November 19th, 2018

Quick thoughts on various issues…

In this holiday shortened week, I'm going to try and keep this missive short and concise with a focus on items within the capital markets and economy that have my attention.

Geopolitical Tremors:

Any illusions that the U.S. – China file will be resolved quickly and easily should be scaled way back following VP Mike Pence's sharp language on China over the weekend at the APEC summit. Daily rumors aside about a deal or no deal, there is a wide gap between what each of the two largest economies in the world want for their nations going forward and it's perhaps best to be prepared from an investment standpoint for each side to dig in their heels for some time to come. The 140 concessions that China included in their letter to the administration is a start, but barely scratched the surface on issues important to this administration, like: cyber espionage, technology transfers, access restrictions, and intellectual property theft. While this is perhaps the most visible topic on America's trade agenda, it isn't the only item as trade negotiations with the EU start to pick back up again. There's also the growing possibility that the USMCA (NAFTA replacement hatched out back in September) may not get passed with Democrats overtaking the house, and this opens up the window that should this fall through, perhaps Trump just backs out of NAFTA entirely.

This isn't the only geopolitical uncertainty hanging over global capital markets as the latest news out of the U.K. indicates that PM Theresa May's 585 page "withdrawal treaty" is DOA. This is a complicated mess with plenty of potential twists and turns in the days and weeks ahead that could include May being ousted, a 'no-deal' exit, or a new referendum. It's very difficult to handicap from an investment standpoint other than to suggest it's far from over, remains a very fluid situation, and creates a large cloud of uncertainty over the U.K. economy.

Beyond the U.K. Brexit file, Europe has to deal with a showdown between Italy and the EU on a budget bill with Italy's newly elected populist coalition holding the line on fiscal spending that exceeds EU guidelines. Make no mistake, Italy is no Greece in terms of scale and potential impact on the EU and global economy should the possibility of Italy attempting to leave the EU have to start being considered by investors.

The Stock Market:

It's becoming more widely accepted among the investing community that a material shift in market complexion, fundamentals, and sentiment is now afoot. Highlighting this transition is the fall from grace of former market darlings that were juiced up by momentum chasing investors and algo trading systems coming into October. Oh, how things have changed, with Nvidia rounding out the fall from grace of these names last week after reporting okay results, but disappointing on its forward outlook. Here is a company that was up a little more than 50% on the year as recently as October 2nd and as of today has declined 49% in less than six weeks. Let me walk you through a math lesson in terms of compounding, because a 50% slide after a 50% gain does not return you to square one. Nvidia started out the year at $193, ran up to $292 (a 51% gain), but a 50% decline from this high brings you back to $149 – leaving it down 23% from the start of the year.

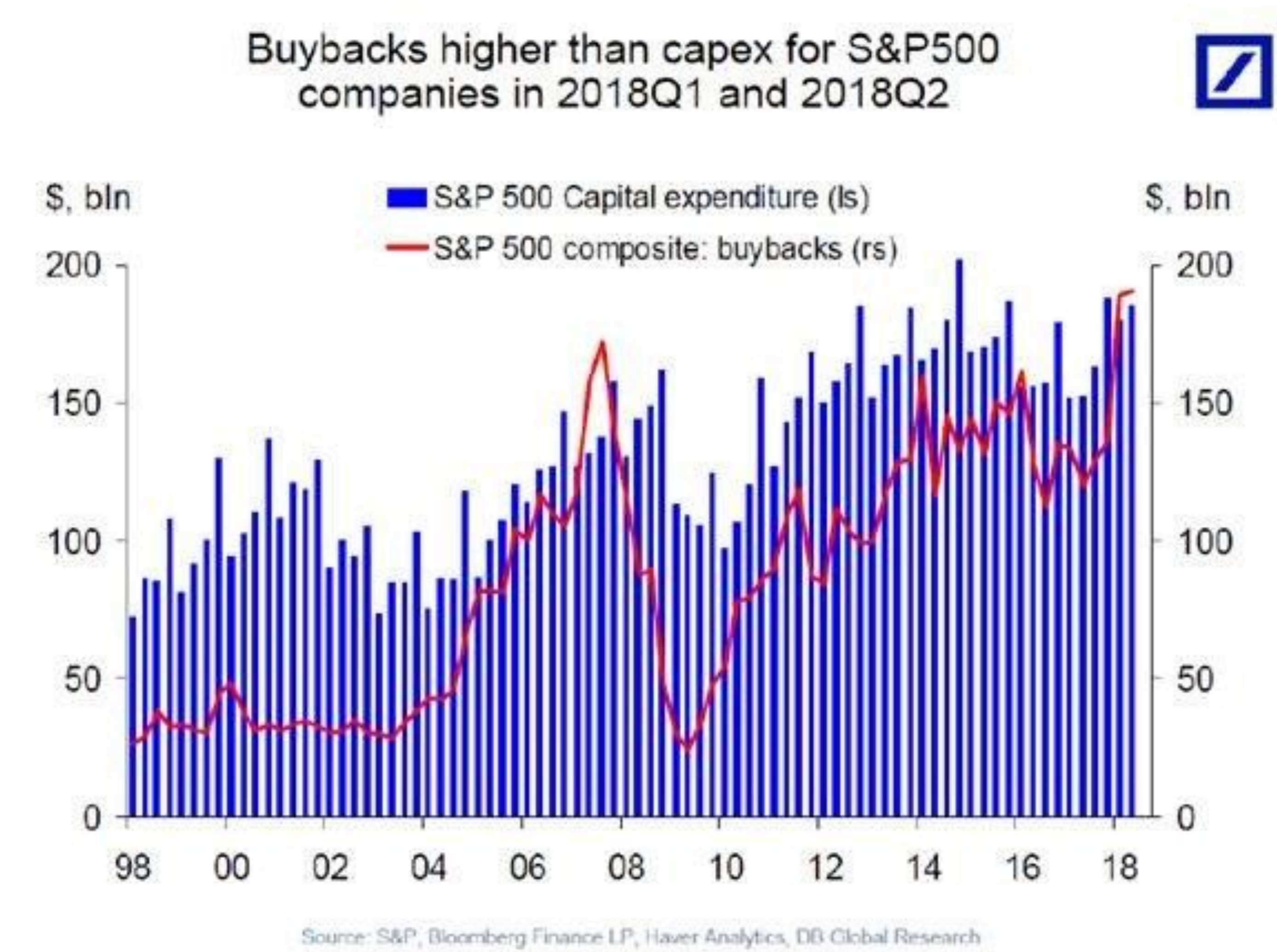
Just as a formality, I'll run through a couple more names, but the more important point about this exercise is interpreting what it is suggesting about the forward outlook.

Facebook (FB) hits its high of $218 on July 25th and now trades at $132 – a 40% decline
Amazon (AMZN) – high of $2,050 on Sept. 4th and now trades at $1522 – a 26% decline
Google (GOOGL) – high of $1,291 on July 27th and now trades at $1030 – a 20% decline
Apple (APPL) – high of $233 on October 3rd and now trades at $186 – a 20% decline
Netflix (NFLX) – high of $423 on June 21st and now trades at $271 – a 36% decline

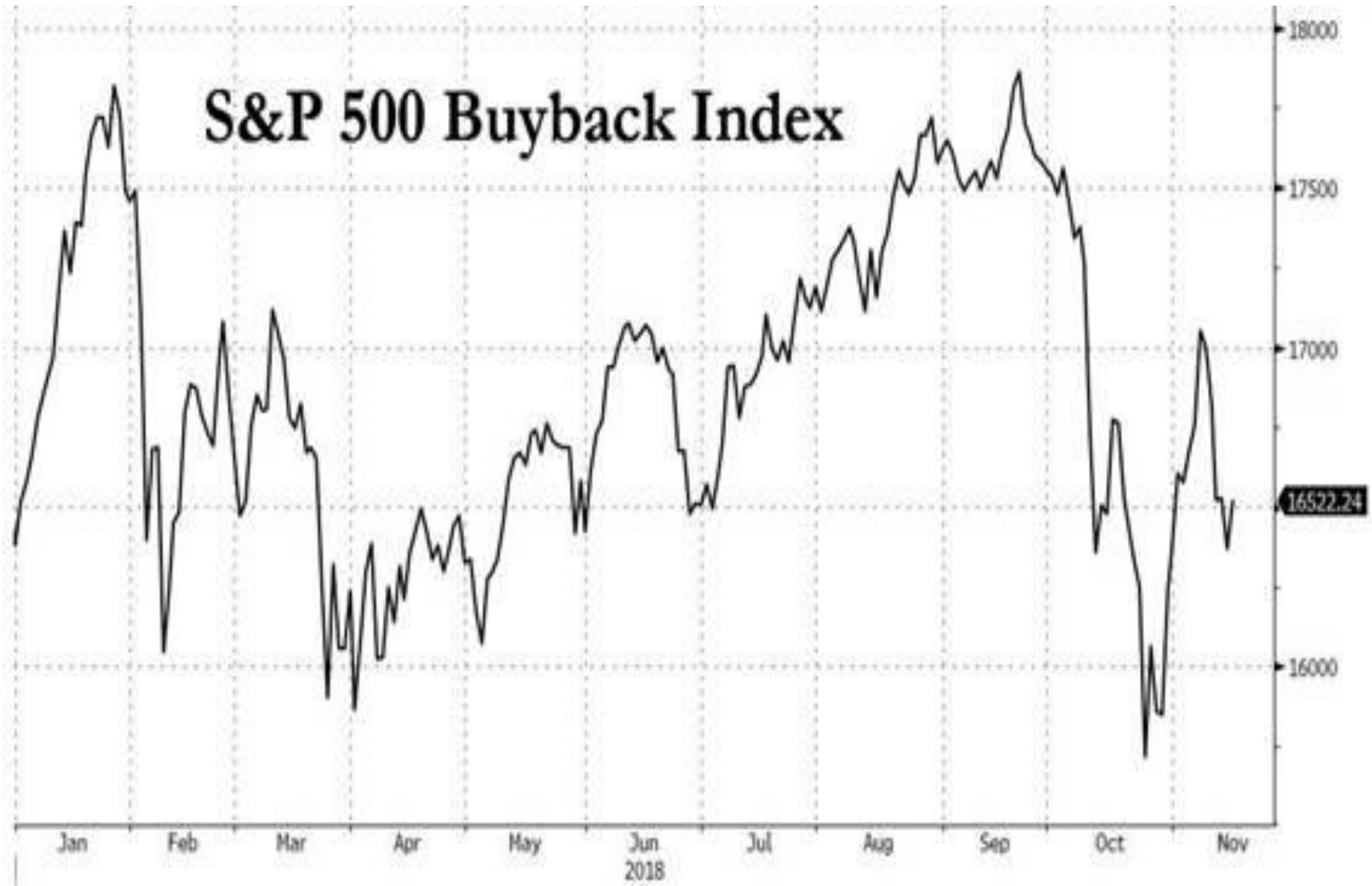
An even more speculative bubble asset that has fared even worse this year is Bitcoin, which slipped below $5,000 today. Consider the irony, as it was just a year ago that this quasi-alternative currency was all anyone wanted to talk about during Thanksgiving dinner as it was approaching its $20,000 peak. This is what happens when the Fed gets well into its tightening cycle – it rings out the excesses and crushes the mania assets that get created in the prior phase of cheap money and excess liquidity.

That's the take away from the price action you're seeing in markets today. The period of easy money and financial excess is over and investors need to recognize this reality whether it's in the crypto space, Cannabis stocks, the FANG cult, or even emerging markets. The time for catchy investment themes and narratives is over for this cycle and one would be well served to refocus their investment strategy on quality, defense, and living to fight another day. It's as simple as that. It doesn't mean you stop working or investing, it's just time to pull in your horns (if you haven't already) and let the cleansing process run its course.

The next question everyone is asking themselves is unknowable: When is it over and how much will it decline? Those aren't bad questions, but they only tell you so much because all you have to go off of is historical data that cannot be applied uniformly to every cycle because they are all different. One example of a clever narrative failing to live up to the billing is the notion that stock buybacks would continue to power the stock market higher. For only the second time in the last two decades, stock buybacks for S&P 500 companies are currently outpacing capex with this last occurring in 2007 which just so happened to mark the peak of that bull market and economic cycle (see chart below from Deutsche Bank).



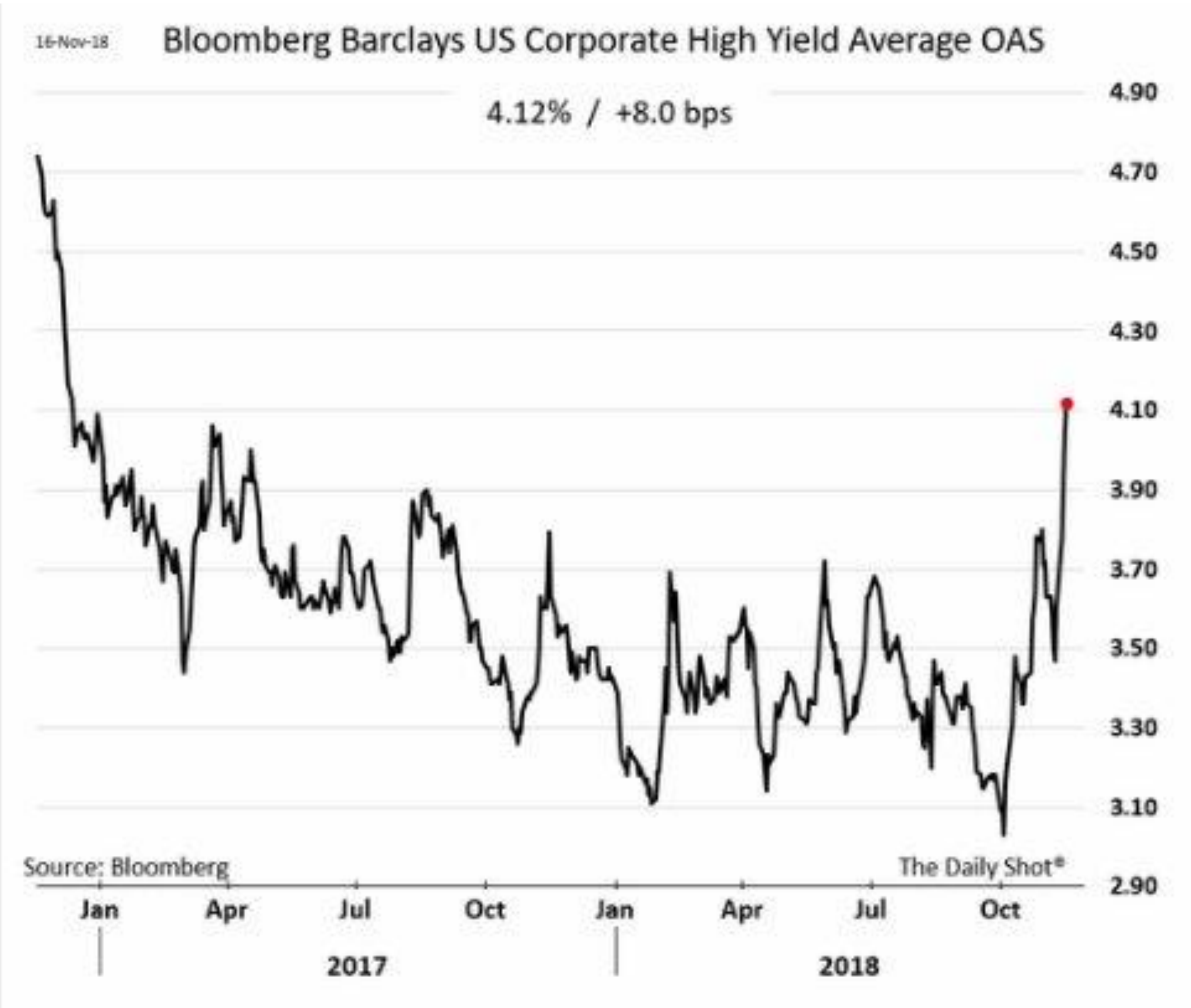
But even with this torrid pace of stock buybacks, already closing in on $800 billion so far in 2018 (a record for a calendar year and on pace to perhaps reach $1 trillion), yet the S&P 500 Buyback Index is unchanged on the year. Makes you wonder where the S&P 500 would be without the benefit of the corporate tax cut gift handed out by this administration's reckless fiscal stimulus package.



Corporate Debt Markets:

Over the last several weeks, corporate debt markets have begun to confirm the weakness taking shape in the equity markets. That the debt market wasn't showing much stress was one of the arguments I've heard made from the bulls during the early stages of the decline in October, but this assertion no longer has as much validity. The average spread in investment grade corporate debt yields over Treasuries has expanded to 134 basis points from 90 basis points in early February. For context, this spread reached 220 basis points back in 2016 when the oil market was entering the trough of its depression experience – so it could be worse, but the directional trend is a concern.

In the high yield space, spreads have expanded by more than 100 basis points over the last month to 415 basis points, but this remains well off the nearly 900 basis point spread level they reached back in February 2016. So once again like in the investment grade space, the trend higher is discouraging, but we are far from alarming levels as of yet.



As an aside, I find it interesting once again in today's action where the stock market is taking a pretty big hit, yet the Treasury market is only generating a modest rally as the yield on the 10-year T-Note is down 2 basis points to 3.05%. In the entirety of this stock market decline that started in October, the best the 10-year Treasury could muster so far is a fall from its peak at 3.25% to 3.05% – based on historical data one would expect a decline of nearly ½ a percent, so perhaps for the first time in a long time the burgeoning U.S. deficit situation is starting to matter.

Oil:

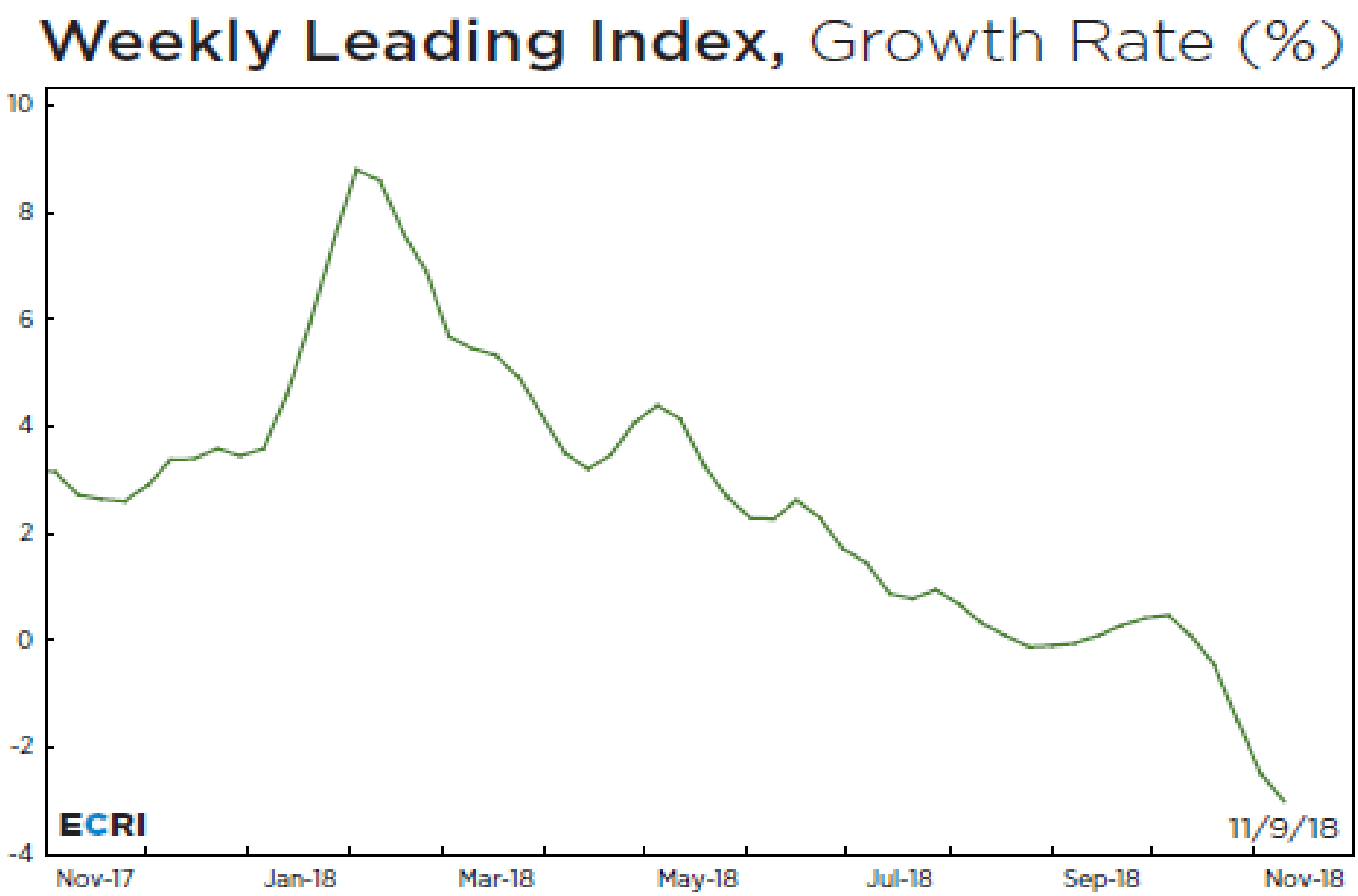
The energy space is one area that has come across our radar of late in a constructive way, seeing as it just put in its sixth consecutive week of declines. There is much more to the energy thesis (oil and nuclear) than just price action, but those willing to entertain a longer-term time horizon may want to consider the recent decline as an interesting entry point. It looks as though there is some progress being made among the views of both Russia and Saudi Arabia that an output cut at the December 6th OPEC meeting is in the cards. After all, it looks as though OPEC and Russia miscalculated their production levels given the amount of waivers that were granted by the U.S. on Iran sanctions. In my opinion these exemptions, as well as recent increases in output, were the main culprits for this latest slide lower, but these events are likely pretty well discounted into current prices.

What's more is that the speculative long position in the futures market that had longs outnumbering shorts by almost a 15:1 ratio (triple the norm) last month has been reigned in considerably. Sure, there remain concerns on the supply front, namely from U.S. shale production which is producing at record levels as the latest rig count tally moved back to March 2015 levels, but me thinks the die has been cast for the OPEC meeting in Vienna for Saudi Arabia to deliver a supply cut, rumored to be in the vicinity of 1.4 mbd – enough to offset the excess production they've been pumping out in advance of the Iran sanction uncertainty.

Global Economy:

Markets everywhere are repricing for a synchronized global slowdown and this is only just now making its way into U.S. economic data. For anyone that is interested, pull up the latest Fed GDP forecasts – Atlanta, New York, and St. Louis – all of them are projecting that real GDP growth is going to log a 2-handle for Q4. Sure, Q2 and Q3 GDP results were strong, but that output coincided with the height of fiscal stimulus for tax cuts and government spending along with a sprinkle of frontloaded activity to get in front of upcoming trade tariffs. Now that we're through that period of artificial stimulus, reality is starting to set back in and the ten consecutive months of decline in the OECD leading economic indicator has been foreshadowing this for some time. Have a look at the Q3 GDP results we got last week from the likes of Germany, Japan, and Italy, all of which showed growth either contracted or stalled. China has been in a growth recession all year and the consumer spending data slowing to a five-month low in October gives little indication that things are about to turn. Fully 70% of global GDP is now in the process of slowing down.

As for the U.S., the ECRI's Weekly Leading Index (WLI) saw its growth rate fall to -3.0% last week which is the lowest level since early 2016. This is the same index that foreshadowed the strong economic results in the middle of the year as this index was running north of 8% in early February.



For those less inclined to believe the big picture macro data points and more interested in taking their cues from the micro company data, what do you make of Nordstrom Inc. selling off 14% last week after posting profits that beat estimates, but also having to take a large charge against delinquent credit card debt? Macy's got wacked last week after beating on both the top and bottom line but missed on full-year revenue guidance. Even the stalwarts got hit – Home Depot was down 4.8% last week and Walmart, which beat on earnings, but its stock price still got taken down by 7.5% for the week.

This all sets up a rather interesting dilemma for the Fed as the pleadings are growing for them to take a pause on their monetary policy normalization quest, and yet they've barely lifted the federal funds rate to 2.25%. Real rates (interest rate after inflation) are flat and the recent high in yield on the 10-year Treasury is 3.25% – is it really possible this is all the tightening the system can handle? It's anyone's guess, but given just a 50-basis point run-up in the cost of capital over the past two months and the pain we're seeing in various parts of the capital markets, one cannot just dismiss out of hand the sensitivity and fragility of the system to even this small of a move in interest rates and liquidity. I must admit that I chuckled a little bit last Thursday after reading the Wall St. Journal's editorial board calling for the Fed to "pause". This isn't to say that I completely disagree, but how do you square the supposed "strongest economy we've ever seen" according to Trump, the longest bull market in history, the S&P 500 still within 8% of its all-time highs, manufacturing and non-manufacturing ISM prints in the high 50's, consumer confidence just off record highs, wage growth knocking on the door of 3%, unemployment at the lowest level in five decades, and inflation at the Fed's price stability target with calls for the Fed to stop tightening monetary policy?

The reality is that these things don't square up, but because of levitating asset prices over the past decade at the behest of Fed policy, investors have been so coddled and spoiled by cheap money and ample liquidity that already with just a modicum of pain, conditional response reactions are being triggered by investors expecting the Fed to bail them out once again. Who would have ever guessed Pavlov's theory would apply as well to human nature as it did to K9's? I get it, no one likes to lose money and this is the biggest drawdown since the Global Financial Crisis with a cumulative $5 trillion decline in global debt and equity markets since the start of

2018. There has never been a bull market or expansion that has gone on forever, and to think that this one will is an unrealistic expectation and defies everything any of us know about history, economics, and finance.

What happens next will be interesting from the standpoint of whether or not the Fed choses to take a pause or pushes forward with further normalization. Me thinks both paths present interesting challenges for investors, but either way at some point it will be in all our best interests for the system to be cleansed by purging the gross levels of misallocated capital that have been built up over the last several years.

Corey Casilio
Partner, Portfolio Manager
101 Ygnacio Valley Road
Suite 211
Walnut Creek, CA 94596
corey.casilio@clpwm.com
925.448.2215

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