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JULY 21, 2022

Third Quarter 2022 Client Review

Dear Client,

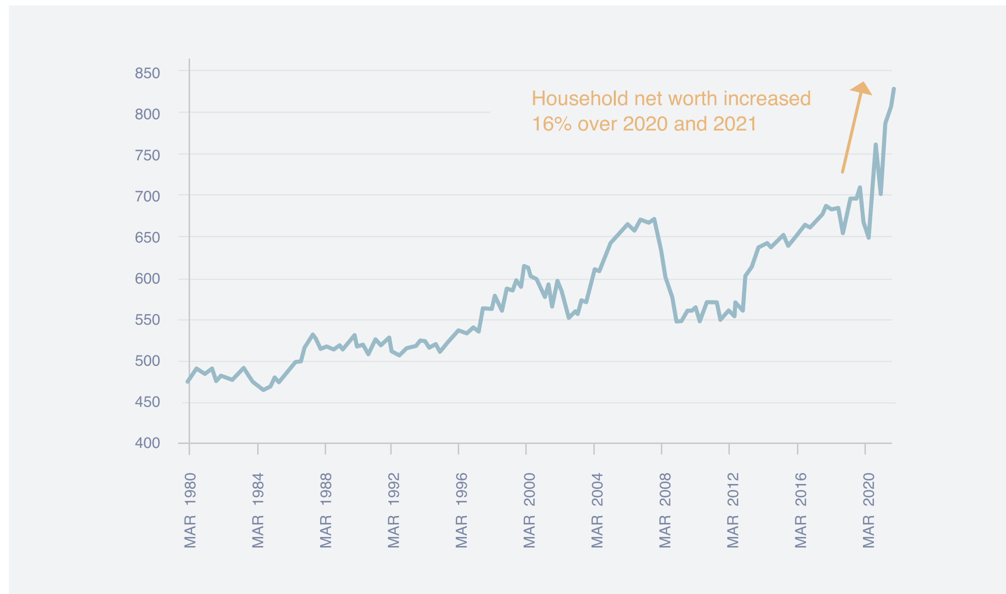
In our "Second Quarter 2022 Client Review," we advised investors to "brace for more market volatility in the coming weeks and months, as well as the possibility that the market correction is not yet over." Far from over, in fact.

The S&P 500 index experienced its worst start to a year since 1970, with stocks declining -20% over the past six months[i]. Energy was the only sector to finish the first half of the year with a positive return (+31.8%)[ii], benefitting in large part from supply constraints tied to the war in Ukraine, which sent the price of a barrel of crude oil above $100 a barrel. Long-term US Treasury bonds also shed -18% in the first four months, posting one of their worst starts in history[iii]. Pressures moderated in the second half of June, but overall it marked a rocky stretch no matter how investors were positioned.

Investors were no doubt shaken-up by this sharp selling pressure, but it is worth reflecting on what the past two years has produced for Americans who own substantial amounts of capital. In the 15 months following the March 2020 bear market bottom, the stock market approximately doubled, marking the fastest level of price appreciation in history[iv]. The housing market also experienced historic appreciation, as low interest rates and a rapid shift to remote work supercharged demand for houses.

Taken together, owning a home and staying invested in equity markets meant capturing one of the most significant wealth creation events in history:

U.S. HOUSEHOLD NET WORTH AS A % OF DISPOSABLE PERSONAL INCOME, EOP %



Source: KKR Global Institute

With the Federal Reserve tightening financial conditions and fiscal stimulus long gone, however, stocks have undergone a rapid adjustment to the altered economic growth outlook. It was only the fifth time in history the index lost -20% or more in the first 6 months[v].

Sharp and steep declines are never easy, but history gives us a silver lining: every time the S&P 500 lost 20% or more in the first six months, the rest of the year was positive 100% of the time[vi]. Returns looking out 1, 3, 5, and 6 years later were also strong and uniformly positive:

SUBSEQUENT RETURNS FOR S&P 500

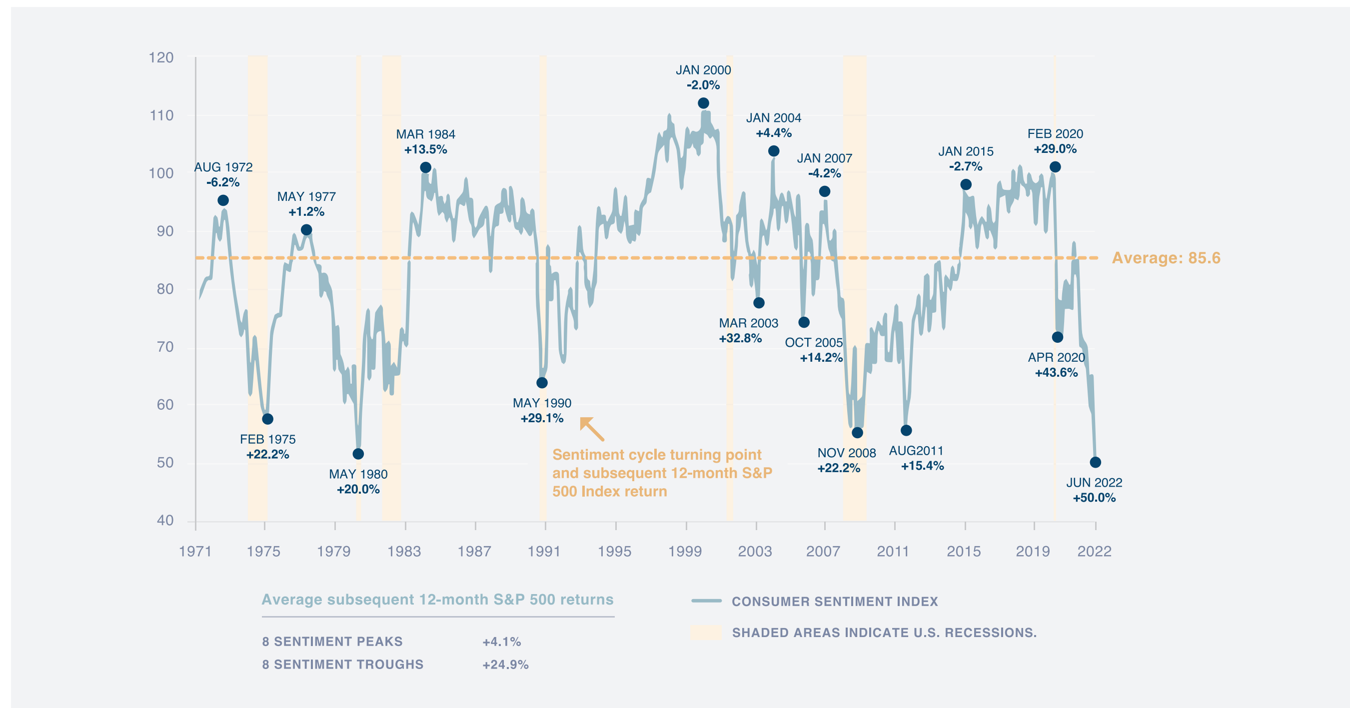
DATE	FIRST 6 MO.	6 MO. LATER	1 YEAR LATER	3 YEARS LATER	5 YEARS LATER	6 YEARS LATER
1932	-45.4%	55.5%	146.3%	130.9%	247.6%	160.9%
1962	-23.5%	15.3.5%	26.7%	53.6%	65.6%	81.9%
1970	-21.0%	26.7%	37.1%	43.4%	30.9%	43.4%
2022	**-20.6%**	**?**	**?**	**?**	**?**	**?**
1940	-20.1%	6.0%	-1.3%	23.7%	49.0%	84.7%
AVERAGE		**25.9%**	**52.2%**	**62.9%**	**98.3%**	**92.7%**
AVERAGE EXCLUDING 1932		**16.0%**	**20.8%**	**40.3%**	**48.5%**	**70.0%**

**Source: Morningstar Direct. S&P 500 price return index. This chart does not include dividends. All returns are cumulative. Past performance does not guarantee future results.*

As investors, we know that expected returns over time include periods when asset prices undergo (sometimes extreme) pressure. But owning capital in the United States means ensuring long-term ownership in the most effective wealth creation engine in the world, even if new value and growth is created in fits and starts over time. We are currently in a period where a historic amount of wealth was created in a short period of time, and now leverage is getting flushed out of the system and financial assets are getting re-priced. We believe this process is best viewed as healthy, not worrisome.

Now is a time to stay the course. Bull markets always follow bear markets, and bear market bottoms almost always happen when conditions feel terrible and pessimism reaches a peak, which seems to match what we're seeing today. In a recent Wall Street Journal-NORC poll conducted with the University of Chicago, a staggering 83% of respondents said the economy was in a poor or 'not so good' state, and 35% of respondents reported being unhappy with their financial situation—the highest level of dissatisfaction in the survey's 50+ year history. The University of Michigan Consumer Sentiment also recently reached its lowest level in history, which has been a leading indicator for strong market returns as seen on the chart below.

CONSUMER SENTIMENT INDEX AND SUBSEQUENT 12-MONTH S&P 500 MONTHS



Source: Factset, Standard & Poor's, University of Michigan, J.P. Morgan

Americans are understandably frustrated with the economy—inflation is driving up the cost of nearly everything. But the level of pessimism is greater than any time in the last 50+ years, which we think implies the pendulum has swung too far.

For context, Americans feel the economy is worse today than it was in 1974, when a deep recession and an energy crisis had people waiting in cars for hours to get gas; worse than 1980, when interest rates were 14.5% and inflation was in double-digits[vii]; worse than 2001, when the U.S. was in recession and also suffered the worst terrorist attack in history; worse than 2008, when the financial system nearly collapsed and millions of people lost their homes; even worse than 2020, when a global pandemic washed the world over in uncertainty.

We know the extreme level of pessimism is being driven by higher food and gas prices and negative media narratives, but we think it is fair to say this economy is not worse than the years mentioned above. Today, every American who wants a job can find several to choose from. There are currently 11+ million job openings across the country—nearly double the amount of typical job openings in years prior to the pandemic[viii]. Households also have close to record amounts of cash on hand—at the end of Q1 2022, Federal Reserve data showed households with $18.5 trillion in cash in checking accounts, savings accounts, and money market funds. Before the pandemic, that figure was $13.3 trillion.

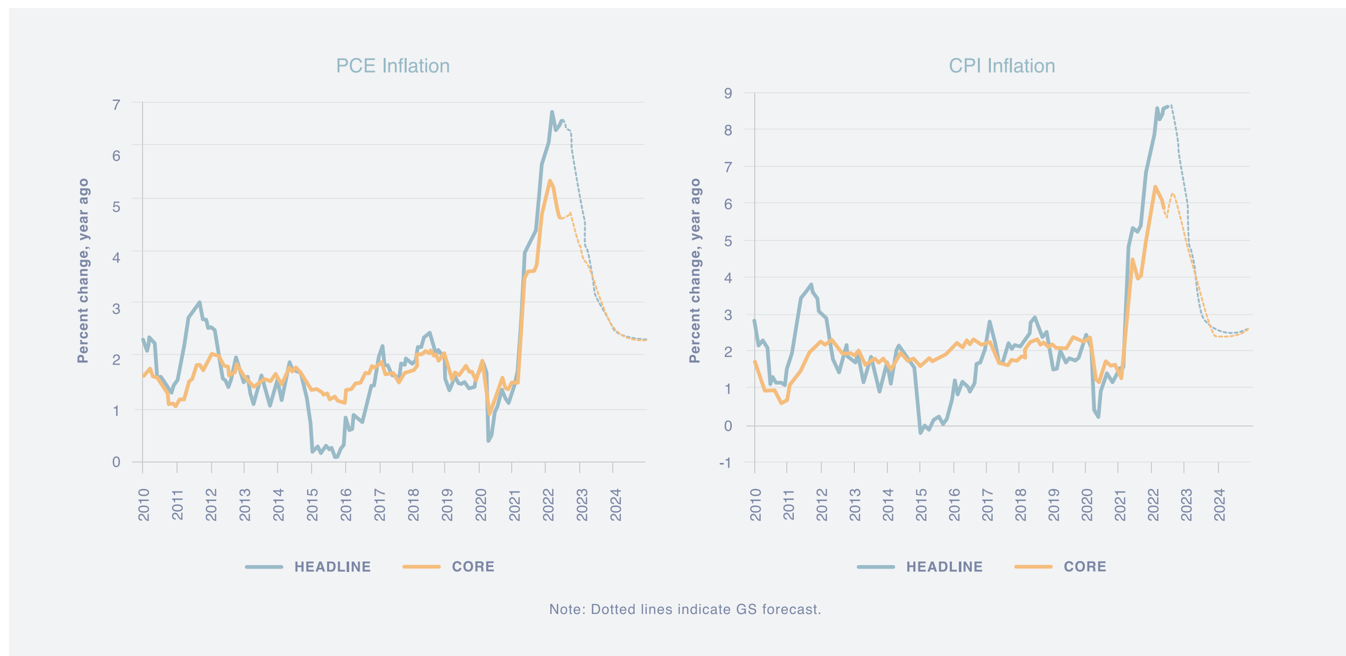
Historically, extreme pessimism has been a bullish signal, which we believe is particularly true today as the economy slows but as labor market conditions remain extremely favorable. If the U.S. economy fares even just modestly better than many expect to in the next year—which we believe it will—that's all the market may need to produce a formidable rally.

Addressing the Inflation Question

Whether or not inflation starts to moderate in future months is a key question not only for policymakers but also for equity market investors. If inflation pressures begin to subside in the second half of the year, it could remove pressure from the Federal Reserve to tighten monetary policy so aggressively, which could provide some relief to equity markets. This outcome would seem highly likely were it not for the ongoing war in Ukraine combined with China's unpredictability when it comes to "zero-Covid" and lockdowns—both of which add substantial uncertainty to supply/demand dynamics in the global economy.

Markets appear, for now, to be wagering that inflation pressures will ease in the coming quarters. Market-based measures of future inflation, like the 5-year and 10-year breakeven inflation rates, have come down in recent weeks, signaling that the bond market may be expecting lower growth and lower inflation looking ahead. Commodity and energy prices have also broadly declined over the last month, perhaps as the market resets expectations for global growth going forward. As seen on the chart on the next page, Goldman Sachs is forecasting that inflation's peak is likely not too far off, assuming it hasn't happened already.

GOLDMAN SACHS IS FORECASTING INFLATION TO PEAK SOON



Source: Goldman Sachs

Addressing the Recession Question

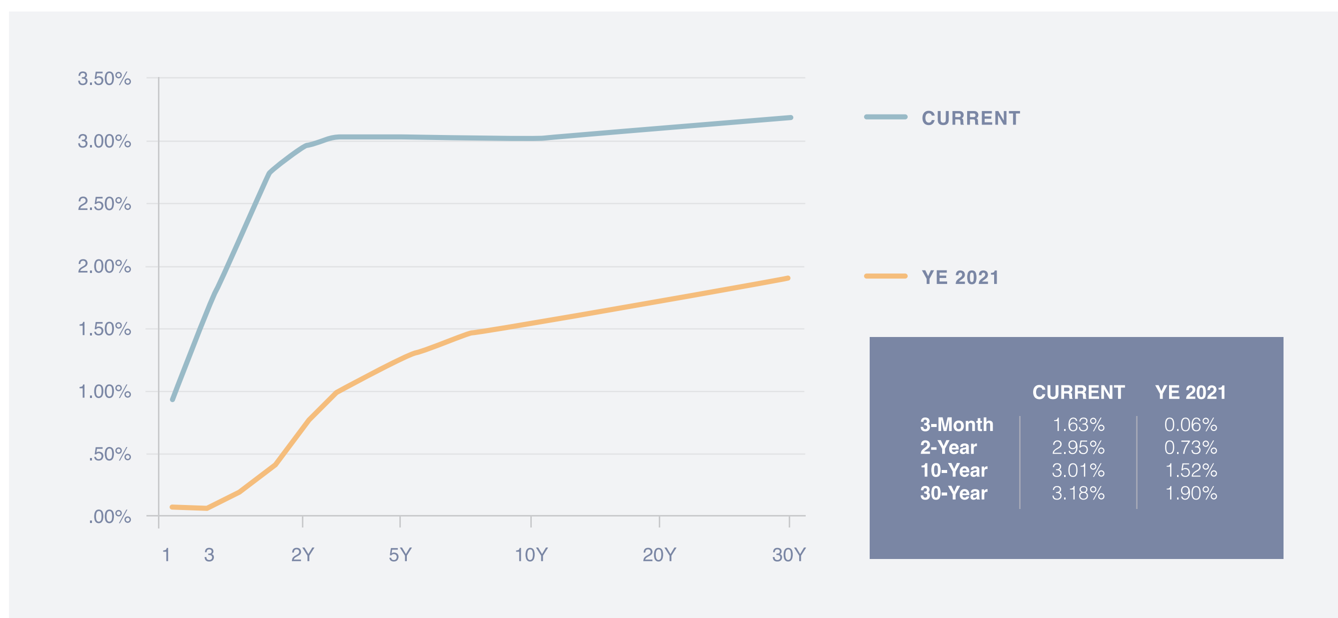
It also now appears possible that the U.S. economy entered a recession in the first half of 2022, which if confirmed would mark a very shallow and atypical contraction. Recessions are most accurately characterized by declining output, rising unemployment, and some level of dislocation in credit markets where businesses and consumers fail to meet financial obligations. Essentially none of these conditions were met in the first half of 2022.

Economic growth is slowing, but Q1 GDP's negative print was largely the result of a big swing in inventories and a surge in imports, both of which detract from the GDP calculation but do not necessarily signal a sharp drop-off in activity. Manufacturing and services indices in the U.S. have yet to dip into contraction territory this year, and have been in expansion mode for 25 months straight[ix].

The past 12 recessions have also all featured rising unemployment, which we have not seen in 2022. Over the past six months, the unemployment rate has fallen from 4% to 3.6%[x], and the just-released June jobs report showed 372,000 new hires for the month, well above economist expectations. There are also 'only' 1.3 million Americans collecting unemployment today, which is 400,000 fewer than before the pandemic. For context, there were over 6.5 million unemployed Americans receiving benefits during the 2008 Financial Crisis[xi].

Banks are also not showing any signs of distress so far. The latest round of Fed 'stress tests' found that banks could easily handle the unemployment rate soaring to 10% and a collapse in stock market and commercial real estate that would wipe out over $600 billion. Even with those unlikely shocks, banks would have capital ratios of 9.7%, which is over double the 4.5% required by law. An upward sloping yield curve also suggests

THE YIELD CURVE IS UPWARD SLOPED BUT FLATTENING



	CURRENT	YE 2021
3-Month	1.63%	0.06%
2-Year	2.95%	0.73%
10-Year	3.01%	1.52%
30-Year	3.18%	1.90%

Source: Credit Suisse

The June Manufacturing and Services PMIs in the United States also are not flashing recessionary conditions either, at least not yet. According to the Institute for Supply Management, the June Manufacturing PMI came in at 53%, which marked a significant deceleration from May's 56.1% but still indicates expansion. A similar outcome was seen in the Services sector, which posted a reading of 55.3% and continues its streak of expansion for 25 months straight. Globally, flash PMIs show most major economies remain in expansion territory, though all have decelerated from the spring. Readings in the low 50s – where most major economies now reside – imply modest growth but not necessarily recession.

Conclusion

The U.S. and global economy are likely headed for a period of below-trend growth, as rising rates and inflation take a bite out of real activity. Below-trend growth is not the same thing as a deep recession, however, and it is important to remember that the stock market's -20% decline in 2022 could mean a good portion of slowing growth may already be incorporated in current prices.

A key focus now should be ensuring participation in the stock market's recovery once it takes hold, which will assuredly be before economic data confirms the U.S. economy is in good shape. Shifts in market direction often happen very quickly, which means patience is critical right now. History also tells us that once the stock market has crossed into bear market territory, the next 12-months return for equity investors is almost universally positive[xiii].

If you have any questions about this review or your portfolio strategy, please do not hesitate to reach out. Thank you for your continued confidence and enjoy the rest of your summer.

Sincerely,

Paul Thompson, Jr CFP
Ascension Capital Advisors

Sources:

[i]Source: Strategas Research
[ii]Source: Strategas Research
[iii]Source: Strategas Research
[iv]Source: JPMorgan
[v]Source: Strategas Research
[vi]Source: Morningstar Direct
[vii]Source: Bureau of Labor Statistics
[viii]Source: Bureau of Labor Statistics
[ix]Source: Institute for Supply Management
[x]Source: Goldman Sachs
[xi]Source: Bureau of Labor Statistics.
[xii]Source: Federal Reserve
[xiii]Source: Morningstar Direct

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