July 10th, 2017

The one constant throughout this cycle is changing its tune…

Last week’s data heavy economic calendar was the focus of most investors’ attention, and for the most part it painted a mixed picture on the health and sustainability of the U.S. expansion. The headline readings on the latest employment report looked good (the internals didn’t exactly pass the sniff test, but more on this later), the results from the latest ISM manufacturing survey suggests this sector is humming along (the corresponding Markit PMI report told a different story), and the auto sales data further validated that the peak in

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this segment of the economy occurred in Q4 of last year.

Nevertheless, there was something in the collective make-up of the data for the optimists and for those investors with a bullish risk asset outlook to maintain such a view, as well as for the skeptics who contend this expansion is not only long in the tooth, but the cracks in the foundation are starting to widen and become even more apparent. The action in the equity markets on the week was little changed with the Dow Jones Industrial Average moving up by +64 points, the S&P 500 adding on +2 points, the NASDAQ Composite +13, and the Russell 2000 Small Cap index ending the week virtually unchanged.

It gets lost in the shuffle with what has been one of the least volatile six-month periods in...
equity market history that the S&P 500 is little changed over the last four months – it first hit the 2,400 level on March 1st and closed last week at 2,425. One could make the case that this has been the pattern in the equity market over the last year where the S&P 500 pushes higher in an abrupt move and then spends a period of time consolidating and digesting at these higher levels before pushing ahead on the next leg up. Have a look back to Q3 2014 through Q2 2016 where the S&P 500 began that period at roughly 2,000 and ended the period just shy of 2,100 – in the interim it traded as low as 1,820 and as high as 2,132. It wasn’t until after the U.S. election that the S&P 500 broke out of the upper end of this range.

Which brings me to the narrative drift that has become so conveniently adopted and interchangeable since the election. Going into
the election there were subtle indications that reflationary undercurrents were afoot with commodity prices perking up (Oil, Copper, Iron Ore, and Steel) and then came the election results that sent these trends into hyper-drive. However, when this reflationary rally in many of these commodity prices stalled in February and then rolled over with Iron Ore and Oil, as two examples, having since entered bear markets (price declines of at least -20%) this narrative was conveniently forgotten in order to move on to the next storyline.

The next narrative was coined by market participants as the ‘Trump Trade’ where the benefits of deregulation, tax reform, and infrastructure spending were going to arrest this economy from the impediments that have been holding it back over the initial eight years of this expansion. Once again, as we’re
finding out, this narrative isn’t as iron clad as most investors initially thought as the repeal and replace of Obamacare appears to either be unlikely, will take much longer than most expected, or just be left behind so this administration can move on to other parts of its agenda. Have a look at the (not fake news) WSJ this morning, with a headline titled “GoP Rift Widens on Health as Senate Returns” on page A1 which in conjunction with John McCain coming right out over the weekend on Face the Nation saying “it’s probably going to be dead” puts any grand ambitions for tax reform into serious jeopardy.

Now it’s important to understand the difference between tax reform and tax cuts, with the former being much more impactful for the economy (a la what Reagan accomplished back in the mid 1980’s and the last time the U.S. had actual tax reform)
whereas tax cuts would have a much more muted positive impact (a la George W.’s tax cuts at the turn of the century). Why I point this out is that while on the surface it looks as though the legislative process appears to be little different between the gridlock that hindered much getting done in the last administration and having a Republican majority in both branches of Congress, I think it would be naïve to underestimate the growing desperation confronting this administration to get something constructive done. Should that be the case then tax cuts look to be as easy a policy path as any agenda item to get some consensus on getting a legislative victory on the board. The fact that the deficit is projected to widen much more than projected at the beginning of the year ($585 billion versus the recent CBO estimate of $693 billion) isn’t going to make their math any easier.
One other point that I think is worth mentioning is that the challenges confronting this administration are material and quite frankly inherited from previous administrations. I’m talking about all the way back to George W. Bush and following 9/11 which is when I believe the gradual deterioration in our global economic footprint on the foreign stage began. Couple this with the highest level of outstanding debt (public and private) in U.S. history. This wasn’t just created in the last six months, but came from years and years of can kicking and decision deferral into the next administration. Unfortunately, you have to play the hand you’re dealt and that is the case with this administration – there is no easy way out at this juncture and therefore in the annals of history they are likely to get more blame than
they deserve if it crumbles or not nearly enough credit if they succeed.

Getting back to the point on the ever-bouncing investment narrative: reflation, ‘Trump Trade’, earnings recovery, low interest rates (this is used as a justification for higher equity valuations), higher interest rates (yes, this too is used as a narrative under the theory that interest rates are going up for the right reasons as economic growth picks up), and I’m sure there are a couple that I’ve left off this list. The reality is that none of these narratives consistently fit the explanation for what has taken shape in the economy or the capital markets. The only constant throughout both the pre-election move in asset prices and the post-election move in asset prices has been the Fed and global central bank actions.
However, this narrative is in the midst of undergoing a material change with most of the major central banks around the world, led by the Fed, more adamantly communicating their intention to tighten monetary policy.

I think it’s best to think through this and lay it out in a big picture context while sprinkling in some of the more recent developments on the current economic data results.

The current economic expansion is closing in on being the second longest in the post WWII era (the below chart runs through year end 2016) moving into its 97th month in July, but what is also born out in the chart is that it has been the weakest expansion in the last seven decades.
And while there is a lot of truth behind the mantra that expansions don’t die of old age, they do lose the benefit of pent-up demand. Said a different way, during an economic recession consumers pull back and defer current spending and consumption as jobs are lost and net worth declines as asset prices fall. Eventually, the recession ends and confidence begins to rise as job growth picks up and then consumption follows as much of the pent-up demand that got stored up during the downturn begins to be unleashed, and that is
why you typically see the strongest part of any recovery take shape in the early stages of the next expansion. However, as you get this deep into an economic expansion you don’t have the built-up demand to provide that burst of activity that draws on inflated product inventory and then sets off a chain reaction of businesses needing to increase production to replace the sold inventory.

Many smart minds have made compelling presentations that this recovery followed the normal course of a business cycle in the first couple years after we emerged from the global financial crisis, but then as this expansion continued it began to differentiate itself from most of the economic expansions in the past. My view is that it is large part the result of unprecedented, untested, and experimental monetary policy employed by the Fed in which they focused on creating a wealth effect
through a rise in asset prices that would work its way through the economy. Here is what former Chair Ben Bernanke had to say in a Washington Post op-ed on November 4th 2010 about QE policies:

“This approach eased financial conditions in the past and, so far, looks to be effective again. Stock prices rose and long-term interest rates fell when investors began to anticipate this additional action. Easier financial conditions will promote economic growth. For example, lower mortgage rates will make housing more affordable and allow more homeowners to refinance. Lower corporate bond rates will encourage investment. And higher stock prices will boost consumer wealth and help increase confidence, which can also spur spending. Increased spending will lead to higher incomes and profits that, in a virtuous
Alright, it sounded good at the time and it was working as asset prices were recovering, interest rates were moving lower, and the economy was recovering. However, fast forward to today and while we’re no longer implementing $600 billion per year in QE we’re still doing QE to the tune of about $20 - $30 billion per month in reinvestment from the bonds on the Fed’s balance sheet that are maturing. And what’s more is that other central banks have joined in on the game with global central bank balance sheets nearly 5x larger than they were before the financial crisis.
Now we have a Fed that, like the flick of switch, in the last eight months has shifted their view that after repeatedly making the case over the last eight years that the economy, while improving, still needed an extremely accommodative level of monetary policy accommodation in the interest of targeting higher asset prices, to now a Fed that is becoming increasingly concerned about financial stability (interpret this as their way
of saying asset prices have moved too far beyond fundamentals).

Here is what Vice Chair Stanely Fischer had to say in a speech he delivered last month:

“Prices of risky assets have increased in most major asset markets in recent months even as risk-free rates also rose. In equity markets, price-to-earnings ratios now stand in the top quintiles of their historical distributions, while corporate bond spreads are near their post-crisis lows. Prices of commercial real estate (CRE) have grown faster than rents for some time, and measures of the amount of operating income relative to the sale price of commercial properties--the capitalization rate--have reached historical lows, suggesting continued pressures in the CRE market despite some tightening in credit.
conditions. Valuation pressures in single-family residential real estate markets appear, at most, modest, with price-to-rent ratios only slightly higher than their long-run trend.

The general rise in valuation pressures may be partly explained by a generally brighter economic outlook, but there are signs that risk appetite increased as well. For example, estimates of equity and bond risk premiums are at the lower end of their historical distributions, and, relative to some non-price-based measures of uncertainty, the implied volatility index VIX is particularly subdued. So far, the evidently high risk appetite has not lead to increased leverage across the financial system, but close monitoring is warranted.”
This speech was delivered on the same day that Fed Chair Janet Yellen remarked, “asset valuations are somewhat rich” and “some valuations look high. There is no uncertainty about that”. And as for good measure, San Francisco Fed President John Williams in a recent discussion came right out and said that the equity market “seems to be running very much on fumes”, and added that he is “somewhat concerned about the complacency in the market”.

Well let’s take a look at some valuation metrics to see if those that wanted to target higher asset prices may be on to something. Anyone who has been reading this missive over the last 18 months should be none too surprised that across an array of valuation metrics the U.S. stock market is one of the most expensive in its history. But in the interest of being thorough let’s run through a
few with some comparisons to prior market cycles.

U.S. stock Market Capitalization to GDP (a Warren Buffet favorite) – data via Larry McDonald from his Bear Traps Report Blog:

- 2017: 175%
- 2000’s: 119% (the all-time high was 181% in 1999)
- 1990’s: 112%
- 1980’s: 61%
- 1970’s: 45%
- 1960’s: 82%

What about on a Cyclically Adjusted P/E (CAPE ratio), only higher in 1929 and the 2000 Tech Bubble?
We can walk through a litany of other valuation metrics, and all of them would show you a similar picture – equity markets are rich relative to history on almost every metric. A valid and appropriate objection to rich valuation claims is that earnings are depressed after falling for five consecutive quarters (Q2 2015 – Q2 2016) and a further increase in earnings will cause valuations to compress. It’s a valid point, as earnings have recovered...
and look like they may continue to do so for another quarter or two, but the stock market did little more than flinch during the five quarters that earnings were in decline. For calendar year 2014, 2015, and 2016 S&P 500 operating earnings flat-lined at roughly $118/share and while the stock market roughly treaded water in 2014 – 2015 before rallying after the U.S. election in 2016, the S&P 500 has appreciated more than +20% while earnings have grown +4%.

What is often overlooked in the valuation discussion is the increased business risk on the part of corporations as their level of total indebtedness as a percentage of GDP sits at an all-time high.
Never mind the fact that the Return on Equity (ratio calculating how efficient companies are at turning out profits with their capital) for non-financial corporations is at 70-year lows.
What about other asset prices?

New homes are selling at their highest price tag in history while home ownership rates are plumbing multi-decade lows. The levitation of house prices has reached such a fever pitch back here in the Bay Area again that Google is buying modular homes for its employees to lure in talent that can’t afford to live in the area (Link to: Google buys 300 modular homes for Silicon Valley employees).

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Asset price inflation has even morphed its way into car prices with the average price tag of a new car eclipsing $35k at the end of 2016 versus an average price tag of approximately $28k in 2007. The latest loan and purchase price data for new and used cars in the June auto sales data aptly sums it up – the length of a new car loan is the longest in history, as is the level of the loan balance being taken out.
NEW-VEHICLE FINANCING TRENDS

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<th>June 2017</th>
<th>Change from June 2016</th>
<th>5-Year Change</th>
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<tr>
<td>Loan Term</td>
<td>69.3 months</td>
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<td>Amount Financed</td>
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<td>APR</td>
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<tr>
<td>Down Payment</td>
<td>$3,687</td>
<td>6.6%</td>
<td>11.7%</td>
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</table>

USED-VEHICLE FINANCING TRENDS

<table>
<thead>
<tr>
<th></th>
<th>June 2017</th>
<th>Change from June 2016</th>
<th>5-Year Change</th>
</tr>
</thead>
<tbody>
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<td>Loan Term</td>
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<td>Monthly Payment</td>
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<td>Amount Financed</td>
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<tr>
<td>APR</td>
<td>7.64%</td>
<td>2.7%</td>
<td>-5.4%</td>
</tr>
<tr>
<td>Down Payment</td>
<td>$2,453</td>
<td>7.1%</td>
<td>11.0%</td>
</tr>
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It doesn’t take a rocket scientist to see where this is going, and it’s not just asset prices, but medical costs and college tuition should be thrown into this schism as well – the ability to maintain the average standard of living is not keeping up with the rising cost of what in the present day are considered necessary.
These trends can go on for a little while, but unless wage earners are seeing a comparable increase in wages to keep up with these expenses then it cannot and will not be sustained. Take last week’s employment
report for example. The headline numbers looked great: +222k in new jobs created, revisions to the prior two months of +47k were solid, and the average workweek increased from 34.4 to 34.5 hours. The household employment survey, on the surface corroborated the establishment data with employment increasing +245k and the labor force grew +361k which argues that the unemployment ticking up to 4.4% from 4.3% was for good reason as more people entered the labor force.

However, the devil was in the details of this report as average hourly earnings came in below expectations at +0.2% m/m (consensus was at +0.3% m/m) which dropped the year-over-year reading to +2.5% (from +2.6% in May) not to mention that the prime working age cohort of men age 25-54 actually saw the level of employment here fall -21k in June.
after declining -92k in May. The big job gains in this report came from the 16-19 year old age bracket (+203k – think seasonal summer hiring) and folks aged 55 and up (+178k). Another goody in the report that requires a little more work than simply looking at the headline numbers is seeing the number of people taking on second jobs continuing to tick higher. This metric is up +5.2% over the last year which is a signal of stress and a notorious late cycle indicator as you don’t typically see households take a second job if they are getting enough income from their first job.

But I got more down into the weeds on the jobs report for this missive than I intended, so let me try and bring it back to a big picture perspective on the employment front. You see the one thing this economic expansion has not had any trouble with is turning out jobs as we
are in the longest period of continuous job growth in history. Yet when you look at the whole of this economic expansion in terms of job gains you see that full-time jobs have increased by 4 million from 2007 – 2017 (calendar year end 2007 is close to the peak of the last cycle) versus an increase in the population of +24 million. In 2007 the U.S. population was roughly 301 million with 122 million full-time workers versus today the U.S. has a population of roughly 325 million and 126 million full-time workers.

Call it what you will, and there are much sharper minds than mine that can provide a better explanation than me – be it automation, robotics, globalization… but it does help to explain why to so many this expansion has never felt like an expansion. It also provides context to just how deep and difficult it has been to work out of the Global Financial...
Crisis and helps explain why the rate of GDP growth over the past 10 years of 1.3% is on par with what the annualized GDP growth rate was for the economy during the decade of the 1930’s.

Let me try and pull this all together before this turns into a thesis paper rather than a weekly missive on what’s on my mind. The strong tailwind that was global central bank support for asset prices throughout the entire duration of this bull market and economic expansion appears to be changing. The clearest explanation for why the Fed is pivoting is because they now see financial stability risks superseding the lethargic economic growth environment. Data dependence, while not irrelevant, is no longer as relevant and the Fed is no longer worried about a weak quarter of growth here or there and all anyone needs to look at to come to that determination is the
growth rate the economy is trudging at for the first two quarters of the year. We got 1.4% GDP in Q1 (would have been almost stagnant if not for the large contribution from the pick-up in the energy sector ramping up production) and the latest estimates suggest Q2 GDP is expected to come in somewhere around 2.0 – 2.5% growth. That is right on par with what this economy has done for the better part of this entire cycle, but what needs to be considered is that we are on the back side of the peak level of activity in this expansion.

Therefore, reinvigorating an acceleration in growth is not an objective, nor would it be likely with the economy (according to the Fed’s calculus) at full employment, the auto sector having peaked and in the process of rolling over, housing looking as though it too has peaked and rolled over, and the same can
be said for the credit cycle and inflation. So, the economy aside, the following chart (in my opinion) explains more about the bull market in asset prices than any set of economic data you can fit to this cycle and it tracks the level of central bank asset purchases back to when QE began. As long as there has been an increasing flow of central bank asset purchases then asset prices have had little to worry about.
The one period where we did experience a sustained period of flattish / weak asset price appreciation was from mid-2014 to mid-2016 when global QE was contracting. It was the meaningful surge in monetary support that was injected into the system in February through the fall of last year that arrested the global economy out of the recession scare in early 2016. As with all monetary policy, this stimulus worked its way through the system with a lag and, in my opinion, was the driving force behind the reflationary rally we experienced in the back half of last year into early spring.

However, here we are in July and we can measure the extent to which China’s policy tightening that started last fall has filtered through the system. We also know that the ECB started tapering its QE policy by 25%
per month in April this year and is expected to announce in September a further reduction by the end of this year / beginning of next year. And then there is the Fed that is targeting the beginning of its balance sheet reduction process later this year.

China is also rolling over

Liquidity conditions have tightened dramatically in China and underlying data is weakening, despite headline growth numbers holding up.

*VARIANTPERCEPTION*

*Source: Bloomberg, Macrobond and Variant Perception*
In addition to the Fed reducing its balance sheet it is looking to implement one more rate hike later this year which would mark the fifth since December 2015 (the last three of which occurred since December 2016 and the economy has yet to fully experience their lagged impacts).

So, there you have it – we’re in an investment environment that has been dependent on the morphine drip of cheap money, abundant liquidity, and easy access to credit having to confront the withdrawal-like impacts of reduced medication. While this is an era of unprecedented monetary policies it’s not new that the Fed eventually pivots to focus on financial stability in the face of an asset bubble. They did it in 1987 which burst the stock market mania at that time. They did it in 1990 which crushed the commercial real estate market and set off a recession to boot.
Eventually the tightening during the 90’s ended with a popping of the Tech Bubble. And then again in the last cycle when the Fed over-stayed its welcome by keeping interest rates nailed at 1% for a year and tightened too slowly into a housing bubble before eventually popping it in what became the worst economic recession since the Great Depression.

I don’t pen this to come off as a fearmonger or alarmist, it is what it is and it has become part of the analysis that investors need to incorporate into their decision-making process. There is nothing to suggest that a collapse is imminent (there never is a bell that rings…), but unless the central banks (who have come out so vocally over the last six weeks) do an about face and walk back on what looks like a predetermined tightening path (the Fed did this last year when they
wanted to hike four times, but only ended up hiking once after the election) then investors should expect a choppier road ahead for asset prices.

The current environment is the antithesis of where we were in March of 2009 – that was the darkest of times for holders of financial assets and no one knew when it would end, but eventually it did.