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THE PER STIRLING CAPITAL OUTLOOK

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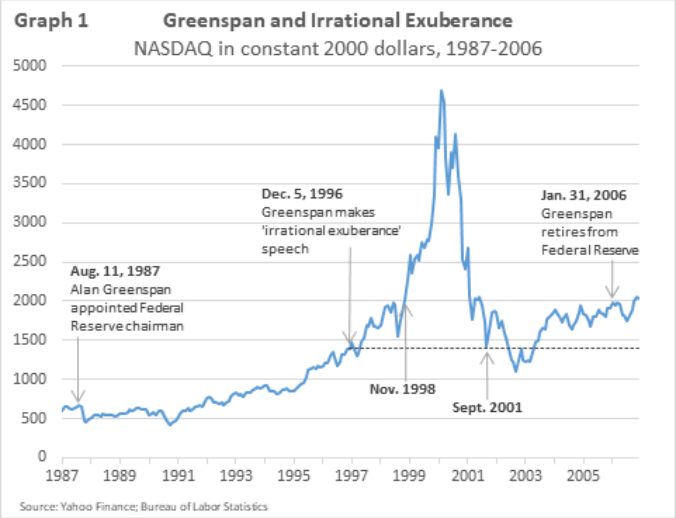
In market analysis, there tends to be very little difference between being early and being wrong, and there may be no better example of this fact than the televised December 1996 speech given by then Federal Reserve Chairman Alan Greenspan, in which he coined the now-infamous phrase "irrational exuberance". At the time, as is the case today, the stock market was moving sharply higher, equity market valuations were very high, and investor sentiment was very ebullient.

Indeed, in the second half of the 1990s, there was outright investor euphoria, and a growing concern, including at the Federal Reserve, that investors were potentially "flying too close to the sun". This concern was a dominant theme in Chairman Greenspan's speech, in which he posited:

"Clearly, sustained low inflation implies less uncertainty about the future, and lower risk premiums imply higher prices of stocks and other earning assets. We can see that in the inverse relationship exhibited by price/earnings ratios and the rate of inflation in the past. But how do we know when irrational exuberance has unduly escalated asset values, which then become subject to unexpected and prolonged contractions as they have in Japan over the past decade?"

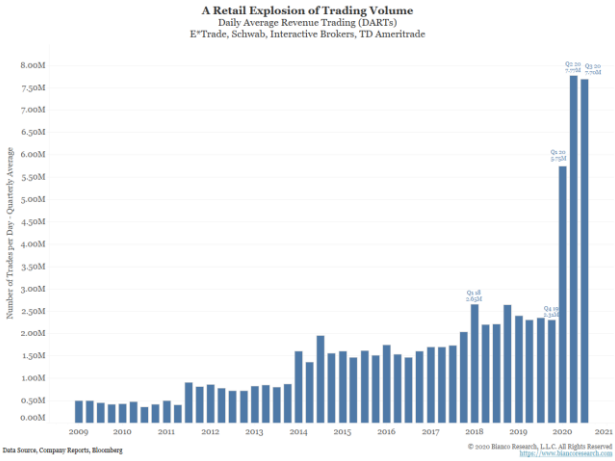


Of course, Chairman Greenspan was ultimately proven 100% correct, albeit notoriously more than three years too early. With the benefit of hindsight, it would have been a particularly frustrating period for any growth investor that heeded Greenspan's cautionary warning, as the NASDAQ Composite Index more than tripled over the course of that three-year period, before ultimately collapsing at the turn of the century back to the levels that existed around the time of Greenspan's 1996 speech.

We believe that the end of the last millennium is a period worthy of our consideration, as it is similar to the current environment on a multitude of levels, including extended periods of low inflation and interest rates, generous market liquidity, a new generation of aggressive individual investors, an investor infatuation with cutting-edge technology companies and, most obviously, very high valuations and very frothy levels of investor sentiment.

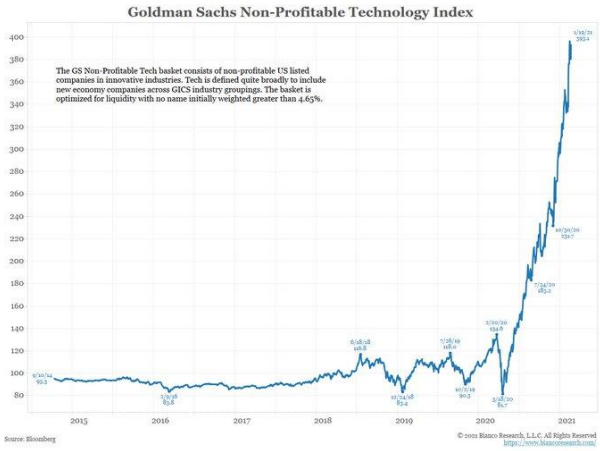
In many ways, the year 2020 experienced the same kind of democratization of the markets that we witnessed back in the late 1990s, when the investor base broadened dramatically.

To put this into some perspective, daily average equity trading volume, which averaged 7.0 billion in 2019, jumped dramatically to 10.9 billion in 2020, and is actually averaging a stunning 14.7 billion shares a day thus far in 2021.



In the late 1990s, this democratization was largely attributed to the novel availability of the internet and on-line trading. In 2020, it was presumably as a result of being more home-based, excess fiscal stimulus, a prolonged lack of sports betting, the introduction of fractional shares, which allowed small investors to invest in more expensive stocks, and the advent of 0% commission trading.

There are many other parallels between now and the late 1990s, including an investor feeding frenzy in cutting edge and emerging technologies, like electric vehicles, biotech, solar energy, Blockchain, cloud services, etc., and a willingness to pay sky-high prices for companies with little or no earnings history. Indeed, according to Goldman Sachs, "in the last 12 months, stocks with negative earnings have outpaced the average stock by 40%".



By 1999, there was a belief in a "new paradigm", where profits were largely irrelevant, where valuations were based upon the "number of eyeballs" that visited your web site, and anyone could seemingly become an instant multi-millionaire by simply putting ".com" at the end of their company name.

While the ultra-innovative, hyper-growth companies of today are generally of a much higher caliber than were their counterparts back in the second half of the 1990s, human nature and the dynamics of fear and greed are not, and indications of speculation and froth are ubiquitous throughout today's domestic equity markets.

So true is this observation that we could literally fill the entirety of this report with examples of it. However, we will limit ourselves to just a few, such as the jump in portfolio leverage, and the huge surge in options trading volume (which increased by 48% in 2020). There is also an absolute frenzy in the IPO market (private companies becoming publicly-traded), which also shares many of the characteristics and scale of the late 1990s internet bubble.

If anything, a combination of asset purchases and liquidity injections by the Federal Reserve has helped to create an environment where risk is merely an afterthought, and investors seem comfortable that the Fed will bail their portfolios out of any trouble that they might get into. After all, they did it during the financial crisis, they did it in 2020, and you can argue that they ultimately did it in response to the bursting of the internet bubble in 2000.

CHART 1: The Current IPO Frenzy is a Replica of the 1999 Internet Craze

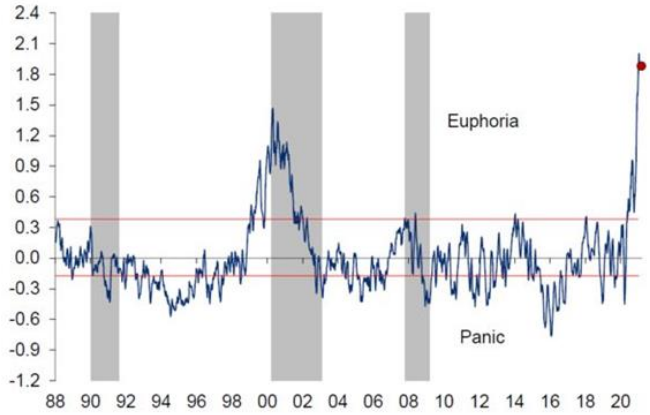
United States
(red line; ratio of Renaissance IPO index to S&P 500; percent appreciation January 3, 2017 to December 11, 2020)
(blue line; ratio of Bloomberg IPO index to S&P 500; percent appreciation August 1, 1995 to July 15, 1999)

Source: Bloomberg, Rosenberg Research

You can also clearly see the speculative nature of the current market environment in the recent surge in the trading of "penny stocks" (company shares selling for less than $1). Indeed, there was a day earlier this month when, according to Rosenberg Research, "six stocks priced under $1 per share made up nearly a fifth of total U.S. volume".

According to Goldman Sachs' chief U.S. equity strategist David Kostin, "Pockets of the market have recently demonstrated investor behavior consistent with bubble-like sentiment, but these excesses present low systemic risk to the broader market given their modest share of market cap."

Figure 8. The Panic/Euphoria



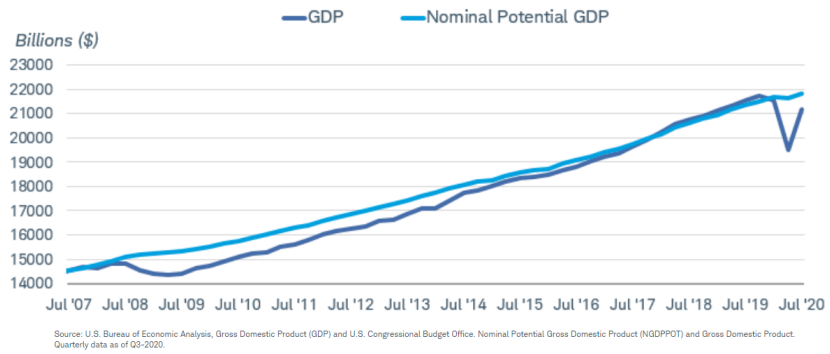
Source: Citi Research, Haver

Even so, this complacency has produced the type of overly-confident and very highly-valued market that has historically not ended well for investors. This fact is, in our opinion, self-evident. However, what is not so obvious is whether that ending occurs next week, next quarter, or three years from now.

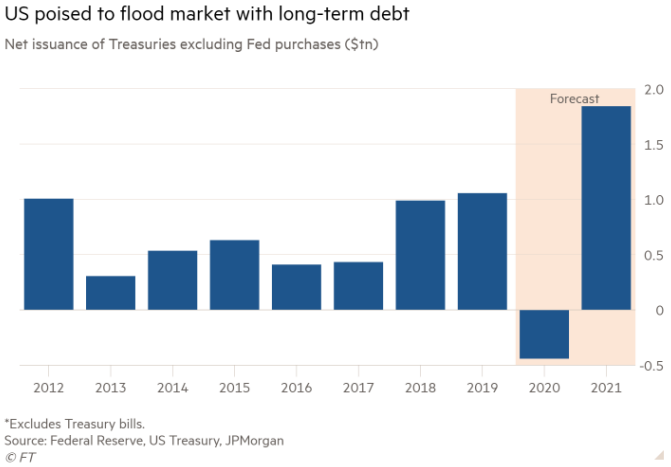
Indeed, we are in no way suggesting that the equity markets don't have a great many reasons to move higher, despite their stretched valuations. Investors seem to be very comfortable with what is ultimately a very centrist political outcome, a much calmer, more predictable administration, a better management of the pandemic, and the likelihood of massive fiscal stimulus (both another CARES Act-type of package and a huge infrastructure spending program). It is at least noteworthy that the Biden/Harris ticket enjoyed the strongest Election Day to Inauguration Day return in stocks since World War II, while the Obama/Biden ticket had previously experienced the worst ever (-19.9% on the S&P 500 Index).

Incoming Treasury Secretary Janet Yellen made very clear the Biden fiscal agenda in her recent testimony to Congress, when she said "Neither the president-elect, nor I, propose this relief package without an appreciation for the country's debt burden. But right now, with interest rates at historic lows, the smartest thing we can do is act big".

Of note, while we expect huge fiscal stimulus, we are less sure that we are likely to see significant tax reform. Indeed, we suspect that Biden's agenda is going to be so full that we question whether he will even attempt tax increases in his first year (or even two) and, if taxes don't go up before the mid-terms in two years, they may not go up at all.

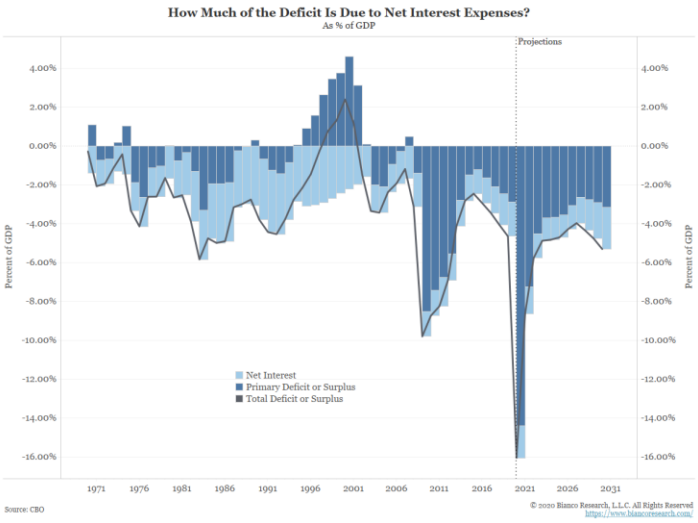


To explain, the Democratic lead in both the House and Senate is razor-thin and, because the majority party almost always loses some seats during the mid-term elections, the window of opportunity for significant tax reform may not stay open for long.



That is not to suggest that the Biden administration would not be pushing hard for higher tax rates on the wealthy if not already fully engaged in addressing a global pandemic, an economic crisis, a social crisis, and trying to unite an incredibly divided country.

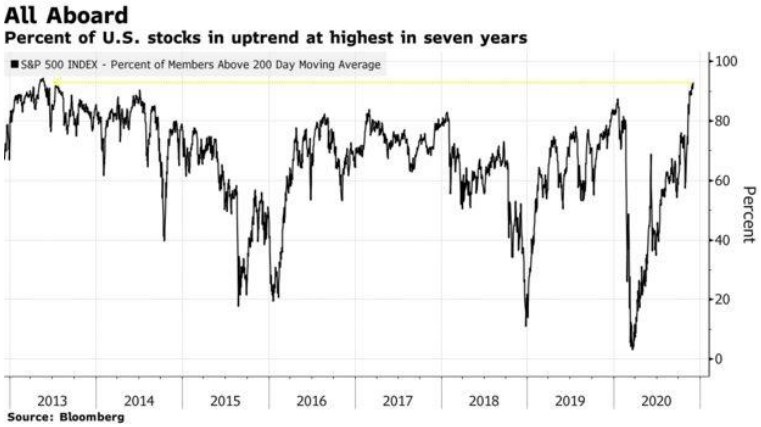
In addition, since raising taxes tends to be viewed as an economic depressant, it would likely prove politically difficult (and potentially financially imprudent) to raise taxes when the domestic economy is still running well below capacity (see above the economy (GDP) versus potential).



That fact, combined with a very strong likelihood of continued monetary stimulus and continued historic growth in the money supply (plus the vaccine roll-out) should produce a very strong economy, and what we expect to be a very fertile environment for the equity markets (particularly in the U.S. and Asia) in 2021.

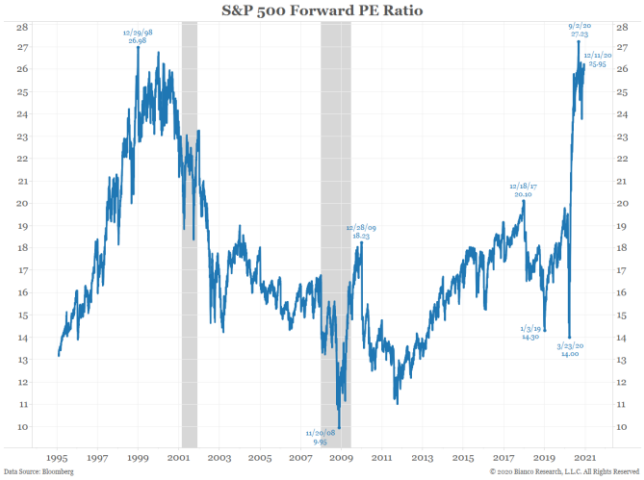
The longer-term consequences of all of this stimulus are likely to be higher interest rates and inflation and a massive debt burden that could be a real problem in the future, particularly if inflation becomes an issue. However, the markets are clearly not yet looking that far into the future.

In the meantime, the market internals are spectacular, and they combine with very strong earnings to produce a stock market that has all of the attributes of a very strong and early-stage bull market. The dilemma is that it is happening at a time of very high valuations and exuberant investor sentiment.



The problem is that, while most bear markets end with very low valuations, where an investor could buy a company's stock for perhaps only ten to twelve times a company's expected earnings per share, the 2020 bear market ended with companies selling for closer to twenty-four times a company's expected earnings per share. This anomaly is due largely to the heroic measures taken by the Federal Reserve, including both asset purchases and an explosion in money supply. As a result, the 2020 bear market was the shortest in history.

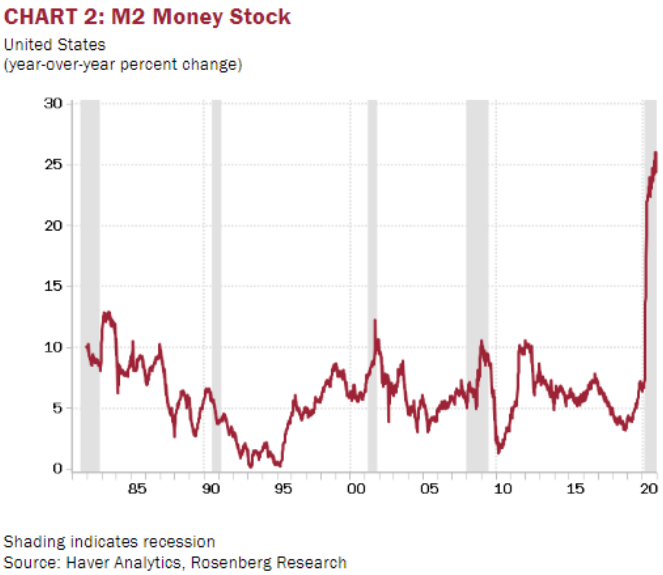
Due to this unique set of circumstances, there is currently quite a dichotomy in equities, which simultaneously seem to have the classic technical characteristics of a new and powerful bull market, but also the valuations and excessively-bullish sentiment of an aging, late-stage bull market.



While all of the aforementioned fiscal stimulus should provide a beneficial support for equity prices, its greatest impact is likely to be on the real economy, interest rates, inflation, consumer spending, etc. Fiscal stimulus has an ability to directly impact and stimulate the real economy in ways that monetary stimulus from the Federal Reserve cannot. Monetary policy's impact on the real economy (particularly with interest rates already effectively at 0%) is indirect. The Fed can basically inflate the prices of financial assets through increased money supply, reduced interest rates, and even direct asset purchases. This makes investors and home owners wealthier, and theoretically more willing to spend which, in turn, stimulates the economy and supports the financial system.

Fiscal policy can specifically target the parts of the economy that are most in need (although the currently proposed programs generally do not), while monetary policy is never that specific. When a central bank raises rates or increases the money supply, it impacts every element of the economy and, because monetary policy works with a lag, it is very difficult to know whether steps have been either excessive or insufficient until well after the fact. Since the onset of the pandemic, the most impactful part of monetary (Fed) stimulus, from a financial markets perspective, has probably been the unprecedented growth in the supply of money circulating around in the economy.

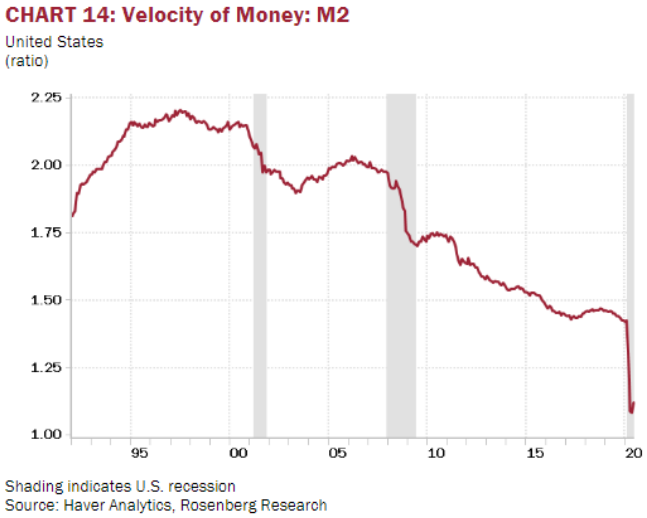
As a tangible example, according to Blackrock's Rick Rieder, domestic savings have increased by a stunning $3 trillion over the past year, despite the pandemic and the worst economic contraction since the Great Depression.



Think of the "real economy" as a glass and money supply as water. Traditionally, the Federal Reserve has maintained a level of money supply that was proportional. Too little money supply would cause the economy to underperform its potential. Too much money supply normally caused unwanted levels of inflation.

However, if you pour two gallons of water (money supply) into an eight-ounce glass (the real economy), the water will soon exceed the capacity of the glass and flood the areas around the glass. The area around the glass is the financial system, and all of this excess liquidity is flooding into the capital markets and pushing prices higher.

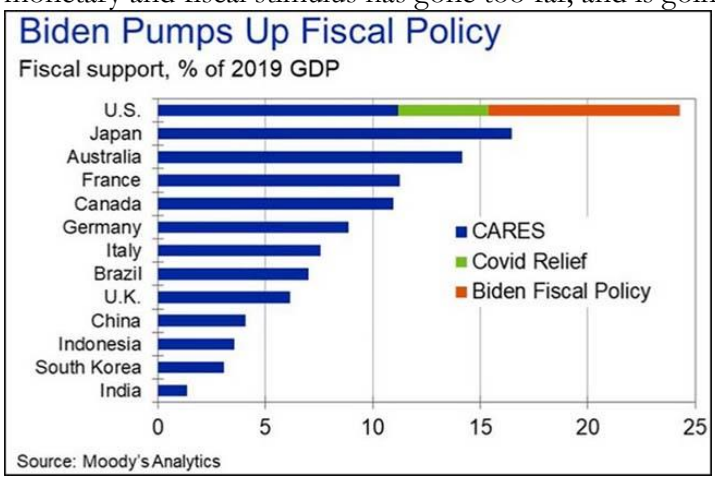
You can see quite clearly in both the above chart of money supply growth and also the below chart of monetary velocity, which measures how often per year each dollar changes hands, that there is dramatically more money floating around in the financial system than can be utilized in the real economy. At present, most of this excess liquidity is flowing into the capital markets and causing inflation in financial assets (rising portfolio values).



Our expectation is that, as we get past the pandemic, and the economy recovers to around its pre-pandemic levels, this money is going to increasingly be employed in the real economy, monetary velocity will start to accelerate, and inflationary pressures will transition from financial assets to wages, raw material costs, and finished goods.

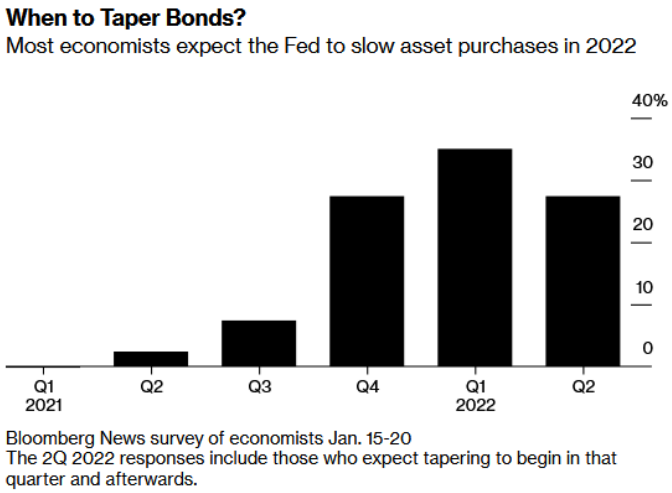
In the meantime, it is not an unreasonable expectation that this powerful, broad, and increasingly global bull market in equities will continue, for so long as investors perceive no end to the current stimulus gravy train, particularly with the bond market, which is much larger than the stock market, being such an unattractive alternative. If anything, rather than the bond market offering any competition for equities on either a yield or total return basis, it is more likely that money will flow from the bond market into the equity market, thus driving stock prices even higher, and exacerbating already very lofty valuations.

The ultimate arbiter of both monetary policy and the fortunes of the stock market is, in all probability, going to be the bond market, and the willingness of investors to accept increasingly negative real yields (the nominal yield minus the inflation rate). At some point, the bond market is going to reach a tipping point, and collectively decide that all of this monetary and fiscal stimulus has gone too far, and is going to inevitably create an unacceptable level of inflation, and investors are going to start demanding higher yields to help offset this risk.



That will push interest rates higher, which will cause the government and Federal Reserve to start withdrawing stimulus, and diminish the ability of the equity markets to sustain such high valuations (a phenomenon called multiples compression). In plain English, whereas investors might be willing to buy stocks for 22 times their expected earnings per share when rates are at rock bottom, as they are today, they may only be willing to pay 17 times expected earnings if rates were to move up one or two percent (i.e., either earnings world need to increase or stock prices would need to decrease).

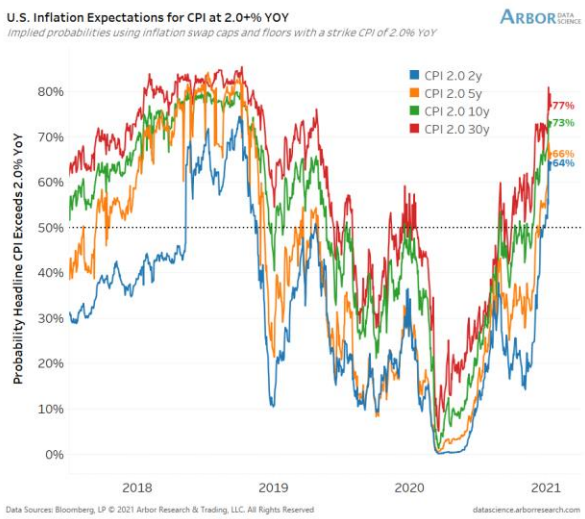
Fed Chairman Bernanke's mere mention of slowing the Fed's purchase of Treasuries caused the so-called "taper tantrum" in 2013, which catalyzed a sharp move higher in interest rates (and lower bond prices). When they tried to slow monetary stimulus in late 2018 (a process that Fed Chairwoman Yellen said would be such a non-event that it would be "like watching paint dry"), the S&P 500 responded with a 20% decline in equity prices, which culminated around Christmas Day, and forced the Fed to reverse course.



We find it hard to believe that either the Federal Reserve or the Federal Government is likely to "take the punch bowl away" until after the U.S. is clearly and sustainably past the worst of the pandemic from both a health and economic perspective so, in a warped way, we are likely in an environment where the equity markets are, in at least some respects, protected by the existence of "bad" pandemic and economy-related news.

One thing that we are highly confident of is that, when the powers that be are on the verge of changing course, they will provide little or no warning, as markets will likely react both sharply and immediately to the first hint of a reversal in stimulus. Indeed, we believe that, as soon as the markets start to anticipate a reversal in stimulus and/or Fed-set short-term rates, the Fed will lose control of interest rates, and the markets will quickly move rates higher.

Valuations largely determine both longer-term upside potential and also the degree of potential downside risk, with highly-valued and overly ebullient markets tending to have significant downside risk and lower-than-average, longer-term upside potential. However, that does not mean that they can't keep going higher over the intermediate term, and potentially by much more than one might expect—just ask Chairman Greenspan.



Indeed, to say that the stock market is significantly overvalued by almost all traditional measures would be one of the most obvious, and thus least useful, observations that we could possibly make, at least over the near term.

Valuation is traditionally a terrible short-term tactical timing tool, even under the best of circumstances, and today's liquidity may prove to be so powerful that it keeps valuation fairly irrelevant. That is, until higher interest rates start to impact equity multiples, and the Fed and government start to "taper" stimulus. In our opinion, inflation becomes of uber importance, because inflation is ultimately likely to be the primary determinant of when we see all of this fiscal and monetary stimulus start to reverse course.

We don't necessarily think that inflation will get much above 2.5% to 3.0% (2.5% would notably be a 28-year high, but suspect that the tail risk is that inflation comes in higher than expected). However, as noted, at whatever point the bond market starts to sniff out unwanted levels of inflation, it is likely going to force the powers that be to reverse course on stimulus, and we think that will be a game-changer for most financial assets.

While the timing of that sea-change is anyone's guess, we still believe that it makes sense to adhere to your investment plan, and to take every prudent opportunity to benefit from all of the governmental tailwinds to grow your wealth now, as the environment is not always going to be so investor-friendly.

We would propose that this is also a very opportune time to take an inventory of just how much risk you have in your portfolio, and to confirm that your portfolio is consistent with your time horizon, your future goals, and your risk tolerance. It probably also makes sense for many to consider diversifying into the international markets, where valuations tend to be much more reasonable and there is less speculative froth.

Ultimately, from the perspective of a truly long-term investor, it is largely irrelevant whether Chairman Greenspan was either "correct" or "too early", as even the forewarned bursting of the technology bubble is just a blip on a chart, if your perspective is long enough. That is also as much the case today, as it was almost a quarter century ago.

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