Volume 114

THE PER STIRLING CAPITAL OUTLOOK

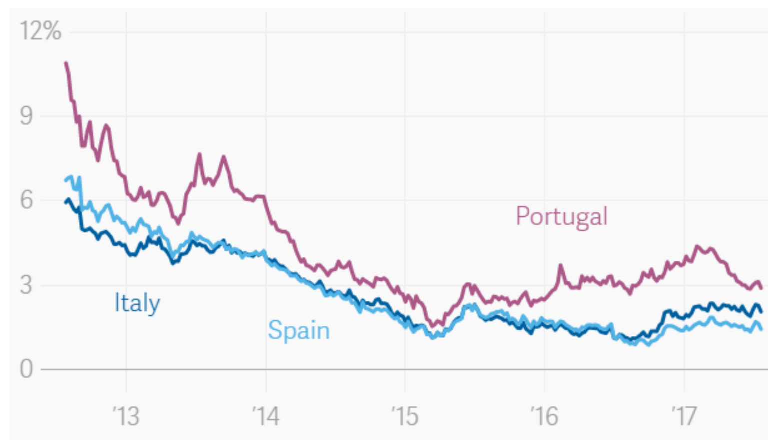
Performance • Perspective • Per Stirling

April 2020

One of our favorite perspectives on historical precedent comes from Mark Twain, who observed that "history does not repeat itself, but it oftentimes rhymes". Perhaps that has never been more true than is the case today.

Back in the summer of 2012, the currency and debt crisis in Europe was growing so severe that many doubted that the Euro would even survive as a currency. Complicating matters was the fact that the Euro currency represented a sort of Gordian Knot in that, once tied, the currency union was designed to be almost impossible to untie.

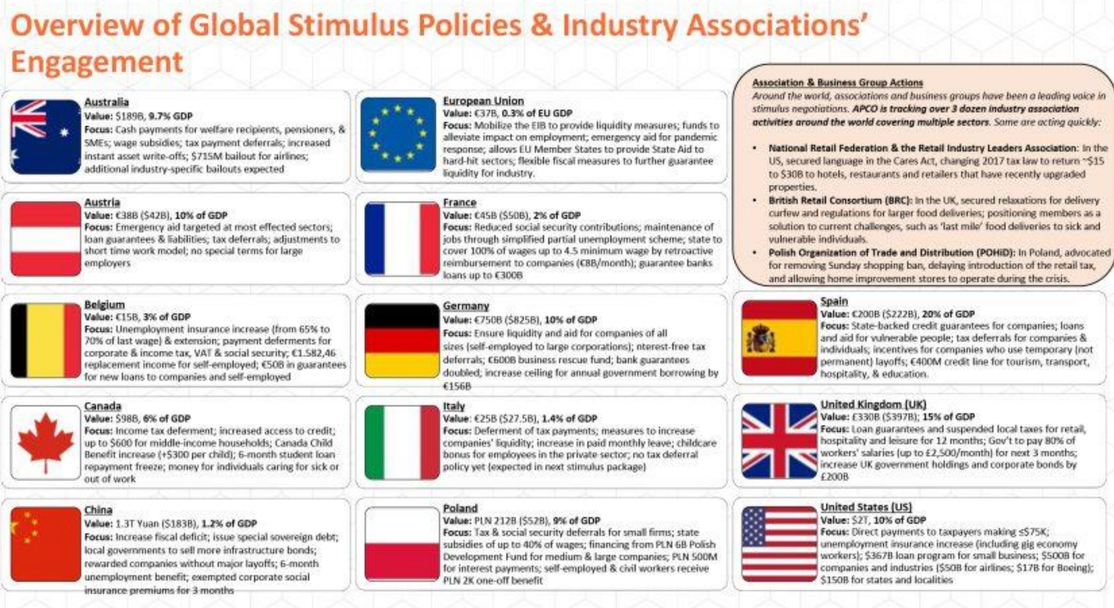
Greece, Portugal and Ireland had already been bailed out by the European Central Bank, and Spain was up next. Hedge Funds were setting their sights on Italy, and were driving down the value of its sovereign debt. However, unlike these other countries, the Italian economy and debt markets were too big to rescue, and the entire 13-year-old currency union was on the verge of collapse with unknown, albeit certainly very severe, consequences. Then, in a July 26th speech in London, European Central Bank (ECB) president Marion Draghi proclaimed that "Within our mandate, the ECB is ready to do whatever it takes to preserve the euro. And believe me, it will be enough." After "talking the talk", Draghi then "walked the walk" through the introduction of massive quantitative easing, asset purchases and negative interest rates.



Remarkably, it was, in fact, "enough", and European interest rates started moving lower, the euro currency strengthened, and the crisis ultimately passed. It was the defining statement of Draghi's career, and his words (or at least the sentiment) have echoed time and time again, as part of the global government response to the current COVID-19 crisis.

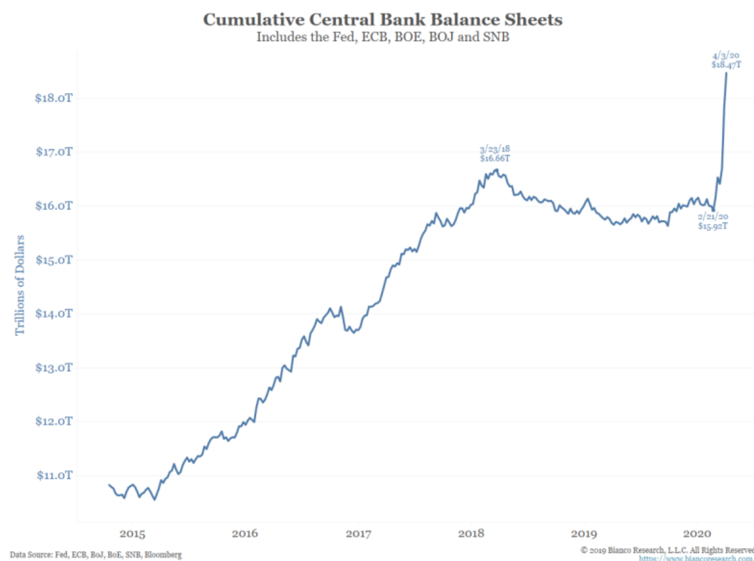
Regardless of the language, the message has been the same. French President Emmanuel Macron vowed to support workers and businesses "whatever the cost", while German Chancellor Angela Merkel committed to "do whatever is necessary" to defend the European economy, and European Central Bank (ECB) President Christine Lagarde committed to do "everything necessary".

Similar commitments were echoed by U.K. Prime Minister Boris Johnson ("whatever it takes"), Spanish Prime Minister Pedro Sánchez ("We will do whatever it takes. We will make it"), and Italian Prime Minister Giuseppe Conte ("the logic of whatever it takes"). Conte even spoke the last three words in English (as Draghi had done back in 2012), just to make sure that everyone fully comprehended the reference.



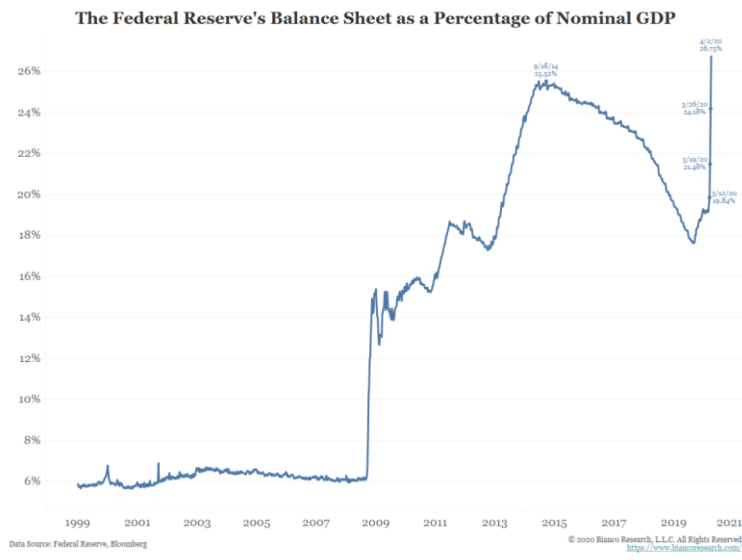
However, none of these commitments, nor the corresponding fiscal and monetary policies (despite their massive size), can even hold a candle next to the fiscal and monetary rescue and stimulus programs rolled out by the United States government and Federal Reserve.

In regard to fiscal policy, it is nothing short of remarkable, in what might have been the most dysfunctional legislative environment in history, that Congress was able to work together to pass the Coronavirus Aid, Relief and Economic Security (CARES) Act so quickly (at least by Washington D.C. standards). It was not only appropriately massive ($2.2 trillion, which is equivalent to 10% of the size of the pre-crisis economy), but also innovative and well considered. It is estimated that this level of fiscal stimulus alone is sufficient to offset a 25% decline in GDP (i.e., a 25% economic contraction) for five months.



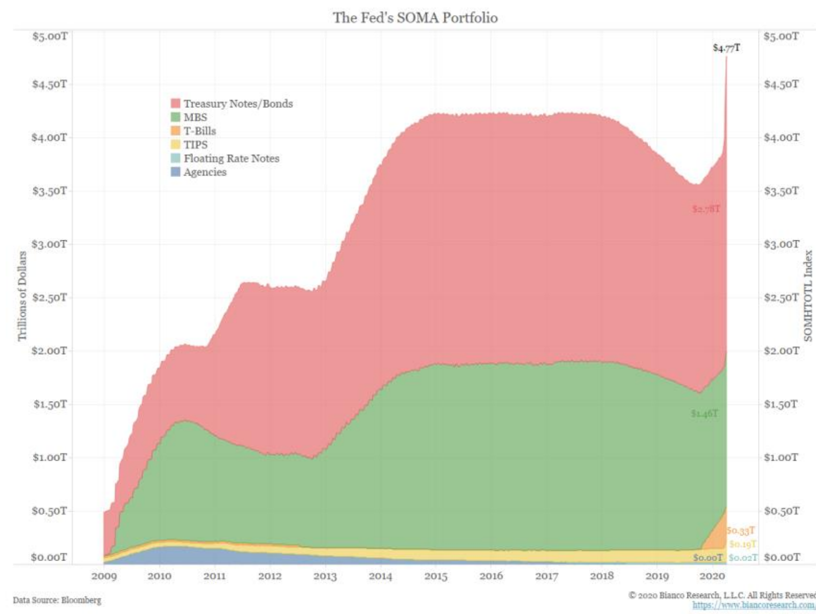
As extraordinary as has been the speed and massive size of this fiscal stimulus, even it is being dwarfed by the Federal Reserve's monetary policy response.

Within a period of less than two weeks, the Fed not only relaunched every tool that they had employed to lift the economy out of the financial crisis, but also utilized virtually every strategy that had been employed by either the European Central Bank or the Bank of Japan, albeit with the notable exception (fortunately) of negative interest rates.



So expansive is the Federal Reserve's response that we could (but won't) use the remainder of this report to detail it. However, what may ultimately be most important is that Fed Chairman Powell had his "whatever it takes" moment on April 9th, when he stated, "There is no limit of what we can do as long as it meets the test of law as amended by Dodd-Frank." Moreover, you can argue that Chairman Powell has been not only pushing the Fed's mandate to the limit, but even pushing it well over the legally-prescribed limit.

Indeed, while the Fed is not allowed to ever suffer a loss in its balance sheet, and thus is theoretically (and traditionally) limited to buying the debt of the federal government and federal agencies, the Fed is now buying everything in sight, ranging from the loans issued under the Payroll Protection Program, to municipal bonds, to ETFs of investment-grade debt, and now even "fallen angels", which describes formerly investment-grade debt that has recently been downgraded to non-investment grade (i.e. "junk") status. While their balance sheet is now hardly risk-free, they are operating with the approval and assistance of the Treasury (so much so that the Fed looks like anything but an independent agency).



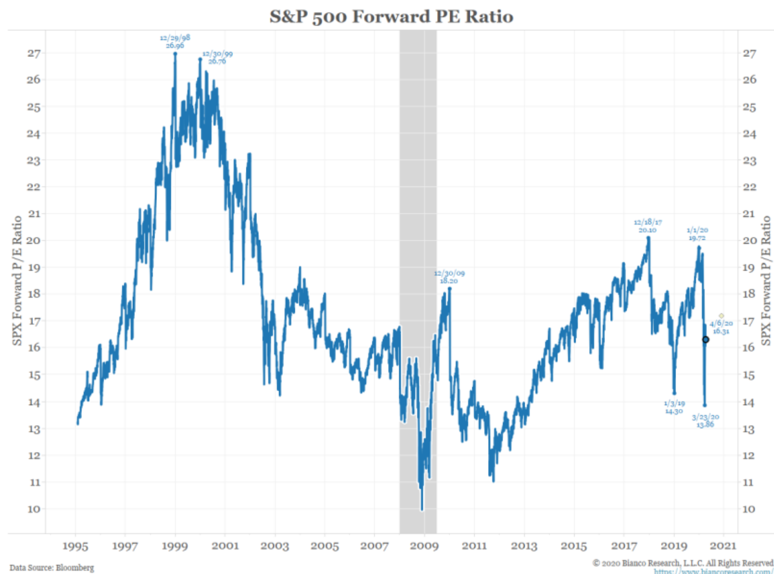
They have also re-introduced quantitative easing on an open-ended and unlimited basis. This means that they are willing to use their unlimited ability to create credit to buy all kinds of financial assets (including even student loans, credit card loans, and auto loans), as a means of helping to keep the economy solvent.

As Chairman Powell just announced: “At the Fed, we are doing all we can to help shepherd the economy through this difficult time…When the spread of the virus is under control, businesses will reopen, and people will come back to work. There is every reason to believe that the economic rebound, when it comes, can be robust.”

Importantly, the Fed’s actions dramatically improved the liquidity in the credit markets, which is also very important to equity investors, as the illiquidity in the credit markets was a significant catalyst in the equity market’s dramatic decline. You can see this improvement in credit market liquidity by looking at the difference in yield between investment-grade debt and government debt (above).

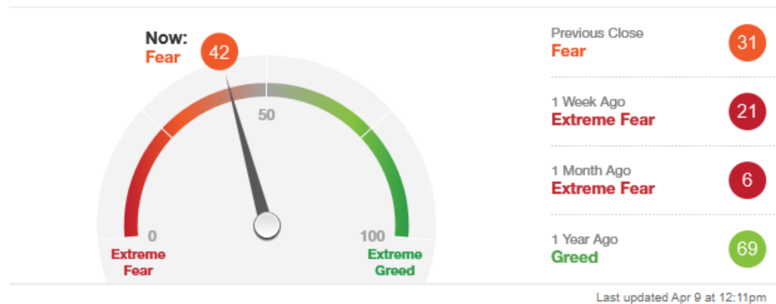
With combined monetary and fiscal stimulus already totaling almost 35% of the size of the domestic economy, with the Fed setting short-term interest rates at virtually 0%, and with the potential, according to Capital Economics, for the monetary stimulus alone to be leveraged to as much as 50% of the size of the economy, it is no wonder that the stock market has now recovered almost exactly 50% of its historic first quarter decline.

The problem is that, by traditional measures, the domestic stock market is no longer inexpensive. Indeed, the Standard & Poor’s 500 Index is selling at over 16 times anticipated earnings and over 18 times trailing earnings, and those forward-looking earnings estimates are very suspect in the current environment.

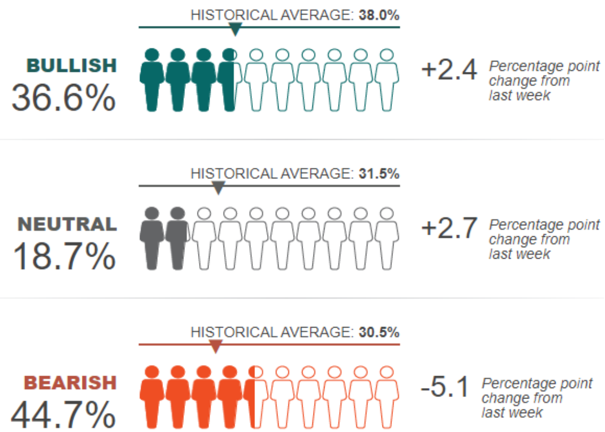


Remarkably, it is not just valuations that have rebounded to fairly normal levels. The same is also true of both investor sentiment and market internals (like breadth, put/call ratios, and volatility), which have returned to more normal ranges, and that suggests that the opportunity to take advantage of a market panic to find value and upgrade the quality of your portfolio holdings may have already passed (at least for the time being).

For a measure of market internals, we will point to the CNN Fear and Greed Index, which does a very good job of blending many of the most important measures of market sentiment, momentum, relative strength, breadth, volatility and risk tolerance into a single, useful indicator.

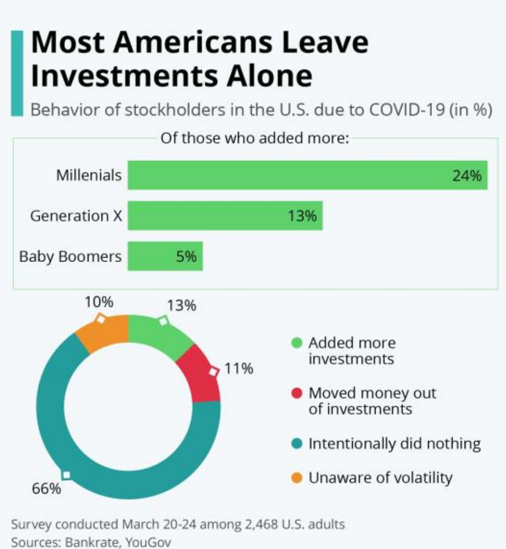


In just over a month, it has transitioned from a reading of "2", which indicated extraordinary levels of investor fear, to a reading of "42", which is almost back to a neutral reading.

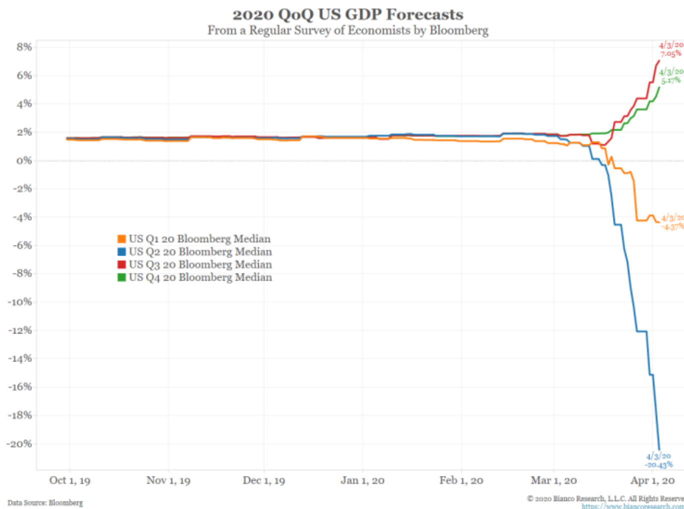


Of equal importance, the American Association of Individual Investors sentiment survey has remarkably returned to a bullish reading of 36.6%, which means that over 36% of respondents now believe that the equity market will be higher in six months than it is today. While bearish sentiment remains high at over 44%, we find it remarkable that bullish sentiment is now less than 2% below its historical norm.

Of note, one of the things that we are finding very hard to explain is how the markets have just experienced what was arguably the shortest, sharpest bear market in history when virtually no one admits to have done any selling of equities. According to a poll conducted by Bankrate and YouGov, 66% of respondents made no changes to their portfolios in the first quarter, and only 11% admitted to doing any selling, which compares to 13% who said that they added to their equity holdings. Amazingly, 10% of respondents said that they were not even aware of the massive market decline, while a poll from Wells Fargo and Gallup showed that very few investors even bothered to call their investment professional in response to the decline. Indeed, sentiment may now even be somewhat overly bullish, with a Citi March 31st survey of institutional clients showing that 80% planned on committing new cash to the equity markets.



So what does this all mean, when the equity markets are still more than 20% below their first quarter record highs, but also more than 20% above their first quarter lows, and when valuations and sentiment measures have already returned to essentially neutral levels, despite the fact that the country is in the midst of one of one of the deepest and most dramatic economic contractions in history?



Indeed, with 20% being the accepted differentiator between bull and bear markets, is this a bull market, due to its greater than 20% rebound off of the lows, or is this just a bear market rally, as the market is still down more than 20% from its record highs?

Unfortunately, as we will illustrate, historical precedent actually favors the second interpretation, but then again, there is remarkably little about the first quarter that fits neatly into historical norms, particularly in regard to the speed and scope of the market and economic contraction. On the other hand, there are many elements of the first quarter experience that played out almost exactly as we had anticipated in our previous writings.

Start Date	Duration (Days)	Advance
Oct. 29, 1929	2	18.2%
Nov. 13, 1929	148	46.8%
Dec. 16, 1930	72	25.8%
Jun. 02, 1931	24	25.8%
Oct. 05, 1931	35	30.6%
Jan. 05, 1932	10	18.2%
Feb. 10, 1932	27	19.7%
Sep. 19, 1932	2	16.1%
Oct. 10, 1932	32	19.6%
Jul. 21, 1933	35	16.9%
Oct. 19, 1933	110	37.3%
Nov. 24, 1937	48	17.5%
Nov. 24, 1937	223	62.2%
May. 19, 1947	393	23.9%
Feb. 12, 1957	153	15.9%
Apr. 04, 2001	47	19%
Sep. 21, 2001	105	21.4%
Jul. 23, 2002	30	20.7%
Oct. 27, 2008	8	18.5%
Nov. 20, 2008	47	24.2%

Specifically, when faced with great uncertainty, markets tend to almost immediately price-in the worst-case scenario, instead of waiting to determine just how bad things are realistically likely to get before reacting. Normally, the selling continues until investor sentiment reaches the "point of maximum pessimism", when the market essentially runs out of potential sellers, and a bottom is put in place. Once the panic stage concludes, investors start to look at economic and market fundamentals more rationally and, upon doing so, almost always realize that the actual scenario is much less dire than was the "worst-case-scenario" that had been priced into the markets, and they bid securities prices higher accordingly.

We believe that this is a good description of the current state of the equity markets, and that this is all part of what we perceive to be a bottoming process (remember that market bottoms are almost always processes rather than events). We have a high conviction in our belief that a bottom is being put in place, and even a growing conviction that the ultimate lows were put in place right around the 2,200 level on the S&P 500 (a level that we had actually identified in a previous writing as a likely target price). That said, we suspect that the markets may have rallied too far, too fast, and that those investors still holding cash may get yet another opportunity to put it to work at lower levels.

There are several things that make us a little cautious in the very near term, including the time-compressed nature of both the decline and the rebound. In fact, there were only twenty-three trading days between the S&P 500's record high and the recent bear market low, whereas the average bear market lasts for eleven months and the median average bear market lasts for seventeen months, with no previous bear market ever lasting less than three months.

It is also noteworthy that the kind of outsized single-day gains that we have seen in the current rebound almost never occur in a bull market, and are instead much more prevalent during bear markets, as is evidenced in both the above list of the biggest single-day advances and the above chart of the S&P 500 during the financial crisis.

While the past is not necessarily prologue, during the fourteen bear markets that have occurred since 1927, there have been twenty separate counter-trend rallies of at least 15%, and an average gain of 25%. Further, there have been only seven times over the past seventy years when the S&P 500 has gained as much as 7% in a day, and they have all occurred during periods of significant disruption. Three took place during the first quarter of this year, three occurred during the financial crisis, and one took place right after the 1987 crash.

Recession Start	Recession End	Length of Recession (Months)	Market Low	Market Low to End of Recession	S&P 500 Peak to Trough
Nov-48	Oct-49	11	Jun-49	4 Months Prior	-30%
Jul-53	May-54	10	Sep-53	8 Months Prior	-15%
Aug-57	Apr-58	7	Oct-57	6 Months Prior	-22%
Apr-60	Feb-61	9	Oct-60	4 Months Prior	-14%
Dec-69	Nov-70	10	May-70	6 Months Prior	-36%
Nov-73	Mar-75	16	Oct-74	5 Months Prior	-48%
Jan-80	Jul-80	6	Mar-80	4 Months Prior	-17%
Jul-81	Nov-82	15	Aug-82	3 Months Prior	-27%
Jul-90	Mar-91	8	Oct-90	5 Months Prior	-20%
Mar-01	Nov-01	7	Oct-02	11 Months After	-49%
Dec-07	Jun-09	17	Mar-09	3 Months Prior	-57%
			Average	**3 Months Prior**	**-30%**

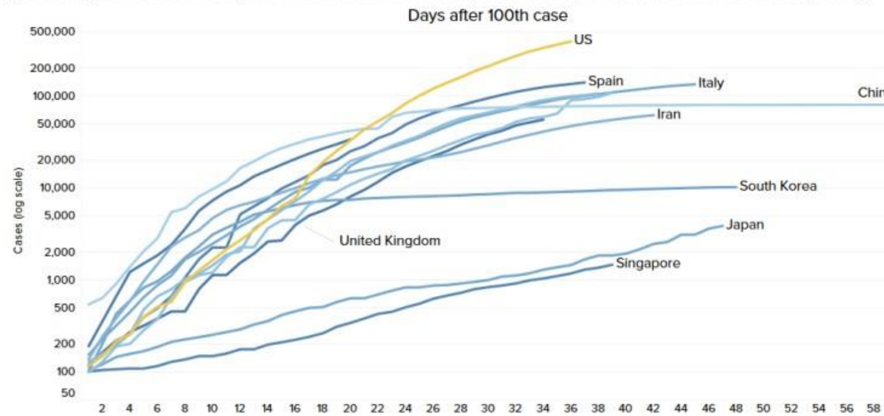
We are also mindful that V-shaped bottoms are rather rare throughout market history, as investors have traditionally wanted some evidence that a sustainable bottom is in place before making major new commitments to equities. As a result, between 70% and 80% (depending on the time periods measured) of significant market lows have included at least one retest of a significant prior low before sustaining a new bull market rally. Of note, we would not expect a full retest back to the absolute lows.

It is also noteworthy that the rebound has been led by the most-heavily-shorted stocks and those with the worst balance sheets and fundamentals, so we suspect that much of the rally has been driven by speculators buying back shares to cover their short positions, as all of the government support left them heavily exposed to losses.

To reiterate, we do strongly believe that the markets are in the process of putting in place a bottom, and that the current environment will prove, over time, to have been a prudent time to both maintain, and even add to, equity holdings. This perspective is certainly supported by the fact that bear markets normally end four or five months before the end of the recession that normally accompanies them, and with all of the stimulus in the pipeline, the timing seems about right.

However, we would also note that so many of the other lessons of history suggest that an investor might be well-served being somewhat cautious and patient at the current time, as there may be better entry points down the road, and we would certainly discourage extrapolating the current rally into the future.

Then again, it is certainly possible that we are guilty of looking for historical precedent for a largely unprecedented chain of events, and that this market will be a precedent-maker rather than a precedent-taker.



Ultimately, the market outlook will be a function of progress on the medical front, where there is growing reason for encouragement.

World Health Organization Director-General Dr. Tedros Adhanom Ghebreyesus just announced that more than seventy countries have joined together in research and that "about 20 institutions and companies are racing to develop a vaccine." More than 200 clinical trials have already been launched and, while expectations remain that a vaccine is still at least a year away, an effective therapeutic drug could be available as soon as this summer. According to former Federal Reserve Governor Kevin Warsh, such a drug could restore at least $1 trillion in economic growth. Further, on April 8th, Dr. Fauci predicted that the U.S. should soon expect to see the "beginning of a turnaround".

To quote the Chairman of Blackrock, Larry Fink, in his March 30th annual letter to shareholders: "The world will get through this crisis. The economy will recover. And for those investors who keep their eyes not on the shaky ground at our feet, but on the horizon ahead, there are tremendous opportunities to be had in today's markets."

We could not agree more.

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.

The CNN fear and greed index (FGI) was developed by CNNMoney to measure two of the primary emotions that influence how much investors are willing to pay for stocks. It is based on the premise that excessive fear can result in stocks trading well below their intrinsic values, and that unbridled greed can result in stocks being bid up far above what they should be worth. CNN examines seven different factors to establish how much fear and greed there is in the market, scoring investor sentiment on a scale of 0 to 100.

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.