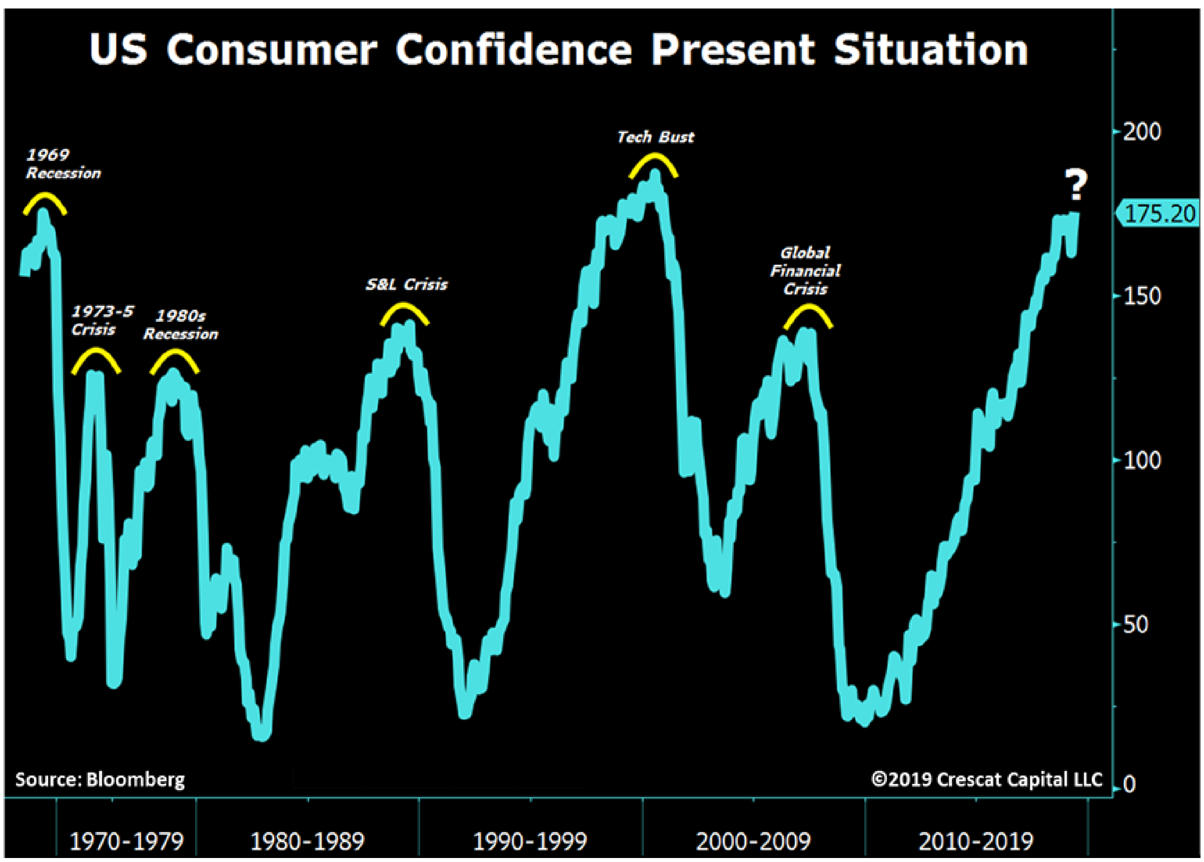
May 28th, 2019

The Data versus The Narrative…
We're at an interesting juncture where both the economy and capital markets are emitting conflicting signals, while at the same time, investor's opinions on what these diverging signals imply varies greatly. Trade wars aside – and I don't mean to belittle what is a very important issue on many facets – but I'd prefer to focus this missive strictly on fundamental data points.

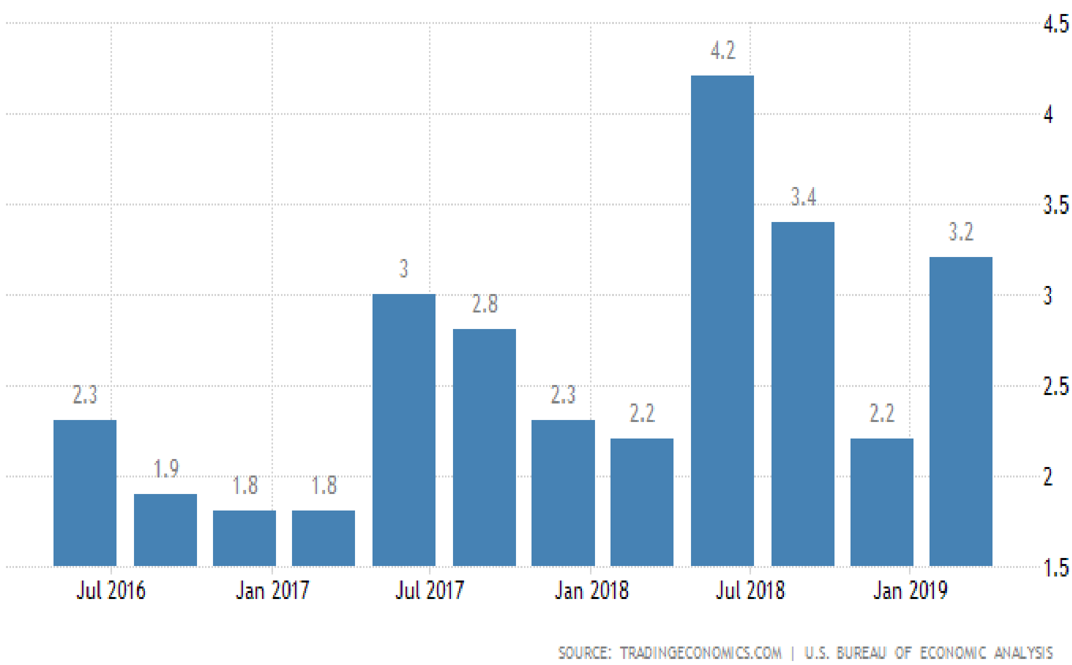
The bulls can rightfully point to data points like the chart below highlighting that consumer confidence just hit its highest level in 19 years, and the only time it was higher in the last five decades was at the peak of the Tech Bubble.



Helping to drive this upbeat sentiment is the fact that the unemployment rate is down to 3.6% and is sitting at its lowest level since 1969.

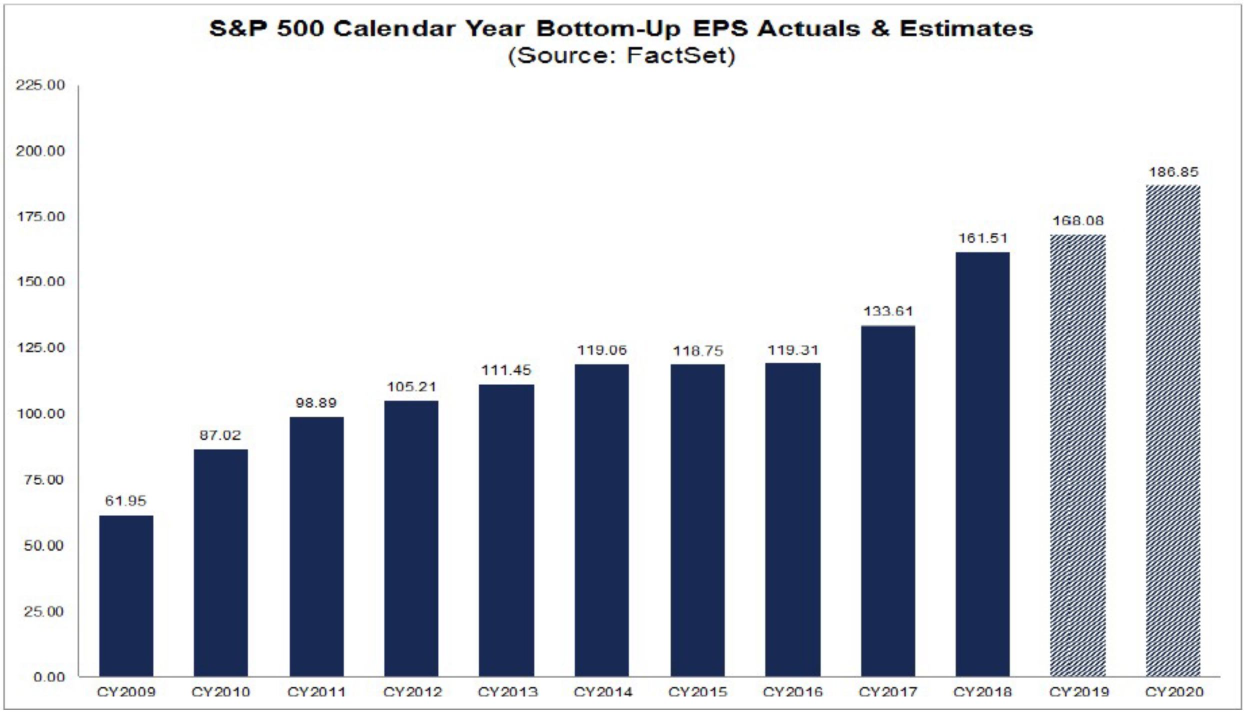
Providing confirmation to a high level of confidence and the low unemployment rate is the following table which tracks the quarterly growth rate of U.S. GDP going back to 2016, where it's obvious to even the naked eye that economic growth has picked up over the last two years. What's more is that over the last four quarters, the growth rate in GDP has come in a little above the heralded 3% pace.

U.S. Quarterly GDP Growth Rate



Then there is S&P 500 earnings growth (using Factset data), which after growing by 21% from calendar year 2017 (S&P 500 earnings of $133.61/share) to 2018 ($161.51/share) is expected to grow by 4% in 2019 (estimated $168.08/share), and 11% in 2020 (estimated $186.85/share).

Bottom-up EPS Estimates: Current & Historical



All of the above makes for a pretty compelling bullish narrative – individuals are feeling good, the employment data looks as good as it has in five decades (at least on the basis of the unemployment rate), GDP growth is expanding at a solid pace, and corporate profits are still growing. None of this data is fake news and anyone using it to support his/her optimistic investment thesis has a fundamental basis to do so.

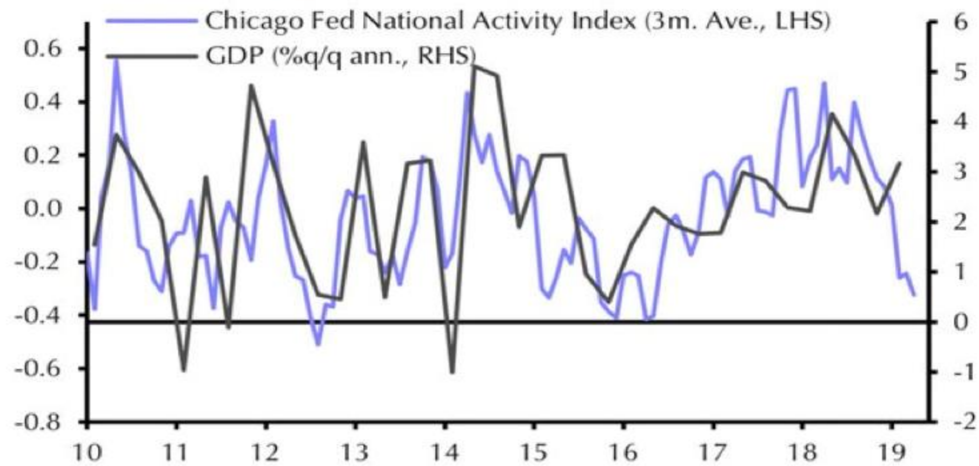
The biggest shortcoming to referencing and relying heavily on the above subset of data points to back-up a bullish investment/economic narrative is that they are all either lagging (tend to change only after activity has already changed) or coincident (showing the current state of activity) indicators of economic or business activity. The lone exception are the forward earnings forecast for S&P 500 earnings from the analyst community, but you kind of have to take them with a grain of salt as their base case for all year-ahead earnings projections is a growth rate of 10 – 12%, of which they then adjust off of as time lapses and new data inputs come in.

The pessimists (or bears) also have a cogent set of data points to make their argument today for why they think caution is warranted and conservative capital allocation strategies should be employed. The main crux of their thesis is that the best the U.S. economy can muster from a growth standpoint is in the rearview mirror. What's more is that the uptick in the data over the last two years wasn't organic but rather spurred along by unrepeatable fiscal and monetary policy stimulus. On the fiscal side, the U.S. benefitted from a large tax cut for both corporations and individuals which definitely lifted consumer sentiment and provided a large one-time lift to corporate profits. Additionally, while this forced the Fed to tighten monetary policy for fear of inflation accelerating too dramatically, their more restrictive stance was tempered by other central banks from around the world eventually having to become more accommodative as capital flocked to the U.S. in search of higher economic growth. Now that the sugar rush from this short-term jolt is behind us, the pace of economic growth is starting to moderate in the U.S., but the lagged impacts from the Fed tightening are starting to have an impact on activity.

Last week's release of the Chicago Fed National Activity Index (CFNAI) very clearly illustrates that a moderation in U.S. economic growth is on its way. It's worth noting that the CFNAI is perhaps the most comprehensive monthly statistical index that proffers the most information on the state of the U.S. economy in any given month, and averages 85 monthly indicators to measure national economic activity. The index came in at a rather anemic -0.45 for April and this marked the third negative reading in the past four months. The Chicago Fed recommends that followers of this index focus on the three-month moving average to smooth out the wiggles and noise, but this metric was also pretty ugly at -0.32 and the April reading marked the third consecutive negative reading (the worst such trend since May 2016).

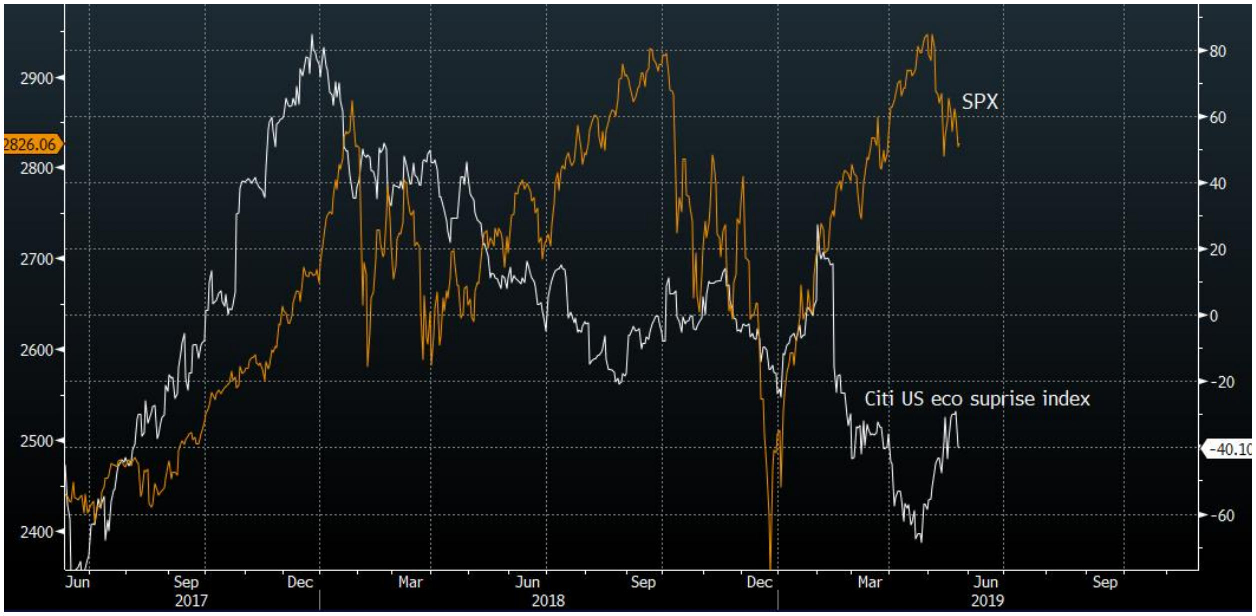
The below chart plots the CFNAI versus GDP as these two metrics have a fairly high statistical correlation, and you can see what the 3-month moving average of the CFNAI is suggesting about where U.S. GDP is heading in the quarters ahead.

Chart 1: Chicago Fed National Activity Index & GDP



Source: Refinitiv

The following chart, which plots the S&P 500 (orange line) against the Citigroup U.S. Economic Surprise Index, is yet another illustration of just how divergent the view has become between incoming economic data versus stock prices. The present gap is even wider today than it was when the S&P 500 peaked back in September 2018, before we went into the Q4 growth scare that saw equity prices careening lower to catch down to the deteriorating economic growth backdrop. One difference today versus then is that U.S. economic growth was on much firmer footing than it is today. Sure, it was decelerating from what was a robust pace of growth in Q2 and Q3, but equity markets reacted as if we were heading off the cliff into a global recession. Hence it wasn't a surprise to see equity prices rally at the start of the year once we saw stability (albeit, at a lower level…) in the incoming data. However, what was and continues to be a surprise is just how much the equity market continued to rally in the face of incoming data that started to roll back over in April.

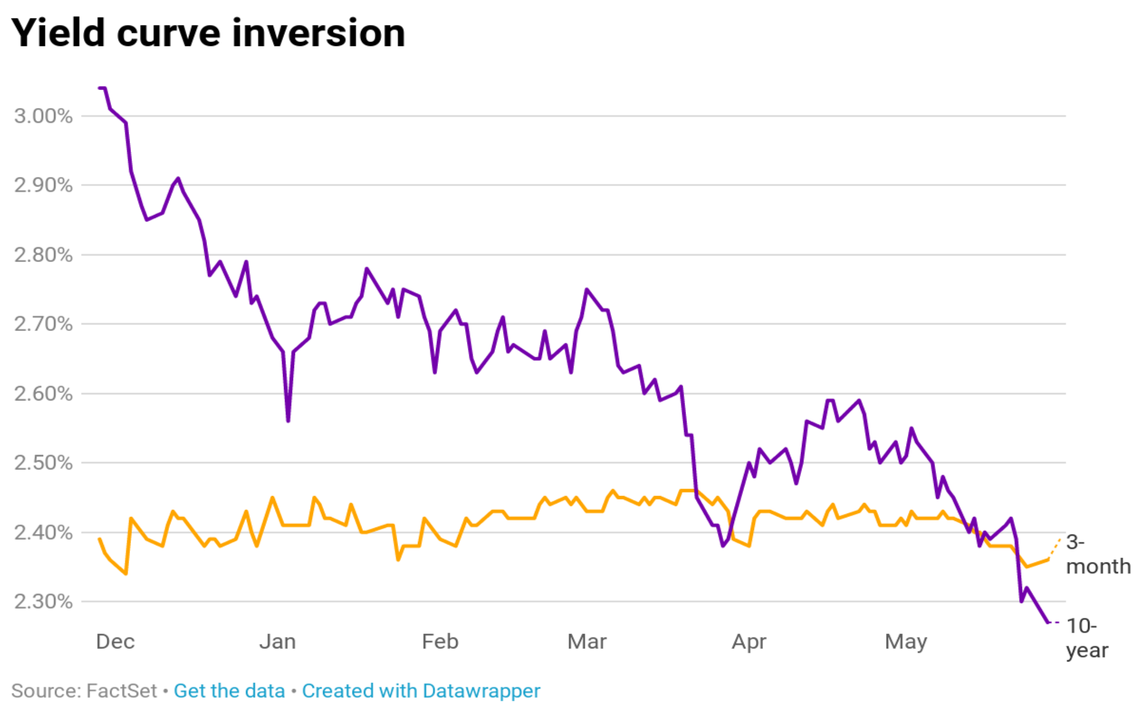


Just as the CFNAI has a strong relationship with U.S. economic activity, lumber prices have historically been a solid leading indicator for S&P 500 earnings. The below chart from Cornerstone Macro details this relationship, which highlights the year-over-year change in lumber prices (red line, advanced six months) versus S&P 500 EPS growth forecasts (blue line), and with lumber prices now more than 20% lower from where they were a year ago, it provides some confirmation for the slowdown in corporate profits that already appears to be underway.

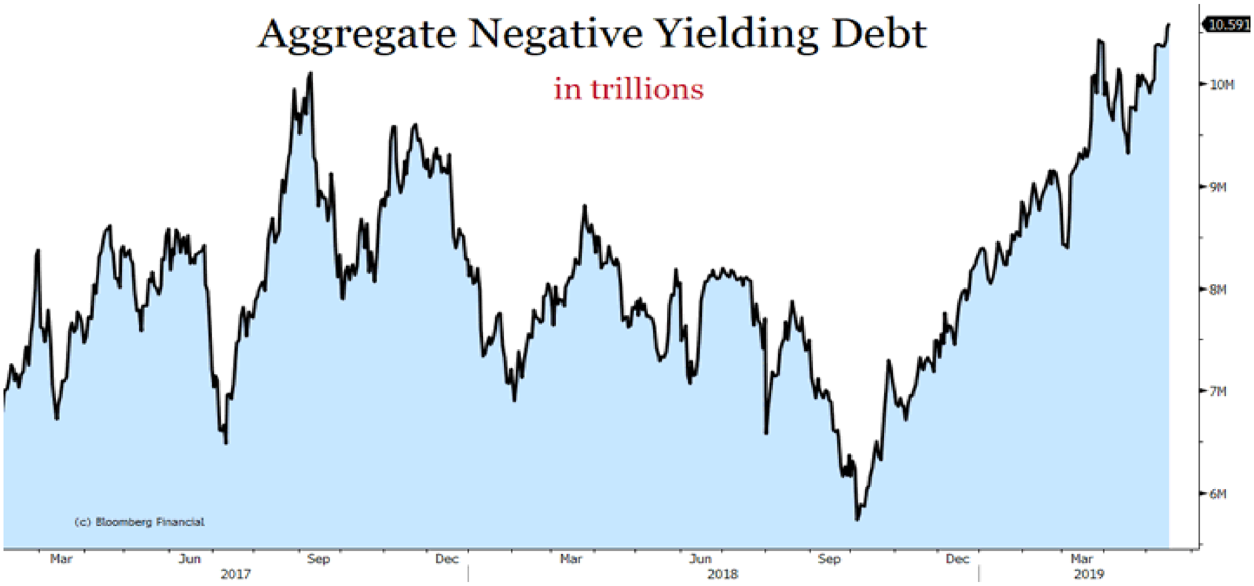
Source: Bloomberg, Cornerstone Macro, U.S. Global Investors

The biggest question both the bears and the bulls are wrestling with is whether the already lowered earnings growth numbers have been cut enough, or do they need to be cut more?

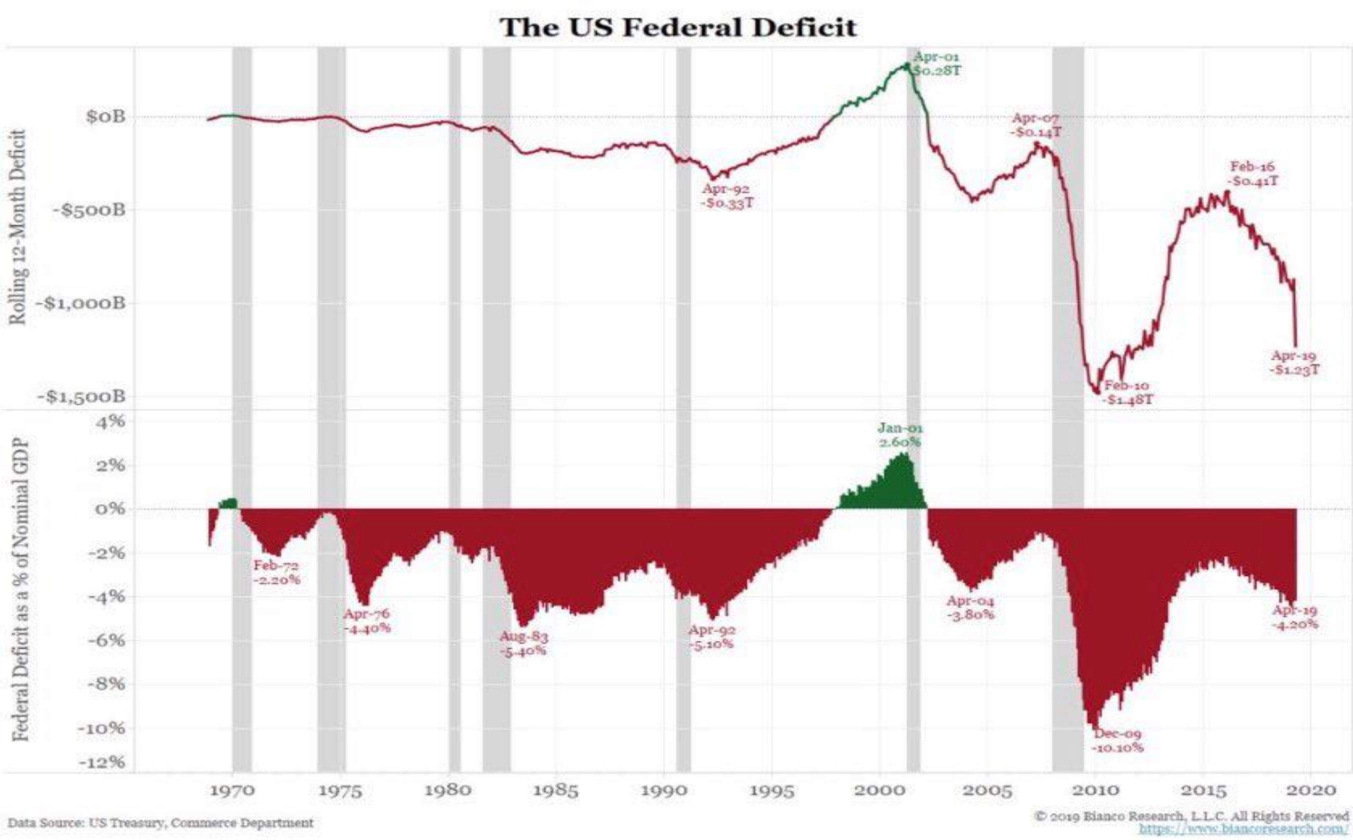
Beyond the divergent fundamental data that is creating this tug-of-war between bulls and bears, we have a similar battle going on between the bond and stock markets. The yield on the 10-year Treasury bond fell to 2.27% today, and this puts it at a 19-month low. Interestingly (and worryingly, I may add), is that this has inverted the yield curve even further than the moderate and short-lived inversion we saw back in late March. At this point the yield on the 2-year Treasury Bond is down to 2.12%, and this is 38 basis points below the top end of the Fed Funds rate at 2.50% – this is the bond market's way of saying the Fed is much too tight and if nothing changes, then the Fed is likely to be cutting rates before the end of summer.



Sure, the argument can be made that yields in the U.S. are being forced lower by international forces, with the German 10-year Bund dipping to a three year low of -0.15%, the UK 10-year Gilt at 0.92%, or the 10-year JGB at -0.9%. Whether it is inverted yield curves or the fact that the global fixed income market is back to approaching nearly $11 trillion in debt with a negative yield (see chart below), it's becoming more difficult for the rose-colored glasses crowd to explain away the growth concerns being transmitted from the bond market.



Speaking of debt, detailed below is the elephant in the room as it showcases the U.S. Federal deficit situation going back over the last six decades. Without question, it looks ugly and one logically has to ask the question, "how, with the 'best' economy in history and unemployment at five-decade lows, can U.S. fiscal deficits be approaching the absolute dollar value levels we saw back at the trough of the Global Financial Crisis?" We'll leave the long answer for another day, because I don't want this issue to dominate anyone's thinking (as anytime one looks at the debt issue in the U.S., it's hard not to go into some dark places), and I know this next comment won't provide much comfort, but it's important and also the reality: the rest of the world is in a much worse place. While on the surface it doesn't seem that comforting of a claim, but in the investing world and as it relates to capital deployment, this relative relationship is a very important variable and distinction. Furthermore, without these government deficits running at the levels they are, the U.S. economy wouldn't be growing at all and on net it would be contracting.



As for my closing two cents on the conflicting signals coming from the data, capital markets, and the narrative, I lean in the direction of what the bond market and deteriorating data are signaling. However – and this is a big but, and I very much wish it was not the case, BUT – there is some validity to the view that investors can't get too negative because with one tweet from the President, a comment from the Fed about interest rate cuts, a supportive and constructive statement on the trade front, or believable progress on an infrastructure bill, the stock market could rip higher. The fact of the matter is that the market as it exists today has become extremely sensitive and, in some ways, governed by its next policy fix, i.e.) QE, a pause in interest rate hikes, tax cuts, infrastructure spending, not so long ago it was a great trade deal that was 95% done… I still have no doubts that should/when things get ugly enough (as was the case in mid-December) the powers that be will come riding to the rescue to stem the tide. As long as it works they'll continue to attempt it, but don't forget that eventually fundamentals, valuations, and investment processes (instead of momentum chasing and speculation) will matter, and it's the complexity of all these dynamic parts that should crystalize why investors should continue to employ prudence, discipline, and risk management with their capital.

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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