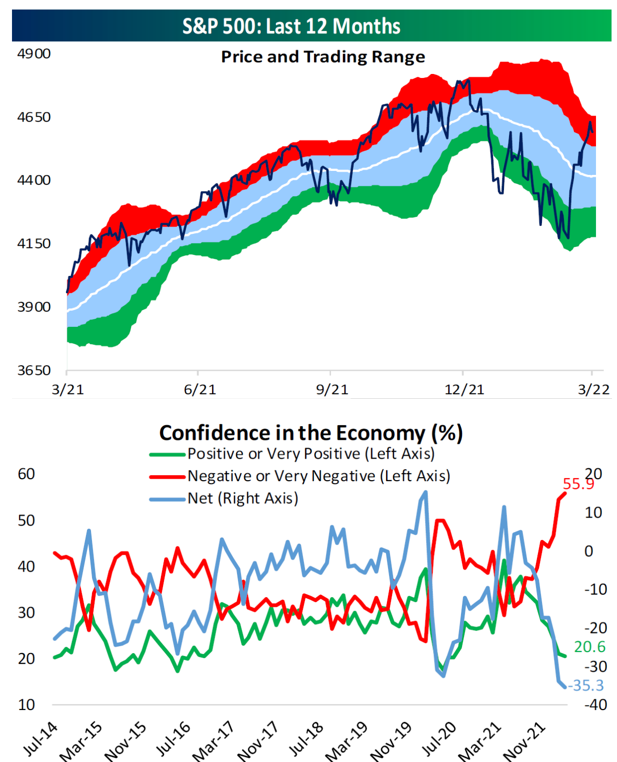
Capital Ideas

04/06/2022

Long time readers of these letters know we prefer to base our market opinions on both technical and fundamental factors. We use technical analysis primarily to focus on short term factors hoping to improve the timing of buy and sell decisions. Currently the two most important technical factors are April's expected seasonal market strength and the late March S&P rally high, which exceeded February's peak. By exceeding highs established in early February the March rally is seen as a signal marking the end of the market correction. Currently that premise is being tested by the recent weakness visible in the S&P price and trading range chart on this page. Current analysis calls for the S&P to remain above 4500 for this to be an end to the correction and not a "dead cat bounce". The fundamental picture is a bit more complicated but very encouraging for the longer-term health of the equity market.

"Top down" fundamental analysis starts with economic data. And in the United States that depends on the consumer. Consumer spending continues to account for 67% of the US GDP. That spending is influenced by consumer's confidence in the economy. Focusing on data from Bespoke Investment



Source: Bespoke Investment Group

we find confidence in the economy at its lowest point since their surveys began. Upbeat feelings toward the future are difficult when wage growth lags consumer price increases resulting in negative real wage growth. That pessimism is being exacerbated by consumer expectations of double-digit prices increases for the foreseeable future. Eliminating those expectations while maintaining currently high employment and strong economic growth

is the Federal Reserve's dilemma. While we recognize that encourages the Fed to raise interest rates, we believe the stock market has discounted much of the effect of those higher rates. We prefer to focus instead on changing future corporate profit margins and their effect on earnings growth. The next few weeks of quarterly earnings announcements and guidance concerning the rest of this year should provide much of the information needed to determine the markets intermediate strength. We recognize that higher interest rates impact corporate profits but believe rising labor costs will now be viewed as a more crucial factor.

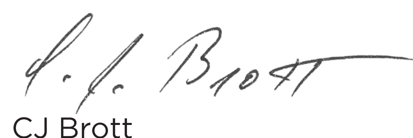
The current focus of financial reporting is an expectation of 1970's style stagflation. While we try to ignore most of the noise generated by financial news outlets, we cannot fail to comment of these comparisons. There are real similarities to that period such as high food and fuel prices, but there are substantive differences. Most important are today's higher labor productivity responsible for much lower unit labor costs. We think this is due to corporate adoption of modern technology. Another key difference between then and now is the pool of labor. In the 1970's the population growth rate was five times greater than today. Boomers were coming of age growing the labor force and the pool of disposable income much faster than today's millennials. While todays "baby bust" generation is aging into the employment pool there are fewer of them, and they are more productive. We think this will allow corporate profit margins to remain high as labor costs remain constrained. In short demographics favor the fundamental strength of corporate balance sheets. For the stock market growing earnings should outweigh the 1970's style stagflation argument of the financial news media's bears. If so, last quarters market pullback was another correction not the start of a long-term bear market.

Now & Then: Economic Indicators

Indicator	Type	1970s	Current
Union Membership	Average	24.0	10.3
Gini Coefficient	Average	0.40	0.49
Population	Ann. Rate	1.0	0.2
Unemployment Rate	Average	7.0	5.2
LFPR	Average	62.6	61.7
Labor Force Growth	Ann. Rate	2.4	1.8
Disposable Income	Ann. Rate	10.1	5.3
Real Disposable Income	Ann. Rate	2.2	-0.2
Real Fed Funds	Average	0.9	-5.0
M3 Money Supply	Ann. Rate	9.0	13.0
HH Debt to GDP	Average	45.7	77.5
CPI	Ann. Rate	8.7	7.4
Core CPI	Ann. Rate	8.1	5.7
Nominal Consumption	Ann. Rate	10.4	12.9
Real Consumption	Ann. Rate	2.4	7.0
Nominal GDP	Ann. Rate	9.9	11.8
Real GDP	Ann. Rate	2.1	5.6
Nonres. Inv. % GDP	Average	13.1	13.3
Res. Inv. % GDP	Average	4.7	4.7
Equip. Inv. % GDP	Average	7.1	5.5
Productivity	Ann. Rate	1.1	1.9
Unit Labor Costs	Ann. Rate	7.8	1.9

Source: Bespoke Investment Group

Sincerely,

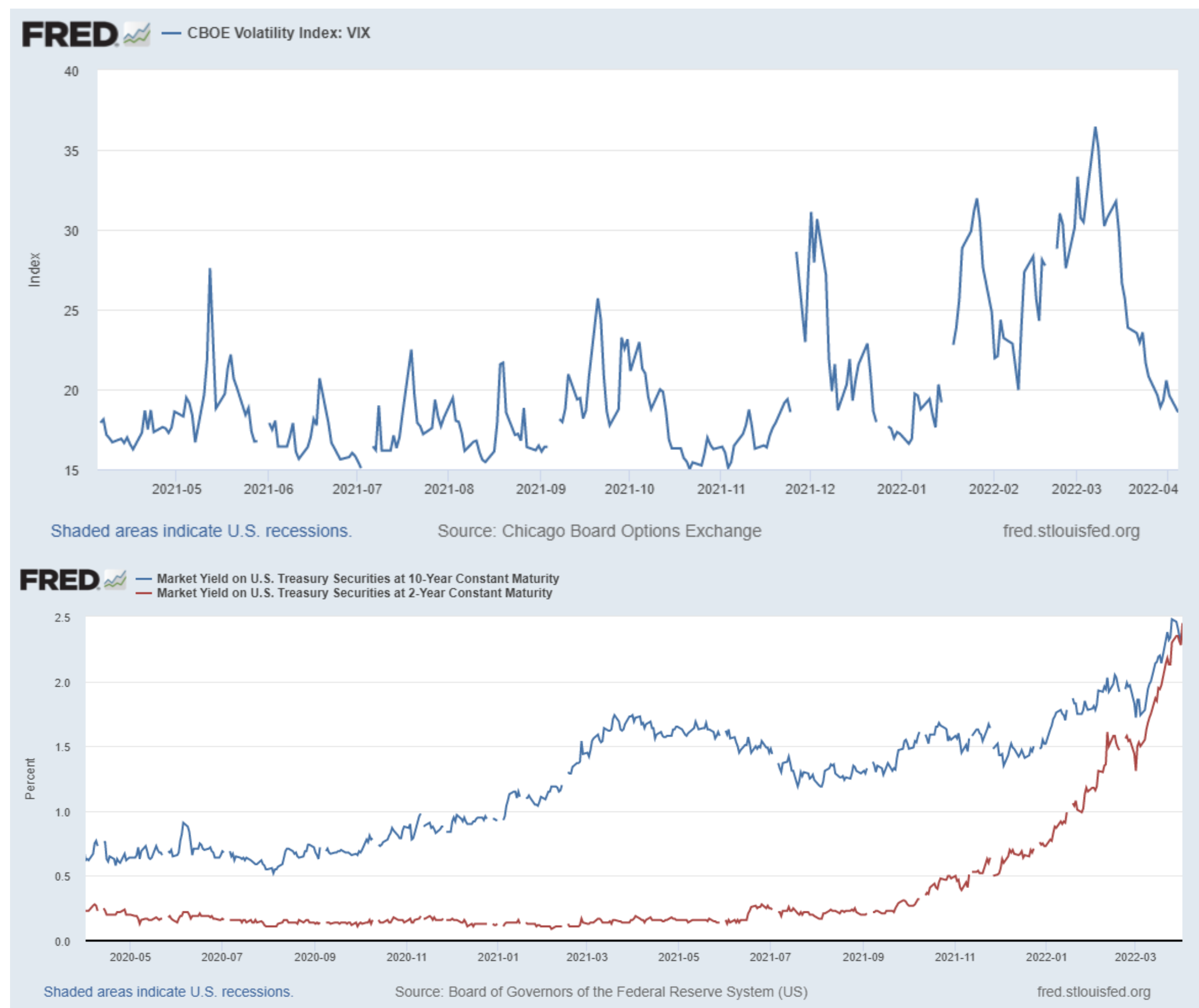


CJ Brott

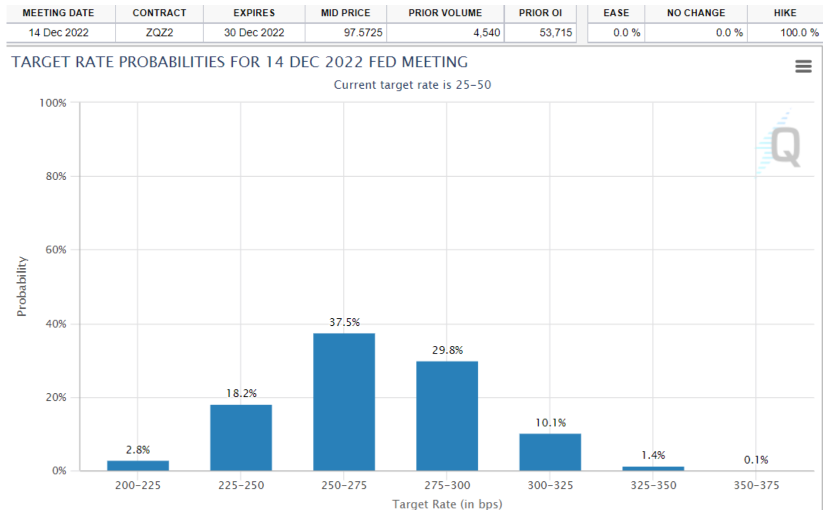
Karen Burns

Investors fared far better in March compared to the first two months of 2022 – the S&P 500 posted a total return of 3.6% during the month, although the index is still down 4.9% year-to-date. While equities rallied, volatility declined meaningfully as the month progressed - the CBOE Volatility Index (the "VIX") closed at 20.56 on March 31 after peaking at 36.55 earlier in the month.

While investors benefited from the equity market rally, many have expressed concern that the Treasury bond market may be indicating a negative signal for the U.S. economy. Specifically, the yield on the two year Treasury note is now above the yield on the ten year Treasury note, indicating that the yield curve is now inverted. While this is a commonly cited data point indicating a greater likelihood of a recession, we believe this is currently indicating the market's expectation that the Fed will raise short-term rates aggressively given elevated inflation. Investors are now expecting the Fed to increase short-term rates (the Fed Funds rate) to roughly 2.75% and 3.50% by the end of 2022 and 2023, respectively, compared to 0.33% currently. Thus, in our view this isn't an indication that investors are flocking to safe haven bonds (longer term Treasury bonds



have sold off meaningfully) but rather a function of a more aggressive Fed. Given credit spreads remain near post-2009 lows, in our view fixed income investors are not signaling that they believe a recession is imminent.



MEETING DATE	CONTRACT	EXPIRES	MID PRICE	PRIOR VOLUME	PRIOR OI	EASE	NO CHANGE	HIKE
14 Dec 2022	ZQZ2	30 Dec 2022	97.5725	4,540	53,715	0.0 %	0.0 %	100.0 %

While elevated inflation (and the Fed's ability to control it) remains an ongoing concern, there are a number of reasons to remain optimistic regarding the U.S. economy. Unemployment remains at the lowest levels since the 1950s, corporate balance sheets remain very healthy against a backdrop of growing earnings, and the consumer has emerged post-Covid with an elevated level of savings. While consumer sentiment has soured meaningfully given elevated inflation, it remains to be seen what the ultimate impact on spending behavior will be. In one scenario, consumers deplete their savings over time and eventually borrow to finance purchases given elevated prices versus meaningfully curtailing spending behavior. This would allow near-term economic growth to continue against a backdrop of persistently elevated inflation and a tight labor market. The end result in this scenario is continued (although perhaps slowing) growth, elevated price levels, and increased borrowing costs driven by Fed policy.

Against this backdrop, what will ultimately drive market behavior is corporate earnings and forward guidance. Companies which are generating a high level of free cash flow and are able to preserve margins (either through expense management or passing through costs to consumers) should benefit. "Longer duration" stocks, meaning companies which are valued based on the expectation of earnings generation and growth in the future, may continue to struggle given investor preference for near-term cash flow through stable to growing dividends supported by near term earnings. Companies with low borrowing needs, high free cash flow generation (which they are paying out through dividends), and pricing power should outperform in this environment.

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

Sincerely,

Andrew Kerai