Volume 82

THE PER STIRLING CAPITAL OUTLOOK

Performance • Perspective • Per Stirling

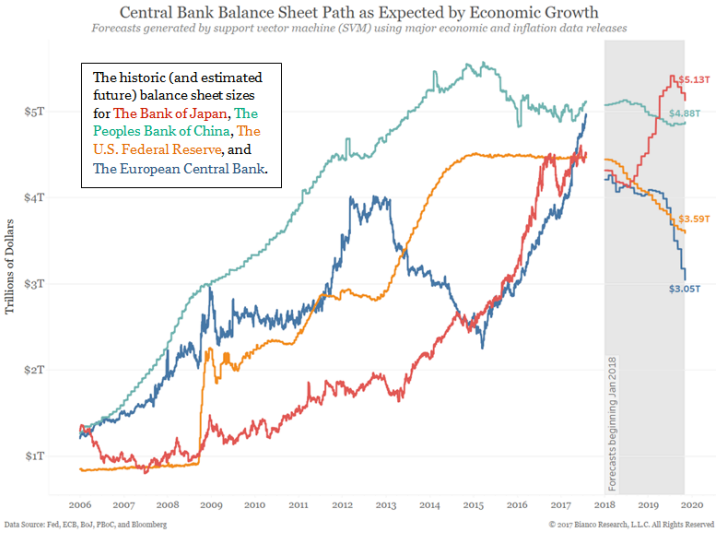
August 2017

Over the past decade, the Jackson Hole Economic Policy Symposium has developed into the preferred venue for the world's major central bankers to influence and offer guidance to both the capital markets and business leaders, and to announce and update their innovative and very aggressive monetary policies.

As the 2017 Symposium has just come to a close, we thought that this would be an appropriate time to talk about the anticipated, albeit gradual, unwinding of so many of the monetary, regulatory and legislative policies that the government put in place to stabilize the global economy, and aid in its recovery from the Global Financial Crisis.

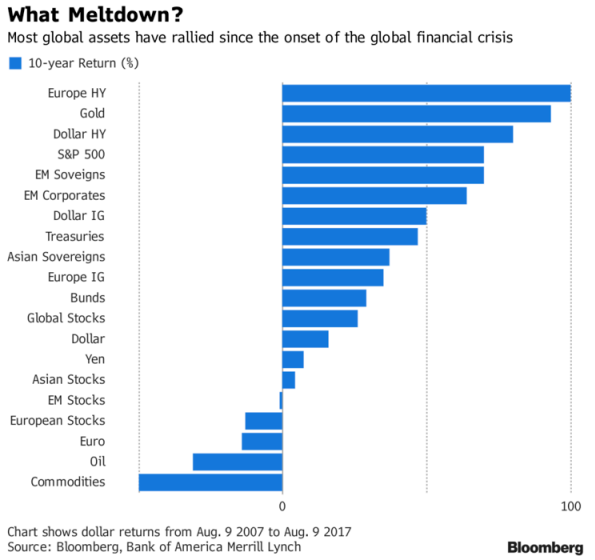
This important inflection point marks a seminal change from quantitative easing to quantitative tightening, from lower rates to higher rates, and from an environment of excessively onerous corporate regulation to one of potentially dangerous and ill-conceived deregulation. There is one other particularly dangerous trend that is showing signs of gaining a foothold, which is a move away from globalism and towards isolationism.

It is noteworthy that former Federal Reserve Chairman Ben Bernanke used the opportunity of the Jackson Hole Economic Policy Symposium to announce the Fed's innovative and extraordinary policy called quantitative easing (QE) which they would employ as a means of creating inflation (higher prices) in financial assets (stocks, bonds and real estate), in order to create a "wealth effect" that would motivate consumer spending. Simultaneously, they pushed interest rates to near 0%, as a means of forcing money out of the banking system and into the real economy as a stimulus.



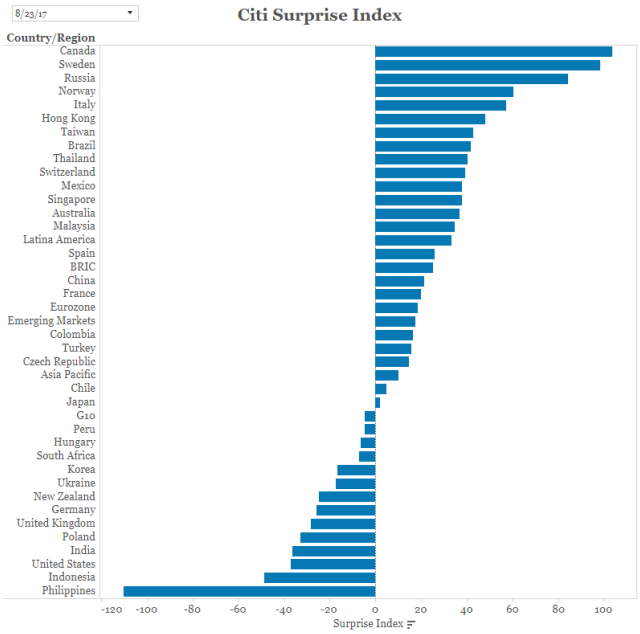
While the Federal Reserve was cushioning the shock to the economy by injecting trillions of dollars of new money into the financial system through an accounting measure (by expanding the size of their balance sheet), Washington reached the conclusion that capitalism could no longer be trusted and, as a result, they implemented massive and burdensome regulations that were so costly to adhere to, according to a 2016 study by the Competitive Enterprise Institute, that the costs of regulation to American businesses now exceeds the amount that they pay in taxes.

As history will attest, the Fed proved very successful in its strategy to reflate (boost) asset prices, and the decision of the central banks in Europe, Britain, Japan, and China to follow the Fed's lead catalyzed a similar surge in asset prices across much of the globe.



The stars in the recovery have been U.S. multinational stocks, lower-quality corporate and emerging market sovereign bonds and gold, while the laggards have included some of our current favorite growth ideas like emerging market and smaller-capitalization European stocks (because they are so undervalued on a relative basis).

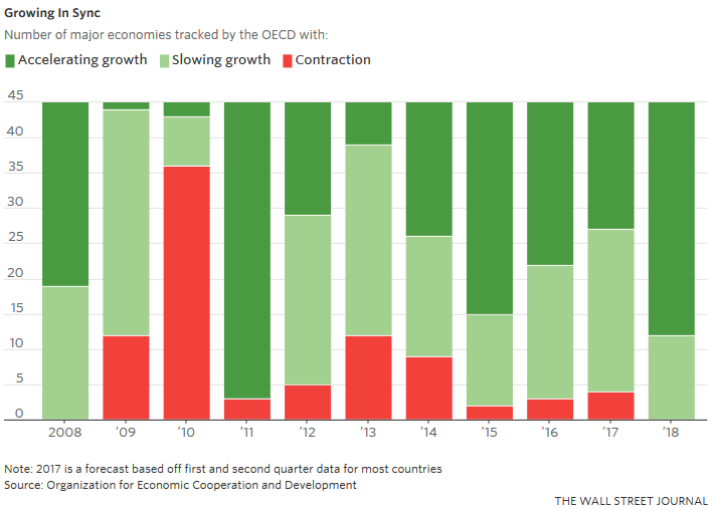
These respective rates of price recovery are very logical. Gold rallied because of the "flight to safety" trade. Lower-quality debt recovered sharply from its near-death experience, as the world's central bankers re-liquefied the global financial system. Large-cap domestic stocks have outperformed their global brethren, because the American government and Federal Reserve responded to the crisis first and with the most force, which meant that the American economy and risk markets were the first to recover.



Even high quality bonds have performed decently since the crisis despite the fact that significant portions of the global bond markets are offering negative yields, and even most of those that have a positive yield still lose purchasing power once you consider the impact of inflation. It just goes to show that, in the middle of a financial storm, sometimes a guarantee to "grow poor slowly" can be a reasonable alternative to the risk of possibly growing poor quickly.

However, in our opinion, the factors that drove the superior performance in the days since the start of the crisis are already more than fully reflected in the aforementioned out-performing groups. Indeed, economic data in places like the U.S. are now coming in worse than expected, which further reinforces the fact that most domestic equities are very expensive relative to their underlying economic fundamentals. In contrast, peripheral Europe, emerging Asia and the Latin American economies are generally surprising to the upside, which reinforces the idea that equities in these countries will likely need to be priced higher to reflect the better-than-expected economic fundamentals.

Of course the good news for almost every asset class, and for the global economy as a whole, is that, for the first time since 2008, there is not a single significant country in recession. Of equal importance, the economies in most countries are not just growing but are also accelerating to the upside.

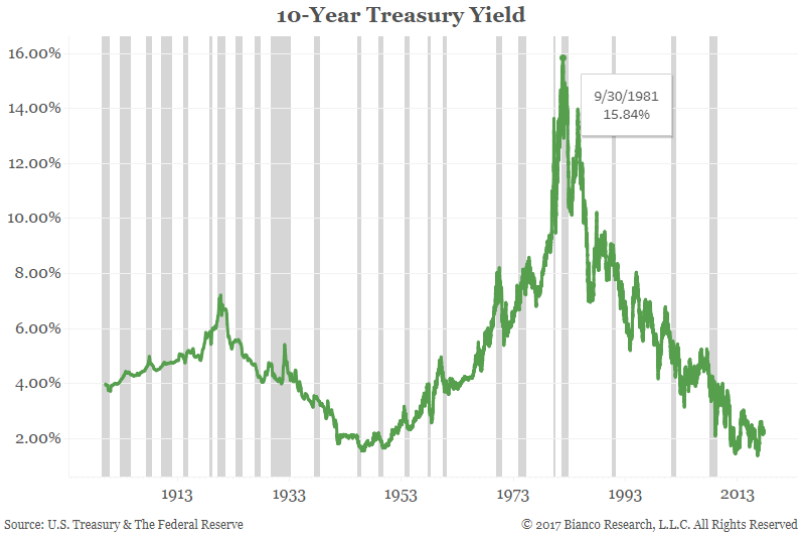


At long last, while challenges still remain in the dismantling of the recovery infrastructure, it seems like the global economy has finally recovered from one of the worst financial disasters in the history of the world.

We stated that it was "good news for almost every asset class" for a reason, as the "dark lining" to this "silver cloud" should clearly be the higher-quality segments of the bond markets, the prices of which have historically moved in the opposite direction of good news. It should be particularly problematic in the current environment, when yields are so low, when bond prices are vastly over-valued by almost any historic measure, and when the bull market in bonds has already lasted so long that it is hard to find anyone investing today who has ever even seen a bear market in bonds.

Granted, the "death" of the bond market has already been "exaggerated" enough to make Mark Twain jealous, so we acknowledge that bonds may continue to surprise us with their resilience, and delay their ultimately bearish fate. Bond prices may be temporarily supported by the uncertainties associated with North Korea, or the Trump Presidency, or the risk of terrorism. We do not know when, but we do know that a decline of substance and duration is a virtual certainty.

Given the perceived inevitability of a substantial decline, as inflation and higher short-term rates ultimately take their toll on bond prices, we should emphasize that bear markets in bonds have historically behaved much differently than have bear markets in stocks.



Indeed, while they experience shorter-term cyclical moves within their secular trends, bond market cycles tend to be much longer term in nature than are equity market cycles. This is borne out by a historic look at longer-maturity Treasury yields, and the fact that the current bull market itself started almost exactly 36 years ago.

Renowned value investor Sir John Templeton famously noted that, "the four most dangerous words in investing are 'This time it's different'", which correctly points out the influence of human nature on capital markets, and its ability to cause markets faced with similar circumstances through history to react in a remarkably consistent and similar way.

	Long-Term Treasuries	
	1926-1959	1960-1982
Starting Yield	3.74%	4.47%
Ending Yield	4.47%	14.12%
Annual Returns	2.73%	3.27%
Volatility	4.24%	9.25%
Max Drawdown	-10.95%	-20.96%

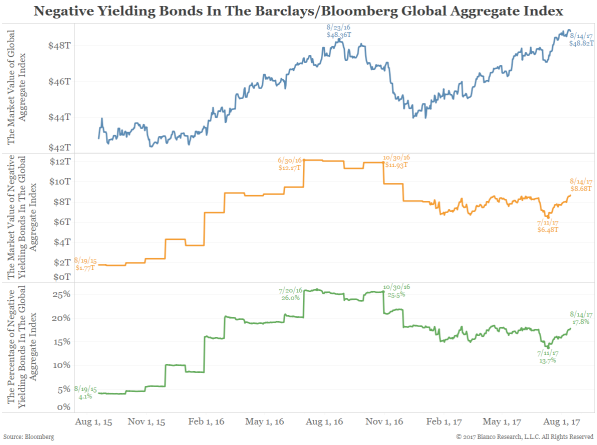
*Through June 1982

If his premise holds true, then there is very little for bond investors to worry about in the anticipated environment of higher short-term rates and an increasing supply of bonds that the markets will need to digest, each of which should push rates higher and bond prices lower. After all, even during the 1926 to 1959 and 1960 to 1982 bear markets in bonds, a combination of the glacial pace of the price decline and the existence of a current yield combined to save the day.

In other words, despite the bonds themselves losing 11% and 21% of their value respectively, the losses occurred over such a long period of time that the annual yield earned on the bonds was more than sufficient to offset the losses in capital value. As a result, even investors who held long-term Treasury debt through the entirety of these multi-decade declines still averaged positive annual total returns (yield minus capital loss) of 2.7% and 3.3% respectively.

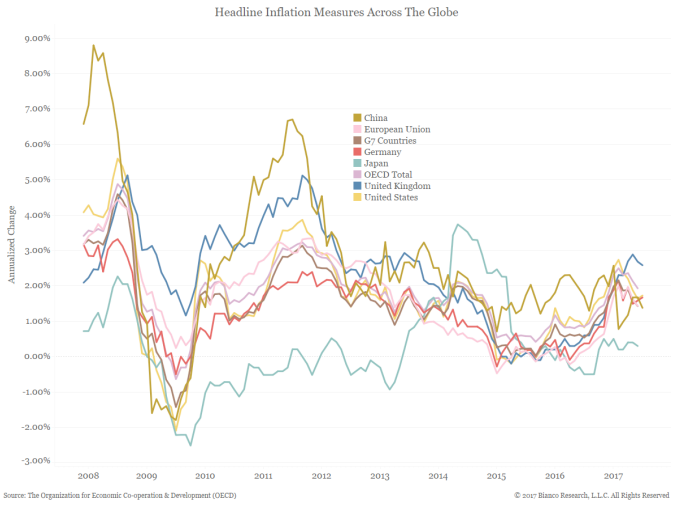
However, there is another insightful Wall Street saying that is a particular favorite of the securities regulators, which is that "past performance is not necessarily indicative of future results". In regards to today's bond markets, we think that investors should pay particular attention to the regulators' warnings, as there are a number of reasons why we expect the inevitable bear market in bonds (whenever it comes) to be considerably less gentle than its predecessors.

The first reason is because of the fact that battening down the hatches and just collecting the dividend is a much less attractive solution today, with the 10-year Treasury currently yielding only 2.15% and 18% of all bonds in the Barclays/Bloomberg Global Aggregate Bond Index (approximately $50 trillion dollars), actually offer a nominal yield of less than 0%.



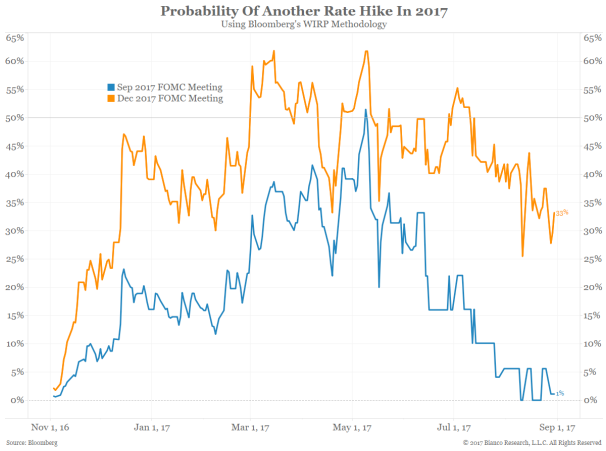
If you are a holder of negative-yielding bonds, you would lose both yield and capital when rates move higher. In addition, so much of the negative-yielding debt is European, where inflation is starting to recover, which suggests to us that about the only thing supporting prices is the willingness of the European Central Bank (ECB) to buy virtually every piece of European debt that they can get their hands on. This further suggests that a sell-off in European debt may drive global interest rates higher as soon as the ECB joins the Fed in shrinking its balance sheet which, as shown in the first chart contained in the report, is expected to happen rather aggressively.

Even if one is earning just over 2% in U.S. Treasuries (one of the highest yields in the world for government debt), there is relatively little yield (43% less than in 1926 and 108% less than in 1960) to offset losses in the nominal value of the bonds themselves, which you would expect to see as a result of higher central bank-set rates.



Another consideration is that the historically low levels of yield may act as a sort of leverage in regard to bond prices. At the start of the two aforementioned bond bear markets, a 1% increase in long-term rates would have been a 27% increase and a 22% increase in yield respectively. However, because of today's low yields, it would actually be a 47% increase in yields, and it is difficult to anticipate how this oddity will manifest itself in prices.

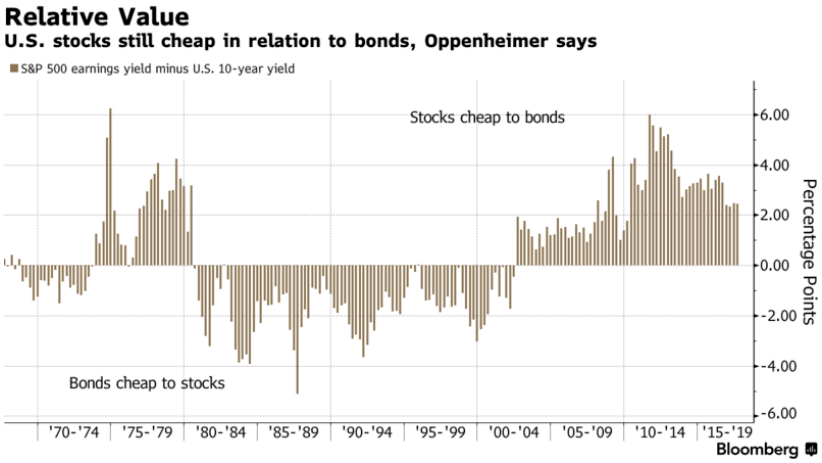
The irony may be that the very shrinkage of central bank balance sheets that we expect will increase the supply of bonds, thus pushing yields higher and bond prices lower, may ultimately prove to be the savior for bonds. To explain, there have been six times in U.S. history when the Federal Reserve has reduced the size of its balance sheet (quantitative tightening). This includes 1921-1922, 1928-1930, 1937, 1941, 1948-1950 and 2000. Five of those six episodes ended in recession, and recessions are the best friend of the long-term, high-quality bond markets, as they tend to lower inflationary pressures and decrease the supply of bonds.



The Fed has made it very clear that the reduction of their balance sheet will be slow and methodical. Market expectations are that the Fed will target an average of $50 billion per month that will be removed from the Fed's balance sheet and reintroduced to the bond market as new supply. Since a relatively constant supply of dollars will be selecting from a greater available supply of bonds, it is to be expected that bond yields should move higher and bond prices should move lower. Wall Street expectations are that this process will take place over the course of four or five years.

As noted previously, there have been many analysts' pronouncements over recent years about the death of the bond bull market, and yields have managed to remain mired at similarly low levels for extended periods in the past. So, for as long as inflation remains low, such a low-rate outcome remains as a possibility, as low inflation will slow the path of the world's central banks towards monetary policy normalization. However, with the exception of Japan, inflation seems to be trending gently higher through most of the world, and such inflationary influences ultimately tend to be contagious, and thus global in their impact.

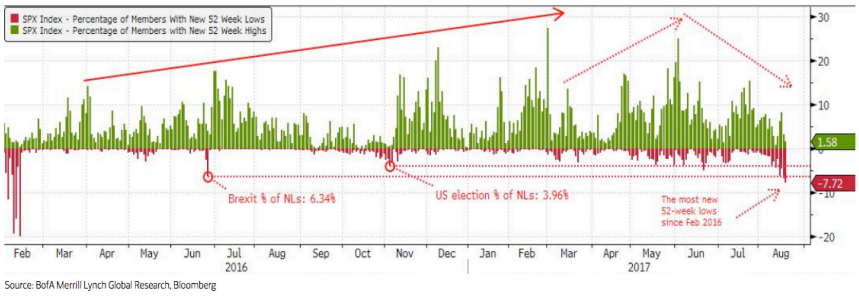
Inflation is all important, which is illustrated by the 1960 to 1982 period in the bond market that was addressed above. While the average annual nominal total return for holders of long-term bonds over the period was 3.3%, the inflation-adjusted return was a loss of more than 2% per year (a total loss of purchasing power of 38%). Of interesting note, when long-term Treasury yields peaked out at almost 16% in 1982, short-term rates were actually approaching 20%, so there was a complete inversion of the yield curve which, as is usually the case, produced a recession (as we have discussed in recent writings).



The central banks very successfully inflated the prices of financial assets around the globe, and many of those assets are currently very expensive relative to their underlying fundamentals. However, on a relative basis, we believe that stocks continue to offer much better value than do bonds. Stocks also look more attractive on an earnings basis, as corporate earnings are surprising to the upside, while bond earning power is limited to their rather pathetic yields.

In addition, tax cuts, which are starting to look like a reasonable possibility, would be much more favorable for stocks than bonds, as will be the economic recovery that is taking hold across most of the world.

That is not to suggest that the domestic stock market is without issues. Valuations are very expensive on a historical basis, and market breadth (a measure of what percentage of stocks is participating in the bull market advance) is turning rather negative. Of note, strong market breadth is normally a requisite for a sustainable equity bull market. Further, as we discussed in last month's report, narrowing breadth is often a sign of a very late stage bull market.



Importantly, bond prices are driven primarily by macro-economic fundamentals, whereas stocks are increasingly trading on their own unique micro-economic fundamentals, which means that, even in a world of highly inflated asset prices, there are still opportunities for adept, stock-picking portfolio managers to add value.

We continue to prefer equity over debt and growth stocks over value stocks. We prefer large capitalization domestic stocks over their smaller brethren, but believe that small and mid-capitalization stocks will start to outperform if tax cuts start to look likely. Outside of the U.S., we continue to be very bullish on the outlook for Europe and most of the world's emerging markets.