Volume 71

THE PER STIRLING CAPITAL OUTLOOK

Performance • Perspective • Per Stirling

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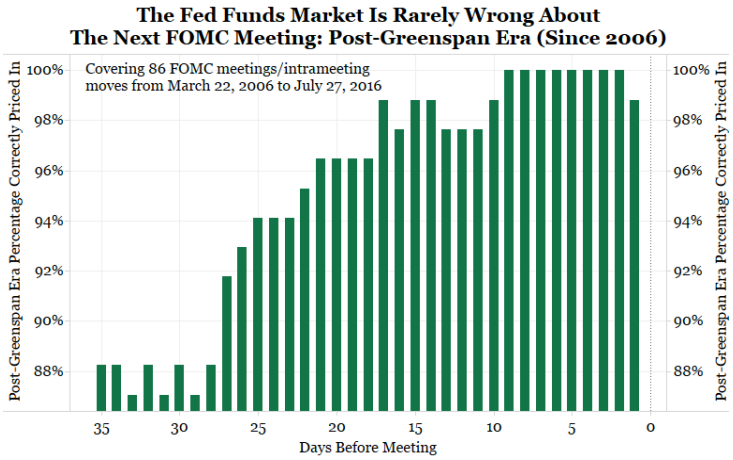
As David Rosenberg, Chief Economist for Gluskin Sheff, recently observed, "summer vacation is over". Summer is known for being a quiescent period in the markets, when trading volumes are very low and Wall Street's primary decision-makers are off vacationing in the Hamptons. This summer was even calmer than usual. As evidence, the Standard & Poor's 500 Index enjoyed a remarkable 43 consecutive days without a single instance when it traded in a range of as much as 1%.

The environment has since changed. The S&P has now traded in a range of more than 1% in 9 of the past 10 trading days, and the Japanese Nikkei 225 Index has just concluded its longest losing streak in 2 ½ years. Those "lazy, hazy days of summer" are now clearly behind us.

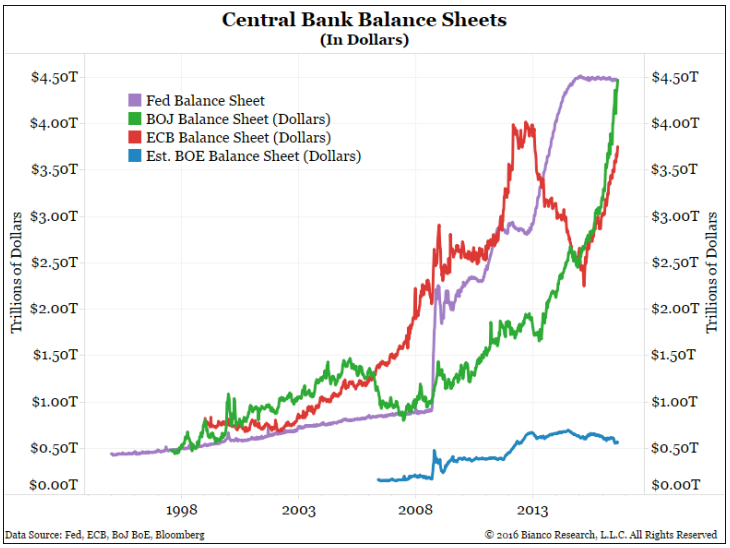
So what caused this sea change in the markets? We attribute the change to a variety of factors. They include a perceived lessening in the level of commitment of the world's central banks to quantitative easing, asset purchases and negative interest rates. They include the recent and somewhat surprising surge of Donald Trump in the polls, and they include the normal seasonal patterns (September is the only month when equities are down more often than they are up and October is known for its history of major equity market sell-offs). Of note, during election years, equities gain an average of 0.5% during the month of September and lose an average of almost 1% during the month of October.

In regard to the perceived change in the prospects for continued heroic monetary policies, it extends far beyond the Federal Reserve's efforts to jawbone higher the market's expectations for short-term interest rates, which is a necessary precursor to an actual interest rate increase. To explain, the Fed offers guidance in order to avoid surprising the markets. As a result, the futures market almost always fully prices in the likelihood of a rate change well in advance of it actually taking place. This fact is illustrated by the Fed Funds futures chart.



Equally important to this sea change has been growing levels of skepticism in both Europe and Japan regarding the ongoing quantitative easing program and their hoped-for benefits. Indeed, at The Bank of Japan's July 28th meeting, they not only provided less monetary stimulus than was expected but also commissioned a study questioning the tangible benefits of quantitative easing.

It is now pretty obvious what that study concluded, as the Bank of Japan used the opportunity of its September 21st meeting to announce that they were making an important change in their monetary stimulus, and that they would no longer be force-feeding a set amount of money into the financial markets every month.

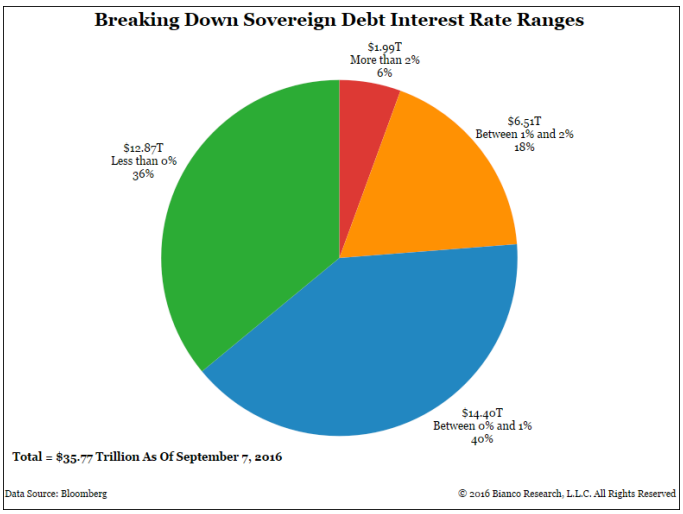


Instead, they are going to use their asset purchases to try to influence the shape of the yield curve (i.e. the relationship between short-term and long-term interest rates) with the ultimate goal of keeping the yield on their 10-year government bond at 0%.

While this may support their bond market, as it assures investors that they can invest in long-term Japanese debt with fairly limited risk, it also means that what has been perceived as a seemingly endless flow of central bank liquidity (which the equity and debt markets have become so addicted to) is now both less certain and less abundant.

A very similar re-examination of the benefits of these programs is playing out in Europe, where the European Central Bank recently announced that they did not even discuss what had been an anticipated expansion of monetary stimulus, and instead called for a similar study questioning the tangible benefits of Europe's quantitative easing programs.

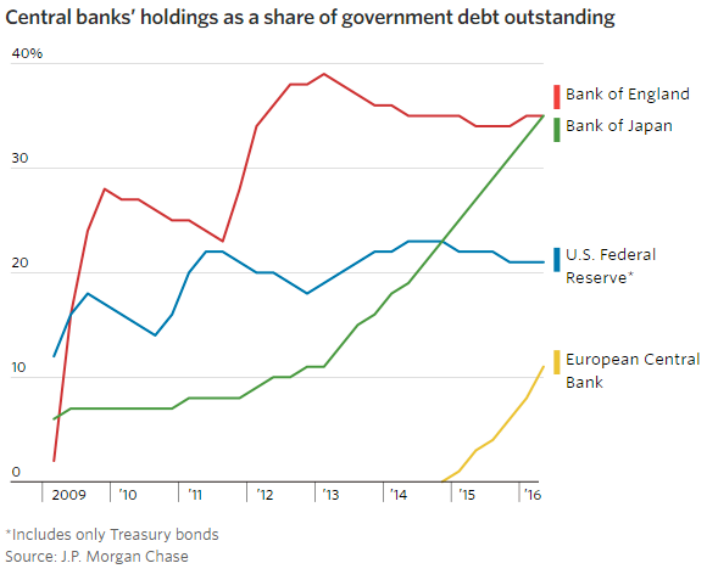
This is a sharp reversal from European Central Bank President Mario Draghi's July 26, 2012 promise to do "whatever it takes" to restore the European economy and defend the euro currency.



Investors responded to this perceived lessening of enthusiasm for quantitative easing and the associated purchase of financial assets (primarily debt) by driving yields higher (bond prices lower) across the globe. This shift is particularly impactful in light of the $12.8 trillion of foreign sovereign debt that has been paying yields of below 0%.

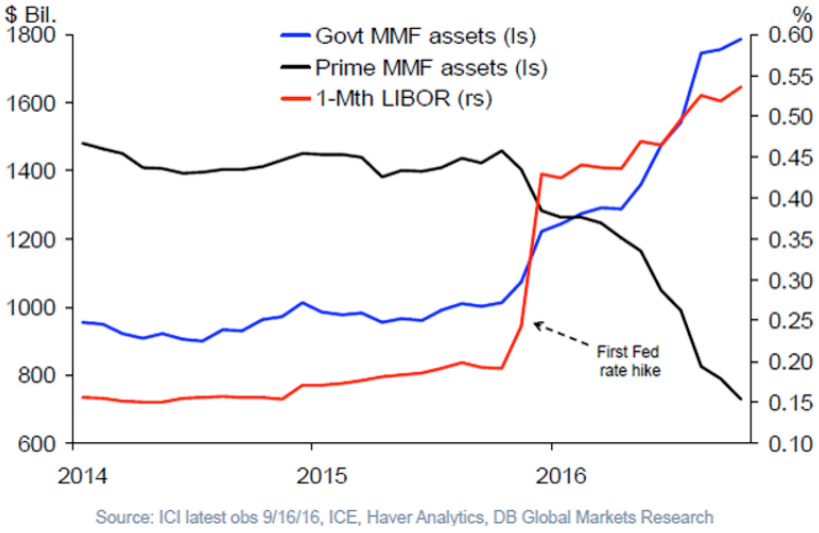
This sum represents 36% of all of the world's outstanding sovereign debt. Investors have been pouring money into these negative yielding securities under the premise that they would still be able to make money by selling them to an even "bigger fool" (the central banks in Europe and Japan), which appeared to be frantically searching for more and more debt that they could buy with all of the money that they were creating through their quantitative easing programs.

The world's four major central banks already own a remarkable percentage of the total outstanding sovereign debt (government bonds) issued by their respective governments. This ranges from an astonishing 35% for the Bank of England and the Bank of Japan and a nominally massive 21% for the U.S. Federal Reserve, to a still quite significant 11% owned by the European Central Bank, which is a relatively new entry in the global asset-purchase game.



If the central banks lose their enthusiasm for these asset-purchase programs (i.e. being the "bigger fool"), there is almost no justification for buying or holding negative-yielding debt. This is why, over recent weeks, over $1 trillion of previously negative yielding sovereign and corporate debt has sold off sufficiently to raise their yields into positive territory. Some of this debt (like in Germany) has since returned to slightly negative yields.

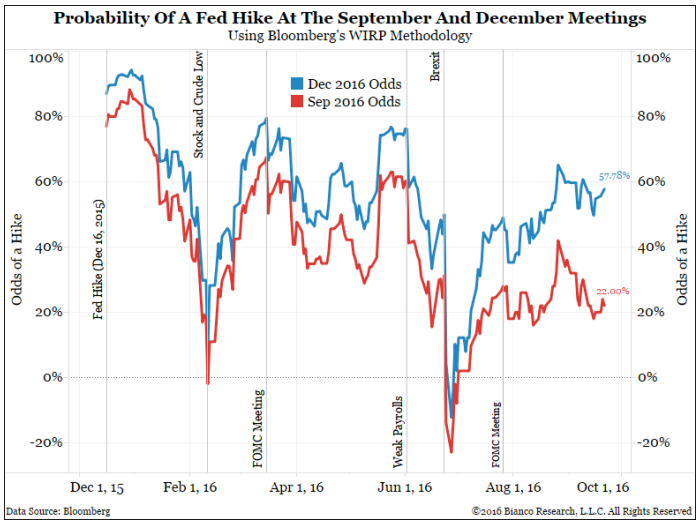
Indeed, for the 10-year German bund, which serves as the benchmark for Eurozone debt, this foray into positive yields was its first since July. Further, the U.S. 10-year treasury yield has climbed four-tenths of one percent over recent months, which seems quite small from a nominal perspective, but which is huge on a relative basis, with 10-year yields as low as 1.37% back in July.



While most of the catalysts are different, we are seeing a similar climb in short-term rates.

The first of the catalysts for higher short-term rates is actually more regulatory than it is market-driven. To explain, the Securities and Exchange Commission is introducing money market reforms in the mutual fund industry, and one of the major changes is that "prime" money market funds, which include basically all money market funds that invest in anything other than government-guaranteed, short-term debt, will no longer consistently trade at a $1 share price (NAV), but will instead have a variable price that is determined by market forces.

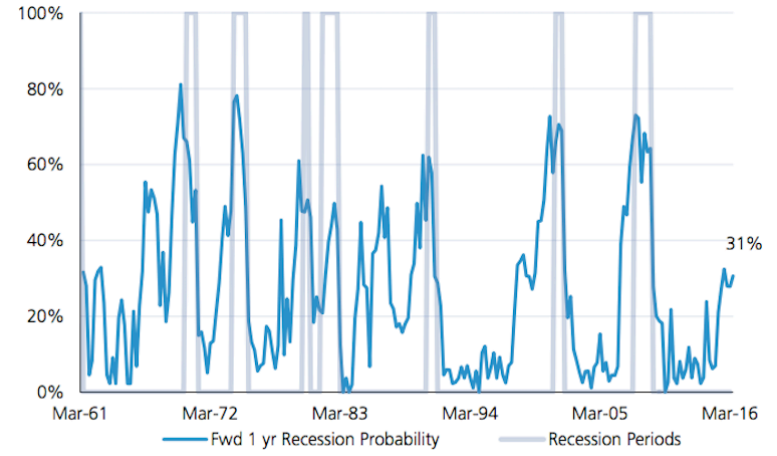
Since this introduces market risks into what has generally been considered a "risk-less" investment, investors are driving down prices in recognition of this new risk, and this is, in turn, driving non-U.S. Government short-term rates higher. Since money is fungible, this regulatory reform is actually driving short-term rates higher across the globe, as you see reflected in the London Inter-Bank Offer Rate (LIBOR), which is the global benchmark for short-term rates (red line above).



Also helping to push short-term rates higher is the increasing likelihood that the Federal Reserve will raise its short-term borrowing rate (the Fed Funds Rate) higher in December. We expect to see the same 0.25% increase that we saw last December, which may harm short-term investor sentiment, but which is unlikely to have any significant and tangible impact on the real economy.

At the same time, there have recently been a stream of speeches from both Federal Reserve Governors and Chairwoman Yellen herself, where they have talked about the "neutral rate" (the interest rate at which monetary policy is neither stimulative nor restrictive), how that rate of neutrality is much lower today than it has been historically, and thus how today's historically low rates are less stimulative (and less of an inflation threat) than most pundits believe.

This perspective, along with the facts that short-term rates are moving higher even without Fed action, and that the Fed has already successfully reduced the money supply by 4% on a year-over-year basis, does call into question the necessity of increasing rates now, particularly at a time when all eight of the most recent important pieces of economic data came in weaker than expected, and the potential for recession, albeit still very modest, is increasing noticeably for the first time in years.



Source: UBS

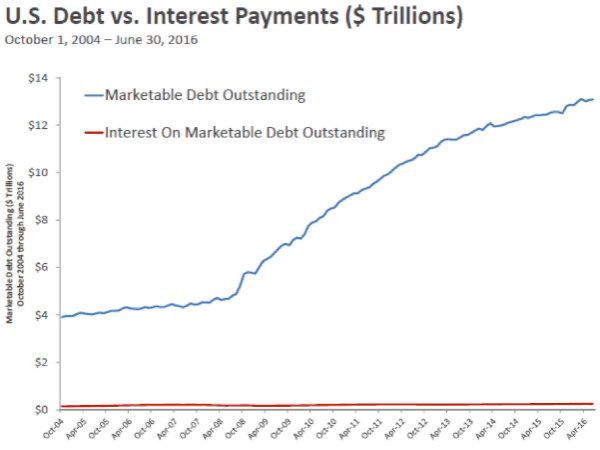
One of the most common justifications for the Fed potentially raising rates is that it would "put some bullets back in the gun" (i.e. allow the Fed some room to cut rates later when the economy faces its next recession). The aforementioned David Rosenberg offers an interesting analogy for this rationale. Specifically, it would be like "shooting yourself in the foot, while at the same time having a lineup of podiatrists at hand to deal with the aftermath."

The bottom line is that monetary policy has taken the global recovery about as far as it can, and now it is time for the world's elected leaders to finally get off of their respective duffs and introduce some fiscal stimulus *en masse*.

Now we acknowledge that there are some dangers associated with this perspective, the most obvious of which is that it will further balloon the world's already massive levels of sovereign debt which, in and of itself, will lead to some significant pain down the road.

However, despite this risk, we maintain that fiscal spending on things like infrastructure will prove to be very important in sustaining this still halting recovery from the Great Recession, as deflationary pressures still abound, and there is still a risk (even if only modest) that the global economy could still slide back into the same kind of longer-term economic quagmire that has weighed on Japan since 1989.

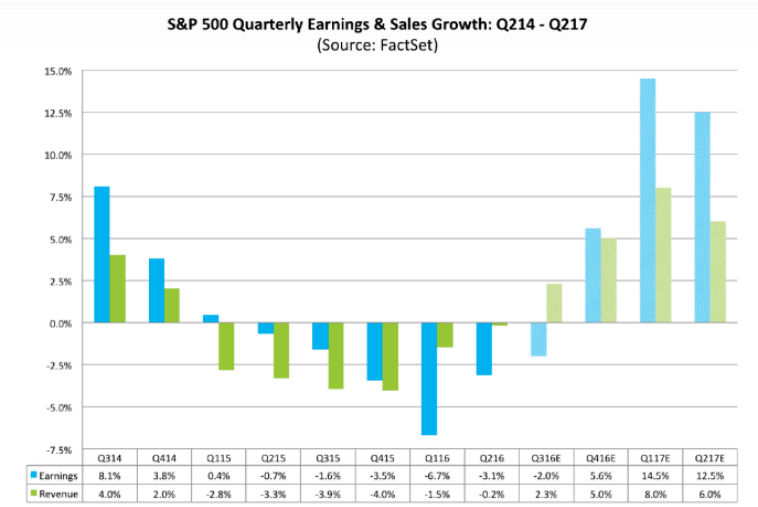
We will also emphasize that this is not a particularly novel expectation, as is shown by the surge in the frequency with which the term "fiscal stimulus" is mentioned in news articles. The baton is being passed from the monetary authority (the Fed) to the fiscal authorities (Congress and the White House), and we suspect that we will see a significant stimulus package regardless of who gets elected as President, which should help to breathe new life into the economy. This should be beneficial for domestic equities in general and domestic small-cap equities in particular.



We believe the opposite to be true in regard to the debt markets, where more and more debt will need to be issued to make up the difference between the fiscal stimulus package and increases in tax revenues, and where the cost of servicing our national debt will become increasingly burdensome as debt levels rise and interest rates move higher.

It is this cost of servicing the national debt that we think will ultimately wreck havoc on the bond market. This factor is largely ignored today, because interest rates have plummeted at essentially the same pace as the debt levels have soared, which has kept the interest expense on the nation's debt essentially flat (red line). However, as the current low interest rate debt matures and needs to be re-financed at higher rates (combined with additional borrowing to finance the fiscal stimulus programs), and the nation's debt burden could become backbreaking. While such a massive surge in the supply of debt would be very negative for the bond markets, the ultimate reckoning may not be immediate. After the Great Depression, long-term U.S. Government bond yields remained mired between 2% and 3% for a full twenty years (1934 until 1956).

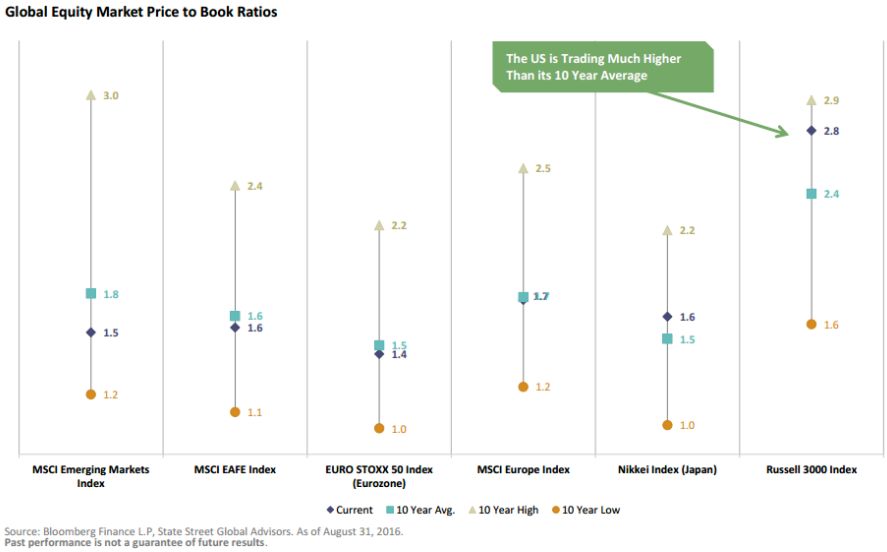
In regard to the outlook for equities, we do look for continued improvement in the global economy, and expect that the recovery will be led by the United States. This recovery, when combined with a lessening of some of the deflationary forces that have weighed on profits since the financial crisis, should help to pull the U.S. out of the profits recession that it has been mired in for almost two years, and this will help to remedy the primary headwind that equities have been facing, which is that they are quite expensive compared to their current earning power.



	Q314	Q414	Q115	Q215	Q315	Q415	Q116	Q216	Q316E	Q416E	Q117E	Q217E
Earnings	8.1%	3.8%	0.4%	-0.7%	-1.6%	-3.5%	-6.7%	-3.1%	-2.0%	5.6%	14.5%	12.5%
Revenue	4.0%	2.0%	-2.8%	-3.3%	-3.9%	-4.0%	-1.5%	-0.2%	2.3%	5.0%	8.0%	6.0%

While perhaps somewhat less important, domestic equities are also expensive by other traditional measures like book value, as is reflected in the chart below.

This chart is also revealing in that it very effectively illustrates that, while U.S. stock are somewhat expensive, most foreign equities are currently rather attractively priced when compared to their historical valuations. Further, since Europe and Japan started their stimulus programs much later than did the U.S., they are also relatively early in their recovery, which means that there is still value to be revealed in their equity markets.



In general, most of the major emerging markets also look relatively attractive, but they do tend to be very susceptible to increases in U.S. interest rates, so it may make sense to wait and see how they handle the anticipated December rate increase before making significant allocations to those markets.

In general, we expect for equities to take some profits in the event of a December increase in the Fed Funds Rate, and suspect that markets will react quite badly (at least initially) if a Trump Presidency looks increasingly likely (because of all of the uncertainties associated with his seemingly ever-changing platform). Aside from these two headline risks, we continue to like the outlook for equities in general for the many reasons detailed in last month's report.