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APRIL 26, 2022

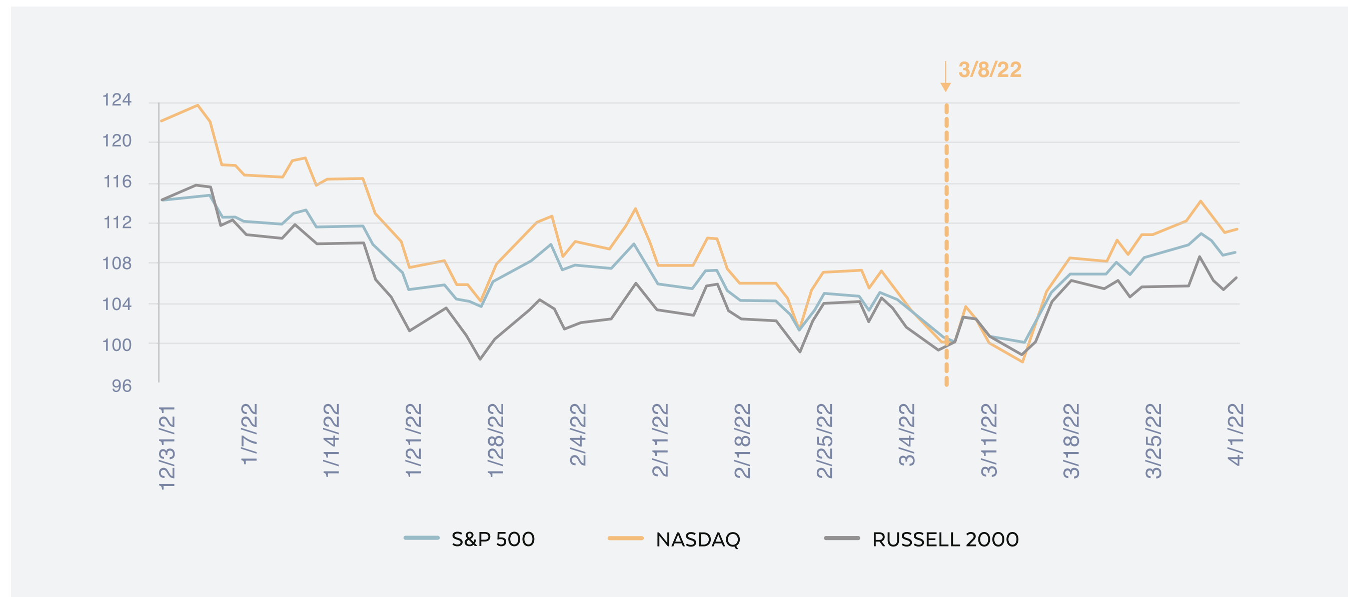
Second Quarter 2022 Client Review

Stocks started the new year on a volatile note. Persistent inflationary pressures have pushed the Federal Reserve to adopt a more hawkish monetary policy stance, and Russia's needless war continues to disrupt commodity markets while weighing heavily on sentiment. U.S. and global stocks spent the first half of Q1 pricing-in these headwinds—from January 1 to the invasion on February 24, the S&P 500 declined -11.3%[i]. The tech-heavy Nasdaq fell even further.

As we noted in our "Update on the Geopolitical Crisis in Ukraine," however, stocks have a tendency to bounce back once a conflict breaks out. Historically, this recovery happens not because armed combat is bullish, but because fighting ends the uncertainty surrounding a possible war. Markets can then weigh the downstream effects of the conflict and associated economic sanctions, to determine whether these effects might be significant enough to trigger a global recession.

It follows that from the day of the invasion to the end of the quarter, all 11 S&P 500 sectors moved higher and the broad index rallied +7.4%[ii]. The Nasdaq and small-cap Russell 2000 also posted solid gains, reversing some but not all of the losses sustained in the first two months. All told, the S&P 500 index fell -4.6% for the quarter[iii], a reasonably modest decline all things considered.

U.S. EQUITY MARKET PERFORMANCE



Source: Charles Schwab; Bloomberg

Ascension Capital continues to believe the risk of a recession and bear market is low in 2022. On the contrary, Fidelity Investments points out that despite some of the challenges the economy faces today, it is "still growing and remains in mid-cycle phase of the business cycle when stock prices may continue to rise despite volatility." On that point, we think investors should brace for more market volatility in the coming weeks and months, as well as the possibility that the market correction is not yet over. Going back to 1928, the average peak-to-trough pullback for the S&P 500 in a given year was -16.3%[iv], and corrections frequently span months. But patience in turbulent times is almost always rewarded—one year after exiting a correction, U.S. stocks gain an average of nearly +14%[v].

The call is for investors to be patient, not worried. A line from a recent Blackrock research note summed it up this sentiment perfectly: *"uncertainties around geopolitical events and domestic monetary policy may persist, but a surging VIX [volatility index] does not need to cause a surge in your blood pressure."* Market volatility is normal and common, particularly when there are many negative stories circulating in the media. **But the U.S. economy and stock market are more resilient than most appreciate.**

From an investment strategy standpoint, the thesis to overweight U.S. equities remains intact. The U.S. has less exposure to Russia than almost every major economy, and economic fundamentals—apart from rising inflation and falling fiscal spending—look strong. Millions of jobs are available, wages are rising, corporations are investing more in labor, software, and IT, and households (in aggregate) have experienced a sharp increase in wealth over the past few years. Consensus estimates have the U.S. economy growing 3+% in 2022.

U.S. stocks also continue to look attractive relative to bonds. The rising rate environment has bond prices in decline—according to the April 1, 2022 Morningstar Market Update, Q1 2022 was the worst quarter for bonds in 20 years, with long-term core bonds returning -11.3%. Because inflation remains high, the real rates on bonds (which are nominal bond yields minus the inflation rate) are also locked in negative territory.

Ascension Capital continues to focus on a diversified approach designed to mitigate market turbulence over time.

Inflation is Running Hot, But the U.S. Economy is Still Strong

From 2009 to 2019, consumer price inflation (CPI) in the U.S. averaged 1.77%[vi]. In February 2022, inflation was running at 7.9% with few signs of abating quickly, marking the highest year-over-year pace of inflation since January 1982[vii]. The producer price index, which measures input costs to businesses, is even higher.

Inflation is not just limited to food and energy. CPI is rising in virtually all categories, from goods to services to home prices and rent. The pandemic and related policies were no doubt the initial drivers of elevated inflation—'over-stimulated' consumers spent massive amounts of dollars on goods that were in limited supply due to factory closures, labor shortages, shipping bottlenecks, and fractured supply chains. These inflation pressures were poised to resolve with time as supply chains normalized. Then Russia invaded Ukraine.

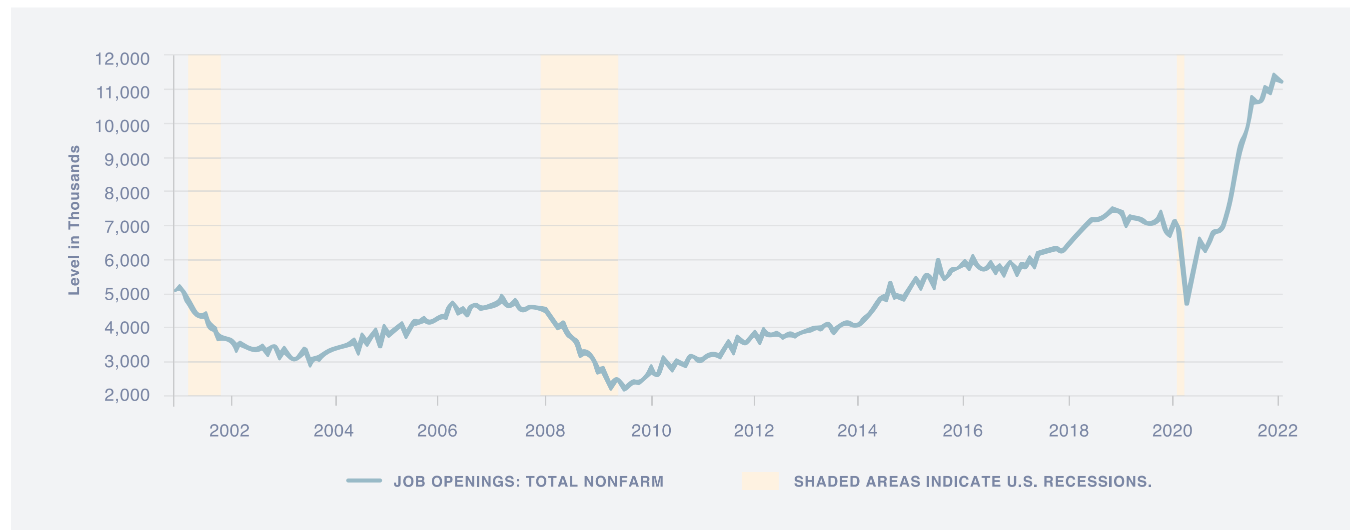
In the wake of the war, commodity prices have surged across many different categories, like oil, natural gas, palladium, wheat, and fertilizer. Shortages of some commodities and rising prices across the board have already begun to reverberate across the global economy, leading to even more inflationary pressures and supply chain issues. As the conflict wears on and more sanctions appear likely, commodity supplies will remain tight and inflationary pressures on the real economy will probably remain elevated.

This environment has reset interest rate expectations higher and has arguably contributed to volatility in the stock market. The Federal Reserve raised the benchmark fed funds rate by a quarter point at their March meeting, but Chairman Jerome Powell and other Fed governors have indicated the Fed's willingness to be more aggressive—suggesting half-percentage point increases are on the table. Fed Governor Lael Brainard, who is awaiting Senate confirmation to serve as the Fed's vice chairwoman, said recently that the central bank will start reducing its balance sheet "at a rapid pace as soon as its May meeting," which notably drove selling pressure in the stock market in the days following her comments.
The U.S. economy faces plenty of headwinds, but a balanced view should also acknowledge solid economic fundamentals that signal more growth ahead.

In the latest jobs numbers release in March, U.S. employers added 431,000 jobs with particularly strong hiring in services industries like restaurants and retail[viii]. The Labor Department also said that hiring in January and February was stronger than initially reported.

The latest release was the 11th straight month where job gains totaled more than 400,000, which marks the longest stretch of consecutive gains dating back to 1939. The unemployment rate fell to 3.6%, which now puts it very close to its pre-pandemic level of 3.5% (which is also a 50-year low). As the chart below shows, there are a historically high number of jobs available in the U.S. economy, and the number of people filing for unemployment has hit a 54-year low[ix].

JOB OPENINGS IN THE US., 2001 - PRESENT

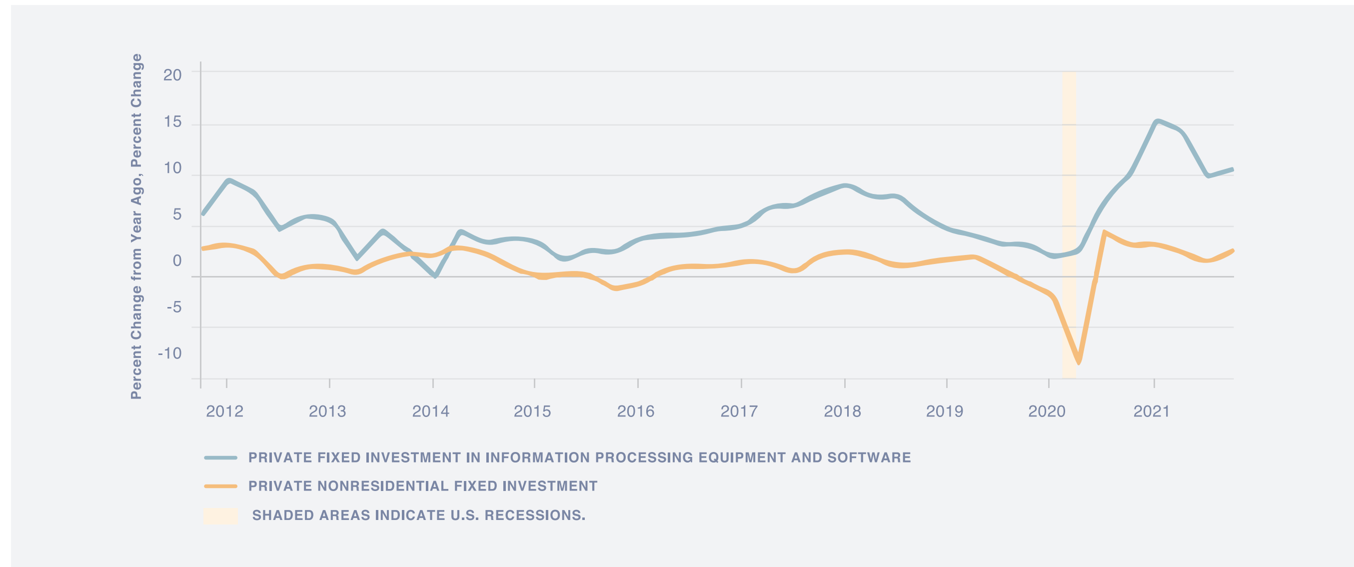


Source: Federal Reserve Bank of St. Louis

U.S. corporations are also flush with cash and have been investing at a solid clip. Private nonresidential fixed investment – a proxy for business investment – jumped 7.4% in 2021, even when adjusting for inflation. This uptick in business spending marked the fastest rate of increase since 2012[x].

Perhaps not surprisingly, U.S. businesses spent the most on software and information-processing (blue line in the chart below), as the need to 'digitize' business operations was catalyzed during the pandemic and is bound to grow as remote work becomes the norm. Spending in this area of IT rose a stout 14% in 2021[xi]. The trend of ramping up business investment looks poised to continue: manufacturing firms surveyed by the Institute for Supply Management said they plan to increase investment by 7.7% in 2022, and services firms – which comprise a majority of the U.S. economy – expect a 10.3% increase.

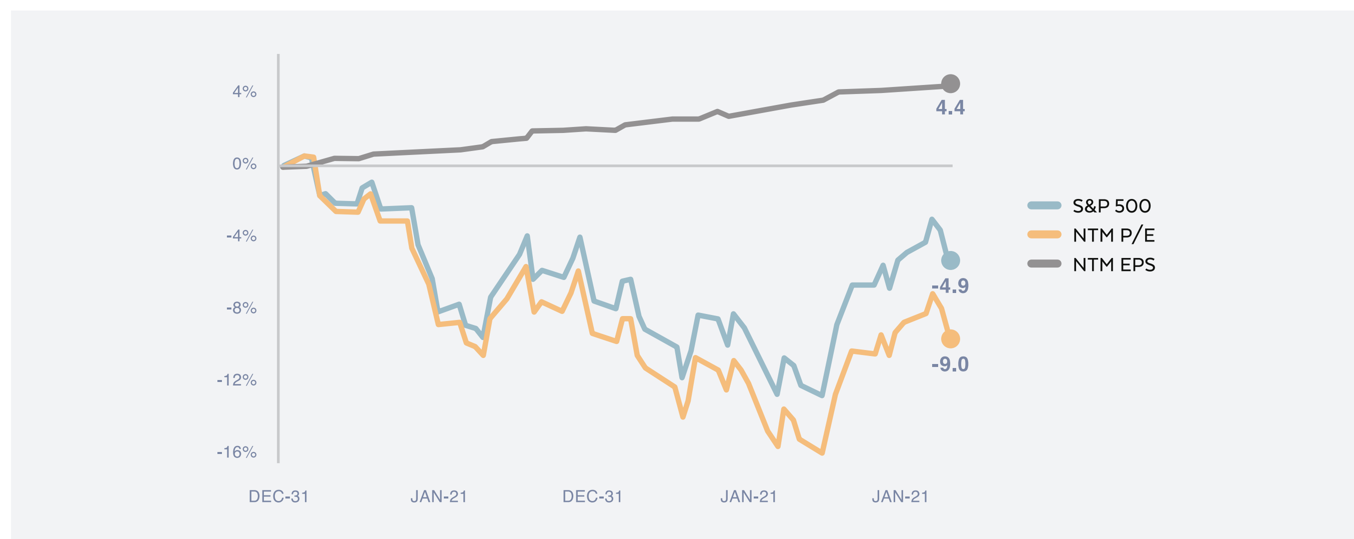
BUSINESS INVESTMENT ON THE RISE, PARTICULARLY IN SOFTWARE AND IT



Source: Federal Reserve Bank of St. Louis

Finally, the earnings outlook for American corporations remains positive for 2022. Though analysts decreased earnings estimates in aggregate for Q1 2022, they also raised earnings-per-share (EPS) estimates for the balance of the year. According to Credit Suisse, forward 12-month EPS estimates increased by 4.4% in the first quarter. Credit Suisse also notes that while earnings estimates were rising, stock prices were falling (see chart below), which caused the forward 12-month P/E ratio for the S&P 500 to fall from 21.3x to 19.5x during the first three months.

PERCENT CHANGE IN THE S&P 500 INDEX, EPS AND P/E - YTD



Source: Credit Suisse

Also, despite higher inflation, rising interest rates, the war in Ukraine, and a resurgence of COVID-19 in China, FactSet notes that analysts have more “Buy” ratings on stocks in the S&P 500 (as a percentage of their total ratings) than at any point in the last ten years. March 2022 marked the second-highest (month-end) percentage of Buy ratings for the S&P 500 going back to at least 2010, which was notably a great year to own stocks.

Conclusion

Investors are weighing a laundry list of unknowns in the current environment—how quickly the Fed will raise rates, whether and when inflation will moderate, how long Russia’s war will continue, whether the war escalates and turns global, and whether the pandemic is truly over. Our base assumption is that equity market volatility will continue as these questions continue to weigh on sentiment.

At the same time, the U.S. economy is on relatively strong footing and history reminds us that markets have endured far worse and proven resilient. When the Korean War broke out in 1950, for example, inflation in the U.S. was close to 20%[xii], Congress was raising taxes to finance the war (the top capital gains rate was 62%!)[xiii], and tens of thousands of U.S. troops were being sent to fight. The economy nevertheless expanded and markets rallied throughout the war. We would argue the U.S. economy is in far better shape today than it was then.

Even still, higher inflation and higher long-term interest rates are likely to pressure valuations in certain areas of the stock market, which we believe could lead to greater dispersion in equity returns and an increased need for active management. Ascension Capital will continue to remain vigilant as economic and market conditions evolve, and as always we will diversify across asset classes to mitigate risk where possible.

If you have any questions about this review or your investment portfolio, please do not hesitate to reach out to us. We hope you have a wonderful spring season, and as always, we thank you for your support and for your continued confidence.

Sincerely,

Paul Thompson, Jr CFP
Ascension Capital Advisors

Sources:

[i]Source: Bloomberg
[ii]Source: Bloomberg
[iii]Source: Strategas Research
[iv]Source: JPMorgan
[v]Source: JPMorgan
[vi]Source: Bureau of Labor Statistics
[vii]Source: Bureau of Labor Statistics
[viii]Source: Bureau of Labor Statistics
[ix]Source: Bureau of Labor Statistics
[x]Source: Federal Reserve Bank of St. Louis
[xi]Source: Institute for Supply Management
[xii]Source: Bureau of Labor Statistics
[xiii]Source: Internal Revenue Service

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