Volume 111

THE PER STIRLING CAPITAL OUTLOOK

Performance • Perspective • Per Stirling

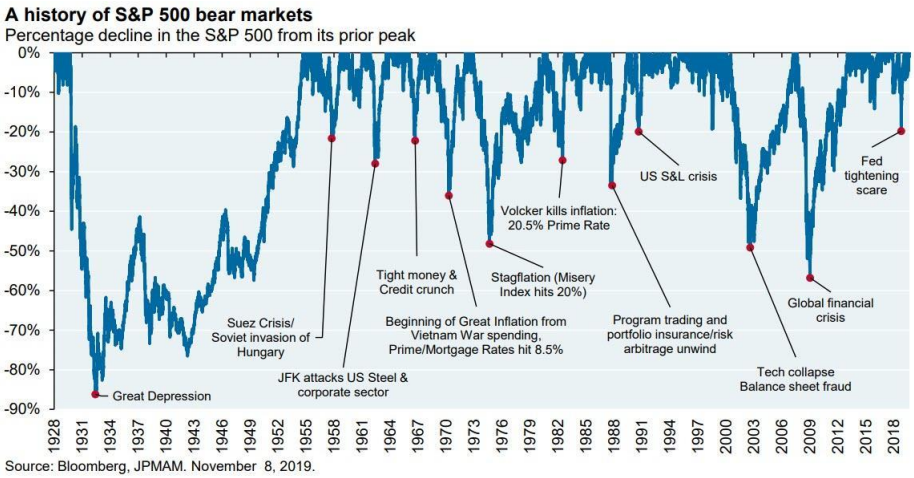
January 2020

The natural state for a capitalistic economy is expansion and, as evidenced by the fact that the domestic stock market has gained value in approximately 74% of all years, the path of least resistance for equity markets is up. As such, it has historically been true that both the economy and equity prices normally continue to grow in value and size until such time when something "breaks" and interrupts the trend.

On occasion, the catalyst for that "breakage" can be an external shock such as a military conflict, or even an economic war, like a trade war or the Arab Oil Embargos. It can also be some sort of governmental or other macroeconomic catalyst, such as a change in tax rates or monetary policy. It could even be a global pandemic, as was the case in 1918.

A very recent example of "breakage" occurred in September of last year, when a combination of tightened restrictions on bank liquidity combined with the Federal Reserve's quantitative tightening program to "break" the repo market and cause a temporary spike in overnight lending rates to almost 10%.

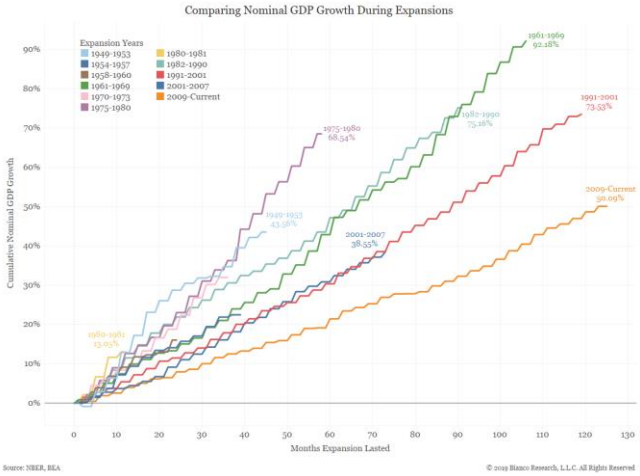
However, more often than not, what causes that breakage is something reaching unsustainably extreme levels, whether it was inflation in the 1970s, equity market valuations in the late 1990s, or credit availability in the 2000s, excesses in one direction normally resolve themselves through a violent economic or market reaction in the opposite direction.



Source: Bloomberg, JPMAM. November 8, 2019.

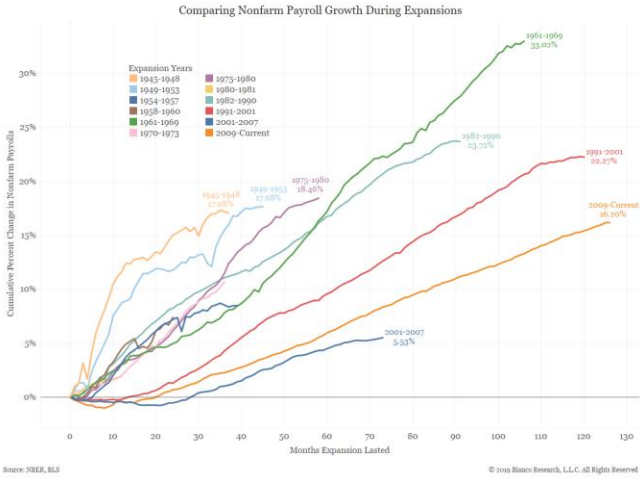
This is why even a growing perception of the potential for something getting out of balance can catalyze a violent reaction in the markets, as was the case in both late January-early February of 2018, when bullish sentiment in the equity markets reached unsustainable extremes, and in the fourth quarter of 2018, when the markets became convinced that the Fed was misgauging the economic environment and was about to embark on a path of overly-aggressive monetary policy tightening that was destined to push the domestic (and likely global) economy into recession.

Similarly, if stock markets (or even other capital markets) start appreciating in an extreme, parabolic way, it can create the kind of excesses in valuation, sentiment and complacency that often coincide with "blow-off tops" and even secular market highs.

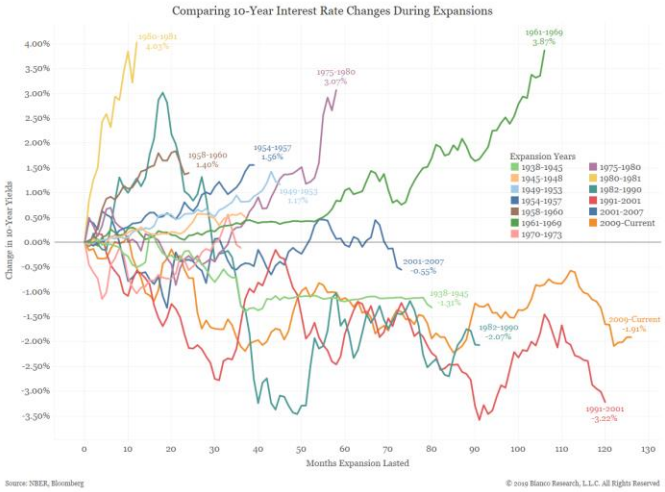


The point is that, more often than not, it is the existence of unforeseen external shocks or the existence of some unsustainably extreme condition that normally portend danger for investors.

Indeed, one of the reasons why the U.S. is currently enjoying both the longest economic expansion in its history and the longest secular bull market in U.S. history is that it has occurred in an environment of very few extremes, whether it be excessively fast growth, inflation, interest rates, employment, etc. Indeed, for the first time in the Nation's history, the U.S. has avoided a recession for an entire calendar decade. The economy has also expanded for a record 126 straight months, which is the longest expansion in U.S. history.

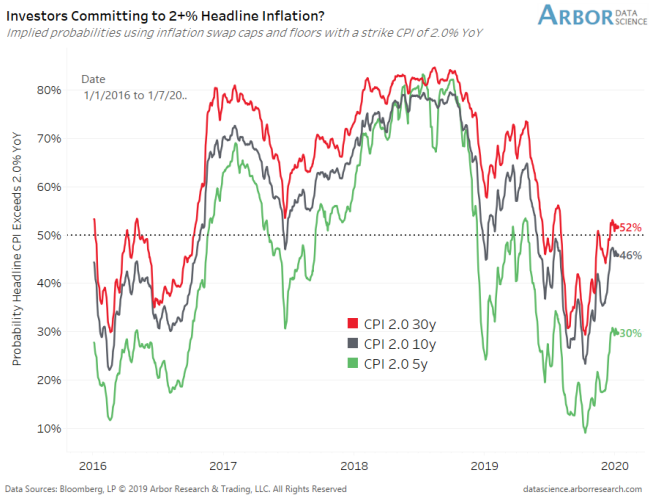


It has truly been an example of "slow and steady wins the race". The modest, albeit steady, pace of economic improvement has helped to avoid both economic excesses and the market turmoil that they normally catalyze. Of note, this is not altogether that surprising, as recoveries from financial crises tend to be both long-lasting and somewhat muted, albeit not to such a remarkable level as seen in the current cycle.



Indeed, part of this slow and steady environment may be both secular and very long lasting, as it appears to be attributable to what the analysts at Arbor Data call DGT (demographics, globalization and technology), each of which are placing significant downside pressure on both interest rates and inflation and, in turn, are allowing the central banks to keep global monetary policy, depending on the country, somewhere between accommodative and stimulative, which continues to support capital markets prices.

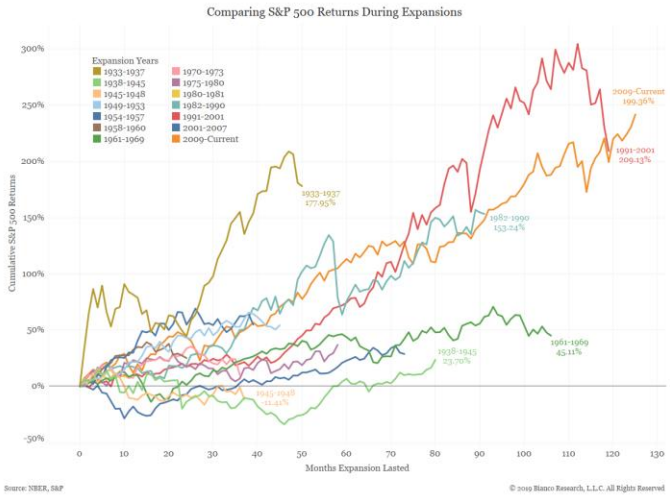
It is, on many levels, this prolonged period of moderation that has kept interest rates down and given the Fed the flexibility to, for the most part, avoid what has historically been one of the most consistent causes of "breakage", which is the Fed's tendency to be overly aggressive in tightening monetary policy, as part of their proactive efforts to prevent undesirably high levels of inflation. Remarkably, this time, the world's central banks have instead struggled against undesirably low levels of inflation.



Regardless, this history points to what is probably the most significant challenge associated with monetary policy, which is that its impact on the economy has very long and variable lags, which means that it is almost impossible for a central bank to know that they have gone too far with a policy until well after the damage has already been done. Moreover, when they ultimately recognize their error and reverse policy (as was the case with the Federal Reserve in 2019, when they cut rates three times after realizing that they had been overly restrictive in 2018), that reversal in policy also has a long and variable lag, which means that its impact will likely take about a year to become evident.

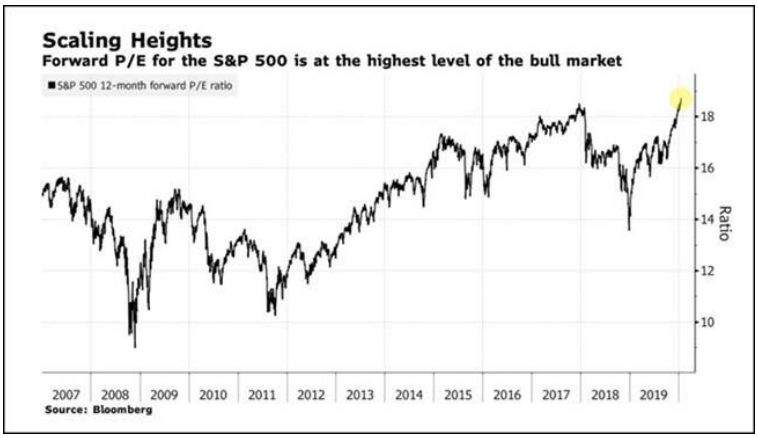
In our opinion, it is therefore also this "prolonged period of moderation" that has allowed for the longest running equity bull market in U.S. history, which has also, until just recently (and with the exception of early 2018), remained relatively free of speculative excesses. Of note, that January-February 2018 period will be a recurring theme throughout this writing, as we perceive some remarkable similarities between the equity markets then and the equity markets now.

That early January 2018 period recorded the highest relative strength readings in the history of the domestic stock markets, and marked the highest levels of valuation, bullish sentiment, monetary liquidity and risk appetite of this ten-plus year bull market. That is, until just recently, when many of those measures have returned to, if not exceeded, the lofty levels of 2018.



As was just pointed out by the Wall Street Journal, in both instances, the stock market had risen approximately 25% over the prior twelve months and, in both cases, the stock market had rebounded about 15% from an August decline. The Q1 2018 euphoria was catalyzed primarily by Trump's corporate tax cuts, which restored global competitiveness to the U.S. corporate tax structure, and the current surge in bullishness is largely attributable to the Fed-driven surge in monetary liquidity and the conclusion of the "phase one" trade deal with China.

Indeed, for the first time since that period almost exactly two years ago, we are starting to see some early indications that the sustainability of this "prolonged period of moderation" could potentially be at risk.



Importantly, that is not necessarily a market timing call, as valuation has historically been a terrible timing indicator in the short run, and because measures of investor sentiment have historically been most useful primarily at major inflection points, when they can be very helpful in identifying "capitulation bottoms" (when the market runs out of potential sellers) and "blow-off tops" (when virtually everyone is bullish, and almost all of the sideline cash has already been invested).

However, while not particularly accurate as a short-term indicator, both valuation and sentiment have historically been very useful in gauging levels of both potential downside risk and longer-term upside potential, as euphoric, overvalued markets tend to both fall much further during declines and gain much less over succeeding market advances, than do more normally-valued markets.

In 2019, domestic stock prices gained around 28% while corporate earnings only grew about 1%, which means that the stock market really did not become more valuable last year, it just became more expensive, particularly when compared to earnings, which is the most common matrix by which stocks are valued.

Valuation metric	Current reading	Analysis
Fed Model	-68.0%	Inexpensive
Equity risk premium (10-year Treasury yield)	3.7%	Inexpensive
Equity risk premium (Baa corporate bond yield)	1.4%	Inexpensive
Rule of 20	19.5	Fairly valued
S&P 500 trailing P/E	20.5	Mildly expensive
S&P 500 forward P/E	17.7	Mildly expensive
S&P 500 price/cash flow	13.8	Expensive
S&P 500 price/book value ratio	3.43	Expensive
S&P 500 5-year normalized P/E	25.8	Expensive
Tobin's Q	1.84	Expensive
S&P 500 dividend yield	1.9%	Expensive
Shiller's CAPE (cyclically-adjusted P/E)	30.2	Expensive
Market cap/GNP	140.0%	Very expensive

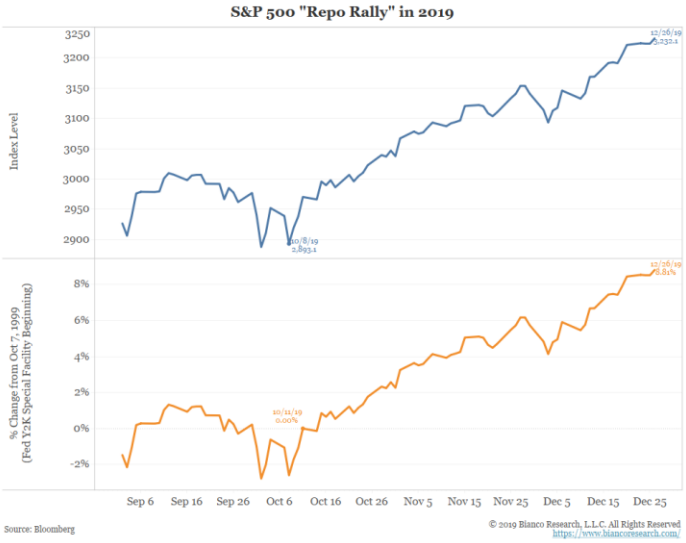
However, while valuations clearly appear quite stretched, one can argue that "value" is remarkably relative in the current environment. To illustrate this point, we will turn to a chart from Liz Ann Sonders, who serves as Chief Investment Strategist for Charles Schwab.

As is illustrated, the S&P 500 ranges from being mildly expensive to very expensive based upon almost every traditional measure, including book value, dividend yield, cash flow and most importantly earnings (both backwards-looking and anticipated future). Indeed, price-to-earnings multiples have just exceeded those set in early 2018, which makes current valuations (versus earnings) the highest of the current bull market and the second highest in history (exceeded only by the 1998-1999 technology bubble). According to Bespoke Investment Group, the market has been statistically "overbought" on 98% of all days since October, which represents the most prolonged period of overvaluation since the late-2017-early 2018 market high.

However, another very important lesson from history is that equity markets have traditionally tolerated much higher valuations during periods of low interest rates, and today's interest rates are approaching the lowest levels since World War II. So important is this relationship (at least historically), that when you view current equity valuations through the lens of the interest rate environment, equity values actually rate as inexpensive. Of note, according to Goldman Sachs, "Low bond yields drove more than 90% of the S&P 500's return last year."

In its simplest form, the continuation of this bull market may very well rely on both interest rates staying relatively low and earnings making at least a reasonable recovery. These are among the generally optimistic assumptions currently being priced into stock and bond markets around the world.

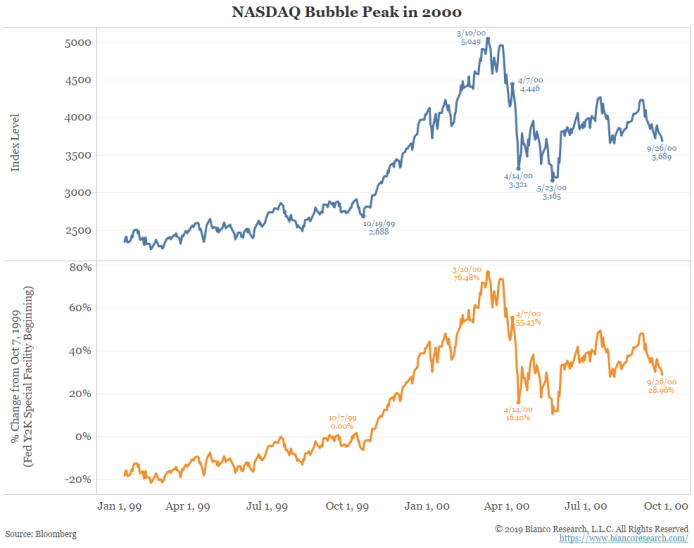
Other bullish assumptions being priced into the markets are the re-election of President Trump (or at least the non-election of Sanders or Warren), and the continued growth in monetary liquidity, which has been moving in near-lock-step with equity prices since September of last year. As we had noted in last month's report, the Fed's decision to balloon the money supply through its "repo" facility has created a scenario where money supply has been growing well in excess of loan demand, and where the excess liquidity appears to be pouring into the equity markets, which helps to explain why the value of the S&P 500 (blue line) matches up almost perfectly with the size of the Fed's repo facility (gold line). In fact, according to Rosenberg Research, there is currently a 95% correlation between the size of the repo facility and the level of the S&P 500 Index.



While no single factor is ever entirely responsible for the price action of the stock market, this incredibly tight correlation certainly suggests that Federal Reserve policy is, despite their protestations that they are not engaging in quantitative easing, having a dramatic and direct influence on the capital markets (both stocks and bonds).

Moreover, and we want to give credit and kudos to the team at Bianco Research, who discovered the following remarkable historical comparison: The current expansion in the repo facility is the Fed's response to a lack of liquidity in the banking system. In 1999, the Fed feared another lack of liquidity in the banking system, when many Americans were expected to stockpile cash ahead of Y2K, resulting in a massive withdrawal of cash from ATM machines. In anticipation of this event, the Fed flooded the banking system with money through its Y2K Special Facility.

However, computer systems did not crash, the banking system barely even noticed the calendar change, and there was no mass withdrawal of cash from ATM machines. As appears to be the case today, the excess liquidity poured into the stock market, and into the NASDAQ in particular.



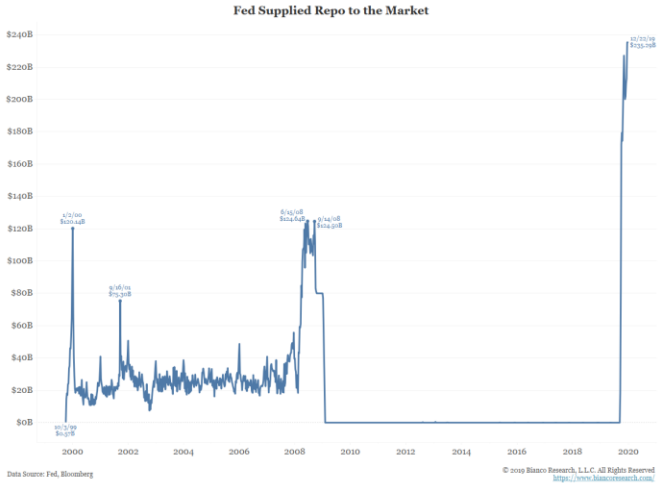
From the start of the Y2K facility on October 19th, 1999 to its withdrawal in March, the NASDAQ experienced a five-month gain of 76%. In comparison, since the September introduction of the repo facility, the S&P 500 has been climbing at an annualized rate of 55%, which we view as clearly unsustainable.

Of note, when the Fed withdrew the funds in March of 2000, the NASDAQ fell by 25% in just a week (its worst week ever).

Comparing the year 2000 to 2020 is no doubt an imperfect comparison, as interest rates were much higher in 2000 (and were climbing), as were equity valuations, which were the highest ever relative to corporate earnings. Remember that, in a market decline, overvalued markets tend to fall much further than do fairly-valued or inexpensive markets, and that markets normally support higher equity valuations when rates are low, as they are today. In fact, the year 2000 started with a 10-year Treasury yield of 6.66%, which is in sharp contrast to today's 10-year Treasury yield of only 1.61%.

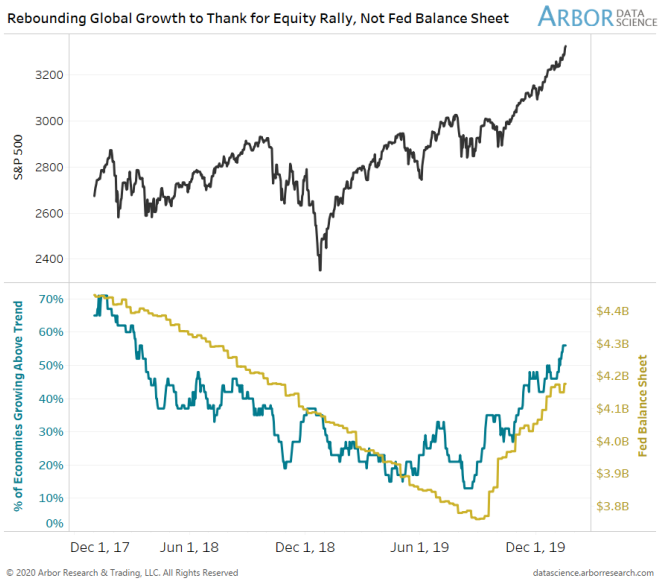
At the same time, as was so wisely stated by Mark Twain, "History does not repeat itself, but it oftentimes rhymes".

It is noteworthy that, while the S&P 500 is valued 123% higher now than it was at its January 2000 peak, the size of the repo facility is already 96% larger than was the Y2K facility, and it has been growing by $60 billion per month, so it is certainly possible that the impact of this liquidity on the equity markets could be comparable between the two periods.



Some analysts are pointing out the possibility that this relationship between money supply and equity prices could be correlation instead of causation. In other words, there is a global economic recovery that is also underway (albeit potentially interrupted by the coronavirus) that likewise shares a very tight correlation with both the acceleration higher in equity prices and the surge in money supply, and that it may be the economic recovery, instead of liquidity, driving equity prices higher, due to expectations for a rebound in corporate profits.

On one level, it may appear to be a moot point whether equity prices are responding to an improving economy or to the excess liquidity, as it is ultimately a combination of increased monetary liquidity and reduced trade tensions that is driving the rebound in global economic activity in the first place. In other words, they are largely inseparable.

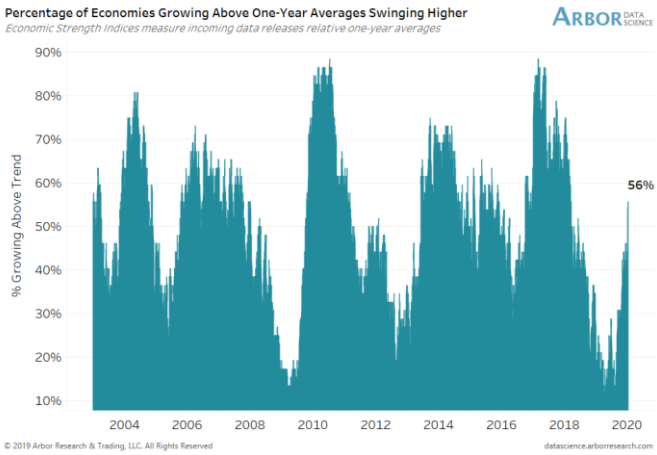


However, on another level, the question is very important because, if the rally in stocks is largely a function of monetary liquidity, then it is being built on what may be a weakening foundation.

It is actually excessive levels of monetary liquidity that, more often than not, have historically caused the types of excesses in valuation, demand and risk appetite that have caused the Fed to slam on the monetary policy brakes and, by doing so, cause a recession.

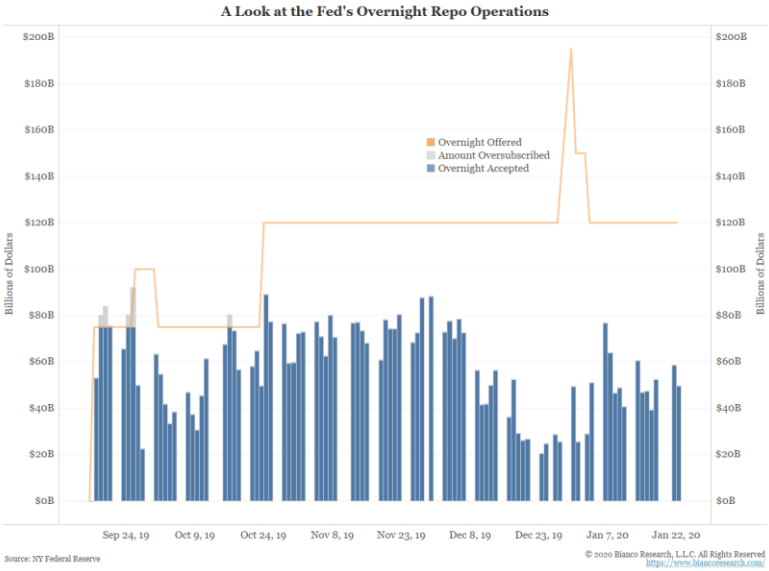
In our opinion, some of those excesses are now starting to manifest themselves. In addition to very high equity valuations (and growing evidence that the individual investor is finally turning bullish, which usually happens near the end of bull markets), we are seeing very speculative activity in the debt markets, where an overwhelming demand for yield in a world where almost none exists is creating an environment where investors in anything but the highest quality debt instruments are not being properly compensated for the risks that they are taking.

Perhaps most concerning of all is the combination of excess credit availability and historically low rates. In fact, the World Bank just warned of the potential for a global debt crisis because of what is now the fastest increase in borrowing since the 1970s, and The Institute of International Finance's global debt-to-GDP ratio has now topped 322%, which is the highest on record.



The Fed is already telling us of their plans to turn off their giant money printing machine, and are offering current guidance that they could stop and ultimately reverse their money creation programs as soon as mid-April. Indeed, Federal Reserve Vice-Chairman Richard Clarida just noted on January 9th that "it may be appropriate to gradually transition away from active repo operations this year" though they "might be needed at least through April, when tax payments will sharply reduce reserve levels." Furthermore, in December, Fed Chairman Jay Powell said that once reserves reach a sufficient level, "it will be appropriate for overnight and term repo [operations] to gradually decline".

Indeed, while only time will tell whether the change is only temporary or not, January has already seen both the Fed lessen the amount of repo funding that it is making available and an actual halt in the growth of the repo facility.

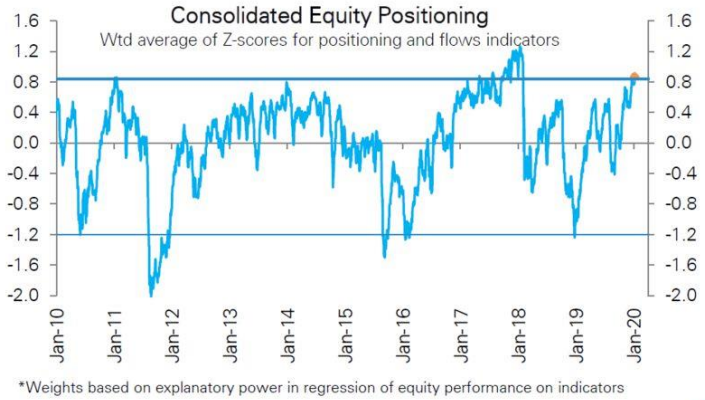


Whether it be now or at some point in the future, when the Fed (and central banks in general) ultimately do decide to turn off the monetary policy spigots, we are going to find out whether or not equity prices can sustain themselves on economic fundamentals, and without the support of billions of dollars of excess liquidity looking for a home.

In the meantime, the markets seem to be betting that, despite their forward guidance, the Fed will be too scared to "take the punch bowl away", particularly during an election year, and with a President who is already threatening the Fed's independence. There is some justification for this opinion. After all, recent history is full of instances of markets throwing temper tantrums, and central banks abruptly changing their monetary policies to keep the markets happy.

As such, this is not necessarily a call to action, but instead an encouragement to be alert to all messaging from the Federal Reserve, and to draw additional attention to the critical role being played by market liquidity. As the late, renowned money manager, Marty Zweig, once said, "You never fight the Fed."

Figure 3: Our consolidated measure of equity positioning is at the top of its historical range and in the 96th percentile



In regards to the coronavirus and its impact on markets, it has historically been true that most similar pandemic threats have had only a very temporary influence on securities prices, and have thus provided buying opportunities for more tactical and/or patient investors.

That said, with equity positioning indicating that most investors are already heavily invested, with minimal levels of cash remaining on the sidelines (the lowest since March of 2013), and a significant majority of key corporate executives believing that U.S. equities are currently overvalued, it does raise the question of just who is left to step in and buy, when something like the coronavirus (or even a left-leaning primary result, of which there may be at least several) catalyzes a market decline. In short, don't get complacent.

Disclosures:

Advisory services offered through Per Stirling Capital Management, LLC. Brokerage services and securities offered through B. B. Graham & Co. Inc., member of FINRA/SIPC. Per Stirling Capital Management and B. B. Graham & Co. Inc. are separate and otherwise unrelated companies.

This material represents an assessment of the market and economic environment at a specific point in time and is not intended to be a forecast of future events, or a guarantee of future results. Forward-looking statements are subject to certain risks and uncertainties. Actual results, performance, or achievements may differ materially from those expressed or implied. Information is based on data gathered from what we believe are reliable sources. It is not guaranteed as to accuracy, does not purport to be complete and is not intended to be used as a primary basis for investment decisions. It should also not be construed as advice meeting the particular investment needs of any investor.

Nothing contained herein is to be considered a solicitation, research material, an investment recommendation or advice of any kind. The information contained herein may contain information that is subject to change without notice. Any investments or strategies referenced herein do not take into account the investment objectives, financial situation or particular needs of any specific person. Product suitability must be independently determined for each individual investor.

This document may contain forward-looking statements based on Per Stirling Capital Management's expectations and projections about the methods by which it expects to invest. Those statements are sometimes indicated by words such as "expects," "believes," "will" and similar expressions. In addition, any statements that refer to expectations, projections or characterizations of future events or circumstances, including any underlying assumptions, are forward-looking statements. Such statements are not guarantying future performance and are subject to certain risks, uncertainties and assumptions that are difficult to predict. 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 Standard & Poor's 500 (S&P 500®) is a market-capitalization-weighted index of the 500 largest U.S. publicly traded companies.

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.