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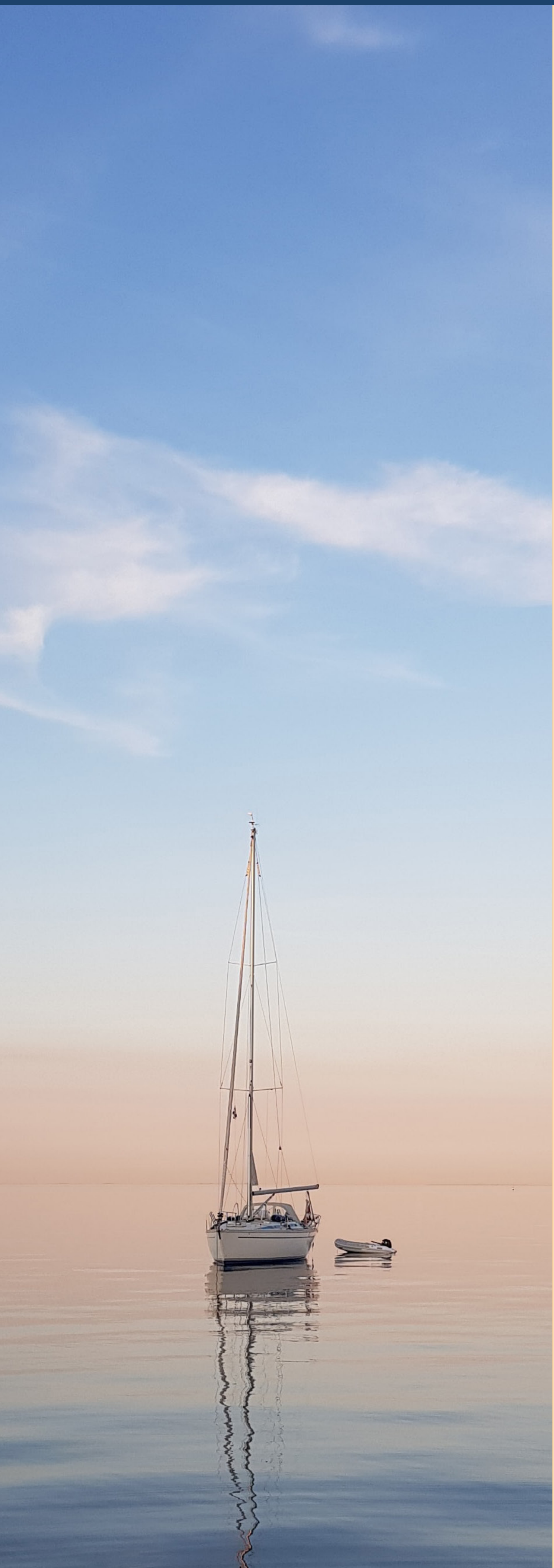


OCTOBER 19, 2022

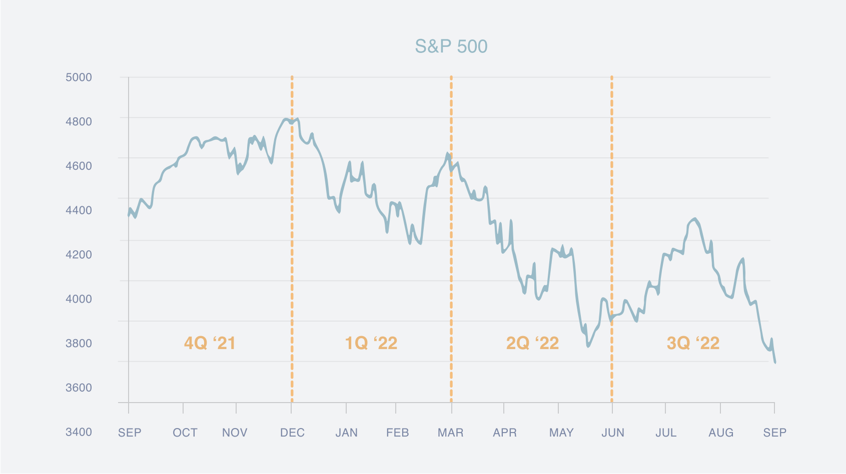
Fourth Quarter 2022 Client Review

Dear Client,

Stocks opened the third quarter with what we now know was a bear market rally. In June and July, investors grew too confident that the interest rate cycle was nearing its peak. Fed funds futures markets were projecting rates would top-out at 3.44% in March of 2023, with rate cuts commencing in May of 2023[i]. These forecasts were far too optimistic, and Federal Reserve Chairman Jerome Powell reset expectations at an August 26 speech in Jackson Hole—making clear the Fed would accept higher unemployment and a potential recession in exchange for tamping down inflation.

Another negative surprise came at the September 20-21 FOMC meeting, where the central bank projected the benchmark fed-funds rate would reach 4.4% by the end of the year[ii]. This forecast was of course higher than the market was expecting, and it also significantly raised the likelihood of a 75 basis point rate hike at the next meeting in November. Markets were again disappointed, and stocks continued selling off.

AN EARLY SUMMER RALLY FADED BY AUGUST



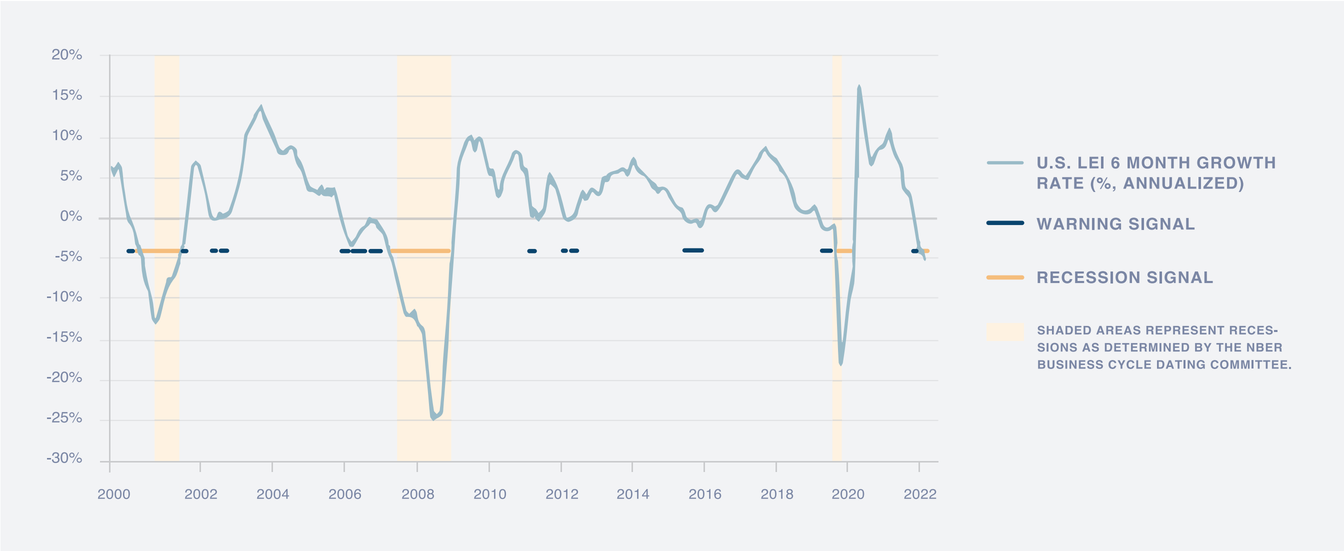
Source: Strategas Research

The third quarter repeated a familiar pattern we've seen in 2022, where every time the markets have tried to price-in a peak in the interest rate cycle, some combination of strong labor market data, stubbornly high inflation, and central bank policy has pulled it back.

We've arguably reached a point in the cycle where strong US economic data is actually bad news for markets, because it implies the Fed needs to do more to slow demand. We know it may seem counterintuitive, but what investors should be looking for now are signs of economic weakness, a peak in inflation data, and even a mild recession. We may be closer to reaching these conditions than many appreciate.

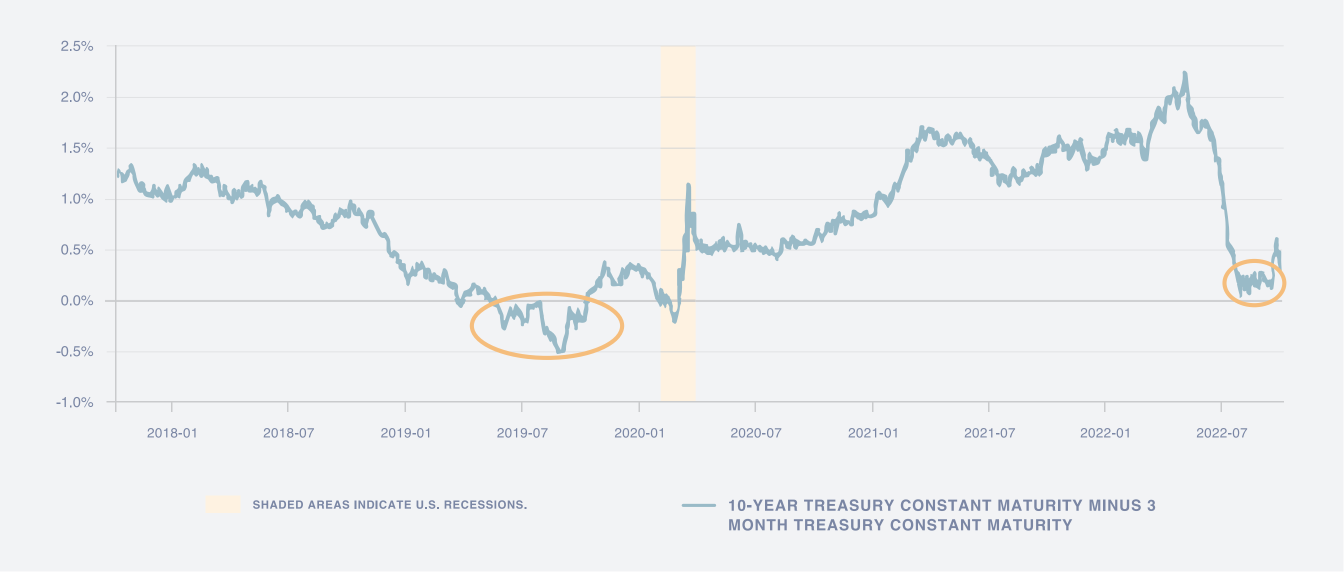
On the economic front, earnings estimates are coming down and S&P 500 profit margins have peaked[iii], which generally implies an economic slowdown is underway or very close. Ascension's two preferred recession indicators—the 6-month growth rate for the Conference Board's Leading Economic Index and the 10-year/3-month US Treasury yield curve—are also both extremely close to signaling recession conditions.

U.S. LEI 6-MONTH GROWTH RATE



Source: The Conference Board

U.S. YIELD CURVE (10-YEAR TREASURY BOND YIELD MINUS 3-MONTH TREASURY BOND YIELD)



Source: Federal Reserve Bank of St. Louis

Additionally, in the US housing market, 30-year fixed mortgage rates have shot past 7%[iv], which has resulted in seven straight months of declines in existing home sales. Permits for future homebuilding have also plummeted to levels last seen in spring of 2020[v]—all signs of economic weakness.

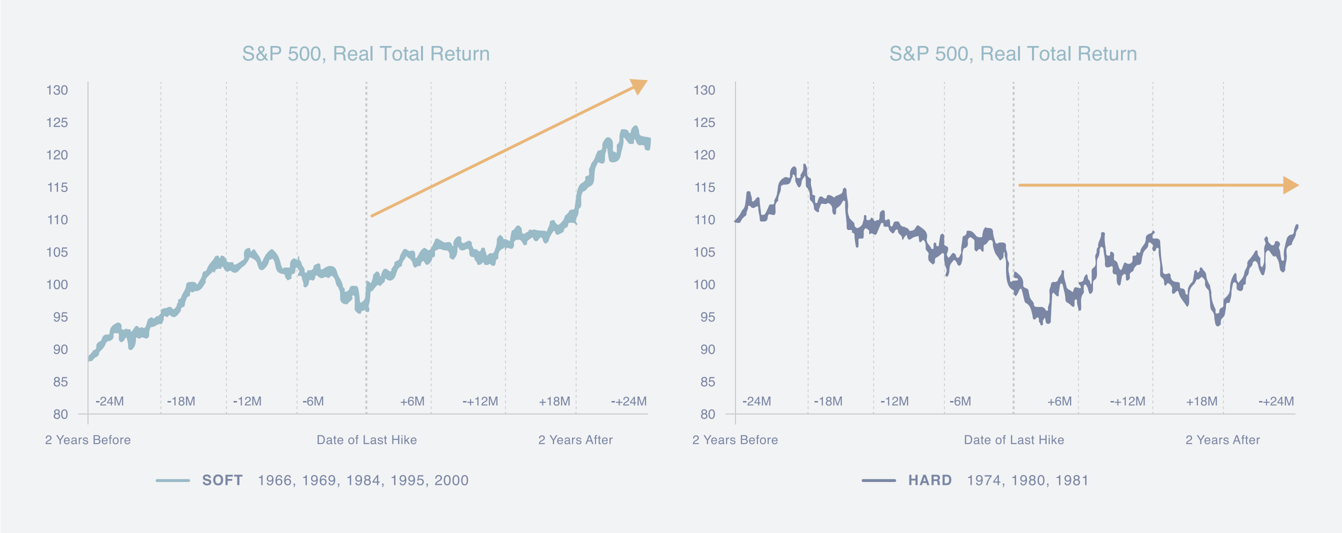
Regarding inflation, rents have been falling month-over-month in many major markets, commodities are at a seven-month low and trading far from peaks, retail inventories are soaring which has caused companies like Nike to cut prices, container freight rates are falling sharply, and the US ISM Manufacturing Prices Paid Index is currently at 51.70—down -36.33% from a year ago[vi]. All of these factors point to reduced inflationary pressure in the months ahead.

There are three key reasons these trends matter to markets:

1. Since 1960, the consumer price index (which measures inflation) has gone above 6% on four occasions, in 1970, 1974, 1979, and 1990. In every instance where CPI peaked and started falling, stocks staged relatively powerful rebounds[vii].
2. Bull markets typically start during a recession, around 6-9 months before a trough in earnings[viii]; and,
3. Stocks tend to perform best when growth is weak but improving, rather than when it is strong but slowing[ix].

The key for markets is if the peak in inflation comes before the Fed has gone too far with rates, which would significantly increase the chances we get a soft economic landing. As readers can see in the chart on the next page, stocks do much better when an economic soft landing follows the Fed's last rate hike.

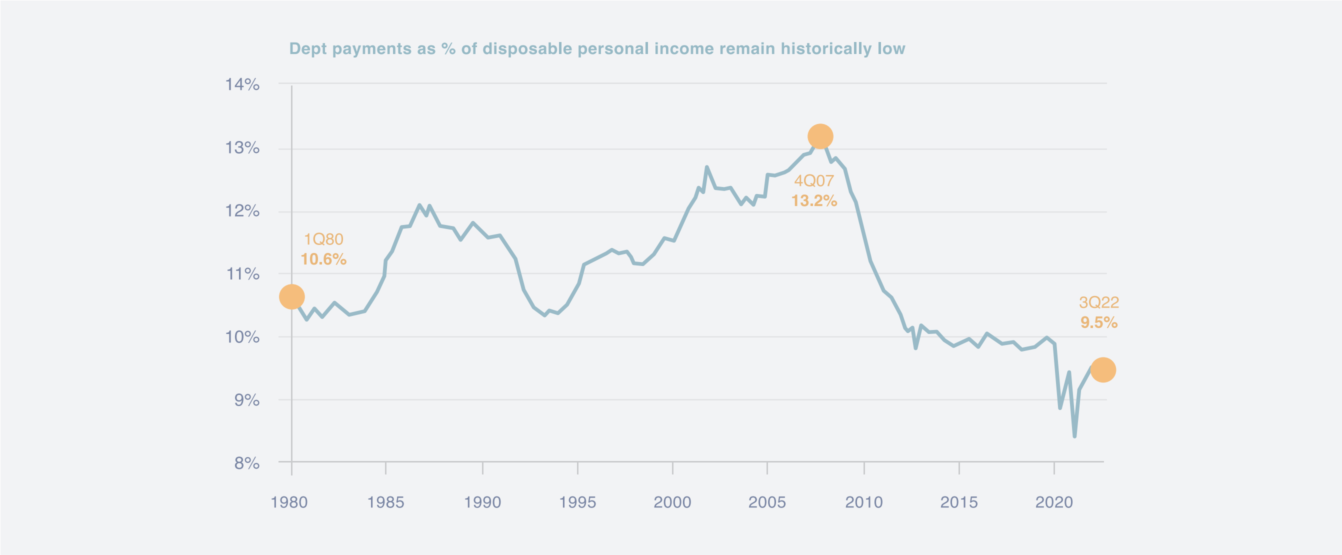
STOCKS PERFORM BETTER IN SOFT LANDINGS VS. HARD LANDINGS



Source: Datastream, Goldman Sachs Global Investment Research

We see the soft landing as a distinct possibility. US consumers are still out spending because of ongoing strength in the labor market, where employers added 315,000 new jobs in August[x]. Initial jobless claims, which had slowly started to tick higher earlier in the summer, have fallen over the past few weeks as employers cling to workers in a historically tight labor market. The legacy of low interest rates is also keeping debt service costs historically low for a majority of Americans (chart below), and the private-sector has also shown few signs that leverage is becoming an issue.

HOUSEHOLD DEBT SERVICE RATIO

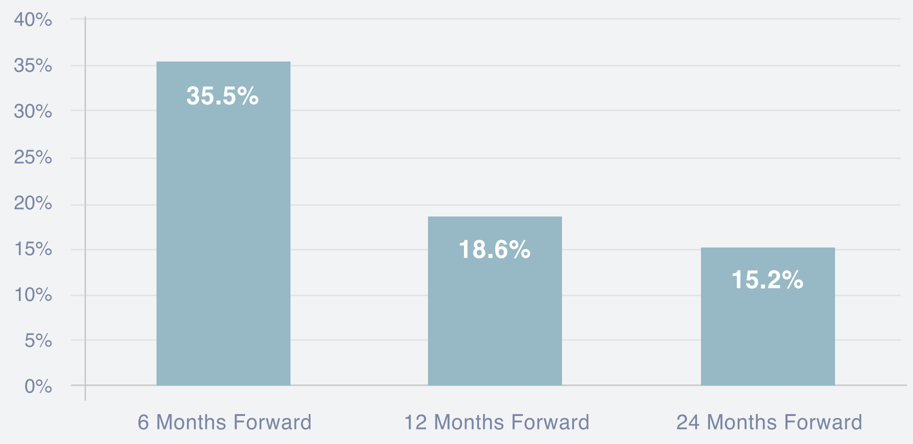


Source: J.P. Morgan Asset Management

While these factors may not prevent a recession, they could help moderate the worst second- and third-round effects of any economic downturn.

The upcoming midterm elections may also bolster the medium-term outlook for stocks. Since 1950, the stock market has risen 100% of the time in the year following a midterm election[xi]. And not only do stocks tend to go up, they tend to go up by a lot:

S&P 500 AVERAGE ANNUALIZED FORWARD TOTAL RETURN FROM MIDTERM ELECTION DATES (1950-2018)



Source: Strategas Research

Relevant to this year's midterms too is the distinct possibility that the House and possibly the Senate both flip to Republican control. Such an outcome would all but ensure that major policy shifts are off the table, giving certainty to markets over issues like taxes and regulation. Historically, when we've had a Democrat presidency and the House and Senate flip, stocks have performed very well in the year that followed:

FORWARD S&P 500 RETURNS FROM MIDTERM ELECTION DATE (1950-2018)

DEMOCRAT PRESIDENCY	SENATE FLIPS FROM D TO R	HOUSE FLIPS FROM D TO R
3 Months	+3.0%	+6.9%
6 Months	+10.1%	+14.6%
12 Months	+18.6%	+18.1%

Source: Strategas Research

Conclusion

The US economy is in a weakening pattern, but that may ultimately be good news for investors. Bull markets tend to start during recessions, well before there is any clear indication that conditions are poised to improve. Data is also indicating that inflation pressures are likely to abate in the coming months, which will provide more clarity as to when the interest rate cycle may actually peak. Throughout history, stocks have fallen as inflation approaches its peak, but have rebounded strongly once CPI starts to come down. We think we're close to this point.

Cyclical bear markets—which are driven by rising interest rates, rising inflation, and falling earnings—have historically lasted about 15 months with average declines of -30%[xii]. The upshot in the current environment is that the market's declines are already in the range of duration and magnitude that what we'd expect to see in a cyclical bear market, which could indicate that anticipated weakness in corporate earnings and economic growth is already priced into stocks. What we're looking for now are more signs that a mild recession is underway and that inflation has topped out, both of which would indicate a turn in the cycle for markets.

If you have any questions about this review or your portfolio, please do not hesitate to reach out to us. We're available as always to answer questions and to offer our best service and advice. Thank you for your continued confidence in our firm.

Sincerely,

Paul Thompson, Jr CFP
Ascension Capital Advisors

Sources:

[i]Source: Bloomberg
[ii]Source: Federal Reserve
[iii]Source: JPMorgan
[iv]Source: Fannie Mae
[v]Source: National Association of Realtors
[vi]Source: Institute for Supply Management
[vii]Source: Goldman Sachs
[viii]Source: Goldman Sachs
[ix]Source: Goldman Sachs
[x]Source: Bureau of Labor Statistics
[xi]Source: Strategas Research
[xii]Source: Goldman Sachs