Volume 105

THE PER STIRLING CAPITAL OUTLOOK

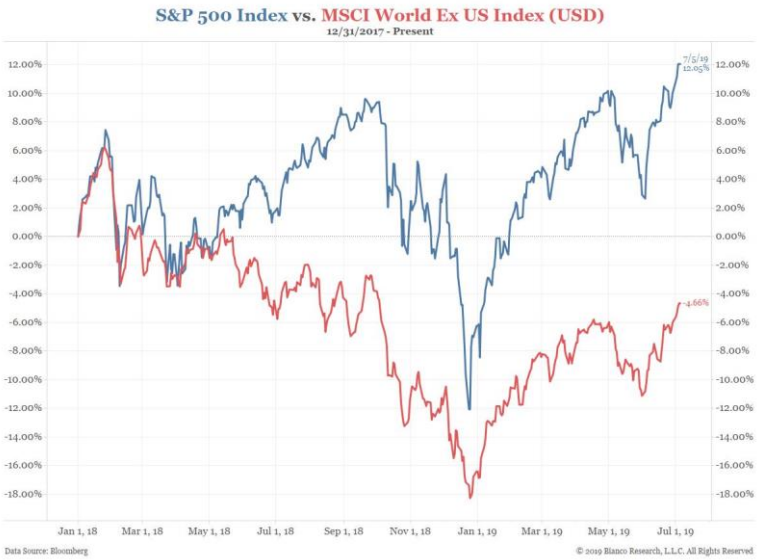
Performance • Perspective • Per Stirling

July 2019

A Wall Street analyst recently referred, in a CNBC interview, to the current stock market as a "wild west market" due to his reasonable observation that investors are ignoring the world's many risks and are "throwing caution to the wind". However, while we believe that he makes a valid point, we think that it is even better defined as a "Mae West market", as we believe it best described by the screen siren's famous line, "When I'm good, I'm very good, but when I'm bad, I'm better".

For years, the U.S. equity markets have dramatically out-performed their foreign peers largely because of the domestic economy having superior economic and regulatory/legislative fundamentals. Domestic factors like tax policy, earnings, gains in productivity, buoyant credit markets and the levels of consumer spending have been "good" on both a nominal and relative basis and investment returns, in 2019 in particular, have been, almost without regard to asset class, very good.

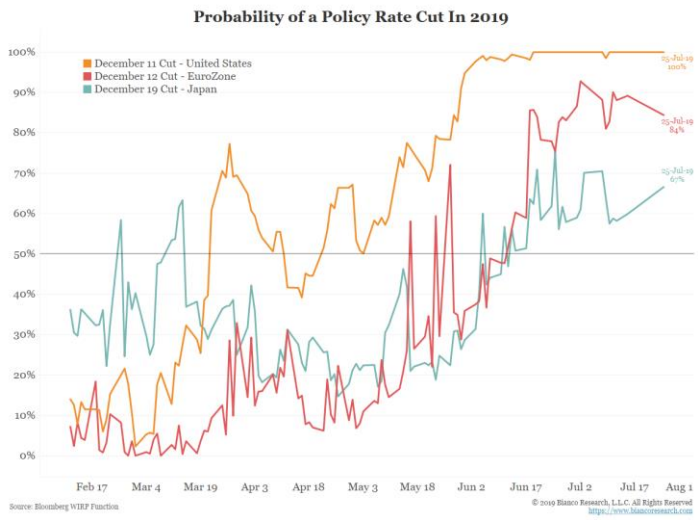
However, while America's fundamental picture still looks good on a relative basis, domestic economic data, corporate earnings, and even corporate buybacks have, over recent months, gone from being strong tailwinds for the equity markets to modest headwinds, while trade uncertainty and a broad deceleration in the global economy is setting the table for a new wave of monetary stimulus from the Fed, the European Central Bank, the Bank of Japan, and even the Bank of China.



This is on top of the recent rate cuts already made by the central banks of Australia, New Zealand, South Korea, Indonesia, and India, and in addition to the ongoing stimulus being maintained in Europe, Japan, and China.

The world's central banks are increasingly returning to the same remedies that they used to lift the global economy out of the Great Recession, and they are doing so in response to a slowing global economic expansion that is very long-in-the-tooth, and which has a variety of ailments, including a likely bubble in corporate credit, which will almost certainly be greatly exacerbated by any significant slowdown.

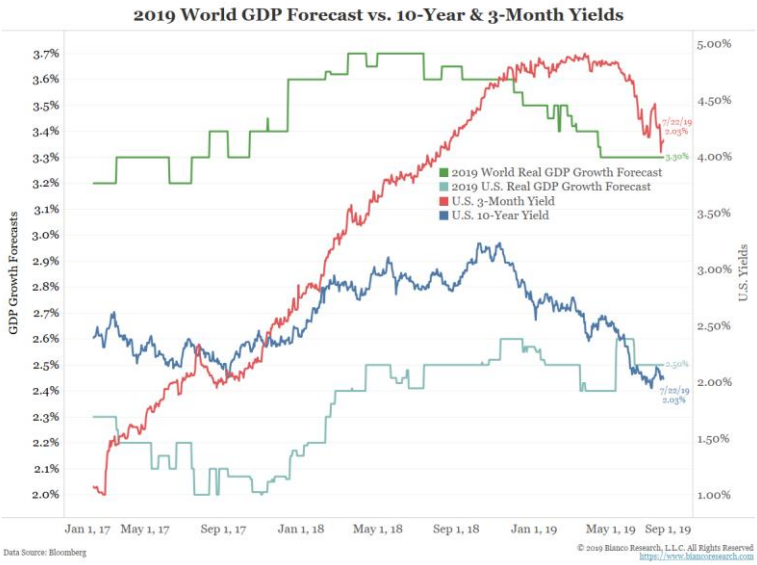
Regardless, the equity markets continue to behave like a patient that is so addicted to a drug (central bank stimulus) that they would rather be sick and keep receiving the drug than to be healthy and not need it.



This phenomenon manifested itself yet again in early July, when stock prices fell sharply on news of much stronger than expected job growth, as it was perceived as diminishing the prospects for aggressive monetary stimulus, and yet hit an all-time high when Fed Chairman Powell noted on July 10th his increasingly dire opinion that, "uncertainties and downside risks surrounding the economic outlook had increased significantly over recent weeks. While they (i.e. Fed members) continued to view a sustained expansion of economic activity, strong labor market conditions, and inflation near the Committee's symmetric 2 percent objective as the most likely outcomes, many participants (i.e. Fed members) attached significant odds to scenarios with less favorable outcomes."

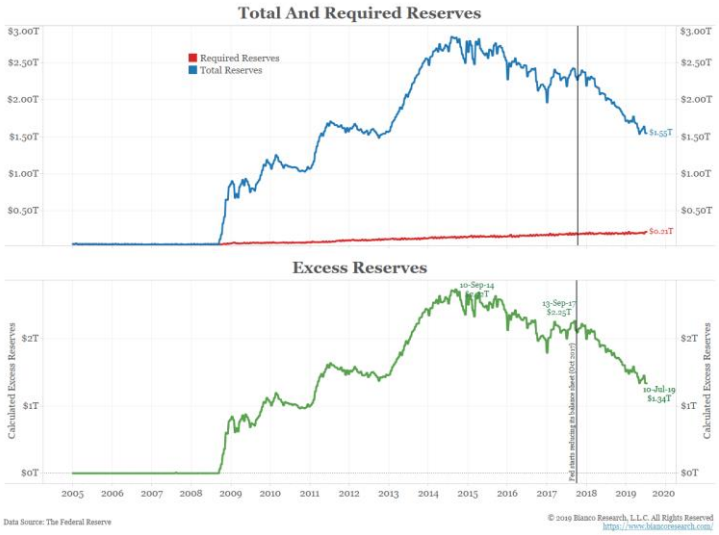
Welcome to the world of "bad news is good news" (a.k.a. "but when I'm bad, I'm better").

Ironically, we would suggest that investors may be worrying unduly that the relative health of the U.S. economy may keep the Fed from easing fairly aggressively, as Chairman Powell has recently made it very clear that "trade developments and concerns about global growth" were the primary catalysts for the Fed's dramatic shift towards easier monetary policy. Indeed, it is not just short-term rates being so affected by these concerns, as evidenced by the fact that U.S. 10-year Treasury yields are tracking trends in global economic data much more closely than they are trends in domestic economic data.



The anticipated stimulus will almost certainly include both lower interest rates and the reintroduction of extraordinary measures like quantitative easing, although we suspect that it will look quite different next time, with a much more direct impact on the economy, and a more populist approach. For example, the Fed may potentially use credit creation to retire student loan debt rather than for purchasing debt securities, as they did during the financial crisis.

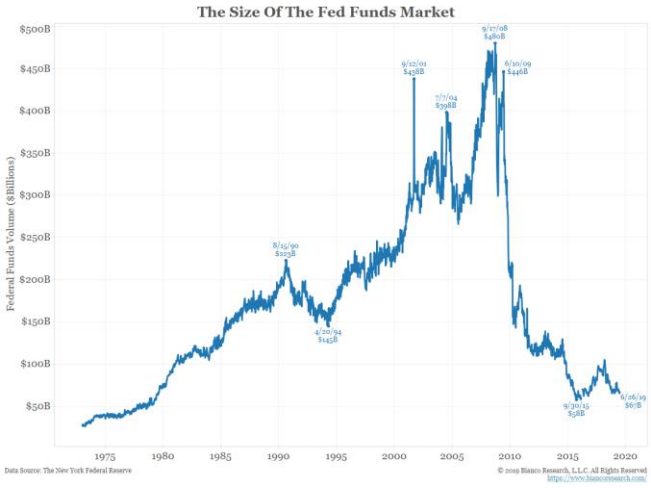
Indeed, we suspect that the next iteration of stimulus will likely include the introduction of monetary policies and tools that the U.S., in particular, has never employed before, like abandoning the use of the Fed Funds Rate as their primary monetary policy tool, and replacing it with the interest rate that the Fed pays on excess bank reserves that banks elect to leave on deposit at the Fed.



At present, banks get paid 2.35% interest (risk-free) on money that they voluntarily leave on deposit at the Fed, which is not only well higher than their cost of capital (checking and savings account rates), but also well higher than even the 10-year Treasury note.

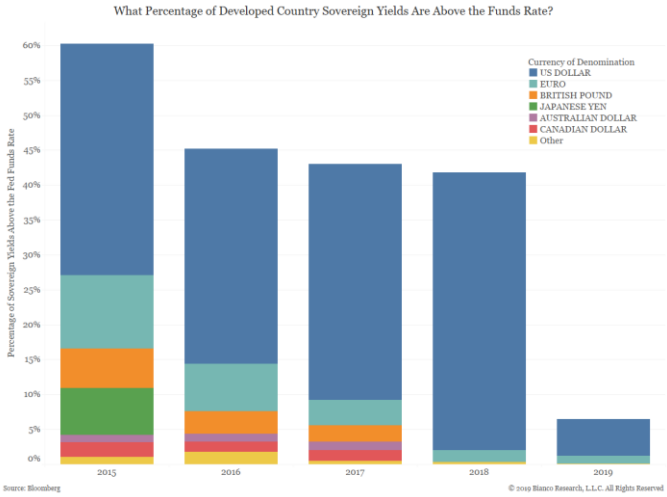
As such, and with long-term rates so low, banks have little incentive to put money at risk by lending it out and, as a result, there is more than a trillion dollars of potential lending power that is sitting unproductively on deposit at the Fed, much of which would likely be invested into the economy, if the Fed was paying a less lucrative rate. You will note that the nominal level of excess reserves had actually been more than twice as large, but has been drawn down as a result of quantitative tightening and a modest increase in lending activity. However, quantitative tightening (the shrinking of the Fed's balance sheet) is scheduled to end in September, which should slow that drawdown dramatically.

Further, with banks still so overly-reserved as a result of quantitative easing, there is almost no demand for overnight bank-to-bank loans, which utilize the Fed Funds Rate. As such, the Fed's traditional tool for adjusting economic growth is becoming antiquated. At the same time, you can see how the interest paid on excess bank reserves could serve as a very effective replacement.



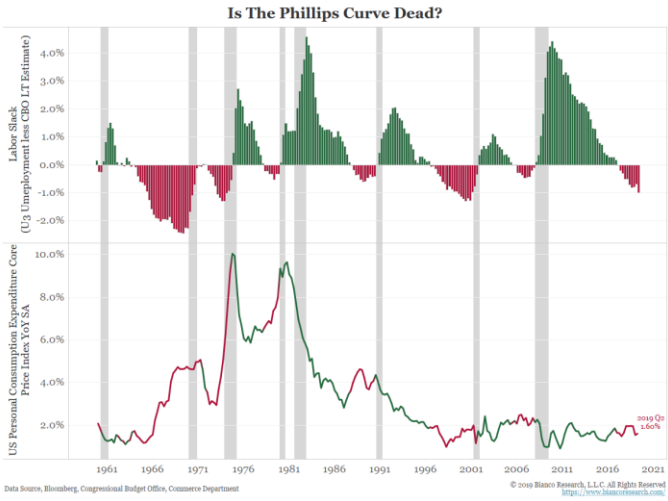
Where this all becomes relevant to an investor is that it is indicative of the ways in which the rules and relationships that investors have traditionally relied upon are going to need to change in a world where 23% of all global debt has a negative nominal yield (including 20% of all global sovereign debt), where the Bank of Japan owns 43% of Japanese government debt and 80% of the value of Japanese equity ETFs, and where the Fed is due to confront the next domestic recession with its primary adjustment tool on the verge of obsolescence, and a Fed Funds Rate of only 2.5%, whereas it has historically taken rate cuts of between 5% and 6.5% to stimulate the U.S. economy out of recession.

Indeed, to gain some appreciation for just how bizarre the current global interest rate scenario is, as recently as 2015, over 60% of the sovereign debt in the world yielded more than the Fed Funds Rate. Now only about 7% of global sovereign debt (of all maturities) yields more than the Fed Funds Rate, which is an ultra-short (overnight) loan rate. Further, 90% of all of the bonds in the world yield less than their respective inflation rates and some European junk bonds are even starting to trade with negative yields.



Perhaps most remarkable of all is the statement made by Fed Chairman Powell on July 11th, when he proclaimed that the Phillips Curve (the long-held and core economic theory that there exists an inverse relationship between the unemployment rate and the rate of inflation) is dead. Specifically, he stated that "The relationship between the slack in the economy or unemployment and inflation was a strong one fifty years ago ... and has gone away." Powell reaffirmed this belief during his testimony in front of the Senate Banking Committee when he noted that the strong correlation between unemployment and inflation "has become weaker and weaker and weaker" over the past twenty years.

This creates a fascinating dilemma for the Fed, as the dual mandate given to them by Congress, is to "promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates". This obviously assumes a trade-off between full employment and inflation that they are called upon to find the golden mean between.



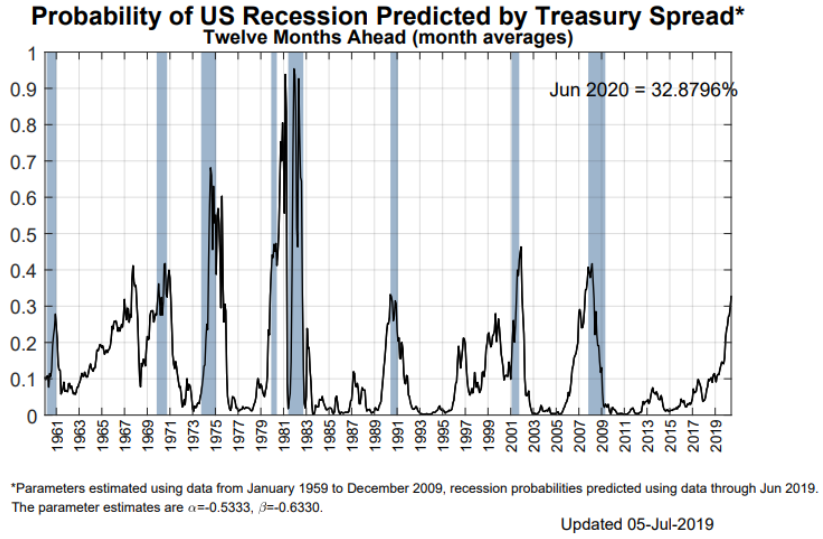
However, Powell has just acknowledged that the trade-off no longer exists, which essentially casts asunder the Fed's mandate from Congress. If the Phillips Curve is obsolete, what are the implications for how the Fed will operate in the future, since they theoretically no longer need to strike a balance between maximum employment and stable prices?

If that does not introduce enough uncertainty, Fed Chairman Powell made an amazing admission on July 11th that potentially has far-reaching implications for future Fed policy when he said that, "we are learning that the neutral interest rate (i.e., the interest rate that is neither stimulative nor restrictive) is lower than we had thought and ... the natural rate of unemployment is lower than we thought. So monetary policy hasn't been as accommodative as we had thought." Talk about a massive *mea culpa*!

One of the other things that we found particularly interesting about the press release issued after the July Fed meeting was their statement that, "downside risks to the outlook for economic activity had risen materially since their (the Fed's) May meeting." In other words, the Fed's perspective is that the macroeconomic risks that they are worried about are a fairly new phenomenon, despite all of the evidence to the contrary.

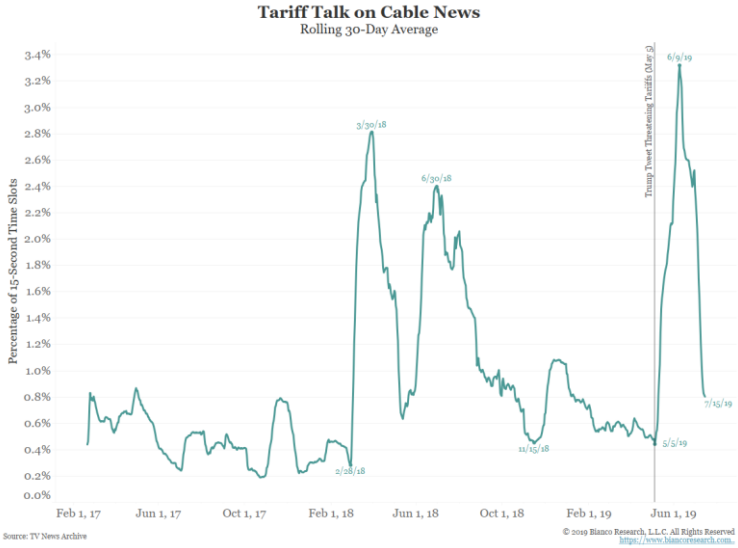
Nonetheless, the very statement that risks had "risen materially" since the May meeting raises a potentially very important question, which is whether this is simply the Fed's effort to save face and excuse the growing possibility that they have been so committed to the normalization of monetary policy (a very admirable goal) that they underestimated the impact that the global slowdown and ongoing trade frictions were having (and continue to have) on the U.S. economy, or if they instead do, in fact, perceive new and additional risks on the horizon that are not yet reflected in financial market prices.

The Fed could also be accused of ignoring the signals being sent by the inverted yield curve (short-term rates being higher than long-term rates), which has long been acknowledged as both a predictor of and catalyst for recessions. The Fed can be excused for believing that the message of the yield curve was likely not as dependable this time, as it was being so distorted by negative interest rates in Japan and Europe, quantitative easing, and "Operation Twist". Indeed, they are probably right, as "Operation Twist" alone (when the Fed sold long-term debt from their balance sheet and replaced it with short and intermediate-term debt) lowered long-term rates by one full percentage point relative to short-term rates.



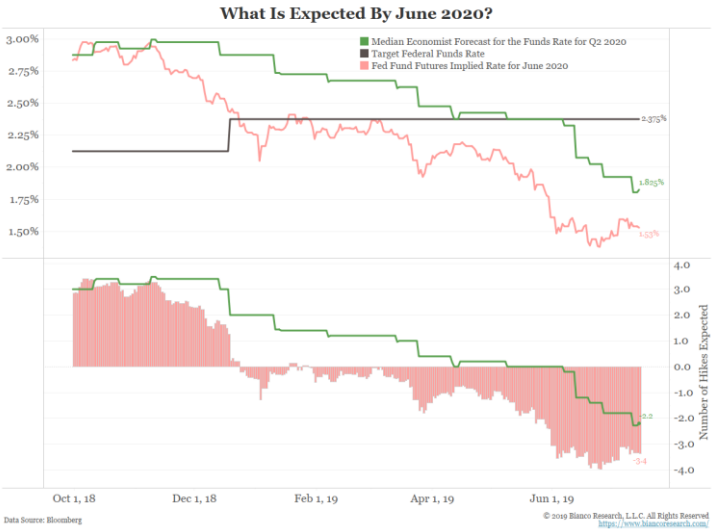
However, they also seem to have underestimated the causational effects of an inverted yield curve, which makes it unprofitable for banks to lend into the economy, and perhaps even imprudent for them to do so, when they can sit around all day paying a national average of less than 0.2% on checking and money market deposits, and depositing those funds at the Fed where they earn a risk-free 2.35%. This dynamic largely explains the massive levels of excess reserves on deposit at the Fed, while the inverted yield curve helps to explain the current 12-year high in the New York Fed's recession probability model.

In regard to trade, with no deadlines coming out of the G-20 meeting, and thus neither immediate expectations for progress nor current threats of increased tariffs, the trade war seems to have, at least temporarily, fallen off of everyone's radar (even Wall Street's).



However, it is not likely to stay off of the radar for long, and its long run impact is likely to be immense. Indeed, according to J.P. Morgan's chief equity strategist Dubravko Lakos-Bujas, the outcome of the U.S./China trade war could move the S&P 500 Index, which currently trades at a value of 2,985, by as much as 800 points in either direction.

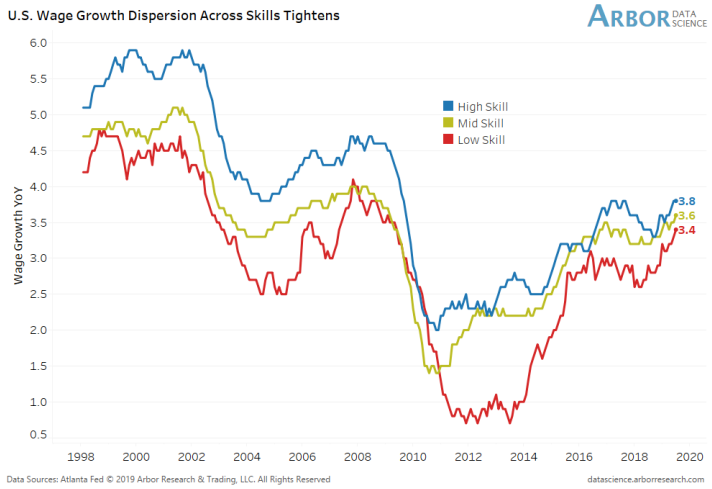
While we still see almost no prospect of a resolution over the foreseeable future, that is not to suggest that the trade conflict is not having a negative impact on the Chinese economy, which just reported its lowest growth rate in 27 years. The problem is that it is also slowing the entire global economy, including the U.S. The longer that the conflict lasts, the more damage that it will do to the global economy. The same is true of the current yield curve inversion. The longer that short-term rates remain higher than longer-term rates, the more damage that it will do to the domestic economy (only the U.S. has an inverted yield curve).



Further complicating matters is the fact that, between the liquidity that the Federal Reserve withdrew from the economy through quantitative tightening and their nine interest rates hikes, the Fed has tightened (according to research from Gluskin Sheff) the equivalent of a massive 4%. Moreover, because there has historically been a lag time of between 12 and 18 months between a policy adjustment and its impact on the real economy, much of the 4% tightening is likely still months away from having its full drag on economic growth.

However, before one gets too gloomy, we still see four significant bullish influences that should help to buoy domestic stocks. First of all, there is every indication that the Fed is about to join in with the world's other major central banks in the reintroduction of massive monetary stimulus. We will come back to this in a minute.

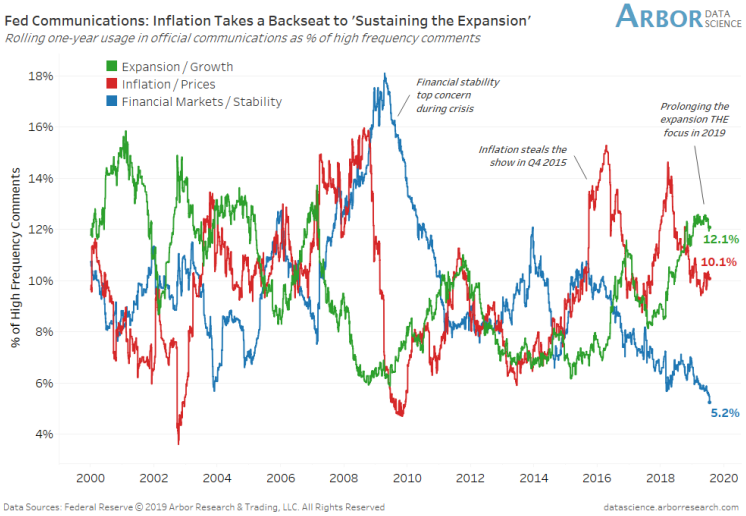
The second support is the amazingly resilient American consumer, who accounts for approximately 70% of the U.S. economy, and who is benefitting from both full employment and accelerating wage growth.



Third, is the fact that earnings expectations have been beaten down so severely that, of the 15% of companies that have reported second quarter earnings thus far, 78.5% have exceeded lowered expectations.

The fourth support is that the domestic stock market is benefitting from a sort of "Goldilocks" scenario in that equity prices are profiting from expectations for monetary stimulus in the form of rate cuts, but not suffering from substantial economic slowing (as would normally be the case during a rate cutting phase), as the weakness that the Fed is expected to respond to is still, at this point, primarily found overseas.

We are expecting relatively aggressive monetary policy stimulus from the Fed for a variety of reasons, starting with the fact that other countries have made it clear that they will be cutting rates, which should further depress longer-term domestic interest rates and, by doing so, further invert the U.S. yield curve. If anything, the Fed may be forced to be even more aggressive in their stimulus than their foreign counterparts, and this expectation is being reinforced by all three of the Fed's most important members, including Chairman Powell, whose dovish statements we quoted above, and who has made no attempt to guide the markets away from their expectations for very aggressive easing.



In addition, influential New York Fed President John Williams just gave a speech titled Living Life Near the ZLB (zero lower bound or 0%) in which he said, "don't keep your powder dry—that is, move more quickly to add monetary stimulus than you otherwise might. When the ZLB is nowhere in view, one can afford to move slowly and take a "wait and see" approach to gain additional clarity about potentially adverse economic developments. But not when interest rates are in the vicinity of the ZLB (as is the case today). In that case, you want to do the opposite, and vaccinate against further ills. When you only have so much stimulus at your disposal, it pays to act quickly to lower rates at the first sign of economic distress."

This view was even further reinforced by Fed Vice-Chairman Richard Clarida, who just proclaimed in an interview on FOX that, "You don't need to wait until things get so bad to have a dramatic series of rate cuts". Of important note, "dramatic" is not the kind of word that the Fed has historically used lightly. Taken together, Fed guidance strongly suggests that it, and the world's other major central banks, are about to enter the fray with both monetary guns blazing, although that does not necessarily portend a full half-point cut at the end of the month.

At the same time, we find it noteworthy that, despite monetary policy guidance being as dovish as any in recent memory, the S&P 500 Index hit a new all-time high only to almost immediately run out of fuel. If there ever was a sign that most of the good news regarding the change in Fed policy is already priced in, this must almost certainly be it.

Ultimately, while we believe that central bank accommodation is a bullish factor for equities, we view it more as a safety net rather than a reason for a new move to substantially higher prices. Rate cuts can help to normalize the yield curve, which will help to alleviate one of the drags on the domestic economy. However, with rates already so low, it is hard to imagine much additional demand for credit being generated by even lower rates. If anything, that is the lesson taken from negative rates in Europe and Japan.

In regard to the two other major challenges, global economic slowing and ongoing trade conflicts, the Fed may ultimately be keeping its fingers crossed that lower rates can sustain the domestic economy long enough to see a successful conclusion of a U.S./China trade deal and some semblance of an economic rebound overseas.

We remain cautiously bullish because of our expectations for central bank stimulus, but expect for the next few years to be very interesting, as the whole world becomes increasingly dependent on the central banks, but at a time when the central banks are still trying to figure out the ground rules for the new monetary world order.