Volume 79

THE PER STIRLING CAPITAL OUTLOOK

Performance • Perspective • Per Stirling

May 2017

We recognize that it may seem hard to even believe, but there was a time when the capital markets were driven primarily by news out of New York, London, Tokyo, and Beijing rather than Washington, D.C. Frankly, as market analysts and commentators, we long for a return to such a period when earnings announcements are more important than presidential tweets, and when the release of economic data holds sway over political scandals.

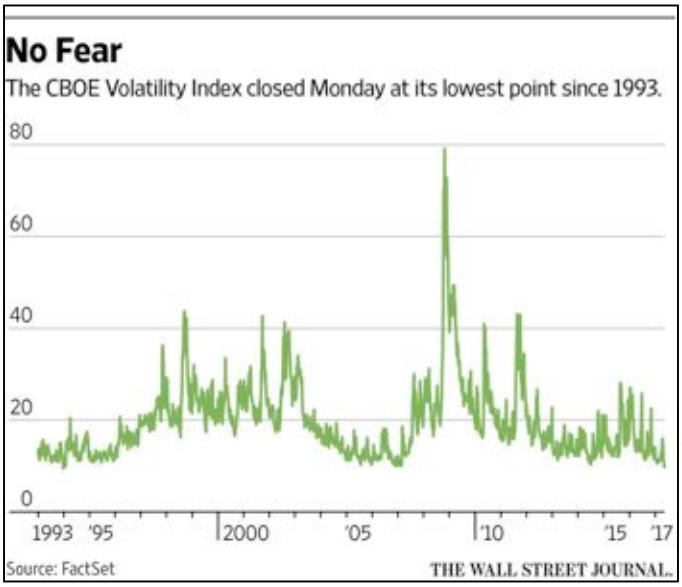
Indeed, we are very confident that virtually every tactical or active money manager would share that same longing, as the world's fiscal and monetary authorities have been actively involved in the market manipulation game since the very early days of the new millennium, and because that active distortion of free-market pricing has largely made market analysis a counter-productive exercise in frustration.

Equally frustrating is the fact that, just we are finally seeing the early signs that the world's governments and central banks are starting to and/or are preparing to lessen their involvement in the capital markets, now that a synchronized global recovery from the financial crisis seems to be underway, the soap opera that is the Trump administration continuously re-emerges as a major potential risk to the markets.

Indeed, there is a very useful gauge called the Economic Policy Uncertainty Index that identifies the moments of major economic turmoil which, according to the index's creators, usually "foreshadow declines in investment, output and employment." It is a calculation based upon a variety of factors, including the frequency of words related to economic uncertainty and politics found in newspapers, Federal Reserve commentary and comments from elected federal officials. It also considers the number of expiring tax laws and the size and scope of the prevailing divergence between economic forecasts.

According to this measure, the election of President Trump stands as the third-biggest source of uncertainty in the index's 30-plus-year history. It is eclipsed only by the 9/11 terrorist attack and the battle over the fiscal cliff in 2011 and, at its peak, exceeded the fear and uncertainty associated with the financial crisis. While this measure has retreated somewhat from its highs, it is once again climbing in response to the firing of F.B.I. Director Comey, and Trump's reported leak of classified information to the Russian ambassador.

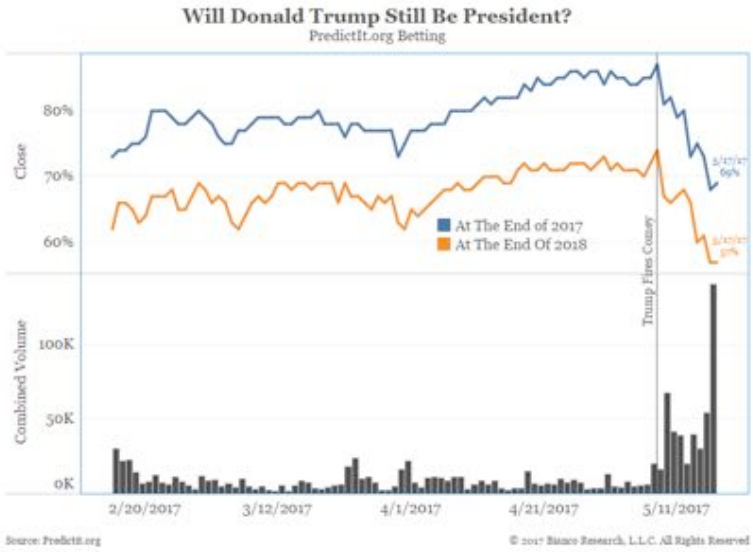
However, the market reaction to this ongoing political firestorm has been counterintuitive at best and simply bizarre at worst. Despite the news flow, the VIX Index, which provides a measure of investor fear and market volatility has just concluded the least volatile fifteen days ever experienced since the index was created in 1990, and the fourth lowest readings overall in the history of the index. Moreover, actual realized volatility has only been lower 3% of the time since 1928.



That is akin to having your heart rate stay normal while in the midst of an automobile accident. It is almost inexplicable, which is particularly notable when you consider the fact that the basis of all investing and market analysis is that markets are ultimately rational and logical, at least over the intermediate to longer term.

Indeed, market history teaches us that, when markets start doing something which, at least on the surface, makes no sense, one had better look under the surface, as there is normally a very important lesson to be learned from the so-called "message of the markets." So, to paraphrase Kipling, just why are investors "keeping their heads when the world all around them seem to be losing theirs?"

It could be that the reason the markets are remaining so calm is because the ultimate bullish resolution for the capital markets would be for Trump the man to go, but for his pro-growth, pro-capital markets agenda to remain intact to be implemented by someone better suited to operate in a political environment.



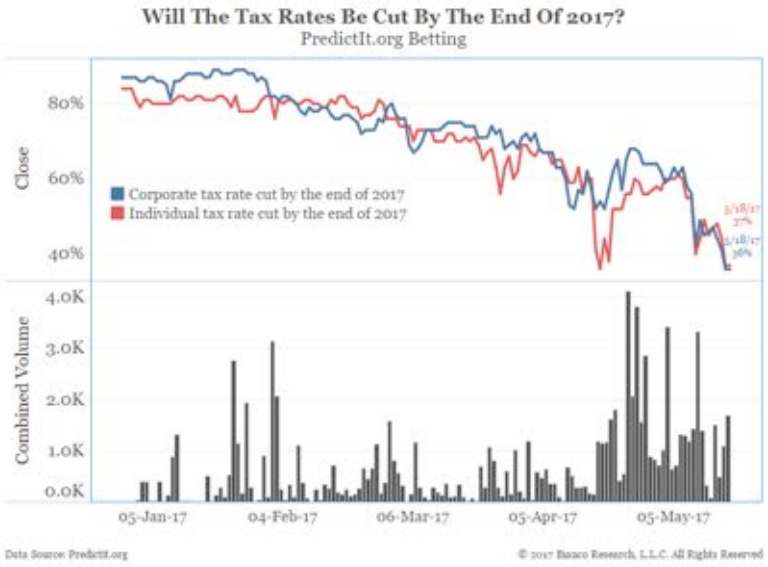
You could also make the argument that investors are simply growing inured to President Trump and his political antics, and have just accepted his brand of politics as the "new normal", which must be tolerated in the name of economic reform.

For that matter, one could argue that the "Trump Rally" was really never more than a fallacy, and that the post-election equity market advance has actually just been a continuation of the bull market that has been underway for quite some time, and that the catalyst for the accelerated move actually has everything to do with the global economic recovery, and very little to do with the election of Donald Trump as president.

This explanation is certainly supported by the fact that virtually all of the so-called "Trump trades" like the U.S. dollar, financial stocks, small-capitalization stocks, infrastructure-related stocks, stocks of companies with high tax rates, etc., all retreated to pre-election levels, after their meteoric post-election advances. Indeed, the "Trump Rally" peaked almost exactly one month after the election.

This interpretation suggests that global equity investors view Trump merely as a sideshow, and that global stock markets have the capacity to advance regardless of the turmoil in Washington, D.C., notwithstanding the potential for significant short-term volatility. Indeed, if the economic agenda of an American president was the primary driver of the global equity market rally, it becomes hard to explain why the domestic markets have lagged most major foreign equity markets this year.

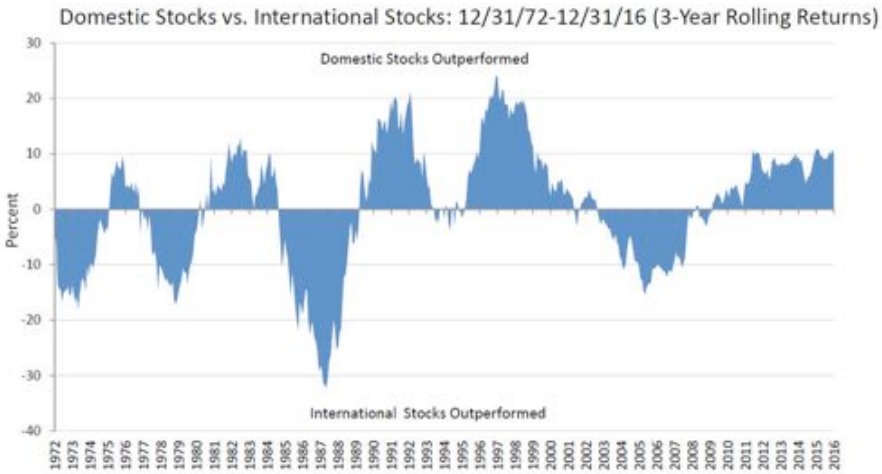
Perhaps the message of the markets is that the chaos out of Washington is to be expected in light of the very steep learning curve faced by Trump, due to his lack of political experience (and perhaps because he does not seem like the kind of man who is likely to take instruction well). At any rate, it could be that investors remain confident that, despite the constant generation of fodder for Saturday Night Live, Donald Trump will ultimately get things figured out in time to salvage at least some components of his pro-business economic platform.



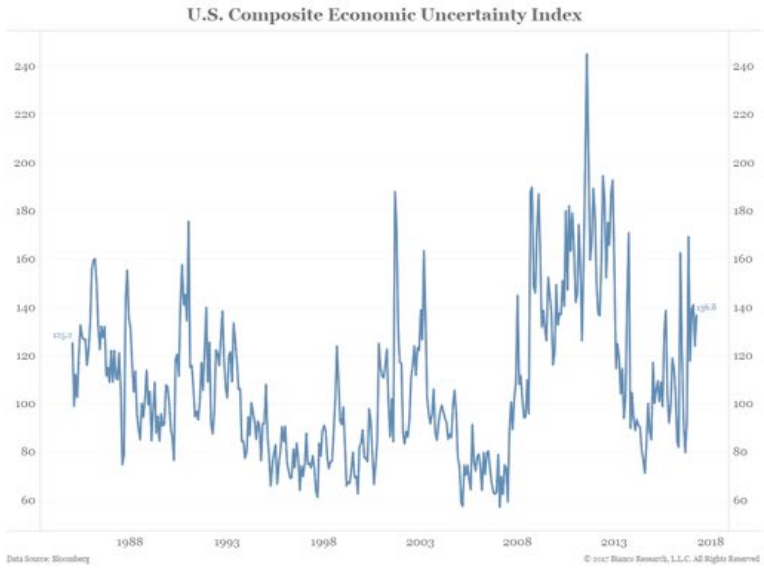
Recent surveys suggest that he had better hurry, as 54% of respondents to the most recent Quinnipiac poll said that they wanted the 2018 mid-term elections to produce a Democratic-controlled House of Representatives. That is in contrast to only 38% who favored the continuation of a Republican-controlled House. While it is a long time before the mid-term elections, it is noteworthy that the 16% divergence in opinions is the largest in the history of the poll.

When you consider all of the above-noted potential explanations for the lack of investor fear and equity market volatility, each of them seems either neutral or bullish in its implications for future equity prices.

However, there is also a rather concerning message that may be taken from the markets, which is that the low volatility and lack of fear is symptomatic of a market that is over-confident and complacent, and this would be troubling because equity market declines, when they do occur, tend to be much more dramatic in complacent markets, and this could be particularly significant when excessive complacency is coupled with excessively high valuations.



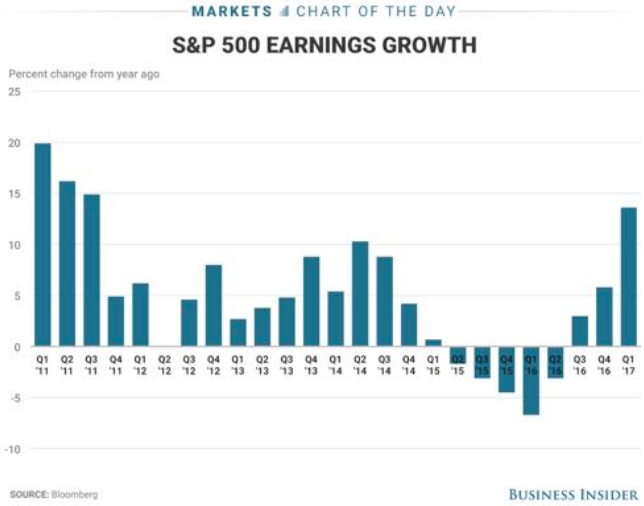
In regard to valuations, it has traditionally been true that U.S. equities sell at higher valuations than do most of their foreign counterparts due to America's stability, rule of law, transparent accounting systems, and normally stable political environment, and that has never been truer than since the 2009 end of the Great Recession. Indeed, those eight years represented the longest period of domestic stock outperformance over the foreign markets of the last 45 years, and this has created a situation where U.S. equities are currently very overvalued relative to earnings, and perhaps even more over-valued relative to their foreign counterparts.



However, unlike times in the past, this attribute of stability seems to be shifting away from the U.S. Indeed, if you compare the trends in the various economic uncertainty indexes around the world, you will see that the United States is the only major economy where economic uncertainty is actually increasing despite the ongoing global recovery from the financial crisis.

That being said, the U.S. does have one major beneficial influence that should continue to power the equity markets higher over the near term, which is that the global recovery is increasingly strong enough to overcome the very poor productivity numbers in the U.S. and thus drive domestic profits markedly higher. Indeed, there are increasingly convincing signs that U.S. companies are not only emerging from their profits recession, but that even top-line revenues have finally turned positive as well.

Indeed, it is not that the outlook for domestic equities is particularly problematic, as we don't see the levels of excessive investor sentiment, economic deterioration, or aggressive contraction in monetary policy that normally ends bull markets. Further, bull markets rarely end as a result of lofty valuations, although overvalued markets are punished the hardest when the correction does ultimately come.



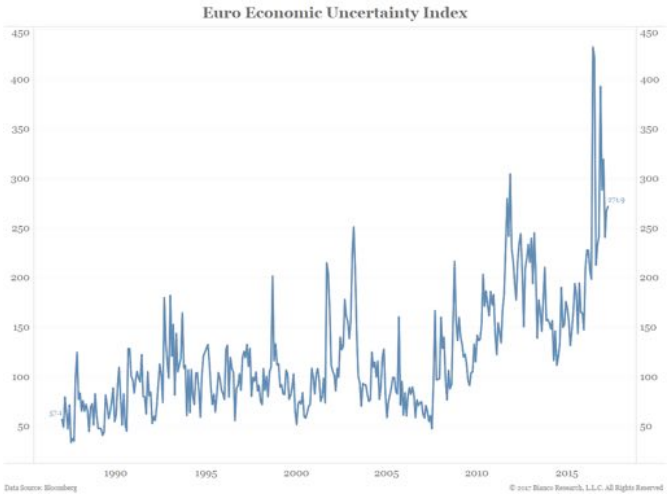
Moreover, it should be emphasized that current valuations are going to look even more egregiously expensive if it becomes evident that certain elements of the Trump agenda, like corporate tax reform and the repatriation of foreign profits, either are not going to pass or are going to be delayed beyond the mid-term elections. In the meantime, we do continue to like the prospects for domestic equity markets.

Importantly, we also believe that, because of their lower valuations, improving economic fundamentals, and the fact that they are so much earlier in their economic recoveries, most of the foreign markets are just starting to price in the emerging global economic recovery, and thus present considerably greater upside potential than do the domestic equity markets.

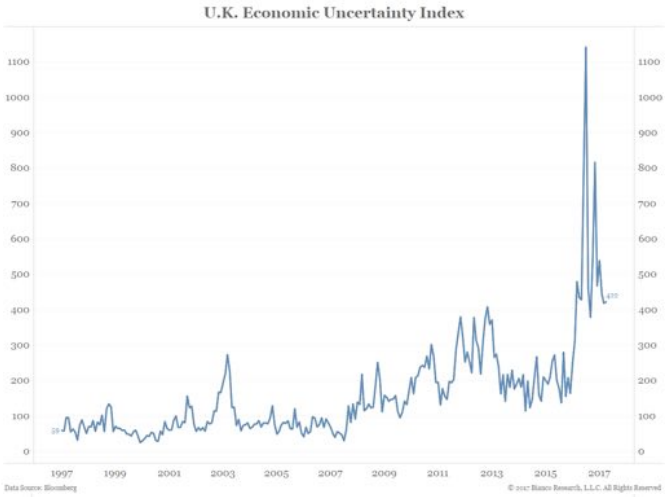
Source: Bloomberg. Data as of 3/31/2017

For example, whereas the U.S. markets trade at a very lofty 18.4 times anticipated earnings, Germany trades at only 14 times, Japan trades at only 16.8 times, the remainder of Asia trades at 13 times and the world's emerging markets, as a whole, trade at only 12.5 times earnings. Japan currently has the strongest earnings revisions of any major economy. Further, the populist movement seems to be losing its grip on Europe which, along with faster economic growth than can be found in the U.S., is a great combination for the European equity markets.

Indeed, the Wall Street Journal just reported that export-oriented U.S. companies are enjoying 15% year-over-year profit growth, as opposed to domestically oriented U.S. companies, which are growing profits at less than half of that rate (6.8%). To us, this speaks volumes about the strength of the recovery outside of our borders, and also helps to explain why smaller domestic stocks have been significantly lagging their larger brethren.

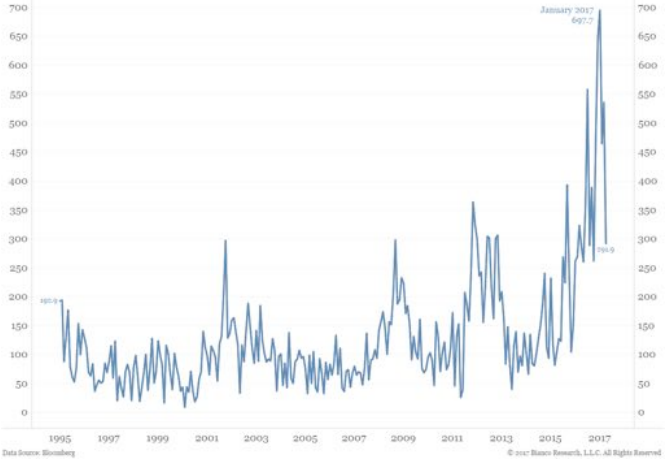


On one hand, the global economic fundamentals are showing every indication of a sustainable and strengthening recovery, and there appears to be compelling investment opportunities across the world's equity markets. It even looks like interest rates are going to remain lower than expected for longer than expected, which means that even interest-rate-sensitive markets like bonds, utility stocks and securitized real estate should "live on to fight another day."



All of this combines to paint a fairly optimistic picture for investors as long as the Trump soap opera doesn't get too out of hand. That is admittedly a pretty big "if," as the optics out of Washington, D.C. are just horrendous.

However, for the time being, and for the aforementioned reasons, investors still appear willing to ignore the political risks and concentrate instead on the emerging economic renaissance. While we believe that this approach will likely prove to be appropriate over the immediate future, it is important to remember that the markets normally find a way to punish complacent investors.



With all deference to Franklin Roosevelt, who said in his 1932 Inaugural Address that, "The only thing to fear is fear itself", in this instance, it may be that the "only thing to fear (at least in the U.S.) is the lack of fear itself."