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THE PER STIRLING CAPITAL OUTLOOK
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Renowned inventor Alexander Graham Bell famously noted that, "When one door closes another door opens; but we often look so long and so regretfully upon the closed door that we do not see the ones which open for us". This flaw in human nature seems particularly evident amongst investors, who generally require significant confirmation before trusting a new market trend, and who will often, to their own detriment, over-stay their welcome in long-standing market trends.

In investing, these transition points are often called "inflection points" when they have short-to-intermediate-term relevance and "secular shifts" when they have significant and long term importance.

We are of the opinion that we are at an inflection point, and perhaps even a secular shift, in both the domestic equity and debt markets. Importantly, it would not be at all unusual to see both the debt and equity markets experience a simultaneous secular shift, as equity and bond (debt) prices tend to react to economic and geo-political news in the exact inverse of one another.

In the past several *Per Stirling Capital Outlooks,* we have offered in significant detail the rationale for why we believe that recent changes in the global macro-economic fundamentals paint an increasingly bullish picture for domestic equities. There is also an argument that can be made in favor of emerging market equities, and even some reason to believe that there is room for a rebound in European equities, although we must question whether or not the additional risk associated with direct European exposure is justified by the potential reward.

Indeed, in the month since our most recent writing, the fundamental reasons for investing in equities have continued to grow, as we will discuss in the second half of this writing. However, in the meantime, we will turn our attention to the "door" that we believe is closing…a closing that would signify the end of a historic, secular bull market in bonds that started all the way back in September of 1981. At that time, the 10-year U.S. Government bond yielded 15.84%. As of the date of this report, the 10-year bond yields only 2.07%, after reaching a cycle low below 1.75% in October of last year.

> The bond market has gone from providing "risk-free return" to providing "return-free risk".
>
> *-James Grant of Grant's Interest Rate Observer*

We understand that saying bad things about bonds after all of the money that they have made for investors for more than thirty years is like spitting on the flag, or kicking a puppy, or (dare we say it), disparaging the valuation of technology stocks back in 1999. We must also acknowledge that this rather bearish perspective is not new to us, as we turned very cautious on bonds over a year ago. At that time, we believed bond yields and prices to be ridiculous. One bull market year later, yields and prices appear nothing short of bizarre.

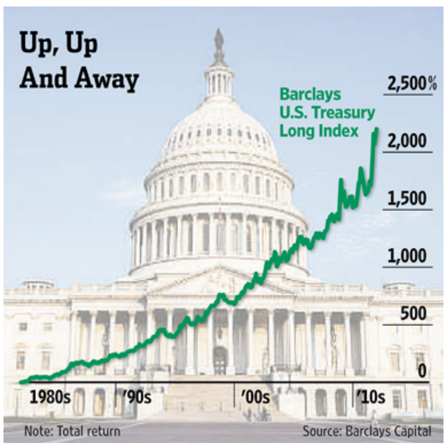
At the epicenter of what we believe will ultimately prove to a major bubble in bonds is the Government bond market, where current long-term yields range from 2.0% to 3.2%.

> "The market can stay irrational longer than you can stay solvent."
>
> - *John Maynard Keynes, Economist*

The problem with our cautious forecast, of course, is that the over-bought condition of bonds is not new, as evidenced by the fact that the pithy James Grant quote from the previous page is actually from December of 2008.

We liken the future prospects of the bond markets to the old saying that, "the market is like a train sitting at the station. You can not dictate the time of departure, but you can see the direction that the train is heading". We believe that the "bond train" is headed south.

Now, there is certainly no guarantee that investors can not get one or two more drops of blood from the bond "turnip". In addition, if the situation in Europe deteriorates in a way that we do not anticipate, or if there were to be a new economic or geopolitical crisis, it would likely give new life to the bond markets. However, we believe that, at this point, it is only a disaster scenario that supports bond prices/valuations and that, over the intermediate and longer-term, bonds are faced with the two-edged sword of negative real yields and probable capital losses.



To explain the concept of negative "real" yields, please consider a scenario where a 30-year U.S. Government bond yields 3%; where the investor holding that bond is taxed at a rate of 30%, and where the current 3.6% per annum inflation rate is constant into the future. The after-tax yield would be 2.1% (3% yield minus 30% taxes). However, with overall prices (inflation) increasing on average at 3.6% per year, the "real", after-tax yield on the bond is a negative 1.5% per year. In other words, if the price of the bond stays the same, the investor will lose 1.5% of their purchasing power every year on the bond investment, even if they hold the bond for thirty years until maturity.

Bond prices are so high relative to stock prices that the yield on the S&P 500 Index and the yield on a 10-year treasury are almost identical.

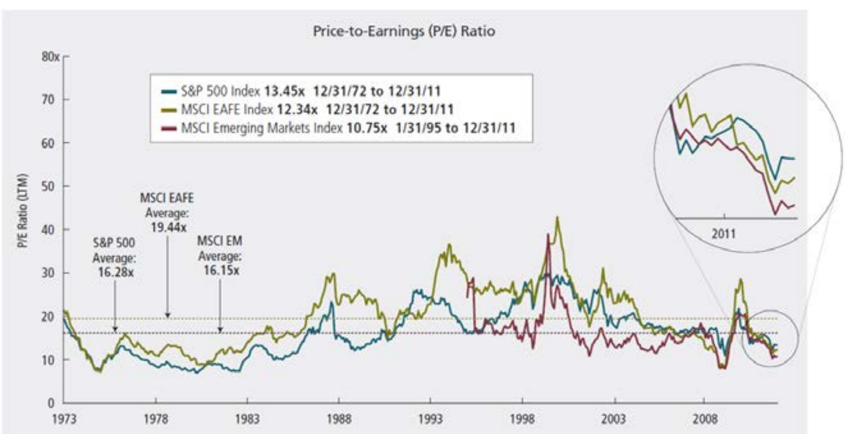
The bottom line, from our perspective, is that bond prices have been driven to "irrationally exuberant" levels by a still prevalent fear that the European economy is going to implode and cause the second coming of the great depression. In the event of such a dire outcome, we could understand the rationale behind investing in treasuries. Indeed, we believe that treasuries and gold might prove to be extraordinary investments under such a scenario.

However, we believe that such a dire result is relatively unlikely now, and becomes less and less likely with every passing day. If we are correct, it means that every improvement in the European situation should produce selling in treasuries, as should every strong economic number, every increase in inflation, and every drop in the unemployment rate. Given our increasingly optimistic global outlook, we are concerned that many holders of high-quality, long-term debt are due for a rude awakening, as the door incrementally but ultimately closes on the global financial crisis.

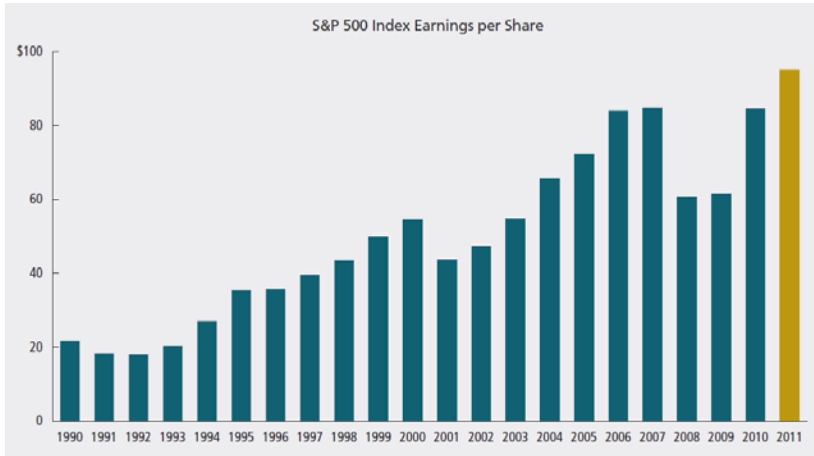
The Barclays' Capital Aggregate Bond Index (blue) provides a broad overview of bond prices versus equities (S&P 500 in red) (2000-2012).

Our biggest concern is with the highest quality debt (particularly U.S. treasuries and German *bunds),* as the only viable justification for current prices seems to be for this disastrous outcome to come to pass.

Of important note, while we believe all of the above to be true, we are not suggesting that one should eliminate all debt exposure from strategic, balanced portfolios. Instead, we are encouraging investors to reduce debt market allocations to the lower end of normal ranges, to strongly emphasize short-term debt over intermediate and longer-duration debt, and to give preference to more economically sensitive forms of debt such as high yield, investment-grade corporate, and emerging market bonds. We also favor other income-oriented investments such as preferred stocks, real estate investment trusts, and the dividend-paying equities of companies that have a proven history of growing their dividends. Even investing in mortgage securities may make some sense, as any future quantitative easing on the part of the Federal Reserve would likely be used to buy up mortgage securities as a means of stimulating housing, keeping rates down, and increasing the domestic money supply.



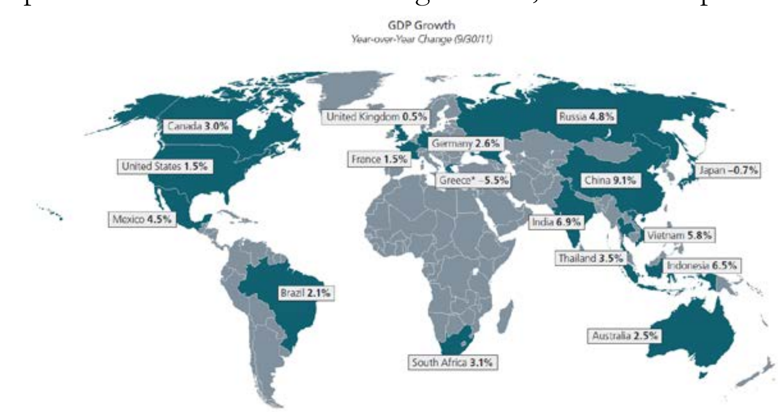
While we believe that it is just a matter of time before the proverbial door closes on the bond markets, we believe that the door is currently opening for the domestic equity markets. We base this perspective on valuations, earnings trends, economic improvement, and on the equity markets' emerging ability to advance in the face of bad news.



The valuation issue is addressed through the chart at the bottom of the prior page, which illustrates current price-to-earnings (P/E) valuations of the domestic, developed foreign market (EAFE), and emerging equity markets versus their historical P/E averages. As of the end of 2011, the S&P 500 Index is selling at a 17% discount from average valuations; the foreign markets (EAFE) is selling at a 37% discount from average valuations, and the emerging markets are selling at a 33% discount from average valuations.

Indeed, America's C.E.O.s consider their companies to be so undervalued that share sales (companies selling their shares to the public) are at the lowest level since 2006 and companies are buying back their shares at the fastest pace in four years. As a result, the number of shares of stock in circulation is actually shrinking for the first time this century.

While valuations appear fairly compelling, earnings trends are simply impressive. S&P earnings-per-share growth rates reached a multi-decade record last year (above), and current earnings announcements are proving to be encouraging relative to somewhat reduced expectations. Thus far this earnings season, 58% of companies reporting have beaten analysts' expectations, 12% have met expectations, and only 30% have missed estimates. It helps to explain why the U.S. has seen the strongest start to the year for the equity markets in 13 years.



Source of chart data: Bloomberg, 9/30/11. GDP (Gross Domestic Product) is the total value of all final goods and services produced in a country in a given year.
*Greece GDP as of 3/31/11.

In regard to the global economy, we are seeing impressive growth in the emerging markets and in the resource-rich economies like Canada, Australia, Russia and Brazil. However, the emerging star may actually turn out to be the United States, where we are seeing gains in employment, housing, and economic growth.

Even as encouraging for equity prices as is the growing chorus of good economic news is the way in which the risk markets like equities and commercial real estate have been able to advance in the face of bad news.

On January 17th Standard & Poor's downgraded the sovereign debt (i.e. government bond) ratings of nine European countries, and both European and U.S. stocks went up anyway. S&P then downgraded the rating on the European Financial Stability Facility from AAA to AA+, thus theoretically impacting the rate that the all-important European rescue fund can borrow funds at, and equity markets just ignored the change. Now it looks like Greece may actually elect to default on their debt in late March, in a disorderly, non-negotiated means and, despite the fact that such a possibility terrified global equity markets just a few months ago, the current equity markets are barely taking notice.

The reason that this may be important is that markets do not react to news in a vacuum. Instead, investors constantly try to anticipate future news by pricing their expectations for the future into current prices. When the news ultimately becomes known, markets end up arbitraging the difference between investor expectations and what turned out to be fact.

We believe that the fact that markets are not reacting negatively to bad news implies that investors have already priced into risk assets the worst of the presently contemplated bad news. This suggests that, when bad things happen, markets do not sell-off, as investors have already priced in that negative outcome. The risk is that reality turns out to be even worse than the most dire of current fears, in which case, the markets would need to price in a worse than expected reality.

The opportunity, which we believe is the most likely outcome, is that the global financial crisis will ultimately be resolved in a way that is less draconian than what is reflected in these fears, which should be great news for risk assets like equities, securitized real estate, and even commodities, and very damaging for inflation-sensitive, flight-to-safety assets like treasuries.

In the very near term, we would not be surprised to see the equity markets pause around current levels, as they consolidate their recent gains. However, over the longer term, we suspect that it is virtually inevitable that all of the quantitative easing and money printing that is going to be required to resolve the crisis will prove to be quite inflationary. It therefore makes sense to us to buy the beneficiaries of inflation (equities, real estate, hard assets, & commodities), and reduce exposures to safe harbors and interest-rate-sensitive assets.

In summary, we think it only prudent to heed the words of Mr. Bell and guard against "look[ing] so long and so regretfully upon the closed door that we do not see the ones which open for us".

-The Per Stirling Asset Management Team