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THE PER STIRLING CAPITAL OUTLOOK

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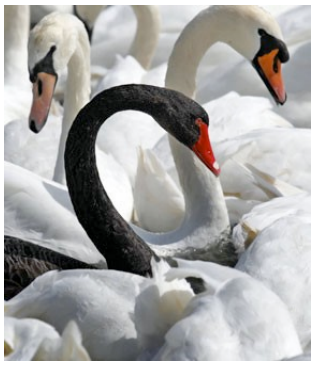
The lexicon of investment terminology is full of animal metaphors, which range from the most basic of descriptors like "bull market" and "bear market" to highly evocative terms like a "dead cat bounce" and a "black swan". This last term seems particularly relevant today, in light of the current election cycle.



A "black swan" is a metaphor that describes an event that is almost totally unexpected, has a major impact, and is often inappropriately rationalized with the benefit of hindsight. From a purely capital markets perspective, a "black swan" describes an occurrence that lies so far outside of almost everyone's expectations that it barely even warrants consideration, and which thus normally catalyzes a violent reaction (in either direction) on the part of investors when it comes to pass.

Thus far, this presidential election has been dominated by an array of improbable events and influences ranging from the rise of Bernie Sanders and Donald Trump to the Wikileaks release of the Clinton e-mails and the airing of Trump's comments about using his celebrity status to sexually molest women (and a resulting flood of accusers sufficient to make even Bill Cosby blush). However, to-date, none of these has been so surprising and so impactful on the capital markets that they would qualify as "black swan events".

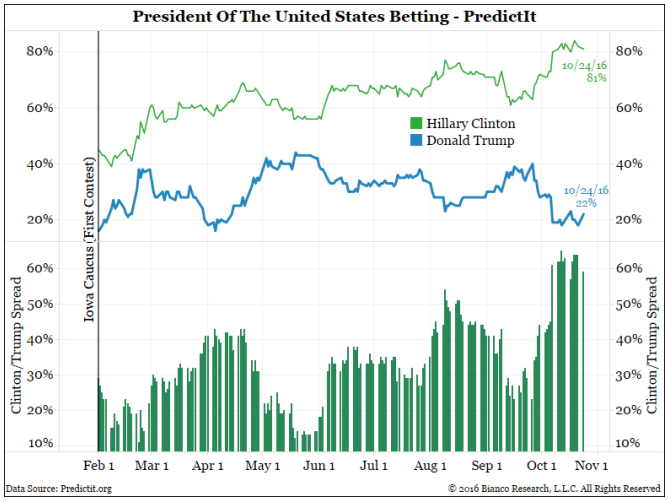
Indeed, Wall Street seems quite confident that it has figured out what the result of the elections will be and, while the expected outcome is less than ideal for investors, it is an outcome that investors have adjusted to, and which they believe that they can live with.

> "When all the experts and forecasts agree – something else is going to happen."
>
> -Bob Farrell,
> Renowned Analyst

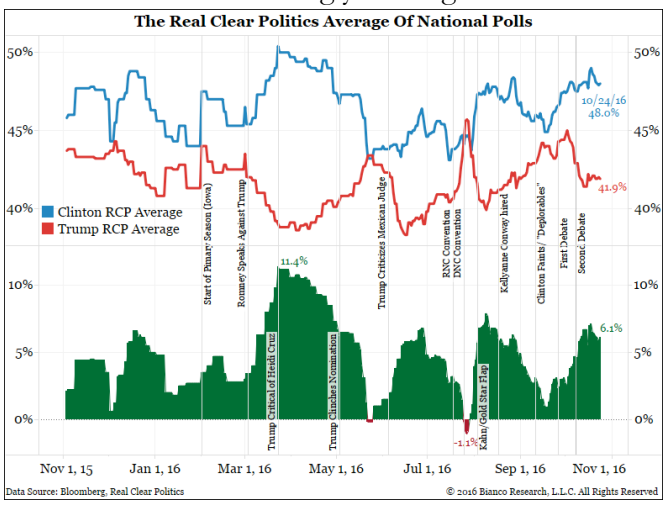
However, as we learned from the surprising result of the June 23rd "Brexit" vote to leave the European Union (which was an outcome that the betting markets assigned only a 6% chance of on the day before the vote), the pundits and talking heads certainly have the capacity to be very wrong. "Brexit" provides a classic example of a "black swan" event.

Indeed, history is full of instances when there seems to be an inverse relationship between the strength of the consensus expectation and the ultimate outcome. While we doubt that this is actually a causal relationship, we certainly understand that perception, as there is virtually no doubt that unexpected outcomes catalyze much greater market reactions than do expected outcomes. This is rational, as expected outcomes are priced into securities well in advance of the outcome actually coming to pass. In contrast, market prices need to adjust sharply (up or down) whenever reality turns out to be significantly different than what was expected, with the size and speed of that price adjustment normally being directly proportionate to the strength of the consensus opinion.

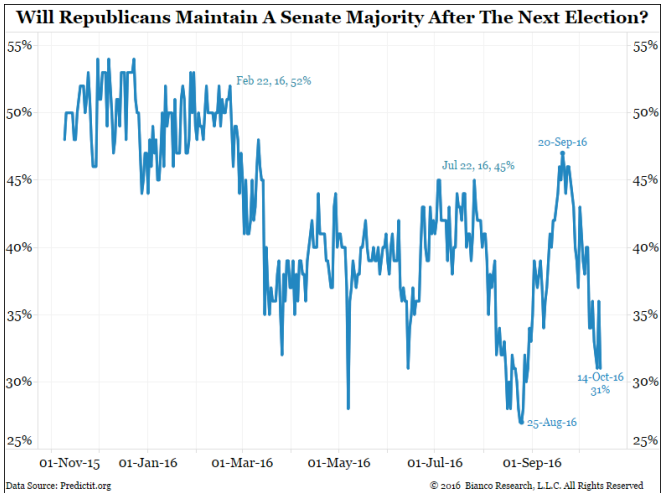
In other words, the biggest surprises (those that surprised the largest number of people) generate the most violent price adjustments. In the case of the "Brexit" vote, it surprised virtually everyone and thus catalyzed the largest 2-day loss of wealth in the history of the capital markets (a sum roughly equivalent to the size of the Canadian economy).



As noted previously, both political pundits and investors appear very confident that they have it all figured out. The odds-makers give Clinton an 82% likelihood of winning the White House, versus 18% for Trump, which is among the greatest spreads of the entire campaign (green bars), and suggests that momentum is increasingly shifting towards Clinton in the final weeks going into the election.

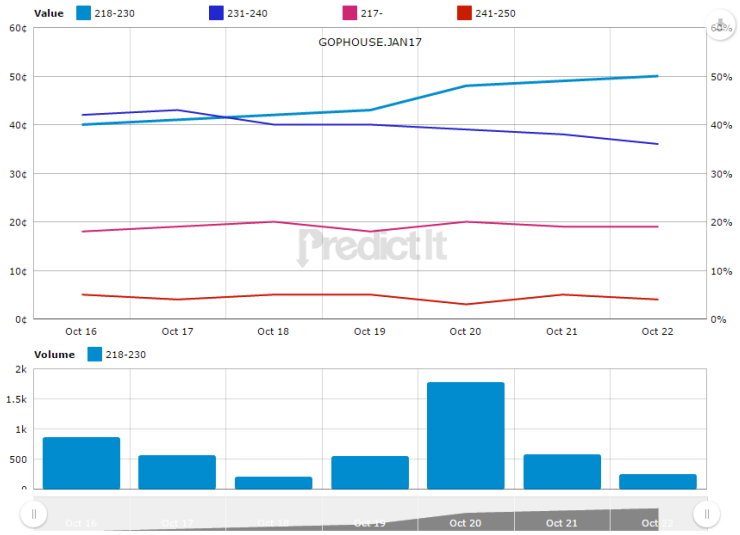


The polls are also pointing to a Clinton victory with the Real Clear Politics Average of National Polls showing support for Clinton at 48.0% and Trump at 41.9%, with the Libertarian and Green Parties expected to garner about 10% of the vote. Perhaps the biggest difference between the current Presidential race and the "Brexit" vote is that, this time, the polls and betting markets are telling the same story. This is in contrast to the U.K., where the betting odds predicted an overwhelming pro-Europe vote while the polls showed a tight race.



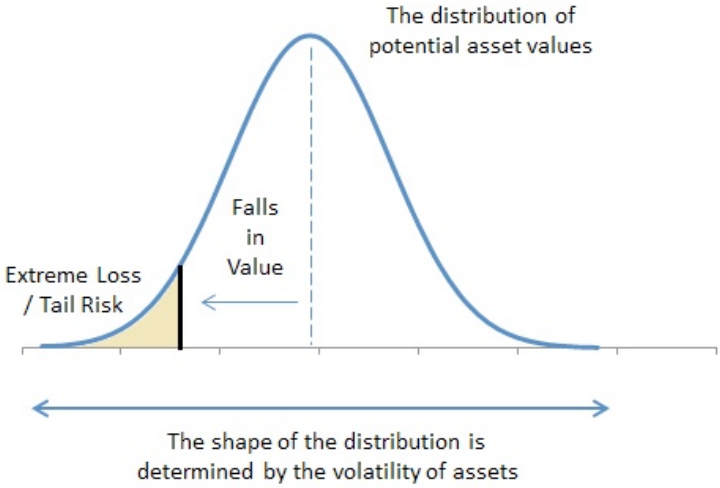
The odds-makers are predicting an outcome in the U.S. Senate that is equally unfavorable for the Republicans, and are assigning a likelihood of only 31% that Republicans will maintain control of that body. This would be a blow to many conservatives, as it will likely clear the way for Secretary Clinton to shift the Supreme Court significantly towards the left, which would likely create a more hostile judicial environment for corporate America. It also makes the control of the House of Representative of the utmost importance to investors, who tend to overwhelmingly prefer divided government.

The "magic number" for the House of Representatives is 218, as that number guarantees either party a controlling majority. At present, the betting markets, like PredictIt, give the Republicans a better than 90% likelihood of maintaining control of the House, which would mean that there would still be some checks and balances on the very populist and anti-business agenda being promulgated by Elizabeth Warren and Bernie Sanders, and which has been driving the Democratic Party hard to the left.



If things go according to expectations we will have divided government, which markets tend to strongly prefer. We will also have someone predictable and seemingly rational in the White House, which markets tend to prefer over all of the uncertainty associated with a potential Trump presidency. While most investors will be less than enthusiastic about many of Clinton's policies, investors tend to deal with bad news much better than they deal with uncertainty. This has been a major theme of our writings throughout most of this campaign season.

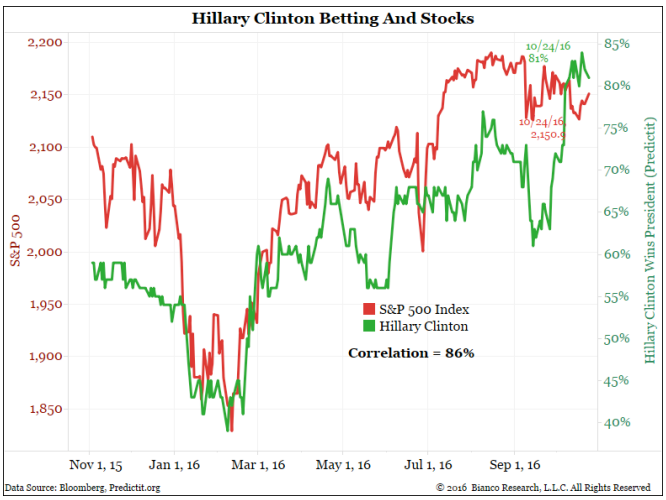
We believe that, if the risk markets get the aforementioned outcomes, then they will be just fine. So where are the "black swans" that we started this writing with?



This is a great time to introduce the concept of "tail risks". When you look at a bell curve of expected results, all of the most widely expected outcomes are contained in the wide body of the bell, with the single most widely expected result identified by the vertical dotted line that runs down the middle. The dotted line represents the outcome that is already largely reflected in asset prices, which means that outcomes near the dotted line will catalyze almost no market reaction.

In contrast, unexpected outcomes (represented by the "tails" of the bell) can cause large price movements in the risk markets, with those outcomes furthest away from the dotted line (consensus expectation) catalyzing the greatest price movements. These normally include negative tail risks (left side of the bell) and positive tail risks (right side of the bell). However, in this instance, it is difficult to imagine what might represent a positive tail risk.

Potential Negative Tail Risks: The outcomes representing the two most obvious candidates for "black swan" status would be a Trump victory and a Democratic sweep of all three branches of representative government: the White House, Senate and House of Representatives. Each is considered highly unlikely, and each would almost uncertainly catalyze a violent (and even global) capital markets reaction if either came to pass.

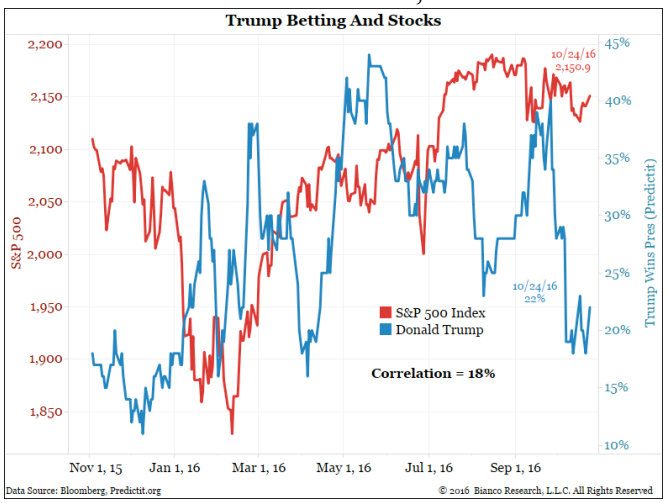


We would expect for a Trump victory to catalyze a much more global reaction, while a Democratic sweep would be primarily concerning to domestic investors.

We should emphasize that, in regard to all of the comments made in this report, we are not necessarily making a value judgment about who would make a better leader or what political party "should" be in power. To the contrary, our commentary is specifically limited to how the capital markets in general, and the risk markets like stocks and securitized real estate in particular, are likely to react to each scenario.

This relationship between the respective political outcomes and the equity markets is, in our opinion, particularly well substantiated in regard to the race for the White House due to the very tight 86% correlation between Clinton's poll numbers and the performance of the Standard & Poor's 500 Index. In other words, equity prices have trended in near lockstep with Clinton's political prospects.

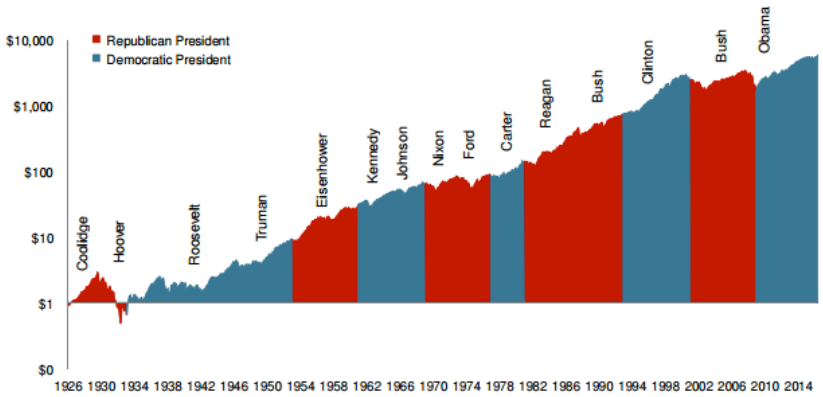
It is noteworthy that there is almost no correlation at all between the stock market and the likelihood (only 18%) of Trump being elected President. On the surface, this seems counterintuitive, as one would expect an inverse correlation rather than an almost non-existent correlation. However, we suspect that it can be explained by the fact that the majority of investors are virtually dismissing any viable possibility of Trump being elected.



Importantly, while the odds-makers assign low probabilities to either a Trump victory or a Democratic sweep, there are reasonable scenarios that could catalyze such a "black swan" type of event. For example, the average Republican could be so disgusted with Trump as their presidential candidate that they don't bother to show up to vote in the so-called "down ballots" (Senate, House, state officials, local officials, etc.), which could lead to a Democratic sweep.

On the other hand, we believe that Trump supporters are generally a lot more enthusiastic about their candidate than Democratic voters are about Clinton, and this could lead to a big difference in voter turn-out and potentially allow Trump to garner more votes despite having fewer supporters. Indeed, it is noteworthy that a poll released on October 26th shows Trump moving ahead of Clinton in the all-important state of Florida.

There is also the possibility that, since a Clinton victory is considered to be such a foregone conclusion, many Democratic voters won't bother to show up at the polls because they feel that their vote would be redundant, and this could conceivably sway the vote towards Trump.

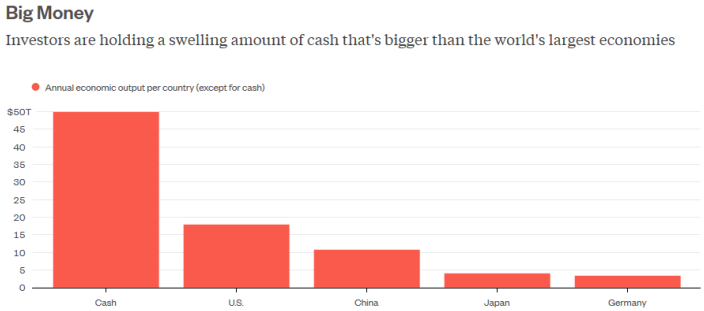


Past performance is not a guarantee of future results. Indices are not available for direct investment; therefore, their performance does not reflect the expenses associated with the management of an actual portfolio. The S&P data is provided by Standard & Poor's Index Services Group.

Further, there is even a risk that the Republican Party as a whole will be so tainted by Trump's reputation and controversial views that it will take years for the party to recover from the loss of its more centrist and more moderate components. Even assuming that the Republicans maintain control of the House, there is speculation that "Tea Party" members will hold most of the power and that Paul Ryan may even lose his job as Speaker of the House.

While markets have historically liked the political gridlock cause by such a political divide, we are less confident that it will be celebrated this time, as we believe that the government is going to need to work together to pass the fiscal stimulus measures necessary to offset what we believe will be lessening monetary stimulus on a global basis.

At this point, evidence suggests that the Trump campaign is currently doing more to harm the "Trump" corporate brand (the value of which has fallen sharply over recent months) than he is doing to the Republican Party, which should help to lessen that risk of a Democratic sweep.

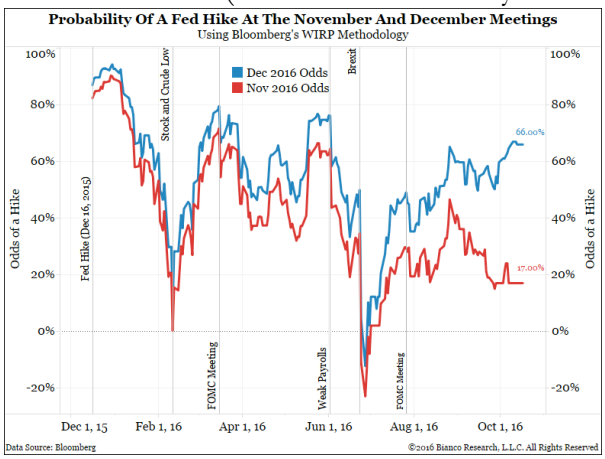


Source: Bloomberg, BlackRock

The estimated cash holdings globally are from BlackRock research, and may be considerably higher

For example, the so-called "generic ballot", which limits its questions solely to party preferences rather than candidates, has showed only minor movement, with Democrats enjoying a polling advantage of only 3% over Republicans. Further, 57% of likely voters say that Trump does not reflect the core values of the Republican Party and only 27% of independents believe that Trump represents the Republican Party. Other polls have shown that voters dislike Clinton so much that they want somebody in power to keep her in check. Each of these recent polls should provide some comfort to the capital markets that the world as they know it will not end on November 8th.

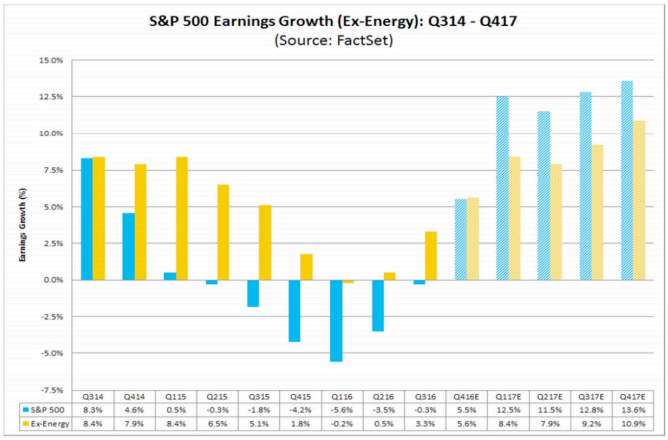
That, of course, assumes that Trump doesn't react to a likely loss with some sort of megalomaniacal response, where he creates a potential constitutional crisis by refusing to accept the election results, and instead initiates a series of election-related lawsuits. You will recall how stocks (which hate uncertainty and instability) sold off dramatically as a result of the election indecision of 2000 and the Florida vote recount. This is an outcome that Trump has already hinted at.



To be clear, we are part of that consensus opinion that believes that we will see Clinton in the White House, a Democratic-controlled Senate and a Republican-controlled House, and do not believe that there is a significant probability of a surprise outcome. As a result, the risks that we perceive are not risks of probability but of potential amplitude. Put another way, we believe that the associated risk is a function of the fact that everyone seems to share this same opinion, and that no credibility is being given to any of the other potential outcomes.

The very fact that there is such an over-whelming consensus opinion means that the reaction to any surprise outcome could be quite severe. In contrast, if you get the outcome that everyone expects, the markets are not likely to react at all. This suggests that the election offers little potential for an upside surprise, while being populated with low-probability risks with significant downside potential.

At the same time, there are some hopeful things that we can point to starting with the fact that the election, with all of its associated uncertainties, will soon be behind us. It is also true that we are entering into what is historically the strongest six months of the year for equities. Indeed, over the past 120 years, the Dow Jones Industrial Average has averaged an impressive gain of 6.8% between the October lows and the end of the year. Obviously, past performance is not necessarily indicative of future results.



	Q314	Q414	Q115	Q215	Q315	Q415	Q116	Q216	Q316	Q416E	Q117E	Q217E	Q317E	Q417E
S&P 500	8.3%	4.6%	0.5%	-0.3%	-1.8%	-4.2%	-5.6%	-3.5%	-0.3%	5.5%	12.5%	11.5%	12.8%	13.6%
Ex-Energy	8.4%	7.9%	8.4%	6.5%	5.1%	1.8%	-0.2%	0.5%	3.3%	5.6%	8.4%	7.9%	9.2%	10.9%

Also encouraging are the facts that the earnings recession seems to be coming to an end, that there is currently the highest level of sideline cash since the dot.com crisis of 2001 (which should help to cushion any decline), and that the futures markets have already priced-in a 66% likelihood of a Federal Reserve rate hike in December, which suggests that the market reactions should be relatively modest, if the rate hike does indeed take place. On top of everything else, while stocks look expensive on an absolute basis, they continue to look very inexpensive on a relative basis, compared to the debt markets, with an 18X price-to-forward earnings multiple in the U.S., 16X multiple in Europe and a 14X multiple in Japan.