

Midterm Elections

100% of House seats and 34 Senate seats are up for election next week. History shows the market tends to turn positive after midterm elections.

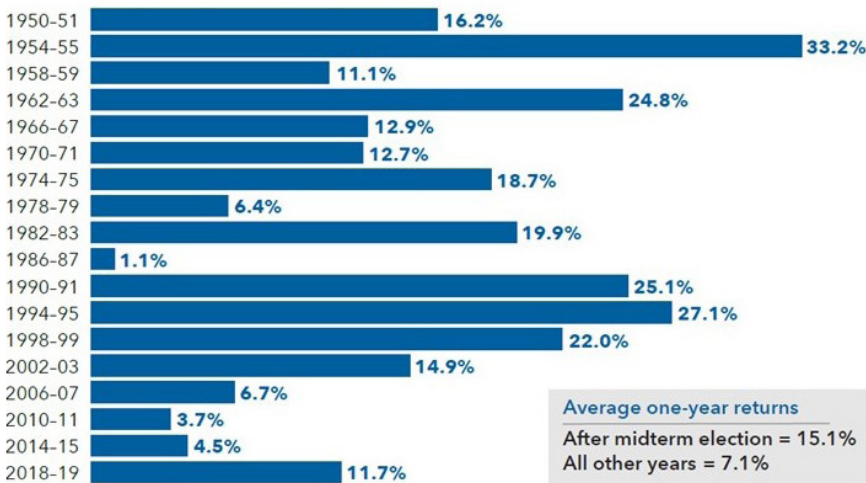
The S&P 500 index price return for the 365 days after midterm elections has been positive since 1950-51 with an average one-year return of 15.1%.

Why?

During the months leading up to midterm elections, market volatility tends to be high as investors are uncertain about the election's results and impact. Once the elections are over, there is a clearer understanding of future policies. The president's party typically loses seats. The changing of power creates gridlock so fewer bills and regulations get passed which businesses prefer because it allows for long-term planning and stability.

Market returns after midterm elections have been strong

S&P 500 Index price return one year after midterm election



Sources: Capital Group, RIMES, Standard & Poor's. Calculations use Election Day as the starting date in all election years and November 5th as a proxy for the starting date in other years. Only midterm election years are shown. As of 12/31/21.

KEY DATES

- 11.2 FOMC Press Conference
- 11.4 Unemployment Report
- 11.10 October CPI
- 11.24 Thanksgiving Day
Stock Market Closed
- 11.30 GDP 3Q Second Estimate
- 12.2 Unemployment Report
- 12.13 November CPI
- 12.14 FOMC Press Conference
- 12.22 GDP 3Q Third Estimate
- 12.26 Christmas Day (observed)
Stock Market Closed
- 1.2 New Year's Day (observed)
Stock Market Closed
- 1.6 Unemployment Report
- 1.12 December CPI
- 1.16 Martin Luther King Jr. Day
Stock Market Closed
- 1.26 GDP 4Q Advance Estimate
- 2.1 FOMC Press Conference



2022 Woes

Wild swings to the market have been common this year. Look at the last two months.

September has a reputation for being a bad month for investors. This September, the S&P 500 fell by more than 9%. The main reason is the Federal Reserve's overnight interest rate increases. The overnight interest rate was increased for the sixth time since Covid on Wednesday (Nov. 2) by .75%.

The effect of the rate increases continue to:

1. Strengthen the US dollar as foreign investment is attracted to the US. All else equal, this puts pressure on global commodities priced in US dollars. Gold and crypto prices have fallen this year despite being supposed inflation hedges.
2. Lead to higher mortgage rates that have slowed the pace of house price appreciation. This may eventually slow growth of the shelter component of inflation. Due to a lag effect, shelter is currently still adding to inflationary pressures.
3. Invert the yield curve. The 2-year treasury note yields more than its 5 and 10-year counterparts. This is one of several leading economic indicators for economic weakness.

October typically can be a decent month for stocks. This year the Dow increased nearly 14% during the month, while the S&P 500 and Nasdaq rose 8% and 4% respectively.

What drove it? Corporate earnings.

Most market participants were pessimistic heading into 3rd quarter earnings, fearing analyst expectations were too high. However, 71% of companies within the S&P index that have reported earnings exceeded expectations. Better than expected quarterly earnings reports caused an October rally in the market. Financials, healthcare, industrials and energy companies generally did better than expected. However, most mega-cap technology companies (e.g., Amazon, Meta, Microsoft) reported disappointing earnings as sales and earnings growth decelerated from higher pandemic levels. Meanwhile, many stocks of companies hurt by the pandemic are seeing better prospects and increased investor interest.



What's Ahead

Volatility will remain for the foreseeable future. The market is in an abnormal environment with high inflation, a war in Europe and aggressive monetary policy tightening by the Fed.

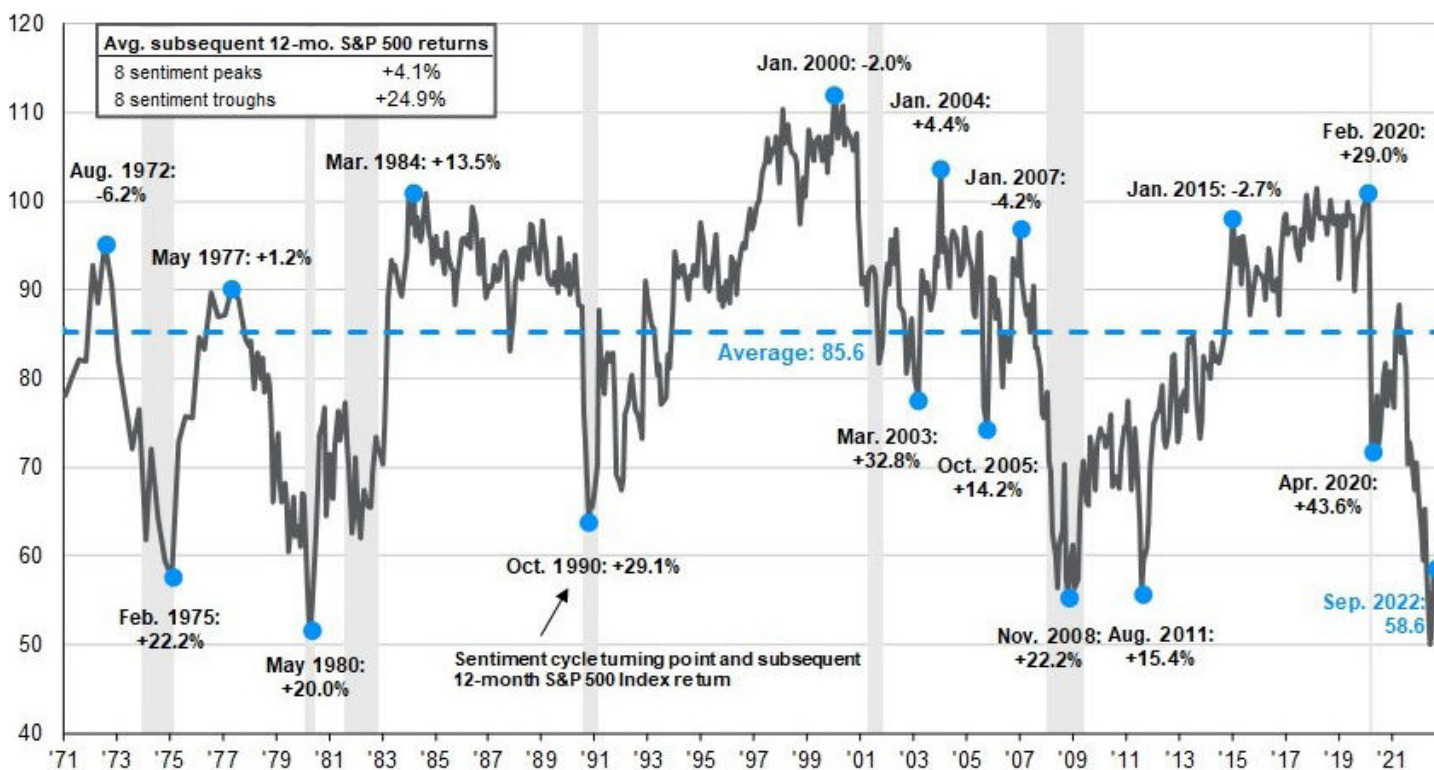
There were signs a bottom might have been reached in September.

Recession Determination? – The U.S. likely entered a recession in the first quarter due to negative Q1 and Q2 Gross Domestic Product (GDP). GDP rose 2.6% in the third quarter. Since 1950, the average recession has lasted 10 months vs. recoveries at 69 months. Bear markets tend to end in the middle of recessions – when all of the news is negative. The best market days can closely follow market bottoms.

Inflation may be the #1 factor affecting the markets over the next 6 months. The Fed's efforts to slow inflation by raising rates has yet to show success. However, the Fed may be near the end of their .75% interest rate increases as it assesses their impact. This could positively effect the stock market, which tends to lead the economy by several months.

Consumer Sentiment Bottomed? – The chart below shows the University of Michigan consumer sentiment index from 1971 to present. During June of 2022 the index hit 50, an all-time low. Consumers were the most negative about the economy than they had been in the survey's history. The index rose slightly in July and September. The average 12-month return following consumer sentiment index bottoms is 24.9% vs. 4.1% returns following peaks. This makes sense as the market tends to be lower in tough times and the market does well in the early stages of a recovery. While short term moves in the market are unpredictable, this one piece of information infers positive months ahead.

Consumer sentiment index and subsequent 12-month S&P 500 returns



Source: FactSet, Standard & Poor's, University of Michigan, J.P. Morgan Asset Management. Peak is defined as the highest index value before a series of lower lows, while a trough is defined as the lowest index value before a series of higher highs. Subsequent 12-month S&P 500 returns are price returns only, which excludes dividends. Past performance is not a reliable indicator of current and future results.

Guided to the Markets – U.S. Data are as of September 30, 2022.

How & Where to Invest

Timing the market is hazardous as the best market days closely follow emotionally charged bottoms – where many investors exit in a panic. This year the pandemic investor’s focus on mega-cap technology and alternative investments pressured the broader stock market. The indiscriminate sell-off resulted in exceptionally attractive opportunities and compelling entry points.

Long-term Compounding – It’s an investor’s best friend. These 30-year charts (below) show the power of compounding. The top chart shows if one had started in 1992 with \$10,000 invested in large-capitalization stocks that investment grew to over \$92K in 2022 after spending all dividends. If one reinvested dividends, the \$10K in 1992 would have grown to \$167K in 2022.

The bottom chart adds small-capitalization stocks, bonds and inflation. Small-cap stocks provide the best return on this chart, growing to \$249K. While small-caps tend to win long-term competitions, they have become relatively inexpensive as mega-cap stocks dominated the last ten years. Most of this time period experienced lower levels of inflation, but that has recently changed. To preserve wealth, a portfolio needs to outpace both inflation and withdrawals. Three tips gained from this chart are:

1. Don’t let normal human emotions drive investment exit at market bottoms
2. The power of cash dividends and long-term compounding
3. Investing in small and mid-capitalization stocks can enhance returns and increase portfolio diversification

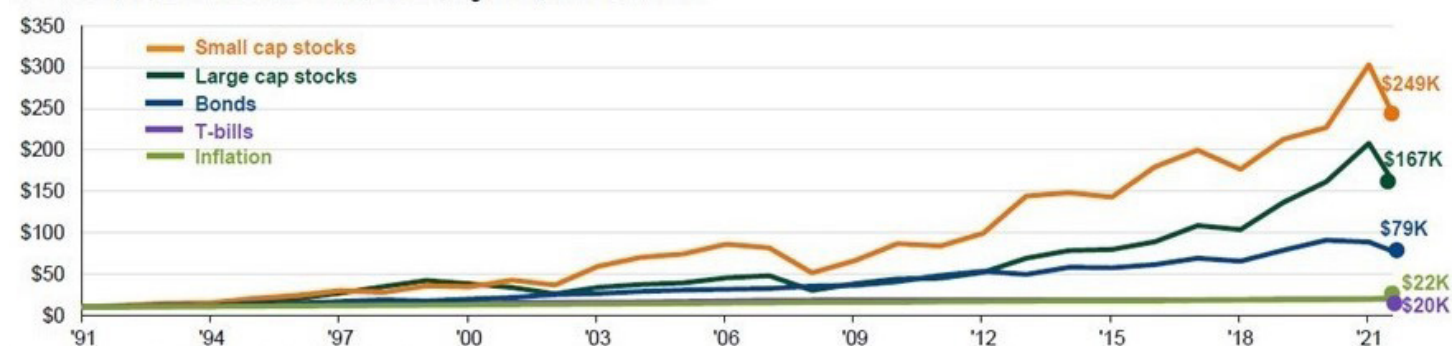
The power of compounding

S&P 500 price return versus total return, growth of \$10,000, quarterly



Major asset classes versus inflation

Growth of \$10,000 from 1991- 2Q22, annual, log scale, USD thousands



Source: Ibbotson, Standard & Poor’s, J.P. Morgan Asset Management.

Guided to the Markets – U.S. Data are as of June 30, 2022.

Equities – Less than half of the exchange-listed firms generate free cash flow. In a period of higher inflation & interest rates, it is important to invest in firms producing excess cash. As debt comes due, these companies can pay down debt (instead of refinancing at much higher rates); use market weakness to make accretive, bolt-on acquisitions; return money to shareholders; and purposefully build cushion inventory to offset supply chain disruptions.

The types of industries and companies that could perform best in this environment and for the long term are:

- Companies with expanding profit margins
- Financials that had earned little on cash balances & reserves in recent years, but should experience material growth of interest income due to rising rates
- Payment processing firms. As inflation increases transaction sizes, revenue may rise faster than costs
- Companies with fixed costs such as an established manufacturing plant that does not have to replace its building or equipment.
- Some natural resources (gold, lithium, negative carbon footprint techniques) may increase in value and can hedge portfolio volatility
- Firms having multi-year patent royalty contracts with fixed terms renewing at higher rates due to increasing consumer product content and technological advancements
- Healthcare companies with advancements accelerating from post-pandemic phase 3 studies

Bonds – Since the mid-1970s, the aggregate bond market never lost this much value in a given year. By the end of September, it decreased 15% year-to-date. Interest rates and bond prices have an inverse relationship. As rates rise, bond prices fall. For those with a need for bonds, ladders of short maturities will limit downside risk.

Question of the Month

During last month's webinar, we were asked: **What are the companies you invest in telling you about their business environment?**

Tim responded: *Each company tells us different things about how they are handling it. Some companies see a slowdown in one part of their business but an acceleration or strength elsewhere. Some of our companies experienced weakness during the pandemic years and now have segments that are rebounding. Some of our companies are opportunistically building inventory to offset the sporadic supply chain disruptions. Just about all of our companies are generating lots of cash. They are tempted to pay down debt as it comes due because they don't like to pay higher interest rates. Many are repurchasing stock at these levels. They can't tell us while they are doing it. They might give indications or announce repurchase authorizations. Knowing our companies, their management, their track record and their most recent indications, we expect to share rising profits with fewer shareholders. Earnings per share should rise that much faster for many of our companies. We are excited about what we are hearing from our management. The smaller the company, the more nimble, agile and opportunistic the behavior. We like what we are seeing.*

IMPORTANT NOTE

The CMC board of directors approved the following deposit limit, starting December 31, 2022:

In order to effectively manage SMID product portfolios, CMC will limit SMID product deposits to \$5 million per account.

Know Someone We Can Help?

Thank you for having the confidence in us. We think of you as part of our family and friends and strive to be the absolute best investment advisors for you and your loved ones. If you have any questions, we are only a phone call or email away. We're here to help!



Clients have referred other family and friends to CMC. If you know of someone who would like to learn more about CMC, have them contact us. Your referral is the greatest compliment.

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Together, we serve as our clients' fiduciary with a focus on growing wealth, preserving capital and generating rising, recurring streams of cash income. We greatly appreciate your confidence in our team, services and results.

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