Volume 117

THE PER STIRLING CAPITAL OUTLOOK

Performance • Perspective • Per Stirling

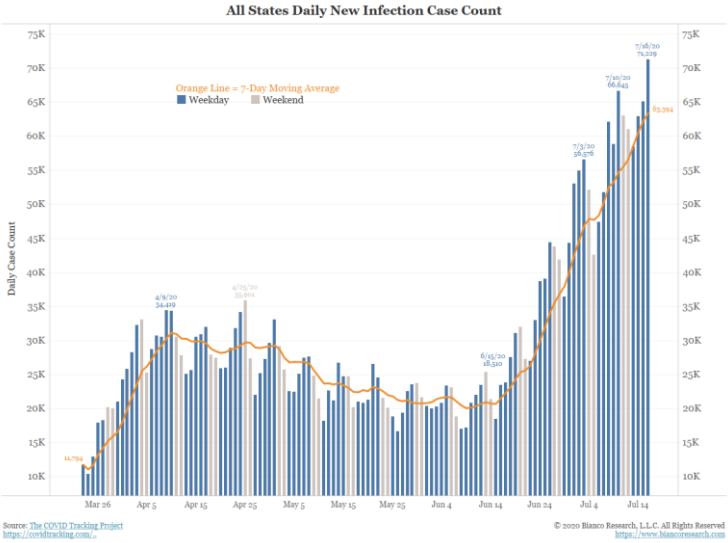
July 2020

The Cambridge Dictionary defines the term "light at the end of the tunnel" as "signs of improvement in a situation that has been bad for a long time, or signs that a long and difficult piece of work is almost finished". From a medical, economic and societal perspective, we believe that there is growing evidence of a distant light, at the end of this long and very dark pandemic tunnel.

This "light" is being powered by two sources. The first is on the medical front, where there are currently 179 different coronavirus vaccines being developed, of which 17 are already in clinical trials, and almost all of which are, at least thus far, reporting very encouraging results.

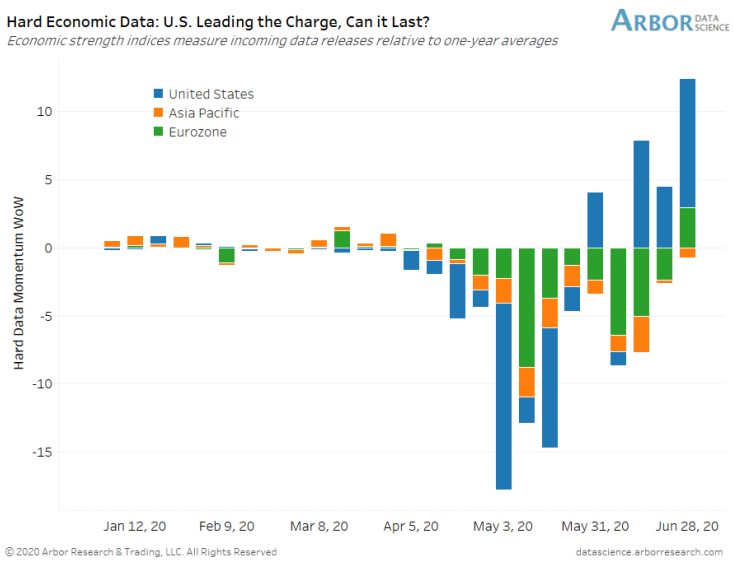
In fact, Dr. Fauci just noted, in an interview with CNN's David Axelrod, that he has been told by the companies developing these vaccines that they "would have doses to the tunes of tens of millions early in the year, and up to hundreds of millions as we get well into 2021", and that "with a successful vaccine — if we could vaccinate the overwhelming majority of the population — we could start talking about real normality again." He went on to say that, "I think with a combination of good public health measures, a degree of global herd immunity and a good vaccine, which I do hope and feel cautiously optimistic that we will get, I think when we put all three of those together, we will get control of this, whether it's this year or next year. I'm not certain".

In the meantime, an improved understanding of how to best treat the virus, a new and relatively effective generation of therapeutics, and a 15-year decline in the average age of COVID-19 patients have already combined to produce an almost one-third reduction in the mortality rate for COVID-19 patients in intensive care. This statistic is particularly impressive considering that it is in spite of the pressures imposed on the U.S. healthcare system by the renewed surge in both overall coronavirus cases and hospitalizations.



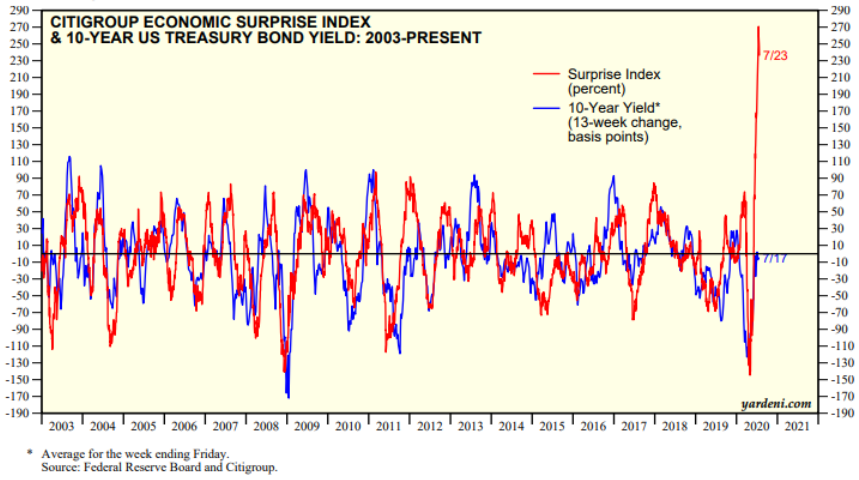
Indeed, as was just noted by Dr. Amesh Adalja, an infectious disease and critical care physician at Johns Hopkins, "It is clear in July 2020 that we know much more about this virus, the complications it can cause, and how to prevent those complications than we did in March 2020."

The other factor powering this distant "light" is the global fiscal and monetary policy response, which has been both historic and heroic. If you look at the U.S., as an example, the coronavirus pandemic blew a $3 trillion hole in the domestic economy, and the Treasury Department and Federal Reserve filled it with approximately $10 trillion of stimulus, a sum more than sufficient to resuscitate the domestic economy from its government-induced coma, and lift it out of intensive care, albeit certainly not out of the hospital.



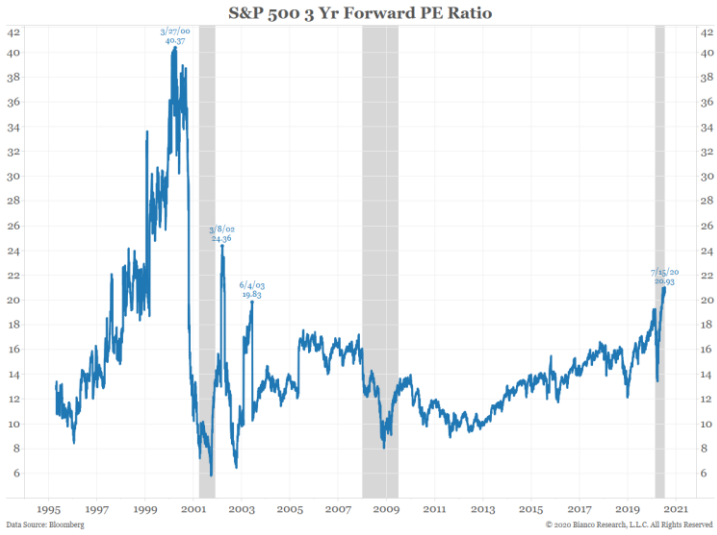
As noted by renowned economist David Rosenberg, "The market is doing the math and seeing the $3 trillion collapse in GDP has been way more than offset by what will be $10 trillion in fiscal and monetary policy stimulus". The economy seems to be doing those same calculations, as shown by its explosive bounce off of the bottom. This extraordinary rebound is displayed in the bar charts (above), which illustrate economic data from the U.S., Europe and the Pacific, as measured against year-earlier levels.

What was probably even more important to the markets than the nominal size of the rebound was the dramatic degree by which the rebound exceeded expectations, as markets are priced based upon future expectations. When actual conditions turn out to be significantly better or worse than expected, the markets need to reprice accordingly (in this instance, with a greater-than-30% rebound in equity prices from their March 23rd lows).



You can see the enormity of this upside surprise in the appropriately-named Citi Economic Surprise Index (red line, above), where expectations are benchmarked at "0" (the black horizontal line) and the variance from the "0" line indicating the size of the surprise (positive for better than expected and negative for worse than expected). It is also noteworthy, however, that the change in yield on 10-Year Treasury notes, which normally tracks the Citi Surprise Index very closely, has barely moved, which suggests either that bond investors do not trust the strength and sustainability of the economic recovery, or that all of the government stimulus is so distorting the bond markets that interest rates can no longer be depended on as an indication of economic conditions.

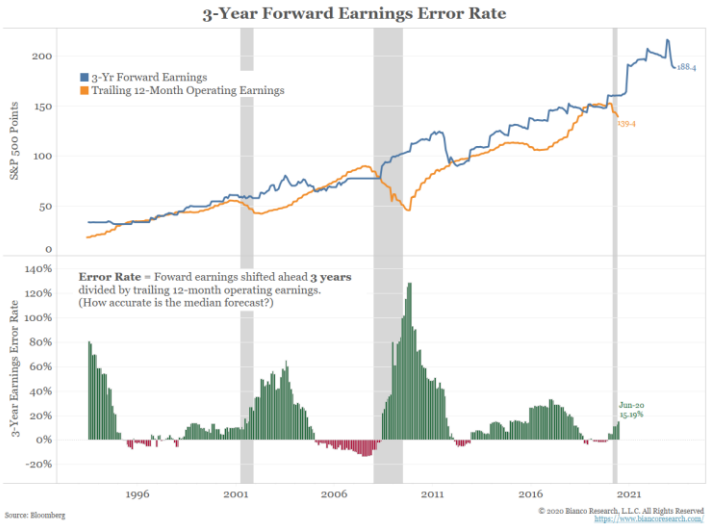
That said, for the time being, we are still very clearly in the aforementioned tunnel, and that light, while increasingly visible, is still some distance away, with at least six to twelve months of travel in front of us, and numerous hardships likely to hamper our progress along the way.



Arguably, it is the perception of this "light" that helps to explain the apparent disconnect between the stock market and the real economy. Indeed, it is nothing for equity markets to discount into current prices the anticipated macro-economic fundamentals for twelve to eighteen months into the future.

That's what equity markets do even during normal times, which is why the stock market is used as a key component of the Index of Leading Economic Indicators, which is designed to estimate economic growth rates over the next several quarters.

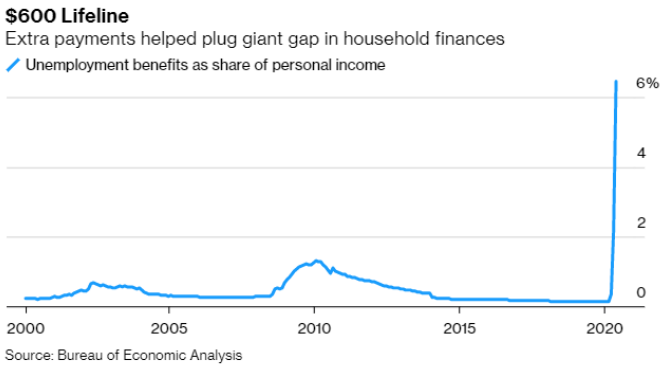
Further, if you make the reasonable assumption, in light of the self-inflicted nature of the economic shut-down and the massive levels of current and anticipated future fiscal and monetary stimulus, that investors are willing to stretch out their horizons a little further, for example to value equities based on anticipated earnings in three years rather than in one year, then stock market prices and valuations both seem much more reasonable, and the equity markets do not seem quite so disconnected from economic reality.



Unfortunately, there is a problem with basing equity valuations upon earnings estimates that far into the future, which is that history shows that such long-term estimates tend to have a significant error rate. Even so, in the current market environment, investors seem more than willing to value equities based upon these somewhat speculative earnings estimates, as they at least provide some reference point at a time of considerable uncertainty. As noted by Desiderius Erasmus, "In the land of the blind, the one-eyed man is king."

Unfortunately, "daily life" does not enjoy this luxury of being able to look ahead to the eventual exit from the tunnel. Housing, food, healthcare, etc. normally need to be paid for in real time and with either credit or dollars already earned. You will note the "normally" qualifier, as the past four months have been anything but normal.

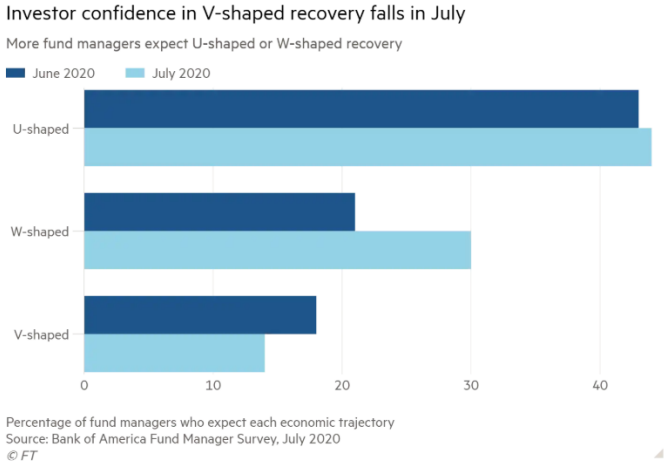
Instead, it has been a time when average earnings have jumped more than 10%, in spite of tens of millions of layoffs, due to a federal program that pays $600 per week over and above state unemployment benefits, thus creating a situation where approximately two-thirds of those laid off are making more being unemployed than they had been making when working. It has even been a time when one could neither be evicted for non-payment of rent nor have utilities shut off for non-payment.



Remarkably, according to new research from the JPMorgan Chase Institute and the University of Chicago, "Jobless Americans are responsible for the bulk of the consumption recovery, with employed Americans still spending significantly less than before the pandemic."

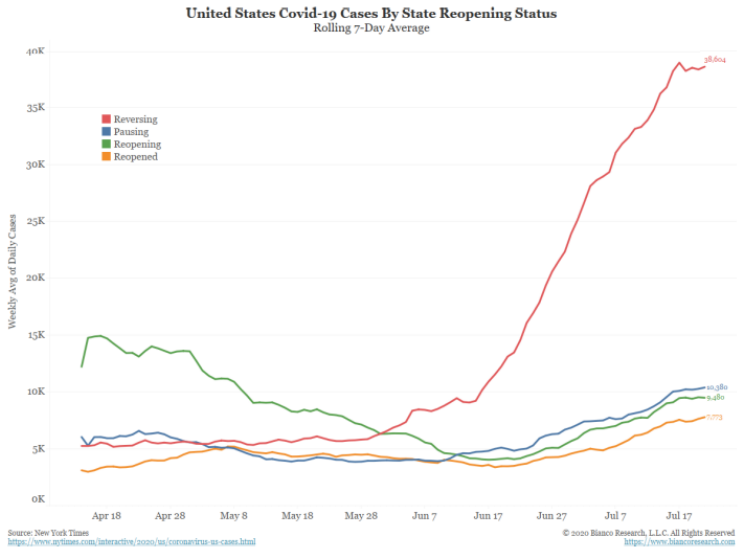
Perhaps of equal importance it has been a time when the federal government provided low-interest payroll protection plan (PPP) loans to businesses, which were forgivable, as long as the recipient used a requisite minimum of the loan to keep employees employed, and also a time when the payment of both 2019 taxes and 2020 quarterly estimated taxes were delayed until mid-year. This just scratches the surface!

This extraordinary policy response also included direct stimulus payments to lower and middle-income families by the Treasury, and massive asset purchases by the Federal Reserve. The resulting much-stronger-than-expected rebound in the economy gave hope that we would see, at minimum, a somewhat slow and plodding, but uninterrupted, "U-shaped" economic recovery, and that we might even ideally benefit from a "V-Shaped" recovery that was almost as sharp and sudden as was the self-inflicted contraction (i.e., the government-mandated shut-down).

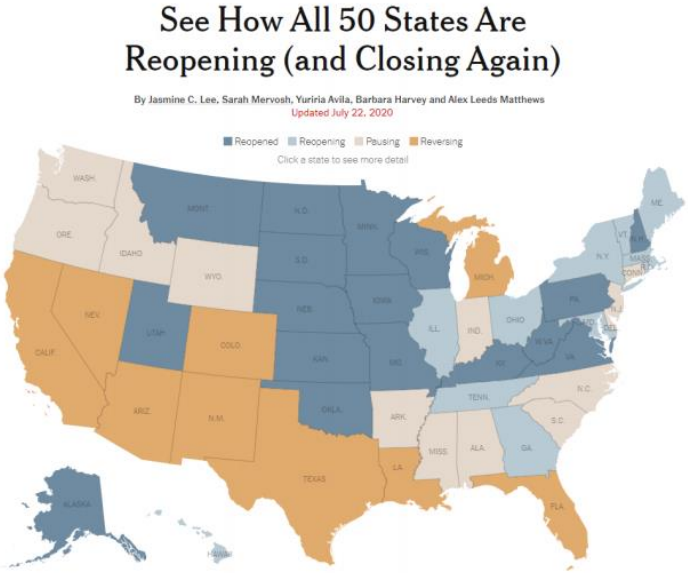


Indeed, given the unprecedented size of the government stimulus, we believe that such an optimistic outcome was not only a viable possibility, but potentially even the path of least resistance, if America (like most other developed nations) had only been able to engineer a sustainable reopening of its economy, without simultaneously causing a resurgence in coronavirus cases. Unfortunately, partisan politics, misinformation, a deeply-divided country, and America's unwillingness to learn from the experience of other countries all conspired against such a beneficial outcome. As was just reported by Goldman Sachs, "Over the last few weeks, the COVID situation in the US has worsened significantly to the point where the US is now a notable outlier among advanced economies". Largely as a result, the prospects for a "V-Shaped" recovery appear to be waning by the day.

Goldman Sachs CEO, David Solomon, spoke on this issue last Wednesday during a conference held by the Economic Club of New York, when he noted that "The economic reality is that we are still facing a very, very uncertain economic environment," and that the U.S. economy will be hampered by high unemployment and a plodding recovery because of the coronavirus pandemic". He went on to say, "I think in the next couple of months you'll see a tamping down of that acceleration, I think you'll see poorer economic numbers," and "I think we're in for a very, very bumpy ride."



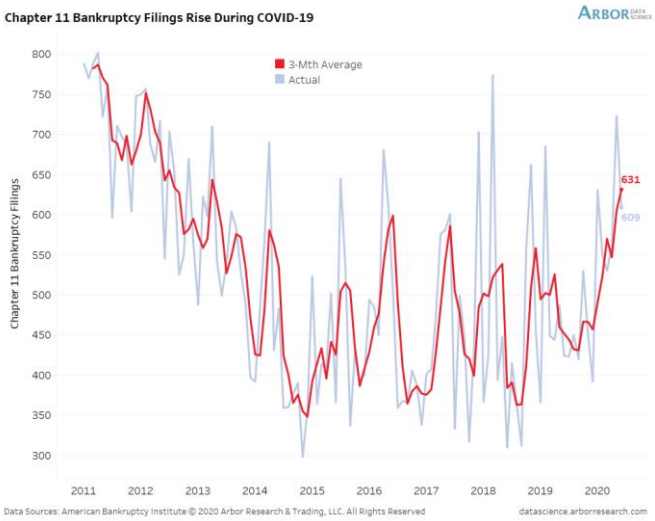
There is a very logical and growing correlation between coronavirus case numbers and steps being taken to reshutter regional economies and, according to a new report from the US Conference of Mayors, U.S. cities could lose $1.5 trillion in economic activity in 2020, even if the pandemic is brough under control later this year. This speaks to the great political dilemma associated with this crisis. You can protect the economy, or you can protect the population, but you can't, at least without an effective and widely adopted vaccine, do both. This perspective was just reinforced by a recent survey from Alignable, which documented that the states that have been most successful in controlling the virus also have the highest percentages of businesses that are now permanently closed.



The objective of the massive government fiscal and monetary stimulus programs has been to build a bridge to the other side of this economic canyon. They have been designed to keep both consumers and businesses solvent until such time when there is a widely-distributed and effective vaccine for the virus and the economy can begin to stand on its own.

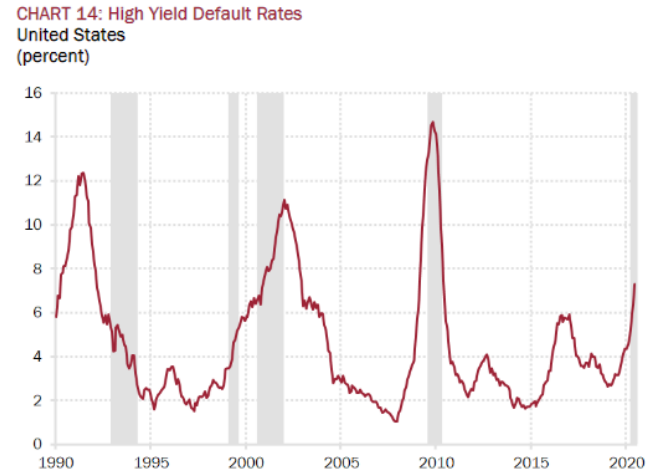
Unfortunately, this continuing surge in case counts is necessitating that this figurative "bridge" be longer, and that it will take longer to cross. This dynamic is now being greatly complicated by the fact that these stimulus programs are starting to expire. As noted, these expiring programs were designed to "buy time" for the development of vaccines and therapeutics, and they have done a good job in this regard. However, the longer it takes to cross that bridge, the more economic damage will occur, much of which we suspect will be longer-term in nature, and beyond immediate repair from either stimulus or a vaccine.

As noted on July 14th by JPMorgan C.E.O. Jamie Dimon, "This is not a normal recession. The recessionary part of this you're going to see down the road…You will see the effect of this recession. You're just not going to see it right away because of all the stimulus". In short, the impact can be delayed, but not entirely avoided, and we believe that signs of that inevitable damage are now starting to manifest themselves in a variety of ways, including a recent surge in bankruptcy filings, a jump in first-time jobless claims, and a decade high level of defaults in the high yield debt (junk bond) market.



As was just noted in a July 10th report from Franklin Templeton, "sharply rising bankruptcies will be the next challenge policymakers will need to address. Solvency conditions will likely continue to deteriorate the longer the pandemic lasts and the longer economies take to recover. Central bank efforts to bolster liquidity in financial markets through extraordinary policy interventions have been effective, but they do not engineer demand, replace lost revenues or cure insolvencies; they only deepen the debt burdens".

Greatly complicating matters is not only the current political wrangling over the next stimulus package, but also the likelihood that the end product will be nowhere as impactful as were its predecessors. Part of this is because certain "bullets" can only be "fired once". For example, they can't defer 2020 tax payments a second time.



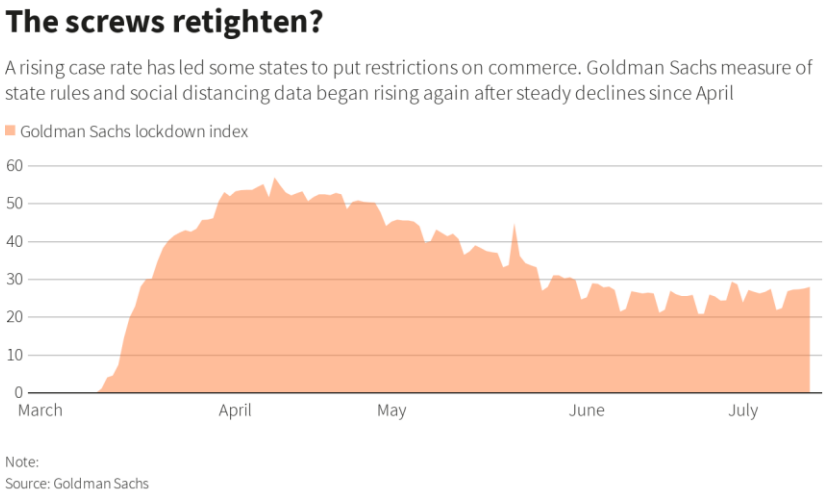
Shaded regions represent periods of U.S. recession
Source: Martin Fridson, Rosenberg Research

In addition, any extension of the Payroll Protection Program (PPP) is unlikely to be as impactful, as many businesses that took loans the first time are now permanently closed, and because the second tranche of PPP funding has unused funds still available.

In addition, federal unemployment benefits will likely be less generous than before, as it actually impairs the ability of the economy to recover, if we continue to pay two-thirds of the unemployed more money not to work than they were making while employed, as it both makes it very difficult for businesses to rehire those employees, and is catalyzing a sharp increase in wage inflation.

Of note, one of the last things that you want to see during a period of deep economic contraction is inflation, as it handicaps the Federal Reserve's flexibility and introduces the risk of "stagflation" (remember the late 1970s).

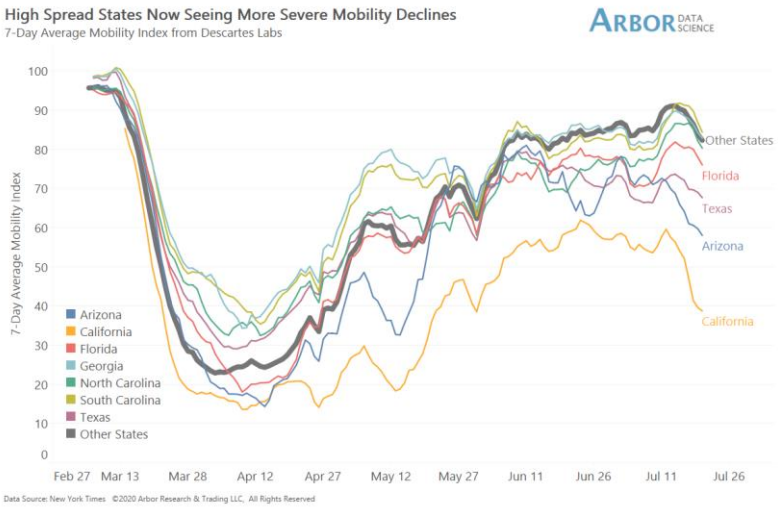
The longer-term implications of all of this stimulus will probably include higher inflation, higher taxes, and the government exercising much more influence and involvement in the economy and capital markets than they have in the past. However, that is a problem for another day and, in the meantime, these programs are essential to our economy's "passage through the tunnel". At minimum, they need to support the economy to the point of a successful re-opening.



We hope to see at least a modest reduction in the case count now that mask wearing is starting to lose its political overtones, and believe that a dramatic reduction in the case count will be essential before winter, when most of everyone's time is spent indoors, where the virus has been proven to spread most efficiently.

Ideally, with a drop in case counts, states will get another opportunity to reopen their economies, albeit in a more thoughtful way that hopefully avoids another resurgence of the virus. Finding a way to safely re-open is of growing urgency, as companies are already starting to exhaust their PPP loans, and will soon lose all economic incentive to keep any employees on the payroll that they do not absolutely need.

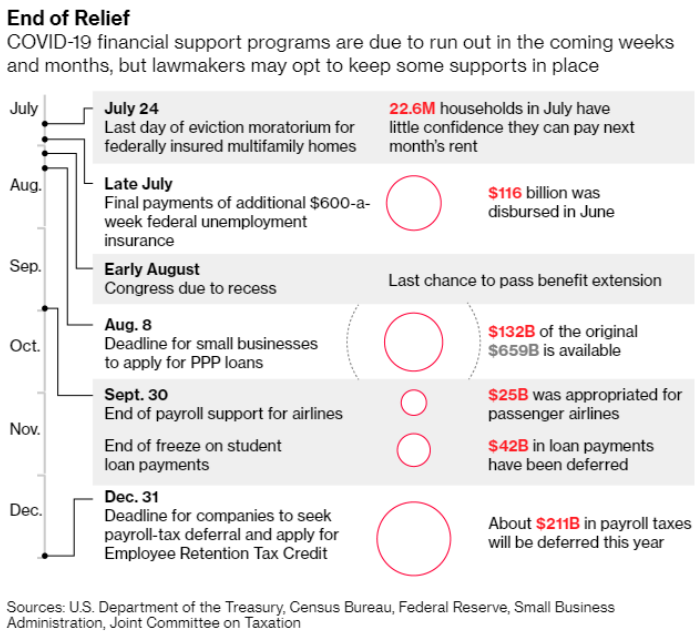
This suggests that the best of the employment rebound is already behind us, at least for the time being and, when you add in the impact of the partial reversal of the "re-opening trade" in four states (Florida, Texas, Arizona, and California) that represent 30% of the U.S. economy, the economic rebound is starting to look more like it is going to be "W-shaped" rather than "V-shaped".



That will be particularly true, if states are not broadly successful in engineering sustainable, resurgence-free economic re-openings, in which case, these stimulus programs will become increasingly essential in sustaining the economy.

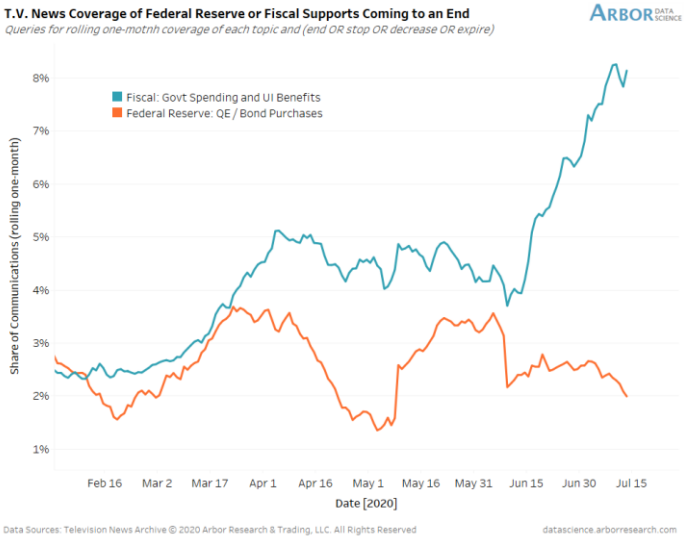
In addition to extending enhanced federal unemployment benefits (which expired on July 26th), an extension of the eviction moratorium, which ended on July 25th, would be particularly impactful, as there are estimates that as many as 2,000,000 Americans are behind in paying their rent.

The light is clearly out there, and the end of the tunnel is likely is sight, but the road ahead appears on the verge of getting notably bumpier. Indeed, with so many potential challenges confronting investors, and the likelihood that support from the government will not be as impactful as it has been in the past, one might ask why the stock market has not given up more of its gains.



We suspect that the answer is two-fold. First of all, there is a massive $7 trillion dollars of sideline cash sitting in money markets, much of which could be put to work buying almost any equity market decline of substance. Second, there is a broad belief in the existence of the so-called "Fed put", which implies that, in the current crisis environment, the Fed will help to support virtually all financial markets in the event of any substantial decline. Importantly, this second belief significantly increases the perceived risks associated with shorting the market or otherwise trying to profit from its decline.

An analysis of T.V. news coverage reinforces the perception that, while the level of government fiscal stimulus may be at risk, the Fed and its willingness to use its unlimited balance sheet to do whatever is necessary to support the economy (and even the capital markets) remains unquestioned.



However, in the shorter term, the risk is that some financial assets are currently being priced as if we are already out of the tunnel, and that the crisis has already passed, which is a source of risk, as the pandemic potentially strengthens and government support likely weakens. In addition, the Fed has, at least temporarily, reduced the size of its asset purchase (quantitative easing) programs, that played such an important role earlier this year in calming and reliquifying the capital markets. At least temporarily, the government seems to be letting some air out of the shock absorbers.

To quote the Bette Davis character from the movie *All About Eve*, "Fasten your seatbelts, it's going to be a bumpy ride". At least, that seems to be, over the short term, the path of least resistance for the economy, and potentially for the equity markets as well.

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 Citigroup Economic Surprise Indices (CESI) are objective and quantitative measures of economic news. They are defined as weighted historical standard deviations of data surprises. The indices are calculated daily in a rolling three-month window.

The Composite Index of Leading Indicators, otherwise known as the Leading Economic Index (LEI), is an index published monthly by The Conference Board. It is used to predict the direction of global economic movements in future months. The index is composed of 10 economic components whose changes tend to precede changes in the overall economy.

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.