aren't making this signature campaign achievement any easier. Not to mention representatives like Susan Collins, Jeff Flake, and Ben Sasse who have proven that they have no problem breaking ranks with the party, given this backdrop I don't know how anyone can have a high level of conviction that tax reform is a foregone conclusion.

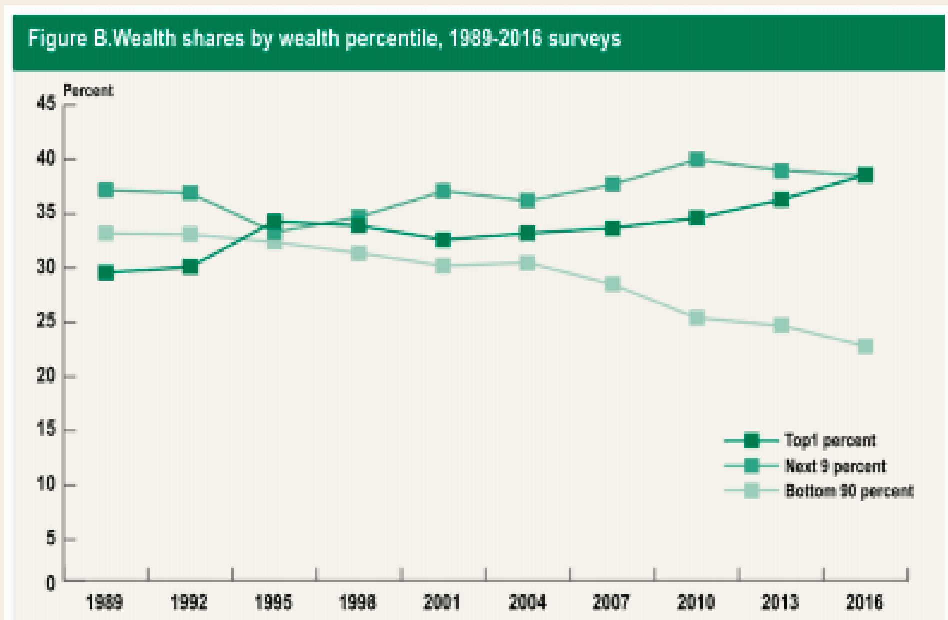
What has caught my attention more than anything else over the last couple of weeks are some of the comments coming from some of the prominent central bank heads from around the world where many of them have been making it a point to comment on asset price levels which is a noticeable change from merely twelve months ago. Over the weekend ECB President Mario Draghi commented that he sees no indications of widespread asset-price misalignments, BOJ President Haruhiko Kuroda deflected analyst criticism that the BOJ's purchases of ETFs was distorting financial markets, to which he responded "I don't think we're seeing excesses building up…", and even Janet Yellen's speech over the weekend hit on stock market valuations that were "above historical averages".

Boston Fed President Eric Rosengren provided some of the most blunt and honest commentary in regards to asset inflation as he expressed concern that some asset prices are on an unsustainable path and that the equity market is "fully priced" with respect to fundamentals. My pointing this out isn't to suggest that investors should be taking valuation and investment cues from central bankers, but rather that I think it is important for investors to be aware of the pivot by the Fed since late June in acknowledging the risks to financial stability due to high asset prices. Look, they are never going to come right out and say it because they can't be seen as creating a panic in markets or show a lack of confidence in their abilities to control a problem they in effect have created, but the message is growing louder by the day that they are becoming less and less comfortable with the extent to which asset prices have outstripped fundamentals.

Me thinks that the growing degree of social inequality is becoming as big of a concern (if not bigger) to them as financial stability. After all it was their data from the Federal Reserve's September 2017 Survey of

Consumer Finances that showed that the wealth share of the bottom 90% of families has declined from 33.2% in 1989 to 22.8% in 2016**,** while over that same time period the wealth share of the top 1% has risen from just below 30% to 38.6%. We know from former Fed Chair Ben Bernanke that QE was implemented to target high asset prices with the expectation that it would trickle down to consumer confidence and consumer spending, however where they miscalculated was that 85% of financial assets are owned by the top 10% and less than 50% of households in the U.S. own stocks. So, while the S&P 500 nearly doubled between 2012 and 2016, average annual U.S. real GDP growth was only 2.2%, roughly half the level achieved during the bull markets of the 1980s and 1990s.

The following chart illustrates the degree to which the wealth share of the bottom 90% declined since 1989, and how this decline accelerated more precipitously after 2007. I'm not making an indictment of the Fed as their intent was to raise the bar for all households, but what is clear in hindsight is the extent to which the benefits from post-crisis policies largely accrued to a narrow segment of the population.




*Source: Federal Reserve*

If the stock market continues to advance to new records and is accompanied by tax rate cuts whose benefits mainly flow to the rich—it will exacerbate the disparity of wealth even further, which will likely add to social unrest and, in time, undermine the value of the dollar.

I want to make sure my comments are not misconstrued as class warfare and this topic is not interpreted through a political bias (one direction or the other), but rather illustrates the instability that the current conundrum presents for policy makers on all fronts (monetary as well as fiscal). It's my opinion that we are reaching a point where further gains in asset prices that are increasingly disengaged from the wealth and income of the average wage earner elevates overall economic, political, and economic risk. The degree to which inequality has risen in the U.S. is one of the major causes of middle-class frustration and social unrest – whether you want to look at the opioid epidemic, multi-generational households, the rise of nationalism… they are all signs of social stress.

It's this backdrop that I think makes a well thought out tax reform plan monumentally important, as it could alleviate stress on many fronts: take pressure off the Fed, provide financial support to those that are most likely to put it back into the economy through increased spending, and alleviate the frustration of the many that feel they've been left behind in this expansion. However, if any tax law change is perceived as merely a tax cut for the rich, it will not rectify the core problem affecting America, namely that the economic and wealth gains are increasingly concentrated among a small subset of the population. Furthermore, if future stock market gains are driven merely by higher profits being plowed back to shareholders, it would exacerbate this core problem.

Referring back to the previous chart you see that the wealth share of the bottom 90% exceeded the top 1% in 1989 and even in the late 90's this gap was much narrower which implies that the economic gains were distributed more broadly in the decades of the 80's & 90's than they have been since the GFC in '07. Hence why it's so important for any tax reform policy to focus on narrowing this gap rather than intensify it. What has also been widely evident in this expansion is that corporations have not been starved for capital – interest rates reached their lowest level in 5,000 years, capital markets have been wide open to supply credit in a yield starved world, and lending standards have become extremely lax.

However, as the following chart shows this backdrop has incentivized the type of corporate activity and/or prudence one would have liked to see in this environment. For the most part corporations have been reluctant to undertake long-term investment projects and instead preferred to take advantage of the low interest rate backdrop by increasing their debt load to buy back stock. S&P Global ratings just published a report detailing that corporate indebtedness is higher now than at the peak of 2002 – 07 cycle. With the Fed moving forward on its rate hiking and in the face of what remains a sluggish nominal GDP growth backdrop, one can only appropriately assume that a rising trend in defaults and downgrades awaits what is a fairly hefty maturity schedule over the next several years (see right-hand side of the below chart).


Source: Calamos Investments

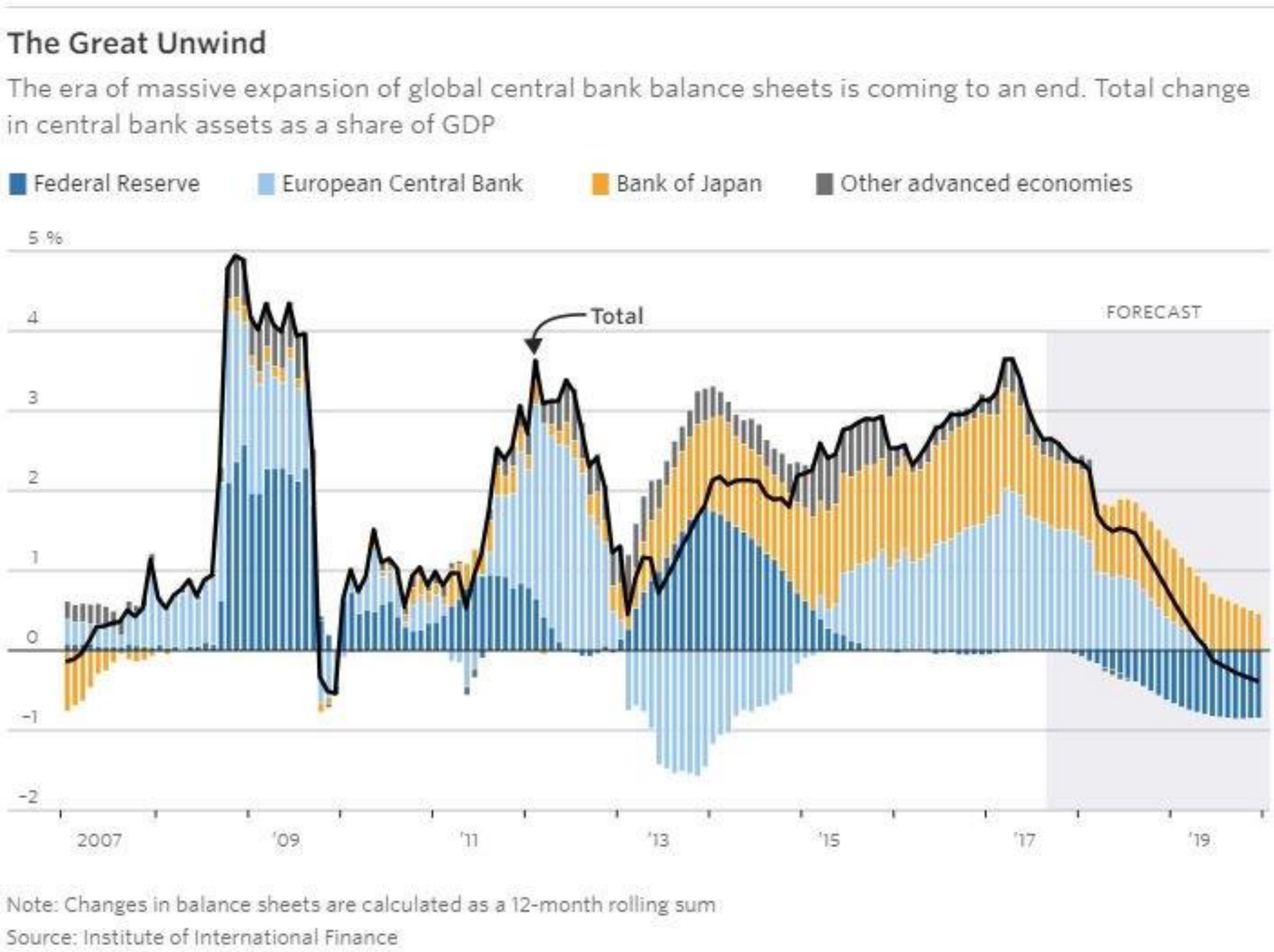
The left-hand side of the above chart illustrates that corporations have been spending more on capex and stock buybacks relative to the cash flow they take in than at any point since 1980 (realize that the grey bars in this chart denote recessions).

What's even more concerning is that the corporate sector has been unwilling to make some hay while the sun is shining by investing into long-lived capital investments during this nirvana period for accessing cheap capital, which is showing through in a U.S. economy that has not made much progress in this post GFC recovery. Yes, I can hear the claims that our way of measuring the economy today are out of touch and it's likely that the antiquated ways we evaluate economic metrics don't accurately track the technological revolution that has been underway. I'll fully concede that point and I fully agree with it, but I still see a U.S. economy where industrial production remains below the level it peaked at for this cycle a full three years ago. Add to this the fact that nonresidential fixed investment-to-GDP of 12.6% remains meaningfully below its early 1980's peak of 15.3%, and that industrial capacity utilization is still almost 5% below its pre-recession high.

All of this leads me to conclude that additional gains in asset prices from here applies pressure on policy makers to act and it's this action (via pressure by capital markets) that will create the catalyst for a policy misstep – either via the Fed and other central banks tightening policy too aggressively or a tax reform package that doesn't reach the constituents that voted for it.

Anyone still looking for an explanation for why asset prices of all stripes continue to move higher irrespective of good news / bad news, rate hikes / rate cuts, missile launches, threats of war, low inflation readings / rising consumer expenditures, stubbornly sluggish economic growth, political dysfunction, all-time low interest rates, near all-time high equity valuation levels… need look no further than the untethered experimental monetary policy being implemented by global central banks which has reached a fever pitch over the last 18 months.

Central banks have been able to print money without any recourse to this point, but the money printing part is about to reverse and we likely won't know the recourse (unintended consequences) until well after the fact.



But as the famed economist Herbert Stein once said, “if something can’t go on forever, it will stop”. Another great investment axiom is that there is no free lunch in investing. It begs the question, if virtually free money via cheap interest rates and money creation via QE was the panacea to economic cycles then why in just the last decade have the smartest minds alive just figured it out? The answer is that this was only intended to be a short-term fix given the potential misallocation of capital that eventually occurs by keeping policy so loose for so long – brings to mind an old childhood short story about a man who had a daughter that could turn straw into gold. But like any addiction it is difficult to accept the pain that accompanies the withdrawal. In this case central banks have overcooked the goose, and while it may not look obvious on the surface with markets making new highs on a daily basis the imbalances are prevalent across the capital market and economic landscape, so it’s important for investors to adjust their portfolio appropriately into a more defensive posture and focus on absolute returns that are necessary to meet your long-term investment objectives. Yes, keeping up with the major averages that have become a one-way street can be exhilarating, but jeopardizing one’s net worth to an environment that history suggests is one of the riskiest set-ups of all-time – just flat out isn’t worth it. Be prudent, be disciplined, and remain diversified.

**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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