ASCENSION CAPITAL Thoughtful Advising

JULY 20, 2023

Third Quarter 2023 Client Review

Dear Client,

For the past year, many economists and major banks have been forecasting a looming economic downturn in the US. It didn't arrive in the first half of 2023.

The Commerce Department reported that real gross domestic product grew at a 2% annualized rate in the first quarter, which marked a significant upward revision from the previous 1.3% estimate. The Labor Department also reported that employers have added an average of 278,000 new jobs each month this year, which is higher than the pre-pandemic average. Workers are also earning more–nominal wages have grown by over 14% over the past two years[i].

Inflation remains elevated and GDP growth is below average, so it would be wrong to say the economy is in great shape and firing on all cylinders. But the economy is also not faltering as many anticipated it would be by now. Growth likely slowed further in the second quarter, but not by much–JPMorgan estimates real Q2 GDP growth of 1.7%.

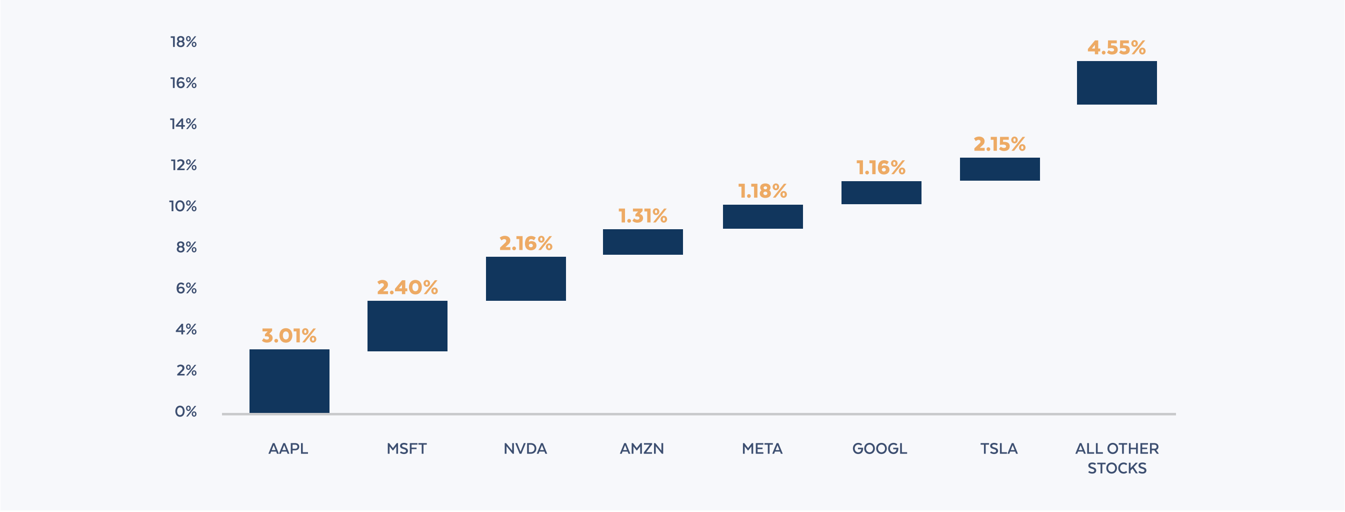
The stock market has a long history of performing well when economic outcomes are better than expected, or at least not as bad as expected. And that's what we think we saw in the first half of 2023. The headline risk surrounding bank failures and the debt ceiling standoff made it seem like crisis was just around the corner, but the US economy outperformed at every turn–and stocks rallied. The S&P 500 index officially entered a new bull market with a 20+% bounce off October 2022 lows, with the index rallying +16.9% in the first six months of the new year[ii].

STOCKS HAVE BEEN RALLYING SINCE OCTOBER

Source: Strategas Research

US equity performance was strong, but it's important to acknowledge how mega-cap companies contributed to total returns, particularly in the technology sector. Enthusiasm for artificial intelligence (A.I.) led to a buying spree in shares of some of the US's biggest tech companies, and as you can see below, the biggest players have accounted for a majority of the index's year-to-date gains:

S&P INDEX YTD ATTRIBUTION

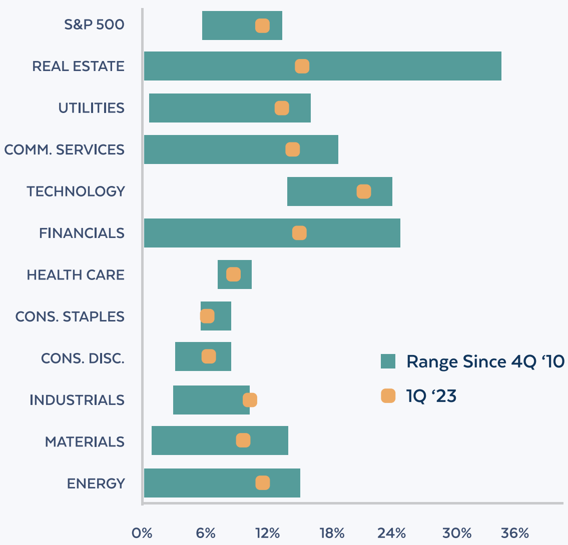


Source: First Trust

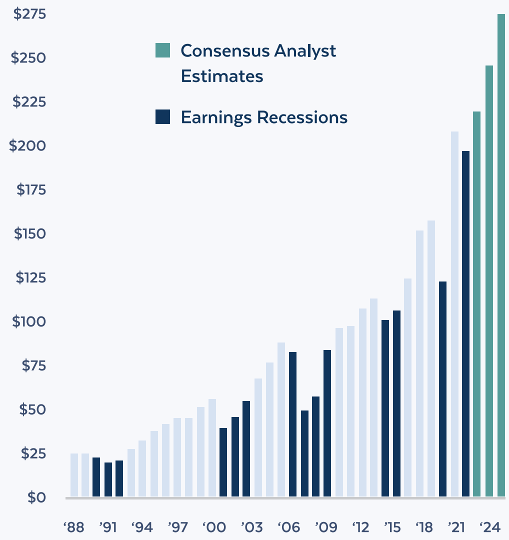
Highly concentrated returns in just a handful of stocks is generally not a sign of a healthy bull market. But it's also true that the rally started taking on more breadth in June, with cyclical stocks recovering. The Technology sector was the clear leader in the second quarter with a +17.2% return, but Consumer Discretionary (+14.6%) and Communication Services (+13.1%) also posted strong performance. Enthusiasm was not limited to large-cap stocks either, with the Russell 2000 (small-cap stocks) rising +5.2% and the S&P 400 index (mid-cap stocks) moving +4.9% higher in the second quarter[iii].

Strong equity performance may also be attributed to resilience in corporate fundamentals, namely in the realm of profitability. Operating margins peaked sometime last year but appear to be stabilizing at relatively high levels (see chart on the left-hand side), while the consensus is for corporate earnings to stage a significant rebound sometime next year.

S&P 500 OPERATING SECTORS BY SECTOR
Current Operating Margins Versus Historical Range**



S&P 500 EARNINGS PER SHARE
Index Annual Operating Earnings, USD



***Quarters with negative operating margins are not shown, with zero set as the lower bound for troughs.* *Source: J.P. Morgan*

In the second quarter, downward earnings revisions have been much less significant than what we saw in Q1 and Q4 2022, and we think the expected -7.0% year-over-year decline obfuscates underlying strength. For one, the Energy and Materials sectors are expected to post significant earnings declines, 45.1% and 28.2% respectively. Excluding these sectors, earnings growth for the quarter rises to 1.4%[iv]. We also expect the third and fourth quarters of 2023 to see a resumption of positive earnings growth, which would make the current quarter the low point of the earnings cycle.

As we've written in past letters, stocks are discounters of future economic and profitability conditions. This explains why they tend to rally when earnings are weak but expected to strengthen - which we again think describes the current environment.

S&P 500 EARNINGS PER SHARE AND EQUITY RETURN

Source: Cambridge Associates

3 Risks to Monitor

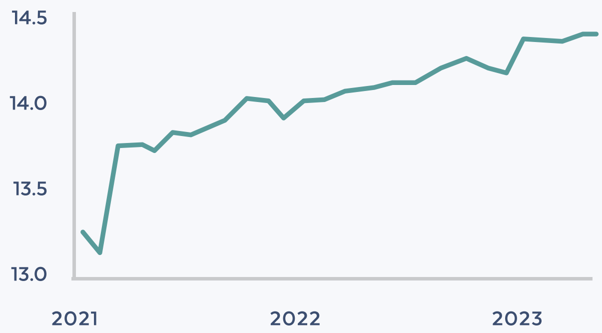
We have so far described a resilient, less-bad-than-feared economic and corporate earnings environment. But there are good reasons not to be pollyannish about where the markets and economy go from here. Here are three.

1. THE U.S. CONSUMER

Consumer spending accounts for nearly two-thirds of US economic output, which makes it one of the most critical metrics to monitor. Economic growth since post-pandemic 'reopening' has been on the shoulders of US consumers, bolstered by stimulus money, rising wages, and plentiful job opportunities. But these tailwinds are arguably starting to fade.

Spending growth has started to plateau (see chart below), with retail spending up a modest 0.1% in May but flat when adjusted for inflation[v].

REAL CONSUMER SPENDING Seasonally Adjusted Annual Rate of Spending (in Trillions)

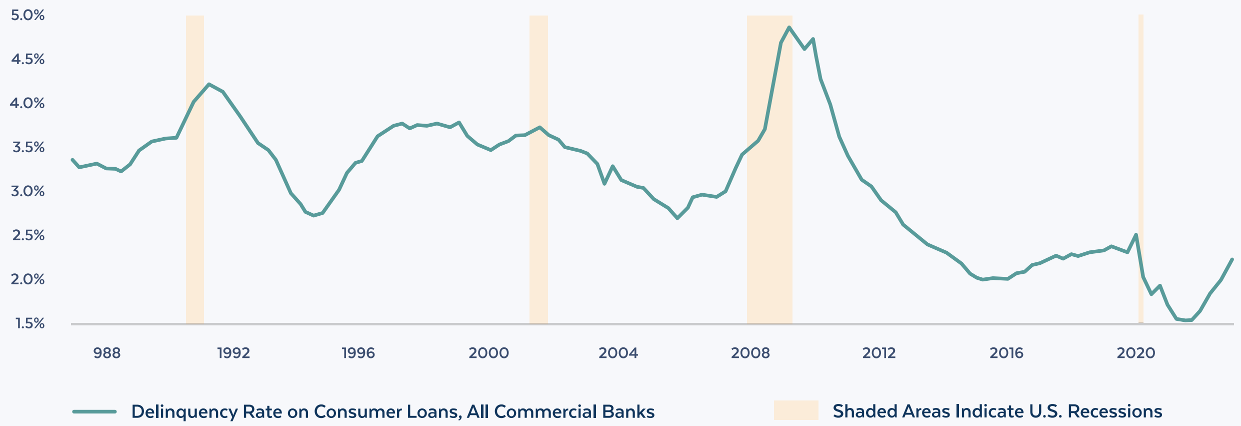


Source: JPMorgan

As mentioned above, the labor market remains tight, with 209,00 new jobs added in June. But payrolls do not tell the entire story, and other key metrics suggest the jobs market may be slightly weaker than headlines suggest. Initial applications for unemployment benefits, a proxy for layoffs, are up approximately 20% this year, and workers are quitting jobs at a much slower rate than last year - suggesting that prospects for better jobs with higher pay are diminishing[vi].

For households, interest rates for credit cards, auto loans, and mortgages are also rising. Higher rates have also taken a toll on loans with adjustable interest rates, which we think has factored into more households falling behind on payments. As seen in the chart below, delinquency rates on consumer loans are on the rise:

DELIQUENCIES ARE RISING



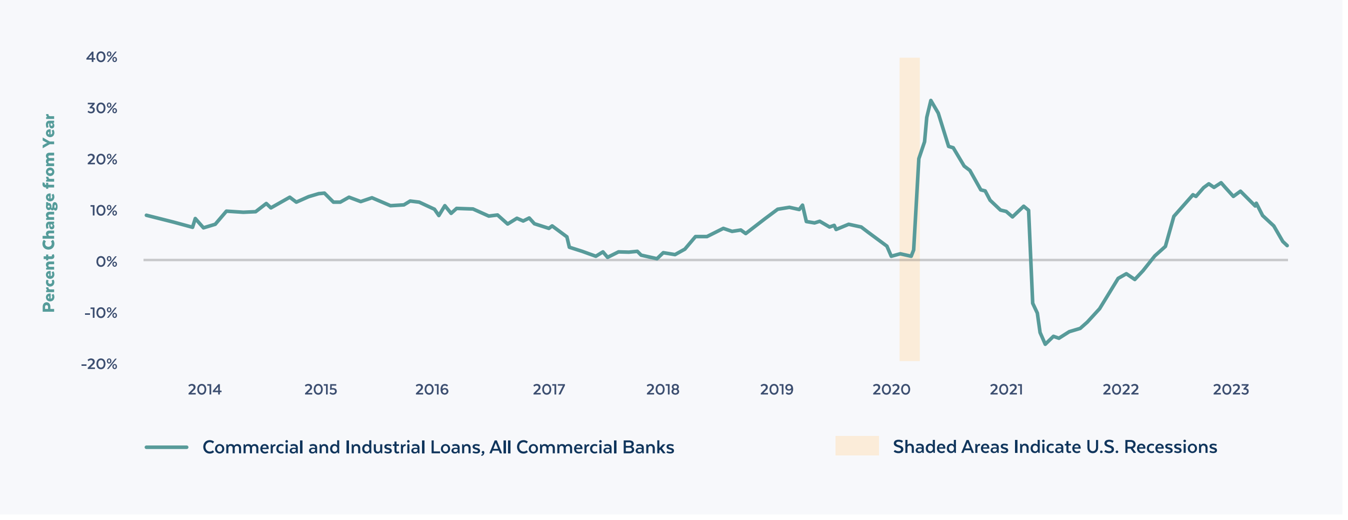
Source: Federal Reserve Bank of St. Louis

We may also see more downward pressure on consumer spending in the fall, when federal student-loan borrowers must resume making monthly debt repayments in October, with interest accruing starting September 1. Estimates show that student loan payments amount to about $6 billion to $9 billion a month, which can have knock-on effects on borrowers' desire to spend. These figures are very small relative to the $1.5 trillion that consumers in the US spend every month, so we shouldn't see market impact, but it is nevertheless worth watching[vii].

2. BANK LENDING AND COMMERCIAL REAL ESTATE

In the wake of the Fed's interest rate hiking campaign and the regional bank stress this spring–the two of which are related–we're starting to see banks requiring more collateral from borrowers and charging higher interest rates on loans. Lending conditions for companies, households, and especially real estate developers are now nearly as tight as they were during the pandemic.

LOAN GROWTH IS FALLING



Source: Federal Reserve Bank of St. Louis

In the corporate world, sales of new bonds have fallen fairly dramatically, and corporate bankruptcy filings are also starting to rise as cash dries up, with the highest number of filings since 2010[viii].

Nowhere has credit tightening been more apparent than in the commercial real estate market, however. In the office space, landlords are not only collecting less revenue from tenants who are not returning to offices, they are also facing higher interest expenses. Banks surveying the environment don't like what they see–the ratio of money lent to property value has fallen to a 30-

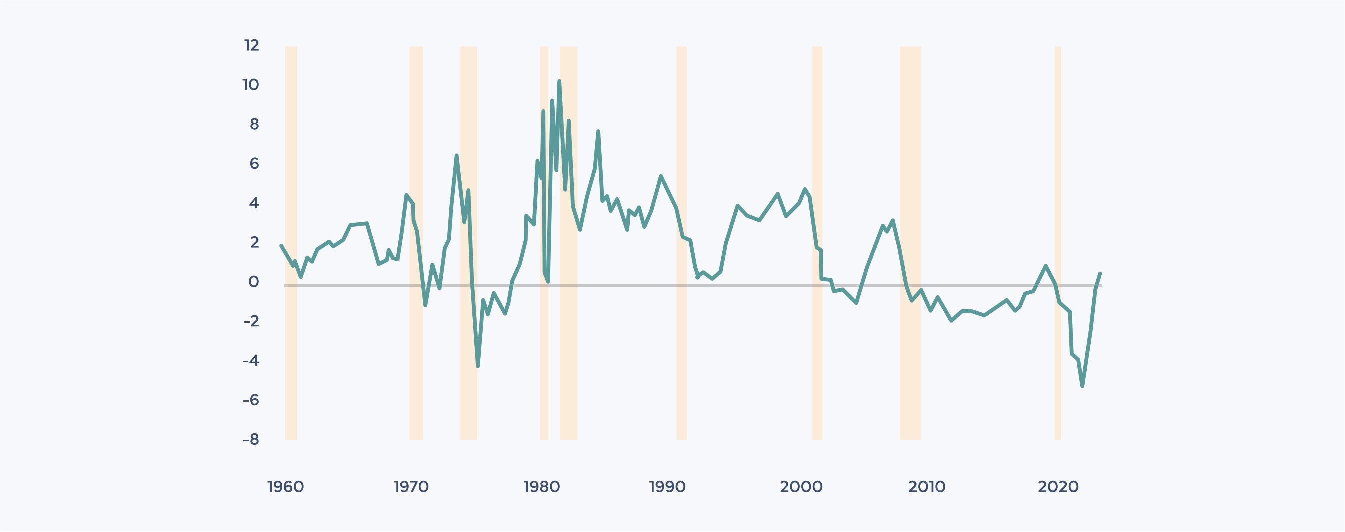
year low, and the debt markets are signaling the trouble. In June, commercial mortgage-backed bonds with AAA credit ratings paid ~2% higher yields than comparable US Treasury bonds[ix].

3. THE FEDERAL RESERVE

Inflation has been trending lower but remains well above the Fed's 2% target. The Fed's preferred inflation gauge, the Personal Consumption Expenditure (PCE) index, was up 4.9% year-over-year in the first quarter, though May's print broke below the 4% level with a 3.8% annualized increase. Core prices, which exclude food and energy, registered at 4.6% in May, a slight improvement from April's 4.7% level[x]. Core prices are what the Fed cares about most, so there is clearly still work left to do. The distance between current readings and the Fed's target suggests at least one or two more rate hikes are likely in 2023.

The good news is that the market is already well aware of the Fed's plans, and the policy terminal rate (where the fed funds rate will peak) is visible on the horizon. There is also a good argument that financial conditions are already sufficiently tight, with the softness in bank lending mentioned above and with the effective fed funds higher than the inflation rate (chart below).

REAL FED FUNDS RATE Effective Fed Funds Rate Less Core PCE



Source: Strategas Research

Conclusion

There has been no shortage of headline risk in the first half of the year, but the US economy avoided worst-case scenarios at every turn. The failures of Silicon Valley Bank, Signature Bank New York and

First Republic sparked fears of financial contagion. But strong capital positions across the largest money center banks–combined with emergency measures from the U.S. Treasury and Federal Reserve–managed to stave off a crisis. Investors then worried the debt ceiling standoff would result in the US defaulting for the first time in history, but that did not happen either.

Instead, the US economy continued growing, and employers added new jobs at a strong clip.

The simple fact is that the US economy has been performing better than expected, which is delaying recession forecasts and also pushing interest rate projections slightly higher. The bright spot looking forward is that monetary policy is already tight, which we think signals that the peak in the interest rate cycle is likely very close - which is good for risk assets looking ahead.

If you have any questions about this review or your portfolio, please do not hesitate to contact us. Thank you as always for being clients.

Sincerely,

Paul Thompson, Jr. CFP

Ascension Capital Advisors

Sources:

[i] Source: U.S. Labor Department
[ii] Source: Strategas Research
[iii] Source: Strategas Research
[iv] Source: FactSet
[v] Source: U.S. Commerce Department
[vi] Source: U.S. Labor Department
[vii] Source: Wells Fargo
[viii] Source: Reuters
[ix] Source: The Wall Street Journal
[x] Source: Bureau of Labor Statistics