Volume 62

# THE PER STIRLING CAPITAL OUTLOOK

Performance • Perspective • Per Stirling

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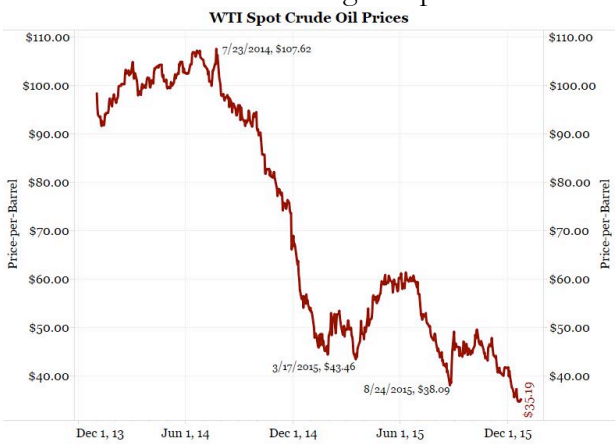
Warren Buffett famously noted that "only when the tide goes out do you discover who's been swimming naked." This quote has particular relevance today as we are finally starting to see free-market pricing mechanisms at work, as market-distorting forces ranging from the Federal Reserve's expansive monetary stimulus programs to the O.P.E.C. oil cartel are increasingly loosening their grip on the markets.


It is a slow adjustment, and its full impact will not be felt for some time to come, but prices are increasingly being set by more traditional factors such as supply and demand and the unique fundamentals of each individual security. This has implications that are both impactful and far-reaching.

For an example of this concept, one needs to look no further than the energy markets, where the O.P.E.C. decision to abandon its role as "swing producer" has caused oil prices to collapse by over 67%. In other words, O.P.E.C. decided to let market forces like supply and demand set the price of oil *in lieu* of their normal practice of conspiring to reduce supply as a means of keeping prices high.

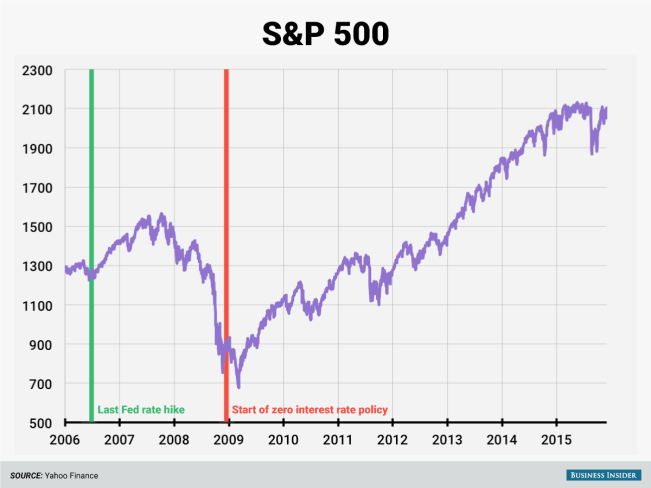
This decision was made to protect their market share, to crush the emerging U.S. shale-drilling industry, and to punish and weaken their traditional enemies (Russia and Iran). It will be very interesting to see just how long free-market forces will be allowed to prevail (especially after Iranian production returns to the market *en masse*), as Saudi Arabia is already needing to issue bonds to support its $100 billion annual deficit, and the International Energy Agency just announced that it will likely still take several more years before O.P.E.C. can effectively price out high-cost producers like the domestic shale-drilling companies.




However, O.P.E.C. is a relatively minor player in the market manipulation game when compared to the global central banks, and now their "tide" is slowly going out, first by "tapering" (i.e. reducing the size of) their quantitative easing programs from $85 billion per month to $0 (as of October of 2014) and second, by increasing interest rates in December, for the first time in almost ten years.

These programs were specifically designed to create asset class inflation, and they were very effective in that regard. Almost all asset classes, including equities, debt securities, real estate, and even certain commodities saw their prices rocket higher over this period of monetary stimulus. However, now that that stimulus is starting to wane, we are starting to see some signs that the opposite is taking place.

As noted, from the start of the Fed's zero percent interest rate policy in late 2008 **(shown in red)** to the early months of 2015, almost all asset classes gained value. In sharp contrast, almost no asset classes made gains in 2015 as a whole. Indeed, as is illustrated by the following chart from Bianco Research, 2015 was an asset allocator's nightmare, as virtually no asset classes outpaced the return on cash.




This is much more unusual than one might think, as there is normally at least one major asset class that produces, at minimum, high single-digit returns. However, according to Bianco's research, 2015 is actually on track to become one of the five worst years for broadly diversified portfolios since 1926 and, if one expands the list to include other asset classes like small cap domestic stocks (-6%), developed foreign stocks (-2%) and emerging market stocks (-15%), 2015 ranks as the worst year ever from an asset allocation perspective.

Our point is not just that it was a difficult year in which to make money, but that we suspect that the across-the-board lethargy is probably largely a function of the aforementioned "tide" going out. With the Fed no longer purchasing $85 billion of debt securities every month, a historic, thirty-year bull market in bonds seems to have lost its last bullish catalyst. With short-term interest rates finally starting to move higher, equities are looking increasingly expensive, and unable to break out of the trading range that has restrained them throughout most of the year. Finally, the Fed's decision to raise interest rates at a time when slowing economic growth and deflation are still a bigger risk on a global basis than are inflation and an overly-hot economy is simply throwing gasoline on a bear market fire in the commodities markets.

This massive reflation in financial and real estate assets was designed by the Federal Reserve and fueled by zero percent interest rates and an overly-abundant money supply. The all-important question is whether or not the economy has seen sufficient improvement to sustain itself (and the prices of risk assets) in the face of stagnant money supply and incrementally higher interest rates.

**Five Worst Years Since 1926**

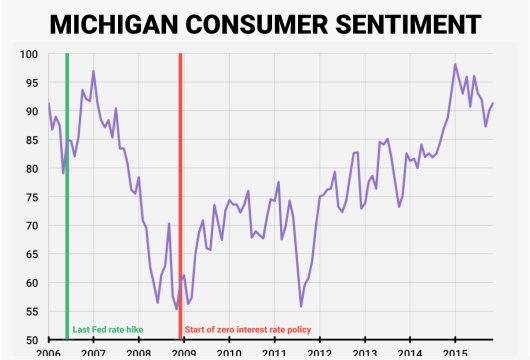
**Yearly Returns**

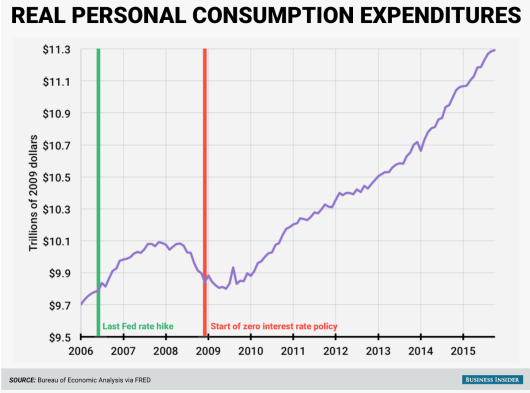
| Year | Stocks S&P 500 | LT Bonds 30yr Tsy | Cash 3mo Bill | Commodities CRB Index | Best Return |
|---|---|---|---|---|---|
| **12/18/2015** | **-0.58%** | **-2.04%** | **0.11%** | **-25.14%** | **0.11%** |
| 1937 | -35.02% | 0.22% | 0.29% | -10.40% | 0.29% |
| 1931 | -43.42% | -5.32% | 1.09% | -20.59% | 1.09% |
| 1953 | -0.96% | 3.63% | 1.83% | -3.12% | 3.63% |
| 2001 | -11.89% | 3.70% | 3.85% | -16.34% | 3.85% |

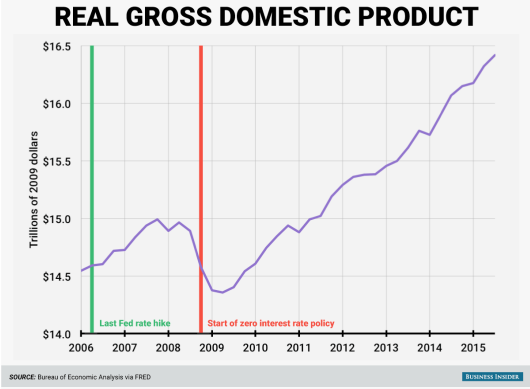
It has been said that it is impossible to know where you are going if you do not know where you have been. With that sentiment in mind, let's take a look at the impact that was had by the very policies that are now starting to be reversed. As we progress through these charts, two things will become very obvious. The first is just how dramatic the benefits of zero percent interest rates have been (and thus the potentials risks associated with higher interest rates). The second is just how much the economy has already

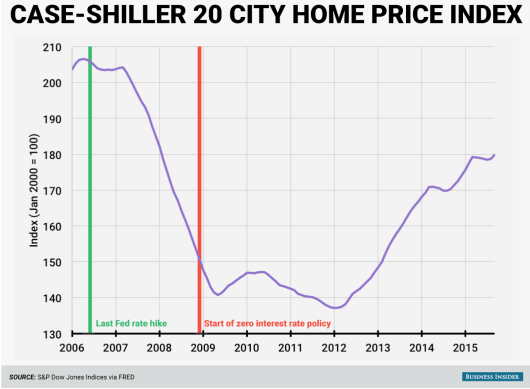
recovered, which suggests that it should no longer be as dependent on the stimulus of zero percent short-term rates.

The Fed's decision to adopt a zero percent interest rate strategy had an immediate impact on consumer confidence, as is reflected in the monthly University of Michigan Consumer Sentiment Index, and this boost in confidence had a direct impact on consumer spending and a follow-through impact on the strength of the U.S. economy itself (hardly a surprise when you consider that consumer spending accounts for about 70% of the size of the U.S. economy).




You will also note that the Fed's announcement of a zero percent interest rate policy coincided very nicely with the bottom in home prices.

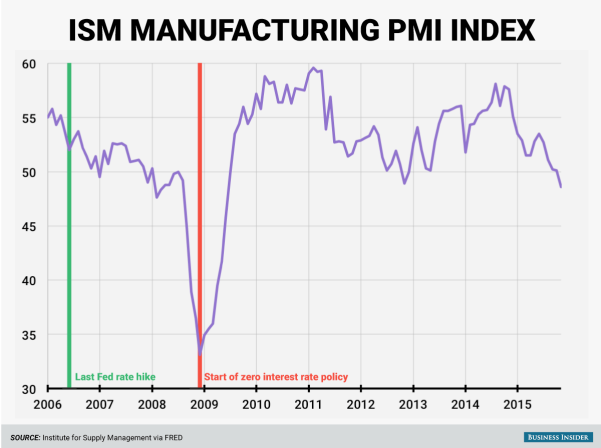
As noted above, this was all exactly according to the Federal Reserve's plan, which was detailed in a November 4, 2010 *Washington Post* op-ed by former Federal Reserve Chairman Ben Bernanke.

In that article, Chairman Bernanke noted his belief that, "Easier financial conditions will promote economic growth. For example, lower mortgage rates will make housing more affordable and allow more homeowners to refinance. Lower corporate bond rates will encourage investment. And higher stock prices will boost consumer wealth and help increase confidence, which can also spur spending. Increased spending will lead to higher incomes and profits that, in a virtuous circle, will further support economic expansion."

With the benefit of hindsight, the Federal Reserve's quantitative easing and zero percent interest rates policies were remarkably successful, particularly when one considers that, over the same period, the makers of fiscal policy (Congress and the White House) were so inept and so dysfunctional that no fiscal stimulus was ever introduced to help pull the domestic economy out of the Great Recession.

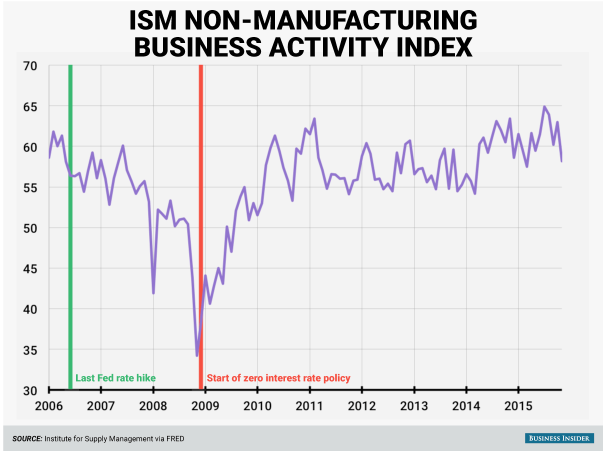
It is largely this lack of any type of fiscal stimulus that calls into question the sustainability of the economic recovery now that the first steps to unwind the Fed's monetary stimulus are being taken.

Indeed, while the advent of the Fed's zero percent interest rate policy initially had a very stimulative impact on both the manufacturing and service sectors of the domestic economy, there is a growing body of evidence that the manufacturing sector is already sliding back into recession. We blame much of this manufacturing sector retrenchment on the surge in the value of the dollar, which is a risk that we discussed in great detail in last month's report.



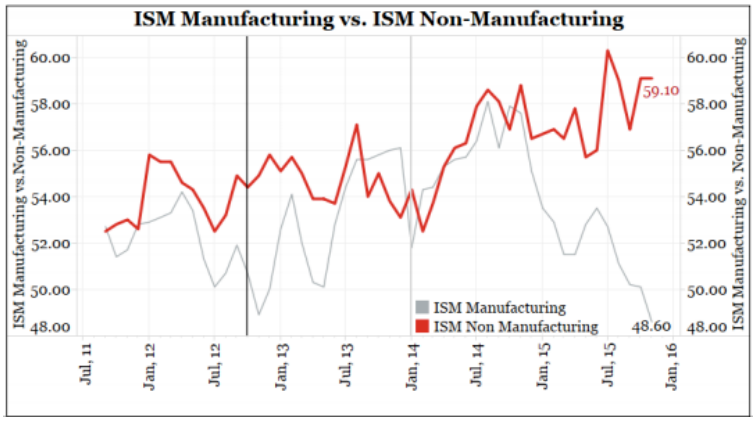

To illustrate the impact of zero percent interest rates on the two major sectors of the economy, we will use two measures from the Institute of Supply Management (ISM). Both are oscillators, which means that any readings above "50" indicate positive growth while readings below "50" indicate economic contraction.

The first of these, the ISM Manufacturing Index, is based on surveys of more than 300 manufacturing firms, and monitors employment, production inventories, new orders and supplier deliveries. The second oscillator, the ISM Non-Manufacturing Index is based on surveys of more than 400 non-manufacturing (i.e. service-sector) firms' purchasing and supply executives, within 60 sectors across the nation.



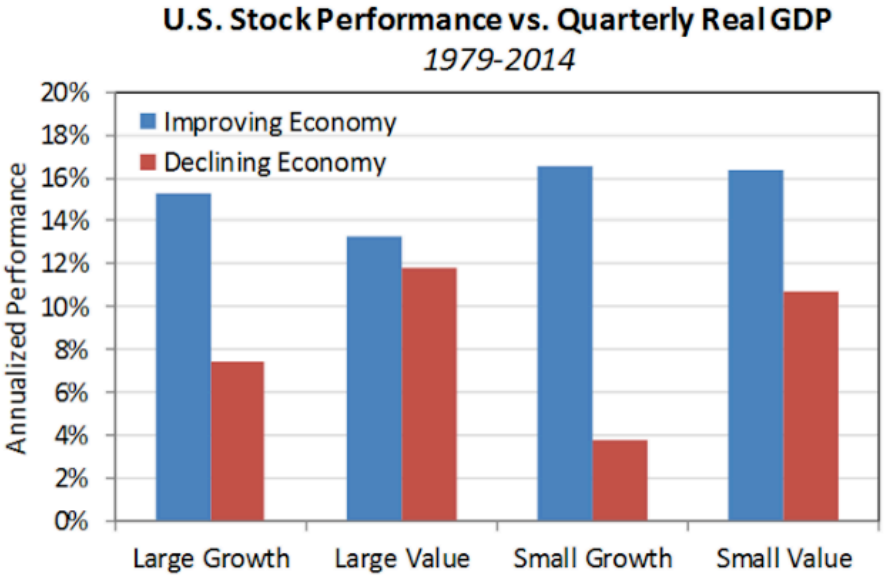

You can see that the manufacturing sector has now slowed into contractionary territory, which would have been extraordinarily concerning 100 years ago. However, as of 2015, the manufacturing sector only represents 12% of the size of the domestic economy.

At the same time, for every $1.00 spent in manufacturing, another $1.37 is added to the economy, which gives it the highest multiplier effect of any economic sector. Manufacturing also accounts for about one in six private-sector jobs and some of the highest wages in the country ($77,506 annually, in contrast to the average worker in all industries who earns $62,546).




The key question is whether the manufacturing slowdown is due to its own fundamentals (a stronger dollar, slowing growth in China, and the devaluation of the Chinese currency), or is it the canary in the coal mine that is flashing a danger sign for the U.S. economy as a whole.

At this point, we are inclined to view the slowdown as being unique to the manufacturing sector, but that it certainly bears watching.
What we do know with certainty is that there has historically been a correlation between the performance of domestic equities and whether the domestic economy is strengthening or weakening, and this tendency is one of the factors that keeps us fairly bullish in our 2016 outlook for the domestic equity markets.




We remain even more bullish in regard to the major foreign equity markets in general and the European markets in specific, where both the manufacturing and service sectors continue to expand. Indeed, the European equivalent of the above ISM Manufacturing and Non-Manufacturing Indexes stand at 52.8 and 54.6 (a four and one-half year high). Recall that any readings above "50" indicate economic expansion. In addition, Europe, Japan and China should each benefit from large and growing monetary stimulus programs that are taking place in their home countries.

We are also assuming that we will continue to see increasing strength in the value of the U.S. dollar, as a result of the U.S. tightening policy at a time when most of the remaining industrialized world is pursuing increasingly accommodative monetary policies, and that these diverging currencies should also benefit foreign economies and international capital markets.

However, while it certainly makes sense that these divergent paths (and higher domestic interest rates) should serve to boost the value of the dollar, these two variables do not exist in a vacuum, which means that a stronger dollar, while likely, is still far from assured. Indeed, if you look at the past five times that the Federal Reserve raised interest rates, the dollar gained strength over two of those periods (1983 and 1984), but actually lost value during three of those periods (1987-1989, 1994, and 2004-2006).

Importantly, the domestic economy either held its ground or even accelerated subsequent to each of the past five monetary tightening cycles, so a domestic slowdown is far from assured. At the same time, it should be noted that most interest-rate-rising cycles are a byproduct of an over-heated economy, which is clearly not the case this time.

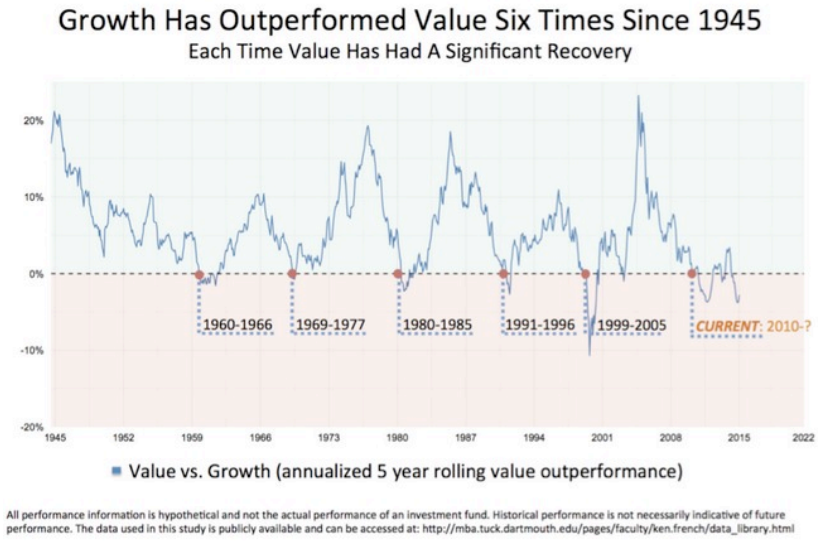
Another reason for our preference for the foreign equity markets relates to earnings generally and price-to-earnings (P/E) multiples in particular. There is a well-documented relationship between interest rates and P/E multiples. When rates are falling, investors are normally willing to pay more for each dollar of equity earnings than they are when rates are rising. As such, investors will normally tolerate higher P/E multiples when rates are falling

and *vise-versa*. As such, with rates now rising, earnings may need to accelerate in order to justify current equity prices.
Current expectations are that domestic corporate earnings will end 2015 down 0.7%, after falling 4.9% in the fourth quarter, while top-line revenues declined by 3.4% (according to *FactSet*). If fourth quarter earnings do, in fact, decline as expected, it will mark the first year-over-year declines over three consecutive quarters since 2009.

As a whole, the year 2015 was notable for its very poor market breadth. While the 10 best performing stocks on the Standard and Poor's 500 Index averaged impressive gains of 19% on the year, the other 490 stocks on the index actually lost an average of 4%. It was also a market dominated by growth stocks over value stocks.

Growth stocks, on average, gained 3% during the year, while value stocks averaged annual losses of 7%. Of interesting note, according to O'Shaughnessy Asset Management, value stocks have outperformed growth stocks in 14 of the past 17 rate-hiking cycles.

It should also be noted that current expectations are for the Federal Reserve to raise short-term rates by one-quarter of one percent three or four times in 2016. That is actually only about one-half as aggressively as rates have gone up on average during past interest-rate-hiking cycles.




Overall, the global economy is expected to accelerate from a 3.1% growth rate in 2015 to 3.4% growth rate in 2016, which is yet another reason for our preference for foreign industrialized markets.

However, we are also working under the assumption that the domestic economy has already recovered sufficiently to withstand the drag that is likely to come from higher domestic interest rates. The U.S. has largely recovered from the global financial crisis. Growth seems sustainable, the unemployment rate has been cut in half and all of the nine million jobs lost during the Great Recession have been replaced. Indeed, the weekly jobless claims numbers are now the lowest since 1973.

We believe that the price correlation between stocks will continue to weaken, which should allow adept stock analysts to add real value to investor portfolios. This would be a remarkable change from recent years, when very few active managers have been able to outperform the equity indexes themselves. We also expect for value stocks to rotate back into favor this year, particularly once we see sustainable signs of stability in the energy markets.

With reduced efforts on the part of the Federal Reserve to keep the markets stable, we also expect for equity market volatility to increase. At the same time, we believe that it will make

sense to "hold on for the ride", as we believe that equities will resume their role as the top-performing asset class in 2016.