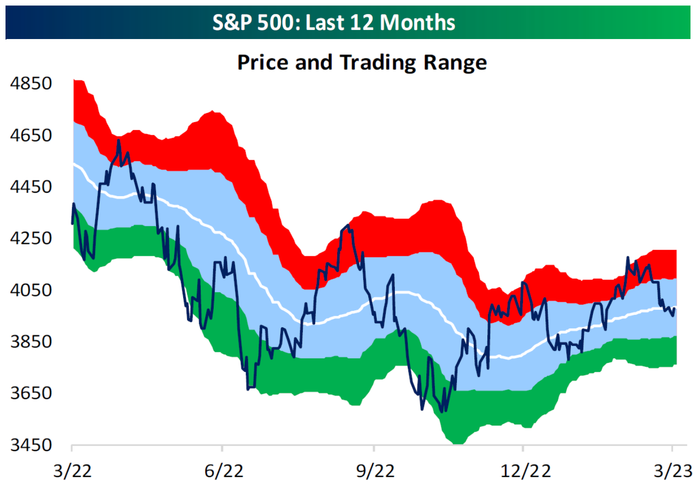
Capital Ideas

03/03/2023

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

Dear Reader,

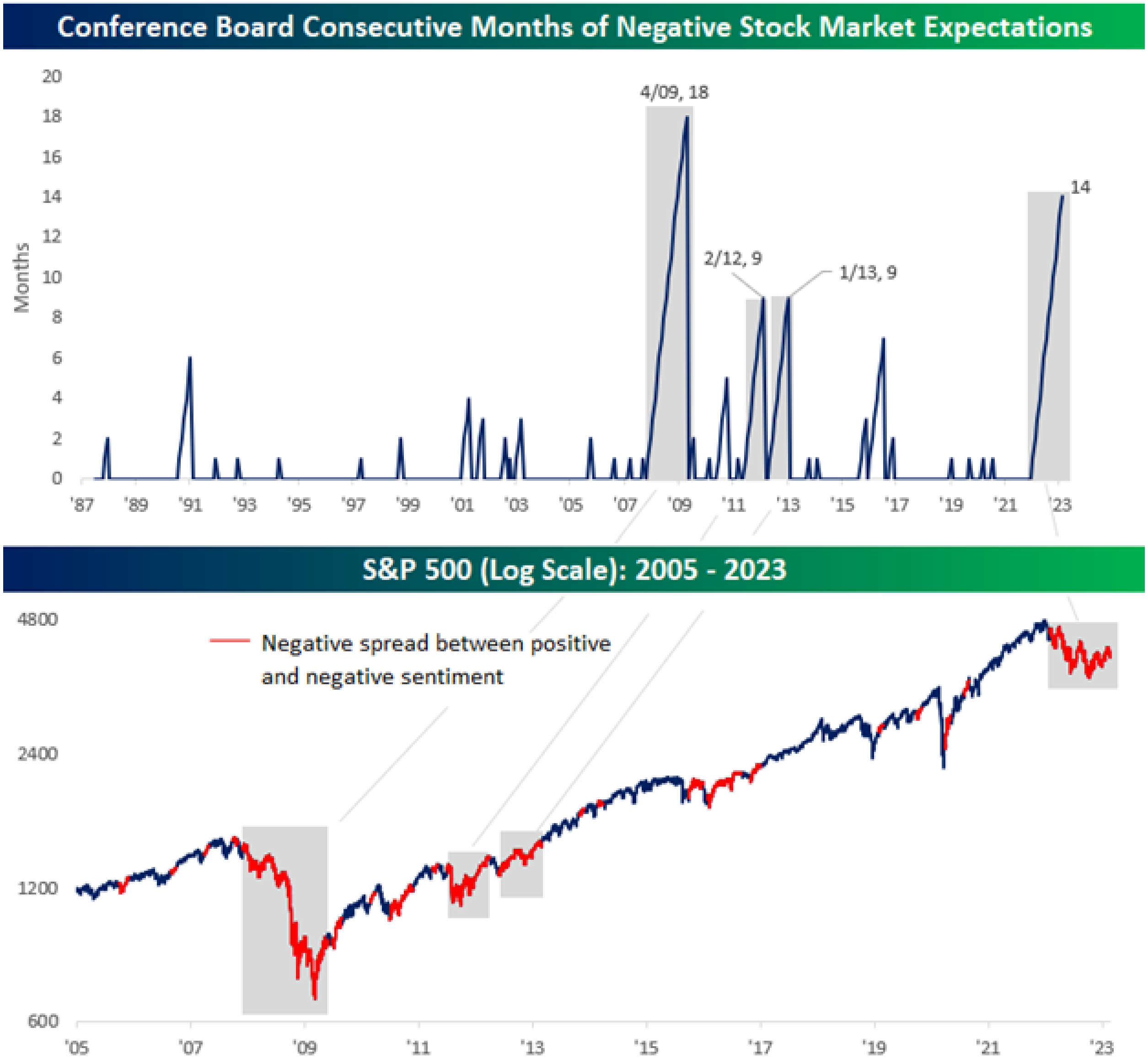
The market's gain in January was reversed in February with the S&P 500 down 2.4% for the month leaving it up only 3.7% year-to-date. As the chart illustrates after an initial decline early in 2022 the S&P 500 has remained range bound trading with a high degree of volatility within that range.



Source: Bespoke Investment Group

We believe the market's inability to break above this band and trade higher is a function of two factors. Current high valuation levels which prevents higher prices, and economic and political issues which currently dominate the headlines. In our opinion while headline risk is always a factor holding back investment enthusiasm, reported corporate earnings and guidance must improve to awaken animal spirits and provide rocket fuel for a new long-term bull market.

While the inability to break above this trading range is frustrating, we generally remain constructive regarding the market's overall prospects. First, we believe the decline across asset values last year may prove to be healthy over the longer term. Higher borrowing costs and competition for funding will create the need for increased efficiency and improved business models. Not only do higher rates improve corporate capital allocation but they tend to dissipate the excess market speculation which may have otherwise continued to drive prices into an unstable bubble situation. We believe this correction in both price and time was healthy for the longer term. Investing in well-run American businesses with access to ample capital, healthy balance sheets, and generating vigorous earnings growth is the best investment decision from our perspective. Those companies which have invested heavily in focused research and development while generating strong free cash flow are well positioned to drive earnings growth through



Source: Bespoke Investment Group

innovation. We believe this innovation will propel the next bull market. We see this next leg up powered by the accelerated adoption of innovation from this R&D spending producing expanding earnings and profit margins as reliance on more expensive and obsolete methods is replaced.

Despite the rally to start the year sentiment regarding stocks remains deeply negative. Given the continued barrage of negative headlines the bearish sentiment is not surprising. In fact since 1987 only the 2008-2009 period produced more consecutive months of net negativity. Setting aside the impact of today's information cascade and constantly inflammatory impact of social media on investor psyche, it is impossible to argue that markets do not react the most swiftly and coherently to all available information relative to anytime in history. This is a trend that will only continue to evolve as technology does.

Referencing the chart above this suggests to us that market cycles may have become both more volatile and shorter. An extreme version of this phenomena occurred during 2020 as markets initially collapsed due to lockdowns but then reached new highs within months. That was by far the shortest bear market in history. With today's rapid information flow markets were able to quickly digest the implications of unprecedented fiscal and monetary stimulus and reprice accordingly. While this fact is generally understood and agreed upon, its implications for stock investors cannot be overstated. This may imply that in the future the average bear/bull market may last for shorter periods than in previous cycles.

As strong believers in Schumpeter's theory of creative destruction we have continued to favor investments in businesses which we believe will generate sustained earnings growth through innovation over the longer term. NVIDIA (NVDA), for example, is now one of our largest stock holdings. The semiconductor manufacturer has been at the forefront regarding the infusion of artificial intelligence and computing, which it expects to drive higher earnings and market share. IBM and Microsoft, two other large holdings we have written about previously, are also embedding elements of efficient automation and investing a substantial percentage of free cash flow in research and development. Should one or more of the traditional auto manufactures such as GM, another large investment, successfully integrate artificial intelligence and gain meaningful market share, the long-term investment thesis for it would be the brightest in at least half a century. As an early mover in the restructuring necessary to accomplish its conversion to EV's we believe this is quite possible. In essence, we are searching for growing businesses which we expect to lead the next leg of a new bull market higher when the economy recovers and earnings growth resumes.

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

Sincerely,

C.J. Brott

CJ Brott

Karen Burns

Karen Burns

Andrew Kerai

Andrew Kerai