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THE PER STIRLING CAPITAL OUTLOOK

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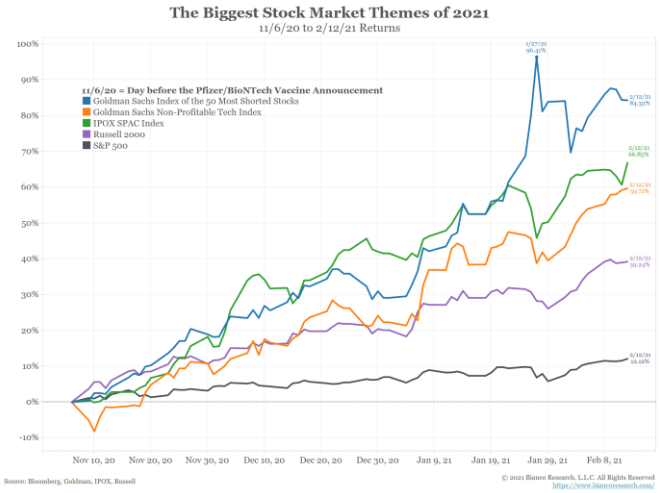
Legendary investor Warren Buffett once noted, very insightfully, that "only when the tide goes out do you discover who's been swimming naked." Mr. Buffet's point is that it rarely becomes evident during a roaring bull market who is overly leveraged, overly aggressive, or improperly diversified. This is particularly true after extended periods when there has been a long-standing consensus opinion amongst investors about the future course of the markets, and that consensus opinion has consistently proven correct… like now.

In those strongly bullish environments, investment mistakes tend to be overwhelmed by the bullish overall trend, and the fact that the prices of most securities go up over time.

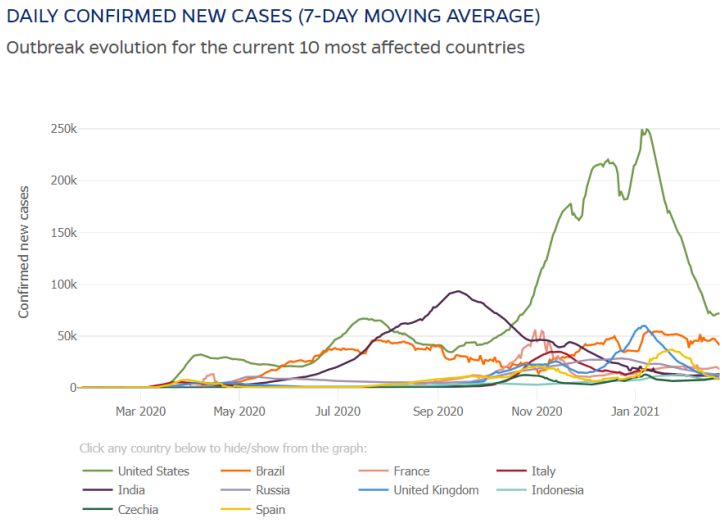
Instead, it is when something changes ("the tide goes out") that investor hubris and poorly constructed portfolios tend to get exposed. That catalyst has historically tended to be macroeconomic in nature, such as a geopolitical event, a change in tax policy, or a change in monetary policy. Indeed, as those of us with enough grey hair might remember, changes in inflation also used to be a very powerful and seminal influence.

We believe that we are quite possibly entering such a "sea change" period, and on a wide array of levels, ranging from medical to economic, and from political to financial. In some regards, this perceived sea change is all about a return to normalcy. Examples of "normalization" might include gaining control over the pandemic, "reopening" the economy, modestly higher interest rates, and a stock market that is much more broadly and rationally based.



This would be in sharp contrast to recent action in the stock market, particularly since the approval of the first COVID vaccine, which has been overwhelmingly dominated by financially weak and heavily-shorted companies, non-profitable technology companies, smaller-capitalization companies that are selling at astronomical multiples, and Special Purpose Acquisition Companies (SPACs), which are essentially "blank check" companies that are designed to buy private companies and take them public, and which investors put money in, in the hopes that the managers select "good" businesses to buy. Some of these have increased dramatically in value before they ever even bought a single company. There is extraordinary speculative fervor, and lots of "skin" to get exposed when the "tide goes out".

While much of this perceived sea change is all about normalization, other elements are all about new extremes, such as unprecedented money supply growth, almost unprecedented levels of economic growth, extraordinary corporate earnings, and levels of fiscal stimulus that dwarf that of Roosevelt's New Deal, as a percentage of the size of the economy.



Of course, everything still begins and ends with the status of the pandemic, and this is an area where the news is overwhelmingly good, particularly in the United States, where the COVID case count is absolutely plummeting.

Indeed, the fact that an estimated 110 million Americans have already survived COVID, and another 33 million have already received at least one vaccine shot, suggests that as much as 43% of the American population already has some level of immunity against the disease. As a result, according to Andrew Brouwer, a University of Michigan epidemiologist, "we may be approaching herd protection."

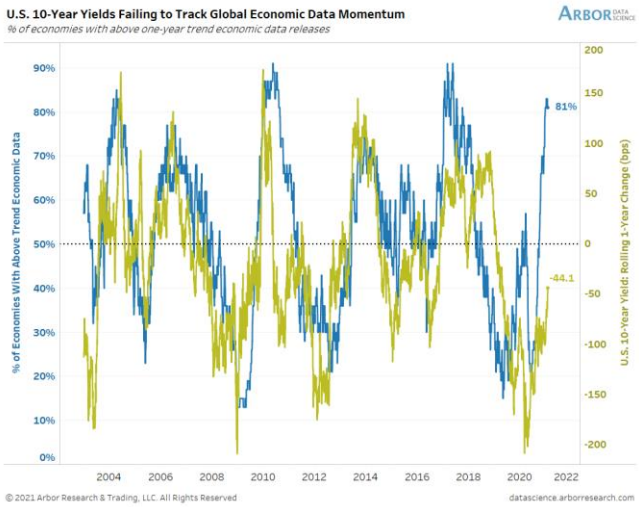
Further, while the pace of the vaccine rollout has been less than ideal (at the current pace, it would take an estimated nine months to fully vaccinate the U.S. population), that is about to change dramatically. According to Bloomberg, the "U.S. coronavirus vaccine supply is poised to double in the coming weeks and months…from the current 10 million to 15 million a week… to almost 20 million a week in March, more than 25 million a week in April and May, and over 30 million a week in June."

While we may not be able to throw away all of our masks quite yet, current expectations are that there will be enough vaccine available by early July for every American to be vaccinated, and that is, in our opinion, the single biggest catalyst for a return to relative normalcy.

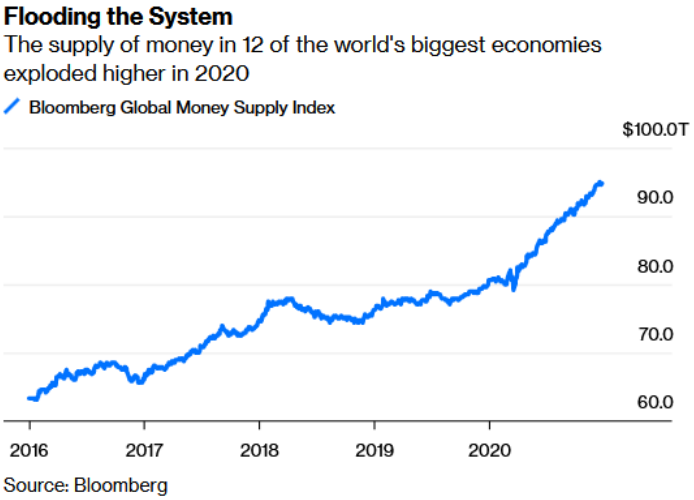
Indeed, one might legitimately question the need to throw yet another $1.9 trillion of fiscal stimulus at the economy, just as it is likely to get a boost from the improving pandemic news, and prospects for a fuller reopening. This concern was recently raised by Larry Summers, who served as Treasury Secretary under Bill Clinton and National Economic Council director under President Obama, and who has expressed his concerns that the impending stimulus package risks overheating the economy and generating undesirably high inflation, while leaving insufficient federal resources for investment in things like infrastructure.

Secretary Summers' concerns aside, the Federal Reserve, the White House and Congress are going to continue throwing stimulus at the economy at an unprecedented rate. This stimulus is coming from several sources, and is being mirrored by central banks around the world.

It starts with quantitative easing, and the central bank purchases of financial assets. The Federal Reserve, European Central Bank, Swiss National Bank, Bank of England and Bank of Japan have combined to purchase 37% of all of the world's outstanding bonds and notes, and the Federal Reserve alone owns 31% of all outstanding domestic bonds and notes, which is serving to keep rates much lower than would otherwise be the case, in light of the global economic recovery that is now clearly underway.

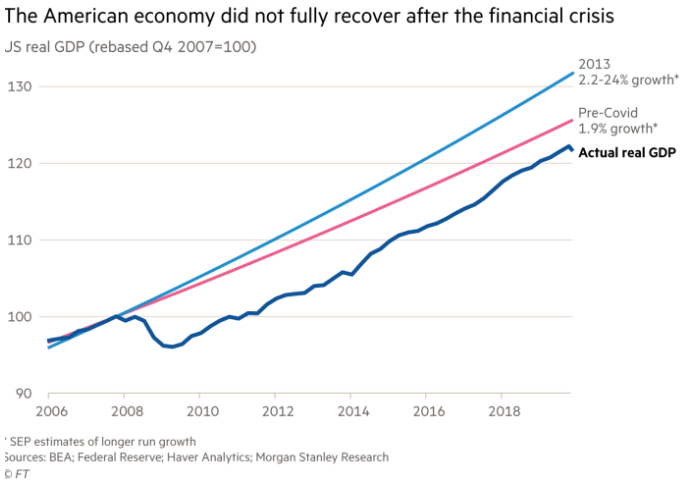


While quantitative easing is maintaining a steady pace, the amount of fiscal stimulus is really accelerating. In 2020 alone, the combination of quantitative easing, government spending and transfer payments (government payments directly to most U.S. citizens), the government injected almost $7 trillion dollars of stimulus into the domestic economy. To put this into some perspective, the pandemic and government-mandated shutdown blew a $2.5 trillion hole in the domestic economy, and they filled it with almost $7 trillion of stimulus. At present, Congress is on the verge of passing yet another $1.9 billion of government spending and transfer payments, and that does not even consider the massive infrastructure program that is expected later in the year. Indeed, according to Rosenberg Research, "when you adjust the Fed funds rate to include the "stimulus" impact of this ballooning central bank balance sheet, the de facto policy rate is -8%!!" Talk about pouring gasoline on a roaring fire.

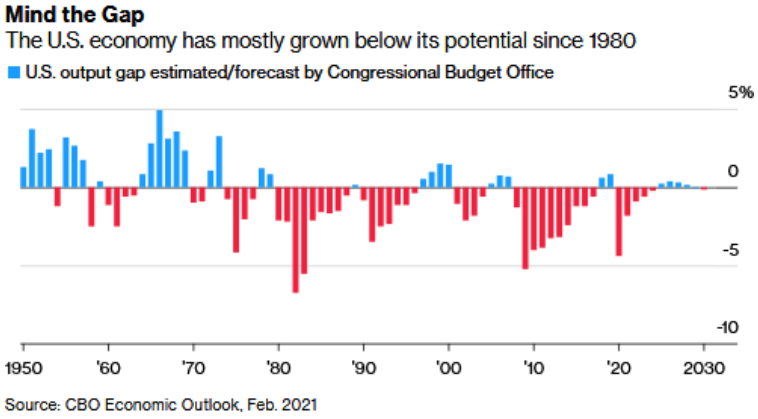


Of equal importance, particularly to the financial markets, has been the explosion in global money supply, which increased by $14 trillion last year, which almost doubles the previous money supply growth record of $8.4 trillion, which was set in 2017. In 2020, broad domestic money supply, as measured by M2, increased by 25%. Over the past forty years, money supply has grown on average by 1% over economic growth, which the Fed views as sufficient to allow the economy to grow, but in a non-inflationary manner. The past year has seen money supply growth that is 30% faster than has been the growth in the economy, and more than 20% faster than the 3.4% increase in the demand for bank credit. The result of this lack of borrowing demand is that all of this excess liquidity has flowed into the capital markets, thus inflating the prices of financial assets.

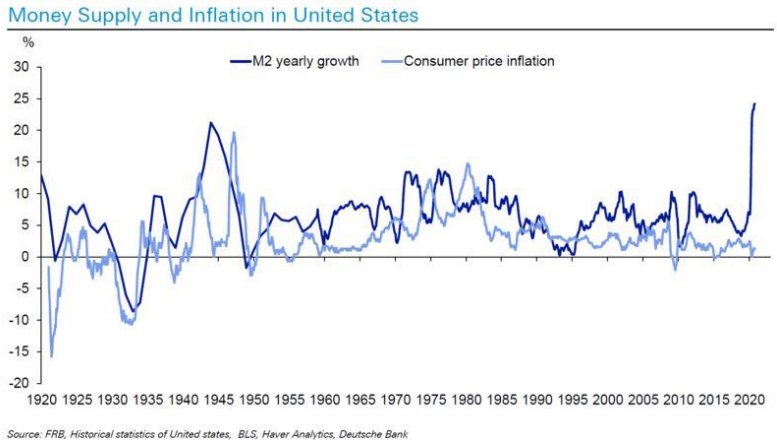
The premise being espoused by both Federal Reserve Chairman Powell and Treasury Secretary Yellen is that the domestic economy never fully recovered from the financial crisis, as a result of the stimulus package employed at the time being insufficient to generate a full recovery, and that economic activity is being further depressed by the pandemic. As a result, they are presuming that there is a significant amount of excess capacity in the economy, and that massive government stimulus can remove this slack and return the economy to full employment, but without risking a resurgence in unwanted levels of inflation.



This is, to some degree, in response to the Fed's new approach to inflation, and their abandonment of their prior practice of keeping inflation at bay by proactively slowing the economy every time that it started gathering steam. As you can clearly see in the bar chart, this approach has caused the U.S. economy to significantly underachieve its non-inflationary growth potential for most of the past fifty years. Indeed, the Fed has been so effective in this practice that they have not only engineered unnecessarily and undesirably low growth, but also problematic and undesirably low levels of inflation.

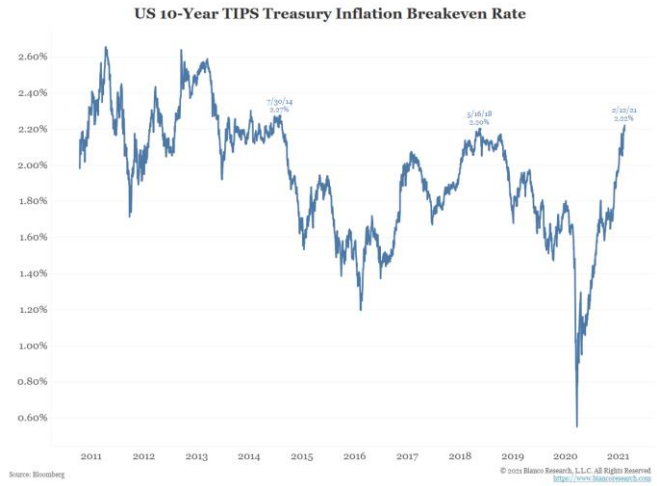


While even the Federal Reserve itself has recognized the error of their ways, as evidenced by the reversal of this policy, which they announced last year, we absolutely understand their prior rationale, as inflation is notoriously difficult to wring out of an economy, once it gets a foothold.



This purposeful reflation of the economy is thus a daring and potentially dangerous strategy, as is hurling massive stimulus at an economy that is already clearly in recovery, particularly when in conjunction with an explosion in money supply (M2), which has, at least historically, been closely correlated with future increases in consumer inflation.

In our opinion, it is all-important whether the deflationary influences of technology, demographics, globalization, digitization and this millennium's array of financial crises keeps inflation below the Fed's targeted average of 2%, or if wave after wave of fiscal and monetary stimulus, combined with a massive surge in money supply, will ultimately manage to create the higher inflation that the Fed wants and the markets fear.



While inflation is not here yet, markets are already anticipating its potential return. You can see this in the so-called 10-year "breakeven rate", which measures the difference in yield between a traditional 10-year Treasury note and a 10-year inflation-adjusted Treasury note, which has a yield that is tied to the inflation rate.

We believe that the prices of almost every type of financial asset have been greatly inflated by the lowest interest rates in history, unprecedented levels of fiscal and monetary stimulus, and a level of money supply that is far in excess of what can be deployed in the real economy (and which has thus poured into the financial markets). It has created a condition where market valuations for equities, debt and credit are each extraordinarily high, and where the continuation of a bull market may be dependent on a continuation of low interest rates and generous stimulus.

Exhibit 66: Cross-asset valuation for the US

Data since 1976 (FCF yield (1990), Credit market data (1997), Government BYs (1921), ERP (2001))

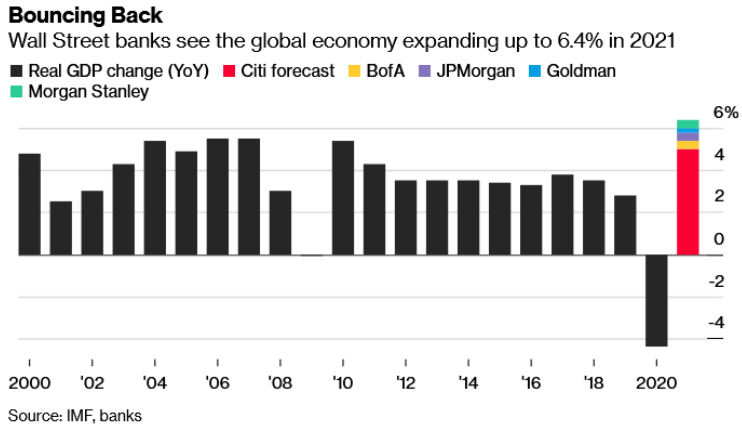
	Metrics	Current Level	Historical Percentile	Median
Equity (SPX)	EV / Sales	3.0	100%	92%
	EV / EBITDA	15.9	99%	
	Price / Book	4.0	92%	
	NTM P/E	22.3	96%	
	NTM Free cash flow yield	3.8	60%	
	Cyclically Adjusted P/E	27.1	88%	
	ERP (%)	5.7	11%	
Rates	Nominal 10-year Treasury	1.0%	100%	93%
	Real 10-year Treasury	-0.8%	87%	
Credit	High Yield YTM	5.4%	100%	
	Investment Grade YTM	2.1%	99%	
	High Yield spread	422bp	64%	
	Investment Grade spread	119bp	64%	

Source: Compustat, Goldman Sachs Global Investment Research

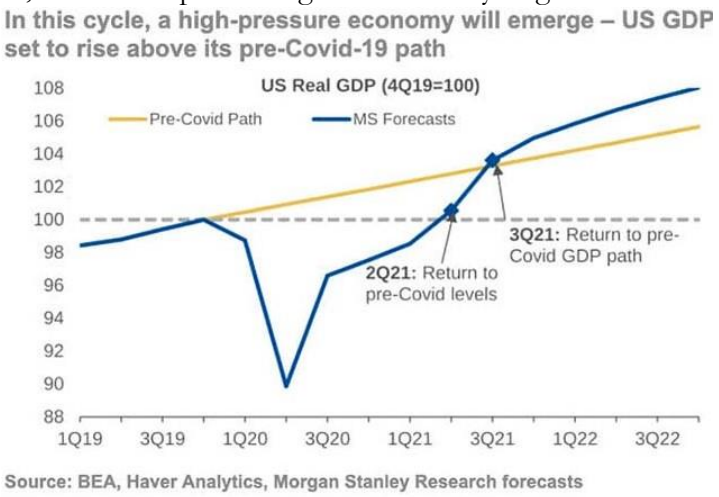
Granted, the Fed has emphatically and repeatedly stated that short-term rates will remain nailed to the floor until inflation exceeds and sustains above 2.5% for an extended period of time. However, it may not be up to them, and we suspect that, if the bond markets start to anticipate an inflation rate that gets uncomfortably high, the Fed could easily lose control of all but ultra-short interest rates, and this could prove quite problematic, in light of the current, very lofty valuations. Indeed, if rates continue higher, as we suspect, this factor is likely to be particularly problematic for so many of the very highly valued stocks that have dominated market returns since the election and the subsequent announcements of vaccine approvals.

While all of this stimulus and excess money supply may create an interest rate scenario that proves problematic for Wall Street, it should be tremendous for Main Street, as economic growth should be nothing short of explosive.

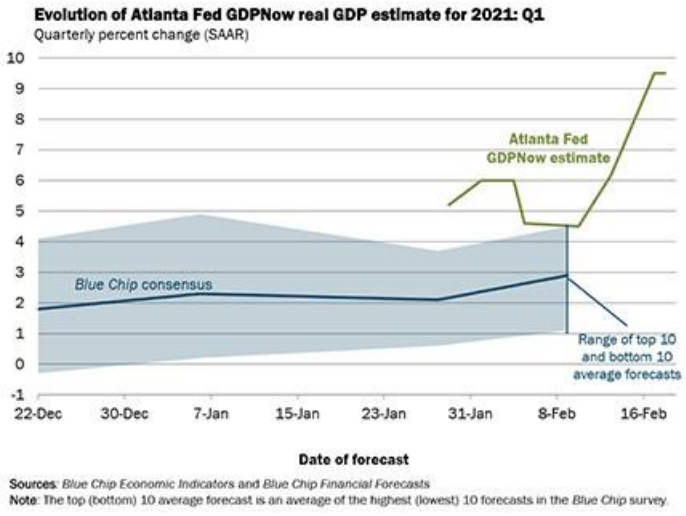
Indeed, while consensus estimates are for domestic growth to exceed 6% in 2021, that does not even include the impact of the additional $1.9 trillion stimulus bill that we expect to pass as soon as this week, or the infrastructure bill that we expect will pass later in the year. The International Monetary Fund (IMF) estimates that the upcoming COVID-19 Relief Bill alone would boost domestic growth to a sizzling 6.5% in 2021, and add an additional 1.3% per year onto domestic growth for each of the next three years.



Even without that expected stimulus, the IMF expects the global economy to grow at 5.5% in 2021, with the U.S. economy growing at 5.1%, Japan growing at 3.1%, and Europe growing at 4.2%. However, there is no doubt where the IMF projects the strongest growth this year. They are expecting India to grow at 11.5% and China at 8.1%. That said, for a very mature economy like that of the U.S., achieving a 6% growth rate would be a pretty extraordinary accomplishment.

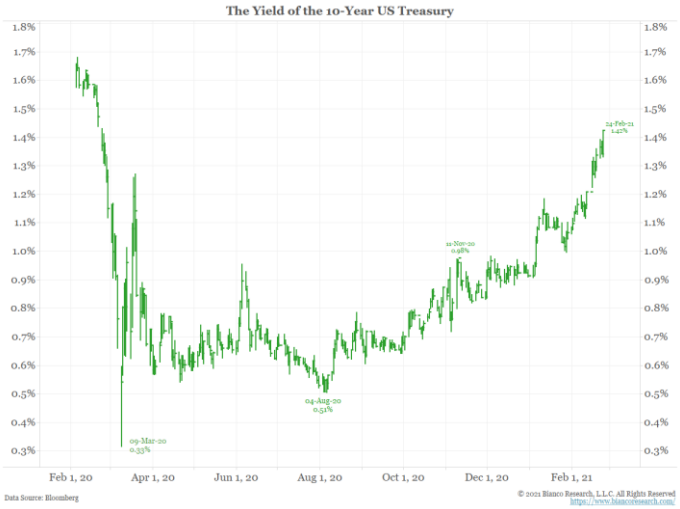


So historic would be the anticipated growth rate that, according to research from Morgan Stanley, the economy could return to its pre-pandemic growth path by the third quarter of this year, which is truly extraordinary when you consider that, less than one year ago, we experienced the worst economic contraction since the Great Depression.



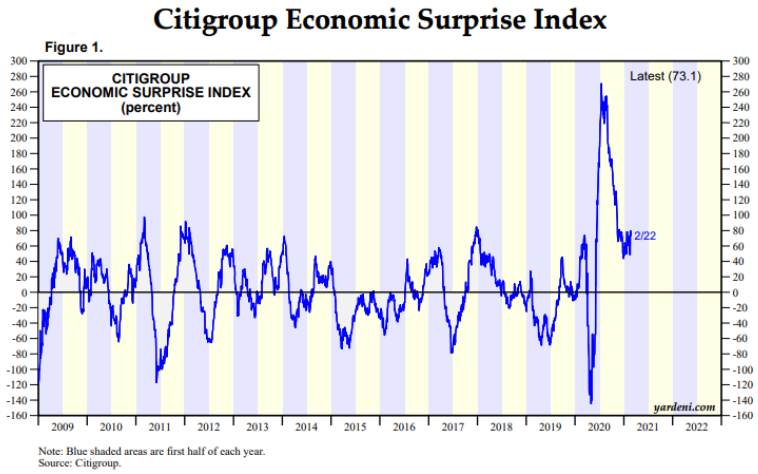
Even more remarkable, the Atlanta Branch of the Federal Reserve maintains a GDP "Nowcast", which endeavors to track how the economy is performing in real time. According to their calculations, the economy is currently growing at a scorching 9.5% rate, which casts yet even more doubt on the prudence of throwing another almost $2 trillion of stimulus at an already roaring economy.

On the surface, it would make sense that all of this good economic news should be great for corporate earnings, and therefore for equity prices. However, there are two reasons why we are hesitant to automatically make that assumption. First of all, higher interest rates and higher inflation tend to "contract market multiples". In other words, equity markets can normally support much more highly valued stocks when rates and inflation are low and/or falling than when they are high and/or rising.



Indeed, since 1928, domestic stocks have averaged only 6.3% per year when inflation is 3% or higher, but have averaged a massive 15.6% annual gain when inflation is 3% or lower. Trend also appears to be important. Since 1928, domestic stocks have averaged only 6.7% per year when inflation was rising, while averaging an impressive 16.5% when inflation is falling. Very importantly, stocks tend to coexist quite well with rates that are moving higher because of stronger economic growth, but suffer if rates are instead moving higher to offset increasing inflation.

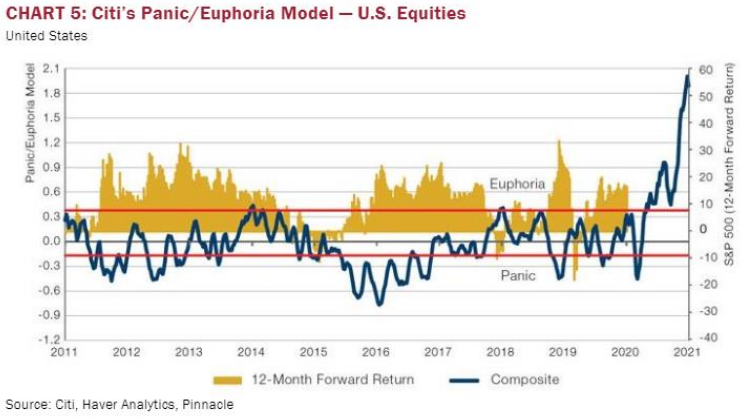
The second reason why we are hesitant to assume that a much stronger economy will necessarily be great for stocks is because it looks like much of the good economic news is already anticipated, and therefore theoretically already discounted into stock prices. You can see this reflected in the Citi Economic Surprise Index, which measures the difference between the expectations for economic data and the actual economic data once it is released. The fact that the dark blue line is approaching the horizonal black line illustrates that, while the data is still better than expected (i.e., it is above the "0-line"), it is now coming in much closer to expectations, thus limiting the potential for stocks to rally on better-than-expected data.



To explain, stock prices normally change either when expectations change or when reality turns out to be different than what was expected. The fact that the blue line is declining suggests that future economic news is less likely to be significantly better than expected, and therefore that much of the economic improvement is already priced into stock prices.

That said, economic reopening and "normalization" should favor value stocks, economically-sensitive cyclical stocks, smaller-capitalization stocks, and lending institutions, while being potentially challenging for higher-quality bonds and more highly valued stocks.

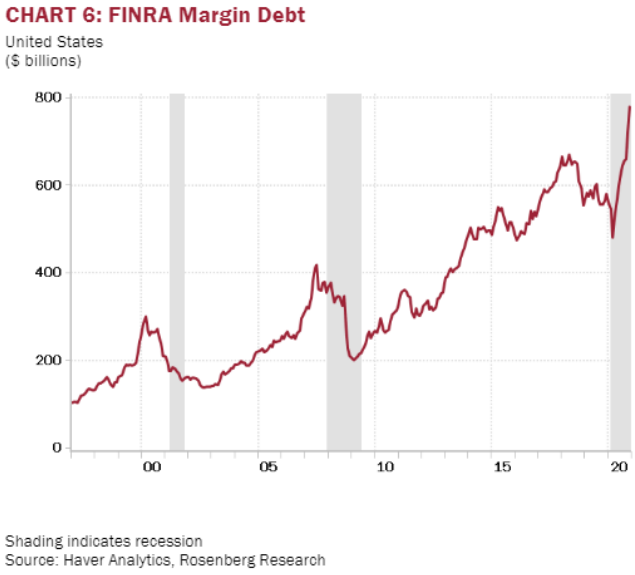
That brings us back to Warren Buffet's analogy of the unclad swimmers and the receding tide. While we maintain that both foreign and domestic equity markets are likely to end the year 2021 as one of the best performing financial asset classes, that does not mean that the U.S. has a particularly "healthy" stock market.



While this does not mean that stocks cannot continue to push impressively higher, it does mean that U.S. stocks, in particular, are very highly valued, and that markets are showing signs of significant complacency and overconfidence.

In fact, a just-published Bank of America survey revealed that the percentage of investors who were "taking higher than normal risks" just reached the highest levels in the survey's more-than-twenty-year history. Further, the Citigroup Panic/Euphoria Model is illustrating unprecedented levels of investor euphoria, and the J.P. Morgan cross-asset complacency index has just reached a twenty-year high. Remember that hyper-bullish, euphoric markets tend to be overvalued and susceptible to decline (usually when the "tide comes out").

Also concerning is the growing influence of a new breed of investors who remind us very much of their predecessors in the late 1990s, who drove an entire generation of highly speculative, primarily internet-based stocks to unparalleled heights, before crashing back to earth. However, this generation is more sophisticated, and is using leverage, options and an ability to coordinate with other investors through platforms like WallStreetBets to move stocks with the power of an institution. In such an environment, where it is sometimes difficult to differentiate certain segments of Wall Street from Las Vegas, it is important that investors remain risk-aware, and not get "over their skis".



While this speculative element is a concern to us, and while we suspect that many of these investors will ultimately get "exposed" by the changing tide, we believe that $7 trillion (and growing) of stimulus, when combined with a resurgent economy, soaring earnings, and prospects for a post-pandemic world, are likely to continue providing significant buoyancy for the "average" stock. Just keep your eye on anything that could put this massive stimulus at risk, such as inflation, rapidly rising rates, or a sharp decline in the dollar, as we believe that the capital markets have become highly dependent on a never-ending supply of stimulus.

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