January 28th, 2019

What I think, what I know, and most importantly – what I don't know…

If you think the geopolitical, economic, and capital market backdrop has been chaotic and confusing lately, well you ain't seen nothing yet. Sure, the government shutdown is over, the stock market has had a nice rally, and global central banks are signaling that they are ready and willing to backstop asset prices and economic growth should the incoming data continue on its decelerating trend. While we have a bit of visibility on these issues, the upcoming week is loaded with market moving items: the next round of the U.S. and China trade talks will take place on Wednesday and Thursday with China's Vice Premier Liu He meeting with U.S. trade rep Lighthizer and Treasury Secretary Mnuchin, Wednesday will also conclude the Fed's FOMC meeting where all eyes will be fixed on the message delivered by Chairman Powell at the 2:30pm press conference, and finally the week ends with two highly coveted economic data releases in the ISM Manufacturing survey (this report has a high level of interest following the rare 5 point fall in December) and the January jobs report will also come out on Friday.

We also have the U.K. parliament voting on amendments to Theresa May's Brexit deal with the EU on Tuesday. The biggest development on this file has been the decreasing probability of a no-deal 'hard' Brexit with the most likely outcome (and the most logical, I might add) being an extension of Article 50 with the deadline for a deal to be reached less than 60 days away. Oh, did I forget to mention that 126 S&P 500 companies will be reporting earnings this week with the tech heavyweight's front and center? Apple, Amazon, Microsoft, Facebook, and Qualcomm all report this week, many of whom are coming off of quarters where they lowered guidance coming into this print. How their results line up with these lowered expectations will likely go a long way in setting the tone and mood of the markets in the near-term.

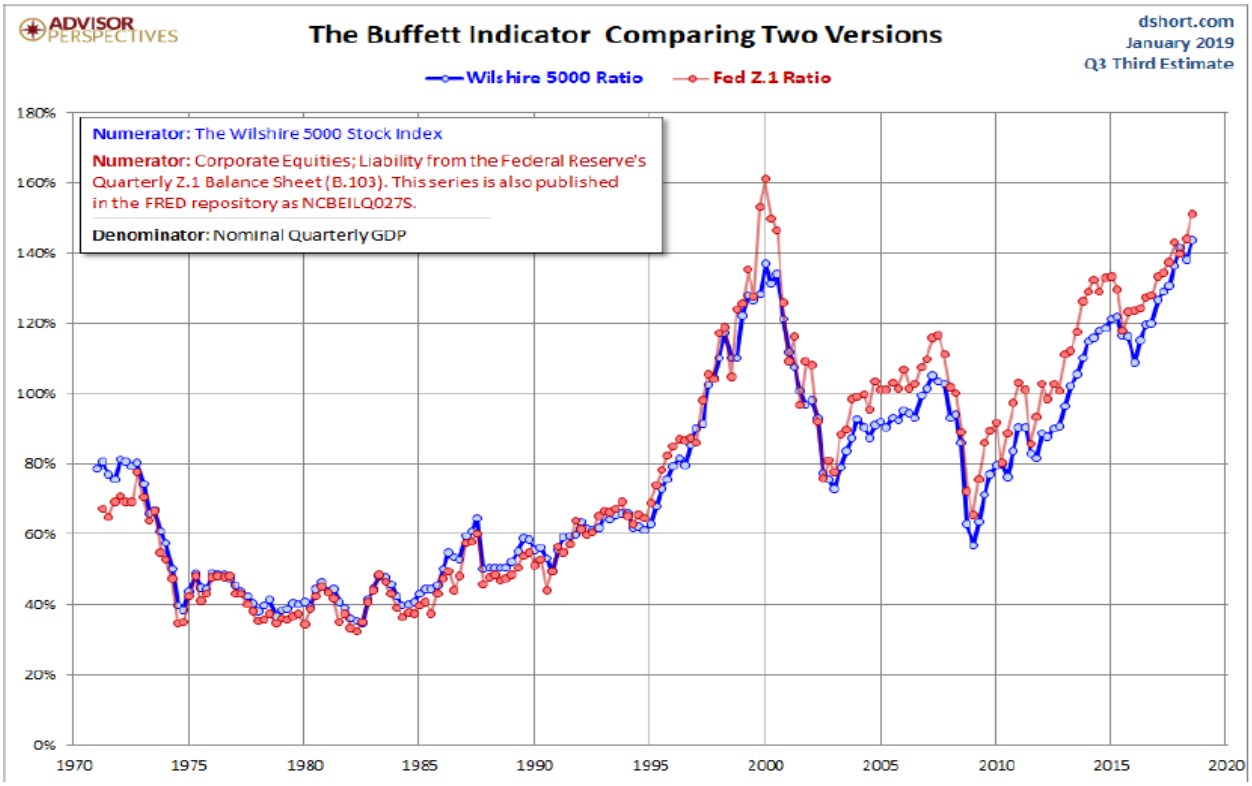
Speaking of mood swings – what a difference a day makes. I have CNBC on in the background as I'm penning this piece and I overheard one of the traders talking about how he's selling 25 – 50% of his positions today after professing how bullish he was on Friday. Kudos to him for his honesty, integrity, and willingness to change his mind, but give me a break if this is what passes as prudent investment advice nowadays. Fundamentally speaking, there is nothing different today than what was apparent on Friday. Yes, Caterpillar (CAT) whiffed on its earnings report with both EPS and revenues coming in below estimates (lowered guidance doesn't help either) and Nvidia (NVDA) preannouncing poor Q4 numbers was a big deal, but should these results really come as a surprise to anyone that's been paying attention? This is a trend that started with FedEx in December, then it was Apple (AAPL), and just last week it was Intel (INTC). This collection of globally oriented companies covers virtually every segment of the economy and together they paint a fairly broad and consistent picture indicating that global growth has decelerated markedly from where it was as recently as this time last year.

Which brings me to the broad stock market in general, where the bulls can rightfully celebrate the impressive 6.3% jump in the S&P 500 to start out the year and the nearly 13% rally from the December lows as an all clear sign that the bear market is over and a resumption of the nearly decade long bull market is underway. The bears on the other hand can still point to the fact that the S&P 500 remains some 10% below its September high, and all that's really happened over the last four weeks is a 75% reversal of the 20% decline from the peak – a completely normal technical occurrence within the confines of a bear market. If you were to compare the initial 20% declines at the start of the last two economic downturns (2000 – 2001 and 2008), you'd learn that it took six and nine months respectively for those initial 20% down-legs to unfold. The recent September to December 20% decline occurred in a matter of three months – so it's completely reasonable to surmise that the market fell too far too fast and a meaningful bounce off of massively oversold conditions should come as little surprise. But now we're at a point where the wheat gets separated from the chaff in that any further progress in either direction (up or down) is likely to come on the back of fundamental developments that justifies such a move.

I want to opine on a couple of broad topics that carry with them a high level of uncertainty, but I prefer to do so by walking through the thought process being used to evaluate said issues rather than attempting to put off the illusion that I know how any of these things will play out with certainty.

The Fed and Central Bank policy:
What I Think: In its simplest form, the Fed is between a rock and a hard place and there was perhaps no clearer illustration of this tough spot than when the Wall St. Journal published an article on Friday titled: "Fed Officials Weigh Earlier-Than-Expected End to Bond Portfolio Runoff". Here we are, nearly ten years into an economic expansion that was aided and abetted by 0% interest rates for seven years, and a period where the Fed expanded its balance sheet via QE from just under $1 trillion to nearly $4.5 trillion all in the interest of supporting and jump starting economic growth – yet after just over one year of reducing its balance sheet by roughly $400 billion they are already talking about slowing this process. What could be driving such an about face, you might ask? The stock market – if you didn't know yet, you do now – the stock market is now driving monetary policy and the 20% decline in a matter of three months was enough to scare the members of the FOMC (who as recently as October 3rd indicated that interest rates were well below "neutral" and balance sheet reduction was on "auto pilot") to do an about face in currently guiding to no more interest rate increases in 2019 and rumors of slowing QT (quantitative tapering).

And what do you expect, given how large the stock market has become relative to GDP? I'll lay out the rough math for those of you that are unaware, but the value of the entire U.S. stock market is roughly $32 trillion while the value of the U.S. economy as measured by nominal GDP is roughly $20.5 trillion. So, the ratio of the stock market to GDP is 156% – the only other time this ratio has been near this level was at the height of the Tech Bubble in 2000 (see chart below form Advisor Perspectives who plots two versions of the Buffet Indicator using the Wilshire 5000/Nominal GDP Ratio and the Fed Z.1/Nominal GDP Ratio).



I sympathize with the Fed's dilemma, but it's more than a bit ironic given it was the objective of 0% interest rates and numerous renditions of QE that were implemented in the interest of increasing asset values. Fast forward to the last 12 months where policy makers have gone out of their way to proclaim that the unwinding of these same policies was having little visible impact on asset prices – recall Janet Yellen's comment that the unwinding of the Fed's balance sheet was going to be "like watching paint dry." Well the stock market is crying uncle with the Fed funds rate at a mere 2.5% and after roughly $400 billion in balance sheet reduction, and this defines the challenges with trying to normalize policy in a completely abnormal economic expansion.

What I know: Ever since Greenspan became Fed Chairman in the late 80's, the excess liquidity and over-accommodative monetary policy has always created a bubble of some form in the aftermath of the Fed overstaying their welcome. In the 1990's it was commercial real estate, in the early 2000's it was tech stocks, and in the last cycle it was housing. All of these bubbles were nurtured by easy monetary policy and then destroyed when the Fed became too restrictive in the ensuing tightening cycle. This time is no different, with the exception being where the bubble has formed and that is in the corporate debt markets. Corporations were highly incentivized this cycle to borrow money at historically low interest rates and a large chunk of this increased leverage was used to buy back their own stock. Unfortunately for the economy this money wasn't used to deepen the capital stock of these organizations, which would have increased productivity and generated some positive rate of return to cover future debt servicing expenses. No, instead this will go down as the weakest capital spending cycle of all time and all the corporate community has to show for it is the highest percentage of outstanding debt to GDP in history.

This ratio is approaching 50% and, like so many other metrics, looks to be in the process of peaking. I really don't think it's a matter of debate at this point that the suppression of interest rates (for as long as they were) has led to a plethora of malinvestment across the economy where the borrowing costs in no way reflect the underlying default risks of the companies doing the borrowing. What has taken place this cycle in the U.S. (and it's the same story around the globe) is that the policy prescription for a debt bubble was adding more debt. It's true that the household segment did de-lever some this cycle, and housing is not the poster child of the excess it was last cycle, but massive increases in debt in the corporate and government sectors has been palpable.

This is why the Fed is backed into the corner it is: trying to raise the cost of capital via higher interest rates into a financial system where aggregate debt is north of $50 trillion (or 248% of GDP compared to 225% of GDP at the peak of the cycle in 2007).

What I don't know: Is the Fed done with its rate hiking cycle? My guess and our research suggest they are, but the bigger question isn't if and when they shift back into easing mode, but rather will these actions have a positive impact? Historically the Fed has cut interest rates roughly 500 basis points to combat a recession. If you look back at the peak of the cycle in 2000, the Fed funds rate was sitting at 6.5% in December 2000 before the Fed went on to cut interest rates to 1% by July 2003. This 550 basis points of easing didn't stop the Nasdaq from losing over 80% of its value or the S&P 500 from being cut in half. The same can be said for the peak of the 2007 economic cycle, where the Fed funds rate peaked at 5.25% and the Fed not only cut rates to 0% in this easing campaign but also found it necessary to provide additional accommodation via QE. The 500 basis points of cuts didn't stop the S&P 500 from falling 57% peak to trough, and it really wasn't until QE was implemented that the decline ended.

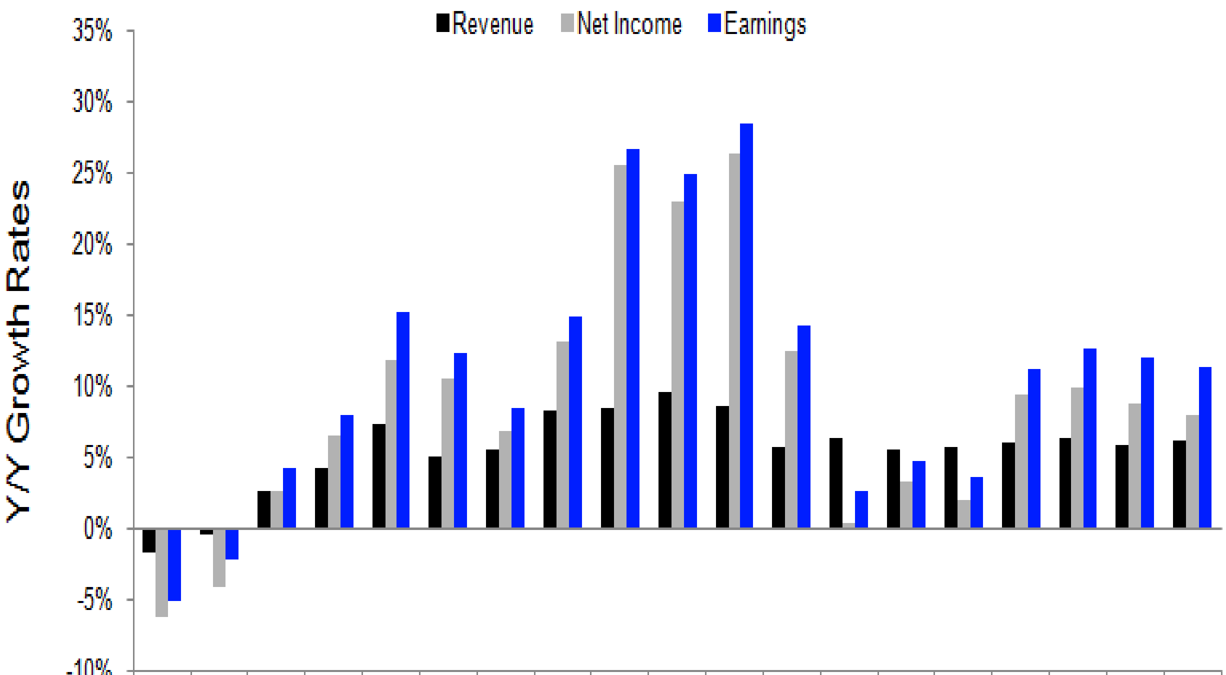
What I'm getting at is that the Fed pivoting from tightening to accommodation, while in the short-run is a celebrated event, the archives of history don't show this to be a good long-term development for risk assets. Reason being is that the Fed in its cryptic parlance is recognizing and confirming that its previous tightening actions are starting to negatively impact growth and inflation. Keep in mind that Fed policy works with an inherent lag (typically 12 – 18 months), so it's fair to assume that the economy will bear the full brunt of all the QT and the last two rate hikes (Sept. & Dec.) in calendar year 2019. Also, keep in mind the Fed is just reaching the point of potentially stopping the tightening process. Economic data and capital markets would likely have to weaken even further from here for the Fed to actually start to take action, and even then, it will take time for this stimulus to work its way into the system.

This leaves several additional questions: Given the Fed has already taken interest rates to 0% and expanded its balance sheet far further than it expected last cycle, what new policy-rabbit are they going to pull out of their hat this time? After all, doing the same thing over and over again and expecting a different result is Albert Einstein's definition of insanity, right? This isn't to say that such actions won't be openly welcomed by capital markets, given the success such policies have had in raising asset prices this cycle, but looking beyond asset prices at the rise in populism, the proliferation of debt, unprecedented inequality, and societal dissention – I wonder if the Fed via their policies find themselves at all responsible for any of these developments. It will be interesting to see how the historians reflect back upon this era and whether they find these policies to be a success or failure. Given how sluggish and weak economic growth has been throughout this expansion, it's hard to conclude at this point that these policies have been a success.

Earnings:
What I think: I think corporate earnings estimates still remain too high for 2019 even after undergoing several months of analysts cutting their numbers. If, as I suspect, global growth continues to decelerate and debt servicing costs continue to increase in tandem with rising wages, then we're looking at a backdrop where corporate profitability has to compete against several variables that they didn't have to in years past. Additionally, when looking at the rate of growth

deceleration outside the U.S., it's hard not to be concerned. South Korea has long been viewed as a canary in the coal mine (both on the upside and the downside) as it relates to forecasting global trade and GDP growth given its extensive ties into the global manufacturing sector. So, last week's release of South Korean exports declining 12% YoY (through the first 20 days of the month) was a bit eye opening in that it is approaching levels it last reached in late 2015 / early 2016 when S&P 500 profits went into a multi-quarter earnings recession.

What I know: We've already seen consensus estimates for full year 2019 earnings growth fall from 10.2% on October 1st to 5.9% as of last week, but what really caught my attention is seeing the growth rate slowdown from 2018 to 2019. The following table from Thomson Reuters details the earnings growth results of the last several years, but pay particular attention to Q1 2018 (26.6%), Q2 2018 (24.9%), and Q3 (28.4%). Now compare those to Q1 2019 (2.6%), Q2 2019 (4.8%), and Q3 2019 (3.6%) – you're talking about more than a 20% slowdown in each of the next three quarters.



	16Q1	16Q2	16Q3	16Q4	17Q1	17Q2	17Q3	17Q4	18Q1	18Q2	18Q3	18Q4	19Q1	19Q2	19Q3	19Q4	20Q1	20Q2	20Q3
Revenue	-1.7%	-0.4%	2.6%	4.2%	7.3%	5.0%	5.5%	8.3%	8.4%	9.5%	8.6%	5.6%	6.3%	5.5%	5.7%	6.0%	6.4%	5.8%	6.1%
Net Income	-6.2%	-4.2%	2.6%	6.6%	11.9%	10.6%	6.9%	13.1%	25.4%	23.0%	26.3%	12.4%	0.4%	3.3%	1.9%	9.4%	9.9%	8.8%	8.0%
Earnings	-5.0%	-2.1%	4.3%	8.0%	15.3%	12.3%	8.5%	14.8%	26.6%	24.9%	28.4%	14.2%	2.6%	4.8%	3.6%	11.2%	12.6%	12.0%	11.4%

Sources: I/B/E/S data from Refinitiv

What I don't know: What multiple will investors be willing to pay for this rate of deceleration? My guess (and history provides support) is that investors aren't willing to bid multiples higher when earnings are decelerating. And here is a lesson for anyone who hasn't already learned it first-hand: forward P/E multiples are a useless valuation metric. Yup, Wall St. and the talking heads on bubblevision always manage to use this valuation metric as a reference point to validate the attractiveness of a given company, and why not when consensus estimates are always higher than trailing earnings. This will always give you the illusion that forward multiples are lower than trailing multiples, but the future earnings number is unknown and, in most cases, revised lower as the actual earnings announcement nears.

Another thing that investors have to handicap at this time is how much of this earnings slowdown is already priced in? It's a legitimate question given the market has just recently gone through a 20% slide, so it's fair to assume some (perhaps much) of this is already reflected in the price. I'm of the opinion that the steep slide in the stock market, the drop in treasury yields, the rally in gold, and the fall in cyclically sensitive commodities was the capital market acknowledging and pricing in the slowdown in global growth and the hit to corporate profits. But even now we're looking at an S&P 500 that is trading at a trailing P/E multiple of 16x, which is still above the historical average and this multiple is on peak profit growth and peak profit margins. The question an investor has to ask is how much of a price adjustment will the overall market go through if it gets positive surprises versus negative surprises – given my perspective and my expectations, my guess is the risk/reward still skews more towards risk than reward.

Liquidity & Recession:
What I think: I spilled a lot of ink on this subject in the opening missive of the year, so I'll spare you the time from regurgitating my view that I think the likelihood of recession occurring this year is better than 50/50 odds and as a result, investors should invest accordingly. But I will rehash some of the data points that are causing me to lean in this direction:

- 10 of the last 13 Fed tightening cycles have ended with the U.S. economy falling into recession (77% odds)
- When the 2s/5s yield curve inverts (as it did in December), the U.S. economy has experienced a recession 80% of the time.
- 100% of the time when the unemployment rate has increased by 0.4 percentage points from its cycle low, the U.S. has entered into recession. The low print in the unemployment rate was reached at 3.7% in November and as of December moved up to 3.9%. (this one is just on the watch list, but moving in the wrong direction and should the unemployment rate rise to 4.1% this year, then watch out).

What I know: What does the price action in various parts of the capital markets over the last year tell us about what may lie ahead for the economy? Keep in mind that the capital markets are one of the best leading indicators of the economy, but too often investors are too quick to dismiss the signals it may be sending. As the saying goes, the stock market has predicted 9 of the last 5 recessions and there is some truth to this in that on several occasions (three in the last five decades) the S&P 500 has slipped into a bear market, but the U.S. economy didn't fall into a recession. But dismissing the signaling value of the stock market because it doesn't have a 100% success rate when it falls into a bear market is akin to missing the forest for the trees regarding what informational content the stock market does provide.

For example, every post-WWII peak in the stock market was followed by a peak in the real economy 9 out of 9 times. Meaning the peak in the stock market did front-run an economic recession 100% of the time, it's just that on several occasions (1987, 1998, & 2011) the market fell 20% (or just shy of 20%) and then went on to make a new high before the expansion ended. There also was an instance in 1990 where the stock market didn't quite fall 20%, yet the U.S. economy slipped into recession. So, the data point all investors have to keep in mind is the September 2018 high of 2,930 on the S&P 500 and whether or not that ultimately turns out to be the peak of the cycle, because what history does inform us about is that the stock market on average peaks 7-8 months prior to the onset of a recession. What about other capital market prices?

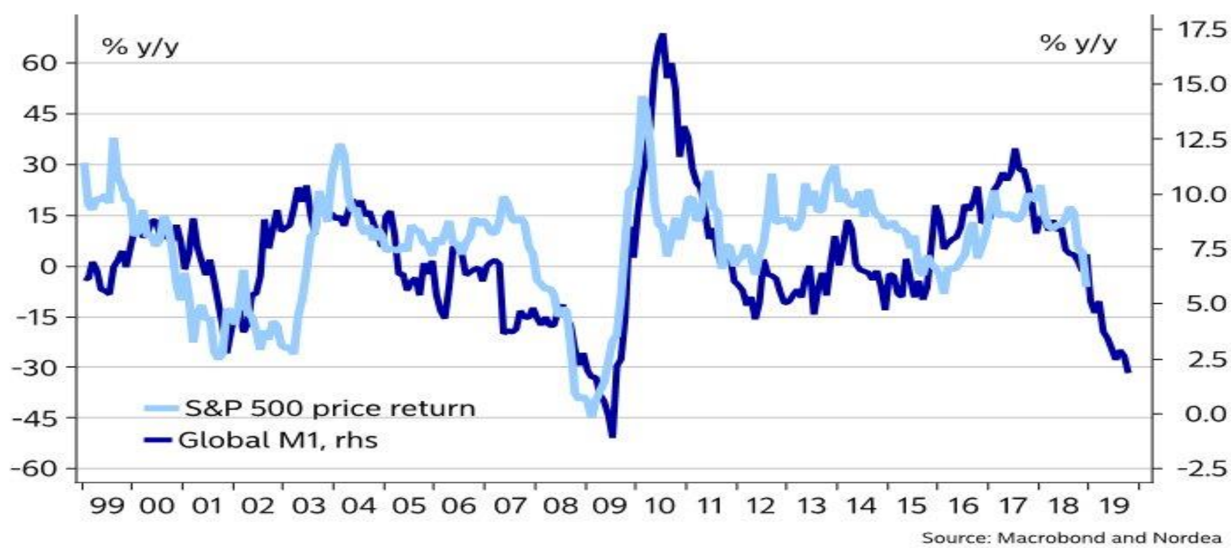
- The yield on the 10-year Treasury on average peaks 2-3 months prior to the onset of a recession (November 2018 at 3.23% is the current peak).
- Credit spreads on average have troughed 9-10 months prior to a recession (spreads hit their tightest levels in January 2018).
- The lead time for the CRB index is quite long and variable but on average peaks 9-16 months prior to a recession (June 2018).

In case you're not already aware, there is no perfect indicator when it comes to accurately forecasting and predicting a recession. That is why it's such a foolish endeavor and why the economics community always misses them, and please don't interpret my laying out some data points that are flashing yellow as a suggestion to you that I know with a high level of certainty and conviction that one is imminent.

The point is to pay attention to an array of evidence that collectively may shift the probabilities in a manner that guides how you allocate capital.

What I don't know: I don't know when a recession will occur, but with this expansion just 5 months shy of becoming the longest in history (currently at 115 months and nearly double the average of 60 months of all past expansions), the Fed doing what it's doing, the incoming global economic data turning down, corporate profits coming under pressure, and the capital markets sending warning signals – it's only prudent and responsible to take notice. What's more is that many of the recession models that have a decent track record are sending a similar message – the latest WSJ poll pegs recession odds at 25% in the coming twelve months (hardly trivial), the JP Morgan model has risen to 43%, and the NY Fed model is at 22% odds (that might sound low, but this model barely got above 30% prior to the last three recessions).

One other data point that isn't sending a very comforting message is global liquidity. Nordea Bank recently highlighted the decline in YoY M1 money growth which is flirting with levels experienced during the GFC back in 2008.



Another measure of global liquidity can be tracked via the world monetary base, which after rising at over a 4% annual rate this cycle is now running at -6.6% on a year-over-year basis. This metric first started to go into negative territory in June and led the U.S. equity market peak by a few months.

You also see that the assets on the G-4 central bank balance sheets turned down into negative territory in November – I don't think it's coincidental that volatility spiked and the market went through an intense drawdown shortly thereafter. Keep in mind that these balance sheets were expanding at a 10% average annualized pace over the past decade and this provided tremendous support for risk assets everywhere.

My intent in conveying this content is not to elicit fear or to be a contrarian, but rather to inform and hopefully assist you in your thinking on the current investment backdrop. Like so many others, I don't have all the answers, and it's not difficult at all for me to admit it, even if that seems inconsistent with so many others in this profession that speak with such confidence and conviction about their view. You see, I don't view a recession as being the end of the world, I actually think it's a necessary element of creative destruction in a capitalistic system. Moreover, they're merely part and parcel of the cycle and there is no sense in denying their existence or even their inevitability. However, if you have a choice, you'd rather not fully participate in the capital destruction that a recession can inflict upon one's capital base if it occurs when you're not prepared. Even if you have a long-term time horizon, it's in your best interest to position yourself appropriately so that you don't undergo a permanent impairment of capital, because that is the biggest risk for investors out there that are dependent on the nest egg they've accumulated over a lifetime of savings. Unfortunately, this level of pain really only occurs on a broad basis during recessionary periods.

Also keep in mind, and this is perhaps one of the most important things I can convey – recessions also create some of the best long-term investment windows that any of us come across during our lifetimes. Recessions are the outlier, given they only occur on average about every 7-8 years, but when they do, they bring about an abundance of opportunity for the patient and prepared.

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.