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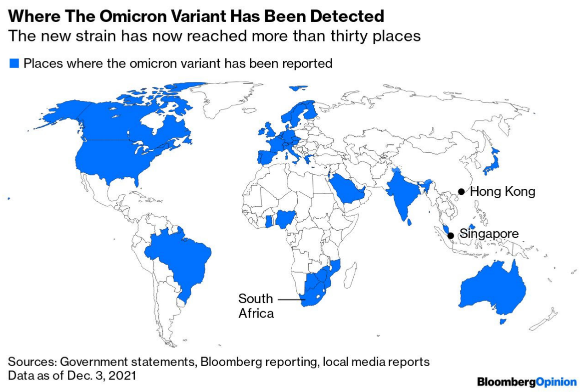
THE PER STIRLING
CAPITAL OUTLOOK
Performance • Perspective • Per Stirling

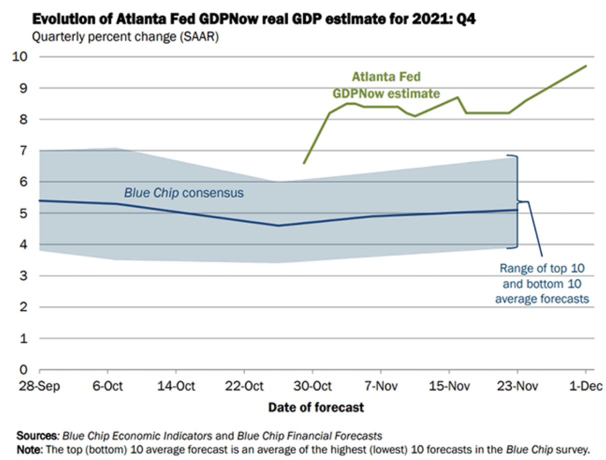
December 2021

As American investors settled in for Thanksgiving this year, it appeared that they had much to be thankful for. While inflation was still a worrisome issue, there were some signs that the supply chain snafus that were exacerbating the problem were starting to unwind, and the Fed continued to offer assurances that inflation would prove to be only "transitory".

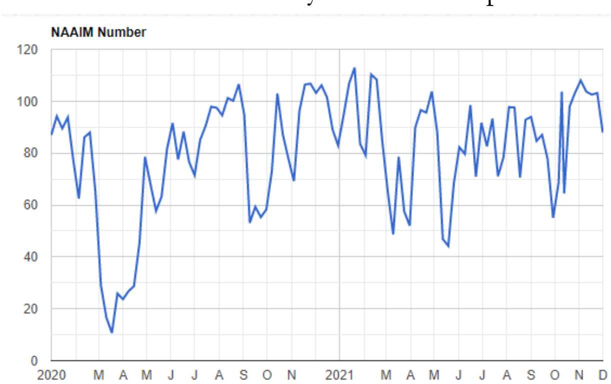


Further, according to research from the Federal Reserve Bank of Atlanta, the recent drop in COVID cases was allowing the U.S. economy to rebound to an annualized growth rate for the fourth quarter of an astonishing 9%-plus (green line, below), while U.S. companies are enjoying their widest overall profit margins since 1950.

Perhaps most important of all, the U.S. was making significant progress against the COVID pandemic, and numerous experts were becoming increasingly optimistic. This included the former FDA Commissioner, Scott Gottlieb, who noted on November 5th that "by January 4th, this pandemic may well be over, at least as it relates to the United States after we get through this Delta wave of infection. And we'll be in a more endemic phase of this virus."



This abundance of good news really boosted bullish sentiment, as was reflected in both investor sentiment surveys and market positioning (evidenced by a general lack of defensive hedges and high equity exposures). Indeed, the average portfolio run by National Association of Active Investment Managers (NAAIM) members held in excess of 100% of their portfolio's value in equities (i.e., they were leveraged) as of November.



As such, the markets were ill-prepared for bad news, which explains the severity of early December's broad equity market decline, as the market outlook of investors turned pessimistic over the course of Thanksgiving Day and the three trading days that followed.

The first shock to the markets was the revelation of the new Omicron variant, which was reported to be both more contagious than its predecessors, and able to infect both the vaccinated and those who had previously been infected.

The other rather nasty surprise awaiting investors returning from their long Thanksgiving weekend was the abrupt about-face by Fed Chairman Powell, and the suddenly hawkish monetary policy stance adopted by the Federal Reserve.

When Does The Market Expect The Fed To Hike?
As of December 8, 2021
Probability of a Move
Green Hike Probability over 50%

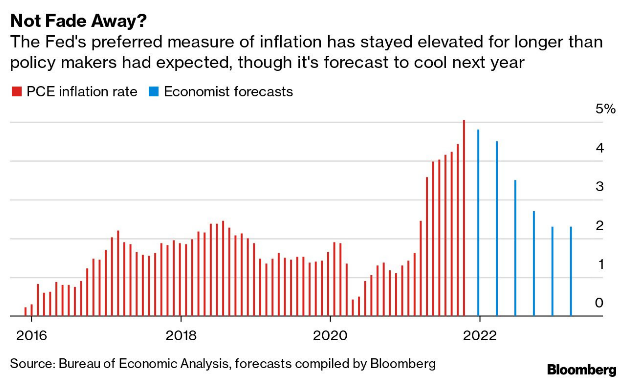
FOMC Meeting	No Hike 0% -0.25%	One Hike to 0.25% - 0.50%	Two Hikes to 0.50%- 0.75%	Three Hikes to 0.75% -1.00%	Four Hikes to 1.00% -1.25%
15-Dec-21	100%	0%	0%	0%	0%
26-Jan-22	93%	7%	0%	0%	0%
16-Mar-22	61%	39%	3%	0%	0%
4-May-22	39%	61%	16%	1%	0%
15-Jun-22	19%	82%	40%	9%	1%
27-Jul-22	13%	87%	53%	19%	3%
21-Sep-22	7%	93%	69%	34%	10%
2-Nov-22	5%	95%	76%	45%	17%
14-Dec-22	2%	98%	89%	66%	36%
1-Feb-23	1%	99%	91%	71%	43%

Source: The Chicago Mercantile Exchange
https://www.cmegroup.com/trading/interest-rates/countdown-to-fomc.html
Bianco Research LLC
www.Biancoresearch.com

The markets were certainly expecting such a hawkish shift in monetary policy at some point, just not so soon, and not without ample warning… and markets tend to hate being surprised, particularly by the Fed. Investors made their displeasure known by pushing the "sell button".

What made the policy change remarkable was not just that Chairman Powell surprised the markets by publicly abandoning his premise that inflation was transitory, and by guiding the markets to expect an accelerated and more aggressive tightening of monetary conditions, but also that he did not hesitate to drop those bombs on the markets when they were already roiling over fresh fears of a new and highly-contagious COVID variant.

Powell noted last week that "it is probably a good time to retire that word [transitory] and explain more clearly what we mean", which the markets are interpreting (we think correctly) as a politically-correct euphemism for "inflation is going to be higher and last longer than we have been predicting". He also noted in last week's Senate Banking Committee hearing that "the economy is very strong and inflationary pressures are high, and it is therefore appropriate in my view to consider wrapping up the taper of our asset purchases, which we actually announced at the November meeting, perhaps a few months sooner".



Powell is right that the Fed needs to more aggressively tighten its monetary policy, as the economy is absolutely booming, and inflation is already running at the highest levels in thirty-one years. That said, the Fed has a long and ignominious history of raising rates too aggressively and at the wrong time, thus catalyzing recessions and equity bear markets. As such, the equity markets almost always get quite jittery when faced with the prospects for higher interest rates.

From our perspective, the slowing and eventual end of these asset purchase programs is hardly a reason for concern, as these programs probably should have ended months ago. The bigger issue is probably one of timing, as the Fed stated that they may end their asset purchases around March, rather than in June or July, which had been their previous guidance.

This issue of timing is all-important, as the Fed previously stated that they would not raise interest rates until after the tapering was completed. As such, we believe that the main importance of the Fed's decision to accelerate the pace of its tapering is that it provides the Fed with the flexibility to start raising rates as soon as March or April, instead of in the previously anticipated June-July period.

RATE HIKES AND RECESSIONS

RATE-HIKE CYCLE	DURATION (MONTHS)	NEXT RECESSION	TIME TO NEXT RECESSION (MONTHS)
4/15/1955-8/23/1957	28	Aug-57	28
9/12/1958-9/11/1959	12	Apr-60	19
7/17/1963-4/4/1969	69	Dec-69	77
3/1/1972-5/1/1974	26	Nov-73	20
12/1/1976-3/3/1980	39	Jan-80	37
8/7/1980-12/5/1980	4	Jul-81	11
5/2/1983-8/21/1984	15	Jul-90	86
12/16/1986-9/4/1987	9	Jul-90	43
3/29/1988-2/24/1989	11	Jul-90	28
2/4/1994-2/1/1995	12	Mar-01	85
6/30/1999-5/16/2000	11	Mar-01	21
6/30-2004-6/29/2006	24	Dec-07	42

So, what does history tell us about the impact of Fed rate hikes? First of all, there has traditionally been a significant lag time between the first rate hike and either a recession or an equity bear market.

In regard to the economy, the lead time between the first rate hike and a recession has historically ranged from eleven months to eighty-six months.

It is also worth noting that, with an estimated real-time economic growth rate in the high single digits, the U.S. economy is likely to start this rate-hiking process a lot further away from recession than is normally the case, thus improving the odds that the Fed may be able to successfully dampen inflation without causing an outright recession.

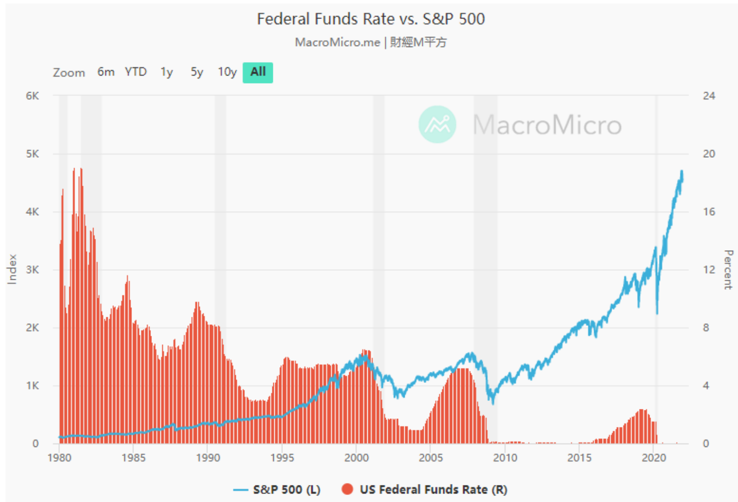
There is also a historical correlation between higher short-term rates and lower stock prices, which is illustrated below.

However, as is the case with the economy, the linkage is neither direct nor immediate. Indeed, it may be among the worst-understood relationships in all of market analysis, as the consensus opinion is that the process of the Fed raising short-term interest rates is very detrimental to stock prices.

However, according to Rosenberg Research, this perception is incorrect and that "the S&P 500, over seven decades of performance, did just as well in periods of Fed tightening as in periods of Fed easing (median of +18% in both conditions)".

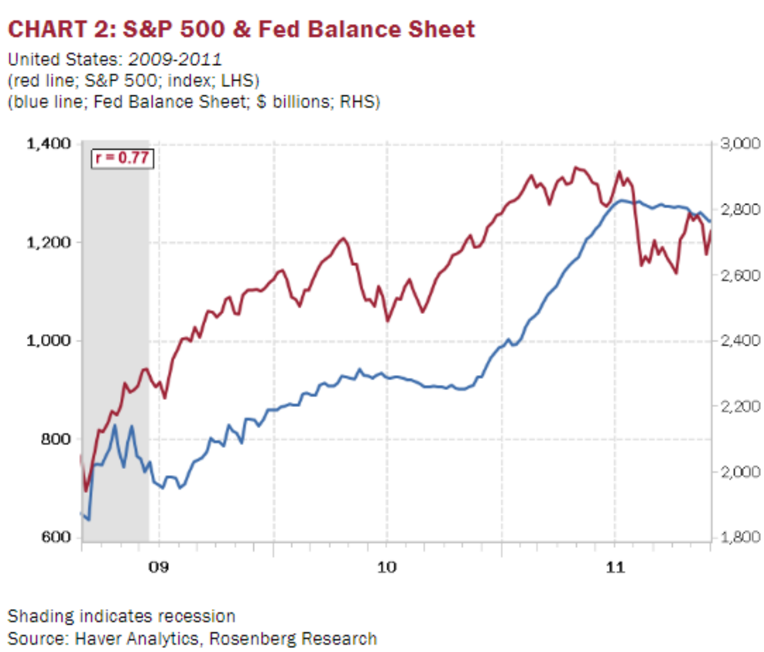
Indeed, it has historically been the period during which the markets are anticipating higher rates (i.e., like the present) when market volatility increases, only to settle down once the rate hikes actually begin.

According to Bob Doll, chief equity strategist at Nuveen Asset Management, "the market over the past 35 years or so is most often up sharply—about 14 percent—heading into the rate hike, fairly flat in the 250 days after (average gain of 2.6 percent) then back to normal once 500 days have passed, with average return in the past six cycles of 14.4 percent". Deutsche Bank further noted a "trend for equity returns to stall 12-24 months after the first hike, which again perhaps reflects the lag in monetary policy", but that suggests a market impact primarily in the final stages of a Fed tightening, which could be at least two years away.



Moreover, if you take the current Fed Funds Rate of 0.25% and add in the five rate increases that the markets are currently expecting to see over the next two years, it would only increase the Fed Funds Rate to 1.5% (assuming the expected hikes of 0.25% each), which is still one of the lowest rates in history.

That is not to suggest that higher interest rates do not impact the markets. If anything, one could easily make the argument that the prospect for higher interest rates has actually been changing the characteristic of the markets since mid-February, when inflation first started gaining a foothold.

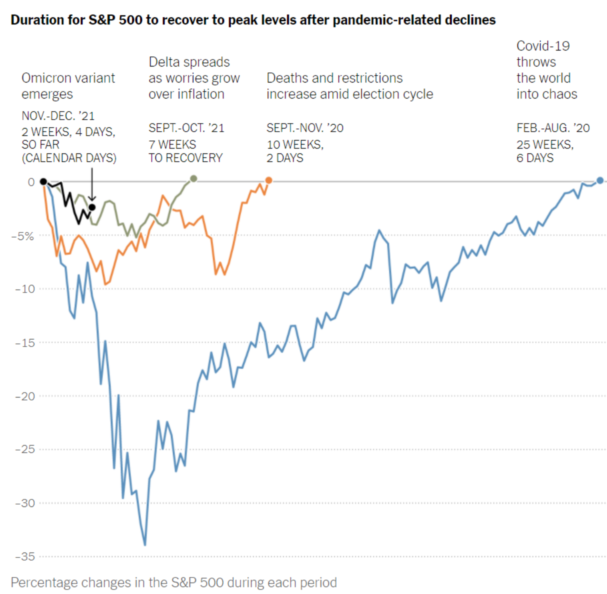


As was recently noted in a research report from Goldman Sachs, "History shows that 'quality' stocks tend to outperform during the three months following an initial rate hike…Firms with strong balance sheets outpaced weak balance sheet companies following each of the 1994, 1999, and 2004 rate hikes, by an average of 5 percentage points… Companies with high returns on capital as well as low volatility stocks also outperformed their lower quality counterparts, by an average of 4 (percentage points) and 3 (percentage points), respectively."

This change is very evident in the below ratio chart that divides a share in the S&P High Quality ETF (a proxy for blue-chip stocks with strong balance sheets) by a share in the ARK Innovation ETF, which is a good proxy for aggressive, innovation-driven companies whose best earnings are potentially years away. When the line is falling, innovative growth companies are outperforming, as was the case throughout 2020, with the exception of the initial pandemic-driven bear market, when investors sought the safety of blue-chip stocks.

Starting in February, however, this relationship changed entirely, when vaccine approvals offered hope for a reopening and emerging inflation drove money out of aggressive growth stories and into value-oriented and cyclical stocks. (This is a performance chart so the Y-Axis illustrates the performance differentials).

While we maintain that there are some compelling, long-term growth stories that will likely make some investors very rich over the next decade, it is very possible that these types of stocks will not return to dominance until the markets perceive that the Fed is in the final stages of its tightening cycle.



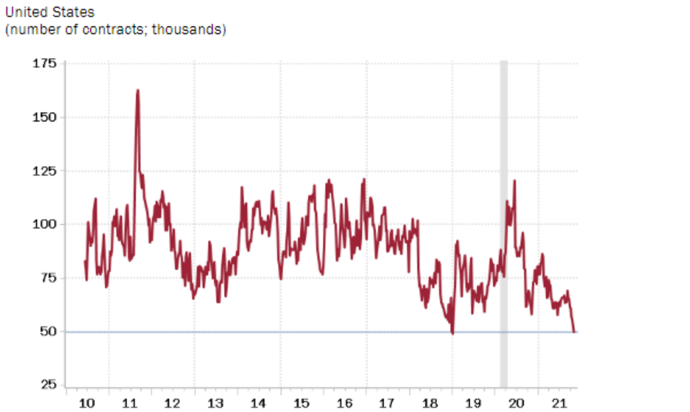
In regard to the Omicron variant, clinical information is just starting to trickle in, but the news thus far seems to be coming in much better than expected. While the variant does appear to be much more contagious than its cousins, and able to partially "escape" current vaccine protections, the symptoms appear to be much less onerous. Indeed, White House chief medical advisor Dr. Fauci told CNN over the weekend that Omicron "does not look like there's a great degree of severity to it."

Moreover, several therapeutics have already been proven effective against Omicron, and early research from Pfizer notes that two-doses are providing strong protection against serious illness and a booster shot provides protection against Omicron that is essentially as effective as two shots were against the original COVID strain, although they noted that a fourth shot may be necessary. Pfizer CEO, Albert Bourla, said this week that the company could develop a vaccine that specifically targets Omicron by March 2022.

It is worth noting that the stock market is taking less and less time to rebound from its declines, after each successive revelation of a new COVID variant (above), which suggests that investors are becoming increasingly inured to the pandemic.

Opinions still vary, ranging from that of a virologist in Singapore who believes that Omicron is so contagious that virtually everyone will catch it before vaccines can be developed, to strategists from JP Morgan, who just introduced their premise that Omicron "might ultimately be a positive for risk markets because it could signal that the end of the pandemic is in sight".

CHART 9: Second Lowest Gross Short Position for the S&P 500 on Record

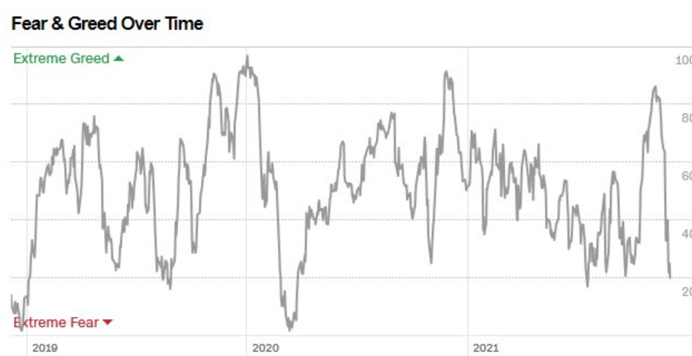


Shading indicates recession
Source: Haver Analytics, Rosenberg Research

Indeed, according to Marko Kolanovic, the bank's Chief Global Markets Strategist & Co-Head of Global Research, "our view is that 2022 will be the year of a full global recovery, an end of the pandemic, and a return to normal economic and market conditions we had prior to the COVID-19 outbreak".

However, the most intriguing comment of recent days may have come from Richard Friedland, who is the chief executive officer of Netcare Ltd., the largest private health-care network in South Africa, so he speaks from experience. He said this week, "So I actually think there is a silver lining here and this may signal the end of Covid-19, with it attenuating itself to such an extent that it's highly contagious, but doesn't cause severe disease. That's what happened with Spanish flu."

One can only hope and pray that his comments prove prescient. In the meantime, the world must wait for more clinical data, and watch to see if Omicron seems likely to supplant Delta, which continues to ravage much of the world.



While, with the benefit of hindsight, it appears that the market's reaction to the revelation of Omicron was overdone, it has, in our opinion, accomplished something very constructive, which is to take a stock market that was characterized by overconfidence, complacency and extreme greed just a month ago (and which had the second lowest gross short position in history), and reversed sentiment 180 degrees to levels approaching extreme fear (according to the CNN Fear and Greed Index).

We often quote the incredibly insightful comment from Sir John Templeton that "bull markets begin in despair, grow on pessimism, mature on optimism and die in euphoria". While it is hard to find many signs of despair, we recently witnessed many indications of pessimism, and that, along with good news on the debt ceiling front and additional stimulus in China, may be just what the market needs to fuel its traditional "Santa Claus Rally".

Enjoy your holidays, and ask for some coal in your stocking. It is up 105.2% this year!

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The CNN Fear and Greed Index (FGI) was developed by CNNMoney to measure two of the primary emotions that influence how much investors are willing to pay for stocks. It is based on the premise that excessive fear can result in stocks trading well below their intrinsic values, and that unbridled greed can result in stocks being bid up far above what they should be worth. CNN examines seven different factors to establish how much fear and greed there is in the market, scoring investor sentiment on a scale of 0 to 100.

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