Volume 80

THE PER STIRLING CAPITAL OUTLOOK

Performance • Perspective • Per Stirling

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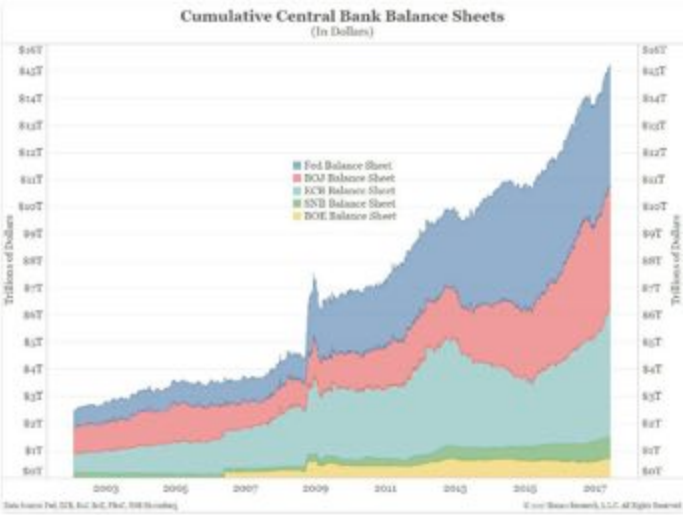
Imagine a family relaxing in a swimming pool, with every family member using a flotation device to remain on the surface of the water. It doesn't matter who is stronger or who is a better swimmer because everyone is being kept afloat by an external force. If the amount of water in the pool is increased, they all elevate together, and if the water level is lowered, everyone moves closer to the bottom of the pool at the same pace.

In many ways, this analogy applies quite nicely to the domestic capital markets for much of the past eight years, ever since the Federal Reserve made the conscious decision, in coordination with the world's other major central banks, to balloon the global money supply, as a means of inflating the prices of both financial and real assets.

Essentially, the Fed created trillions of dollars of credit, which they used to buy both treasury debt and asset-backed securities, thus pushing down interest rates and replacing bonds, which can't be spent, with cash, which can. This, in turn, both stimulated U.S. consumer spending, which represents approximately 66% of the domestic economy and 20% of the global economy, and lifted inflation up from what had been dangerously low levels.

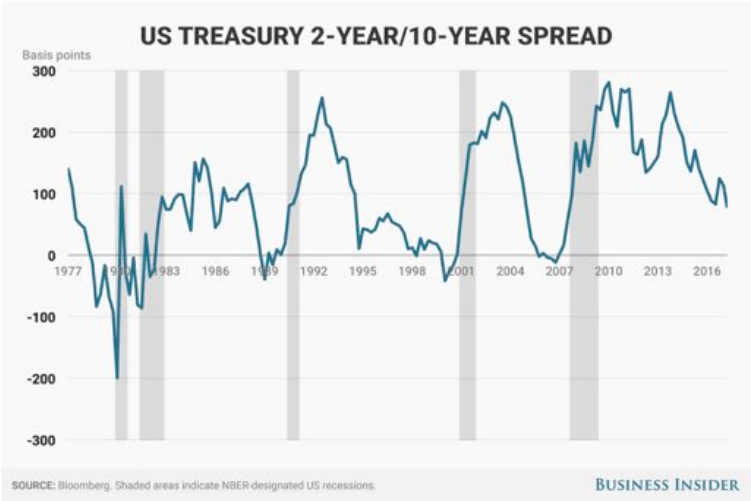
From a purely capital markets perspective, they dramatically increased the amount of money sloshing around in the economy (i.e. added water to the pool) under the correct premise that, if you dramatically increase the amount of money bidding for a relatively fixed number of assets, the competition will drive the prices of those assets (stocks, bonds, homes, etc.) higher.



This strategy catalyzed one of the biggest and longest bull markets in U.S. history; helped to re-liquefy the financial system, and incentivized the banks to start lending again.

Since the resulting reflation in equities, bonds, and real estate was caused primarily by simply increasing the amount of water in the pool, it also created a situation where not only did almost all asset classes (except oil) gain value at the same time, but where the majority of assets within each asset class appreciated by a similar amount and at approximately the same pace. This helped lead to the popularization of index investing, and made it virtually impossible for most active portfolio managers to, with any consistency, outpace the broad markets themselves (because everything went up and down in unison).

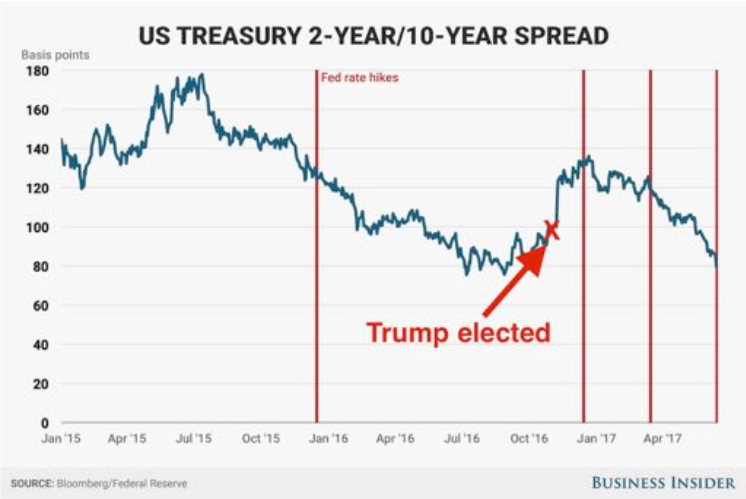
The associated economic and earnings recovery has helped to sustain the equity bull market beyond the October 2014 end of the Fed's monthly injections of more and more water into the pool (a.k.a. quantitative easing). Similarly, while the end of quantitative easing meant an end to the growth of the Fed's bond-buying program, bonds are nonetheless also enjoying a relatively impressive resurgence, based upon falling interest rates in Europe and Japan, persistent deflationary pressures, and a growing concern that the Federal Reserve is embarking on a change in monetary policy that could send the U.S. back into recession.



All the while, the Federal Reserve's decision to continue raising short-term rates at a time when global deflation and slowing domestic growth are keeping long-term rates near historic lows is "flattening the yield curve" (i.e., shrinking the difference between long and short-term rates). At present, the difference between 2-year and 10-year treasury yields is the narrowest since 2007, and only 0.40% separates both 2-year rates from 5-year rates and 5-year rates from 10-year rates.

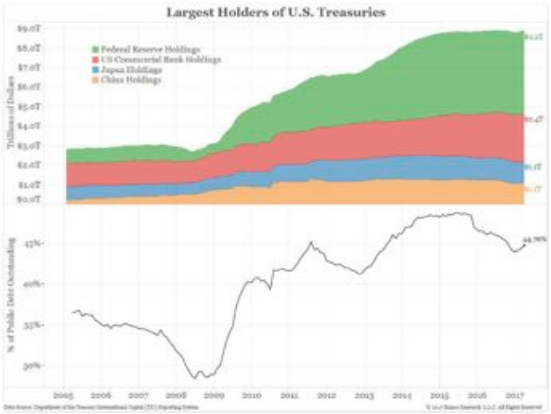
While this revelation may, on its surface, seem just about as exciting as wet cardboard, an even partial inversion of the yield curve, where short-term interest rates are actually higher than are longer-term rates, has historically proved worthy of paying attention to. Indeed, an inverted yield curve (shown by a reading below the "0-line") has preceded each of the past seven recessions (shaded areas). This is only logical, as an inverted yield curve is primarily a market-based manifestation of investor expectations for slowing growth and lower inflation.

Indeed, each of the four times that the Fed has raised rates during this economic cycle the yield curve has flattened (long and short-term rates have converged). This is a normal causal relationship, which is why monetary tightening is often a precursor to an inverted yield curve.



However, as referenced above, there is also a causal relationship between an inverted yield curve and a slowing economy. To explain, banks and other lending institutions "borrow" the money that they lend out from their depositors, and they pay short-term rates for those funds (checking account, money market and certificate of deposit rates). In contrast, consumers and businesses that take loans from a bank normally pay long-term rates because they are borrowing for longer periods of perhaps 5 to 30 years.

You can start to appreciate the deleterious impact of an inverted yield curve, where the short-term rates that banks borrow at are higher than what they can loan the money out for. In such an environment, banks can no longer afford to lend, which restricts economic liquidity and impacts both consumer spending and the housing market, which can catalyze a recession.



Indeed, the yield curve does not actually need to fully invert to cause major problems in the financial system. With each incremental narrowing between long and short-term yields, it makes it less and less profitable for banks to lend, particularly on a risk-adjusted basis and, when lending is no longer profitable, banks will tend to do what they did during the financial crisis, which is to just buy government debt or leave their depositors' money on deposit at the Fed, and that can cause the economy to seize up, just like an engine without oil.

Importantly, no economic indicator is perfect, and an inverted yield curve is no exception, as it has given a few "false positives" over its long history, the most recent of which was in 1966, when a recession did not start until two years after the inversion occurred.

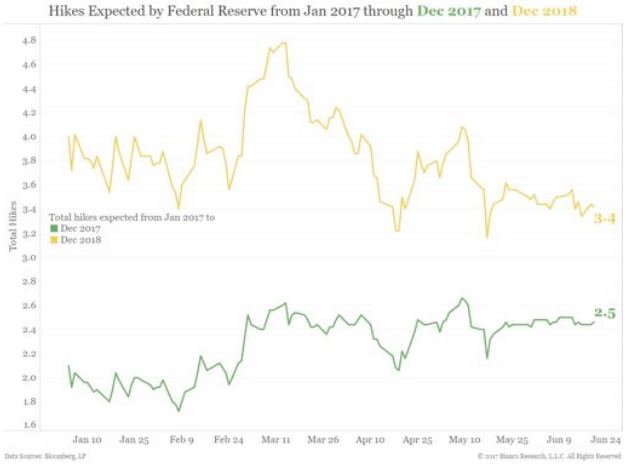
Moreover, we continue to witness unprecedented levels of government interference in and manipulation of the capital markets (primarily credit creation and asset purchase programs), and it is probable that this fact is itself distorting the shape of the yield curve, which calls into question whether or not this signal can be relied upon at all in the current environment.

Indeed, there was actually a Federal Reserve program deployed in 2011 called "Operation Twist", through which the Fed sold short-term securities from their own balance sheet and bought equal amounts of longer-maturity debt from the markets for the sole purpose of distorting the shape of the yield curve.

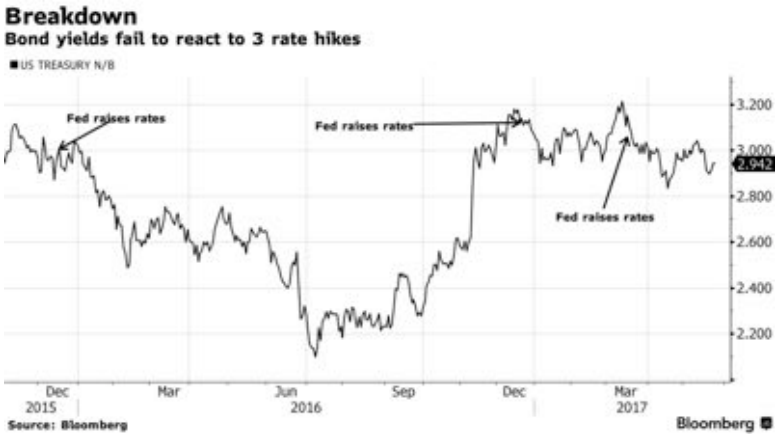
Nonetheless, because of the normally interdependent relationship between monetary policy tightening, an inverted yield curve and economic slowing, we believe that these yield curve dynamics continue to bear close watching. This is particularly true in light of the notable shift that is underway in the Federal Reserve's approach to monetary policy.

From our perspective, there have recently been several substantial changes in the way in which the Federal Reserve sees its role. First of all, until recently, the Fed appeared to use any piece of weak economic data as an excuse to justify delaying further increases in short-term rates. However, now that the economy is actually starting to show some signs of slowing, particularly when compared to expectations, the Fed is signaling that both the slowing and the emerging signs of disinflation are merely temporary, and that they still expect to raise rates one more time in 2017 and three more times in 2018.

It is noteworthy that the bond markets do not believe them, as illustrated by the fact that the fed funds futures contract is only pricing in one and one-half Fed rate hikes by the end of 2018. Indeed, if you consider how markets are reacting to each Fed increase in short-term rates, it appears that bond investors are betting that the Fed will become overly aggressive in removing its stimulus and push the economy back into recession. As you can see, long-term yields have actually fallen subsequent to each increase in short-term rates. The fourth Fed rate increase took place last week and, while not illustrated below, long-term rates have declined even further since that time.



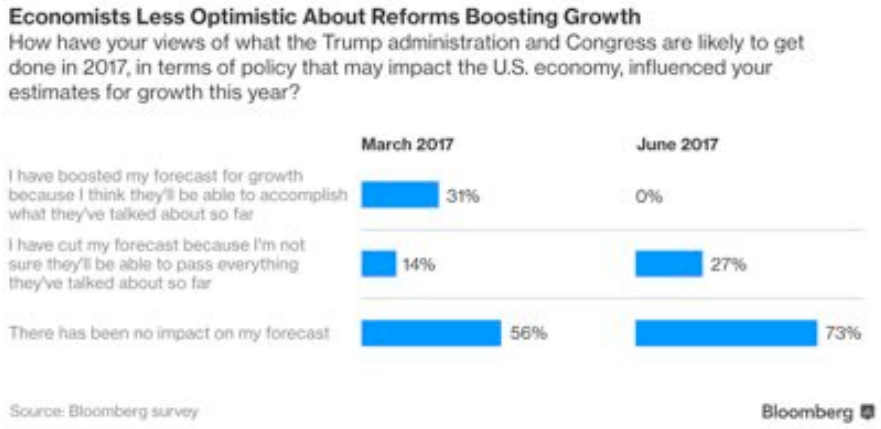
A third change that we perceive in regard to the Fed's view of its role can be found in its members' growing references to high asset prices and market valuations. The Fed understands the implications of its decision to put so much water in the pool and thus drive asset prices to historically elevated levels, and they seem increasingly determined to take whatever steps necessary to avoid being scapegoated as the cause of the next asset bubble.



That objective is likely to lead to higher short-term rates, and the start of the process of shrinking the Fed's balance sheet (actually draining water from the pool).

This draining process is expected to start in September and, according to Fed guidance, is expected to be achieved by capping the amount of maturing debt in their $4.5 trillion portfolio that they can reinvest (up to the red line). That means that the amount of maturing debt (blue bars) that is above the red line will need to be reabsorbed by the markets, which should drive longer-term interest rates higher and replace cash in the economy, which can be spent, with debt, that can't, thus effectively further reducing the "water" level that has been supporting asset prices.

On one hand, this would probably steepen the yield curve, which would allow banks some profit margin to justify lending, thus lessening the risk that an inverted yield curve and/or a lack of lending from the banking system would be the catalysts for the next recession. On the other hand, such a strategy would accelerate the draining of the liquidity (pool water) that had first elevated and then supported the prices of financial assets throughout the recovery from the "Great Recession".



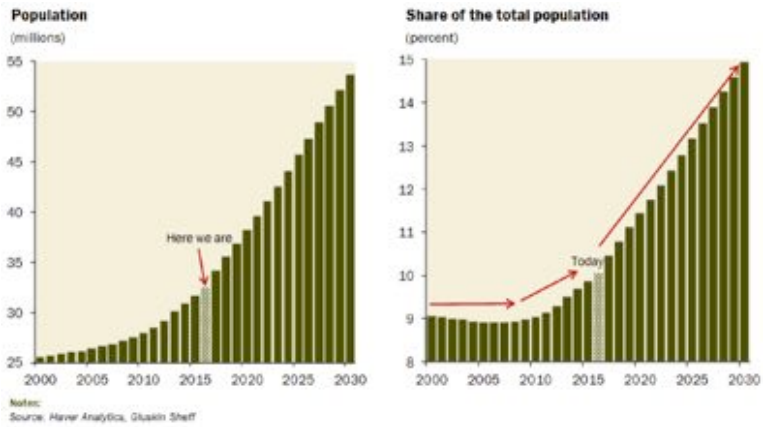
Of note, despite the Fed already raising rates four times, we still believe that it would be inappropriate to say that they are actually "tightening" monetary policy. In other words, because monetary stimulus is still at such extraordinarily high levels, it is more like they are "unloosening" [sic] or going from really, really, really stimulative to only really, really stimulative. However, no matter what you call it, the days of being able to count on expansive monetary policy to keep financial assets afloat should increasingly become a thing of the past.

Of course, the reduction in monetary stimulus could easily be replaced by fiscal policy and legislative reform, if Washington could get its house in order, and the market impact of economic reform or tax cuts would likely be quite substantial now that Wall Street has largely written off any likelihood of legislative successes or fiscal stimulus.

Moreover, if you look under the surface, you will see that, while Trump has had virtually no legislative successes, he has been quite active with executive orders and the cutting of burdensome regulations, which should, over time, increase both productivity and corporate profits.

You can see this reflected by the enormous reduction in the number of pages contained in the Federal Register of government agency rules, proposed rules, and public notices. However, the economic benefits of deregulation tend to be at least intermediate term in nature so, with monetary stimulus on the wane and fiscal stimulus still in doubt, we expect for the unique fundamentals of each security to become increasingly more important than the monetary policies that have supported the broad markets since the days of the crisis.

In other words, with the water level of the pool being slowly drawn down, it will become all-important to identify who is the strongest swimmer after all. From an asset class perspective, we are decidedly neutral on the bond markets. With current yields and inflation rates already near historic lows, we see very little upside potential, unless the U.S. were to experience a deep recession or another financial crisis.



On the other hand, it is also hard to envision much downside risk in the broad debt markets for both the various reasons noted in the body of this report and because of America's graying demographics.

These charts detail the number of people and the percentage of the population turning age 70, and suggest that, despite the lack of value in bonds, there will be an ongoing demand for fixed income that should help to support bond prices for some time to come. This is particularly true when you consider that, according to Gluskin Sheff, less than 4% of the average household balance sheet is currently in bonds. The average family has three times as much in cash and six times as much in equities.

However, we still maintain our preference for equities over debt, but believe that the seemingly inevitable, albeit very gradual, Fed draining of liquidity from the pool will be a seminal moment for equity investors, as it will separate the weak swimmers from the strong ones.

We continue to favor European equities, particularly in light of the prospects for a "soft Brexit", and also find opportunities in Japan and the world's emerging markets. In the U.S., we generally prefer large-capitalization stocks of companies that derive much of their revenues through exports, which is where a disproportionate share of U.S. earnings growth is coming from, and because we believe that the U.S. dollar has already experienced most of its advance.

We will also make a controversial call (even within the firm's own partners) that, for the first time since the advent of the Fed's quantitative easing programs, we expect to see adept stock selection start adding significantly to risk-adjusted returns. We base this premise on two things: 1) the Fed will start draining liquidity, which has been the great equalizer between securities, and 2) we are already seeing the correlation between stock prices drop to the lowest levels since 2006, as some investors are already getting started on the process of differentiating between the strong swimmers and the weaker ones.