



November 6th, 2017

Eating the seed corn...

This metaphorical expression, which describes the action of consuming seed today to stave off starvation at the expense of future needs, is what has repeatedly come to mind over the last several months as a way to encapsulate the present-day reality of this 101-month-old economic expansion. This past week presented investors with a deluge of economic data, further White House intrigue, escalating geopolitical risk out of the Middle East, more record highs in major U.S. equity averages, and we finally received the details of the highly anticipated tax reform package. With so much to digest, it's best to attack it in small bites.

Let's start with the data and the October nonfarm payroll report released on Friday that showed the U.S. economy added 261k jobs last month which came in below consensus expectations for a print north of 300k. As has been the case with much of the economic data over the last several months, this jobs report was skewed by the hurricanes in August and September, so it's prudent to average it out over the last couple of months rather than judge it on a standalone basis. In addition to the 261k new jobs created in October, the BLS reported +90k in upward revisions over the previous two months so the -33k print in September was revised upward to a positive 18k – pushing the string of consecutive months of jobs growth to an unprecedented 84 months. Over the two months following the hurricanes, job growth has averaged 140k which is a bit below the three-month average of +162k and a deceleration from the 12-month average of +170k. A moderation in the rate of job growth should be expected with an unemployment rate that last month fell to a drum-tight 4.1% which marked the lowest level in the last 17 years.

However, that 4.1% unemployment rate isn't all it's cracked up to be when you consider that the reason it fell to this level is because the labor force contracted by 765k. If not for this decline in the labor force, the unemployment rate would have risen to 4.5% from the 4.2% level it was at in September. Furthermore, with the employment to population ratio declining to 60.2% from 60.4%, it suggests that there remains a whole lot more slack in the labor market than the traditional employment rate statistics suggest (including the U-6 rate which fell to its lowest rate since December 2006 at 8%).

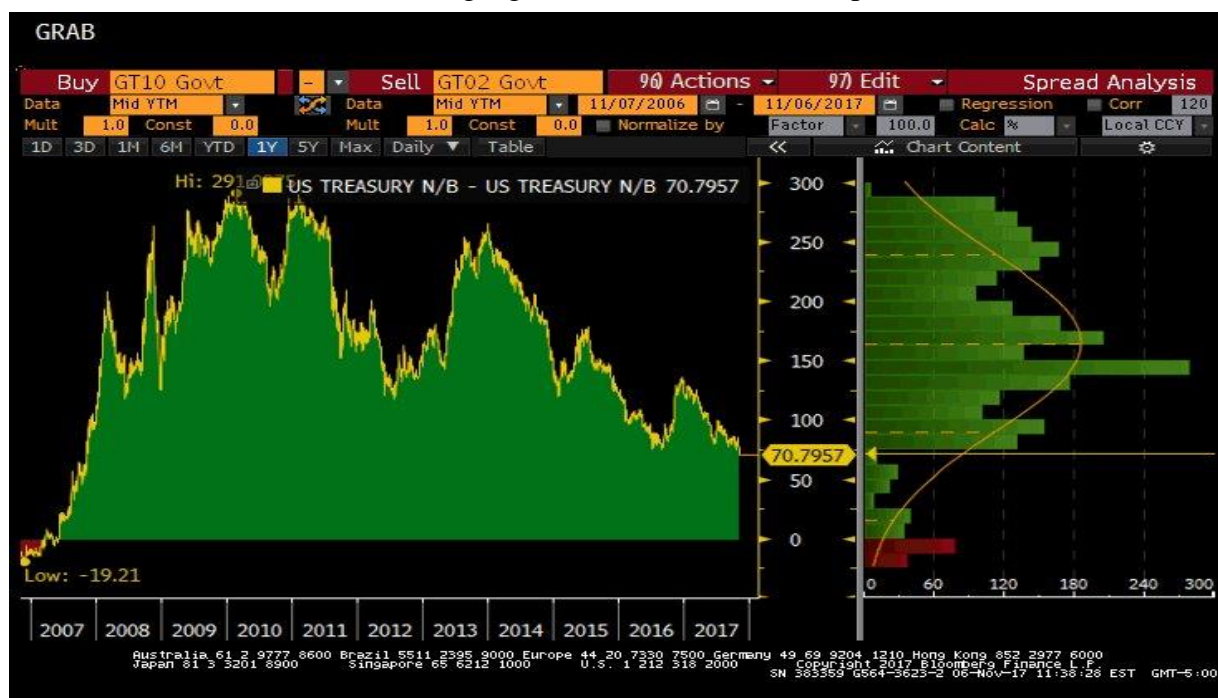
Outside of all the headline numbers that gets the media all giddy with excitement, the real disappointment was born out in the wage data which just continues to lack any verve what-so-ever that wage acceleration is afoot. Average hourly earnings fell 0.04% in what is the first negative print since December 2014 (this is a 1 in 50 event, just to give you some context at how rare an occasion wage declines are...) which dropped the YoY trend to 2.4% from 2.8%. This puts the Fed in a bit of a bind in regards to their rate hiking aspirations whereas the unemployment rate has been below 5% for 18 straight months and yet over this interval of time the YoY pace of wage growth has declined from 2.6% to 2.4%. It was only a couple years ago when soon-to-be former Fed Chair Janet Yellen was expressing her opinion that inflation does not become an issue until wage growth moves into a range of 3% – 4%.

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This lack of wage growth was corroborated by the income and spending data released at the start of last week, where the spending data rose by 1% (the best month-over-month showing since August 2009), but personal income only rose a modest 0.4%. For those following along, you saw that right – spending once again outstripped income, which has become a reoccurring trend over the past year, but it's the income story (not debt-financed spending) that is the true measure of sustainable economic growth and household standards of living. Real disposable income (this is earnings after-taxes and inflation) fell in September and marked the third decline in the last four months which equates to real incomes growing at a 0.2% annual rate over this time frame. So what has spending done during this four-month window where real incomes have been virtually flat? Answer: Real consumer spending has expanded at a 2.8% annual rate. How can spending outstrip income by a factor of three? Answer: Debt.

Looking at this relationship over the last twelve months shows a similar trend (albeit less extreme) where spending is up 2.7% which is double the 1.3% increase in real disposable income. On a year-over-year basis this trend in spending outstripping income has occurred in every month since November 2015. This is the definition of living beyond one's means, or as a farm boy like myself thinks about it – eating your seed corn. However, you need to extend this analysis a bit deeper to truly appreciate just how stretched the 70% of the economy we call 'the consumer' really is. The gap between spending and income is filled from two sources: 1) taking on additional debt, which we know households have done with outstanding debt levels at new all-time highs, and/or 2) paring down their savings rates. On the latter front we have seen personal savings fall from 6.0% two years ago to 4.5% a year ago to 3.1% currently.

Keep this in mind when drawing any inferences about the health of the U.S. economy from this juncture going forward because without the decline in household savings rates to their lowest levels in 17 years and outstanding household debt levels ballooning back above levels that prevailed prior to the '07 Credit Crisis, GDP growth would be closer to dawdling a 1-handle rather than the 3-handle we've seen the last two quarters. This is something that hasn't been overlooked by the bond market and provides some explanation for why the yield curve (whether one looks at the 10s/2s or the 30s/5s) has flattened to its most compressed levels since this expansion began back in 2009. Now to be fair, the 10's minus 2's curve is still around 70 basis points which is only modestly below its historical average level of about 100 basis points – so there remains a ways to go before fears of an inverted curve and corresponding recession should ignite 'shelter in place' investment action, but it is a warning sign that deserves its due respect and attention.



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Speaking of living beyond ones means, how else can you describe the release of the highly anticipated tax policy from the House of Representatives last week? I'm doing my best to try and articulate in as objective and non-political a fashion as possible when I comment on anything relating to politics in this missive nowadays – so with that being said I'll share a few thoughts. The biggest take away for me is I still can't understand how a government that has doubled the level of Federal debt over the last 10 years with a budget deficit that has now expanded over the last two fiscal years believes that it needs to supply the economy with even more fiscal stimulus. Look, I get it and as I described above the U.S. consumer looks as though it is in dire need of a boost to their pocket book, and on the surface this plan looks like it will provide that in the short-run. It's the long-run impacts as well as the unintended consequences and poor timing of rolling out this plan that worries me most. Even the most generous models that have scored this plan in terms of dynamic scoring still indicate it will add nearly a trillion dollars to the deficit over the next 10 years.

First off, suggesting that this plan will pay for itself is just as much lip service today as it was the first time it rolled off the tongue of this administration, and all anyone has to do is go back in the record books for verification. Go back to 1980 when Reagan cut the top marginal income tax rate from 70% to 50% and then cut it further in 1986 to 28% by 1990 and yet over that decade the deficit-to-GDP ratio rose from 2.3% to 4.1%. As for the Federal debt-to-GDP ratio, it rose from 32% to 55%. So did these tax cuts or tax reforms pay for themselves? The answer is an emphatic NO! Well Corey, this current package is mainly focused on the benefits the economy will accrue from a massive corporate tax cut. Ok, Reagan did this as well when he cut the top marginal corporate rate from 46% in 1986 to 34% by 1992. Any guesses as to whether these ended up paying for themselves like advertised? Yup, you guessed it: the deficit-to-GDP ratio rose to 5.1% from 4.7% and the Federal debt-to-GDP ratio rose from 47% to 62%.

Don't get me wrong, I don't think what happens to the debt level is the only variable that matters in this equation, but I do think these elected officials should at least have the integrity and respect for its citizenship to be up front and honest with realistic outcomes.

What also needs to be understood is how different the fundamental footprint is today relative to three decades ago when we last had broad based tax reform. The demographic profile of the U.S was just coming into its sweet spot with the median age of the Baby Boomer near 30 years old back then compared to 62 today. Furthermore, the fertility rate in the U.S. fell to its lowest rate in history last year at 62.5 per 1000 women, which doesn't paint a flattering picture for labor force growth down the road to support the entitlement crunch that's going to hit as more and more boomers enter the retirement ranks.

I don't want to get too far down in the weeds on this subject because there is still a long way to go before this becomes law, and it's likely that a lot will change before anything ultimately gets passed, but this 'ostrich' strategy of sticking our heads in the sand and ignoring the structural headwind of excessive debts piled up with little focus on Federal spending isn't a viable long-term strategy. What this plan looks like to me at this point is a trade-off of tax cuts today for what will lead to tax hikes in the future if there is no corresponding marriage of spending discipline.

Oh, and one more thing for all the hoopla and hysteria over all the benefits that will accrue from the \$2.5 trillion dollars in corporate cash locked up overseas: 1) It's not all coming back, and why would it when over 90% of the world's population lives outside of the U.S. and many of these regions have much stronger economic growth rates and long-term opportunities, 2) the last time the U.S. implemented a tax holiday for repatriated foreign profits, only 843 of the eligible 9,700 companies participated and it amounted to a little over \$300 million in capital brought back to the states, with the majority of the capital being used to shore up corporate balance sheets, buyback stock, and payout one-time special dividends to shareholders, and 3) the majority of offshore cash is concentrated in only a few companies. The following table was pulled together by Stephanie Pomboy and entails only companies that make up the S&P 500. Combined these constituents

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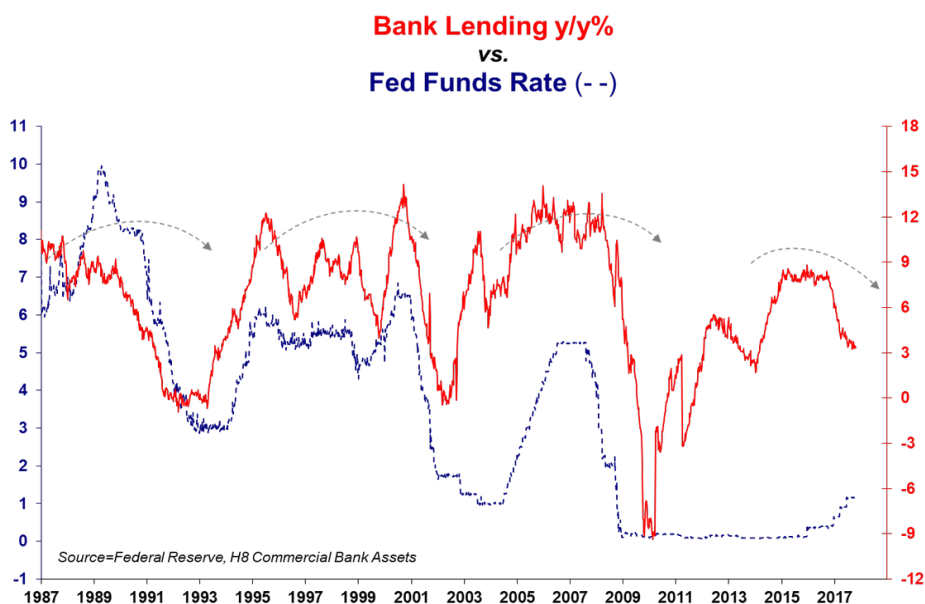
hold approximately \$1.75 trillion in cash and more than 50% of this total cash stake is held by the top 25 companies by market cap that make-up the S&P 500. You can also look at the table and conclude that the top 10 market cap companies in the S&P 500 have more cash on their balance sheets than the bottom 400 companies in the index. It begs the question of just how broad an impact a repatriation tax holiday can have with such a high level of cash concentrated in such a small collection of companies?

S&P 500 Companies by Mkt Cap	Cash & Cash Equiv's	% of Total Index Cash
Top 10	\$633b	36%
Top 25	884	52
Top 100	1375	79
Bottom 400	375	21
Total	\$1750b	100%

Source=Bloomberg, S&P

What gets lost in the big picture view of this administration's laser focus on tax reform is what is going on with the rest of the overall economy at this juncture. One of the major drivers of this recovery was the creation of a whole new credit cycle which makes the debt binge that was built up prior to the '08 credit crisis look like merely an opening act for today's main event. Much of the debt excesses built up in the last cycle were centered around real estate assets and the view that real estate values could never decline. That debt build-up has been displaced (not eliminated) by the run-up in federal government debt, corporate debt to fund stock buybacks soaring to record highs, a massive rise in credit card loans, an explosion in subprime auto loans, and commercial and industrial loans on bank balance sheets growing at a pace that is two-times faster than nominal GDP.

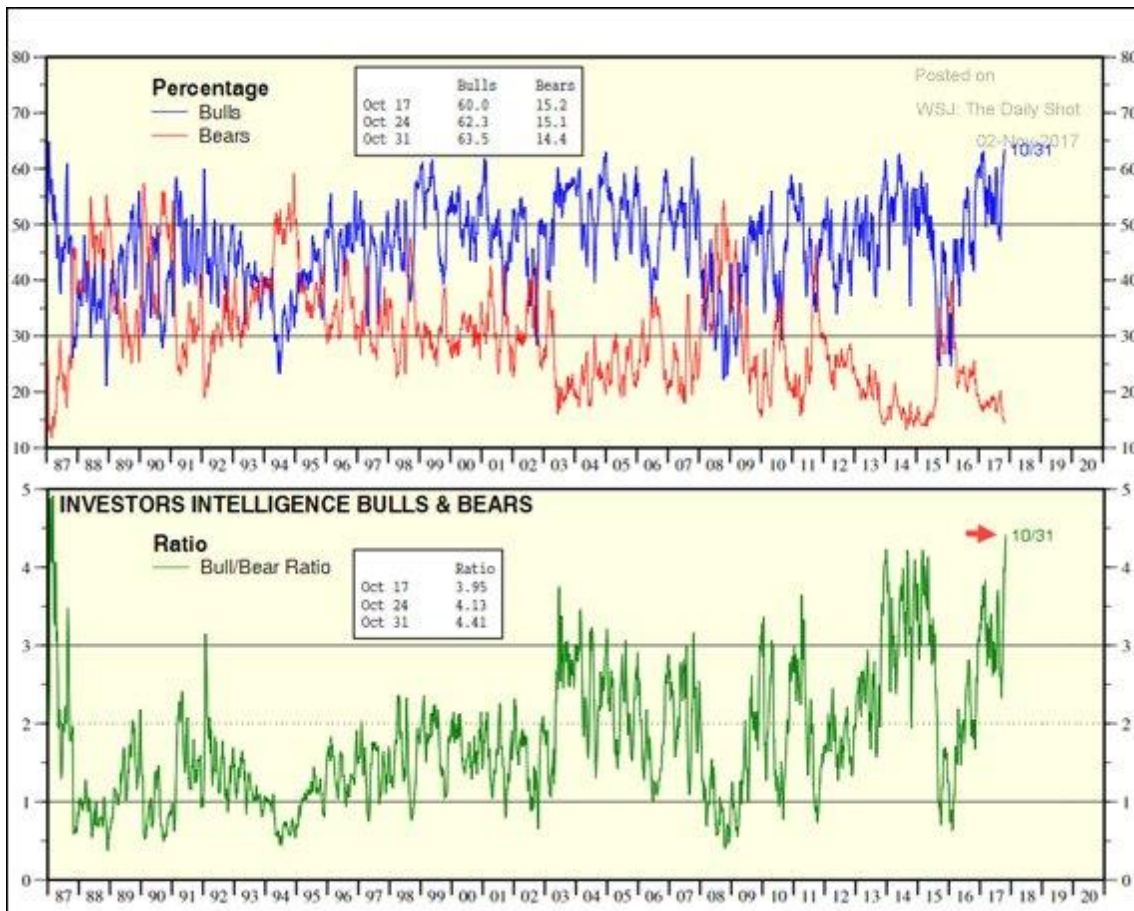
As a quick aside, the yearly trend in the YoY rate of change in the bank lending data is something to watch and if we don't see a reversal to arrest this deceleration in growth soon then it is worth getting much more cautious on the near-term economic picture than many are today. It's one of those "live by the sword, die by the sword" analogies when a financial system is dependent and wedded to a continuous growing stream of additional credit.



When you step back and look at the big picture today, it's just a bit surreal and incredibly ironic that here we are not even a decade removed from what was the most severe credit induced economic recession since the Great Depression and it looks like we've learned little to nothing from it as the imbalances are right back in place (although in different areas this time) to do it all over again. To put it in perspective, nonfinancial debt to GDP peaked in the U.S. during the last cycle at 228% and this metric stands at 250% today. Sure, interest rates are lower today than they were then which has made it more palatable to service this increased level of indebtedness, but that static level of thinking presumes that interest rates will remain at these historically low levels indefinitely. This won't be the case as the Fed is already marching forward on its rate hiking cycle and should we get a debt financed fiscal stimulus package at a time when the unemployment rate is already approaching a 3-handle, it will stoke inflationary pressures which will put the Fed in a bind to hike rates at a quicker pace to counteract this inflationary impulse.

This is the delicate and very complicated environment we are in today where the math is just overwhelming with the level of liabilities embedded into the system currently. This is singularly responsible for the low levels of growth, underlying inflation, and bond yields that have been the hallmark of this recovery for the last eight years. Once again, this in my opinion is why the long-end of the Treasury yield curve continues to remain anchored with yields lower today than where they started the year, even with this recent reflationary pick-up in the economy over the last couple quarters and in the face of a Federal Reserve that has hiked rates three times in the last year with another one expected in December.

So here we are in the mother of all asset price rallies where the GPS system only knows one direction, and that is 'up' which has ushered in a level of investor complacency rarely experienced in the archives of history. The most recent Investors Intelligence poll showed the bull to bear ratio expanding to its widest level in the past 30 years and just inside the most extreme reading ever recorded just prior to the 1987 stock market crash.



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This just illustrates how rare of a state global equity markets are in today when you have this level of complacency at a time when U.S. equity market valuations are in the 99th percentile and 5 of the 7 voting members of the Federal Reserve Board are set to be replaced. Yeah, you like how I just threw that in there – where the brain trust that brought us the lowest interest rates in U.S. history and unprecedented balance sheet expansion via QE is set to retire into the sunset just as the unwind of these policies gets underway. What we have to look forward to in 2018 is a collective 35 years of Federal Reserve Board experience leaving their post (Yellen, Fischer, and the latest rumor is NY Fed President William Dudley is going to announce his retirement this week) at a time when the economy and capital markets have never been more intertwined on the policies they are leaving behind.

For anyone on the look-out for excesses showing up in the capital markets look no further than European high yield debt, where a current yield of 2% is 30 basis points below the level of interest the AAA rated U.S. government has to pay on its 10-year Treasury bonds. My friends, that is just flat out insane, and no matter how much money Mario Draghi and the ECB are committed to printing to continue buying European corporate debt, this is a risk / reward relationship that doesn't make any sense. It's not as though U.S. investment grade or even non-investment grade debt proffers much better of a risk / reward trade off, but it just illustrates (in my opinion) the segment of the capital market that is most distorted this cycle: corporate credit.

Anywho, invest accordingly because we are pushing the extremes in many asset classes of price levels relative to fundamentals that history suggests have been the tails of previous market cycles. This isn't to say this type of environment can't persist for a little while longer, and there isn't going to be a bell that goes off and tells everyone the party is over so it's important to remain disciplined and prudent with your asset allocation. Over the last several weeks we've seen the major averages move to new all-time highs on the back of weakening breadth and lower volumes, both indications of floundering conviction. Moreover, nearly half of the gain for the S&P 500 in the month of October came from just five technology stocks (FB, AMZN, APPL, GOOGL, and MSFT).

I expect that the combination of what is soon to be an experience void remaining at the Fed with a broadening list of late cycle economic signals, balance sheet reduction, additional tapering by the ECB in January, and at least one more Fed rate hike in December are very likely going to lead to a much less calm and much more choppy market before too long. The fact that the S&P 500 having now gone 44 consecutive days without closing down by 0.5% or more, which has only happened one other time in the last 50 years, tells you all you need to know about how abnormal this year's price action has been.

With that in mind, tilting U.S. portfolio exposures up the quality spectrum and towards companies with less economic cyclicalities is appropriate and this recipe is also appropriate for the fixed income side of portfolios as well. Equity markets outside the U.S. trade at a discount and some of this is for good reason, so be aware of what and why you're gaining exposure to as the U.S. dollar will play an important role going forward in adding to or detracting from investment results.

In the words of Howard Marks, "Move forward, but with caution."



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