Volume 78

THE PER STIRLING CAPITAL OUTLOOK

Performance • Perspective • Per Stirling

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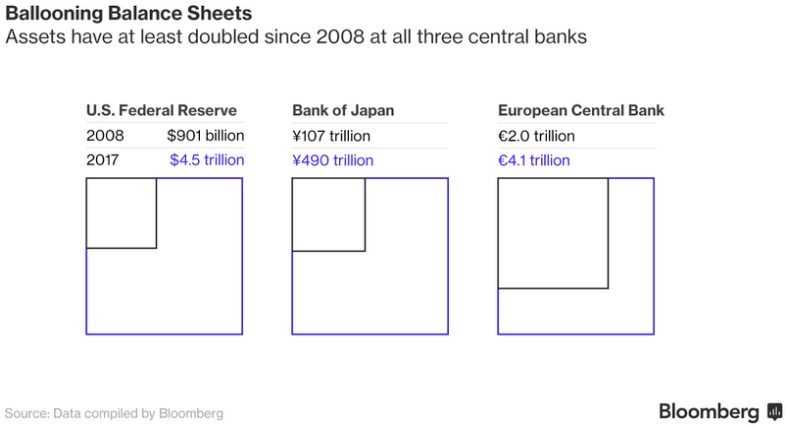
One of the themes that we often emphasize in our writings is that, as the old adage says, "Money flows to where it is treated best". Sometimes this relates to the process of allocating between asset classes (stocks, bonds, cash, real estate, alternatives, etc.). Sometimes it applies to differentiating within asset classes (short-term versus long-term debt; small-cap versus large-cap stocks, or one sector over another). Sometimes, it relates to the process of allocating from a geographic perspective.

The 2007-2008 Financial Crisis and its aftermath provide a dramatic and textbook example of this phenomenon. The United Stated was the origin and epicenter of the crisis, which helps to explain why the monetary, fiscal and legislative response was so swift and so powerful. After the initial, gut-wrenching (for investors) failure to pass the TARP Bill, both the government and Federal Reserve jumped into action with a package that was nothing short of economic adrenalin.

Lawmakers and regulators guaranteed mutual fund money markets; used programs like TARP to restore liquidity to the financial system, and consolidated troubled financial institutions into more stable ones. This was soon followed by the Fed, which launched a series of quantitative easing (money creation and asset purchase) programs that ultimately reached almost $4 trillion dollars in size.

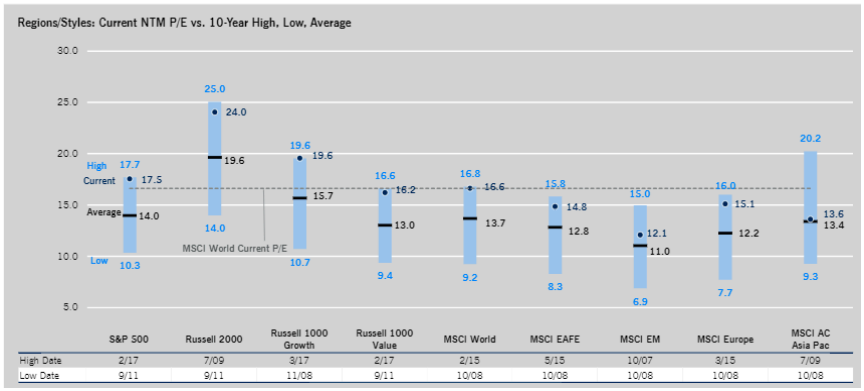


All the while, most of the remaining industrialized world seemed frozen, like a deer caught in a car's headlights, while the world's emerging markets became submerging markets. Europe really did not begin to stabilize until European Central Bank President Mario Draghi's July 2012 promise to do "whatever it takes" to defend the euro currency, and Japan did not commit to any significant stimulus until the December of 2012 introduction of the massive and multi-faceted "Abenomics" stimulus program. This was years after the heroic response of the U.S.

It is therefore no wonder that the recovery in the United States is so much more advanced than is the recovery in the rest of the world. U.S. government actions ultimately helped to create an environment where money was "treated" better than it was virtually anywhere else in the world and the owners of that money responded accordingly.

Unlike most of the world, the U.S. economy provided investors with positive interest rates, an appreciating currency, economic expansion, and profit growth. As a result, the domestic capital markets became big beneficiaries of inflows from both foreign investors and even foreign governments, and these inflows certainly manifested themselves in inter-market comparisons.

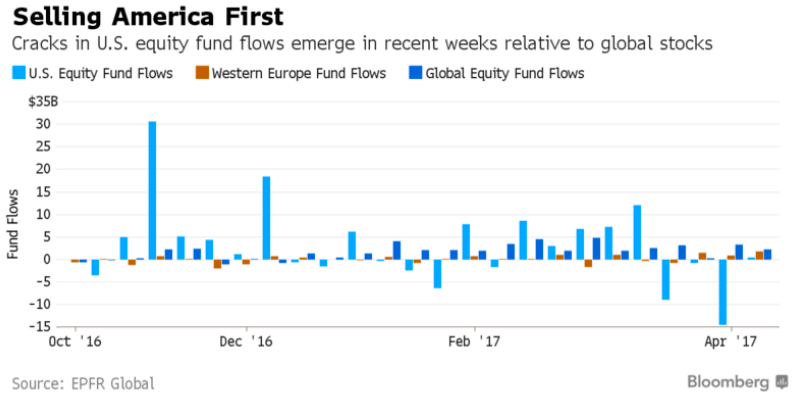
Valuation analysis



Since the current leg of the equity bull market started on March 9, 2009, the S&P 500 Index of blue chip domestic stocks has gained a stunning 249%. In contrast, over the same period, the Japanese Nikkei 225 blue chip index has gained a lesser 165% (136% when currency-adjusted), and the European equivalent, the STOXX 600, gained an even more modest 141% (103% when currency-adjusted). This has helped to create a massive divergence between the valuations of domestic equities and that of their foreign counterparts.

This global preference for U.S. assets, which has prevailed since the crisis, is perhaps even more evident when you consider the shift in global market capitalization. At the crisis lows, the domestic markets accounted for 32% of global equity market value. Since then, it has surged to 37%, while Japan has shrunken from 9% to 7% and European market share has declined from 18% to 13%.

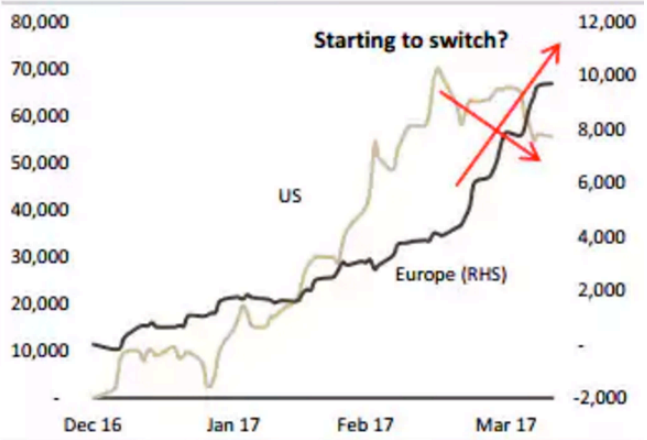
It has been a great time to be a domestic equity investor, but it has also been a time when equity prices have improved much more than the economic fundamentals of the underlying companies, and this has left U.S. stocks very highly valued from a historical perspective, relative to both their own earnings and to many foreign equity markets.



What makes this value divergence particularly interesting now is that many foreign economies, particularly in Western Europe, seem to finally be feeling the benefits of their much-delayed stimulus measures, and are starting to get some economic traction, just as the U.S. economy did several years ago. Further, since the U.S. is starting to show some signs that the domestic economy and inflation rate are shifting into low gear, it seems to be an opportune time to reassess exactly where your money is likely to be "treated best" in the future. Indeed, in light of the recent ETF and mutual flows out of domestic equities and into foreign equities, it appears that we are not the only ones posing that question.

In fact, early April witnessed the largest weekly outflow of money from domestic equity funds ($2.7 billion) since September of 2015. In contrast, emerging market funds received an additional $2.4 billion of investor money and European funds saw inflows of $905 million (the most in three months). Indeed, since mid-December, there has been a notable change in investor preferences from domestic stocks to European stocks and, on a year-to-date basis, the world's emerging (less-industrialized) markets are among the top performers.

Figure 4: YTD cumulative inflows to US vs EU Equity ETFs ($mn)



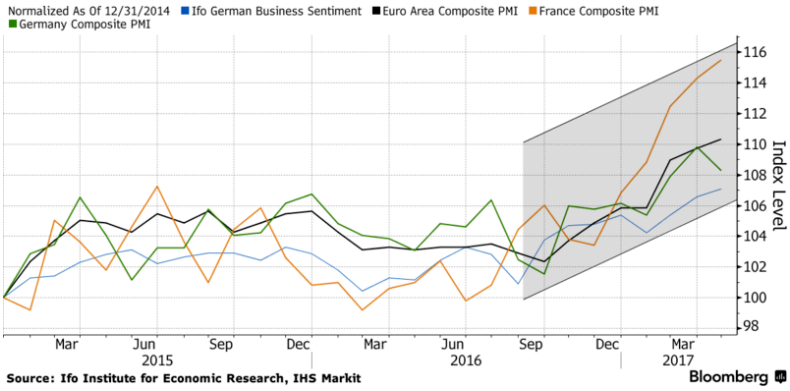
Source: UBS Global Equity Finance, Bloomberg

The Markit Flash Eurozone Purchasing Managers Index, which measures the strength of the European manufacturing sector, is now showing the fastest growth in six years and productivity is once again rising (as opposed to declining in the U.S.).

Further, while the Italian elections, which must take place before May 23rd, remain as a political risk, the other elections in Europe have revealed a generally pro-European Union, anti-populist sentiment, which should continue to be very equity-market-friendly, and this is perhaps no more evident than in last Sunday's French elections, which will still require a run-off, but where polls now very strongly favor a victory by the moderate, pro-EU Finance Minister Macron over Le Pen, who is an ultra-right-wing nationalist who wants to pull France out of the European Union.

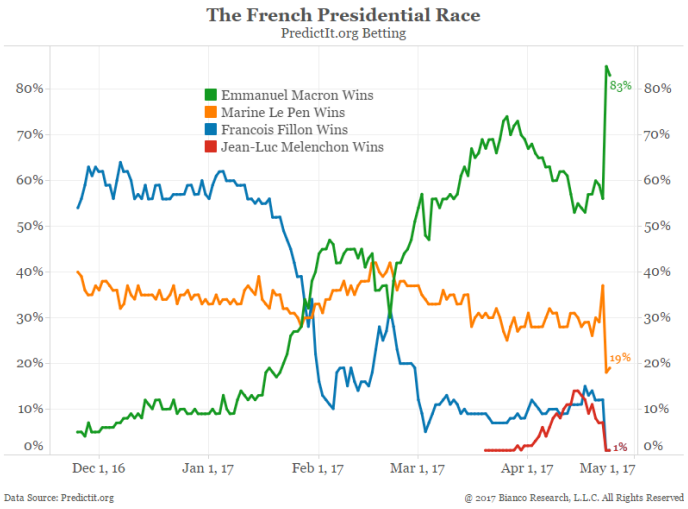
Strengthening Recovery

German business confidence joins array of positive euro-area data



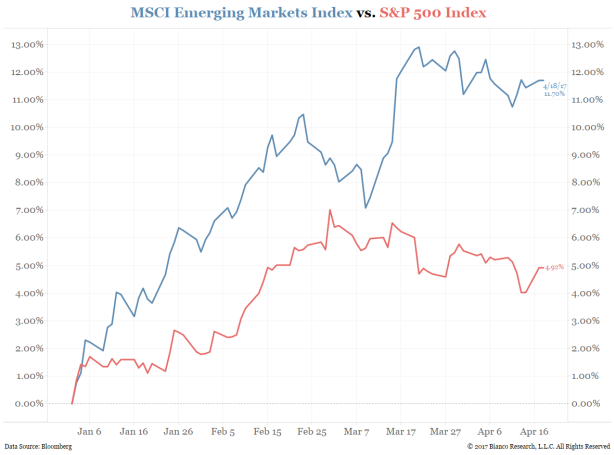
Source: Ifo Institute for Economic Research, IHS Markit

Bloomberg



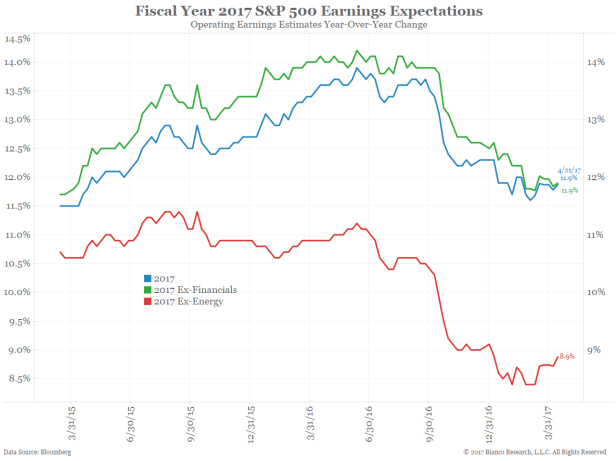
Of note, one of the reasons why the current odds are so heavily skewed in Macron's favor is because all of the other major presidential candidates endorsed him almost immediately after the conclusion of the first round of the election. From our perspective, this greatly reduces the risk of the kind of polling errors that were so evident in regard to the U.S. elections and the "Brexit" vote.

In addition to Europe, we believe that the emerging markets offer a rather compelling investment picture due to their improving economies, lessened risk of U.S. protectionist policies, and reduced currency and debt-related risk now that the strength in the U.S. dollar is, at minimum, moderating. On average, industrial production in the emerging economies has climbed dramatically from 2.6% growth to 4.2% growth over the past year.

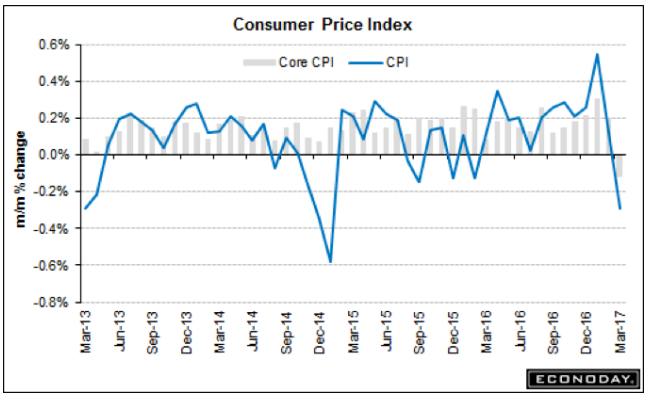


Over the same period, imports increased from a small decline to a positive 6.3%, which is a sign of increasing consumer demand, and exports have increased to a positive 3.8% rate from a -1.7% decline, which is an indication of economic recovery.

Of equal importance, the recent 11% increase in emerging market currency values versus the U.S. dollar has allowed emerging market inflation rates to drop from 5% to only 3.8%, which returns some monetary policy flexibility to their central banks. It has also allowed sovereign debt issued by these countries to rally, as yields fell from an average of 5.25% to 4.5%.

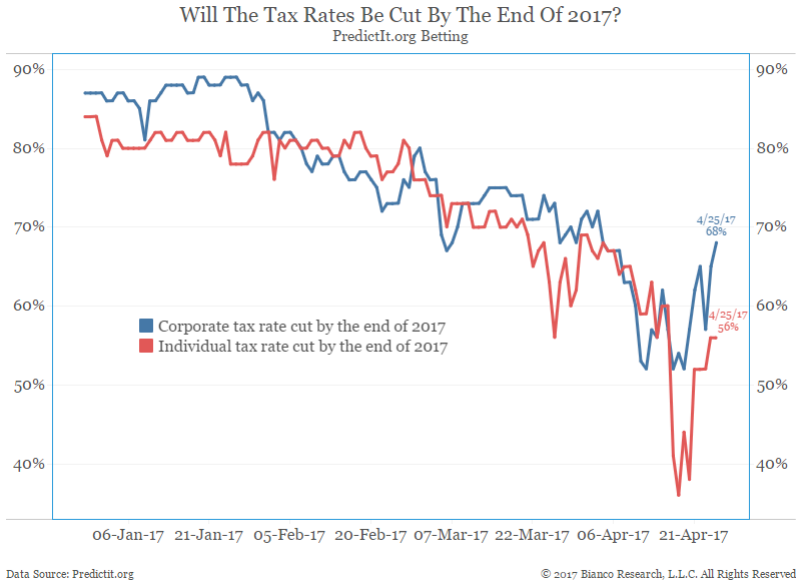


We also like the fact that price-to earnings multiples on emerging market stocks average a very modest 15.5 times trailing earnings and only 12.2 times anticipated future earnings. This is in sharp contrast to the U.S., where price-to-earnings multiples (around 20 times) are among the highest in history. In addition, the total capitalization of the U.S. stock market now represents 207% of the size of the entire economy. This is more than twice the long-term average of 102%, and well above the historical average of 138% that has prevailed when interest rates have been at around current levels.

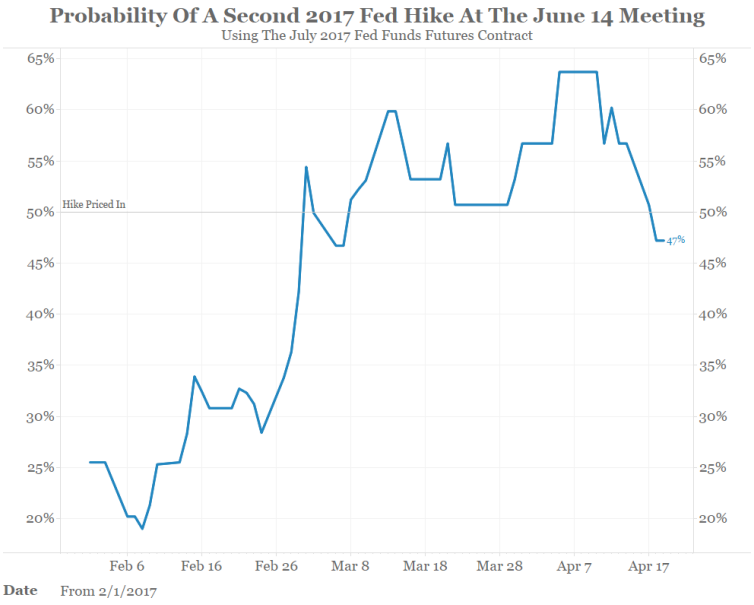


To be clear, our concerns over the prospects for the domestic equity markets are intermediate to longer-term in nature. In the interim, we continue to like the prospects for the domestic equity markets for a variety of reasons, starting with the facts that we are seeing some of the fastest earnings growth in years, and that we do not expect for the Fed to get aggressive in raising interest rates for the simple reason that inflation is actually starting to fall again.

We are also increasingly encouraged by some of the recent developments coming out of Washington, D.C. To start with, there is evidence that President Trump has been distancing himself from the more extremist and reactionary members of his team like Steve Bannon and Peter Navarro, and increasingly relying on the more practical and more moderate members of his team like Gary Cohn, Jared Kushner, and Rex Tillerson. Of interesting note, two of the three are Democrats.

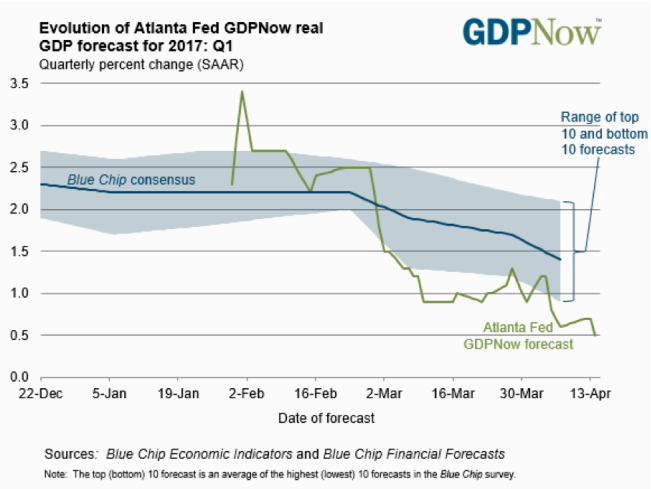


With this perceived change in influence, there has been a significant shift towards the center in Trump's agenda, and a move towards negotiation and compromise in his strategy. Trump has recently reversed his opinion on N.A.T.O., Russia, China, the Export-Import Bank, and the potential reappointment of Fed Chairwoman Janet Yellen. That is not even to mention the reversal on policy priorities (healthcare reform was moved back to the top of the list and funding for the border wall was dropped from the budget), and the fact that Donald Trump, the "America First", isolationist candidate has become President Trump, who has recently authorized a missile attack in Syria, the dropping of the "Mother of All Bombs" in Afghanistan, and who is now moving a carrier strike force towards North Korean waters.



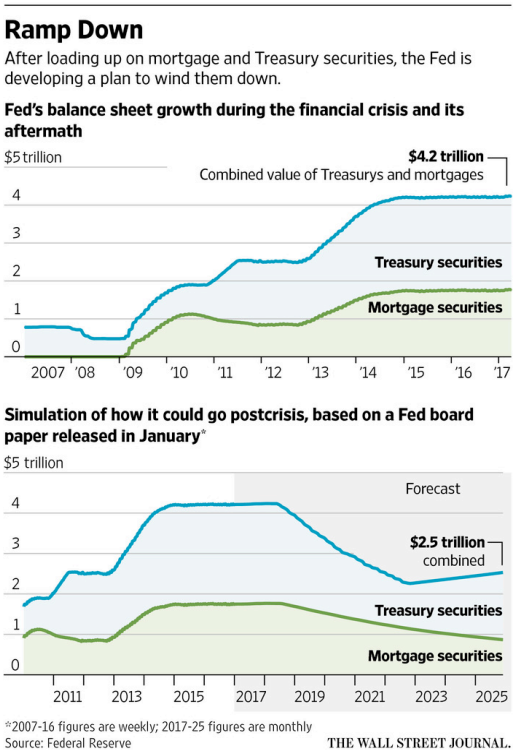
This new, more cooperative approach also appears to be yielding some political results, and the "Trump agenda" of tax reform, healthcare reform, repatriation, and fiscal stimulus seems to have new life, particularly since there appears to be general Republican agreement on the partially discredited idea of using dynamic scoring to make the reforms revenue neutral (at least on paper), which is necessary to pass permanent reforms without help from the Democratic Party. Unlike static scoring which is based on simple arithmetic, dynamic scoring tries to anticipate the effects of a legislative change (to economic growth, productivity, consumption, etc.), and to factor in the ultimate impact of those effects into budget calculations.

The asset class that should, by almost all measures, treat money worse than any other, is the debt market, but that has been the case for years, and yet bonds have continued to gain value because of low inflation, negative interest rates overseas, a domestic economy that really slowed in the first quarter (although we do expect a rebound in the current quarter), and central banks all over the world that are spending trillions of dollars buying debt to keep interest rates low (and bond prices supported).



However, while we believe that the aforementioned factors will continue to support bond prices in the near term, we are concerned that the debt markets will ultimately be made to pay for the excesses of a thirty-plus year bull market that has been further inflated by massive government intervention, which is starting to change from being a tailwind to a headwind.

A global economic recovery is in place, the European Central Bank will likely start tapering its quantitative easing program this year, and the Federal Reserve is not only raising rates, but also making plans to shrink the size of its balance sheet by selling off, or at least not reinvesting the proceeds from, the trillions of dollars of debt that it purchased through its quantitative easing programs (thus adding greatly to supply).



Indeed, we believe that the anticipated withdrawal of monetary stimulus and the eventual end of direct government intervention in the capital markets may prove to be the single most important theme for investors over the intermediate term, as it should allow free market influences like supply and demand and economic fundamentals to reassert themselves as the primary arbiters of securities prices.

Lessening government interference, which has served to indiscriminately inflate the prices of all financial assets, should reinvigorate this process of money flowing to where it will be treated best, which we believe will be primarily in growth assets.

While we do continue to like the domestic equity markets, we are concerned that they are in the later stages of their recovery from the financial crisis and that most of the good news is already reflected in asset prices. This is in sharp contrast to the economic and equity market recoveries being experienced in Europe, the emerging markets, and even Japan, which we view as being in their very early stages. As we had noted at the end of last month's report, "We think that it is time to update your passport".