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THE PER STIRLING CAPITAL OUTLOOK

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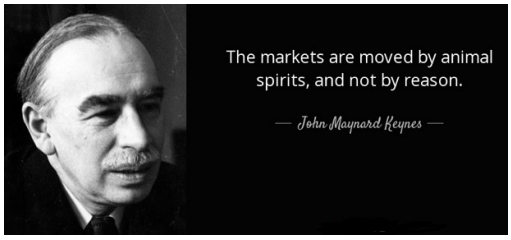
In his 1936 book entitled *The General Theory of Employment, Interest and Money*, economics pioneer John Maynard Keynes introduced the concept of "animal spirits" into the analysis of how the owners and managers of companies make business decisions and how investors make investment decisions.

His premise was that strong company and/or macroeconomic fundamentals (earnings, interest rates, proprietary technology, competitive position, economic growth rates, tax and/or regulatory environment, etc.) are not a sufficient catalyst, in and of themselves, to motivate either a business decision or an investment decision. According to Keynes, while these fundamental factors are important, the existence of "animal spirits" is equally important, and a requisite in any decision to take action.

Animal spirits describe a confidence about the future and optimism that one can achieve success. It is what drives entrepreneurs to start new businesses. It motivates companies to hire and to invest capital into new capacity. It is what gives a new home buyer the confidence to buy a house. Animal spirits are a requisite for growth and innovation in a free-market economy. However, animal spirits are also a two-edged sword.

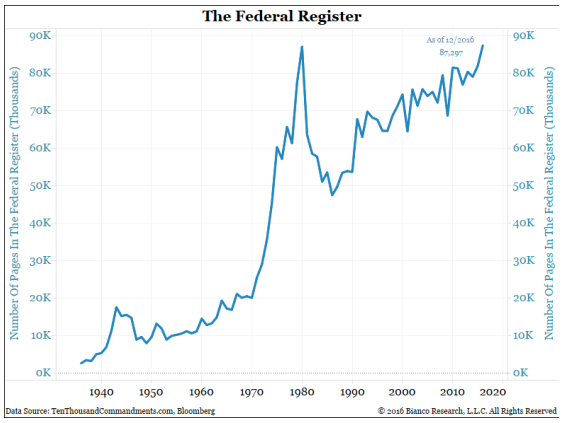
Too much animal spirits can lead to speculation, and imprudent and excessive risk-taking, the consequences of which have, throughout history, always been both severe and far-reaching. The most recent example of this phenomenon is the 2007-2008 global financial crisis. However, it is only one of many examples, including the South Sea Company bubble of 1711–1720, the Mississippi Company bubble of 1719–1720, the Dutch "tulip mania" of 1637, the "Asian Contagion" in 1997, the bursting of the Japanese real estate and equity bubbles in 1989, and the Great Depression of 1929 to 1939.



At the same time, too little in the way of animal spirits leads to insufficient levels of risk-taking and entrepreneurship, a lack of lending within the financial system, and a lack of hiring and capital investment. On the consumer front, it is reflected in a lack of confidence to buy large ticket items like homes, cars and appliances, This phenomenon explains so much of the economic malaise, disinflation and sub-par growth that has characterized the global economy in the days since the global financial crisis.

While President Obama is clearly leaving the U.S. economy in much better shape than it was in eight years ago, he has also presided over one of the slowest recoveries in modern history, which we believe has much to do with a conscious and deliberate decision on the part of the government and its regulators to crush those animal spirits so thoroughly through regulation and control that speculation would never again get so out of hand as it had prior to the crisis.

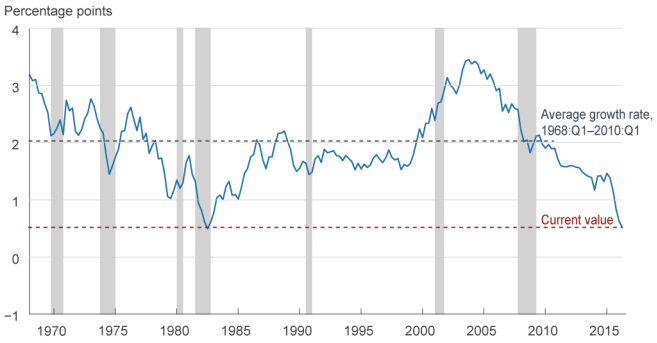
The government thus punished business for its excesses by imposing onerous and burdensome regulations under the premise that profit leads to greed and greed ultimately leads to crisis. A quantifiable measure of this "strangulation through regulation" can be found by measuring the size of the Federal Registry of rules and regulations, which has grown to a massive 87,297 pages over the post-crisis period.



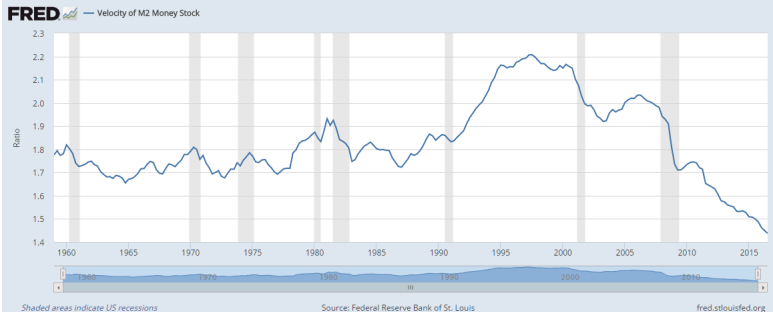
The politicians and regulators further determined that the financial system can't be trusted or left to its own devices, so the government took steps to stymie growth in the sector through onerous regulation, tighter lending standards, higher reserve requirements and severe limits on former profit centers like proprietary trading.

This difficult lending environment coupled with a lack of animal spirits has weighed heavily on U.S. productivity generally, because companies have lacked the confidence to invest in new productivity-enhancing technology and equipment. This poor productivity growth has not only weighed very heavily on corporate profit growth, but has also made it difficult for companies to afford and/or justify employee raises.

Figure 2. Productivity Growth, 25-Quarter Rolling Window



This lack of animal spirits has also stymied lending in the banking system, as would-be borrowers have not had enough confidence to borrow, while a general lack of risk appetite has made most banks very unwilling lenders. The impact is that, while the Federal Reserve created over $3 trillion of new money that it injected into the financial system through quantitative easing, most of this money was just held by banks as excess reserves and never made it all of the way into the real economy.



You can see this reflected in money velocity (a measure of how often each dollar changes hands) which, as you can see, has been steadily declining. Ultimately, it does not matter that the economy is awash in Fed-provided money, if it is also so devoid of animal spirits that no one wants to borrow, and that is even when money is offered at virtually 0% interest rates. The even more extreme case has been in Japan and Europe, where lenders literally pay borrowers to borrow (due to their negative interest rates). Even in that bizarre situation, largely because of an extraordinary lack of animal spirits, many businesses and entrepreneurs just "hunkered down" instead of taking advantage of a never-before-seen opportunity to get paid to create, grow, or leverage a business.

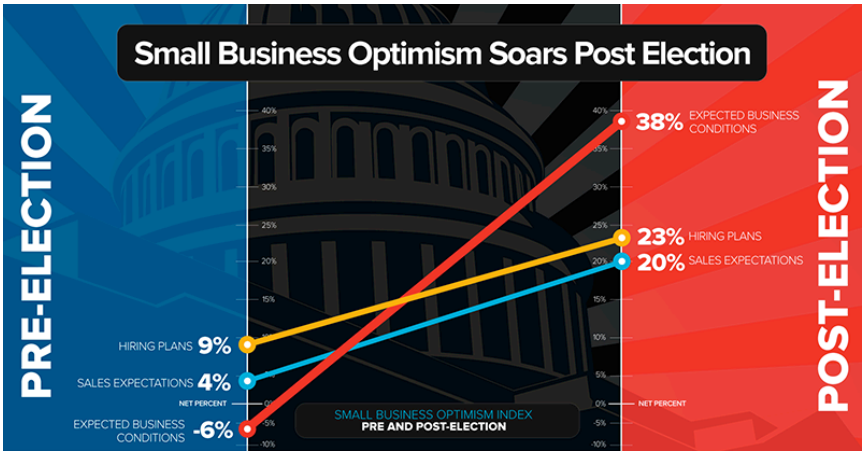
Furthermore, owners of both companies and risk assets went into the election with an overwhelming consensus belief that this regulatory stranglehold was going to get much worse under a likely Clinton administration that was being pulled to the far left by the anti-business, anti-wealthy platform being advanced by rising Democratic Party stars Bernie Sanders and Elizabeth Warren, each of whom promotes the perspective that the duty of a business is to improve the standard of living of its employees rather than that of its shareholders.

Without even commenting on the merit of that perspective, it should be self-evident that the policies that they support would be highly detrimental to shareholders of American businesses.

With this to look forward to, and no relief in sight in terms of fiscal stimulus, tax reform, or further monetary stimulus, the prospects for a return to strong and sustainable growth were looking increasingly dim. Indeed, there was growing concern that the U.S. would suffer through the same kind of long-lasting economic malaise that has characterized the Japanese economy since the 1989 bursting of their stock market and real estate bubbles (including six recessions).

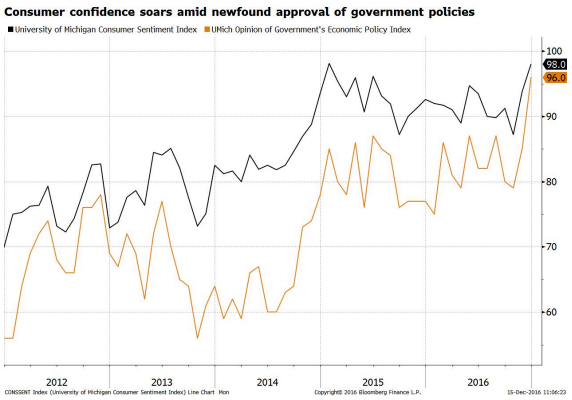
Essentially, the American economy and financial system were grounded with no perceived chance for parole. And then something changed, and the animal spirits once again started stirring in both the economy and the risk markets.

Maybe it was an election outcome with single-party rule, and the prospect of a long-awaited end of political gridlock. Maybe it was simply a time when the markets and economy needed someone like Trump to shake things up. Perhaps it was the promise of an agenda that features fiscal stimulus, reduced regulation, tax reform, and a smaller, less interventionist government. It may even be partially because the Fed is finally leaving behind the emergency policies that have prevailed since the crisis, which offers a hopeful sign of a return towards normalcy. For whatever reason, and probably for all of those reasons, the all-important animal spirits are returning, and their return is catalyzing the largest post-election rally in the history of the U.S. stock market.



However, the stock market is only one of many places where you see evidence of this apparent return of animal spirits. Another important example is found in the surveys of small business sentiment. This is a very important business segment as almost all net new job growth comes from small companies. Since the election, expectations for increased hiring have jumped from a 9% gain to a 23% gain. Similarly, expectations for sales improvement have jumped from 4% to 20%, and expectations for general business conditions have reversed from a projected 6% decline to a 38% improvement.

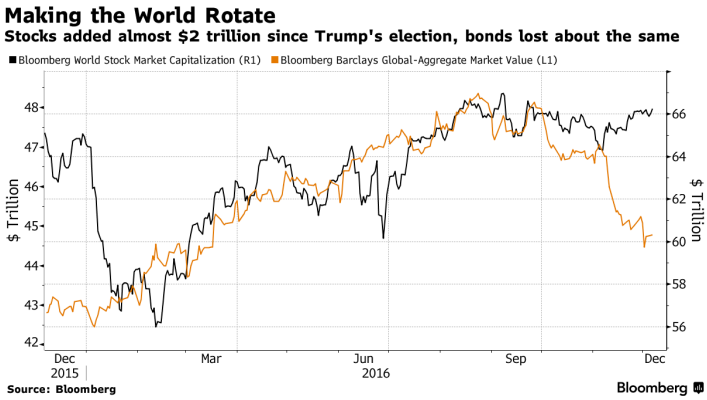
We are seeing similar post-election jumps in consumer confidence (the University of Michigan Consumer Sentiment Index), in the public's approval of government economic policies (the University of Michigan Government's Economic Policy Index) and even in homebuilder sentiment (the National Association of Homebuilders Market Index), which has just hit a new 11-year high. Each of these measures of sentiment moved sharply higher immediately after the elections.



This change in sentiment is also manifesting itself in surveys of investor sentiment, including the just-released fourth quarter Wells Fargo/Gallup Investor and Retirement Optimism Index, which just reached a nine-year high (a reading of 96, which is up significantly from the third-quarter reading of 79). Retiree optimism jumped a huge 36 points to a reading of 117, while non-retired investor sentiment gained a smaller, but still impressive, 11 points to a reading of 89.

In that poll, 46% of investors responded that the election outcome made them more confident in the prospects for the U.S. economy over the next 12 months, while 38% said that the election results made them feel less optimistic. Fifteen percent said that the election had no impact on their outlook.

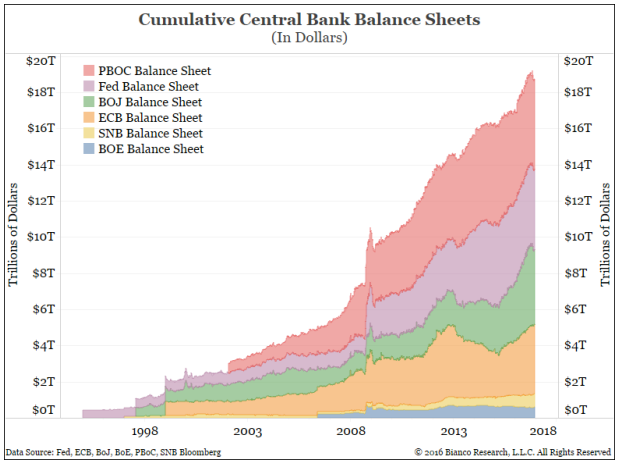
In that same survey, 57% of investors said that they felt positive about the economy in 2017, while 38% had a negative outlook. In total, half of all respondents expected for the election results to have a positive impact on their net worth, while 28% responded that the election would have a negative impact.



Perhaps what was most interesting was how investors responded to questions about the magnitude of the election impact, where a surprisingly large 37% of investors responded that they expected for the election results to have a "major influence" on their net worth.

Of course, the ultimate survey of investor sentiment is the capital markets themselves, where the equity markets have increased in value by approximately $2 trillion since the election, while the debt/bond markets have actually declined in value by a similar amount. Investors have added money to stock funds for nine straight weeks and have pulled cash from bond funds for seven consecutive weeks. Since the election a massive $100 billion has poured into domestic equity ETFs alone, while money has been fleeing the bond markets.

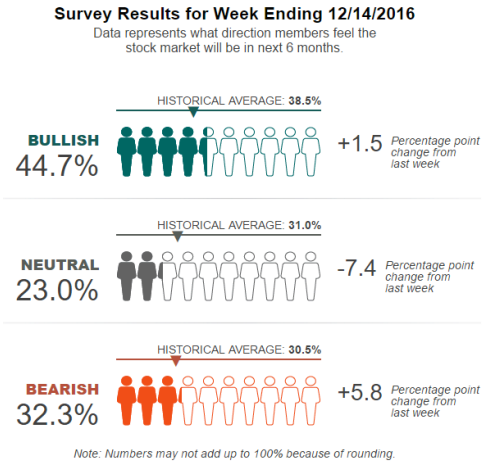
From an equity investor's perspective, it is great that the animal spirits are returning to the markets and the economy. However, there is also an element of risk and a hint of warning that comes with a more speculative environment. This is particularly true when you add a more speculative mindset to an equity market that is already very highly valued based upon most traditional measures.



The situation is particularly complicated this time as, since late 2008 the markets and the economy have been almost entirely dependent on monetary stimulus from the Federal Reserve and the world's other central banks. It was the only thing that the markets had to hold on to for all of the aforementioned reasons, and the markets became very dependent on the Fed's policies (and very concerned in light of the fact that those policies were being slowly reversed).

However, the Fed's policies did their job, which was to stabilize the economy by inflating the prices of financial assets (stocks, bonds and real estate), and thereby creating a wealth effect that helped to pull the economy out of its deep recession. These policies accomplished their stated goals through central bank purchases of the financial assets themselves (a direct impact). However, these policies had only a muted and indirect impact on the underlying economy, and this has created a situation where bonds became outrageously overvalued relative to their inflation-adjusted yield and stocks became very overvalued relative to the earnings and revenues produced by the underlying companies.

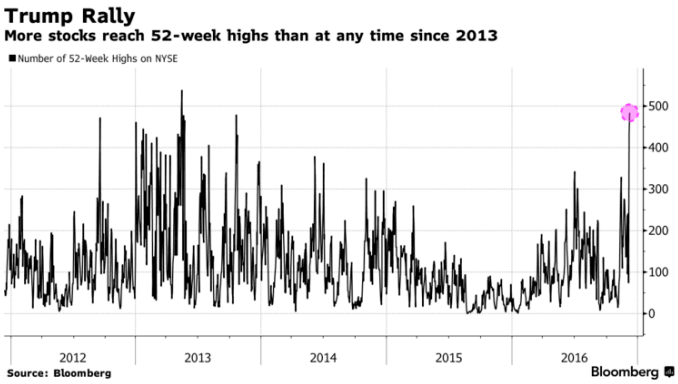
While the bond markets are a little less egregiously overvalued now because of their dramatic post-election decline, the excitement regarding the election results has taken domestic equities to some of the highest valuations (versus earnings) in the history of the markets.



On the other hand, we do take some comfort from the fact that individual investor sentiment, while improving significantly, has yet to show any signs of ebullience. Indeed, a larger than average percentage of individual investors remains bearish in their six-month outlook for domestic equities, and bullishness remains below 50%. Further, only 52% of Americans own any equities at all, which is the lowest ownership percentage since Gallup started polling for that data 19 years ago. While the past is not necessarily prelude, it has historically been true that bull markets very rarely end until most individual investors are both very bullish and heavily invested.

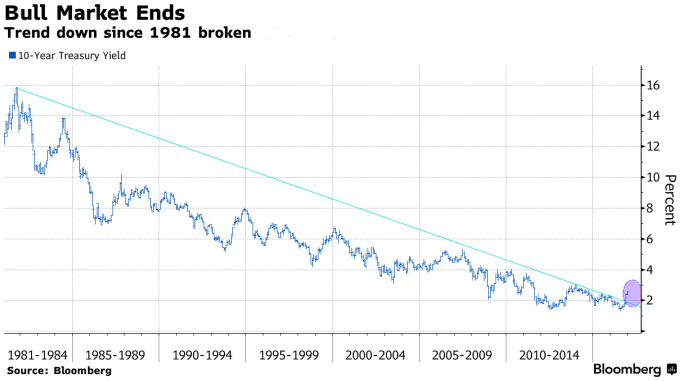
Equity valuations are nonetheless a problem, but not necessarily an immediate risk, as valuations have historically proven to be a very poor timing tool. Where valuations are important is in the consideration of risk, as overvalued markets will tend to fall much further when they do fall than do more reasonably valued markets.

However, valuation issues can be resolved without necessitating a price decline, and this is what we believe investors are betting on: that the return of animal spirits, a less onerous regulatory burden, corporate tax reform (rates dropping from 35% to 15%), fiscal stimulus of as much as $1 trillion of infrastructure spending, and the proposed repatriation of an estimated $2.5 trillion of overseas profits back to the U.S. will boost earnings sufficiently to return equities to more reasonable valuations.



While we do not believe that, even with the Republican sweep, we will see all of these things come to pass, we do believe that, for so long as President-Elect Trump stays away from some of his more extreme campaign promises, the election results will prove to be quite bullish for equities and very negative for the prices of debt securities. Moreover, we believe that the equity markets are likely to benefit from one more potentially huge macroeconomic influence, which is the long-awaited "great rotation" of money out of bonds, and into stocks, which we believe is finally underway and, if we are correct, this could very conceivably extend the current bull market in equities by years.

In the short run however, there are a few reasons for caution, and there are a few reasons why one should not necessarily extrapolate the current post-election rally too far into the future.



To start with, because capital gains tax rates are expected to fall next year, many would-be sellers could be waiting until next year to sell, which may explain the one-sided strength of the equity markets. It may also translate into pent-up selling early next year. Second, there is traditionally a honeymoon period for equities between Election Day and Inauguration Day, when all things still seem possible and before Washington politics become obstructionist. During this period, equities have historically advanced 80% of the time.

Indeed, it is probable that Trump's Inauguration Day (and the days immediately thereafter) may be of particular importance, as investors can finally start to discern which of Trump's more outrageous comments were just campaign rhetoric and which ones should be taken seriously (and reflected into the prices of securities).

Of note, Trump's traditional negotiating style relies upon unpredictability and brinksmanship, and we expect him to employ that same confrontational style on the trade, legislative, and foreign policy fronts. Given how much the equity markets despise uncertainty, we expect for volatility to pick up considerably under the new political regime, but we also expect a rewarding and bullish environment for growth-oriented investors.