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THE PER STIRLING CAPITAL OUTLOOK

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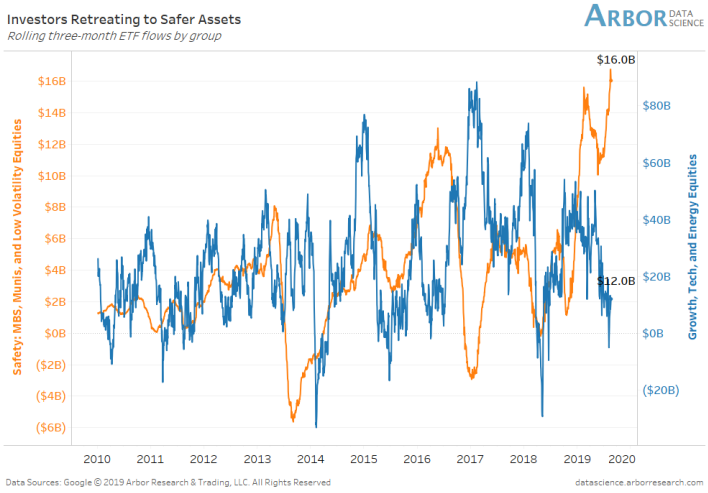
There is an old saying in the sport of boxing that you don't need to worry about the punches that you can see, as you can prepare for them. Instead, it's the punch you don't see coming that knocks you out. In some regards, the capital markets work in much the same way. Markets are discounting mechanisms that, when they work properly, identify virtually all factors that can impact the future value of securities, and price in those factors well in advance of the changes actually manifesting themselves.

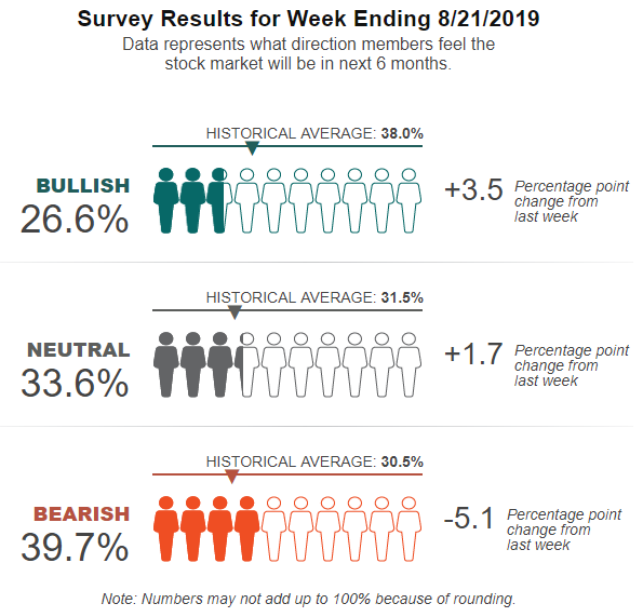
There have certainly been numerous times throughout history when investors have been confronted with a variety of negative macroeconomic factors that were, on their own, as bad or worse than any of the potentially negative factors faced by investors in the current environment. At the same time, it is hard to imagine any time in history when there has existed such a wide array of obvious and potentially very negative macroeconomic fundamentals (i.e. potential punches) as investors face today which, from a contrarian perspective, could arguably (or at least potentially) be quite bullish.

You need look no further than the front page of the newspaper, where you will find a global manufacturing recession, Iran's attacks against commercial shipping, North Korean missiles, Brexit, a potential clash between India and Pakistan (both nuclear powers) over Kashmir, political unrest (take your pick of Italy, Argentina or Venezuela), growing potential for the return to a very anti-business/anti-investor political agenda in the U.S., and a growing trade conflict between Japan and South Korea.



That list does not even include many of the potentially most dangerous risks to the capital markets, such as the ongoing rioting in Hong Kong, the likelihood of a continuing escalation in the U.S./China trade conflict (and the potential for it to morph into an even more damaging currency war), an inverted yield curve, a trend towards negative interest rates overseas, and the potential failure to pass the USMCA agreement (the replacement for NAFTA), which could snarl supply chains throughout Mexico, the U.S. and Canada. It's like Randall "Tex" Cobb said when asked for his impressions of his lopsided loss to heavyweight world champion Larry Holmes. Cobb replied, "I didn't think his hands could take the abuse."

Fortunately, investors have an advantage that Randall "Tex" Cobb apparently did not. Each of the aforementioned risk factors are already "known knowns". In other words, these are the punches that are so obvious that all investors should be seeing them and, according to market theory, they are therefore not the punches that investors need to worry unduly about, as markets are being provided with more-than-ample opportunities to discount any potential negative impacts into prices.



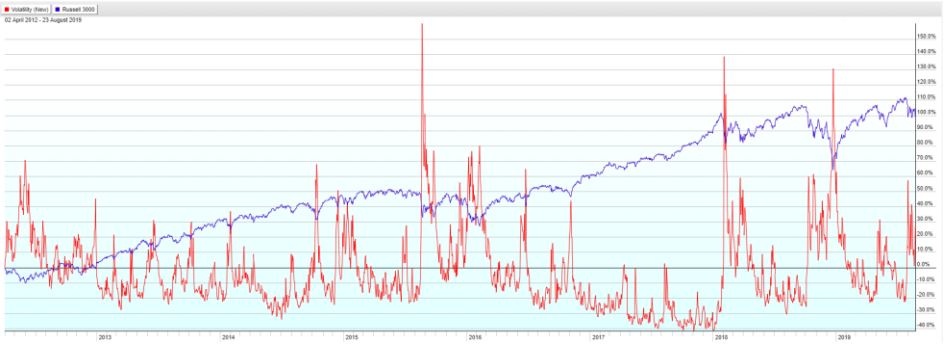
If anything, history strongly suggests that the very existence of such an extensive list of negatives may actually be quite bullish for equity markets, as it builds a very tall "wall of worry", which describes the sum total of fears that are causing investors to either sell securities or stay on the sidelines. Each negative factor is another brick in that wall and, in theory, the taller the wall, the larger the amount of cash that is sitting on the sidelines, and is thus available to ultimately fuel the market's next advance.

To illustrate the point, the latest American Association of Individual Investors survey of investor sentiment reveals very high levels of investor fear and pessimism, which is almost certainly a manifestation of the aforementioned "wall of worry". If 40% of this 150,000-member representative group (a good proxy for individual investors) believes that the stock market will be lower six months from now, there is a significant likelihood that many individual investors have already sold as many of their equities as they are likely to sell, which is the type of activity normally seen at market lows rather than market highs.

Indeed, the potentially bullish implications of such a substantial "wall of worry" are not limited to the build-up of sideline cash as, when fundamental changes are efficiently recognized by markets in advance, investors tend to "buy the rumor and sell the fact", or vice-versa. In other words, investors frequently, as an example, sell stocks on anticipation of "bad" news only to buy them back once the "bad" news actually comes to pass.

To paraphrase legendary investor Sir John Templeton: "Bull markets begin in despair, grow on pessimism, mature on optimism and die in euphoria".

History clearly suggests that optimal buying opportunities occur at the point of maximum pessimism, and that the existence of such a tall "wall of worry" should be very bullish, assuming that the markets are doing their job properly by discounting these many risks into current market prices, which is an important point of debate.



You can actually see that inverse relationship between fear and market opportunity displayed graphically through the VIX "fear index", which measures levels of investor fear based upon the price that investors are willing to pay for portfolio protection via the options markets.

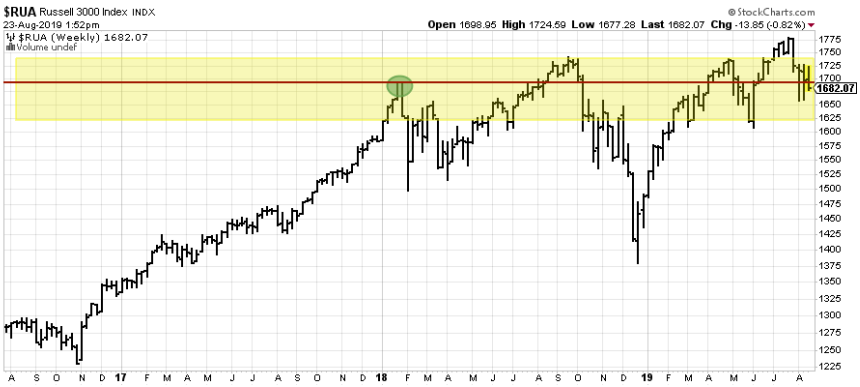
The tight correlation between surges in fear (red line) and lows in the stock market (blue line) are quite evident. However, the chart also illustrates that the fear index currently sits at a level of only 28, which is well below readings normally associated with high levels of investor fear and/or concern, and that is despite the current profusion of potentially bearish macroeconomic and geopolitical influences, which may suggest investor complacency.

That could be a warning sign that the relative stability of the domestic indexes is actually indicative of American investors becoming so inured to the constant stream of one crisis after another that they are just ignoring many of these risks, and are thus not properly discounting these potential negatives into the prices of blue-chip equities in particular.

After all, despite this array of potential concerns, domestic equity markets are down only modestly from all-time highs, and price-to-earnings multiples remain at notably higher than average levels on both a trailing and forward-looking basis. In addition, mutual fund cash levels, while above the 10-year average of 4.6%, are still sitting at only 5.1%, which certainly does not reflect a risk-off mentality.

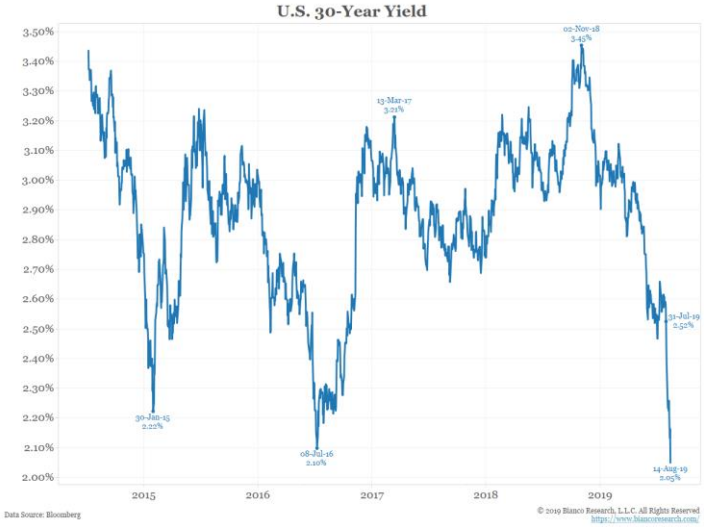
In contrast, if you were to analyze a chart of the world's equity markets excluding the U.S. (as represented by ACWX), you could make a strong argument both that foreign markets are doing a more efficient job of price discovery than are their blue-chip U.S. brethren, and that, as a result, most foreign equity markets actually peaked back in January of 2018, in what we consider to be a textbook capitulation "blow-off top", complete with a significant surge in volume and clear signs of investor euphoria, which usually accompany stock market tops.

Since that time, the domestic blue-chip stock indices have effectively divorced themselves from the downtrend of their foreign counterparts. Even so, a look at the broad U.S. stock market (the Russell 3000 Index) shows that even the relatively-resilient domestic markets have largely been mired in a trading range since that January 2018 peak, and are once again trading below their January 2018 highs. This includes the blue-chip S&P 500 Index, which is now basically unchanged over the past twelve months, and has again fallen below its January 2018 highs.



The declines in most foreign equity markets over the past twenty months, combined with the inability of the domestic markets to make any progress over the same period, lend credence to the idea that investors are at least taking some of these risks into consideration.

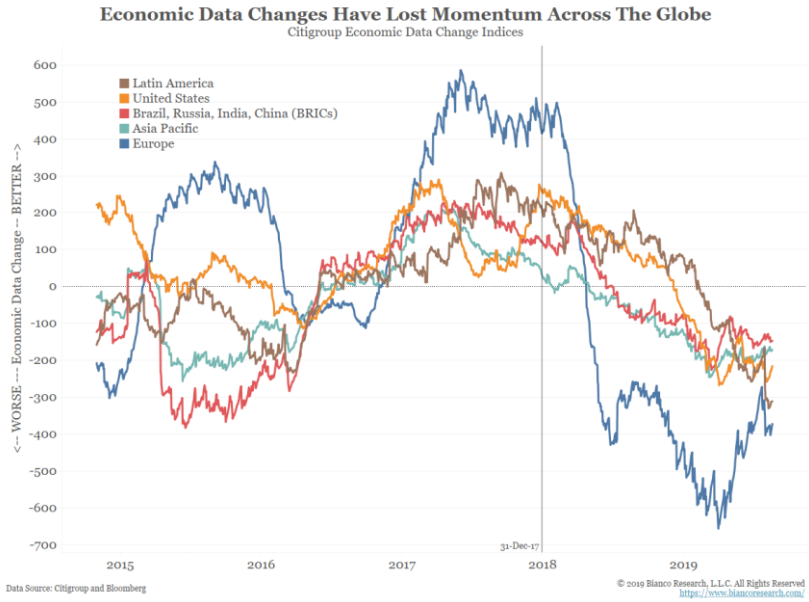
Even so, the different markets are sending divergent messages, and only time will tell who is correct. To look at the domestic "blue chip" benchmark, the S&P 500, you would think that almost all is well with the world. However, smaller domestic stocks (which are now down 16% from their record highs), emerging market stocks, most commodities, developed market foreign stocks, and virtually every bond market in the world are all telling an entirely different story.



They are telling a story of a slowing global economy, and even an increasingly likely global recession. That story is being reinforced by the growing trend towards inverted yield curves (short-term rates being higher than longer-term rates) and one of the fastest declines in longer-term rates in history.

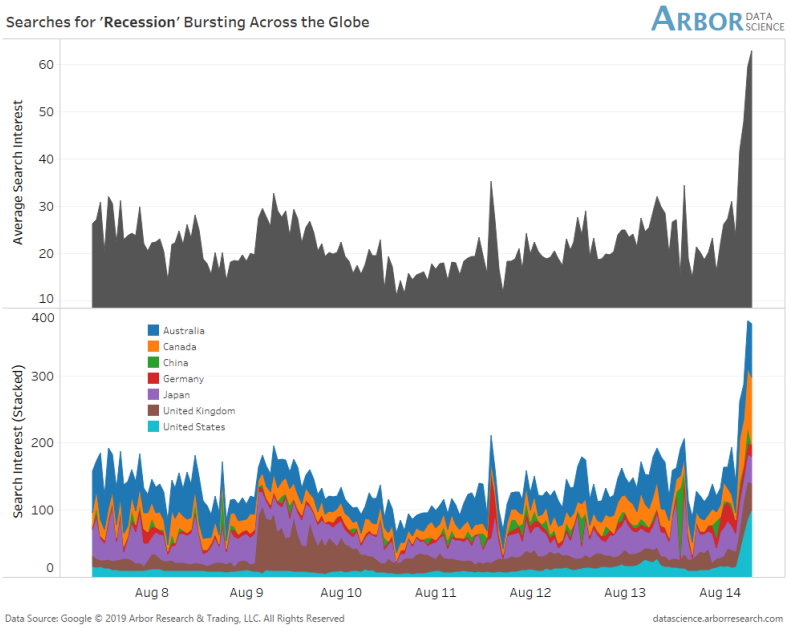
Indeed, if one looks at the data objectively, one could easily conclude that both the global equity markets and the global economy reached their peaks for this cycle some twenty months ago, and that domestic blue-chip stocks have, at least thus far, managed to remain as an outlier from this trend due to a variety of factors ranging from Trump's corporate tax cuts to the fact that the S&P 500 Index offers a higher yield than virtually any bond market in the world. It is also worth noting though, that many of the large U.S. companies whose stocks have led the market over recent years are on the front lines of the U.S./China trade conflict, and could potentially suffer the most damage as a result.

As noted above, the poor overall equity market performance of the past twenty months may itself turn out to be a modestly bullish factor, as it indicates that markets are processing at least some of these potential negatives (seeing the punches), which diminishes the risk of a "black swan event".



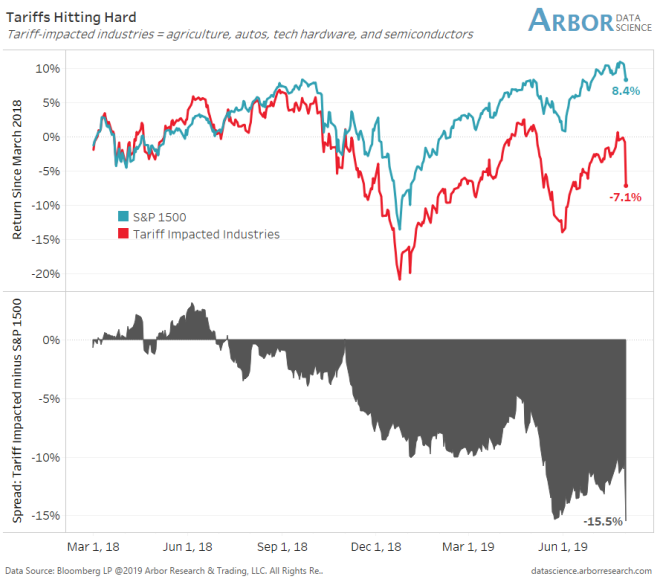
Investopedia defines a "black swan" as "an unpredictable event that is beyond what is normally expected of a situation and has potentially severe consequences. Black swan events are characterized by their extreme rarity, their severe impact, and the practice of explaining widespread failure to predict them as simple folly in hindsight." The sudden collapse of Lehman Brothers in 2008, which largely ushered in the financial crisis, would be a recent example of a black swan event.

A black swan is a punch that isn't seen, and it can thus be devastating. The fact that most markets are reacting to these potentially negative factors is likely a good thing, as it indicates an ability on the part of investors to recognize and adjust to negative news, although that does not necessarily mean that the markets are efficiently pricing in sufficient risk.



Ironically, that is both the good news and the bad news for investors. The good news is that the markets, with the possible exception of domestic large cap stocks, seem to be rational (i.e., they are discounting the increasingly troubled macroeconomic outlook), which should make a black swan event less likely. The bad news is that markets, with the possible exception of domestic large cap stocks, are, in fact, reacting to the increasingly troubled macroeconomic outlook, which also makes it likely that portfolio values may suffer over the near term, as markets continue adjusting to those increasingly troubled global fundamentals.

Of course, there is still the global central banks who, as we noted in last month's report, are about to enter the fray with both monetary barrels blazing. This creates an understandable optimism, as they have already bailed out investors so many times this millennium.



However, as Fed Chairman Powell noted in his August 23 speech at Jackson Hole, there is no "rulebook" on trade wars and "no recent precedents to guide any policy response to the current situation…While monetary policy is a powerful tool…it cannot provide a settled rulebook for international trade. The global growth outlook has been deteriorating since the middle of last year. Trade policy uncertainty seems to be playing a role in the global slowdown and in weak manufacturing and capital spending in the United States".

In short, the only thing that can offset the economic damage caused by an ever-expanding (and increasingly global) trade conflict is for the trade conflict to be resolved. This perspective gains particular importance if you agree with Goldman Sachs' assessment that the odds for a successful US-China trade deal have collapsed from 80% last April to only 13% today.

Interest Rates in the *Developed* World

As of 8/15/2019

Country	Policy Rate	6-Month	1-Year	2-Year	3-Year	4-Year	5-Year	6-Year	7-Year	8-Year	9-Year	10-Year	15-Year	30-Year
Switzerland	-0.75	-1.20	-1.14	-1.16	-1.17	-1.19	-1.19	-1.18	-1.17	-1.17	-1.21	-1.16	-0.93	-0.68
Germany	-0.40	-0.78	-0.82	-0.92	-0.97	-0.96	-0.91	-0.91	-0.89	-0.84	-0.78	-0.72	-0.58	-0.28
Netherlands	-0.40	-0.85		-0.89	-0.93	-0.91	-0.85	-0.79	-0.76	-0.69	-0.66	-0.59	-0.48	-0.27
Sweden	-0.25	-0.50		-0.66		-0.74	-0.72	-0.67		-0.59	-0.51	-0.41	-0.25	
Denmark	-0.65	-0.76		-0.92	-0.94		-0.92	-0.88		-0.80		-0.68		
Finland	-0.40		-0.82	-0.84	-0.84	-0.83	-0.80	-0.70	-0.66	-0.57	-0.53	-0.44	-0.28	-0.03
Japan	-0.10	-0.23	-0.24	-0.28	-0.29	-0.31	-0.32	-0.34	-0.35	-0.34	-0.29	-0.24	-0.06	0.16
Austria	-0.40		-0.74	-0.83	-0.83	-0.82	-0.76	-0.71	-0.63	-0.61	-0.55	-0.46	-0.21	0.09
France	-0.40	-0.73	-0.75	-0.81	-0.87	-0.86	-0.80	-0.73	-0.66	-0.59	-0.52	-0.44	-0.15	0.37
Belgium	-0.40	-0.82	-0.75	-0.81	-0.85	-0.79	-0.71	-0.67	-0.60	-0.53	-0.46	-0.39	-0.13	0.44
Ireland	-0.40		-0.65		-0.67	-0.65	-0.60	-0.49	-0.40		-0.27	-0.16	0.14	0.64
Spain	-0.40	-0.54	-0.54	-0.59	-0.57	-0.47	-0.40	-0.28	-0.20	-0.15	-0.07	0.03	0.43	0.88
Portugal	-0.40	-0.57	-0.56	-0.62	-0.49	-0.41	-0.36	-0.23	-0.16	-0.12	-0.01	0.07	0.40	0.90
Italy	-0.40	-0.25	-0.14	-0.02	0.35	0.51	0.75	0.79	1.00	1.06	1.07	1.33	1.83	2.35
United Kingdom	0.75	0.72	0.53	0.44	0.33	0.34	0.33	0.28	0.30	0.34	0.32	0.41	0.67	0.95
Australia	1.00	1.02	0.88	0.72	0.66	0.66	0.66	0.71	0.76	0.81	0.87	0.89	1.10	1.44
New Zealand	1.00		1.73	0.75			0.79		0.90			1.01	1.19	
Canada	1.75	1.63	1.53	1.30	1.25	1.20	1.14		1.13			1.09		1.30
United States	**2.13**	**1.85**	**1.70**	**1.50**	**1.45**		**1.42**		**1.48**			**1.53**		**1.97**

Indeed, it is telling that the central banks of 24 different countries have cut rates by a cumulative 1,085 basis points (10.85%) this year, and yet the median stock market returns in the countries whose central banks have cut rates is down more than 7% from the highs. The ex-USA Global stock market is off over 8% and emerging market equities are down more than 12%, and domestic stock markets are down over 6%.

It is equally telling that, when European Central Bank Governing Council member Olli Rehn told the Wall Street Journal that the European Central Bank should come up with an "impactful and significant" stimulus package at their September meeting (normally the type of statement that would catalyze a dramatic equity market rally) the MSCI All-Country World Index instead fell to its lowest level since the start of June, while global bond prices continued to soar despite the potential inflationary implications of such a stimulus program.

It is becoming increasingly evident that monetary policy can no longer serve as a panacea for all of the world's economic ills, and we are concerned that the equity markets continue to have unrealistic expectations regarding the ability of central banks to yet again come riding to the rescue.

In conclusion, we have always believed that any tactical investment decision has two components. The first is to determine the most probable future fundamental conditions. The second is to determine how much of that future outlook is already reflected in current prices. From our perspective, the future fundamental conditions look increasingly dire, which greatly increases the importance of the second question: "How much of that future outcome is already priced into securities markets?".

If the markets are doing their job and properly reflecting the risk environment, risk markets could be propelled higher once bricks start being removed from such a tall "wall of worry" (i.e., some of these issues start getting resolved).

On the other hand, the greatest risk could be that investors may have become so inured to the constant flow of one crisis after another that negative macroeconomic factors which, in a less crisis-driven environment, would be efficiently reflected in financial asset prices over time, are currently just being ignored, and accepted as part of a perceived "new normal". After all, one of the definitive characteristics of a "black swan" event is that the abject failure to predict them is viewed as simple folly with the benefits of hindsight.

Depending almost entirely on how efficiently markets are pricing in all of these risks, this extraordinary collection of potential negatives could be either extremely bullish or very bearish. And, of course, everything could change with a single tweet, so keep your guard up and your chin tucked in, as this could be quite the "slugfest".

Therefore, actual returns could differ materially and adversely from those expressed or implied in any forward-looking statements as a result of various factors. The views and opinions expressed in this article are those of the authors and do not necessarily reflect the views of Per Stirling Capital Management's independent advisors.

Neither Asset Allocation nor Diversification guarantee a profit or protect against a loss in a declining market. They are methods used to help manage investment risk.

The Volatility Index (VIX) is created by the Chicago Board Options Exchange (CBOE). It is designed to produce a measure of constant, 30-day expected volatility of the US stock market, derived from real-time, mid-quote prices of S&P 500® Index (SPX) call and put options.

The Russell 3000 Index is a market-capitalization-weighted equity index maintained by the FTSE Russell that provides exposure to the entire U.S. stock market. The index tracks the performance of the 3,000 largest U.S.-traded stocks which represent about 98% of all U.S incorporated equity securities.

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 MSCI All Country World Index (ACWI) is a market capitalization weighted index designed to provide a broad measure of equity-market performance throughout the world. The MSCI ACWI is maintained by Morgan Stanley Capital International (MSCI) and is comprised of stocks from 23 developed countries and 24 emerging markets.

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.