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THE PER STIRLING CAPITAL OUTLOOK

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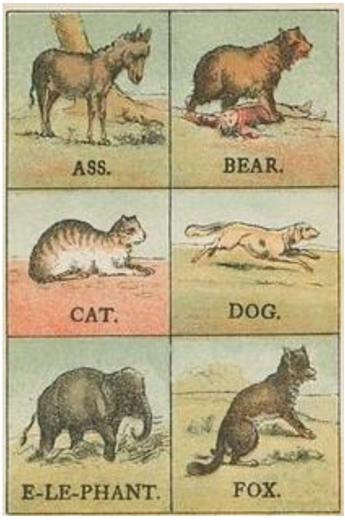
Lions and tigers and bears, oh my! Well, not so much "bears", at least for the time being.

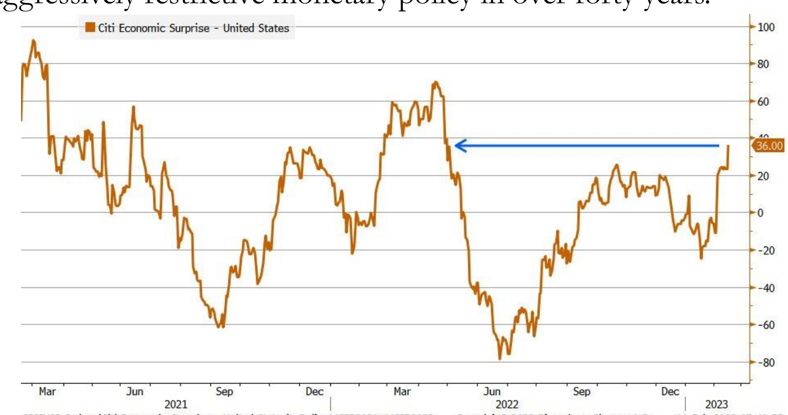


The turn of the calendar to the year 2023 seems to have brought with it the return of animal spirits, and appears to, at least temporarily, have turned equity market leadership on its head.

In general, all of the market sectors and asset classes that suffered the biggest losses in 2022 have come roaring back to life in 2023, while those high-quality, value-oriented stocks that feature strong balance sheets and high free cash-flow, and which provided shelter in the midst of last year's market storm, suddenly find themselves out of favor.

More specifically, the attention of investors seems to have shifted from these higher-quality stocks to their much more speculative brethren, as a result of what appears to be a growing belief that the Fed will manage to pull off the impossible (at least the highly improbable)-- an economic slowdown that is sufficient to return inflation towards the Fed's 2% target, but which is so targeted and subtle that the economy manages to avoid slipping into recession.

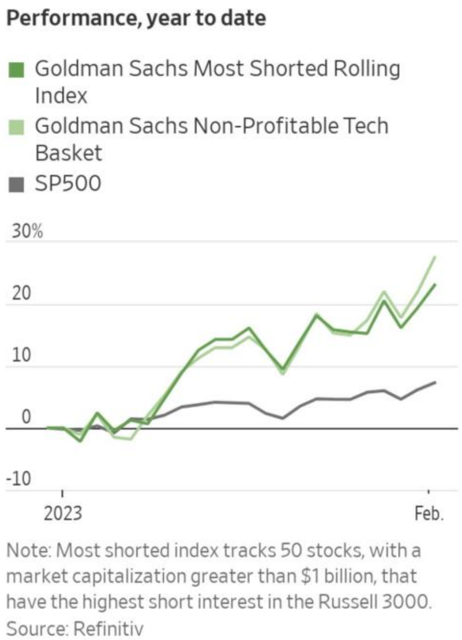
While, in the current environment, this would probably be the monetary policy equivalent of landing a Boeing 747 on an aircraft carrier, it is an outcome that is now at least worthy of consideration, after seeming to be nothing more than a pipe dream for much of the past year. After all, in addition to the U.S. currently having the lowest unemployment rate in over fifty years, its economic growth rate actually appears to be accelerating, despite the Fed's implementation of the most aggressively restrictive monetary policy in over forty years.



You can see this reacceleration in economic growth in the Citi Economic Surprise Index. Further, the fact that the current reading of 36 is above the zero line means that economic growth is also coming in above analysts' expectations.

Not unlike landing a 747 on an aircraft carrier, engineering an economic "soft landing" is highly problematic and rarely achieved. However, the largely speculative nature of this year's rally suggests that equity investors are pricing in both the avoidance of a recession and an impending end to Fed rate hikes. In our opinion, expecting such a beneficial combination of outcomes is both counterintuitive and potentially mutually exclusive.

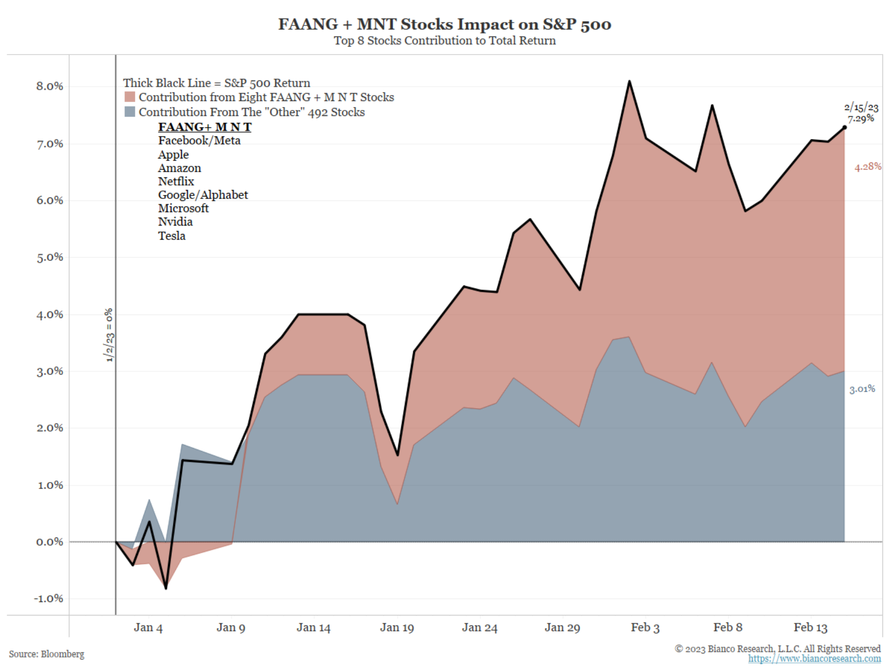
Making things even more puzzling is that investors are not just buying the broad stock market or investing in reasonably-valued blue chip stocks, but are instead largely pouring money into the most speculative and aggressively-valued parts of the capital markets. As was just noted on February 15th by JPMorgan Chase & Co. chief strategist, Marko Kolanovic, "This behavior is not just fighting but also taunting the Fed, with crypto, meme stocks and unprofitable companies responding best to Fed communications." (1)



This year, money has poured into the junkiest of the junk, with all ten of the top-performing S&P 1500 stocks being stocks that were severely beaten down in 2022, by an average of more than 67%. In 2023, these stocks are up by an average of more than 70% on a year-to-date basis. (2)

Further, the most heavily-shorted stocks in the S&P 500 have soared 21% over the first six weeks of the year, which beats the returns of the broad market by 13% on a year-to-date basis, while the Goldman Sachs index of non-profitable technology companies has rocketed higher by 25% over the first six weeks of the year. Indeed, investors seem to be so committed to buy every stock decline, without regard to company fundamentals, that companies that have failed to meet analysts' earnings expectations have actually managed to outperform the broad market in the five days following their earnings disappointments. (3)

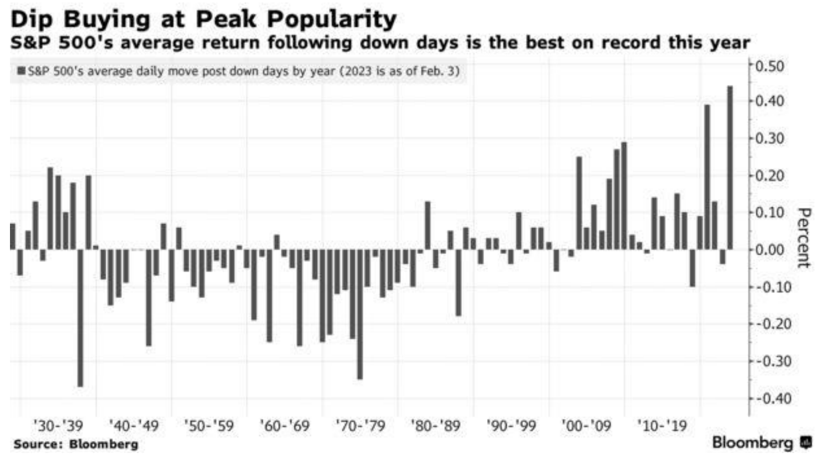
To be clear, it has not been just the "junkiest of the junk" driving the market this year, as some of the leadership, in the S&P 500 in particular, has come from money pouring into the ultra-expensive so-called FANG-plus stocks (Facebook/Meta, Apple, Amazon, Netflix, Google/Alphabet, Microsoft, Nvidia and Tesla).



These eight stocks, which average an outrageous price of 36.4 times their earnings (4) and represent 24% of the S&P 500's market capitalization, have accounted for 60% of that index's year-to-date returns. (5)

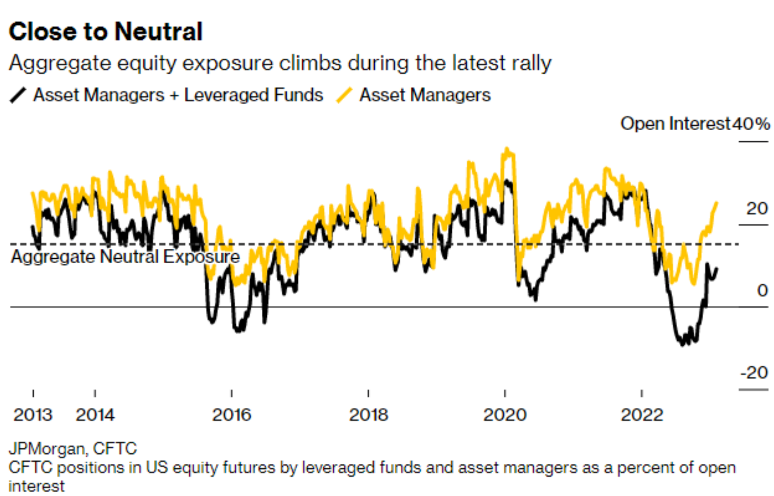
In this new "risk-on" environment, individual investors have also returned as aggressive buyers of equities (and even cryptocurrencies like bitcoin). According to J.P. Morgan, "trading orders from the retail army in stocks and exchange-traded funds accounted for 23% of the market's total volume in late January, above the previous high of 22% reached during the 2021 meme mania." (6)

Investors have been particularly aggressive in buying every dip in the markets, and are being well rewarded for both their newfound optimism and their blind faith, as the rebound from negative days on the S&P 500 has, on average, been the strongest in the past one hundred years.



The renewed animal spirits, when combined with the return of the individual investor and a decided lack of caution, catalyzed a massive bout of short-covering (buying back stocks that speculators had previously borrowed and sold, under the premise that they would be able to profit by buying back and repaying the borrowed stocks at lower prices than what they sold them for).

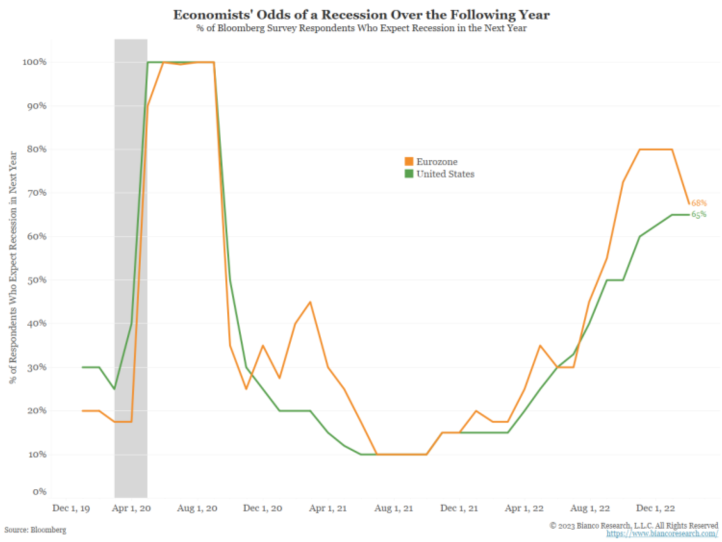
According to Goldman Sachs, this was amplified by the biggest short-squeeze (the buying back of shorted shares) on the part of hedge funds since 2015, which propelled lower-quality stocks sharply higher over the first six weeks of the year. (7)



However, according to updated data from JPMorgan Chase and Deutsche Bank AG, "money managers have cut $300 billion of bearish bets and are now positioned more in line with historic norms — robbing the market of pent-up demand just as the Federal Reserve warns its inflation-fighting battle is far from over". (8)

"The shift in positioning has taken a broad array of investors from underweight to holding equities closer to the average of the past decade. Investors are now the closest to neutral positioning than they have been since the second quarter of last year, when the Fed began ramping up interest rates." (8) In other words, the fuel (short-covering) that has largely powered this impressive year-to-date rally in speculative and beaten-down stocks may now be running low.

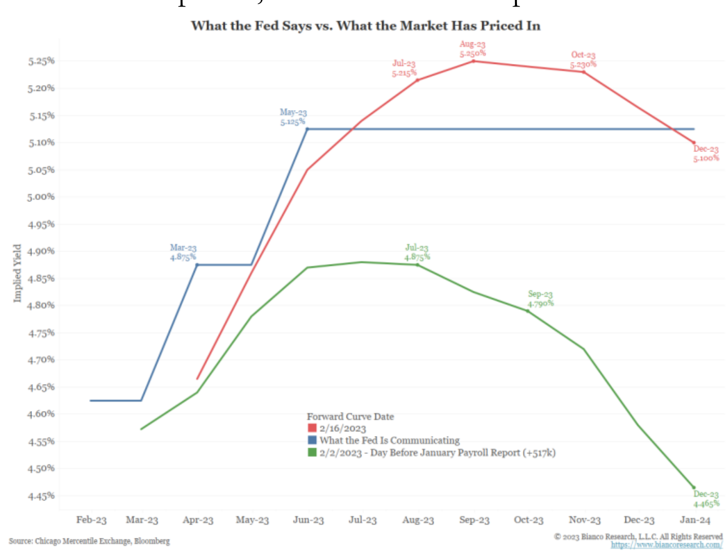
From our perspective, the challenge for stocks in general, and lower-quality and more speculative stocks in particular, is that this rally seems to be built upon the premise that the Fed is nearly done raising interest rates AND that the economy will manage to avoid a slowdown of any substance.



Our concern is that these two assumptions are likely mutually exclusive, and that the Fed is, in our opinion, unlikely to curtail its interest rate hikes until after the economy slows enough to both realign the number of available jobs with the number of available workers and crush the last embers of inflation.

As was just noted by Nick Timiraos in a February 13th interview on CNBC, in reference to the Federal Reserve, "if they don't see the slowdown, it means that they are going to take steps to try to create a slowdown. Whether that means a higher terminal rate, or just, you know, holding at a higher level for longer, I think that's what we are going to find out in the weeks ahead, but a "no-landing" (i.e., the lack of a significant slowdown) here is not consistent with what the Fed says they want". (9)

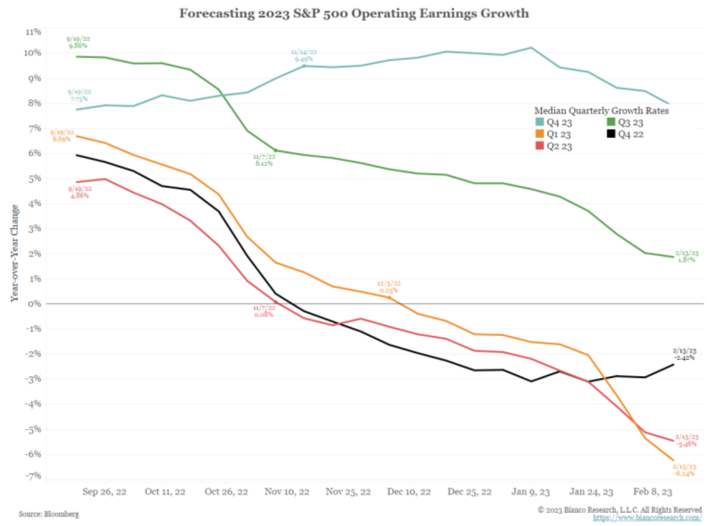
Importantly, in addition to being the chief economics correspondent for the Wall Street Journal, Mr. Timiraos is known as "the Fed whisperer", because he is the reporter that Fed Chairman Powell normally leaks stories to whenever he wants to offer forward guidance to the markets. As such, his is considered to be a very well-informed perspective.



In many regards, the bond market has already largely priced-in the likelihood of rates moving higher, and of the Fed keeping them higher for longer than the markets had previously been anticipating.

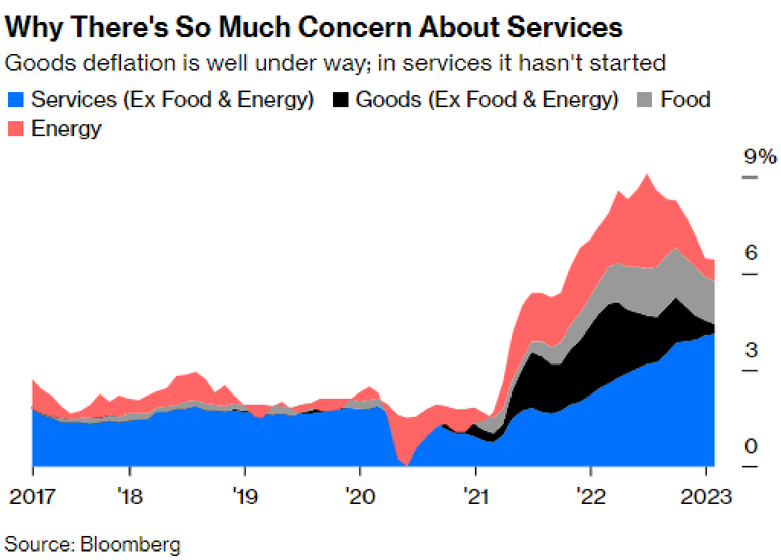
Indeed, since January 18th, when expectations for short-term interest rates (as expressed through the Fed Funds futures markets) hit their lows for this economic cycle, they have soared higher by seven-tenths of one percent (70 basis points), thus bringing the bond market largely in-line with guidance by the Fed. You can see this in the above chart.

In contrast, equity investors continue to "Fight the Fed", and have actually pushed the S&P 500 higher by 5% over that same period of time. From our perspective, this is in most regards quite irrational, when you consider that 1) at over 18 times expected 12-month earnings, the stock market is already very expensive, 2) that earnings expectations are already falling quite sharply, and 3) that when interest rates move higher, investors are traditionally unwilling to pay as much money for each dollar of corporate earnings.



We believe that current investor sentiment is reflecting a level of complacency and bullishness that may be overly optimistic in the current environment. There are also some signs of speculative froth, which you never like to see, as it suggests that, at minimum, this impressive advance needs to take a pause.

Ironically, each of the aforementioned challenges is ultimately a function of the fact that we are suffering from an overabundance of riches. The economy has recovered from a modest first half of 2022 contraction, and is now showing signs of accelerating. The employment market is so strong that there are almost two jobs available per every one person looking for work. The most recent retail sales report confirmed that consumer spending is very strong, which is of particular importance in the U.S., as consumer spending represents approximately 70% of the American economy. (10) In addition, portfolios are rebounding, financial conditions are loosening, and the prices of goods are starting to fall.

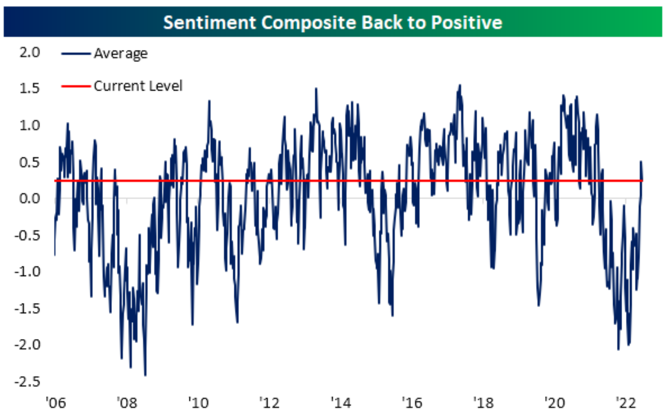


Indeed, things are so good that they are arguably bad. The increasing economic strength, increasing financial liquidity and strong consumer spending is likely to motivate the Fed to keep raising interest rates. The very tight labor market is keeping wage inflation very high, which will make it very challenging for the Fed to reach its 2% inflation target. Rebounding portfolios increase consumer confidence and thus increase consumer spending, which exacerbates inflation and, while goods prices are falling, service-sector inflation is accelerating, largely due to the impact of higher wages. This is of critical importance, as the service sector represents over 69% of the economy. (11)

To return to the words of Nick Timiraos "if they don't see the slowdown, it means that they are going to take steps to try to create a slowdown. Whether that means a higher terminal rate, or just, you know, holding at a higher level for longer, I think that's what we are going to find out in the weeks ahead, but a "no-landing" here is not consistent with what the Fed says they want".

Things are so good that they are bad, because the Fed believes that the labor market is too tight, that there is too much money sloshing around the financial system, and that the economy must be forced into a slowdown of some substance to finally bring inflation back under control, which means that they are unlikely to take their foot off of the brake until things are noticeably less good than they are today.

On top of everything else, investor sentiment has now returned to rather ebullient levels, and this is probably one of the last things that the Fed wants to see, as it encourages risk-taking at a time when the Fed is attempting to dampen market excesses.



* Average of z-scores of AAII and Investors Intelligence bull-bear spreads and NAAIM Exposure Index.

As was just noted by JPMorgan Chase & Co. chief strategist, Marko Kolanovic, the "prevailing sentiment is of exuberance and greed". (12) This suggests that markets have probably rebounded too far, too fast, and that most asset classes will need to, at minimum, retrench over the very near term.

Over the more intermediate term, we still find the aforementioned high-quality, low-valuation stocks that provided a shelter during last year's storm relatively attractive. This is in contrast to most of the stocks that have driven the market higher in 2023, which may be more vulnerable if the Fed continues to tighten monetary policy, as higher interest rates tend to punish lower-quality stocks, highly-valued stocks and speculative stocks with little-to-no earnings most severely.

We have no doubt that there will come a time when more speculative investments will have their time in the sun on a more sustainable basis, particularly once economic growth has moderated, service-sector inflation is under better control, and the Fed is approaching a new easing cycle.

However, we remain of the opinion that the Fed still has at least two or three interest rate hikes in front of it, and we do believe that the Fed will ultimately be successful in catalyzing, at minimum, a mild economic contraction. This expectation suggests to us that, while we are very bullish on most capital markets over the next two-to-five years, it still makes sense to emphasize quality and reasonably-priced securities in one's portfolios.

While this opinion is largely out of consensus, and may cause us to underperform over the near term, particularly if the recent rally in higher-risk assets regains its footing, we still think that it makes sense to remain somewhat cautious until such time when we have reason to believe that the Fed's crusade against inflation is more definitively approaching its conclusion.

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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.

Goldman Sachs (GS) most-shorted basket contains the 50 highest short interest names in the Russell 3000; names have a market cap greater than $1 billion.

Goldman Sachs (GS) non-profitable technology basket consists of non-profitable U.S.-listed companies in innovative industries. Technology is defined quite broadly to include new economy companies across GICS industry groupings.

The S&P Composite 1500 combines three leading indices, the S&P 500®, the S&P MidCap 400®, and the S&P SmallCap 600®, to cover approximately 90% of U.S. market capitalization. It is designed for investors seeking to replicate the performance of the U.S. equity market or benchmark against a representative universe of tradable stocks.

Citigroup Economic Surprise Index represents the sum of the difference between official economic results and forecasts. With a sum over 0, its economic performance generally beats market expectations. With a sum below 0, its economic conditions are generally worse than expected.

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