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THE PER STIRLING CAPITAL OUTLOOK

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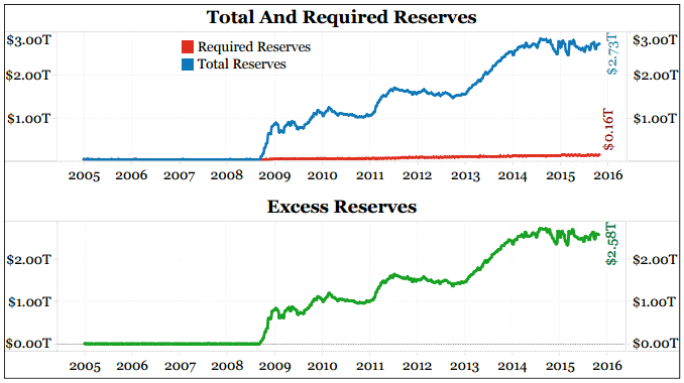
In December, we are likely to witness an extraordinarily unusual scenario of a major economic power (the United States) not only raising rates for the first time in over nine years, but also tightening monetary policy at a time when virtually all of the remaining industrialized world is moving their monetary policy in the exact opposite direction.

This creates an environment in which many economic and capital markets factors (like currencies, commodities, interest rates, asset flows, corporate profits, etc.) may react in some important and potentially very unpredictable ways.

To put this impending interest rate increase into some perspective, in 2008, the Federal Reserve launched the largest monetary stimulus program in history with two well-defined goals in mind. The first was to drive interest rates on savings vehicles to virtually 0%, as a means of forcing money out of savings institutions and into the capital markets, where it could be put to work in the real economy. The second was to create asset class inflation under the premise that, if you increase the value of the American consumers' homes and investment portfolios, it would create a sort of "wealth effect" that would encourage consumption and stimulate the economy.

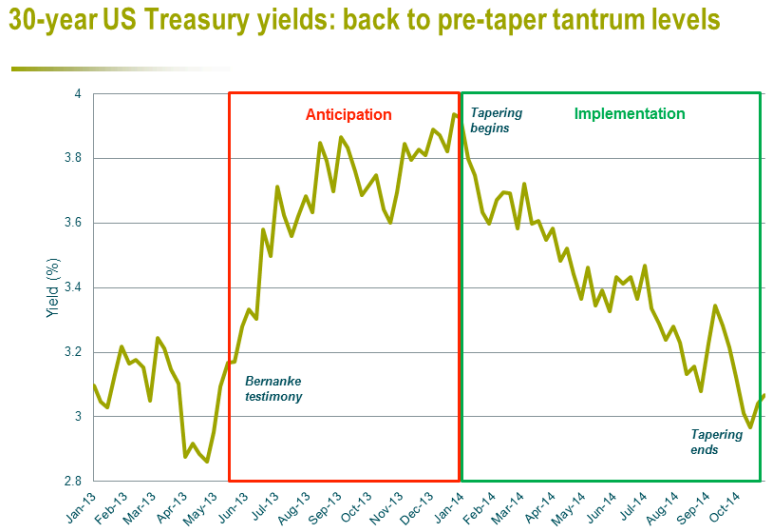
We suspect that their plan was not as effective as they had initially anticipated, as a huge amount of the more than $3 trillion dollars that they injected into the financial system never made it into the economy through bank loans, as the banks instead just left it on deposit at the Federal Reserve (in the form of "excess reserves") and remained content to make a low but risk-free return on the difference between what they were paying savers for deposits and what they were receiving on their own deposits at the Federal Reserve.

While clearly not as effective as the Federal Reserve had hoped, their zero percent interest rate policy (a.k.a. ZIRP) and quantitative easing (money creation/asset purchase) policies did serve to stabilize the economy and facilitate a modest, but seemingly sustainable economic recovery in the United States.



The critically important role of these policies is why the Federal Reserve has been so slow, so deliberate and so transparent in their efforts to wean the domestic economy off of its need for monetary stimulus. After all, the last thing that the Federal Reserve wants is for the capital and/or real estate markets to have a violently negative reaction to the withdrawal of stimulus which, in turn, creates a "negative wealth effect" that could put the economic recovery at risk.

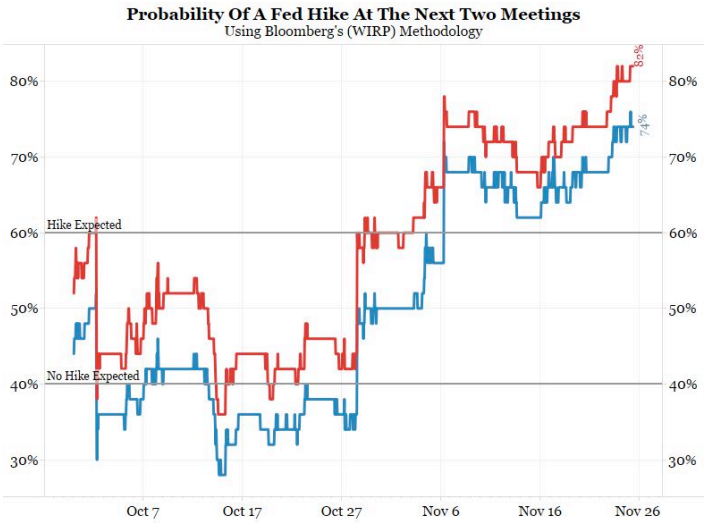
In fact, the anticipated rate increase would actually be the third of four steps toward monetary policy normalization. The first was the summer of 2013 announcement from the Fed that they were preparing to "taper" (i.e. gradually reduce the size of) their asset purchase program that ultimately purchased over $3.5 trillion (roughly the size of the German economy) of U.S. Government debt and asset-backed securities. This announcement resulted in the so-called "taper tantrum", which temporarily pushed both emerging market equity and global bond prices sharply lower (i.e. yields higher).



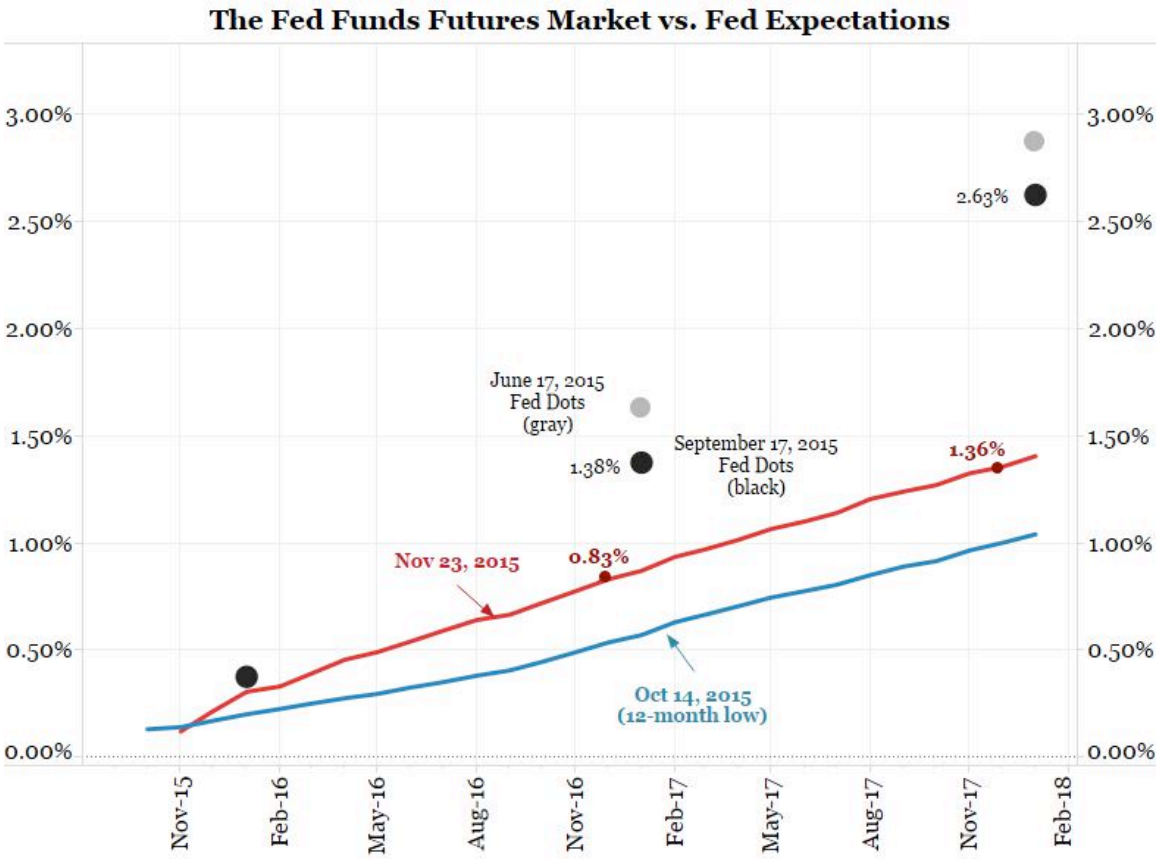
The fourth and final stage of normalization is the shrinking of the size of the Fed's balance sheet, first by letting their existing holdings mature without replacing them, and then ultimately through outright asset sales from the Federal Reserve's $3.5 trillion portfolio of debt securities. This will probably not start until after the interest rate increasing cycle is well underway, which may be as much as several years into the future.

As was noted in a November 19th speech by Fed Vice-Chairman Stanley Fischer to the Asia Economic Policy Conference at the Federal Reserve Bank of San Francisco, "We have done everything we can to avoid surprising the markets and governments when we move, to the extent that several emerging market (and other) central bankers have, for some time, been telling the Fed to 'just do it.'"

The Fed has been as open and obvious as possible, and this should help to dampen the impact of higher rates on the capital and asset markets, as something so well anticipated should already be largely reflected in prices.



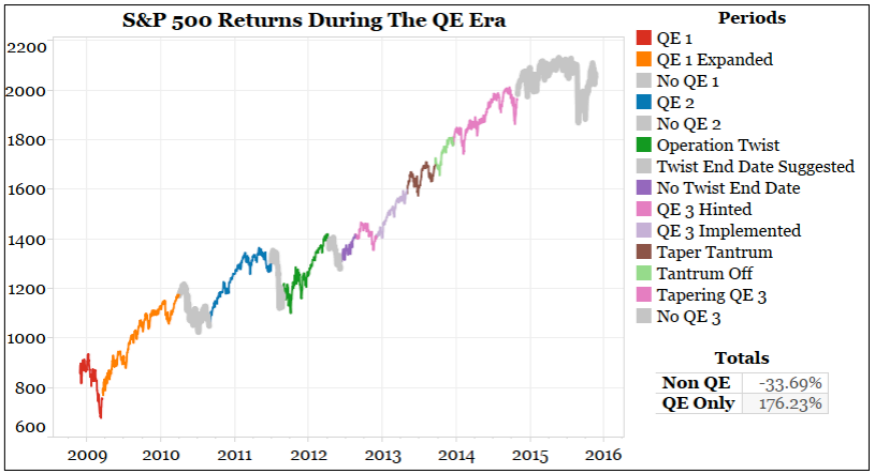
That is a reasonable expectation, which is at least partially confirmed by the Fed Funds futures markets, which are now assigning a 74% likelihood of a December rate hike and an 82% likelihood that the first rate increase will take place at one of the next two Fed meetings. This expectation is further supported by the soaring value of the U.S. dollar, a surge in the yield of 2-year notes, and the near collapse of many global commodity prices.



On the other hand, while this first rate hike seems to be well anticipated, a comparison of the Fed Funds futures (the red and blue lines representing what "the markets" think) to the average expectations of the voting members of the Federal Reserve, as noted in the minutes of the most recent Federal Reserve meeting (the black dots representing what the Fed thinks), you will see that the dots are considerably higher than are the lines. In other words, the voting members of the Federal Reserve expect future rates to be higher than the markets expect, which suggests that, while the markets are in fact discounting some of the implications of higher rates, there is still more adjustment to come.

Moreover, this policy change has the potential to create great macroeconomic uncertainty at a time when the world's capital markets have become extraordinarily dependent on expansive monetary policy. To illustrate this important and very close correlation between Federal Reserve policy and the capital markets, we offer two facts.

First of all, according to a recent Deutsche Bank study, during the period from 1994 to 2011, if you owned the Standard & Poor's 500 for only eight days per year, you would have made 80% of the gains made in equities over those 17 years. Specifically, those days were the 24-hour period before each meeting of the Federal Reserve, when the average gain has been 0.5% per day.

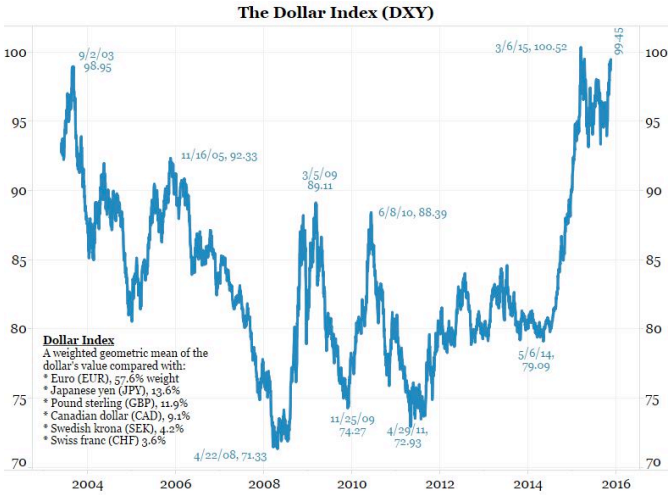


Second, as is illustrated in the Bianco Research

chart of the Standard & Poor's 500 since the 11/25/08 start of the Federal Reserve's quantitative easing programs, the S&P has gained a net 176.23% during periods when there was expanding monetary stimulus and has lost a net 33.69% during times when there was not increasing levels of stimulus (periods illustrated in grey).

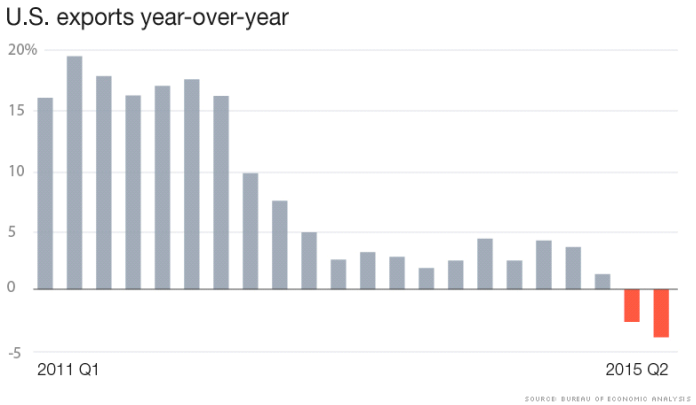
While we do not believe that it necessarily follows that equity prices must fall in response to Federal Reserve tightening, it does illustrate the historic importance of the relationship and the headwinds that the rate hike is likely to create.

Importantly, because markets are forward-looking, we do not need to wait until the rate increase takes place to gain an understanding of its likely implications. Since the level of interest rates is a prime determinant of the global demand for a currency (and therefore the price of a currency), it only makes sense that the first place where you would expect to see expectations for higher rates reflected is in the currency markets, where the dollar has been soaring since May of last year, when former Federal Reserve Chairman Ben Bernanke first warned about "tapering" (i.e. the gradual reduction in the dollar amount of debt that they were buying every month).



As soon as the Bernanke comment was made, it became evident that the United States was on a very different path than every other major industrialized country, in that the U.S. was slowly moving toward tightening just as the rest of the world was increasingly committed to significant monetary easing. This divergence explains the parabolic rise in the dollar against the currencies of its major trading partners (the Dollar Index or DXY).

A strong currency can be very beneficial in the later stages of an economic expansion, as it helps to mitigate inflation and increases the purchasing power of the American consumer.



However, due to the after-effects of the financial crisis, deflation (falling prices) remains a much bigger risk than is inflation, and domestic inflation remains well below the Fed's 2% target rate. Indeed, if you compare the difference in yield between inflation-adjusted treasury debt and non-inflation adjusted treasury debt of the same duration, you will see that inflation is expected to remain below 1.3% over the next three years and below 1.6% over the next ten years. In this case, the risk of a stronger dollar is that it will exacerbate these deflationary trends, which

would retard consumer spending and put additional downward pressure on both interest rates and domestic growth.

Another problem associated with the stronger dollar is that it makes the prices of U.S. exports uncompetitive compared to similar products made in other parts of the world. Similarly it puts domestic companies at a competitive disadvantage with the U.S. consumer, as the prices of foreign goods get lower and lower. As a result, a strong dollar will tend to stifle growth in manufacturing sector employment.

The strong dollar should be of particular concern for big U.S. multi-national companies, which derive approximately 45% of their total revenues from exporting to other countries, and this is already having an impact on U.S. corporate profits.

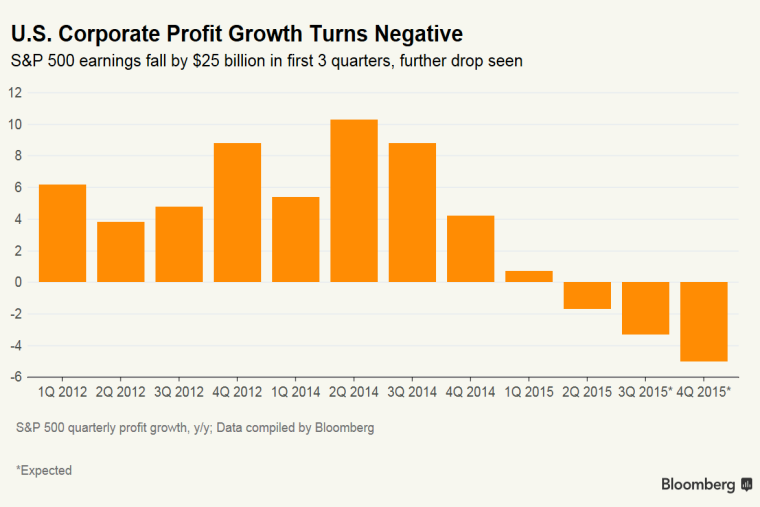
S&P 500 Revenues by Geography (Mkt Wgt)	U.S.	Europe	Asia	Other
Energy	38%	18%	7%	38%
Materials	42%	24%	12%	22%
Info Tech	44%	14%	19%	23%
Industrials	57%	17%	14%	12%
Health Care	60%	17%	6%	16%
Cons Staples	63%	7%	3%	28%
Cons Disc	73%	10%	3%	14%
Financials	80%	8%	7%	5%
Utilities	96%	0%	1%	3%
Telecom	100%	0%	0%	0%
S&P 500	**55%**	**13%**	**8%**	**24%**

Source: RBC Capital Markets Research, Capital IQ

Indeed, profits from S&P 500 companies have fallen by about $25 billion in the first three quarters of this year, and a further drop is expected before the end of 2015, largely due to significant losses in the energy sector.

According to a just-released report from Bloomberg, the aggregate revenue for S&P 500 companies has fallen by $287 billion over the same period last year. On a share-weighted basis, S&P 500 profits were down 3.3 percent year-on-year in the third quarter, making this earnings season the worst since 2009, and marking a second consecutive quarter of negative earnings growth

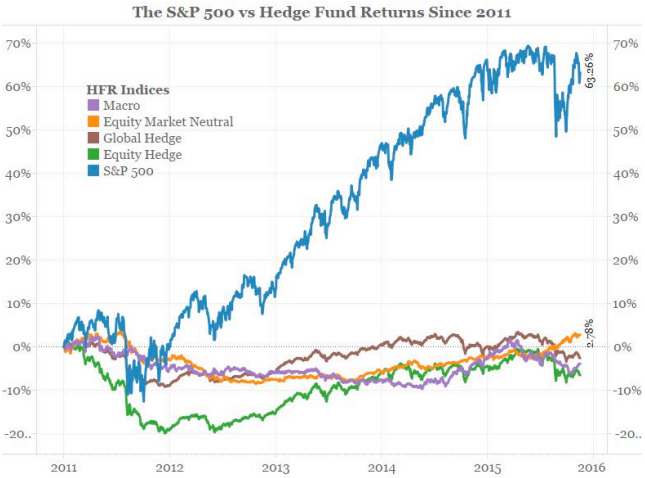
However, despite this trend toward declining earnings, we continue to like the domestic equity markets for a variety of reasons, including our expectations for foreign investment flows into domestic equities, a recovering economy, and improving job growth. Also important to us is the fact that the domestic equity markets have reacted to a growing array of both geopolitical and macroeconomic risks (expectations of higher interest rates, the Paris terrorist attacks, the Turkish downing of a Russian fighter jet, and the Russian response of moving advanced anti-aircraft weapons into Syria) by moving higher in each instance. One of the most useful definitions of a bull market is a market that advances in the face of bad news.



However, as much as we like the domestic equity markets,

we like the European (and even Japanese) equity markets even more. They are less expensive relative to earnings than are domestic stocks, they have the benefits of increasingly stimulative monetary policies, and they are likely to benefit from a stronger dollar, as it makes their goods more attractive to the American consumer. The ongoing terror threats in Europe certainly have the potential to create great volatility, and we consider additional attacks to be quite likely. However, we also expect for these threats to keep governments and central banks even more supportive of the capital markets than they would otherwise be.

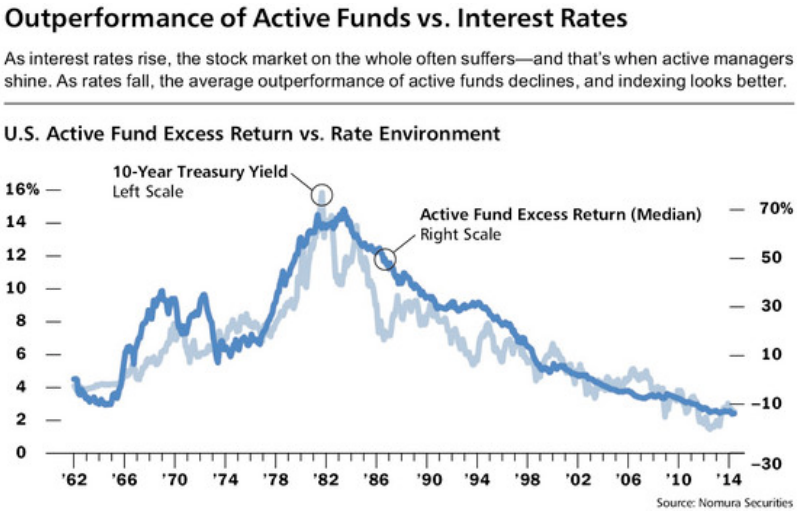
The least expensive of all global equity markets tend to be found in the emerging market space, and there are some well-respected analysts who are starting to make a case for investing in these developing economies. However, we still have two major concerns that leave us quite cautious. First of all, the recent devaluation of the Chinese currency has hurt the global competitiveness of most other manufacturing-based emerging economies. Second, since the external debt of most emerging markets is valued in U.S. dollars, each increase in the value of the U.S. dollar effectively increases the indebtedness of these countries.



While a stronger dollar will no doubt present a modest headwind for U.S. investors investing overseas, we do believe that the potential rewards of adding to European and, to a slightly lesser extent, Japanese equities is well worth the risk.

We also suspect that we are likely to see a shift in domestic outperformance to portfolios that emphasize securities selection and tactical allocations over simply seeking a broad exposure to the equity markets.

Frankly, since the start of the Fed's quantitative easing programs, it has been very challenging for more tactically oriented managers to out-perform the broad indexes themselves. Nowhere is that more evident than in the hedge fund space which is, at least theoretically, comprised of the best tactical managers in the world. However, central bank policies have distorted the pricing of markets and frequently left more-tactical managers making the worst possible decisions at the worst possible times.



There are two reasons why we suspect that this relationship is likely to change over the intermediate term.

First of all, with the Federal Reserve continuing to

"normalize" its monetary policies, markets should trade increasingly on their own unique fundamentals instead of central bank policies, and this should help to restore value to fundamental and technical analysis. Second, in light of the fact that active portfolio management tends to outperform the markets when rates are rising and underperform the markets when rates are falling, the anticipated Federal Reserve decision to start raising interest rates should breathe new life into the portfolios of "stock pickers" and tactical allocators. It will be interesting to see if history repeats itself.