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THE PER STIRLING CAPITAL OUTLOOK

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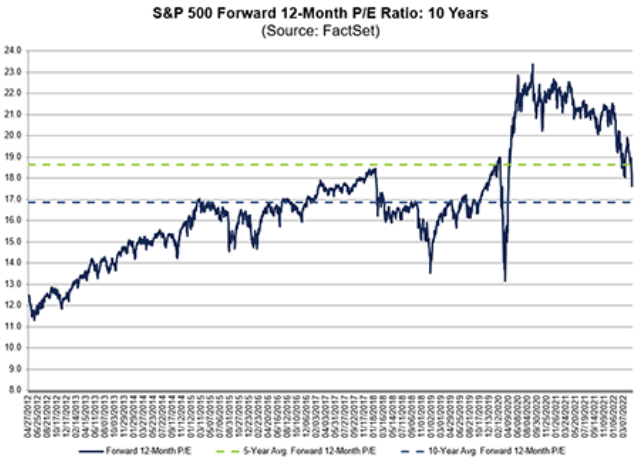
The technology-heavy NASDAQ Composite Index just experienced the worst January through April period in its history (-21%), with more than 45% of listed stocks falling by at least 50% from recent highs, more than 22% falling by at least 75%, and 5% plummeting by at least 90%.

The carnage in the 10 largest technology-oriented stocks (Facebook, Apple, Amazon, Netflix, Alphabet [Google], Alibaba, Baidu, NVIDIA, Tesla and Twitter) was similarly remarkable, with a massive 30.9% decline over the first four months of the year. Moreover, since mid-November, the NASDAQ has lost $7 trillion of value, which is equivalent to one-third of the size of the U.S. economy.

Even the "blue-chip" Standard & Poor's 500 Index has taken a beating, largely due to its substantial exposure to many of these same companies. The index just suffered its worst January through April decline since 1939 (-13.3%). Indeed, fifty percent of S&P 500 stocks have now fallen by at least 20% from their highs. The downdraft also impacted smaller public companies, with the Russell 2000 Index declining by 16.7% over the period. That is the bad news.

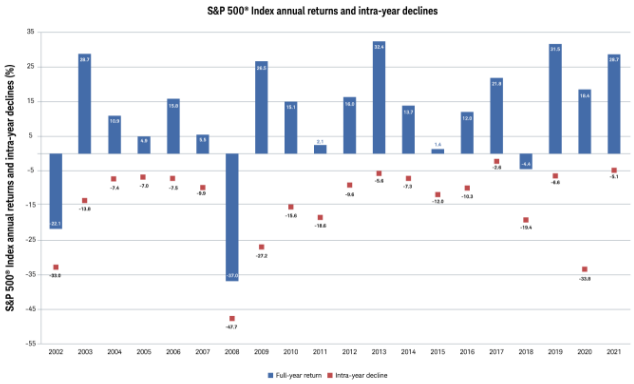
That is also, in some respects, the good news, as it suggests that stocks and (to a lesser extent) bonds have already removed many of the speculative bullish excesses that characterized the markets at the start of the year.

Indeed, the S&P 500 Index started the year selling at a very expensive 21.5 times next year's anticipated earnings. By the end of April, it was selling at a much more modest 17.7 times anticipated earnings, and that arguably overstates the current valuation as, if you exclude the five largest (very highly-valued stocks), the remainder of the index now sells for less than 16 times anticipated earnings.



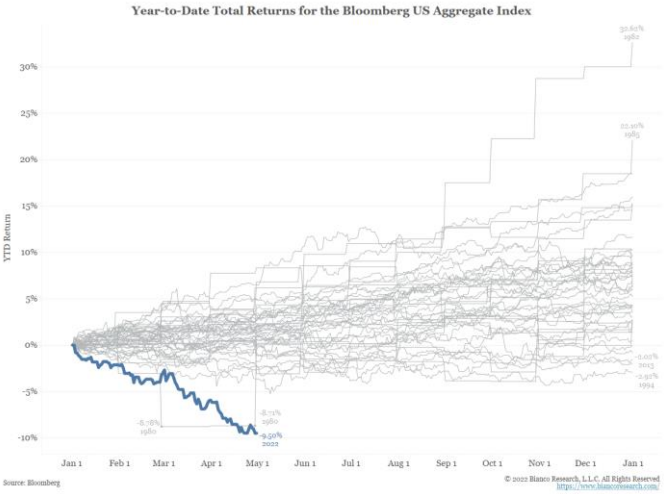
Of interesting note, according to the Stock Trader's Almanac, the 23 "corrections" (i.e., declines of between 10% and 20%) that the S&P 500 has endured since 1945 have averaged 14%, which happens to be the scope of the current decline, and lasted, on average, for four months, which happens to be the duration of the current decline.

While not necessarily predictive, it does add some perspective to the current correction. In addition to improving valuations, the scope and breadth of the decline are flushing out speculative excesses like leverage and investor euphoria and sending some readings of investor sentiment, such as the American Association of Individual Investors (AAII) Bull/Bear Survey, to some of the least bullish readings in history. Markets normally bottom at or near the point of maximum pessimism.



It also shows that, aside from the arguably long-overdue shellacking of the aforementioned mega-cap technology stocks, and the ongoing pounding of speculative and/or non-profitable growth stocks, this year's opening stanza is not that out of the ordinary. Indeed, aside from these sectors, this year's decline looks very similar to the garden-variety correction that the S&P 500 has historically experienced, on average, every two years.

Of critical importance, rather than serving in their traditional risk-mitigation role, bonds sold off on some of the same factors (inflation and tighter monetary policy) that are driving stock prices lower, and also posted record January-through-April losses (-9.5%). In an environment when virtually nothing, aside from commodities, has avoided the carnage, the past four months have been particularly brutal for most investment portfolios.

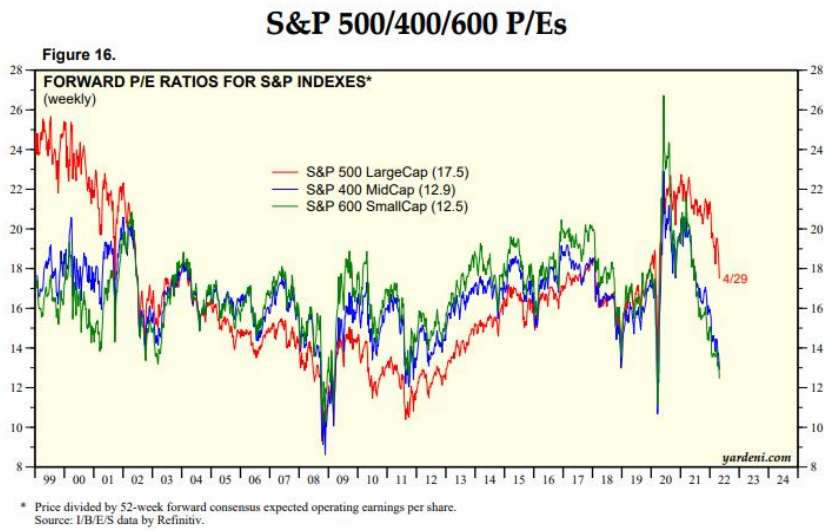


So brutal, in our opinion, that some of the fundamental and technical conditions that normally accompany market bottoms are starting to appear, which suggests that this is arguably a time to not only put together a shopping list of what to buy when conditions improve, but to also start looking for indications of a potential market bottom.

So, what do bear market bottoms tend to look like; what are the common elements that they tend to share, and what do these historical tendencies suggest about the current market's proximity to a bottom in terms of both price and time, which can be very different?

Mark Twain once quipped that "history does not repeat itself, but it oftentimes rhymes". Similarly, while no two bear market bottoms are identical, there are certain elements that are common to most important market lows. We think that it is helpful to break these benchmarks into two categories: 1) factors that suggest that a bear market could potentially be within range of a bottom and 2) factors and characteristics that are more confirmatory in nature, and which can help to provide a level of confidence that a sustainable market bottom is indeed in place.

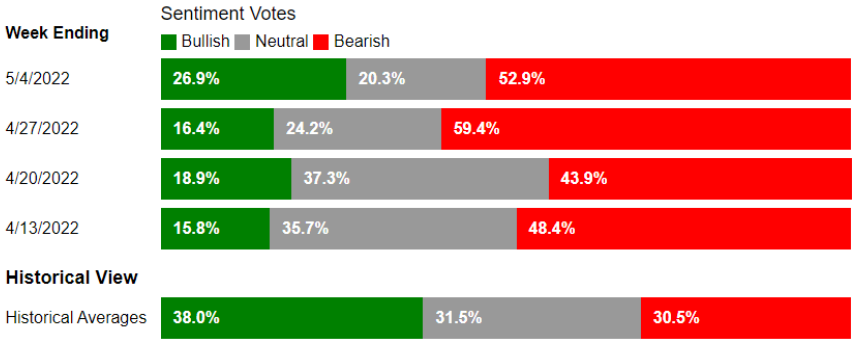
From our perspective, we are seeing more and more examples of the factors that fall into the first group, which suggest that a market low could be approaching, but are still hard-pressed to find significant evidence of the second group's confirmational factors and characteristics, which suggests that, at this point, the bears are still in control.



In regard to the components of the first group, we have already mentioned two of the most important, namely a return to more reasonable valuations and a significant surge in bearishness, which suggests that the market may be running out of potential sellers, which is a requisite for most bear market bottoms.

In regard to valuations, the large-capitalization S&P 500 is now trading at 17.5 times next year's anticipated earnings. While not necessarily inexpensive, as past bear markets have tended to bottom with a forward-looking price-to-earnings multiple of between 10 and 15 times anticipated earnings, recall that, if you simply remove the five largest stocks from the index, the remaining stocks are trading at less than 16 times anticipated earnings. Moreover, the mid-capitalization S&P 400 Index and small-capitalization S&P 600 Index are each now trading at below 13 times anticipated earnings, which is well below their average valuations.

From a contrarian perspective, sentiment tells an even more bullish story. While there are many ways to measure sentiment, one of our favorites comes from the American Association of Individual Investors, as it provides insight into what the average, non-professional investor is thinking.



At present, there are almost twice as many respondents who believe that the S&P 500 will be lower in six months than there are those who believe that the market will be higher six months from now.

While current readings do actually show an increase in optimism over recent weeks, this is actually a modest negative, as it suggests that investors have not yet given up hope, and because bear markets tend not to end until the last potential sellers have given up hope and sold their positions. At the same time, it does indicate that much of the selling has already occurred, which suggests that the bear market is at least getting long in the tooth.

Recall the very insightful statement from Sir John Templeton that "bull markets are born in despair, grow on pessimism, mature on optimism, and die on euphoria", which points out the importance of fear and despair as an indicator of potential bear market lows.

A useful tool that helps to quantify fear and despair is the VIX Index, which measures fear by examining the price that investors are willing to pay for portfolio protection through options that move in the inverse of the markets. In the chart, the VIX is shown in green and the S&P 500 Index in black.

You will see that there tends to be a very close correlation between spikes above 35 in the VIX (which we have already seen multiple times in 2022, including last week) and significant tradable lows in the S&P 500. The good news is that it further affirms the extreme bearish sentiment, which is bullish from a contrarian perspective, and may even allow for a bounce over the near term. Indeed, we have even seen bear markets end with a similar reading on the VIX, such as in December of 2018.

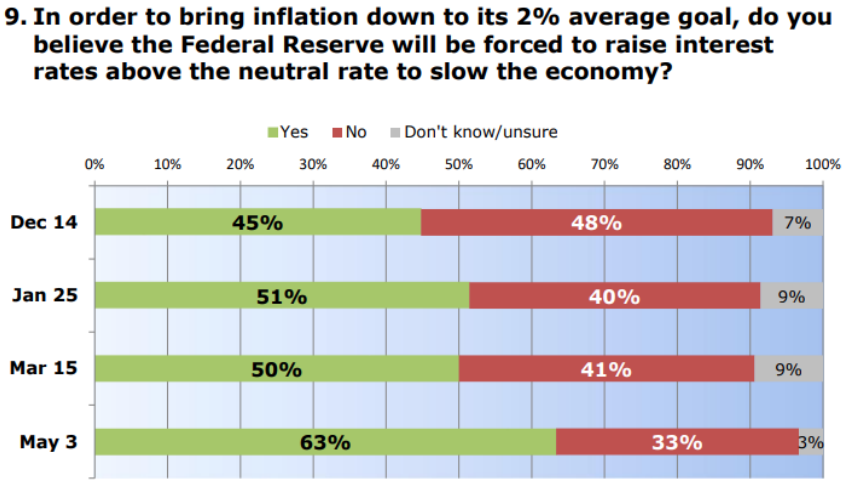
The bad news is that it is not necessarily indicative of capitulation, which we will discuss below in detail, and which is one of those confirmation signals that offers strong evidence that the last potential seller has sold. Those moments of extreme fear, usually offer the best possible buying opportunity for brave investors, and are normally accompanied by readings on the VIX of at least 40, which is still some distance from the current reading of 34.7.

Another bullish element that falls into that first group is the development of an apparent "shelf of support" (yellow shaded area), where investors have shown a willingness to buy anytime that the market has fallen into, or even slightly below, this range. On one hand, this may turn out to be quite bullish, as this is a phenomenon that often happens in the final innings of a bear market. On the other hand, such a shelf of support normally provides comfort to investors for as long as it remains intact, and keeps them from getting overly bearish. Unfortunately, such a level of technical support also tends to keep investors from capitulating, which is a requisite for ending most bear markets.

From our perspective, the shelf of support suggests that the equity markets are likely approaching a bottom in terms of time, but that the market will likely need a strong break

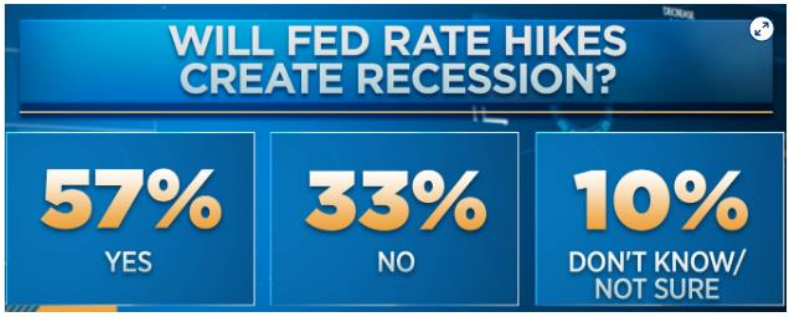
below this shelf of support to erase any feelings of investor comfort, and shake out the last of the potential sellers, thus setting up the conditions for a classic bear market bottom.

Next, we would like to return to a theme that we have been emphasizing in our writings throughout this year, which is that markets do not normally wait for the fundamental backdrop to improve before they rebound higher. Instead, they tend to bottom when the vast majority of investors comprehend and react to just how bad the worst case scenario is likely to be. Historically, by that point, the vast majority of potential sellers have already sold, thus traditionally marking the lows of the decline.



For an example of this phenomenon, one needs look no further than March of 2020, when the markets hit the panic lows of the pandemic. They did not bottom because the pandemic ended. They did not even bottom because of the creation of a powerful vaccine, which was still a year away, and was generally presumed at the time to be several years away. No, they bottomed because virtually all of the potential sellers had sold (look back at that date on the previous chart of the VIX), and because the Fed provided the markets with a monetary policy lifeline.

This time, we are very skeptical that the catalyst for a market bottom will come from the Fed, which would arguably prefer that people feel less rich, as it helps them in their battle against inflation. However, it might come from news of a peak in inflation. While we have no illusions about inflation receding quickly, we believe that it could very possibly peak in the first half of the year, and that such a sea change would be celebrated by both stock and bond investors.



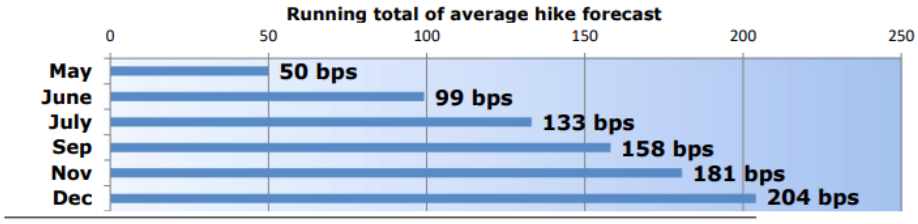
CNBC Fed Survey

In the meantime, the May 3rd "CNBC Fed Survey" of portfolio managers suggests that a majority of investors are finally starting to "comprehend and react to just how bad the worst case scenario is likely to be". As shown in "Chart 9" above, two-thirds of polled portfolio managers are now expecting the Federal Reserve to raise short-term rates above the neutral rate (perceived to be 2.4%) in an effort to purposely slow the economy and 57% now believe that it will result in the economy going into recession.

Moreover, while far short of the 3%-plus of interest rate hikes predicted by short-term debt traders for the year 2022, professional portfolio managers are now at least anticipating just

over 2% of increases, which reflects a significant increase in hawkishness from previous surveys.

Ultimately, at its core, a bear market is the process of bulls being converted into bears, and thus becoming sellers, while a bull market is the exact opposite. Once the last potential convert has been converted, the market runs out of potential buyers and/or sellers, and the market cycle ends.



CNBC Fed Survey – May 3, 2022

As such, bull markets tend to end with "blow-off tops", where the last begrudging market skeptic finally invests their money, and bear markets tend to end with capitulation bottoms, which tend to be characterized by massive trading volume, incredibly negative breadth (with the vast majority of trading volume in declining stocks), and a scary breach of a perceived shelf of support.

Of course, while our opinion is that we will likely see the markets capitulate more fully before the ultimate bottom is reached, not every bear market ends according to this classic playbook, and you could even make an argument the we have already seen enough signs of capitulation to warrant a market bottom, including a day last week when declining volume swamped advancing volume by more than 9 to 1 (traditionally one of the confirming indicators).

There are a couple of investor behaviors that would cause us to re-evaluate our expectation that a further sharp breach of technical support will be required to mark the ultimate market low. These would include evidence of investors starting to buy into market declines, as opposed to the current trend of investors selling into any market rally. Even more impressive, and more convincing, would be a willingness of investors to rally the market in the face of "bad" news, as this is a classic sign of a market running out of potential sellers.

At this point, while we believe that there is a growing likelihood that we are fairly close to a market bottom in terms of time, we are less convinced that we are fully there in terms of price, although it increasingly feels like investors may finally be starting to capitulate. In either event, we are both making our shopping list for when conditions improve, and are actively looking for signs of a market bottom, and the prospects for a new bull market to come.

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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.

The Standard & Poor's MidCap 400 Index provides investors with a benchmark for mid-sized companies. The index, which is distinct from the LargeCap S&P 500®, is designed to measure the performance of 400 mid-sized companies, reflecting the distinctive risk and return characteristics of this market segment.

The Standard & Poor's SmallCap 600 Index seeks to measure the small-cap segment of the U.S. equity market. The index is designed to track companies that meet specific inclusion criteria to ensure that they are liquid and financially viable.

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.

The Bloomberg Barclays US Aggregate Bond Index measures the investment grade, US dollar-denominated, fixed-rate taxable bond market. The index includes Treasuries, government-related and corporate securities, and municipal bonds.

The VIX Index is a calculation designed to produce a measure of constant, 30-day expected volatility of the U.S. stock market, derived from real-time, mid-quote prices of S&P 500® Index (SPX℠) call and put options. On a global basis, it is one of the most recognized measures of volatility -- widely reported by financial media and closely followed by a variety of market participants as a daily market indicator.

The price/earnings ratio, also called the P/E ratio, tells investors how much a company is worth. The P/E ratio simply the stock price divided by the company's earnings per share for a designated period like the past 12 months. The price/earnings ratio conveys how much investors will pay per share for $1 of earnings.

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