Volume 104

THE PER STIRLING CAPITAL OUTLOOK

Performance • Perspective • Per Stirling

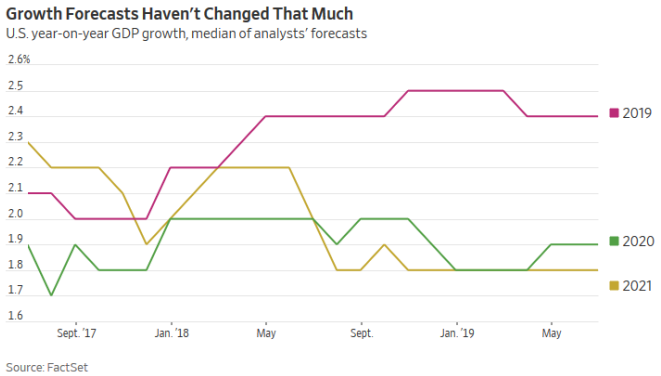
June 2019

As anyone who has ever watched an old western movie can tell you, one could always count on the cavalry to come charging in at the last minute and "save the day". For much of the past thirty years, at least in the economic realm, that responsibility has fallen on the shoulders of the world's central bankers in general, and the U.S. Federal Reserve, in particular.

Whether it was the bursting of the Japanese real estate and equity market bubbles, the "Asian Contagion", the Long-Term Capital Management Crisis, the Russian debt default, the bursting of the technology bubble, the sub-prime crisis, or the Global Financial Crisis, the central bankers have always come charging to the rescue with their arsenal of rate cuts, asset purchases, and quantitative easing.

Off in the distance, investors once again hear the sound of a bugle blast, in the form of increasingly dovish Fed commentary, which likely foretells the arrival of the Fed cavalry just in time to theoretically, once again, save the day. However, this time, the cavalry is coming off of a very long and exhausting campaign, and has arrived at the battle decidedly low on ammunition.

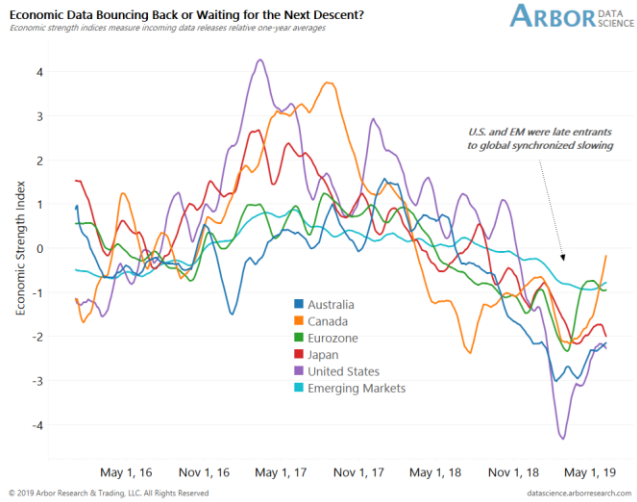
Even so, the anticipated return of a dovish Fed has rejuvenated the equity market's animal spirits after a sharp May decline, and provided the fuel necessary for the major indexes to rally back for a retest of their historic highs. After all, with the "Fed put" (i.e., the premise that the Fed will ultimately step in and save the markets if any decline gets too severe) back in place, what could possibly go wrong? Right?



While there was a facetious element to the preceding question, it is true that the Federal Reserve has shown a well-documented willingness to support the prices of financial assets, particularly in the years since the onset of the financial crisis. Moreover, the central banks of Europe, Japan, and China have proven even more willing than the U.S. to backstop their markets. As an example, the Bank of Japan currently owns approximately 80% of the value of all Japanese equity ETFs and almost half of all outstanding Japanese sovereign debt.

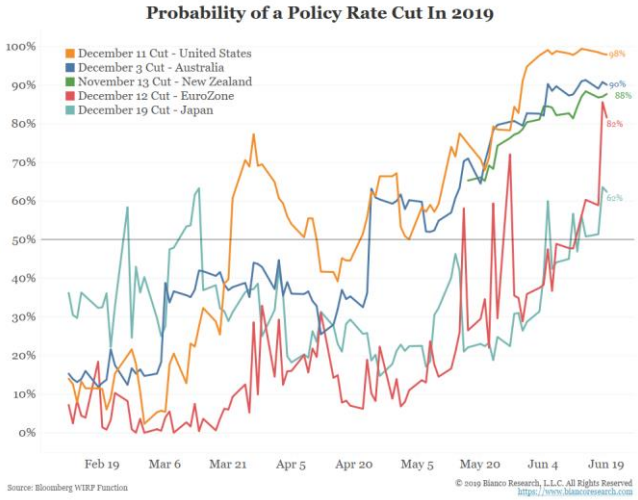
Importantly, while there is a growing array of economic justifications for the Fed cavalry to intervene, most of them are notably hard to detect when looking at current economic data or mainstream economic forecasts. After all, expectations for domestic economic growth are basically unchanged from where they were during the third quarter of last year.

This perspective was just reaffirmed in the June 19th Fed statement that, "The Committee continues to view sustained expansion of economic activity, strong labor market conditions, and inflation near the Committee's symmetric 2 percent objective as the most likely outcomes, but uncertainties about this outlook have increased. In light of these uncertainties and muted inflation pressures, the Committee will closely monitor the implications of incoming information for the economic outlook and will act as appropriate to sustain the expansion". It is the end of the statement that announces the cavalry's expected arrival.



The obvious question is that, with "sustained expansion of economic activity, strong labor market conditions, and inflation near the Committee's symmetric 2 percent objective as the most likely outcomes", why are the Fed Funds futures markets discounting a 100% likelihood of a rate cut in July (with some potential for a larger-than-expected 0.5% rate cut), a 90% chance for a second rate cut in September and a 65% likelihood for a third cut in December?

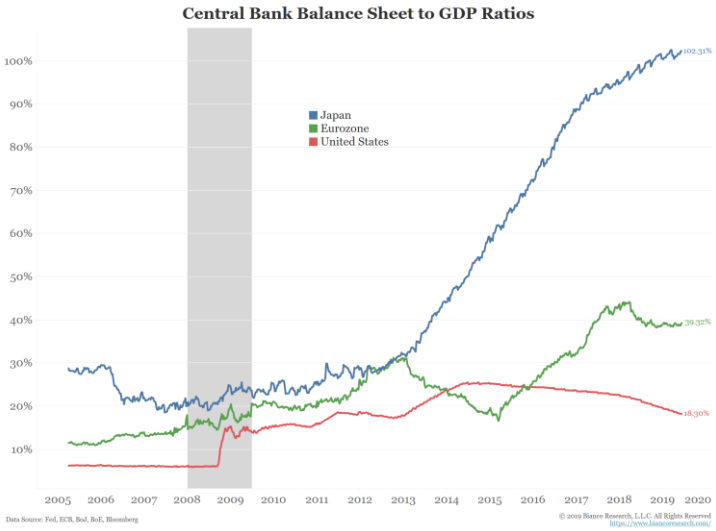
The answer is likely found in Chairman Powell's post-Fed meeting press conference, when he noted that "we have been mindful of some ongoing crosscurrents, including trade developments and concerns about global growth", and that "In the weeks since our last meeting, the crosscurrents have reemerged. Growth indicators from around the world have disappointed on net, raising concerns about the strength of the global economy."



There is clear evidence that mid-2017 marked an inflection point from the world enjoying a synchronized global economic expansion to the world experiencing a synchronized global slowing. It was a slowdown that, until the fourth quarter of last year, the U.S. and the world's emerging markets (led by China) seemed largely immune to.

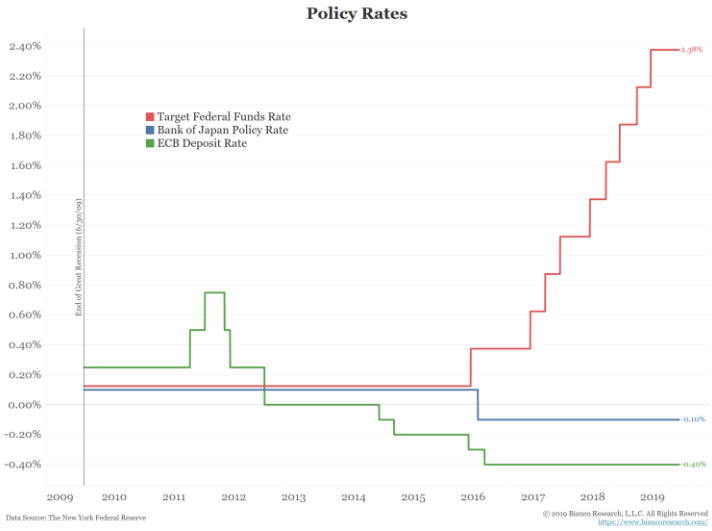
As the slowdown has become more globalized, so have the expectations for monetary easing, with markets now pricing in rate cuts in the United States, Europe, Japan, Australia, and New Zealand before the end of the year, with China already stimulating fairly aggressively. At this point, the message of the markets is remarkably clear, investors are counting on the world's central bankers to counter the synchronized global slowing with synchronized monetary stimulus.

If anything, it is the U.S. whose monetary policy is out of sync with the rest of the world, as the Fed was the only central bank that took any significant steps to unwind the heroic and extraordinary stimulus measures employed during the global financial crisis.



This includes both the shrinkage of the Federal Reserve's balance sheet and the increase in the Fed Funds target rate (i.e., short-term rates). In regards to the Fed's balance sheet, it has been reduced from approximately 26% of GDP (i.e., the size of the American economy) to just over 18%. This is in sharp contrast to the situation in Western Europe, where the balance sheet of the European Central Bank has been reduced somewhat, but still stands at over 39% of the size of the Euroland economy, and especially Japan, where there has been no shrinkage, and where the Bank of Japan's balance sheet is still larger than the Japanese economy as a whole.

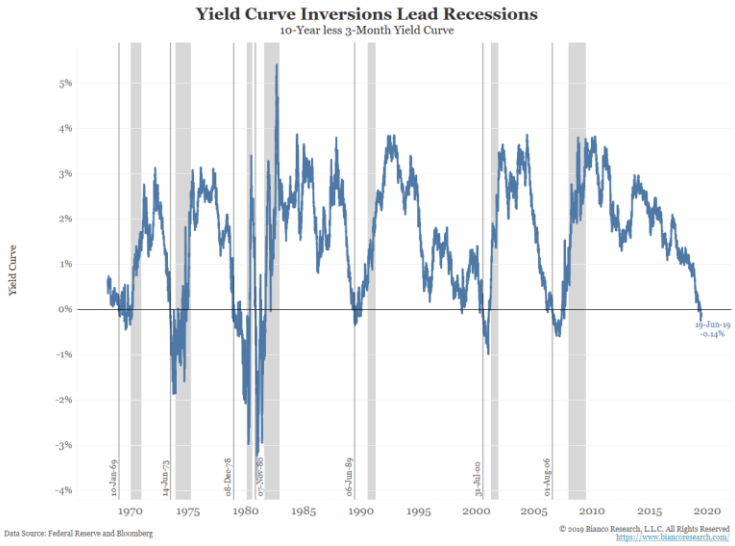
The difference between the respective central bank targets for short-term interest rates is equally dramatic, with the Federal Reserve targeting an overnight lending rate of +2.38%, and the European Central Bank (-0.40%) and Bank of Japan (-0.10%) actually targeting negative overnight lending rates.



At minimum, these comparisons illustrate that the Federal Reserve is much less stimulative than are its foreign counterparts, and when you throw in the fact that most of the domestic yield curve remains inverted (i.e., short-term rates are higher than are longer-term rates), it further suggests that the Fed's monetary policies are currently overly restrictive. If nothing else, this wide divergence in policies has served to significantly increase the value of the U.S. dollar, which diminishes the ability of American manufacturers to be price-competitive against foreign competition.

As such, there is certainly an argument for the Fed to cut short-term rates and to move forward with the scheduled September end of quantitative tightening (the shrinking the Fed's balance sheet), if for no other reason than to bring U.S. monetary policy more in line with the rest of the world.

A second justification for the Fed adopting a more dovish set of monetary policies is because so many forward-looking economic indicators are starting to flash yellow warning signs. These start with the very fact that the yield curve inversion is now well established, which has historically been an almost infallible indication of an impending recession, and continue with an array of "soft" or survey-based data in general, and the surveys of corporate executives in particular.



The issues associated with the inverted yield curve are illustrated in the graphics immediately above and below.

When the blue line falls below 0%, it means that short-term rates are higher than long-term rates (an inverted yield curve), which has historically been very problematic for the economy, as it has regularly not only effectively predicted recessions (indicated by gray vertical lines), but actually helped to cause them.

To explain, banks borrow money from depositors at short-term rates and then lend the money to borrowers at intermediate or long-term rates. When it cost banks more to borrow money than they can make by lending it, banks have no incentive to lend. As such, financial liquidity becomes severely restricted and the economy grinds to a halt. The longer that the curve stays inverted, the more damage that it causes. Data from Bianco Research suggests that ten consecutive days of inversion seems to be an important benchmark, as yield curves have historically remained inverted once they have been inverted for at least ten straight days, as is presently the case.

How Long Until The Recession?

When the 3M/10Yr Curve Inverts For **10 Consecutive Trading Days**

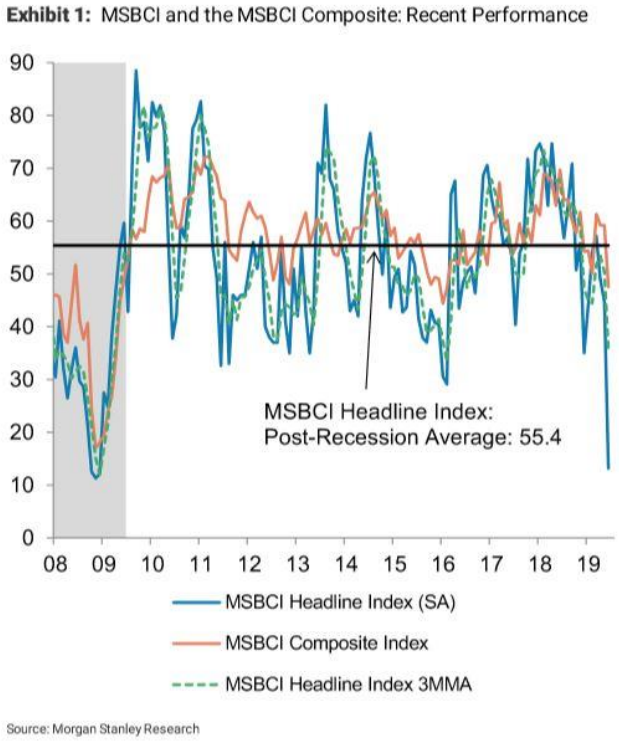
Date of Inversion	Consecutive Trading Days Inverted	Date of Next Recession	Calendar Days to Next Recession
1/10/1969	24	Dec-69	325
6/14/1973	177	Nov-73	140
12/8/1978	91	Jan-80	389
11/7/1980	102	Jul-81	236
6/6/1989	30	Jul-90	390
7/31/2000	135	Mar-01	213
8/1/2006	217	Dec-07	487
6/20/2019	16	????	????
Average	**111**		**311**

1/10/1969 = inverted for 24 calendar days, went positive for 33 days, then inverted again for 53 days
6/6/1989 = inverted for 30 calendar days, went postive for 9 days, inverted again for for 26 days

As you can see, the lag between an inversion and the impending recession varies greatly, but has averaged 311 days over the course of the past fifty years. Since a Fed decision to cut short-term lending rates (and particularly multiple cuts) should push short-term rates lower across the economy and start to normalize (un-invert) the yield curve, thus helping to facilitate lending activity, this is yet another justification for rate cuts, despite the fact that current economic data continues to look quite healthy.

What looks considerably less solid are the leading indicators of economic growth on a global basis. Indeed, the Organization of Economic Cooperation and Development's Composite of Leading Indicators just fell for a 17th straight month with 92% of the 37 member countries reporting leading economic indicators at weaker than year-ago levels.

Sentiment in the business sector is equally downbeat, with the Morgan Stanley Business Conditions Index just suffering its biggest monthly drop in history, and its lowest overall reading since the Great Recession, and surveys of corporate executives turning increasingly negative.

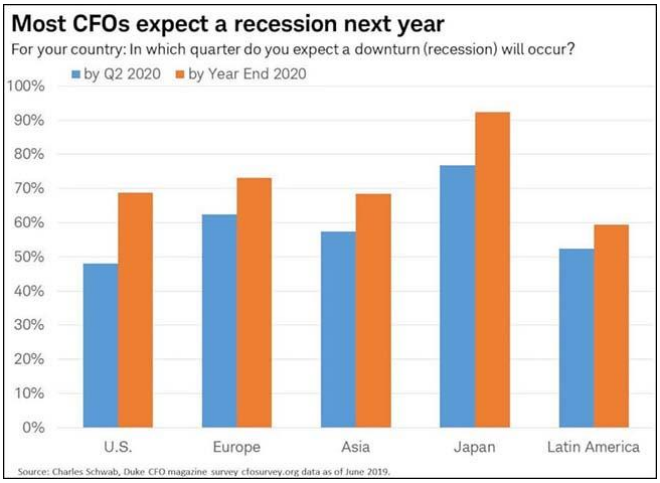


The just-released Duke University/CFO Global Business Outlook survey showed that 48.1% of Chief Financial Officers now expect a recession by the second quarter of 2020, and 69% expect for a recession to begin before the end of 2020.

The latest Business Roundtable Economic Outlook survey revealed a very similar sentiment, as did the National Association of Business Economists survey.

In the current monetary policy environment, the potential for a recession, while always an important consideration, takes on an extraordinary importance on two levels. The first is in regard to the equity markets, and the fact that "insurance cuts" on the part of the Fed, which successfully keep the economy out of recession, have historically been very bullish for equities, while easing cycles when recessions are not successfully avoided have produced a very different outcome.

According to Gluskin Sheff, since the 1980s, rate cuts have generally been quite bullish for equities, with the year after the first rate cut averaging equity market returns of +9.5%, and the year after the last rate cut averaging returns of +22%. However, if a recession ensues, the S&P 500 Index actually averages a loss of -7.2% in the year after the first rate cut.



Barclays performed a similar analysis, and determined that the S&P 500 averages a gain of more than +21% when the Fed employs "insurance cuts" to successfully keep a soft patch in the economy from turning into a recession, but loses -17% if a recession is not avoided.

The second reason for the currently outsized importance of avoiding a recession was alluded to previously, which is that the Fed (i.e., the cavalry) is engaging in this battle with a quite limited supply of ammunition.

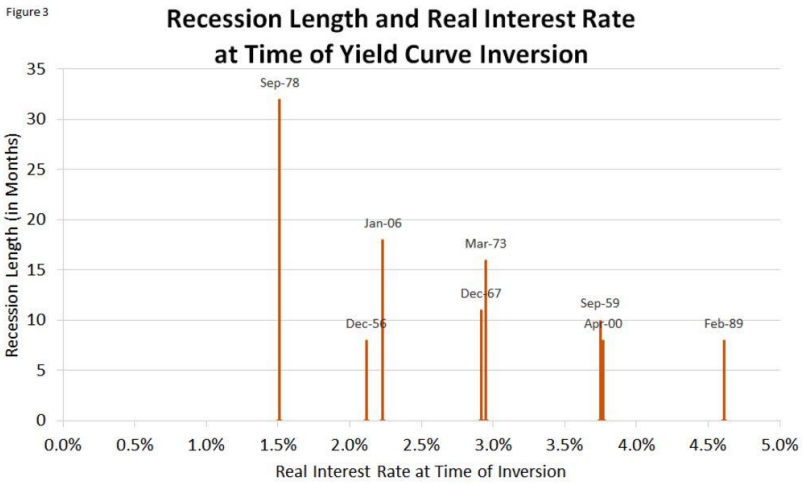
It is with this in mind that we believe that the single most critical question is whether the anticipated easing will be the first of several "insurance cuts", like in 1995-1996 and 1998, where a recession is successfully averted, or the start of a full-blown easing cycle, in response to a recession.

Table 1: Summary statistics for recent Fed rate cutting cycles

Cycle	Reason	FF Start (%)	FF End (%)	Total Cuts (bps)	Cuts in First Month (bps)	Cuts in First Year (bps)	Cycle Length (Months)
'89-'92	Recession	9.75	3.00	-675	-50	-150	40
'95-'96	Inflation	6.00	5.25	-75	-25	-75	7
'98	Market	5.50	4.75	-75	-50	-75	2
'01-'02	Recession	6.50	1.00	-550	-50	-475	11
'07-'08	Recession	5.25	0.25	-500	-50	-325	15

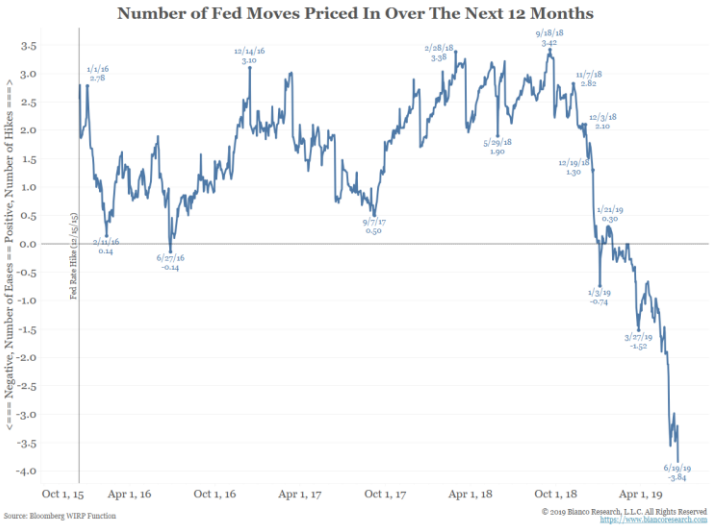
Source: BofA Merrill Lynch Global Research, Bloomberg

If the later, then the Federal Reserve faces a difficult task, as it has, in modern history, needed to cut rates by between 500 basis points (5.0%) and 675 basis points (6.75%) in order to successfully stimulate the economy out of recession. This time, with the Fed Funds rate at only 2.5%, the Fed only has 250 basis points to work with.



NOTES: The date above each bar is the date of the yield curve inversion. The interest rate used is the yield on the 10-year Treasury note, converted to real terms. For the severity of the recession, we used the duration measured in months.
SOURCES: National Bureau of Economic Research, Bureau of Labor Statistics, Federal Reserve Board of Governors and the Federal Reserve Bank of Philadelphia.

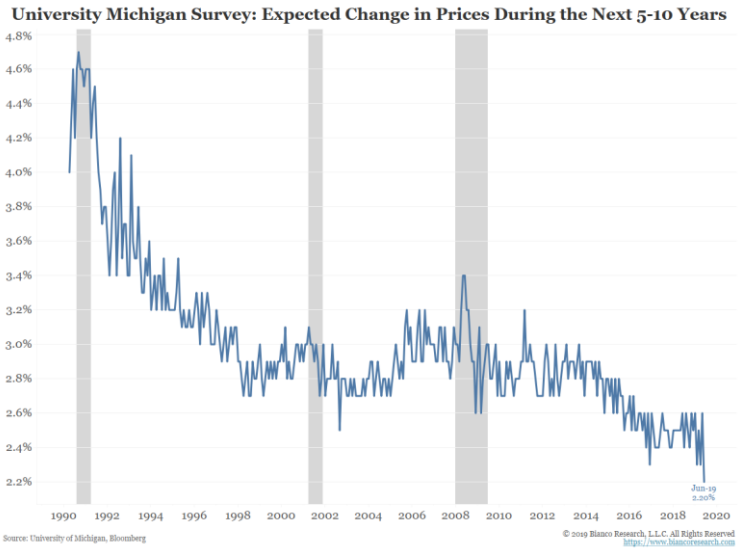
In light of this dynamic, it should be no surprise that recessions that start when rates are already low, as they are now, tend to last much longer, as the Fed simply does not have sufficient firepower to deal with them aggressively.



Of note, current expectations are that the Fed will stimulate very aggressively this time, with 3.84 rate cuts (almost 100 basis points of interest rate cuts within the next 12 months) already priced into the futures markets.

We view such aggressive expectations as a source of risk for equity investors, as it suggests that most bullish, potential rate-cut-related news is already discounted into stock prices, thus potentially leaving relatively little room for further appreciation and significant room for disappointment, if the Fed lowers rates less aggressively than expected.

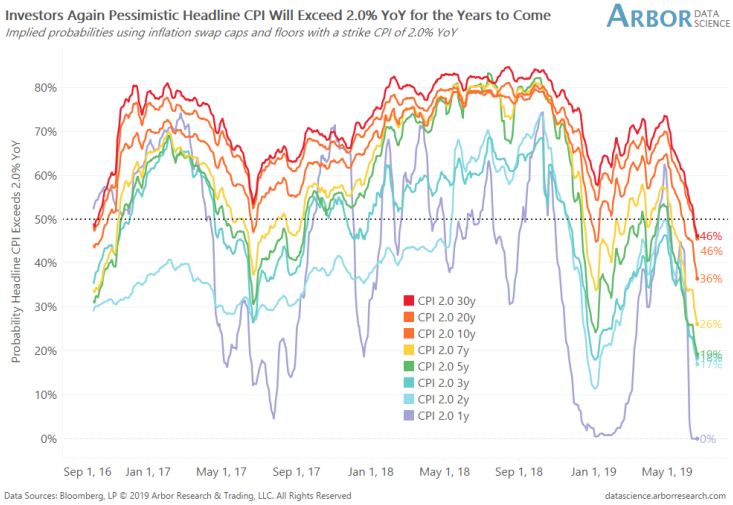
Trade plays an incredibly important role as well, as we believe that, if tariffs are imposed on the remaining $320 billion of Chinese imports, the chances and proximity of recession will increase exponentially. By the same token, on the off chance that China and the U.S. do make significant headway in negotiating a trade deal, we suspect that it will greatly reduce the scope and perhaps even the likelihood of Fed rate cuts.



This perspective was just reinforced by Fed Chairman Powell, who noted in his June 19th press conference that what happens in regard to the trade war is "central to the change in the outlook" and that "it's really trade developments and concerns about global growth that are on our minds".

Just as we are concerned that the markets may be pricing in too much good news in terms of rate cuts, we are also concerned that investors are overly optimistic in regards to the prospect for a successful trade deal between China and the United States, at least over the immediate future.

One further factor that we would be remiss if we did not address, and which may be a major, albeit largely unspoken, motivation for the Fed moving towards monetary stimulus is the growing perspective that inflation is not only non-existent now, but that its return is unlikely at any time in the foreseeable future.



This is reflected in inflation data all over the world, and most recently reinforced by the University of Michigan Long-Term Inflation Survey, which reflects the lowest inflationary expectation for the next five-to-ten years (2.2%) in the history of the survey. Moreover, the options markets are pricing in less than a 50% chance that inflation will exceed 2% for the next thirty years.

While this may sound great from a consumer's perspective, this virtual lack of inflation, either current or expected, is a point of growing concern for the Federal Reserve, which is increasingly worried that current American disinflation could morph into actual deflation (falling prices), as was the case in Europe five years ago and in Japan intermittently over the past several decades. The bond markets certainly seem to be sniffing out signs of deflation, as global bonds have just experienced their biggest inflows in more than four years.

The Federal Reserve would almost certainly prefer to hold its rate cuts in reserve, and just "jawbone" the markets into doing their bidding. However, with the markets currently discounting a 100% probability of a July rate cut, the Fed will likely be careful not to shock the markets, and will thus either lower rates in July as expected, or start guiding the markets to expect a different outcome well in advance of that July meeting.

With such dovish expectations for interest rates already built into equity prices, it is hard to imagine the Fed surprising investors with better-than-expected news, which is ultimately what moves equity prices higher. The one exception to that might be a larger-than-expected fifty basis point (0.50%) cut in July, which we do think is a real possibility, and which would provide a positive surprise, as markets are currently only assigning it a 22% likelihood.

In the interim, equity prices seem to have priced-in a great deal of bullish news, without necessarily having taken into account many of the potential risks associated with the trade conflict, the slowing global economy, Iran, and potentially undesirably low levels of inflation. While experience teaches that you should "never fight the Fed", and while there is every possibility that the "cavalry" rides in with enough ammunition to, once again, "save the day", we remain somewhat concerned about the equity market's current risk versus return potential, and that still keeps us somewhat cautious over the immediate term.

The Standard & Poor's 500 (S&P 500) is an unmanaged group of securities considered to be representative of the stock market in general. It is a market-value-weighted index with each stock's weight in the index proportionate to its market value.

The Organization of Economic Cooperation and development's Composite of Leading Indicators is designed to provide early signals of turning points in business cycles showing fluctuation of the economic activity around

its long-term potential lever. CLI's shows short-term economic movements in qualitative rather than quantitative terms.

Past performance is no guarantee of future results. The investment return and principal value of an investment will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost. Current performance may be lower or higher than the performance quoted.