The Challenges and Opportunities in the U.S. Stock Market

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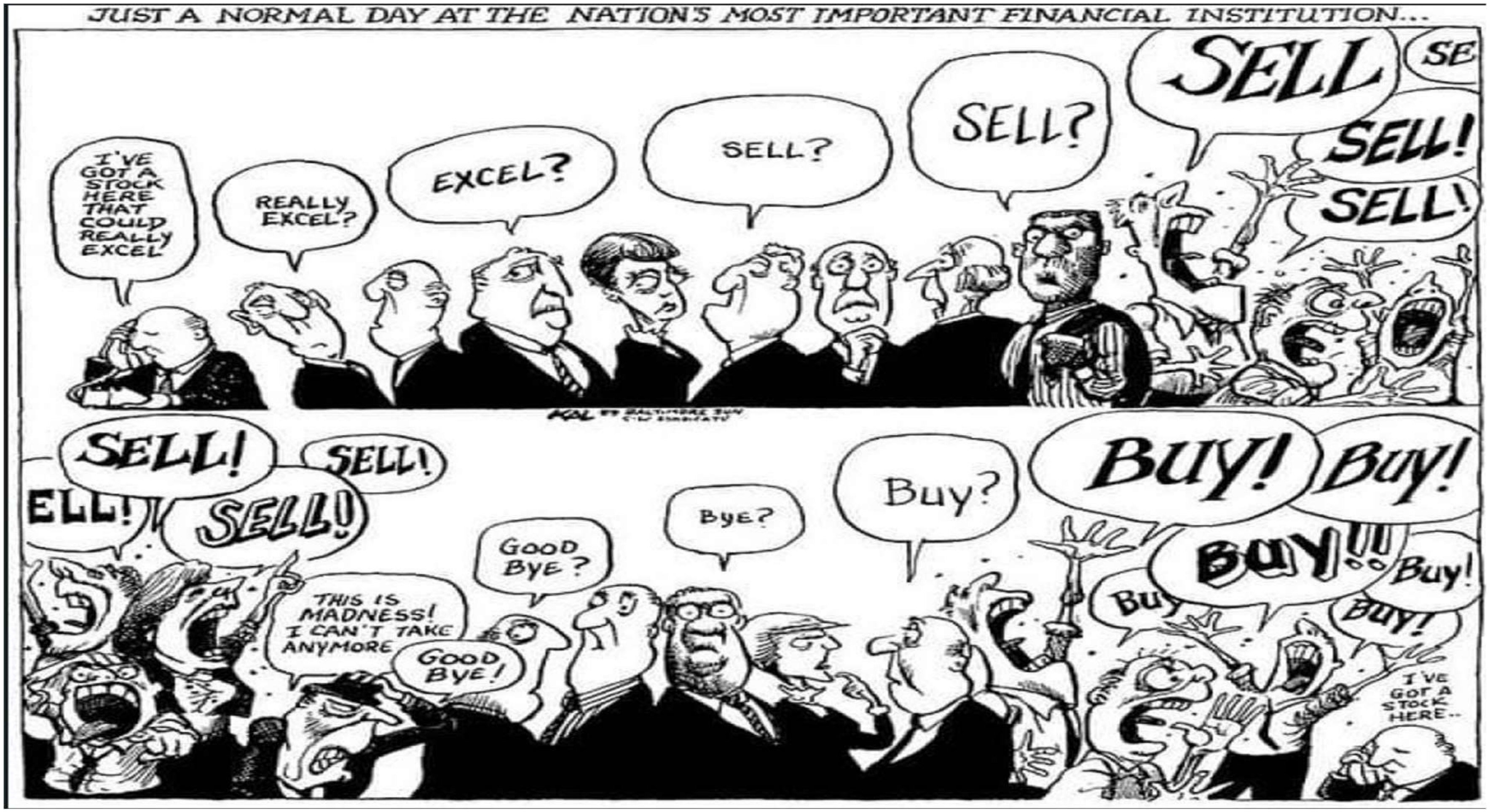
American Association of Individual Investors (AAII)

Austin and San Antonio, Texas Presentation

January 2023

Candor Asset Advisors



Source: Baltimore Sun

Agenda

- Setting the stage
- Challenges
- Opportunities

Like a good movie here is an intro to set the stage

- COVID-19 hits the world in December 2019 and spreads rapidly thereafter.
- Governments impose lockdowns and global economic activity plummets. The US stock market dives 31% from January to March 2020.
- Governments implement significant fiscal and monetary stimulus to prop up the economy. Vaccines help manage the virus.
- Consumer demand and economic prospects improve. Real estate and stocks appreciate.
- Inflation accelerates due to an improving economy and COVID lockdown related supply chain issues.
- The Russia/Ukraine War starts in February 2022 and fuels a rise in commodity prices.

What type of economic landing is in our near-term future?

Soft landing … If so, stocks will likely do fine over the near term

Hard Landing…. If so, stocks will likely weaken over the near term

Pictures from flickr.com, https://www.wyff4.com/

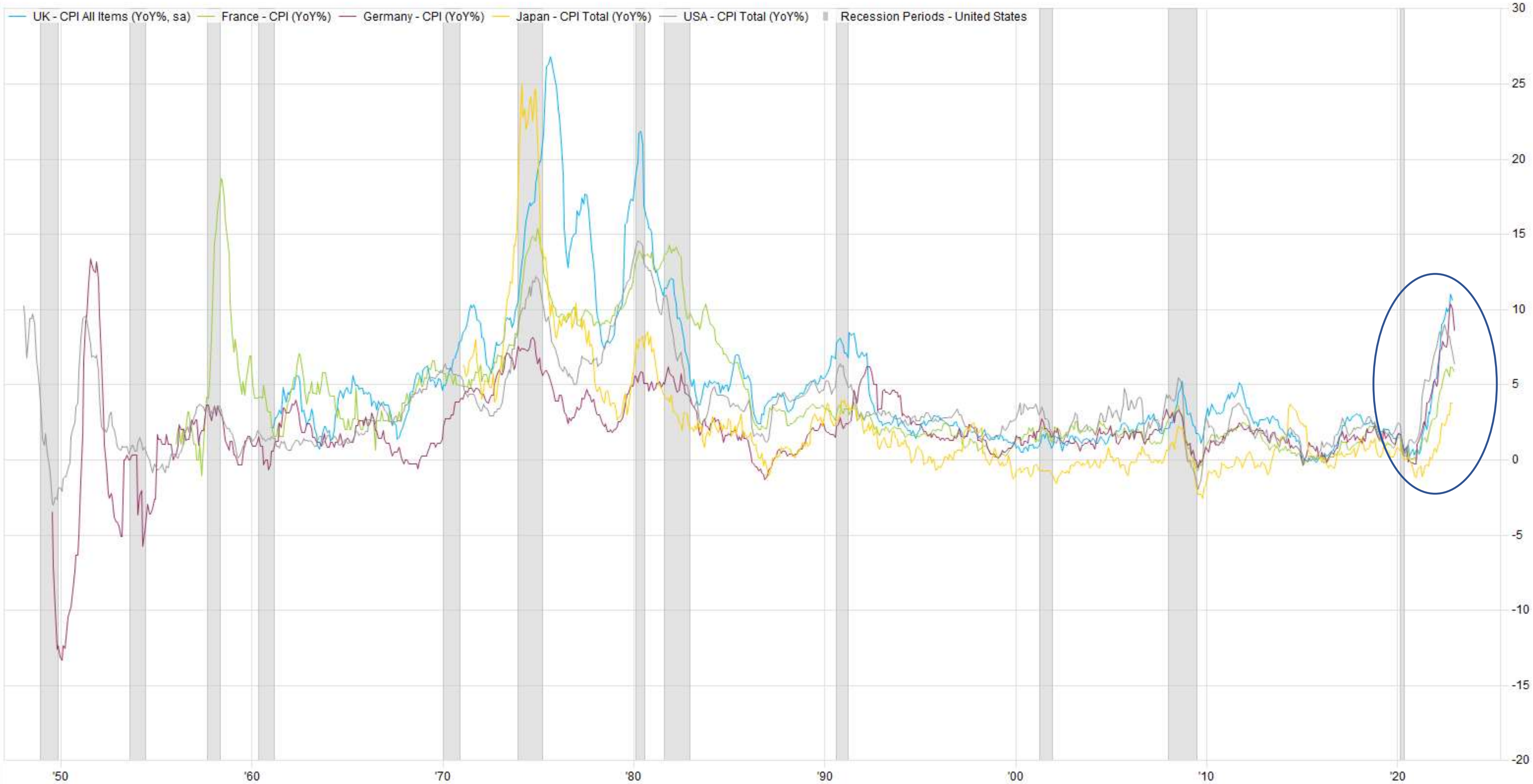
Challenges

- Inflation remains elevated and interest rates continue to rise
- Economic data suggests a slowdown
- Recessions, rate hikes, and bear markets are often associated with one another
- Earnings look vulnerable
- Investors appear to be pricing in a soft landing

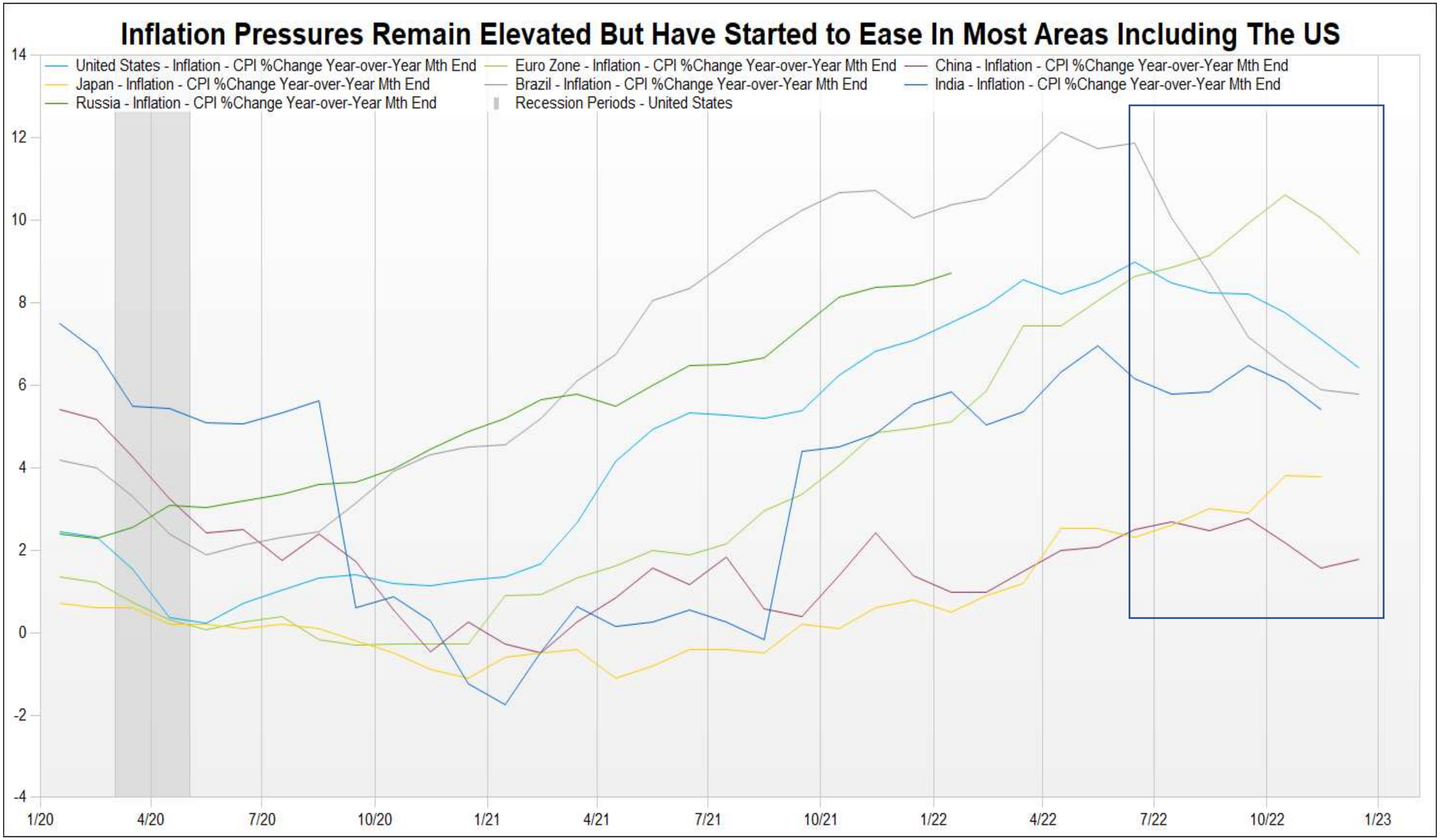
1st Challenge:

Inflation remains elevated and interest rates continue to rise

Inflation Hasn't Risen This Quickly and/or Been This High Since The 1980s



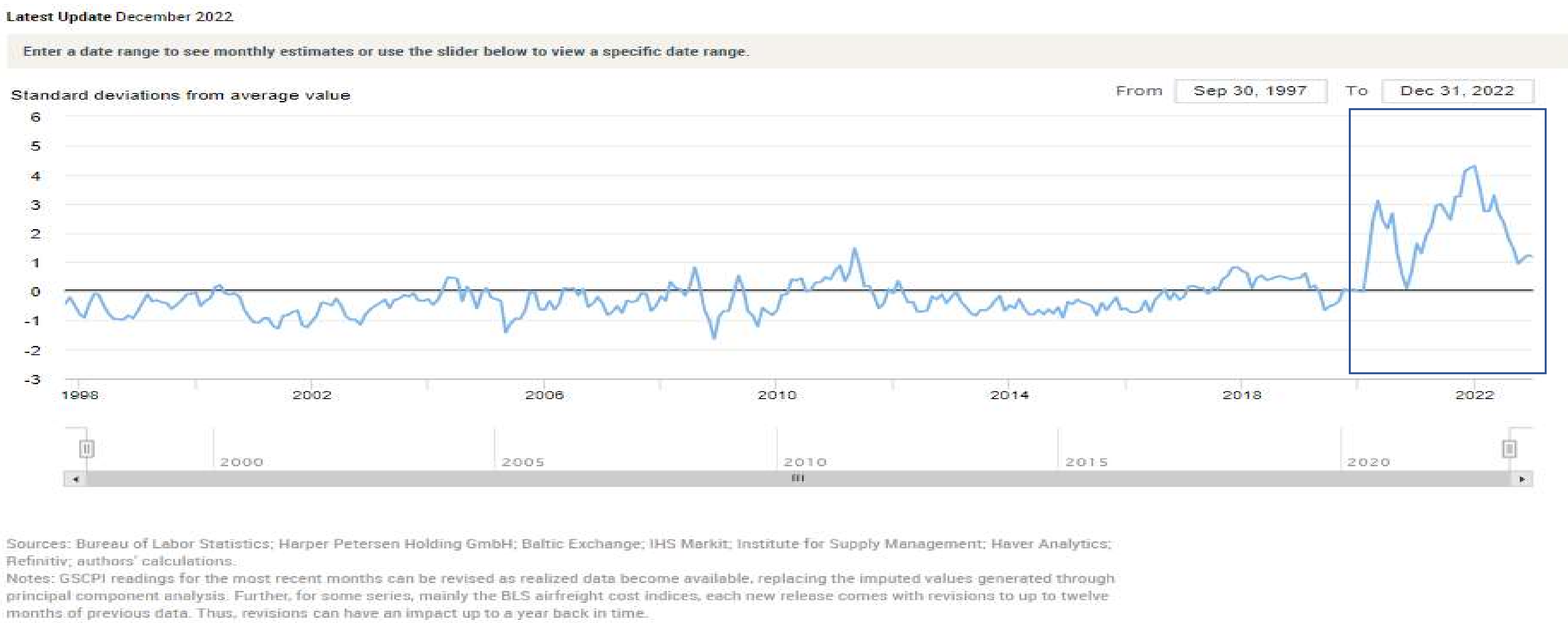
Source: FactSet



Source: FactSet

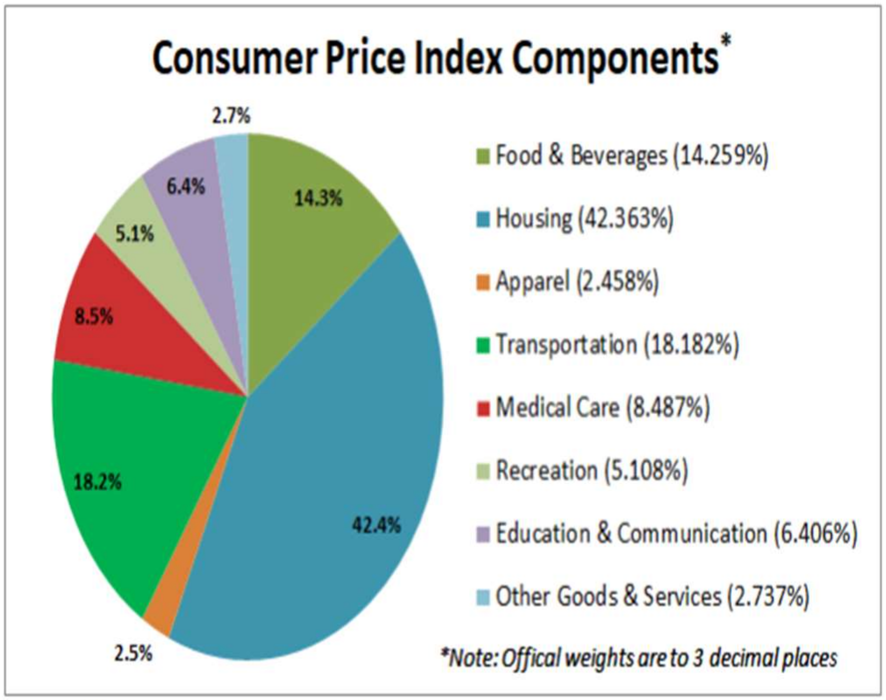
Global supply chains have been strained since the start of COVID-19. Bottlenecks have eased recently.

Global Supply Chain Pressure Index



Source: New York Federal Reserve

Housing, transportation (tied to energy prices) and food & beverage are the most important inflation components and they have been inflation leaders. Inflation may moderate in these areas.



Source: BLS; The most recent annual reweighting was in December 2021

Higher Mortage Rates Are Hurting Housing Demand & May Help Limit Future Home Price Appreciation

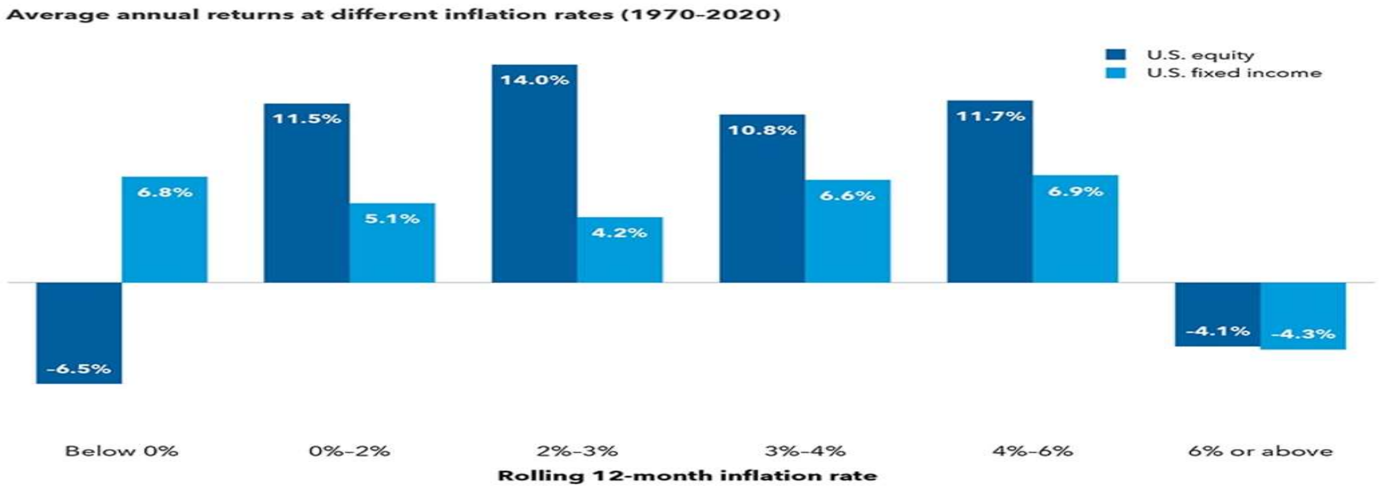
30 Year Mortgage Origination Date	12/31/2021	12/31/2022
Purchase Price	$ 500,000	$ 500,000
Prevailing 30 Year Mortgage Rate	3.11%	6.42%
# of Payments	360	360
Monthly Payment	$2,137.80	$3,134.08
Payment Increase		46.6%

The Energy Markets Are Solving How To Address Oil & Gas Supply Related to The Russia/Ukraine War

	Natural Gas Henry Hub	Crude Oil WTI
12/31/2021	$ 3.82	$ 77.78
2/23/2022	$ 4.59	$ 96.84
6/30/2022	$ 6.54	$ 114.81
12/30/2022	$ 3.52	$ 85.91
1/13/2023	$ 3.70	$ 84.03

Source: FactSet, Candor Asset Advisors Research

The debate continues over how much inflation will decelerate. If inflation significantly retreats, investment returns may hold up well. If inflation persists above 6%, investment returns may continue to take a hit.



Sources: Capital Group, Bloomberg Index Services Ltd., Morningstar, Standard & Poor's. All returns are inflation-adjusted real returns. U.S. equity returns represented by the Standard & Poor's 500 Composite Index. U.S. fixed income represented by Ibbotson Associates SBBI U.S. Intermediate-Term Government Bond Index from 1/1/1970–12/12/1975, and Bloomberg U.S. Aggregate Bond Index from 1/1/1976–12/31/2020. Inflation rates are defined by the rolling 12-month returns of the Ibbotson Associates SBBI U.S. Inflation Index.

Memo:

2021
Inflation 7.1%
US Equity 28.7%
Fixed Income -1.6%

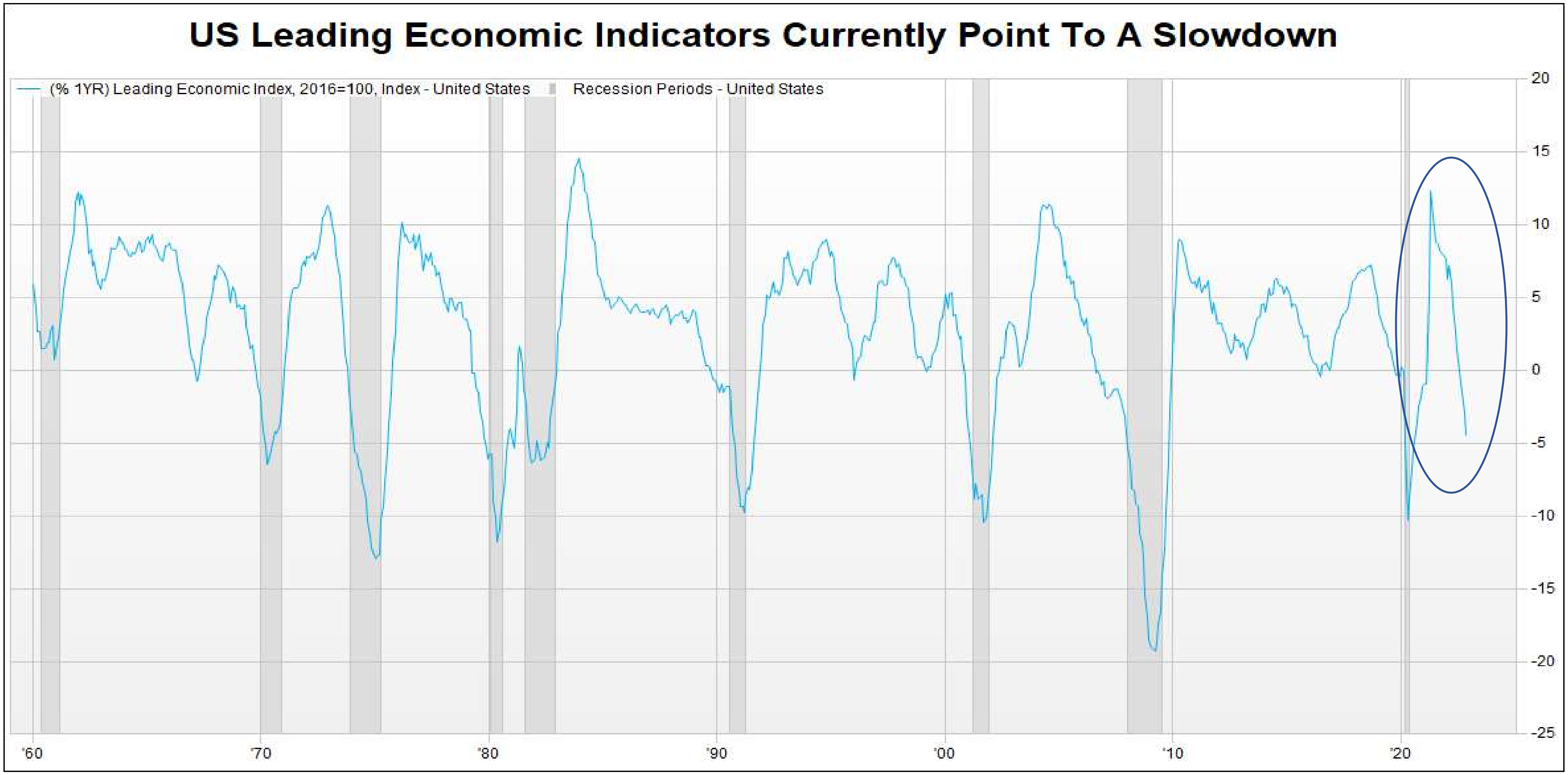
2022
CPI Inflation 6.4%
US Equity -18.1%
Fixed Income -13.0%

Source: Capital Group

Past performance is not a guarantee or predictor of future performance. Stocks are not guaranteed and have been more volatile than other asset classes. Government bonds and Treasury bills are guaranteed by the full faith and credit of the United States government as to the timely payment of principal and interest. Diversification does not eliminate the risk of experiencing investment losses.

2nd Challenge:

Economic data suggests a slowdown

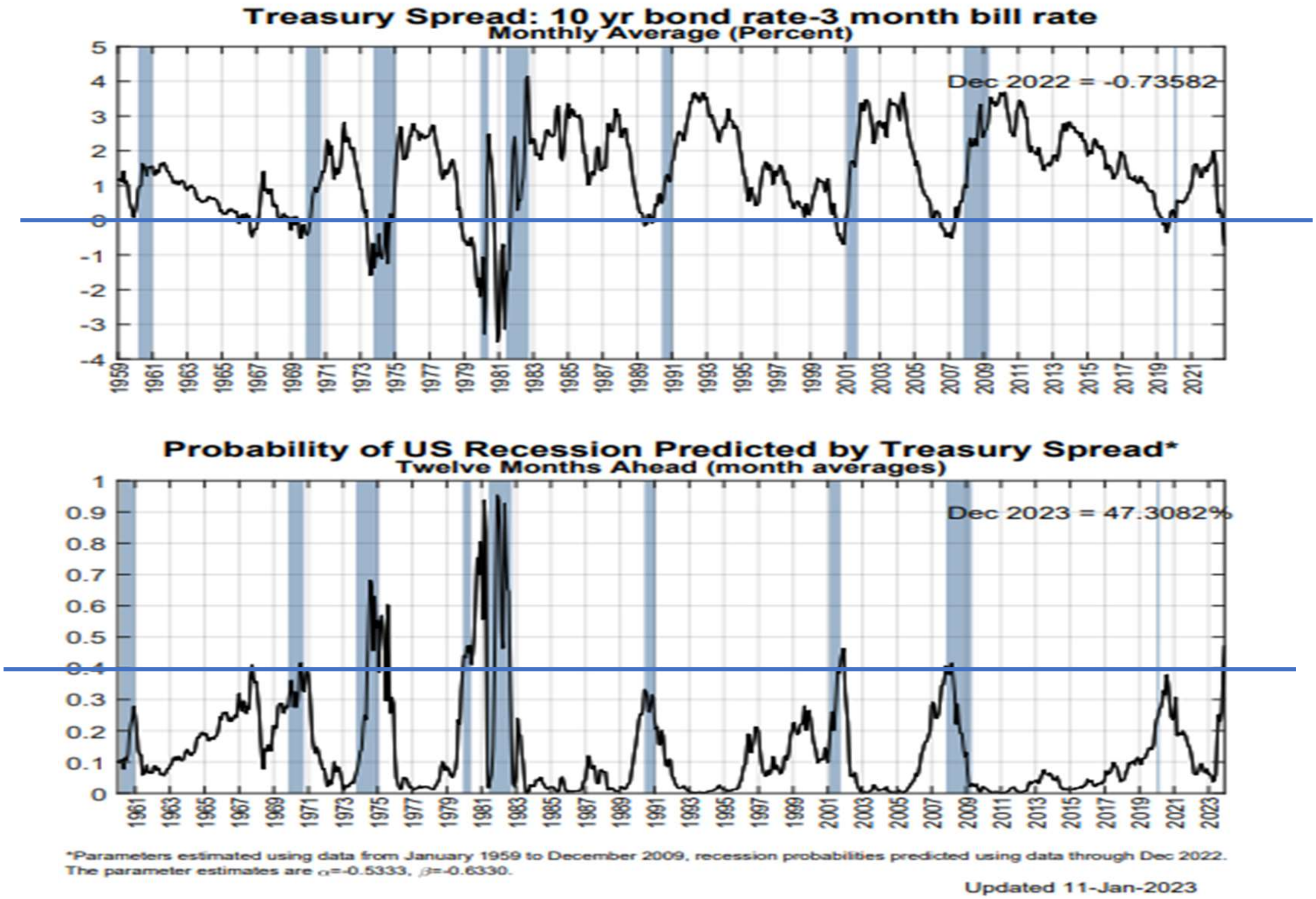


According to NBER, a recession is defined as a significant decline in economic activity lasting more than a few months. Economic activity has slowed recently. Whether we are already in a recession is debatable.
Source: FactSet

The New York Federal Reserve's Recession Probability Model has done a good job predicting recessions since the 1960s

Today's reading suggests a 47% probability of a recession

Source: New York Federal Reserve



3rd Challenge:

Recessions, rate hikes, and bear markets are often associated with one another

Significant rate hikes and/or a recession are usually bad news for stocks. Expect more muted returns in the near term.

- Since 1926 we have had
  - 12 Significant Rate Hike Periods
    - 3 have occurred in isolation
    - 2 occurred during a recession
    - 7 have occurred within 6 months of a recession or bear market
  - 15 Recessions
    - 5 have occurred in isolation
    - 5 have occurred during bear markets
    - 5 have occurred within 6 months of rate hikes or a bear market
  - 11 Bear Markets
    - 2 have occurred in isolation
    - 5 have occurred during a recession
    - 4 have occurred within 6 months of rate hikes or recessions

Investment returns are more muted during recessions

Since 1926	US Large Cap Stocks	US Small Cap Stocks
Average Monthly Returns	0.97%	1.26%
Median Monthly Returns	1.31%	1.48%
Average Monthly Return 6 Months Prior to Recession	0.47%	0.62%
Average Monthly Return 12 Months Prior to Recession	0.94%	5.98%
Average Recession Monthly Returns	-0.25%	-0.59%
Median Recession Monthly Returns	0.17%	-0.79%

Source: CFA Institute and Ibbotson

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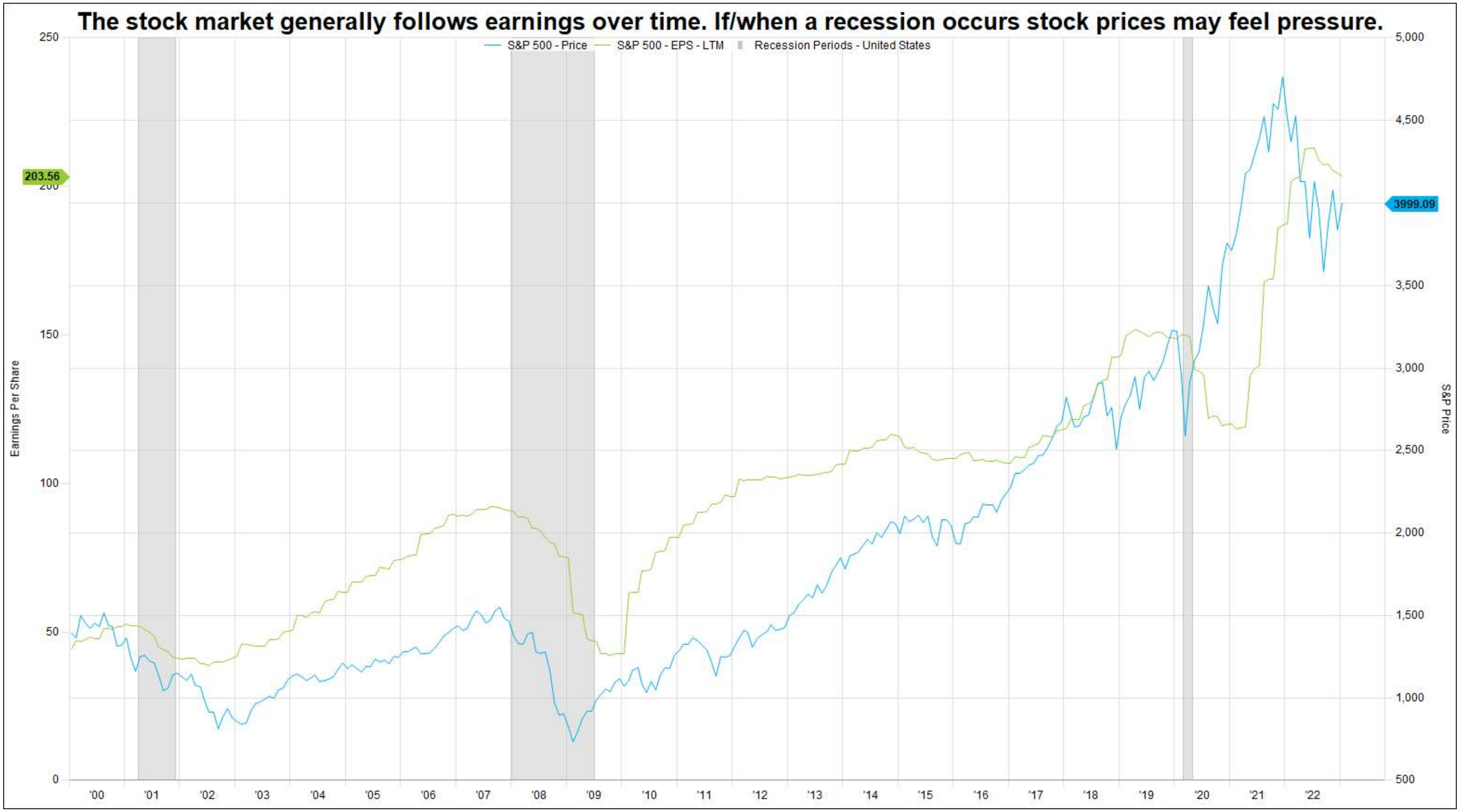
4^{th} Challenge:

Earnings look vulnerable



Source: FactSet

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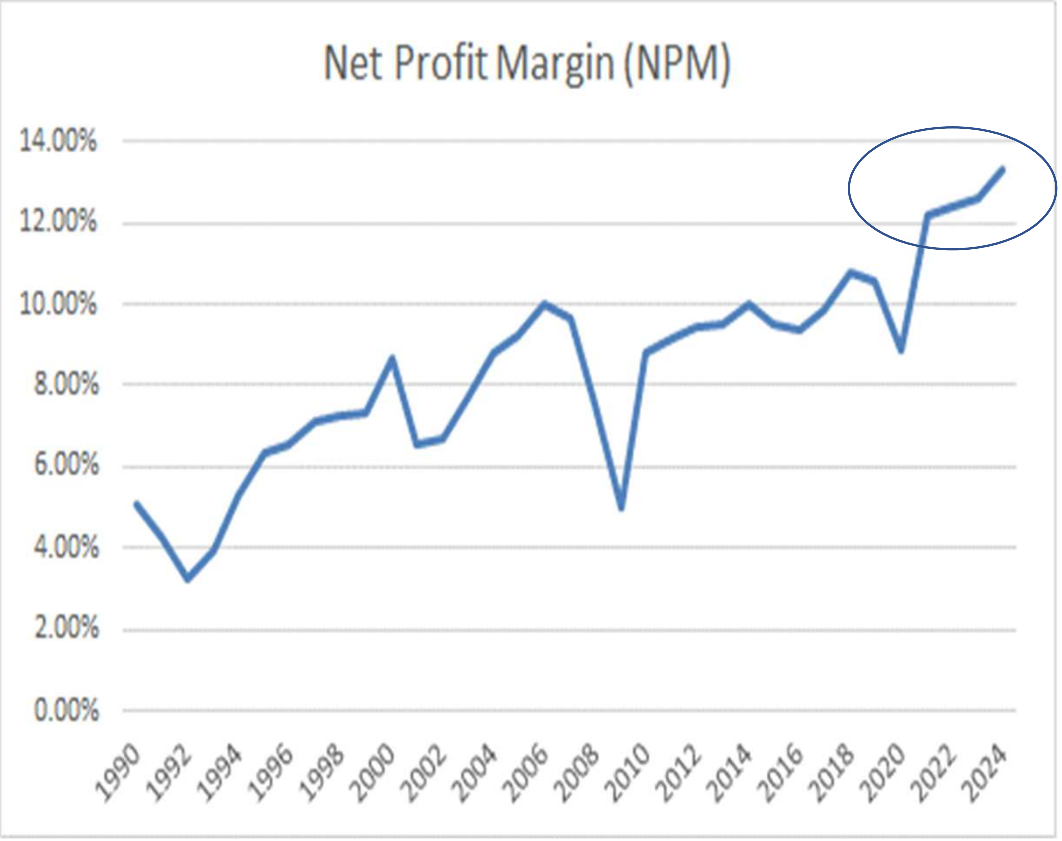
Margin contraction is an earning risk

Consensus forecasts call for S&P earnings growing 16.7%, 4.5% and 10.3% in 2022, 2023 and 2024. This forecast assumes historically strong margins despite higher interest costs and labor cost pressures.

If companies have trouble passing on cost inflation, margins may be vulnerable. If margins contract profits will be pressured. This trend would likely serve as a stock headwind.



Source: S&P and FactSet

Consensus estimates appear vulnerable if/when a recession occurs

	Consensus Estimates			Past Recessions	If Recession Starts in	Implied
	2021A	2022E	2023E	Since 1990	2023E	Revision
Sales Per Share	$1,535.60	$1,760.40	$1,809.90		$1,765.15	-2.5%
Annual Growth	14.0%	14.6%	29.5%	0.3%		
EPS	$187.11	$218.37	$228.16		$178.23	-21.9%
Annual Growth	56.0%	16.7%	4.5%	-18.4%		
Dividend Per Share	$57.65	$65.50	$68.78		$65.56	-4.7%
Annual Growth	2.3%	13.6%	5.0%	0.1%		

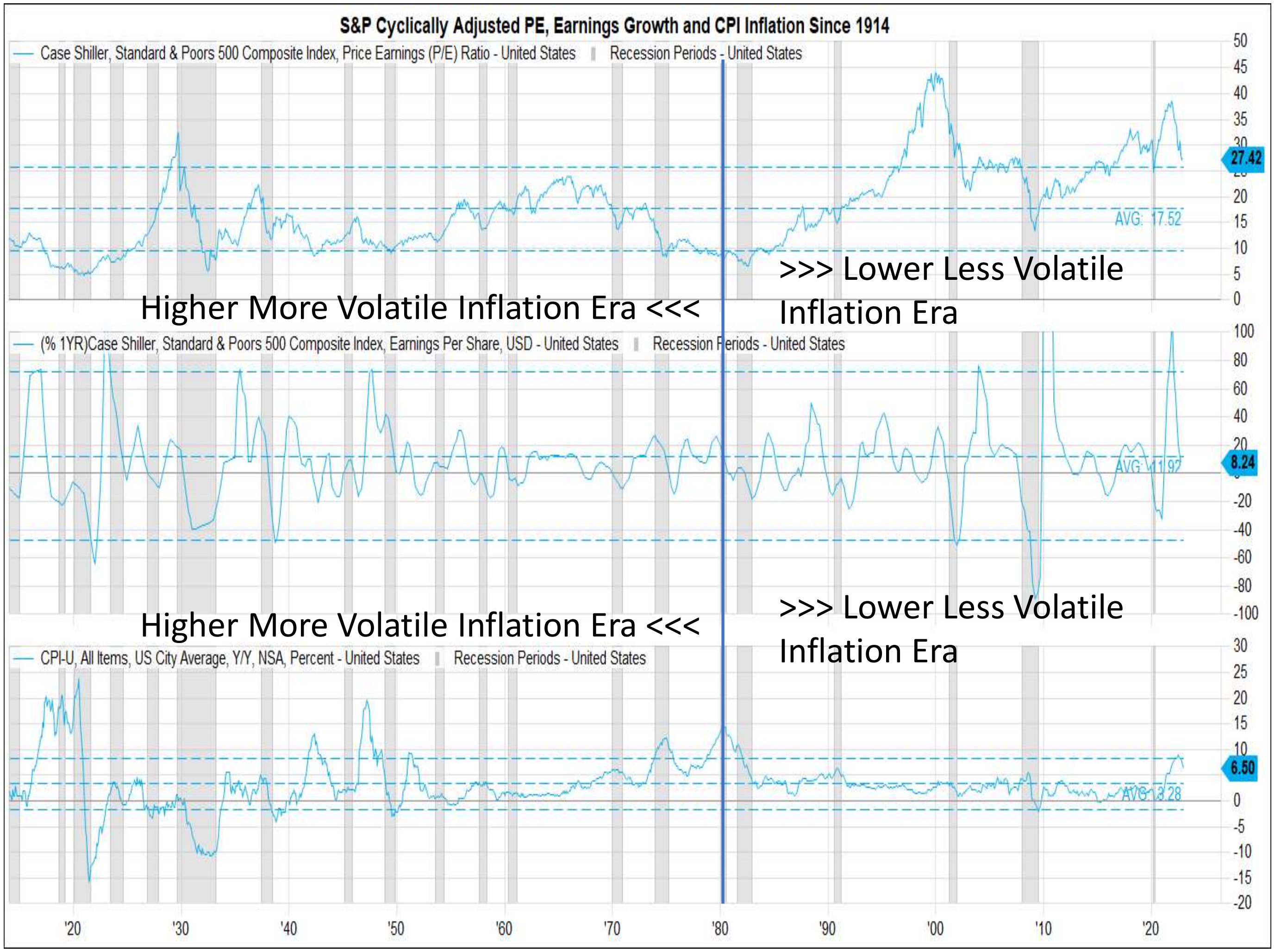
Source: Candor Asset Advisors and FactSet

5^{th} Challenge:

Investors appear to be pricing in a soft landing

The Valuation Debate: Is The Stock Market Expensive or Near Averages?

The Answer Depends on Your Relevant Time Frame



Source: FactSet

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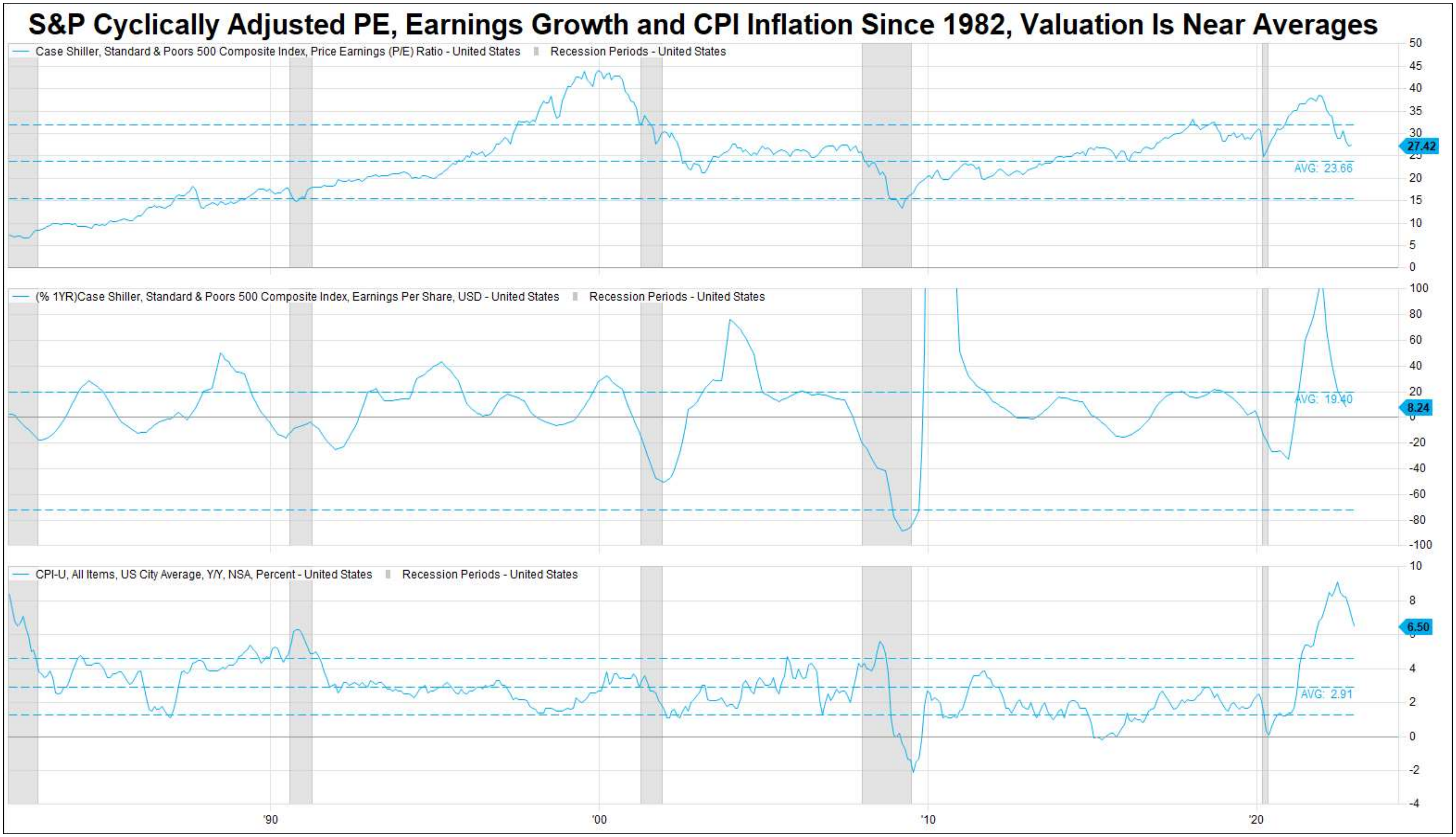

Source: FactSet

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Stock market valuations are near 25-year averages implying a soft landing is factored in

S&P 500 valuation measures

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S&P 500 Index: Forward P/E ratio

Valuation measure	Description	Latest	25-year avg.*	Std. dev. Over-/under-Valued
P/E	Forward P/E	16.65x	16.82x	-0.05
CAPE	Shiller's P/E	27.96x	27.93x	0.01
Div. Yield	Dividend yield	1.81%	1.99%	0.53
P/B	Price to book	3.42x	3.10x	0.40
P/CF	Price to cash flow	12.42x	11.19x	0.56
EY Spread	EY minus Baa yield	0.17%	0.27%	0.05

Source: FactSet, FRB, Refinitiv Datastream, Robert Shiller, Standard & Poor's, Thomson Reuters, J.P. Morgan Asset Management.
Price-to-earnings is price divided by consensus analyst estimates of earnings per share for the next 12 months as provided by IBES since December 1997 and by FactSet since January 2022. Current next 12-months consensus earnings estimates are $231. Average P/E and standard deviations are calculated using 25 years of history. Shiller's P/E uses trailing 10-years of inflation-adjusted earnings as reported by companies. Dividend yield is calculated as the next 12-months consensus dividend divided by most recent price. Price-to-book ratio is the price divided by book value per share. Price-to-cash flow is price divided by NTM cash flow. EY minus Baa yield is the forward earnings yield (consensus analyst estimates of EPS over the next 12 months divided by price) minus the Moody's Baa seasoned corporate bond yield. Std. dev. over-/under-valued is calculated using the average and standard deviation over 25 years for each measure. *P/CF is a 20-year average due to cash flow availability.
Guide to the Markets – U.S. Data are as of December 31, 2022.

J.P. Morgan
ASSET MANAGEMENT

Past performance is not a guarantee or predictor of future performance. Stocks are not guaranteed and have been more volatile than other asset classes.

If we have a hard economic landing, we likely have additional stock bear market risk

- The average bear market decline is 41% since 1926. The current January 2022 bear market decline topped out at 25% in October 2022. The cumulative drop is now 16.7%.

Bull and bear markets

Bull markets			Bear markets		
Bull begin date	Bull return	Duration (months)	Market peak	Bear return*	Duration (months)*
Jul 1926	152%	37	Sep 1929	-86%	32
Mar 1935	129%	23	Mar 1937	-60%	61
Apr 1942	158%	49	May 1946	-30%	36
Jun 1949	267%	85	Aug 1956	-22%	14
Oct 1960	39%	13	Dec 1961	-28%	6
Oct 1962	76%	39	Feb 1966	-22%	7
Oct 1966	48%	25	Nov 1968	-36%	17
May 1970	74%	31	Jan 1973	-48%	20
Mar 1978	62%	32	Nov 1980	-27%	20
Aug 1982	229%	60	Aug 1987	-34%	3
Oct 1990	417%	113	Mar 2000	-49%	30
Oct 2002	101%	60	Oct 2007	-57%	17
Mar 2009	401%	131	Feb 2020	-34%	1
Mar 2020	114%	21	Jan. 2022**	-25%	9
Averages	**162%**	**51**	**-**	**-41%**	**20**

A bear market is defined as a 20%+ drop from the previous market high. Bear market returns cited here are price returns. The January 2022 bear market peaked at 25% and has now registered a 16.7% cumulative drop. The average returns cited exclude the January 2022 figure as this bear market continues.

Source: JP Morgan Asset Management

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A silver lining is the stock market is forward looking. History suggests the stock market typically bottoms during a recession as investors increasingly focus on the pending recovery.

Market inflection points, recessions and the unemployment rate

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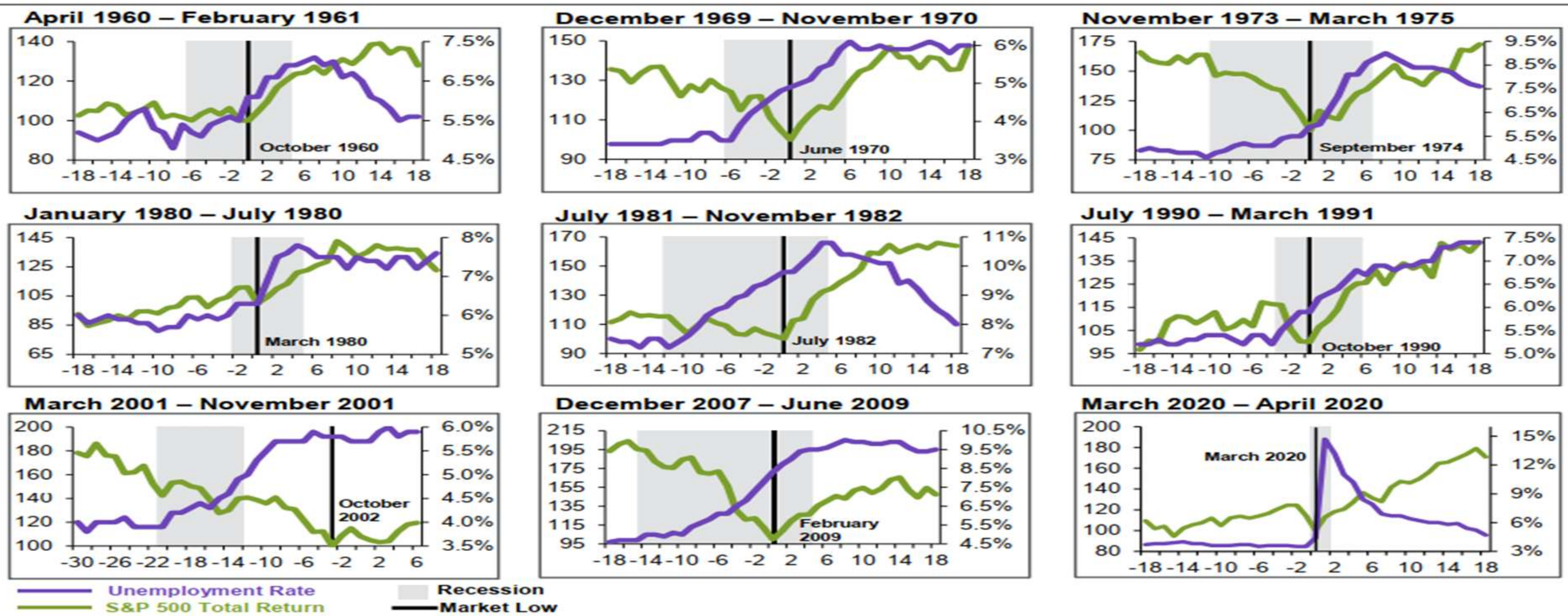

Source: BLS, Ibbotson, J.P. Morgan Asset Management. Time zero represents the numeric low of the S&P 500 Total Return Index associated with the recessionary period defined by the shaded grey area; data shown in months. S&P500 Index is rebased to 100 at time zero.
Guide to the Markets – U.S. Data are as of September 30, 2022.

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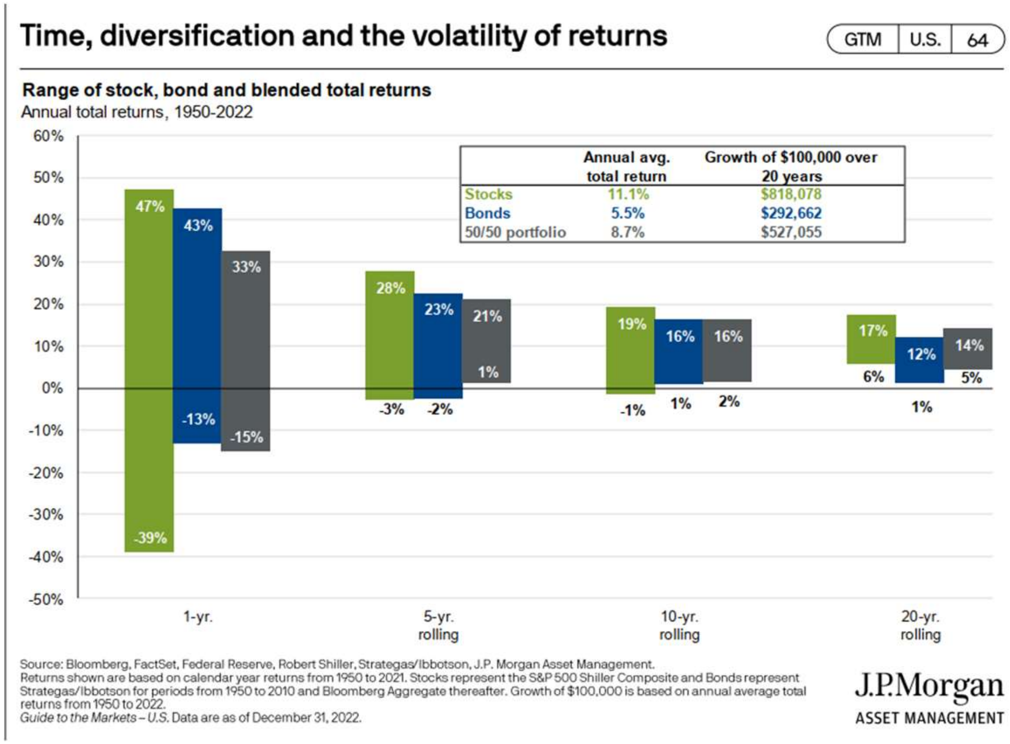
Opportunities

- Passive indexing
- Enhanced indexing
- Sectors & Individual stocks

1st Opportunity

Passive Indexing: Ignore the noise and focus on asset allocation and the long term to achieve your financial goals

Key allocation concept: Stocks are the most volatile in the short run while volatility across stocks and bonds is similar over the long run



Asset allocation perspective:

You should possess these traits to be invested in common stocks

- Average to high risk tolerance
- Average to high risk capacity
- An intermediate to long time horizon

If don't have these traits, please re-evaluate your stock allocation.

If you have these traits, history suggests you should enjoy solid returns over the long run.

Source: JP Morgan Asset Management

Past performance is not a guarantee or predictor of future performance. Financial plans are hypothetical in nature and intended to help you in making decisions on your financial future based on information that you have provided and reviewed. Assumptions need to be reviewed regularly. Stocks are not guaranteed and have been more volatile than other asset classes. Government bonds and Treasury bills are guaranteed by the full faith and credit of the United States government as to the timely payment of principal and interest. Diversification does not eliminate the risk of experiencing investment losses.

US stock studies since the 1950s have stressed the same thing: The Importance of Staying Invested

- 1954-1994 Return Study
  - S&P earned a 11.4% annual return
  - If you were out of the market during the best performing days
    - 2% of the time you earned an 8.3% annual return
    - 4% of the time you earned a 6.1% annual return
    - 8% of the time you earned a 2.7% return
- 1980-2018 Return Study
  - S&P earned a 11.65% annual return
  - If you were out of the market and you missed the
    - 5 best days you earned a 10.38% return
    - 10 best days you earned a 9.53% return
    - 30 best days you earned a 6.87% return
    - 50 best days you earned a 4.71% return

The 1980-2018 study assumes an investment tracks the returns of the S&P index and includes dividend reinvestment but does not reflect the impact of taxes, which would lower these figures. “Best days” were determined by ranking the one-day returns for the S&P index within this time period and ranking them from highest to lowest.

Source: Peter Lynch *One Up On Wall Street*, Fidelity

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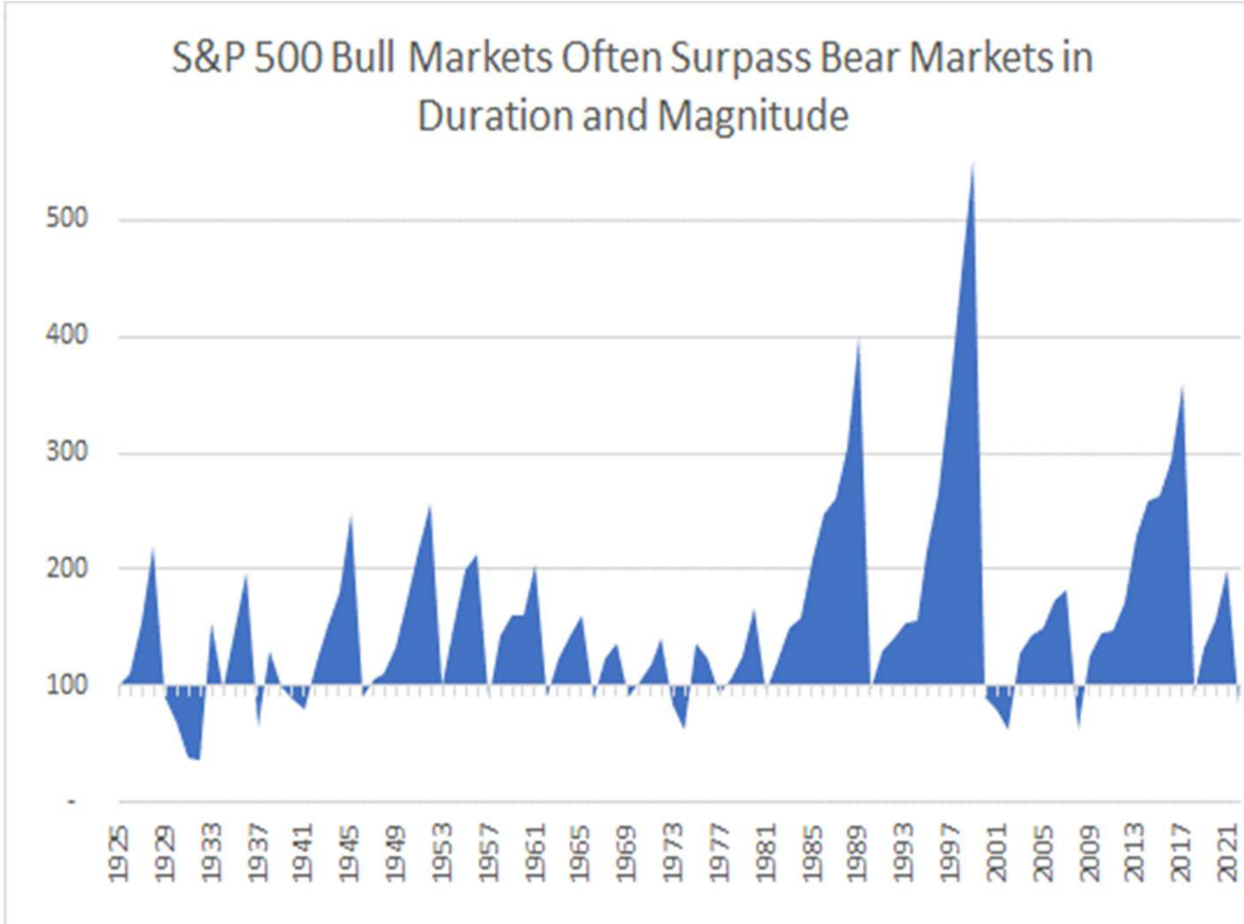
Riding out the current rough patch is usually the best advice for most stock investors.

ETF to consider: Vanguard Total Stock Market <VTI>



Source: CFA Institute, Ibbotson, Candor Asset Advisors

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2nd Opportunity

Enhanced Indexing: Focus on areas of the market that outperform over the long run and are under valued

Stock Factors That Have Outperformed The Overall US Stock Market Over The Long Term

Factor	Captures Excess Returns From	Rationale	Metric	Data Since	Average Annual Excess Return: Since Inception	50 Years	20 Years	10 Years
Value	Stocks that have lower prices relative to their fundamental value	Investors want to say they are invested in the current era growth stories and over estimate the durability of growth. Value stocks have greater leverage, lower margins and lower return on asset. Investors need to be compensated for taking greater risk with value stocks	Price/Book Value	1926	3.0%	3.2%	-1.3%	-1.5%
			Price/Dividends	1927	1.7%	2.3%	0.5%	-2.3%
			Price/Earnings	1951	5.2%	3.8%	0.1%	-1.7%
			Price/Cash Flow	1951	3.8%	2.9%	-0.5%	-4.5%
Size/Small Cap	Smaller firms by market capitalization relative to their larger counterparts	Smaller firms are under followed relative to larger firms. Smaller firms have more leverage, lower margins and return on assets and investors need to be compensated for taking greater risk with small cap stocks.	Market Capitalization	1926	1.8%	1.0%	3.3%	-2.2%
Quality	Stocks earn higher investment returns and enjoy lower capital intensity	Higher quality firms possess competitive advantages/moats that enable these firms to outperform	Investment	1963	3.5%	4.4%	1.1%	1.4%
			Return on Equity	1963	3.9%	4.0%	4.3%	4.8%
Momentum	Stocks that enjoy positive relative returns	Investors under estimate the persistence of superior performance	Price Movement	1927	6.4%	6.6%	-0.2%	2.1%
Low Volatility	Stocks that have lower volatility, beta and/or idiosyncratic risk	Investors over pay for more volatile stocks in the pursuit of higher investment returns	Beta	1963	5.0%	5.5%	5.7%	7.4%

Source: Ken Fama US data library through November 2022 and top 30% versus bottom 30% of universe cited.

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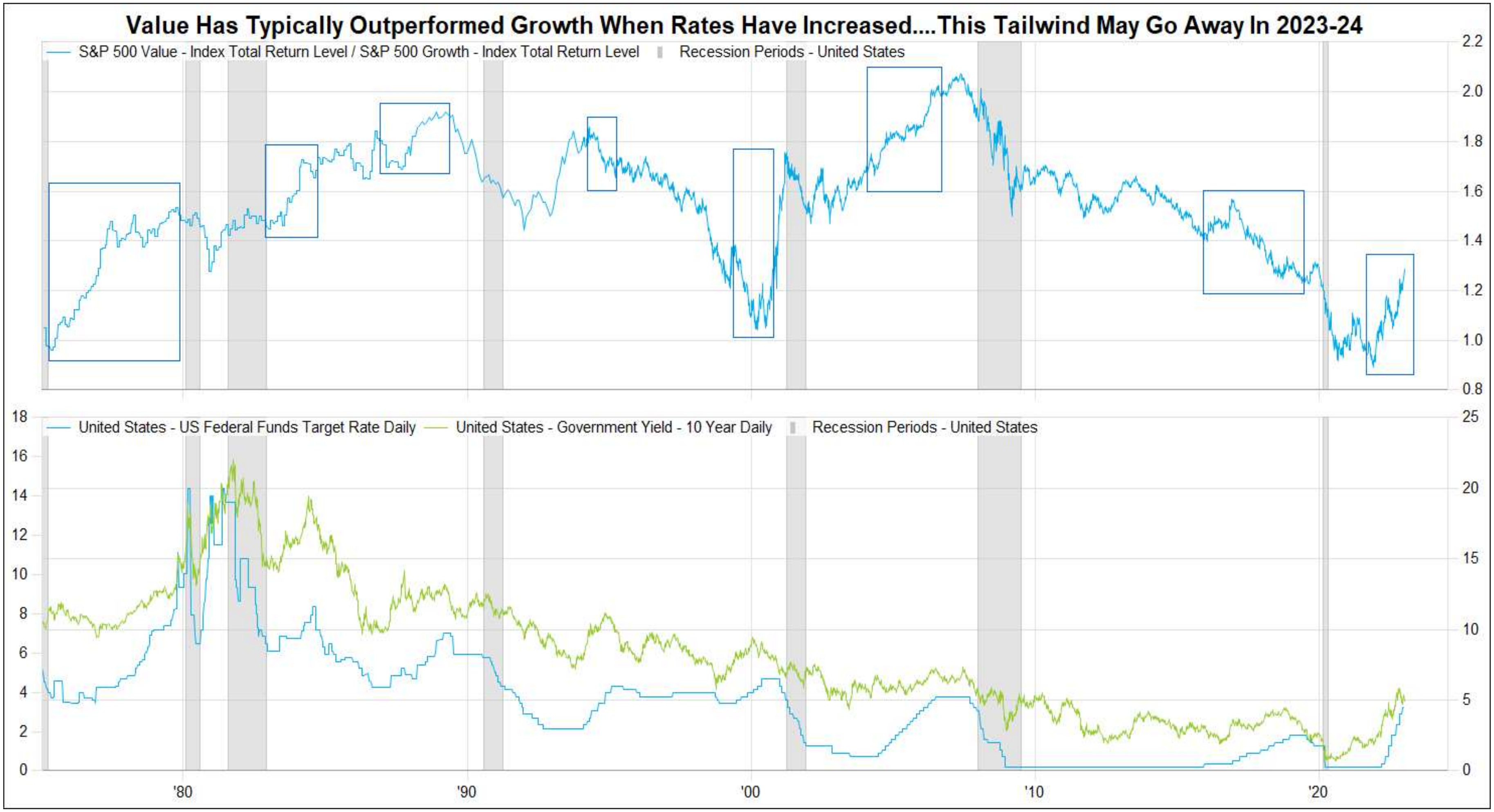

Source: FactSet

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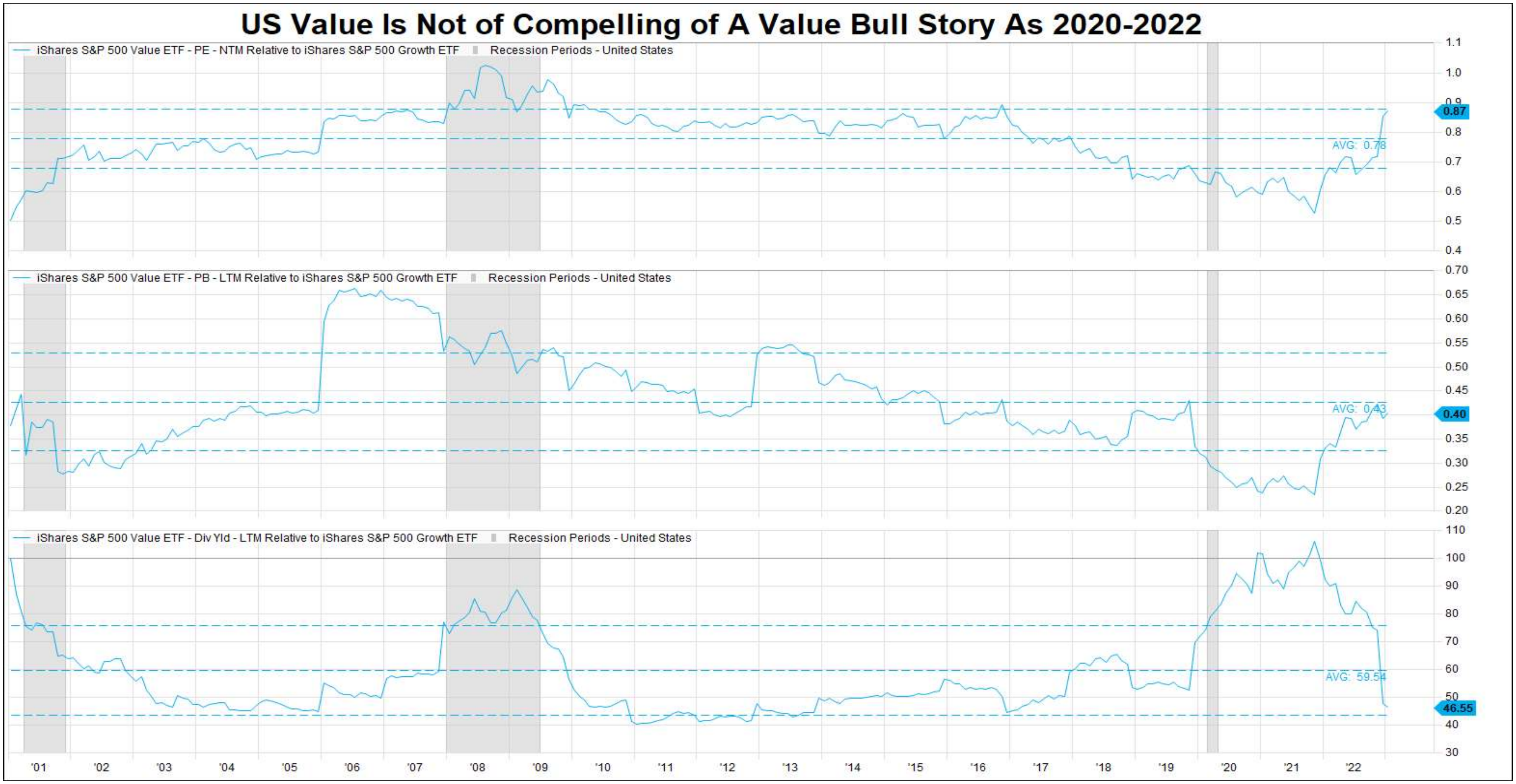
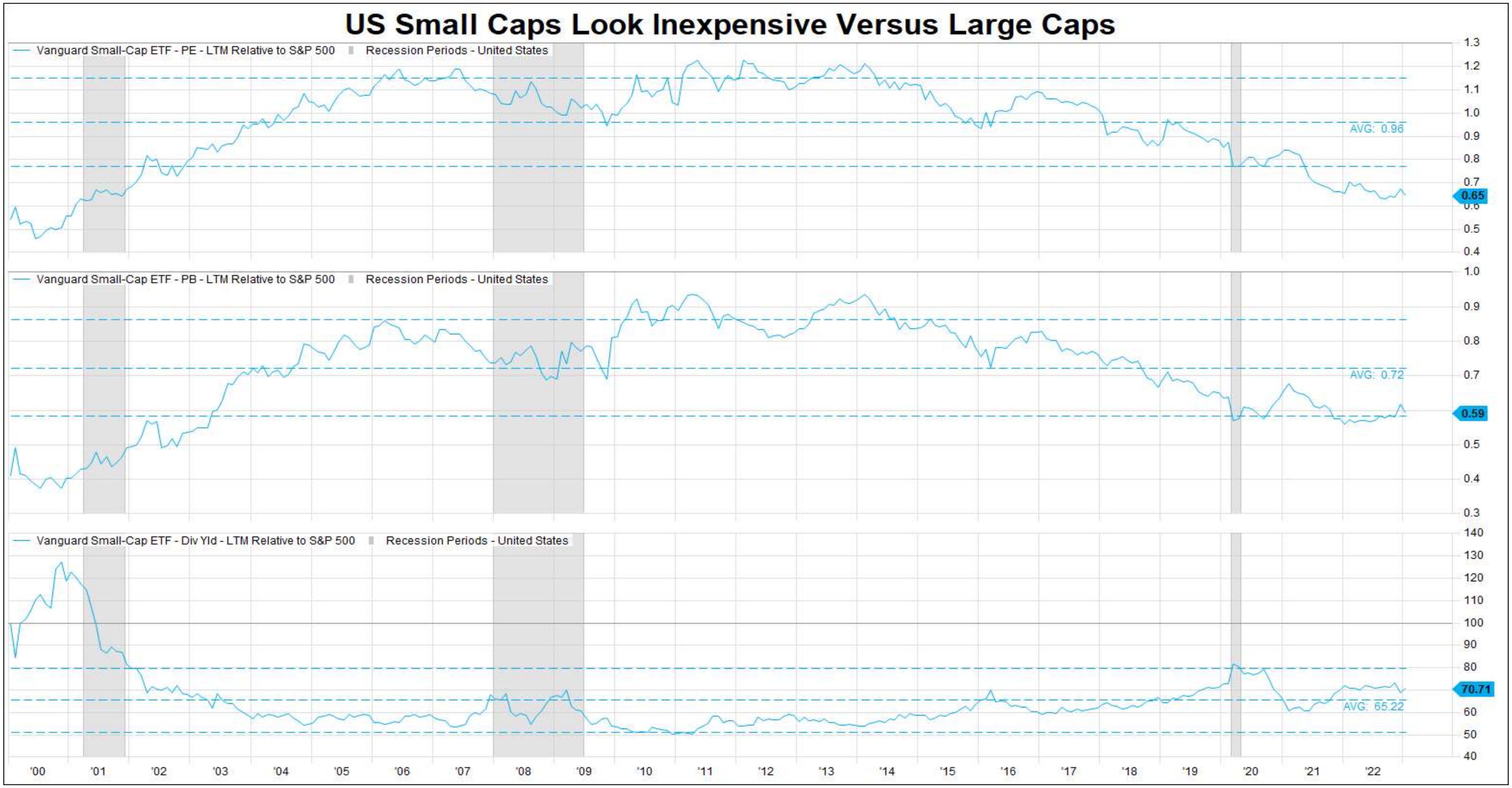


Value ETF to consider: Vanguard Value <VTV>

Source: FactSet

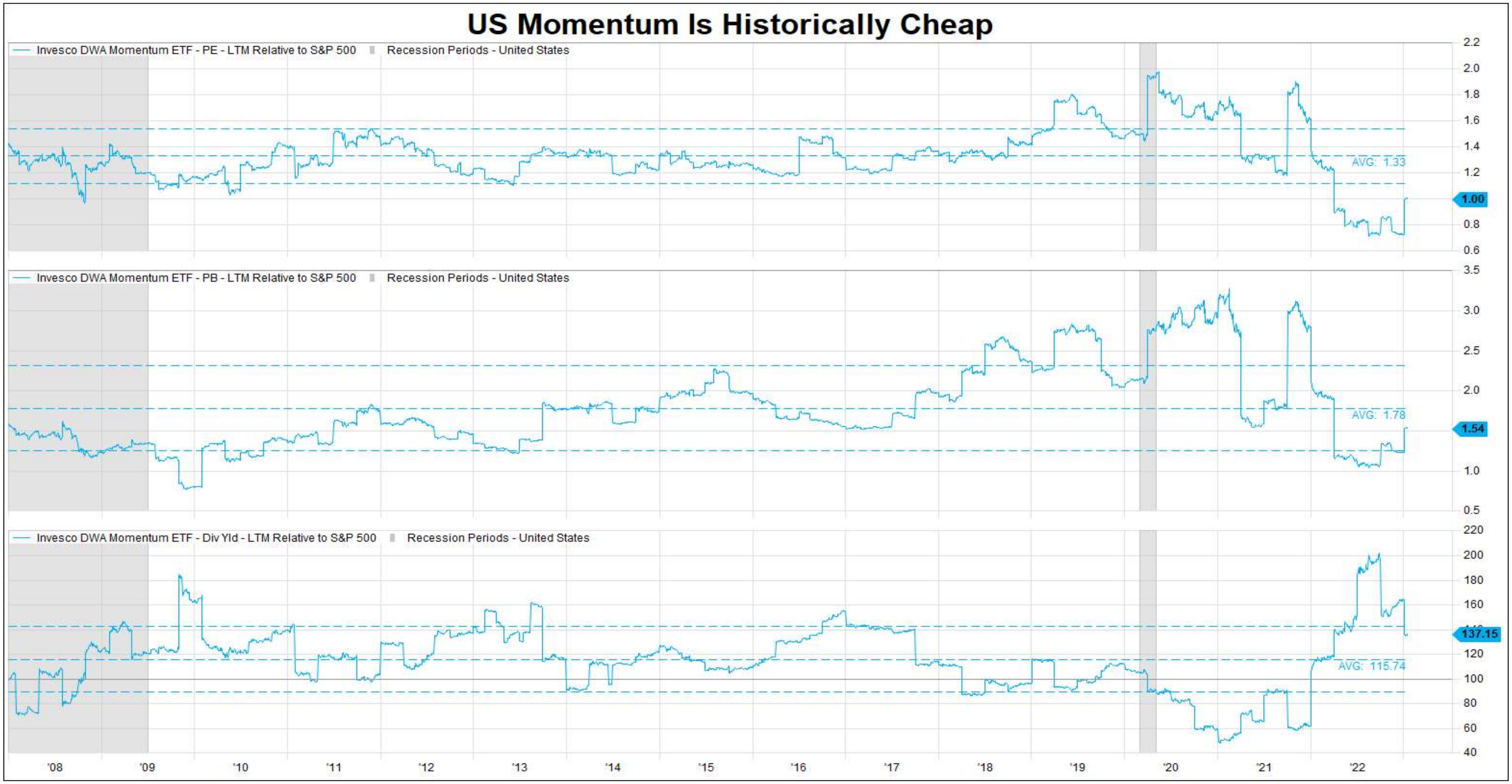
Past performance is no guarantee of future results.



Small Cap ETF to consider: SPDR S&P 600 Small Cap Value ETF <SLYV>

Source: FactSet

Past performance is no guarantee of future results.



Momentum Cap ETF to consider: iShares MSCI USA Momentum Factor ETF <MTUM>

Source: FactSet

Past performance is no guarantee of future results.

3rd Opportunity

Sectors & Stocks: Focus on areas of the market that look the most compelling

Overall Perspective

Leaders: Communication Services, Financials, Consumer Discretionary
Laggards: Real Estate, Utilities, Consumer Staples

	Average Ranks			Overall
	Momentum	Near Term Valuation	3-5 Year Potential	Rank
Sector				
Materials	11	3	1	**4**
Communication Services	5	2	2	**1**
Consumer Discretionary	1	9	3	**3**
Consumer Staples	6	6	9	**9**
Energy	7	5	4	**5**
Financials	2	1	6	**2**
Health Care	8	4	7	**7**
Industrials	3	7	8	**6**
Real Estate	10	11	11	**11**
Technology	4	10	5	**8**
Utilities	9	8	10	**10**

Rank Scale: 1 Best, 11 Worst; Momentum calculated using FactSet 2023 relative earnings growth and Value Line timeliness rankings; Near Term Valuation and 3-5 year potential from Candor Asset Advisors Research; ETFs to consider: Communication Services <XLC>, Financials Sector SPDR Fund <XLF>, Consumer Discretionary Fund <XLY>

Compelling stock ideas

- Comcast <CMSCA>
  - Comcast possesses an entrenched cable communication business that represents about 70% of total annual cash flow. In most markets Comcast is one of 2 or 3 providers for fixed-line internet access. Broadband usage continues to grow as consumers use it for entertainment, shopping and education. The costs to enter and compete in this area are substantial while regulatory barriers are noteworthy. Comcast has been able to scale incremental investments and strengthen their competitive offering.
  - Cross selling wireless to existing broadband customers has worked successfully to date and we expect this to continue.
  - The Peacock direct to consumer media business should see improved profitability over time. Comcast has been making significant investments and we expect either the unit will scale as management anticipates or they will cut expenses as needed to improve the bottom line.
  - The stock is compelling at 11x earnings and offers a 2.8% dividend yield.
- US Bancorp <USB>
  - US Bancorp is a premier regional bank that enjoys a strong moat centered around cost advantages (low-cost deposit base, excellent operating expense base relative to sales and a strong underwriting culture) and high switching costs. These benefits enable USB to consistently enjoy a superior return on asset and return on equity than peers. US Bank uses this superior profit generation to extend the competitive advantage, pursue attractive growth opportunities and return remaining cash flow to shareholders.
  - The Union Bank acquisition strengthens US Bank's position in California with consumers and small businesses. US Bank's integration expertise and scalable operating model should enable US Bank to achieve an attractive acquisition investment return.
  - US Bancorp is well positioned for the growth in digital banking given their existing operating scale and strong payments position. Payments represents 26% of sales and should be a relative growth driver.
  - The valuation is attractive at a 11x earnings and a offers a 4.1% dividend yield.
- Polaris <PII>
  - Polaris is the market share leader in the attractive off-road vehicle segment with 33% share. They are also the #2 player in snowmobiles, boats and motorcycles. Polaris' advantages stem from a strong brand name, distribution network, production scale and product innovation expertise. A strong ROIC underscores the strength of the franchise.
  - We see the company making significant improvements in supply chain in the coming quarters. The gains should occur as COVID-19 related bottlenecks are resolved. These actions should help deliver sales and margin improvement.
  - Aftermarket should serve as a partial sales and profit cushion if/when a recession occurs.
  - The stock is compelling at 10x earnings and offers a 2.4% dividend yield.

Source: Candor Asset Advisors Research

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Appendix

- COVID-19
- Economic backdrop
- Fiscal and monetary policy
- Recessions, corrections, bear markets and rallies
- Stock studies
- Opportunities expanded

- To view the appendix please email Bill Hawes to request it @: bhawes@candorassetadvisors.com

For more information

- Check out our website at:

www.candorassetadvisors.com

- We discuss where we see opportunities in stocks, fixed income and other asset classes in our investment strategy commentaries
- Sign up to receive our insights by emailing us @:
  - info@candorassetadvisors.com
- To schedule a conversation, use the following link:
  - https://calendly.com/bhawes-1/brief_conversation

William E. Hawes, CFA, CFP®
President & Chief Investment Officer

With over 22 years of industry experience, Bill brings a wealth of knowledge in investment management. Prior to earning his MBA, Bill worked in mortgage banking and insurance, and the insights gained provided him with a broader perspective of the financial issues facing clients.

Bill has been a Chartered Financial Analyst since 2000 and is a member of the CFA Society of Austin. Bill also enjoys golf, travel, studying history, watching his favorite sports teams and spending time with family.

Before founding Candor Asset Advisors, LLC, Bill co-created and managed Century Management's Large Cap Absolute Value and Large Cap Value strategies. Bill also analyzed companies in a variety of industries for the firm's all cap value strategy.

Prior to moving back to Texas, Bill served as an equity analyst for Engemann Asset Management in Southern California. He co-managed a mid-cap growth fund and served as an multi-sector analyst for the mid cap and large cap growth team.

After graduate school, Bill served as co-portfolio manager and equity analyst at Franklin Templeton. While there he served as portfolio manager on All Cap, Large Cap Core and Consumer Sector portfolios. Notable institutional clients included CalPers, Mitsui Trust, Norges Bank and Penn Mutual. He also spent considerable time analyzing auto, transportation and consumer stocks.

Bill earned his Master in Business Administration from the University of Southern California. While there he also served on USC's MBA student investment fund.

Between his graduate and undergraduate studies, Bill worked at North American Mortgage Company in California as a management trainee and later as a financial analyst and marketing coordinator. The experience gave him a better understanding of the mortgage and real estate markets which he leverages to this day.

Bill earned his Bachelor of Business Administration from the University of Texas at Austin. While a student, he also served as a special agent for Northwestern Mutual. The experience gave him an understanding of life and disability insurance and the work ethic, tools and temperament needed to grow a financial services practice.

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