August 7th, 2017

Summer snoozing…

There's no question, of late the Dow Jones Industrial Average has been grabbing all the headlines as it hits new all-time highs ending last week on a 9-day winning streak en route to eclipsing the 22,000 mark, but some of the other major market indices lack a similar enthusiasm. Take the S&P 500 for example which has now gone 13 sessions trading within an 8-point band (closing at 2474, 2473, 2473, 2470, 2477, 2478, 2475, 2472, 2470, 2476, 2478, 2472 and 2477), or the Russell 2000 Small Cap Index which hit 1,388 in early December, yet closed on Friday at 1,412 (less than a 2% gain over the last eight months). The Dow Transports Index has also been lagging of late as it's down -5% from the all-time highs it reached in mid-July.

At the current time, these divergences are nothing for investors to be alarmed about, but they are worth monitoring as we move through August and into September. As of now, chalk it up to the 'dog days of summer' with many trading desks operating on skeleton crews and algorithms driving the price action. However, the mild weakening of market breadth is also noteworthy:

NYSE Stocks at 52 Week Highs

- Aug: 94 (data as of August 3rd)
- July: 124
- June: 201
- May: 171
- April: 191
- Mar: 263
- Dec: 485

% of NYSE Stocks above their 200 Day Moving Average

- July: 58%
- Jun: 58%
- May: 64%
- Apr: 65%
- Mar: 67%
- Feb: 72%

*data via @BearTrapsReport

As for the economic data reported last week it continues to be a mixed bag, but the main takeaway is that the economy continues to muddle along this 2% real GDP growth trajectory. This is consistent with what the U.S. economy has been able to produce in the post-GFC world. Last week's jobs report for July was a pretty solid report with +209k new jobs created, the unemployment rate falling to 4.3% from 4.4%, and the year-over-year trend in wages stuck at the +2.5% level they've been at for four months. All in all, there wasn't much that stuck out to me on the plus side or the minus – it's odd to say, but it was pretty ho-hum from my perspective. Sure, the headline number of +209k is an attention grabber, but job growth has perhaps been the one variable that has been unwavering throughout the entirety of this expansion. Last month represented a record 82nd consecutive month of job growth and yet this economic recovery remains the weakest on record in the post-WWII era.

Sure, President Trump can tweet about the record high stock market six months into his term, but one has to wonder what has fundamentally changed since the comment he made on September 26th of last year where he said, "we are in a big fat ugly bubble, and we better be awfully careful". Look I'm not trying to be cute here, but I have a hard time piecing together a narrative that attributes much of the rise in the stock market to anything this administration has been able to achieve legislatively. Yes, there has been traction on the deregulation dial (or the lack of any further increase in regulation), but if this were really moving the needle then you would expect that economic growth would be pushing above 2% through the first half of the year. We'll see what the second half brings, but the latest batch of data (outside of employment) continues to show signs of an economy that is losing momentum, not gaining:

- Auto sales declined again in July and are negative YoY for four straight months and twelve of the past fifteen.

- ISM manufacturing data came in a tad softer than expected, ticking down to 56.3 from 57.8 in June with most of the components declining in July relative to June. The good thing is that the declines are coming from what are solid levels so there remains quite a bit of room for further declines until concern is warranted. Though, as an aside it will be interesting to see how the moderation in drilling activity in the energy sector works its way through the economy in the second half of the year. It's clear in the GDP prints for Q1 and Q2 that the resurgence in U.S. drilling activity has had a meaningful impact on the manufacturing sector, but with the rig count data starting to plateau and many E&P companies announcing capex cuts in their Q2 earnings reports, any impact this might have will likely first show up in the PMI data in the months ahead. The bloated inventory levels in the auto market as well as the weakening sales trends is another fundamental development that puts the manufacturing resurgence at risk in the second half of the year.

- ISM non-manufacturing index fell 3.5 points in July to 53.9 to what is the lowest level on this metric since August of last year and the month-over-month slide was the steepest decline since November 2008. Like its manufacturing brethren the internals showed a weakening trend across the board: business activity/production, new orders, employment, supplier deliveries, inventories, backlog of orders, and new export orders all declined while prices, inventory sentiment, and imports were the only segments to show increases with the rise in inventory sentiment being a contrarian negative signal.

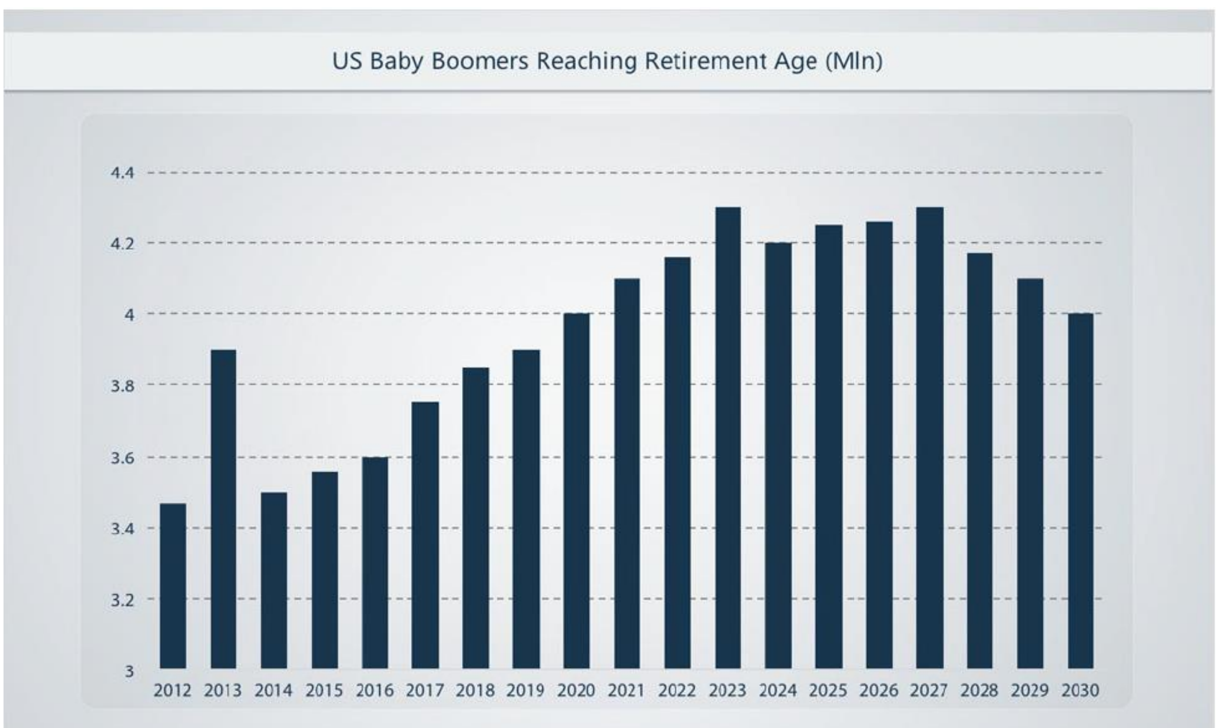
The way I see it is that on a whole the economy continues to hang in there, but the hand-off from the first half of the year to the second half of the year looks feeble. What will be different in the second half relative to the first half is a much more difficult comparison in terms of year-over-year performance, and this goes not only for economic activity readings, but also corporate profits. You see, what is about to work its way through the system and go from being a tailwind to a headwind is the material repricing in the commodities markets as well as global liquidity.

Perhaps this can be most clearly illustrated by breaking last year into two halves – the first half, where we began the year with a legitimate concern that the global economy was sliding into a recession (ISM manufacturing readings were sub 50, oil fell below $30, credit spreads blew out by several hundred basis points, and global central banks rushed to the rescue with the highest level of liquidity since the onset of the GFC). By the time we got to the second half of 2016 global recession risks were squashed, manufacturing PMI's moved back above the 50 level, oil and other commodity prices moved substantially off their lows, credit spreads contracted, and global central bank liquidity was working its way through the system.

Keep this in mind as we move into the second half of 2017 where oil prices are little changed from where they were a year ago (also OPEC is out of moves to try and prop things up any longer), most of the manufacturing PMI numbers look to have peaked and are starting to roll-over, automotive production is setting up for a very challenging second half, many of the global central banks that rushed to the rescue are now pulling back with some even tightening policy, and the easy year-over-year comparisons for corporate profits ended in Q2.

This doesn't imply nor assure that bad outcomes await risk oriented investors in the second half, but with volatility levels in both the equity and fixed income markets at historic lows and valuations in both markets at or near historic highs, it would behoove investors to prepare themselves for the reemergence of a two-way market (not the one-way street that the first seven months of this year have produced).

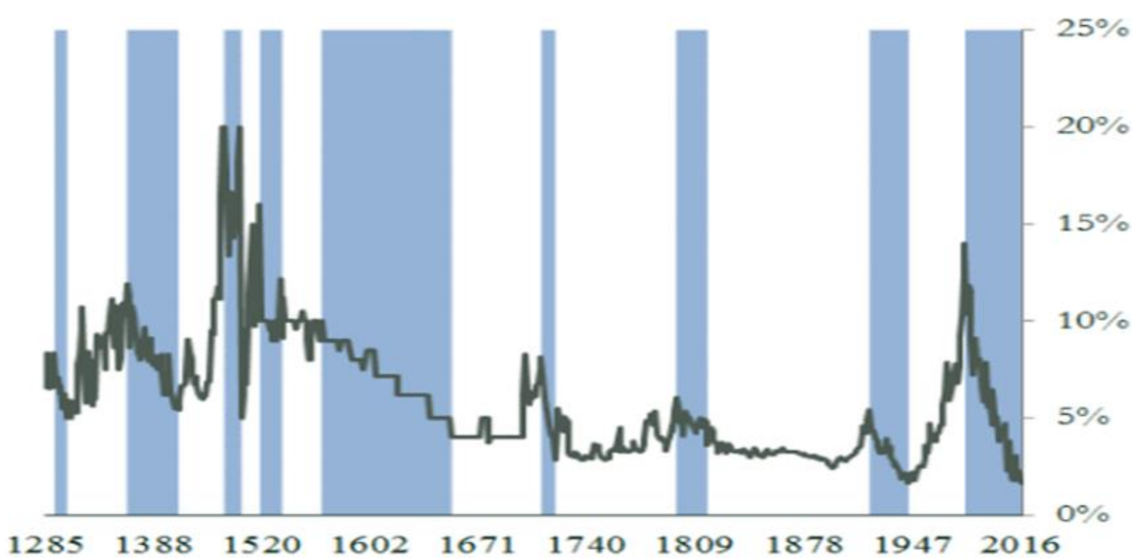
Over the last several weeks I've been making it a point to highlight some longer-term investment themes that our work is leading us towards. Perhaps the biggest theme I see out there is demographics and not only the challenges it presents, but also the opportunities. In a nutshell, over the next decade and a half we are going to bear witness to the most successful, wealthiest, and largest population set (The Baby Boomers) in U.S. history transition from the work force to the retirement ranks. This transition is sure to leave some tremors in its wake and set off structural changes that will impact the U.S. economy for decades to come. However, I want to highlight one part of this theme that I think is imperative for investors to consider and that is how these 'Boomers' will achieve their financial objectives in retirement.



You see, as we all celebrate and cherish the record highs in both stock markets and bond markets perhaps we all too conveniently overlook what transpired to get us to this point, and that is unprecedented monetary policy actions not only at home but around the world. Back during the GFC the Federal Reserve took aggressive and (in hindsight, one would conclude) necessary actions to rescue the financial system from imploding. However, here we are a full eight years into the recovery that began in July 2009 and the Fed has taken very few steps to unwind much of the monetary support that has been provided to the system. Debating the merits, pluses, and minuses of these policies is for another time and place, but what I think is important for investors to assess is where we are today and what it implies about future investment returns.

Let's start with interest rates and the below chart which according to the Bank of England illustrates that the global risk-free rate (defined as the yield of domestically-held short-dated government bonds whose default risk is assumed to be negligible) has never been lower.

Chart 1: The Global risk free rate since 1285



Given the fact that interest rates are at seven hundred-year lows, the consensus view among the investment public is that they have nowhere to go but up. And while I'm inclined to agree with this belief, I remain unconvinced that this is an inevitability, after all look at the chart and outside of some intermittent spasm periods it looks as though interest rates have held pretty much below 5% for the last 200 years. My point isn't to get into an analysis and/or view on the level and timing of a change in interest rates – in the near-term I remain of the view that the global financial system cannot handle higher interest rates given the outstanding levels of debt, dis-inflationary forces, and ageing demographics, but that's for another time and place.

With interest rates at the lowest level in a generation and the risk that we may remain in a "lower for longer" environment for some time to come, then this puts retirees in an odd predicament in regards to finding a home for the nest egg they've been building throughout their professional careers. As a result, the equity market has become the beneficiary almost by default, and this isn't to suggest that this is a good or bad thing, but history would suggest that it's not the panacea that this historic bull market makes it out to be.

But, investors should see the writing on the wall and that is that the equity market is going to become (if it's not there already) the income vehicle via dividend payments that the boomer generation is going to have to rely on to subsidize their retirement spending. This by no means is to suggest that investors should abandon prudence, discipline, portfolio diversification, and other time-tested investment truisms for allocating their capital, but the fact of the matter is that the market that historically has been available to those living on a fixed income has been rendered useless for those that haven't saved enough to live off of income generated in the low interest rate world we're in today.

Furthermore, I want to caution investors that the state of the capital markets and economy that exists today will not remain permanent and will require adjusting and adapting to them as has always been the case. For instance, investors would be doing themselves a disservice today by ignoring the current rich valuations in the equity market and assuming they'll persist indefinitely. Let's call a spade a spade and at least acknowledge that broadly speaking the valuation of the U.S. equity market has only been higher in 1929 and late 1999 / early 2000. Neither of those proved to be a great entry point to be loaded to the gills with equities as it took more than two decades and more than a decade, respectively, to recover those lofty price levels in the crashes that followed those periods.

Also keep in mind that we're very late in this economic cycle with a growing number of metrics starting to show just how late, and what makes the current environment extremely challenging for investors is that at the later stages of the last two economic cycles in 1999 and 2007, the yields on 10-year Treasury bonds were north of 6% and 5% respectively. So back then investors had an alternative that they could rotate their capital into that provided a reasonable level of return if they wanted to lower their risk profile. However, with the yield on the 10-year T-note around 2.25% today that trade-off is much tougher to make. As a result, what we don't know yet but will find out when we get there, is just how many investors have been forced into areas that they otherwise wouldn't be in if they had a reasonable investment alternative.

To summarize, just as this demographic bulge moves into their lifecycle where income and security become a necessity because they are unlikely to be able to recover from a material drop in the value of their nest egg, they are being presented with an investment environment where global interest rates have never been lower (as a result bond prices are at/near all-time highs) and a stock market that has never been higher with a valuation backdrop that has rarely been more expensive.

Any Boomers reading this please don't get depressed – this is a challenging set-up for sure, but not one that you can't overcome. It will just require some patience and caution at the current time as Mr. Market will provide you with ample opportunities over the next several decades of your retirement, just as he has during the decades it took to build this nest egg.

In addition to the income demands that the Boomer cohort will need, it is worthwhile to extend this analysis to understand where this demographic will be spending their money – travel/tourism, recreation, entertainment, leisure, and hospitality to name a few (experiences over possessions). Another aging demographic play is healthcare and in particular biotech and medical technologies, and don't overlook the cruise lines and especially those that have a sound balance sheet to go along with their dividend payouts.

Corey Casilio
Partner, Portfolio Manager
101 Ygnacio Valley Road
Suite 211
Walnut Creek, CA 94596
corey.casilio@clpwm.com
925.448.2215

Casilio Leitch Investments is a private wealth management firm, focused on providing financial advisory and investment management services to individuals, families, and institutions. The firm was founded on the principles of Character, Integrity, and Trust and pledges to abide by these principles, dutifully focusing on our fiduciary responsibility to our clients throughout our financial advisory relationship.