



March 5th, 2018

Willing to have an open mind...

If you haven't noticed, the price action in capital markets this year is telling investors that times have changed and those longing for a return of the stable, steady-state, gradual ascent in asset prices that investors experienced last year need to recalibrate their thinking to recognize that uncertainty on several fronts is increasing and, as such, so is volatility. What uncertainties am I talking about?

1. **Fiscal Policy:** Last year investors chose to focus their attention squarely on all of the “good stuff” this administration was bringing to the table (i.e. deregulation and tax reform) and casually dismissed any of the bad stuff as just political rhetoric, thinking that the “bad stuff” (protectionism, immigration, and political dysfunction) would never come to fruition. Well, it looks like investors and prognosticators may have been a little too complacent in minimizing the potential risks that the “bad stuff” was just campaign lip service and that these policies would never see the light of day.
2. **Monetary Policy:** Markets are still trying to gauge whether new Fed Chair Jerome Powell will coddle the stock market in the same “kid glove” manner that his predecessors Bernanke and Yellen did before him. It's still early in his tenure but based upon his remarks at last week's testimony in front of Congress, Mr. Powell doesn't seem nearly as interested as his predecessors in wedding his policies to the performance of the stock market. He came right out and said that the recent correction in the stock market was a non-event in terms of policy, that the economy was on solid footing, fiscal stimulus should provide an additional tailwind going forward, and that he is more confident that the Fed will finally reach its inflation target. If anything, this leads me to believe the Fed is leaning more towards 4 rate hikes this year than the 3 hikes currently being priced in by markets.
3. **Inflation:** Look, I continue to adhere to the view that on a secular basis (long-term) the deflationary forces of aging demographics, over-indebtedness, and technological innovation will win out in driving inflation lower. However, one cannot overlook the broadening out of cyclical inflationary forces currently at play: lumber prices are up 40% over the past year, industrial metals prices are on fire with hot-rolled coiled steel up 32% YoY (and this is before the recent tariff announcement), soybean and wheat futures are up 9.5% and 13% respectively, not to mention an unemployment rate at 4.1%, initial jobless claims at their lowest level in 49 years, and a growing list of companies pointing out on quarterly conference calls that wage pressures are building. Add to this an output gap that has been closed for over 6 months now, and capacity utilization rates that are nearing cycle highs and you have yourself a fairly toxic cocktail to inflame near-term inflationary forces.

4. Interest Rates: What I'm really getting at here is the risk higher interest rates pose to an equity market that at its January 26th high was trading at an 18-year high forward P/E ratio of 18.4 (and that included the earnings bump from the lower corporate tax rate). I can still hear the talking heads on bubblevision lamenting on and on about how equity valuations – which have only ever traded at higher valuations 5% of the time in the history of markets – were justified due to the low interest rate backdrop. With a 1- and 2-year T-Note now donning an interest rate north of 2%, it's reasonable for investors to at least consider that the TINA (There Is No Alternative) philosophy may have some competition. This rise in interest rates is broadening out beyond just U.S. Treasuries with the three-month Libor rate pushing above 2% for the first time since 2008. Perhaps many of you aren't too familiar with Libor, but it is the rate that more than \$350 trillion of debt and derivatives contracts are priced off of, so with this moving up to nine-year highs it suggests that liquidity problems within the plumbing of the financial system may be coming our way. As the chart below shows, we're talking about interest rate levels on 1-year and 3-month debt instruments that have increased roughly threefold since 2016 (with a big jump coming in just the last six months):



Here is what Larry McDonald, author of the very insightful Bear Traps Report, thinks of the move:

*“The surge in three-month Libor matters because the entire ecosystem of U.S. short-term corporate finance is being repriced. The Street is finally waking up to credit risk tied to rising rates. In recent months we’ve warned, at the current pace of spending in Washington – a year from now we’re looking at quarterly Treasury auctions in the neighborhood of \$23B – \$26B for long bonds vs. \$13-\$15B now. **But above all, we must keep our eye on short-term, adjustable rate corporate finance.**”*

What I'm getting at with all of this is that there is no free lunch in this business. Over the last eight years since the GFC ended the entire global financial system has become accustomed to low interest rates, stable but positive economic growth, and predictable fiscal and monetary policy that went out of their way to not upset stability. It was these policies that enabled some of the unintended consequences that will challenge us

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all going forward, such as an ever-increasing debt load where the overriding decision variable for taking on more debt was whether it fit into a company's or household's ability to service the payment stream – very little thought (if any) went into actually having to pay off the liability at some point.

Looking forward over the next 2-3 years shows a corporate refunding calendar where a huge amount of debt will need to be rolled over at higher rates than when the debt was last refinanced. This refinancing will be occurring at a time where half of the investment grade bond market in the U.S. is BBB rated (that is the lowest rung on the investment grade credit ladder). What investors haven't experienced yet (but likely isn't too far out into the future) is a widening in credit spreads which will kick-off a rise in delinquencies and a tightening in financial conditions which will ultimately spill over into equity valuations. This is how cycles behave, and this is what will be a challenge to those that continue to adhere to the "buy every dip" playbook of yesteryear. That playbook needs to be put back on the shelf to be referenced again some time down the road when we move into the early stages of the next expansion.

The interview transcript of legendary investor Paul Tudor Jones by Allison Nathan of Goldman Sachs is a must read ([Link to: Paul Tudor Jones Warns The Fed Is About To Lose Control](#)) in which Mr. Jones summarizes in a most colorful fashion the predicament newly appointed Fed Chair Jerome Powell finds himself in going forward:

Paul Tudor Jones: Let me describe to you where I think Jerome Powell is right now as he takes the reins at the Fed. I would liken Powell to General George Custer before the Battle of the Little Bighorn, looking down at an array of menacing warriors. On the left side of the battlefield are the Stocks—the S&P 500s, the Russells, and the NASDAQs—which have grown, relative to the economy, to their largest point not just in US history, but in world history. They have generally been held at bay and well-behaved, but they are just spoiling to show their true color: two-way volatility. They gave you a taste of that in early February. Look to the middle and there waits the army of Corporate Credit, which is also larger than ever relative to the economy, as ultra-low rates have encouraged it to gain in size, stature, and strength. This army is a little more docile right now, but we know its history, and it can be deadly when stressed. And then on the right are the Foreign Currency Fighters, along with the Crypto Tribe, an alternative store of value that only exists because of the games central banks are playing; the opportunity cost of Crypto is so low, why not own some? The Foreign Currency Fighters have strengthened by 10% over the past year. Compounding the problem, they have a powerful, ascending leader, the renminbi, to challenge the US dollar's hegemony as the reserve currency. All of these forces have been drawn to the battlefield because of our policy experiment with sustained negative real rates.

So Powell looks behind him to retreat. But standing there is none other than Inflation Nation, led by the fiercest warmongers of them all: the Commodities. He might take comfort that he is not alone on the battlefield. But then he looks over at the Washington, DC, fiscal battalion and realizes they are drunk on 5% deficit beer. That's what Powell is facing, whether he recognizes it or not. And how he navigates this is going to be fascinating to watch.

What also caught my eye over the weekend was an article from The Mercury News, titled “[Sunnyvale Home Shatters Record With Enormous Price Tag](#)”. For those of you who aren’t familiar with Sunnyvale, it’s a suburb outside of Silicon Valley (traditionally less expensive than the neighboring cities of Cupertino and Palo Alto) that has seen property prices skyrocket as this article goes on to point out; where a two bedroom, two bath, 848 square foot home recently sold in two days for \$2 million. It was originally listed for \$1.45 million, so the final sales price was \$550k above the asking price and put this sale in the record books as the most expensive per square foot (\$2,358) home sale ever recorded in Sunnyvale. We’re told to never judge a book by its cover, but for those of us that do the occasional window shopping, here is a look at what the buyer got for their \$2 million:



If only there were signs of excess somewhere...

The step-up in volatility this year is the market’s way of suggesting that we are in a new regime, one that argues for “selling the rips” and selectively “buying the dips”. Look around and tell me what you see? I see an economy that is growing but nearing the end of its rope in terms of being able to accommodate additional supply-side stimulus (a.k.a. large scale fiscal spending). I see a corporate earnings backdrop that is beyond solid, but that is akin to driving by looking through the rear-view mirror when you consider that 90% of this year’s growth in earnings expectations comes from the boost of a lower tax rate, implying that only 10% of the earnings growth is coming from organic sources. Up until recently I would have also put on this list that I see signs of synchronized global growth, which to be fair is still ongoing, but the bloom has come off this rose of late. It’s not that synchronized global growth is no longer occurring (it is), but the rate of change (that is, the second derivative) suggests that this trend is rolling over. So, it looks as though this trend in global growth is peaking out, and to be fair we’re still looking at data points that on an absolute basis are high, which suggests that should they continue to roll over there is a long way to go before they hit levels of concern.

I see plenty of things that give me pause – tariffs, the potential for a retaliatory trade-war, massive twin deficits, a weak dollar relative to other currencies, rising geopolitical tension, a new and unproven Fed Chair, cyclical inflationary pressures, and rising interest rates, to name a few.

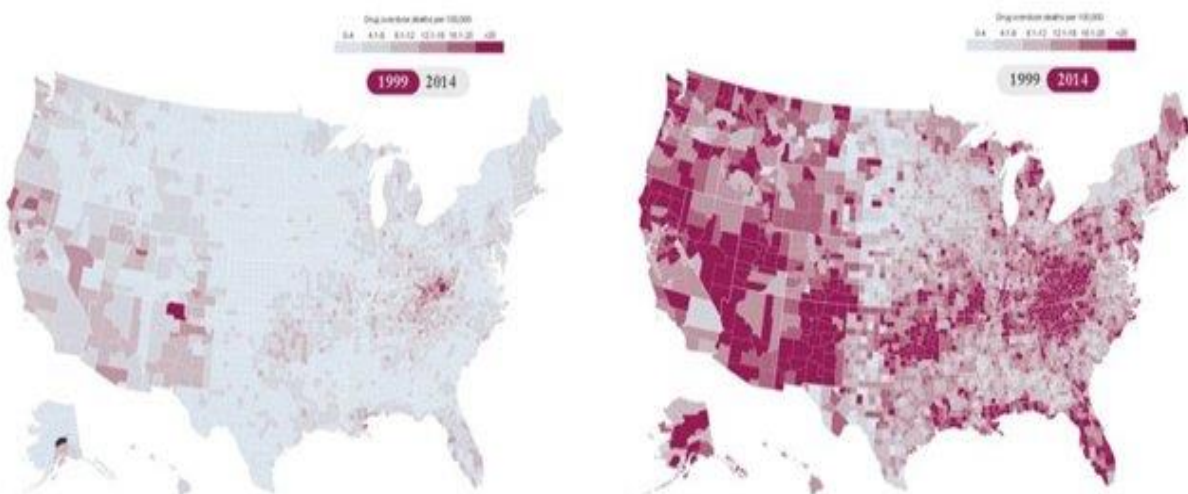
Add it all up and I am of the opinion that the mosaic of data points towards a stock market that is very much undeserving of a premium multiple any longer. However, it's worth noting that since this correction began in early February, the stock market has been trading very technically according to key Fibonacci levels. With that being said, it would be reasonable to expect a move in the S&P 500 up to the 2,735 area before some stiff resistance comes into play. Should the S&P be unable to move above this level and retain those gains for a couple days, then it would become highly likely that we revisit the February lows. Should we revisit those lows, it's also likely that we take out those levels and ultimately trade down to the 2,450 level. A deeper dive into the arithmetic shows that this correction may not be fully completed until 2,322 is hit on the S&P 500.

As they say, forewarned is forearmed. Anyone who has been de-risking their portfolio while stockpiling some cash and getting their shopping list ready should be prepared to start putting some of that capital to work below the 2,500 level on the S&P 500 and get more aggressive with buy tickets in the low 2,400's.

I've purposely refrained from jumping into the ring on the debate over the recent tariff announcements by the Trump Administration. Economics 101 and history both are pretty clear on this front in that tariffs benefit the few to the detriment of the many. However, I'm also of the view that the global financial system (the U.S. in particular) is approaching a critical juncture in which the status quo, where the U.S. has carried the "exorbitant privilege" of being the world's reserve currency, is approaching its expiration date. Since the U.S. took on the role of the world's reserve currency from the Brit's back in the early 1940's, the global financial system has evolved to accentuate and deepen this arrangement. Over the years (and in particular over the last three decades) this relationship has hinged on the rest of the world supplying goods to the largest consumption bucket on earth (the U.S.) in exchange for the U.S. supplying our trading partners with paper money.

In its simplest form, we swapped our industrialized system, which was transitioning to a consumption lead system, for goods produced by the lowest cost provider ([See: Sir James Goldsmith's prophetic interview with Charlie Rose back in 1994](#)). After all, we had some of the highest income per capita and wealth per capita levels in the world, so it made sense to take advantage of the set-up to import the cheapest goods to feed our consumption demand.

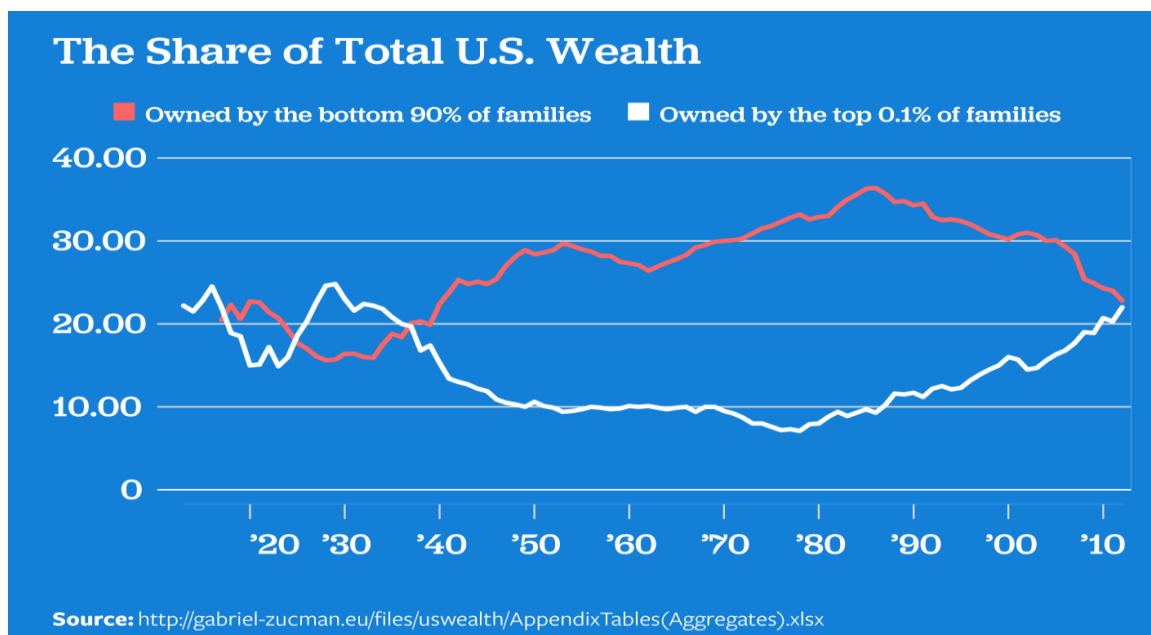
However, when I see charts like the one below that shows on the left-hand side the number of drug overdoses in the U.S. in 1999 vs. the map on the right-hand side in 2014, it raises more questions than answers for me.



<https://www.theguardian.com/society/ng-interactive/2016/may/25/opioid-epidemic-overdose-deaths-map>

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Couple this troubling trend in the exponential rise in drug overdoses with inequality in the U.S. reaching its most extreme level since the 1930's, and once again I'm left with more questions than answers.



I'm not at all suggesting that tariffs, protectionism, anti-immigration, and a push towards reversing globalization are a solution to these issues, but it's become more difficult to deny that the system we have today is not benefitting everyone.

Don't confuse my lack of being able to get my head around this issue with adamant support for the path this administration is going down, and I'm by no means a raving fan of President Trump, but at some point we all have to look at each other and acknowledge that there is a reason that populism is growing around the globe. There is a reason that Donald Trump won the U.S. election – one thing that's becoming more obvious though, is that it wasn't Russia. Perhaps the explanation for this outcome can be as shallow as saying it was only because of his ability to sell voters on the promise of a better future – a message which they have so passionately yearned to hear from someone for far too long. Whether he is able to deliver that outcome is a completely different question, but once again I am finding it more difficult to just go along with what the textbooks say about globalization being good for everyone when we have a fair amount of first hand evidence that suggests it may not be as simple as that.

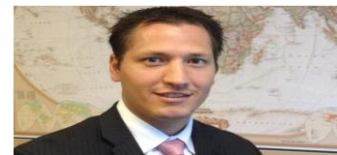
Look, I know I'm fumbling around on this issue, but I guess all I'm really getting at is that I'm willing to entertain this debate with a bit more of an open mind than perhaps would have been the case a decade ago. What is more important as a society and an economy is that it becomes more widely recognized that what exists today needs to be viewed with some fresh eyes and an unbiased disposition. Perhaps not assuming that what was should always be is the best step forward towards a sustainable solution.

After all, would it really be all that bad if the U.S. was able to reindustrialize itself? Don't get too carried away here as I'm not talking about ramping up coal burning plants and abrogating the progress the U.S. has made towards a more respectful view of the environment and what we leave behind for future generations, but more so reclaiming some of our lost manufacturing prowess and the societal benefits that accompany it. After all, we have the technology and the human capital to do so – what we've lacked is the vision and incentive to get ourselves back into the competition.

My hope would be that this administration has worked through a long-term strategy to contemplate the impacts of the choices they are making today. Because this is a strategy that, to be a long-term success, would need to be able to be built upon and carried out by administrations beyond just this one. Should a strategic, well thought-out, and applicable reindustrializing of the U.S. system show measurable societal benefits outweighing the costs, I would gladly trade some short-term pain that would come with such a transition of this magnitude for the potential long-term benefit that it very well could procure. What worries me, though, is that we are more than a year into this administration's term and we have witnessed little evidence to suggest that strategic long-term thinking is a major strength of this leadership team. If that proves to be the case, where this protectionist policy is just a collection of half-measures so they can check a box on their campaign promises for the Trump base, then there is legitimate reason to worry about both the short and long-term consequences of these actions.



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