Volume 63

THE PER STIRLING CAPITAL OUTLOOK

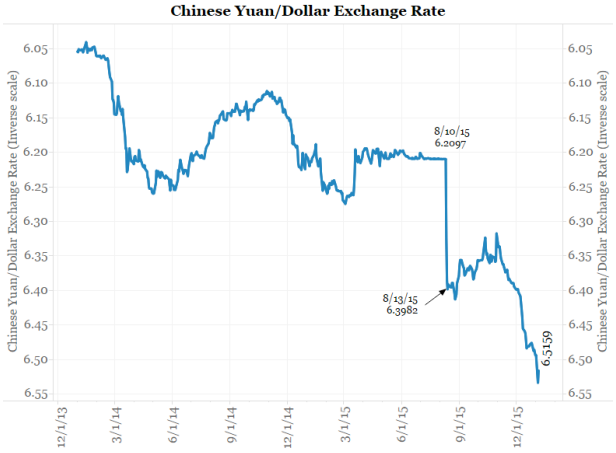
Performance • Perspective • Per Stirling

January 2016

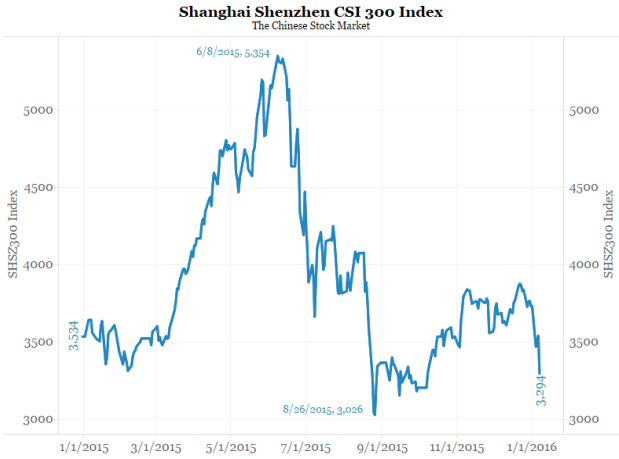
Renowned investor Sir John Templeton famously noted that "The four most dangerous words in investing are 'This time it's different.'" However, with all deference to Sir John, and in light of recent market history, he clearly should have prefaced his comment with the term "all other things being equal", as market dynamics in early 2016 are clearly different than they were in 2015.

For evidence, you need look no further than the reaction of the global capital markets to China and its economic slowdown, its equity bear market (a greater than 20% decline), and the ongoing and very significant debasement of its currency, the renminbi (a.k.a. the yuan).

This is the second time in less than six months that we have witnessed this triumvirate of bearish factors unfold in China. The same thing happened in August, when the economy slowed more than expected, the Chinese stock market fell in excess of 20% and the Chinese currency experienced an even more violent devaluation.



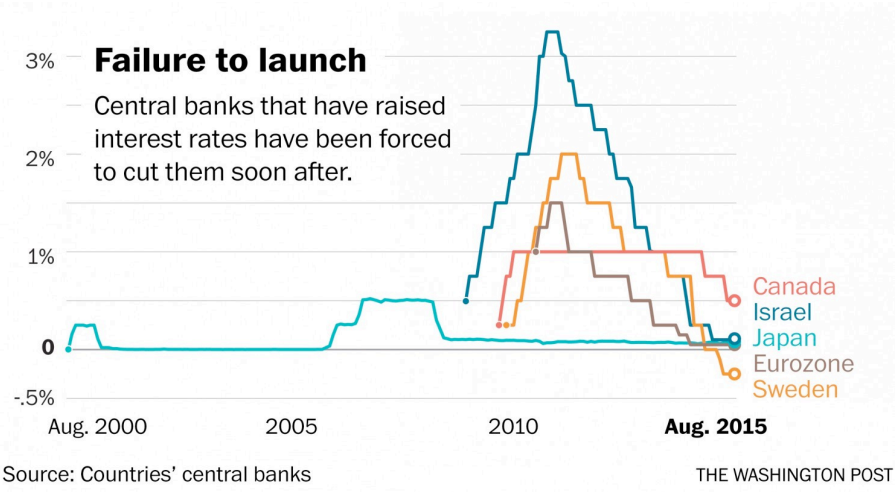
At that time, the reaction in the global capital markets outside of China was both muted and very short-lived. However, five months later, this same convergence of influences has helped to catalyze the worst start to a year in the history of the domestic equity markets, and the worst start to a year for the global equity markets in over two decades.



What happened to cause this wholesale change in global inter-market dynamics? We believe that it was the broad-based investor realization that the central bankers were either running out of bullets or were no longer willing to support asset prices as part of their economic recovery plans.

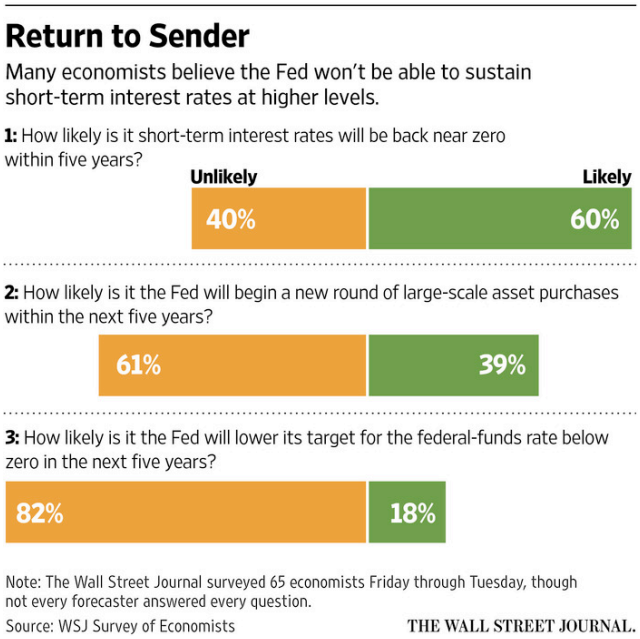
The Chinese and Japanese markets and economies continue to deteriorate despite all of their massive stimulus programs; the previously ambitious stimulus plans of the European Central Bank are being restrained by the ECB's German contingency, and the Federal Reserve ceased its quantitative easing policies over a year ago.

Finally, the Fed's decision to raise short-term interest rates in December was basically the tolling bell that confirmed the end of the role of central bankers as the protector and guardian angel of the global capital markets… that is, unless the Federal Reserve is forced by deteriorating macroeconomic conditions to reverse its current course, and return to its previous highly stimulative programs.



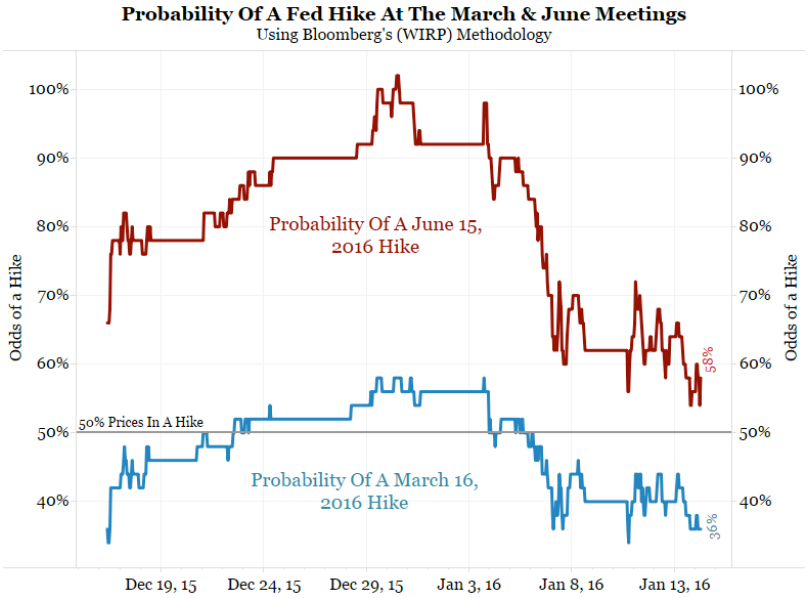
This notion is not as far-fetched as it may seem at first. A handful of other central banks have attempted to raise short-term interest rates in the years since the depths of the financial crisis, and each has needed to reverse course and bring rates back down. This includes the European and Swedish central banks, which have actually dropped interest rates to below 0%.

From our perspective, it would send a terrible message if the Fed was forced to reverse course on monetary policy, as it would basically acknowledge that the global recovery is unsustainable and that, despite the central banks using virtually every tool in their tool box, the global economy remains mired in the financial crisis. Nonetheless, the fed funds futures contracts are already confirming investor expectations that the Fed will be much less aggressive in tightening rates than was expected just two weeks ago, while a survey taken last week of Wall Street economists is now predicting both negative domestic interest rates and a new quantitative easing program within the next five years.



In the meantime, global equity markets have run well ahead of economic fundamentals, as a result of central bank-inspired confidence and a general belief that the central banks would come to the markets' rescue in the event of any decline of substance. We believe that this dynamic was weakened with the end of the Fed's quantitative easing programs and then changed entirely with the first interest rate increase. With this perceived safety-net gone, investors are marking down prices in acknowledgement of the new, higher risk environment.

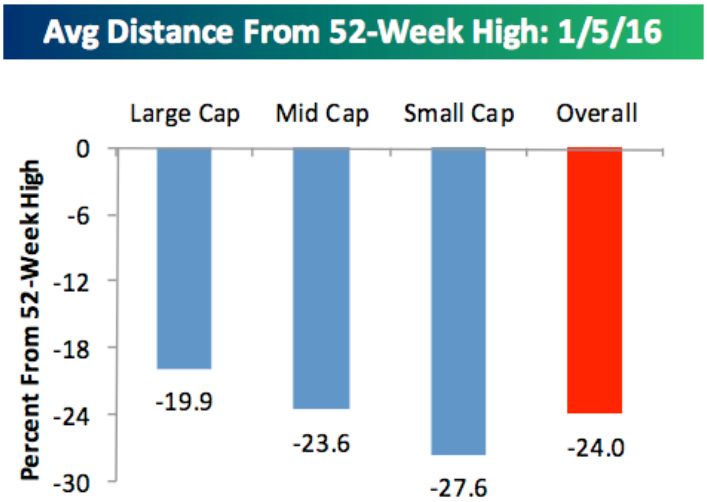
Through the first two weeks of the year, domestic large-cap stocks (S&P 500) are down 8.0%, mid-cap stocks (S&P 400) are down 9.2%, and small cap stocks (Russell 2000) are down by 11.3%. Stocks in specific sectors, like transportation, biotech, banking, energy and semiconductors are down considerably more than the averages.



Foreign markets have fared no better, with markets in the Pacific Rim averaging year-to-date losses of 8.8%, with the region's largest markets (China and Japan) declining 18.6% and 9.9% respectively. European stocks are down on average by 9.4% on a year-to-date basis.

However, just looking at the past two weeks would suggest that the current decline is a 2016 phenomenon. To the contrary, the majority of domestic stocks are already down more than 20% from their highs of the past 52 weeks, while the energy sector is down by 33%, the biotechnology sector has declined by 29%, the transportation sector has fallen by 28% and the materials sector has declined by 26%. Likewise, the average large-cap stock in the Pacific Rim is down by 17.8% from its 52-week highs, and the average large-cap European stock has declined by 15.9% since its 52-week highs. The numbers look much worse when you consider the losses in mid and smaller-capitalization foreign stocks.

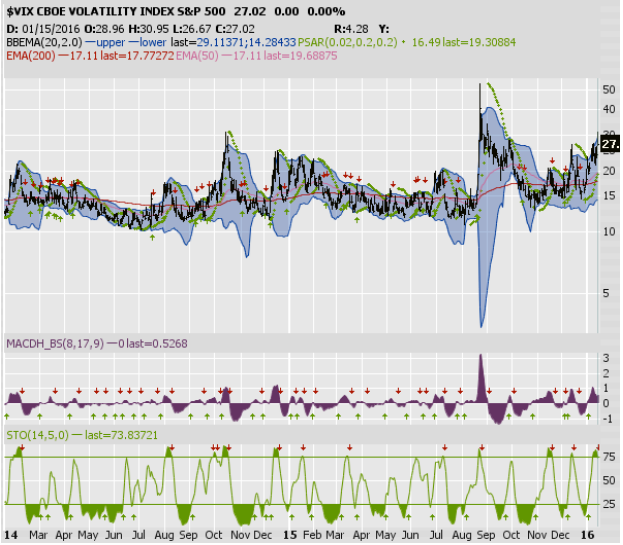
Indeed, the general downtrend in global equity markets actually started in May of last year, when the average stock in the S&P 500 was priced more than 22% higher than it is today. However, because of the extraordinarily high 2015 returns posted by a few stocks that are very heavily weighted in indexes like the S&P 500 and NASDAQ, it did not look like a bear market on the surface. As was pointed out in last month's *Per Stirling Capital Outlook*, 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 in the index actually lost an average of 4% in 2015. In short, the January decline did not mark the start of a new bear market. It just took an 8-month-old "stealth" bear market and brought it into the consciousness of the investing public.



It is, therefore, our perception that the all-important question is not whether we are in a bear market (which we view as a foregone conclusion) but instead, in light of the already dramatic losses, when will the losses become significant enough to fully discount the markets' various fundamental challenges. These include a slowing global economy (the International Monetary Fund has cut its global growth forecasts four times over the past year and Japan has just entered into its fifth recession in the past seven years), an earnings recession, and the negative macro-economic news discussed at the beginning of this report. It also includes the growing array of geo-political challenges to the capital markets, including the North Korean nuclear weapons test, recurring instances of terrorism, crashing commodity prices, and the proxy war between Saudi Arabia and Iran.

The potentially good news is that we may be getting close to those levels, and that what we have witnessed since the start of 2016 is simply the "capitulation phase" that occurs at the end of virtually all bear markets. To explain, the vast majority of bear markets end in a very violent move which is sufficient to force the last of the potential sellers to sell in a panicky, "get me out at any price" type of environment. It is ultimately this running out of potential sellers that causes a sustainable market bottom to be put in place.

We are starting to see a variety of signs of capitulation. However, it is important to emphasize that this is essentially a counterfactual (for example, all Great Danes are dogs, but not all dogs are Great Danes). In this case, virtually all bear markets end with capitulation, but not all bouts of panic selling are sufficient to constitute capitulation. That will still require the test of time.

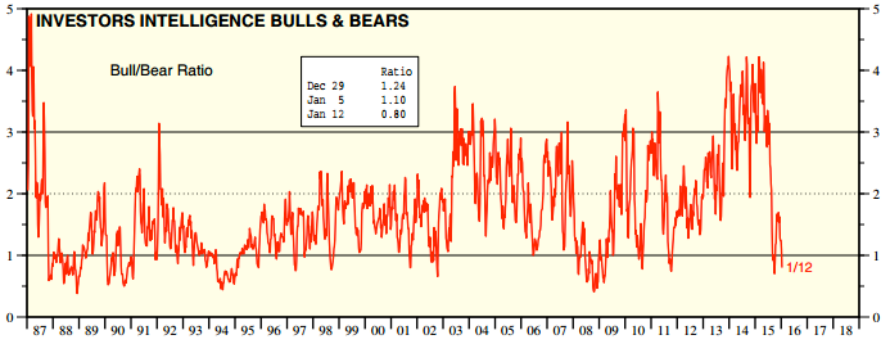


However, we do believe that we have seen sufficient losses; sufficient signs of panic and sufficient signs of a potential market bottom to suggest that a potential low is at least a viable possibility, and that any additional reductions in equity allocations should therefore be delayed until after we see if the markets can find support around current levels.

One of the reasons why we believe that selling may have become excessive is found in looking at the VIX (a.k.a. "fear index"), which is derived from the prices that investors are willing to pay for protective options. This index not only rocketed 48.4% higher over the first two weeks of 2016, but is also now back into the range that coincided with significant equity lows in October of 2014 and September of 2015. In our opinion, the current $27 price on the VIX is not so high that a bottom is a foregone conclusion. However, it is high enough where a low of substance is at least a real possibility.

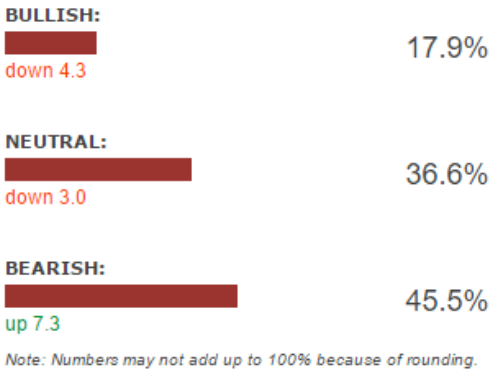
Put another way, we view the current reading as being high enough to indicate an environment where the market may be running out of potential sellers, but not so extraordinarily high that it indicates the existence of huge short positions that could cause a massive short-covering rally, as investors are forced to buy back shares to replace those that they borrowed and sold short.

Another quote from Sir John Templeton also seems particularly *apropos* in this discussion, which is that "bull markets are born on pessimism, grow on skepticism, mature on optimism and die on euphoria". Keeping in mind this premise that market bottoms (either short or long-term) occur when bearishness is highest and the last of the potential sellers have sold, there are several other sentiment indexes that echo both these readings of extreme bearishness and this potential for at least a near-term market low.



The first of these is the Investors Intelligence U.S. Advisors' Sentiment Report, which analyzes all of the major investment newsletters and categorizes them as bullish, bearish or neutral. Because each of these newsletters has the ability to influence the opinion of thousands of investors, it has historically been an excellent gauge of extremes in investor sentiment. At present, it has a value of less than "1", which illustrates extreme levels of bearishness.

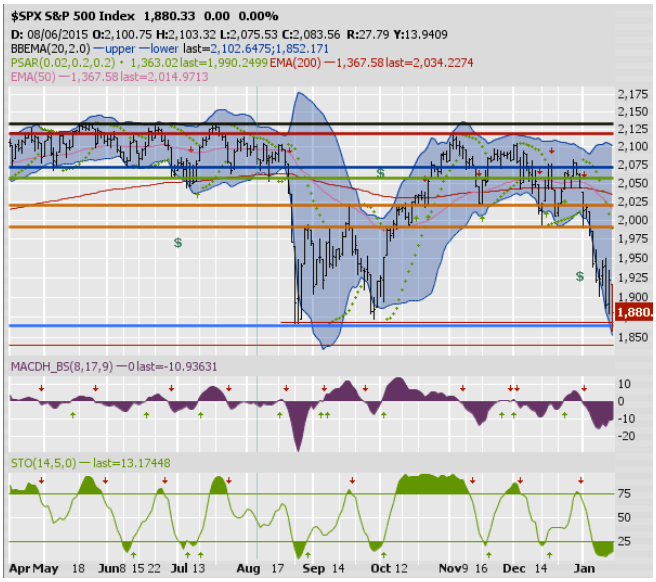
When we have seen similar readings of extreme bearish sentiment in the past, it has usually coincided with the end of very substantial equity market declines. We believe that it is equally telling that this indicator has dropped from reading in excess of "3" (which was indicative of excessive and Fed-inspired levels of bullishness and complacency) to a reading of below "1", which is normally indicative of a significantly oversold market, all in less than one year.



Also confirming these levels of extreme bearishness (and the premise that a majority of the potential sellers have already sold) is the American Association of Individual Investors Sentiment Survey, which polls their more than 2,000,000 members on their 6-month outlook for the equity markets. The 17.9% bullish number compares to the long-term average reading of 38.7% and the 45.5% bearish reading compares to the long-term average of 30.3%. The 36.6% neutral number compared to a long-term average reading of 31.1%, and should be added to the 45.5% bearish number, as it represents investors who are primarily long-term bullish but who are looking for a short-term decline. Moreover, the CNN/Money Magazine Fear and Greed Index is now giving readings of "extreme fear", which is a remarkable reversal from the Index's "neutral" reading of only two weeks ago.

Yet another reason why we give credibility to the idea that we may be approaching a sustainable market low is the human (and investor) tendency to repeat behavior that had proved rewarding in the past and to avoid behavior that had proved detrimental in the past.

Last week, the Standard & Poor's 500 Index reached price levels that twice in 2015 proved to be exceptionally profitable buying opportunities (when things seemed just as black as they do today), and we expect to see astute buyers once again coming in around current levels (horizontal blue line).



Indeed, since this area of support is so obvious, it may take a temporary breach of these levels to cause the last of the potential sellers to give up, thus causing that all-important moment of capitulation. It is also noteworthy that the green stochastic oscillator at the bottom of the chart is below "25", which suggests a market that is significantly oversold on a technical basis.

Credit analyst Ed Hart used to say that "we have reached a point in time when the demand for certainty far exceeds the currently available supply". One can only imagine what he would say if he was alive today.

Three weeks ago, the Fed was providing guidance to the markets that they should expect four interest rate increases in 2016. Three weeks later, the global economy and risk markets look as vulnerable as they did five years ago, and the Fed's decision to raise rates in December looks to many like an ill-timed move of historic proportions.

We suspect that, as usual, the truth will turn out to be somewhat less draconian. From a purely fundamental perspective, we believe that many of the world's equity markets, while not necessarily compelling bargains, are rather attractively valued as a result of this broad market decline, and that investors who put money into the markets around current prices will be very well served over the course of the next several years.

However, there is also a very emotional component to this decline, and trying to predict the short-term behavior of a crowd of hundreds of millions of truly scared investors is a fool's paradise. This is, in our opinion, particularly true when they are simultaneously coming to grips with the fact that central banks are no longer either willing or able to prop-up the capital markets as part of their recovery plan from the financial crisis.

We expect for the equity markets to move sharply in one direction or the other, and that the direction of the markets over the intermediate term will likely have much to do with whether or not the S&P 500 Index is able to hold critical support around current levels.

To re-emphasize the words of Sir John Templeton, "bull markets are born on pessimism, grow on skepticism, mature on optimism and die on euphoria". That is why the world's top investors thrive during periods of despair. That's when you find the best opportunities.