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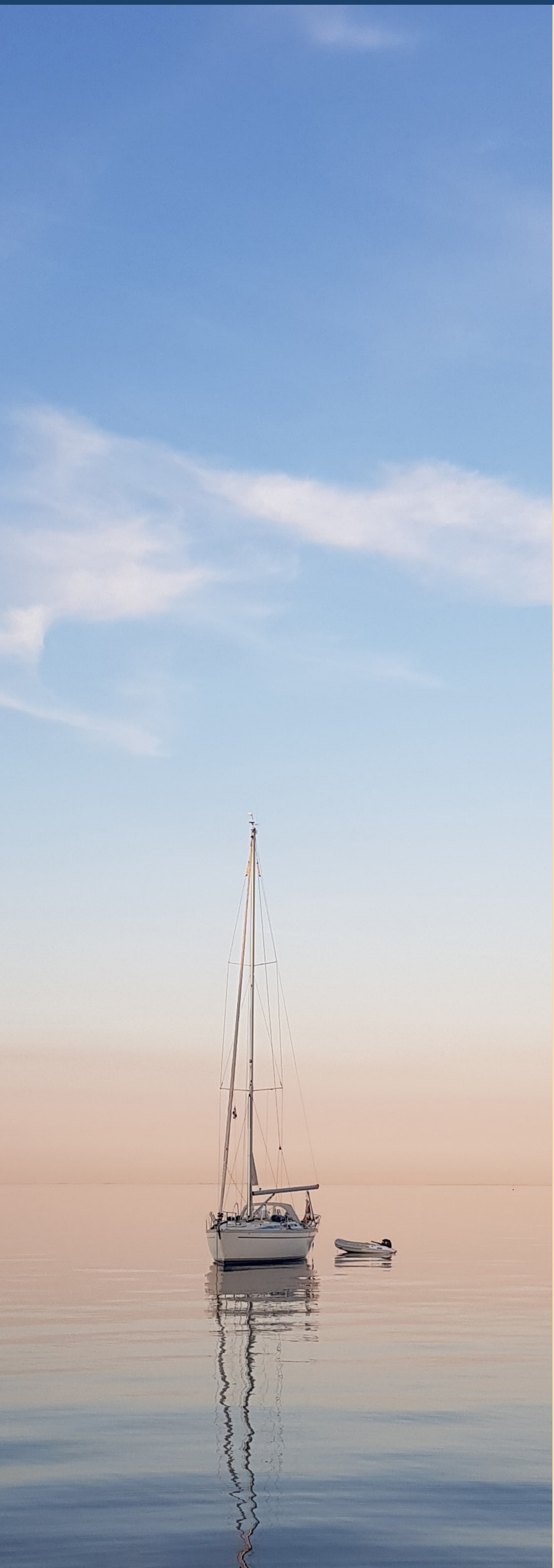


January 26, 2022

First Quarter 2022 Client Review

Dear Client,

2021 was quite an unusual year for the world, but not necessarily for the capital markets. U.S. stocks strongly outperformed foreign shares, with every sector in the S&P 500 finishing up +15% or more[i]. Volatility was also relatively subdued—there were only 55 trading days with moves of 1% or more in either direction (compared to 109 in 2020), and only seven days with a move of 2%[ii] or more. Bond yields moved higher, but still finished the year close to historic lows.

Above average equity market returns with below average volatility is not what many would expect from a year that featured political turmoil, a never-ending pandemic with a particularly impactful wave (Delta), a messy exit from America's longest war, snarled supply chains, decades-high inflation, and an Omicron wave in time for the holidays. Just to name a few.

The divergence between strong stock market performance and negative overall sentiment about the economy and everyday life bears out in the data. The University of Michigan Consumer Sentiment index has plummeted by double digits for two years in a row, while over the same period the S&P 500 has delivered two banner years of double digit gains[iii]. Our view on this divergence is consistent with what we've always known about the investment landscape. That is: media narratives rarely reflect underlying economic fundamentals.

Stocks do not fixate on negative news as much as the media and we humans do. For markets, there was one story that mattered above all else: **in 2021, U.S. companies reported some of their best financial results ever**. According to Strategas Research, S&P 500 operating earnings are on track to have increased by 49% in 2021, with a revenue jump of 15.8% and a profit margin surge to highs well in excess of pre-pandemic levels. Financial data firm Refinitiv said total 2021 sales from S&P small-, mid-, and large-cap companies were higher in aggregate than pre-pandemic, and profit growth was even stronger. Investors who focused on these fundamentals and tuned out everything else likely had a good year.

THE S&P 500 REACHED 70 NEW HIGHS IN 2021

Source: Strategas Research

It was a good year for the broad U.S. equity market, but there were also plenty of traps and dead-ends to navigate. The "meme stock" and SPAC craze early in the year basically blew out by mid-summer. An index tracking SPACs was down -33.1% from its mid-February peak and -15.3% for the year[iv]. In the traditional IPO world, of the 384 companies that went public in 2021[v], 255 ended the year trading below their offer price. Cryptocurrencies were boom-bust, and investors poured millions into the emerging, highly-speculative digital art market (via non-fungible tokens, or NFTs). A world awash in liquidity had investors all over the risk curve.

There was also a major rotation in the growth versus value trade. Through May 14, global growth stocks were up only +3.7% compared to value's +16.1% return, but from mid-May to the end of the year growth rose approximately +18% to value's +5%[vi]—leaving the two styles close to even for 2021.

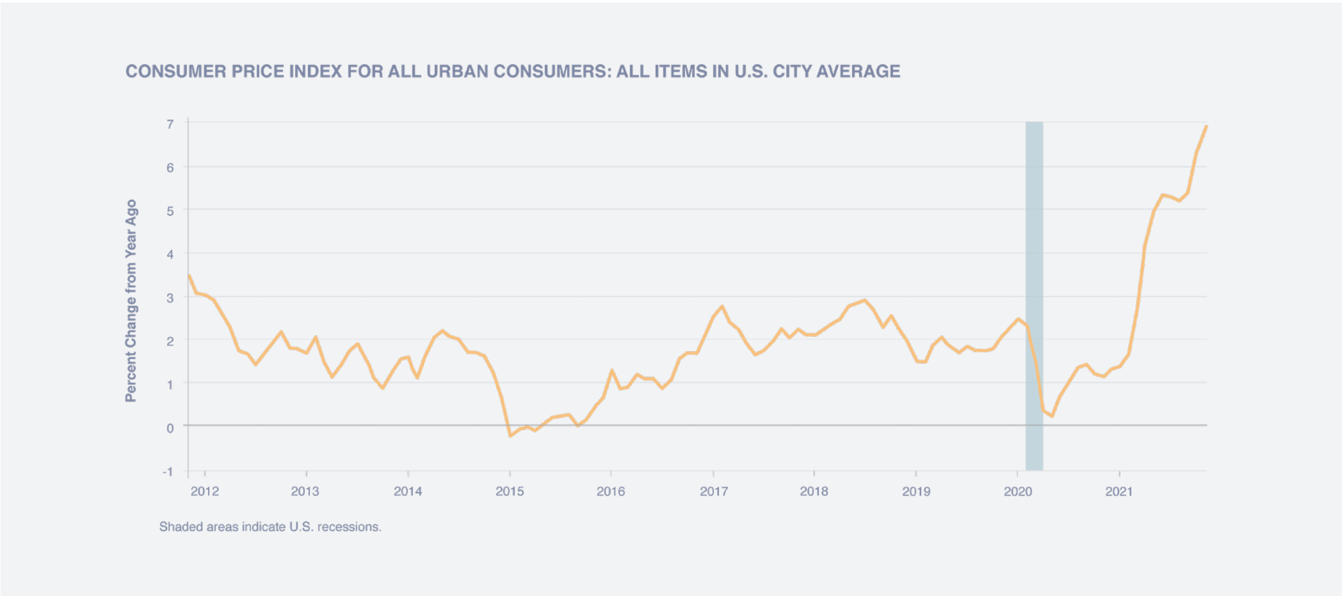
Defensive assets such as investment-grade bonds, U.S. Treasuries, and gold were all negative in 2021[vii]. The takeaway: it did not pay to bet against U.S. economic growth, as unusual and uneven as the year might have been.

Finally, the 10-year U.S. Treasury bond finished the year yielding 1.52%[viii]. Compared to the roughly 3.4% earnings yield on the S&P 500 as of December 31, 2021[ix], stocks remained the most attractive asset class to start the new year, in our view. Our expectation for continued economic and earnings growth in 2022 supports a continued overweight to equities. But as we will discuss in the next section, bond yields are on the move and the Fed is turning more hawkish, which could create headwinds for some categories of stocks and could result in heightened volatility in the coming quarters.

Inflation, Interest Rates, and the Federal Reserve

Inflation was probably the most-discussed topic at Thanksgiving dinners around the country last year. And for good reason—in Q4, prices in the U.S. rose at their highest year-over-year rate in over 30 years.

INFLATION JUMPED CONSIDERABLY IN 2021



Source: Federal Reserve Bank of St. Louis

Price pressures largely stemmed from too much consumer demand bumping up against supply chain problems and labor shortages—what we might classify as a good, resolvable problem given some time. Goldman Sachs forecasted core CPI inflation to peak in Q1 2022 and then to drop back to 3.5% by December 2022, which would have placed it modestly higher than the Fed's target range.

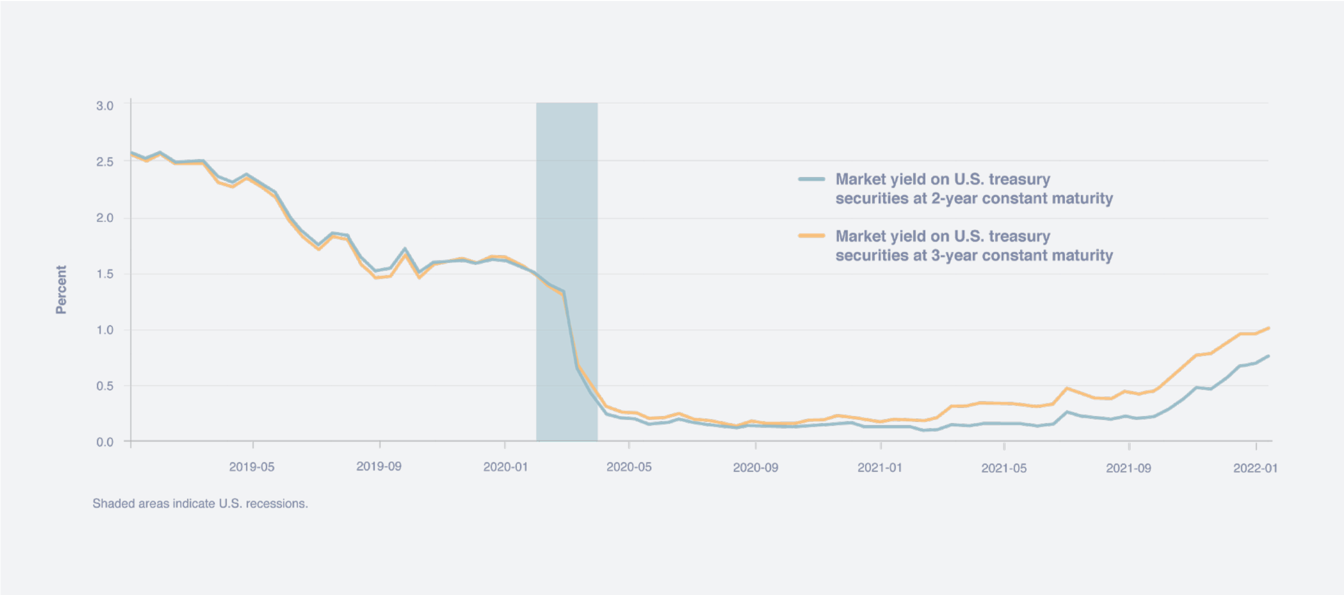
For the better part of 2021, the Fed anticipated inflation pressures would ease as the U.S. employment picture improved, which would have given policymakers a smooth exit ramp for removing monetary accommodation. In fall of last year, the Fed's plan was to taper and end QE in the first half of 2022, and then to gradually raise rates in the second half. Persistent and higher-than-expected inflation altered those plans.

Minutes from the Fed's December 14-15 meeting, published on January 5, 2022, make it clear the Fed is indeed more urgently concerned about prices: "*participants generally noted that...it may become warranted to increase the federal funds rate sooner or at a faster pace than participants had earlier anticipated.*" The minutes also noted that some participants see it as "*appropriate to begin to reduce the size of the Federal Reserve's balance sheet relatively soon after beginning to raise the federal funds rate.*" During the previous rate hike cycle in the 2010s, the Fed waited about two years before reducing its balance sheet.

Stocks sold off sharply on January 5 when the Fed minutes were released, and volatility has increased in the weeks since. As we write, the S&P 500, Nasdaq, and the small-cap Russell 2000 index are all in correction territory. Market action may feel jarring relative to the low-volatility 2021, but we would urge investors to stay patient. We view the current selling pressure as a short-term re-pricing given changes to the interest rate outlook, and our forecast for strong U.S. economic growth in the new year remains unchanged.

Bond yields also rose to their highest levels since early April 2021[x] on the news, continuing a trend we identified late last year. In the chart below, you can see the 2-and 3-year U.S. Treasury bond yields have already bounced off lows and are moving in a noticeable uptrend. Short duration Treasury bond yields tend to rise when investors anticipate tighter central bank policies.

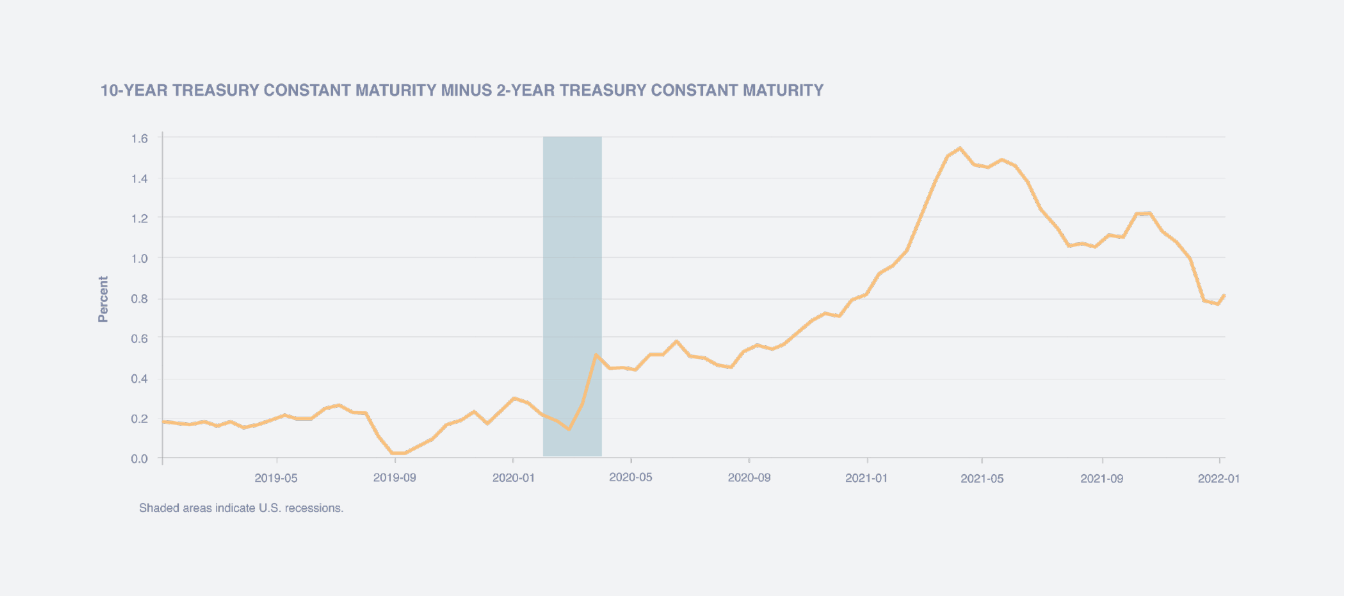
SHORT-TERM TREASURY BOND YIELDS HAVE BEEN MOVING HIGHER



Source: Federal Reserve Bank of St. Louis

Historically, the yield curve has been a good forward-looking indicator for the economy, which is why rapidly rising short duration U.S. Treasury bond yields are worth watching closely. In the chart on the next page, the yield curve is presented as the 10-year U.S. Treasury bond yield minus the 2-year U.S. Treasury bond yield. A declining line means the yield curve is flattening, and if the line falls below 0%, it means the yield curve is inverted. As seen below, the yield curve is clearly in a flattening pattern, making it a key indicator to watch in 2022.

THE YIELD CURVE HAS BEEN IN A FLATTENING PATTERN



Source: Federal Reserve Bank of St. Louis

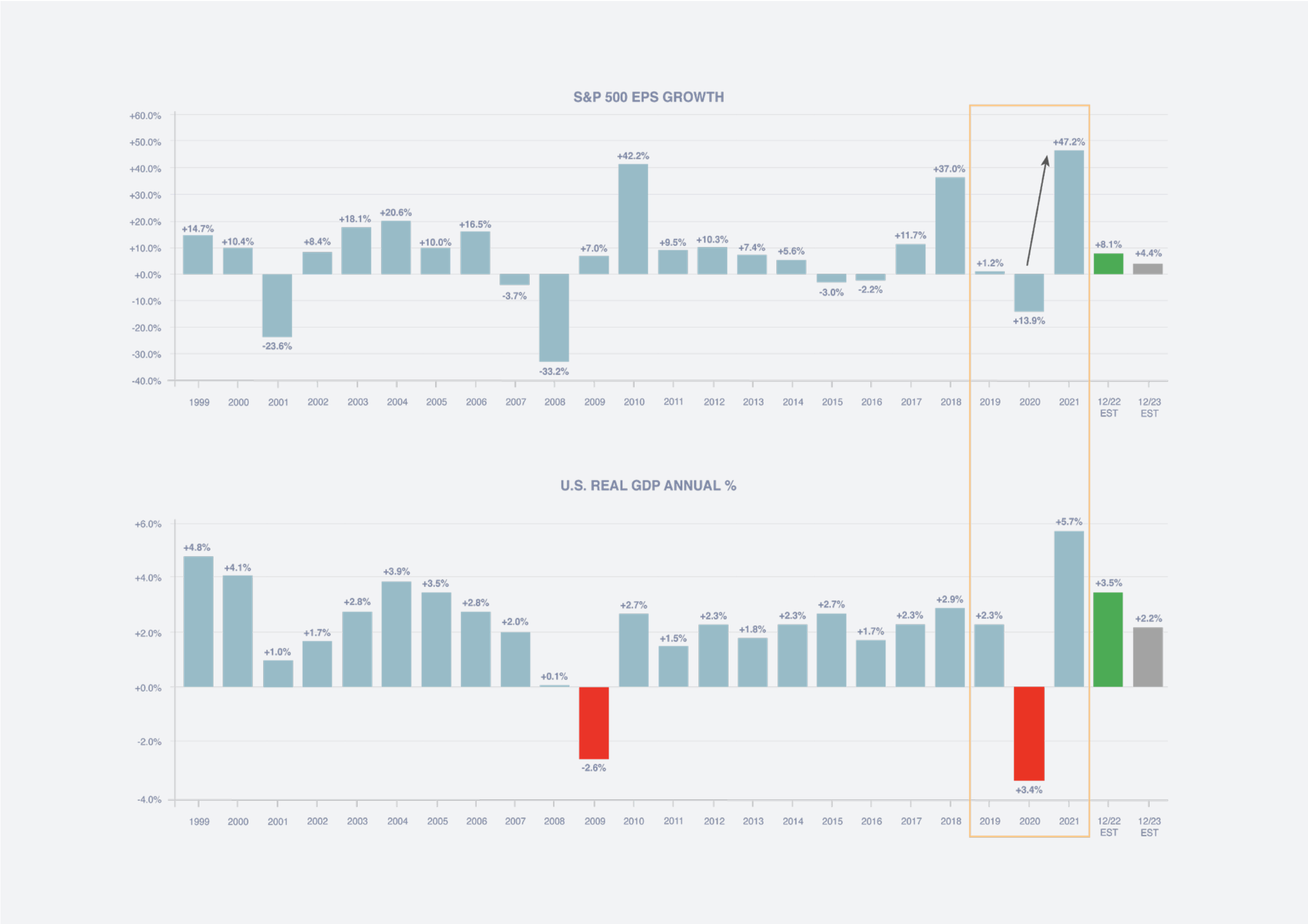
An inverted yield curve signals credit markets are not very healthy, but it is not an immediate indicator of recession and/or bear market. There is usually time for investors to act—initial yield curve inversion has only aligned with a bull market peak twice since 1971[xi], and the yield curve today is still upward sloped.

The U.S. Economy Poised for More Growth in 2022

Rising inflation and interest rates, a hawkish Fed, and a flattening yield curve are all key factors to watch in the new year. But a balanced view should also consider the positive backdrop of durable economic growth, record profits, a very tight U.S. labor market, rising wages, record household net worth, and an undeterred U.S. consumer. For 2022, we see these tailwinds as stronger than the headwinds detailed in the previous section.

As mentioned in the introduction of this letter, U.S. corporate earnings posted a sharp year-over-year jump in 2021[xii]. U.S. GDP also recovered nicely, even with the Delta-induced drag in Q3. Strong growth rates last year will mean tougher comparisons in 2022, but we still expect modestly positive earnings and GDP growth in the new year (see chart on next page).

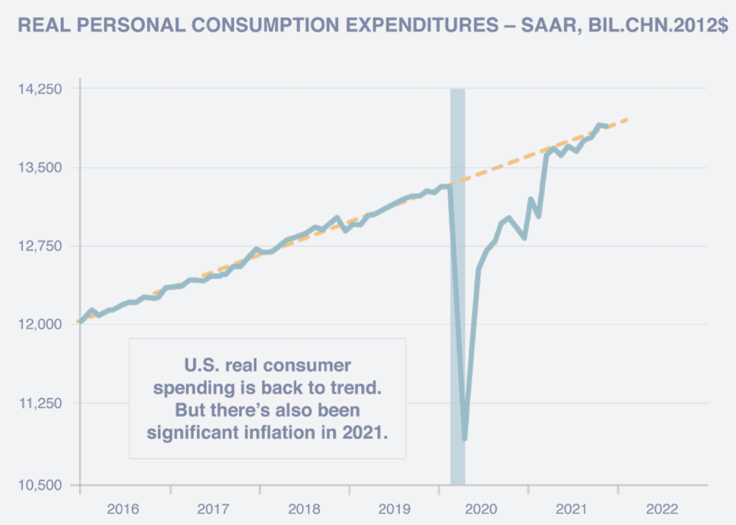
EARNINGS AND GDP GROWTH RATES LIKELY TO MODERATE IN 2022



Source: Goldman Sachs

U.S. consumers also remain in good shape—buoyed in 2021 by accumulated savings and the largest wage increases in 20 years, consumer spending returned to record highs and is back to its pre-pandemic trend (see chart on next page).

U.S. CONSUMERS CONTINUE TO SPEND



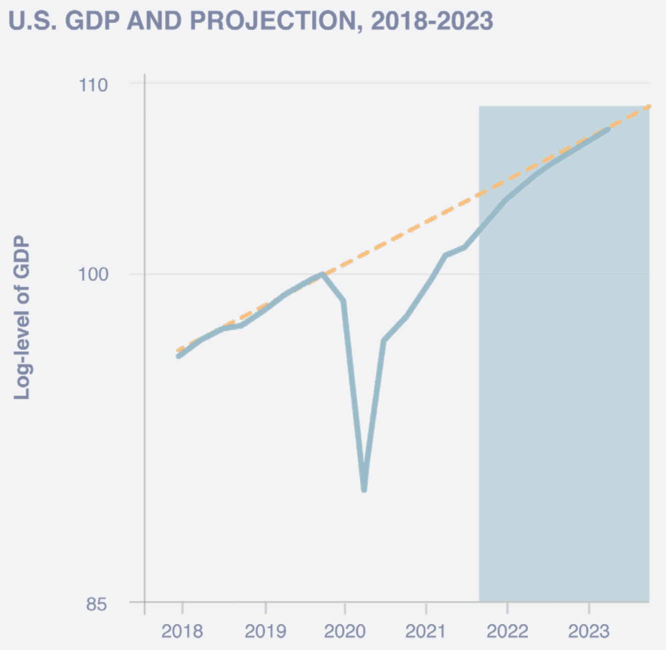
Source: Strategas Research

For private sector workers in aggregate, wages grew at a 4.6% year-over-year pace in Q3 2021, with the biggest increases landing in service sector occupations like retail and hospitality. For higher skilled workers in management, business, and financial occupations, wages rose by a lesser 3.9% over the same period, but this increase still marks the fastest pace of rising wages since 2003 for this group[xiii]. According to the Conference Board, employers are setting aside an average of 3.9% of total payroll for wage increases in the new year, the most since 2008.

The jobs market also remains historically tight. The number of people filing for unemployment registered at 207,000 for the week ending January 1, which is near levels last seen in 1969. Job openings in the U.S. also continue to reach record highs, with an estimated 12 million available jobs by the end of last year. 1 million new jobs were added in Q4 2021, which underscores the desperation of companies to bring on new workers to meet robust demand[xiv].

The Omicron variant is likely to factor in Q1 2022, but each new wave of the pandemic has had a diminishing impact on economic growth. As Blackrock points out, “the big picture is unchanged: less growth now is more later” (see chart on next page).

MORE U.S. GDP GROWTH EXPECTED IN 2022



Source: Blackrock

Conclusion

In previous letters, we have alluded to the stock market likely being due for increased volatility. Our goal in communicating this possibility is to remind investors that market volatility—and even a full-on stock market correction of -10% or more—would be a normal and even healthy outcome. Sudden market downturns almost always feel worrisome and out-of-the-blue, but more often than not it is just the stock market being the stock market. The biggest pullback in 2021 was only -5%, so the current market correction feels more normal than out-of-the-blue.

Indeed, inflation, rising rates, and a hawkish Fed all present headwinds to equity markets in the year ahead. But it is also important to acknowledge that the Federal Reserve is moving off a position of extraordinary accommodation. If the Fed follows through with ending QE, raising rates a few times, and shrinking its $8.76 trillion balance sheet, it will still likely finish 2022 looking accommodative by historical standards—a point many miss.

We continue to see economic growth and rising corporate earnings as dominant forces driving the markets in 2022. We do not believe all areas of the market will do well—navigating higher input costs and inflation requires strong balance sheets and pricing power, and rising rates are likely to result in multiple compression in certain areas of the market. As ever, we will take great care in making investment decisions on your behalf.

If you have any questions about this review or your portfolio, please do not hesitate to reach out to us. We wish you a Happy New Year, and hope you stay safe and healthy in these winter months.

Sincerely,

Paul Thompson, Jr CFP
Ascension Capital Advisors

Sources:

[i]Source: Strategas Research
[ii]Source: Goldman Sachs
[iii]Source: Bloomberg
[iv]Source: Jay Ritter, University of Florida
[v]Source: Bloomberg
[vi]Source: Strategas Research
[vii]Source: Strategas Research
[viii]Source: U.S. Department of the Treasury
[ix]Source: Bloomberg
[x]Source: U.S. Department of the Treasury
[xi]Source: Goldman Sachs
[xii]Source: Strategas Research
[xiii]Source: Strategas Research
[xiv]Source: Bureau of Labor Statistics

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