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THE PER STIRLING CAPITAL OUTLOOK

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Expectations and sentiment are incredibly important in regard to their influence on both the economy and the markets. In regard to markets, too much bullishness is bad, because it means that most of the potential buyers of securities have already bought, and that there is very little sideline cash remaining to drive the markets higher. Excessive bearishness is, in contrast, good, and for the exact opposite set of reasons. Indeed, history proves that the markets tend to move in the exact opposite direction of prevailing investor sentiment any time that said sentiment reaches extremes.

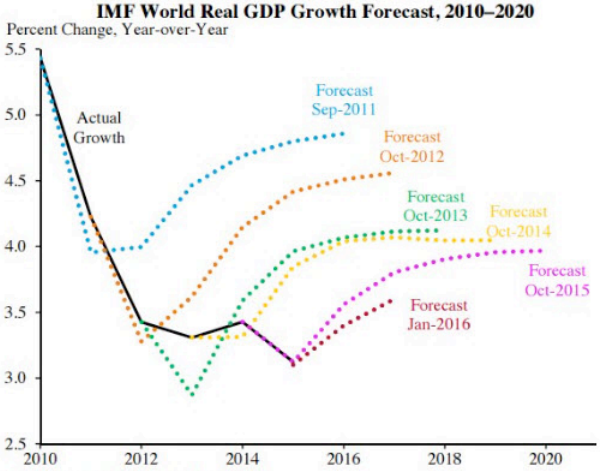
When it comes to the economy, the impact of sentiment is that, even when it is misdirected, it tends to serve as a self-fulfilling prophecy. For example, expectations of increasing inflation can actually catalyze future inflation, as it impacts consumer behavior by making consumers less price sensitive and even draws future demand into the present, as consumers want to buy now before prices theoretically move higher.

Similarly, when sentiment becomes very negative, even when it is a misperception and the economy is quite strong, it can cause consumers to diminish their willingness to spend and cause workers to forego efforts to find a better job, which, in turn, stalls the economy.

This risk of poor sentiment is very real today, as most of the world economy outside of our borders faces a vast array of very significant challenges, ranging from negative interest rates and an overly strong Japanese yen to risks of deflation and falling expectations for future growth.

Figure 3-1

IMF World Real GDP Growth Forecast, 2010–2020

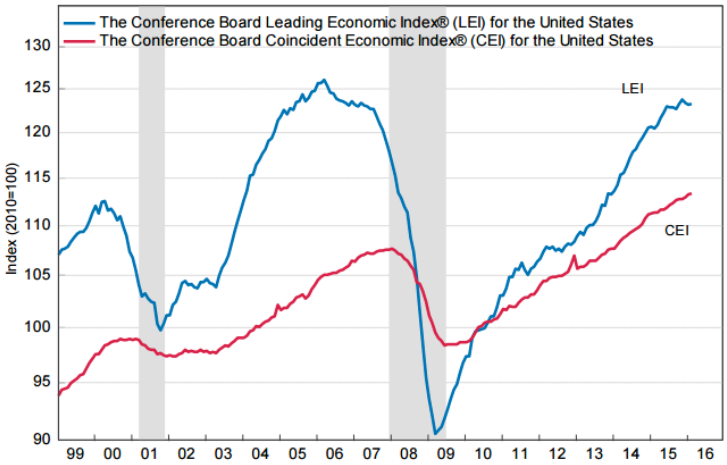


Source: International Monetary Fund (IMF).

At the same time, the political process in the U.S. (particularly Trump's rants that the U.S. is due for a "massive recession" if he is not elected and Sanders' contention that the entire U.S. economic system is broken and corrupt) is starting to impact domestic sentiment and put what is a fairly healthy economy at some risk.

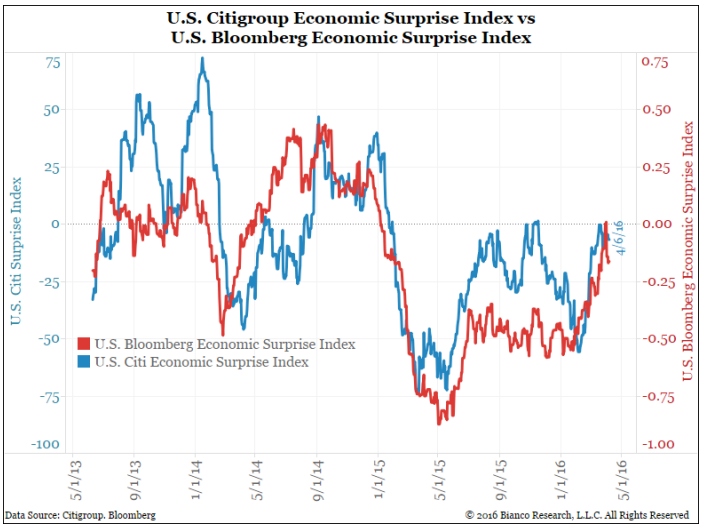
While there is no doubt that the domestic economy continues to face a variety of challenges, its single most important component, the job market, is experiencing one of its strongest rebounds in decades. Indeed, the number of initial jobless claims just fell to only 253,000, which is tied for the lowest reading of new jobless claims in almost 43 years. However, the economic recovery spans far beyond job growth. When considered as a whole, the recovery continues to look both moderately impressive and sustainable over the intermediate term.

This continuing economic improvement is illustrated in two broad-based economic models from The Conference Board, which show the strength of forward-looking (anticipatory) economic indicators in **blue** and the health of coincident economic indicators in **red**. While there has been a very modest deceleration in the pace of improvement in the forward-looking indicators, there still remains in place a strong upward trend in both measures. Of note, the two shaded areas of the chart indicate periods of economic contraction (recessions).



However, despite the ongoing signs of improvement in the economy, a new CNNMoney/E*Trade survey of Americans who have at least a $10,000 balance in an online trading account, showed that over half of respondents (52%) gave the U.S. economy a "C" grade, while another 15% graded the economy as a "D" or "F." Moreover, the just-released Gallup U.S. Economic Confidence Index, which measures the difference between respondents who think that the economy is improving versus those who think that it is worsening, is currently at a 22 percentage point gap (59% say that the economy is getting worse and only 37% say that the economy is getting better), which is the worst reading since August of last year.

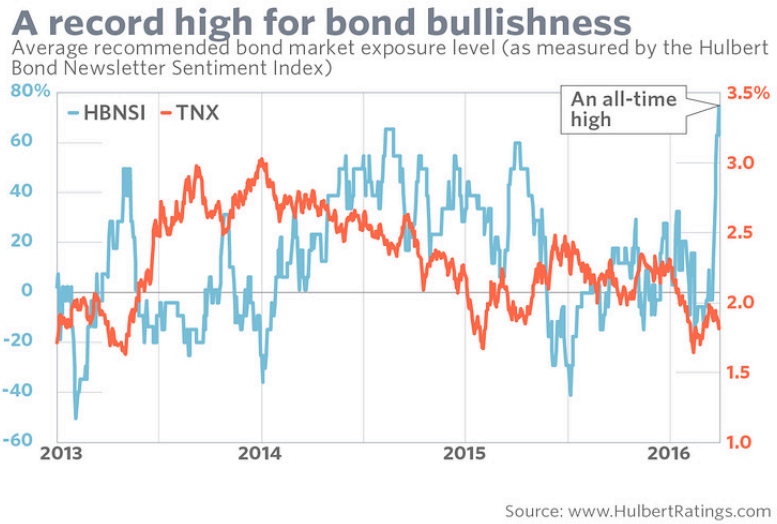
Indeed, same-store sales for the restaurant industry turned negative in March for the first time in years. This may be a very telling statistic, as many analysts consider "eating out" to be the ultimate discretionary decision.



You can clearly see this discrepancy between economic facts and perception illustrated in the Citigroup and Bloomberg Economic Surprise Indexes. When the lines are rising, as they have been since May of last year, economic and earnings data are coming in generally better than was expected, which confirms this divergence.

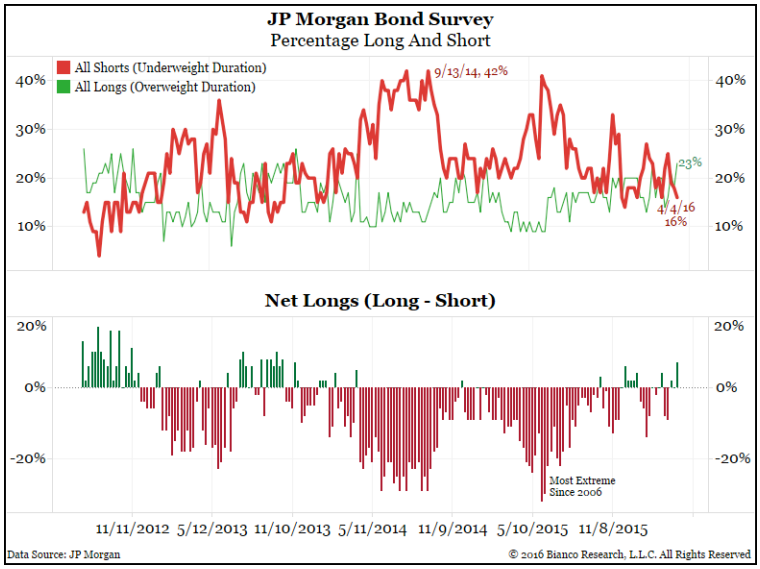
In light of this growing discrepancy between economic confidence and domestic economic data, the two most important questions going forward may be: 1) can the domestic expansion continue in the face of the damage being caused to sentiment by disingenuous politicians and 2) will the U.S. recovery become strong enough to pull the rest of the world economy into recovery, or will the problematic economies overseas be so damaging that they drag the domestic economy down to their level.

In the meantime, all of this pessimism is causing money to pour into what we consider to be vastly over-valued sovereign and high-grade bond markets. Indeed, according to the Hulbert Bond Newsletter Sentiment Index (which measures the bullishness of the fixed-income newsletters that advise tactical bond traders), we are currently seeing the highest level of bond market bullishness since the Index was founded in the mid 1980s. Equally noteworthy is how quickly sentiment reached these stratospheric levels. In one month this index rocketed from a level of -11.8% to the current record 74.7%.



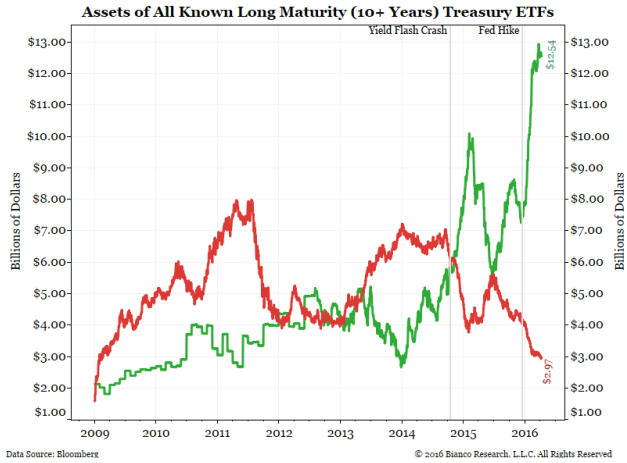
However, these signs of excessive bond bullishness extend well beyond these record sentiment readings. They can be found in investor behavior itself.

To start with, you can see it when you consider the duration of bonds that are currently in the highest demand. For example, in the J.P. Morgan Bond Survey, you can see that, for one of only a few times in recent years, the green line (long maturity demand) has crossed above the red line (demand for shorter durations). The fact that investors are now emphasizing longer maturities over shorter maturities implies that they are expecting a slowing economy, continued low inflation, a lack of further Federal Reserve tightening and the potential for actually experiencing negative interest rates in the United States. We believe that this expectation will likely prove to be wrong on all counts.



This excessive bond market bullishness is further reflected in the way in which investors are using ETFs (exchange-trades funds), which provide the flexibility to make money whether interest rates go up or down (i.e. bond prices move down or up). Specifically, if you consider the following chart which illustrates the composite prices of all of the available ETF proxies for the ten-year U.S. Treasury note, the line in green shows the price movement of all such ETFs that benefit from rates going down. In contrast, the red line illustrates the price movements of all such ETFs that lose value when rates go up.

You will note that until the start of 2015, bond investors were pouring money into those ETFs that would benefit if rates moved higher (as being shown by the strength of the red line). This makes sense, as most of the prevailing opinion on Wall Street was for inflation to increase, for the economic recovery to accelerate, and for rates to move higher.



Long Assets

	4/6/16
iShares 20+ TSY	$9.70
Vanguard Extended Dur	$0.52
iShares 10-20 TSY	$0.84
SPDR LT TSY	$0.58
Vanguard LT TSY	$0.51
PIMCO 25+ Zeroes	$0.25
Direxion 20+ TSY 3X Bull	$0.08
Proshares Ultra 20+ TSY	$0.05
Powershares 25+ TSY 3X Bull	$0.01
iPath LT Bond Bull	$0.01
All Long Assets	$12.54

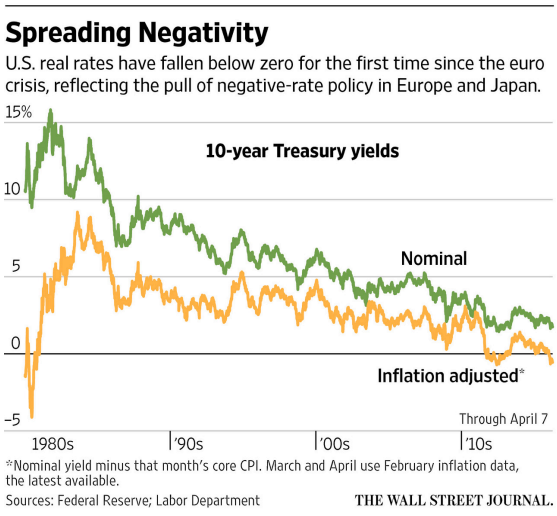
Short Assets

	4/6/16
ProShares Ultrashort 20+ TSY	$1.93
ProShares Short 20+ TSY	$0.58
Direxion 20+ TSY 3X Bear	$0.32
ProShares 20+ TSY 3X Short	$0.07
PowerShares 25+ TSY 3X Short	$0.03
iPath Long Bond Bear	$0.02
Direxion 20+ TSY 1X Bear	$0.01
All Short Assets	$2.97

However, as is normally true with investment markets, they ultimately confounded the majority opinion once that consensus became extreme, and did the exact opposite of what everyone expected.

However, the outperformance of the red line over the previous period is now being dwarfed by the explosive outperformance of the green line which, in our opinion, is indicative of not only a complacent, over-confident and vastly over-bought bond market, but also a market that, for the reasons noted in paragraph one of this report, put the potential for a long-term bond market top in place.

To be clear, this is not a short-term timing call. Bonds have been vastly overvalued for years and, to paraphrase Mark Twain, "the rumor of their death has been greatly exaggerated" for an extended period of time. For evidence, you need look no further than the previous chart and the dominance of the red line until just over a year ago.

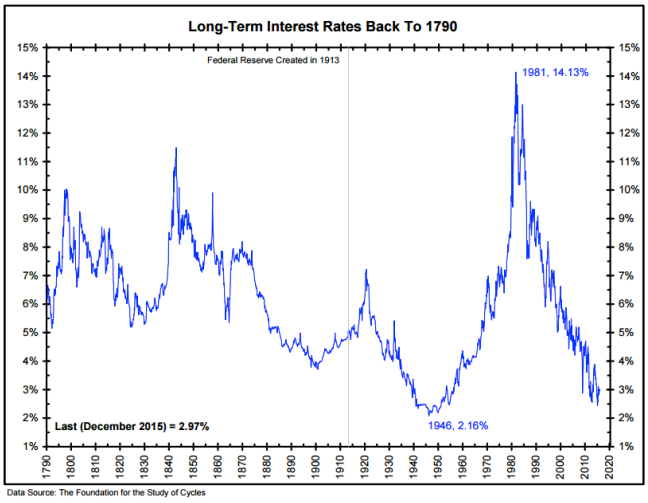


It is also not a recommendation for everyone to sell all of their bond positions. Indeed, strategic managers make a very strong case for holding fixed income in portfolios at all times, as it helps to dampen the volatility of more growth-oriented positions.

That point aside, there are a growing number of reasons for caution in the bond markets, in addition to the aforementioned overly ebullient bullish sentiment. This includes the fact that, for only the second time since the early 1980s, the benchmark ten-year Treasury note actually pays a negative "real" (i.e. inflation-adjusted) yield. While that is still a far cry from the significantly negative nominal ten-year yields found in Japan and parts of Europe, a negative real yield seems to us to be very poor compensation when you consider the risks to capital that investors are undertaking in longer-term treasuries.

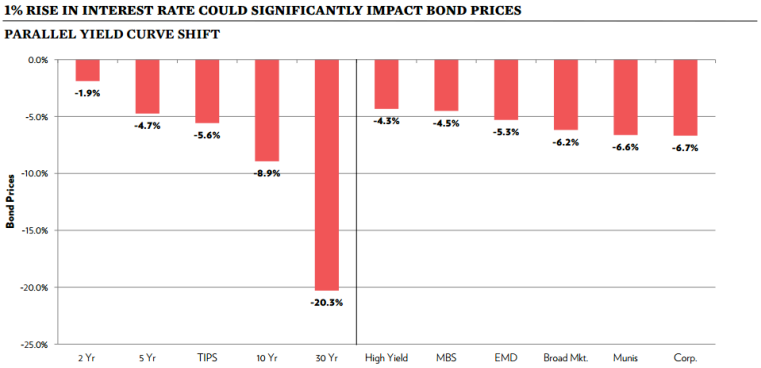
It is also important to keep in mind that, with a 10-year Treasury yield of only 1.86%, it takes only a very small capital loss to create negative total returns in a bond portfolio.

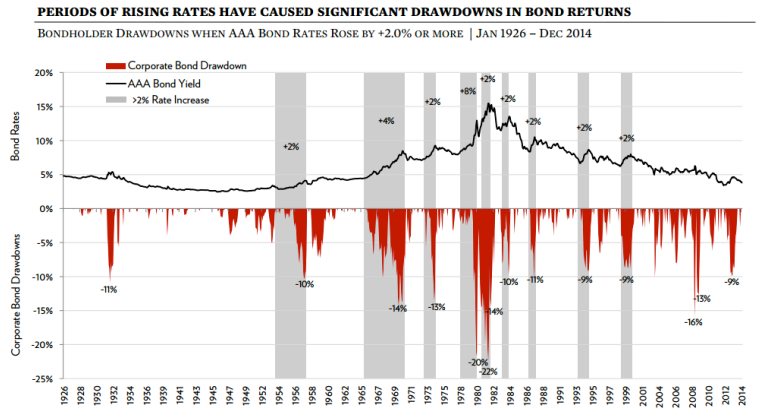
We understand that concerns about losses in the bond markets may fall upon deaf ears, as very few investors (and even fewer money managers) have ever even seen a bear market in domestic high-quality debt, and numerous polls over recent years have illustrated that the average American is wholly confident that bonds can't lose value, and that investing in U.S. Treasury securities is as safe as putting your money in a bank.



While we strongly disavow this perception of bonds, we also understand it. After all, ever since Federal Reserve Chairman Volker broke the back of hyper-inflation back in 1981, long-term interest rates have fallen sharply almost every single year and, since bond prices and interest rates always move in the inverse of one another, caused one of the greatest bull markets in the history of the global debt markets. At the same time, one of the first lessons learned by almost every analyst is that "trees don't grow to the sky" and no asset class goes up forever.

A useful example of this point was the investor poll taken at the end of 1999 that showed average annual return expectations for domestic equities of 26% per year for the next ten years. As we all know, these expectations and reality diverged dramatically.

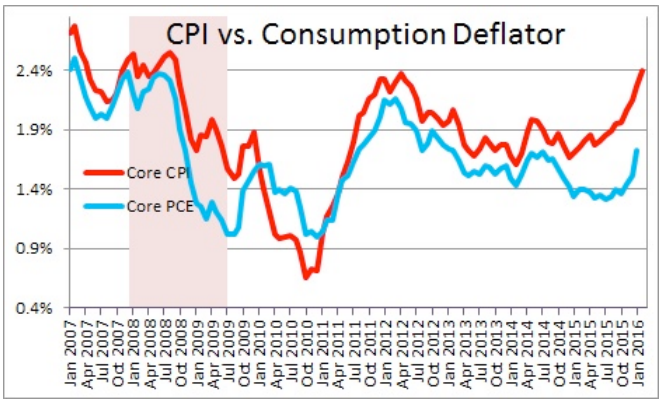




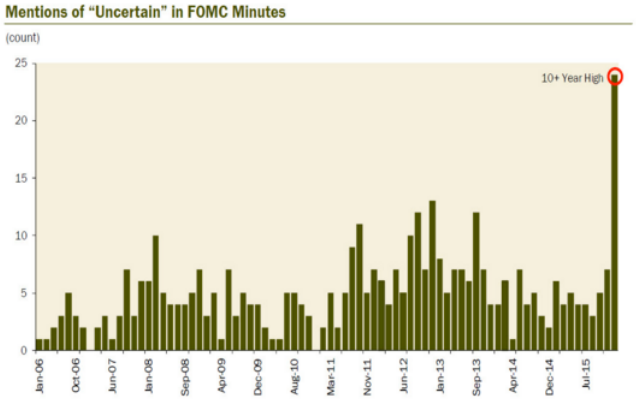
Indeed, the lessons of history are that trees do not, in fact, grow to the sky, and that bond market losses can be sharp when interest rates do ultimately move higher.

The bar chart shows the percent losses that would be experienced by different kinds of bonds in the event of a 1% increase in the yield of the 10-year Treasury note. The long-term chart shows the historical losses in the bond markets when AAA-rated bond yields have risen at least 2%. This is not a prediction, but is instead a reminder that, in a free market, and despite today's prevailing sentiment, the bond market is ultimately a two-way street, and that it is not likely to be a pleasant experience when this massive interest rate "super-cycle" ultimately unwinds.

Unfortunately, the timing of this inflection point remains very unclear, and continues to be further complicated by three extraordinary influences: 1) the long overdue return of inflation, which is the arch-enemy of bond investors, 2) newly adopted, albeit informal, Fed mandates, and 3) the preponderance of negative interest rates around the world.

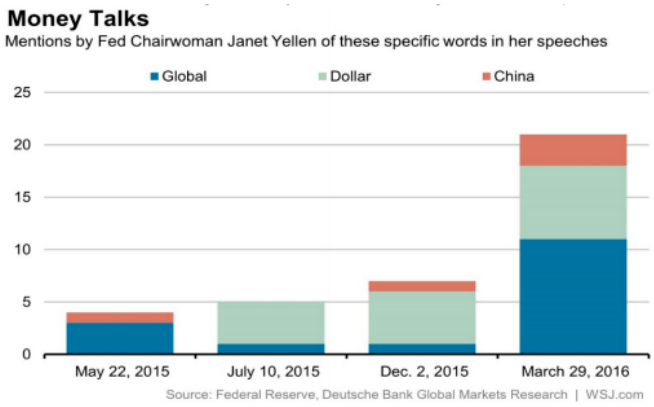


It is a point of fact that inflation, which has been long delayed by the strong deflationary trends in Japan and Europe, is finally starting to return to the U.S. on a consumer level. In a normal world, this would be as expected, as would it be for the Federal Reserve to start "tapping on the brake" (i.e. raising rates) in order to keep inflation under control. This, in turn, protects bondholders by keeping inflation from hurting the purchasing power of their yield.



However, in this environment of massive central bank involvement in the global economy, the Federal Reserve is no longer limiting itself to its traditional mandates "of maximum employment, stable prices and moderate long-term interest rates." Instead, under Chairman Bernanke, the Fed adopted the role of trying to maintain the stability of the global financial system. You will see this new role reflected in these charts that measure the dramatic increase in the use of the words "uncertainty" in the minutes of recent Federal Reserve meetings, and in the increasing frequency with which Chairwoman Yellen has referred to the terms "global," "dollar," and "China" in recent speeches.

Frankly, we are not critical of this increasing global sensitivity. We are just noting that the traditional defender of bond market investors (the Fed) is going to try to save the world instead. Indeed, Yellen recently said that the Fed was willing to let the economy "run hot" at the risk of longer-term inflation, as she wants the US economy to gain enough economic momentum to pull the rest of the world out of its doldrums. That should be great news for the global economy, but bad news for bond investors.



At the same time, with $7 trillion dollars of government bonds (27% of all outstanding sovereign debt) currently paying negative nominal yields, it is hard to imagine bond investors getting hurt very badly, at least not for a while. After all, it is "hard to break your arm falling out of a basement window."