January 17th, 2017

Transitioning from conjecture to actual policy will be complicated…

It was a pretty tepid week for U.S. equities with the Dow Jones Industrial Average ending the week nearly 80 points lower (-0.39%) than where it began the week, the S&P 500 was virtually flat (-0.10%), with the Nasdaq Composite bucking the trend as it climbed +0.93%. Anyone taking a closer look at the major averages would see that it's been nothing more than 'to and fro' price action for almost five weeks now:

- The S&P 500 first closed above 2,270 on December 13th and since has traded as low as 2,233 and as high as 2,282 while closing last week at 2,274.

- The Dow Jones Industrial Average first closed above 19,900 on December 13th and since has traded as low as 19,718 and as high as 19,999.63 while closing last week at 19,885.

- The Russell 2000 Small Cap Index first closed above 1,385 on December 8th and since has traded as low as 1,346 and as high as 1,392 while closing last week at 1,372.

Over the past month (21 trading days) the Dow Jones Industrial Average has traded within a range of 1.07%. According to Ryan

Detrick, Senior Market Strategist at LPL Financial, this is the narrowest range going back to the year 1900.

As you see, a lot of chop, but not much going on since the month long ramp following the Trump victory. The markets that have been moving over the last five weeks are not exactly confirming the ‘animal spirits’ nirvana spewing out of the preponderance of confidence surveys since the election. Yep, I’m talking about the bond market here where the yield on the 10-year Treasury bond after surging to 2.60% from 1.88% just prior to the election has settled back down to 2.40%.

A similar fate is playing out in the currency markets where the U.S. dollar index surged to north of $103 at its post-election peak, but has since settled in around the $101 level. To my eyes the dollar index and interest rates are the two most inclusive capital market prices to inform an investor in which direction the wind is blowing for U.S. growth and inflation. And this post-election rally in risk assets is almost entirely predicated on an expectation that economic growth – due to a boost in the pro-growth/pro-business Republican policies of deregulation, infrastructure spending, and tax cuts – will jolt U.S. economic growth out of the +/- 2% growth rate that it has been stuck in for the eight years of this post-Global Financial Crisis expansion.

However, the back-off in U.S. interest rates suggests that the bond market is already fading this ballyhooed growth prognosis that many other asset classes quickly priced in. Here is what the WSJ had to say about this over the weekend:

"The yield decline and recent pullback in the U.S. dollar's value suggest that investors are reassessing their initial enthusiasm for the so-called Trump trade, in which expectations of higher growth and inflation fueled sharp gains in U.S. stock indices, the dollar and prices of many commodities".

The one broad based U.S. equity index that continues to forge ahead is the tech heavy Nasdaq Composite which made a new all-time high again last week. Me thinks this is a bit reminiscent of what occurred in 2015 where broad based economic, earnings, and stock market growth was hard to come by and the FANG trade (an acronym for Facebook, Amazon, Netflix, and Google) was all any investor needed to or wanted to own because they were part of a very narrow group of stocks that were appreciating in value. So far this year the Dow is up a little more than 0.5% with the S&P 500 up a little over 1.5% (not shabby by any means), but Facebook is up 11.5%, Amazon is up 9%, Netflix is up 8%, and Google has appreciated by almost 5%.

Very quietly, gold has staged a fairly impressive rally to begin the year as it pushed above $1,200/oz last week for the first time since November 22nd. The fact that gold is performing the way it is in the face of what is still a pretty firm U.S. dollar index is worth noting and perhaps is reclaiming some of its glitter as geopolitical uncertainty indices surge to their highest level in years.

Before moving on to this next comment, let me restate again that I am agnostic when it comes to politics – meaning I could care less what side of the aisle any U.S. citizen falls when it comes to their party of preference.

They have their reasons for it, and it's irrespective of what I think – so no matter what, I'll respect their right to that liberty to choose. Ok, now that that's out of the way let me reiterate again my surprise as to how equity markets have reacted with such complacency since the November 8th elections – shoot first, ask questions later as is typically the case with Mr. Market.

But as we approach inauguration day at the end of the week, the honeymoon period will end and the real work begins. As such, vague and broad stroke policies about deregulation, tax policy, and infrastructure spending will no longer placate an enthusiastic Mr. Market that has pushed up stock prices to their most expensive valuation levels of this cycle (it's worth noting that on some valuation metrics stock prices today have only been exceeded in 1929 and 2000).

It’s one thing to get elected by tapping fears and anxieties stemming from job insecurity and financial hardship while pointing fingers at regulation, globalization, and existing policies. It’s an entirely different thing when you are confronted with putting together solutions to fix or improve upon these perceived shortcomings. Last I checked, regulations, while perhaps on some levels represent a cumbersome expense on business, they also serve a purpose of protecting consumers and the environment. It’s not as though regulation in the energy sector stopped U.S. oil production from rising to a level on par with Saudi output, or stopped financial institutions from extending credit this cycle with outstanding debt levels at all-time highs.

No, I’m not a staunch liberal and I do think that some good can and will come from some of the policies being bandied about in the new administration, but we are now reaching the point where talk and innuendo need to transition to reality. If it doesn't or it ends up being delayed for an extended period of time then President-elect Trump's comments from back on September 26th, may deserve more merit today then they received back then:

> "*We're in a bubble right now. And the only thing that looks good is the stock market but if you raise interest rates even a little bit, that's going to come crashing down. We are in a big fat ugly bubble, and we better be awfully careful".*

But this isn't to be confused with the following comment after he won the election on December 26th:

"The world was gloomy before I won – there was no hope. Now the market is up nearly 10% and Christmas spending is over a trillion dollars".

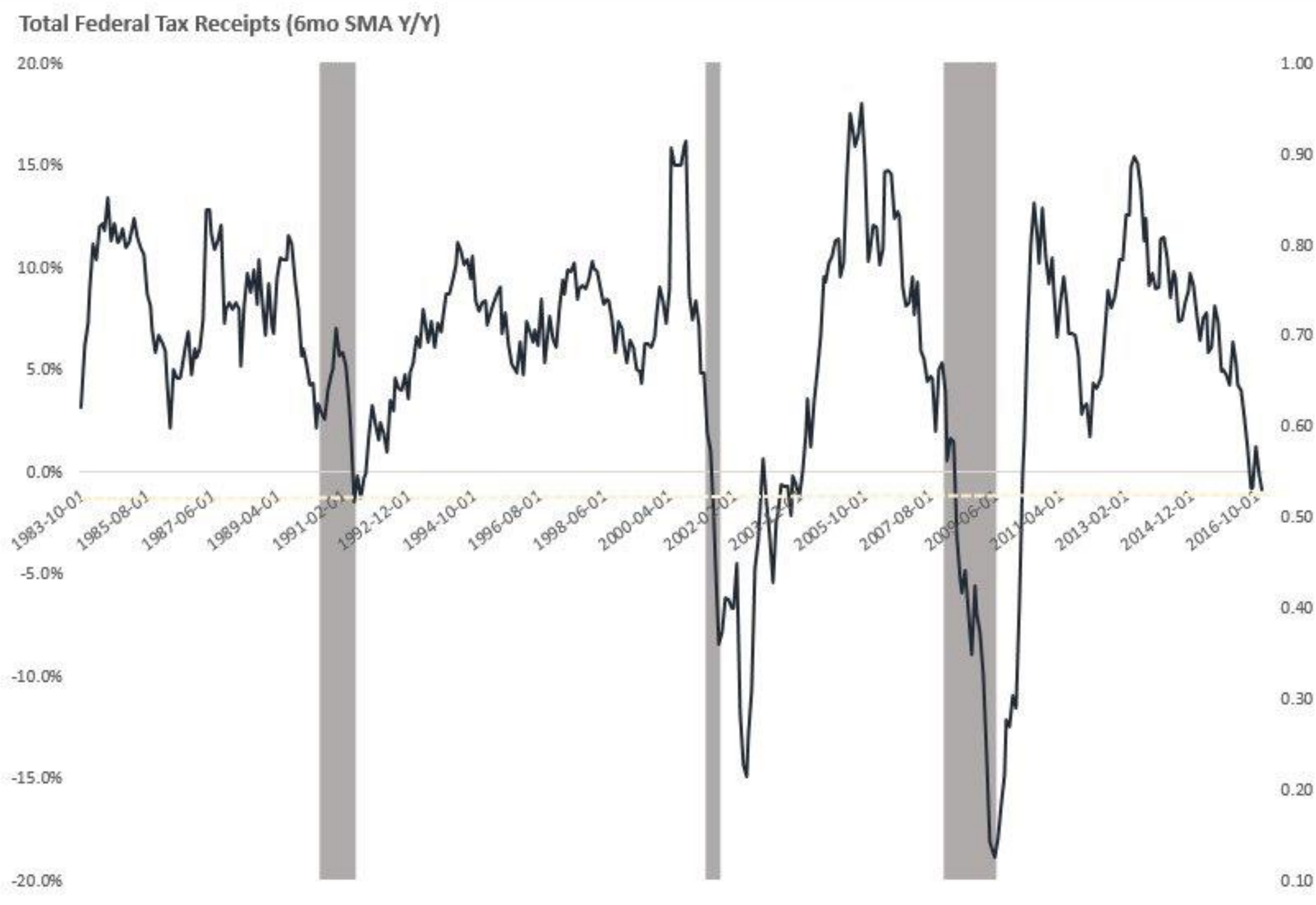
You can't make this stuff up, but if we were in a bubble before the election then what do you call it now with the Dow Jones Industrial Average 1,500 points higher?

All joking aside, all I'm getting at is that while there are elements of the Trump policy agenda that are clearly pro-growth (which investors have made significant wagers behind them being done deals) what has been overlooked is that this rush to judgement disregarded the possibility that they get watered down by his protectionist bent. Complicating the economic calculus of any fiscal stimulus is the Fed, where a growing view among the various

Fed Presidents is that a short-term fiscal boost may not be necessary.

And in the event that a fiscal package does get done it may fast track the Fed's interest rate hiking cycle from what is expected to be 2-3 hikes this year to perhaps 4-5 hikes. This would be a rather toxic mix for an economy that is already leveraged to the hilt, but able to service that debt load because of the low interest rate environment. This is one of the occasions where investors may want to be careful what they wish for because a faster than expected and sustained rise in interest rates may prove to be a tourniquet to growth.

There is also this minor element of paying for or targeting a revenue neutral fiscal package which perhaps is taking on heightened interest with federal tax receipts going negative as we closed out 2016.



Source: Pervalle, US Treasury

Over the last month I've seen claims among some economic prognosticators that this new policy agenda will unleash a wave of entrepreneurial activity that will propel annual GDP growth to north of the 4% level (I've even seen some forecasts for 6%). I guess it's possible, but keep in mind that the supply side of the economy moves much slower than movements in the demand curve. And it's the demand side of the economy that continues to be restrained by poor demographics, high debt levels, and inequality.

The World Bank came out last week and upped its global GDP growth rate up to 2.7% from the 2.3% pace in 2016. Keep in mind that last year's growth rate was the weakest year of growth in this expansion. In the report they forecast that U.S. real GDP growth would come in around 2.2% for 2017 which only looks good relative to the 1.6% pace the U.S. experienced in 2016. For some perspective, 2.2% real GDP growth is no better than the average for what we have seen in what is currently the weakest U.S. recovery ever recorded (including the 1930's).

So yes there's that, and one more comment on the Fed as it relates to cycles. There has been 13 rate hiking cycles in the post-WWII era with 10 of the 13 ending in a recession. I know its blasphemy to even mention the R-word at this time, but on average, tightening cycles last two years which means we are in year two of this one. I know this cycle is anything but normal, but economics works in a manner where the trade-off to growth is typically inflation and higher interest rates. This is not a forecast, but rather just an observation and should serve as reminder to investors that there is no such thing as a free lunch.

President-elect Trump is about to take the post of arguably the most difficult and important job on the planet and as the leader of the most powerful and financially significant country in the world, yet he is doing so with some of the lowest approval ratings on record for a transition president. Two things come to mind when trying to be objective about the relevance of the data in the table below: 1) the accuracy of polling data over the last year should be interpreted with more than a little skepticism (Brexit and U.S. Presidential election), and 2) it offers little in the way of actionable data for investment purposes or what it may ultimately mean for the future.

Do you approve or disapprove of the way ... is handling his presidential transition?

	Approve	Disapprove	No opinion
	%	%	%
Donald Trump			
2017 Jan 4-8 ^	44	51	4
2016 Dec 7-11	48	48	4
Barack Obama			
2009 Jan 9-11	83	12	5
2008 Dec 12-14	75	17	8
2008 Dec 1 †	78	13	9
George W. Bush			
2001 Jan 15-16	61	25	14
2001 Jan 5-7	65	26	9
Bill Clinton			
1993 Jan 14-15 ‡	68	18	15
1992 Dec 18-20	67	15	18
1992 Nov 19-20 ‡	62	14	24

^ Asked of a half-sample; † USA Today/Gallup poll on Gallup Daily tracking survey; ‡ Gallup/Newsweek poll

GALLUP

There is likely any number of sound theories as to why these numbers are where they are and many of them probably more thoroughly vetted than mine, but whatever they are, what continues to befuddle me more than anything is what an appropriate valuation multiple is for the stock market in this current reality. What we do know is that more than five decades of concerted effort towards globalization is under assault. Populism is on the rise and for U.S. citizens it is no longer just a foreign problem we can reference as happening in other countries, but never in ours.

It started with Brexit and the U.K.'s decision to separate itself from the EU which, like the U.S. Presidential election, is transitioning from the ballot box to practical implementation with PM Theresa May set to make comments this week on her strategy for invoking Article 50 and beginning the process of breaking away from the EU. As a quick aside, the way the British Pound has been trading of late it looks as though Sterling is pricing in a "hard Brexit" – the one where Merkel and company make an example out of the Brits so as to dissuade any other EU members from getting a similar idea.

Now we see the nationalistic baton being passed here stateside, and who's to say at this juncture whether this ultimately ends up being a bad or good thing (my analysis and judgement leads me to think the former, but I do hope it's the latter). What has become clear (if it wasn't already) is that Trump is a disruptor and seems hell-bent on tearing down the institutions (as flawed as they may be) that ushered in decades of relative stability: NATO, U.S. intelligence (ironic the flack this sector is getting given the tranquility from terrorists U.S. citizens have experienced since the dreadful 9/11 attacks), NAFTA, and to a certain degree capitalism (a politician telling a global company that serves a worldwide consumer base where it can and can't set up shop).

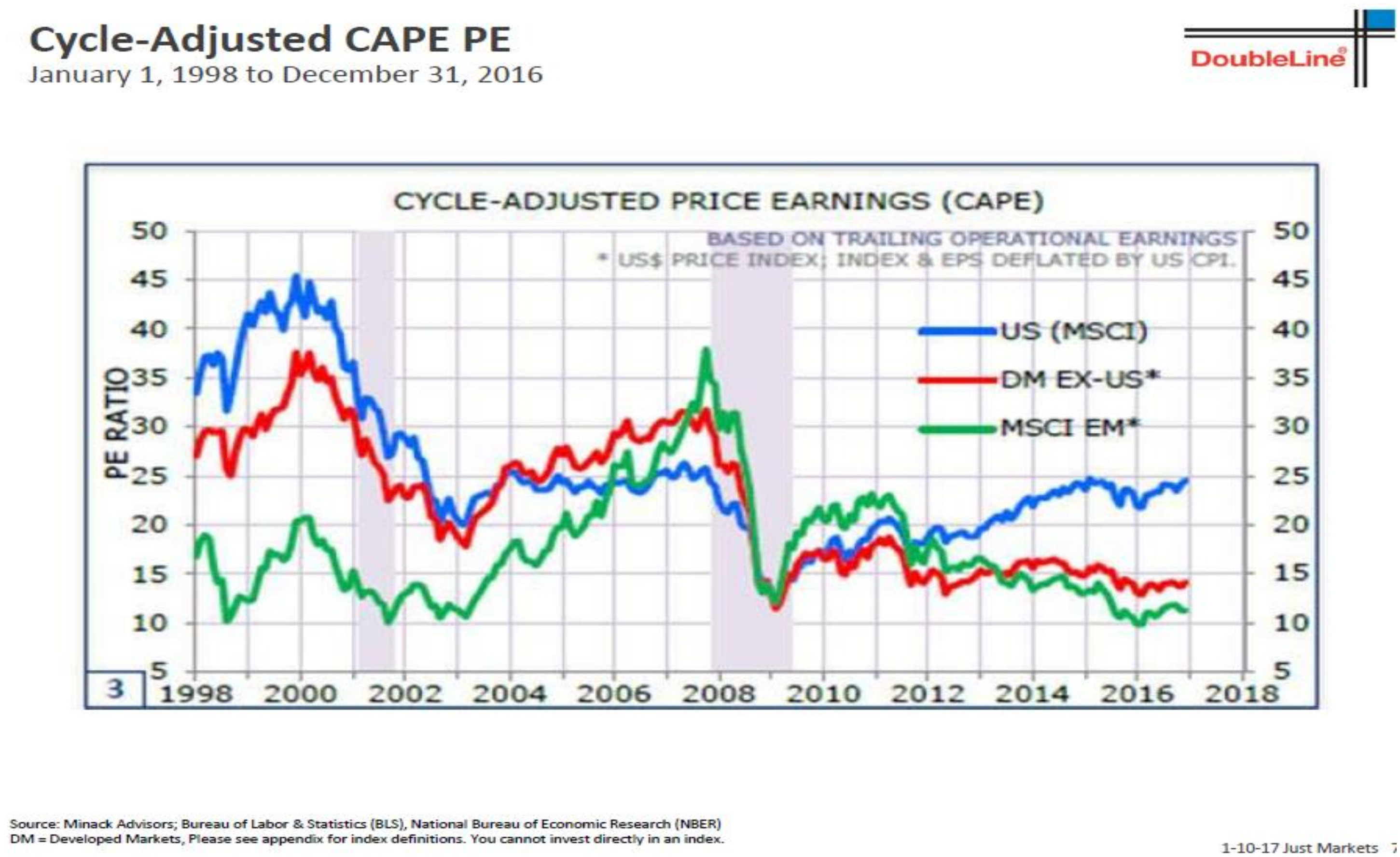
History is replete with examples on how policies of nationalism, populism, and isolationism turn out – the implication of "America first" and everyone else tied for second is a game changer in terms of global order. Like I said, no one at this juncture knows with any certainty how this ends up, but rest assured that creating global divisions rather than embracing global unity will almost assuredly be accompanied with unforeseen consequences.

This tactic of throwing out aggressive statements about reigning in other countries taking advantage of the U.S. and then walking back such comments as an opening bid in a negotiation is a slippery slope. Powerful leaders, not only in their local regions, but on a global basis in both Germany and China have come out over the last several days with retaliatory comments about this inward shift in nationalistic views.

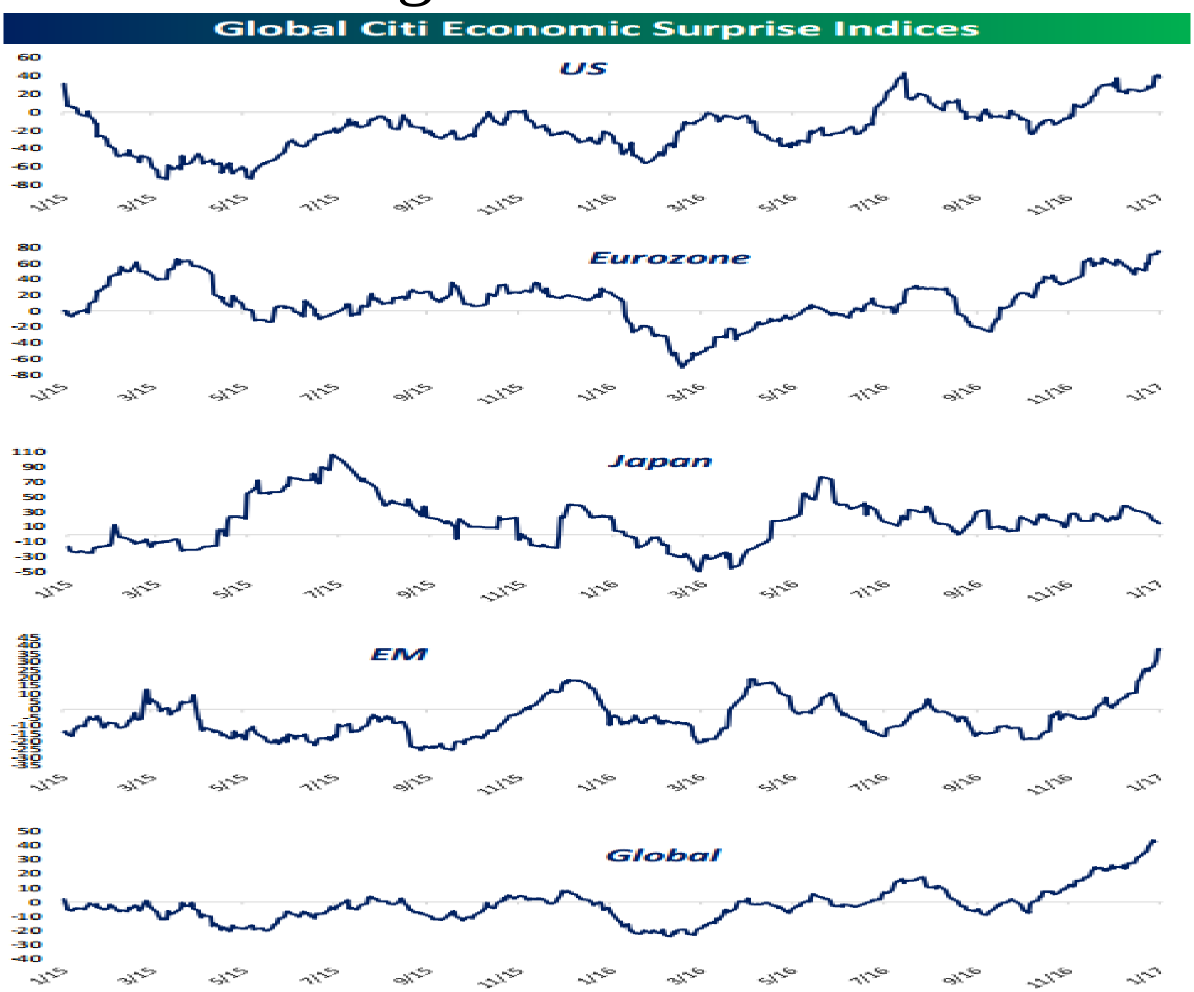
This is where I differ with the consensus view on U.S. equity markets at the moment – this uncertainty premium should lower the valuation multiple assigned to a risk based asset, not raise it. However, last I checked the market didn't much care about what I think.

So in an investment universe that in most areas is devoid of value, the one area that continues to stand out is international equity markets relative to the U.S. The below chart from a presentation put on by DoubleLine's

Jeff Gundlach highlights the valuation discount both international Developed Markets and Emerging Markets are trading at relative to the U.S.



While there are clear political and structural risks that accompany these regions (and that may explain why they trade at lower valuation levels), one would also have to acknowledge the counterpoint that some portion of these risks are already in the price. However, it's not just the valuation discount that is compelling as the momentum indicators have picked up, fundamentals are improving, central banks have more ammunition and willingness to support growth, and their weakening currencies have drastically improved their global competiveness. The following chart from Bespoke Research plots the pickup in the Citi Economic surprise index across various regions.



Like the U.S., economic growth has picked up across the board, but unlike in the U.S. (where this index has not broken out to new cycle highs) we are seeing a break out in the Eurozone and Emerging Markets. All of this is why investors should evaluate their exposure to overseas markets as it relates to areas with balanced to favorable risk/reward trade-offs.

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.