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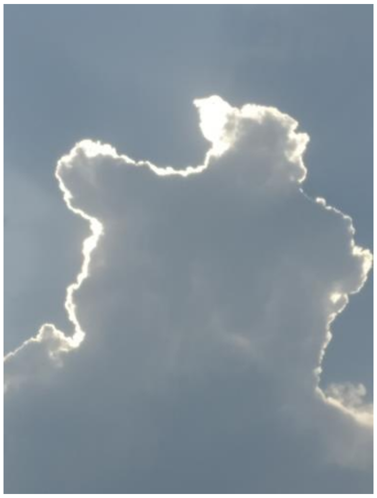
THE PER STIRLING
CAPITAL OUTLOOK
Performance • Perspective • Per Stirling

July 2022

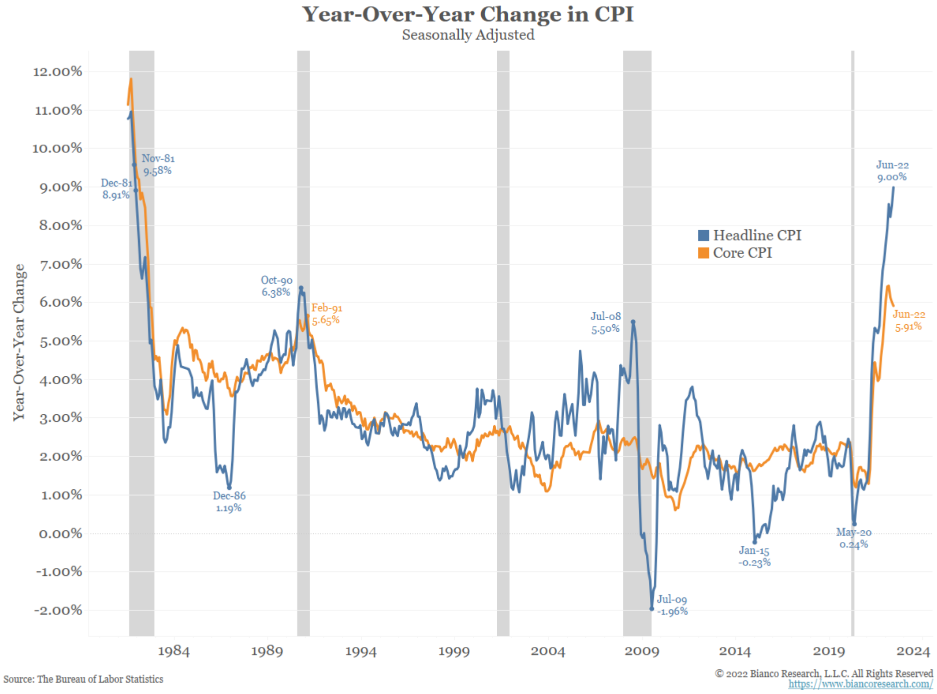


Inflation is an economic storm that reached new heights of ferocity on July 13th, when the June consumer price index came in at its highest level in 41 years. If maintained over the longer term, the reported 9.1% year-over-year inflation rate would be sufficient to cut the purchasing power of one's savings in half approximately every 7.5 years. In other words, under such a scenario, in seven or eight years, it would require spending $10,000 to purchase what you can buy for only $5,000 today.

Further, the June consumer price index revealed the largest month-over-month increase in inflation since the start of the pandemic.[1] Even worse, the just-released producer price index of wholesale inflation posted a stunning 11.3% year-over-year gain which, if maintained, would double wholesale prices every six years or so.[2]

However, despite its historic severity, it now seems increasingly likely that this inflation storm cloud may be developing a silver lining. Indeed, with commodity prices declining sharply over the past six weeks and both market-based and survey-related expectations for future inflation showing signs of moderation, there is a growing argument that inflation may be at or near its ultimate peak for this economic cycle.

If the aforementioned trends continue, it could have significant implications for the markets, including a potential bottom in the high-quality bond markets, and an improving intermediate-term outlook for the equity markets.



Year-Over-Year Change in CPI
Seasonally Adjusted

Source: The Bureau of Labor Statistics

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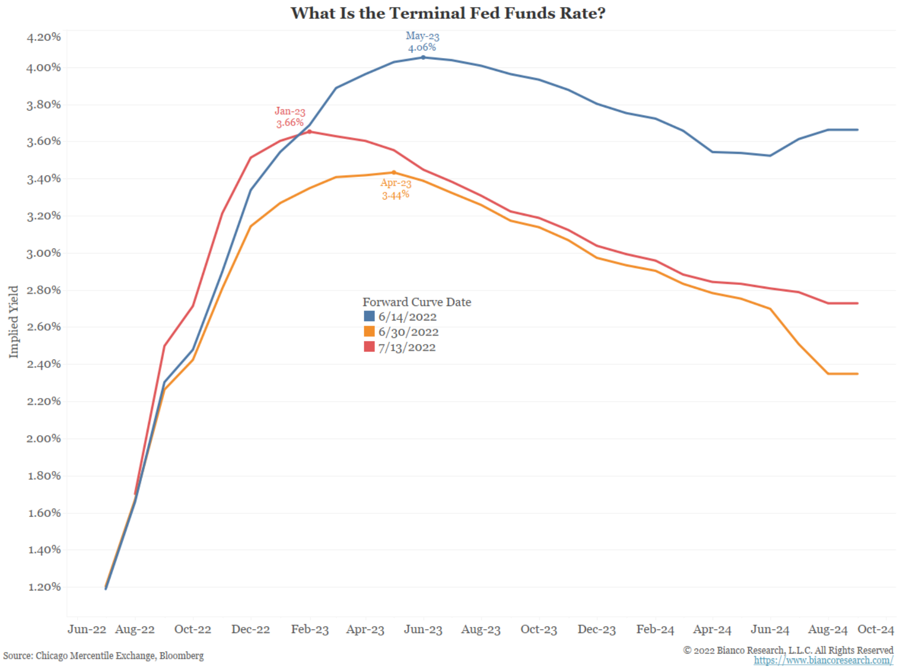
Importantly, our increasingly optimistic outlook is not based on expectations for the imminent demise of inflation, which is the bond market's arch enemy, but instead due to two perceived factors.

The first is a seeming increase in the Fed's inflation-fighting credibility, as a result of their increasingly draconian steps to battle inflation through aggressively higher short-term interest rates, quantitative tightening (i.e., the unwinding of the Fed's massive, pandemic-driven stimulus) and a shrinking of the inflation-adjusted money supply.[3] The second reason is a growing perception that the economy is headed into recession, if it is not already in one, and the reasonable expectation that the recession will ultimately return inflation to lower and more sustainable levels.

Indeed, we believe that this could be a "bad news is good news" scenario for investor portfolios, and that bonds could again be a reasonably attractive place in which to invest, particularly since we believe that bond prices are likely to find very good support around their mid-June lows, and that interest rates may meander somewhat lower (which would push bond prices higher) over the second half of the year.


What Is the Terminal Fed Funds Rate?

Source: Chicago Mercentile Exchange, Bloomberg

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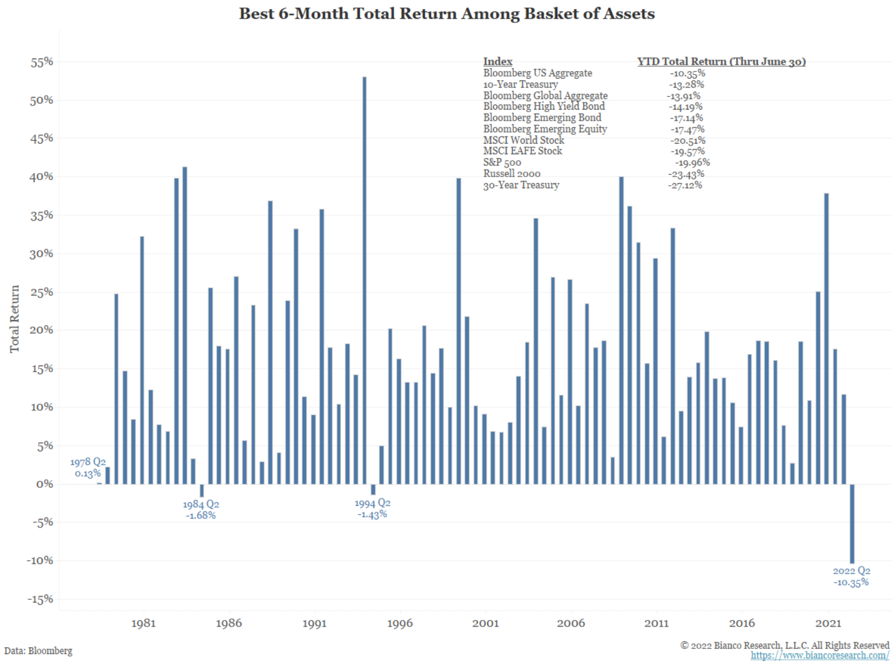
You can see these changing investor expectations in the Fed Funds futures contract. Only a month ago, markets were expecting the Fed to stop raising rates next May, at a peak short-term rate of 4.06%. Only a month later, the Fed is expected to stop raising rates in January at a rate of only 3.66%. Perhaps even more importantly, markets are expecting the Fed to reverse course and start lowering rates shortly thereafter, although we suspect that this expectation may be a bit premature.

That said, this more bullish perspective was just reinforced by St. Louis Federal Reserve Bank President James Bullard on July 15th, when he noted in a Reuters interview that, while the Fed's "commitment to getting to 2% inflation is unconditional, …inflation can come down relatively quickly, down to 2% over the next 18 months, if the Fed plays its cards right".[4]

The benefit of any such improvement in the interest rate outlook (even if rates just stabilize) would likely extend well beyond the bond markets, as it should help to restore the viability of one of the core tenets of portfolio construction, which is that building a diversified portfolio of non-correlated assets has historically proven to provide a significant shock absorber for portfolios, as some asset classes will normally "zig" while others "zag" (i.e., trade independently from one another), thus reducing overall portfolio risk and volatility.

Unfortunately, however, inflation, particularly when combined with reduced financial liquidity (as we have now), tends to punish all financial assets both substantially and simultaneously, with the presumed exception of gold, and even gold has lost over 6% of its value this year (as of July 21st). Indeed, one major factor that has made the first half of 2022 so extraordinarily unusual (and so challenging) is that virtually no financial asset class posted positive returns, thus eliminating most benefits of portfolio diversification.

Even if one had been so insightful as to have put 100% of their portfolio in the best performing of the major financial asset classes, the Bloomberg U.S. Aggregate Bond Market, they would still have lost 10.35% of their portfolio value during the first half of the year. Perhaps even more remarkably, if they had been unfortunate enough to invest everything in U.S. Government 30-year Treasury Bonds, they would have lost over 27% over the period.


Best 6-Month Total Return Among Basket of Assets

Index	YTD Total Return (Thru June 30)
Bloomberg US Aggregate	-10.35%
10-Year Treasury	-13.28%
Bloomberg Global Aggregate	-13.91%
Bloomberg High Yield Bond	-14.19%
Bloomberg Emerging Bond	-17.14%
Bloomberg Emerging Equity	-17.47%
MSCI World Stock	-20.51%
MSCI EAFE Stock	-19.57%
S&P 500	-19.96%
Russell 2000	-23.43%
30-Year Treasury	-27.12%

Data: Bloomberg

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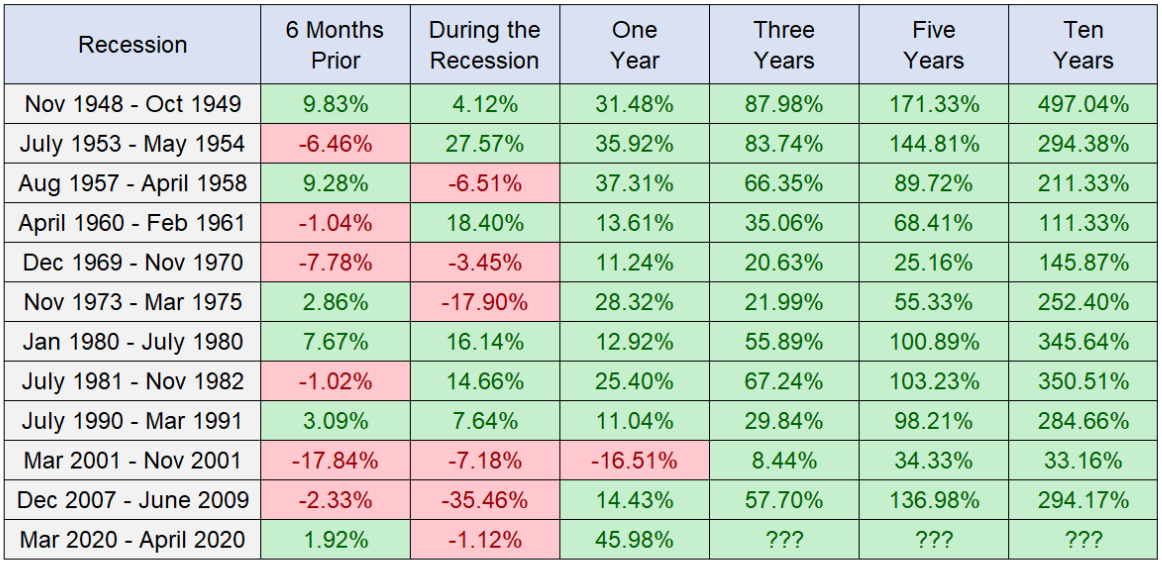
In short, in 2022, there has been virtually no safe harbor from the storm, and no substantial benefits from diversification. That said, if as it increasingly appears, investors are now getting past their peak inflation fears, and this allows for market-set rates to trend lower over time, it would likely restore many of the traditional defensive benefits of portfolio diversification, in addition to benefitting interest rate-sensitive stocks and bonds.

At present, we believe that investor attention is slowly shifting from inflation-related concerns, to anxieties over the growing potential for a recession, which does introduce the question of whether investors are essentially just jumping out of the frying pan and into the fire. However, we would suggest that, for three primary reasons (assuming that a recession, as expected, effectively quells inflation), the answer should be a resounding “no”.

First, it is traditionally much easier for the Fed and Congress to stimulate the economy out of recession than it is to quell rampant inflation (just ask former Fed Chairman Volcker). Second, inflation hurts everyone, regardless of economic status, while recessions have a more limited impact (the small percentage that lose their jobs and the relatively small percentage of businesses that close). The risk to jobs seems particularly limited at present, when there are 1.9 job openings for every person looking for a job.

Third, as 2022 has illustrated, high inflation decimates investment markets by pushing interest rates higher, thus depressing bond prices, while simultaneously compressing market multiples, which is basically a fancy way of saying that investors are assigning less value to each dollar of company earnings, which depresses stock prices.

In contrast, bonds normally benefit from recessions, which tend to push down both interest rates and inflation, while even equity markets, because they are forward-looking, can perform well during recessions. Indeed, the domestic equity markets (see the above) have posted positive returns in six of the twelve U.S. recessions since World War II, with only two of the six negative return periods posting double-digit losses.[5]



Recession	6 Months Prior	During the Recession	One Year	Three Years	Five Years	Ten Years
Nov 1948 - Oct 1949	9.83%	4.12%	31.48%	87.98%	171.33%	497.04%
July 1953 - May 1954	-6.46%	27.57%	35.92%	83.74%	144.81%	294.38%
Aug 1957 - April 1958	9.28%	-6.51%	37.31%	66.35%	89.72%	211.33%
April 1960 - Feb 1961	-1.04%	18.40%	13.61%	35.06%	68.41%	111.33%
Dec 1969 - Nov 1970	-7.78%	-3.45%	11.24%	20.63%	25.16%	145.87%
Nov 1973 - Mar 1975	2.86%	-17.90%	28.32%	21.99%	55.33%	252.40%
Jan 1980 - July 1980	7.67%	16.14%	12.92%	55.89%	100.89%	345.64%
July 1981 - Nov 1982	-1.02%	14.66%	25.40%	67.24%	103.23%	350.51%
July 1990 - Mar 1991	3.09%	7.64%	11.04%	29.84%	98.21%	284.66%
Mar 2001 - Nov 2001	-17.84%	-7.18%	-16.51%	8.44%	34.33%	33.16%
Dec 2007 - June 2009	-2.33%	-35.46%	14.43%	57.70%	136.98%	294.17%
Mar 2020 - April 2020	1.92%	-1.12%	45.98%	???	???	???

Sources: NBER, Returns 2.0

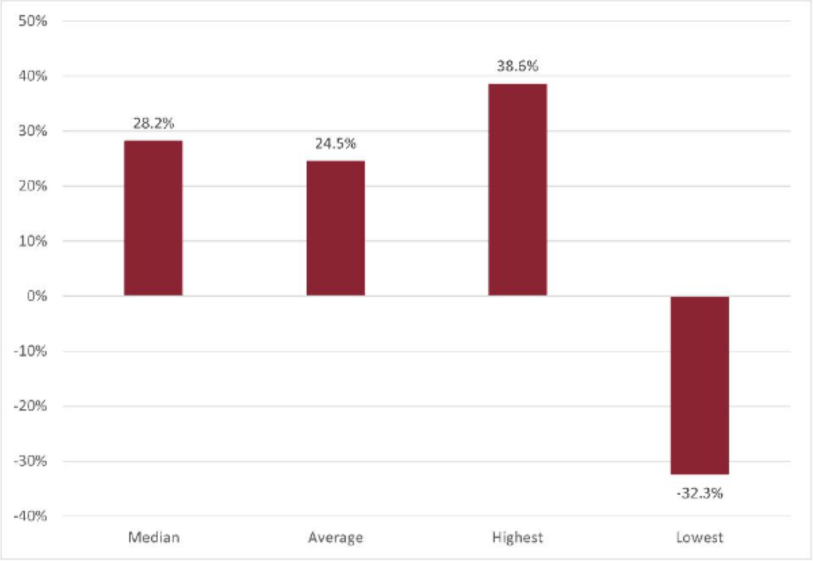
Moreover, while the past is no guarantee of future results, the average returns in the 1,3,5, and 10 year periods after the start of a recession have historically been nothing short of spectacular.

Even so, it would be understandable for an investor to want to simply avoid any recession-related angst, whether it be over falling corporate profits, rising unemployment, bankruptcies, etc., by simply staying out of the equity markets until after the conclusion of the recession.

However, that fails to consider the forward-looking nature of investment markets, and the likelihood that most securities will have priced-in most of the implications of a recession long before the contraction actually occurs.

This was well documented in the July 3, 2022 edition of Forbes Magazine, which pointed out that the stock market has historically rebounded off its lows by an average of 28% by the time that the economy hits its recession lows and that, with the exception of the 2001 recession, which was driven primarily by the bursting of the technology stock bubble, the S&P 500 had already started a new bull market before the economy emerged from 11 of the last 12 recessions.[6]

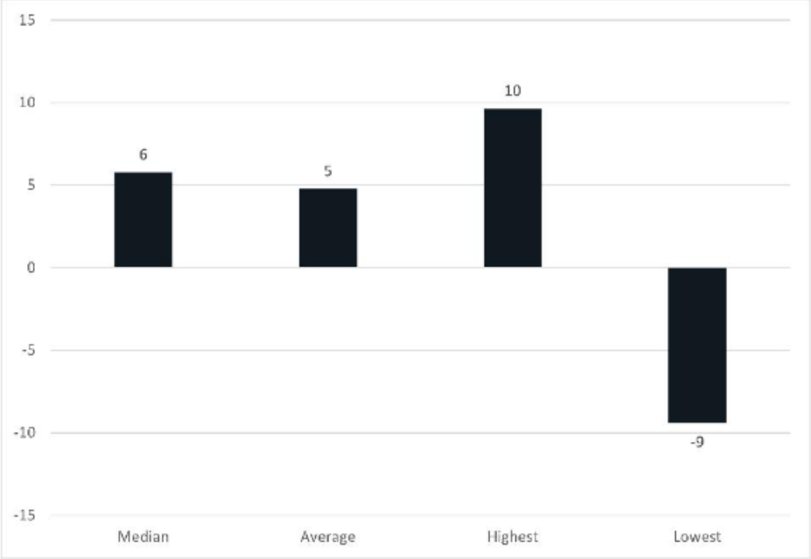
Furthermore, as was also noted in that Forbes article, stocks normally bottom out five or six months before the economy does, and have bottomed out as much as ten months before the economy. The outlier was again 2001, when stocks didn't hit their lows until nine months after the economy bottomed out.



S&P 500 Return From Trough To GDP Bottom GLENVIEW TRUST, BLOOMBERG

As noted, securities tend to be forward-looking, which suggests that much of the risk of an impending recession is likely already priced into both stocks and bonds, particularly stocks.

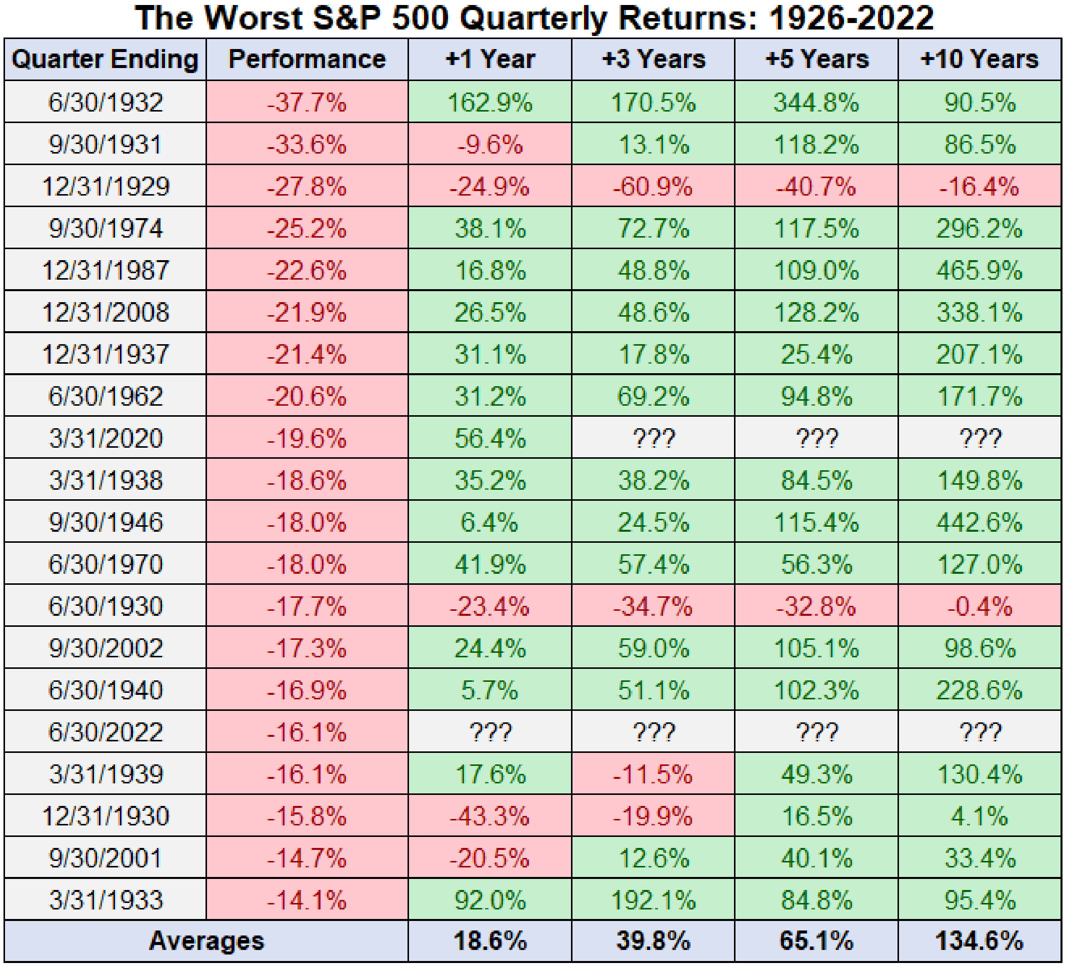
To put the scope of the current decline into some perspective (according to data from Charles Schwab), the average S&P 500 stock is down by 29% from their year-to-date highs and 32% from their 52-week highs, while the average Russell 2000 (small and mid-cap) stock is down by 41% from their year-to-date highs and 48% from their 52-week highs. Even more remarkably, the average stock in the technology-heavy NASDAQ Composite is down by 43% from their year-to-date highs and 51% from their 52-week highs, and this index includes many of America's largest and most important companies.[7] In short, the bear market losses go far beyond what is suggested by just looking at the headline numbers for the major indexes.



Months From Stock To GDP Bottom GLENVIEW TRUST, BLOOMBERG

While such deep and broad-based declines are gut-wrenching for most investors, history suggests that such deep declines are actually something to be celebrated by investors whose time horizon is measured in years rather than in months, and the worse the returns have been, the more profitable the following years have historically tended to be. Again, the past is not necessarily prologue.

However, if you look at the twenty worst quarterly returns since 1926, the average return over the following one-year period has been 18.6%, while forward three-year cumulative returns have averaged 39.8%, forward five-year cumulative returns have averaged 65.1%, and forward ten-year cumulative returns have averaged 134.6%.[8]



The Worst S&P 500 Quarterly Returns: 1926-2022

Quarter Ending	Performance	+1 Year	+3 Years	+5 Years	+10 Years
6/30/1932	-37.7%	162.9%	170.5%	344.8%	90.5%
9/30/1931	-33.6%	-9.6%	13.1%	118.2%	86.5%
12/31/1929	-27.8%	-24.9%	-60.9%	-40.7%	-16.4%
9/30/1974	-25.2%	38.1%	72.7%	117.5%	296.2%
12/31/1987	-22.6%	16.8%	48.8%	109.0%	465.9%
12/31/2008	-21.9%	26.5%	48.6%	128.2%	338.1%
12/31/1937	-21.4%	31.1%	17.8%	25.4%	207.1%
6/30/1962	-20.6%	31.2%	69.2%	94.8%	171.7%
3/31/2020	-19.6%	56.4%	???	???	???
3/31/1938	-18.6%	35.2%	38.2%	84.5%	149.8%
9/30/1946	-18.0%	6.4%	24.5%	115.4%	442.6%
6/30/1970	-18.0%	41.9%	57.4%	56.3%	127.0%
6/30/1930	-17.7%	-23.4%	-34.7%	-32.8%	-0.4%
9/30/2002	-17.3%	24.4%	59.0%	105.1%	98.6%
6/30/1940	-16.9%	5.7%	51.1%	102.3%	228.6%
6/30/2022	-16.1%	???	???	???	???
3/31/1939	-16.1%	17.6%	-11.5%	49.3%	130.4%
12/31/1930	-15.8%	-43.3%	-19.9%	16.5%	4.1%
9/30/2001	-14.7%	-20.5%	12.6%	40.1%	33.4%
3/31/1933	-14.1%	92.0%	192.1%	84.8%	95.4%
Averages		**18.6%**	**39.8%**	**65.1%**	**134.6%**

What makes these numbers particularly intriguing this time is that we have not just experienced one of the twenty worst quarterly returns since 1926, but have just experienced (back-to-back) two of the twenty worst quarterly returns since 1926.

This is not to suggest that the current bear market is necessarily over, as history suggests that bear markets normally end with a "bang" (capitulation) rather than a "whimper" (where a market simply gets so bearish that it ultimately just runs out of potential sellers).

If anything, history suggests that the equity markets still have the potential to make lower lows before this bear market finally reaches its ultimate conclusion.

However, and we believe much more importantly, history also suggests that the next three, five and ten years could be highly rewarding for longer-term equity investors.

As was noted by Mark Twain, "history does not repeat itself, but it oftentimes rhymes".

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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.

Definitions

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.

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.

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 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 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 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 Global High Yield Corporate Bond Index is a rules-based market-value-weighted index engineered to measure the below-investment-grade, fixed-rate, global corporate bond market.

The MSCI World Index is a broad global equity index that represents large and mid-cap equity performance across all 23 developed markets countries. It covers approximately 85% of the free float-adjusted market capitalization in each country.

The MSCI EAFE Index is designed to represent the performance of large and mid-cap securities across 21 developed markets, including countries in Europe, Australasia and the Far East, excluding the U.S. and Canada. It covers approximately 85% of the free float-adjusted market capitalization in each country.

The Bloomberg Global Aggregate Index is a flagship measure of global investment grade debt from twenty-four local currency markets. This multi-currency benchmark includes treasury, government-related, corporate and securitized fixed-rate bonds from both developed and emerging markets issuers.

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