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THE PER STIRLING CAPITAL OUTLOOK

Performance • Perspective • Per Stirling

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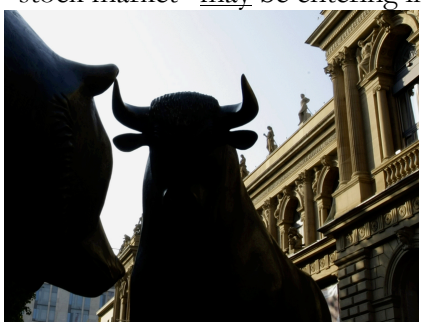
It seems like, all of a sudden, television and print media are full of stories about how the "stock market" may be entering into a "bear market," and each respective reporter

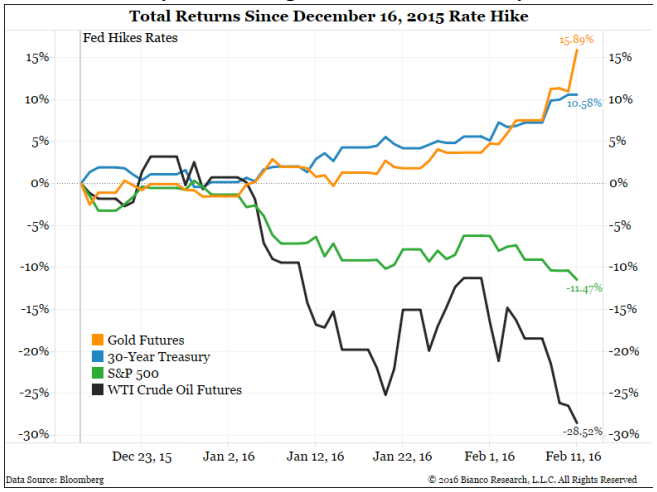


references one of the two most popular benchmark indexes (the Standard and Poor's 500 Index and the NASDAQ Composite), neither of which has yet declined by at least 20% (the standard definition for a bear market).

However, these indexes can significantly obscure the true condition of the domestic equity markets because they are capitalization-weighted. As such, large companies have a much bigger influence on the value of the index than do smaller companies which, in turn, allows the out-sized price movements of a few large-capitalization leaders (or laggards) to make an overall index or market look deceptively strong or deceptively weak.

Last year provided a great example of this phenomenon, when the 10 best-performing stocks on the Standard and Poor's 500 Index averaged impressive gains of 19% on the year, while the other 490 stocks in the index actually lost an average of 4%. Despite this divergence, the index itself was remarkably unchanged on the year. However, even this perception of a flat market obfuscates the severity of this decline, during which the majority of U.S. stocks have already fallen by over 25% from their 52-week highs.

That general downtrend has both continued and accelerated through the first six weeks of 2016, which has thus far produced the worst start to a year for equities in the history of the domestic stock market. Equally telling is the fact that it has also been the best start to a year in the history of the gold and U.S. Government bond markets.

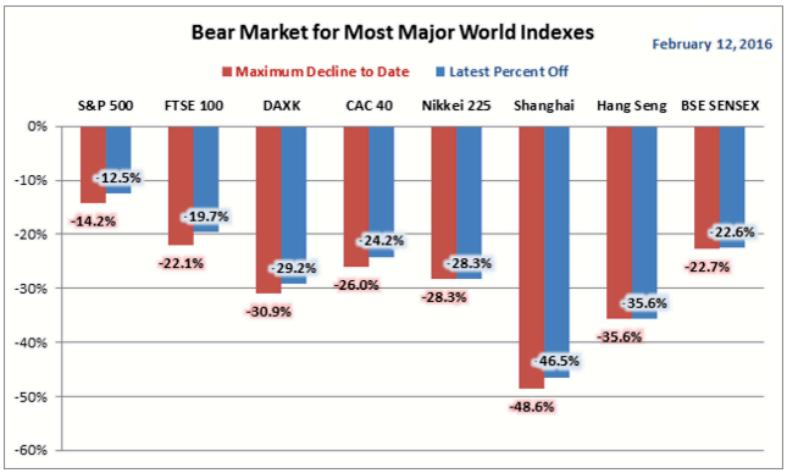


The aforementioned media reports ignore the obvious, which is that most equity securities around the globe, including in the U.S., have been in a bear market since early last summer.

The question should thus not be whether we are/will be in a bear market. That answer is self-evident.

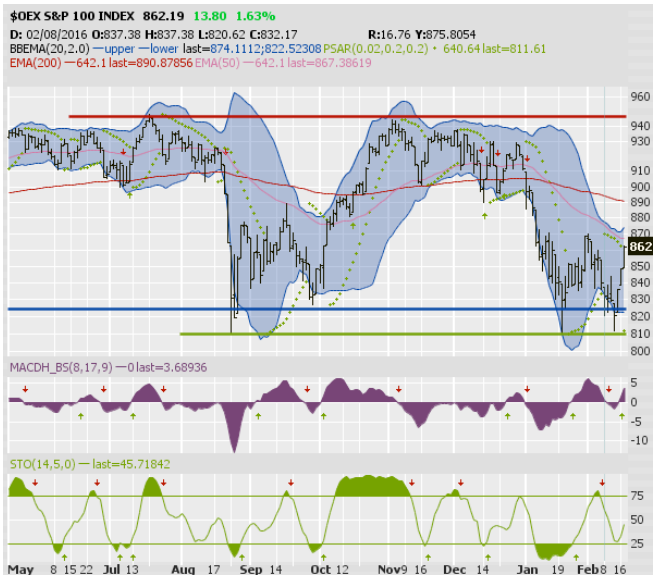
Instead, the more useful and much more provocative questions should be "when will the bear market end?" and "what are the signs that you should look for to help to identify and confirm a likely bear market bottom?" We will use the opportunity of this writing to attempt to shed some light on these two questions, and why we believe that some of the answers are more immediately bullish than many people might think.

There are certain signposts that analysts look for to help identify market lows, and there are certain requisite things that must take place before virtually any bear market can end. One of those things is "capitulation," which is the point at which things appear so incredibly bleak that the last potential sellers finally give up hope and sell their shares. At that point of maximum despair, the market runs out of potential sellers and begins a bottoming process.



Please note the use of the word process, as market bottoms tend to be processes rather than events. We believe that it is very likely that this bottoming process began with the vicious sell-off and then upside reversal on January 20th of this year, when trading volume was twice normal levels and twenty-nine stocks declined on the day for every one stock that went up. Carrying forward the theme from the January edition of this report, this is the sort of market action that you often see at market lows.

For additional confirmation of this low, you want to see it successfully re-tested and, for the time being, that appears to have taken place last week, with a bounce off of the January 20th lows (a level that it will be critically important for the markets to remain above).

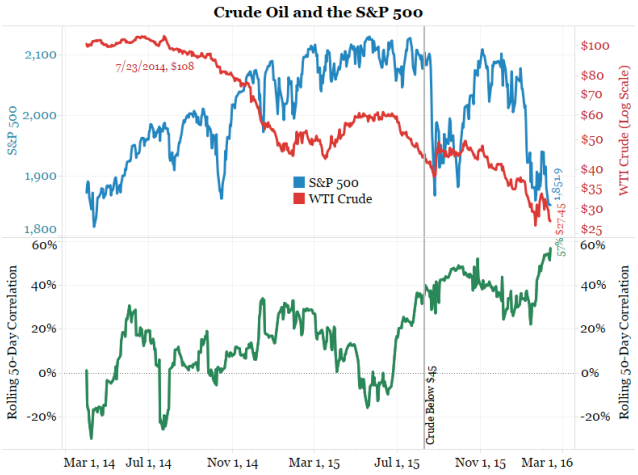


It is also encouraging that investors finally "knocked down the last man standing," as the old saying goes. In other words, bear markets very rarely end until investors aggressively sell so-called "Teflon stocks" that seem almost immune to the sell-off until late in the decline. We believe that this purging took place in the first half of February.

In other words, the technical picture for the equity markets generally, and the U.S. markets, in particular, suggest the near-term potential for a sustainable low in this nine-month-old bear market. Indeed, we find a variety of reasons to be encouraged.

At the same time, there is an old saying that "fundamentals always beat technical." In other words, based upon investors' current expectations for the global economy and its various components, the outlook for the markets looks rather favorable. However, that will all change if the economy underperforms those expectations generally, or slips into recession. In such a case, risk markets would need to adjust lower to price in the new, less optimistic scenario, which we believe would be sufficient to reverse this fairly bullish technical set-up.

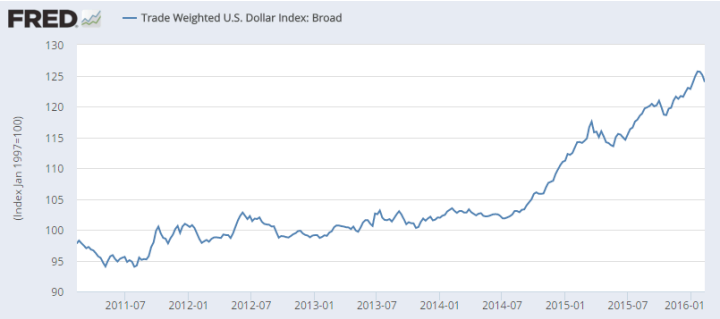
Even more than usual, this should ultimately come down to a question of whether the global macro-economic fundamentals are better or worse than are current market expectations. The best case scenario is, of course, that the economic fundamentals actually turn out to be better than what the markets are pricing in, which we also believe is a real possibility.



On the surface, there seems to be little doubt that the capital markets are currently pricing in a recession, with the majority of domestic stocks down more than 25% from their most recent highs, most global interest rates at or near historic lows, and commodity prices (aside from gold) in absolute collapse.

Indeed, one of the challenges that the market faces is its increasingly tight correlation with the price of oil, as shown by the green line in the oil/S&P 500 chart, which measures the average correlation over the past fifty days at 57%. However, when you look at 2016 alone, the price correlation is actually closer to 95%.

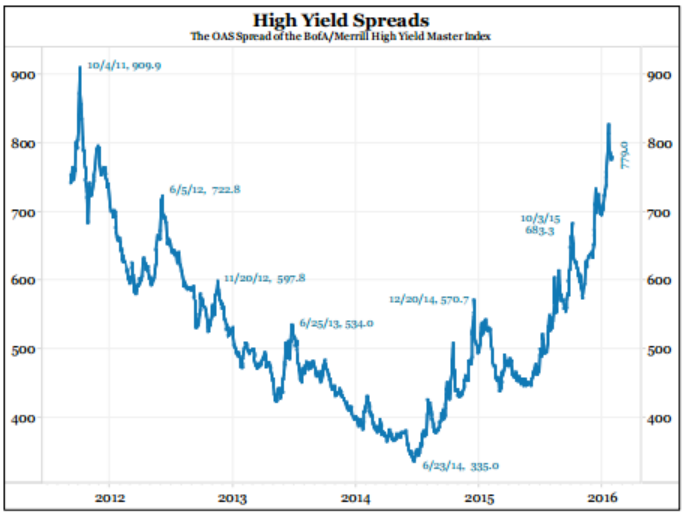
The plunge in oil has been problematic for equities on a number of levels starting with the carnage that $30 per barrel oil is having on oil company profits. However, it goes far beyond the energy sector. Weakness is being felt in many peripheral industries, and has had a particularly severe impact on the financial sector, where there is a fear that many smaller energy companies will face bankruptcy if oil does not recover soon, which could really hurt the solvency of America's banks. An estimated 35% of publicly traded energy exploration and production companies around the world are considered at a high risk of bankruptcy.



No matter how interesting the equity markets look from a technical perspective, we doubt that any equity market rally will prove sustainable if the energy markets can't at least stabilize right around current levels. Indeed, history suggests that the collapse in oil may prove to be a godsend to the economy, where it puts savings into consumer budgets and drives down the cost of manufacturing and transportation. As a result, it may also be a godsend to investors, as is supported by a recent Hartford Funds study that shows that the S&P 500 has gained an average of 27% in the one-year period following each of the four post-1984 oil price drops of at least 50%.

The other absolute must for the domestic equity markets is that the economy as a whole needs to stay out of recession. This is going to be almost entirely up to the services sector of the economy. As we noted two months ago, the manufacturing sector is already in recession, and the strong dollar is making it increasingly more difficult for American manufacturers to remain competitive against foreign competition.

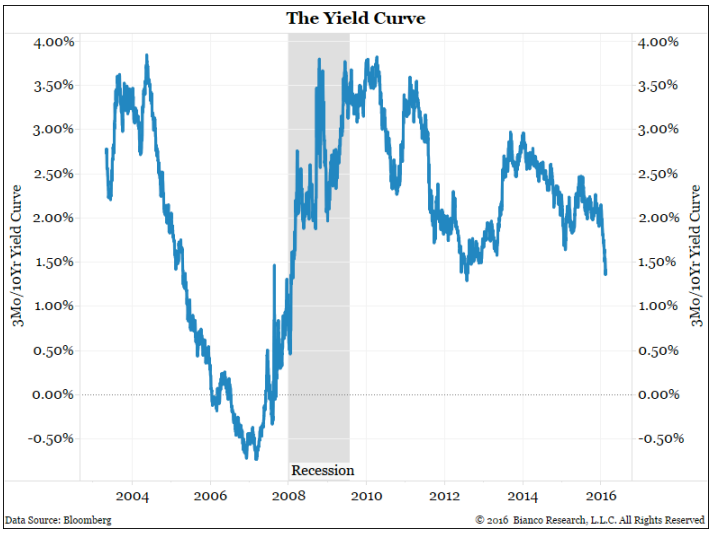
We noted above the traditional analytical interpretation that the capital markets are pricing in an impending recession. Risk assets have been sold off *en masse* and frightened investors are willing to lock in guaranteed losses by investing in negative-yielding sovereign debt. There is even a risk that the markets become part of a self-fulfilling prophecy, where market losses become so severe that they actually cause a recession. We saw that happen as recently as 2008.



The same recessionary message is being sent by the high-yield bond market, where the yield difference between moderately safe credits and very risky credits is growing wider and wider, which is the market's way of anticipating an increasing risk of defaults. That risk spread is currently almost double what it was during the heart of the financial crisis.

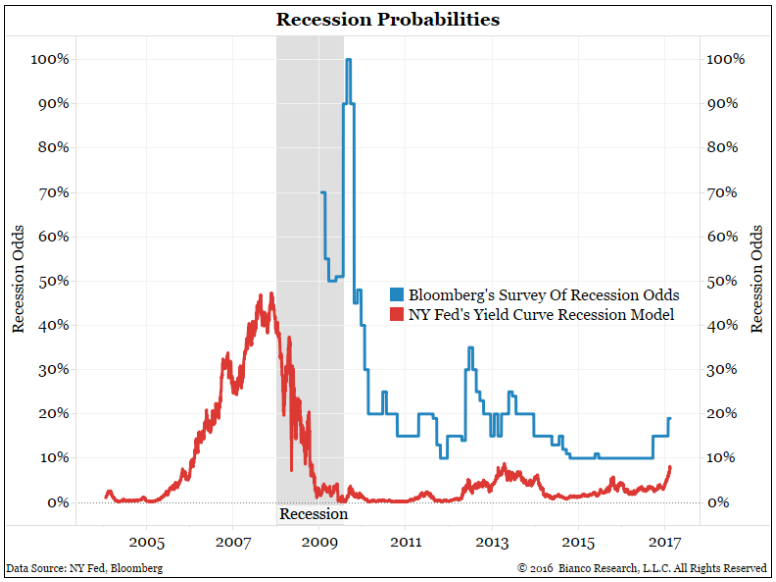
It is further echoed by the shape of the yield curve shown below. When this line is falling, the difference between long and short-term rates is narrowing, which means that investors are pricing in lower expectations for inflation and growth. If it inverts completely, where short-term rates are higher than are long-term rates, it almost always presages a recession.

On the other hand, it is very possible that the markets are actually sending a false message this time, and that both the collapse in oil and the bear market in equities are in response to Saudi Arabia's attempt to crush the domestic shale fracking industry and the end of the Fed's quantitative easing program, instead of some bearish macroeconomic call on the global economy. Similarly, the widening credit spreads in the high-yield market could be largely a reflection of the collapse in energy prices and a corresponding hit to the ability of many energy companies to service their debt, instead of a call for a broad-based recession.



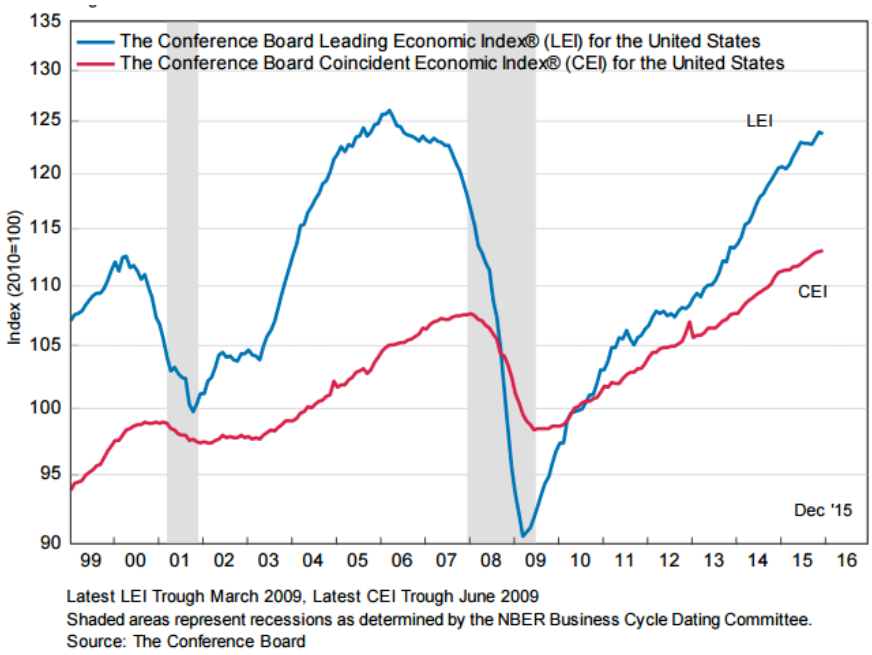
This is the dilemma that analysts face in the current environment. The markets seem to be predicting recession in no uncertain terms while, as we will see, the economic data itself tells a very different story. This is particularly true of what is probably the single most important set of economic statistics. We are referring specifically to the employment numbers, where the economy has been averaging gains in excess of 200,000 new jobs per month, and where we are finally starting to see some signs of better quality jobs and wage gains.

There are a great many ways to look at the economy and its future prospects. One of them is simply to poll a broad array of Wall Street economists, and ask them what they think. This is the approach used by Bloomberg, which is indicated with the blue line. This survey was actually started during the 2008-2009 recession, so it does not have a particularly long track record. At the same time, it has proven rather accurate during its short history and handicaps the likelihood of a near-term recession at only about 20%.



Another method is to build economic models based upon the shape of the yield curve. This is reflected in the Fed's Yield Curve Recession Model (red line), which assigns less than a 10% likelihood of a domestic recession over the near term. While we certainly wish that both indicators were trending in the opposite direction, the nominal likelihood of recession being assigned by both measures is remarkably low, particularly when compared to the strong recessionary message being sent by the capital markets themselves.

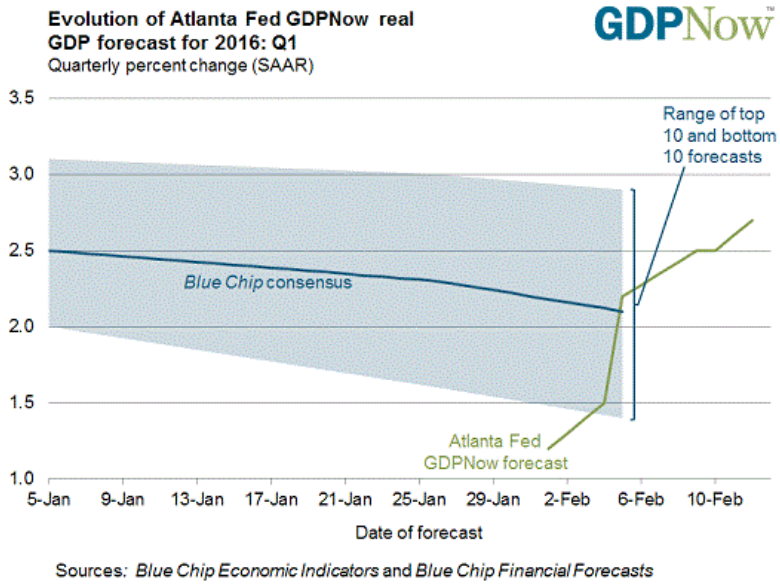
If you look at a composite of economic data itself, as opposed to the yield curve or the opinion of economists, there seems to be even fewer signs of an impending recession.



The Conference Board's Leading Economic Indicators composite includes, as examples, average weekly hours, initial claims for unemployment insurance, manufacturers' new orders, consumer goods and materials, the ISM® Index of New Orders, building permits, new private housing units, stock prices, the Leading Credit Index™, the interest rate spread, and average consumer expectations for business conditions. This broad-based composite of forward-looking economic indicators (blue line) continues to move nicely higher and is showing no hint of an impending recession (which are shown in grey).

While the Coincident Economic Indicator, which contains measures of current economic strength (the red line), is not quite as strong as are the leading indicators, they too still illustrate an economy that continues to meander higher, despite the negative tone of the financial markets.

The Federal Reserve itself, despite all of its research and tools, and the academic brilliance of its members, does not have a great track record when it comes to anticipating future economic conditions. However, this all started to change in 2011 when the Atlanta Branch of the Federal Reserve started refining its GDP Now forecasting tool, which is not only frequently updated (five to six times per month), but which has, over its admittedly short history, produced forecasts that have generally been insightful, accurate and timely.



Far from predicting recession, this forecasting tool is expecting domestic growth to accelerate to between 2.5% and 3.0% in the first quarter, which would be a dramatic improvement over the 1.5% or so growth rate that the U.S. economy has been mired in.

The capital markets seem to be sending a recessionary warning signal and the economic data seems increasingly to send the all-clear signal. This dichotomy is quantified through two indexes compiled by Cornerstone Macro. One emphasizes financial markets data and the ability of capital markets to discount future outcomes and places the risk of a near-term economic contraction in the U.S. at a substantial 50%. The other index blends market data with economic data like loan delinquencies and inflation-adjusted income, and handicaps the likelihood of a domestic recession over the near term at only 28%.

We are inclined to believe that the economy will not only avoid a near-term recession, but that economic data will ultimately prove to be considerably stronger than what is being discounted in the prices of the investment markets, which should provide a very bullish catalysts if we are correct.

In general, we believe that the risk markets look very over-sold, and that they are already pricing in an economic outcome that is probably overly bearish. This condition, when combined with the bullish technical set-up, should, in our opinion, create some very fertile ground for investment gains. We just need for energy prices to stabilize around current levels and for the domestic economy to continue on a growth trajectory. While there will be times when that will seem like a very tall order, we are inclined to view the current market as a classic opportunity to buy stocks after a fairly dramatic decline. At the same time, we expect for markets to remain highly volatile over the near term, so be prepared to hold on for a bumpy ride.