Capital Ideas

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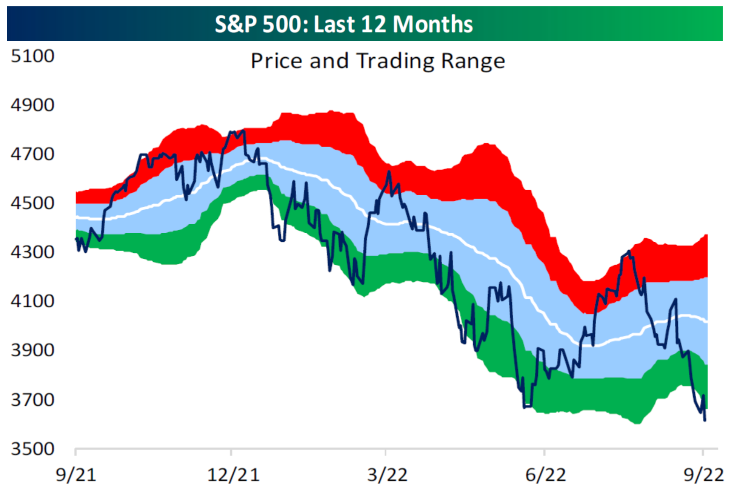
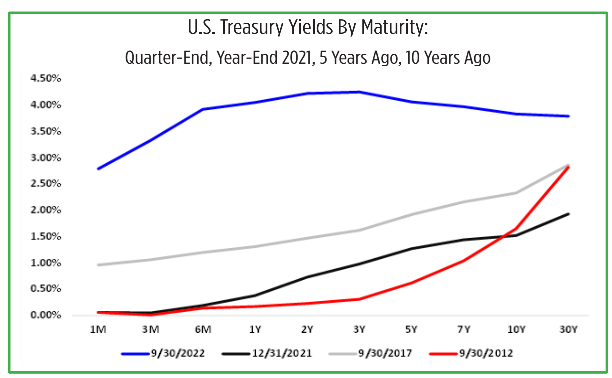
Dear Reader,

The sell-off at the end of August continued throughout September – the S&P 500 declined 9.2% during the month. Stocks have now posted three consecutive quarters of negative returns, the first time this has occurred since the first quarter of 2009. The market continues to be highly sensitive to macroeconomic headlines regarding inflation and Federal Reserve policy.

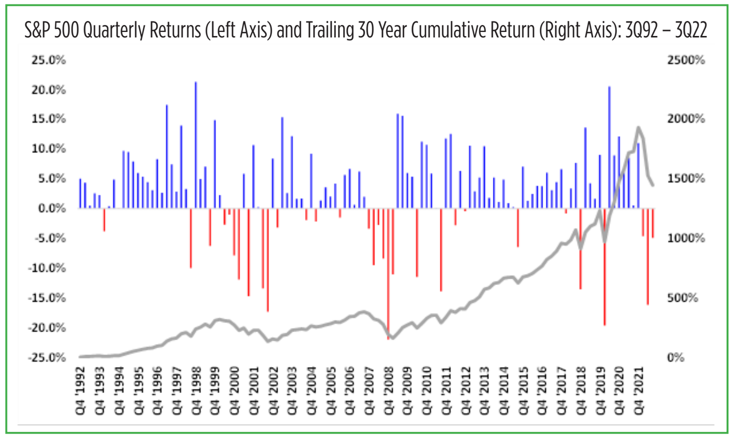


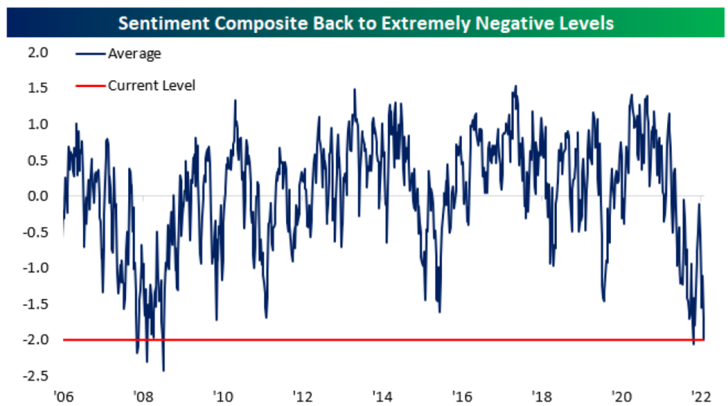
Source: Bespoke Investment Group

The primary culprit behind the recent sell-off is a familiar one this year – anxiety regarding inflation, Federal Reserve hawkishness, and the near-term path of interest rates. The market has continued to price in Federal Reserve rate hikes and aggressive monetary policy (including selling bonds held on the US Treasury's balance sheet), as reflected in lower bond prices and higher rates across the yield curve. As shown in the chart below, the bond market has very quickly moved from pricing in virtually no rate hikes to 400-450 basis points (300 bps of hikes have already occurred this year) over the course of 2022. This largely reflects the Fed playing "catch-up," having failed to raise rates last year and quickly pivoting aggressively to reflect their view that high inflation is a stickier issue than previously thought. Now, many are worried the Fed (and perhaps other central banks across the world) will commit a policy mistake by increasing rates too aggressively, which could result in unnecessary economic hardship while failing to adequately curb inflation.



One popular strategy for timing moves in and out of the stock market is to sell everything whenever the S&P 500 breaks below its 200-day moving average price then buy the portfolio back when the S&P moves back above that average. The theory is based on the attempt to own stocks only in up trending markets. And the classic definition of a market in an uptrend is one trading above the 200-day moving average. Following this technique, you would avoid some large market declines. And from 1992 until the present your return would have been 477% or 5.86% annualized. However, over that same period, the S&P rose 809% for an annualized return of 7.43%. The primary reason for the difference in returns is missing the sharp moves higher in the early days of market rallies. These returns measure only the difference in price movements between a buy and hold and a simple market timing system. The real loss for long term investors is from dividends. Over the last 30 years the return from the S&P's price appreciation was 809% with dividends added in the total return becomes 1,576%.



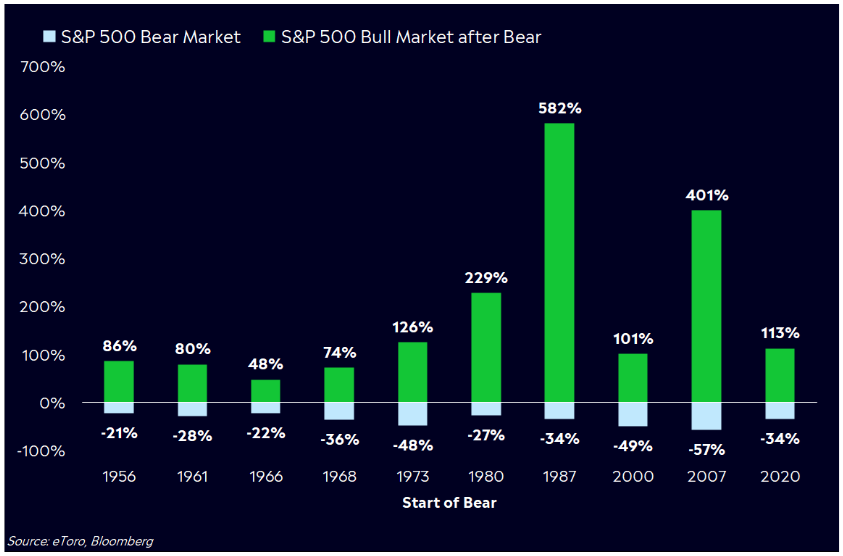


** Average of z-scores of AAII and Investors Intelligence bull-bear spreads and NAAIM Exposure Index.*

Source: Bespoke Investment Group

Over this 30-year period several bull and bear markets have played out. At the bottom of each whether 2002, 2009 or this most recent period it has always been tempting to sell out and await better days. The temptation is normally strongest near the lows in prices when anxiety turns to panic, and a rational approach becomes impossible. We may be near that point in market sentiment now. The composite sentiment index compiled by Bespoke Investment Research is currently very near the lows reached in June of this year when the market bottomed on heavy panic selling. The only other time sentiment has been this negative was the low reached in March of 2009. Yet while negativity is peaking the recent decline in the S&P has failed to take prices significantly below June's lows. This sort of divergence is one of the signs that selling may have already peaked and regardless of the news better markets may lie ahead.

All that said, while there remains no shortage of things to worry about (as we are constantly reminded by the latest pundit eager for airtime), the most important thing for investors to keep in mind is that all bear markets eventually end, followed by the start of a new bull market. Both the magnitude and duration of these bull markets typically significantly dwarf the prior bear markets that caused so much pain for investors at the time. For example, following the bear market of 1987 (driven by the crash on Black Monday), investors enjoyed a roughly 7x increase in stock prices over the next 12 years.



Perhaps a recent sports reference could help put this in perspective. Recently, New York Yankee Aaron Judge tied Roger Maris' American League single-season home run record of 61. When Maris hit his 61st home run on October 1, 1961, the S&P 500 was at 68. He broke Babe Ruth's record of 60 home runs set in September 1927, when the index was at 16. At the close on September 28, when Judge hit his 61st, the S&P closed at 3,719.

Morale of the story – stay invested. While there's no way of knowing if the next player to break the home run record will again wear Yankee pinstripes, it's a good bet stocks will be meaningfully higher when he does. While market corrections, bear markets, and volatility can be frustrating and painful in real time, it is important to remember they are a healthy part of functioning markets and price discovery, ultimately leading to the resumption of a new uptrend.

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

RECORD HOLDER	**Babe Ruth**	**Roger Maris**	**Aaron Judge**
Record Home Run Date	9/30/1927	10/1/1961	9/28/2022
S&P 500 Index Level	16	68	3,719
Annualized Stock Market Returns (Beginning with Year 1900)	1900 to Ruth **+ 9.1%**	Ruth to Maris **+ 9.2%**	Maris to Judge **+ 9.8%**