Capital Ideas

November 8, 2023

Capital Ideas Advisors
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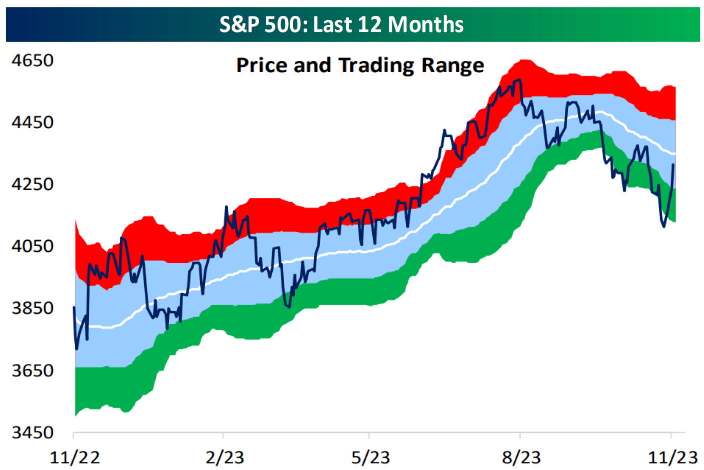
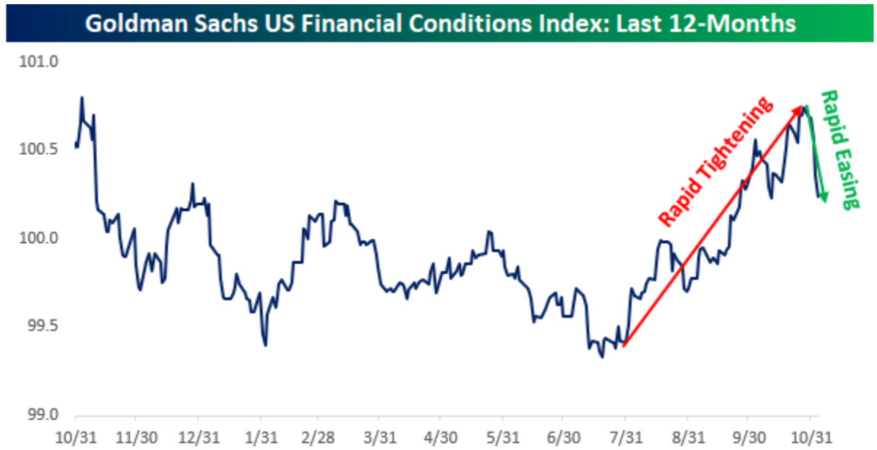
Dear Reader,

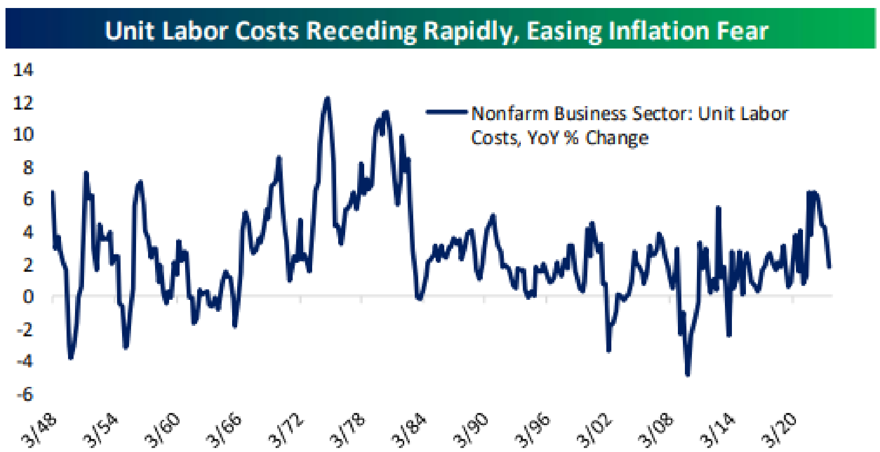
The sell-off in stocks which began in July appears to have hit its nadir on October 27th when markets turned up and gained almost 6% in the following week. This may well be another example of bull market action as the wall of worry to be climbed is quite high. Not only do investors have to discount unpredictable interest rates, potentially explosive oil prices and the possibility of war spreading in the middle east; but November 17th represents the current date when the US government may shut down due to lack of funding. Throw in an upcoming presidential election in a highly divisive political climate and buyers have every reason to hesitate. Yet once again the markets have exploded off the lows and seem to have enough energy to hold their gains. In our opinion this price action is due to both improving fundamentals and very favorable technical market conditions.



Source: Bespoke Investment Group

Technically the markets had become extremely oversold in price while still not demonstrating equivalent internal weakness. This was evident from the situation in which the price of most stocks became extremely extended to the downside. Yet accompanying advance/decline lines continued to display "normal" readings during the decline. In addition new lows in price never expanded to the extent that would be expected with this type of extended decline. In the meantime money market balances continued to rise to new weekly highsindicating continued liquidation as investors sold and retreated steadily to the sidelines. As measured by the weekly AAII members poll bullish sentiment remained at abnormally low levels during the entire July through October period. By remaining at these extreme levels for such an extended period these and many other technical measures indicated the potential for a rapid price recovery, once a stimulus to turn prices occurred. And in the middle of this pile of dry tinder such a spark was created by the rapid drop of longer-term interest rates which began October 27th. That decline in rates was part of a rapid easing of the Goldman Sachs Financial Conditions Index. That same index had signaled a potential steep market decline in July when it tightened suddenly. Now its easing is signaling what could be a rapid recovery in stock prices. The validity of that signal has yet to be proven but this type of rapid decline has only happened 5 times since 1982. The last decline of this magnitude took place in November 2022, just after the start of this bull market in October of last year.





Source: Bespoke Investment Group

Interest rates are a major part of the Goldman index. The sudden decline in interest rates could not have happened without an abrupt change in investors outlook for the economy. The most important change concerns a shift in the expected inflation rate. A shift to a more favorable inflation outlook was made possible by several recent events. First the US Treasury announced a reduction in the amount of new financing for the last quarter of the current year. This was coupled with an announcement by the BLS that labor cost increases are slowing, and productivity is increasing markedly. Capital and labor costs are probably the two most important parts of corporate production costs. With those costs declining and productivity improving the outlook for profit margins should improve. Currently those margins are at historically high levels. Analyst worries concerning a contraction in those margins has been at the root of an exceptionally dour forecast of future earnings. We believe as that outlook improves, and analysts begin to raise earnings guidance perceptions of improving market fundamentals will help extend the current advance.

We believe the current advance is the beginning of the "second leg" of the bull market which began in October of 2022. While the "second leg" is normally the longest part of any advance no market moves in a straight line. So while we believe prices will eventually move higher we are not so optimistic that we will throw caution to the wind. In any market opportunities to deploy dry powder present themselves. As they do we want to use them to position your investments according to your risk tolerance. We know many of you are reading this version of our monthly letter for the first or second time. If you have questions please call us. We are almost always available and if not will reach back out to you shortly. Thank you for your continuing patronage.

Sincerely,

CJ Brott

Karen Burns

Andrew Kerai