MAY 2, 2023

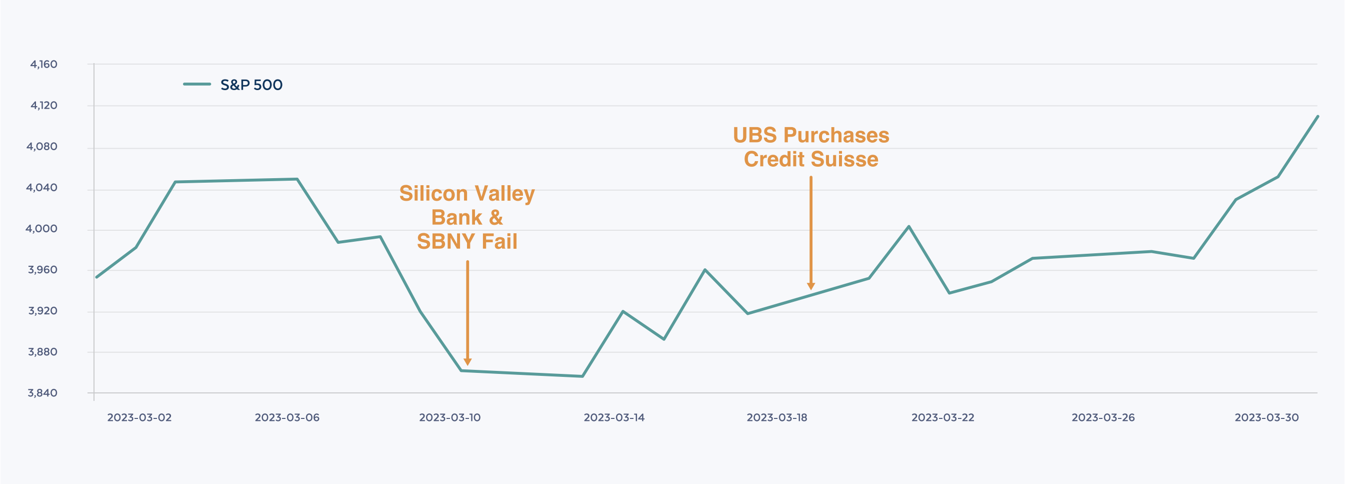
Second Quarter 2023 Client Review

Dear Client,

The failures of Silicon Valley Bank and Signature Bank New York—as well as UBS's takeover of Credit Suisse—dominated financial news headlines in the first quarter. In our March 23 letter to clients, we framed the risk of financial contagion as very low. Our analysis at the time pegged the US banking system as extremely well-capitalized, with Tier 1 capital ratios at very solid levels and loan-to-deposit ratios at almost their lowest levels in 50+ years[i].

A month later, we still view contagion risk as very low, even with the most recent failure of First Republic Bank. With a clearer picture emerging of what exactly took place across all of these failed banks, we firmly view the bank stress as more of a crisis of mismanagement than a symptom of systemic risk lurking throughout the banking sector. As Jamie Dimon wrote in his annual shareholder letter, "many of the risks were hiding in plain sight[ii]." Market action seemed to align with this perspective—stocks rallied for three consecutive weeks starting on March 13.

STOCKS RALLIED IN MARCH IN RESPONSE TO THE BANK STRESS



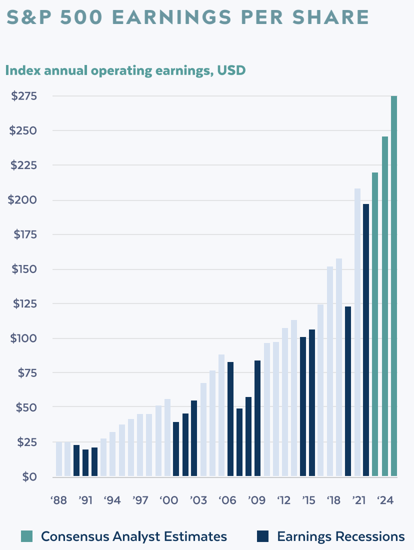
Source: Federal Reserve Bank of St. Louis

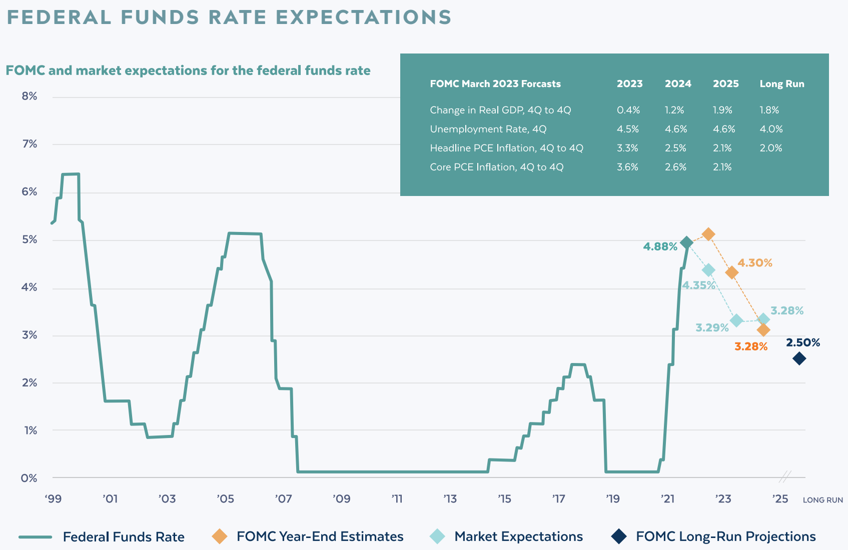
Over the course of the first quarter, investors shifted capital to growth, technology, and cyclical stocks, as evidenced by sector outperformance for Technology (+20%), Communication Services (+18%), and Consumer Discretionary (+13%)[iii]. We believe this "risk on" rotation was a wager that bank stress could hinder economic growth later in the year, which we think considerably raises the odds of a Fed "pause" or even rate cuts later this year. In response to bank stress, the Federal Reserve also expanded balance sheet liquidity by $755 billion, reversing five months of quantitative tightening[iv]. This liquidity likely served as a tailwind for risk assets as well, as we believe it has in the past.

In the fixed income markets, US Treasury bonds across nearly all durations rallied for the quarter, with the 10-year bond yield declining from 3.9% to 3.47%[v]. The 2-year Treasury bond yield fell slightly more than the 10-year, which caused the yield curve inversion to reach its deepest level in 40 years[vi]. Combined with the likelihood of tighter credit conditions and lending standards resulting from bank failures, we think the case for a recession has risen since the beginning of the year.

A higher likelihood of recession is not necessarily bad news for financial markets—quite the opposite, in our view. The bank failures' downstream impact on loans, credit, and economic activity—which could translate into headwinds on employment—could ultimately be the outcomes the Fed wants for its inflation fight. In this sense, bad news for the economy has been good news for the interest rate outlook, which we think is also good news for stocks. The Federal Reserve is now forecasting only one more 25 basis point rate hike in this tightening cycle[vii].

From an investment standpoint, if we anticipate borrowing rates will be lower in future years than they are today—while corporate earnings are expected to stage a recovery a few quarters or even a year from now—we think that should be construed as a positive. As seen in the charts on the next page, both of these conditions are apparent today, and as we wrote last quarter, “we want to be positioned ahead of the recovery, not on the sidelines waiting for green shoots to appear.”





FOMC March 2023 Forcasts	2023	2024	2025	Long Run
Change in Real GDP, 4Q to 4Q	0.4%	1.2%	1.9%	1.8%
Unemployment Rate, 4Q	4.5%	4.6%	4.6%	4.0%
Headline PCE Inflation, 4Q to 4Q	3.3%	2.5%	2.1%	2.0%
Core PCE Inflation, 4Q to 4Q	3.6%	2.6%	2.1%	

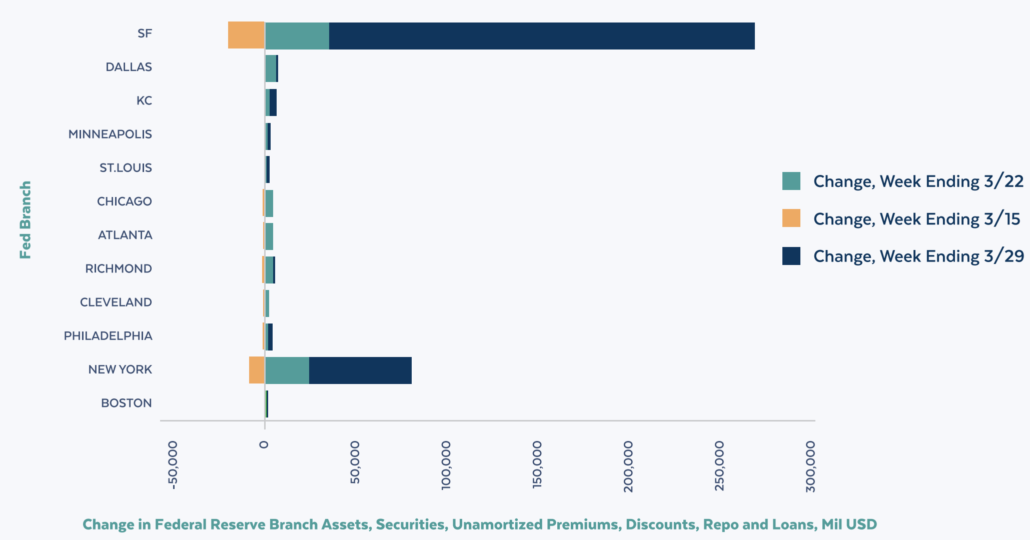
Source: JPMorgan[viii]

A Brief Update on U.S. Banking Stress

In the month or so since SVB’s failures, about $350 billion in fixed rate securities have been swapped for cash at the Federal Reserve’s emergency Bank Term Funding Program (BTFP). For some, this is a clear sign of ongoing stress in the banking system.

As a feature of the program, the Fed does not disclose which banks borrow. But we can obtain clues about how *widespread* the issues may be, since banks must access the program via their regional Fed branch. If assets across Federal Reserve regional branches shot higher, it would be a clear sign of a systemic problem. The data shows otherwise—a vast majority of BTFP activity has come from San Francisco and New York, which we think shines the spotlight squarely on Silicon Valley Bank, First Republic, and Signature Bank New York.

CHANGE IN FEDERAL RESERVE BRANCH ASSETS (MARCH 2023)

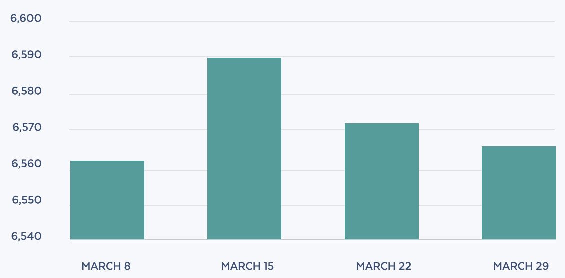


Source: Federal Reserve

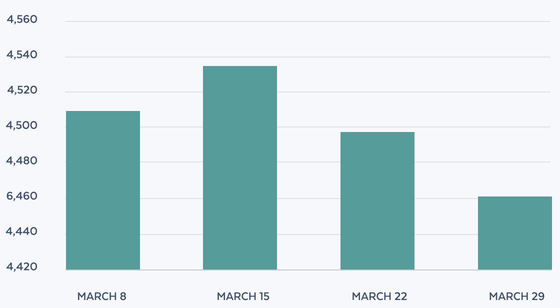
We again see financial contagion as unlikely given current conditions, but we think there are two risks to track going forward. The first is the legislative impulse to respond to a crisis with more regulation, which can create uncertainty in the banking sector.

The second is the degree to which credit and lending standards tighten as the year progresses. Banks may decide that a dollar in reserves is better than a dollar lent, which can have a meaningful impact on economic activity and perhaps employment. Banks outside of the largest 25 account for 40% of all loan activity, and small banks in particular are responsible for 67% of all commercial real estate lending[ix], so this will be an important metric to watch. So far, we have not seen a meaningful decline in loan activity at large or small banks:

LARGE BANK ASSETS (LOANS, SEASONALLY ADJUSTED)



SMALL BANK ASSETS (LOANS, SEASONALLY ADJUSTED)



Source: Federal Reserve

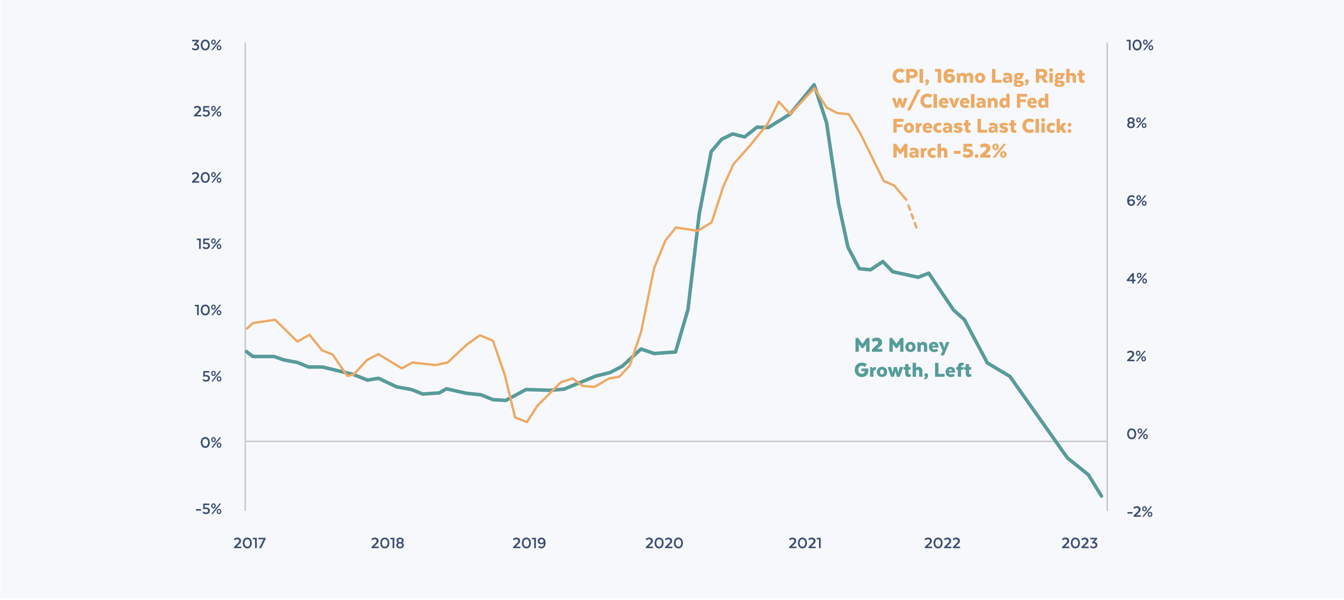
JPMorgan estimates that bank lending growth could slow from +12% in 2022 to +2% in 2023[x], which would likely create a drag on economic growth (-0.8% by JPMorgan estimates[xi]) and perhaps employment. But they also note that "the credit sensitivity of an economy is tempered when growth impulses are strong and there is less need for credit[xii]." Corporations have spent years borrowing at ultra-low rates and building up cash reserves, which should limit external financing needs for strong companies. As JPMorgan put it, "the need for credit is more muted in periods of healthy balance sheets[xiii]," which we think keeps the argument for a mild recession intact.

The Outlook for Interest Rate Policy

The Fed has made clear their goal of slowing down GDP growth in an effort to fight inflation. As mentioned above, bank stress and the likely effect on loan activity and credit conditions could do some of the Fed's work for them, which we think could give way to the Fed 'pausing' their rate hike campaign after their next meeting.

Two other key data points are bolstering the case for a Fed "pause" either at or after the next meeting. The first is M2 money supply declining by $130 billion in February and -2.4% year-over-year, which marks the fastest rate of decline in M2 since the 1930s[xiv] (chart below). Changes to the consumer price index tend to lag M2 money growth, which suggests we could see a significant anchoring effect on inflation in the coming quarters.

M2 MONEY GROWTH & CPI

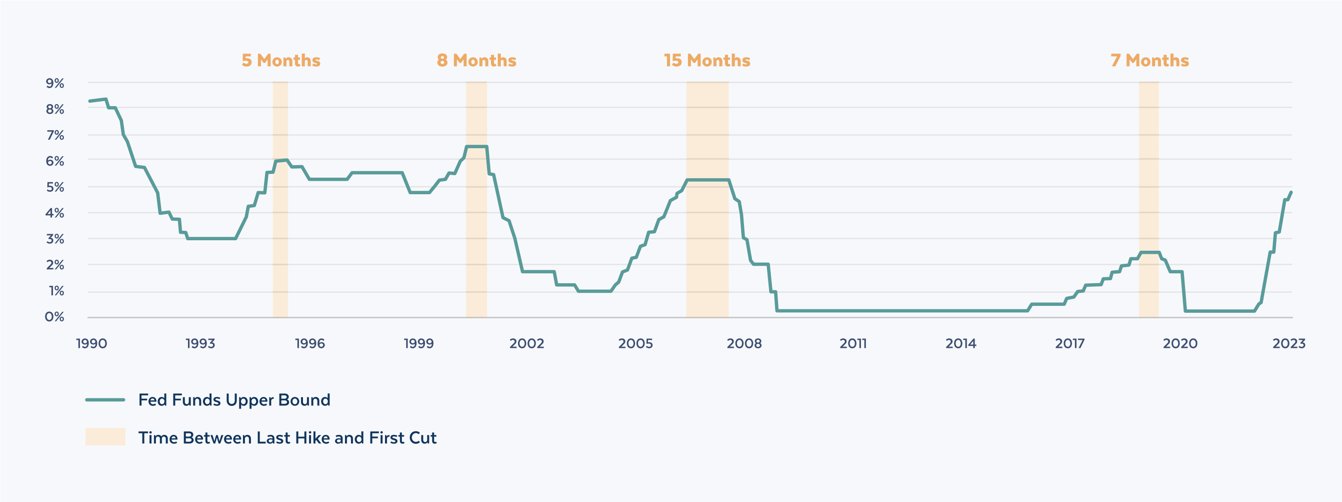


Source: Strategas Research

The second data point is the number of nonfarm job openings in the US, which in February fell in to 9.9 million from January's 10.6 million. This figure is down considerably from the peak of 12 million job openings reached in March 2022[xv], and signals that rate hikes are easing labor market pressures - particularly wage pressures - without triggering mass layoffs (at least not yet).

If the Fed does indeed decide to pause rate hikes, history suggests the length of the pause could be anywhere from 5 to 15 months before rate cuts commence. This timeline aligns pretty well with expectations for rate cuts in early 2024, and in our view makes a compelling case for being optimistic about stocks over the next year.

HISTORICAL PAUSES IN RATE HIKE/CUT CYCLES



Source: Bloomberg

Conclusion

We think the table is set for a peak in the interest rate cycle, likely this summer. We've also made the case this quarter and in previous quarters that inflation should continue in a downtrend, barring another commodity market shock or some other extraneous factor—with geopolitics being the biggest risk.

The remaining question is how the US economy will respond, which seems near impossible to forecast given the ongoing resilience of US consumers and the labor market. There appear to be three possible outcomes:

- The US avoids recession altogether;
- The recession is 'mild' as just about everyone is predicting; or,

- A recession is worse than expected, perhaps because credit fundamentals deteriorate more sharply as lending standards tighten and borrower demand plummets.

What's interesting about these scenarios, in our view, is that the case for equities is relatively strong in each one. Avoiding recession would likely register as a positive surprise for markets, and we think a mild recession is already baked into stock prices—meaning no surprise power. The final scenario might result in a retesting of the bear market lows, but at the same time, it would likely accelerate the timeline for rate cuts—which we think brings the forward-looking bull case front-and-center once again.

In the coming months, we believe it will be important to monitor bank lending activity to assess the spillover from recent failures, as well as to look for confirmation that weakening inflation keeps the door open for a Fed pause. A debt ceiling showdown will also be high on our radar.

If you have any questions about this review or your portfolio, please do not hesitate to reach out to us. We thank you for your continued confidence in Ascension Capital.

Sincerely,

Paul Thompson, Jr CFP

Ascension Capital Advisors

Sources:

[i]Source: JPMorgan, "Eye on the Market: Silicon Valley Bank Failure," March 10, 2023.
[ii]Source: JP Morgan Chase & Co., Jamie Dimon 2022 Annual Shareholder Letter.
[iii]Source: Strategas Research, "Quarterly Review in Charts," Q1 2023.
[iv]Source: Strategas Research, "Quarterly Review in Charts," Q1 2023.
[v]Source: U.S. Department of the Treasury, Daily Yield Curve Rates.
[vi]Source: Strategas Research, "Quarterly Review in Charts," Q1 2023.
[vii]Source: Federal Reserve, "March 22, 2023: FOMC Projections materials, accessible version."
[viii]Source: JPMorgan Asset Management, "Guide to the Markets," Q1-2023.
[ix]Source: The Wall Street Journal, "Banking Turmoil Tests the American Consumer," March 21, 2023.
[x]Source: JPMorgan, "Hamburgers for Wimpy? Gauging the credit shock," March 30, 2023.
[xi]Source: JPMorgan, "Hamburgers for Wimpy? Gauging the credit shock," March 30, 2023.
[xii]Source: JPMorgan, "Hamburgers for Wimpy? Gauging the credit shock," March 30, 2023.
[xiii]Source: JPMorgan, "Hamburgers for Wimpy? Gauging the credit shock," March 30, 2023.
[xiv]Source: Strategas Research, "Quarterly Review in Charts," Q1 2023.
[xv]Source: Bureau of Labor Statistics

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