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THE PER STIRLING CAPITAL OUTLOOK

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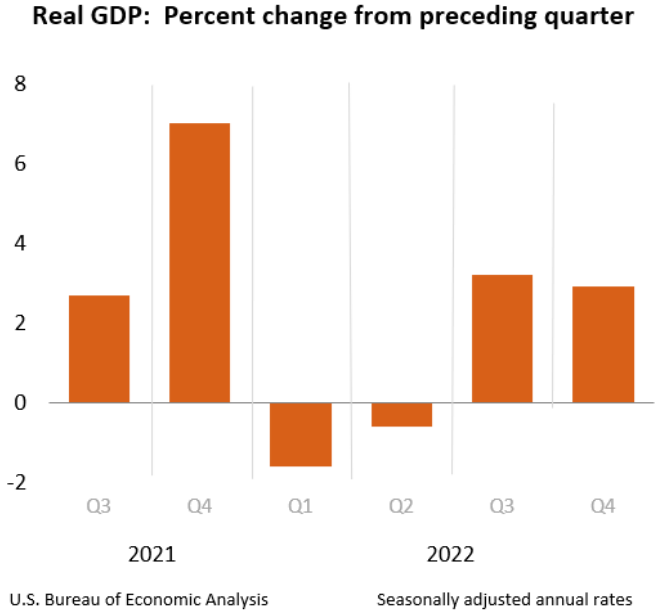
We are very honored and excited that, in February, Per Stirling's Chief Investment Officer will be giving the keynote speech at the annual conference for FPA-DFW, which is the largest Financial Planning Association chapter in the country.

The topic will be "The Capital Markets & the Macroeconomic Environment: A View from 40,000 Feet", and will essentially be a somewhat condensed version of the market updates made available to Per Stirling's advisors on a monthly basis.

We thought that it would be a worthwhile exercise to take one or two of the major themes detailed in each of the presentation's six major sections, and summarize them in this month's commentary.

The Economy:

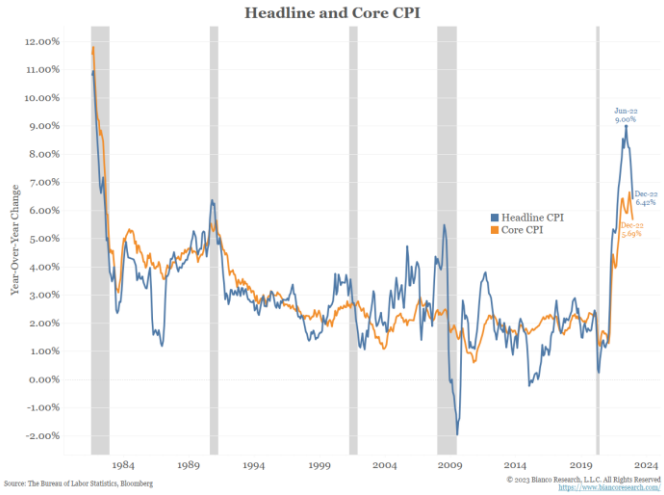
The best way to describe the domestic economy is probably "resilient", as it continues to grow at a remarkable pace, despite the Fed pursuing the most aggressively restrictive monetary policy in 41 years. Indeed, the Commerce Department just announced that the economy grew by 2.9% in the 4th quarter of 2022, which was slightly stronger than the 2.8% growth rate that was projected in a recent Dow Jones survey of economists.[1]



While this does reflect a modest slowing from the 3.2% growth rate witnessed in the third quarter, it is nonetheless is a fairly remarkable achievement for a mature economy facing aggressive monetary tightening. The job market is also remarkably strong, with 1.74 jobs currently available per every one person looking for work.[2]

With the economy still running at such a strong pace, there is a growing belief that a recession, which seemed like a foregone conclusion as recently as a month or two ago, could potentially be avoided, and that any recession, if one were to occur, would be only mild. Indeed, in the just-released quarterly survey from the National Association of Business Economics, the odds of recession were downgraded to 56% from an almost 66% likelihood only three months ago.[3] Even so, we still expect that the U.S. will experience a mild recession in 2023, and this has both bullish and bearish implications.

On one hand, if the economic contraction is relatively mild, that would suggest that corporate earning will not need to decline as much as many expect, which should be bullish for equities.



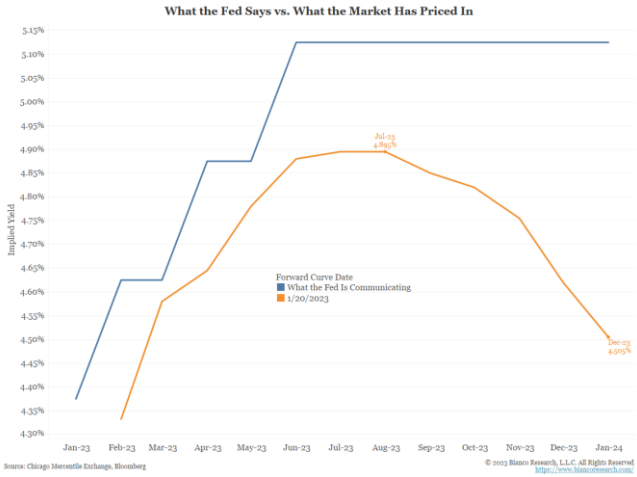
On the other hand, if the contraction is only mild, the Fed may feel no urgency to reverse their aggressively restrictive policies, which would likely leave interest rates both nominally higher and higher for longer, which could limit the upside for equity prices.

Inflation:

The decidedly great news on the economic front is that inflation is not only reversing sharply from last year's highs, but also that there is a growing array of reasons to expect that the decline will even accelerate over the coming months.

That said, there is still a significant risk outstanding, which is that, while inflation seems very likely to continue its decline, it may not fall far enough to motivate the Fed to take their foot off of the proverbial economic brake, which would likely keep downward pressure on both economic growth and equity prices.

It was originally the surge in inflation that catalyzed the global central banks to adopt such aggressive tightening policies, and we believe that it is ultimately this drop in inflation that will allow for a reversal in these policies, and a likely and associated return to powerful bull markets in risk assets. Futures markets are predicting that this sea-change will take place around July of this year, which might make sense, if inflation was the Fed's only concern.

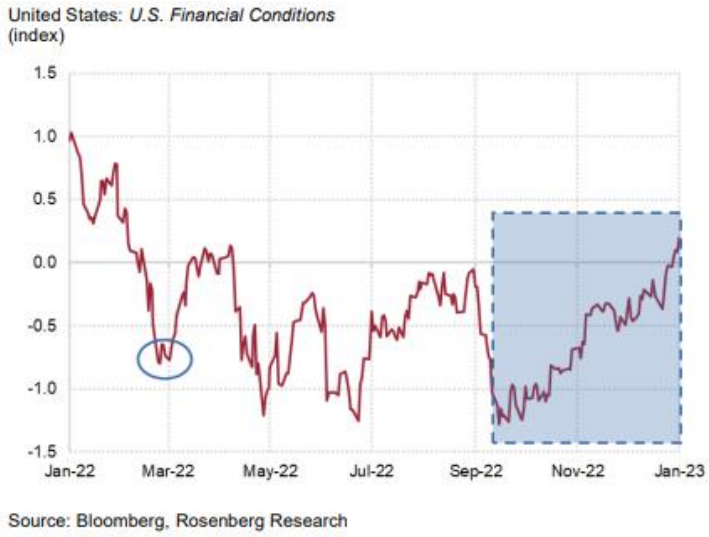


Unfortunately, we suspect that the Fed has concerns beyond inflation, which is being manifested in a remarkable divergence between the future policy course that the Federal Reserve's guidance is clearly suggesting (blue line), and the future course of monetary policy that is being priced into the markets (gold line).

Monetary Policy:

We suspect that this is the single most important chart in the presentation, as we believe that it is virtually inevitable that these two lines converge over time and that, as we noted a month ago, "if investors are correct, and the Fed is forced by circumstances to reverse course and lower rates, it could potentially be very bullish for markets. However, if investors are wrong, and markets ultimately need to adjust their interest rate expectations upwards towards Fed guidance, it could cause the bearish trends of 2022 to extend well into 2023". We believe that this still holds true.

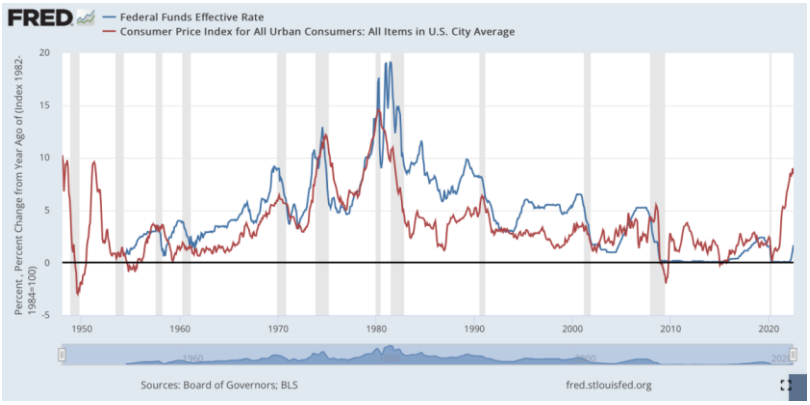
So, why the divergence between Fed guidance and market expectations? We have several theories starting with the (we think correct) idea that the Fed is questioning the appropriateness of the very accommodating monetary policies that have prevailed over recent decades, and which have featured excessively high levels of monetary liquidity, excessively low levels of inflation-adjusted interest rates, and a pervasive belief in the so-called "Fed Put", which describes the belief that the Fed can always be depended upon to use monetary policy to bail out both investors and the economy anytime that a recession or bear market emerges.



There is a growing perception that these policies have both encouraged and facilitated excessive risk-taking, in addition to greatly exacerbating last year's surge in inflation, and have catalyzed a string of market bubbles and financial crises over recent decades.

While the markets seem to be assuming that monetary policy will default back to these days of "easy money", the Fed seems increasingly committed to a return to more rational and measured monetary policies. The Fed noted its concern about this presumably flawed investor perception, when it warned about this perceived "misperception by the public of the committee's reaction function" in the minutes of their December meeting.[4]

The Fed's dilemma is that this anticipated return to easy money policies is causing equity and bond prices to move higher, market-set interest rates to move lower, credit spreads (the risk premium to invest in lower-quality debt) to narrow, and the dollar to decline sharply. This combination of outcomes serves to stimulate the economy and exacerbate inflation, such that current financial conditions are even easier than they were before the Fed started raising interest rates back in March (4.5% ago). This suggests that the Fed will likely need to remain restrictive until financial conditions moderate.



We suspect that a third reason for this divergence is rooted in the history of Fed policy in the 1970s and 1980s, when the Fed moved interest rates up and down with inflation rather than just keeping rates high until after inflation actually receded to the desired target. The result was that the Fed was unable to bring inflation back under control until Chairman Volcker ultimately drove short-term rates up to 20%, thus effectively breaking the back of both inflation and the economy. Chairman Powell has made it very clear that he models himself after Chairman Volcker, and that he is committed to avoiding the mistakes of forty years ago.

The Debt and Credit Markets:

With interest rates near multi-year highs, and the Fed seemingly fully committed to driving inflation down towards its 2% target, the debt and credit markets look more interesting than they have in years. Indeed, inflation-adjusted yields are the highest that they have been in over a decade, and fixed income yields are higher than dividend yields from equities for the first time in years.

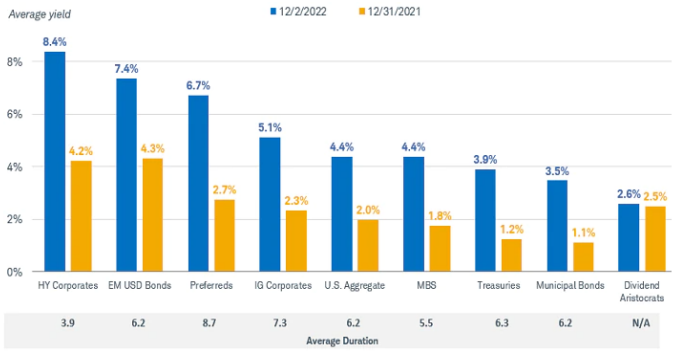
Real yields are the highest since 2009

Source: Bloomberg.
US Generic Govt TII 2 Yr (USGGT02Y INDEX), US Generic Govt TII 5 Yr (USGGT05Y INDEX), US Generic Govt TII 10 Yr (USGGT10Y INDEX). Daily data as of 12/05/2022. **Past performance is no guarantee of future results.** For illustrative purposes only.

Perhaps even more important is the relationship that has historically existed between inflation and the correlation between stocks and bonds. Historically, when inflation is abnormally high, as was the case in 2022, stocks and bonds tend to trade in near unison, which helps to explain why balanced portfolios invested in stocks and bonds performed so poorly last year.

However, with inflation now in retreat, it seems reasonable for stocks and bonds to once again trade on their own unique fundamentals, which should hopefully restore the traditional diversification benefits associated with adding bonds into investment portfolios.

Yields in fixed income investments are well above dividend yields for the first time in several years



Source: Bloomberg, as of 12/02/2022 versus 12/31/2021.

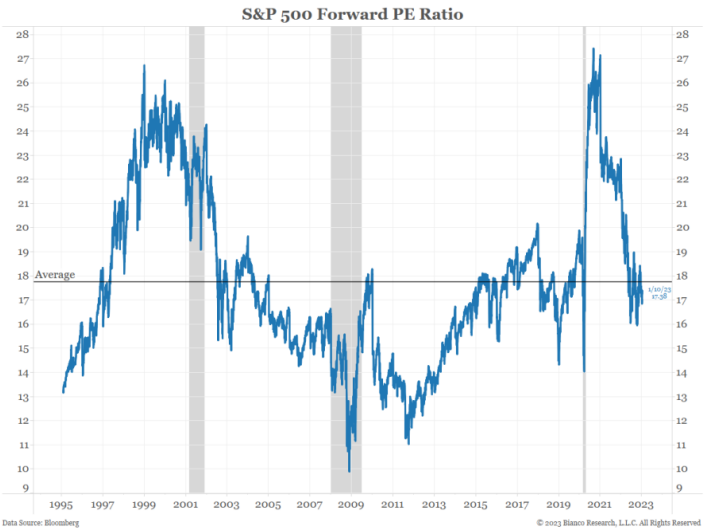
Indexes represented are: Bloomberg U.S. Aggregate Bond Index (U.S. Aggregate), Bloomberg U.S. Corporate Bond Index (IG Corporates), Bloomberg U.S. Corporate High-Yield Bond Index (HY Corporates), Bloomberg U.S. Municipal Bond Index (Municipal Bonds), ICE BofA Fixed Rate Preferred Securities Index (Preferreds), Bloomberg Emerging Market USD Aggregate Index (EM USD Bonds), Bloomberg U.S. MBS Index (MBS), Bloomberg U.S. Treasury Index (Treasuries), and the S&P 500 Dividend Aristocrats Index (Dividend Aristocrats). Yields shown are the average yield-to-worst except for the Dividend Aristocrats which is the average dividend yield. **Past performance is no guarantee of future results.** For illustrative purposes only. Indices are unmanaged, do not incur fees or expenses, and cannot be invested indirectly.

Domestic Equities:

With inflation being increasingly brought under control, a recession (and particularly a deep recession) becoming less likely, the Federal Reserve apparently approaching an end to their tightening (rate rising) cycle, and equity valuations having been reset to much more reasonable levels over the course of the severe 2022 bear market (during which JP Morgan estimates that the average retail investor lost almost 40%[5], the equity markets appear rather compelling for investors who have a minimum two to three-year time horizon.

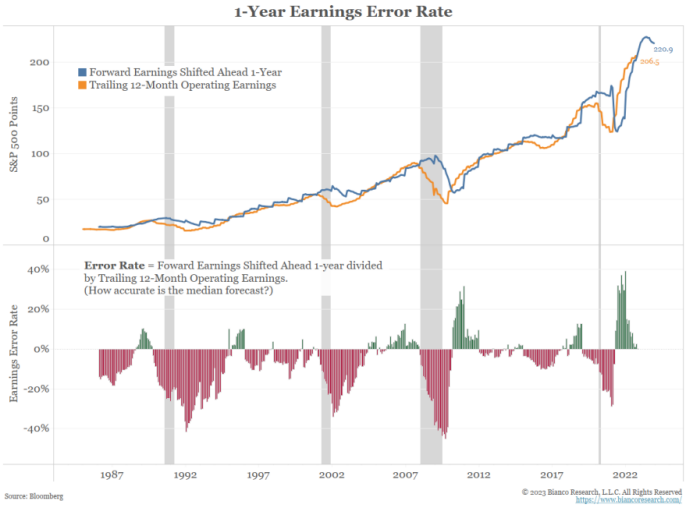
The open question increasingly appears to be what is the outlook for equities over the near term and (very importantly) whether or not the U.S. experiences a recession in 2023.

The recession question is likely of great significance, as equity valuations (using the S&P 500 as a proxy) have retreated back to average levels relative to earnings. This suggests that, assuming that Wall Street's earnings projections are relatively accurate, equities may have already priced-in a significant amount of their potential bad news.



This is where the risk of a recession becomes increasingly important, as history suggests that, when recessions do emerge, analysts tend to over-estimate future earning by between 20% and 40%.

In other words, in the event of a recession, and the historical implications for earnings estimates, the equity markets could easily go from being fairly-valued to very highly-valued. This is why, despite the fact that the January rally has been led by the growth and lower-quality stocks that suffered the most in 2022, we prefer to emphasize (to quote from last month's commentary) "high-quality equities with low valuations, strong balance sheets, high free cash flow, and a commitment to shareholder-friendly policies like paying dividends and repurchasing shares, as opposed to long-duration growth stocks with high valuations, or whose best potential and earnings are likely years into the future".



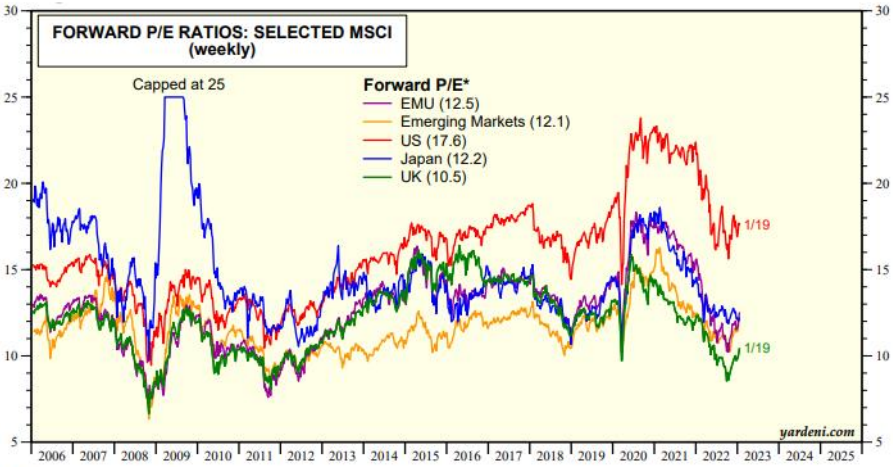
To put the importance of the recession question into some perspective, according to the Wells Fargo Investment Institute, of all bear markets since 1946, the average decline with a recession was -35.8% versus only -27.9% on average without a recession.[6] Thus far, the S&P decline has basically met the expectations for a non-recessionary bear market, but has quite a way to go before meeting the downside expectations for the average bear market that includes a recession.

Foreign Equities:

Much as is the case with most fixed-income investments, foreign equity investments offer some appeal for one of the first times in recent years. The decline in the dollar has really benefitted most emerging markets, as most external emerging markets debt is denominated in U.S. dollars, which means that a falling dollar reduces their debt burden. They have also benefitted from the reopening of the Chinese economy, after years of pursuing its "zero-COVID" policies.

Europe has also benefitted from a much warmer than expected winter, which lessened significantly its risk of both an energy crisis and a deep recession. Remarkably, European equity markets have now outperformed most domestic equity markets since the date of the initial Russian invasion of Ukraine.

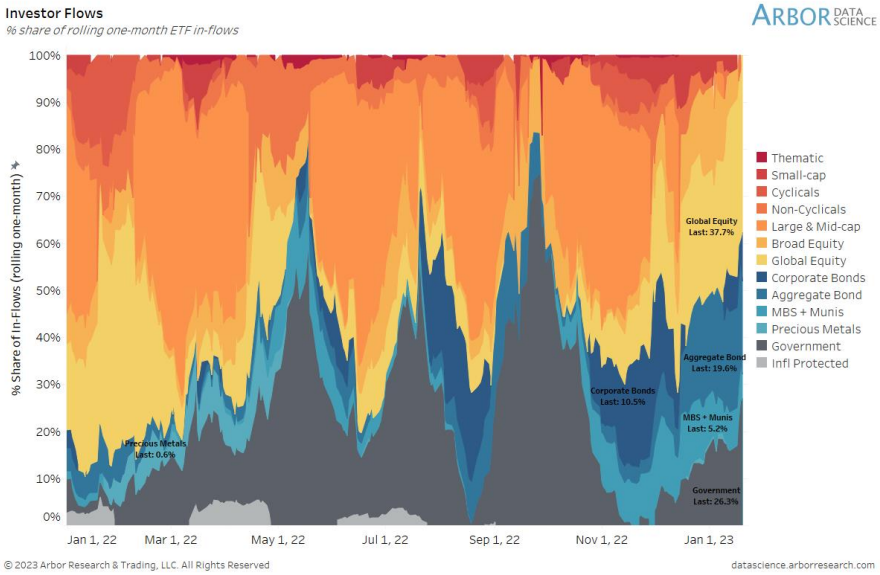
Overseas economies are also facing less onerous inflation issues than are being addressed in the U.S. This is largely due to the fact that, while foreign central banks pursued monetary policy stimulus similar to that employed by the Federal Reserve, they did not employ the aggressive fiscal stimulus that was utilized in the U.S.



* Price divided by 12-month forward consensus expected operating earnings per share.
Source: I/B/E/S data by Refinitiv.

In addition, foreign markets are much less expensive compared to expected earnings, with the U.S. selling at 17.5 times expected earnings, while the European Monetary Union countries, emerging markets, Japan, and the United Kingdom are selling only at 12.5, 12.1, 12.2 and 10.5 times expected earnings respectively.

In addition, after underperforming the U.S. markets for 15 consecutive years, foreign markets have been dramatically outperforming their domestic brethren since the market lows of last October, and recent studies of ETF flows show that U.S. investors are moving large sums of money from domestic stocks to both the foreign stock markets and to bond markets in general.



While challenges still remain, we expect for 2023 to be a much better year for investors than was 2022, and we expect for the following two-to-three-year period to be even better still. Bear markets and recessions are painful experiences for most investors, but the opportunities that they create, and the value that they restore, tend to create a very fertile environment for longer-term investors.

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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.

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.

Core CPI refers to inflation based on the consumer price index (CPI), covering the inflation of all the goods and services except the volatile food & fuel prices, excise duties, income tax, and other financial investments.

The Atlanta Fed GDPNow forecasting model provides a "nowcast" of the official estimate prior to its release by estimating GDP growth using a methodology similar to the one used by the U.S. Bureau of Economic Analysis.

The Chicago Fed's National Financial Conditions Index (NFCI) provides a comprehensive weekly update on U.S. financial conditions in money markets, debt and equity markets, and the traditional and "shadow" banking systems.

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

Citations

(1) "U.S. GDP rose 2.9% in the fourth quarter, more than expected even as recession fears loom", Jeff Cox, Posted 1/26/2023 https://www.cnbc.com/2023/01/26/gdp-q4-2022-us-gdp-rose-2point9percent-in-the-fourth-quarter-more-than-expected-even-as-recession-fears-loom.html

(2) "Job Openings to Unemployed Persons Rate Remains Near Highs", Arbor Data Science, Posted 01/2023

(3) "Businesses see lower odds U.S. in or entering recession, NABE says", Lindsay Dunsmuir, Posted 01/23/2023 https://www.reuters.com/markets/us/businesses-see-lower-odds-us-or-entering-recession-nabe-says-2023-01-23/

(4) "Minutes of the Federal Open Market Committee", Board of Governors of the Federal Reserve System, Posted 12/13-14/2022 https://www.federalreserve.gov/monetarypolicy/fomcminutes20221214.htm

(5) "Individual traders are down bad this year", Neal Freyman, Posted 12/9/2022 https://www.morningbrew.com/daily/stories/2022/12/09/individual-traders-are-down-bad-this-year

(6) "Analysis: Potential U.S. recession could feed an already vicious bear market", Lewis Krauskopf, Posted 07/28/2022 https://www.reuters.com/markets/us/potential-us-recession-could-feed-an-already-vicious-bear-market-2022-07-28/#:~:text=Bear%20markets%20accompanied%20by%20a,a%20recession%2C%20their%20data%20showed