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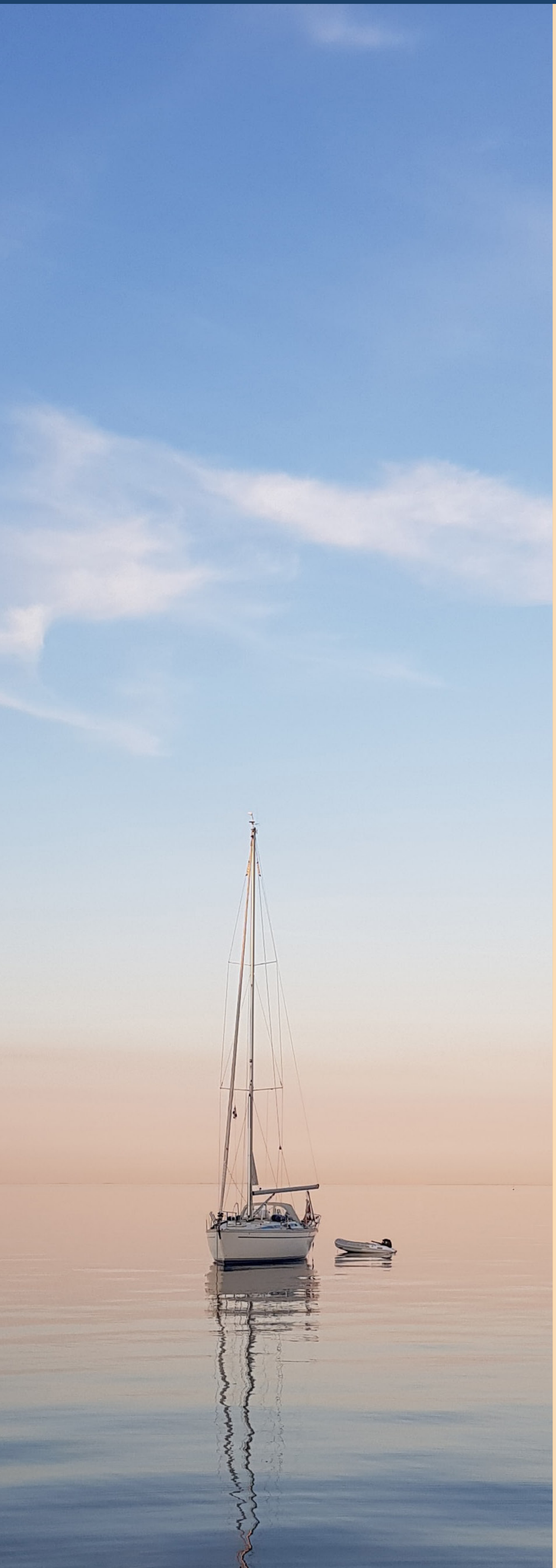


OCTOBER 19, 2021

Fourth Quarter 2021 Client Review

Dear Client,

S&P 500 companies experienced a strong second quarter, posting 95% earnings growth on 25.3% higher revenues[i]. To be fair, these figures represent growth compared to Q2 2020, which of course was very weak as a result of the pandemic. However, it is also true that corporate earnings data was significantly better-than-expected—FactSet reported that a staggering 90% of companies posted positive earnings-per-share (EPS) and revenue surprises, many by wide margins. In short, the post-lockdown, post-restriction economic rebound was great for business.

Circumstances changed with a late summer surge in Delta cases, however, which seemed to hit the 'pause' button on robust economic activity. Consumers trimmed spending on hospitality services and travel in July, and supply constraints—tied to worker and input shortages, reduced factory capacity in Asia, rising shipping costs, and port delays—led many economists to significantly cut GDP growth estimates for Q3. Forecasting firm IHS Markit lowered their third quarter GDP growth projections from 7.8% in July, to 3.6% by late September, to 1.5% just last week. These forecasts are routinely wrong, but the takeaway is that U.S. economy likely grew at a slower pace than previously anticipated.

Other macroeconomic headwinds started to appear late in the quarter, which contributed to September volatility. The Federal Reserve signaled 'tapering' plans for later in the year, debt ceiling drama unfolded (and continues to unfold) in Washington D.C., hiring was weaker-than-expected in the U.S., and China dealt the global economy a range of uncertainties spanning manufacturing weakness, a real estate bubble, an energy crisis, and state-driven economic reforms. With the September pullback, the S&P 500 essentially finished flat for the third quarter (+0.6%)[ii].

S&P 500

Source: Strategas Research

This confluence of late summer 'headwinds' has led the financial media to increasingly cite the economic "S" word: stagflation. For readers who are not familiar, stagflation refers to an economy with high inflation and low or negative growth. When inflation rates run higher than GDP growth rates, the 'real' growth rate of the economy turns negative, which is of course a bad outcome.

We believe stagflation worries are overblown, however. The concern focuses too much on a small data set (summer months), and dire projections do not account for the possibility—or in our view, the likelihood—that strong economic growth was not lost to the Delta surge, just delayed by a few months. We think the growth missing from Q3 will show up in Q4 and in early 2022.

Indeed, looking ahead to Q4, the Delta-induced blip in economic activity appears to be fleeting. Consumers remain in a strong financial position with a record $142 trillion in net worth[iii], and falling Covid-19 risks coupled with easing labor supply constraints should normalize consumption patterns towards services. Though September jobs growth was weaker-than-expected, the labor market could eventually get a boost from school re-openings and the end of expanded federal unemployment benefits.

While some view a soft patch in U.S. economic growth as the driver of September volatility, we see the selling pressure as more greatly tied to China. The world's second largest economy is managing multiple issues at once, from a slowing economy, to heavy-handed government intervention across a variety of sectors, to an energy crunch, and finally to the looming default of property developer Evergrande.

We will explain these issues in more detail in this review.

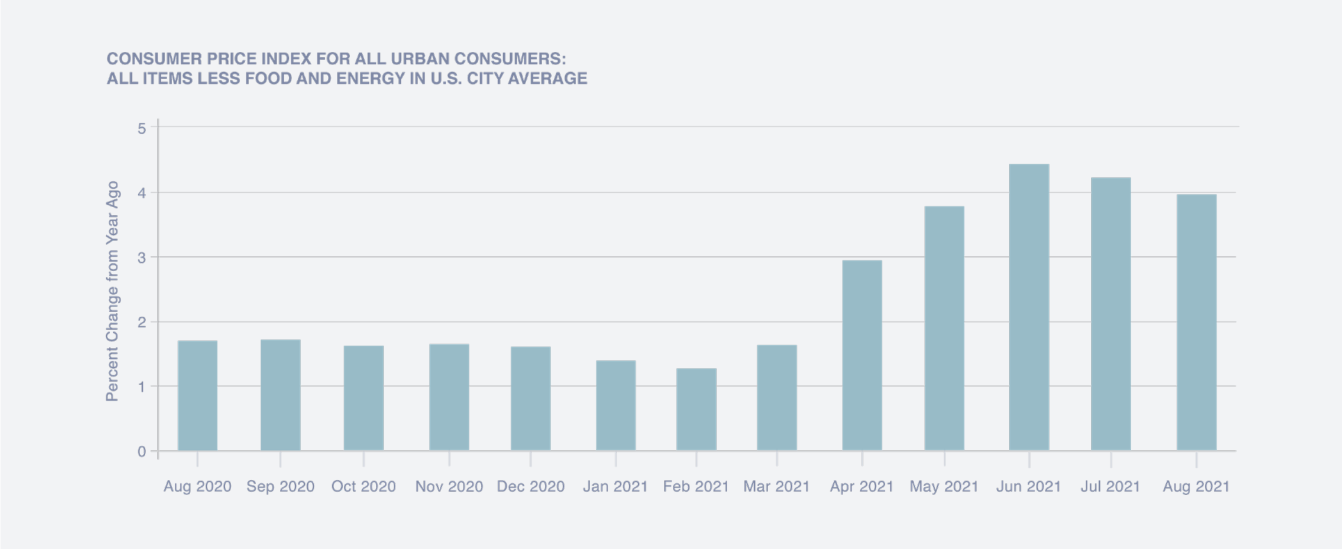
The U.S. Economy is in Growth Mode, But It's Not Perfect

The U.S. economy lost a little steam over the summer as the Delta surge led to a slight retrenchment. Consumers pared spending in July, as retail sales—which measures purchases at stores, restaurants, and online—fell 1.1% compared to June[iv]. In August, factories and service providers, as measured by the IHS Markit surveys of purchasing managers, also saw activity dip. On the service-sector side, the purchasing managers index fell to an 8-month low of 55.4, while the manufacturing index sank to a 4-month low[v]. The economy was still growing in late summer, just at a much slower pace than earlier in the year.

Source: IHS Markit

Inflationary pressures also persisted. The Labor Department's consumer-price index was 5.3% (including food and energy) in the 12 months ending in August, which is a level of inflation the U.S. economy has not seen in over a decade. Fed Chairman Powell attributes the sharp price increases to strong demand being met by supply constraints, which the Fed believes should resolve in time. The question is, how much time? Chairman Powell recently conceded that inflation is broader and more structural today than it was earlier in the year.

WHEN STRIPPING OUT FOOD AND ENERGY, INFLATION IS STILL ELEVATED



Source: Federal Reserve Bank of St. Louis

At a two-day meeting held in September, the Federal Reserve did not make any changes to policy, but they did set the stage to begin 'tapering' their quantitative easing program, potentially as soon as the November 2-3 meeting. Gradually trimming the $120 billion in monthly purchases is often framed as monetary tightening, which could generate volatility in the stock market. But the reality will likely look much different, in our view.

For one, the Fed clearly telegraphs their plans well in advance, which greatly reduces the possibility of a negative surprise for markets. History also suggests that 'tapering' need not be a negative event. When Fed Chair Ben Bernanke implemented the QE taper from the summer of 2013 to the fall of 2014, the S&P 500 rose over +20% (see chart on next page)[vi]. There was volatility along the way, but the taper did not change the overall trend of the economy or markets.

THE S&P 500 OVER THE LAST DECADE

Source: Federal Reserve Bank of St. Louis

To take a bit of a contrarian view, we would welcome a Fed announcement to taper and eventually end QE purchases. Fed intervention keeps downward pressure on long-dated U.S. Treasury bond yields, which squeezes bank profits and removes incentives for more bank lending – not great for the economy. An underappreciated effect of reducing monthly purchases is lower demand for long duration Treasury bonds, which should put upward pressure on yields. The end result may be a steepening yield curve, which is generally a positive leading indicator for economic activity.

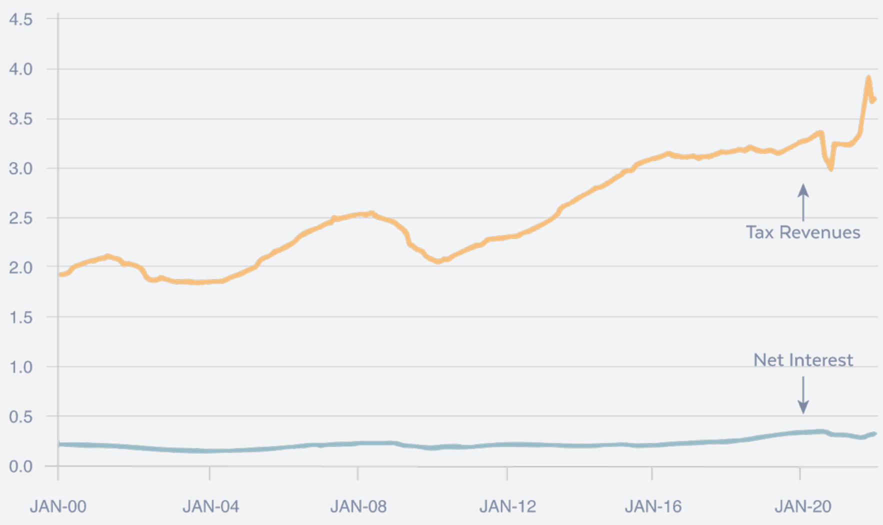
A bigger risk, in our view, is if inflation forces the Fed to raise interest rates more quickly than anticipated. As Strategas Research recently noted, "*it doesn't take an active imagination to wonder whether the Fed can actually raise rates again without significant pain and major dislocations in the global economy. Although the central bank swears that it does not target asset prices, the sheer size of financial assets today relative to the size of the economy suggests that the tail may wag the dog.*"

Another headwind that appeared in September was the debt ceiling drama that featured prominently in the headlines. As of this writing, the Senate has passed (along party lines) a short-term agreement to raise the borrowing limit into December, which undoubtedly means the debt ceiling debate will return to the headlines in December. When that happens, investors should largely ignore the issue—the risk of U.S. default is mostly bark with no bite.

The debt ceiling issue is often misrepresented by the media and even elected officials. In short, not raising the debt ceiling puts the government at real risk of missing—or being late on—entitlement payments like Social Security, veteran's benefits, and child tax credits. Such an event would be detrimental to sentiment and generate amplified media attention, but it would not technically be a default or even a credit event. Entitlements are government obligations and commitments, not debt.

In order to truly default, the U.S. Treasury would need to miss a principal or interest payment on a bond. The risk of that actually happening is very low—the U.S. Treasury does not need Congress's authorization (or Congress-approved funding) to issue new debt to refinance a maturing bond, nor is Congress needed make interest payments on debt. As you can see in the chart below, the U.S. has ample tax revenue available to make interest payments on time, thereby avoiding default.

FEDERAL TAX REVENUES & NET INTEREST PAYMENTS, $TN



Source: Strategas Research

The Elephant in the Global Economy: China

There is trouble brewing in the world's second largest economy. For years, analysts have been warning of a real estate bubble bursting, which now appears imminent. At the center of the story is Chinese property developer Evergrande, which has racked up more than $300 billion in liabilities (2% of China's GDP) and has some $37 billion in outstanding debt due within the next year. Evergrande has already missed $40+ million in dollar bond coupon payments due, with more on the way. In a sign of contagion, Chinese luxury developer Fantasia Holdings Group also missed a $206 million dollar bond payment recently[vii].

It appears increasingly likely that the Chinese government will not be stepping-in for a full bailout, instead allowing international investors to take losses while managing an orderly unwinding of the company. China may restructure Evergrande's onshore debt, sell assets and business units to the state, and use the central bank to ensure credit keeps flowing to solvent property developers. Markets appear to be pricing-in this outcome and incorporating default risk, as evidenced by a sharp spike on U.S. dollar junk bonds from Chinese companies. An economic 'hard landing' does not appear likely.

These are significant issues for China, but we do not see systemic risk for global or U.S. markets. For one, 2022 is a key year for President Xi Jinping, when China hosts its twice-per-decade Communist Party congress and will decide whether to extend his leadership. President Xi has every incentive to manage this crisis in an orderly manner, and China has the resources to do so. Second, we note that when turbulence in China impacted U.S. markets back in 2016, commodity prices declined and U.S. high yield spreads materially widened. We are not seeing these indicators today—commodity prices remain high, and spreads remain tight in the U.S. high yield market, where the issuance window is wide open.

Conclusion

The highly anticipated 'post-pandemic economic boom' took a pause in Q3, as yet another Covid-19 surge led consumers to retrench in July and August. Supply chain issues also continue to create imbalances, with long delivery times and price pressures on inputs. Among other macroeconomic headwinds that could contribute to market volatility in the short-term, the ongoing debt ceiling showdown, sticky inflation, and China's property bubble remain going concerns.

The upshot for investors, however, is that these macroeconomic headwinds all appear to be temporary, and none appear significant enough to derail the growth trajectory of the U.S. Most economists expect the forgone growth in Q3 2021 to show up in Q4 and in 2022. The Federal Reserve raised its full-year GDP growth forecast for 2022 to 3.8% in September, up from 3.3% in their June forecast. U.S. corporations also continue to report strong consumer demand and expectations for robust earnings growth in the coming quarters.

If you have any questions about this review or your portfolio, please do not hesitate to reach out to us. As always, we thank you for your continued confidence in Ascension Capital. We hope you enjoy the transition to fall and some holiday time with loved ones.

Sincerely,

Paul Thompson, Jr CFP
Ascension Capital Advisors

Sources:

[i] *Source: FactSet*
[ii] *Source: Strategas Research*
[iii] *Source: Federal Reserve*
[iv] *Source: U.S. Commerce Department*
[v] *Source: IHS Markit*
[vi] *Source: Federal Reserve Bank of St. Louis*
[vii] *Source: Bloomberg*

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