May 30th, 2017

Fed policy mistake – one of many underappreciated risks…

It's a pretty quiet start to the week with several markets around the world observing holidays and capital markets reacting in step with 10-year Treasury yields slipping a bit to 2.23%, the Dow & S&P 500 modestly lower, and global equity markets flattish as well. ECB President Mario Draghi delivered some dovish comments yesterday as he indicated there was no immediate need to pull back policy accommodation any further at this time which was a subtle surprise given the strong economic data out of the European economy over the last six months.

With economic growth in Europe so far in 2017 the strongest of all developed market economies, one has to wonder what it would take for Draghi to take additional steps beyond the initial tapering of QE by 25% in April. Moreover, are investors supposed to read into this inaction as a forewarning that central bank leaders see current economic strength as nothing more than a transitory surge in activity that will end up being yet another false start of hoped for sustainable growth that has been the case since the Global Financial Crisis ended in 2009?

What has been becoming clearer with each passing batch of monthly economic data since February is further validation that the reflationary impulse that started last summer and gained some steam following the Trump victory appears to have run its course with an array of indicators and market price signals reversing their post-election moves. For example the yield curve as measured by the 10s minus 2s spread is back down to 92 basis points (a level it was at last October), the U.S. dollar index has wiped out all of its post-election gain, the Russell 2000 Small Cap Index (while still above its pre-election levels) is little changed from where it was in early December, and a whole host of commodities are experiencing meaningful price declines (since February Iron Ore -36%, Copper -9%, Oil -12%, and Corn -6.5%).

To be frank, what stands out more than any other indicator as the anomaly is the S&P 500. Here we have a situation where the Citigroup Economic Surprise Index has collapsed from +60 to -40 (a fifteen-month low) over the course of two months as the soft survey data which spiked following the election is falling and converging on what was already lackluster hard economic data (the hard data is in the process of weakening on what was already a fragile foundation as well), and yet the S&P 500 broke out above 2,400 last week to a new all-time high.

Yeah, sure we got a positive revision last week to Q1 GDP from +0.7% to +1.2%, and don't get me wrong this is a welcomed development, but let's hold off on scheduling the parade as that is still an annualized growth rate with a 1-handle in front of it. What's more is that the pro-growth / pro-business agenda that conjured up so much hope following the GOP sweep that for the first time in this expansion, fiscal policy was actually going to be a positive contributor to economic growth (relative to acting as a tourniquet throughout the Obama administration) is evaporating into thin air.

As challenging as it’s been for this administration to get any momentum going on the U.S. policy front it looks as though the foreign policy ambitions are equally vexing. On the heels of a visit from the U.S. President, to hear the most powerful leader in Europe (Angela Merkel) come out publicly and not mince words when she says in a speech that it’s time to “take our fate into our own hands” and that “the EU can no longer count on America” one has to consider the potential shifts afoot given these comments are coming from a major American ally. Also consider that North Korea launched yet another ballistic missile over the weekend which flew 280 miles and landed inside Japan’s economic zone.

All of this is on top of the faint progress thus far in U.S. policy initiatives with health care reform having little chance of passing the Senate in its current form – even considering what many GOP House members concluded as a favorable CBO score for their plan (so instead of almost 24 million Americans losing access to healthcare it is estimated to be only 23 million and premiums set to soar over the next couple of years – come on…) and the just revealed budget that has zero chance of being passed since it relies too heavily on overly optimistic growth assumptions to fund the nearly $2 trillion in tax cuts.

I'll say it again to stave off any angry emails coming my way for not being fair to our President – me being critical of him is not personal, it's about capital markets and the narrative that has been perpetuated to the public since November that one man would and could cure all that ails us. In reality that was never a fair set up for him or this administration to begin with, but they embraced it and fueled it themselves with over ambitious expectations that they are subtly walking back (will they also own it if it goes the other way?). After all, the history books tell us that on average the President gets about 50% of his agenda enacted over his term and even the best of them get a little better than 60% accomplished. Only time will tell where Trump falls relative to the averages, but any objective observer would have to admit that he hasn't made it any easier on himself with all the distractions and complications.

My concern is more about investors and what this hopium rally potentially means to them should it continue to go unfulfilled, because none if it has mattered to equity markets at this time. Yet a growing number of cracks are showing up in the economic and credit data, as well as market internals. Two meaningful ingredients that standout as not confirming this latest leg up to new all-time highs over the past couple weeks are breadth and volume. As for breadth, only 4 of the 11 sectors that make up the S&P 500 are at new highs and two of these four are Consumer Staples and Utilities – both sectors that investors typically consider to be defensive and viewed as safe harbors in anticipation of an economic downturn.

Another fly in the milk of the Trump rally narrative is the fact that three key sectors of the market that stood to benefit the most from his policies – Energy, Materials, and Financials – have all underperformed the market this year and don't forget small cap stocks which as a group are up only 1%. Of all these underperforming areas so far this year, according to my lens Energy stacks up as the most constructive on a long-term framework. Here you're talking about an industry that has been under severe stress since oil prices peaked almost three years ago, they've taken steps to recalibrate their companies to this new price reality, and you could make the argument they've already been through their recession. This isn't to say there aren't more challenges ahead, but in a market with very few cheap valuation opportunities this is one sector where some value can be found.

Back to the broad market – I want to touch on what caught my attention more than any other piece of data last week and that was what happened in corporate profits in Q1. Here I'm talking about the unscrubbed numbers that we get from the quarterly GDP report (National Income and Product Accounts) which include all companies (public and nonpublic, big and small) which fell -1.9% versus Q4, taking the year over year change to +3.7% at the end of Q1 from +9.3% at the end of last year (the 5-year compound annual growth rate now stands at a meager +0.9%). What's more is that on an economy wide basis – once again including all companies that make up corporate America – corporate profits remain -4.8% below their Q4 2014 cycle high.

Perhaps this data does as good a job as any at explaining the expression 'the economy is not the stock market and vice versa' because anyone who has tuned into any of the talking heads on bubblevision over the last several weeks would know that S&P 500 earnings in Q1 were up by more than 15% relative to Q1 2016. For sure, one of the best quarters of year over year earnings growth in this entire expansion. What doesn't get the attention it deserves in all the excitement about how great the earnings season was is that these reported results from S&P 500 companies are "operating" profits which exclude a whole range of undesirable items and of course incorporate stock buybacks (which have been extremely beneficial in this low interest rate environment where companies have taken on debt to repurchase stock) and provide a material upside skew to earnings per share figures.

So while S&P 500 company profits have made a new all-time high at the end of Q1, perhaps equity investors should at least take some notice that "operating" EPS data may not be accurately capturing the deteriorating profits picture in the broad economy. What was also noteworthy about the NIPA profit numbers from the GDP report was the decline in profit margins to 8.26% which makes sense given the increasing wage pressures (albeit below what is typical this deep into an expansion) relative to the overall subdued level of inflation.

One last thing on this earnings picture for all those investors out there today cheerleading this market higher on the premise that it's fundamentally supported (validated) by the reemergence of earnings growth: since S&P 500 earnings peaked on a trailing 12-month basis back at the end of 2014, the S&P 500 has appreciated more than +17% while earnings are up less than 1%. If you want to look at NIPA corporate profits on the entire economy which peaked in Q3 2014 and are still down almost -5% below those highs, the divergence with a +22% gain in the S&P 500 looks even more extreme.

You see, this is what gets lost in translation between our industry and our responsibilities as professionals when attempting to educate the public about what is really going on. Based upon the price action, someone who didn't follow financial markets closely would conclude that everything must be great and equities are trading at all-time highs for fundamentally justified reasons. But that's not necessarily the case because what is really going on at this time is that investors are willing to pay a more expensive valuation today for the same level of earnings that the S&P 500 was providing over two years ago.

This is typically the case when you get into the late stages of a bull market and economic expansion. What is most worrying to me is that investors have pushed equity market valuations in this cycle to the second highest level in history – yep, we are beyond the levels that preceded the Great Depression and only trail the lofty levels that accompanied the Tech Bubble in the late 1990's. This puts uninformed investors into a bit of a quagmire as it becomes extremely difficult to not give in to the herd mentality that stocks will never go down and the business cycle has been abolished. Hence, I found myself torn between the emotions of humor and anger when hearing Jeremy Seigel during a CNBC interview on Friday justifying his view that the stock market could go higher from current levels because they haven't yet exceeded the valuation level they got to on one occasion in the entire history of the stock market.

Think about that for a moment – there is a very intelligent, informed, researched, and historically literate market aficionado choosing to focus his comments on what he would advise anyone who is watching to take away from his discussion that they should favor a 1 in 100 outcome (meaning stock prices moving materially higher from here) over a 99 in 100 outcome that over the next two to three years valuations and the stock market mean revert to historical averages.

The irony with Professor Seigel's upbeat outlook on the U.S. stock market was that in the same week Seth Klarman (considered one of the smartest and best money managers in history) struck a much more cautionary tone in his latest letter to clients where according to Business Insider in contrasting today to the start of the financial crisis, Klarman wrote:

> "When share prices are low, as they were in the fall of 2008 into early 2009, actual risk is usually quite muted while perception of risk is very high… By contrast, when securities prices are high, as

> they are today, the perception of risk is muted, but the risks to investors are quite elevated."

This concept of risk and the existence of it at the present time seems to be too easily disregarded (if not forgotten) by many of the talking heads in the media. Which is unfortunate because I imagine every one of them means well and wants the best for investors, but if it was that easy then wouldn't every investor be rich? What is easy to lose sight of at the height of an extended bull market is the memories of the tough times that investors must endure to experience the good times. It just so happens that in the 17.5 years that makeup this century investors have had to endure two occasions where the S&P 500 was cut in half and as a result it's easy to overlook the fact that since the S&P 500 peaked at

1,566 in March of 2000, the total gain on the index is just over +3% per annum.

I'm going to end this missive with yet another cautionary tone, not because I enjoy it (I don't, I actually long for the days of being a bubbling optimist…), but because I remain of the view that investors should continue to exercise prudence, discipline, and discretion. Play some defense, step up the quality in your portfolio, and continue to shift some of your risk capital into overseas markets which are at different parts of the economic expansion and equity bull market cycles where liquidity and cyclical tailwinds are more evident. This isn't to say these markets will be immune to developments in the U.S. economy and equity bull market, but you do have a more favorable margin of safety via cheaper valuations in these markets.

Here in the U.S. we are not only late into this economic cycle, but it appears more evident than at any time since the GFC that the Fed is going to push forward on this rate hiking cycle until something pops. This is typically the modus operandi for the Fed and what history would suggest when you consider that 10 of the last 13 Fed tightening cycles in the last six decades have ended with a recession. And while this rate hiking cycle seems to be tepid at this juncture considering the Fed has only hiked three times, and with Fed funds futures putting an 80% probability that they will hike for a fourth time in a couple weeks, investors have to consider the starting point of 0% which is where they have been for almost eight years.

The only reference point the history books offer for any semblance of a parallel for investors today is the 1930's. It's more than interesting that real GDP growth annualized at a little more than +1.3% over that decade – not that much lower than what the U.S. has experienced over the last 10 years with the one big exception that in the last 10 years we had to add about $10 trillion in additional debt to achieve the current growth levels.

In both periods, cyclical expansions followed deep economic downturns and in the case of the 30's the recovery was aided by the New Deal and in the current expansion we chose the path of unprecedented monetary policy accommodation. One of the main reasons the aftershocks of the '07 – '09 recession weren't nearly as severe as the Great Depression was because of all the social safety nets in place to help support those in need during this go around.

My intention in walking down History Lane is not to alarm anyone, but to attempt to learn from it and garner any knowledge it can provide to inform our investment decision making process at present. You see another difference between then and now is that the recovery from ’32 – ’37 was sharp and swift whereby the current recovery, while lacking in magnitude, has certainly made up for it in duration. However, with the recovery back in ’37 well into its fifth year the Fed decided to hike rates on the heels of what it interpreted as a durable recovery. What they underestimated is how deep balance sheet recessions can cut and the duration of time it takes for these recoveries to be fully established. As a result, all it took was a move in policy rates from zero to 50 basis points before the economy relapsed back into a recession.

This is a lesson that the current Fed is well versed in given former Chairmen Bernanke's molding of monetary policies used in this post-Financial Crisis era was based off of his work studying the Great Depression.

However, what no one yet knows (and we are sure to find out in the next couple of years) is how all of this ends. You see, it's easy to look back at the last eight years as an owner of financial assets and be emboldened to proclaim victory and applaud the Fed for their bold actions. Why this is more than a tad premature is because very little of the monetary policy experiment has been unwound at this time. It's not until more of this monetary punchbowl is taken away from the economy and capital markets that we will truly be able to evaluate whether this was just an illusion of a recovery or one that is self-sustaining.

This week will be sure to provide investors with a little more color on the health of the overall economy given it encompasses the first week of a new month and lots of data to decipher. Let me sign off this week's missive by sharing some wise words from the father of value investing, Benjamin Graham (with an assist from Mark Yusko as I lifted this quote from his presentation):

> "The best way to measure your investing success is not by whether you're beating the market but by whether you've put in place a financial plan and behavioral discipline that are likely to get you where you want to go. In the end, what matters isn't crossing the finish line before

anybody else but just making sure that you do cross it."

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