ASCENSION CAPITAL Thoughtful Advising

OCTOBER 20, 2023

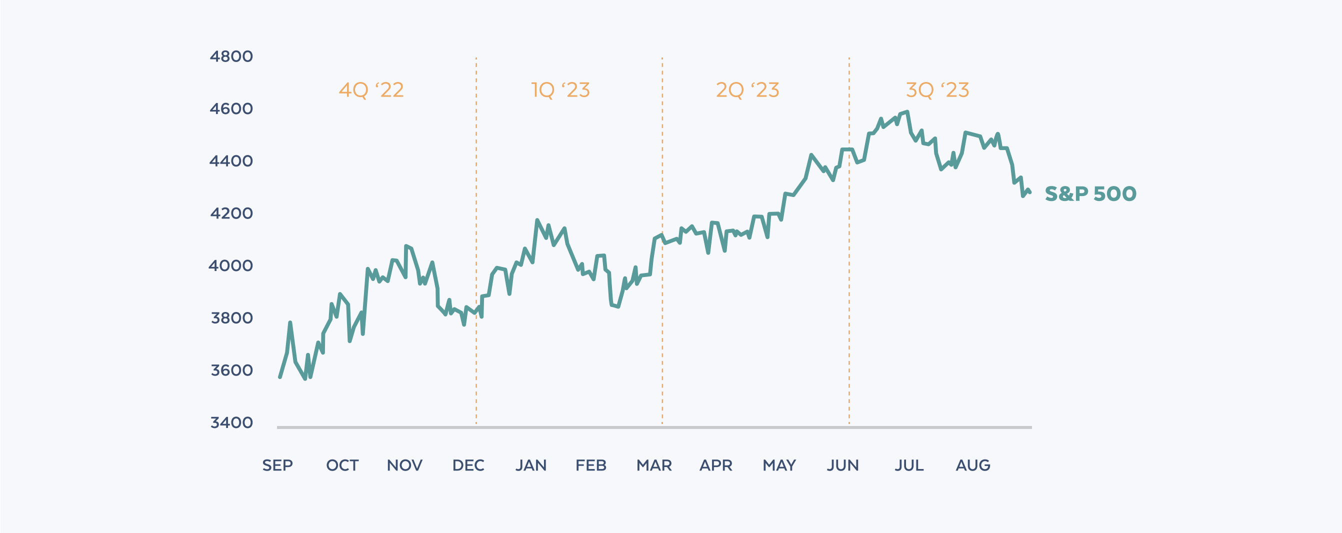
Fourth Quarter 2023 Client Review

Dear Client,

Stocks were pressured lower in the third quarter by rising 10-year U.S. Treasury bond yields. In the three months ending September 30, the yield on the 10-year climbed from 3.86% to 4.57%[i], while the S&P 500 fell -3.3%[ii] over the same period. To sum up the third quarter in a single sentence: *Interest rates went up, and stocks went down.*

Rising yields and falling stocks marked a departure from the first half of 2023, when Treasury bond yields moved mostly sideways as inflation trended lower and as investors and economists anticipated a mild economic recession. We noted last quarter that the recession never arrived, and it's even possible the U.S. economy defied expectations and *accelerated* in Q3. In our view, it's this hotter-than-expected economic growth that drove bond yields higher–and stocks lower–for the quarter.

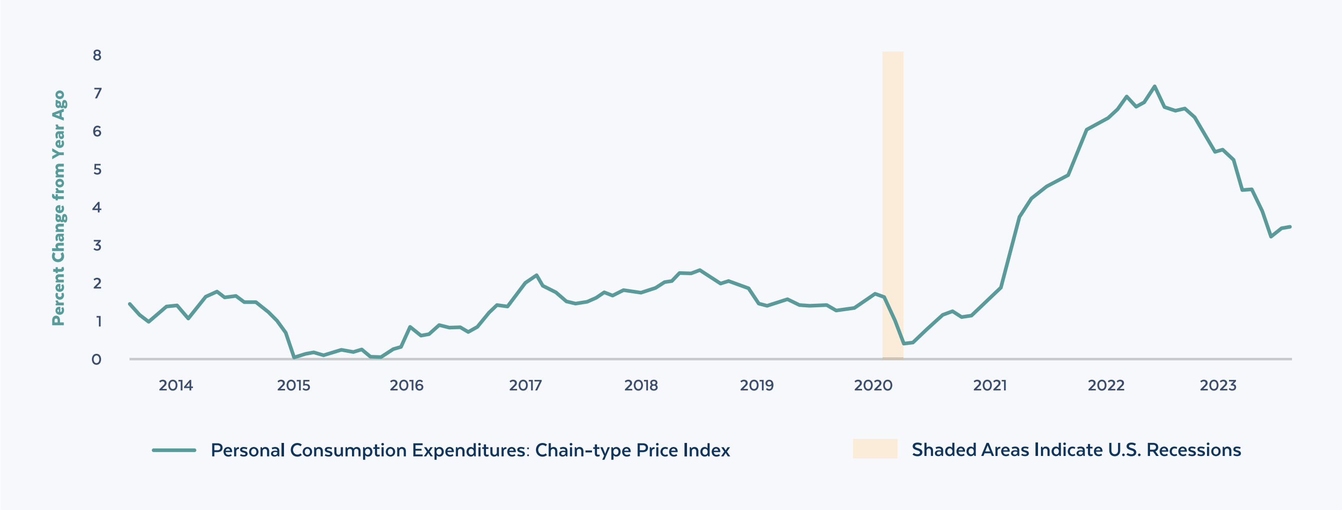
UPWARD PRESSURE ON RATES PUT DOWNWARD PRESSURE ON STOCKS



Source: Strategas Research

Interest rates can also be pushed higher by rising inflation and/or inflation expectations, but we didn't see either of those conditions in the third quarter. In September, core CPI (which strips out food and energy) was up 0.3% from August and 4.1% year-over-year, an improvement from August's 4.3% print. Importantly, when core CPI is looked at over a 3-month period, it increased at an annual rate of 3.1%, which is a substantial improvement from the 5% annual rate recorded in the spring[iii]. The gauge the Fed watches most closely, the headline personal consumption expenditure (PCE) price index, has also been in steady decline since last June:

PCE PRICE INDEX



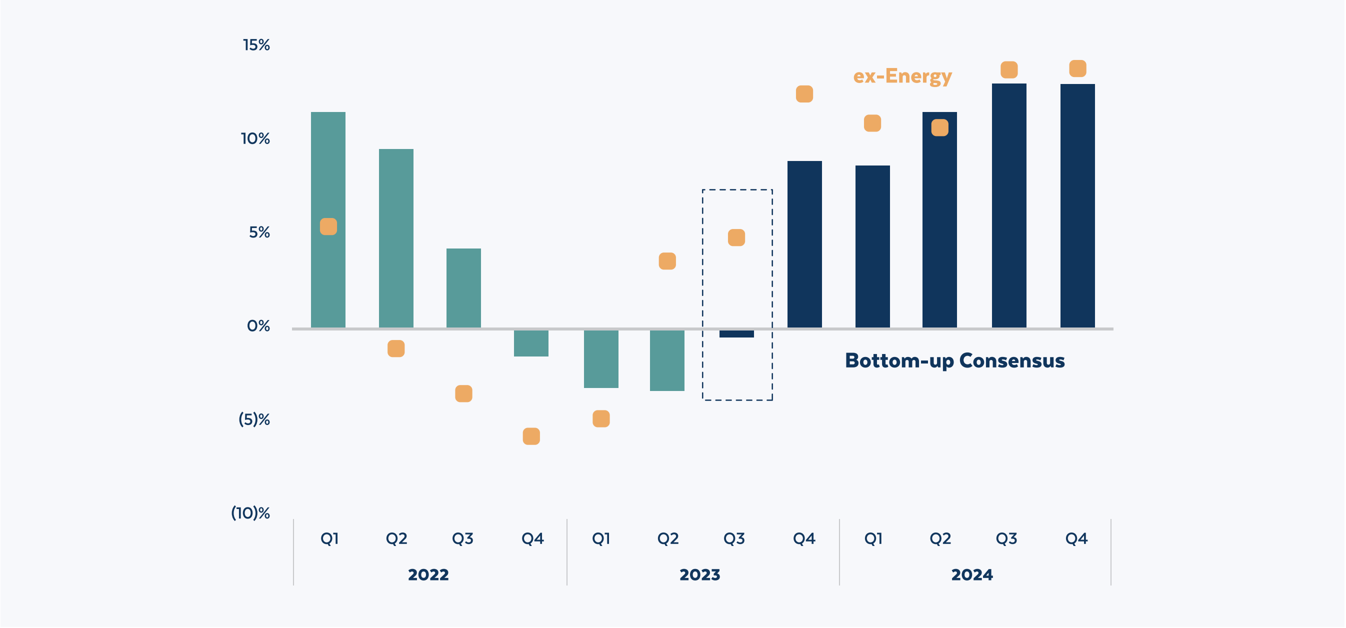
Source: Federal Reserve Bank of St. Louis

Goldman Sachs notes that inflation expectations have returned to 2% compatible levels, and they are also forecasting core PCE inflation will continue its downward trend to settle at 3.3% year-over-year in December 2023[iv].

That leaves economic growth as the primary factor pushing interest rates higher, in our view. Goldman Sachs economists are forecasting a strong +3.5% Q3 2023 GDP growth rate[v], while the Atlanta Fed's GDPNow forecasting tool estimates +5.1% GDP growth over the same period (as of October 10, 2023) [vi]. Both of these forecasts could ultimately be wrong, but all signs point to the same takeaway: the U.S. economy likely posted above-average growth in the third quarter.

Earnings insights from Corporate America seem to support this narrative, with bottom-up next twelve month (NTM) earnings estimates for S&P 500 companies climbing 4.5% over the past nine weeks. Goldman Sachs notes that *"sell-side analysts have not been this optimistic entering earnings season since 4Q 2022 … [with] the median stock expected to grow earnings-per-share by 2%.*[vii]*"* The headlines may emphasize that earnings growth in Q3 2023 is poised to be negative for the fourth straight quarter. But a closer look would reveal the EPS decline being driven almost entirely by the Energy sector, whose earnings are forecast to decline -38% year-over-year. Excluding Energy, S&P 500 EPS is forecasted to grow by 5% (see the gray dots on the chart below)[viii].

EARNINGS GROWTH MAY HAVE TROUGHED IN Q2, AND COULD REACH +9% BY Q4 2023 (AS OF OCTOBER 5, 2023)



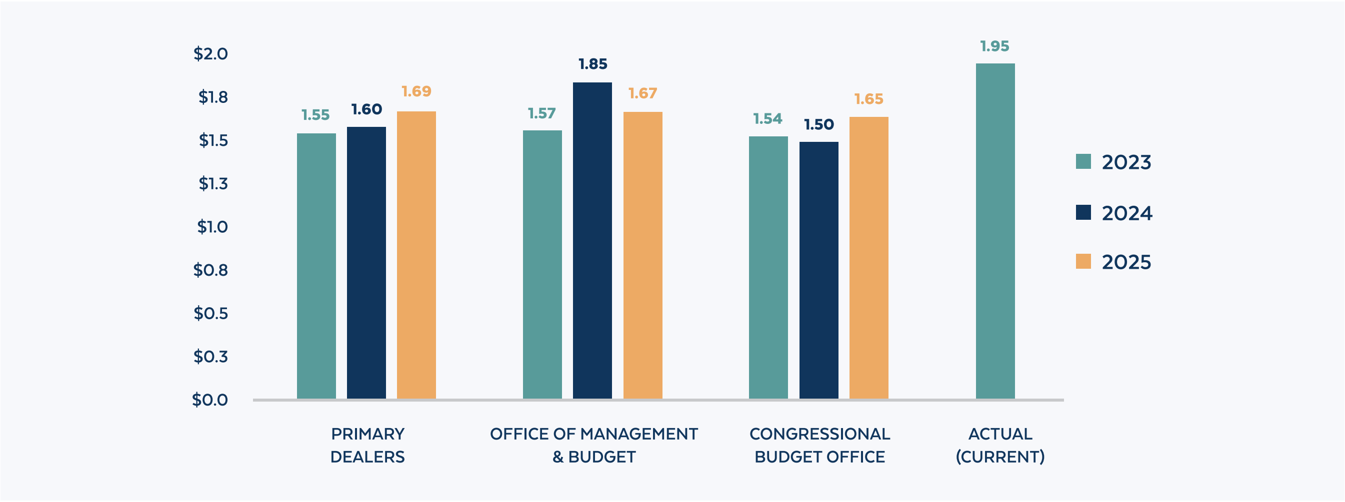
Source: FactSet, Goldman Sachs Global Investment Research

The U.S. jobs market also continues to signal sustained economic demand. In September, nonfarm payrolls rose by a stout 336,000, the largest gain since January[ix]. The Labor Department report also showed that job gains were widespread across industries, pointing to growth that is broad-based. Not all investors embrace a strong jobs market, because of the implication on wages–and thus inflation. But September's report showed that total hourly earnings rose just 0.2% from August and 4.2% year-over-year, a continued improvement from previous readings. When annualized over the last three months, wages grew at a 3.4% rate, which is compatible with 2% inflation[x].

> "Putting this all together, rates are moving higher because the Fed (and the market) is coming to realize that US growth is more resilient than previously anticipated[xi]."
>
> – GOLDMAN SACHS ECONOMISTS

One final note about rising bond yields involves U.S. debt and deficit spending. There have been some recent stories suggesting that bond yields are soaring because of rising bond supply, particularly as the U.S. runs a primary (ex-interest) deficit much larger than has been the case historically. Without legislation to curb spending or raise revenues, some estimates show U.S. debt rising from 96% to 123% of GDP over the next 10 years[xii]. Nearly all of the increase would be driven by the primary deficit. As seen in the chart below, deficit spending is running much higher than anticipated.

TREASURY QUARTERLY REFUNDING: FISCAL YEAR DEFICIT FORECASTS



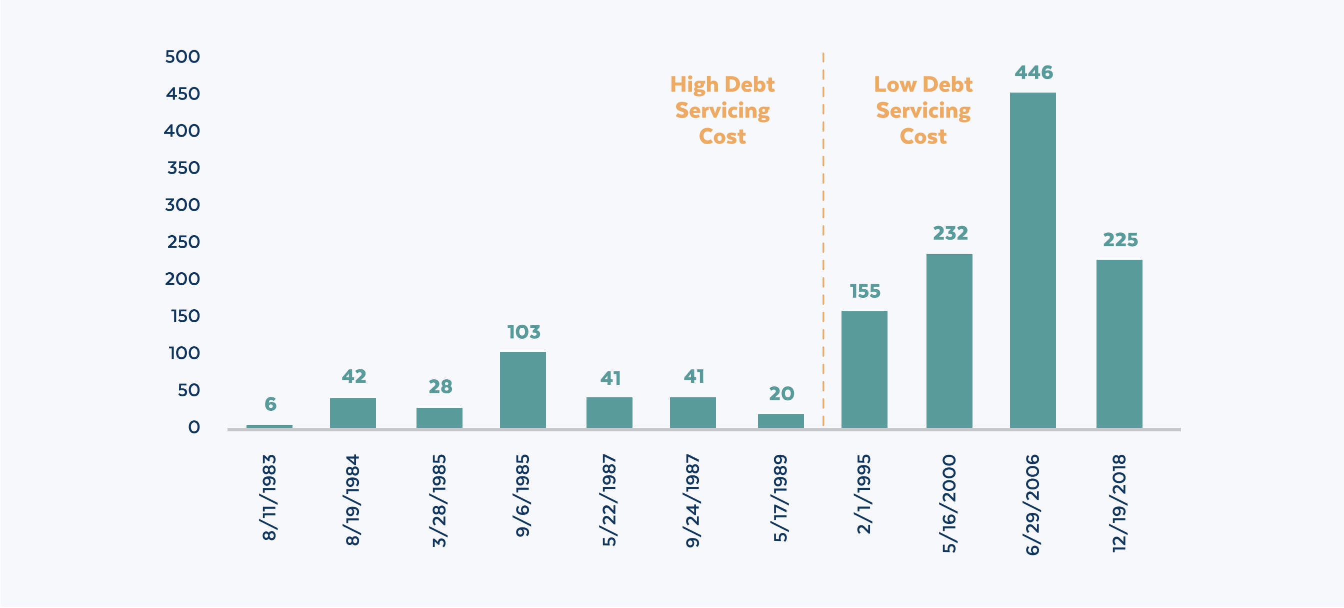
Source: Strategas Research

If the U.S. is issuing more bonds as international demand for Treasurys is also falling, the supply/demand imbalance would pressure rates higher. But the limited data available to date does not–at least as of this writing–confirm this to be the case. The latest Treasury bond auctions show the market is having little trouble absorbing new issuance, and foreign holdings of U.S. debt are up over $500 billion since October 2022 and approaching an all-time high[xiii].

The upshot looking forward is that higher interest costs on U.S. debt could result in a greater appetite for fiscal tightening. Ongoing congressional gridlock and an upcoming presidential election may not make deficit reduction legislation likely in the coming year, but history suggests Congress may soon view it as an economic imperative. According to Goldman Sachs, *"elevated nominal interest expenses intensified the focus on fiscal restraint from the mid-1980s to the mid-1990s, leading to several rounds of deficit reduction legislation over that period. One of the motivations for deficit reduction during that period was that interest expense was crowding out other more productive–or at least more popular–areas of spending[xiv]."*

A 'forced tightening' of U.S. fiscal policy would be a welcomed development, in our view, not only for its potential impact on long duration rates but also because it would provide the Federal Reserve more leeway to ease from current 5.50% upper bound fed funds rate. We also know from history that the Fed is more likely to cut rates quickly when debt servicing costs are high, as they are becoming now.

DAYS FROM LAST FED RATE HIKE TO FIRST FED RATE CUT
(SEPT. 1982 - PRESENT; PERIODS WITH AT LEAST 3 RATE HIKES)



Source: Strategas Research

Risks to Growth

We've made the case that economic growth likely ran hotter-than-expected in Q3 2023. Sharply rising interest rates make it clear, though, that strong growth is not necessarily the desired outcome for investors or the Federal Reserve. For the sake of inflation and interest rate policy, a "not-too-hot and not-too-cold" economy is what we want to see. Though counterintuitive, we may want to welcome modest economic headwinds in Q4 2023 and beyond - factors that are not strong enough to derail the expansion but could feasibly reduce GDP growth rates in coming quarters.

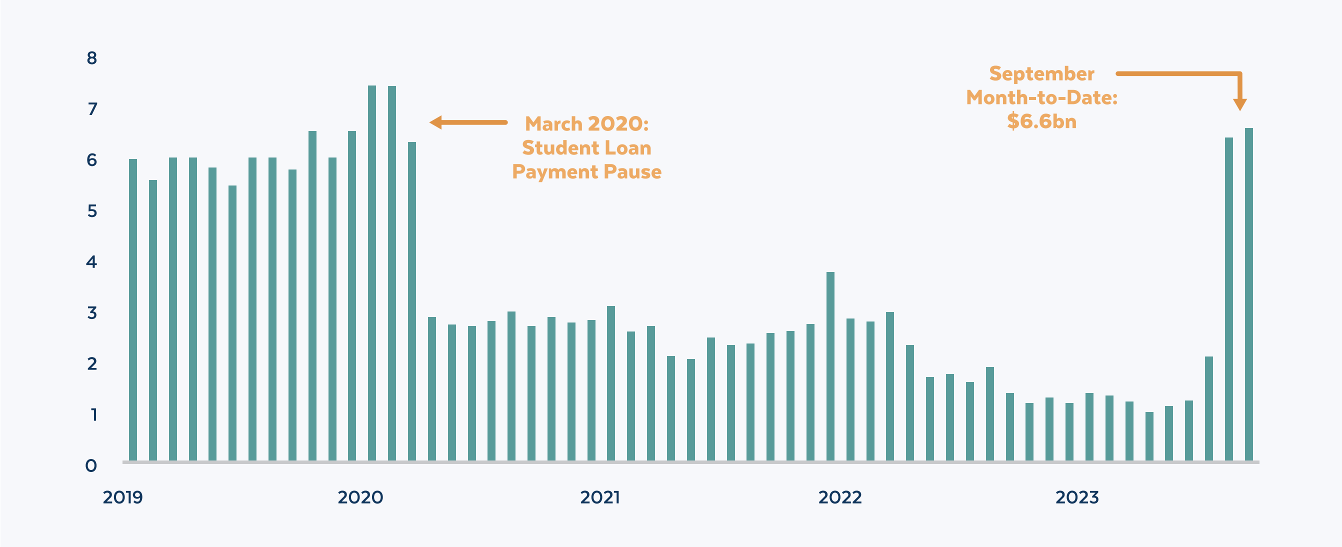
Some of these headwinds may be in play now. When asked about potential risks to economic growth looking ahead, Federal Reserve Chairman Jerome Powell summed them up this way: *"It's the strike, it's government shutdown, resumption of student loan payments, higher long-term rates, oil price shock[xv]."*

The risk of a government shutdown was taken off the table shortly after Chairman Powell made his comments, as Congress reached an agreement to extend government spending for 45 days. But with the House speakership vacated and a little over a month before Congress must address spending again, it is plausible a spending fight factors prominently in the headlines in Q4.

Worker strikes could reduce output, particularly in the U.S. auto industry. But it's important to note that UAW strikes would not shut off U.S output completely, as there are many foreign-owned and non-UAW plants across the country. From a pure inflation standpoint, all new cars make up just 4% of the U.S. CPI basket[xvi], and it's also worth noting that strikes would not affect production across Mexico, Asia, Europe, and the rest of North America. Local economies like Michigan's are likely to be far more affected than the national economy.

Student loan repayments could have an effect on U.S. consumer spending, which is the engine of economic growth. By some estimates, loan repayments will divert about $100 billion from American's pockets over the next twelve months[xvii], with payments starting just before the holiday shopping season.

EDUCATION DEPARTMENT CASH COLLECTIONS BY MONTH (TREASURY DEPT., $BN)



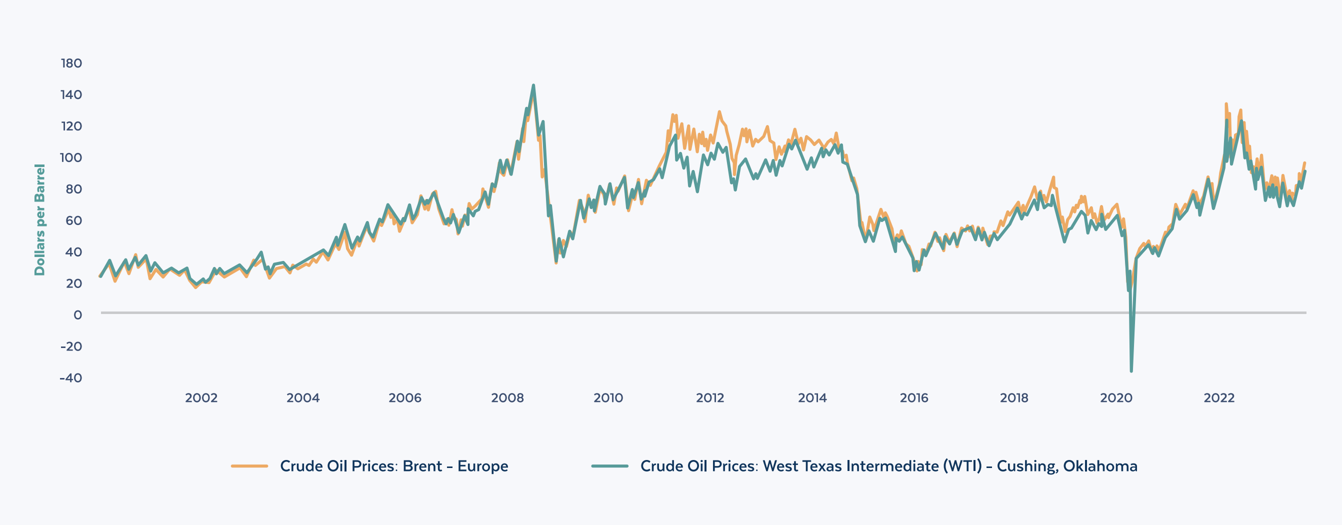
Source: Strategas Research

$100 billion seems like a substantial figure, but not when compared to the $18 trillion U.S. consumers spend each year. Overall, analysis suggests that student loan payments could subtract about 0.8% from consumer spending growth in Q4, which would only slow it to 1.4%[xiii].

The final headwind to address is rising oil prices. There are obvious drawbacks to higher oil prices, like higher gas prices. Oil is also used in the production of everything from plastics to fertilizers, impacting the cost of food and other goods and services that exist downstream.

These are all valid concerns, and ones that could impact growth at the margins. But higher (and volatile) oil prices are also nothing new to markets, which have withstood $100+ oil before. In the chart below showing the historical price of a barrel Brent Crude and West Texas Intermediate, readers can see a four-year period when oil prices hovered in the $100 a barrel range. These were also years when the economy grew consistently - albeit modestly - and stocks remained locked in a bull market. Modest growth, recall, is a good thing.

THE U.S. ECONOMY CAN WITHSTAND HIGHER OIL PRICES



Source: Federal Reserve Bank of St. Louis

Conclusion

Goldman Sachs refers to the aforementioned economic headwinds as "Q4 potholes," which they think raise two key questions looking ahead:

1. If growth falters too much, are Fed funds rate cuts back on the table and rates recede?
2. If the growth potholes prove to be just that–temporary events that reverse themselves in 1Q24–are we setting ourselves up for stronger earnings growth in 2024 than is currently anticipated[xix]?

We continue to believe that either outcome warrants a quality-focused, diversified, cautiously optimistic approach to equity markets. In the first scenario, we do not want to be allocating away from equities in an environment where interest rates are falling. In the second scenario, we also do not want to allocate away from equities just as earnings growth is turning positive and perhaps even accelerating.

As we were finishing up this quarter's letter, the awful news broke of Hamas launching an attack on Israel. The humanitarian toll of another war is disheartening to say the least. Looking at the situation from a pure asset management standpoint, we do not see this regional conflict exacting an economic toll on the global economy or commodity prices. We may see some volatility in the short term, but our other insights in this letter pertaining to economic growth and interest rates remain unchanged.

If you have any questions about this review or your portfolio, please do not hesitate to reach out to us directly. We thank you for your continued confidence in Ascension Capital Advisors, and we wish you a festive fall season.

Sincerely,

Paul Thompson, Jr. CFP®

Ascension Capital Advisors

Sources:

- [i] *Source: U.S. Department of the Treasury*
- [ii] *Source: S&P Global Indices*
- [iii] *Source: U.S. Bureau of Labor Statistics*
- [iv] *Source: October 2023 Report, Goldman Sachs Equity Research*
- [v] *Source: October 2023 Report, Goldman Sachs Equity Research*
- [vi] *Source: Federal Reserve Bank of Atlanta*
- [vii] *Source: October 2023 Report, Goldman Sachs Equity Research*
- [viii] *Source: October 2023 Report, Goldman Sachs Equity Research*
- [ix] *Source: U.S. Department of Labor*
- [x] *Source: U.S. Department of Labor*
- [xi] *Source: October 2023 Report, Goldman Sachs Equity Research*
- [xii] *Source: October 2023 Report, Goldman Sachs Equity Research*
- [xiii] *Source: "Digging Into Bond Demand Fears," Marketminder.com*
- [xiv] *Source: October 2023 Report, Goldman Sachs Equity Research*
- [xv] *Source: "U.S. Economy Can Withstand One Shock, But Four at Once?" The Wall Street Journal, September 24, 2023*
- [xvi] *Source: "Into Perspective: The U.S. Auto Labor Dispute and Recession Worries," Marketminder.com*
- [xvii] *Source: Strategas Research*
- [xviii] *Source: "Will Restart of Student Loan Payments Be the Last Straw for Consumers?" The New York Times, September 15, 2023*
- [xix] *Source: October 2023 Report, Goldman Sachs Equity Research*