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THE PER STIRLING CAPITAL OUTLOOK

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Thus far, 2022 has been a year of extremes, with the highest levels of inflation in more than forty years forcing the Federal Reserve to pursue the most draconian monetary policies since Ronald Reagan occupied the White House, Paul Volcker was the Chairman of the Federal Reserve, and Whitney Houston was lighting up the Billboard Charts.

Indeed, Fed Chairman Powell has stated on numerous occasions that he is as committed to aggressively fighting inflation as former Fed Chairman Paul Volcker had been, which is a potentially terrifying prospect for markets, given that Volcker's policies drove short-term interest rates up to over 20% and caused two severe back-to-back recessions. Importantly, Chairman Powell just reiterated that level of commitment to inflation-fighting in his August 26th speech at the Jackson Hole Economic Conference, when he said:

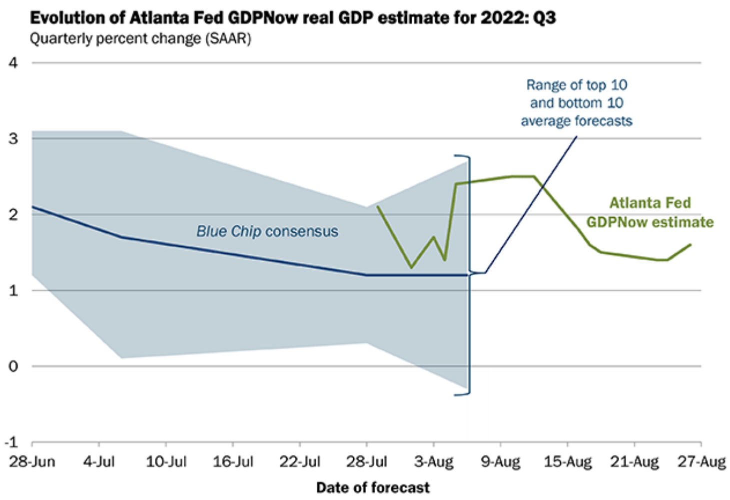
"Restoring price stability will take some time and requires using our tools forcefully to bring demand and supply into better balance. Reducing inflation is likely to require a sustained period of below-trend growth. Moreover, there will very likely be some softening of labor market conditions. While higher interest rates, slower growth, and softer labor market conditions will bring down inflation, they will also bring some pain to households and businesses. These are the unfortunate costs of reducing inflation. But a failure to restore price stability would mean far greater pain." [1]

We think that it is important to keep in mind that Powell had little choice but to sound very hawkish, after he (and the Fed as an institution) lost so much credibility last year, when they kept interest rates far too low for far too long, and maintained quantitative easing (bond buying) for too long, under the premise that inflation would prove to be only "transitory".

Ironically, the supposedly transitory nature of inflation was the crux of Powell's speech at last year's Jackson Hole Conference. The Fed therefore has an urgent need to rebuild its credibility through both hawkish forward-guidance and aggressive anti-inflation policy actions.

Secondly, and of equal importance, while inflation is very similar today to how it was forty years ago, and while there is again a risk that such an aggressive monetary policy on the part of the Fed will ultimately cause a recession, the economy overall, the strength of corporate and household balance sheets, the level of consumer spending, etc. are all much healthier today than they were then. As such, we believe that today's economy is therefore in much better condition to weather an ongoing round of monetary policy tightening by the Fed than was the case in the 1970s and early 1980s.

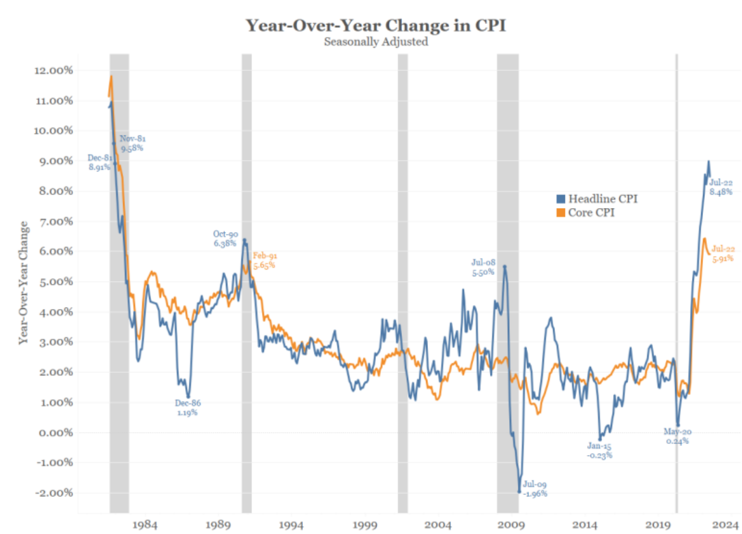
Thus far this year, investors have been faced with several untenable outcomes. On one hand is the prospect of continued out-of-control inflation, which is destroying the value of Americans' savings. On the other, is a set of Fed policies that sometimes seem destined to cause a deep recession. In the middle is the worst of all outcomes, stagflation, where investors and consumers would be faced with the combination of runaway inflation and a slowing, stagnant economy, which is a confluence of negative outcomes that are almost impossible to address simultaneously through monetary policy.



Sources: *Blue Chip Economic Indicators* and *Blue Chip Financial Forecasts*
Note: The top (bottom) 10 average forecast is an average of the highest (lowest) 10 forecasts in the *Blue Chip* survey.

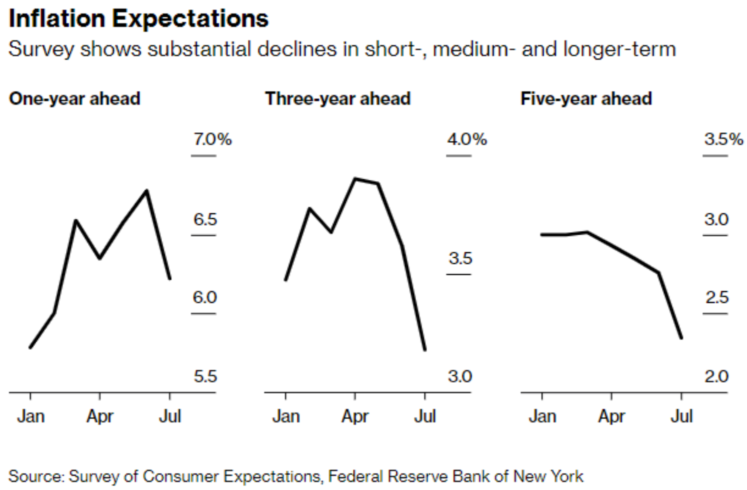
However, to the surprise of most, recent inflation, economic and employment data is suggesting that Fed policy actually has the potential to achieve a "golden mean" outcome of a "soft landing" or an only modest recession, which could be sufficient to dampen inflationary pressures, but not severe enough to cause significant job losses or a prolonged downturn in economic growth. While still too early to tell for sure, the prospects for a "not too hot, not too cold" economy could give investors at least some cause for optimism that seemed virtually inconceivable only a few short weeks ago.

Indeed, after accurately identifying an economic contraction in the first and second quarter of this year, the Atlanta Fed GDP Nowcast (above), which attempts to gauge economic conditions in real time, is now suggesting a return to positive, albeit modest, economic growth in the third quarter. This perspective is being further supported by the most recent non-farm jobs payroll number, which reported a massive 528,000 gain in employment. Such a strong number is inconsistent with an ongoing recession.



Perhaps of equal importance was July's modest drop in consumer inflation from 9.1% to a still very high 8.5%. While only a *di minimis* decline, the fact that this drop is being accompanied by a more substantive drop in both consumer and market-based expectations for future inflation adds credibility to the idea that, while inflation is still unacceptably high, the U.S. may indeed have seen the peak in the inflation rate, as we had suggested was increasingly possible in our July commentary.

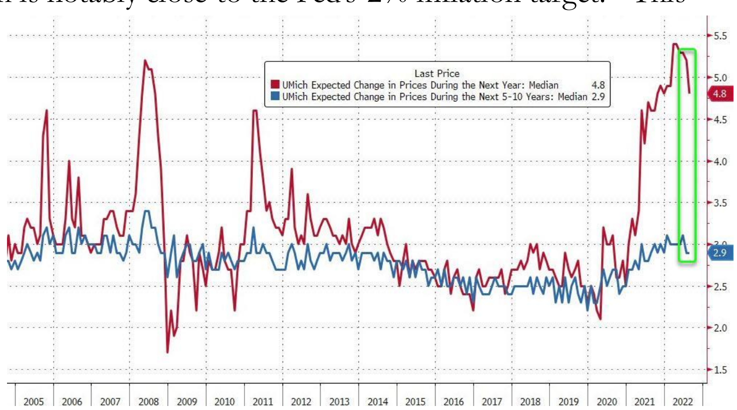
When you exclude food and energy, the so-called "Core" Consumer Price Index increased by a less onerous 5.9%, 40% of which was attributable to the 5.7% annualized increase in the shelter component, which is also offering some hopeful signs of moderating. [2]



The drop in expectations for future inflation is also potentially quite important due to its impact on consumer spending decisions and, by correlation, their resistance to current price increases.

For example, someone is probably more willing to pay inflated prices today, if they think that prices will be even higher in the future. However, if a consumer believes that price increases are more likely to be only temporary, they will be more inclined to defer the purchase until prices retreat, which lessens inflationary pressures.

According to the New York Fed's just-released Survey of Consumer Expectations, consumer expectations for US inflation three years ahead fell to 3.2% in July, from 3.6% the previous month. It was the second straight monthly drop. The outlook for inflation in the coming year fell significantly, to 6.2% from 6.8%, while inflation expectations for the next five years fell to approximately 2.25%, which is notably close to the Fed's 2% inflation target. [3] This improving trend was further reinforced by the August 26th release of the University of Michigan Inflation Expectations number, which also showed a notable decline, particularly in near-term inflation expectations.

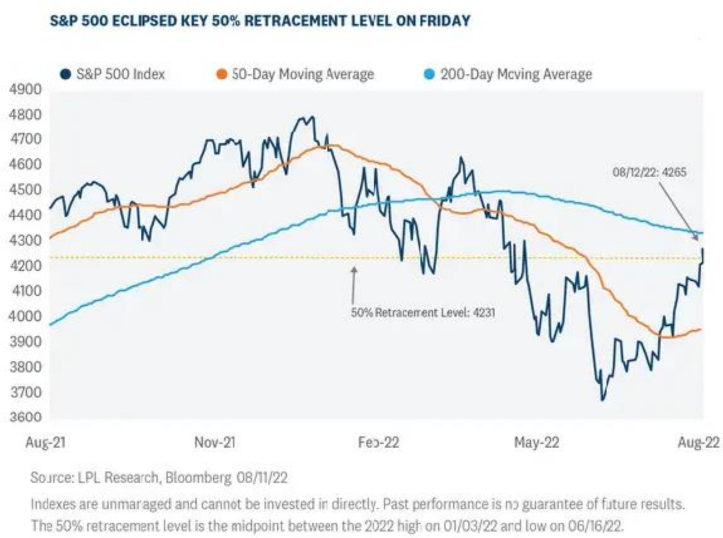


This improving sentiment regarding inflation allowed longer-term interest rates to retreat from this year's remarkable surge higher. We believe that the sharp decline in the 10-year Treasury bond's yield from its mid-June level of 3.48% to 2.53% by the end of August is of particular importance as, in 2022, equities have tended to lose value whenever the 10-year yield is above 3.0% and to rally higher once yields fall below that level. As we write this commentary, 10-year yields have returned to just over 3.0%. [6]

Equity markets responded to this improving backdrop with a dramatic rebound. After the worst January through June period in decades, the markets rallied spectacularly from their mid-June lows. Specifically, the S&P 500 rebounded by 17% [7], while the Dow Jones

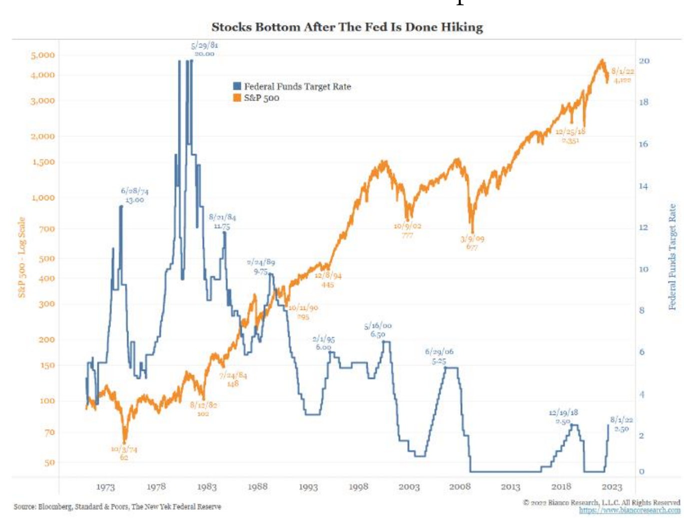
Industrial Average jumped by 14% and the NASDAQ Composite Index rallied by more than 20%. [8]

Perhaps of equal importance, the S&P 500 recaptured over 50% of its to-date bear market losses (actually 52%). While the past is not necessary prologue, CFRA Research points out that, "since WWII, every time the S&P recovered 50% of the bear market price decline, while the 500 may have re-tested the prior low, it never set a lower low." In other words, over the past 75 years, after such a substantial rebound, the markets have sometimes gone on to retest their prior lows, but have never dropped below those lows. [4]



Further, as was just noted in Bloomberg, "since 1926, stocks have recovered more than half of a 10% or larger decline 79 times and only once, in March 1930, did the market reach a new low before setting a new all-time peak". As such, history does suggest a reasonable likelihood that the market lows seen in June may prove to be the ultimate lows for the overall bear market. [5]

Indeed, such a powerful rally does introduce the possibility that the bear market is over, and that a new bull market started in the middle of June. If you read financial publications or watch business programming, you will see that more and more market professionals are making that argument. For our part, there are a variety of reasons why we remain somewhat skeptical, starting with the fact that we have yet to see the sort of "get me out at all cost" capitulation phase that almost always occurs at bear market lows.



It is also historically true that bear market bottoms tend to occur both after the Federal Reserve stops tightening monetary policy and, as often as not, after the Fed has also already reversed course and started easing monetary policy (lowering rates and expanding money supply), and we don't expect the Fed to start lowering rates until the second half of next year at the earliest.

If anything, the powerful rally of the past two months just served to shift market sentiment from extraordinarily bearish to relatively neutral, and to return the stock market to historically overvalued levels.

Indeed, since the June lows, the ratio of stock prices to expected earnings has jumped from a modestly priced 15-times earnings in June to a historically overvalued 19-times earnings in August, which seems very hard to justify in an environment where the economy and earnings are slowing and the Fed is aggressively tightening monetary policy. [9]

Fed Cycle and Market Bottoms

Last Rate Hike	Market Bottom	First Cut	When Did Stocks Bottom?
12/19/2018	12/24/2018	7/31/2019	After the LAST hike but BEFORE the first cut
6/29/2006	3/9/2009	9/18/2007	18 month AFTER the Fed started CUTTING
5/16/2000	10/9/2002	1/3/2001	20 months AFTER the Fed started CUTTING
2/1/1995	12/8/1994	7/6/1995	BEFORE the last hike, by about 2 months, BUT, the stock market never corrected more than 10%
2/24/1989	10/11/1990	7/26/1989	15 months AFTER the Fed started CUTTING
8/21/1984	6/24/1984	10/2/1984	About a month before the LAST hike. But stocks corrected only 14% over the previous 9 months.
5/29/1981	8/4/1981	12/4/1981	About 20 months AFTER the Fed started CUTTING
6/2/1974	10/3/1974	1/9/1975	About 3 months AFTER the LAST Fed hike

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You may recall from last month's commentary that, over the past fifty years, the Federal Reserve has never ended a rate hiking campaign until after the Fed Funds Rate is higher than the Consumer Price Index.

At present, the gap between the two measures is still a massive 6.6%, which should be reduced by a combination of inflation moving lower and short-term rates moving higher. In addition to our expectation for higher rates well into 2023, the pace of quantitative tightening (the shrinkage of the Fed's balance sheet) is about to double in September to $90 billion per month. While there is so much excess liquidity sloshing around in the financial system that quantitative tightening may not have a significant impact over the near term, it will ultimately drain money out of both the economy and the financial markets.

The Fed Has Never Stopped Hiking Before Fed Funds > CPI

Tightening Cycle	Fed Funds Peak	Date	CPI	Real Fed Funds
1973	11.00%	8/30/1973	7.40%	3.60%
1976-1980	20.00%	3/3/1980	14.80%	5.20%
1980	20.00%	12/5/1980	12.50%	7.50%
1983-1984	11.75%	8/24/1984	4.30%	7.45%
1986-1989	9.75%	2/24/1989	4.80%	4.95%
1994-1995	6.00%	2/1/1995	2.90%	3.10%
1999-2000	6.50%	5/16/2000	3.20%	3.30%
2004-2006	5.25%	6/29/2006	4.30%	0.95%
2015-2018	2.50%	12/19/2018	1.90%	0.60%
2022	*2.50%**	*7/27/2022*	*9.10%**	*-6.60%*

* If rate hikes ended today

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There are a few other reasons why we suspect that the stock market may ultimately retest some of the lows that were established earlier in the year. These include the fact that "V-shaped" bottoms are fairly rare in the stock market (markets usually retest prior lows at least once), that much of the powerful rally that took place since the June lows was driven by short-covering (the forced buying back of stocks that were previously borrowed and sold by speculators), and the fact that the biggest beneficiaries of the rally were low-quality, largely unprofitable, and very heavily-shorted stocks.

All of that being said, history suggests that there is some good news in the fact that inflation may have peaked, that the equity markets were able to retrace more than half of their to-date bear market losses, that supply chains are becoming increasingly unsnarled, and that the economy remains more resilient than most had expected. Indeed, it would not surprise us if the size and impressive breadth associated with the summer rally is sufficient to change the character of this current market cycle from one where investors have been selling into every rally to one where investors may start buying every substantial dip in prices.

Further, while the U.S. economy is still likely to face a more significant contraction, primarily as a result of the very aggressive tightening of monetary policy by the Fed, it now looks like such an outcome is more likely to happen in the second half of 2023 than in 2022. To explain, monetary policy has historically worked with "long and variable lags", which suggests that these aggressive tightening moves by the Fed won't have their full impact on the economy for at least another nine to twelve months.

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

It is also worth remembering that markets tend to price-in recessions long before they actually take place, and that the S&P 500 has actually gained ground during five of the past ten recessions, with post-recession years traditionally enjoying very strong equity market returns.

In our opinion, what may ultimately prove most important is that, with a slowing, but still surprisingly resilient economy, and potentially moderating inflationary pressures, it means that the Federal Reserve may not need to be quite as aggressive as many have feared and that, as a result, the U.S. may be fortunate enough to experience only a "soft landing" or a modest recession, in lieu of the very deep recessions that we experienced in the 1970s and 1980s, which was the last time that we had similarly high levels of inflation and a similarly aggressive tightening of monetary policy by the Fed.

Put another way, the worst-case scenarios noted earlier in this commentary are starting to look increasingly less likely, at least for the time being, which should ultimately be very good intermediate and longer-term news for the equity markets. Indeed, we believe that much of the powerful equity market rally that started in mid-June, rather than being an indication that the bear market has fully run its course, was instead in recognition of the growing perception that the presumed worst-case scenarios are becoming increasingly less likely.

Importantly, market bottoms tend to be a process rather than an event, and we are inclined to believe that this time will be no different. As noted, we remain somewhat skeptical that the powerful rally off of the June lows is the start of a new bull market and, by extension, that the 2022 bear market is over. However, we are increasingly of the opinion that the recent rally was likely indicative of an early stage in a bottoming process. While, in our opinion, this battle between bulls and bears over the control of the market trend will likely take some to ultimately be resolved, we do believe that the bottoming process has now at least begun.

To bastardize somewhat the legendary words of Winston Churchill: In our opinion, “it is not the end, but it is the beginning of the end, and it is well passed the end of the beginning”.

Definitions

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.

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 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.

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.
The Federal Funds Rate (FFR) is the average interest rate that banks pay for overnight borrowing in the federal funds market.

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Image #5 "UMich Inflation Expectations Ease Further, Consumer Sentiment Bounces Off Record Lows", Tyler Durden, Posted 08/26/2022 https://www.zerohedge.com/personal-finance/umich-inflation-expectations-ease-further-consumer-sentiment-bounces-record-lows