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THE PER STIRLING CAPITAL OUTLOOK

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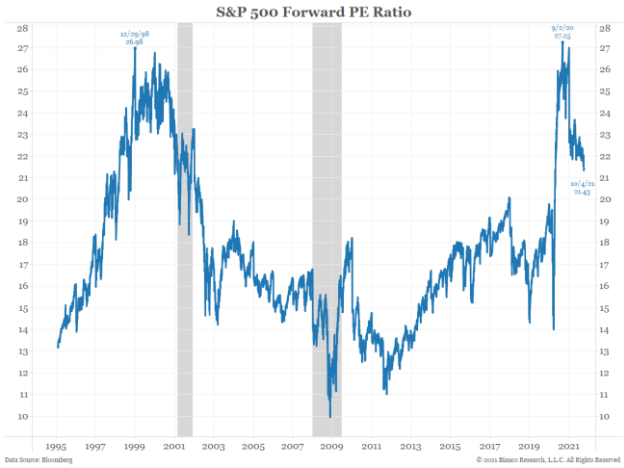
We had a very rewarding experience last week when one of the firm's Directors was the featured guest on the prestigious *Barron's Live* blog. As part of our preparation for that event, we spent some time trying to anticipate what kinds of questions might be asked by the moderator and/or the audience, and then organizing our thoughts on what our responses might be.

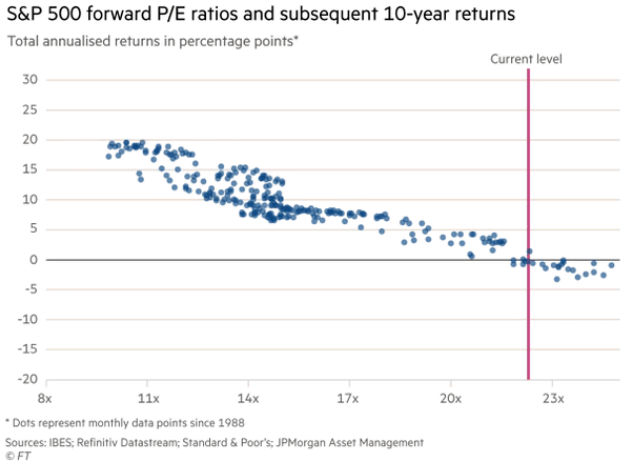
As it turned out, we found it to be a rewarding and insight-gaining exercise, so we thought that we would take a break from our more traditional format and instead use this commentary to tackle a few of the questions that we had prepared for in anticipation of this event.

Q: The domestic stock market has just experienced its first decline of at least 5% this year. Has that correction run its course, or does the market need to decline further to correct some of its speculative excesses/very high valuations?

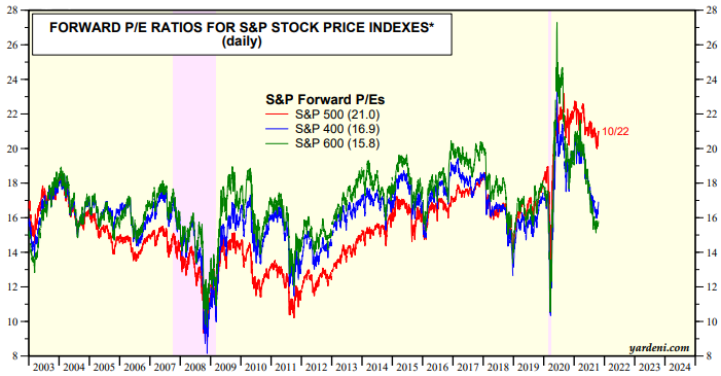


We would suggest that, in many regards, that is actually two separate questions. There is no doubt that equity market valuations have moderated over recent months but, with most domestic equity indexes already back at or near their previous highs, that moderation has more to do with an impressive increase in anticipated corporate earnings than it does the September pullback.

The bottom line is that domestic blue-chip equities, as represented by the S&P 500 Index, are still very expensive, and are priced (relative to future earnings expectations) at levels unseen since the late 1990s technology stock bubble. To put today's very high valuations into some perspective, when the S&P 500 Index has sold at similarly high valuations in the past, its average annual return over the following decade has been approximately 0%. While that is not necessarily our expectation, particularly given the perceived lack of viable alternatives, it does help to put current valuations into some perspective.

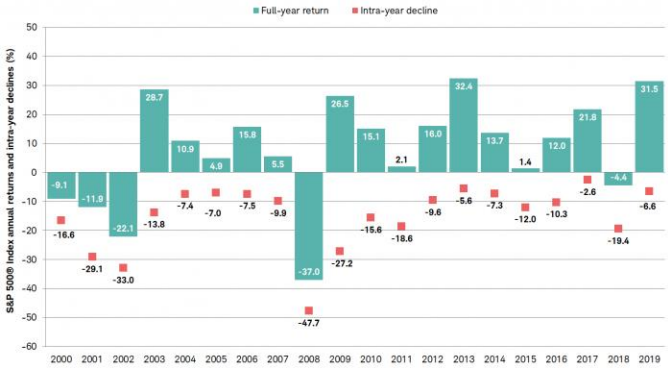


It should be noted, however, that this issue of excessive valuations is somewhat confined to larger stocks in general, which trade at twenty-one times anticipated earnings, and the mega-cap growth stocks in particular. As an example, the "FANG" stocks (Facebook, Amazon, Netflix, and Google [Alphabet]) trade, on average, at 46.3 times anticipated earnings and, if you were to remove those four stocks from the S&P 500 Index, it would drop the price-to-earnings multiple of the index down to 18.8 times anticipated earnings. Moreover, small and mid-sized company stocks trade much more in line with historic norms, and are priced at only 15.8 and 16.9-times anticipated earnings respectively. The same is true of the foreign equity markets, where the emerging markets, European markets, and Japanese equity markets are selling, on average, at 12.5, 15.5, and 14.5 times anticipated earnings (respectively).



As for whether or not the abrupt September decline was sufficient to restore balance and remove speculative excesses from the stock market, we rather doubt it, as the stock market actually averages three 5% or greater declines per year, and many intra-year corrections of much greater than that.

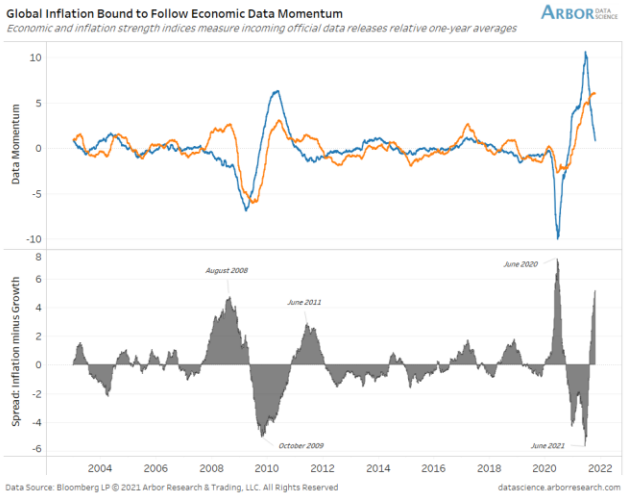
At the same time, we suspect that this question has less-than-normal relevance in the current market environment, as we have had large rotational corrections throughout the year, during which individual sectors fell out of favor only to be replaced by leadership from other sectors. This rotation under the surface has buoyed the overall index against any declines of substance in 2021. That said, like a duck floating peacefully on the surface of a pond, you see a very different picture if you look under the water.



According to research from Charles Schwab, 91% of all stocks in the S&P 500 have declined by at least 10% at some point in 2021, with the average stock declining by 18%. Of stocks listed on the NASDAQ Composite, 90% have declined by at least 10%, but with an average decline of a whopping 38% while, in the Russel 2000 Index of smaller-capitalization stocks, 98% have declined by at least 10%, with a similarly impressive average decline of 34%. In total, more than half of all stocks traded on the New York Stock Exchange have fallen below their long-term uptrend in 2021, as defined by their 200-day moving average.

In short, while there are segments of the domestic equity markets that remain highly valued, we have seen rotational price corrections throughout the year. In addition, during the September decline, most measures of investor sentiment turned rather cautious, trading volume surged, and fear levels spiked, thus suggesting modest capitulation. All things considered, we believe that the market rebound from recent lows is likely sustainable.

Q: Economic growth is showing signs of slowing, while inflation looks increasingly problematic. Are these trends likely to reverse themselves as the global economy reopens, or is stagflation becoming a longer-term risk?

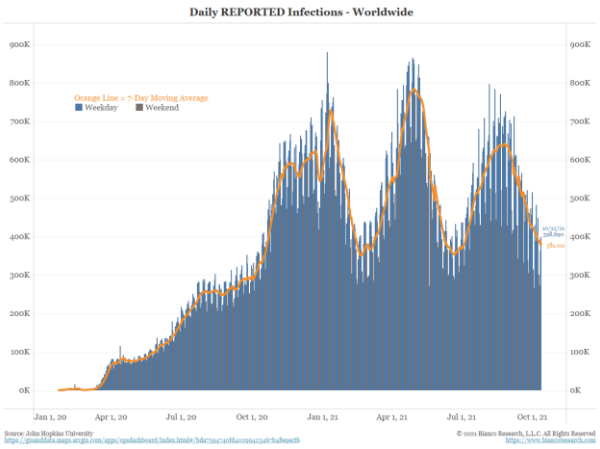


Stagflation might be best defined as a combination of undesirably high inflation and undesirably slow economic growth, and it presents a unique challenge to the Federal Reserve, as any attempt to stimulate the slow economy is likely to exacerbate inflation, and any attempt to dampen inflation is likely to further weigh upon the economy.

Stagflation is a very rare phenomenon that has historically been catalyzed by one or more major external shocks. For example, the last period of sustained stagflation took place in the 1970s, and was greatly exacerbated, if not outright caused by, a series of macroeconomic shocks, including the 1973-1974 oil embargo, the 1979 oil shock, and the October 1976 decision to no longer peg the dollar to the price of gold.

We have stagflation again now, as you can see reflected in the above chart, with the falling blue line representing economic data and the rising gold line representing inflation. Indeed, you can see just how rare it is for growth and inflation to be moving inverse of one another.

We believe that stagflation is once again being catalyzed by a major external shock, this time the global covid pandemic, which has been a two-edged sword. On one hand, the pandemic has snarled supply chains, thus creating shortages and pushing prices sharply higher. On the other hand, the massive payments made by the government to the help the American consumer through the pandemic has boosted savings rates, increased wealth overall, and generated a demand for products and services that is so strong that it would be difficult to satisfy even without all of the fouled supply chains.



That's not to even mention that the Fed has ballooned the money supply to literally unprecedented levels, which is something very much in common with the 1970s, when the Fed made the error of trying to "monetize" the oil shocks by dramatically expanding then money supply, thus exacerbating overall inflation.

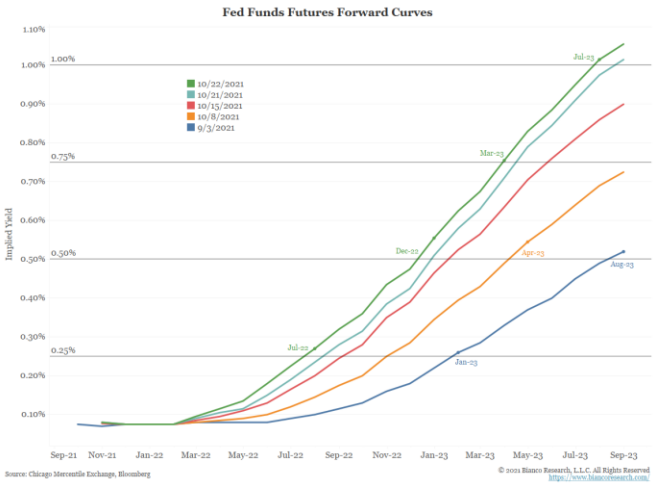
Importantly, however, we do not believe that this is going to be a repeat of the 1970s, when unions were much stronger, when contracts were written with large and automatic wage escalators, and when both the Johnson and Nixon White Houses regularly ran roughshod over the Fed, and coerced them to adopt overly accommodative policies that were designed to help the incumbent president politically, but at the expense of inflation.

If anything, today's longer-term macroeconomic factors of globalization, digitization, demographics and technology should ultimately return as deflationary influences, once the world emerges from the pandemic and the global economy more fully reopens, which is something that we believe could occur as soon as the second half of 2022.

Q: The Fed has indicated that it is on the verge of tightening monetary policy, starting with a tapering of their asset purchase programs and continuing with increases in short-term rates as soon as next year. What is your outlook for monetary policy, and how do you expect it to impact the financial markets?

We fully expect for "tapering" to start this year, and think that a November start is most likely, with tapering concluding by mid-2022, and a growing likelihood that the second half of next year will witness as many as two increases in short-term rates by the Fed. We will emphasize again that "tapering is not tightening".

In other words, the Fed is not touching the brakes. Instead, they are incrementally and methodically taking pressure off of the accelerator by reducing their purchases of financial assets by an estimated $20 billion per month (down from $120 billion per month currently). That suggests the addition of at least another $400 billion plus of quantitative easing before tapering is completed, which is larger than the entire QE2 stimulus program.

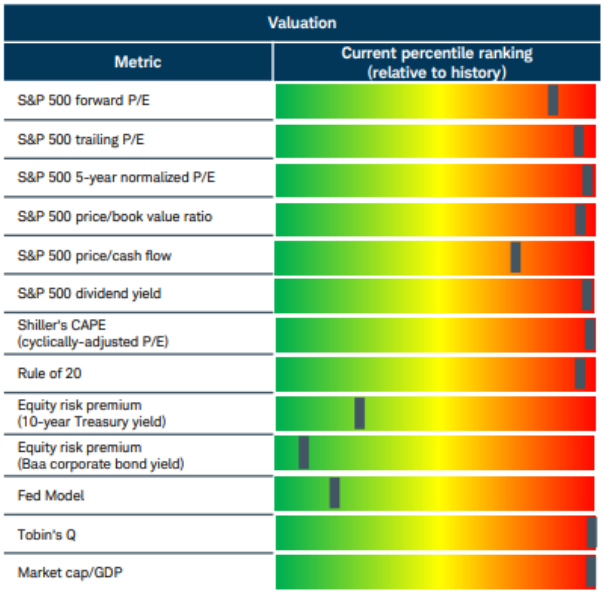


With the exception of 2013, when Bernanke surprised investors with an unexpected comment about a future tapering, bonds have weathered tapering and the end to QE quite well, and we anticipate a similar outcome this time. While tapering does ultimately remove the Fed as a major buyer of debt, which one would logically expect to drive rates higher and debt prices lower, it also tends to weaken the economy and reduce the risk of future inflation, which has in the past been more than sufficiently bullish to offset the impact of the reduced Fed purchases.

Equities, on the other hand, have not fared as well in the face of reduced liquidity, and not only sold off after the end of each of the Fed's so-called Q.E. programs (during the Global Financial Crisis) and had a modest decline of about 6% in response to the 2013 tapering, but also suffered through a full-blown bear market in the fourth quarter of 2018, when the Fed assured investors that tapering would be so boring that it would be "like watching paint dry".

However, while only time will tell, there are three reasons why equities may weather monetary tightening better this time than in the past. First, the Fed's announced change from a proactive monetary policy to a reactive one makes it less likely that the Fed will over-tighten policy and cause a recession, which has traditionally been Wall Street's primary concern. Second, in the current environment, equity investors may be more fearful of inflation than they are of a Fed-induced recession and thus welcome tightening. Third and finally, the Fed has stated that their tightening is not on "autopilot" this time, which suggests that the Fed will change course when and if economic growth appears to be at risk.

That said, higher interest rates do tend to compress (lower) stock market multiples, which is important to keep in mind when equity valuations are already at extremes based upon any measure that is not primarily based on interest rate levels (as shown in green on the grid).



Even so, we believe it very possible that equity investors will ultimately determine that the benefits of lower inflation are even more important than is the reduction in Fed liquidity, in which case both tapering, and ultimately even higher interest rates, are likely to be viewed by equity investors as more of a neutral than as a negative.

While markets are on the verge of losing, over time, the massive monetary and fiscal stimulus programs that have provided them with powerful tailwinds over the past twenty months or so, we continue to believe that interest rates will remain relatively low despite accelerating inflation, and that domestic equities will continue to provide relatively attractive returns, despite their high valuations, if for no other reason than the facts that there are so few viable alternatives, that the world is absolutely awash in money, and that all of that money ultimately needs to go somewhere. That's the benefit of being the "best house" in an increasingly challenging "neighborhood".

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The Russell 2000 Index measures the performance of approximately 2,000 small-cap companies in the Russell 3000 Index, which is made up of 3,000 of the biggest U.S. stocks. The Russell 2000 serves as a benchmark for small-cap stocks in the United States.

The Nasdaq Composite index tracks the performance of about 3,000 stocks traded on the Nasdaq exchange. It's mainly used as an indicator of how well companies in the tech sector – both large and small – are doing.

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