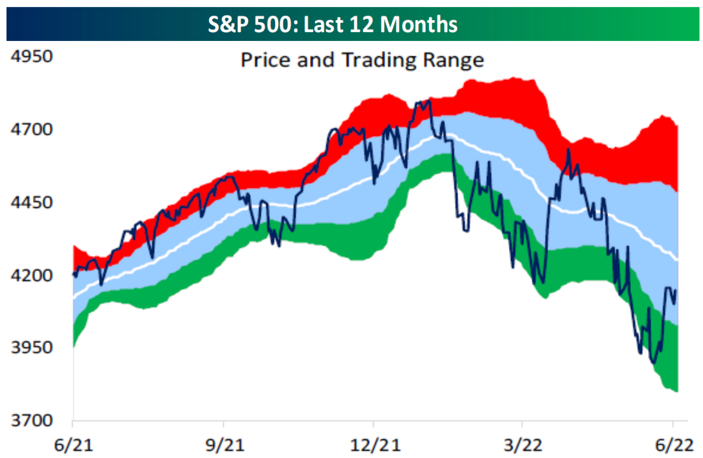
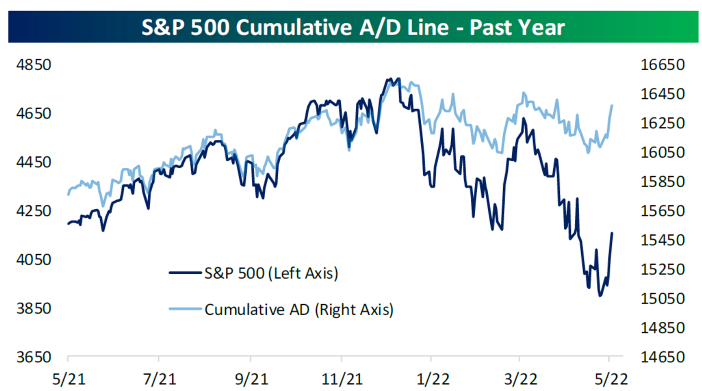
Capital Ideas

06/06/2022

It is yet to be decided if the powerful rally closing out May was the beginning of a new bull market. That can only be determined when, in the long term, the market averages set new high prices. That is secular and our focus will be short term. The evidence both technical and fundamental shows that earlier lows in May should be sustained. Investors were encouraged as the market rallied on news of economic indications showing a slowing inflation. BLS statistics indicated CPI, PPI and Import Prices all declined slightly during the latest period (3/31 to4/30). Technical data indicated market internals were far stronger than prices would indicate as the long-term Advance/Decline improved markedly even while the S&P 500 made new lows. Another sign of the improving risk situation was extreme Price/Earnings multiple compression. In the last 12 months P/E's for trailing twelve earnings declined 36%. More telling was the decline of 26% in the P/E of future 12-month S&P earnings. The ability to buy earnings at such a deep discount was enough to lure many participants back into stocks. Although inconclusive the short term outlook in late May was very positive.





Source: Bespoke Investment Group

In the intermediate term two major negatives are still to be resolved. First is the potential of a longer-term trend reversal. Potentially the 200-day moving average of the S&P may be rolling over. Since the 2008 lows this long-term indicator has moved steadily higher. The recent decline beginning last September may be enough to turn that rising trend

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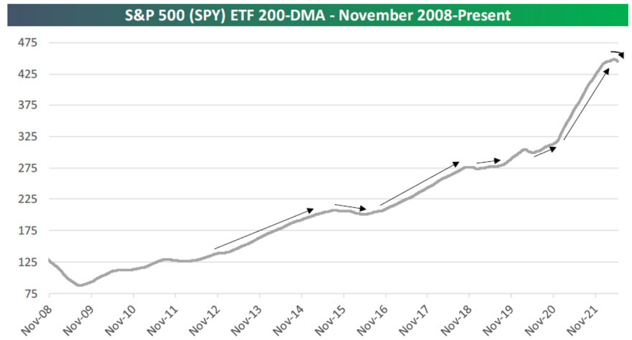
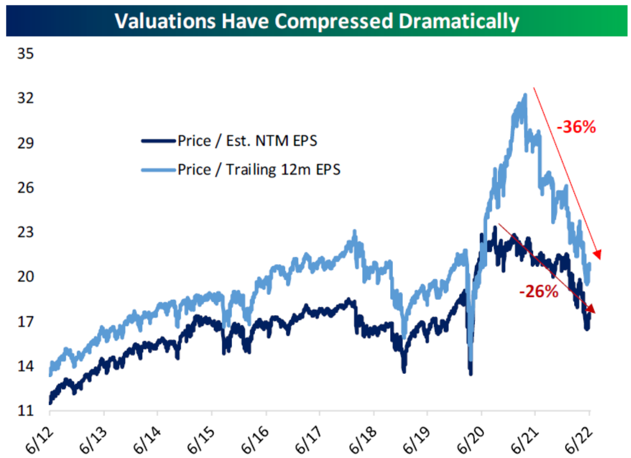
lower. Should that occur we would assume the market lows in May were temporary and take further defensive action. Exacerbating the potential for lower prices is the potential for higher interest rates. Various Fed governors including the Chairman himself have indicated they intend to continue raising interest rates until inflation is reduced by 75%, from the current 8%+ to their preferred target of 2%. Higher interest rates should further compress P/E's while simultaneously reducing corporate earnings. A study of Treasury rate charts indicates those higher rates are coming sooner rather than later.





Source: Bespoke Investment Group

Because the Fed is primarily focused on inflation the markets future direction will be very dependent on the outcome of BLS inflation data. This week the BLS will release readings for May. April's slowing inflation was possibly proof of an old Wall Street adage "the cure for high prices is high prices". That is becoming clear as consumers began to slow purchases with inflation rising faster than wage increases. While not counted directly in CPI calculations, food and energy are important components of daily living. Consumers are already switching to cheaper food brands and evidence is mounting that people may soon be driving less. In anticipation of this trend change we recently sold one-half of the DBC (commodity index fund) we bought last year in anticipation of higher priced food and energy. The rapid price rise was similar to the 100% price increase ARK funds experienced in 2020. ARKK's increases were so great over a brief period we sold portions of those positions as the advance continued. Now we feel it is time to "rebalance" and sell portions of DBC using the proceeds to buy back small amounts of the massively depreciated ARK funds. Because we cannot be completely convinced market lows have been established we will only commit those proceeds generated by the DBC sale to rebalance into ARK. Until such time as markets and the economy demonstrate further indications of future strength we intend to hold currently high cash positions and continue researching suitable investments for your portfolio.

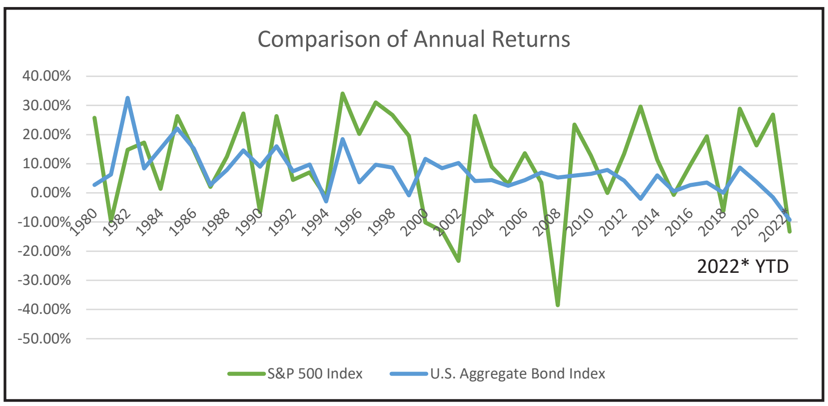
Sincerely,

CJ Brott

Karen Burns

Elevated market volatility continued during May. While the S&P 500 posted a flat return during the month, the index was down roughly 8% at the low point on May 20 before recapturing all losses to rally into month-end. This degree of elevated volatility has been a consistent theme throughout the year for both equity and bond investors. The yield on the 10 year U.S. Treasury note, for example, has ranged from a low of 1.49% to start the year to a high of 3.17% in the first half of May. To put that in perspective, an investor holding a 10 year Treasury note (typically viewed as a safe haven asset) suffered roughly a 14% decline in principal value in less than five months!

While equity market volatility is to be expected, it is unusual for both stocks and bonds to experience this degree of drawdown in such a short period of time, especially given the four decade long bond bull market that began in the early 80s. In fact, since the inception of the U.S. Aggregate Bond Index in 1976, there has been only one full year (1994) in which both U.S. equities and bonds both posted negative returns.



In our view, the market is recalibrating to a new environment consisting of higher inflation and higher interest rates, which has resulted in a negative hit to equity market valuation multiples. The higher level of inflation, driven by a combination of elevated energy prices, supply chain shortages, and persistently strong consumer demand, has driven the Federal Reserve to quickly pivot to a hawkish stance following a period of unprecedented monetary stimulus. While it remains to be seen how aggressive the Fed will ultimately be, thus far in 2022 the market appears to be doing a good deal of the central bank's work for it as evidenced by reduced equity valuations and significantly higher bond yields.

The near-term economic backdrop remains uncertain. However, we believe there are some reasons to be cautiously optimistic. While U.S. consumers are currently being stretched given elevated pricing levels and shortages of goods, they have entered this inflationary period with a significant buildup of savings (estimated at roughly $2 trillion). In addition, we have seen anecdotal evidence that supply chain issues may be abating at least somewhat – Walmart and Target, for example, both highlighted a significant buildup of inventory levels on recent earnings calls. While it may be too soon to suggest that inflation has peaked, especially regarding food and energy prices, if companies can make incremental progress regarding supply chain bottlenecks, that would likely reduce some inflationary pressures plaguing consumers since the middle of last year, which have accelerated meaningfully in 2022. In the most optimistic scenario, the Fed's hawkish pivot reduces consumer demand just enough to help cool inflation but not enough to induce a recession. Meanwhile, as businesses are able to more easily procure products at the same time demand begins to soften, the rate of inflation may start to decline meaningfully towards the back half of the year. Such a scenario would provide a fertile environment for equities and corporate earnings growth in our view.

Many investors have understandably been frustrated by the current market environment. The range of outcomes regarding macroeconomic events is quite wide, as reflected by the sell-off so far in 2022 and the fact that both investor and consumer sentiment are now extremely negative. While we outline the bullish case in the above paragraph, the pessimistic scenario would involve the Fed hiking interest rates to the point demand is significantly reduced, a recession occurs, yet inflation remains persistently high fueled by further increases in energy and food prices along with continued shortages of goods (i.e. stagflation). If this were to occur for an extended period of time, excess consumer savings would eventually become depleted resulting in an uptick in loan defaults and an absence of dry powder to fuel future consumption. While this is not our base case expectation, we acknowledge that it is far from an impossibility.

That said, market pull-backs such as this have generally presented attractive entry points for long-term investors who selectively deploy capital into high quality companies that have sold off meaningfully. Aside from energy-sensitive businesses, there has been little place to hide, creating opportunities to begin accumulating shares of companies which may have been too richly priced half a year ago.

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

Sincerely,

Andrew Kerai