Volume 67

THE PER STIRLING CAPITAL OUTLOOK

Performance • Perspective • Per Stirling

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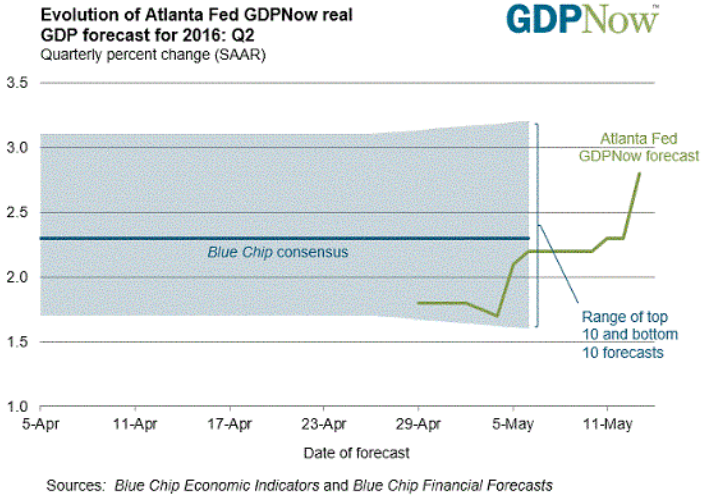
1930s actress Mae West famously said that "too much of a good thing can be wonderful!" Increasingly, the capital markets are starting to disagree with that perspective, as we seem to be transitioning from a "bad news is good news" market, where weak economic news and geopolitical risk was treated as bullish, because it kept the Federal Reserve from raising rates to a "good news is bad news" market, where signs of geopolitical stability and economic recovery are perceived as bearish, as they open the door to the prospect of tighter monetary policy (i.e. higher short-term interest rates).

We have been noting for months our belief that both the domestic economy and domestic inflation have started a sustainable ascent and that the economic system, at least in the U.S., is starting to normalize. Moreover, in regard to the Fed's prescribed dual mandate of low inflation and maximum employment, we believe that the Fed should just declare "mission accomplished" and turn their attention to slowly unwinding their massive stimulus programs. After all, levels of consumer inflation have now reached the Fed's 2% target and the nation's current 5% unemployment rate is back down to levels that have, in the past, sometimes caused excessive levels of wage inflation.

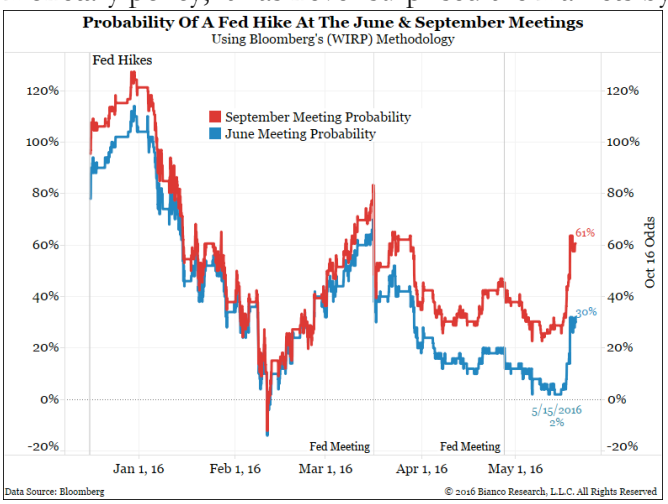
Under more normal circumstances, we believe that it would be a foregone conclusion that it was time for the Fed to continue with the raising of short-term rates that it started last December. This is particularly true when the Fed's most accurate predictive measure, the Atlanta Fed GDP Now Forecast, is expecting a significant acceleration in domestic economic growth.



However, even as recently as a month ago, the Federal Reserve was offering verbal guidance that they were willing to let the economy "run hot", even at the risk of unwanted levels of inflation, in order to give the U.S. economy the upside momentum that it needs to break out of its current malaise, and to hopefully pull the rest of the world's economy along with it.

Because of this type of "dovish" guidance and the Fed's oft-repeated concerns about the geopolitical and macro-economic risks overseas, the markets had become complacent and had barely even started pricing in the potential of another rate hike before September or even December of this year. Indeed, despite a recent array of Fed Governors warning of a potential rate increase as soon as June, the markets were only assigning it a 4% probability as recently as a week ago.

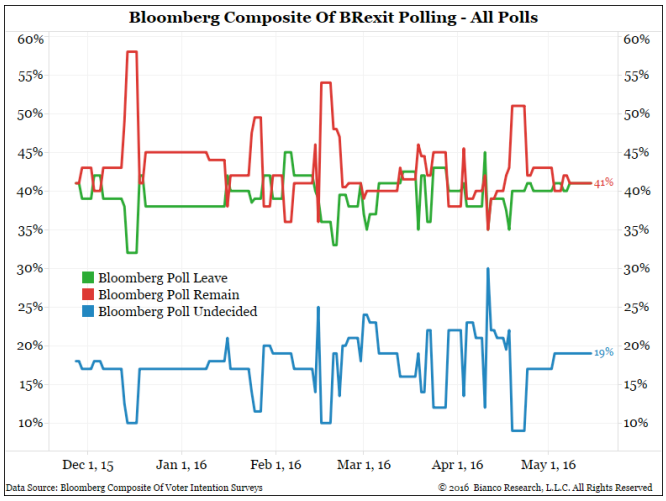
This is particularly noteworthy when you consider that, as was noted by Bianco Research, in the twenty-two years since the Federal Reserve started offering forward guidance on monetary policy, it has never surprised the markets by moving interest rates before the expected change was already largely priced into the futures markets.



However, on May 18th, the Fed released the minutes of its April 26-27 meeting in which they noted that "most participants judged that if incoming data were consistent with economic growth picking up in the second quarter, labor markets continued to strengthen, and inflation making progress toward the committee's 2 percent objective, then it likely would be appropriate for the committee to increase the target range for the federal funds rate in June".

As noted, the Fed has traditionally tried very hard not to surprise markets, and has actually historically tended to follow the lead of markets rather than lead them. In this light, it is quite remarkable that the Fed would make such an abrupt about-face, and it makes one wonder what would cause such a sudden change in guidance.

The first interpretation is that the Fed should be taken at its word, and that they do actually intend to raise rates in June either because the economic rebound is proving to be much stronger than expected or because unwanted levels of inflation are proving to be a bigger risk than they had previously perceived.



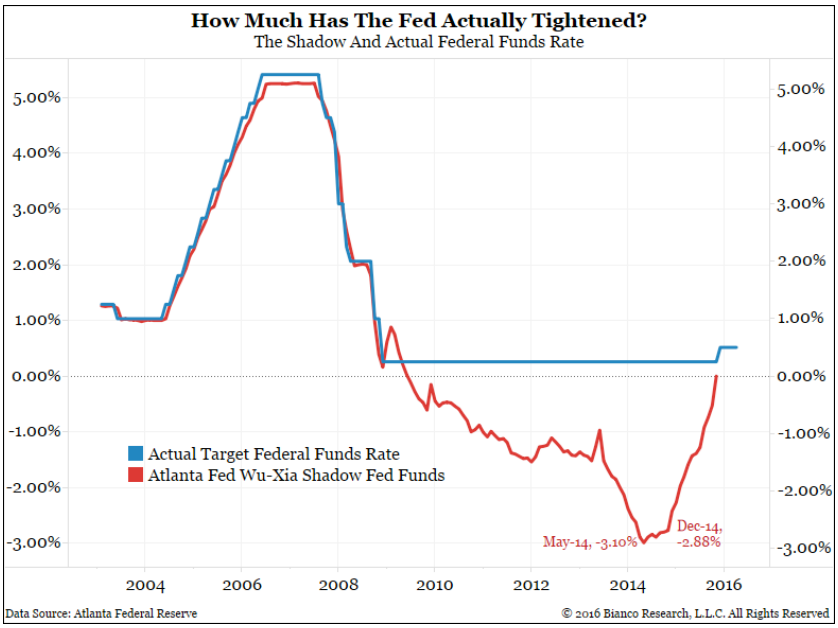
Frankly, we think that, through their comments, they have painted themselves into a corner that may force them to either raise rates in June or risk losing credibility. Even so, we suspect that it is far from assured that they will actually raise rates next month.

There are two primary reasons for our skepticism. First of all, the June Fed meeting is only about a week before the "Brexit" vote, which will decide whether or not Britain will withdraw from its membership in the European Union (EU). Because there is reason to be concerned that a Fed rate hike and a withdrawal from the E.U. in such close succession might cause significant angst in the capital markets, we believe that it would be prudent for the Fed to wait until at least July to even consider changing policy. Of note, while the "prediction markets", where large sums of money are wagered on various outcomes, only assign a 30% likelihood to an "exit" vote, the poll numbers are essentially 40% for, 40% against and 20% undecided. The outcome of the "Brexit" vote is clearly too close to call.

Our skepticism over a June rate hike is further reinforced by the fact that the markets are only assigning a 30% likelihood to it and, as noted above, the Fed has historically worked very hard to avoid surprising the markets.

Indeed, we suspect that the primary reason for such a "hawkish" (pro-rate hike) set of minutes was to make the Fed relevant to the markets again. Essentially, the markets had become so convinced that the Fed would not raise rates until December (or September at the very earliest) that investors were ignoring Fed commentary, and that is very problematic when "jawboning" the markets is one of the few (and least precarious) of the tools that the Fed still has at its disposal.

Put another way, in order for the Fed to maintain the flexibility to change monetary policy without surprising the markets, the Fed must be able to guide investor opinion in the direction of future monetary policy, which the Fed was unable to do for so long as their commentary was being ignored. For example, on the Tuesday prior to the release of the Fed minutes, three Fed governors (Robert Kaplan, John Williams and Dennis Lockhart) each warned that the Fed might raise rates as soon as June, and yet the markets (the Fed Funds futures) only assigned a probability of just over 10% to that outcome. The hawkish tone of the minutes effectively restored both the Fed's relevancy to the markets and its flexibility in regard to the timing of interest rate changes.

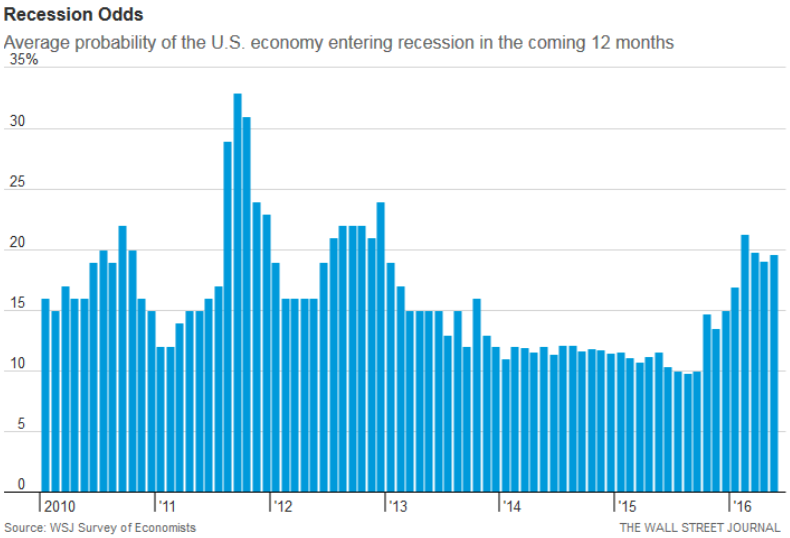


That being said, there is no doubt that some Fed governors are telling the markets to be prepared for between two and three rate increases this year. We just do not think that is particularly realistic. We expect that we will probably get a rate increase in December, once the elections are over, and that we might get a summer increase (June, or more likely July), if the Fed is concerned about the economy and/or inflation getting out of hand between now and the elections (in order to stay out of the political fray, they will probably avoid any changes as we approach the elections).

The important part is that we think that the equity markets can handle such a slow and methodical pace of tightening. Of equal importance, we believe the economy can also handle modestly higher rates, and might even benefit from them. Moreover, there is at least some reason to believe that future rate increases may be both fewer and farther between than many expect, when you take into consideration what has already taken place.

While there has, to-date, only been a single 0.25% increase in the official Fed Funds Rate, there has actually already been a quite substantial tightening in monetary policy when you include the Fed's tapering and then eventual end of its quantitative easing (money creating) policies.

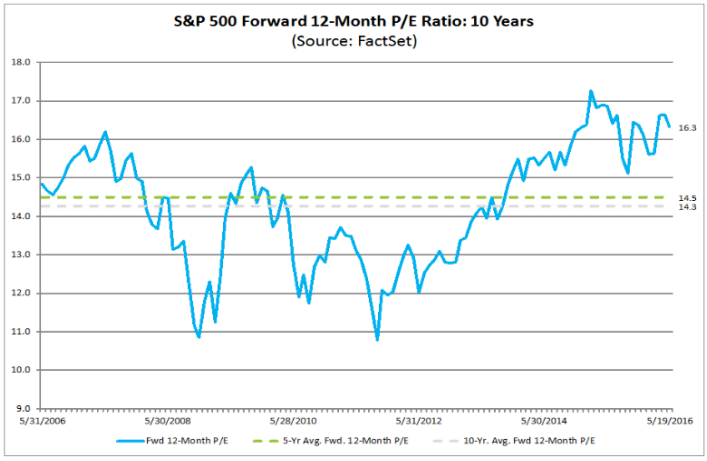
To quantify this overall reduction in monetary stimulus, economists Cynthia Wu and Fan Dora Xia at the Atlanta Federal Reserve created the "Shadow Fed Funds Rate". This rate has moved up from an effective low of -3.10% in May of 2014 to the current 0%. In other words, monetary policy has already tightened by the equivalent of over 3%. It is no wonder that stocks are struggling and that the economic recovery remains sub-par.



We suspect that the good news is that we are already further along in the unwinding of stimulus and the normalization of the economy than a single 0.25% rate increase would imply and further, that earnings and economic growth are expected to continue improving in spite of these tighter monetary conditions.

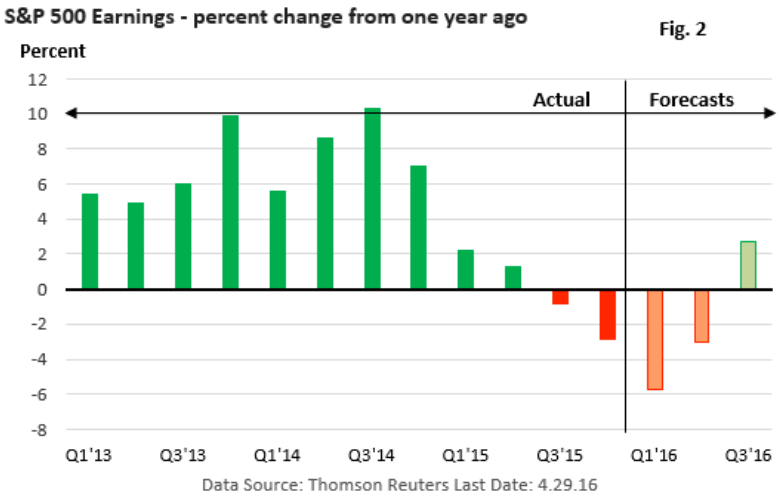
One thing that history teaches us is that equity bull markets very rarely die of old age or exhaustion, but instead normally meet their demise due to either the economy slipping into recession (with an associated decline in corporate earnings) or interest rates moving sharply higher. Because of this causational relationship, equity markets can actually be as interest-rate-sensitive as are the bond markets.

Fortunately, the risk of the U.S. slipping back into recession over the next year still seems quite low, which is affirmed by the most recent Wall Street Journal poll of economists. The odds did increase in anticipation of the December rate increase, but the real economy seems destined to continue improving.



The same is true of corporate earnings, which were absolutely terrible (-6.8%) in the first quarter. It was the first time since the financial crisis that earnings have declined for four consecutive quarters, and largely accounts for why stocks are now relatively expensive compared to the earnings that they produce (a price-to-earnings ratio of 16.3, as opposed to an average of 14.5).

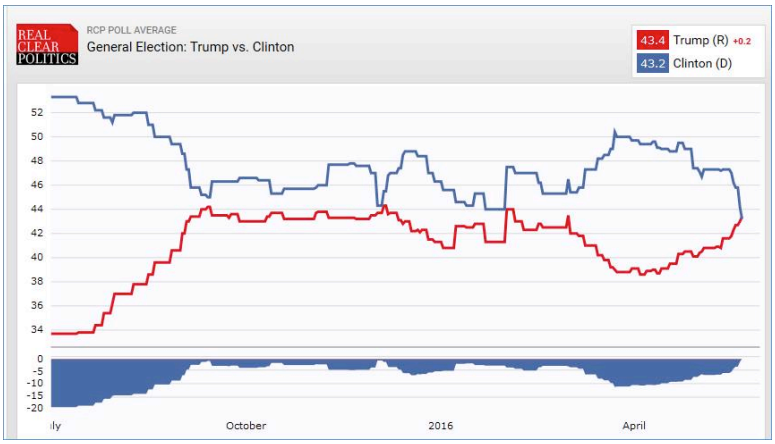
However, according to analysts' estimates, the first quarter of this year is expected to be the trough for earnings, with smaller losses expected in the second quarter and corporate America returning to profitability by the third quarter, which should help to bring stock valuations closer to normal ranges.



In other words, stocks should start to look more attractively valued as earnings improve, for so long as interest rates do not go up too much and stock prices do not appreciate faster than earnings improve.

Over the longer term, equity prices are almost always driven by these same three variables: earnings, interest rates and the strength of the economy. However, over the next six months, there will be a wild card that has the potential to overwhelm everything else. We are referring to the Presidential election, the outcome of which, according to recent polls, is now a virtual toss-up.

It is also what might most appropriately be called "an ugly contest", as the Washington Post-ABC Poll and the NBC-Wall Street Journal Poll showed Clinton (55%) and Trump (61%) to be the most disliked candidates in the long history of each respective poll.



Polling Data

Poll	Date	Sample	MoE	Trump (R)	Clinton (D)	Spread
RCP Average	5/13 - 5/19	--	--	43.4	43.2	Trump +0.2
ABC News/Wash Post	5/16 - 5/19	829 RV	3.5	46	44	Trump +2
NBC News/Wall St. Jrnl	5/15 - 5/19	1000 RV	3.1	43	46	Clinton +3
Rasmussen Reports	5/17 - 5/18	1000 LV	3.0	42	37	Trump +5
FOX News	5/14 - 5/17	1021 RV	3.0	45	42	Trump +3
CBS News/NY Times	5/13 - 5/17	1109 RV	3.0	41	47	Clinton +6

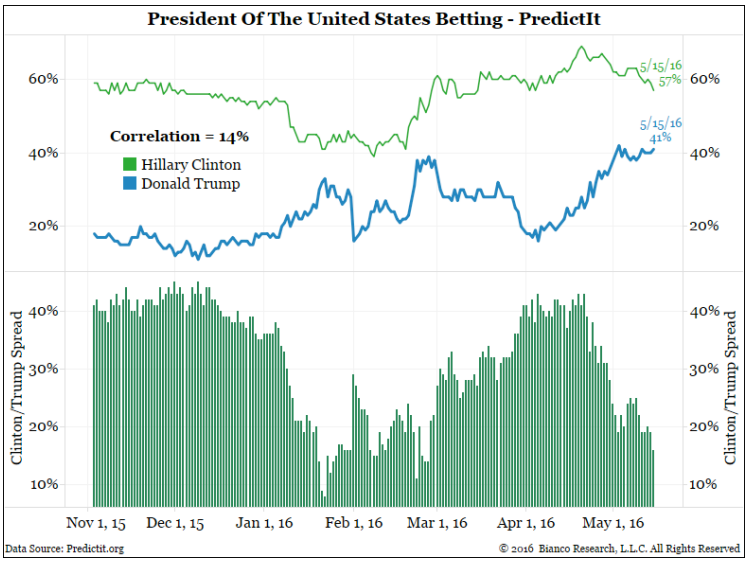
All General Election: Trump vs. Clinton Polling Data

Interestingly, while Clinton and Trump are locked side-by-side in this unpopularity contest, Sanders actually leads Trump in head-to-head polling by a remarkable fifteen percent (54% to 39%). Perhaps this is to be expected when less than half of millennials still favor a capitalistic system.

The prediction (betting) markets view the election outcome a little differently than do the polls, and still have Clinton ahead by a double-digit, albeit rapidly shrinking margin.

We have often noted that, given a choice between good news, bad news and uncertainty, investors, while preferring good news, generally prefer bad news over uncertainty. They at least know what the bad news is and can discount it into the prices of securities.

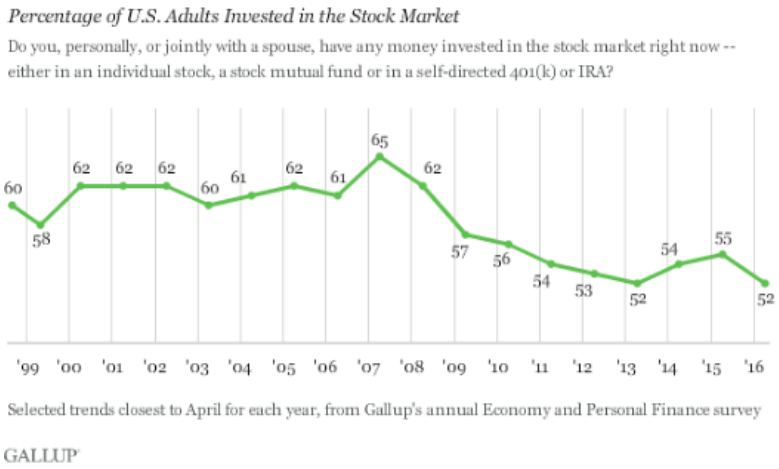
You can never know if you have fully priced-in uncertainty, and the natural reaction is for investors to price-in the worst case scenario. Markets and most businesses view Clinton as "bad news" and Trump as "uncertainty", which is why stock prices have closely tracked Clinton's polling numbers. It is also why, according to a just-completed survey by the Financial Times, lobbying groups representing a wide array of American businesses expressed their preference for Clinton by a ratio of two-to-one.



These groups have historically leaned very Republican.

Nonetheless, we do believe that two things are true regardless of who gets elected. First, both candidates love debt and are expected to greatly expand the deficit, which should create yet another headwind for the bond markets. Second, we believe that monetary policy has basically reached the limits of its usefulness, and thus expect for this additional debt to be used for fiscal stimulus, including infrastructure rebuilding, which should benefit industrials and other types of cyclical stocks.

In regards to the equity markets as a whole, we remain relatively constructive due to the outlook for a stronger economy, stronger corporate profits and our belief that the Fed will continue to move in very measured steps in its tightening of monetary policy. We are also encouraged by both the pervasive bearishness on Wall Street and one of the lowest levels of public participation in the equity markets since the turn of the century.



Indeed, at the recent Barron's Round Table, institutional investors were the most bearish on equities that they have been in the survey's 20-year history.

Traditionally, bull markets end when Wall Street is ebullient and public participation in the markets is near all-time highs… not the other way around. From our perspective, the equity markets remain mired in a long-term trading range and are fairly close to the top of that range. We do think that the equity markets will ultimately break out to the upside before the end of the year, particularly once the earnings outlook improves, but that we will need to be a little patient. In the meantime, we believe that there will be plenty of opportunities for generating returns through individual stock selection.