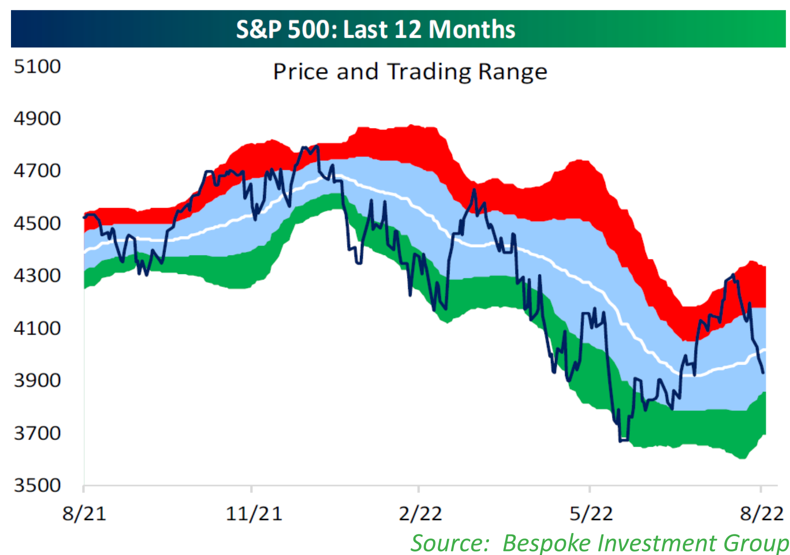
Capital Ideas

09/07/2022

Capital Ideas Advisors
12720 Hillcrest Rd., Suite 910
Dallas, TX 75230

Dear Reader,

Following a strong July, market choppiness returned last month. Volatility was particularly pronounced following Federal Reserve Chairman Jay Powell's hawkish remarks on August 26th at the annual economic symposium in Jackson Hole, Wyoming.



Source: Bespoke Investment Group

The return of elevated market volatility is a clear reminder that the near-term economic outlook is still uncertain. Despite the market's difficulties this year, we still believe there are reasons for investors to become cautiously more constructive about its future performance. We continue to observe current high frequency economic data and are paying particular attention to inflation and consumers' attitudes toward their overall economic health. The confusion created by such mixed data as the current strong labor market yet record low consumer sentiment is creating the elevated levels of anxiety generally referred to as "a wall of worry". The longer the current economic dichotomy exists the greater the probability that investors will simply want to disengage from all investments and seek the perceived safety of cash. Two thoughts occur to us concerning this situation. First cash earns very little, and inflation is a huge tax to pay to own it. Second, all bear markets end when every participant who wishes to sell has done so.

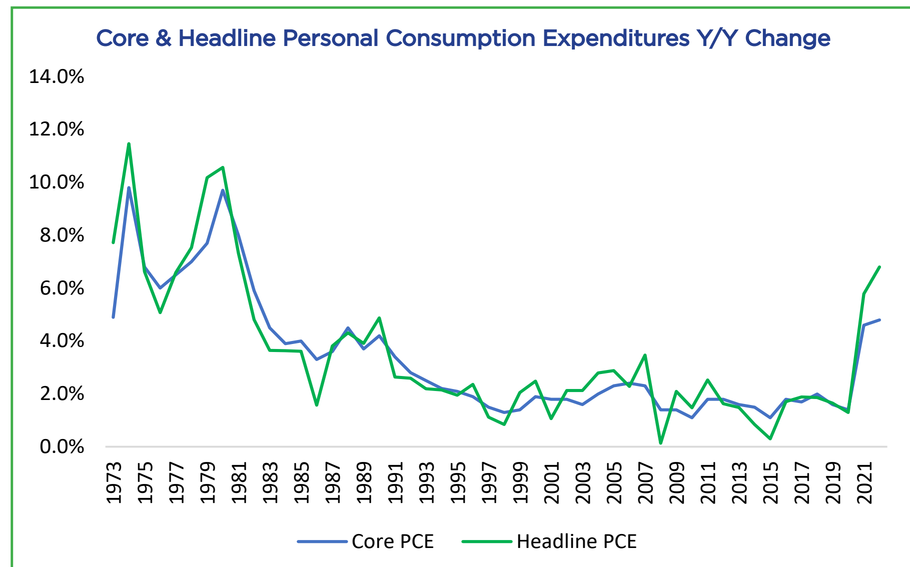
Generally, when coming out of challenging market periods, better near-term visibility supported by fresh data points has provided support for market stabilization and eventually the start of a new bull market. This is particularly true in the late stages of challenging economic events. For example, during the financial crisis of 2008/2009, stocks had lost 57% of their value through

March 2009. At that point investors had reacted to their worst fears and everyone who wanted or was forced to sell had done so. This marked the low in stocks and they posted a return of +23% for the full year of 2009. This was despite negative real GDP growth of 2.6% proving that markets discount the future not past events. Importantly, by March of 2010, despite the awful economic environment, investors became confident enough in their forward visibility to begin buying stocks again.

Today's key anxiety among market participants continues to boil down to inflation and the potential for a near-term recession. Investors are parsing through the multitude of data releases trying to get a better sense whether the highest inflation rate in four decades is finally moderating. Meanwhile, the question remains whether a more hawkish Federal Reserve will lead the U.S. economy into a painful recession with higher unemployment, lower consumer demand, and pressured corporate earnings.

Without a doubt, the last 12 months have been an exceedingly difficult market environment to navigate. We are experiencing a historically sudden shift away from unrestrained credit growth and virtually endless monetary and fiscal accommodation to record setting monetary tightening. In this historically volatile credit environment, investors are attempting to recalibrate asset values in real time. While market sell-offs thus far in 2022 have been painful, they are a necessary and healthy part of asset price discovery. From our perspective, investors want clarity regarding two questions. First, has inflation peaked and how quickly it will trend lower and second, whether we are in a recession and if so how severe it ultimately turns out to be.

While we believe definitive answers to these questions are far from settled, market participants are now beginning to analyze key economic data being generated in this back half of the year. As the current period of high inflation and Fed hawkishness persists, high frequency economic releases will capture the impact of monetary policy changes on the underlying economic environment. Perhaps more importantly, companies have now had time to adjust to higher levels of inflation, including better information on supply chain logistics and inventory levels. We have faith in the ability



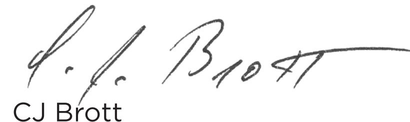
of American businesses to navigate these challenging environments. We are however skeptical of the Federal Reserve's ability to manage inflation. This is primarily due to the Fed's program of reducing goods production with higher rates. This stands in direct conflict with Congress' plans to increase consumption demand by creating more "free" money.

We see ample evidence that companies are beginning to adapt to the evolving landscape. For example, Target and Walmart are heavily discounting certain inventory and reducing orders for hard goods. And in earnings calls, many large businesses have highlighted creative solutions to address supply chain issues. We are not yet prepared to decide whether the U.S. is currently in an official recession, or even if one is imminent. And the official distinction is not really that important as it is only made well after the fact. But we will stick by our belief that market direction will always be driven by expectations for the U.S. economy and corporate earnings results.

Looking to that future we believe there is little that fundamentally threatens the health and foundation of the American economy. In the late 70s/early 80s, interest rates, inflation, and the unemployment rate all hit double digits, marking the worst economic climate since the Great Depression. In 1999-2000 the economy staggered as numerous valueless tech companies collapsed putting many investment banks at risk of collapse. In 2001 the US endured its worst terrorist attack on domestic soil and a significant corporate earnings recession with earnings down 31% Y/Y. In 2008 the highly levered commercial banking system was at risk of worldwide failure. Today, we do not see an economy that resembles that level of fragility. While current elevated inflation and a hawkish Fed continue to pressure markets, we believe current investor pessimism is excessive. In our view the U.S. economy is in significantly better condition than it was during past periods it is currently being compared with. So we believe market downside should be more limited than current negative sentiment indicates.

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

Sincerely,



CJ Brott

Karen Burns

Andrew Kerai