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THOMPSON DAVIS ASSET MANAGEMENT

THE INVESTOR INSIGHT

OCTOBER 2022

BACK COVER:
Grinding Through a Bear Market

CELEBRATING 20 YEARS AS AN INDEPENDENT RIA

Q3 Commentary

As we enter the final quarter of 2022, investors continue to battle the worst bear market since The Great Recession of 2008 as both the stock and bond markets probe new lows for the year. Several factors continue to plague the markets, none more pronounced than the Federal Reserve's aggressive rate hikes as it fights the highest US inflation rates in 40 years. Globally, central banks around the world also have been on an unprecedented rate hike path to tame inflation. This has combined with the war in Ukraine to send global equity markets into a yearlong bear market, and even safe havens such as bonds have suffered declines of more than 20%. Little has been spared in this march lower. What we are facing currently is "supply side inflation"—high demand for goods and services, but limited supply, which generates inflation in proportion to the magnitude of the imbalance between the two. Thus, only increases in the supply of these goods and services can reduce inflation.

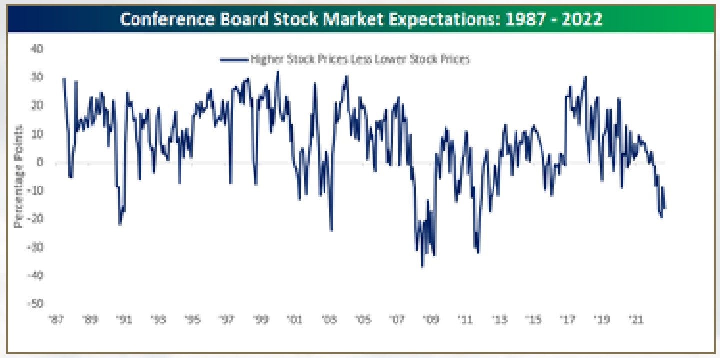
That said, is the cure (rate hikes) worse than the disease? As I mentioned in my last commentary, the Fed means well but tends to be late, reactionary, and (more often than not) goes too far. The round of rate hikes since March is unmatched in its speed and magnitude. Inflation data seems to have peaked, in my opinion, when the Consumer Price index printed a 9.1% increase. That has since dropped approximately 10% from those highs, and most input commodities (with the exception of oil due to the war) have rolled over dramatically. Thus far the rate increases have brought down housing and other interest-sensitive sectors, but the Fed seems to be fighting supply side inflation with a very blunt instrument, which cannot solve supply side inflation. For example, raising rates to a very restrictive level will not produce more food, oil, and other needed goods—only an increase in the supply of those will do that. What the rate hikes are producing is demand destruction. Take mortgage rates, which have more than doubled YTD, causing the housing market to come to a near standstill as potential home buyers deal with sticker shock. This has led many commodities to plummet (e.g., lumber is down more than 72% from March highs).

So, while the Fed's aggressive stance can tame some interest rate–sensitive sectors, doing too much can endanger the economy, in my view, and stocks have been reflecting this fear since the Fed's speech in Jackson Hole. I do not envy the Fed's job—it is trying to thread a needle after 13 years of quantitative easing and a Fed Funds rate of virtually zero over that period. While it still hopes for a "soft landing" at the end of this rate hiking cycle, in my view it's hard to envision such a scenario, unless the Fed starts paying attention to more high-frequency economic data, which clearly seems to be showing the stresses of the rate hikes to date. (Typically, it takes up to six months for rate changes to impact the economy.) My hope for Q4 is that the Fed becomes more data dependent and does not overshoot. Mounting evidence indicates that the rate changes are having widespread impacts on various industries already. Companies such as Walmart, Target, and FedEx (which has lowered its outlook three times over the past month) have reduced their outlooks for this year. As of the writing of this commentary, these moves have had a profound impact on the stock prices of many companies, in a variety of industries.

–continued inside–

Amazon	-46%	3M	-60%
Facebook	-68%	General Motors	-54%
Verizon	-43%	DuPont	-56%
PayPal	-74%	Nike	-57%
Netflix	-70%	Intel	-65%
FedEx	-56%	Tesla	-50%
Advanced Micro Devices	-66%	Ford	-57%
AT&T	-51%	Nvidia Corp.	-68%
JP Morgan	-41%	CarMax	-62%
Disney	-56%	Stanley Black & Decker	-68%
Target	-47%	Vanguard Total Bond Market	-22%

Source: Bloomberg Analytics



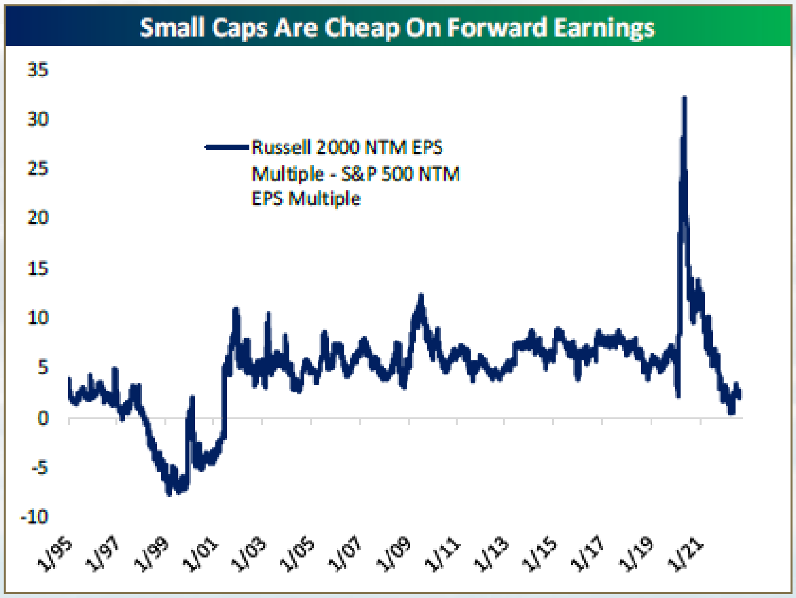
Above are some examples of how far off their highs the share prices are for many well-known Blue Chip, technology, and growth companies (and even the bond market).

Investors have few tools for understanding bear markets such as the current one, but experience is one tool. If you have lived through many different bear markets, as I have over my 32 years in this business, you have likely seen the downdrafts, recessions, volatility, and general sense of confusion (and sometimes panic) in the media about what is really happening. But those who have witnessed them have also been there for the even stronger bull markets that have followed historically. Bloomberg Analytics points out that from 1929 to 2021, there have been 26 bear markets. While that number may seem big, over that same period there have been **27 bull markets**—all of them bigger than the bear market that proceeded them. From 1929 to 2021, the average bear market resulted in a decline of 36% for stocks. In contrast, the average bull market resulted in **gains of 114%**.

There are three types of bear markets: (1) Structural (The Great Recession of 2008); (2) Event-Driven (COVID-19 pandemic); and (3) Cyclical (what I believe we are currently experiencing). The latter type is more closely tied to the business cycle, and often coincides with a peak in profit margins, rising interest rates, elevated inflation, and/or deceleration in economic growth. Cyclical bear markets average declines of 30% (about where we are now, by the way) and durations of a little over a year. In my estimation, we are currently in month 11 of this cyclical bear market—most equities peaked last November. Could we go lower/could this last longer? Of course, anything is possible, but I feel that slowing economic data and receding inflation pressures should give the Fed cover to become much more "data dependent"—especially as we move into 2023.

That said, I believe it's time for investors to start thinking about what's on the other side of the bear market. Even in the most relatable period when it comes to aggressive Fed tightening—the late 1970s under Fed Chair Paul Volker—the S&P 500 enjoyed solid returns following rate hikes that eventually broke the back of inflation and led to a decade of an average annual S&P 500 returns of 18%–19% during the 1980s (according to Bespoke Research). The bottom line for investors is that over the past 80+ years, the S&P 500 has generated outsized returns emerging from bear markets, whatever their type. Valuations have retreated significantly over the past year, creating what I believe are excellent opportunities. For the first time since "The Great Recession," we are uncovering companies that are selling at or below book value. This also comes against one of the most negative sentiment backdrops I have seen in my career. Recent surveys by The American Association of Individual Investors (IIAA) are at their most bearish in more than 50 years. This also true for professional money managers, who are at record bearishness and holding record cash levels. Can the crowd be right? Historically they have not been, and when these extremes occur they tend to be at or near market bottoms.

Those of you who have read my commentaries over the past few years recall that many of the indexes are being dominated by a handful of larger growth companies. Given that the indexes are market cap weighted, these stocks had an enormous impact on the index performance. Those same names have been some of the bigger losers in the bear market selloff—"Growth" companies with high valuations that have come down significantly over the past year. "Value stocks," according to Morningstar, have underperformed "growth stocks" for the past decade. As with many bear market recoveries, stocks that dominated the prior bull market tend not to be the outperformers in the next bull market. Thus, at this point in the cycle it is value stocks that look poised to outperform going forward. Like the period after the 2000 Tech Bubble, value stocks did exceptionally well (and that period was also dealing with a rising rate environment). According to Bespoke Research, small-caps (particularly small



cap value stocks) are the cheapest relative to the S&P 500 than they have been in more than a decade.

Given the current backdrop, with the Fed likely to overdo it on rate hikes, we are keenly focused on value stocks with domestically oriented revenue (due to the strong dollar during rate hike cycles). We are seeing even more companies selling at or near book value, many of them with insider buying that looks attractive. While we cannot rule out a recession and we have had two consecutive negative GDP quarters (the definition of a recession), we feel the market has already priced in a large amount of this—equity index declines are averaging 34% with the NASDAQ approaching –40%. Some of the broader indexes are now at levels not seen since mid-2018. Like so many times throughout history, these types of sizable pullbacks tend to create excellent opportunities for patient, long-term investors who are willing to stay the course in volatile times and take advantage of the exceptional bargains that present themselves.

We expect to do just that as we move into Q4 and 2023. As Warren Buffet has said so eloquently, "be fearful when others are greedy, and greedy when others are fearful." With the almost daily negative headlines and investor sentiment readings at record lows, fear seems to be the dominant force in the markets currently, and thus we aim to take advantage. As always, thank you for your trust and we look forward to updating you as we end 2022 and enter 2023.

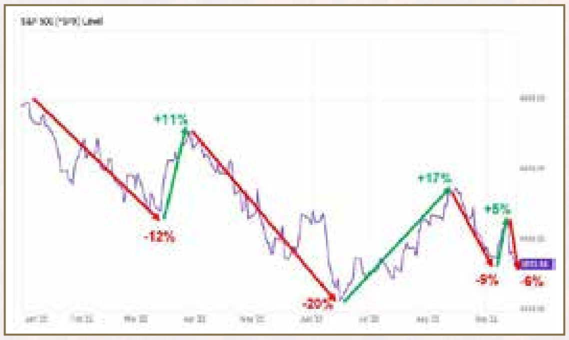
Sincerely,

William D. Davis Jr.
CEO and Portfolio Manager

Grinding Through a Bear Market

Bear markets can present opportunities for long-term investors, including the opportunity to question previously held investing beliefs. While the concept sounds simple, it can be painful to stomach. Every bear market has the potential to cause feelings of panic and despair, forcing investors to assess their fortitude to stick with their long-term investing plans. Markets are currently caught in a volatile pattern of selloffs and rallies. Understanding the behavior side of finance can be just as important as the quantitative side when it comes to long-term success.

Are we in a recession? Technically, yes—two negative quarters of GDP growth is the definition of a recession, and we are there. Inflation is raging at 40-year highs. Interest rates are rising at their fastest pace in history. Federal Reserve officials are determined to crush inflation by raising rates, no matter what it takes. Doing so has caused the market volatility we are seeing (see chart below). Markets don't like uncertainty—e.g., "When will inflation begin to subside so the Federal Reserve can pause on rate hikes?".



Market corrections are normal, but every bear market and recession is unique in its own way. Markets are constantly evolving over time but what is a constant is human behavior. Younger investors should be elated with the current market correction. Dollar cost averaging through 401(k) after a significant pull back in the market should be welcomed if one has a long-term time horizon. As seen in the chart below, the duration of a market correction has a wide range of outcomes.

Retirees are seeing their nest eggs taking a hit, but on the flip side, we finally have some yield! Short-term Treasuries are now yielding 4%, and that means higher rates on savings accounts, CDs, money markets, and short-term bond funds. It can indeed be difficult to ignore all of the negativity that is in the news and surrounding the markets, but the best advice may be to remember that bear markets are inevitable, but "this too shall pass." Putting money to work may not always feel good in your gut, but it potentially can have meaningful impact on your financial future down the road. Know your plan and stick to it.

— Brant Jones, CFP®

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