

Historical Market Volatility

So far, 2022 is a stark reminder how the financial markets can swing dramatically – including sharp declines.

At the end of April, the S&P 500 was down more than 13% for the year; not the start of the year investment advisors and investors desire. But it's important to look at the financial markets over longer periods of time.

Since 1980 the annual returns for the S&P were positive in 32 of 42 years with an overall average annual return of 9.4%. During this same time period, the S&P market declined on average 14% during the year before bouncing back to a positive return most of those 32 years.

As of May 18, we have experienced over a 17% intra-year drop in the S&P to date – above the average since 1980.

There are many factors causing today's volatility:

- Inflation and the Fed's reaction to it
- Russian – Ukraine war
- Overvaluation with Meme and mega-cap stocks

What does this mean? These factors likely will remain for the foreseeable future. But there are some consumer strengths that may play a positive role. A stronger labor market as of late has bolstered wages and higher-earning consumers tend to increase their discretionary spending. There also is pent-up demand for travel. This consumer strength along with the sequel of Covid reopenings this spring and summer could strengthen the economy.

Keep in mind: In a volatile or non-volatile market, long-term investing is better than timing the market. Long-term compounding is an investor's best friend; normal human emotions are an investor's worst enemy.

KEY DATES

- 5.4 FOMC Press Conference
- 5.6 Unemployment Report
- 5.11 April CPI
- 5.26 GDP 1Q Second Estimate
- 5.30 Memorial Day
Stock Market Closed
- 6.3 Unemployment Report
- 6.10 May CPI
- 6.15 FOMC Press Conference
- 6.20 Juneteenth
Stock Market Closed
- 6.29 GDP 1Q Third Estimate
- 7.4 Fourth of July
Stock Market Closed



Russia – Ukraine War

The visions of cruelties and horrors of Russia's invasion of Ukraine remain prevalent. While our hearts are with the people of Ukraine, our job is to assess the war's economic and company specific effects.

Historically, geopolitical conflicts have minimal impact on long-term US equity performance.

To date, this war has caused sharp volatility in specific assets. Oil, wheat, nickel, bond prices and stocks of companies with exposure to Russia and Europe have been impacted. This may continue for some time.

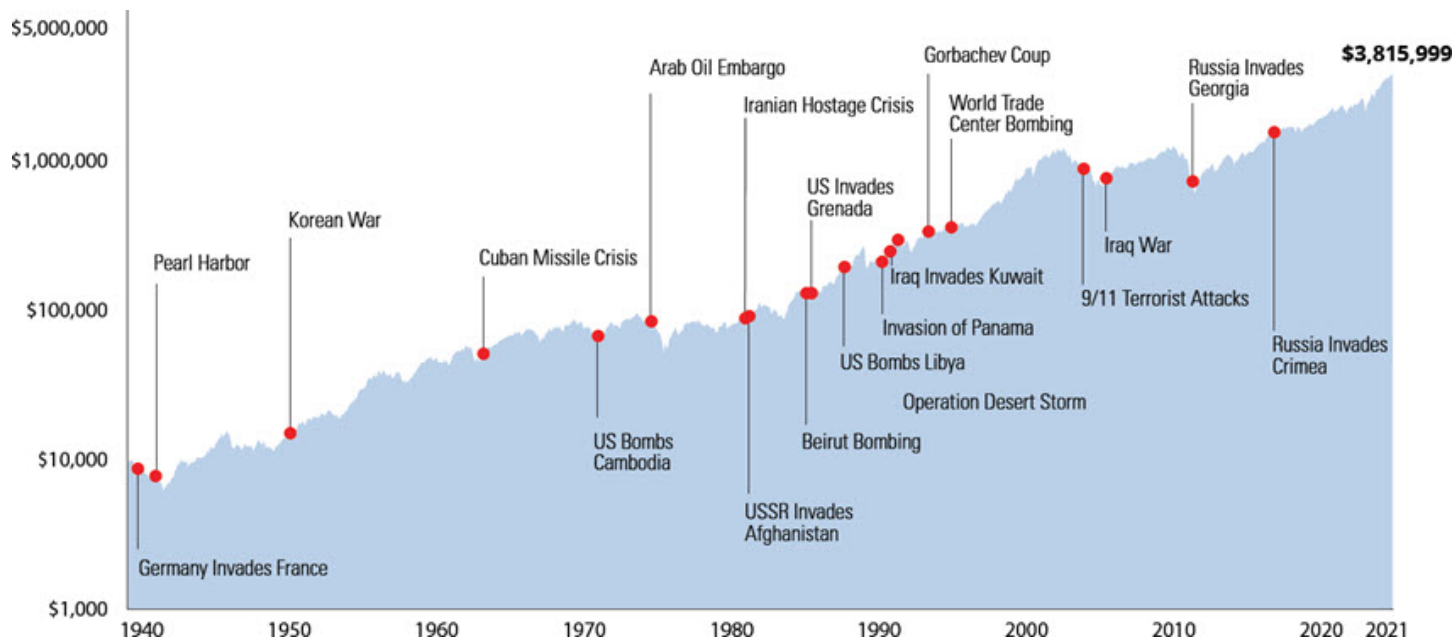
Combined, Belarus, Russia and Ukraine account for over half of the world's exported wheat and sunflower oil. They also account for a large portion of the global trade of other grains, seeds, oils, energy, fertilizer, processed metals and raw and/or rare materials, like nickel and cobalt.

When a commodity is fully utilized globally, any disruption can result in rising prices. Shipping disruptions and delays result in shortages and general inflation. Consumers substituting one product for another will drive the substitute prices higher. As the supply of goods normally exported by the affected countries declines, global prices of those goods can surge.

Rising employment and our country's low dependence on Russian oil, should allow our economy to withstand financial challenges resulting from this war.

Geopolitical Conflicts Have Had Minimal Impact on Long-Term Equity Performance

Growth of \$10,000 in the S&P 500 Price Index (1940–2021)



Data Sources: Morningstar, Ned Davis Research, and Hartford Funds, 3/22

Federal Reserve on the Move

Since our last FOCUS newsletter, the Fed has increased rates by 0.75% and indicated more rate hikes over the next 12-18 months.

Recently, Fed Board members have stepped up their anti-inflation rhetoric and suggested the possibility of raising rates sooner with larger rate increases. As a result, overnight interest rates may reach 2% by this fall and 3% in a year.

The Fed also stopped expanding its balance sheet for the first time since the pandemic. Its reduction of its balance sheet is called tapering. In this process, the Fed purchases fewer bonds than its portfolio has maturing. Who will buy hundreds of billions of dollars of US debt in place of the Fed?

What does this mean? The US government's issuance of debt is expected to increase. Outstanding levels of mortgage debt should rise over time with housing prices at an all-time high and a slowly expanding number of new houses. As the supply of bonds increase and the Fed cuts its bond holdings, bond interest rates must rise to attract other investors.

What you need to know: As we wrote in our last newsletter, it's prudent to avoid long-duration investments such as long-term bonds, preferred stocks, common stocks of firms that have negative earnings or negative cash generation and investments with high valuation multiples (P/E, P/S). As their present values use interest rates to discount future cash flows, present values of long-duration assets should decline as interest rates rise.

Recurring High Consumer Prices

The Fed warned of rising inflation, but speculated it would be "transitory." This assessment was wrong.

The consumer price index (CPI), which measures the month over previous month increase in prices for consumer goods, is near a 40-year high of 8.3% in April.

We believe inflationary effects will continue for several reasons.

- Many food companies are contracted to provide six to nine months warning before price increase announcements become effective. Prices of cooking oils and grains have skyrocketed. As substitute grains are purchased, herds that cannot be fed are culled, and fertilizer shipments don't materialize, more food types will be in short supply. The US consumer will see more price increases this fall.
- Millions of jobs remain unfilled. Companies need to pay higher wages to retain and attract workers. They will pass that increase in the form of higher prices to consumers. Historically, this genie is hard to re-bottle.
- A shortage of trained tradesmen has led to a housing shortage. Low housing turnover, rising house prices and higher mortgage rates leave more consumers renting. Nationally, rents rose a record 11.3% last year, according to real estate research firm CoStar Group.

Even if CPI nears its peak, consumers paying over 8% more for goods must reduce their discretionary spending. Wage increases have not caught up to their pain. Last year the national average wage increase for workers was 4.5%¹. When adjusted for current inflation, workers still have 3.5%-4% less to spend on things like iPhones, restaurant meals, etc.

1. Source: Bureau of Labor Statistics

Value vs. Growth

Up until November of last year, growth stocks have had a tremendous ride, resulting in extraordinary PEs.

We believe the pendulum is swinging to stocks with more reasonable evaluations.

Both rising inflation and recurring inflation can trigger interest rates hikes. Inflation and rising interest rates tend to be good for value stocks and bad for growth stocks.

Many value stocks can be of firms that have:

1. Large, established fixed cost bases (like a forge or factory) whose costs don't rise as fast as inflation. However, the salvage value of the fixed assets and property might increase over time
2. Strong cash generation and fixed cost, laddered debt. As interest rates rise, their cash earns more interest, but the fixed rate debt does not immediately change. When the debt finally matures, it is worth less due to compounding inflation.

Value stocks are thought to be short-duration assets. Unlike growth stocks whose valuations can fall as interest rates rise, value stocks are priced more for their current operations.

S&P 500 Annualized Performance by Decade

Era	Growth Stocks (20% of the Market with Highest P/E)	2nd Highest 20% by P/E	Middle 20% by P/E	2nd Lowest 20% by P/E	Value Stocks (20% of the Market with Lowest P/E)	Winner
1950s*	15.8%	15.7%	20.7%	19.9%	27.0%	Value
1960s	6.8%	5.4%	9.5%	13.2%	15.0%	Value
1970s	2.4%	6.7%	8.2%	11.6%	12.0%	Value
1980s	12.3%	17.2%	17.8%	19.6%	19.1%	Value
1990s	18.7%	16.7%	14.8%	17.7%	17.2%	Growth
2000s	-2.5%	2.1%	4.1%	4.7%	9.4%	Value
2010s	14.4%	15.2%	11.7%	13.9%	11.6%	Growth
2020s (12/31/2019 - 2/26/2021)	31.3%	18.9%	4.9%	8.5%	10.0%	Growth
Total	9.7%	11.1%	12.0%	14.0%	15.6%	Value

Sources: Ken French Database, CRSP, from 6/30/1951 - 1/31/2021, with WisdomTree database using S&P 500 for February 2021.

* 1950s commences with beginning of data (6/30/1951).

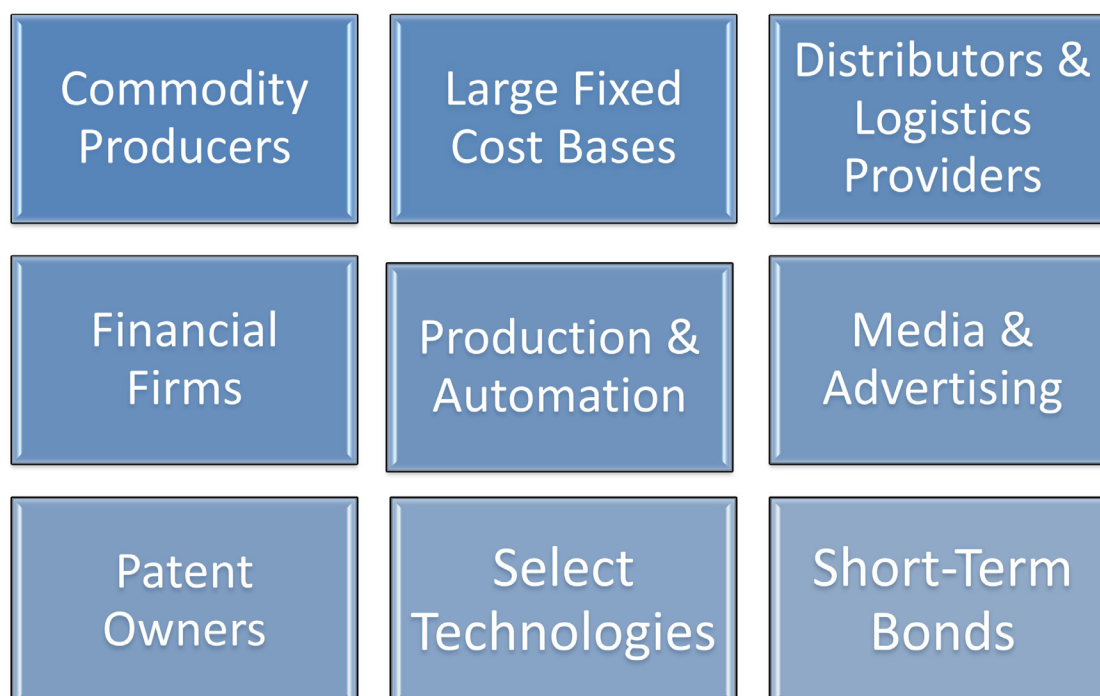


Inflation-Ready Portfolio

Historically, stocks outperform other assets in a rising inflation environment. Our strategy is focused on the sectors and their leaders that can thrive in an inflationary environment.

- **Commodity Producers:** Product prices tend to rise faster than costs. Many initial costs like land, mine, factory, forge have been fixed long ago.
- **Distributors & Logistic Providers:** The cost of the inventory, warehouse and trucks has already been locked-in. As prices rise, the value of the existing inventory and products rise, but the land and building costs do not.
- **Financial Firms:** Revenue and earnings can rise with interest rates.
- **Production & Automation:** Established producers can raise production to full capacity without incurring additional robotics, factory or land costs.
- **Media & Advertising:** Can receive a set percentage of customer advertising revenue. As advertising costs rise, the set percentage of that larger amount can result in rising revenue and earnings in dollars.
- **Patent Owners:** Can receive a set percentage of end-product sales from manufacturers using their technology. As end-product prices rise, the set percentage of that larger amount can result in rising revenue and earnings in dollars.
- **Select Technologies:** Established producers can raise production to full capacity without incurring additional robotics, factory or land costs. Technologies that increase efficiency are worth more during times of inflation when cost savings are highly sought.
- **Short-Term Bonds:** When all interest rates rise, the value of long-term bonds decrease more than short-term bonds. Our portfolios consist of shorter maturities to reduce this risk and provide opportunities to reinvest at higher bond rates as short-term bonds mature.

Inflation-Ready Portfolio



Thank You

We thank you for having confidence in us. If you have any questions, we are only a phone call or email away. We're here to help!



**Know a family member or friend we can help?
Please feel free to have them reach out to us.**

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