Ascension Capital
Thoughtful Advising.

FEBRUARY 16, 2023

First Quarter 2023 Client Review

Dear Client,

2022 was a year beset by challenges, led by the Russia-Ukraine war, global supply chain disruptions, high inflation, rising interest rates across much of the developed world, and pronounced economic weakness in Europe and China.

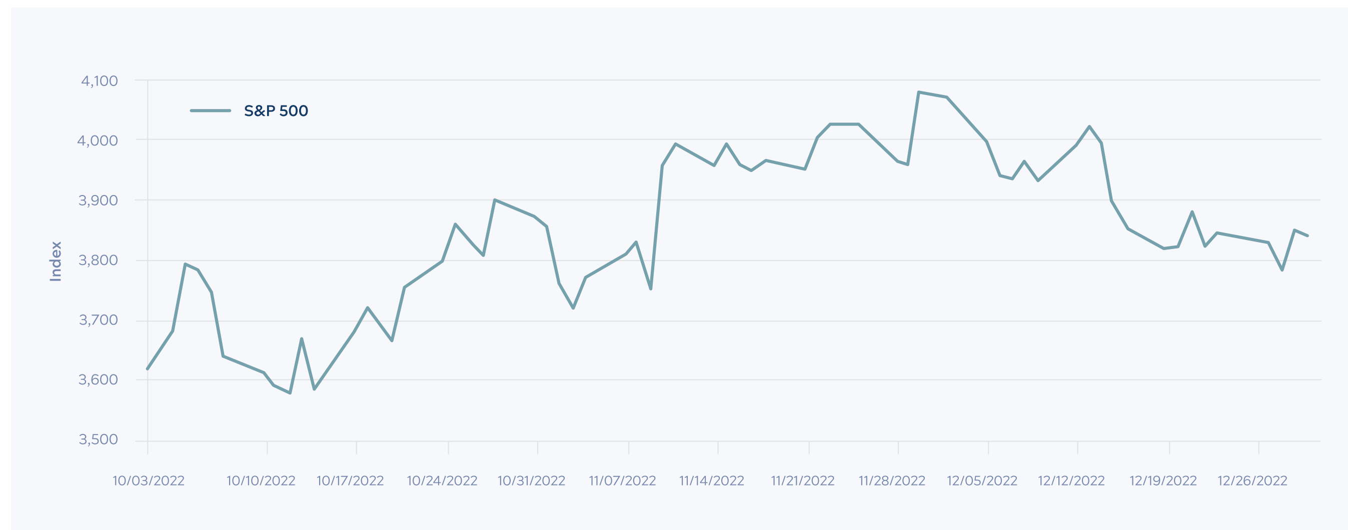
Inflation in the US and around the world was of course a central issue. But the US economy also proved very resilient despite rising prices and other headwinds. In 2022, GDP grew at an annual rate of +3.2% in Q3 and +2.9% in Q4, and corporate earnings are estimated to have grown 4.2%[i] for the year. The economy also added a stout 4.5 million jobs in 2022[ii], the second best year for job creation dating back to 1940. The defining factor for both equity and fixed income markets[iii], however, was a hawkish Federal Reserve and upward pressure on bond yields, which led to a significant re-rating of most risk assets.

Selling pressure over the course of the year was most pronounced in riskier segments of the market, which had previously been the biggest benefactors of the liquidity surge that characterized 2020 and 2021. Cryptocurrencies, SPACs, and high-flying tech stocks were beaten down in 2022. Growth stocks (-29.1%) lagged value stocks (-7.5%) by

a wide margin, while the broad S&P 500 index (-18.1%) fell by about half as much as the tech-heavy Nasdaq (-32.5%)[iv].

Despite plenty of negative headlines in the quarter and an overarching sense of malaise in the media, the fourth quarter was actually quite good for US stocks. The S&P 500 rallied +7.6% from October lows[v].

U.S. STOCKS' STRONG Q4 DID NOT RECEIVE MUCH FANFARE



Source: Federal Reserve Bank of St. Louis

Ever-shifting business conditions make equity market volatility fairly common. But rarely do we see across-the-board selloffs in fixed income at the same time as a stock market drawdown, like we did in 2022. Inflation's upside surprise caused the Federal Reserve to shift from quantitative easing (QE) to quantitative tightening (QT), a process that's been taking place relatively slowly. The Fed has been trimming its bond portfolio by $95 billion a month since September 2022, which has only shrunk it balance sheet to $8.4 trillion from the record $9 trillion reached in April 2022[vi].

A bigger impact has come from aggressively raising the benchmark fed funds rate from 0.1% to 4.4%. Bond yields followed suit, with the 10-year US Treasury bond yield more than doubling from 1.6% to 3.88%[vii]. As bond yields rise, bond prices fall, which resulted in the US bond market delivering two consecutive years of negative returns for the first time since 1958-1959[viii].

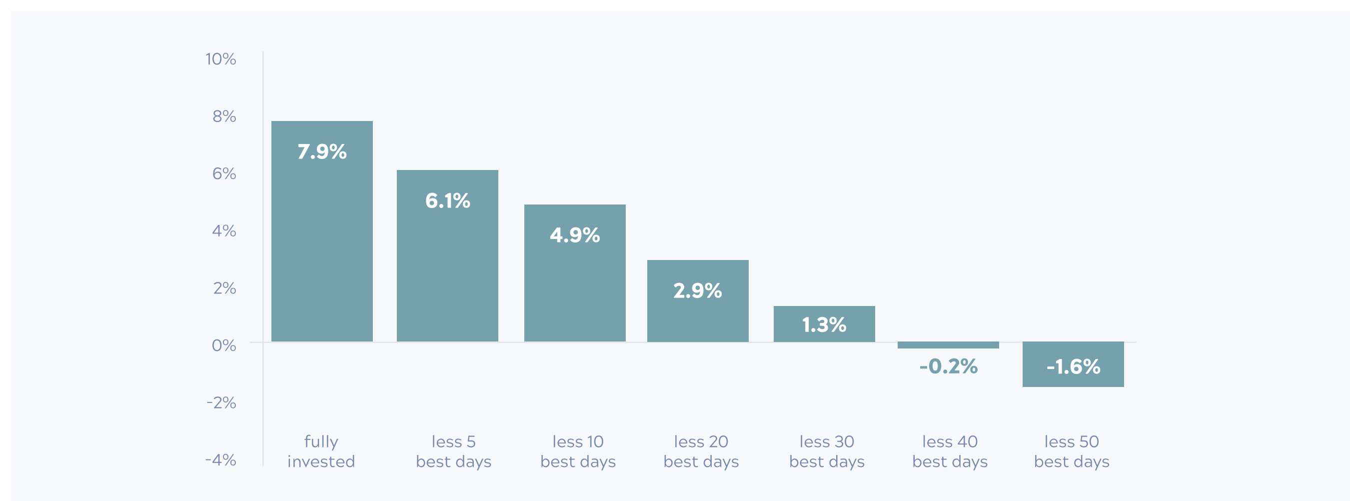
Looking ahead to 2023, we see improving conditions and opportunities for both equities and fixed income.

As we wrote in last quarter's client review, bull markets typically start during a recession and before corporate earnings reach a low point. That's because the stock market is a discounter of future

economic and business conditions. In other words, if we expect the US economy to struggle in the first half of 2023 and to improve later in the year or even into 2024, it would make now the time to own stocks, in our view. And since corporate earnings estimates have already come down considerably, we are anticipating inflection points and opportunities for investors over the next few months.

We also know from history that the very early days of a new bull market often come in the form of a "v-shaped" bounce, which is only apparent months or years later with the benefit of hindsight. If recession fears grow and negative media coverage of economic weakness start to take hold in the next few months, we would see that as a signal to double-down on efforts to stay calm and patient. Markets historically tend to do best when conditions feel the worst. And as the table below demonstrates, missing any part of the market recovery could mean sacrificing long-term returns.

S&P 500 COMPOUND ANNUAL GROWTH RATE (JANUARY 1,1995 - DECEMBER 31, 2022)



Source: Strategas Research

On the fixed income side, we think relief will come as the Fed moderates the pace of rate increases and eventually hits the pause button. Among major Wall Street banks, there is really no consensus as to whether the Fed will "pivot" to cutting rates in 2023 or perhaps 2024. Some believe a recession will alter the Fed's stance, while others think the Fed will lift rates to a peak and keep them there into 2024. Time will tell.

What we do know—again using history as a guide—is that long-term bond yields tend to peak before the Fed finishes raising rates, which may explain the rally (falling yields, rising prices) in long duration US Treasuries we've seen over the past few weeks. While performance in US Treasuries is off to a good start in 2023, we do not think it is likely Treasury yields will fall much further from here. We do believe, however, that fixed income will be less of an impediment to broader financial market conditions and returns in the new year.

To summarize, we'll share this insight from Wells Fargo's Investment Institute, which we think offers a concise outlook for the new year:

> ***"Bear markets are ultimately a function of price and time. We believe both will run their course in 2023. While we expect 2023 to be a volatile and challenging year as we make this transition, paradoxically we believe it may create strong opportunities for investors to reposition for growth and back into a more pro-risk stance as the next economic recovery and bull market emerge."*** [ix]

The Case for Economic Resilience and Falling Inflation

According to a *Wall Street Journal* survey of 23 of the US's largest financial institutions, nearly 80% of their top economists forecast a recession in the new year. As mentioned above, earnings estimates are coming down, which generally implies an economic slowdown is underway or very close. In last quarter's letter, we also pointed readers to recession indicators like the 6-month growth rate for the Conference Board's Leading Economic Index and the 3-month/10-year US Treasury yield curve, which both continue to send recession signals.

Goldman Sachs is one of the banks that does not think the US will enter a recession in the next 12 months, and we found their arguments compelling. Goldman concedes that financial tightening is a severe drag on growth, but they also see countervailing forces that could keep the economy resilient in the face of headwinds.

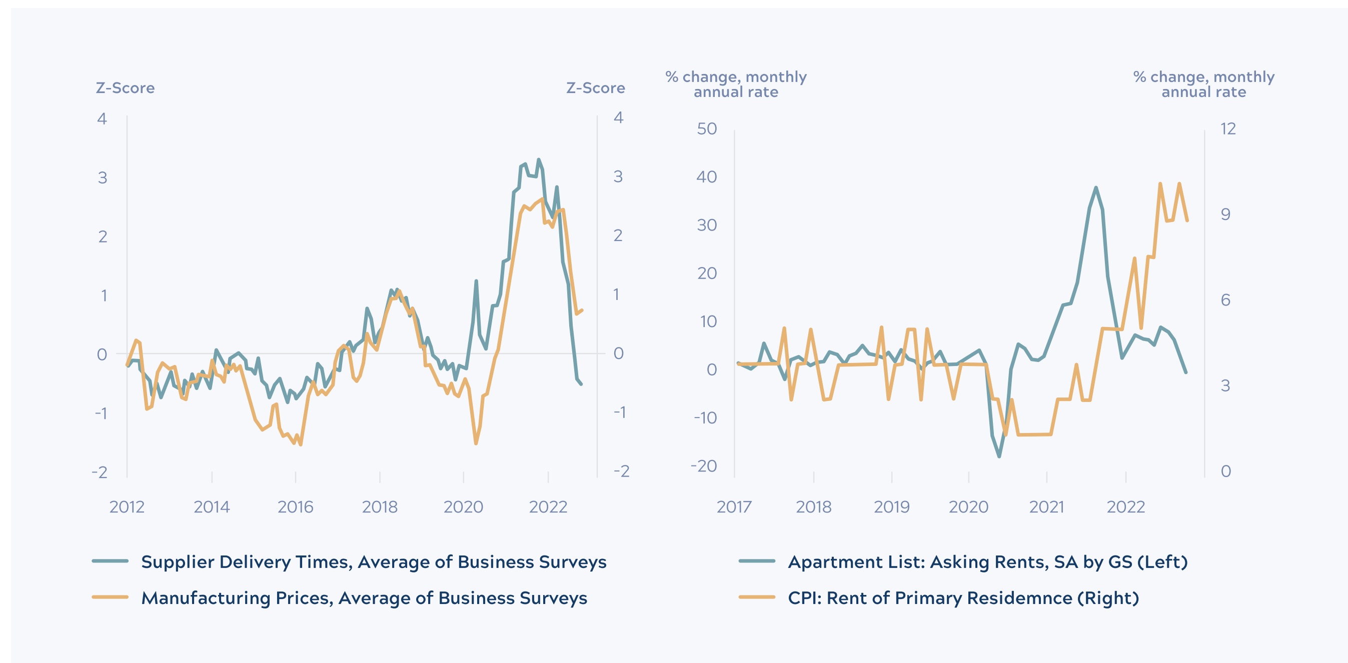
The first is real disposable income, which fell sharply in the first half of 2022 because of fiscal tightening and high inflation. Goldman believes that falling inflation combined with rising wages could push real disposable income up +3% in the new year, which would buttress consumer confidence and lead to increased spending. Since spending accounts for roughly two-thirds of US economic output, strong consumer finances would be a major plus.

Second, Goldman believes core inflation can fall without significant job loss.

Price pressures related to supply chain disruptions have almost entirely faded, giving way to falling costs for semiconductors, used cars, gas, appliances, and a range of other goods that contributed significantly to last summer's inflation surge. Inflation in the manufacturing sector has also improved greatly, as measured by the prices-paid index (see left-hand side of the chart on the next page).

Housing is also poised to bring inflation down. Existing home sales have fallen -32% over the past 10 months, and home prices have also come down from peak levels. In the rental markets, the supply of new apartments has hit a 40-year high, and more than 500,000 new apartment units are expected to hit the market by the end of 2023—the highest total since 1986[x]. We're already starting to see rents falling from peaks in many major cities (including Houston), but this improvement is yet to show up in headline inflation data since it works on a lag (see right-hand side of chart below).

KEY INFLATION DATA IS TRENDING LOWER

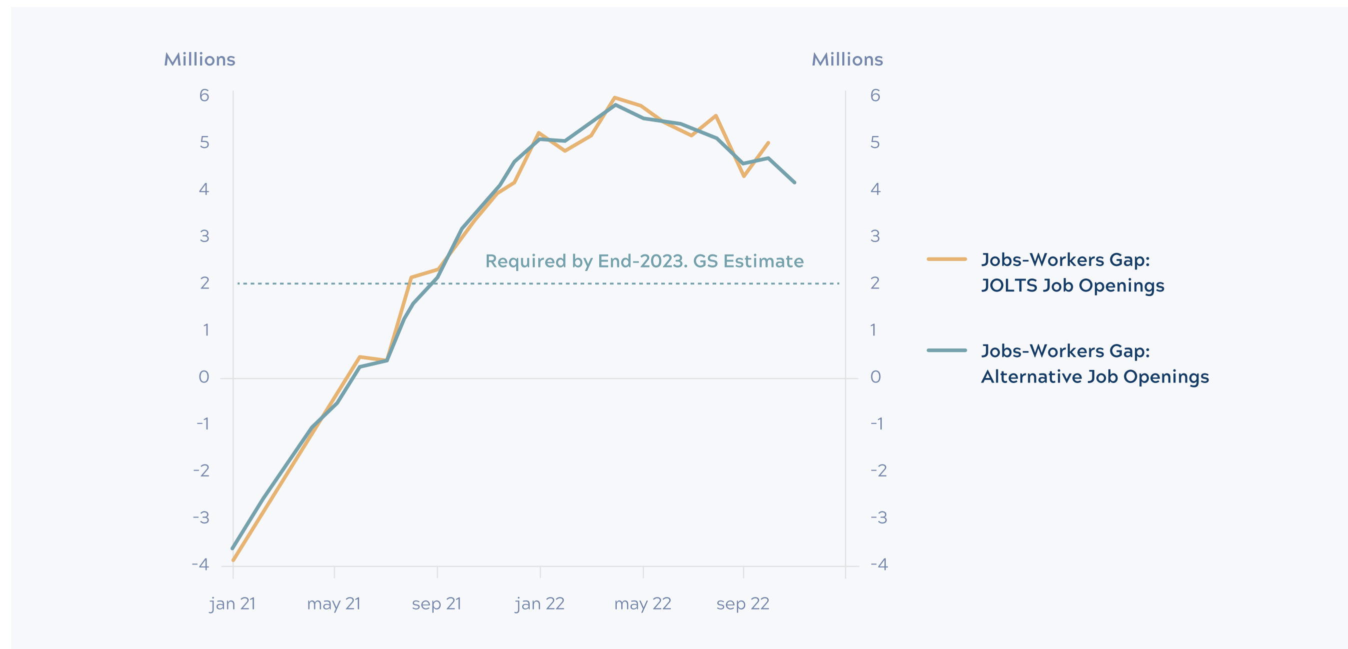


Source: Goldman Sachs

Lastly, it's true that one of the Fed's biggest concerns is not 'goods' inflation—which has been trending in the right direction—but 'services,' which tends to have closer ties to the jobs market and wages. In comments following the Fed's December meeting, Chairman Powell said "the labor market continues to be out of balance, with demand substantially exceeding the supply of available workers." This imbalance puts upward pressure on wages, which can in turn influence companies to raise prices to make up for higher costs.

Goldman's view here is that overheating in the post-pandemic labor market "showed up not in excessive employment but in unprecedented job openings, which are much less painful to unwind." In theory, the economy could simply shed unfilled jobs instead of eliminating existing ones, relieving pressure on wages in the process. Goldman thinks the ratio of open jobs to available workers only needs to shrink to 2 million (from the current 4 million) to bring wage growth down to a rate compatible with the Fed's 2% inflation target:

THE GAP BETWEEN AVAILABLE WORKERS AND JOB OPENINGS IS STARTING TO FALL



Source: Goldman Sachs

Conclusion

We think the Federal Reserve will moderate and eventually end rate hikes in 2023. By mid-year, the Fed may find that fed funds rate is higher than CPI, and that job openings have fallen enough to cool wage inflation pressure. This scenario would make the peak of the interest rate cycle much easier to forecast, which should also factor as a significant tailwind for stocks, in our view.

Weaker corporate earnings in the first half of the year seem assured, which may actually present opportunities for investors to position ahead of the earnings recovery. Historically, bull markets have started when the economy is at its weakest and corporate earnings are approaching a trough, both of which are conditions we could see materializing in the coming months.

We also remain firm believers that the US economy is stronger, more dynamic, and more resilient than most appreciate. Even if the economy does enter a recession sometime in 2023, we would expect it to be mild with a strong recovery waiting on the other side. As investors, we want to be positioned ahead of this recovery, not on the sidelines waiting for green shoots to appear.

If you have any questions about this review or your portfolio, please do not hesitate to reach out to us. Also, if you happened to miss our recent webinar on bear markets but would like to view it, please give

us a call or email smcbride@ascensioncapital.com. We'll happy send you a link to view. Thank you as always for your confidence in Ascension Capital and for being clients.

Sincerely,

Paul Thompson, Jr CFP

Ascension Capital Advisors

Sources:

[i]Source: Bureau of Economic Analysis
[ii]Source: FactSet
[iii]Source: Bureau of Labor Statistics
[iv]Source: Strategas Research
[v]Source: Bloomberg
[vi]Source: Federal Reserve
[vii]Source: U.S. Department of the Treasury
[viii]Source: Strategas Research
[ix]Source: Wells Fargo Investment Institute, Q4 2022
[x]Source: National Association of Realtors

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