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THE PER STIRLING CAPITAL OUTLOOK

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As renowned investor Howard Marks famously noted, "In the real world, things fluctuate between 'pretty good' and 'not so hot', but in the investing world, things go from 'flawless' to 'hopeless'". We have just witnessed a dramatic and violent example of such a transition.

Until a week ago, we were in a "heads, the bulls win, and tails, the bears lose" type of market, where the glass was seemingly always viewed as half-full, and negative fundamental news was being perceived (or mis-perceived) as being bullish (or at least benign) for risk assets.

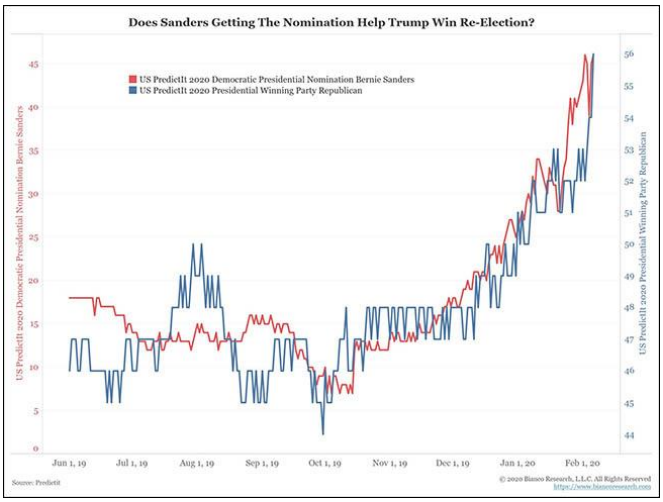
In less than a week, investor sentiment switched from what legendary investor Leon Cooperman characterized as "the early stages of knocking on the door of euphoria", with many measures of investor sentiment illustrating speculative levels of bullishness, to a period of sheer investor panic, and the largest two-day point drop in the history of the Dow Jones Industrial Average, presumably because of changing perceptions of the market risks imposed by the spread of the coronavirus on one hand, and, to a lesser extent, the prospects for the potential presidency of Bernie Sanders on the other.

This dramatic shift in sentiment can be viewed graphically through the VIX "fear index" (below), which reached extraordinarily low levels in December and January (indicating complacency and overconfidence), only to soar over the past week to levels that reflect a surge in investor fear, albeit not to a level that necessarily suggests that selling has been overdone. Such capitulation buy signals normally require VIX readings above 40, as opposed to the current reading of only 25.

Only a week ago, the domestic markets in particular viewed the coronavirus as something isolated largely to China, the implications of which were assumed to be both temporary and far-removed from the U.S. Indeed, the pandemic was initially viewed as being bullish for markets, as it was likely to cause a massive and global influx of fiscal and monetary stimulus, which would add additional octane to a domestic economy that really did not need it.

Just a week later, there is a growing consensus that this pandemic is increasingly likely to stall the nascent global economic recovery, which suggests that, rather than boosting an already strong and improving economy, the additional stimulus may be necessary just to keep the U.S. out of recession (and perhaps Japan and Europe out of something even worse).

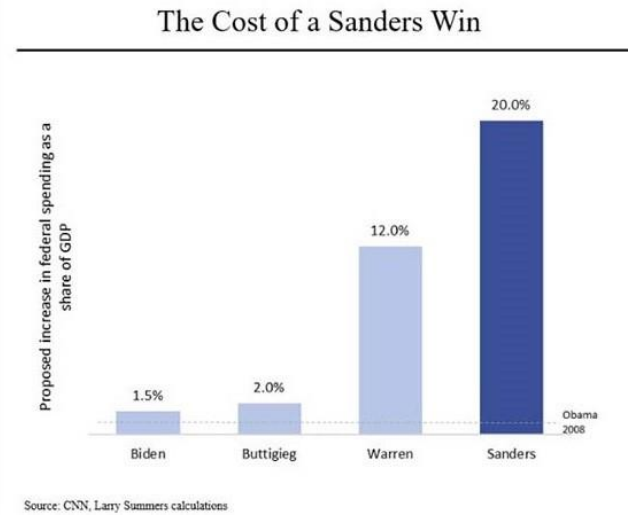
This dramatic shift also extends to the political realm, where the growing likelihood of Bernie Sanders being the Democratic nominee for president was being viewed as bullish, as the markets were convinced that it would almost guarantee a Trump re-election, based upon the conviction that Americans would never select a self-proclaimed socialist as president.



You can see this belief reflected in the prediction (betting) markets, which illustrate a remarkably close correlation between the perceived odds of Sanders being the Democratic nominee and the odds of Trump being re-elected. This is particularly true since December, when Sanders started his impressive charge to go from forgotten man after his heart attack to the presumptive Democratic nominee.

Markets have been largely ignoring the potentially draconian impact that a Sanders presidency could have on the economy, the capital markets, and the "investor class"; the fact that many younger voters do not view "socialism" as something negative, and the fact that a just-released (taken February 14-17) Wall Street Journal/NBC poll showed Sanders beating Trump in a head-to-head contest with 49% support versus 46%.

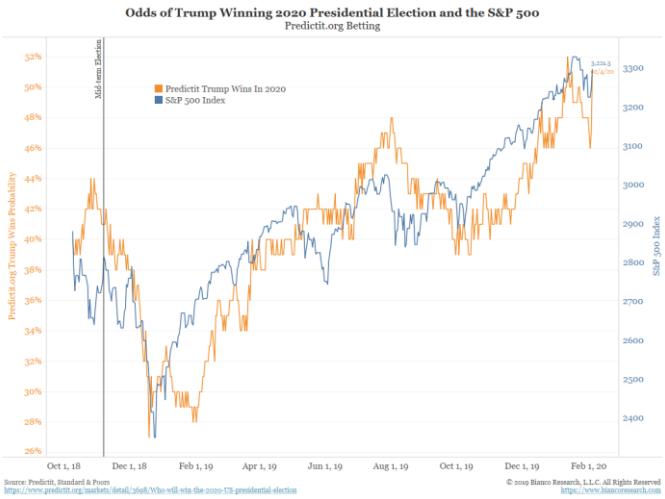
Our initial reaction is to view this cavalier investor attitude as an indication of complacency and over-confidence, which is often the precursor for a significant decline, which could already be underway.



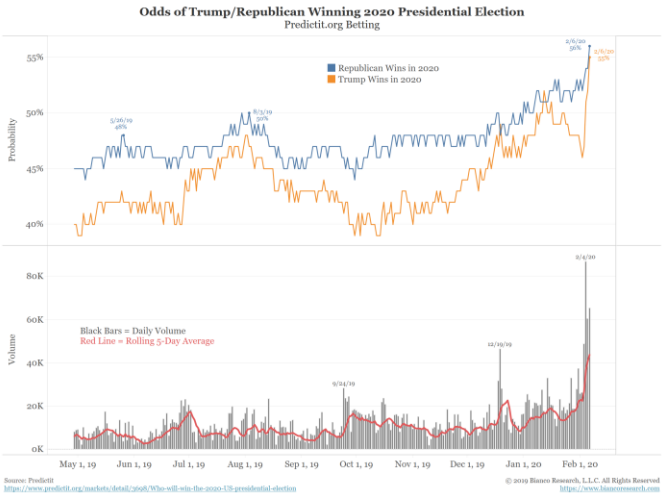
However, on some levels, history does suggest that investors have been prudent thus far to "look through" and be undeterred by these risks. Indeed, history seems to suggest that these issues should be viewed as if they were "tail risks" on a bell curve, where the greatest probability is that the ultimate results will be either benign or transitory, and thus insignificant to a long-term investment plan. However, there are also potential outcomes (tail risks) that, while of lesser probability, could be very bearish for risk assets.

We will use the opportunity of this writing to examine whether or not investors should take comfort in the lessons from history, and largely ignore these perceived risks, and also to take a look at a new phenomenon that may help to explain the stock market's recent resilience in the face of these risks, but which might also be a troubling sign for investors over the intermediate and longer term.

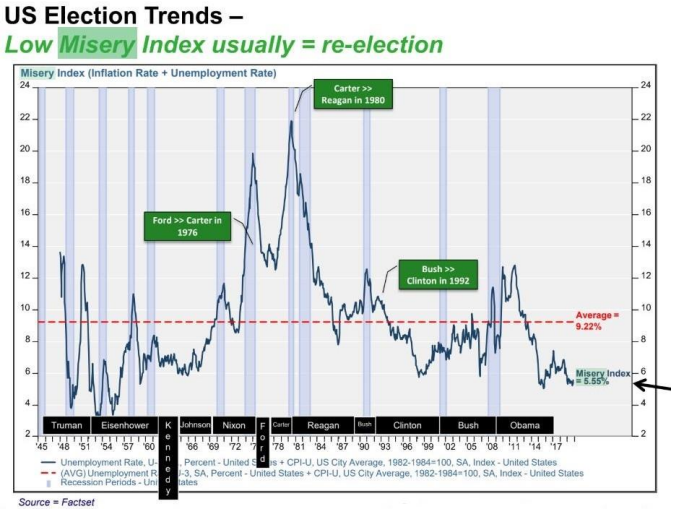
We will first address the issue of a potential Sanders presidency, albeit with the preface that what follows will be an economic/market commentary, and not a political one. It is based upon the premise that equity investors, very reasonably, prefer a Trump presidency to a Sanders one. For evidence, one need look no further than the chart (left) that tracks both the likelihood of a Trump re-election, according to the prediction markets, and the stock market, as represented by the S&P 500 Index. The tight correlation between the two is very evident and highly rational.



There are numerous political prediction models that are based upon economic fundamentals, and virtually all of them are predicting a relatively easy Trump victory. Further, the prediction markets, which are probably being influenced by a post-impeachment bounce and the highest approval rating of Trump's presidency, are assigning an almost 60% likelihood to Trump being re-elected. Moreover, as illustrated by the above chart, the stock market is certainly predicting that Trump will be re-elected, although we suspect that most investors would be fine with any president not named Sanders or Warren.

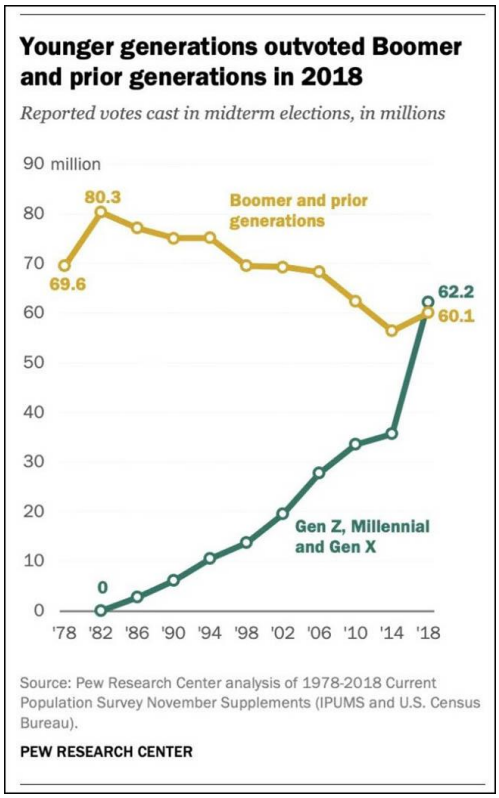


One of the most popular of these economy-based prediction models is the "Misery Index", which simply adds the unemployment rate to the inflation rate, thus making it a measure of both consumer earnings and consumer purchasing power. While the past is not necessarily prelude, it has historically been true than an incumbent president is almost always re-elected when this measure is below average (like now) at the time of the election (and vice-versa).



If, as is often the case, markets follow historic precedent, investors are perhaps prudent to ignore the risk associated with a Sanders presidency. Then again, there was also a time when virtually everyone seemed equally certain that Trump was unelectable.

One of the reasons why investors seem so confident that Sanders cannot get elected president is because, unlike Republicans, almost all of whom define themselves as conservative, a little less than half of Democrats consider themselves to be liberal.

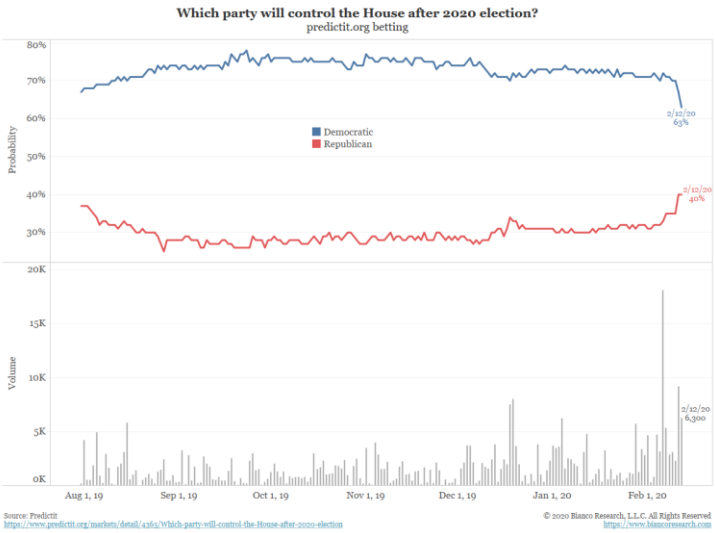


However, we do not take great comfort from that statistic, as a just-released Hill-HarrisX survey reported that 65% percent of registered voters who are either Democrats or Democrat-leaning independents said that it was more important to choose a nominee who could beat Trump than one who they agreed with on the issues. Only 35% of respondents emphasized issues over electability.

Moreover, for the first time this campaign, an ABC News/Washington Post poll shows that Democrats believe that Sanders is the candidate with the best prospects for unseating President Trump.

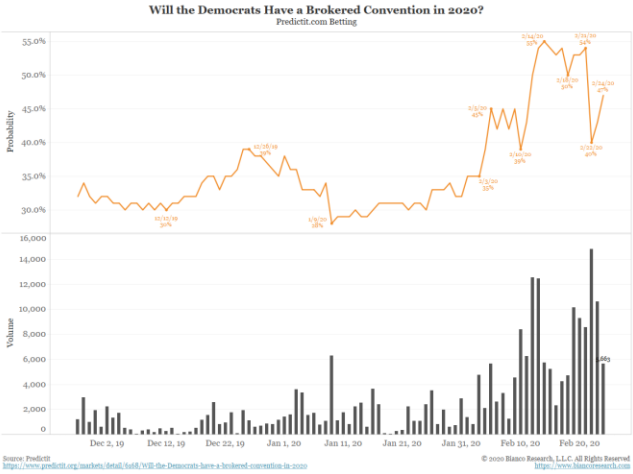
We suspect that it will all come down to the level of voter turnout, with younger voters not only being big Sanders supporters, but also having a recent history of voting in higher and higher percentages.

Voter turnout is also likely to be of critical importance to the "down ballot elections", and there are two theories in this regard that propose very different outcomes. The first theory is that any turnout sufficient to get Bernie Sanders elected would also likely deliver both houses of Congress to the Democrats, in which case you could even see Alexandria Ocasio-Cortez as Speaker of the House, which would be an absolute nightmare for Wall Street. This would not be at all unusual, as every president since 1992 has controlled both houses of Congress in the first two years of their first term. This includes Clinton, Bush, Obama and Trump.



The other theory is that having Sanders as the Democratic nominee will alienate the approximately 50% of Democratic voters that consider themselves to be moderates, and this could cause very poor turnout among Democratic voters, which could not only cost the Democrats the White House, but also both houses of Congress. You can see this potentiality graphically through the prediction markets, where the chance of the Republicans recapturing the House of Representatives has increased steadily since Sanders started climbing higher in the polls, albeit still a minority likelihood.

Of note, if the Democrats do end up in a brokered convention (a real possibility), history suggests that it should benefit Trump, as throughout U.S. history, only one nominee coming out of a brokered convention has ever won the presidency, and that was when Dwight Eisenhower defeated Adlai Stevenson, who also came out of a brokered convention.



Importantly, President Trump's primary achievements have been a strong economy and a strong stock market, which his team will emphasize heavily in the upcoming campaign. This is where the potential for a global pandemic could heavily influence the outcome of the U.S. elections, as it could potentially catalyze both a recession and a bear market, if it spreads too wide or persists for too long.

History, however, also suggests that long-term investors might be well served to largely ignore the current COVID-19 coronavirus, as virtually every pandemic since the 1918 Spanish Flu (which killed approximately 60 million people) has ultimately proven to be a buying opportunity rather than a long-term reason to sell.

Indeed, if you look at each major epidemic of the past forty years, the S&P 500 Index has generally rallied strongly once the virus passes its peak. On average, the market has been 7.95% higher six months after the peak of the epidemic, and 14.15% twelve months after.

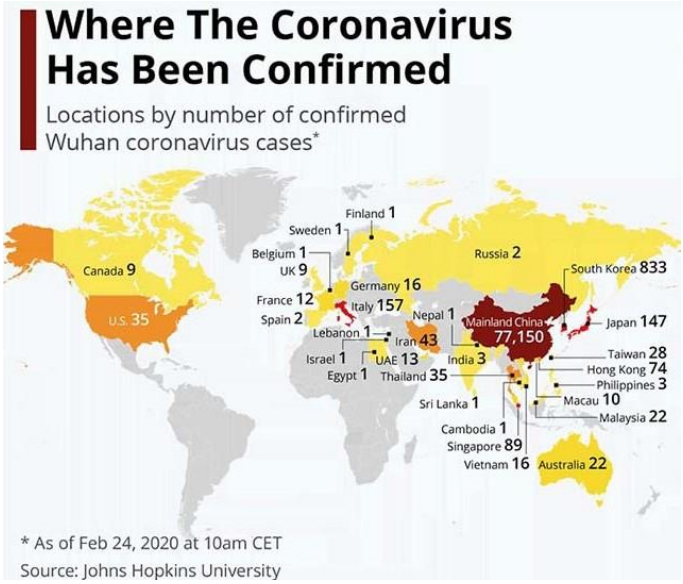
Epidemic	Month end	6-month % change of S&P	12-month % change of S&P
HIV/AIDS	June 1981	-0.20	-10.73
Pneumonic plague	September 1994	8.22	26.31
SARS	April 2003	14.59	20.76
Avian flu	June 2006	11.66	18.36
Dengue Fever	September 2006	6.36	14.29
Swine flu	April 2009	18.72	35.96
Cholera	November 2010	13.95	5.63
MERS	May 2013	10.74	17.96
Ebola	March 2014	5.34	10.44
Measles/Rubeola	December 2014	0.20	-0.73
Zika	January 2016	12.03	17.45
Measles/Rubeola	June 2019	9.82%	N/A

—Source: Dow Jones Market Data

The relevant questions are therefore if history is a good guide in this instance, whether or not the current coronavirus is comparable to its predecessors, and whether or not the global economy is sufficiently different now than in past instances, such that a different outcome should be expected this time.

We believe that a good starting point to understand the implications of the ongoing global coronavirus epidemic is the February 11th report from Oxford Economics, in which they laid out three coronavirus scenarios.

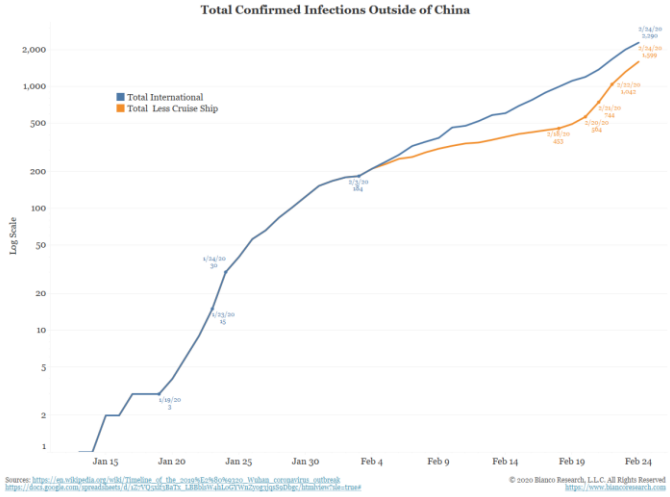
Their base scenario was that the virus would remain largely contained in China and that the global economic impact would be short-lived and relatively modest. Their second and somewhat less likely scenario was that the pandemic would spread across Asia, and reduce global growth by a fairly massive $400 billion in 2020. Their third and least likely scenario was that it becomes a global pandemic, which would cut $1 trillion from global growth, and force both the U.S. and Europe into recession by mid-2020. Japan may already be in recession.



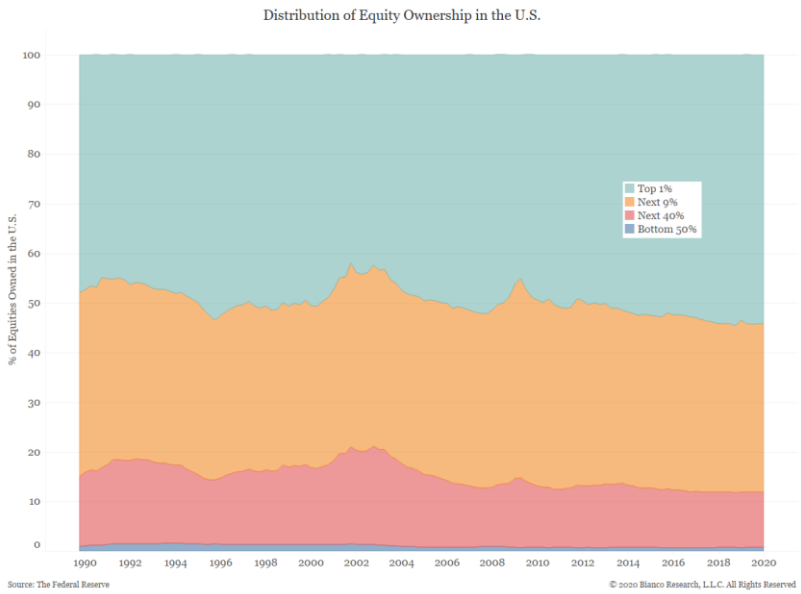
Sadly, with the coronavirus now infecting people in 35 countries, and every continent except for South America, their base scenario seems hopelessly over-optimistic. If anything, the world might even be closer to their third scenario than their second one. Indeed, approximately 50% of the 2,000-plus coronavirus cases outside of China have manifested themselves over just the past four days.

Legendary investor Sir John Templeton observed that "the four most dangerous words in investing are 'it's different this time'", and time may prove him right yet again.

However, the markets (and the world at large) seem to be coming to the conclusion that the past may not be a particularly great guide in this instance, as this virus seems to be particularly insidious, as it is both unusually contagious and uniquely difficult to contain, as carriers can be contagious well before they have any symptoms.



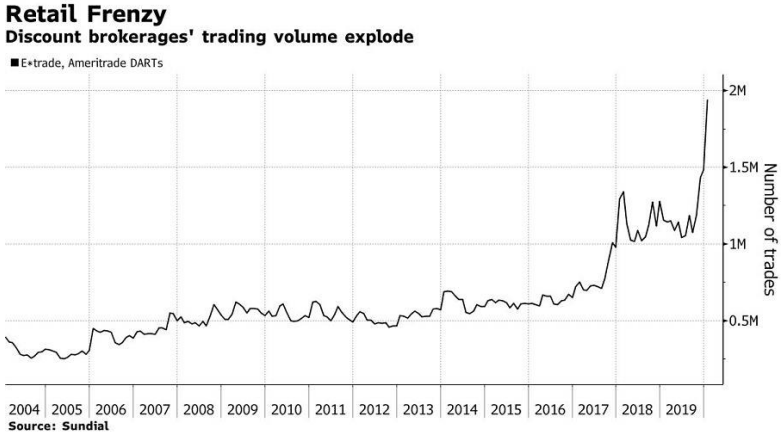
It is also being recognized that the global economy is much more intertwined today than in the past, and that China (parts of whose economy have ground to a halt) is now a much greater part of the world economy. For example, when the SARS outbreak occurred in 2003, China represented just over 6% of the world economy. Now it represents not only over 17% of the world economy, but also as much as 40% of total global growth (as opposed to only 4% in 2003). Moreover, China is much more closely integrated into the global economy, and is responsible for producing 20% of global unfinished goods and 35% of global manufacturing output. They are the heart of the global supply chain, and Wuhan, which is the epicenter of the virus, is China's industrial heartland. This will almost certainly have far-reaching implications for manufacturing all over the globe, and this is the new reality that is currently being priced into equity markets worldwide.



On a much-needed optimistic note, Oxford Economics expects for the eventual economic recovery to be "swift", once the virus peaks, and for full-year global economic growth to still reach 2.9%.

One of the mysteries related to these events is why the domestic equity markets ignored these risks as long as they did, to the point of not only setting one record high after another, but even pushing the value of highly speculative stocks like Tesla and Virgin Galactica up by over 100% and 200% respectively in just a couple of months. Indications are that it was caused by a massive reversal in investing demographics.

Over the past thirty years, equity shares have been changing hands from smaller investors to the wealthiest Americans, which helps to explain much of the giant and growing divergence between the "haves" and "have-nots". In fact, over that period, the top 1% wealthiest Americans bought $1.2 trillion in company shares, while the rest of the population sold more than $1 trillion of stocks. Partially as a result, the wealthiest 1% of Americans now own more than half the dollar value of equities owned by US households, while the bottom 90% only own 12% of equity value. Specifically, according to Goldman Sachs, "the wealthiest 1% (aqua) own 54.20% of all equities. The wealthiest 10% (aqua and orange) own 88.1% of all stocks, and the bottom 50% (dark blue) own just 0.8% of stocks". This change in ownership may help to account for the market's lower volatility over recent years.

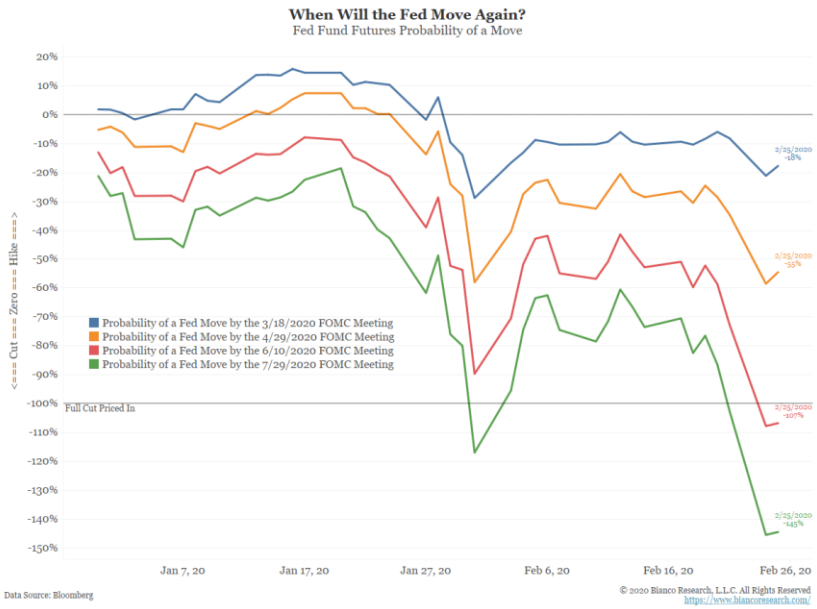


However, starting last October, small investors started pouring into the stock market. This is normally a warning sign, as it usually occurs very late in bull markets, and oftentimes actually marks the top of the market cycle. However, this time, Wall Street largely ignored this signal, as this surge in small investor trading volume started at the same time that the major discount brokerage firms like Charles Schwab, TD Ameritrade and Fidelity eliminated commissions on most on-line trading, which resulted in an absolutely massive surge in trading volume, much of which poured into the market's most speculative and/or growth-oriented stocks. As noted by Jason Goepfert, president of Sundial Research, "Retail traders have become manic."

Indications are that this massive surge of new money may be the force that allowed the markets to surge to record after record, despite very high valuations and significant fundamental headwinds.

It is said that the difference between amateur investors and professional ones is that professional ones make better guesses. Our guess is that the selling still has further to go, as we are not yet seeing signs of capitulation.

At the time of this writing, the S&P 500 is down about 8% from its recent highs. To put this into perspective, since 1927, there have been 222 pullbacks of at least 5%. While not necessarily of predictive value, it is at least noteworthy that during the 222 times when the market corrected at least 5%, the median decline was 8.2% and the average decline was about 12%.



Despite the Fed guidance that they do not expect to lower interest rates, we expect to see waves of both fiscal (government spending) and monetary (liquidity and interest rate) stimulus on a global scale, as the world tries to offset the negative economic impacts of the epidemic. At present, the markets are pricing in a 52% chance of a Federal Reserve rate cut in April, an 84% chance of a cut in July, a 60% chance of a second cut in September and a 45% chance of a third cut in December.

We expect for a combination of this stimulus and the eventual waning of the coronavirus (which we suspect will take some time) to catalyze a rebound in the global economy, and a continuation of the secular bull market in equities, and that the aforementioned risks will ultimately prove to be just another bump in the road for long-term investors. In fact, we suspect that the markets will ultimately treat the coronavirus, in particular, much as if it were a giant hurricane or other national disaster in terms of economic and market impact.

That said, investors hate uncertainty more than they even hate bad news, because they don't know how to price-in uncertainty, and we think that investors are likely to be over-supplied with uncertainty for much of 2020. As such, we are expecting a more volatile year. This is certainly the message of the bond market where the 10-year and 30-year Treasury are putting in all-time record low yields.

For those investors who have some cash, we think that it is still a bit too early for bravery, but that the current environment, like similar environments throughout the history of the capital markets, will likely ultimately present investors with an exceptional buying opportunity.

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The Dow Jones Industrial Average (DJIA) is an index that tracks 30 large, publicly-owned companies trading on the New York Stock Exchange (NYSE) and the NASDAQ.

The VIX Index is based on real-time prices of options on the S&P 500® Index (SPX) and is designed to reflect investors' consensus view of future (30-day) expected stock market volatility. The VIX Index is often referred to as the market's "fear gauge".

The Standard & Poor's 500 (S&P 500®) is a market-capitalization-weighted index of the 500 largest U.S. publicly traded companies.

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