FREE

THE CLIENT LETTER

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Valuations Don't Matter…Until They Do

February, 2022

Warren Buffett once said: "***Price is what you pay, value is what you get.***" One of the things I find interesting about relatively new investors is their expectation that a stock's price must move in tandem with the news or operations of the underlying company. I often hear: "XYX stock has to go up because the company is doing well". If only it were that simple my friends. Reminds me of the old Roy Rogers quote: "***Investing in stocks is easy, only buy the ones that go up - as for the ones that go down, don't buy those***."

The market is experiencing a sharp pull back in January which will catch some off guard and at the very least get many people's attention. Believe it or not, this is perfectly normal and perhaps a good thing.

Market valuations in my opinion got a bit stretched after three years of attractive returns. This can happen from too much cash chasing too few stocks just like we've seen in the real estate market during the same period. I do not think this marks the end of the economic expansion. Rather, I think financial markets are simply reacting to the Feds admission that they will raise interest rates this year.

Higher interest rates are generally not good for most financial assets - at least in the short run. I won't bore you with the mathematics of "net present value of a future stream of earnings", but suffice it to say, if an investor can get enough interest from a fixed guaranteed investment like cash, it could eventually compete for money that would go into the stock market. Consider this example: With interest rates near zero on cash, an investor might be willing to pay a higher price for the dividend yield and earnings growth potential of a company's stock. However, if that investor can get 5% safely holding their cash (yes, I remember a time when money market accounts paid 5% interest) they may be less likely to pay a higher price for the same company stock. In that scenario, stock prices would fall and valuations compress because investors are satisfied holding higher interest cash instead.

This doesn't mean the economy is doing poorly or a particular company is earning less money, just that investors are valuing those stocks lower because the interest they can get sitting on the sidelines. Folks, I believe that is precisely what's happening now in the market. Investors are adjusting values downward to account for potentially higher interest rates.

However, even if the Fed raises rates three or four times, I think yields will remain relatively low enough for stocks to remain an attractive way to outpace inflation. They say that history doesn't repeat itself but often rhymes, this scenario reminds me of 2018 when the Fed raised interest rates several times and the stock market fell 18% in the fourth quarter as a reaction. At that point the Fed reversed course and actually cut rates making the drop in stock prices a good buying opportunity in hindsight.

There's no way to say whether that will happen this time but there are a couple of reasons, in my opinion, why interest rates may not rise ***too*** far:

1. It would be hard for our interest rates to rise unless the rest of the world's interest rates rise as well. Otherwise, foreigners will simply purchase our bonds at higher interest yields thus driving rates back down again.
2. If interest rates rise too much, the government may struggle to pay the interest on the debt. And while the government doesn't directly control market interest rates, there is a self-serving interest to keep them low.
3. Higher interest rates generally make the US dollar stronger. With the greenback already at high levels compared to other currencies, this hurts our competitive position from a manufacturing standpoint. Simply put, too much dollar strength is not necessarily a good thing if you're trying to stay competitive abroad.
4. The bond market is signaling only moderate increases in interest rates. The interest rate on the 10 year Treasury bond is around 1.8% as of this writing. While this is up from around 1% last year, it is still relatively low by historical standards.
5. Mortgage rates have recently risen by almost one percentage point. If they rise much farther, I would expect a slowdown in housing prices - perhaps giving the Fed reason to pause at some point. As of this morning, new home prices rose only 3% over a year ago. This is down from an 18% increase the year prior. There is a direct relationship between mortgage rates and housing prices.

Bottom line: I still believe we are in a long-term secular bull market that started in 2009 after the great financial crisis. Historically, these type secular markets can last 15 to 20 years***, albeit with sharp pull backs along the way***. Consider the 18% decline in 2018 and the 35% decline from the pandemic in 2020 as examples. These declines were swift and scary but in a secular bull market they proved temporary and good entry opportunities for investors. I would consider any correction from higher interest rates to be a similar situation.

Stocks perhaps got overvalued based on ultra-low interest rates and some investors are getting a quick education in "valuation". But once stock prices reset and more clarity is known around Fed rate hikes, I would expect the economic recovery to continue. In the meantime, feel free to file your January investment statements in the unopened envelope in which they arrive. After all, sometimes the simplest advice is the best advice.

Quick note on tax forms

Most Raymond James tax forms come out near the end of February. However it is possible you may get an amended tax form that may come out in March. Amended forms generally are the result of one of the underlying investments recharacterizing a dividend or interest payment, generally something very minor but necessitating an amended 1099 tax form. If you are wanting to complete your taxes, my suggestion is to go ahead and use the initial tax forms you receive but do not submit your final return until mid-March to make sure no amended forms are issued.

Also, for clients with IRA accounts, Raymond James changed the name of their custodial company for IRAs in 2021. This may cause IRA account owners to get two different tax forms related to any activity or withdrawals made. One form for the previous custodial name and another for the newly named custodian name. Please note, if you get two forms related to your IRA, both are necessary as they add up to the complete calendar year's activity.

Cole's Corner

I'd really like to retire sooner rather than later and spend more time with my grandkids, can I? Are we saving/investing enough? Is now the time to sell my business, and if so, what in the world will I do from here on out? How can I consolidate and simplify my life more? These are all recent and common questions we've fielded in the last year. Brick and I can help guide you and provide clarity to these important questions through in-depth financial planning software and analysis. This software can run simulations looking at multiple scenarios and market environments to give you realistic possibilities.

As a Certified Financial Planner™, I have the experience and the planning tools to help create a personalized plan and investment strategy to help clients retire on their terms. And as Brick likes to say: "We've seen the movie before". So let us know if you're interested in our financial planning process (it'll only cost you a little of your time).

As always, we thank you for your business, your friendship and the trust you place in us. Feel free to share this letter with anyone you feel may benefit. Edie, Cole and I are happy to answer any questions you may have. Until then, wishing you health and happiness.

Regards,

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