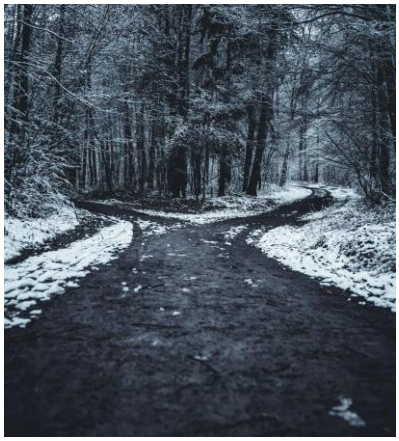
Volume 137

THE PER STIRLING CAPITAL OUTLOOK

Performance • Perspective • Per Stirling

March 2022

We are in the midst of the largest war in Europe since World War II; there are very elevated tensions between numerous nuclear superpowers; consumer confidence is far worse than it was at the most uncertain point of the pandemic, and the U.S. bond markets are experiencing the second worse start to a year in history, while 75% of all NASDAQ-listed stocks and over 50% of S&P 500 stocks are in a bear market (down 20% or more from their recent highs).



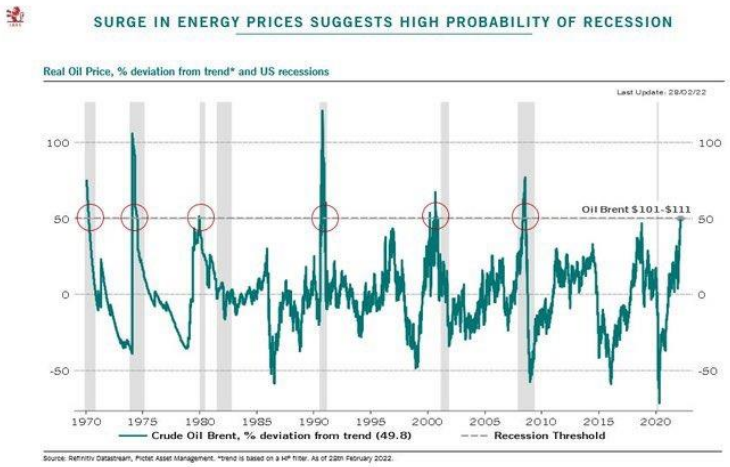
Importantly, when consumer confidence has experienced similar collapses in the past, it has historically foretold impending recessions (shown below in grey). As a result of these factors and more, it is hardly surprising that a growing number of analysts, portfolio managers and economists are predicting that the Fed will, as has been its historical tendency, abandon its inflation-fighting path, and instead once again come riding to the rescue of the economy and markets like it was the cavalry in an old John Wayne western.

Unfortunately, we do not share that highly optimistic expectation. To the contrary, we believe that the war in Ukraine is going to significantly worsen inflation and thus further harden the Fed's resolve to get inflation back under control, almost regardless of the consequences. Indeed, while Russia's invasion of Ukraine continues to dominate the news headlines, we maintain that it is inflation that continues to dominate the future outlook for the economy, the stock market, interest rates, and ultimately the portfolio of virtually all of our readers.

That is not to suggest that the war is unimportant from an economic and markets perspective. Instead, it is to posit, assuming that military conflict with Russia does not spill over to a N.A.T.O. country, that the biggest economic and capital markets impact of the war is likely to be its very negative, inflation-related consequences, and the resulting impact on central banks and monetary policy.

Prior to the invasion, there was a clear and obvious path for the Fed of aggressively raising interest rates, and shrinking its balance sheet, to battle inflation. However, as a result of the war, the Fed, and the world's other major central banks, are being made to choose between two distinct and mutually-exacerbating options. They can take the more dovish path of delaying, diminishing or even reversing their anticipated tightening of monetary policy, in the name of supporting a slowing economy, lifting consumer spirits, and supporting the prices of financial assets. This is how the Fed addressed the oil shocks of 1973 and 1979, and it produced hyper-inflation and ultimately stagflation (low-to-no-growth, with high inflation).

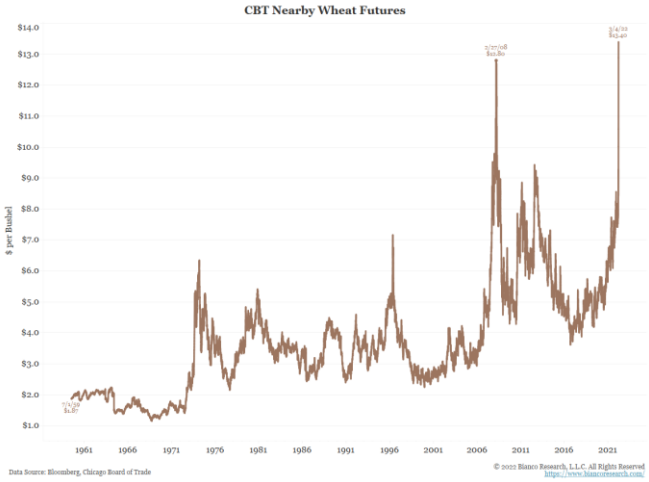
Alternatively, global central banks, and the Fed in particular, can remain steadfast in their commitment to fight inflation, which is almost certainly what is best for the economy in the long run, even if, over the near term, it portends a quite difficult environment for both the economy and the financial markets.



Russia's invasion is already greatly exacerbating the inflation problem, which was severe even before the first Russian tank crossed the border.

This is initially being seen in the soaring prices of crude oil and other raw materials, and is almost certain to get even worse, as a result of the sanctions against Russia. Moreover, the war is about to have a huge influence on the price of many foods. Indeed, wheat prices have jumped by 40% over just the past week (to a 14-year high), and even if today's extraordinary prices prove unsustainable, they are almost certain to remain both high and highly impactful.

Ukraine is known as the breadbasket of the world and, prior to the invasion, was one of the three largest exporters of grain on earth. The country is estimated to have the capacity to feed around half a billion people. Russia and Ukraine combine to produce a quarter of the world's wheat and one fifth of the world's corn, and the production from both countries is likely to be severely compromised. Indeed, in Ukraine, farmers are approaching the time to begin both harvesting their winter wheat crop and planting corn and sunflowers (Ukraine's three biggest harvests), and yet many of the fields are in active war zones.



While oil prices may decline once military action starts to wind down, they have already rallied by over 50% and, while the past is not necessarily prologue, it is noteworthy that, over the last fifty-plus years, every 50% increase in the price of crude oil has produced (or at least been immediately followed by) a recession, as identified in the above chart in grey.

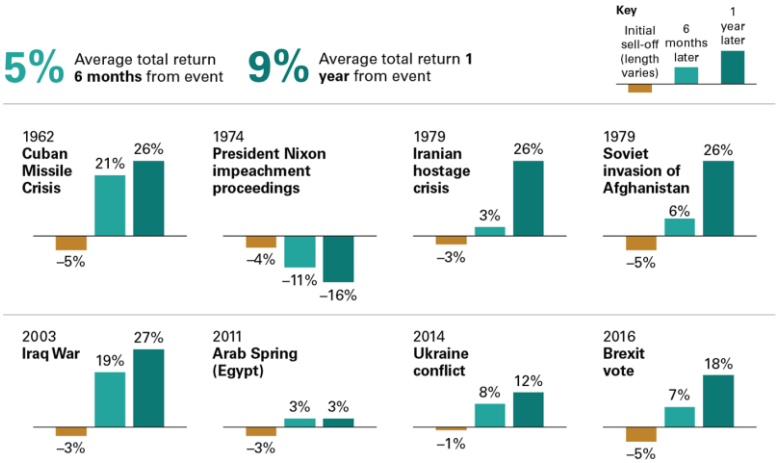
Moreover, even if diminished military action were to allow oil prices to decline, Ukrainian farmers won't get a second chance to harvest this year's crops. Further complicating matters is the fact that Russia is reportedly the biggest producer of fertilizer in the world, which could have implications for crop yields across the globe, if it gets embargoed or Russia decides to withhold it. It is little wonder that wheat prices just experienced their biggest weekly gain in history.

Moreover, as was pointed out by Fed Chair Powell in his March 3rd testimony in front of Congress, the war in Ukraine is further disrupting global supply chains, and that restoring efficient supply chains is absolutely essential to any effort to get inflation back under control. Indeed, credit rating agency Moody's just declared that "the greatest risk facing global supply chains has shifted from the pandemic to the Russia-Ukraine military conflict and the geopolitical and economic uncertainties it has created".

Another fact that could have far-reaching consequences to the global supply chain is that Russia and Ukraine are major exporters of certain elements essential to the production of semiconductors, including neon (where Ukraine had accounted for 70% of the world's supply) and palladium, where Russia had accounted for 40% of the world's supply.

If anything, by exacerbating already problematic levels of inflation, further snarling global supply chains and weakening global growth, the war is elevating the risk of stagflation and greatly complicating what was already an immensely difficult job for the Fed.

As we discussed in last month's commentary, these types of geopolitical events rarely have a long-term impact on the capital markets in general, and on stock markets in particular. Indeed, there is a well-known phrase attributed to London financier Nathan Rothschild in 1810 that an investor should "buy on the sound of cannons, and sell on the sound of trumpets". In other words, buy on the panic associated with war, and sell the news of peace as, by that point, the majority of good news is already fully priced into securities.

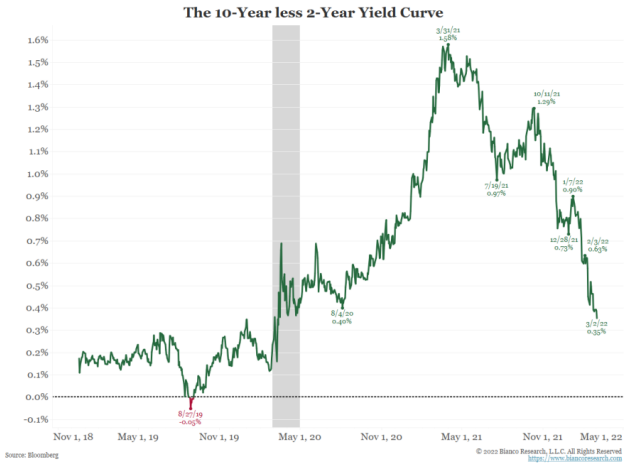


Even this time, it has not been bad advice, as the Dow Industrials, S&P 500, NASDAQ Composite and 10-year Treasury bond are all flat to slightly higher in price from the date of the initial invasion to the date of this report. However, we challenge that conventional wisdom, as we think that the financial implications of this war are likely to last for quite a while. First of all, history tells us that, when sanctions like those being imposed on Russia are put in place, they tend to last for years rather than weeks or months. Second, we believe that the war and its aftermath will have a sustained impact on the global economy, through its effect on both inflation and global supply chains.

On top of everything else, financial system-related sanctions against Russia are expected to restrict global liquidity, which is likely to slow the global economy, particularly when you consider that these sanctions-based restrictions are being implemented while the world's central banks are also simultaneously draining liquidity from the global economy.

As we have noted over recent commentaries, we believe that the so-called "Fed Put" (the perceived practice by the Fed of bailing out the financial markets any time that they experience substantial declines, under the premise that it adds stability to the financial system) has essentially expired, at least until such time when inflation is under much better control.

All things considered, while the invasion of Ukraine certainly made the Fed's job much more difficult, and greatly elevates the risks associated with any mistakes in monetary policy, we believe that it also made the need for the Fed to fight inflation even more urgent and more essential, even if it risks a recession and the potential for bear markets in stocks and bonds.

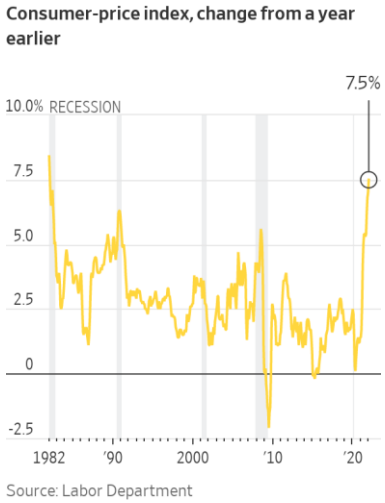


As was just pointed out by renowned economist David Rosenberg, "The Fed has never before started its tightening campaign with real GDP [inflation-adjusted] growth this low, the yield curve this flat, and the stock market this weak".

The aforementioned yield curve is a particularly important gauge of the prospects for a recession, the potential for which seems to be seems to be gaining credibility in the Treasury markets, where the difference between the yield on the 2-Year Treasury and the 10-Year Treasury is now less than one-quarter of one percent (0.24%).

This is potentially very important, as short-term bond yields converging with longer-term bond yields (i.e., a "flattening yield curve") has historically been a very reliable indicator of not only a slowing economy, but also a likely recession. At present, the Treasury yield curve is the flattest that it has been since the panic lows of the pandemic in March of 2020.

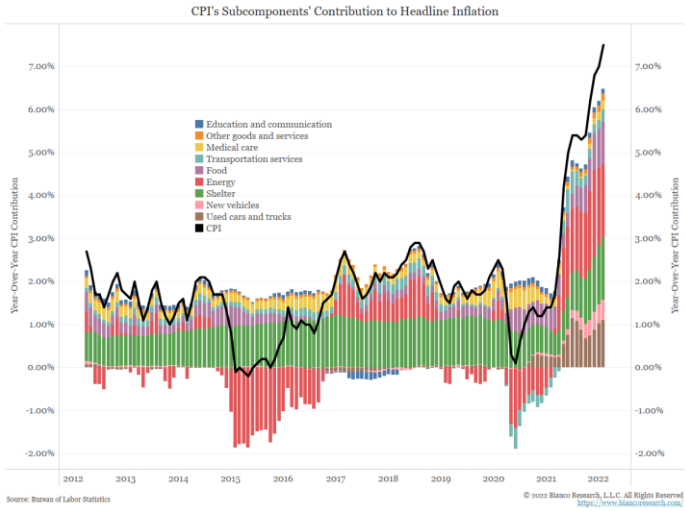
Regarding the question of which path the Fed is likely to take, Chairman Powell himself may have already told you all that you need to know about the Fed's intentions. During his congressional testimony on March 3rd, there was a very telling exchange with U.S. Senator Richard Shelby, who asked Powell if he was "prepared to do what it takes, without any reservation, to protect price stability", and if he was willing to be as "draconian" as former Chairman Volcker had been in battling inflation.



Powell replied, "Well, let me say I knew Paul Volcker. I think he was one of the great public servants of the era - the greatest economic public servant of the era. And I hope history will record that the answer to your question is yes".

For those readers who are young enough to have missed the hyperinflationary period of the 1970s and early 1980s, Volcker's policies were indeed so draconian that there was even an attempt made on his life. He drove short-term interest rates up to 20%, which rocketed mortgage rates to 18% and the prime rate to 21.5%, while causing two deep, back-to-back recessions (1980 and 1981-1982). The deep and prolonged equity bear market that resulted drove the S&P 500 price-to-earnings multiples all the way down to 8 times earnings. It is currently 19.3 times earnings. While Volcker did successfully wring inflation out of the economy, we can only hope and pray that Powell can avoid being so draconian as was his predecessor.

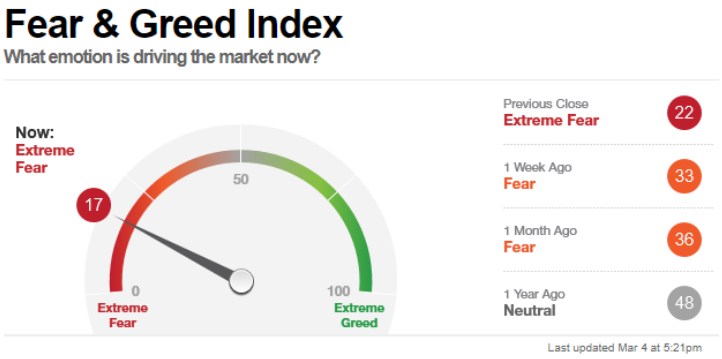
It should be emphasized that, while consumer inflation rates are dangerously high at 7.5%, that is still a far cry from the hyper-inflation of the 1979-1980 period, when inflation averaged a stunning 13%, which is almost twice current levels, and sufficient to double the American consumer's cost of living in just over five years.



Renowned value investor, Sir John Templeton, famously noted that "Bull markets begin in despair, grow on pessimism, mature on optimism and die in euphoria".

We thought that it was important to reintroduce this valuable perspective, particularly in light of what has been an admittedly rather gloomy commentary. We would also like to most strongly emphasize a very important point that we made in our January *Outlook*, which is that "market declines tend to end long before the fundamental news gets better (earnings improve, interest rates and inflation decline, etc.). Instead, markets tend to bottom once the vast majority of bad news is known and understood by the vast majority of investors".

We are starting to see indications that we may be approaching this point in the U.S. markets, as manifested by very elevated readings of investor fear (shown is the CNN Fear and Greed Index). That said, we are still waiting to see the signs of abject panic and capitulation that normally accompany significant market lows, and which we expect will likely ultimately be necessary to mark a significant market bottom this time.



Regarding the foreign equity markets, we wrote a month ago about their remarkably inexpensive valuations. Well, they continue to get less and less expensive. At the same time, the current market is being driven by news headlines rather than valuations, and we would limit exposure to foreign markets until either the headlines improve, or we see clear and obvious signs of investor capitulation.

In contrast, we are finding some specific opportunities in the U.S. that are performing well in this environment, and there are even signs that the blue-chip indexes may be finding some technical support around current prices. As such, while we encourage keeping portfolios more defensive than normal, we believe that it probably makes sense to give the domestic markets an opportunity to see if they can stabilize around current levels of support before making any further substantial portfolio allocation changes.

That said, strategic, long-term-oriented investors might want to use the current volatility to at least partially rebalance portfolios back to core allocations, while more tactical investors might do well to hold onto their cash, with the goal of reinvesting in the future at still lower prices.

Such declines are always stressful, but they are also necessary, and tend to both make the market healthier by removing speculative froth and returning the prices of securities to more reasonable valuations, and create opportunities to both upgrade the quality of one's portfolio and profit from the values that are being created.

Baron Rothschild recommended that investors "buy when there's blood in the streets, even if it's your own blood". Some years later, an unknown author added the codicil that one should wait a little while "if the blood is more than ankle deep".

We believe that an extraordinary buying opportunity awaits equity investors later in the year, but that the blood, unfortunately, is likely to get even deeper before the bulls are ultimately able to reclaim control of the market trend.

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.

Real gross domestic product (GDP) is a comprehensive measure of U.S. economic activity. GDP measures the value of the final goods and services produced in the United States (without double counting the intermediate goods and services used up to produce them). Changes in GDP are the most popular indicator of the nation's overall economic health.

Dow Jones Industrial Average is a price-weighted average of 30 actively traded blue-chip stocks, primarily industrials including stocks that trade on the New York Stock Exchange. The Dow, as it is called, is a barometer of how shares of the largest US companies are performing.

NASDAQ Stock Market is the first electronic stock market listing over 5000 companies. The Nasdaq stock market comprises two separate markets, namely the Nasdaq National Market, which trades large, active securities and the Nasdaq Smallcap Market that trades emerging growth companies.

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.

The Consumer Price Index (CPI), which is produced by the Bureau of Labor Statistics, is a measure of the average change over time in the prices paid by urban consumers for a market basket of consumer goods and services. Indexes are available for the U.S. and various geographic areas. Average price data for select utility, automotive fuel, and food items are also available.

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.