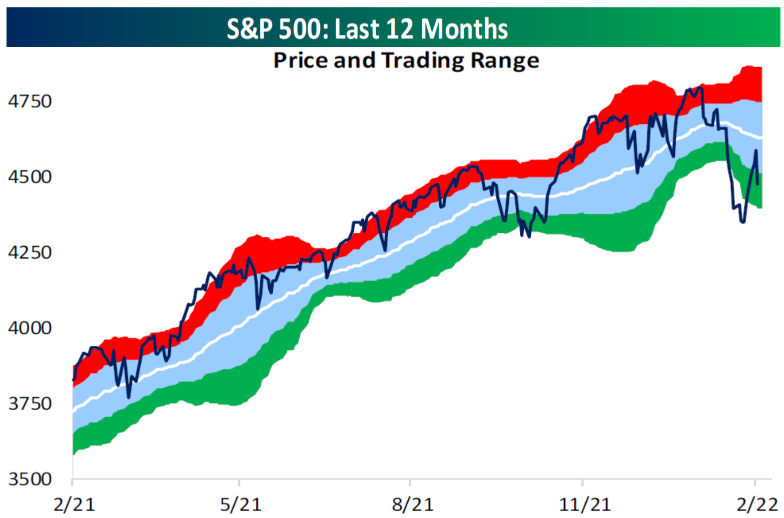
Capital Ideas

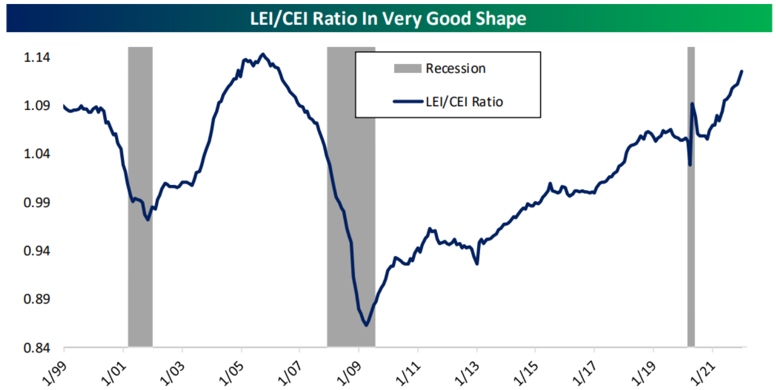
02/04/2022

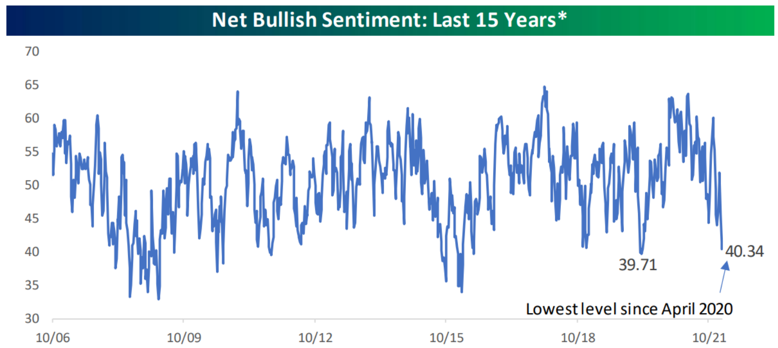


Source: Bespoke Investment Group

Long time clients know we have the most investment confidence when both fundamental and technical indicators are positive. And while we pay attention to current news and politics we always try to separate that noise from our investment decision process. That separation does not apply to news concerning Federal Reserve policy. It is a key fundamental component of our thinking concerning the economy and subsequentially corporate earnings growth. Recently the Fed has stated its intention to shift from extreme credit creation to a more moderate expansionary stance. With that change Fed policy will occupy a larger position in our thinking. But we do not want to join the crowd by overreacting to future credit tightening as investors did in the month of January. According to Bespoke last month was one of the very few times since 1928 when the S&P declined in January by such a large amount. And it was only the fourth time since 2000 that the month contained so many days of high volatility. We could go on with the superlatives, but it is easier to see the results in the S&P 500 chart above. The red and green bands delineate two standard deviation ranges above and below its moving average price. An extreme move outside that range is very unusual and normally precedes a reversal of the trend. As a pure technical indicator this is an unusually reliable signal of short-term reversals. The S&P's rally at the end of the month was such a reversal.

Adding to our confidence in the market's upside potential are strong fundamental readings on the economy. And one of our favorite economic statistics is the ratio of leading to coincident economic indicators. Almost without exception it turns down before a recession. Again, the chart is worth a thousand words. Except for the COVID shutdown, when the ratio turned lower six months beforehand, lead times have been even longer in signaling economic distress. Currently the ratio has recovered fully from the shutdown shock and looks very healthy going forward. As an indicator of continuing economic strength, it negates much of the current economic concern generated by the newest COVID variant. We believe it was the combination of the Omicron variant with concerns over Fed policy that carried the market to last months extremely oversold levels. Apparently while investors panicked the economy continued to signal continuing strength.





Composite of sentiment from AAII, II, and NAAIM surveys.

Source: Bespoke Investment Group

The severity of pervasive negativity becomes apparent in the extreme sentiment readings generated among investors both individual and institutional. Using a ratio which combines readings from investment letter writers, professional investment managers and serious individual investors Bespoke derives an indicator which they call Net Bullish Sentiment. Last weeks reading is the lowest since April 2020, the month after the COVID shutdown lows. Slightly more extreme negative readings occurred only during the 2008 housing debacle and the 2015 panic known simply as "the taper tantrum".

Long time clients know we tend to be contrarian in our thinking. We believe the best buying opportunities are present when fear is the greatest. The January market decline was most likely one of those times. As market volatility retreats and signals appear that the low of January 24th will survive any subsequent selling, we expect to find new investments suitable for your portfolio. Until then your reserves will remain in cash. As always, we thank you for your patronage and encourage you to call us with any questions or concerns.

Sincerely,

C.J. Brott

CJ Brott

Karen Burns

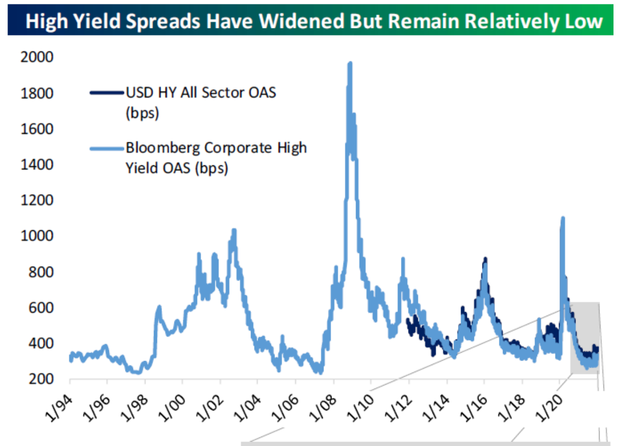
Karen Burns

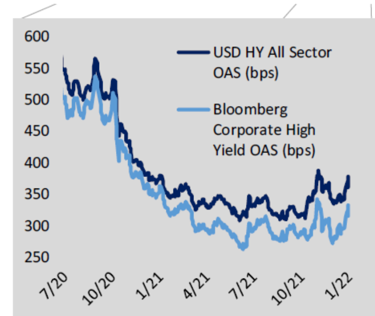
I would like to first express what a pleasure it is to join the outstanding team at Capital Ideas. The firm has proven to be an excellent fiduciary for over nearly three decades, and I am looking forward to the continued success of the organization for the benefit of our clients. I was immediately impressed by the top-tier level of client service that is a core part of the culture at Capital Ideas.

Previously, I served as a portfolio manager for a number of investment strategies and accounts. Given my background in fixed income and credit, I am excited to bring some complementary perspective to the firm's investment process and views regarding markets. I would like to take this opportunity to wish all of our clients a prosperous 2022 and look forward to meeting you. January was a difficult month for equity investors. The S&P posted a return of -5.3% with elevated levels of volatility throughout the month. Notably, however, high yield bond spreads, which typically widen meaningfully during periods of equity market volatility, were relatively flat during January and remain near decade lows.

This implies that large institutional investors view the fundamental economic backdrop and corporate balance sheets as very healthy. As shown on the chart to the top right, following the 08/09 financial crisis, credit spreads have widened meaningfully three times – late 2011 (US debt downgrade/Eurozone debt concerns), late 2015/early 2016 (plummeting energy prices/concerns regarding energy companies' ability to service debt), and March 2020 (onset of Covid mitigation measures). In each of these three instances, investors were clearly concerned regarding the overall economy and the ability of companies to service their debts. As a result, they re-priced corporate bonds at higher yields to compensate for this elevated level of risk.

While these fears turned out to be over-blown (corporate defaults have remained low following 2009 and are virtually non-existent today), the point remains that when





Source: Bespoke Investment Group

bond investors (which are typically large institutional buyers) believe elevated economic risk may be on the horizon, credit spreads typically increase meaningfully. That simply hasn't happened thus far in 2022 despite the equity market sell-off. Thus, while equity investors may be concerned regarding the impact of tighter Federal Reserve policy, the consensus among bond investors appears to be that the fundamental state of the economy is strong. This view is also supported by current economic data showing strong consumer balance sheets and historically low unemployment. To the extent that the economy remains on strong footing, the equity market sell-off may be driven more by sentiment or panic versus fundamental reasoning, presenting attractive buying opportunities as 2022 progresses.

As always, we thank you for your patronage and encourage you to call us with any questions or concerns.

Sincerely,

Andrew Kerai