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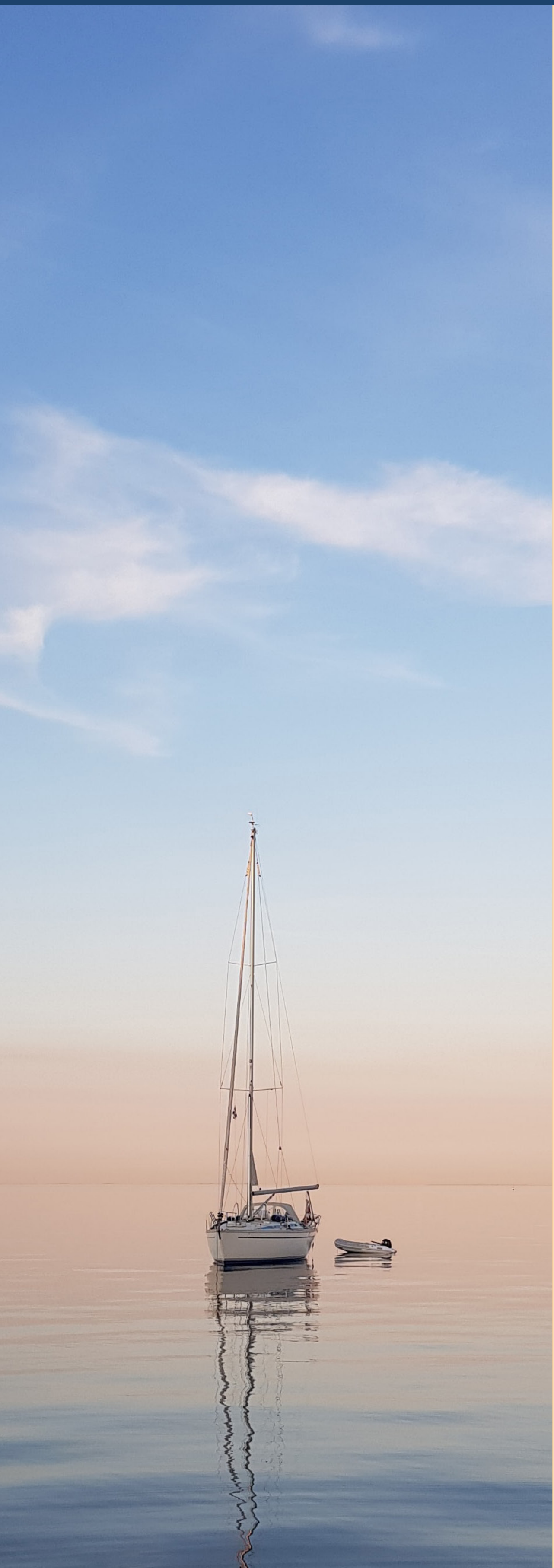


MAY 10, 2021

Second Quarter 2021 Client Review

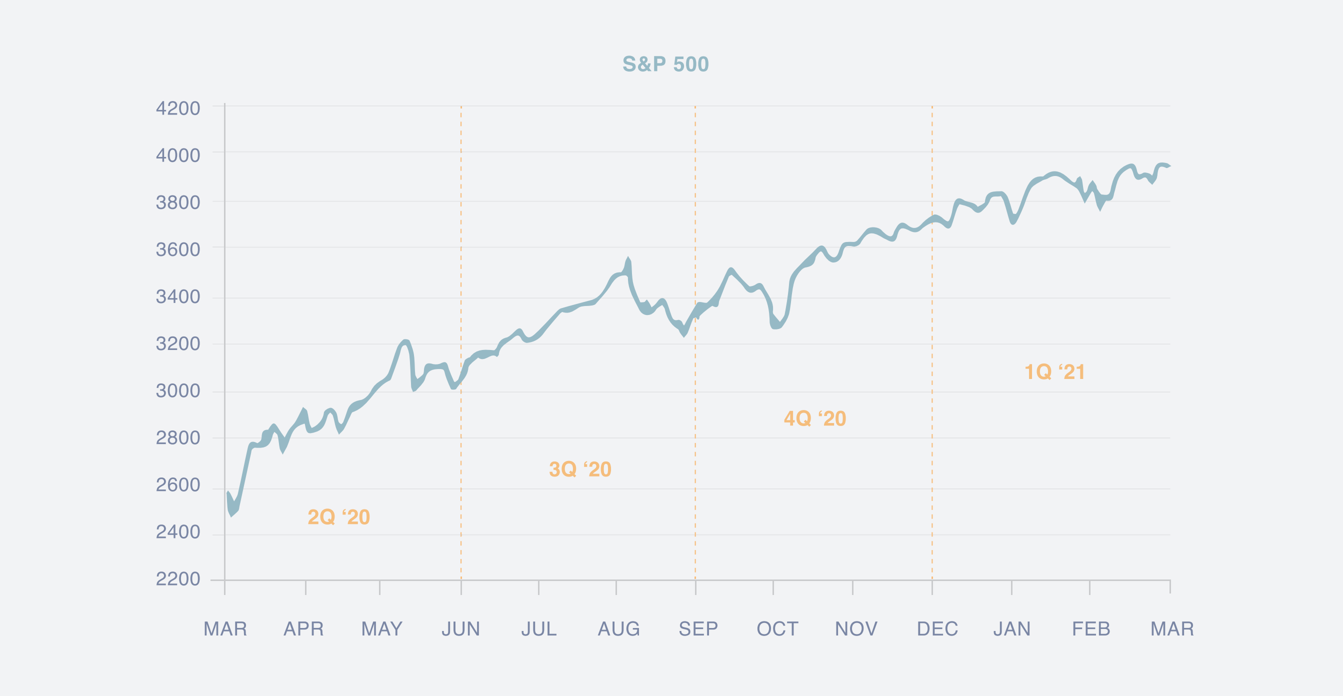
Dear Client,

U.S. stocks marched higher in the first quarter, with the S&P 500 pushing through 17 new highs and reaching 4,000 for the first time[i]. "Risk-on" sentiment is being driven by improving economic data, a sense that the pandemic is nearing its end in the US, and what is perhaps the greatest fiscal stimulus experiment in the country's history. The latest stimulus installment, at $1.9 trillion, amounts to a staggering 9% of GDP[ii].

The first quarter also saw surging U.S. Treasury bond yields, with the 10-year U.S. Treasury rising by approximately 80 basis points in the first three months—the third largest quarterly increase in over 10 years[iii]. In a sense, long-term interest rates in Q1 were telling us what stocks have been telling us for almost a year now: that the recession is behind us and the economy is positioned for a strong rebound, with growing concerns of inflationary pressures down the road.

A largely positive economic outlook has given way to a so-termed "reopening trade," which has driven an accelerated rotation into cyclical stocks, favored value over growth, small-cap over large-cap, and helped boost shares in sectors most impacted by the 2020 shutdown, like Energy and Financials. We wrote last quarter that we expected 2021 to deliver large increases in vaccine uptake, a growth rebound, and impacts from a "wall of liquidity." So far, we think each factor has played a key role in driving asset prices higher.

THE S&P 500 HAS POSTED STEADY GAINS OVER THE LAST YEAR



Source: Strategas Research

From a sector perspective, capital rotation was most evident in Energy and Financials. In 2020, Energy was the worst performing sector in the S&P 500, posting a 33.7% decline. Financials was near the bottom of the pack as well, falling 1.7% last year. In Q1 2021, however, Energy and Financials were the two top performers, rising +30.9% and +16%, respectively[iv]. Energy is benefitting from rising crude oil prices and demand resurgence in the global economy, and Financials have been helped by rising rates and a steepening yield curve.

Rising interest rates put some pressure on high valuation stocks in Q1, many of which can be found in the Technology sector. Any time 10-year U.S. Treasury yields rose sharply, we saw selling pressure in growth, tech, and other high valuation categories. We believe this trend could continue throughout 2021. All told, the S&P 500 Technology sector was up by +2.0% for the quarter, which was significantly lower than the S&P 500's +6.2% return[v].

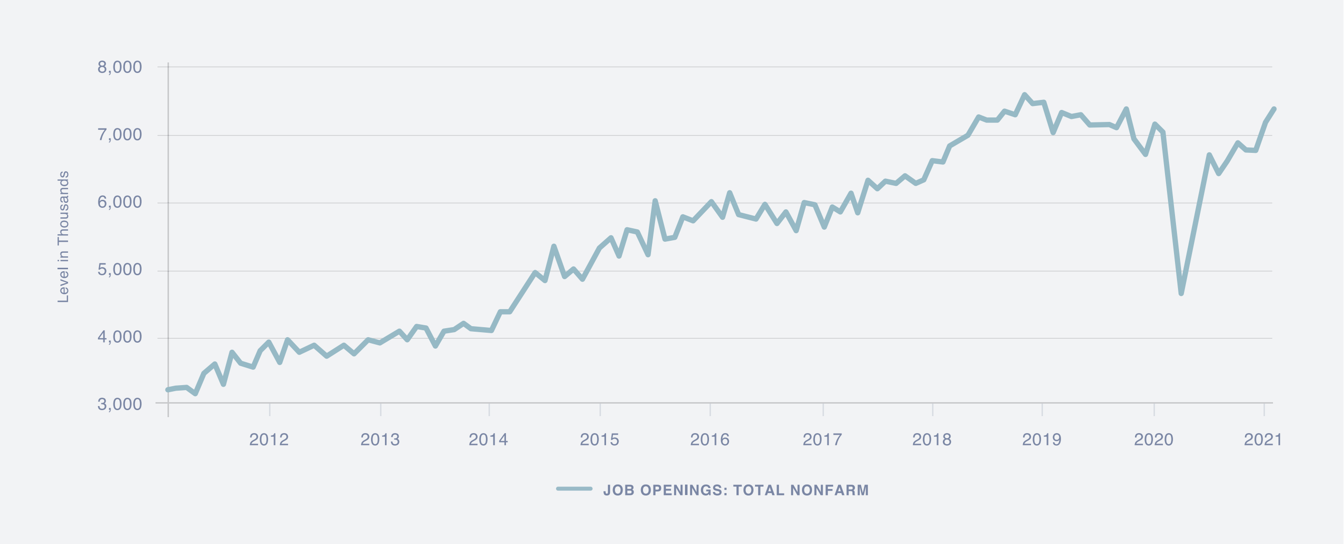
As we will describe below, we think the U.S. economy is on firm footing for strong growth in 2021. The rallying stock market has been reflecting this positive outlook. To be fair, P/E ratios are somewhat elevated given the robustness of the rally, but it is also true that S&P 500 companies are delivering overwhelmingly better-than-expected earnings. Going back to 1994, U.S. companies have beaten earnings by an average of 3.6%[vi]. About halfway through earnings season in Q1 2021, that number is 22.8%[vii]! All told, S&P 500 companies on are track to post their fastest rate of earnings growth since 2010.

Economic Growth on the Horizon

Almost every key labor market indicator flipped green in March. Overall hiring accelerated for the month, with U.S. employers adding a seasonally adjusted 916,000 jobs—the strongest gains since August 2020 and well above economist expectations[viii]. Most sectors in the U.S. economy saw growth, led by leisure and hospitality (+280,000), which also likely provided fuel for the aforementioned 'reopening trade[ix].'

In the Federal Reserve's recently published Beige book, a common theme emerged: employers were reporting *shortages* of workers. Most acute shortages were for drivers, entry-level, low wage workers, child care, nurses, and information technology. Media narratives often suggest the labor market is badly battered with a long recovery ahead, but hard data suggests otherwise. If someone really wants a job in the U.S. economy today, they can find one.

JOB OPENINGS HAVE SHOT BACK UP TO PRE-PANDEMIC LEVELS



Source: Federal Reserve Bank of St. Louis

More evidence that current perception may be disconnected from reality: new business formation. Applications for new businesses hit nearly 1.4 million in Q1 2021, which marks the second highest quarterly total in over 15 years[x]. Applications for businesses that could employ multiple workers also approached its highest quarterly tally, indicating that entrepreneurs have been emboldened by what they see as an opportunity for new growth.

To be fair, some of these business start-ups may be because folks cannot find the jobs they want, or because they do not want to work in a crowded office or space with a lot of public interaction. But the takeaway is still clear: the U.S. economy is pushing ahead, with innovators and new growth opportunities forming in the wake of a major recession. We say this quite a bit, but these types of trends are *yet another reason not to bet against the U.S. economy.*

Around the world, demand is also returning at a faster pace than many expected. Global factories are struggling to keep up with orders, creating supply chain bottlenecks and delaying inventory restocks. According to the ISM, the index of factory activity, which accounts for new orders, production, inventory levels, and commodity prices rose to its highest level in over 37 years. Rising demand is broad-based and affecting every major industry, but it is also causing supply shortages which puts pressure on costs. The most recent US PMI data showed manufacturing input prices rising to levels last seen in 2009, with manufacturer delivery speeds at their lowest levels since 2007.

Perhaps the most acute shortages are being seen in the supply of semiconductors, which seems to stem in part from a global movement to buy new computers and other electronics for home office setups. Semiconductors are also used in cars, and several major automakers—Ford, GM, Toyota, Honda—have been forced to halt or slow production of various makes and models due to lack of essential components. The end result is that factories are reporting the sharpest rise in prices for inputs they've seen in nearly 10 years, which could add to inflationary pressures this year.

Given these supply chain issues are a by-product of soaring demand, these all amount to 'good problems' for the economic recovery. At the same time, however, the ability of companies to pass through rising input costs to consumers will likely be a key determinant of the trajectory of S&P 500 profit margins.

Interest Rates and Valuations

The 10-year U.S. Treasury bond yield started 2021 at 0.93% and finished Q1 at 1.74%[xi], marking a major selloff that could persist in some form for the balance of the year. Goldman Sachs sees the 10-year yield at 1.9% by the end of 2021, driven higher by rising inflation expectations and accelerating economic growth.

We have long expected interest rate 'normalization' as the economy shifted back into growth mode, so rising rates do not necessarily send off any alarm bells. Rates are still very low in a historical context. The speed of the adjustment in rates may create temporary consternation in markets, as certain over-leveraged investors and speculators have to adjust their positioning. To the extent higher rates take excessive froth out of the market, however, we ultimately view the volatility as a good outcome.

Rising bond yields may drive downside volatility in certain high valuation multiple stocks, but for stocks in general, rising rates have not necessarily been a bad omen, historically. LPL Research crunched the numbers. Over the last ~60 years, the S&P 500 rose an average of +17% during periods of rising bond yields, which lasted an average of 25.8 months (see chart on next page).

HIGHER RATES ARE USUALLY BULLISH FOR STOCKS | S&P 500 INDEX RETURN UNDER A HIGHER 10-YEAR YIELD

RISING RATES START DATE	RISING RATES END DATE	DURATION (MONTHS)	CHANGE IN 10-YEAR TREASURY YIELD	S&P 500 GAIN/LOSS
12/26/1962	8/29/1966	44.7	1.7%	18.3%
3/16/1967	12/29/1969	34.0	3.6%	1.3%
3/23/1971	9/16/1975	54.6	3.2%	-18.1%
12/30/1976	9/30/1981	57.8	9.0%	8.7%
5/4/1983	5/30/1984	13.1	3.9%	-7.9%
8/29/1986	10/16/1987	13.8	3.3%	11.8%
10/15/1993	11/7/1994	12.9	2.9%	-1.4%
1/19/1996	7/8/1996	5.7	1.5%	6.7%
10/5/1998	1/21/2000	15.8	2.6%	45.8%
6/13/2003	6/28/2006	37.0	2.1%	26.0%
12/30/2008	4/5/2010	15.4	1.9%	33.3%
7/24/2012	12/31/2013	17.5	1.6%	38.1%
7/8/2016	10/5/2018	27.3	1.9%	35.5%
3/9/2020	2/25/2021	11.8	1.0%	39.4%
Average Median % Positive		25.8	2.9%	17.0%
		16.6	2.4%	15.0%
			100.0%	78.6%

Source: LPL Research, Factset 03/03/21

Here is Goldman Sachs's take on the issue: *"We believe equity valuations should be able to digest 10-year yields of roughly 2% without much difficulty. A 10-year yield of 2% and a constant S&P 500 forward EPS yield of 4.5% (the inverse of a 22x P/E multiple) would reduce the yield gap between stocks and bonds to approximately its 45-year average of 250 bp."* In other words, rising rates in 2021 and beyond may be problematic for overpriced pockets of the market, but not necessarily for the market at-large.

Fiscal Stimulus in Overdrive

President Biden signed the $1.9 trillion 'American Rescue Plan' into law on March 11. The bill included direct payments to most American households, a significant expansion to the child tax credit, an extra $300/week in unemployment benefits through September 6, and billions of dollars across state and local education, Covid-related public health measures, and additional business loans.

There is plenty more in the bill. To appreciate the scope of direct payments, consider a young, middle income family with three kids. By qualifying for the stimulus checks and the child tax credits, they could receive somewhere in the neighborhood of $15,000 from the federal government in 2021. In short, the bill is massive, and a majority of dollars are making their way into the real economy. The chart on the next page demonstrates the clear impact of stimulus payments and income tax refunds on retail sales.

FISCAL STIMULUS MAKING ITS WAY INTO THE REAL ECONOMY

Source: Strategas Research

Biden's $1.9 trillion stimulus—and the $3.3 trillion in government spending that came before it—have driven savings higher and boosted the economy with (arguably short-term) 'demand-side' stimulus. Even with trillions already spent, the government wants to keep going. The proposed $2.3 trillion infrastructure bill is a 'supply-sided' stimulus, with the administration attempting to invest in physical and human capital as a means to increase the economy's productive potential. The administration is, in effect, proposing to raise taxes on corporations while also picking the winners for its new investment and spending plans—not necessarily the most efficient use of capital. Trillions of dollars of new spending will no doubt drive growth in targeted sectors and industries, but it seems less likely to lift growth across all sectors and industries. It depends on where the funding ultimately goes.

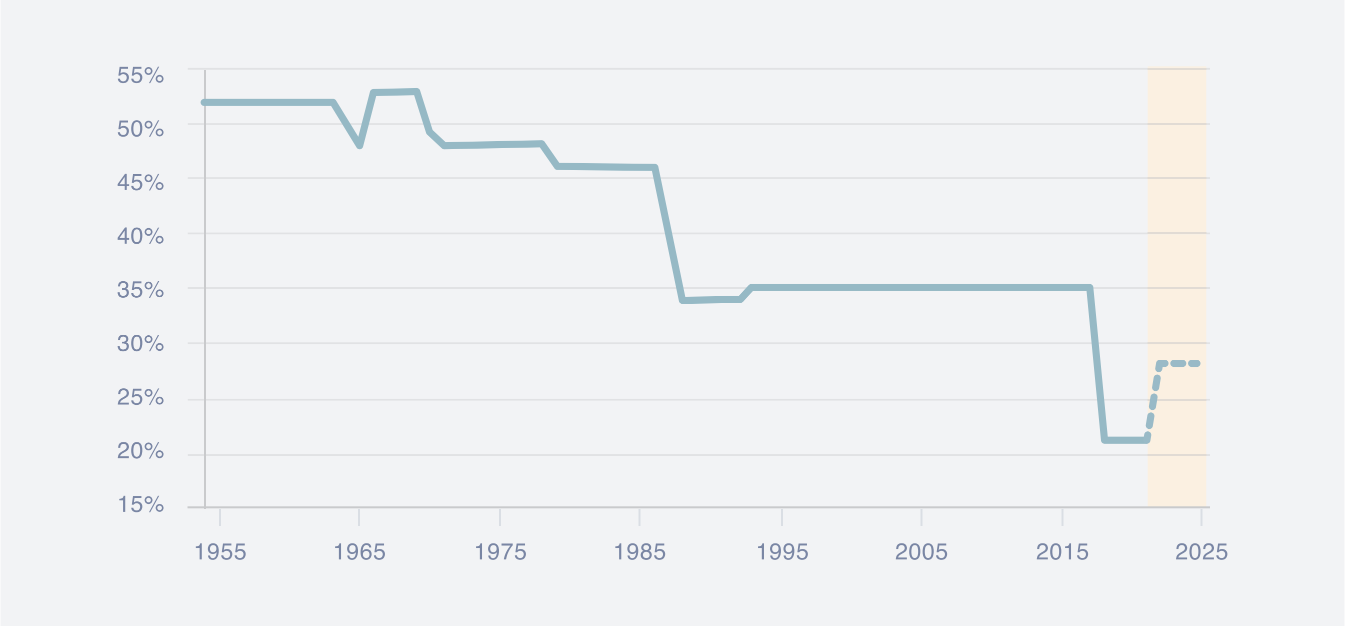
BREAKDOWN OF BIDEN'S INFRASTRUCTURE PLAN

Note: Totals are rounded estimates | *Source: The White House*

According to Gavekal Research, the bill would *steer government procurement, research and development subsidies, direct investment and tax credits. Its aim is to reward industries that create jobs at home, support US manufacturing, maintain the US technological lead over China, reduce carbon emissions and improve living standards for the disadvantaged.* Funding for the projects would be spent over eight years, which implies a steady stream of investment from the federal government to sectors like Industrials, Materials, Communication and Technology.

In order to pay for the plan, the administration is proposing to raise the corporate tax rate from 21% to 28%. Of note is that the Trump administration cut the corporate tax rate from 35% to 21%, so Biden's aim for 28% may indicate a new, lower benchmark for the corporate tax relative to previous decades. Prior to the 2017 Tax Cut and Jobs Act, the corporate tax rate had been above 30% since World War II.

U.S. STATUTORY CORPORATE TAX RATE*



**Rate for top tax bracket, federal taxes only | Sources: IRS, White House*

According to Gavekal Research, a higher corporate tax rate will impact earnings, but perhaps not by as much as some fear. Their research estimates that an increase to 28% will reduce after-tax corporate return on invested capital (ROIC) by 0.50%, from 4.9% to 4.4%. They also estimate U.S. equity earnings yields would fall approximately 0.20% from 2.1% to 1.9%, which essentially places them close to in-line with 10-year U.S. Treasury bond yields.

The bill is very far from becoming law, and even moderate Democrats have reservations. The Biden administration appears to be throwing most of its political capital behind this plan, raising the chances that some form of the bill gets passed eventually—perhaps through the budget reconciliation maneuver that does not require Republican support.

Conclusion

Excluding the shutdown-induced bear market that lasted just over a month last year, the stock market has been in a sustained upswing since the end of the 2008 financial crisis. Recent headlines and storylines give the impression that returns have gone parabolic across every asset class, and we are hearing a lot more about speculative investing in stocks like GameStop and categories like SPACs. Risk-taking is on the rise.

There are really two takeaways here we want to share with readers:

1. Flashy news stories of the 'get-rich-quick' variety only inspire us to redouble focus on earnings growth and quality, which is what we do here at Ascension; and,
2. As more and more optimism builds in the market, it is usually a sign we can expect increased market volatility down the road. We are prepared for this outcome.

Looking back over the last year, the stock market has not endured a technical "correction," meaning a decline of 10% or more over a few weeks or a few months. This stretch of rising stock prices is longer than average, so we would actually see a correction as a healthy and normal outcome. All that to say, we expect episodes of bumpiness and 'reality checks' on the market this year, and it is important to remember that even good stocks can and do get caught in the short-term fray. It will be key to stay the course and remain patient during volatile episodes.

If you have any questions about this review or would like to speak to us more about our outlook or portfolio strategy, please do not hesitate to contact us. We hope you have a lovely spring season and enjoy more time outdoors. As always, thank you for your continued confidence.

Sincerely,

Paul Thompson, Jr CFP
Ascension Capital Advisors

Sources:

[i] Source: Bloomberg
[ii] Source: Strategas Research
[iii] Source: U.S. Department of the Treasury
[iv] Source: Strategas Research
[v] Source: Strategas Research n
[vi] Source: FactSet
[vii] Source: FactSet
[viii] Source: Bureau of Labor Statistics
[ix] Source: Bureau of Labor Statistics
[x] Source: Small Business Administration
[xi] Source: U.S. Department of the Treasury