



October 8th, 2018

A time for thought and reflection...

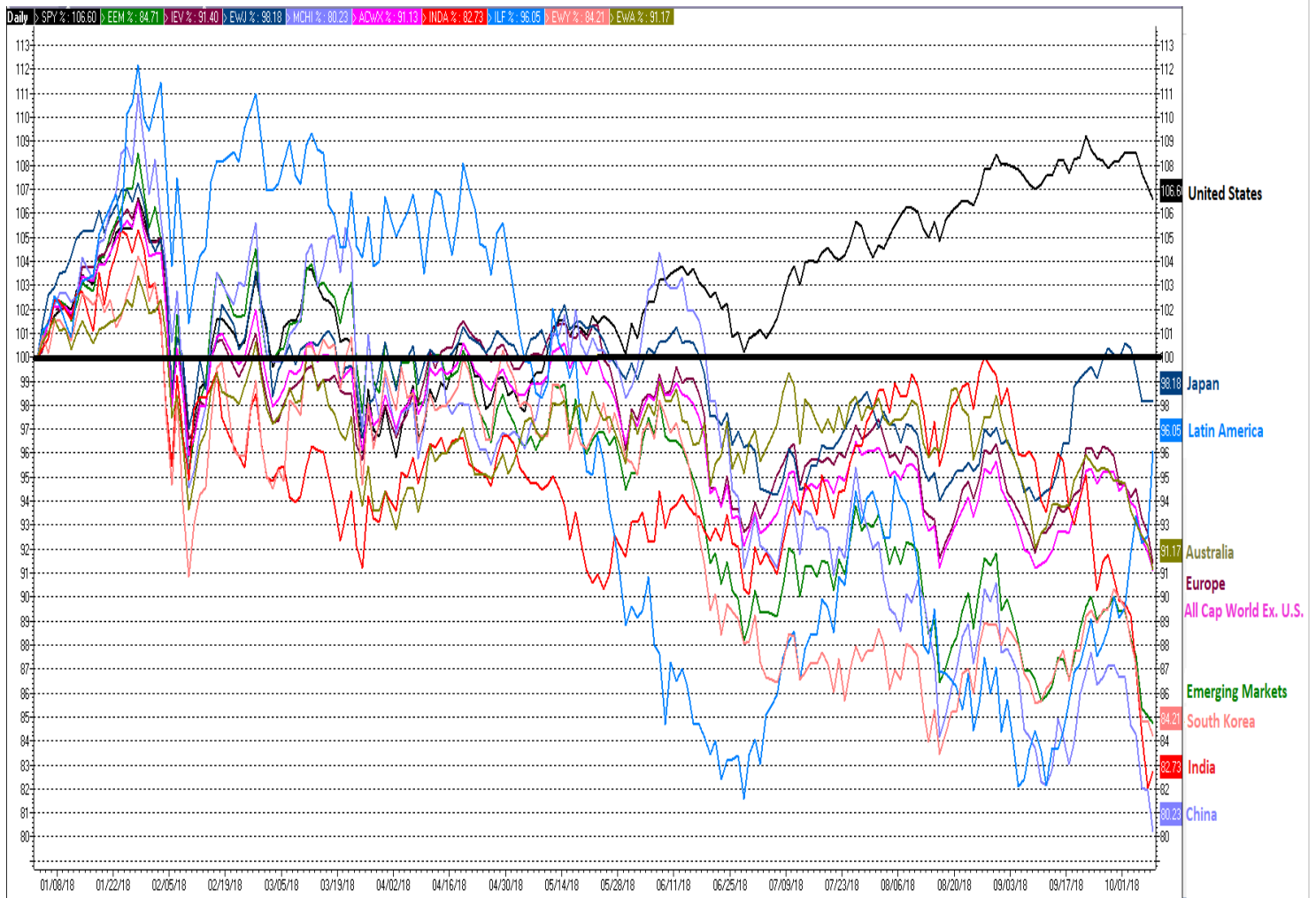
Since the volatility blow-up at the end of January that sent the S&P 500 down more than -12% over five trading days, I've maintained the view that capital markets are in a state of transition from a near 10-year period of cheap money and excess liquidity to a backdrop with a rising cost of capital and constrained liquidity. Former Merrill Lynch Chief Stock Market Analyst, Robert Farrell, best sums up such a phase transition:

“Change of a long-term trend 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 condition. Moreover, in a shift of 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.”

The price action in capital markets last week was the latest reminder to investors that a change of character is afoot. On the surface the Dow Jones Industrial Average declined a measly 11 points, the S&P 500 gave back 28 points (-1%), and the NYSE Composite declined 90 points (-0.7%) – none of which stands out as anything more than casting a pebble into the ocean. But those big, liquid markets were safe havens compared to the more risk oriented, high growth areas of the market that performance chasing investors have been piling into for years, such as: the Nasdaq Composite -3.2% on the week, Russell 2000 Small Cap Index -3.8%, the S&P 400 Mid Cap Index -2.55%, and Emerging Markets down -4.85%. Even more worrisome and, in my opinion, the culprit for this downside volatility in equity prices, was the spike higher in interest rates across the yield curve. A couple weeks ago I penned a missive drawing attention to the rising cost of money in which interest rates on the 10-year and 30-year Treasury bonds were flirting with breaking above multi-decade downtrend channels. These levels were pierced to the upside last week with the 10-year Treasury ending the week at 3.23% and the 30-year at 3.40% – the highest closing levels since 2011 and 2014, respectively.

So not only did the growth sectors of the stock market take it on the chin last week with this material break higher in interest rates, but so too did various segments of the bond market – the supposed conservative part of a diversified investor's portfolio. Intermediate-Term Treasury bonds (7 – 10-year maturities) were off -1.4% on the week, Long-Term Treasuries (20+ years) declined -3.61%, the Investment Grade Corporate Bond Index fell -1.73%, High Yield bond index -1.32%, and the broad-based Vanguard Total Bond Market Index lost -1.18% on the week.

What will perhaps surprise most investors out there today is not that both stocks and bonds lost money last week, but that this trend has been going on all year long. Let me say it again, but perhaps with a different spin: outside of U.S. stocks, virtually every other asset class (foreign equities, fixed income, real estate, and commodities) has lost money this year. The following chart includes 10 global equity indices across the world rebased to 100 at the start of the year through last Friday. The only market still above 100 is the S&P 500, while all other indices are at some relative level of bad.



It's a similar story for the bond markets as well, as the only place an investor could have invested capital in fixed income this year and still be on the plus side would have been to roll short-term Treasury bonds (inside of 1-year maturities).

What is one to make of such a divergent backdrop, where U.S. equities are taking up the mantle of the world's reserve asset? Yes, you read that right – there is a fundamental basis to conclude that U.S. Treasuries have ceded the reserve asset status to U.S. corporations. Perhaps for the first time in 70 years, U.S. deficits and the growing level of federal debt are starting to become a problem. Anyone that looks at the math can easily conclude that the \$21 trillion (and growing) outstanding federal debt is untenable – in particular when one accounts for the \$100 trillion entitlement liability that isn't on the books of the federal government (but that doesn't mean it's not there). Just have a look at the 2018 budget deficit that is forecast to reach \$985 billion (22% of the \$4.4 trillion federal budget) and rise to \$1 trillion/year starting next year for the foreseeable future.

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This is where the numbers start to become pretty daunting, but the latest numbers from the Treasury Department show that Uncle Sam paid out \$523 billion in interest expense last year. And with the latest estimates out of the CBO showing that the national debt will rise from \$21 trillion today to over \$33 trillion by 2028, they also assume (with a modest grind higher in interest rates) that the interest expense to service this level of outstanding debt will reach \$1 trillion / year. It is this mindboggling math that has led many high-ranking officials in the Defense Department (of all places) including Admiral Mike Mullen, former Chairman of the Joints Chiefs of Staff, to conclude that “the most significant threat to our national security is our debt.”

How does all this tie into the economy and capital markets? The biggest and most obvious connection is through the increased issuance of Treasury bonds to fund expanding deficits along with refinancing the \$21 trillion in already outstanding debt. For example, over the second half of 2018, the Treasury plans to borrow \$770 billion – a more than 60% increase from the same period last year. The net supply of Treasury securities will more than double this year to over \$900 billion, and rise to nearly \$1.2 trillion in 2019. That means that Uncle Sam needs to attract this additional capital from some other source to fund itself – this is an important variable that is sucking capital from the rest of the world into the U.S. and also why U.S. interest rates are rising.

Yes, the Federal Reserve is raising rates and this is also a variable in the equation, but if you’ve been closely following interest rates, it’s the Fed that is just following along the path where capital markets have already pushed them. Last week’s surge higher in yields coincided with almost a perfect storm of Fed speeches and a slew of economic data that was white hot. The employment report, while on the month adding a below expectations +134k jobs in September, when accounting for the +87k in positive revisions shows a labor market still averaging +190k in job gains over the last three months. What stood out to me more than the job gains or the unemployment rate falling to a nearly 40 year low of 3.7% is the clear signs that the U.S. economy is running out of labor. There is such a thing as too much of a good thing and the labor market is walking this fine line at this point. Consider that since May, folks with a high-school diploma or less have been responsible for 100% of the employment gains in the U.S. Think about what this implies for productivity, training costs, and profit margins for companies.

On top of the employment report, we got an ISM manufacturing survey that remains extremely strong, and an ISM non-manufacturing report that hit its highest level in two decades at 61.6 in September. However, what stood out most to me when reviewing the ISM non-manufacturing survey was the following comment:

Anthony Nieves, who oversees the ISM survey of purchasing and supply managers, said businesses in the services sector were increasing inventories, importing and exporting in anticipation of coming trade actions.”

There was also another item for investors to consider, as it pertains to the end of fiscal year budget spending at both the Federal and local level of government, that should make them think twice before extrapolating strong trends in the recent economic data too far into the future. Another comment from Mr. Nieves on the matter:

“...many local municipalities, which are counted as service-sector contributors, had fiscal deadlines looming, encouraging spending.”

This is a rather precarious set-up in that some of the additional verve being born out in the economic data over the last several months has more than a hint of several nonrecurring factors: 1) pulling forward activity to get in front of tariffs, and 2) government spending using up their budget allocations before fiscal year-end. To the extent these factors are artificially lifting the data will be borne out in time, but for the here and now,

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the market and Fed are taking it at face value, which is why last week's comments from Chairman Powell reiterating the Fed's intention to hike rates four more times over the next twelve months helped to pop interest rates to multi-year highs.

So, let me try and tie this all together:

- The U.S. has one of the strongest economic backdrops in the world
- This strength is in part a reflection of organic activity, an influx of global liquidity, and historic fiscal stimulus
- As a result of this strength, interest rates across the yield curve have moved to multi-year highs, the U.S. dollar has remained strong relative to foreign currencies, and this has provided cover for the Fed to continue on its tightening path
- With the U.S. dollar still the world's reserve currency (over 80% of global trade and 63% of foreign currency reserves), a higher price of money in the U.S. creates ripple effects around the rest of the world (higher rates / depreciating local currencies) which thus far has played out by slowing growth in the rest of the world
- But we also have a U.S. economy that is starting to show some of its warts via its late-cycle nature and sensitivity to higher interest rates with the downturn in the housing and auto sectors
- Moreover, the labor market is super tight and with the Trump administration's focus on resetting prior trade pacts, which are sure to disrupt global supply chains, this is a toxic cocktail that will keep upward pressure on input costs and inflation
- Additionally, we have oil prices that are pushing up to their highest levels in almost three years and reaching a point where they are becoming a net negative for everyone outside of oil producing entities.

All of this coincides with a stock market as measured by the S&P 500 that as I type is hovering at the same level it was eight months ago. Yes, rarely have I ever experienced a period where the stock market has been so celebrated for being flat over the course of an eight-month period, but this is the environment we have today. However, I would argue that a lot of fundamental and valuation variables have changed in a meaningful way since the S&P 500 first reached these levels at the end of January. Most of these variables have transitioned from tailwinds to headwinds over this time and this is especially the case for corporate profits. We are set to kick off Q3 earnings season at the end of this week, and I see that since the start of the third quarter analysts have trimmed their estimates to +21.6% YoY from +23.4%. Still a very solid level, but directionally a deceleration from both Q1 and Q2 and the cuts in forecasts are the opposite of what we saw at this same time in Q2.

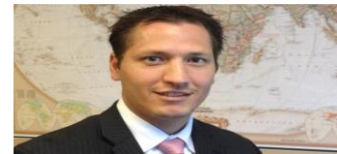
A strong dollar / weak foreign currencies, higher interest rates / lower bond prices, cycle high inflation readings / downward pressure on corporate profit margins, rising wage pressures / tight labor market, ballooning federal deficits / crowding out private credit, and tightening monetary policy / contracting global liquidity – these are all contrasting dynamics that should heighten investors' awareness of increasing risk in the financial system. There remain few signals (outside of select emerging markets) within the capital markets that suggest a severe repricing of risk assets is imminent, but this is no time for complacency.

Things have changed and the impacts of these changes are not entirely clear, but the time for relying solely on passively indexing one's portfolio and thinking that the efficiencies of markets will do the rest may be nearing its expiration. The premise of EMH (Efficient Market Hypothesis) has been the backbone of the financial services industry for almost four-decades, but almost this entire span of time encompasses a 38-year period where interest rates declined from 15% to 0%. I'm of the view that no longer can investors rely solely on the notion that a 50/50 stock / bond allocation will achieve their investment objectives going

forward, given that the four-decade long decline in interest rates will not be replicated. Analytical rigor, deep thinking, hard work and a little bit (or a lot) of luck are necessities for future investment success. These changes won't play out overnight, some will transpire over decades, but understanding they are afoot is what is important.



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