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THE PER STIRLING CAPITAL OUTLOOK

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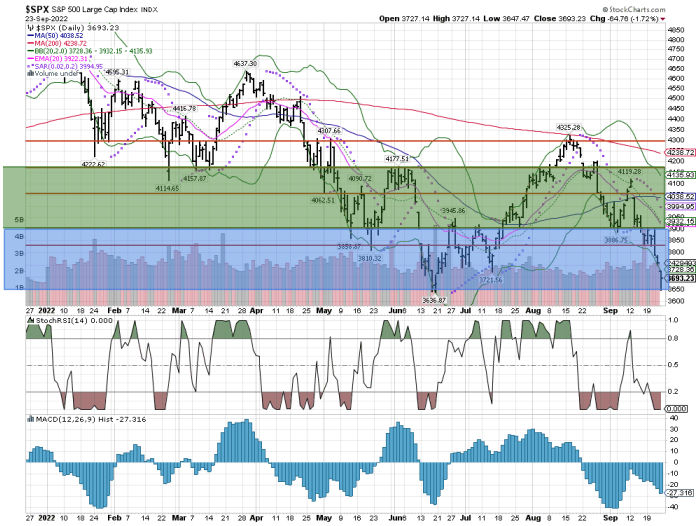
"It is not the end, but it is the beginning of the end, and it is well passed the end of the beginning".

We concluded last month's commentary with the above bastardized version of a line from Winston Churchill's so-called "Victory Speech", which he presented after Britain effectively repelled a German invasion during World War II through their defeat of the German Luftwaffe. Many consider it to have been the turning point in the war in Europe.

We used this altered quote to draw a parallel between this historic turning point and what we posited at the time was potentially the start of a bottoming process that will ultimately mark the turning point in this market cycle.

As we had noted at the time, bear market bottoms tend to be an extended process rather than an acute event. And they tend to require confirmation, which is normally provided by markets establishing an emotional, panic-driven low (like this past June), and then successfully retesting those lows on at least one or two occasions, before investors feel confident that a bottom may be in place. Of course, there are exceptions to this tendency, including 1987, 1989, and 2020, each of which were largely "V-shaped bottoms". However, these tend to be a rarity in market history.

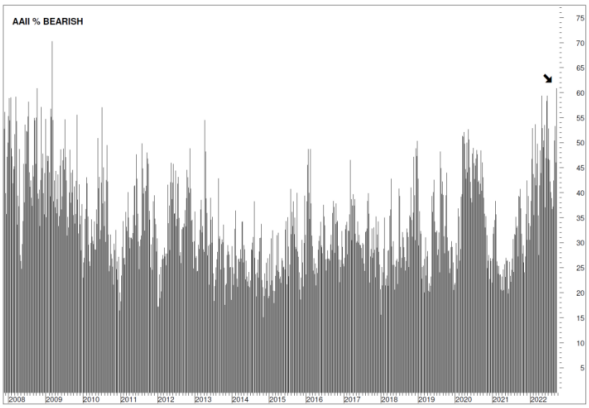
Further, we noted our perspective that the bottoming process was likely underway; that it began with the sharp decline into mid-June and the huge rally in the S&P 500 from those June lows to the August highs. We still suspect that the equity markets are in the process of probing for a sustainable bottom, and that the sharp decline over recent weeks is yet another (and potentially very important) stage of this bottoming process.



In last month's commentary we reemphasized our long-held premise that any sustainable market bottom would need to satisfy two absolute requisites: a successful retest of the June lows and definitive evidence of investor capitulation. While it is far too early for it to be deemed definitive, it is at least noteworthy that, on September 23rd, the S&P 500 tested the previous lows for the year and then rebounded smartly to close the day. You can see this retest at the bottom of the blue shaded area.

From a technical perspective, it will be important that this level of support hold, particularly since a failure to do so would represent the first time since World War II that the stock market has rallied sufficiently to recover 50% of its bear market losses, only to then go on to make a new bear market low. This potentially successful test of the lows, particularly when combined with the incredibly bearish sentiment reflected in investor surveys, could lead to at least a modest bounce in the equity markets over the near term.

CHART 5: AAII Sentiment Survey: Bearish
United States
(percent)

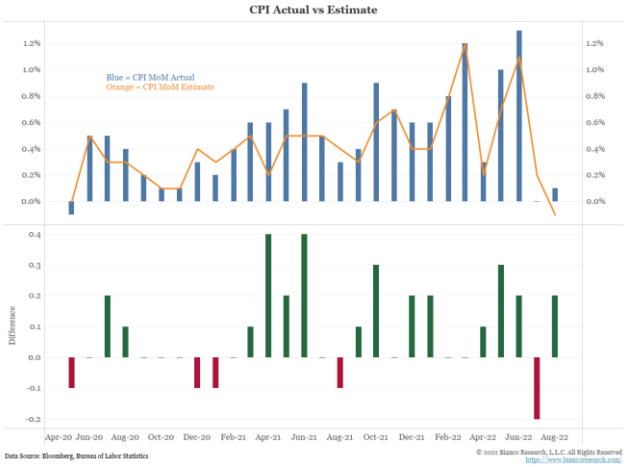


Source: Rosenberg Research

The American Association of Individual Investors' most recent investor sentiment poll (which asks if the respondent thinks that the domestic stock market will be up or down six months into the future) just registered its most pessimistic reading since 2009, and one of the twenty lowest readings achieved since the survey began in 1987[1]. From a contrarian perspective, this would normally be viewed as a very bullish signal, as such a strong bearish number suggests that much of the potential selling has already occurred.

That said, we are hesitant to assign too much credibility to this successful retest of the lows (at least initially), as it occurred on less-than-impressive trading volume, and because we believe that a breach of this level of technical support will ultimately be necessary to generate what we believe to be the other requisite for a bear market bottom, which is investor capitulation.

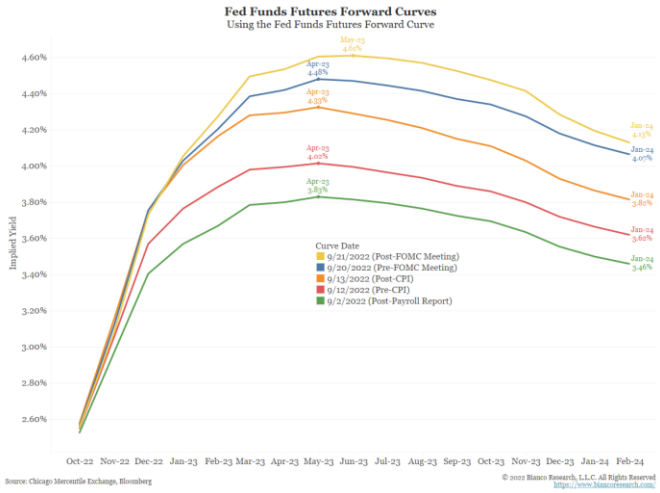
In our experience, at least one of three conditions need to be met before a bear market will come to an end. The first of these is that the markets have effectively and broadly priced-in the worst-case scenario, in which case future news is likely to be better than expected, and the market will move higher in response to better than expected news.



We view the 2020 pandemic-driven bottom as an example of this. The pandemic was certainly not over, and a vaccine was expected to take years to develop, so the market did not bottom because of improvement on the medical or economic front. Instead, the markets bottomed because investors priced-in the worst conceivable outcome, and it created the conditions necessary for a massive recovery, once the Fed provided a catalyst.

Unfortunately, we do not see that as being the case today, as we believe that expectations for 2023 corporate earnings are still far too optimistic at 8%, whereas we actually expect flat to negative earnings next year. Further, economists continue to underestimate inflation, as they have done in seventeen of the past nineteen months (above).

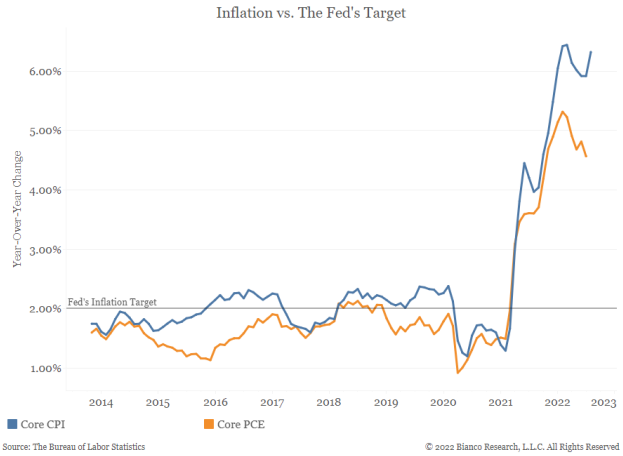
Moreover, the Fed Funds futures contracts show that the markets are still expecting the Fed to start cutting interest rates by May of next year, which seems almost inconceivable to us in the current environment. Despite the Fed's definitive statements to the contrary, there remains a belief that the Fed will ultimately come riding in like the cavalry to rescue the markets (the so-called "Fed put"), as they have done consistently since 1987.



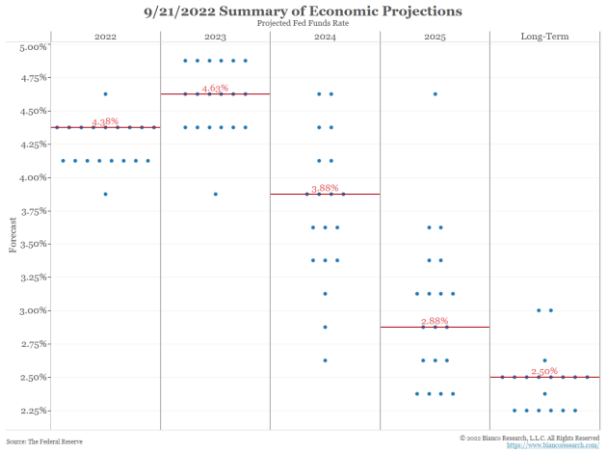
We would argue that this belief is likely prolonging the bear market, as it is keeping many individual investors from fully capitulating.

Bear markets can also reach their end when the fundamentals change for the positive, and there are a few things that we can point to in this regard.

First of all, while inflation remains stubbornly and unsustainably high, the measure of inflation preferred by the Federal Reserve, the Core Personal Consumption Expenditures Index (Core PCE), which is much less heavily weighted towards the housing component, has been making steady progress lower (gold line).



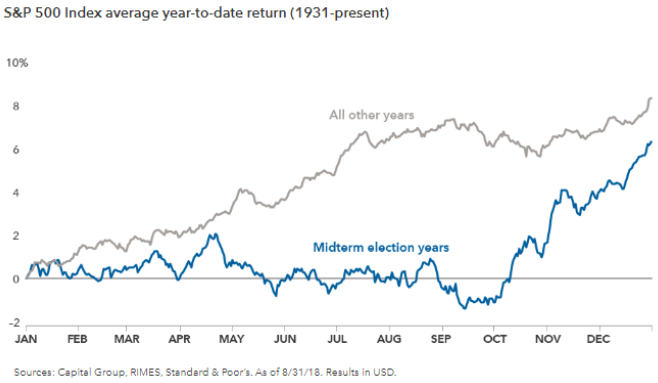
Moreover, both market-based and survey-based measures of expected future inflation are falling sharply, and suggesting a return towards the Fed's 2% inflation target.



In addition, both Fed guidance and the Fed's so-called "dot plot", which details their expectations for future monetary policy, are anticipating another large surge in short-term rates before the end of the year, but only one or two small increases next year, with rates starting to fall significantly in 2024 and 2025.

Furthermore, Fed Chairman Powell just noted in the question and answer session that followed the September 21st Fed announcement that interest rates have already moved to the "very lowest level" of restrictive, which may be important, as a move into restrictive monetary policy is a primary objective of the Fed, as they attempt to slow the economy[2].

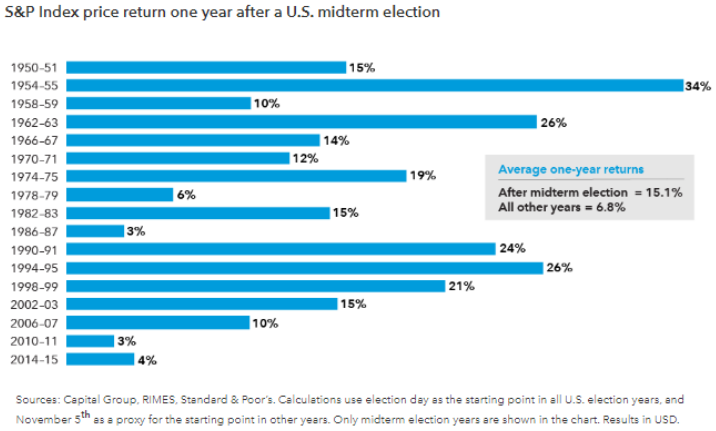
If expectations for both future inflation and future rate hikes are starting to recede, that suggests a potentially very bullish intermediate-term outlook for both the economy and the equity markets.



One other potentially very bullish influence may come from the upcoming elections, where there is a strong and historically rather dependable tendency for the stock market to be quite weak during the first nine months of mid-term election years, only to move sharply higher once investors get past all of the election-related uncertainty.

Of note, mid-term elections tend to be associated with much higher uncertainty than presidential election years, because the president's party traditionally loses a large number of seats as a result of mid-term elections, and because the lower voter turnout associated with mid-term elections makes their outcome much more difficult to predict.

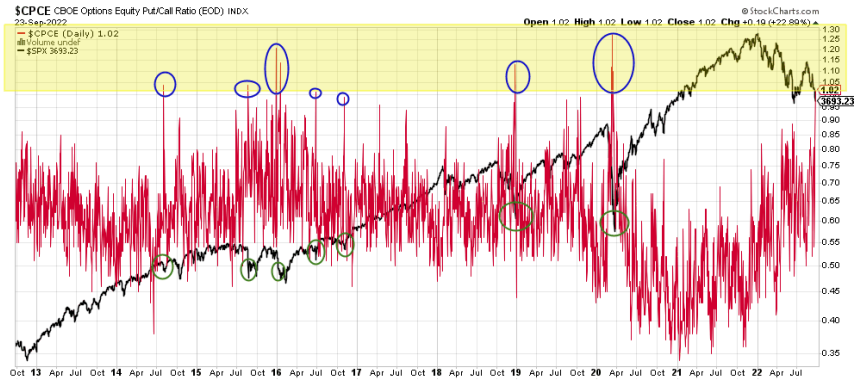
We are not suggesting that the election resolution, and/or the resulting lessening of political uncertainty, will be a more powerful influence on the markets than will be inflation, monetary policy and the state of the economy. However, in the current environment, when there seems to be uncertainty around every corner, and an upside catalyst seems particularly difficult to identify, an increase in political clarity could bring the markets some element of relief.



While each of the aforementioned factors can play an important role in the formation of a bear market bottom, there is one element that we consider to be more important and more essential than any of the rest, and that is an environment of capitulation, which is not just valuable as a potential indication that the proverbial "last potential seller" of equities has sold, thus suggesting that a bottom is in place. It is also valuable as it is generally less subjective than many of the other indicators discussed above.

Capitulation takes place when investors start to panic and sell positions regardless of price. It is when investors forgo hope and reach the depths of despair. It is a condition when fear overwhelms greed, and investors lose faith in the financial markets. It is a time when the last potential seller sells and there is a lack of willing buyers. It tends to be the most dramatic and frightening stage of the bear market, and tends to cause a greater decline than most investors expect. It is the point of maximum pessimism, and it normally provides a generational opportunity to buy stocks and other risk assets.

The good news is that, for the first time in this major bear market, we are finally seeing early indications of capitulatory sentiment and trading activity, which suggests to us that a final bear market bottom may be close in terms of time, although not necessarily in terms of price. It is perhaps worth remembering that major bear markets have a history of ending on big October sell-offs, and that, in most years, the equity markets tend to be strongest between mid-October and mid-April. While the past is not necessarily prologue, these are long-term and notably consistent tendencies.



Perhaps most encouraging of all is something that we have been writing about and anticipating for months. The CBOE Equity Put Call Ratio, which has a remarkable track record of identifying bear market bottoms once it crosses above 1.0, finally crossed that level last week (albeit just barely), for the first time since the 2020 pandemic bear market lows.

Indeed, you can see on the above chart the remarkable correlations that has historically existed between significant lows in the stock market and readings above 1.0 on this indicator (shown in the yellow band). The S&P 500 is in black and the put/call ratio in red.

The other complimentary tool that measures capitulation is the VIX Index, which is also known as the "fear gauge".

High readings on this measure suggest that fear is so high that a significant majority of potential sellers have already sold, thus creating the conditions for a potential bullish reversal in market trend. Readings above 30 have often indicated a level of bearishness that can support a short or intermediate-term move higher, while readings above 40 often indicate the potential for a more-permanent and substantial move higher. The S&P 500 is in black and the VIX Index is in green.

Last week, this indicator crossed modestly above the 30 level, which certainly supports the idea of a potential bounce. However, it is still well short of the 40 level (the yellow band) that would offer confirmation that a permanent bottom is likely in place.

That said, it is possible that the VIX may not provide the same indications of capitulation as it often has in the past, as it is a tool used primarily by institutional investors to hedge their equity risk, and there are indications that many institutions reduced their equity exposure (and thus the need to hedge equity exposure) some time ago.

In contrast, evidence suggests that it is individual investors that have refused to sell their equity holdings, despite their historically bearish outlook. This may be attributable to the aforementioned and continuing belief of individual investors in the "Fed put".

Asset Allocation Results for August 2022 :

		Current percentage of portfolio
Stock Funds	—	34.08%
Stocks	—	30.39%
Stocks Total		64.47%
Bond Funds	—	11.35%
Bonds	-	3.01%
Bonds Total		14.36%
Cash	—	21.17%

For evidence, you need look no further than the fact that, according to the last survey from the American Association of Individual Investors, their membership is still allocating almost 65% of their portfolios to equities, despite the fact that over 60% of this same group of 150,000 individual investors believes that equity prices will be even lower six months from now[3].

Indeed, Michael Hartnett, who serves as the Chief Investment Strategist Bank of America Global Research just categorized investor sentiment as "unquestionably" the worst it's been since the financial crisis of 2008 which, from a contrarian perspective, should be quite bullish[4].

All things considered; we believe that there is a growing body of evidence that suggests that a bottom could potentially be close in terms of time. That said, the final leg of a substantial bear market has a historical tendency to be sharp and swift, which leaves us inclined to wait for some additional confirmation of a bottom before shifting from defense to offense.

After all, this is not just a garden-variety bear market. Instead, it is essentially a process of, at least partially, unwinding literally decades of excessive levels of monetary liquidity, unjustifiably (and even irresponsibly) low levels of interest rates and unreasonably high valuations on most financial asset classes, including stocks, bonds and real estate.

We often quote legendary investor, Sir John Templeton, who very insightfully noted that "bull markets are born in despair, grow on pessimism, mature on optimism and die in euphoria". While we saw many examples of euphoria in 2021, a broad and persuasive psychology of despair is increasingly dominant in the markets as we approach the end of 2022, and this should provide substantial high-octane fuel for the eventual rebound.

The Allied victory is Europe was not ensured by the German defeat in the Battle of Britain, and many bloody battles still laid ahead. That said, it was a critical turning point, and arguably a requisite for an eventual Allied victory. Similarly, while a potentially successful test of the June lows and a spike in measures of capitulation do not necessarily mean that the bottoming process is now complete, and that the bear market has put in its ultimate lows, we believe that these factors are nonetheless a requisite for an eventual end to the bear market. More confirmation and more time are still needed, but these are arguably encouraging signs that a "critical turning point" could once again soon be at hand.

While defense remains as our theme of the day, we are growing increasingly enthusiastic about the opportunities that are being created by this unwinding of excesses, and we are busy researching potential buying opportunities for when we get additional confirmation of capitulation, and further indications of an associated, and more-permanent market low.

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Neither asset allocation nor diversification guarantee a profit or protect against a loss in a declining market. They are methods that can be used to help manage investment risk.

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

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.

Personal Consumption Expenditures Price Index (PCE) released each month in the Personal Income and Outlays report, reflects changes in the prices of goods and services purchased by consumers in the United States. Quarterly and annual data are included in the GDP release.

CBOE Equity Put Call Ratio is calculated by taking the overall number of cautious put options sold each day on the Chicago Board Options Exchange and dividing by the overall number of bullish call options sold.

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

Citations

(1) "AAII Sentiment Survey: Highest Level of Pessimism Since March 2009", AAII Staff, Posted 09/22/2022 https://www.aaii.com/latest/article/21557-aaii-sentiment-survey-highest-level-of-pessimism-since-march-2009

(2) "Powell Q&A: My main message has not changed at all since Jackson Hole", Adam Button, Posted 09/21/2022 https://www.forexlive.com/centralbank/powell-qa-my-main-message-has-not-changed-at-all-since-jackson-hole-20220921/

(3) "Asset Allocation Results for August 2022", AAII Staff, https://www.aaii.com/assetallocationsurvey

(4) "Risk Assets Swept Up in Rout as 'Fear Gauge' Soars", Rita Nazareth, Posted 09/23/2022 https://www.thinkadvisor.com/2022/09/23/risk-assets-swept-up-in-rout-as-fear-gauge-soars/?kw=Risk%20Assets%20Swept%20Up%20in%20Rout%20as%20%27Fear%20Gauge%27%20Soars&utm_source=email&utm_medium=enl&utm_campaign=dailywire&utm_content=20220923&utm_term=tadv

(5) Image #12 "Asset Allocation Results for August 2022", AAII Staff, https://www.aaii.com/assetallocationsurvey