



February 13<sup>th</sup>, 2017

### **A very high stakes poker game...**

It's been a one way street in terms of the price action in U.S. equities since the election with the S&P 500 having rallied nearly +10% without experiencing so much as a speedbump to interrupt the ascent. From mid-December through late January the S&P 500 flat-lined in what now (in hindsight) looks to have been a period of consolidation and digestion before giving way to a break to the upside over the last three weeks. There's been no shortage of ink spilled or text typed to shape a narrative to explain the drivers of what has been an impressive move. In its simplest and yet broadest sense, it's best to be characterized as a confluence of variables and not just any one thing:

- Investors got closure to three hotly contested and highly debated events (in terms of what it meant to the economy and capital markets given certain outcomes) with the U.K. referendum, the U.S. election, and the Italian referendum. In both cases the expectation going into them was that a "No" vote in the U.K. referendum and a Trump victory in the U.S. elections was sure to usher in a market panic, economic uncertainty, and global instability, none of which ended up materializing. It's fascinating to look back and assess the speed at which markets adjust today – following the U.K. vote markets sold-off hard for two days before ramping back, for the U.S. election the sell-off lasted half a night, and following the Italian referendum the sell-off was down to hours.
- Economic data around the globe started to meaningfully accelerate to the upside in September of last year. This pick-up in economic momentum continued through the end of 2016 and so far with what we have seen in the January data is that while the upside momentum has subsided, there has been very little give back in the activity levels.
- The corporate earnings recession that began in the second quarter of 2015 and set off a string of five straight quarters of earnings declines ended in Q3 2016. This improvement in corporate profits continued in Q4 earnings season with S&P 500 profits growth coming in around +5% YoY and earnings growth in Europe turned positive for the first time in five years.
- Commodity prices troughed and arrested themselves from a bear market that started in 2011 for some commodities and ended with oil finding its footing on the back of a coordinated OPEC cut at the end of 2016 – a cut in which we're learning compliance is north of 90%, well above where it has been in previous cuts.
- Monetary policy remained extremely accommodative throughout the year. Coming into 2016 the Fed was guiding markets to expect four rate hikes throughout the year, yet they were able to get one on the board with two weeks to go in the year. In January the BOJ took a stab at negative interest rates which they then altered later in the year to focus on pinning the 10-year part of the JGB curve at a 0% interest rate level. In addition to targeting interest rates the BOJ continued to implement and increased their QQE asset purchase program of buying both stocks and bonds. The ECB announced in March that they were going to allow corporate bonds to be purchased through their

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QE program. In February and March of last year the Chinese government injected over \$1trillion of credit into their system in an effort to stimulate economic activity. And, last but not least, the BOE jumped into the fray in late June with their own QE program following the surprise outcome of the U.K. referendum.

It's this last bullet point (central bank policy) that I continue to view as the most important and influential for asset prices going forward as I remain of the view that it has been and will continue to be the engine that drives all the other variables.

The optimism (hopium) permeating out of investors, corporate executives, legislators, and small business owners since Donald Trump was elected President and the Republicans gained control of both the House and Senate has been both remarkable and surprising. I'm not sure I can find a sentiment survey – be it a Gallup poll, investor sentiment, consumer confidence, or business confidence – that hasn't spiked to cycle or multi-year highs in this post-election period on the expectations that deregulation, tax cuts, and infrastructure spending are a certainty to arrest the economy from what has been the weakest recovery in the last six decades.

There is no question that the unleashing of animal spirits in the business community could potentially unlock years of underinvestment and soak up a significant portion of the excess capacity that exists in the economy today. The fact that total industry capacity utilization rates are still hovering around the 75 level (lowest level since the fall of 2010 when the U.S. was coming out of the recession and before that you'd have to go back to September 2008 to find a number this low) and the broad U-6 unemployment rate sitting at 9.40% (near its lowest level since the recovery began, but this metric fell below 8.0% and 7.0% at the trough of the '03-'07 and late 90's expansions, respectively) indicates that too many parts of the economy have not fully participated in this recovery.

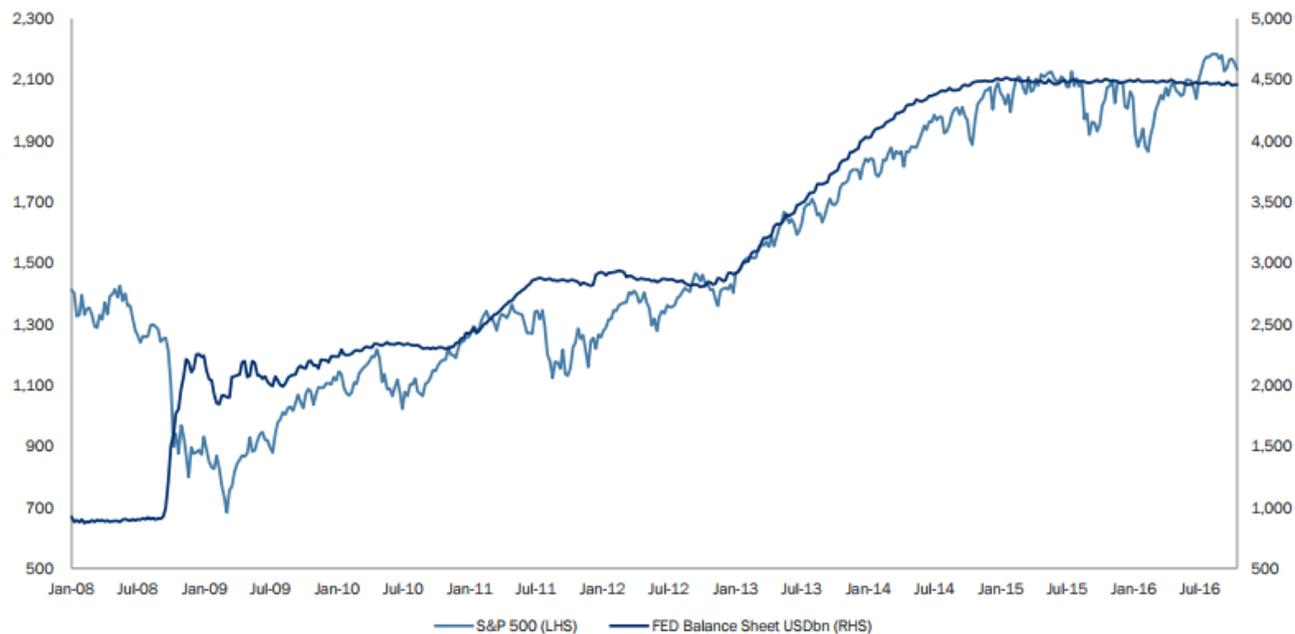
This is where I am most optimistic that deregulation and a well-crafted infrastructure spending program can have a meaningful impact on the economy and people's lives.

However, while a pro-growth and pro-business fiscal policy agenda could move the needle in terms of the economy I'm wary about how this may impact asset prices in stocks, bonds, and even real estate. It's important for all investors to keep in mind that the stock market and the economy are not the same thing.

As I mentioned earlier, this is the weakest economic expansion in more than six decades, but this feeble expansion is juxtaposed against the second best equity bull market in history. The most important variable driving this fundamental disconnect has been the positive relationship between the stock market and the size of the Fed's balance sheet. The following chart graphs this relationship going back to before the Global Financial Crisis where the Fed's balance sheet stood at just under \$700 billion dollars, to when the Fed stopped expanding its balance sheet (\$4.5 trillion) once it ended its QE program in October 2014. What you also see in this chart is that starting in late 2014 the equity market for the most part pretty much flat-lined until the third quarter of last year when stock prices started to move up once again.

## QE ACHIEVED ITS PRIMARY OBJECTIVE – DRIVING UP ASSET PRICES

Example: Fed balance sheet expansion vs S&P 500



Source: Bloomberg, Astellon calculations

Most investors attribute the move higher in U.S. equity markets late last year to the election results, and it's hard to argue against that view, but what also deserves some consideration is the continued QE policies being employed by the BOJ, ECB, BOE, and PBOC. One of several things I took away from last year is that central bank asset purchases became fungible, meaning it didn't matter where or who was doing them – so long as someone was and collectively it was large enough to subsidize the global economy.

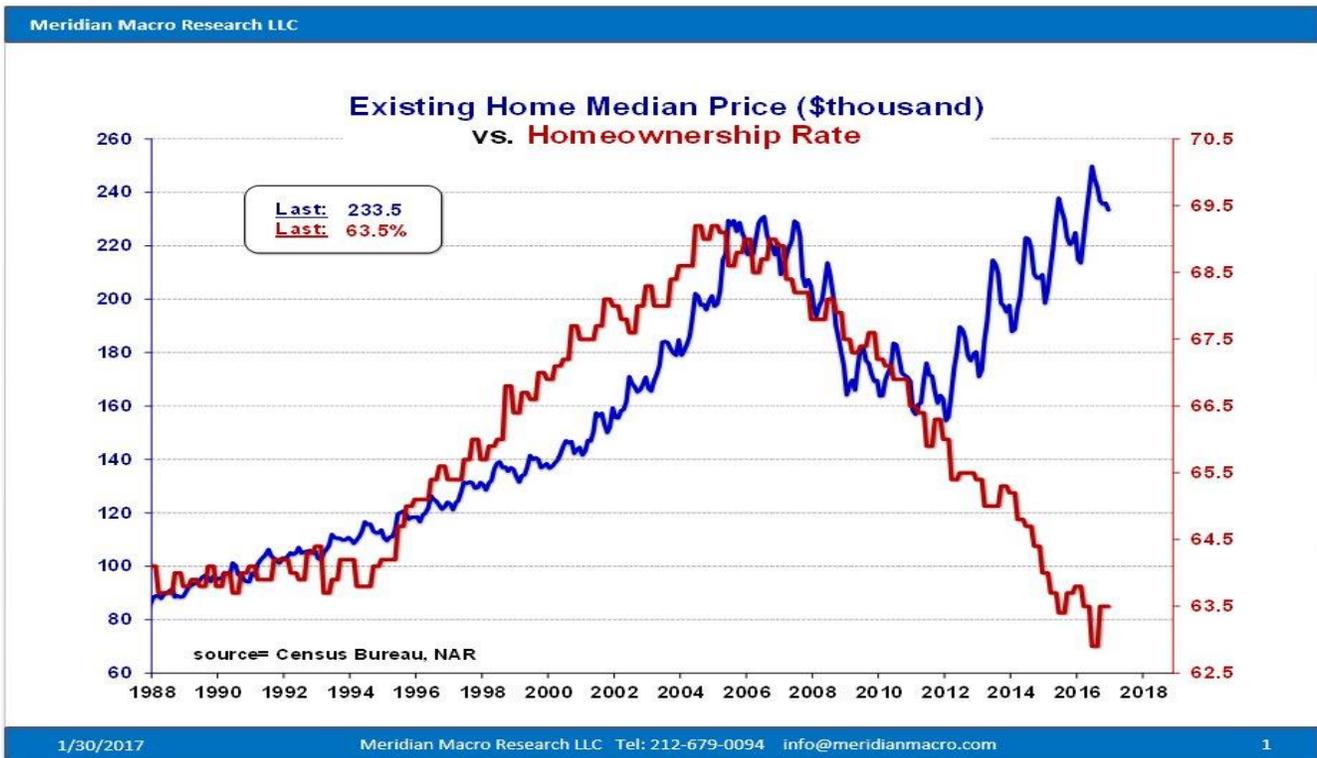
Stock prices have not been the only beneficiaries of these global expansionary monetary policies with global bond yields reaching their lowest levels (both short and long-term rates) in 5000 years. The below chart from BofA Merrill Lynch shows a history of U.S. interest rates going back to the 17<sup>th</sup> century as rates last year hit their lowest levels ever. Let me remind you that bond prices and interest rates move in opposite directions, meaning that when interest rates go down, bond prices go up. So within the last six months, as yields in various segments of the bond market reached their all-time lows, prices reached all-time highs.

**Chart 8: The Lowest US Bond yields since WW2**



Source: BofA Merrill Lynch Global Investment Strategy, Global Financial Data, Bloomberg. Monthly data

Housing is another material asset class that many investors have exposure to whether it be through investments or just the home they reside in. The real estate market, be it residential or commercial, has also participated in the asset price bull market with many real estate indices making or nearing new all-time high levels. The following chart from Meridian Macro Research plots the Existing Median Home Price versus the Homeownership rate in the U.S., where the median price of an existing home is near an all-time high while the homeownership rate is near a three decade low.



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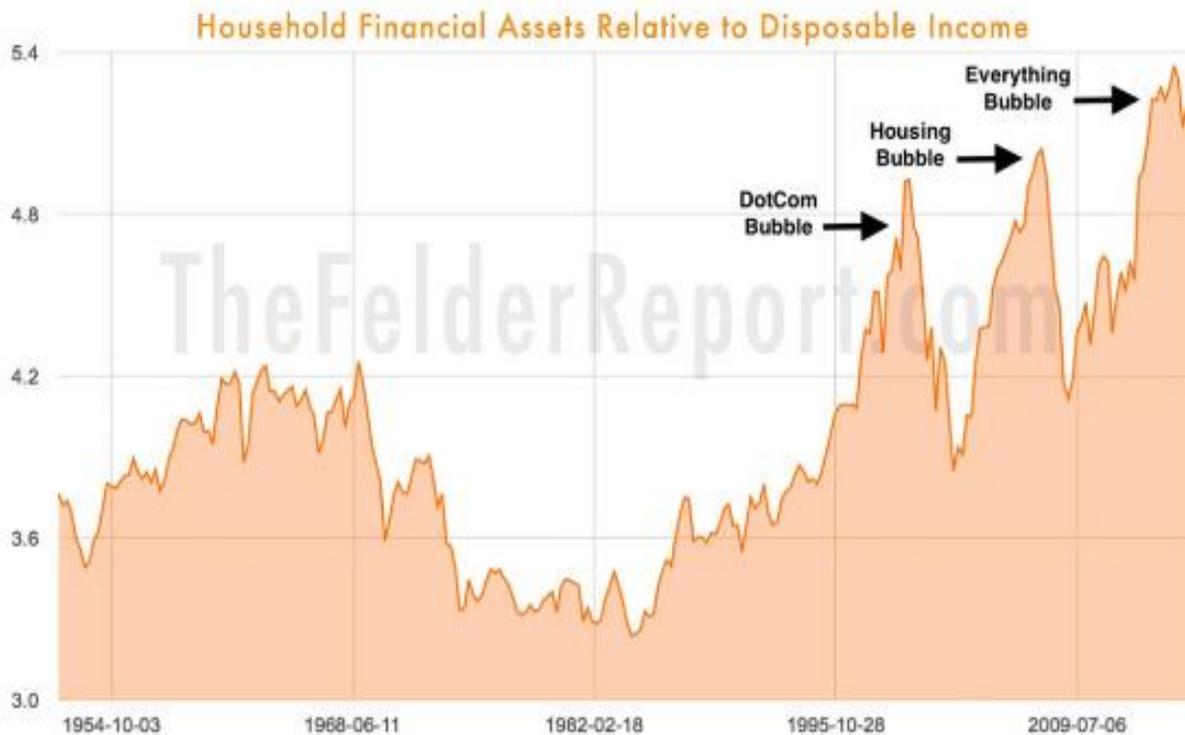
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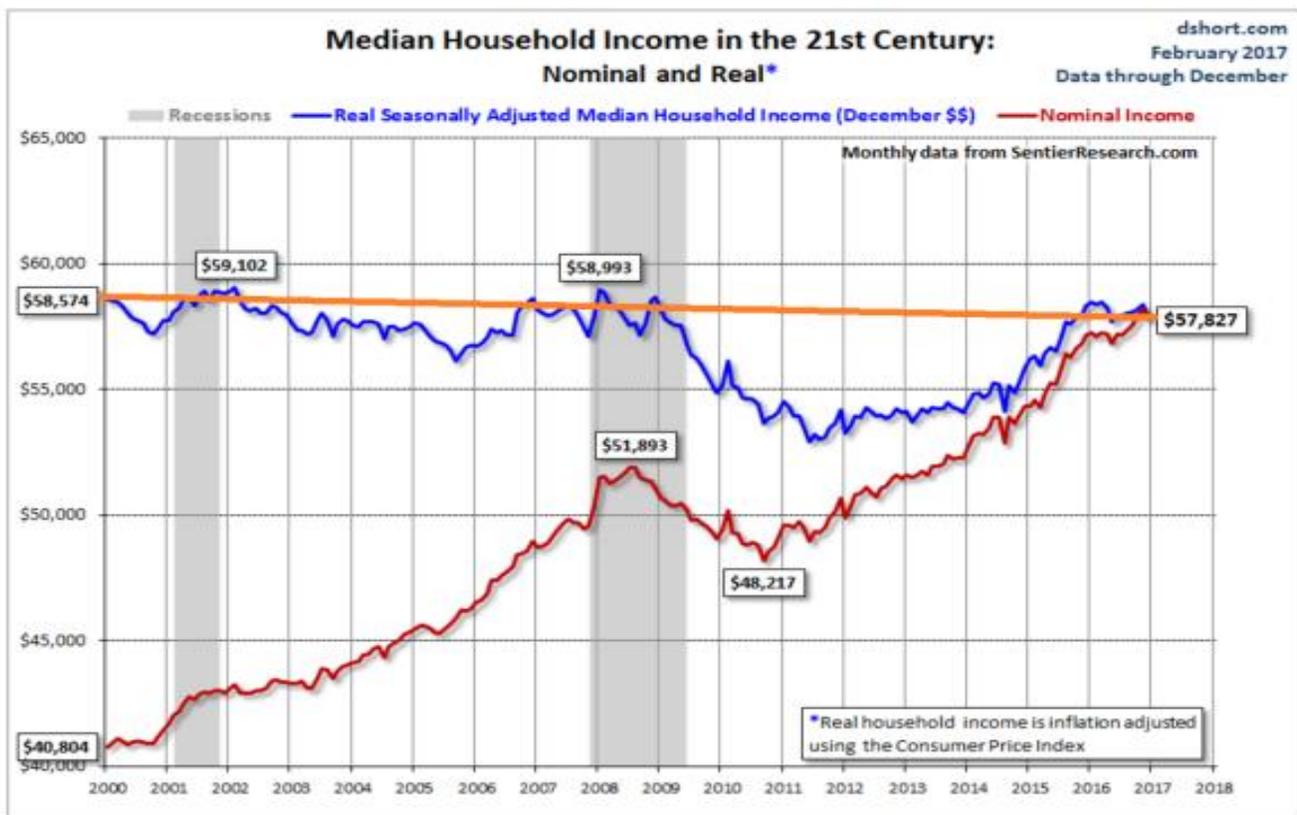
Don't mind the alligator jaws that have opened up on the right hand side of this chart, with home prices and home ownership rates materially diverging from what up until 2012 was a pretty tight positively correlated relationship (yes, that sarcasm is intended). The list of fundamental data that has diverged meaningfully from market prices and historical relationships continues to grow by the day.

Which brings me to the following chart from Jesse Felder that plots the level of Household Financial Assets relative to Disposable Income in the U.S.:



It's of little surprise that with the stock, bond, and housing markets in the U.S. at or near all-time highs that this chart looks the way it does. Many astute minds can take issue and debate his use of the bubble term highlighted with the three corresponding peaks in this chart over the last two decades – Dotcom Bubble, Housing Bubble, and now the Everything Bubble, but they are definitely worthy of an informed understanding.

The attainment of an absolute all-time high in any asset price isn't in-and-of-itself a reason to be fearful, because the achievement of such a feat could very well be validated by fundamentals that support such an outcome. There are two variables in this chart: Household Financial Assets, which is a collective accounting of the net worth households in the U.S. have in their homes, stocks, bonds, cash... (this data is pulled from the quarterly release of the Federal Reserves Flow of Funds report), with the other data point being Disposable Income (income available after paying taxes). The chart below details the level of Median Household Income both in real terms (a.k.a. adjusted for inflation) and in nominal terms since 2000.



Seeing that real Median Household Income is still below its all-time high reached back in 2002 and even below the peak level achieved prior to the Global Financial Crisis should elicit a bit of reservation among investors holding assets today. It begs the question that if income is no higher now than it was at the peak of the Tech-bubble and Housing Bubble, why should investors have any confidence today that these price levels can be sustained when that wasn't the case at the last two peaks?

The short answer is that it can't be sustained. Sure, central banks have been able to increase the size of their balance sheets and that has had a meaningful impact on propping up asset prices, but this is where the biggest adjustment/risk lies (in my opinion) this year. At the current time capital markets are making the assumption that a transition from monetary policy to fiscal policy will go off without as much as a hitch. This assumption in my view is extremely naive and imprudent, especially for anyone acting as a fiduciary of other people's capital.

So let's recap the set-up that this cavalier (in my opinion) assumption is built on. U.S. stocks are trading at their highest valuation level of this cycle (two standard deviations above their historical average on a P/E basis), and on other valuation metrics the only time in history stocks have been more expensive was 1929 and 2000, yet on some other metrics stocks have never been more expensively valued (median P/S and EV/EBITDA).

The U.S. economy is nearing the 93<sup>rd</sup> month of this expansion (far outstripping the average 59 month length of all expansions since the 1930's) and showing increasing signs of its maturity and late cycle nature. What's more is that it does not have the secular tailwinds of yesteryear as the "killer D's" of Debt and Demographics will prove to be too severe of a headwind for any policy concoction to overcome. The current level of outstanding debt on the U.S. economy is at an all-time high and this is across the spectrum of government debt (Federal, State, and Local), corporate debt, and household debt. The only reason why borrowers are able to service this level of outstanding debt is because interest rates are at all-time lows.

As for demographics, population growth in the U.S. slowed to its slowest pace (0.7%) last year since the mid-1930's – with population growth running below 1.0% every year since the opening years of the 21<sup>st</sup> century.

Let me remind you that economic growth can be simplified to productivity growth plus labor force participation growth (population growth). Below is an excerpt from a research piece by Dr. John Hussman on this relationship:

“In practice, nearly all of the variation in GDP growth over time is explained by the sum of employment growth plus productivity growth... Given existing U.S. demographics, even if we assume an unemployment rate in 2024 of just 4%, civilian employment would reach 157.2 million jobs in 2024, resulting in an average annual growth rate for civilian employment of just 0.4% annually over the coming 8 years... Over the past decade, productivity growth has declined from a post-war average of 2% to a growth rate of just 1% annually, with growth of just 0.5% annually over the past 5 years... Combining the plausible ranges of employment and productivity growth in the coming years (but ignoring the possibility of outright recession), the bounds of average U.S. economic growth over the coming 8 years range between 0.7% annually to an extremely optimistic 3.2% annually, with a likely midpoint of less than 2% annually for real GDP. That figure aligns with the central tendency of long-run real GDP growth expectations from the Federal Reserve, which recently fell to 1.85% annually.”

The irony in this empirical data is that the solution to remedy this demographic shortfall is increased immigration and the fix to improve productivity is technological innovation – something that will only further hollow out U.S. manufacturing. In the event that President Trump follows through on his anti-immigration and anti-globalization campaign promises then it's reasonable to expect that economic activity will be even further constrained in the future.

What also needs to be considered as one evaluates the set-up for the challenging investment environment that lies ahead is the rise of populism and nationalism that is spreading around the globe as citizens start to push back against a system that has for too long benefited the few relative to the many. A striking example to provide some context for why voters are lashing out and targeting their displeasure against the elites is the fact that at the end of 2015, the 62 wealthiest people in the world comprised as much wealth as the bottom half of the world's population. By the end of 2016 it took only the 8 wealthiest people in the world to comprise the same amount of wealth as the bottom 50% of the world's population.

I'm not blaming them, as it's not their fault, but if history has taught us anything it is that growing inequality is a recipe for unrest and change (sadly, in the past this ultimately has led to war).

This recipe for change resulted in the rise of Theresa May in the U.K., the election of Donald Trump in the U.S., the expected resignation of PM Renzi in Italy following last Decembers landslide referendum vote, the rise of Marine Le Pen in France... all are outcomes of developed markets looking favorably at nationalism over globalization.

Which brings me back to where I started with this dangerous assumption that eight years of unprecedented monetary policy accommodation can transition to fiscal policy support without blinking an eye. I hope and wish it were that easy, but call me crazy as I continue to be of the view that hope is not a prudent investment strategy.

The genesis of the conundrum that confronts us today on the debt side of the ledger dates back 35 years to the early 80's when interest rates started their multi-decade decline. Since then (with the tailwind of the baby boomers moving through their life cycle) the answer from the Federal Reserve to each economic soft patch (recession) or global liquidity event was to cut interest rates and push money into the system. In hindsight the result of the action always seemed to work, so if it's not broke then why fix it? Well, eventually when you're dealing with a variable that ultimately has a floor, as is the case for interest rates which is the cost of money, and you've held them at this floor level (or very nearly if you want to consider the 0.50% Fed Funds rate level we are at today) for over eight years, you have to realize that you've exhausted the effectiveness of this tool to stabilize the economy during any future setback.

What's more is that you've reached the limits in terms of being able to lower the cost of borrowing for all creditors in the system. You've reached the limits in terms of the amount of consumption you can pull forward by incentivizing households and businesses to borrow for current consumption at the expense of future consumption. And, lastly you've lost control of the ability to drive future borrowing capacity – that limit (which is unknown) has now been transferred to the capital markets who will dictate when and how much is enough debt as they set the terms and cost they are willing to extend credit at in the future.

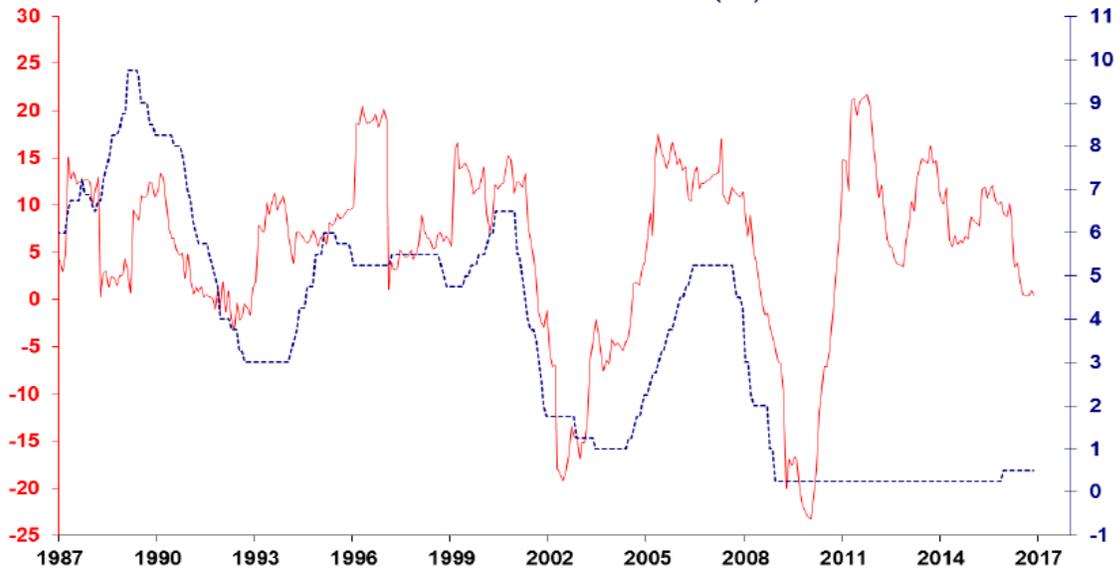
This is something that struck me more than any other data release last week when I saw in the Fed's Q1 Senior Loan Officer Survey the sharp drop in the share of banks' willingness to extend installment credit to households falling to 6.3% from 15.6% in Q4, which pushed this metric to the lowest level in seven years. Also of interest in this report was that it represented the sixth straight quarter that banks tightened loan standards to large and medium sized businesses. Perhaps with the talk of reform for the Dodd-Frank bill underway this trend will change, but in an economy dominated by debt and access to credit, this is something to keep an eye on.

The interplay between the Fed and fiscal policy, hopium versus valuations, economic growth versus inflation, and capital markets versus liquidity makes for an extremely and complicated tonic blend for investors to navigate this year. Only time will tell whether this year will be like years past, where no matter what happened investors always had the Fed backstop to come in and provide a shot of morphine to dilute any short-term downside pain. Agitating this investment strategy this year is the visible uptick in inflation not only in the U.S. but around the world. And unlike the Fed, who has a dual mandate of price stability and full employment, most other central banks just have a single mandate (price stability). So, beginning in April we will start to experience a withdrawal of some of the global QE that has been supporting asset prices over the last twelve months, starting with the ECB tapering its QE by \$25billion/month. It's likely that the BOE will decide to stop its asset purchase program this year and China has already made announcements earlier in the year that inflation is moving up and they are pulling back on monetary policy accommodation.

It's this game of high-stakes poker being played between extremely complacent and confident equity investors versus a material transition in policy, with expectations that every landing is going to be stuck that is interesting to me. Without question if we get an acceleration in economic growth then this will go a long way towards mitigating the strong secular challenges facing the U.S. economy, but it does not remove them. Another important player in this high stakes poker game is time. When will we get tax reform and what will it look like? Same for an infrastructure package, because already we are seeing some fading of this cyclical reflation pick-up in the economic data that started last spring and really took off in September.

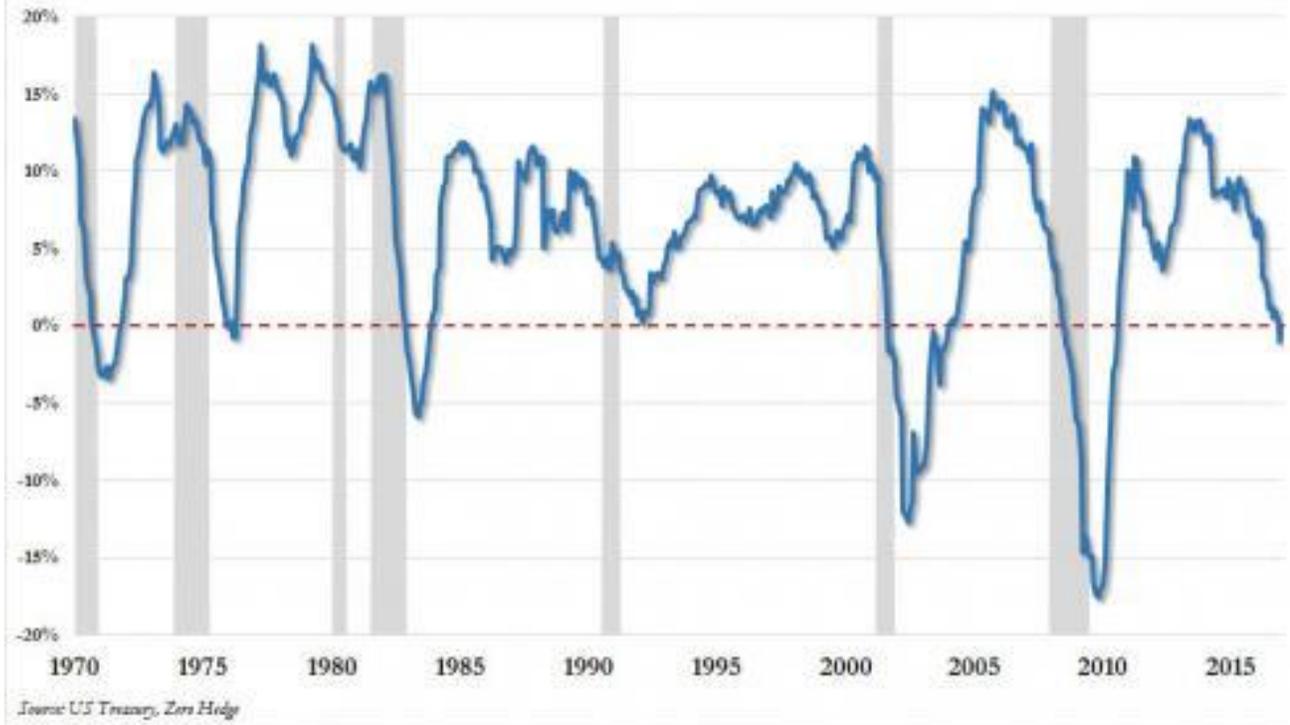
Just one example of data that just doesn't match up is the continued strength in the monthly jobs report where in January the U.S. economy added another 237k jobs. That is a solid month of job creation, yet wages were weak and this is akin to what we've seen in personal income tax receipts data showing that personal income growth is actually declining (see chart below).

### Personal Income Tax Receipts y/y% vs. Fed Funds Rate (- -)



This is not a data point that can be chalked up to a one-off when you compare it to a similar trend in the year-over-year growth rate of Federal Government Receipts which just tipped into negative territory.

### Federal Government Receipts (12Mo Rolling) YoY



When you consider that income taxes are the largest revenue source for Uncle Sam, it not only stops you in yours tracks when you see it go negative (look at the chart over the last 45 years and you decide when a decline of this level and at this rate into negative territory didn't coincide/foreshadow material economic

weakness), but also highlights that the consumer is quite weak. This helps to explain why outstanding credit card balances have pushed back up to near all-time highs.

All I'm getting at in this week's missive is that the complexity and dynamics of the capital markets at the moment are much deeper than the impression being provided by a stock market that has rallied for six straight days (9 of the last 10). Over the last several months I've reluctantly put capital to work knowing how this game is played and that expensive can get more expensive, but that by no means relinquishes anyone's responsibility for prudence. With investor sentiment survey readings and market positioning euphoria readings indicating the market is well out over its skis on a short-term basis, it's likely best to hold some dry powder (or build some up if you don't have any) for a better entry point in the coming months.

The juncture we are getting to in this bull market cycle can rectify itself in one of several ways, with the two most obvious being fundamentals rapidly improving to catch up and justify where prices are, or eventually Mr. Market starts calling everyone's bluff and investors' chip piles begin to wither. In any game of poker, let alone the high stakes game investors are playing today, "if you can't spot the sucker at the table then it's probably you". One of the key players at the table, Chair Yellen, will be testifying in front of congress over the next several days and that will provide investors with the most updated assessment of her view heading into the March FOMC meeting.



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