Volume 70

THE PER STIRLING CAPITAL OUTLOOK

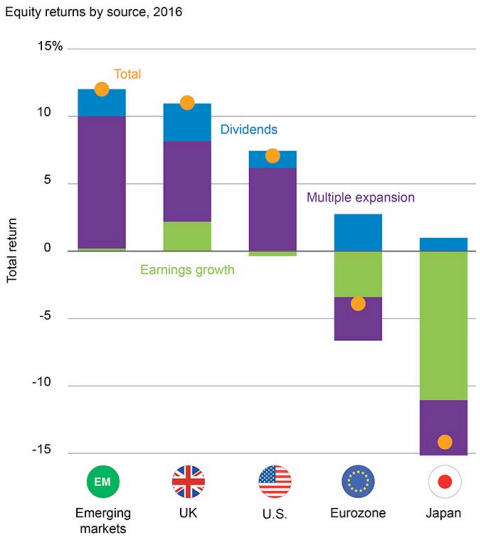
Performance • Perspective • Per Stirling

August 2016

It is said that nothing will increase the readership of an investment commentary more than putting a bear (or three) on the cover. However, this is not our intent, nor is it our intent to suggest some kind of imminent decline in asset prices.

To the contrary, while there is certainly an array of bearish influences that one can point to, we believe that there is an equally diverse array of bullish market influences that serve to counter-balance the bearish ones, and help to preserve a sort of "golden mean" or "Goldilocks" environment, where things are just strong enough to support a modest economic and earnings recovery but just weak enough to keep the world's monetary and fiscal authorities fully engaged in supporting the global economy and capital markets.

Indeed, we believe it to be very possible that the current combination of geopolitical risks, slow economic growth, a tentative recovery in corporate profits, U.S. demographics, etc. may allow portfolio values to continue meandering higher, and for considerably longer than conventional wisdom would suggest. If anything, the perceived abundance of bearish news serves the equity markets well, as it keeps cash on the sidelines, which can fuel the next leg higher.

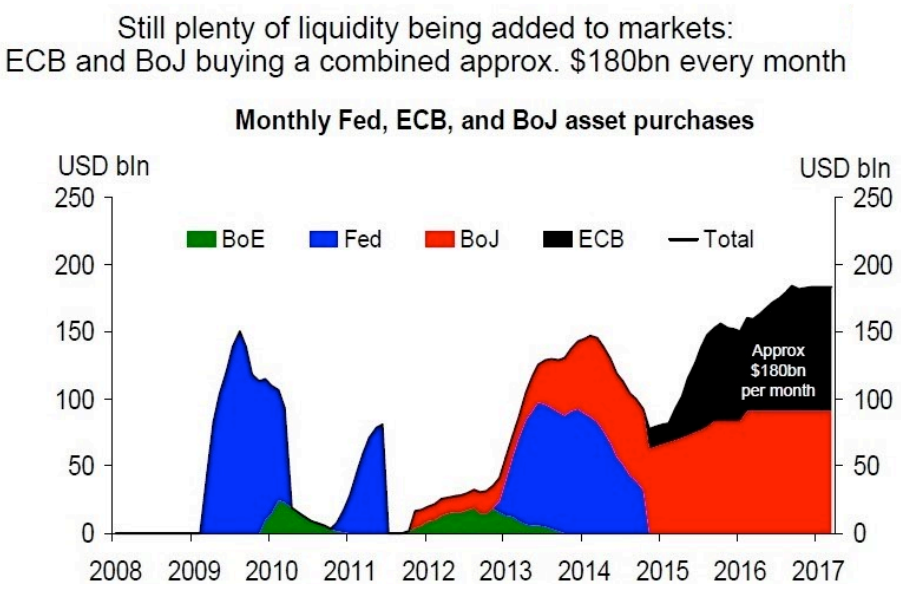


Sources: BlackRock Investment Institute, MSCI and Thomson Reuters, July 2016.
Notes: All returns are year-to-date. All returns are in local currency except emerging market returns, which are in U.S. dollars. Earnings growth is based on the change in aggregate 12-month forward earnings forecasts. Multiple expansion is calculated as the price change minus earnings growth.

We believe that things are not too hot, and they are not too cold. Neither are they too hard or too soft. We believe that, all things considered, they may be "just right" for a continuation of the current status quo which, while hardly exciting (the least volatile trailing 30-day period in the past two decades), is proving to be quite investor friendly.

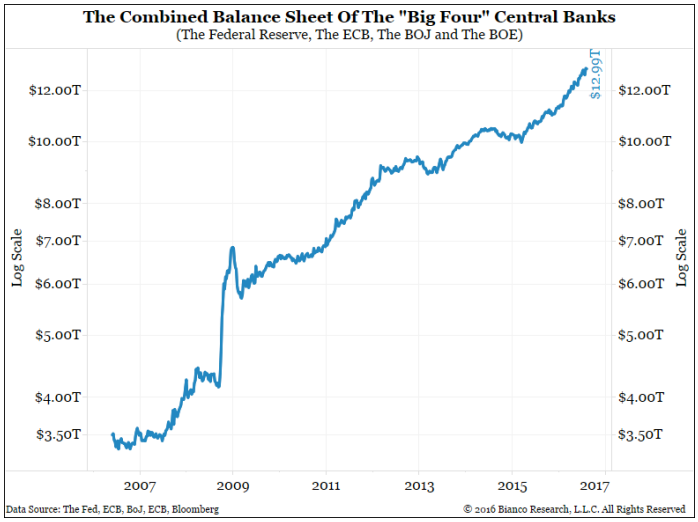
As examples: 1) While the US economy looks strong enough to keep the rest of the world out of recession, the European and Japanese economies are so weak that the Fed cannot afford to tighten monetary policy. 2) While the United States is approaching full employment and is starting to see some early signs of inflation, deflation is so pervasive in Europe and Japan that the Fed will be very limited in their ability to raise rates. 3) The US bond market is outrageously over-valued on a historical basis, but dramatically undervalued compared to the world's other major sovereign bond markets, which will keep U.S. interest rates very low. 4) U.S. stocks are very over-priced on a historical basis, but very under-valued compared to the bond markets (which represent the major competitor for investor dollars), and this should not only keep equity valuations high, but also allow them to move even higher (multiples expansion, as shown in purple).

We attribute the existence of this series of economic checks and balances to the very unusual divergence between the various global economies. To explain, because most economic cycles are based on macroeconomic factors like supply and demand, and because the global economy is so inter-connected, most economic expansions and contractions are global in nature, and are experienced simultaneously in most major economies.



However, this time, the economic cycle is out of unison because it is instead based upon the timing and volume of heroic monetary policies ranging from quantitative easing to zero-percent interest rates. The U.S. reacted first and most forcefully, and as a result, is far more advanced in its recovery from the financial crisis than are its traditional European and Japanese trading partners.

You can see this progression in the chart of asset purchases (quantitative easing), and how the U.S. Fed (blue) was so proactive early on. You can also see how most of the monetary stimulus is now being provided by the Bank of Japan (red) and European Central Bank (black).



Central bank asset purchases (quantitative easing) largely catalyzed the huge rallies in the domestic stock and bond markets, and it seems reasonable to expect that it will similarly benefit capital markets in the countries where it is originating. Indeed, because money is fungible, this policy of creating money out of thin air and using it to purchase financial assets is beneficial to the price of financial assets across the globe. This is a point worth considering in light of the fact that, even though the Fed has frozen the size of its stimulus program, the combined stimulus from the central banks of England, Europe, Japan, and the United States continue to increase sharply (and this does not even include the monetary stimulus being pumped into the global economy by China, which is reported to be massive).

The world's emerging markets, on the other hand, have largely been driven by the plummeting prices of most commodities, the strength of the dollar, and their susceptibility to higher U.S. interest rates, which has caused them to move with less-than-usual regard to the state of the world's more industrialized economies.

The Recovery/Expansion Is Already Fairly Long

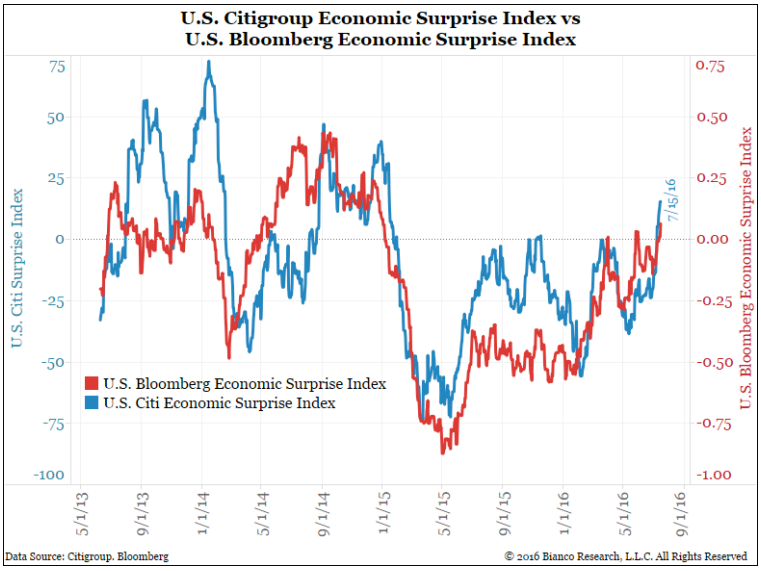
Recessions	Duration (Months)	Expansions	Duration (Months)
1945	8	1945-48	37
1948-49	11	1949-53	45
1953-54	10	1954-57	39
1957-58	8	1958-60	24
1960-61	10	1961-69	106
1970	11	1970-73	36
1973-75	16	1975-80	58
1980	6	1980-81	12
1981-82	16	1982-90	92
1990-91	8	1991-2001	120
2001	8	2001-07	73
2008-09	18	2009-?	90 So Far
Averages:		Averages:	
1854-1919	21.6	1854-1919	26.6
1919-45	18.2	1919-45	35.0
1945-2009	11.1	1945-2009	58.4

There is an old Wall Street expression that "trees don't grow to the sky", which simply means that things don't go up forever.

After all, even quantitative easing and zero-percent interest rates can't keep this bull alive forever, and it is admittedly starting to show its age on two fronts. The first of these is just a matter of time itself, as the current advance is the second longest running and fourth most powerful equity bull market in U.S. history.

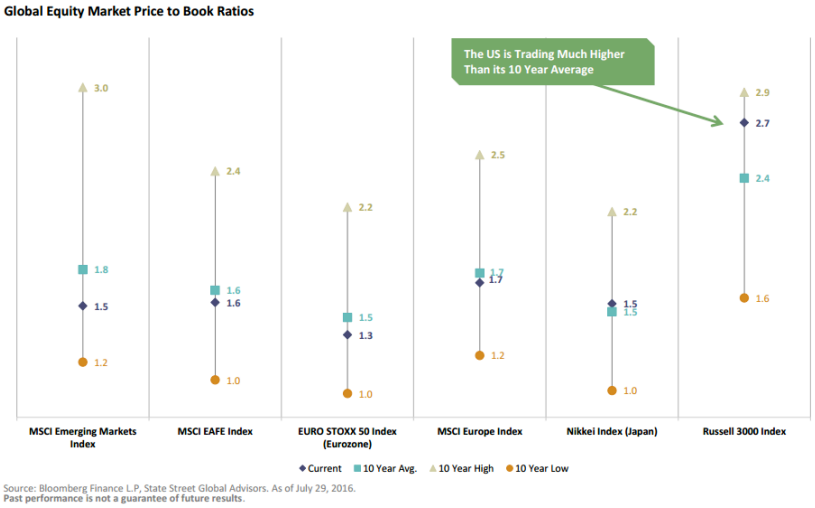
The domestic economic recovery itself faces similar age-related challenges, as this is already the third longest running economic expansion since World War II. If the economy were to slip into recession, we would expect for it to be very negative for equities, and a huge boost to high-quality bonds.

However, for a variety of reasons, we don't see a near-term recession as being any more likely than is a near-term bear market in equities. To start with, recoveries from periods of financial crisis tend to be very slow and lumbering, which keeps inflationary pressures down and keeps the Fed on the sideline thus allowing for long-duration recoveries. Second, between the $2.7 trillion of new money that the Fed used for asset purchases and the lowest interest rates in history, there is still tremendous monetary stimulus sloshing around in the economy and financial system. Third, for more than a year, the Bloomberg and Citigroup Economic Surprise Indexes have been trending higher, which means that the combination of economic data and corporate earnings announcements are turning out to be stronger than expected.



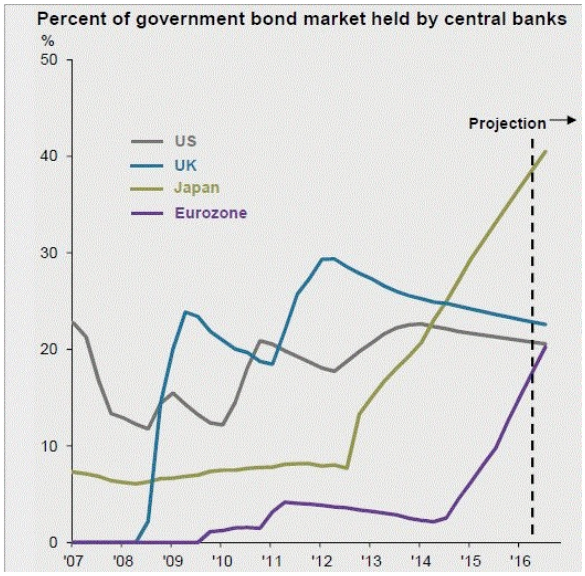
We view this as important for two reasons. First of all, this trend suggests a continuingly improving economy. Second, this trend should continue to be bullish for equities, as securities like stocks are priced according to expectations and, when news turns out to be better than expected, equity prices normally adjust higher in recognition of the better news.

The other factor most often quoted by stock market bears is that the stock market is very expensive when compared to the earning power of the underlying companies, and there is no doubt that, from a historical perspective, they are correct. The same is true of other valuation measures like book value, where U.S. equities, as represented by the Russell 3000 Index (which includes America's 3000 largest public companies) are not only expensive compared to their historical averages, but are also very over-valued compared to other public companies around the world.



However, at the risk of sounding "Pollyannaish", we are also not particularly concerned about U.S. equity valuations as a near-term risk. This is partly because interest rates are at historic lows, and because investors have historically been willing to pay much higher equity valuations when rates are low. It is also because, while equities may look expensive from a historical perspective, they actually look like bargains on a relative basis, when compared to the speculative froth found in many real estate markets, and the astronomical valuations found in the high quality bond markets. (Quantitative easing almost universally inflates the price of financial assets.)

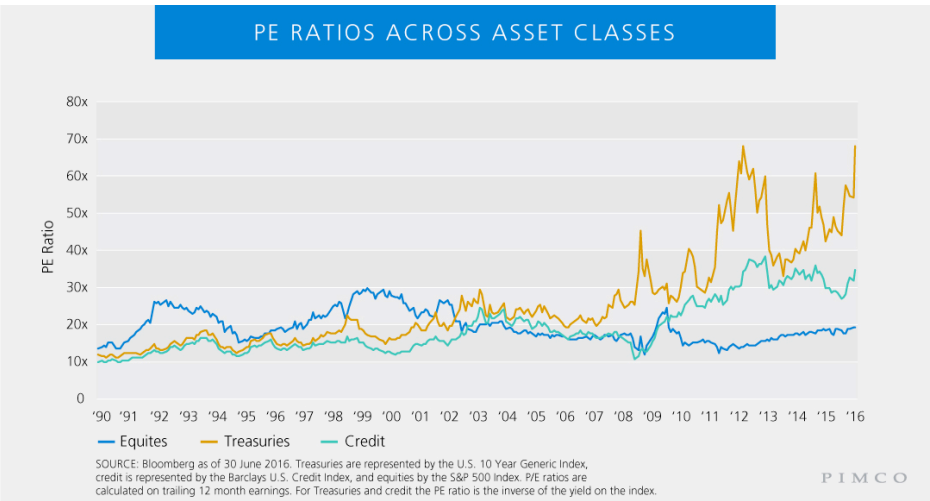
Indeed, regardless of whether you use earnings or dividends as your measure of valuation, equities look like a compelling value when compared to the fixed income markets, which represent the main competition for investor funds.



Much of this is due to the fact that the world's major monetary authorities have used quantitative easing strategies to buy up so much of their own bond markets that the central banks of Europe, the U.K. and the U.S. now own between 20% and 30% of all government debt, and Japan now owns approximately 40% of all outstanding Japanese sovereign bonds.

All of this central bank-generated demand has swamped supply and thus pushed interest rates so low that a full one-third of the global supply of government debt now pays a negative yield. Even in the U.S., where interest rates remain relatively high compared to the rest of the industrialized world, the 10-year government note only yields 1.6%, which is notably lower than the 2.1% dividend yield found on the S&P 500 Index, and suggests that equities are remarkably inexpensive compared to debt.

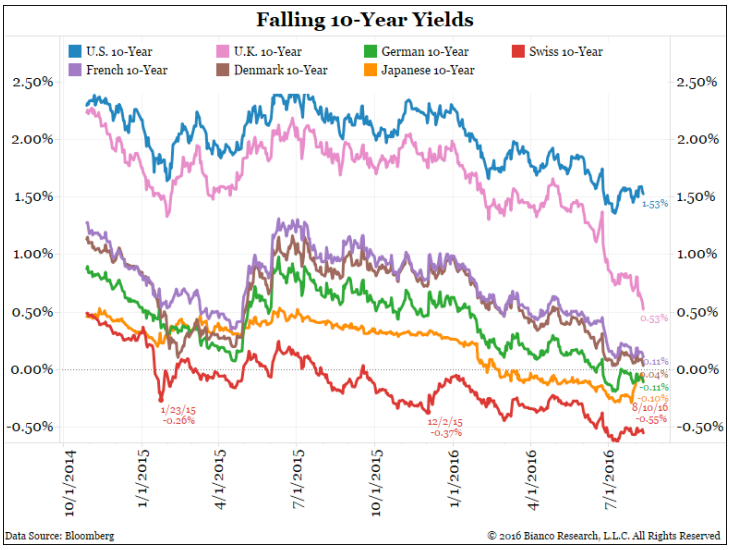
Indeed, in order for the yield on the S&P 500 to fall to the current level of 10-year treasury yields (all other things being equal), the equity index would need to rally an additional 30% from current levels.



Moreover, the relative attractiveness of equity yields is only one part of the equity valuation story. If anything, the relative under-valuation of equities versus debt becomes even more compelling when you compare the two asset classes based upon price-to-earnings multiples.

On average, domestic equities trade at a price-to-earnings multiple of 20 times earnings, which is admittedly rather expensive on a historical basis. However, things look very different when viewed from a relative perspective. Based upon the same measure of price-to-earnings, investment-grade (high-quality) corporate bonds trade at a price-to-earnings multiple of a massive 35 times earnings and U.S. Treasury debt trades at an astronomical valuation of 70 times earnings.

Granted, stocks and bonds trade differently from one another, and bonds are historically a less volatile asset class. However, the markets appear to be assigning an unjustifiable risk premium to equities (stocks) versus debt (bonds) at a time when we believe that interest rate risk may make bonds (unless held to maturity) the asset class with greater downside risk.

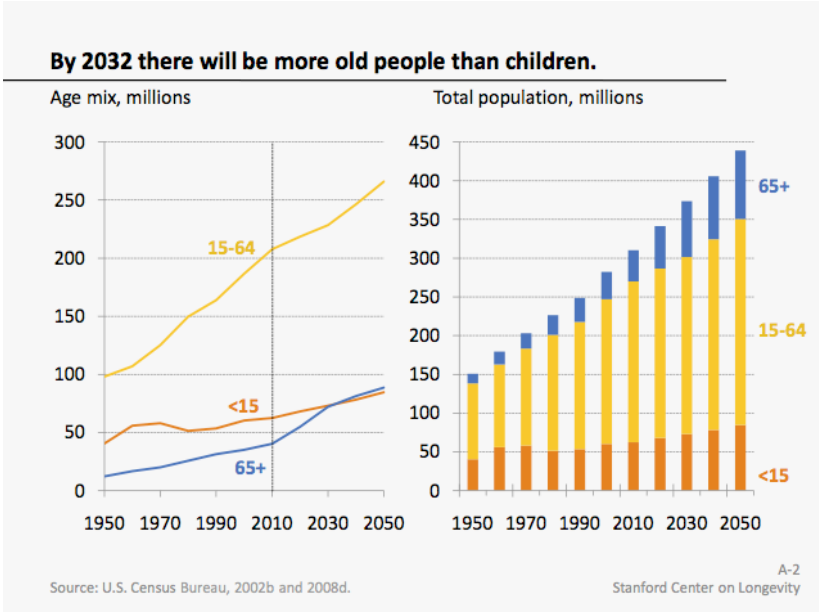


In a world where the supply of money is growing by leaps and bounds (see the fourth graphic in this report), the money needs to go somewhere and, while equities are not cheap on an absolute basis, they appear to be reasonably attractive on a relative basis.

This ratio also suggests that high-quality corporate bonds are very undervalued compared to treasuries, as the number of investment-grade corporate bond defaults would need to double from 1% to 2% in order to justify the valuation difference between corporate debt and government debt, which we consider quite unlikely without a prolonged U.S. recession which, as noted, we do not view as an immediate risk.

Ironically, what may turn out to be very supportive of future equity prices is the very factor that was supposed to cause a massive, generational selling of equities. We are referring specifically to America's aging demographics and the 80 million baby-boomers that have spent the past six decades changing everything from economics and finance to healthcare and politics. Demand from this group caused home prices to soar. It caused the biggest equity bull market in U.S. history as this group started investing for retirement, and it helped to drive debt yields to the lowest levels in history, as this group started retiring and thus shifting from a growth objective towards an income objective.

The theory has been that, with 1.5 million Americans now turning 70 each year, it would start a secular bear market in equities, as hundreds of billions of dollars shifted from stocks to bonds. However, with equities now less expensive, higher yielding and potentially even safer than bonds (due to interest rate risk), one must wonder if that trend will reverse back in favor of equities as a source of both higher yield and a potential hedge against inflation.



No, trees still don't grow to the sky, and we agree with the growing number of high-profile bears that the prevailing combination of weak global growth, a profits recession, high valuations, and negative interest rates make an eventual bear market virtually inevitable.

Indeed, we have little doubt that the global capital markets are ultimately due for a significant downward adjustment once the global economy starts to normalize, and the world's various central banks and governments finally feel confident enough to step back from the markets and let free-market forces once again determine fair-value and price. We just happen to think that the aforementioned bears are simply too early, and that the normalization of the global financial markets and the resulting return of traditional price discovery will be very slow in coming.

Further, we fully expect that the world's monetary and fiscal authorities will try to manage this return to normalcy once the global economy is again stable enough for it to take place, and to do everything in their power to minimize the pain associated with the removal of stimulus and the return to a free-market pricing model.

While we remain confident that the Fed (and other central banks) will be modestly successful in this regard, we also recognize that it is just a matter of time before those three bears ultimately decide that Goldilocks looks a lot more appealing for dinner than does a bowl of porridge. In the meantime, while the potential for short-term volatility always exists (particularly in environments like the present), we think that the odds are that Goldilocks will remain with us for longer than most pundits think.