
**March 19th, 2018**

# Follow the bread crumbs…

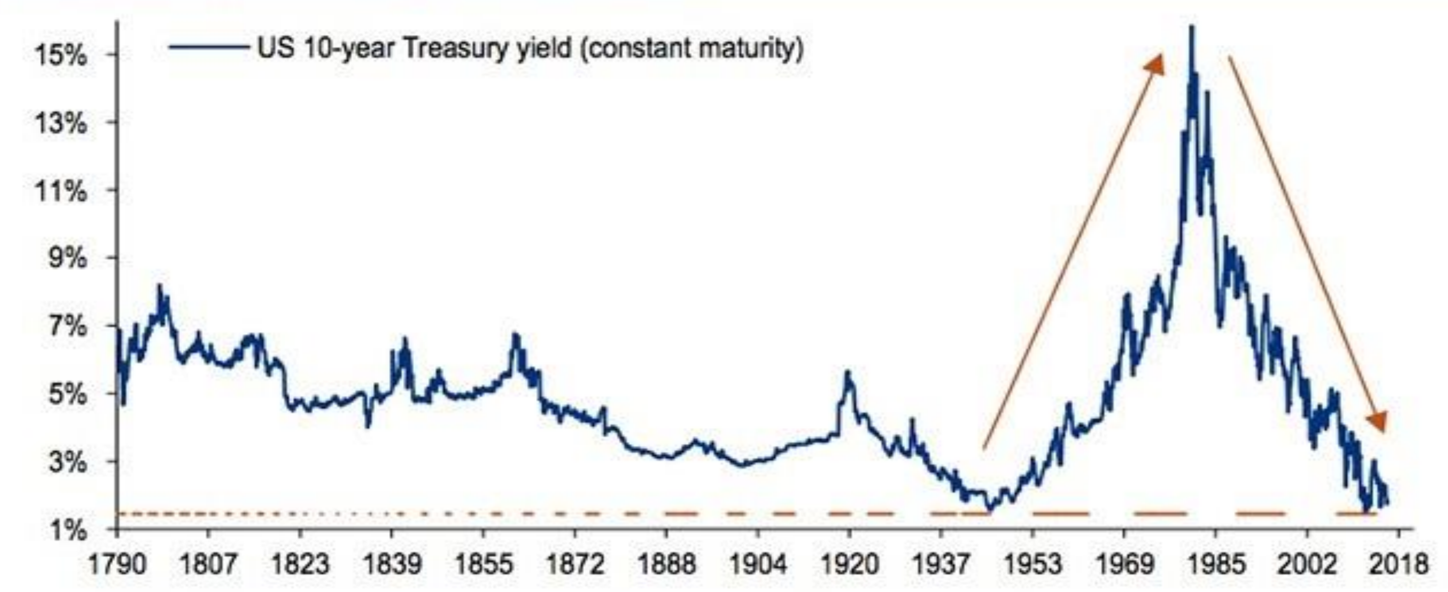
You often see me reference in these missives the sage words of Robert Farrell, who held the post of Chief Stock Market Analyst at Merrill Lynch for 25 years. Perhaps my regard for his investment principles stems from the origins of my career at Merrill Lynch, where his understanding, respect, and command of capital market dynamics helped bridge the gap between academic financial theory and real life practical application. To this day, Mr. Farrell retains his well-earned reputation as a Wall Street Legend and is bestowed in some circles with the title of the dean of stock market research.  As you may have already surmised, the reason for this prelude to Mr. Farrell is because I'm going to revisit another piece of sage advice he proffered years ago that I believe is quite pertinent today:

> *"Change of a long-term secular nature is usually gradual enough that it is obscured by the noise caused by short-term volatility.  By the time secular trends are even acknowledged by the majority they are generally obvious and mature.  In the early stages of a new secular paradigm, therefore, most are conditioned to hear only the short-term noise they have been conditioned to respond to by the prior existing secular condition.  Moreover, in a shift of secular or long-term significance, the markets will be adapting to a new set of rules while most market participants will be still playing by the old rules."*

A couple things come to mind when contemplating this abstract thought with capital markets today: Interest rates, and outstanding debt levels.

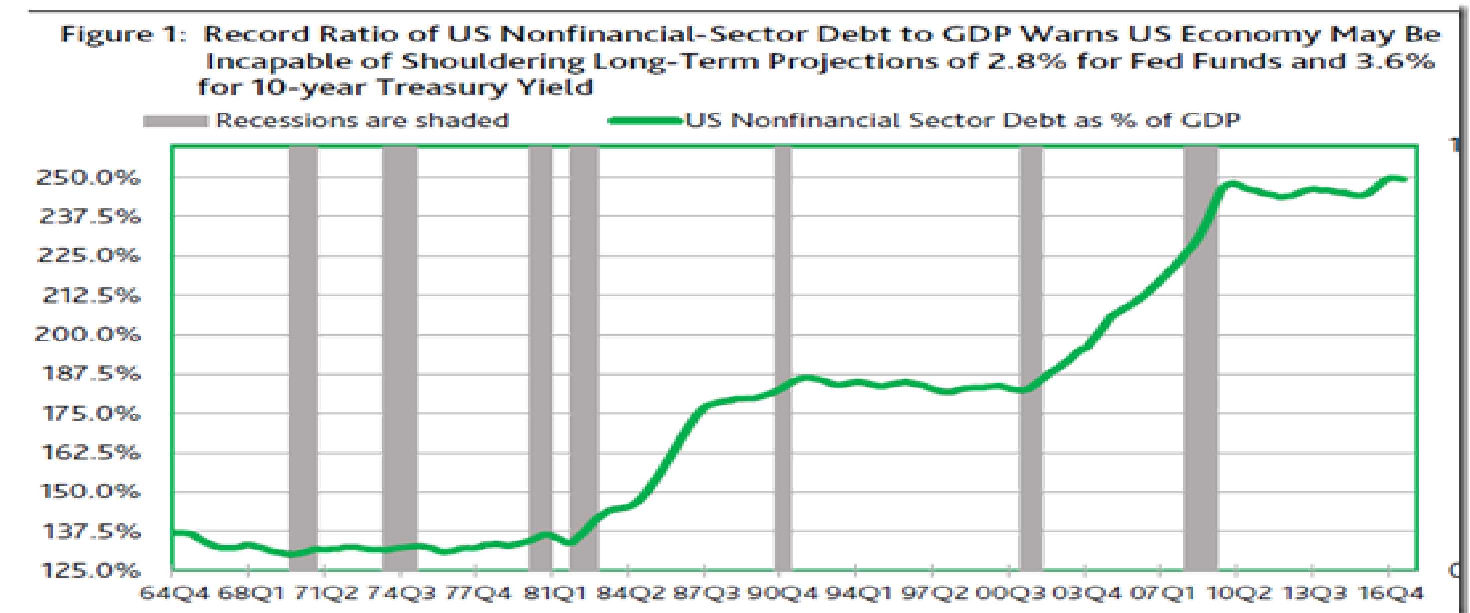
It should be no surprise to investors that in July of 2016 global interest rates reached their lowest levels in recorded history.  That in and of itself is saying something, but contextualizing this development using the last six or seven decades is more insightful and relevant for investors today.

**Chart 8: The Lowest US Bond yields since WW2**




Source: BofA Merrill Lynch Global Investment Strategy, Global Financial Data, Bloomberg. Monthly data

Marry the precipitous decline in U.S. interest rates since they peaked in 1981 with the increase in total non-financial debt outstanding, and you have on your hands a rather complex dynamic with a plethora of unknown outcomes and very little wiggle room for error.




I know these two charts don't exactly line up on the time scale, but what is obvious from the debt-to-GDP chart above is the methodic, gradual, and persistent growth in debt relative to the size of the economy from the time interest rates peaked in the early ‘80’s to the present day.

All of which highlights the dilemma challenging investment decisions going forward in regards to whether we are in fact nearing an inflection point that no investor has experienced since the ‘60’s and ‘70’s. I caution anyone against extrapolating the rise in rates from their post-WWII lows into the early 1980’s with the current environment because simple math indicates that such a rise is not possible without bankrupting the entire financial system. But what is worth pondering and what markets are having a difficult time digesting at the current time is the more aggressive rise in interest rates since last September, and at what level of interest rates is too much before equity markets need to be repriced meaningfully lower?

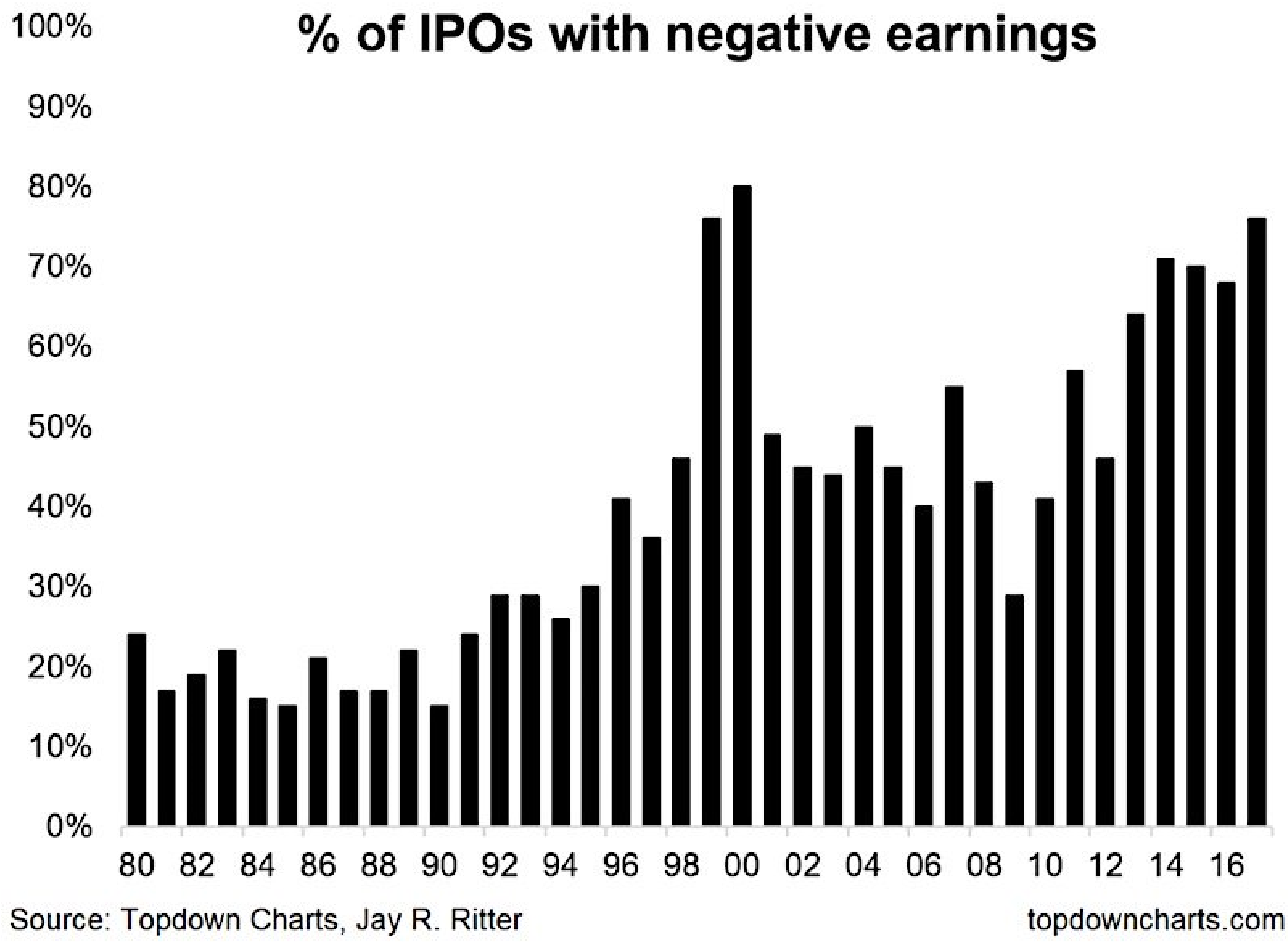
This is the big picture conundrum markets are wrestling with this year which has given rise to the steep increase in volatility, a narrowing of market leadership, and broadening stress signals in credit markets. But what makes the price action in the capital markets over the last six weeks especially interesting is that you're not seeing your typical 'flight to safety' reaction function as has typically been the case in risk-off episodes. Today's price action is a perfect illustration: As I type this, the Dow Jones Industrial Average is down 400 points, the S&P 500 is off 50 handles, the Nasdaq is off nearly 2.5%, and yet the US dollar is down 0.5% and Treasury bonds are on either side of unchanged. The fact that the U.S. dollar (the world's reserve currency) and U.S. Treasury bonds (the world's reserve asset) aren't experiencing an influx of capital in a typical flight to safety bid during such a risk-off day is atypical behavior relative to market history.

It perks my curiosity and is worth pondering the wise words of Mr. Farrell as to whether or not we are in the early stages of a new secular paradigm shift?  Where interest rates and debt levels are today suggests that the table is set for such a shift to evolve, but only time and hindsight will tell whether this turns out to be the case.  Nevertheless, me thinks investors should be respectful of the message Mr. Market is sending with the heightened level of volatility and erratic swings in stock prices. Heed the message from battle tested practitioners like Mr. Farrell and fade the "nothing to see here, nothing to worry about, everything is awesome" groupthink populating the TV screen on bubblevision.

This market hasn't been driven by fundamentals for some time now, and of late it seems to be completely driven by technicals. It's not an accident that the S&P 500 rallied up to 2,800 last week and couldn't make any further progress beyond that point, because that level represented a perfect 78.2% Fibonacci retracement from the intra-day low posted on February 9th. If the technicals continue to dictate the price action (and there is little reason at this point to think this won't be the case), then it's likely that we've already reached the high point of this rally (perhaps we could have one more levitation into the 2,810 – 2,820 level) and what comes next is a retest of the correction lows, if not a push to lower lows into the 2,400 level on the S&P 500.

Add another check mark to the growing list of data points flashing late cycle signals. The

WSJ recently ran an article using data compiled by professor Jay R. Ritter from University of Florida where his work found that 76% of the companies going public in 2017 had trailing 12-month earnings per share that were negative.  This is the highest percentage of companies to go public with no profits since… drum roll… you guessed it – 2000!



Keep in mind this is a coincident indicator and makes all the sense in the world for the founders of these companies to take advantage of an amicable marketplace to issue equity to the public.  It is also noteworthy to be aware that the peak readings in this data series in the last two expansions (‘99/’00 and ’07) coincided with the bull market highs for those cycles.  It will be interesting to follow how this trend evolves going forward.

As for the economy, it continues to be a mixed bag and the data last week didn’t build on the positive tone of the February payroll report. Contrary to the consensus narrative coming into this year, the U.S. economy is showing little evidence that it is on the cusp of a sustainable acceleration in growth.  Yes, the economy managed to put up two consecutive quarters of 3% GDP growth in Q2 and Q3 of last year, and then followed that up with a not too shabby +2.6% growth print in Q4. However, Q1 looks to be off to a rather weak start with the Atlanta Fed recently cutting their Q1 real GDP growth estimate to 1.8%, which is a far cry from the 5.4% estimate the consensus wash gushing over at the start of the quarter.  In all fairness this is notoriously the case with their model and for anyone who has taken the time to read their methodology on the website, they would understand this to be the case.

Last week's retail sales data put an exclamation point on the soft underbelly of the household consumer and really undermined the perceived strength in the February payroll report.  Retail sales declined for the third straight month in February and on a price-adjusted basis the annualized rate of contraction over the past three months is

-4.4%.  This is the weakest reading in nearly six years, and it's just a flat out tough number to square with payrolls putting up a +313k print and consumer confidence checking in near cycle highs.  One thing to consider with regards to consumer confidence is that it's a lagging indicator in that it peaks just prior to when a recession begins and troughs just as the next expansion is set to get underway.

There were some other interesting morsels in the retail sales report, like grocery store sales receipts dropping for the second consecutive month and pharmacy sales down for the fourth consecutive month.  It makes you wonder what is going on when you see necessity type purchases decline for a sustained period of time, whereby the declining trend in YoY nominal restaurant receipts (considered to be a much more discretionary expense) over the last three years (+8.6% in Feb. '15, +7.8% in

Feb. ’16, +3.6% in Feb. ’17, to +2.7% in Feb. ’18) is quite indicative of a consumer that is much more thrifty with their spending.

One theme the economic optimists hang their hat on is the upcoming positive impact from the tax cuts and other stimulative fiscal policy measures.  I won’t argue with this point in regards to the potential short-term bump they could provide over the next couple of quarters. However, my base case expectation is that any potential bump will be quickly forgotten as we move into the end of the year when reality begins to set in, in that the tightening impact of the Fed removing the punchbowl is a much more dominant economic force.  Same story goes for the jump in corporate profits from last year to this year, but once we get into the third quarter and analysts start to update their models for 2019 earnings, they will be penciling in growth rates that are handsomely receding.

The one thing we all will be left with following the sugar rush of this fiscal agenda is the historical hard evidence that tax cuts don't pay for themselves, especially when government spending is mushrooming higher. The U.S. is at a point that the deficits are swelling to such an extent that the Treasury is now considering issuing short-term T-bills to alleviate the pressure across the curve.  The weak bid-to-cover ratios in the recent Treasury auctions say it all, in that finding buyers for the debt of the largest economy in the world is not nearly as easy as it used to be.  Don't get me wrong – it's not as if many parts of the world are in any better position than the U.S., but none of these other regions find themselves holding the exorbitant privilege of being the world's reserve currency issuer.

Hence, we've relied upon the rest of the world funding our debts for so long that it's made us somewhat vulnerable should they chose to back off at the margin in their Treasury purchases.

This vulnerability is especially challenging with this administration moving forward on the protectionist side of its agenda. Closing the capital account surplus and reducing the current account deficit at the same time as you're running fiscal deficits to unprecedented levels is a surefire recipe to exert pressure on interest rates moving higher.

You can't borrow your way to prosperity – heaven knows many have tried, but it just isn't sustainable. I came across a really interesting piece of research from Peter Cook of Real Investment Advice where he mapped the annual and cumulative change in GDP over the last decade versus the annual and cumulative change in Treasury Debt Outstanding (TDO). What he was getting at is that in the calculation of GDP by the Bureau of Economic Analysis (BEA), government spending is counted as a positive contributor to economic output. It doesn't matter whether government spending is funded by incoming tax receipts or if it is funded by issuing additional debt, it's all the same in regards to GDP accounting. The below excerpt summarizes his findings:

> *"Because deficit spending is additive in the calculation of GDP, it makes sense to compare the amount of deficit spending to the amount of GDP growth produced each year. The first four columns in the table below show the annual GDP, the annual dollar change of GDP, the total amount of Treasury debt outstanding (TDO) and the*

*annual dollar change of TDO. Comparing the second and fourth columns, it is easy to see that the annual increases in TDO regularly exceed the increases in GDP.*

| | Nominal GDP | $ Change GDP | TDO | $ Change TDO | Chg. TDO as % of GDP Growth |
|---|---|---|---|---|---|
| 2007 | 14,685 | | 9,229 | | |
| 2008 | 14,550 | (135) | 10,699 | 1,470 | n/a |
| 2009 | 14,567 | 17 | 12,311 | 1,612 | 9733% |
| 2010 | 15,230 | 664 | 14,025 | 1,714 | 258% |
| 2011 | 15,785 | 555 | 15,222 | 1,197 | 216% |
| 2012 | 16,297 | 512 | 16,432 | 1,210 | 236% |
| 2013 | 17,000 | 703 | 17,156 | 724 | 103% |
| 2014 | 17,736 | 736 | 18,141 | 985 | 134% |
| 2015 | 18,287 | 551 | 18,922 | 781 | 142% |
| 2016 | 18,906 | 618 | 19,976 | 1,054 | 170% |
| 2017 | 19,736 | 831 | 20,492 | 516 | 62% |
| Totals | 182,780 | 5,051 | 172,605 | 11,263 | 223% |

*The final column to the right shows the increase in TDO as a percentage of the annual change in GDP growth. When the ratio is greater than 100%, the increase in TDO is responsible for more than 100% of annual GDP growth. The annual increase* *in TDO exceeded annual GDP growth in each of the years from 2008-2016. The only year in which annual GDP growth was greater than the increase in TDO was in 2017, possibly due to the debt ceiling caps, which have now been lifted.*

*The cumulative figures are even more disturbing. From 2008-2017, GDP grew by $5.051 trillion, from $14.55 trillion to $19.74 trillion. During that same period, the increase in TDO totaled $11.26 trillion.* ***In other words, for each dollar of deficit spending, the economy grew by less than 50 cents.*** *Or, put another way, had the federal government not borrowed and spent the $11.263 trillion, GDP today would be significantly smaller than it is.*

As odd as this economic and bull market cycle has been at times, there remain a number of characteristics it has in common with previous cycles. The one that stands out the most is the Fed once again overstaying their welcome with accommodative policy. Just like in the late '90's with Tech Stocks and in '05 – '07 with Real Estate and Credit, the Fed has engineered another asset bubble in their quest to create a wealth effect and generate consumer inflation. We're only now getting the late cycle inflationary pick-up, but asset inflation has been around for some time now. Just like any good risk manager, the Fed is assessing the situation and evaluating scenarios to gently let the air out of the balloon, but they are far too smart to not know they are playing with fire.

Yes folks, the current paradigm is complicated and I know the picture I'm painting doesn't look too rosy, but ignoring it doesn't make it go away. In hindsight, that was the story for

2017 where anything and everything that happened received the benefit of the doubt as being universally bullish. Tax cuts, deregulation, corporate profits, muted profit margin pressures, synchronized global growth, moderate inflation, subdued commodity prices, accommodative monetary policy, and ample central bank liquidity – the train has left the station on all of these fronts, be it they are in the rearview mirror or they are in the midst of going from a tailwind to a headwind, which means it's time to adjust accordingly. Take a look at equity markets around the globe and it's hard to definitively conclude that the synchronized global growth story still has the same verve that it had a short three months ago, with global equity markets rolling over: German DAX -5.4% year-to-date, French CAC -1.7% ytd, Japan's Nikkei 225 -5.6% ytd, China's Shanghai Composite -0.85% ytd, and India's SENSEX -7% ytd. Those investors who haven't taken action to rebalance and de-risk their portfolios (raise cash and lower beta) should use this recent bounce as an opportune time to do just that.

**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.