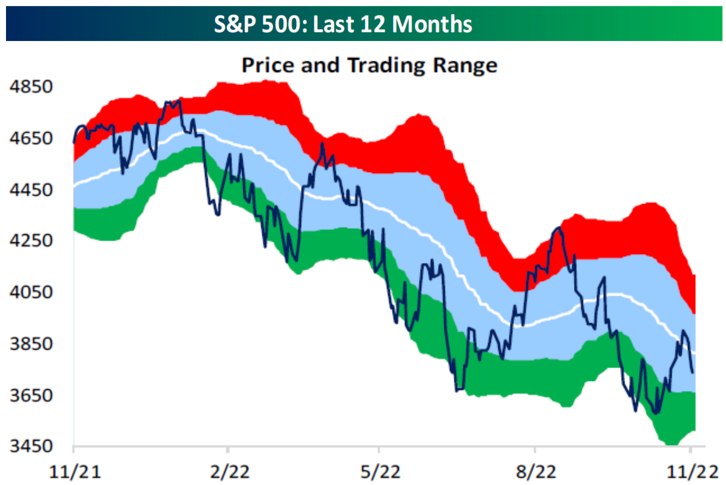
11/07/2022

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

Dear Reader,

October brought a welcome relief rally as the S&P 500 posted an +8.1% return for the month. Against a backdrop of persistent inflation, higher interest rates, and waning demand globally, investors continue to seek clarity regarding corporate earnings over the near to medium term. And while investors know mid-term election years often bring elevated volatility, still it's unclear to what extent this overhang has influenced market behavior. Fortunately we will soon know which party will control Congress for the next two years and what that might imply for fiscal policy. We hope that will reduce anxiety and lift investor confidence going forward.

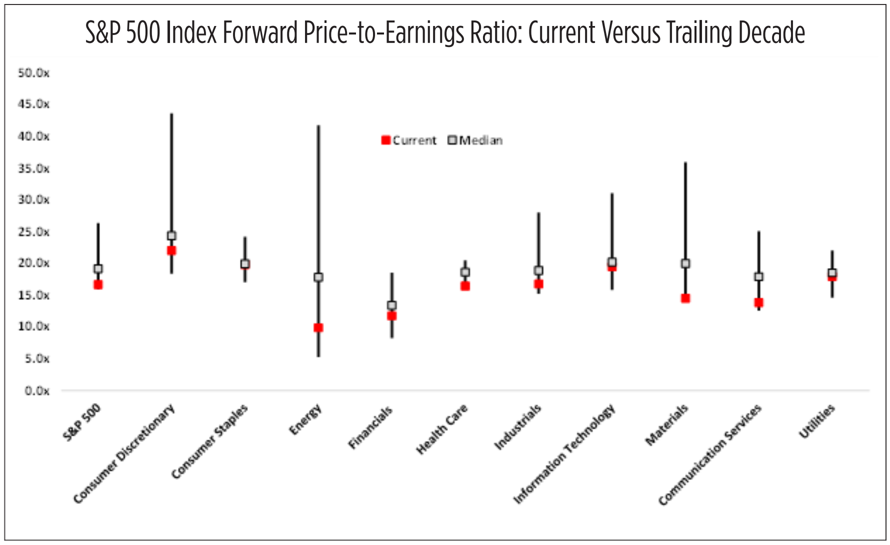


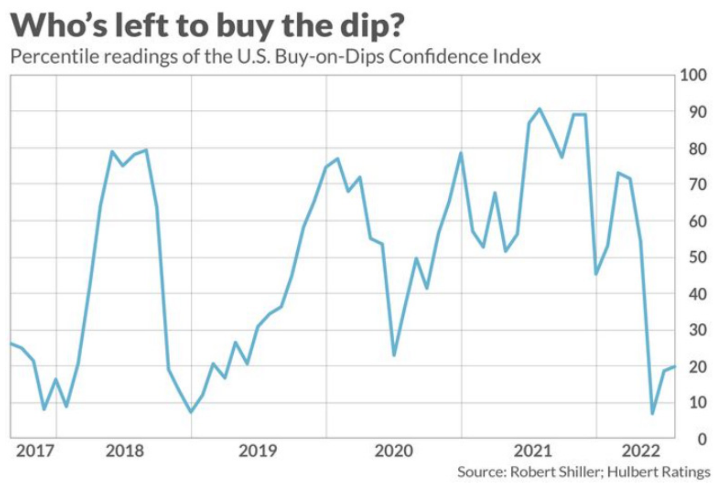
Source: Bespoke Investment Group

Given the magnitude of the equity market sell-off year to date many question whether valuation levels are attractive enough to begin putting excess funds to work again. We note the S&P 500 closed the month at 3,872 or 16.7 times the 2023 earnings estimate for the index. This compares to the average earnings multiple of 19.2 times for the past decade and 18.46 since 1950. In our opinion the fundamental pricing of the market is attractive. This coincides with very depressed consumer sentiment. What is missing to allow us to commit reserves is positive price momentum. We believe this will come when the S&P breaks out of its intermediate term downtrend.

The correction in valuations has been sudden and painful. Much of the excesses from a valuation perspective, such as poorly managed, unprofitable businesses trading at elevated multiples of sales or accessing financing at extremely generous terms, have been removed from the market quickly and violently. It's not hard to find technology stocks, for example, down well over 50% for the year, as the most richly valued companies and cyclical sectors have been hit the hardest.

While much is made concerning the 20% decline in stocks, we believe the over 30% decline in long term US treasury securities is even more dramatic. This would be just the fourth time over the past half century that stocks have declined more than 20% for the full year, while bonds have declined in value also. We note yields on ten-year U.S. Treasuries have ballooned to 4.08% from 1.51% at the start of the year. That "double barrel" decline in markets has hurt all investors, particularly those who looked for stability in bond prices to protect their diversified portfolios from stock volatility. We continue to believe that the 40-year bull market in bonds ended some years ago and interest rates will begin to respond once again to fluctuations in inflation rates. We think as this process reasserts itself the relationship between price earnings ratios and treasury rates will become more important and therefore rates will once again become a key variable in stock valuations.





Investors that have remained bearish despite lower prices generally have one core view: If you compare the valuation of the stock market historically, it is near its long-term average, perhaps slightly above. Furthermore, and perhaps even more importantly, negative corporate earnings revisions are already underway. Those in the bearish camp believe stock market valuations should instead be lower versus historical averages given the negative impact of rapid, sizeable interest rate increases and deteriorating corporate earnings momentum.

While this view certainly has merit and has proven accurate thus far in 2022, we'd offer some counterpoints to that perspective. First, the composition of the stock market index has changed meaningfully over time. What used to be an index primarily composed of industrial and manufacturing companies, typically carrying lower price earnings multiples, now has its highest weighting in high P/E technology stocks. Just four large technology companies Apple, Amazon, Microsoft, and Google, for example, account for a combined 20% of the entire index. Thus, we believe to assess how under or over valued the stock market is, investors would be wise to look at how the composition of the index has changed so meaningfully over time.

While forecasting company earnings in an environment such as this is challenging, we take comfort in the fact that, from our perspective, there remains nothing structurally broken in the economy. To be clear, the highest inflation in more than four decades coupled with waning consumer demand is troubling. However, we aren't experiencing the same type of systemic threat posed by the potential collapse of the global banking system in 2008. And we are not being threatened by the unknown of what was to come after the COVID lockdowns in March 2020. Therefore, we believe that, while volatility this year has been predominately driven by macro events, such as Federal Reserve policy meetings, economic data releases, and the war in Europe, corporate earnings will as always dictate the long-term trend of the stock market.

In essence, the valuation adjustment, from our standpoint, has largely occurred. This often marks the initial leg lower of a bear market as investors grapple with a wide range of possible outcomes. Normally based on their perception of dark clouds on the horizon, investors imagine and therefore discount the worst and react by selling down to that level. At this point, investors have been reminded ad nauseum about interest rate increases and the danger of an overly aggressive Federal Reserve. Absent a major surprise from Chairman Jay Powell, we believe potential further downside risk for stocks from higher rates may be limited. While further economic weakness is a very reasonable base case, we believe it will be earnings results, relative to market expectations, that will ultimately determine how stocks respond as we move into the new year.

Most importantly, for long-term stock investors, time is always the greatest asset. Valuation levels will fluctuate higher and lower over time due to changes in interest rates, sentiment, or many other reasons, but the long-term trend for corporate earnings growth in the aggregate while uneven has been higher which ultimately results in growth of the economy and stocks eventually finding new highs.

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