



October 23rd, 2017

Three themes I'm looking at...

Equity markets continue to march higher which has given rise to a growing herd of investors throwing caution to the wind and jumping on the momentum train. The momentum trade has been a successful one so far this year, but with equity markets becoming quite divergent from fundamental reality, it begs the question of how long this period of euphoria can last. Given the recent price action in equity markets that know only one direction (up), it's important for investors to understand how market momentum works. I loosely define it as not being a reflection of ultimate truth, fundamentals, or reality, but rather a reflection of current prices and direction which can be completely irrespective of future reality or fundamentals. However, over the next six months both the optimists and the skeptics are going to have a clearer line of sight on deciding the long-term winner of this tug-of-war which is clearly favoring the momentum crowd at the moment.

It's my opinion that from now through the second quarter of next year investors are going to have answers to what I consider to be the three biggest themes that have driven capital market action over the last 18 months: 1) monetary liquidity, 2) fiscal hope, & 3) fundamental reality.

Monetary Liquidity: It's well known by now that the Federal Reserve started its Quantitative Tightening program this month by reducing the amount of maturing Treasuries and Mortgage Backed Securities that it reinvests on a monthly basis by a cumulative total of \$10 billion per month. This balance sheet reduction policy will scale up by an additional \$10 billion per month each quarter from now until it reaches a cap of \$50 billion per month by the third quarter of next year. Just as we had very little historical references to go off of when the Fed first introduced these experimental policies to arrest the economy and capital markets from the retrenchment of the Global Financial Crisis, investors find themselves in a very similar position today as we confront the gradual unwind of these policies. What we do know with the benefit of hindsight is that these policies have worked masterfully at delivering on their stated objective of raising the level of asset prices as the Fed was buying assets, but contrary to thinking these policies would have a similar impact on the unwind (by lowering asset prices as the balance sheet size is reduced) the Fed members have been rather vocal in their speeches that they expect the balance sheet unwind to be akin to watching paint dry.

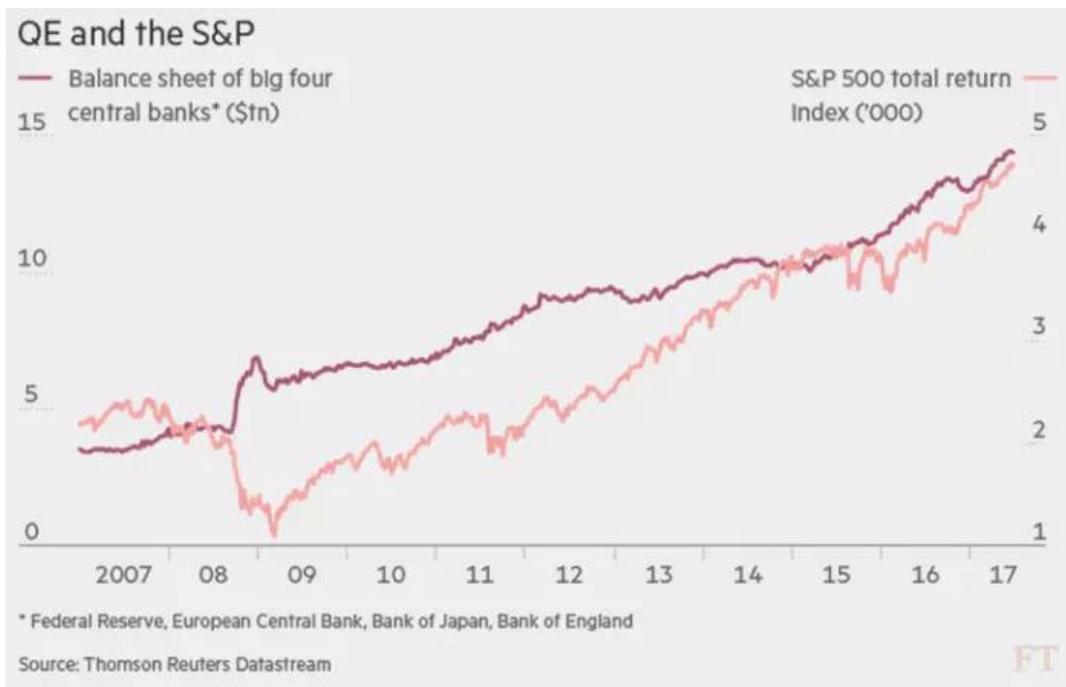
Looking at the chart below from BofA Merrill Lynch's Global Investment Strategy team which plots the level of the S&P 500 against the size of the Fed's balance sheet provides some context that would suggest investors perhaps shouldn't be acting in such a complacent manner as they are at present in regards to equity prices continuing to rise ad infinitum.

Chart 5: Central bank disobedience



Source: BofA Merrill Lynch Global Investment Strategy, Bloomberg

Looking back to the inception of the rise in the Fed's balance sheet in '08 – '09 it's pretty clear that there is a highly positive correlation between the S&P 500 and the size of the Fed's balance sheet, and it's not until just recently in mid-2016 that this relationship started to breakdown with the S&P 500 continuing higher without further increases in the Fed's balance sheet. This divergence in what had been a fairly persistent relationship is attributable to several variables, including: the surprising sweep by the GOP in last Fall's election and the pro-business / pro-growth agenda they are attempting to push forward, a synchronized pick-up in economic growth around the world, but also (and often overlooked) global central banks picking up the QE baton and increasing the size of their balance sheets at the most robust pace since the depths of the GFC.



* Federal Reserve, European Central Bank, Bank of Japan, Bank of England

Source: Thomson Reuters Datastream

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The latest estimates I've seen indicate that global central banks have purchased north of \$2 trillion worth of financial assets so far in calendar year 2017. However, why this is important for investors is that while this windfall of liquidity has helped push global asset prices to cycle highs as well as stimulating global growth, this tailwind is approaching its expiration date. Just recently the Fed began the process of reducing the size

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of its balance sheet, the BoJ has begun to reduce the size of its asset purchase program, and this week markets are expecting the ECB to announce as much as a 50% reduction in the size of its asset purchase program (from \$60 billion per month to \$30 billion) starting in January with the program potentially being fully phased out in Q4 next year.

Should these plans be implemented as central banks have laid out then this will mark one of the biggest changes that capital markets will have to adjust to since the GFC, given that outside of brief short-term spurts central banks (collectively) have been expanding the size of their balance sheets since 2008 and no one (both inside and outside of capital markets) knows what the true value of asset prices are today without a meaningful tailwind of global central bank money printing behind them.

It was rather interesting to read through Fed Chair Janet Yellen's speech that she gave on Friday where she spent some time with what reads as her way of 'greasing the skids' for going back to unconventional monetary policy tools before they've even moved out of the starting blocks for removing such policies:

“Does this mean that it will take another Great Recession for our unconventional tools to be used again? Not necessarily. Recent studies suggest that the neutral level of the federal funds rate appears to be much lower than it was in previous decades... The bottom line is that we must recognize that our unconventional tools might have to be used again. If we are indeed living in a low-neutral rate world, a significantly less severe economic downturn than the Great Recession might be sufficient to drive short-term interest rates back to their effective lower bound”.

This my friends is why complacency in capital markets appears to be nearing a fever-pitch where nothing seems to spook the markets anymore. We have central bankers that have pushed asset prices to such extremes that any indications of weakness, be it in asset prices or the economy, are quickly squashed with the reassurance that they'll come running to the rescue with additional monetary support. At some point policy makers are going to have to stop celebrating and clamoring about the broadening of global economic growth and trade, yet at the same time suggest that things are not strong enough for them to get on with a sustained tightening in policy.

Fiscal Hope: It came as little surprise that last week the Senate voted to pass the budget resolution and it looks as though the House will do the same in short order, all of which sets the stage for negotiating a tax reform bill that will not be subject to a filibuster by Democrats. Markets rallied on the news, and why not as this is only the sixth or seventh time stocks have ramped higher on the potential for tax cuts – give me a break on the suggestions that equity prices haven't yet priced in any level of tax cuts. In my opinion, when we do finally get a plan that actually has some details behind it and has a high probability of passage that it will be a 'sell the news' event.

While I remain of the view that there is a lot of pressure for this administration to get something done on this file and as a result we are likely to get something rather than nothing, but what we ultimately get is more likely to resemble tax cuts rather than tax reform. Keep in mind the GOP is made up of a diverse group of representatives with a large presence of fiscal hawks that may have a difficult time ignoring the \$1.5 trillion increase in the fiscal deficit that this plan is estimated to add over 10 years. Consider that last week we learned that the deficit for the 2017 fiscal year rose to \$666 billion or 3.5% of GDP (an increase from 3.2% the year before). What is incredible about this is that the deficit has increased now for two consecutive years and this is occurring with an economy that is near full employment and in the midst of challenging for the second longest economic expansion in history. To me this attests to just how structural the budget gaps have become in taking the national debt load to over \$20 trillion and just imagine what would happen to the deficit with further increases in interest rates on this outstanding pile of debt. Perhaps this as good a reason as any to think that interest rates can't rise much given the financing pressure it will put on Uncle Sam.

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After all, it's not as though the U.S. economy ever went through much of a deleveraging phase following what in hindsight we deem the popping of a credit bubble which made the last recession more severe than many of its predecessors. The amount of leverage today is so much bigger than it was only ten years ago, and this is in both absolute and relative to national income terms. In the U.S. alone \$14 trillion has been added to the aggregate level of non-financial debt since the peak of the last credit bubble – a whopping tally that now totals more than \$47 trillion. The only reason why debt servicing capabilities are intact while defaults and delinquencies stay low is because interest rates are near all-time lows.

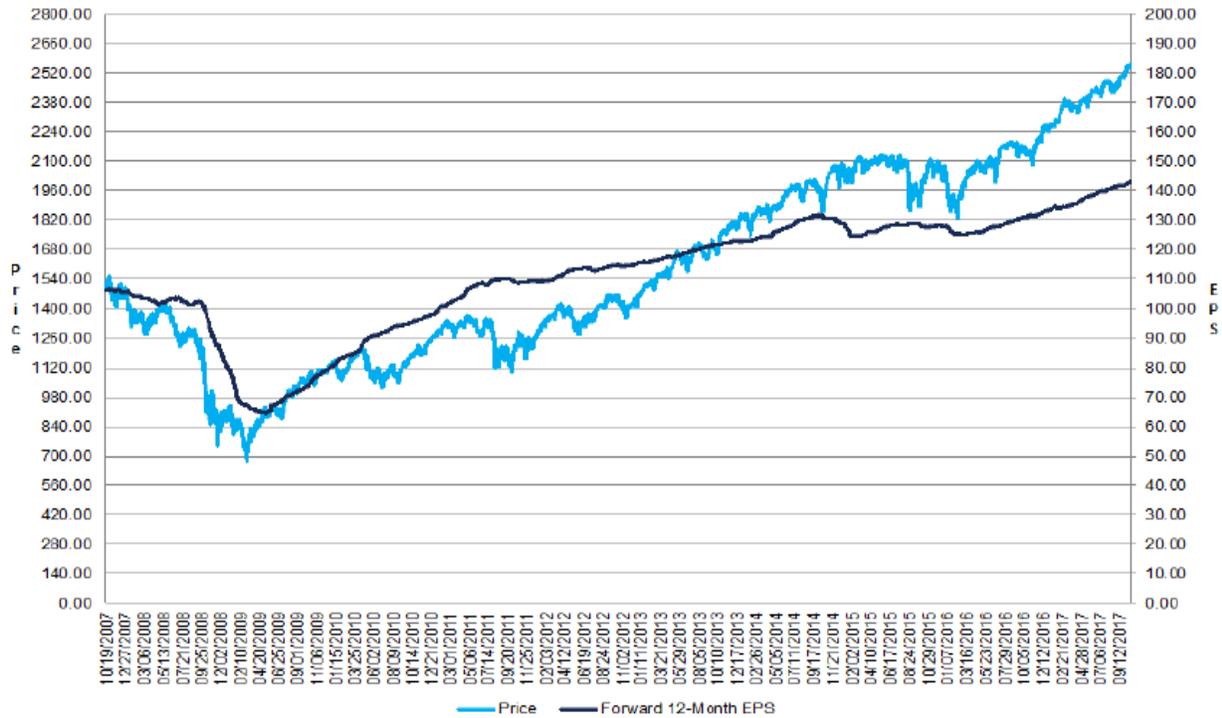
This is why I cringe anytime I hear the mantra “tax cuts will pay for themselves” given the historical precedence that suggests nothing but the contrary. Look back at what happened to the debt level following both Reagan's and Bush's tax cut and back then the U.S. economy was running debt and deficit levels that were far lower than exist today. I'm not saying that it's a guarantee that tax cuts won't pay for themselves (I'm always willing to keep an open mind), but this shouldn't be their base case given history and the current debt profile of the system. After all, how much longer can we continue to push out the liability for one generation's excesses onto to the next?

Anywho, it's worthwhile to note the differences of the tax bill from the House and the Senate, which will take time to iron out via committees and then be put to a vote before anything can be signed by the President. Not to mention the President's coattails in terms of approval ratings aren't exactly providing the umbrella of security for any representative that is staring down the barrel of a contested election in 2018. The latest Gallup poll has President Trump with a 36% approval rating and a 59% disapproval rating; Rasmussen has him at 41% and 57%, respectively. So while the President's base remains solid, the Independent and fringe voter that was looking for change are not liking what they are seeing to this point.

Fundamental Reality: This week will bring about the heaviest week of Q3 earning season, so we will all have a better handle of how things stack up than what we've seen so far in the early going. What we have seen hasn't been all that flattering where according to FactSet's data, 76% and 72% of companies have reported earnings and sales (respectively) above estimates, but this is only adding up to a blended earnings growth rate for the quarter of 1.7%. Thomas Reuters earnings estimate are tracking EPS growth of 4.2% for Q3, so we'll have to see how things progress over the next several weeks, but these aren't exactly the fundamental results the markets were expecting based upon the levitation we've seen in stock prices. This is perhaps best illustrated in the below chart from FactSet that plots Forward 12-month EPS estimates vs. the price of the S&P 500 over the last 10 years.

S&P 500 Change in Forward 12-Month EPS vs. Change in Price: 10 Yrs.

(Source: FactSet)



As the chart shows, Forward 12-month EPS peaked a little north of \$130/share back in Q3 2014 and just over the last several quarters has moved up to the \$142/share level. This equates to a roughly 9% increase in EPS estimates over the last three years while the S&P 500 has increased from 2050 to 2575 (or over 25%). Hence why equity valuations are at the most expensive level of this cycle and rivaling some of the richest valuation levels ever reached in the history of the stock market.

McDonalds Corporation (yup the ‘Golden Arches’ fast food restaurant is the one I’m referring to) is a great case study for investors to only begin to grasp the dichotomy emerging between the fundamentals and prices which is becoming warningly distorted by the perpetual flow of capital into passive ETF’s. This by no means is a knock against indexation or ETF’s, both of which I think are great financial innovations for investors, but perhaps we are in the midst of witnessing first-hand the limits and impacts these vehicles can have on the efficient allocation of capital.

The following table was curated by Michael Lebowitz of 720 Global, whose research and analysis I’ve come to appreciate and respect over time. What is summarized in the table is a comparison of the price level and fundamental makeup of McDonald’s over the last five years (Q2 2012 through Q2 2017).

	6/30/2012	6/30/2017	Total Growth	Annualized Growth
MCD Stock Price	88.53	153.16	73.00%	11.59%
P/E (ttm)	16.62	25.14	51.25%	8.63%
Revenue*	27,452	24,179	-11.92%	-2.51%
EBITDA*	2,521	2,635	4.51%	0.89%
GAAP Net Income*	5,498	5,079	-7.62%	-1.57%
EPS	5.33	6.23	17.01%	3.19%
Cash Flow*	4,149	3,976	-4.15%	-0.84%
Debt Outstanding*	13,682	29,006	112.00%	16.22%
Total Assets*	35,387	32,785	-7.35%	-1.52%
Total Liabilities*	20,093	34,785	73.12%	11.60%
Shareholder Equity*	15,294	(2,000)		
Shares Outstanding*	1,016	815	-19.80%	-4.32%
Buyback Adj. P/E (ttm)	16.62	30.83	85.50%	13.15%
Buyback Adj. EPS	5.33	4.97	-6.74%	-1.39%
* millions			720GL 	

Ladies and gentlemen this is what is meant when you hear the term “financial engineering” in the corporate community. Let me be clear that McDonald’s is absolutely not doing anything wrong in that it is adhering to regulatory reporting standards, but what you see is a company whose stock price has appreciated 73% over the last five years while Revenue (sales) have declined almost 12%, Net Income has declined nearly 8%, and debt outstanding has more than doubled. In a nutshell McDonald’s (as a result of its strong balance sheet, loose lending conditions in capital markets, and a fervent reach for yield by investors) has been able to buyback nearly 20% of its shares outstanding over the last five years which has created a fascinating financial illusion of increasing its Earnings Per Share (EPS) by 17% over this time period while all other earnings metrics are suggestive of a company in fundamental decline.

This is not a one-off or unique to McDonald’s as it highlights (to varying degrees) what I’ve been seeing with many large-cap blue chip companies over the last several years. What’s more is that while these companies are becoming fundamentally less attractive for investors that actually do a little bit of analysis today – it doesn’t matter to investors who no longer consider them as an ownership stake in a company, but rather a company that just so happens to be in an ETF that they’re purchasing.

Another example where the fundamental story just doesn’t comport with reality is in the Russell 2000 Small Cap index which everyone who tunes into bubblevision is well aware by now that these are the companies that stand to benefit the most from tax cuts. I won’t refute that sentiment, but I do take issue with the lack of depth that follows this extremely shallow rationale for investing in this small cap index today. Not only is this an index that is trading at a P/E ratio between 60x and 100x (depending on how you compute the earnings), but it’s an index that has now rallied over 25% since the election last November while the earnings estimate for this asset class has declined 8% over that interval. Come on now – you just can’t make this stuff up.

Look, while history would suggest that these divergences don’t persist forever, it would be disingenuous of me to suggest that they’ve mattered much over the last 18 months. No, it’s the investors that use fundamentals as a primary guide in their investment decision making process (like myself) that have been

wrong over this time frame where the right call has been to climb aboard the liquidity train that has been rolling down the tracks.

And while the liquidity train appears to be nearing its destination with several central banks starting to apply the brakes, it's too early to call whether a shift from liquidity driven markets back to one driven by fundamentals is at hand. One thing is for sure, and that is that if this transition were to take shape today, asset prices broadly speaking (especially risk assets) are priced too richly for a reversion back to the +/- 2% GDP growth profile of the last decade. Unfortunately, there are very few signs that developed market economies can grow much above this level without the heavy support of central bank QE.



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