January 9th, 2017

Opportunities abroad…

U.S. stocks got off to a solid start to begin 2017 with the S&P 500 gaining 1.7%, the Nasdaq surging 2.56%, and the Dow Jones Industrial Average lifting by a little more than 1%. The headline grabber over the weekend was the Dow coming within a whisker of breaching the 20k mark in Friday's trading when it got up to 19,999.63 @ 12:43 p.m., but didn't quite have the gusto to get over the hump. It's highly probable that this 20k milestone will be reached, but if history is any guide, maybe investors shouldn't get too anxious – when these key milestones have been reached in the past they then went on to act as ceilings for years.

One part of the stock market that caught my attention most last week was the lagging performance of the Russell 2000 small cap index which rose by 0.75%, which was less than ½ of the move up in the S&P 500. Keep in mind that this was the part of the market that was most celebratory following the Trump victory, as it is expected to be the biggest beneficiary of lower tax rates and less regulatory oversight. Unlike the Dow, S&P 500, and Nasdaq this index was the lone standout last week in not being able to close back above its all-time high from a month ago.

Time will tell whether this equity market segment serves as a canary in the coal mine for the broader market and it is something to keep an eye on to gauge whether the Trump honeymoon rally is losing steam or just a pause that refreshes.

Moving on to some other markets, it looks like bonds are in the midst of reestablishing a new trading range between 2.25% – 2.60% on the 10-year Treasury yield. Irrespective of the insanely bearish sentiment and market positioning in the Treasury market, this tug-of-war between rising cyclical inflationary expectations and the pro-business fiscal policy agenda stoking economic optimism versus the secular deflationary forces of demographics, debt, and technology will be one of, if not the, key variables that dictate the tenor of capital market prices throughout 2017.

There is no shortage of academic literature that's been penned over the years delineating the negative consequences of excess indebtedness and how this ends up capping any ability for interest rates to move meaningfully higher. Italy and Japan serve as two current day examples with both being two of the most highly indebted sovereigns in the world, both moving in and out of several recessions over the last decade, and both currently being the beneficiaries of the most aggressive central bank policy actions in history where interest rates are being nailed to the floor, which has drastically diminished the financial stress of servicing debt to GDP ratios of +130% and 229% respectively.

This global debt overhang is surely something that will continually cloud the Fed's ambitions to normalize interest rates this cycle, with current forecasts for three rate hikes in 2017. Recall how they guided markets to expect four rate hikes in 2016 following their December 2015 rate hike and after all was said and done, they were only able to get one on the board for the year.

Oil prices started out the year in mild fashion, rising around 0.5% last week. With the OPEC cuts set to take effect in the first six months of this year, everyone is likely waiting with bated breath to see if the agreement is honored when January production numbers come out in early February. Also grabbing investor's attention is the continual rise in U.S. drilling rigs with the Baker Hughes numbers showing rigs rose again for their 10th straight week. The rig count is now at its highest level since December 2015 and let me remind you that U.S. oil production back then was 9.225 million barrels a day compared with current levels of 8.77 million barrels per day as reported last week by the EIA.

The increase in drilling activity is a net positive for the U.S. economy as we are seeing play out in the manufacturing data over the last couple months and if it arrests oil prices from spiking higher while maintaining a price in this $45 - $60 per barrel range then I think it's a constructive underpinning for both the economy and oil companies. What we've seen from many of the oil company's earnings reports is that a lot of fat has been taken out of the system, costs along the supply chain have been slashed, and most domestic production is profitable in the $50/barrel range. So, this lifts a dark cloud from a key segment of the economy that was additive to economic growth in the early part of the cycle and is considered a leading cyclical sector for the equity market.

We were on the receiving end of a wide swath of economic data last week which on the whole was more positive than negative, but it did have that rate of change shift from 'great' to 'good' complexion to it.

Let's start with auto sales which surged in December to 18.3 million sales at an annual rate, pushing the calendar year tally to a new cycle high of 17.5 million units for all of 2016. On the surface this a solid number which should give a lift to Q4 GDP, but when you look under the hood this figure was boosted on the back of a massive round of discounting. J.D. Power data found that the average discount amounted to $3,542/vehicle which is the equivalent of 10% off the list price – the last time we saw discounts this large was at the height of the Great Recession.

The ISM manufacturing index (the key bellwether gauge for U.S. factory activity) posted a larger than expected increase to a two-year high of 54.7 in December from 53.2 in November, beating consensus expectations for a print of 53.8. The internals of the report were solid as well with production, employment, and new orders all rising and more than offsetting the decline in inventories and supplier delivery times. If there was a fly in the ointment it was the fact that only 11 of the 18 industries reported growth (still the majority, but down from the peak of 13 in June) and six reported contraction. So, on the margin what transpired was that we maintained the levels we saw in November but were unable to make further improvement.

The ISM nonmanufacturing index came in above expectations at 57.2 in December (matching the level from November) and is at its best level since October 2015. Similar to the ISM manufacturing index the internals were so-so with 12 of 18 industries posting growth (three contracted versus two last month), but this is down from 14 in November. Unlike the manufacturing index there was a meaningful deterioration in some key components with backlogs sagging below 50 (48 from 51 in November), new export orders slid sharply to 53 from 57, and employment declined to 53.8 from 58.2.

Like I suggested, not bad, but a clear step back from “great” to “good” on these data sets. What will be interesting to see is if the actual hard data (auto sales being one that met the mark) echo the substantial improvement in the survey data (consumer confidence, Gallup pools, CFO survey…) that we have seen in this post-election period. Thus far we have seen more than $3/4^{ths}$ of the survey data surprise to the upside (animal spirits at play), but it’s been roughly 50/50 in terms of the actual hard data output that has bested expectations.

History is replete with periods where a wide gap has emerged between the “touchy feely” survey data and the “hard” stuff, where in the past it has been beneficial to stick with trusting the latter.
Which brings me to Friday’s jobs report where the U.S. economy added +156k jobs in December, missing consensus estimates for a print of +175k and below November’s upwardly revised tally of +204k. The unemployment rate ticked up to 4.7% from the cycle low of 4.6% in November, but finished 2016 at the lowest point to end a year in a decade. The most encouraging part of this employment report was the 2.9% year-over-year growth in wages from 2.5% in November to the fastest pace since May 2009.

Looking under the hood of this employment report reveals a labor market that closed out 2016 on some rather soft footing. The total 2.2 million jobs created in 2016 was the fewest since 2012 with the 3-month average to close out December of +165k indicating that a deceleration in job creation is underway when compared to the 6-month average of +189k. Surely, hope springs eternal and this could just be a temporary soft patch that reaccelerates once the new leadership regime takes office, but that's not to suggest that it will be an easy task with what looks to have been a persistent problem getting individuals back into the labor force this cycle with the employment-to-population ratio ending 2016 at 59.7% versus 63.3% in 2008.

Here are a couple items within the labor report that temper my enthusiasm that this pivot is afoot:

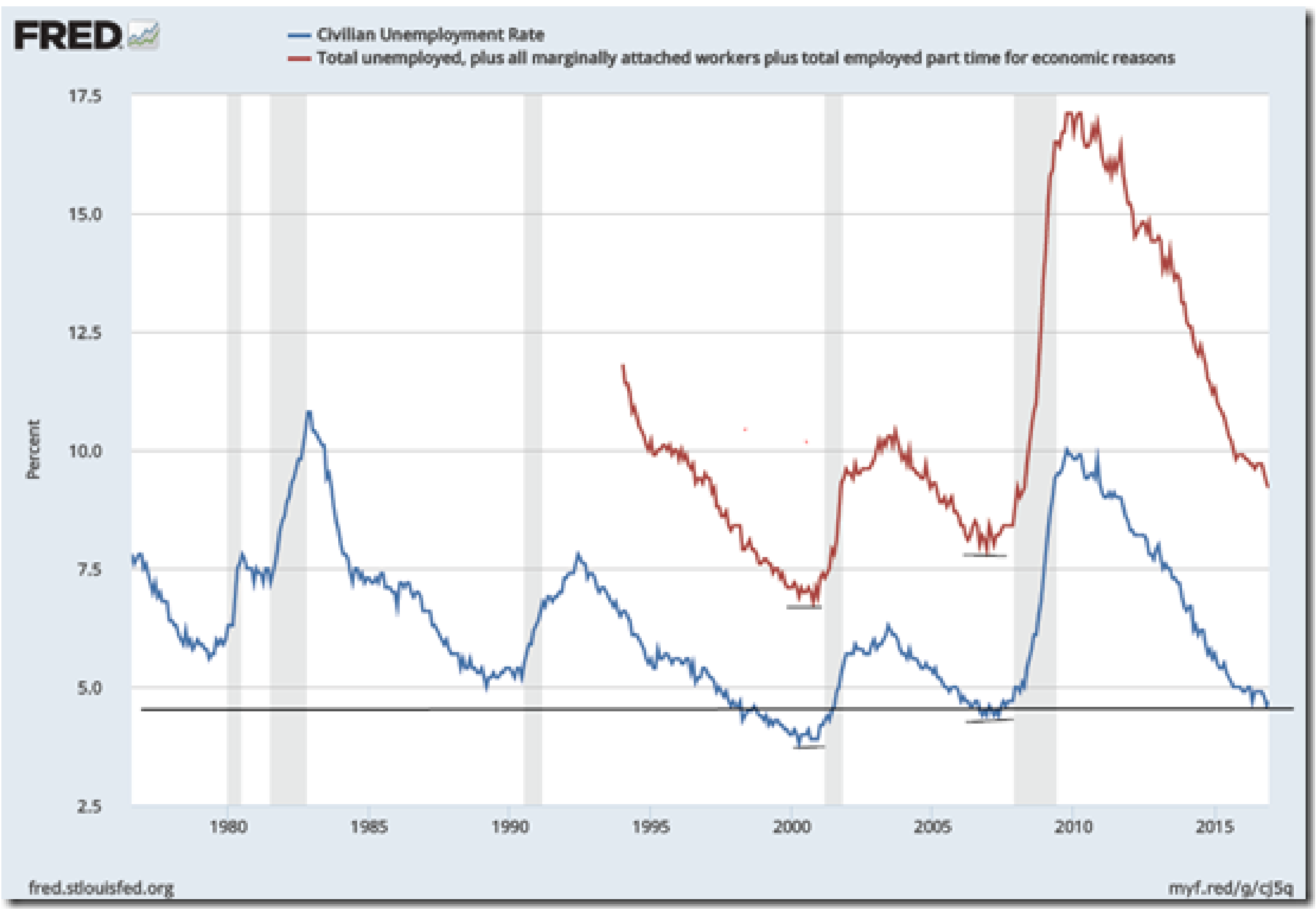
- Private sector employment increased +132k (+1.9% YoY), the weakest since May.
- More than half the job gains in December were part-time.
- Temporary help services (a leading indicator for future job growth) declined -15.5k (+1.6% YoY), the first decline since August.
- Aggregate hours worked, which represents the complete gamut of labor market input to GDP growth, rose by less than 0.2% MoM in December, merely recouping the
November dip, and on a three-month basis the trend has receded all the way down to a mere +0.8% annual rate which is

towards the low-end of the range of the past three years.

The slowdown in hours worked is puzzling given the low unemployment rate and accelerating wages. Why would employers grant higher wages if labor demand is not that strong? It must have to do with a supply shortage and this rings loud and clear in the fact that there are still more than 95 million people not in the labor force, of which 23.5 million of them are in the prime working age cohort of 25 to 54 years of age.

I'm not at all saying that this was a terrible jobs report, but this report is a continuation of what has become a persistent problem with jump starting economic growth to +3% from the 2% level that to date makes this the weakest recovery on record in the post-WWII era. All you have to do is juxtapose the record-high job openings from the monthly JOLTS report against record high levels of labor force disengagement and you don't have to be a rocket scientist to conclude that there is some dysfunction beneath the veneer. Fixing this disconnect is well beyond my paygrade and while reduced regulation, lower taxes, and infrastructure spending just may be the right medication to placate the pain it is not the vaccination to wipe out the virus (in my opinion).

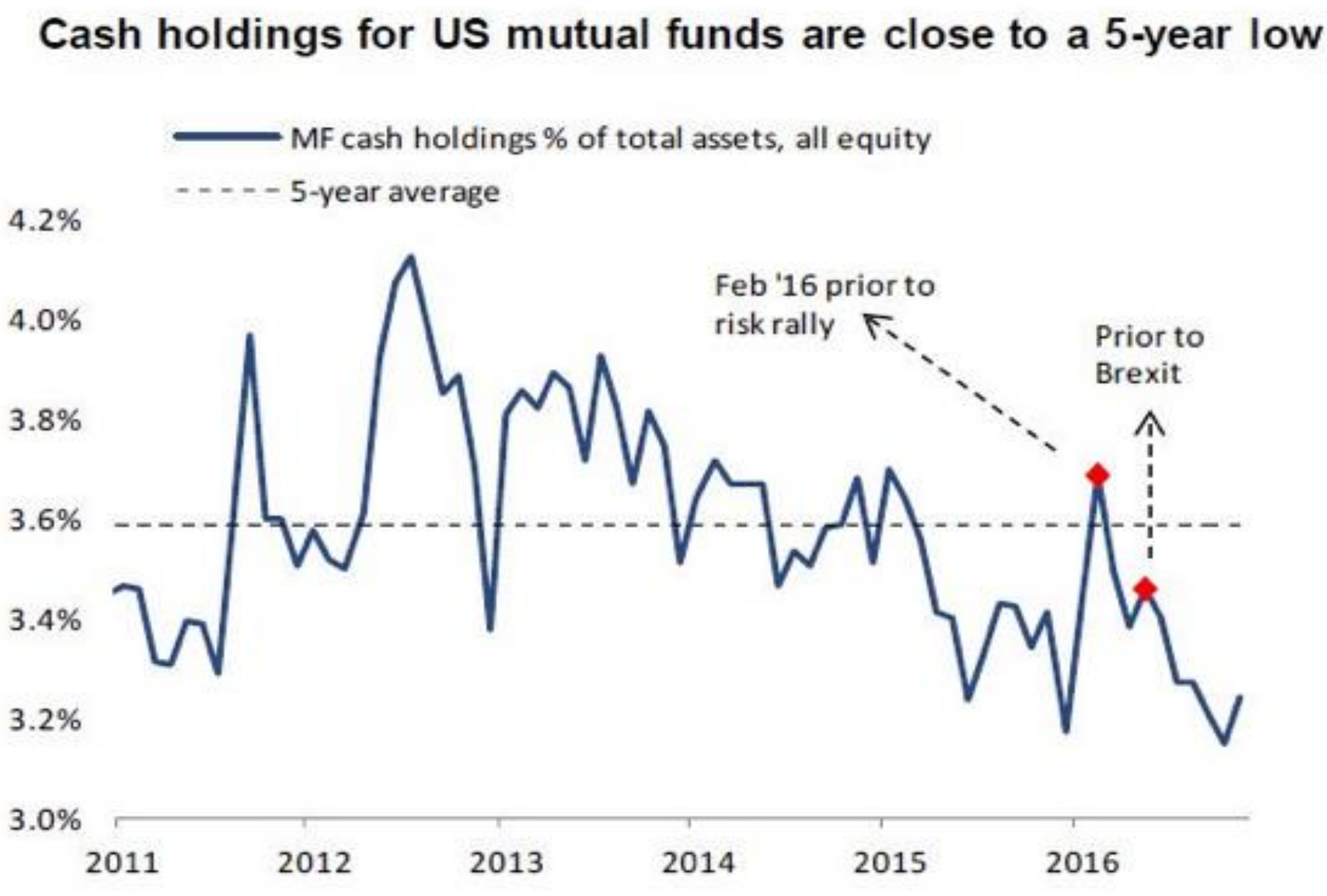
After all, the current 4.7% unemployment rate is below what it was at the peak of the last two "normal business cycles", 1979 and 1989. I define "normal business cycles" as a cycle that was not heavily reliant or built upon monetary policy morphine which ultimately ended with an economic/financial bubble. See the chart below that plots the U-3 (blue line) and the U-6 underemployment rate (red line) over the last four decades and as you can see from the blue line (U-3) we are below unemployment readings that in past "normal cycles" marked a low in the unemployment rate. The U-6 was not measured prior to 1994, but my guess is that it currently is not far out of line with where it probably was in '79 and '89.



All this circles back to a capital market environment that is priced as if nothing could go wrong, i.e:

- Investor sentiment measures have exploded in this post-election period with the latest data from the Investors Intelligence survey showing the bull camp expanded to 60.2% from 59.8% last week while the bear camp shrank to 18.4% from 19.6%. By themselves these are not big week-over-week changes, but the 41.8% bull/bear spread is reaching the upper-end of extremes as it relates to optimism. Rare is the day that the market has a lot of upside from such extreme herd mentality readings.
- Market Vane bullishness on equities has similarly risen to the high-end of the cycle range, up to 65% from 63% a month ago and 60% two months ago.

This optimism isn’t just resonating with individual investors as U.S. equity portfolio managers have been busy putting money to work as their cash asset ratio has slipped to near cycle lows of 3.2%.



All I’m getting at here is that the best time to buy (put more capital to work or increase your equity exposure) is when these readings are at the opposite end of the spectrum. Readings like this strongly suggest that a lot of optimism is already reflected in the price and these levels should be interpreted from a contrarian perspective.

You want to talk about priced for perfection? Look no further than the High Yield corporate bond market (nearly 20% of the index is made up of oil related companies) where spreads have fallen back to near the tightest levels of this cycle and completely unwound the spread expansion due to the 2015 oil price collapse. I realize that companies have taken many constructive measures to shore up their balance sheets while the credit spigot continues to flow, but should we really be back to cycle low spread levels with oil prices more than 50% lower than the +$100/barrel level in 2014, and total corporate credit outstanding at all-time highs (even if oil prices are 50% higher than the 2016 lows of $26/barrel)?

Keep in mind that all this optimism and money that has flooded into the markets (Trimtabs was out with a report last week announcing that inflows into equity exchange traded funds soared by a record amount in

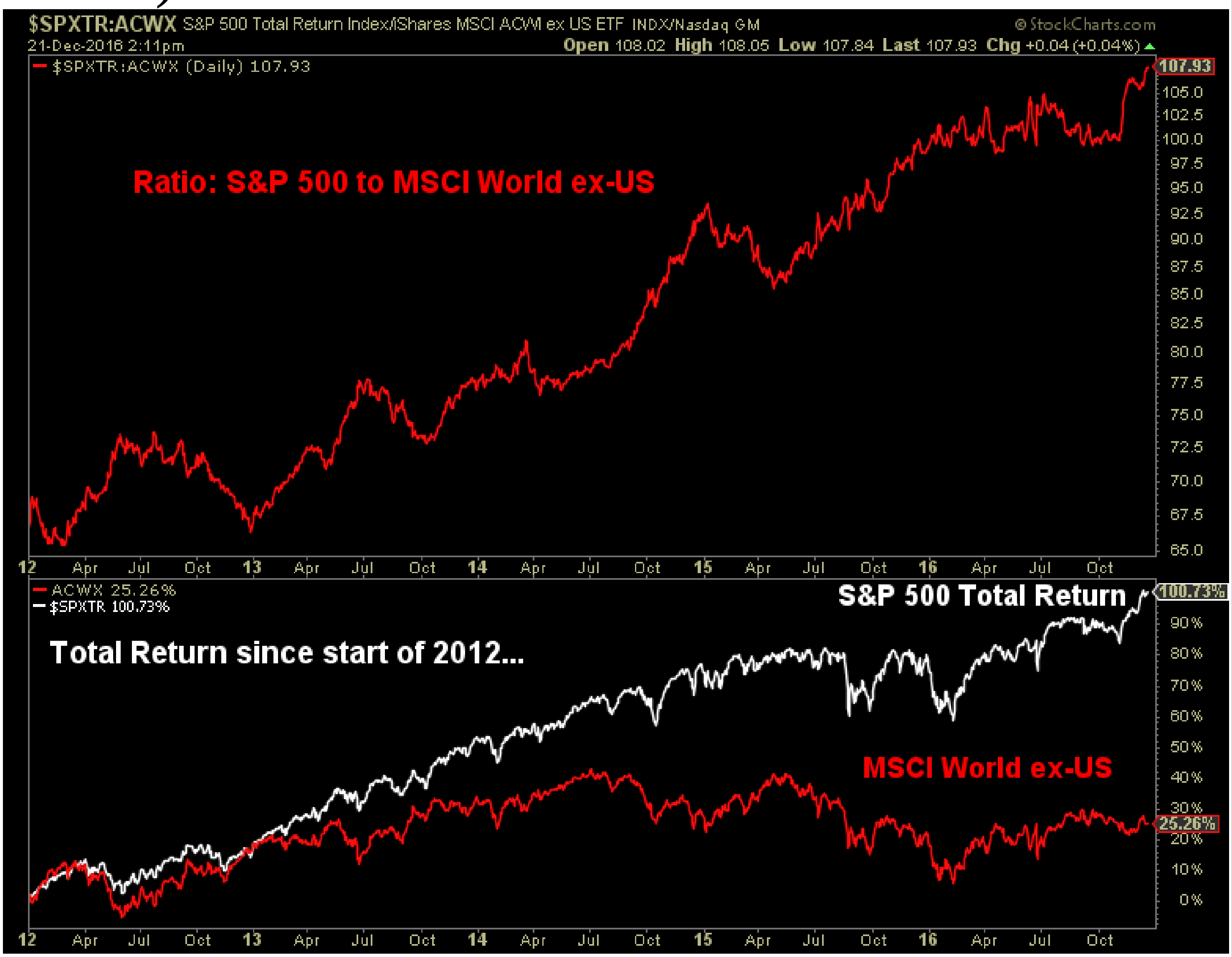
December – almost $60 billion following a little more than $50 billion in November) has made what was already a richly valued stock market even more expensive. Yes, analysts have put pen to paper and updated their 2017 earnings expectations where they expect the S&P 500 to earn $130/share. This is a little more than 10% EPS growth from the estimated $118 the S&P 500 is expected to earn for 2016 (an earnings tally it has managed to flat-line at since 2014).

No matter how you slice it, whether it's a 19.2 P/E on trailing earnings or 17.5 P/E on forward earnings, both are meaningfully above their 16x and 14.5x historical averages. And this is with an untested president, geopolitical risk intensifying, and the slimmest margin of error for political fragility in quite some time.

Look, I could go through a litany of risks that worry me at the current time (China foreign exchange reserve drawdown, emerging market currency volatility, upcoming European elections, the dollar index holding near its 14 year high when outstanding dollar denominated debt is at an all-time high…) but the fact of the matter is that markets continue to be pretty comfortable ignoring them. At some point they will matter, and if we learned anything from last year it's that a lot of time can pass before any of these risks materialize – and even then they may not matter.

So until they do matter, the best action as an investor is stay disciplined, have a plan and adjust/adapt when necessary, use diversification as a risk management tool (but not the only tool with asset prices at or near all-time highs in most markets – stocks, bonds, and real estate), and focus on opportunities where valuations have yet to be bid up.

One area where valuation is favorable relative to U.S. equities is in the international equity markets, which have lagged the U.S. equity market over the last four years (see chart below).



In addition to cheaper valuations we are seeing a gradual improvement in fundamentals and earnings revision ratios have been improving at a stronger pace than is the case with U.S. equities. The below chart (courtesy of Meb Faber and his "Global Value" portfolio) highlights the relative performance of international equities versus the S&P 500 over the last three decades where you can see that periods of under and outperformance can persist for some time, but eventually this fulcrum swings back the other way. We are currently in a period where international equities have underperformed U.S. equities since 2010 and is pushing a duration of time that is unmatched. A new permanent reality or opportunity? Me thinks the latter.

This isn't to say that if the U.S. market sneezes these markets don't catch a cold, but the margin of safety is much wider than in U.S. equities which should provide a bit of a downside buffer. Furthermore, these markets are far from wart free and they do carry a higher level of volatility, but a lot of these potential risks are known and my guess is that some degree of this is reflected in the price (hence the cheaper relative valuations).

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

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