February 25th, 2019

The power of the Fed…

I don't see much value in my scribbling in this week's missive about the impressive, if not epic, nine-week winning streaks in the Dow, Nasdaq, and Russell 2000 – it's almost the same case for the S&P 500, with the exception of a slight weekly decline five weeks ago. Nevertheless, most investors who didn't panic during the depths of the market's plunge in December have likely seen their portfolio values recover back to close to their high-water marks from last year. Without question, this is a welcomed development for investors and the bulls have definitely achieved some significant developments along the way. For one, breadth is much improved from where it was at the start of the year when less than 1% of S&P 500 constituents were trading above their 50-day trendlines versus more than 90% today. Also, we have the NYSE advance-decline line breaking out to new highs and all of the major U.S. equity indices have now pushed above their 200-day moving averages.

So, from a technical standpoint much of the damage that was done late last year has been repaired, and this is no subtle feat given that it took an 18% rally in a matter of two months (which, I might add, is a very rare occurrence). The most recent lift higher in asset prices is coming on the back of "substantial progress" in the US-China trade talks where it has become an almost certainty that some form of a deal gets done. News began to come out Sunday afternoon that President Trump has decided to postpone any further increase in tariffs (from 10% to 25%) as the two sides seem to be close on a deal. What that deal ultimately entails and whether it actually gets at the deep-rooted issues of IP theft, technology transfers, and subsidies is another story, as all that really concerns the capital markets at the moment is the fact that there doesn't look to be any further escalation on this front which would further aggravate an already softening global growth backdrop.

Let's see, what else do I want to check-off for posterity's sake before getting to what I really want to elaborate on this week? Ah yes, Brexit, where it looks as though PM May is going to push for an Article 50 extension that would delay the initial deadline which is right around the corner on March 29th. The EU has apparently gone as far as conveying to May that it will extend the UK's membership to 2021, but we'll see how the Parliamentary members feel about this cloud of uncertainty hovering above their heads for another 18 months. What else? Oil has been on a tear as it pushed up to three-month highs this morning with WTI trading over $57/bbl. However, a tweet by President Trump this morning, hinting at oil prices getting too high, has pushed the price down by 3% at the moment, so we'll see if this ends up marking a turning point for this commodity. This will be something to watch as last summer President Trump went on a similar Twitter crusade against high oil prices and that message coincided pretty closely with the high of the year for the price of oil.

The oil market has become a rather interesting market to watch as it's become a major part of the U.S. economy, given we now produce roughly 12 million-barrels-per-day. The Wall St. Journal is running with another story in today's paper titled "Frackers Face Harsh Reality as Wall Street Backs Away", shedding additional light on the continuing lack of profitability from most U.S. shale production at current prices and the fact that investors are starting to wise up to the years of red ink that has been piling up on the financial statements for these investments. I continue to have a bifurcated view on the sector as I think the complete lack of investment (outside of the shale basins) over the last five years will create a supply shortage some years down the road, but at the current moment demand growth globally has been slowing down, which tells me that this recent spurt of strength has been driven in large part by supply controls out of OPEC members.

Let me move on to what I think is the big driver behind the market spasms (in both directions) since October of last year, and that is the global central banks. I know this is a nuanced subject area and one rife with debate, but I don't think anyone can have an opinion on capital markets today without acknowledging just how much central banks' messaging and actions matter. Keep in mind that it was the robotic interest rate hiking path and escalating scale of balance sheet roll-offs (the removal of excess liquidity) throughout the second half of 2017 and through 2018 that eventually caused the capital markets to spasm late last year. Since late December (in the face of a continued deterioration in economic and fundamental data from around the globe), we have witnessed Fed official after Fed official come out an openly admit that it was the financial market maelstrom in Q4 that caused them to relent on any further monetary tightening for the foreseeable future.

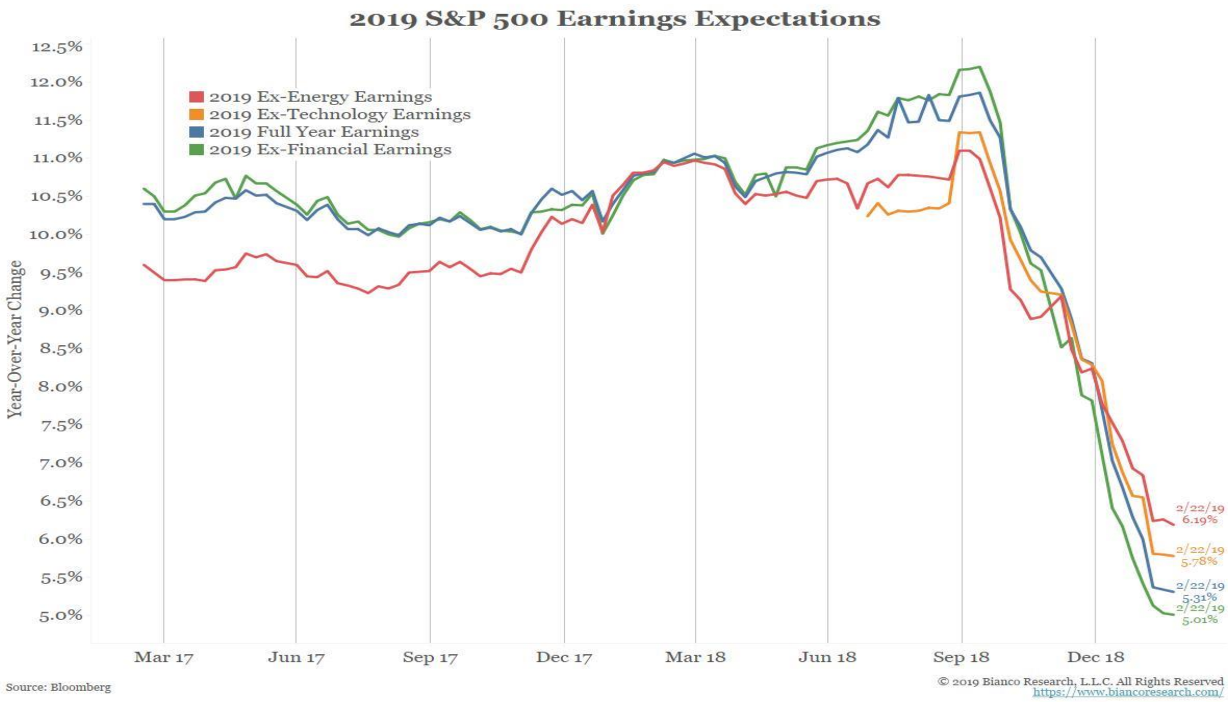
It was the swift and drastic plunge in the capital markets in Q4 that was Mr. Market's way of telling the Fed "you guys are going too far", to which all members of the Fed have responded, "we hear you", and have since backed off. Following the Fed's lead, other central banks from around the world have stepped up and began putting their foot back on the monetary policy accelerator. The People's Bank of China (PBOC) looks to be in panic mode with the level of stimulus they have been injecting into the Chinese economy. So much for the deleveraging campaign the politburo started instituting 18 months ago, as the current implementation of liquidity injections and fiscal stimulus eradicates the temporary era of financial prudence aimed for by Chinese leaders. The ECB is reviewing the process for extending another life line to European Banks via a fresh TLTRO, and expectations are increasing that it's only a matter of time before another round of QE is announced given the ECB has not hiked interest rates once this cycle. The Royal Bank of Australia (RBA) has shifted into a dovish posture with markets starting to price in a rate cut as the next move down under, and the Bank of Canada (BOC) has moved to the sidelines while indications mount that the fiscal policy makers up north ease amortization schedules to revive mortgage demand in weakening the Canadian real estate market. Oh, did I mention that the BOJ is sending out overtures that it is sensing the need to do more, which is why the 10-year JGB yield is back below zero?

In short, what we're seeing is an all-out blitz by central banks around the world following the Fed's lead in stepping in to support the economy and backstop the slide in asset prices. And you know what – it has worked, with global equity markets having gained some $7 trillion in value back since the turn of the year. My view remains that the Fed has already tightened too much and any back pedaling at this point is too little, too late, but time will be the ultimate arbitrator of this opinion. But outside of anyone's opinion (mine included) is that it is now abundantly clear that the Fed sees too much risk to the U.S. economy from a prolonged and steep decline in asset prices. Chairman Powell and other members of the Fed have already shown their hands in terms of where this pain threshold is… and that is at the December lows. The response since those levels were reached in December has been a 180-degree pivot in tone, and should markets take another dive over the next six months then the next step won't be to up the rhetoric, but rather to step in with action. And by that, I mean rate cuts, and if that doesn't work then they'll go back to expanding the size of their balance sheet via QE.

You may applaud and embrace this reality, or (like me) you may be disappointed that this is what has become of our capital markets – either way it is what it is and we have to deal with it. But a couple of things come to mind in terms of pondering what this may imply from an investing standpoint. So far investors are running with the playbook they've learned over the last decade of these policies being employed, and that is to buy risk-assets as they are the ultimate beneficiaries of excess liquidity and low interest rates. So, while investor euphoria seems to have returned with reckless abandon, what doesn't seem be to garnering as much thought and attention is the decaying effectiveness these policies are having on the actual economy. Yes, if we get to June with this economic expansion intact then we'll be seeing headlines hitting the papers about this being the longest U.S. expansion on record. What will likely get left out is the fact that this still remains the weakest expansion in terms of growth in the post-WWII era, one that has been aided and abated by the largest increase in debt across the financial system (government, corporate, and household) on record.

So here we are, where thus far we've experienced all of the good that low interest rates and money printing can provide, yet with the Fed having tried to reduce its balance sheet by just over 10% from its peak level of $4.5 trillion and increasing the fed funds rate to just 2.5%, it's became pretty clear that we aren't ready or able to deal with the removal of what were initially intended to be emergency policy measures. It's no wonder why we're seeing more and more adherents coming to the fore in support of Modern Monetary Theory (MMT), which basically stipulates that government debts and deficits don't matter because the Fed can just print more money to pay for whatever government spending is necessary. This is a very slippery slope in my opinion, but given what's transpired over the last decade I can't say I'm shocked to see the growing embrace of such theories from the far-left side of the political spectrum. But I'll say this, and that is that money does not create wealth but merely attaches a numerical value on goods, services and assets. If the idea is to print money to inflate your way to prosperity, then I'd make the argument that it's just a monetary illusion where everything goes up in price, leaving no one better off in real terms.

Apologies for the digression as I get back to the topic at hand, and that is the thought that here we are ten years removed from the global financial crisis, and yet the global economy remains so fragile that central banks around the world continue to be needed to come to the rescue to support asset prices. The extent to which these policies have infiltrated the financial and economic systems has rendered true price discovery a near impossibility. I don't say this in a cavalier manner as I understand and appreciate the gravity of such a statement, but it grows more challenging by the day to connect market prices with fundamental value across asset classes. A simple example is corporate profits, where according to the chart below from Bianco Research, analyst earnings estimates for 2019 earnings were between 10 – 12% as of mid-October and have since been cut in half to 5 – 6%.



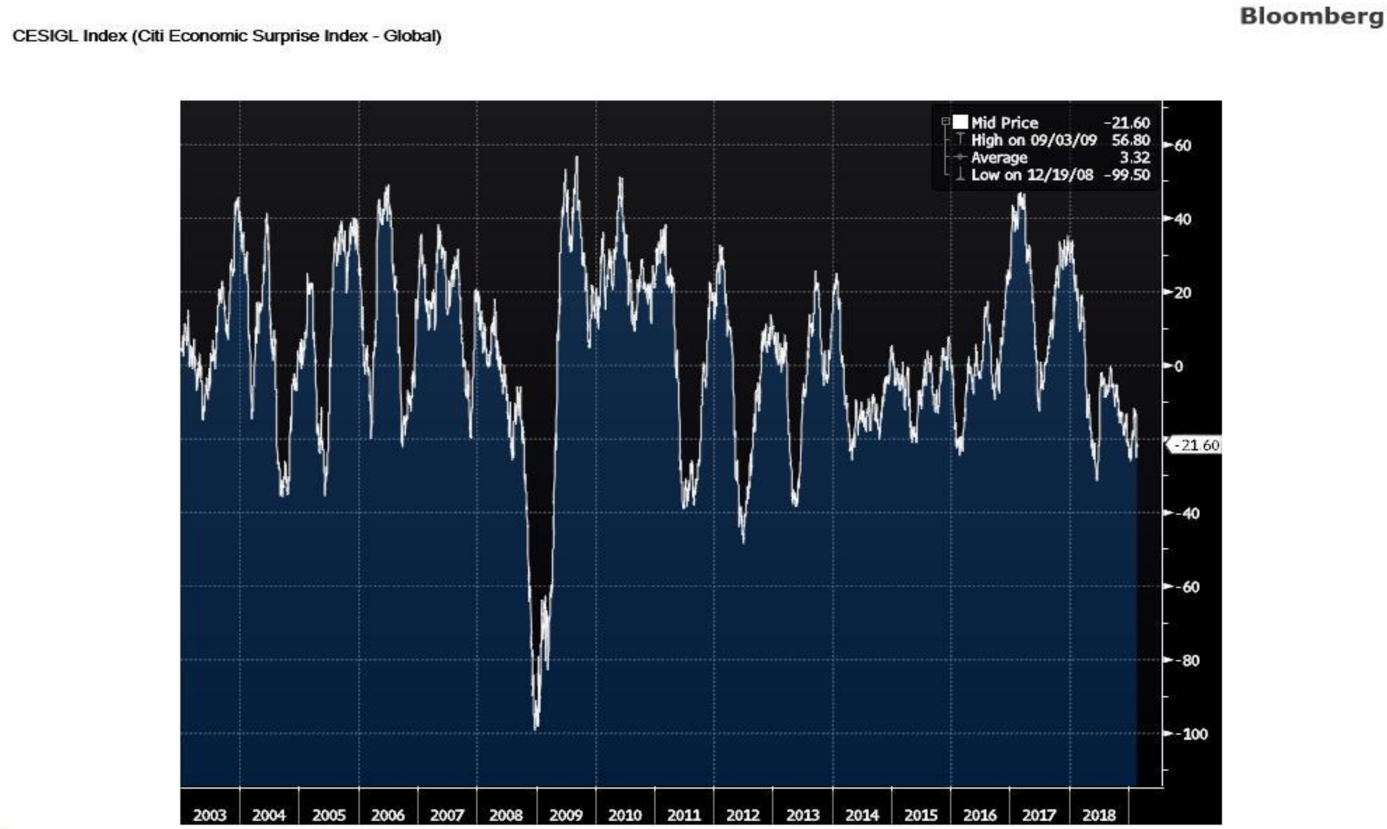
Yet the S&P 500 is trading today at virtually the same level it was in mid-October. It's not just corporate profits either, as we'll find out later this week when Q4 GDP is released, but we've already seen estimates fall from +3% to 1.7% and Q1 estimates are coming in around the +1.5 to 2.0% level. So not only have corporate profits been cut in half, but so too have expectations for economic growth. These aren't just one-off data points, as I'll go through a whole host of data below that is suggesting anything but a global economy that is stabilizing, let alone inflecting towards acceleration:

- January Japanese Exports sunk -8.4% YoY in January in what was the biggest contraction since October 2016. Exports to China plunged -17.4% YoY with the most pronounced weakness coming from semiconductors and machine tools – areas that wouldn't be experiencing material declines if the global economy was humming along.
- Exports in Thailand slumped -5.7% YoY in January – the third contraction in as many months.
- South Korea's trade numbers were the real eye opener given the importance this open economy has to supply chains across an array of cyclical sectors. Through the first 20 days of February, exports fell -11.7% YoY and imports plunged -17.3%. These figures were for February and tell you something about demand conditions and generally how soft the Asian economy is.

Some may argue that we already know that Asia's economy is weak and that is why China is stimulating like mad, but this doesn't tell us much about the U.S. economy. Well here are some metrics on the U.S. economy where I've tried to be as objective as possible in finding the silver lining, but in the end, they speak for themselves:

- Existing home sales through January have declined at a -19.8% annualized pace over the last three months.
- Auto sales through January have declined at a -17.6% annualized pace over the last three months.
- Core Capex Orders through December: -4.8%
- Core Retail Sales through December: -1.7%
- Manufacturing Workweek through January: -1.0%

I could go on, but a better summary can be gained by looking at the Citi Global Economic Surprise Index which is at -22.6, the same level it was at on December 24th when markets were at their lows. This index has been below zero for 227 days and counting – a day count that has only been exceeded by the Great Recession in 2008 – 09.



So many people remained so anchored to the +304k print in the January payroll report that they quickly dismiss any other data point that runs counter to the optimism it espouses. Forget the fact that in the latest NABE survey, 42% of economists believe a recession will hit in 2020, 25% see it as a 2021 story and only 10% see it as a possibility in 2019. Hallelujah, we don't have to worry about a recession in 2019, but don't mind the fact that 67% of economists see one coming in 12 – 24 months.

Look, I remain of the view that a recession in 2019 is a coin flip – so I can't sit here today and provide much more benefit than to proffer 50/50 odds, and even this is a best guess. But I'm firmly of the view that markets are totally devoid of economic realities at the present time. With each incoming piece of weak economic data, it becomes clearer to see why the Fed pulled the about face they did over the last two months – because the risk of an economic downturn is on the rise and they want to get in front of it. Though what is most shocking is the degree to which the markets jumped to price in (and price out) the possibility of such a downturn before it's even occurred. The proliferation of quant models, momentum driven strategies, algo trading, and leveraged ETF's have perpetuated the disconnect between fundamentals and prices and created an environment where the laws of economics and finance have been turned on their heads. These types of investment strategies appear to be front running policy and history because they have been conditioned to anticipate the reaction function of central banks in response to deteriorating conditions before a bear market or investor panic even occur.

I don't expect that such an environment can persist indefinitely, but in the meantime it's tough to have a high level of conviction behind investment recommendations in such an artificial environment. There is no doubt that coming into this week the momentum and breadth indicators of the equity market are bullish, but even so the divide between prices and fundamentals continues to widen. In such an environment I continue to think investors need to maintain their discipline and rely on a prudent portfolio allocation with a risk management process. I know focusing on any semblance of risk management has been a portfolio constraint over the last two months, but recall how beneficial it was to have such strategies in place in Q4. Furthermore, I continue to think that in the equity markets investors can find opportunity and value in high quality, Blue-chip, dividend growth companies, but let the recent events with Kraft-Heinz serve as a reminder that you can't blindly rely on the research of someone else to keep you abreast of a fragile company with a long history and storied reputation. It won't surprise me if by the end of this cycle, Kraft is looked back on as a canary in the coal mine as they are far from the only company that has leveraged up their balance sheet to fuel stock buybacks and maintain a dividend above what the operating metrics of the company would justify.

In addition to an equity focus on safe income at a reasonable price, short-term Treasuries remain a solid return generator in lieu of cash and provides holders with the optionality of redeploying this safe investment into other opportunities when/if they present themselves. Some exposure to precious metals (gold and silver) is prudent in my view and while the near-term return profile may be challenged given the strong run they had in the second half of last year, but with the Fed likely done with its tightening campaign and the growing chorus of government deficits not mattering – me thinks the long-term benefits of gold look very constructive. Lastly, patience – I remain of the view that this year and perhaps the next 18-months will be all about patience for those who have been awaiting a favorable opportunity to get more aggressive at more favorable valuation and price levels in both the corporate credit and equity markets. Mr. Market provided a brief window of opportunity in mid-December, and I still don't think that was the last window that will be opened.

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.