Volume 126

THE PER STIRLING
CAPITAL OUTLOOK
Performance • Perspective • Per Stirling

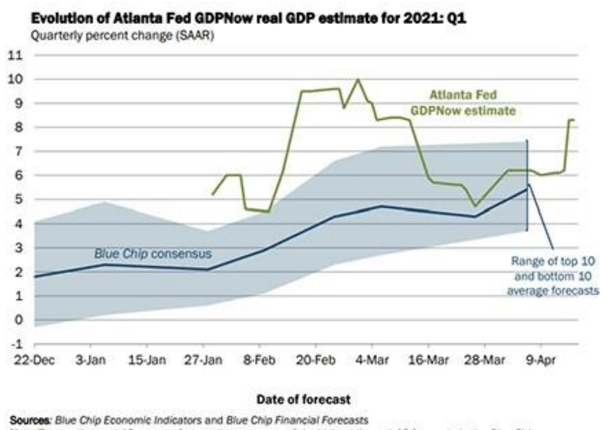
April 2021

In a recently published interview with Barrons Magazine, we noted our belief that, "This is a very strange market on many levels. We have sentiment levels and valuations of a very old, mature bull market. But we have monetary and fiscal policies of a young, emerging bull market, and an economy just coming out of a recession."

In many regards, we believe that how this dichotomy resolves itself, and whether or not it catalyzes unwanted levels of inflation, will be a prime determinant of both how the stock and bond markets perform as a whole, and what segments of those respective markets are likely to present the most attractive opportunities over the intermediate term.

The United States' economy and financial markets have, for more than a year, been the beneficiary of exploding money supply growth, historically-low interest rates, monetary policy that has been unprecedented in terms of scale and scope, and massive fiscal spending and direct government payments to individuals. To put things into some perspective, current transfer payments from the federal government now account for 21% of all U.S. personal income.

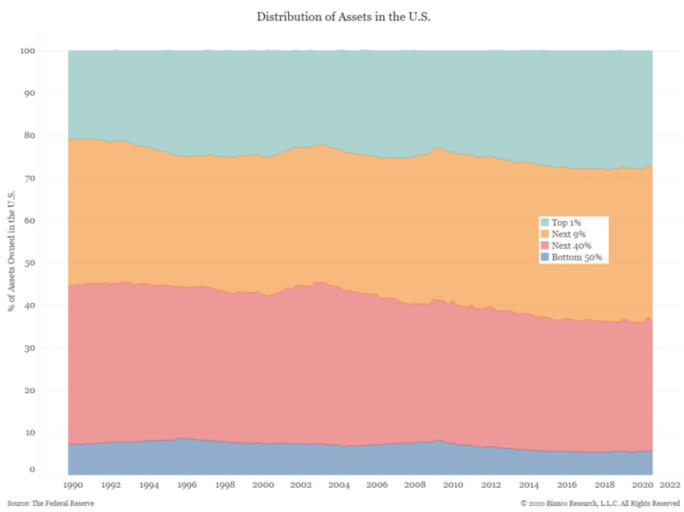
This unprecedented level of stimulus, and the resulting expectations for extraordinary economic growth, are arguably already reflected in the prices of most equities, as evidenced by the fact that the S&P 500 Index is now trading at 29.9 times trailing earnings, which is the second highest valuation in history.



The impact of this huge stimulus on the real economy has been similarly remarkable, with the domestic economy currently growing at rates that we have not seen since the 1980s. According to some of the "nowcasts" produced by the Federal Reserve, which attempt to gauge growth in real time, the domestic economy is currently growing at a rate in excess of 8%, which is almost unheard of for such a mature, fully-industrialized economy as that of the U.S.

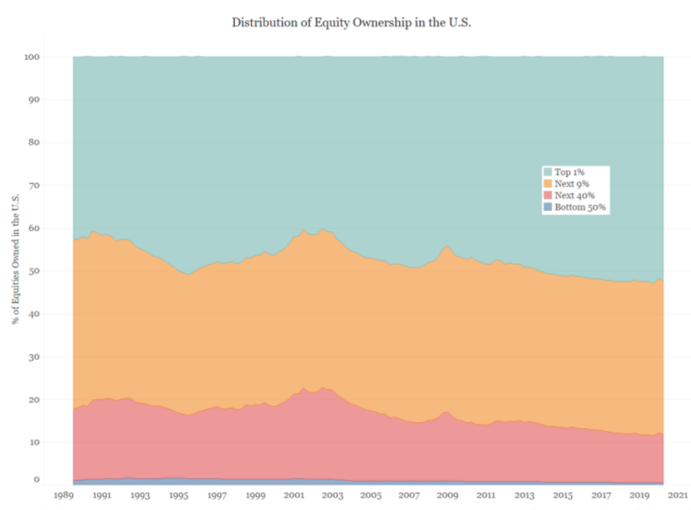
Yes, the economy is absolutely soaring, and equity valuations have reached levels that have historically caused the Federal Reserve to start, at minimum, "jawboning" the markets lower, or even increasing interest rates outright, to help dampen speculation in the financial markets and cool off the economy, and yet this is the environment in which Treasury Secretary Yellen and Fed Chairman Powell, along with Congress and the Biden administration, continue to inject massive levels of stimulus into the economy, in an unprecedented and potentially profligate way.

It is almost impossible to appreciate either the significance or the uniqueness of the aforementioned dichotomy without putting it in historical context, as we maintain that its existence would have been a virtual impossibility only a few years ago, when Republicans still claimed to care about deficits, when the Federal Reserve was committed to an inflation-fighting policy that relied upon slowing the economy every time that it gained any significant steam, and before the global pandemic opened the door to unbridled fiscal and monetary stimulus that, since it has not (at least thus far) generated undesirably-high inflation, has emboldened the progressive wing of the Democratic Party to push for policies that more and more closely resemble full-blown modern monetary theory (MMT).



This controversial (to say the least) school of thought (MMT) maintains that a sovereign country with its own currency can just print whatever money is needed to pay for anything and everything that it wants. That is, up until the point when inflation becomes a problem, and the government needs to raise everyone's taxes to cool off the economy.

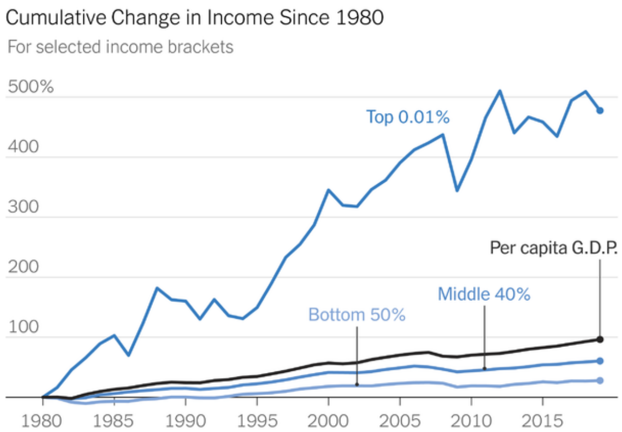
The force behind this apparent mismatch of heroic, emergency-type stimulus measures with some of the strongest economic growth that the U.S. has experienced in forty years is President Biden's ambitious plan to reshape the U.S. economy, while simultaneously redistributing wealth across the population, in an effort to reduce the massive and arguably unsustainable divide in our country between the "haves" and the "have nots".



While the financial burden of at least partially paying for this ambitious plan is reportedly to be borne by just the highest 0.32% of earners (approximately 500,000 households), we suspect that this projection may prove to be overly narrow.

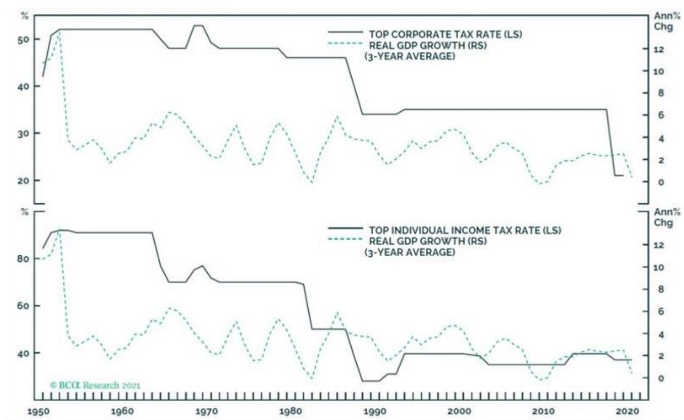
Unfortunately, from our perspective, and that of most of our clients, one of the easiest ways to redistribute wealth is by taxing gains on capital, the vast majority (90%) of which is owned by the top 10% of U.S. income earners. As such, it is no surprise that President Biden has just floated a trial balloon of increasing the capital gains tax on those earning $1 million per year and above to 39.6% plus the 3.8% Obamacare tax. If passed into law, it would be the highest capital gains tax rate since the 1920s.

While our perspective is that Biden, who is known as an experienced and shrewd negotiator, is just staking out an extreme position from which to negotiate, we will note that we thought the same thing about the size of the massive fiscal stimulus programs that have already been passed, but where Biden amazingly got virtually every penny that he had initially asked for.



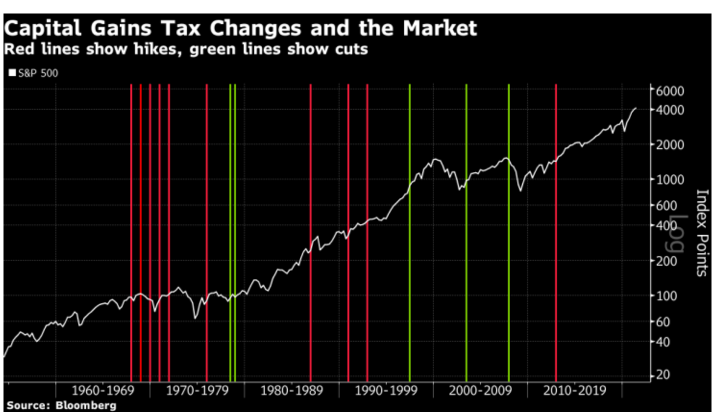
Ironically, an argument can be made that the Republicans, particularly those in the Senate, are actually responsible for pushing the Biden agenda so far left of center. Biden has noted his preference for negotiated, bipartisan legislation. However, since virtually no Republican will vote for any of the Biden-proposed legislation, Biden has needed every Democratic vote, and that has necessitated accommodating the demands of the progressive left.

It is outside of our purview to comment on which perspective is correct, or "better" for the country from a societal perspective. Our primary concern is instead the likely impact of this political theater on the capital markets and on the economy.



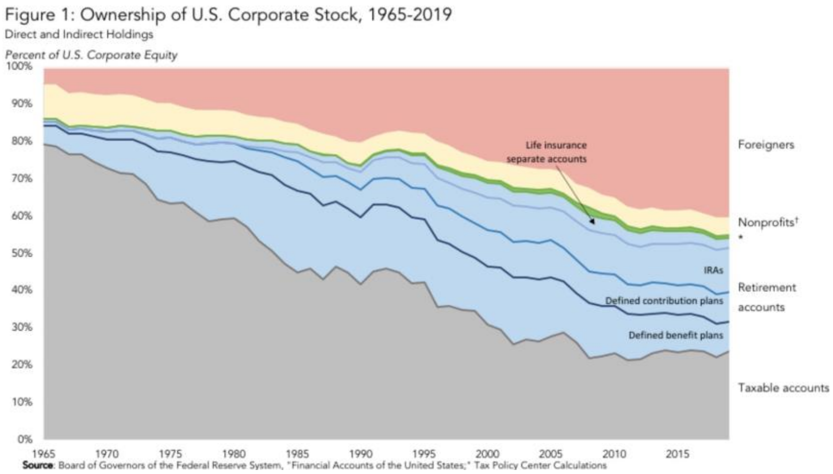
Fortunately, the lessons of history are that changes in corporate and/or capital gains tax rates have only very rarely had a substantial and/or sustained impact on either market performance or economic growth.

Moreover, history suggests that the economic impact of raising taxes on the wealthy also has little economic impact, as it has not historically affected spending decisions. As such, while we don't like higher taxes in general, and higher taxes on capital in particular, we do not view them as a particular threat to either the economy or the markets.



Indeed, a recent UBS Global Wealth Management report documented that they found "no relationship" through history between capital gains tax rate changes and stock market performance, although they did note that "while we can't rule out some additional modest equity market volatility as investors react to this proposal, we think it will be very short-lived". It is perhaps noteworthy that there was a fair amount of preemptive selling (tax-driven, profit-taking) in anticipation of the 2013 capital gains tax rate hikes.

Indeed, according to John Hancock Investment Management, expectations of the tax increase catalyzed withdrawals of $38 billion out of U.S. equity funds and ETFs in the six months prior to the tax hike. However, that withdrawal was more than offset by $58 billion of inflows over the following six months, which helped to power the S&P 500 Index to a cumulative 18% gain over the 12-month period. Obviously, the past is not necessarily prologue.



Further, Goldman Sachs just projected that the capital gains tax rate will probably adjust higher to only 28%, as opposed to the 43.4% maximum rate (including in the Obamacare tax) being proposed by President Biden. This is fairly consistent with comments from West Virginia Democratic Senator Joe Manchin, whose vote seems to be essential for the passage of any tax legislation, and who has already said that he would not vote for any corporate tax rate above 25%.

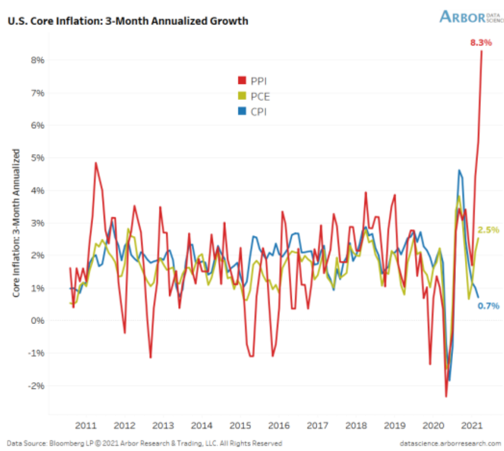
Also important, as was just noted by UBS, only about 25% of the domestic stock market is owned by U.S. investors outside of tax-deferred accounts, so the impact of any increase in capital gains tax rates may prove to be rather limited. That said, if selling were to emerge in anticipation of a capital gains tax hike, it would make sense that the most highly appreciated assets, like technology stocks and crypto-related assets, would be the most vulnerable.

Of note, in both 1969 and 1993, tax increases were made retroactive to the beginning of the year in which they were passed so, while not necessarily likely, retroactive tax increases can occur.

The bottom line is that there has historically been almost no correlation between higher capital gains taxes, higher income taxes for the wealthy, or even higher income taxes on corporations, on one hand, and either economic growth or equity market returns, on the other. Further, higher corporate taxes seem a bit less threatening when you consider that they only equate to about 1% of the size of the U.S. economy (GDP).

All things considered, it should be very challenging for Biden to get the full extent of his proposed tax increases, when you consider the razor-thin Democratic lead in the Senate, and the existence of a couple of more conservative Democrats. In short, while most investors (ourselves included) would rather have lower taxes than higher taxes, we are not particularly concerned about the impact of higher taxes on either the economy or the equity markets.

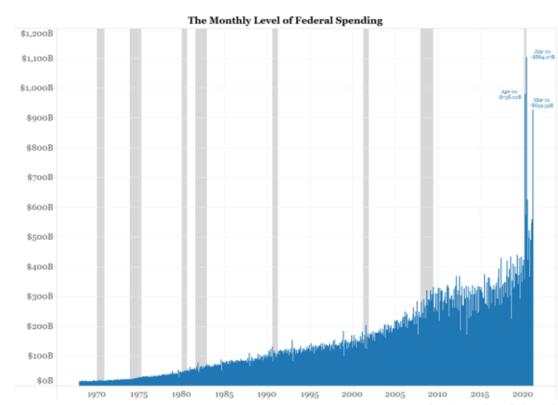
The same cannot be said for the risks associated with higher interest rates and, even more impactful, higher inflation. Indeed, while inflation is still, at this point, mostly limited to wholesale and raw materials prices (PPI), the fact that longer-term interest rates have already almost tripled off of their lows has had a significant impact on the equity markets, with many of last year's biggest winners undergoing a sharp correction, and many of the last decade's most disappointing stocks being among this year's top performers.



Indeed, it is very possible that the most recent market response to higher rates may provide some insight into future market leadership in the event that, as we expect, we see interest rates climb higher again after their recent retracement to slightly lower levels.

History teaches us that, while stocks historically perform better than average when rates are low and/or falling and worse than average when interest rates are high and/or rising, that is not necessarily a reason to associate higher interest rates and market declines, as stocks tend to tolerate higher rates fairly well, as long as they are increasing in response to a stronger economy and greater demands for credit, and not in response to unwanted levels of inflation. From our perspective, it is the outlook for inflation that is all important to America's economic prospects, and to the outlook for its stock and bond markets as well.

It is also the primary risk being created by pouring more and more fuel (monetary and fiscal stimulus) on an already roaring economic fire. So far, so good. The federal government is spending money like drunken sailors, and supply-chain problems are emerging all over the globe, and yet inflation still remains quiescent on the consumer level.

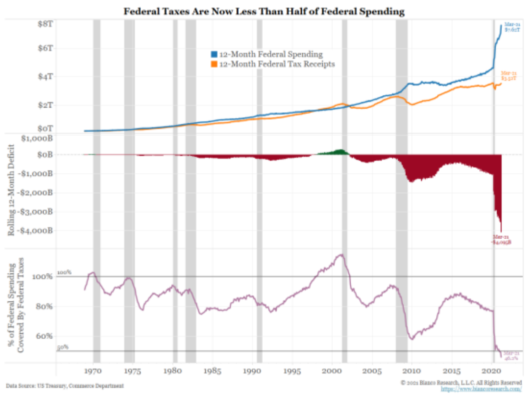


Labor costs are climbing, as are commodities prices, raw materials prices, and wholesale prices in general, but in this world where virtually everyone shops on-line, and where a consumer's various options are ranked by cost and retailers instantaneously lose market share if they try to raise prices, the cost increases are just not yet finding their way to the consumer level.

Of course, it is probably not great news for future corporate profits if the producers, wholesalers and retailers are needing to absorb all of those cost increases. An optimist would say that this drag will be more than offset by the much stronger than normal economic growth, and they may be right. However, that will not matter over the intermediate term, if inflation overheats, and the Federal Reserve is forced to stand on the economic brakes.

Moreover, unless the MMT crowd is right, and the government can spend as much as it wants without negative ramifications, then we will eventually need to pay for all of these stimulative excesses.

Of note, federal government tax revenues already pay for less than half of current spending, and President Biden's proposed tax increases would not even come close to paying for his proposed new spending programs, so the U.S. is accumulating a massive debt that will need to be either paid for with future tax increases or financed by future sales of government bonds.

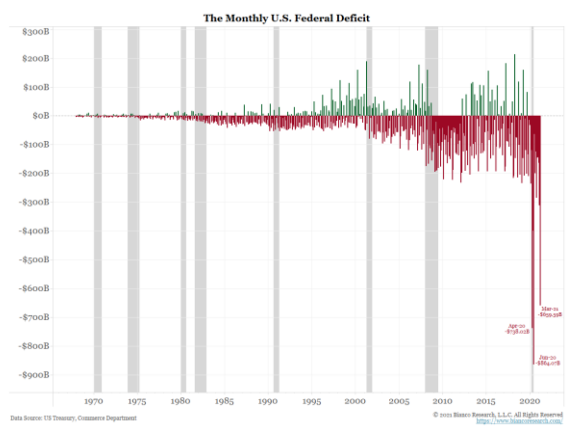


According to Larry Lindsey (former director of the National Economic Council, and economic policy advisor for the President George W. Bush) the Treasury will need to finance a deficit equivalent to 23% of GDP over the next year. However, total U.S. savings is approximately 7-8% of GDP each year, which leaves a massive hole to be filled by foreign investors/sovereign funds and bond buying by the Federal Reserve. Rates may very well need to rise to entice buyers into Treasuries.

True, there is no significant retail inflation thus far, but these policies remind one a little of the story about a man who jumped off the roof of a forty-story building and, as he passed each floor on the way down, was heard saying, "so far, so good". Classic economy theory dictates that this dive off of the 40th floor is going to end very badly, in this instance with undesirably high levels of inflation, but thus far, everything is "so far, so good".

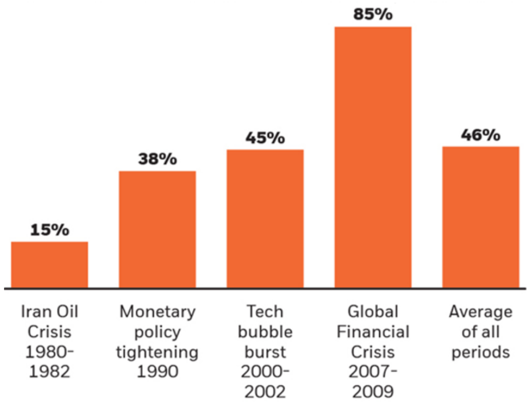
Of course, as noted, some of the new economic theories cast doubt on whether or not excessive inflation is necessarily the predetermined outcome of these policies. Time will tell.

That said, if interest rates do move higher, whether it be in response to either stronger growth or higher inflation, it would tend to hurt growth stocks most of all, and particularly companies that have promising intellectual property, but for whom profitability may still be years into the future. This does potentially argue for value stocks over growth stocks in the current environment, or for at least reintegrating value stocks into portfolios, after decades of underperformance and disinterest from the investing public.



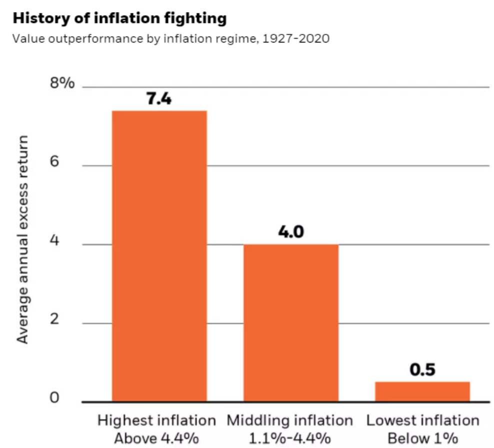
Over recent decades, the domestic economy has been characterized by low inflation, nominally low and falling interest rates, and slow-to-modest economic growth, which has been almost institutionalized by the Federal Reserve and their previous policy of fighting inflation by keeping economic growth well below its potential. The low rates of inflation have limited pricing power for most companies, thus limited their earnings potential, while Fed policy has shortened their growth cycles. It is in this environment that investors have been willing to pay a hefty premium to buy the shares of those relatively few innovative and/or mega-cap growth stocks that have been able to produce either exceptional and recurring earnings or truly compelling (normally intellectual property-related) reasons to invest in their future growth.

As noted, the Federal Reserve has changed its approach to inflation, and will no longer proactively slow the economy through higher interest rates just because growth is accelerating, and will instead wait until inflation actually proves its ability to exceed and sustain above their 2% target, before tightening monetary policy. In theory, this should allow the economy to have a higher growth ceiling and more prolonged periods of economic expansion.

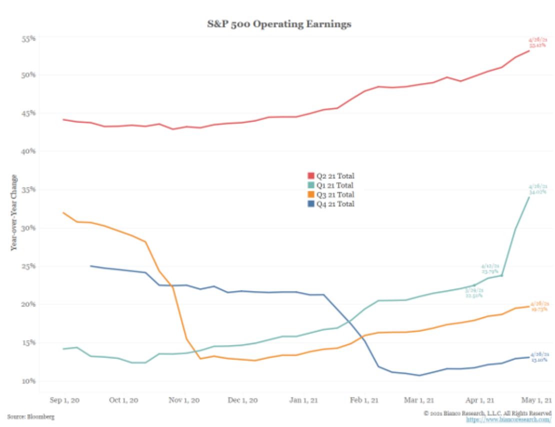


This may provide a whole new lease on life for the majority of public companies, who don't have to worry as much that the Fed is going to "take the punch bowl away just as the party is getting started" (as the old expression goes). This helps to level the playing field between the "average" stock and the relatively few hyper-growth and mega-cap growth companies that have led the equity markets for most of recent history.

While we have historically generally favored growth stocks, there are currently several factors that may at least temporarily make "value" stocks the more attractive segment of the equity markets, particularly from a risk-adjusted return perspective, starting with the fact that value stocks have historically dramatically outperformed the broad stock market in the two years following recessions (see above), and because 2020 produced the most severe contraction since the Great Depression.



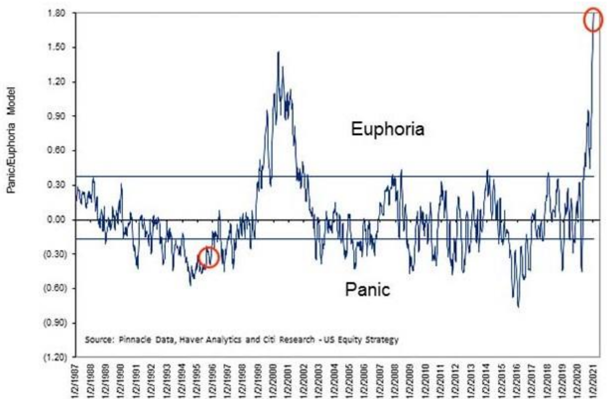
Also potentially favoring value stocks, in what we expect to be an environment of higher inflation and higher interest rates, is the fact that value stocks have historically significantly outperformed the broad markets in periods of mild to high inflation, probably because so many value stocks benefit disproportionately by an ability to increase prices.



To summarize through another of our quotes from the Barrons article, "Because of the reopening of the economy from the pandemic shutdown, and thanks to all of the fiscal stimulus, we have a unique opportunity to get growth-stock-type earnings from plain, normal, average, everyday stocks, and you don't have to pay extraordinarily high multiples to get those earnings."

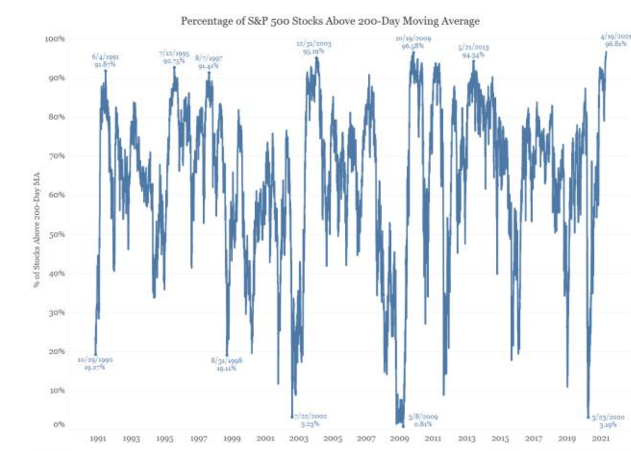
There is one more argument that we will make in the favor of value-oriented stocks in this environment, which is that stocks that are selling at lower valuations tend to weather market volatility much better than do more highly valued stocks.

While this may seem like a strange thing to consider at a time when the economy is booming, earnings growth is explosive and stimulus is abundant, it is important to remember that markets are forward-looking, and that this is all already "known news". Indeed, the risk may be that we are approaching the point of maximum good news, where most of the admittedly great news is already reflected in share prices, but where relatively little of the potential negatives, like higher inflation, higher taxes, higher interest rates from the Fed or an increasingly likely "tapering" of the Fed's quantitative easing (financial asset-buying) programs, are being discounted into current prices. If anything, this apparent complacency may be the most immediate threat to the current uptrend.



You can see just how much of this good news is already reflected in investor sentiment through the Citi Panic/Euphoria Model, which clearly shows excessive levels of euphoria, complacency and bullish sentiment. You can also see evidence of this overly ebullient sentiment in the number of S&P 500 stocks that are above their 200-day moving average (the highest reading on record), which is basically a technical way of saying that almost every stock is in a powerful primary uptrend, which is normally an indication of a strong and sustainable bull market.

However, while long-term declines almost never begin when market breadth is strong, it can actually be problematic over the intermediate term when breadth numbers are at such an extreme, as it means that most stocks may already be approaching their near-term potential, and very few stocks have been left behind by the rally.



Put another way, bull markets are a process of turning bears into bulls, and these types of numbers do call into question whether there are still any bears left to convert, or any stocks that are not already trading at or above fair market value.

We still believe that we are in a strong equity bull market, and that stocks are likely to finish the year at prices higher than they are today. However, in the short-to-intermediate term, we are mindful that, while the economic and earnings news is nothing short of spectacular, that good news is likely already reflected in current valuations, whereas there is little indication that the markets are discounting much in the way of any potentially negative news.

Whether it is higher interest rates, higher inflation, higher taxes, a tapering of the Fed's quantitative easing programs, or some unknowable geopolitical shock, the world in 2021 will ultimately cease to be so seemingly perfect, and we should expect that equity market risk and volatility will ultimately need to reflect that changing reality.

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 publicly-traded companies in the U.S with each stock's weight in the index proportionate to its market. It is not an exact list of the top 500 U.S. companies by market capitalization because there are other criteria to be included in the index.

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.