
# February 27th, 2017

## Don't chase – It's time to wait and watch…

The Teflon equity market powered ahead last week with the Dow Jones Industrial Average pulling a rabbit out of the hat in the last thirty minutes of trading on Friday to close higher for the 11th consecutive day. It was the third straight weekly gain for the Dow, with the S&P 500 and the Nasdaq running their weekly winning streaks to five.

The composition of the equity market rally over the last couple of weeks is leading some (including myself) to be skeptical on the sustainability of this recent leg higher, but little of that seems to matter at this moment with the momentum and trend clearly to the upside.  What I mean by the questionable composition is the fact that volumes are lagging the price action and it's the defensive sectors that are now leading the market higher with Utilities surging +4% last week and the Consumer Staples sector gaining +1.5%, while the Energy and Financial sectors declined -1.2% and -0.2% respectively.

It's not just the defensive parts of the stock market sending mixed signals, but bond prices are moving higher as yields are in decline. The yield on the 10-year T-note has worked its way down to 2.32% (causing bond prices to rally in five of the past six weeks) from its high of 2.6% reached in mid-December.  Gold was up 1.6% last week and year-to-date has gained more than +10% (almost double the gain in the stock market) while the U.S. dollar is down more than 1% on the year as the Japanese Yen (the other perceived global safe-haven currency) sees renewed strength.

These are all anti-cyclical price signals from capital market instruments that trade with a global macro-economic expectation and collectively they are hinting that the bloom may be coming off the reflationary move in asset prices that began in earnest last September. Yes, this reflationary move and the pick-up in global growth momentum started before Trump won the U.S. Presidency and it was his pro-growth / pro-business policy agenda of deregulation, tax cuts, and infrastructure spending that acted as an accelerant to perpetuate an already embedded trend.

But now we are getting to the point where actions speak louder than words, with

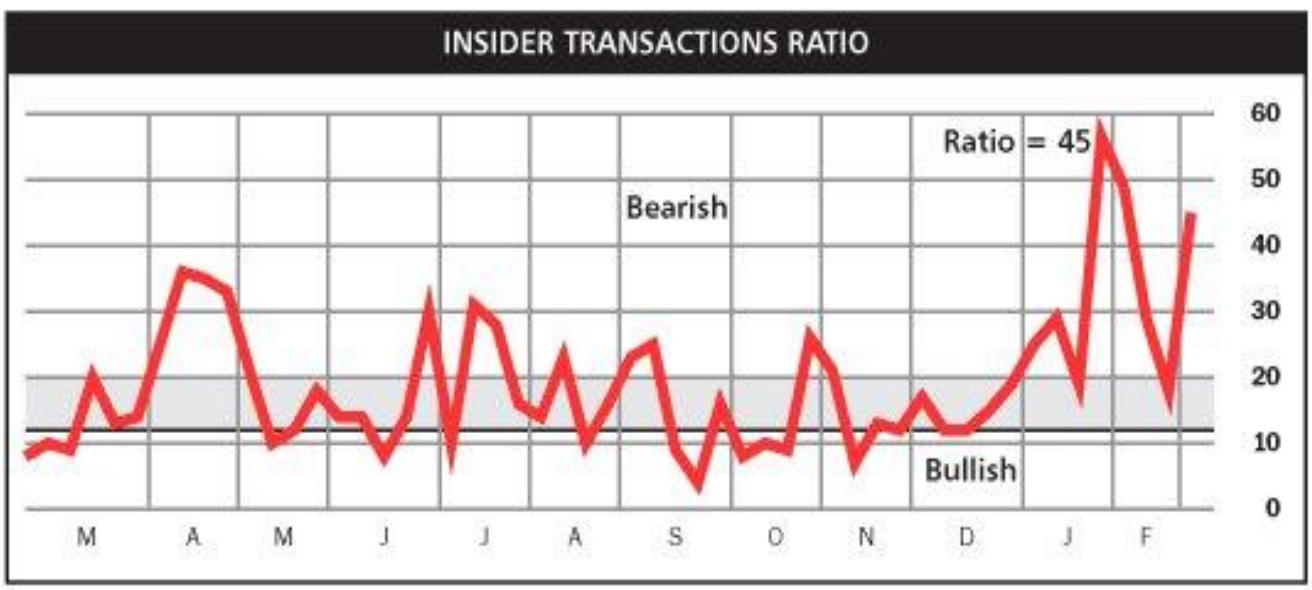
President Trump's State of the Union address on Tuesday night the big event of the week for investors. Look, I haven't been in this industry long enough to be considered a 'wise old owl', and I'm definitely no 'spring chicken' either, but never in my career have I seen a market continue to celebrate and recycle the same news as has been the case with this administration's agenda. I mean how many different adjectives can be used to describe tax cuts ("massive", "phenomenal", "bigly"), yet we have little in the way of anything tangible to work off of, and it seems as though the timeline for the good stuff continues to get pushed further out on the calendar while the bad stuff (such as protectionism, anti-immigration, and anti-globalization) takes center stage.

I'm trying to do my best to steer clear of touching on politics in these missives given it's difficult to say anything without eliciting judgement from one side or the other. But come on, at this point all we're getting is the part of the Trump agenda that all of my industry contacts proclaimed he would back off of once elected. On the immigration front I would recommend interested readers have a look at the working paper recently put out by the National Bureau of Economic Research (NBER), "The Economic Contribution of Unauthorized Workers: An Industry Analysis" where they estimated that if the millions of unauthorized workers are removed, even temporarily, the drainage of this labor (even if these individuals are working under the table they are adding to domestic production) will cause a drag on real GDP of around -3%.

To put this level of economic contraction into perspective, it would represent the second deepest recession (just behind the ‘08 -‘09 credit crisis) in the post-WWII era.

One other thing that I think is being viewed way too complacently on the economic front in terms of potential protectionist actions taken by the current administration (tariffs, border-adjustment-tax, targeting currency manipulators…) is the lack of awareness or discussion on possible retaliatory actions from foreign governments. It’s a bit naïve to expect that we will implement a policy where our country benefits to the detriment of another nation and assume that they are just going to idly stand by. We’ve been down this road before folks and it led to the Great Depression, a period in time that is best to be learned from and left in the history books – this isn’t a forecast, but rather just an observation.

Why this seems to matter so little to markets continues to puzzle me, but last I checked the market doesn't really care what I think. Meanwhile, the executives who are presumed to know more about their businesses than any outsiders have sold $7.8 billion of stock in February (this is the most in six years) while buying totaled only $380 million.  The below chart plots the Insider Transactions Ratio which shows the spike in insider selling so far in 2017.




Ratio of Insiders Sales to Buys. Readings under 12:1 are Bullish. Those over 20:1 are Bearish.
The total top 20 sales and buys are 523,850,663 and 11,675,695 respectively;    Source: Thomson Reuters

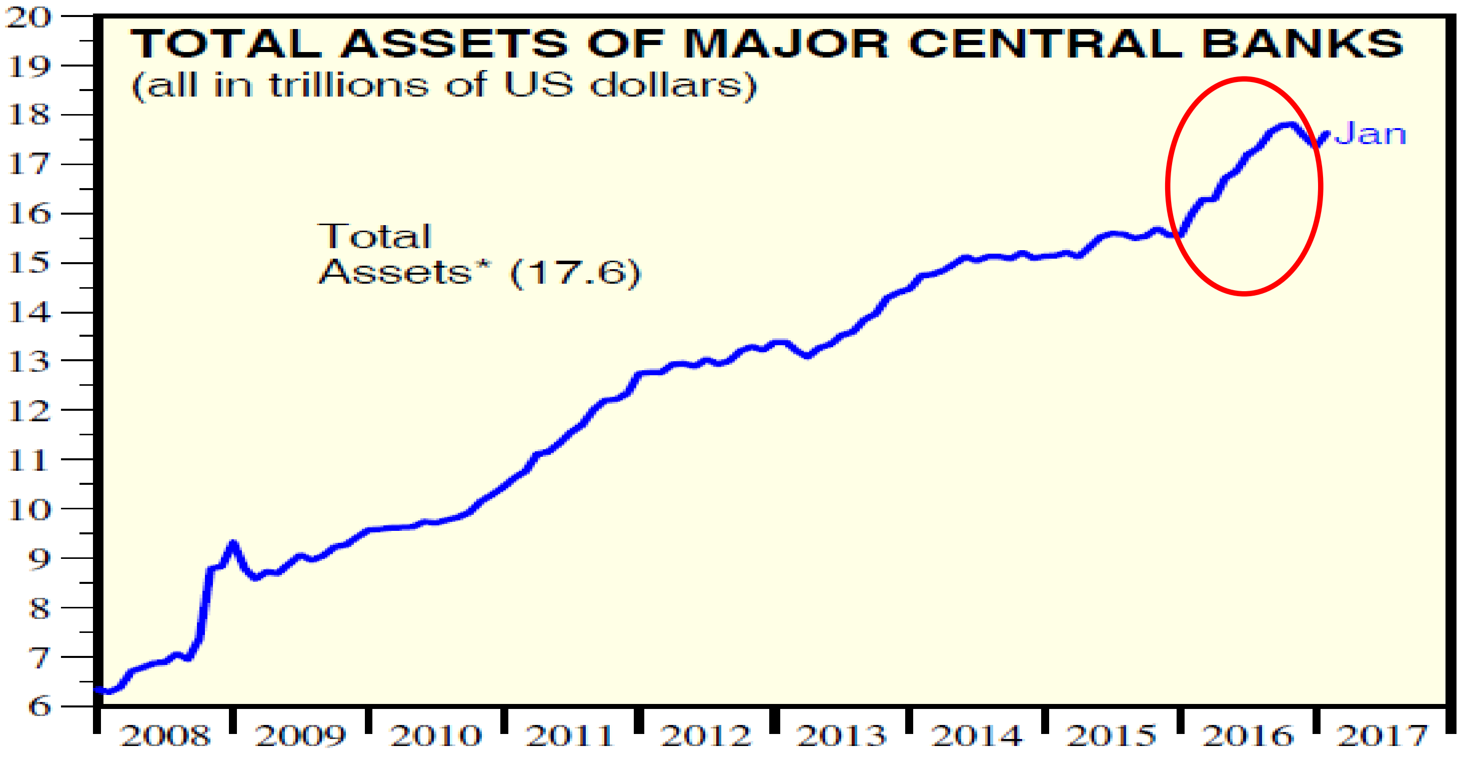
Keep in mind this is only one data point in a vast array of information, as selling by insiders occurs for many reasons – so take note, but don't allow this data to dictate a meaningful shift in one's investment strategy. If anything, what I take away from it is that we are in a stretched valuation environment (hence more insiders selling than buying) and as a result we are seeing corporate managers with concentrated single security exposure take advantage.

Coming into 2017 I've had this next three month period (March, April, and May) circled as a pivotal juncture that would dictate actionable allocation adjustments for portfolios. The framework for my thinking is as follows:

- It was a year ago at this time when risk assets started their rally off of what was the worst start to a calendar year in U.S. stock market history. The major driver of this about face was a rumored "Shanghai Accord" agreement at the G-20 meeting in late February 2016. It was also around this time when the global central bank dominos started to fall, with the ECB upping their QE policy while also allowing for corporate bonds to be purchased, the BOJ increased their QE asset purchase program, the Federal Reserve started to back off their guidance for four rate hikes throughout 2016, and over a four week period China injected north of $1 trillion in credit into their economy. The reaction in capital markets from mid-February 2016 into the late spring was the U.S. dollar index weakened considerably versus other foreign currencies which alleviated much of the short-term funding stress on emerging market economies, oil prices bottomed, interest rates in the U.S. rolled over after flirting with 2% on March 11th until they bottomed at around 1.35% shortly after the Brexit vote in early July, and equities around the globe started to rally.

- Monetary policy continued to be ultra-accommodative throughout 2016 as fears of unknown outcomes, such as the U.K. referendum and the U.S. Presidential election, kept central banks from taking any action in advance of these votes as they didn't want to be viewed as potentially impacting the outcome. Moreover, the BOE actually jumped into the accommodation fold following the surprise Brexit vote and added to the global monetary stimulus. All the while China was aggressively providing both fiscal and monetary support to stabilize its economy in what some analysts estimate as the largest stimulus injection since just following the Global Financial Crisis in 2009. It's a reasonable guess that some of the incentive behind China's actions were in large part to ensure Xi Jinping (China's top official) is able to further consolidate power in this fall's twice-a-decade congressional elections.

**Figure 1.**



- Monetary policy always works with a lag so it wasn’t until mid-to-late summer that it looked as though this stimulus was having an impact on the global economic data, and then once we got past the U.K. referendum vote (and the additional liquidity plus QE from the BOE) that by September economic momentum was picking up around the globe.

- Add in the surprise Republican sweep in the U.S. elections with their pro-business / pro-growth policy agenda and you got a spike in animal spirits that pushed economic surprise indicators across the globe to even further highs.

How all this ties into the near-term outlook (call it the next three months) is that in the two months following the U.S. election there has been a widening divergence between soft economic data (survey based measures like PMI's, consumer confidence, NFIB Small Business survey…) and hard economic data prints (retail sales, industrial production, exports and imports, wage growth…) that is unlikely to persist. The question that will be resolved once we have the data in hand over the next couple of months (we get the February data in March, and the March data in April…) is which way these divergences close.

Will the spike in confidence, sentiment, and animal spirits lead to an actual increase in activity, production, and output? Or was this just a sugar rush of hype and hope on the back of campaign promises that were much easier to say during rallies and debates, but are much more difficult to legislate given it's Congress that actually writes the laws and where trade-offs and compromise enter into the equation.

Much of the January data has already been reported and what we've seen so far is that global economic activity has maintained the levels it reached in December – some data a little better, some a little worse, but by and large we have not seen a continued acceleration in the data that was obvious from September through December. However, if over the next several months the incoming economic data fails to show further acceleration (let alone start to roll over) I'm of the view that it will be very difficult for the stock market to hold on to its gains over the last several months – especially given it's at its richest valuation levels of this bull market cycle and rivaling some of the richest valuations in history.

On the other hand if economic momentum gains some steam and we get confirmation that this acceleration in global activity is real then that should provide a tailwind that is actionable for investors to react to.

What's more is that there is a fairly low probability that the stimulus injected into the system in 2016 is sustainable or will be repeated in 2017. We've already seen China begin to tighten policy back in November, the Fed appears to be more adamant about hiking rates three times in 2017, the ECB will start to taper its QE program by 25% in April, and BOE Governor Mark Carney has hinted at reducing accommodation in 2017.

So here we are once again at this juncture we've seen time and time again throughout what has been the weakest economic recovery in the post-WWII era, with numerous bouts of

GDP peaking its head above 3% growth for a quarter or two to only then learn over the ensuing several quarters that it wasn't sustainable. I don't think this time is different and I believe that the secular headwinds of poor demographics and over-indebtedness will keep the developed markets in this perpetual circle of reflexivity where they take one-step forward and one-step back. But it's important as an observer and practitioner of capital markets to keep an open mind while assessing probabilities to an array of possible outcomes.

With that being said I think it is prudent for investors at the moment to continue to fade or step-aside from the on-going melt-up in the equity market. That is to say once again I don't believe it's prudent to put new capital to work before getting the latest read on the global economy with the slew of incoming data that's coming over the next week and the next several months for that matter. In addition to the data there is a Fed meeting on March 15th with market probability metrics flirting with 50/50 odds that we see a rate hike at this meeting.

One last thing investors need always remind themselves of is that risk goes both ways. I know it's easy to ignore and be dismissive of risk when you're staring at a stock market that hasn't seen an intraday range of greater than 1% for 48 straight days (longest streak in 40 years), or hasn't closed down more than 1% in more than 90 trading sessions, or hasn't experienced a 10% correction in over a year. But don't lose sight of long-standing fundamental relationships that have persisted in market history for longer than any of us have been alive – for example the fact that when you buy a stock you are purchasing a stake in the future cash flow and earnings stream of that entity. Whereas, if your choice of ownership is an index fund that tracks the S&P 500, then you should be aware that annual operating earnings for the S&P 500 peaked in Q3 2014 at $114.51 and as of Q4 2016 earnings season operating earnings have declined -7% while the price of the S&P 500 has gained +20%.

It makes me cringe when I hear analysts tout that one of the most bullish arguments for the stock market is the fact that the earnings recession is over. While true, they fail to mention that the S&P 500 rallied +6% during the five quarter earnings recession that saw S&P 500 profits plunge -22%. Come on, earnings go down and stocks rally, earnings stop going down and stocks rally, and now we have earnings moving up a little and stocks rally – it is a Teflon market.

This is a trend that is not sustainable and the fact that S&P 500 earnings are at the same level today as they first reached back in 2013 when the S&P 500 was trading around 1,800 should give plenty of investors pause to assess how razor thin of a margin of safety they are willing to accept at a juncture of such heightened uncertainty, complexity, and potential tectonic global shifts.

---


**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.

---