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THE PER STIRLING CAPITAL OUTLOOK

Performance • Perspective • Per Stirling

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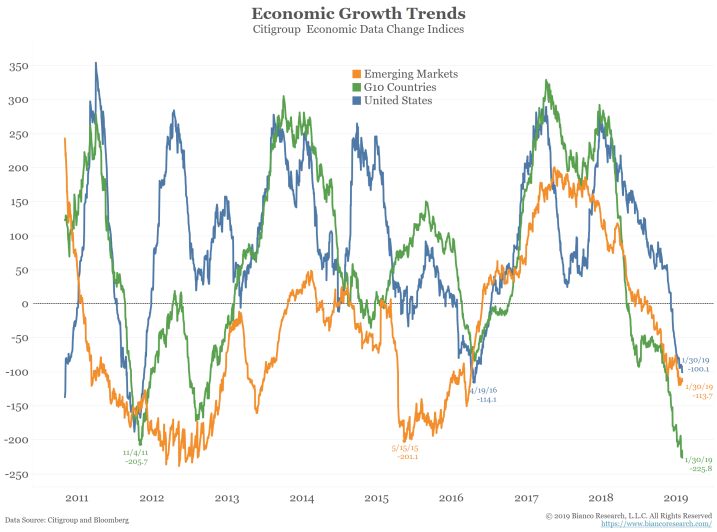
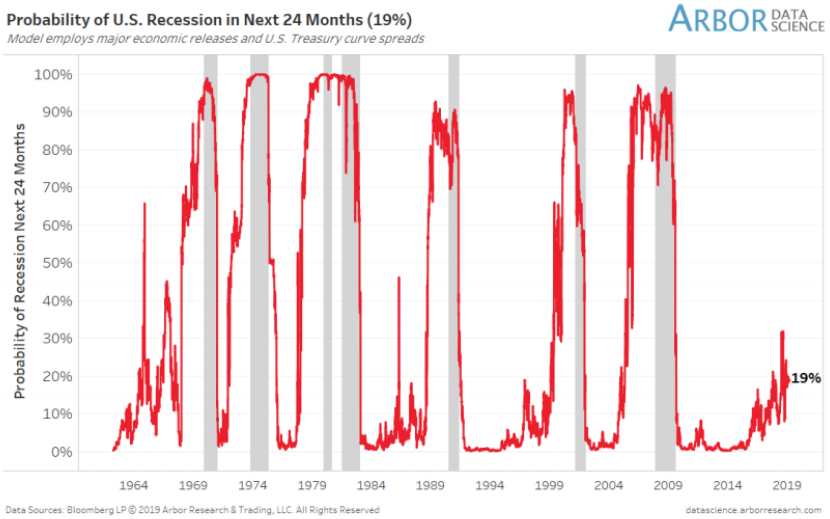
Renowned economist John Maynard Keynes was one of the great thought leaders of his day. However, he was regularly criticized for some of his opinions morphing over time. During one particularly high-profile government hearing, when Keynes was being criticized for being inconsistent, Keynes reportedly fired back "When the facts change, I change my mind. What do you do, sir?"

If Keynes were alive today, he and his reputation for ever-evolving opinions would fit right in, particularly amongst the world's central bankers, as we have just witnessed a hawkish-to dovish reversal in monetary policy-related guidance that would have made even Keynes' head spin.

Of course, this reversal in monetary policy guidance did not occur within a vacuum, as the Fed clearly perceived that, over a very short period of time, the "facts" had indeed "changed". The minutes from the December Fed meeting laid out an uber-bullish view on the domestic economy. The minutes noted that overall economic activity continued to rise at a "solid rate", that the labor market was "strong", and that consumer spending, which accounts for approximately two-thirds of the domestic economy, was expanding "strongly."



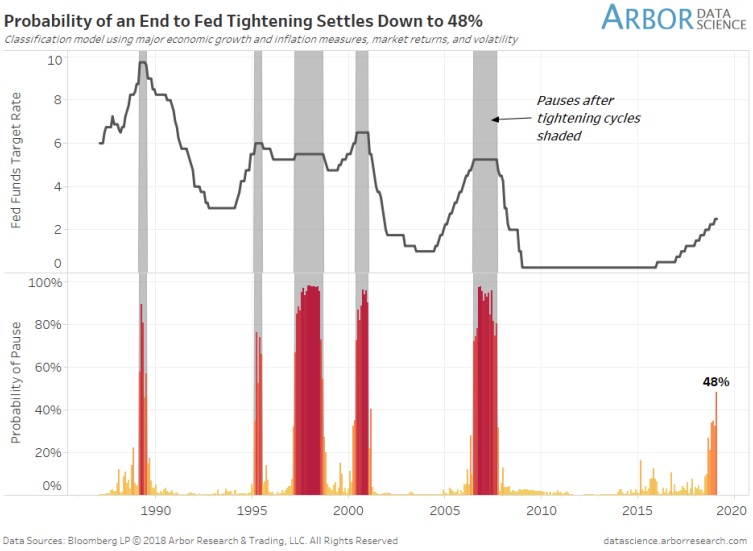
The just-released minutes from the January Fed meeting painted a much bleaker picture, and emphasized an array of risks to the economy, including "the possibilities of a sharper-than-expected slowdown in global economic growth, particularly in China and Europe, a rapid waning of fiscal policy stimulus, [and] a further tightening of financial market conditions."



Suddenly, the open question is no longer whether or not the Federal Reserve will raise rates too much (or shrink their balance sheet so much) that they, as per usual, over tighten and catalyze a recession. Now, the question has become whether or not they have <u>already</u> over-tightened and, by doing so, put the longevity of this near-record economic expansion in doubt.

This is not necessarily a criticism of the Federal Reserve, as it is standard operating procedure for central banks to proactively move rates higher to cool off an economy before inflation becomes embedded, which is particularly important, as undesirable levels of inflation are very difficult to wring out of an economy once they gain a foothold.

The need for proactivity is because of the nine to twelve-month lag (i.e. the "monetary policy lag") that normally exists between when a central bank changes interest rates and when that change impacts the real economy. This is why central bankers have traditionally raised rates before inflation ever becomes an issue, and why most recessions are ultimately and unwittingly caused by overly-zealous central bankers.



As former Federal Reserve Chairs Bernanke and Yellen noted in a panel discussion earlier this year at the annual meeting of the American Economic Association in Atlanta, "Expansions don't die of old age. They get murdered." Chairwoman Yellen further clarified the point by saying, "Two things usually end them [expansions]. One is financial imbalances, and the other is the Fed." Of course, she is not suggesting that the Fed is somehow malicious and wants to see recessions.

To the contrary, the Fed is just trying to maintain a golden mean balance between maximum sustainable employment and modest and sustainable levels of inflation. Unfortunately, because of the monetary policy lag, the Fed almost never knows that monetary policy has become too restrictive until it is far too late. Moreover, once they do determine that policy has gone too far and that they thus need to reverse course, it takes the same nine to twelve months for the new policies to have their stimulative effect on the economy.

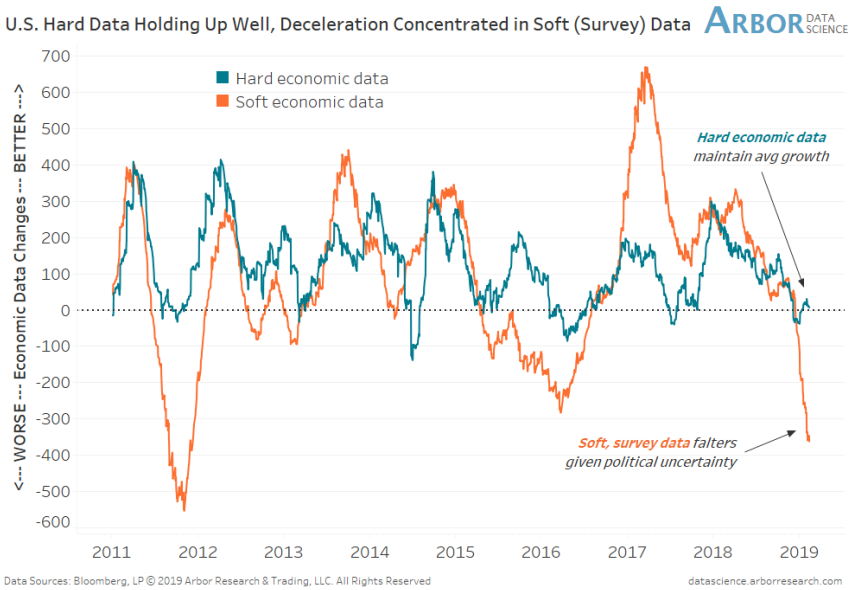
One of our favorite economists, Jim Bianco, whose team at Bianco Research produces some truly compelling insight, offers an interesting explanation for the Fed's inability to accurately predict recessions. He agrees that economic expansions usually get "murdered" by the Fed, but that it is important to look at the murderer (the Fed and its policies), and not the victim (the economic data) to determine if a recession is coming. By this reasoning, the Fed almost always fails to see recessions coming, as they are looking outward at the data rather than inward at a mirror.

We are of the opinion that it is vitally important to try to determine the specific factors that caused not only the Federal Reserve, but also central bankers around the world, to make such an abrupt about-face in policy guidance. After all, the implications are potentially very different for the securities markets depending on whether central bankers are responding to deflation, recession, financial instability, geopolitical turmoil, or even the waning effects of Trump's tax cuts and fiscal stimulus.

Yes, the Fed minutes did refer to the global slowdown, the diminishing benefits of past fiscal stimulus, and "a further tightening of financial market conditions", the last of which could be interpreted in a number of ways. However, we hesitate to simply accept this rationale at face value since each of these conditions was probably at least as prevalent in December as it was in January, and yet the Fed not only raised rates in December, but also told us to expect two more hikes in 2019 and the ongoing shrinkage of their balance sheet (quantitative tightening).

Moreover, many of the factors that caused the Fed to tighten policy in the first place still exist. The unemployment rate is at a historic low, the domestic economy is running near full capacity, and the current expansion is only four months away from setting a new record for the longest economic expansion is U.S. history.

According to classic economic theory, if there was ever a fertile environment for the onset of an unhealthy level of domestic inflation, this should be it. However, instead of standing hard on the economy's brake to proactively stop inflation before it gets started, the Fed is instead sending the message that they are willing to push the boundaries of economic capacity and, by doing so, purposefully risk the onset of higher inflation.

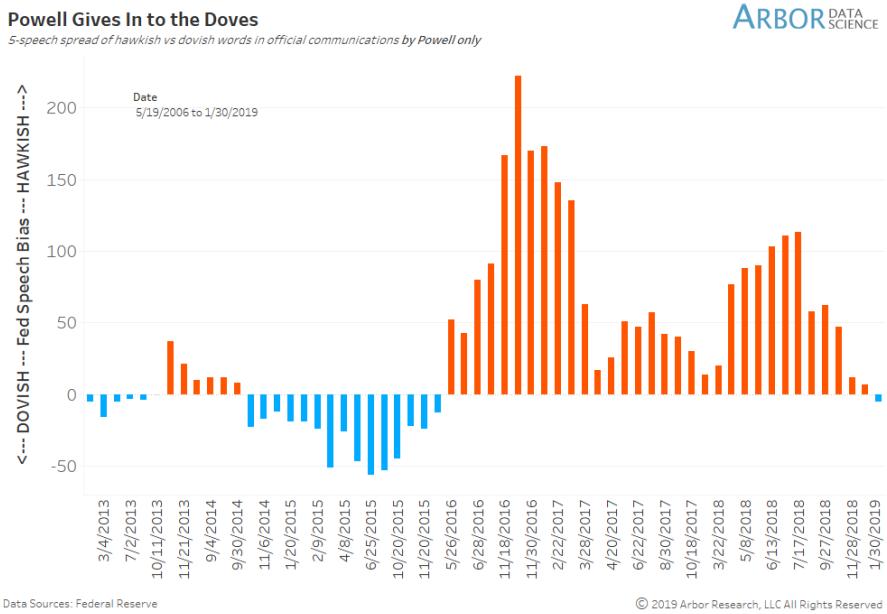


The above chart provides one possible explanation for this conundrum, as it illustrates the massive divergence between actual hard economic data (shown in blue), which continues to run at a slightly faster than average pace, and forward-looking, survey-based data that is anticipating a sharp economic slowdown.

There is also a sympathetic magic component that makes this divergence potentially very important, particularly since consumer spending drives two-thirds of the domestic economy, and because a lack of business and/or consumer confidence can drive changes in behavior thus potentially allowing today's weak forward-looking perspective to drive down future real "hard" economic data.

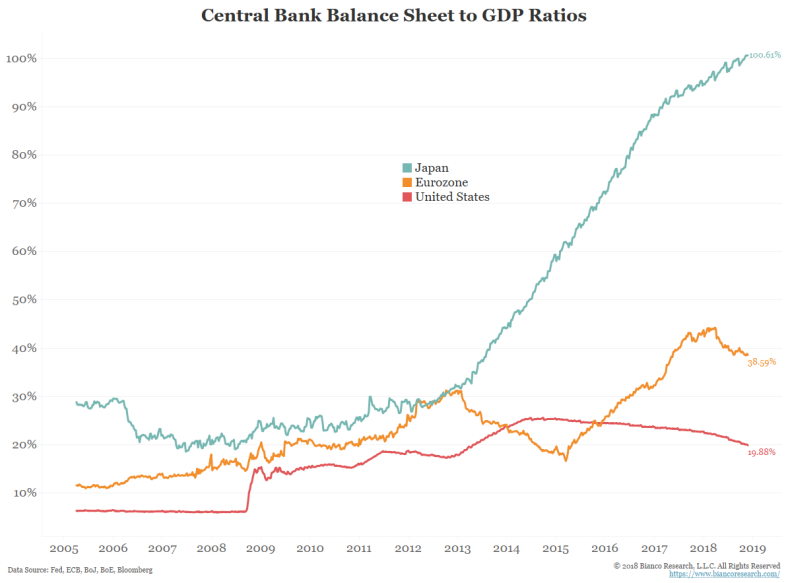
We attribute this divergence between hard and soft date largely to today's extreme political uncertainty, trade-related uncertainty, and the negative impact on confidence caused by the shrinkage of the Fed's balance sheet (quantitative tightening) which, according to the January Fed minutes, will ideally conclude before the end of the year.

It should be emphasized that making a determination to stop raising rates at this point in the cycle would be a very weighty decision on the part of the Fed, due to the fact that it would leave them somewhat compromised in their ability to battle future economic contractions. To explain, the Fed has historically cut interest rates by an average of 5% when fighting past recessions. If they stop raising rates now, it will mean that they will only have half that amount to work with when called upon to combat the next economic downturn.

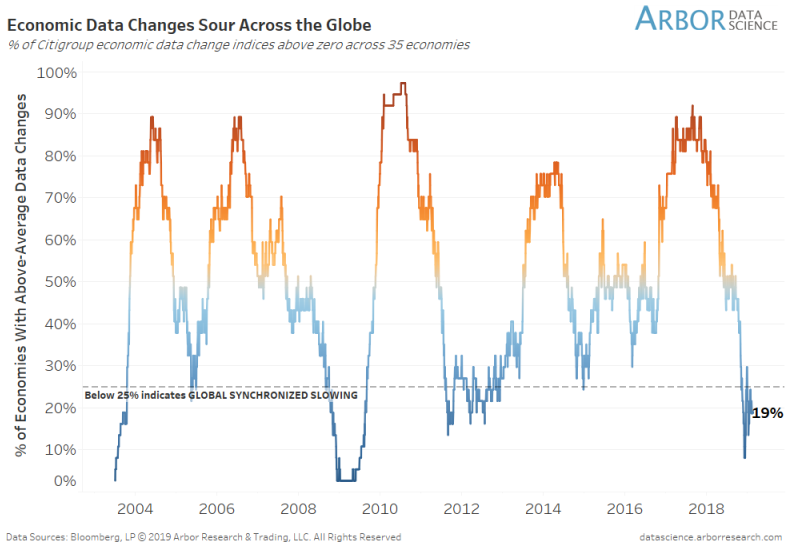


This sea-change at the Fed could also be explained if one were to assume that they had made the decision to act as "central bank to the world", under the premise that the sudden and sharp downturn being experienced in economies outside of our borders will inevitably drag the domestic economy down with them, if left unabated.

Supporting this premise is the fact that the Federal Reserve is virtually the only major central bank that has the tools necessary to provide economic stimulus, as most other central banks are still holding their short-term rates at or below 0% and, unlike the Federal Reserve, have done little or nothing to unwind their massive quantitative easing programs, some of which are actually much larger as a percentage of the respective economies than those employed by the Fed.

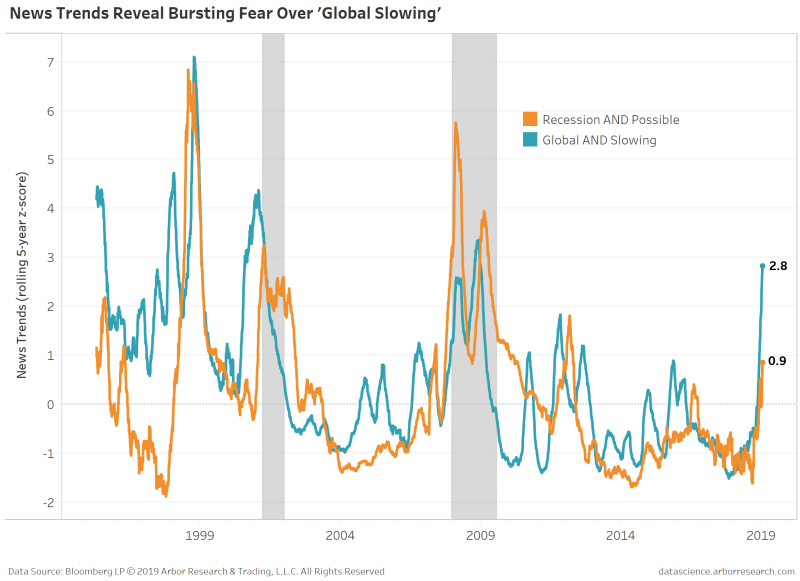


To fully appreciate just how limited other central banks are in terms of further lowering rates as a means of stimulating their suddenly slumping economies, consider the fact that, of all outstanding bonds, bills and notes in the world today, 27% of them (representing $11 trillion) yield less than 0%, and less than half of them yield as much as 2%. Moreover, the percentage of the global bond market with negative yields has increased by a stunning 21% just since the end of October, which suggest that the bond markets are anticipating a sharp global slowdown.



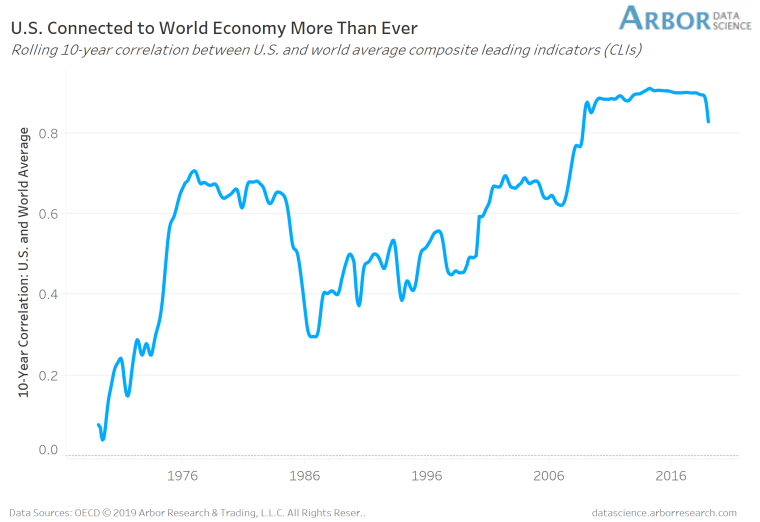
In our opinion, it is actually this bizarre interest rate structure that allows the Federal Reserve the flexibility to risk inflation becoming embedded into the domestic economy because, even if inflation-adjusted "real" yields were to become less attractive as inflation moves higher, there is a diminished risk of domestic rates moving notably higher, as the incredibly low rates overseas are likely to keep foreign demand for U.S. debt securities very high thus pushing prices higher and keeping yields relatively low.

Of note, there is little doubt of the need for stimulus (some of which might also be achieved through the successful conclusion of a U.S.-China trade deal, and just as easily undone by the proposed imposition of tariffs against European auto manufacturers).



In the meantime, the Organization of Economic Cooperation and Development's Composite of Leading Indicators fell for the thirteenth month in a row, which represents the most prolonged stretch of weakness in 2 ½ years. Moreover, the weakness is pervasive, with 95% of the world's economies now contracting from year-ago levels, which is the worst growth participation since May of 2012 when Europe was in recession and the U.S. appeared on the verge of joining them.

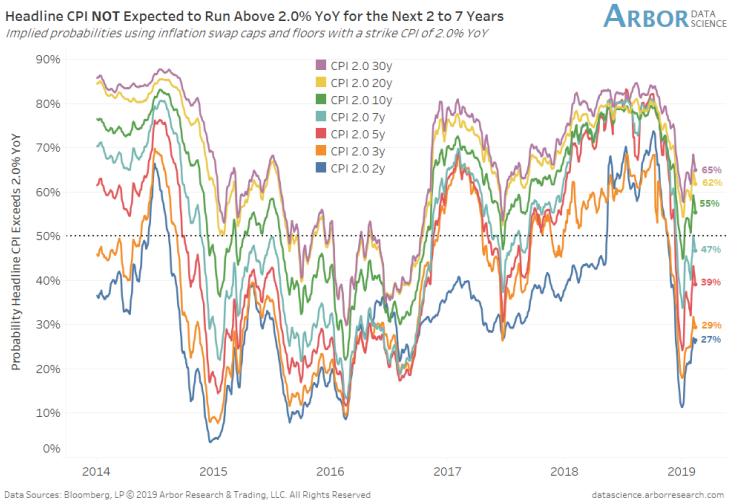
This is a remarkable reversal in trend, particularly when you consider that one year ago 80% of the world's economies were accelerating from year-earlier levels. The world economy as a whole has morphed from a synchronized global upswing to a synchronized global downturn. On top of everything else, global trade volumes have contracted over the past three months at the fastest pace in almost four years.



As we have discussed at length in recent writings, we believe that the reversal of the Fed's quantitative easing stimulus programs (particularly when combined with such trade-related uncertainties) bears much of the responsibility for this sharp and sentiment-driven reversal.

As suggested in the Fed minutes, another possible motivation for the change in Fed bias may be as an offset to the waning influence of last year's fiscal stimulus and tax cuts, and as protection against what former Fed Chairman Bernanke predicted would happen when all of the stimulus ran out, specifically that "in 2020, Wile E. Coyote is going to go off the cliff and look down."

We suspect that yet another important catalyst for this seminal change that is receiving much less attention has to do with inflationary expectations and their impact on future inflation.

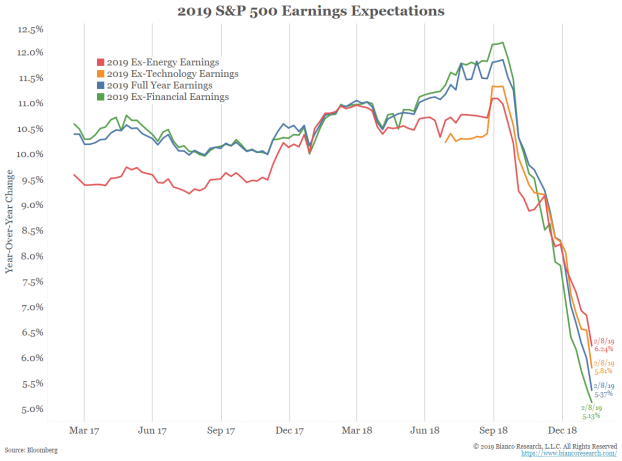


In fact, Fed policy makers have recently raised concerns that years of inflation remaining anchored below the Fed's 2% target may have actually caused dis-inflation to become embedded in the economy which, in sharp contrast to historic precedent, may actually motivate the Fed to nudge prices higher. After all, from the perspective of a central bank, deflation is the worst possible outcome, as they have virtually no tools in their arsenal to combat it. This perspective was just reinforced by Fed Vice- Chairman Richard Clarida, who noted on January 10th that "Because expectations of future inflation are such an important determinant of actual inflation, central banks are as much in the business of anchoring inflation expectations as they are of managing actual inflation."

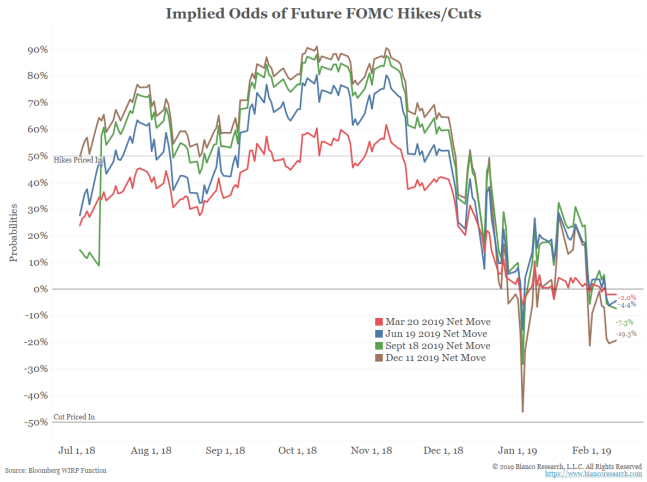
We believe that analyzing the specific reasons behind the shift in Fed policy is all-important from an investor's perspective, as the answer has far-reaching, and intermediate-term implications for everything from corporate profits and inflation, to interest rates and the sustainability of the current, near-record economic expansion.

In addition, if further interest rate hikes are even only temporarily on hold, it could have significant implications for the market outlook over the immediate term, as it removes a major "brick" from the "wall of worry", which we defined in last month's commentary as "the composite of concerns that keep bearish investors and their money (i.e. the fuel to power future advances) on the sideline", and thus prolongs the bull market.

At present, we are growing concerned, at least over the short term, that too many bricks have already been removed from the wall of worry, which suggests to us that the markets are running low on the fuel necessary to drive prices substantially higher. In our December commentary, we posited that the markets were pricing in more bad news than they were likely to actually encounter. Now we are concerned that the equity markets, in particular, are pricing in too much good news, which is ultimately likely to leave investors disappointed.



In addition to pricing out any potential for future rate hikes (an increasingly reasonable assumption) and pricing in a resolution to the trade negotiations with China that the markets will actually applaud (and not generate a "sell the fact" response), investors seem to have forgotten about the distinct possibility of an earnings recession in the U.S., a substantial global slowdown, and the fact that China represents just one front of America's multi-front trade war.



To be clear, we continue to believe that 2019 will prove to be a nicely profitable year for the holders of global equities, and that the domestic markets will be among the best performing markets for the year. That said, there are indications that the equity markets are both pricing in overly optimistic outcomes to some intermediate term events, and largely ignoring some important risks. Further, the equity markets are quite overbought on a technical basis. As such, while we still like equities, and while they may continue to surprise on the upside, we are concerned that risk markets may have come too far, too fast in their recovery from the Christmas Eve lows, and may need to trade down or sideways over the near term, as they digest their recent gains.

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