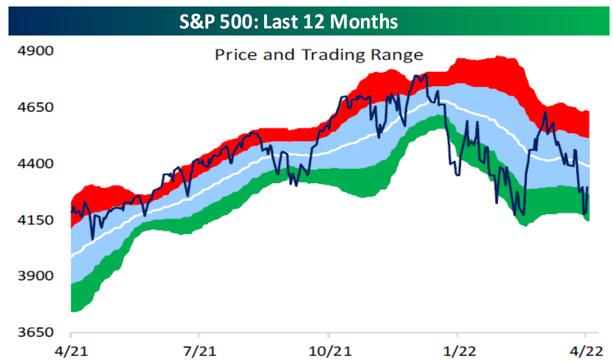
Capital Ideas

05/04/2022

Last month when we wrote this letter our short-term technical indicators were signaling a potential end to the S&P 500 correction with a complicated but optimistic fundamental picture in the economic data. Today the fundamental data is mixed, with manufacturing output, employment, housing, and measures of the consumer weaker. While the deceleration of core inflation, for the first time since last July, was an encouraging sign of strength current data still points to a slowing economic landscape. This was confirmed by the much slower GDP growth in the 1st Quarter. While 4th quarter 2021 GDP grew at 6.7% the 1st quarter 2022 report was a -1.4%. It is possible the data may be pointing to a potential recession defined as 2 or more consecutive quarters of a contracting economy.

In addition to the slowing growth reported on April 28th one of our long-term proprietary technical models turned negative for the 5th time in the last 30 years. The model is based on a “forgetting” algorithm that weights current data against earlier numbers. It is designed to detect major trend changes, so it smooths out the volatility of the short-term swings placing emphasis on secular trend changes

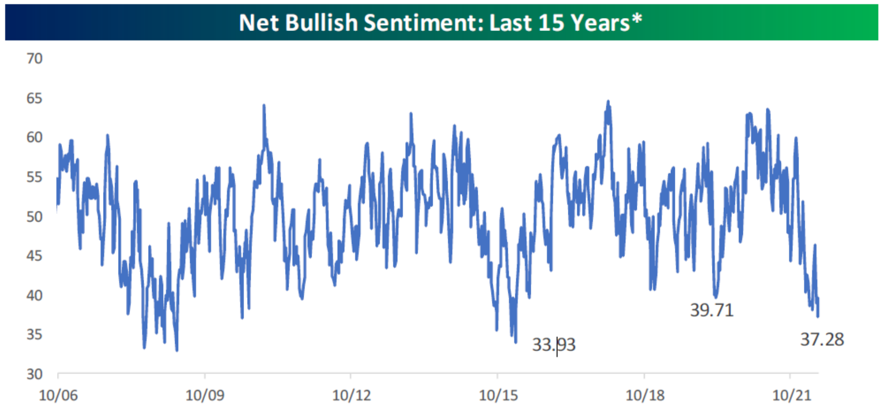


Source: Bespoke Investment Group

in market direction. According to this model the long-term trend may have changed from positive to negative for the first time in more than 10 years.

Based on the potential changes being signaled by our model, on 4/12 we made the decision to trim many positions in your portfolios by 20% to 30 %. This was in anticipation of both increasing volatility in a down trending market and potential for future disappointing economic numbers. Because we were attempting to decrease risk and future volatility the sales were made in the higher growth and volatility equities such as the ARK funds.

While the economic outlook is dreary at best the short- term technical picture for the market may not be as gloomy as the previous paragraphs suggest. One hopeful signal that for the short term this correction may have run its course is the recent AAII sentiment survey. According to AAII Bullish sentiment for the month of April fell by 16.4% and bearish sentiment surged to 59.4%, its highest level since March of 2009. Combining the 2 the bull/bear spread of -43% is its lowest reading since March 2009. Short term this is a sign that the majority of investors wanting or needing to sell have already done so. With no potential overhang of stock for sale and new amounts of cash on the sidelines the glass may now be seen as “half full”. While this may not be “the bottom” the charts illustrate that the last 6 times the spread was below -40 the markets average performance one month to one year out has been much greater and consistently more positive than the norm.



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

Source: Bespoke Investment Group

Currently we can’t say with certainty the correction is over, but we are optimistic that we have experienced the lion’s share of the decline and look forward to a better second half for 2022. We will continue to look for investments that in our opinion will outperform considering future conditions. Until those investments are available, we will continue to hold higher than usual amounts of cash. As always please call us with any questions or concerns and know that we appreciate your patronage and trust during these difficult times.

Sincerely,

Karen Burns

CJ Brott

S&P 500 Forward Returns Following Different Levels of Bullish Sentiment: 2006 - 2022

	One Month		Three Months		Six Months		One Year	
Decile	Average Chg (%)	% Positive	Average Chg (%)	% Positive	Average Chg (%)	% Positive	Average Chg (%)	% Positive
<10	1.23	60.8	2.21	66.2	5.61	71.2	14.23	80.8
10-20	0.53	66.3	2.48	66.3	4.45	67.9	10.83	79.2
20-30	0.86	59.8	2.52	69.1	6.28	78.2	11.77	84.4
30-40	0.86	68.3	3.92	78.0	5.98	75.6	12.60	86.1
40-50	1.31	72.3	2.62	68.7	4.68	74.1	8.63	79.5
50-60	0.41	63.9	1.47	68.7	4.12	74.4	7.39	78.8
60-70	0.57	67.1	1.62	68.3	2.38	65.9	7.08	79.0
70-80	0.24	66.3	2.51	72.3	4.51	75.6	8.80	80.0
80-90	0.34	63.9	1.69	78.3	4.45	77.8	7.20	85.3
90-100	0.82	70.7	2.10	79.3	5.07	82.7	7.32	73.4
All Periods	**0.71**	**65.9**	**2.31**	**71.6**	**4.74**	**74.4**	**9.55**	**80.6**

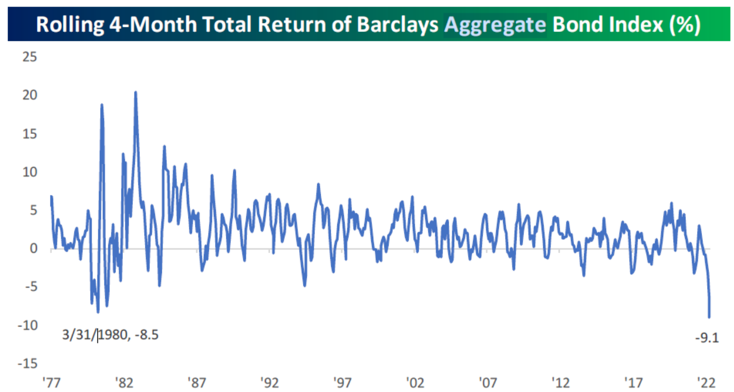
Source: Bespoke Investment Group

After the rally in March, equity investors had a painful month during April – the S&P 500 was down 8.8%, dragging the 2022 YTD return to -13.3%. Bond investors also suffered – the yield on the 10 year U.S. Treasury note ended the month at 2.89% compared to 2.33% at the end of March and 1.51% at year-end 2021. The U.S. Aggregate Bond Index has posted a total return of -9.1% YTD which is the worst return on record.

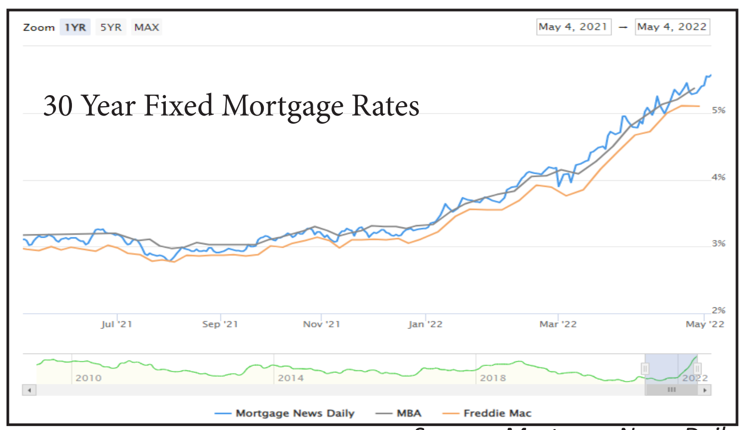
The drivers behind elevated volatility remain the same – persistently high inflation and uncertainty regarding the impact of the Federal Reserve's hawkish pivot. After many years of significant fiscal and monetary support, it is unclear how consumers and businesses will fare as their costs increase given higher inflation and interest rates. For example, the average rate on a 30 year mortgage is now 5.4% compared to 3.3% at December 31, significantly increasing the cost of home ownership for prospective new buyers.

U.S. consumers appear to be noticing the negative effects of rising costs – sentiment is at the lowest level since 2011.

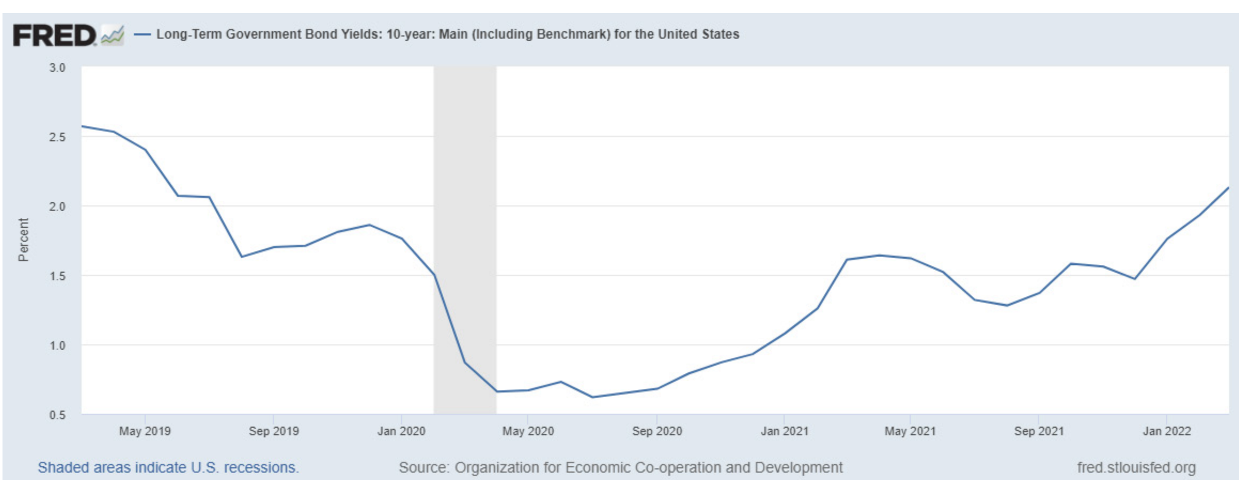
While the removal of monetary stimulus, a higher interest rate environment, and elevated inflation are concerning, there are also positives. Corporate earnings have generally remained strong – of the companies that have



Source: Bespoke Investment Group

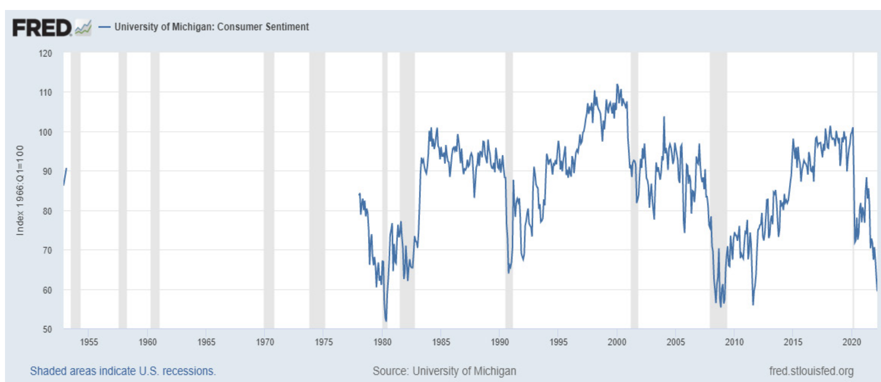


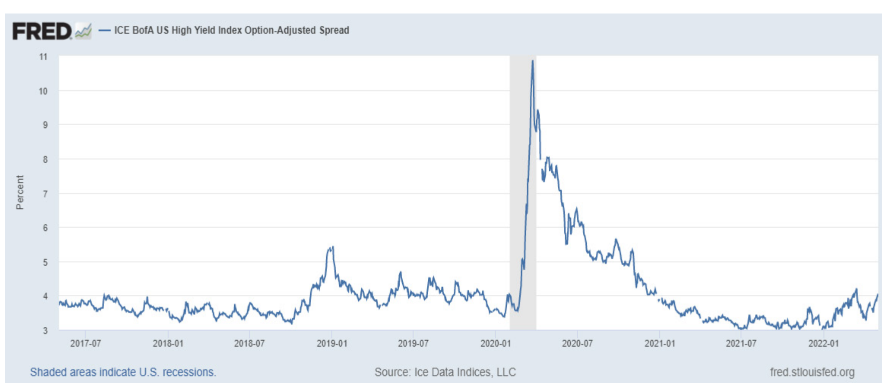
Source: Mortgage News Daily



reported first quarter earnings so far, 80% have reported results above estimates. While sentiment has significantly soured, consumer balance sheets are still healthy given elevated savings levels achieved during 2020 and 2021 due to stimulus payments and, to some extent, lower spending levels during lockdowns (especially in 2020). In addition, credit investors do not appear to expect defaults for businesses to increase meaningfully over the near term, which would typically occur during a deep recession. High yield corporate bond spreads are currently at 3.97%, which is slightly elevated compared to 3.1% at the beginning of the year but nowhere near the levels seen in 2008-2009 or during peak panic in 2020.

Looking forward, investors (as reflected by recent market moves) are trying to determine if inflation will trend lower over the near to medium term and if corporate earnings will continue to trend higher and to what degree. Earnings growth for S&P 500 companies is expected to come in at 9.8% over the next year. We, along with other market participants, are watching to see if those estimates come down, although they have yet to do so. In addition, if the rate of inflation does not decline meaningfully as the year progresses, it is unclear how long consumers can afford to maintain current spending behavior, especially as their borrowing costs increase.





In short, while the current earnings picture remains solid, the go-forward outlook is uncertain. That said, we believe the sell-off presents compelling opportunities for long-term investors as the market has significantly been re-valued lower. For businesses that are strongly positioned with pricing power, healthy balance sheets, and strong free cash flow generation, investors are now able to build positions at a lower price relative to earnings generated by these companies.

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

Sincerely,

Andrew Kerai