

Merrill's Former Market Expert Says This Is Different From 1999

- Clough called dot-com bust but left firm before proven correct
- Profits this time justify prices, no 'silly IPOs,' he says

By **Alexandra Semenova**

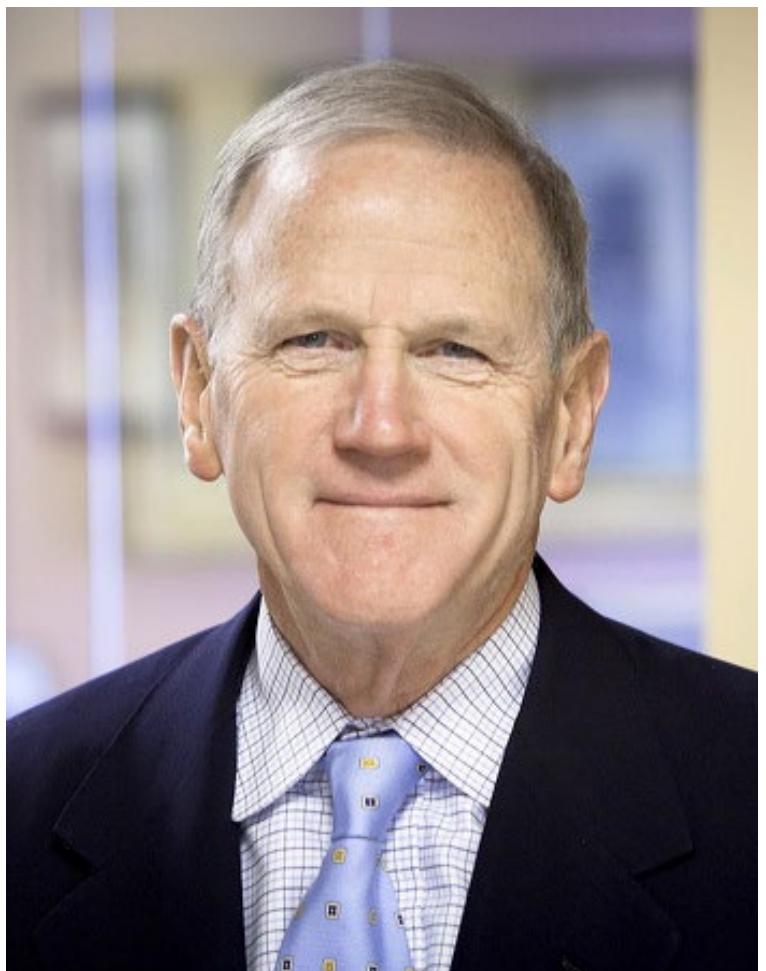
The stock market's unrelenting rally this year has claimed its share of celebrity bears, the best known being JPMorgan Chase & Co. market strategist Marko Kolanovic.

It's a story practically as old as Wall Street itself. Just ask Charles Clough, Merrill Lynch & Co.'s chief global investment strategist from 1987 to 1999, who stayed bearish through the dot-com boom of the late 1990s, but only was vindicated after ultimately leaving the firm.

Looking at today's market, Clough says it's nothing like that era. Now 82 and still running his eponymous hedge fund Clough Capital Partners L.P., he sees companies generating the cash flow to justify their swelling share prices. The economy is doing well. Inflation and interest rates are poised to come down. And in his eyes, equities have plenty of room to move higher.

When comparing the current stock market to the dot-com bubble, "the differences are far more important than the similarities," he said in an interview. "The cash generation and the scale of these companies suggest that they'll be around for a long time and continue to be very profitable."

Clough's hedge fund celebrates its 25-year anniversary this year. Prior to joining Merrill, where he became one of Wall Street's most revered forecasters, he spent time at Cowen & Co., the Boston Company, Colonial Management Associates, Donaldson, Lufkin & Jenrette, and Alliance Capital Management Co. He also is an ordained permanent deacon in the Roman Catholic Archdiocese of Boston and serves in that capacity at his local parish in Massachusetts.



The conversation has been edited for length and clarity.

Despite some recent turbulence, the US stock market has had an incredible run since last year. Does it have staying power?

We have a very positive view. The most important thing that's going on in the economy is inflation is coming back down. It got its start back in 2020 and 2021, largely because there was a series of enormous stimulative packages. At the same time, there were supply restrictions because of Covid. We're really in the reverse of that dynamic. One of the things that makes us fairly confident that demand will be sluggish enough to help inflation come down is defaults on credit cards. Credit card usage really boomed in this expansion as fees went from 12% to above 20%, so that can't be sustainable. We're even seeing defaults on auto loans. Meanwhile, the Fed is watching immigration add to the labor supply and more companies using short-term labor. So if you put demand and supply together, inflation continues to go down. If that's the case, interest rates, especially on the short end, will come down too. This is all bullish for equities. Our thinking is if you look out beyond the volatility that is happening right now, the right strategy is to stay invested, particularly in equities. And with the amount of money sitting at the short end of the yield curve today, there's plenty of fuel for equities looking forward.

Earnings growth is finally expanding beyond the Magnificent Seven and the Fed has started its cutting cycle. Will other groups take over stock market leadership?

The large-cap tech companies are in a world of their own. But that doesn't mean as interest rates come down, there can't be other areas of opportunity. You can see what's going on in the aerospace and defense sector. It's been a very quiet sector for the last 30 years, ever since the collapse of the Soviet Union, and now there's an awful lot of technology and demand to catch up. We look at the housing shortage. Builders have held up very well, and we think durables related to the housing cycle will continue to do well.

How have things been since leaving your role at Merrill and starting your own shop?

We're at 25 years of life, which for a small boutique is a long time. In our portfolio mix, we have both partnerships and closed-end mutual funds. I guess the popular term is a hedge fund. We've got two: one in the medical area, and the other, a broad-based long-short hedge fund. We think thematically where profit cycles will occur and then invest heavily in those industries. The closed-end mutual funds have been around for close to 20 years and that turned out to be a pretty good balance of business. The hedge fund sector has been in some decline for the last few years, although it's a very efficient way of protecting money, so I think it will come back. In the meantime, it's been good to have both of those businesses. A year ago, we took on two exchange-traded funds, they've done very well. Right now, it looks like the firm is sustainable.

During the end of your tenure at Merrill, you were bearish at a time when Wall Street was extremely optimistic. What's it like to go against the grain?

That's just part of the job. There was no reason to get upset about it because the market can do anything it wants. We knew we were right, and we were able to keep analyzing the situation. People were interested in what we had to say. And I think it worked out very well. I remember I watched Cisco Systems pretty carefully, because at the time it was probably the largest investment firm for the dot-com boom with all of the telecommunications infrastructure that had to be built. When I first started going negative,

the stock went up six times before it declined 95% from its high of \$82 in March 2000 to less than \$10 in late-2003.

What worries your clients now?

What is the Fed going to do? What is the election going to do? How is China is going to work? There's always something on the horizon. The most important thing is to have some basis for making investment judgments. What we have tried to perfect over the years is understanding the credit cycle. How money and credit work through the economy are ultimately the deciding factor. What the Fed is doing and how liquidity looks are far more important than elections, international affairs and most of the things people worry about.

What's the best investment call of your career?

The best call I ever made was that interest rates were going to come down, and that call still stands. We have not seen the low in interest rates — the decline that began in the early 1980s. The secular decline in interest rates is not over. It lasted all through the 90s and through the early 2000s. It was interrupted by the reactive government response to the Covid excess of money expansion that happened in 2021. But that's unwinding now. You have to ask yourself: Interest rates went down for 40 years before Covid interrupted everything. What were the reasons and have those reasons changed? The interest rate cycle that began in 1981 has to do with global demographics. It has to do with the fact that there's so much balance sheet debt in private sectors throughout the developed world. And of course, technology is a major factor in the decline in inflation. That's why the analysis we do of credit cycles is so important in creating conviction in our views. I would say that's the most useful call because it's still out there and people are underestimating how far interest rates can ultimately fall.

Do you think Wall Street's practice of setting S&P 500 year-end targets is helpful for clients?

No, I think it is a silly practice. If people could do that, they'd be calling their broker from their yacht. Understanding the dynamics behind the economy and the impact on the capital markets is much more important than picking a target.

What's in your portfolio?

We own Microsoft Corp., Alphabet Inc. and Amazon Inc. We are invested in some of the major US defense companies, Raytheon Co. and General Dynamics Corp. in particular, because there's a clear profit cycle. We are invested in the home builders, DR Horton Inc. and Lennar Corp. There are some ideas where we think there are cycles somewhat independent of the economy. There's a liquefied natural gas cycle, and we're looking for companies that will exploit that.

Are there risks investors are underestimating right now that keep you up at night?

Whatever is out there, you'll be fine. We are confident in our strategies. Know what you don't know and work very hard to understand what that is, but don't lay at night worrying about things. As long as you've done the work and understand the dynamics of the market, the only thing you might be wrong on is timing, and that's not a problem. The biggest issue for the capital markets would be if the Fed continued to raise short-term interest rates and shrink the size of its balance sheet. I think erratic central bank policy would be the one thing that would get you awake at night.

There is debate right now around how much the Fed will cut interest rates in the coming months. How important is the magnitude of cuts?

The direction is more important than the magnitude. If you look at the interest rate any major money center bank is offering on regular demand deposits right now, it's about 10 basis points. Some are lower. If you're a very good client, they'll up it. But the only reason they can up it and get a spread is because they can repo a deposit with the Fed and get Fed funds. That goes away next year. So the bank is telling you what the real price of money is, what they're ready to go out and bid for a deposit. Within a year to 18 months, I think people will be surprised, maybe even astounded, at how fast short-term interest rates have come down. Because there's no demand for deposits. The market has a sense that the demand for money is low. Interest rates are coming down, and I think people will be surprised at the speed with which that happens.

You've had a long and prolific career in the financial industry. What continues to motivate you?

It's fun. It's important to stay alive. It's important to keep objectives in your life. And I can't imagine doing anything else. I just don't know what I would do with myself if I didn't have financial issues to talk about.

SOURCE : "Bloomberg"

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