Volume 150

THE PER STIRLING
CAPITAL OUTLOOK
Performance • Perspective • Per Stirling

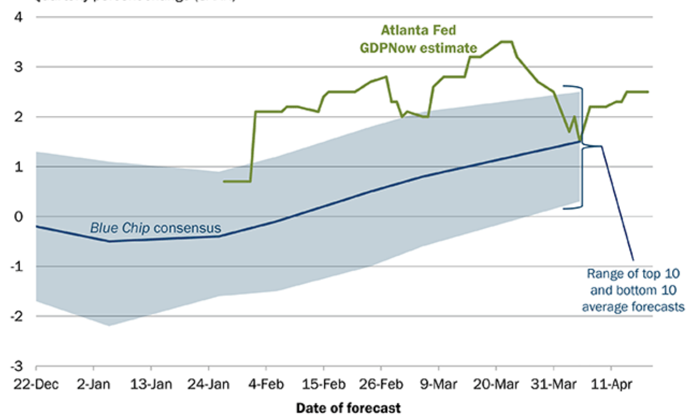
April 2023

Aesop's Fables includes the cautionary warning to "be careful what you wish for, lest it come true!" That is a pretty amazing piece of insight for a narrative written 260 years before the birth of Christ. We are all familiar with the more modern version of this cautionary warning, "be careful what you ask for, you just might get it." No matter how you say it, it is a sentiment that, in the current environment, should arguably be reflected on the front page of every financial publication and investment commentary.

After all, for the better part of a year, investors have been waiting and waiting for the economy to finally slow enough to allow the Fed to at least pause, if not reverse outright, its campaign of steadily higher interest rates.

It has been an environment where bad news was thus viewed as good news, as every piece of "bad" economic news meant that investors were just one step closer to the economy slowing enough to weaken an overly-tight labor market, and allow inflation to return towards the Fed's 2% target. At that point, the Fed could take their foot off of the proverbial "brake", and investors could start looking forward to the eventual onset of the next powerful bull market in equities.

Well, it now seems that the long-awaited slowdown is almost inevitable and, while signs of a contraction are not yet obvious in most coincident data (the Atlanta Fed currently estimates that the U.S. economy grew by 2.5% in the first quarter), the forward-looking indicators of economic growth are now clearly pointing towards decelerating growth, if not outright recession, in both the U.S. and throughout most of the world.

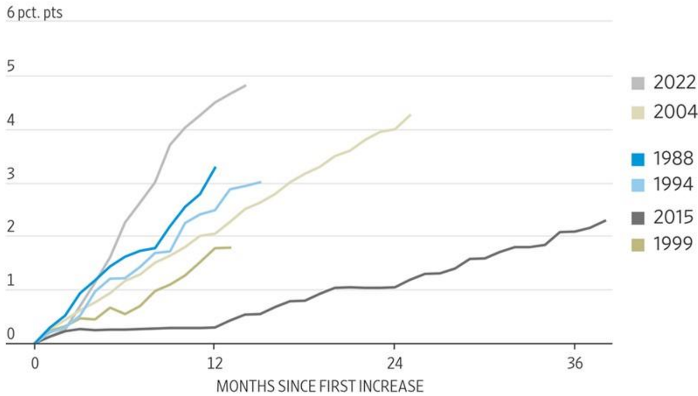


Moreover, while we have long anticipated a modest recession in late 2023 to early 2024, a number of new economic challenges, such as the current credit crunch, suggest to us that we are now likely due for something more substantial than we had previously anticipated. While we are not necessarily looking for a deep recession, we do expect for what follows to be an economic contraction that most Americans will tangibly "feel" in their daily lives.

So, will this anticipated "bad news" be the "good news" that investors have been looking forward to? We certainly think so, but just not yet.

Indeed, we find it extraordinarily telling that the Fed raised interest rates again in March, despite the fact that the consensus opinion of the Fed's over 400 Ph. D. staff economists was that the economy is already likely to enter into recession in 2023. It is perhaps even more telling that current forward guidance from the Fed suggests that they are likely to raise rates <u>at least one more time,</u> when they meet in May, despite the fact that the International Monetary Fund (IMF) just warned that "a hard landing — particularly for advanced economies — has become a much larger risk" and that "the fog around the world economic outlook has thickened."[1]

Cumulative change in federal-funds rate since start of initial rate increase

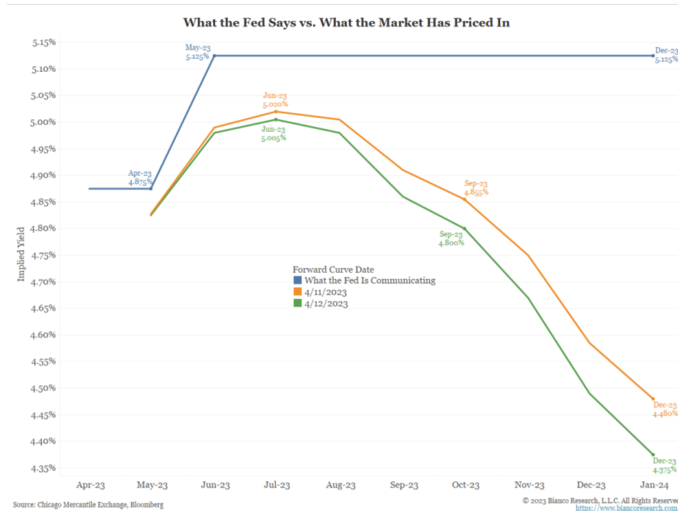


Source: Federal Reserve

For obvious reasons, one might expect for the worlds' central banks to almost immediately take their foot off the "brake", particularly in light of the significant lag between interest rate hikes and their economic impact, which is broadly perceived to be somewhere between eight and eighteen months. This suggests that a significant majority of the impact from the historic accumulation of rate hikes that already took place is only now starting to be felt in the economy.

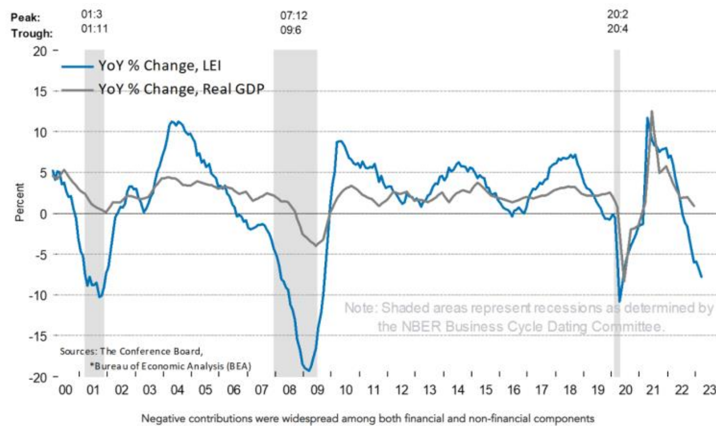
In point of fact, Fed Funds futures strongly suggests that this is exactly what the Fed will do, and specifically that the Fed will raise interest rates by one-quarter of one percent in May, and then cut interest rates by at least one-half of a percent by the end of the year.

You will note that this expectation is in direct conflict with what the Fed is saying that they are going to do in regard to rates (blue line), which suggests to us that investors clearly believe that economic conditions will become so dire that the Fed will be forced by circumstances to abandon their fight against inflation, and to stimulate the economy through lower interest rates, an expansion in money supply, and potentially even an end to quantitative tightening.



Quantitative easing is basically the reversal of the hyper-expansionary policies that the Fed introduced in the wake of the COVID pandemic, through a $95 billion per month reduction in the Fed's balance sheet. Quantitative tightening basically reduces economic liquidity by taking cash (which can be spent) out of the economy, and replacing it with government debt (which cannot be spent).

We view this remarkable divergence between the forward guidance being provided by the Fed about future monetary policy and investor expectations for what the Fed will actually do (rather than just say) regarding interest rate policy as a point of risk, particularly since we believe that the Fed will ultimately stick to their guns, and keep interest rates both higher and higher for longer than most investors expect.

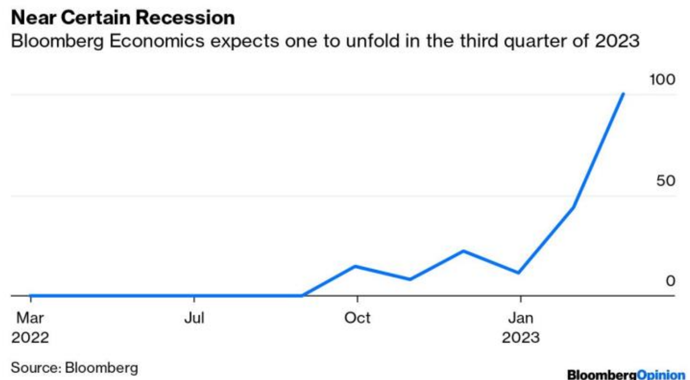


The problem is that the markets are expecting (and are therefore pricing securities for) a very different scenario.

We view the Fed's continuing commitment to restrictive monetary policy (i.e., slowing the economy through higher interest rates and reduced money supply and credit) in the face of a growing likelihood of a significant slowdown in the economy (see the above chart of the Conference Board's Leading Economic Indicators) as confirmation that they are perfectly willing to accept both a recession and a significant weakening in the labor markets as necessary evils to get inflation back under control.

This policy should not be a surprise, as Powell has tried to prepare the markets for this sustained battle against inflation for almost a year. In May of last year, Powell warned that the U.S. could feel "some **pain**" as the central bank raises interest rates to fight inflation, and that "restoring price stability is an unconditional need — it's something we have to do." [2]

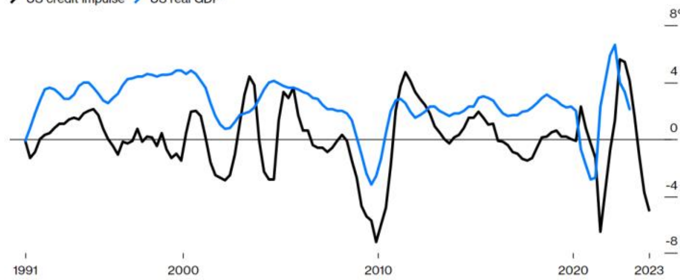
He issued another warning during his Jackson Hole speech on August 26th of last year, when he said "while higher interest rates, slower growth, and softer labor market conditions will bring down inflation, they will also bring some **pain to households and businesses**… These are the unfortunate costs of reducing inflation. But a failure to restore price stability would mean far greater pain." [3]



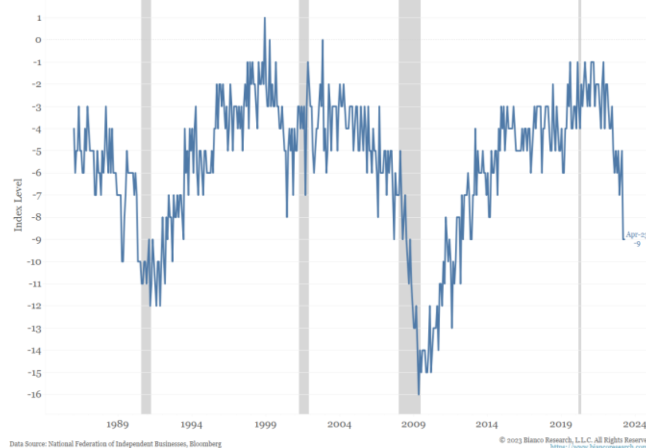
We think that the likelihood of recession should be evident to almost everyone, including the Fed.

However, we continue to believe that the Fed will remain resolute, and that they are prepared to tolerate both an economic contraction and a surge in the unemployment rate, if that is what it takes to finally break the back of inflation. We believe that another factor to consider is the Fed's need to rebuild its credibility, after its disastrous premise that inflation was only transitory, and its decision to keep interest rates pegged near 0% for far too long, thus further exacerbating inflation. Reversing course on policy before they effectively quell inflation would almost certainly further damage the Fed as an institution that relies heavily on the power of their words to guide the markets and the economy.

All things considered, we would consider a recession likely even if the Fed were to not only stop raising rates, but even started cutting them. This is partially because of the likelihood that most of the rate hikes that already occurred are yet to have their full impact on the economy. It is also because of the recent, albeit limited, banking crisis.

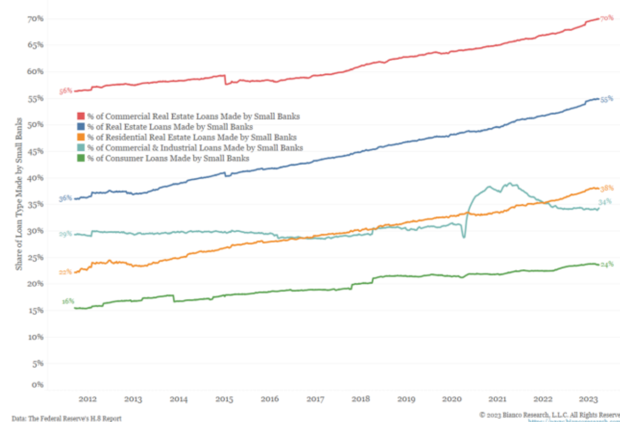


Perhaps "limited" is too gentle a word as, while the number of bank failures has been very limited, at least to-date, there is still a massive flow of money out of the banking system into mutual fund money markets and Treasury bills, due to the much higher yields available in those non-bank assets. With less money to lend, and prospects for a recession on the horizon, banks are tightening their lending standards and loaning out less money, which is producing a significant "credit crunch". As you can see above, tightening credit conditions (black line) have historically been a significant weight on "real GDP" (inflation-adjusted economic growth) (blue line).



Indeed, Federal Reserve Bank of Chicago President Austan Goolsbee recently hypothesized that the credit contraction produces the economic impact of an additional 25 to 75 basis points (0.25%-0.75%) of rate hikes by the Fed. [4]

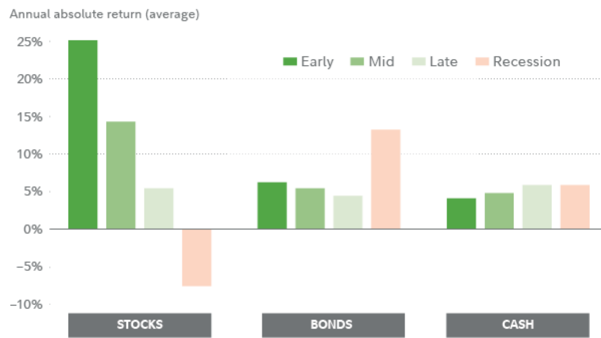
What might be equally important, at least from an investor's perspective, is the impact that tighter credit conditions have historically had on small and mid-sized companies, which tend to be much more dependent on bank loans, as they do not enjoy the same ability to raise capital through the bond markets that larger companies have. It is one of the reasons why we believe that it is likely prudent to reduce exposure to smaller capitalization stocks until at least such time when the Fed pivots, and actually starts cutting rates.



Similarly impacted by their high interest rate-sensitivity is real estate in general, and commercial real estate in particular. Indeed, when you consider that 70% of all commercial real estate lending is currently done by the same small banks that are experiencing a shrinking deposit base, it also makes us rather cautious about investing in commercial real estate-related securities like REITs (real estate investment trusts).

So, what does this expected environment likely mean for capital markets in general? If we use history as a guide, the answer is probably exactly what you would expect. Recessions are the one part of the economic cycle when stocks tend to fall more than they go up.

Investment returns before, during, and after recessions



Past performance is no guarantee of future results. Asset class total returns represented by indexes from the following sources: Fidelity Investments, Ibbotson Associates, and Bloomberg Barclays as of March 31, 2021. Source: Fidelity Investments proprietary analysis of historical asset class performance, which is not indicative of future performance.

In contrast, bonds tend to make their greatest gains, as recessions tend to lead to lower interest rates, and lower interest rates cause the prices of almost all bonds to move higher.

It is noteworthy that, once the recession ends, and the next expansion begins, both stocks and bonds tend to produce better-than-average returns, as the early stages of recovery tend to feature low inflation and falling interest rates, while the returns derived from both asset classes tend to diminish in the later stages of recovery, as inflationary pressures start to build, and investors start to anticipate the return of higher interest rates.

Once the economy enters into recession, the sectors that have historically outperformed are consumer discretionary stocks (like Amazon, Home Depot and McDonalds), consumer staples companies (like Procter & Gamble and Coca-Cola), healthcare-related stocks, and utilities.

Once the economy starts to emerge from recession, more economically-sensitive stocks tend to retake their traditional leadership roles, including financials, real estate, and technology, in addition to industrial and materials-related companies.

Some types of stocks have historically performed better than others in recessions

EQUITY SECTOR	RECESSION	EARLY
Financials	--	+
Real estate	--	++
Consumer discretionary	+	++
Technology	--	+
Industrials	--	++
Materials		+
Consumer staples	++	
Health care	++	--
Energy		--
Communication services	-	
Utilities	++	--

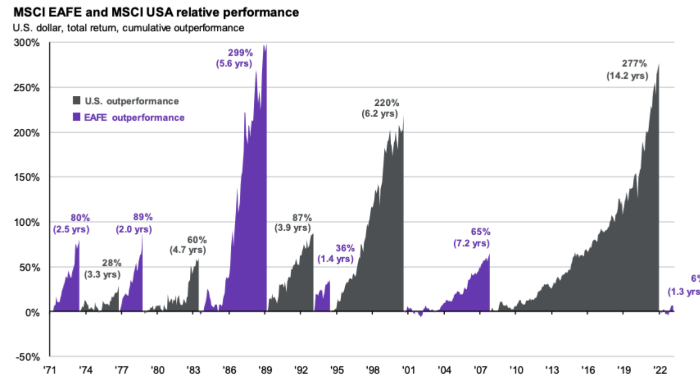
++ Consistently overperform   -- Consistently underperform   No clear pattern
\+ Overperform   - Underperform

Unshaded (white) portions above suggest no clear pattern of over- or under-performance vs. broader market. Double +/- signs indicate that the sector is showing a consistent signal across all three metrics: full-phase average performance, median monthly difference, and cycle hit rate. A single +/- indicates a mixed or less consistent signal. Annualized returns are from 1962-2020, represented by the performance of the largest 3,000 US stocks measured by market capitalization. Sectors are defined by the Global Industry Classification Standard (GICS®). Source: Fidelity Investments (AART), updated as of March 31, 2021.

It is noteworthy that consumer stocks, including both staples and discretionary stocks have historically tended to hold their own almost regardless of the economic cycle, which is particularly telling when you consider that consumer spending accounts for approximately 70% of the entire U.S. economy. [5]

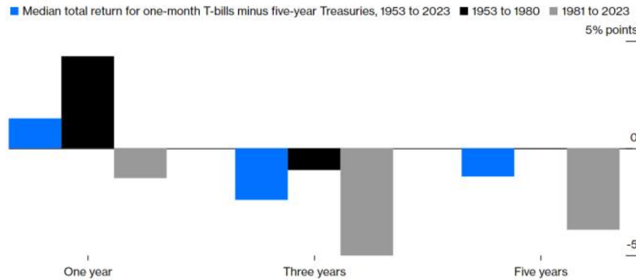
In the current environment, we believe that it makes sense to invest in larger, high-quality companies, that have predictable earnings, strong balance sheets, high levels of free cash flow, reasonable valuations (a few mega-cap tech stocks aside) and low interest rate-sensitivity.

We also think that it makes sense to increase one's holding in the international equity markets, which should benefit from what we expect to be a falling U.S. dollar, plus much lower valuations, and the fact that they are finally outperforming domestic markets after fourteen long years of underperformance.



In addition, unlike in the U.S., most foreign countries did not supplement their pandemic-related, aggressively-stimulative monetary policies with similarly aggressive fiscal policies, which means that they are not as hindered as the U.S. is, by a need for their central banks to drain excessive liquidity from their financial systems.

In regard to fixed income, the lesson of history is that in periods like the present, when the yield curve is inverted (short-term rates are higher than longer-term rates), investors tend to make better returns by investing in intermediate and longer-term securities, despite the fact that short-term securities currently have higher yields. Historically, the higher initial yields have been more than offset by the capital gains enjoyed by somewhat longer-term maturities, as interest rates ultimately fall along with inflation.



Another important lesson from history is that one should emphasize higher quality debt securities when the yield curve is inverted, and that lower quality debt has historically underperformed Treasuries in similar periods by an average of more than 5% (in the year following the inversion).

We recommend sticking with higher-quality securities (regardless of asset class), avoiding excessive risks, and keeping some cash available to take advantage of investing opportunities as they arise.

High-yield spreads been volatile, and an inverted yield curve has generally been followed by negative excess returns

Starting 3-month/10-year Yield Curve Slope	Average next 12-month excess return
Less than zero	-5.3%
Between 0 and 100 basis points	-1.0%
Between 100 and 200 basis points	3.5%
Above 200 basis points	6.9%

The investing environment in the U.S. should start to get better in the not-too-distant future, once more of the pandemic-related excesses have been removed from the global financial system. We just do not believe that we are there quite yet.

Disclosures

Advisory services offered through Per Stirling Capital Management, LLC. Brokerage services and securities offered through B. B. Graham & Co., Inc., member of FINRA/SIPC. Per Stirling Capital Management, LLC, and B. B. Graham & Co., Inc., are separate and otherwise unrelated companies.

This material represents an assessment of the market and economic environment at a specific point in time and is not intended to be a forecast of future events, or a guarantee of future results. Forward-looking statements are subject to certain risks and uncertainties. Actual results, performance, or achievements may differ materially from those expressed or implied. Information is based on data gathered from what we believe are reliable sources. It is not guaranteed as to accuracy, does not purport to be complete and is not intended to be used as a primary basis for investment decisions. It should also not be construed as advice meeting the particular investment needs of any investor.

Nothing contained herein is to be considered a solicitation, research material, an investment recommendation or advice of any kind. The information contained herein may contain information that is subject to change without notice. Any investments or strategies referenced herein do not take into account the investment objectives, financial situation or particular needs of any specific person. Product suitability must be independently determined for each individual investor.

This document may contain forward-looking statements based on Per Stirling Capital Management, LLC's (hereafter PSCM) expectations and projections about the methods by which it expects to invest. Those statements are sometimes indicated by words such as "expects," "believes," "will" and similar expressions. In addition, any statements that refer to expectations, projections or characterizations of future events or circumstances, including any underlying assumptions, are forward-looking statements. Such statements are not guarantying future performance and are subject to certain risks, uncertainties and assumptions that are difficult to predict. Therefore, actual returns could differ materially and adversely from those expressed or implied in any forward-looking statements as a result of various factors. The views and opinions expressed in this article are those of the authors and do not necessarily reflect the views of PSCM's Investment Advisor Representatives.

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

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 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 MSCI USA Index is a stock market index that measures the. performance of large- and mid-cap companies in the U.S. With 625 constituents, the index covers approximately 85% of. the market capitalization in the U.S.

The Bloomberg USD High-Yield Corporate Bond Index is a rules-based, market-value-weighted index engineered to measure publicly issued non-investment grade USD fixed-rate, taxable and corporate bonds.

Citations

(1) "I.M.F. Lowers Growth Outlook Amid Financial System Tremors", Alan Rappeport, Posted 4/11/2023 IMF Lowers Growth Outlook Amid Financial System Tremors - The New York Times (nytimes.com)
(2) "Powell: Fed's fight against inflation may bring 'pain'", Sylvan Lane, Posted 05/17/2022, https://thehill.com/business/3491772-powell-fed-will-wage-painful-fight-against-inflation/
(3) "Powell warns of 'some pain' ahead as the Fed fights to bring down inflation", Jeff Cox, Posted 08/26/2022, https://www.cnbc.com/2022/08/26/powell-warns-of-some-pain-ahead-as-fed-fights-to-lower-inflation.html
(4) "Fed's Goolsbee Calls for Policy Caution Amid Credit Uncertainty", Catarina Saraiva, Posted 4/11/2023 https://www.bloomberg.com/news/articles/2023-04-11/fed-s-goolsbee-calls-for-policy-caution-amid-credit-uncertainty?sref=YfRIauRL
(5) "Components of GDP Explained", Kimberly Amadeo, Posted 01/18/2022, https://www.thebalancemoney.com/components-of-gdp-explanation-formula-and-chart-3306015#:~:text=GDP%20is%20the%20sum%20of,output%20of%20its%20underground%20economy.&text=Consumer%20spending%20comprises%2070%25%20of,components%20of%20the%20U.S.%20economy.