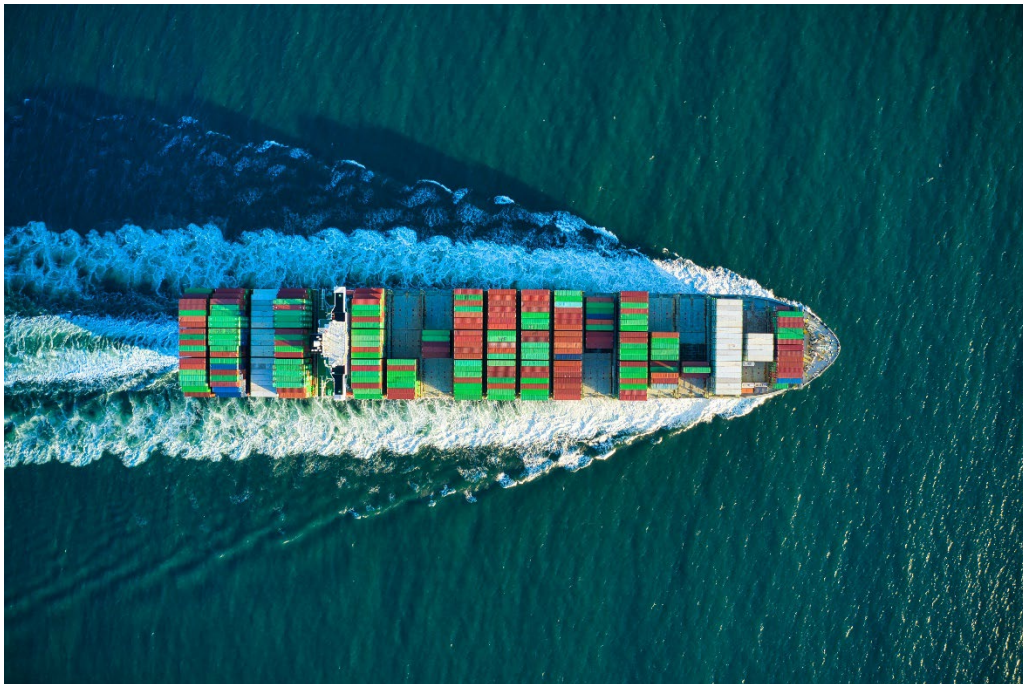




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# Capital Markets Outlook 1Q 2023



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## Summary

### Outlook

- Inflation remains the key driver of markets and the economy. Recent developments suggest room for optimism. We expect inflation to decelerate gradually in coming months.
- Slower economic growth should pave the way for monetary policy tightening to pause, but rate cuts are not a certainty in 2023.
- Many asset classes offer attractive investment opportunities after a volatile 2022.

### Key Risk

- Economic growth could be slower than expected if inflation does not come down enough for central banks to stop raising rates.

## 2022 Review

Economic and market conditions were challenging in 2022. Historic volatility in equities and fixed income was driven by high inflation, Russia's invasion of Ukraine, and aggressive monetary tightening. These shocks to the market were extreme and led to one of the worst years for a balanced investor in history.

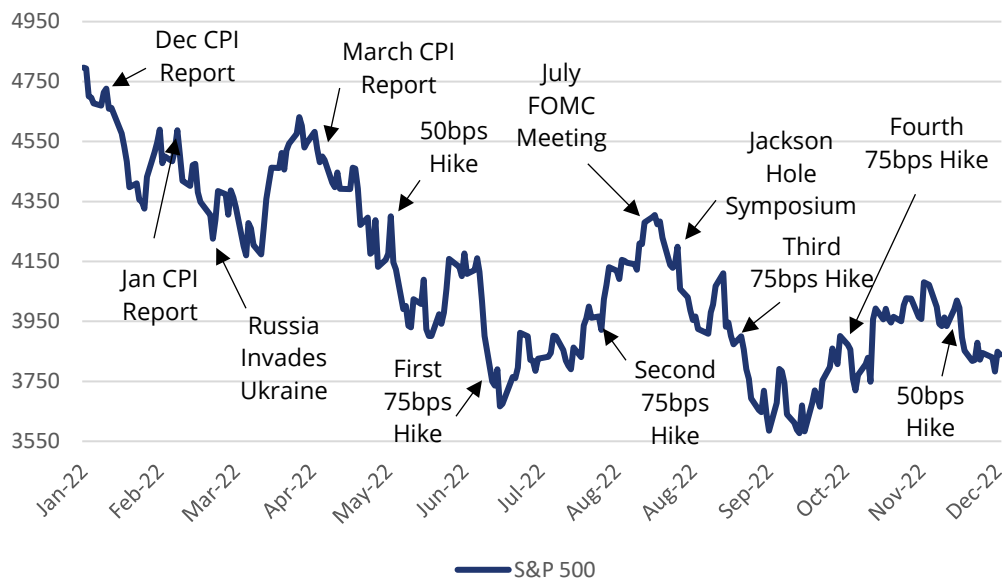
	Q4	2022
<b>Large Cap</b>	7.6%	-18.2%
<b>Mid Cap</b>	10.7%	-13.1%
<b>Small Cap</b>	9.0%	-16.2%
<b>International</b>	14.7%	-14.4%
<b>Emerging Markets</b>	10.3%	-20.6%
<b>1-3 Year Treasuries</b>	0.7%	-3.9%
<b>7-10 Year Treasuries</b>	0.6%	-15.2%
<b>20+ Year Treasuries</b>	-1.9%	-31.2%
<b>Aggregate Bond</b>	1.6%	-13.0%
<b>TIPS</b>	1.9%	-12.2%

Source: S&P 500 Index, S&P MidCap 400 Index, S&P SmallCap 600 Index, MSCI EAFE Index, MSCI Emerging Markets Index, ICE US Treasury 1-3 Year Bond Index, ICE US Treasury 7-10 Year Bond Index, ICE US Treasury 20+ Year Bond Index, Bloomberg US Aggregate Bond Index, Bloomberg US Treasury Inflation Protected Securities Index



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After the initial declines in the first half of the year, stocks rallied on optimism that inflation had peaked and would start to meaningfully change directions. However, after the Fed announced it would not consider economic growth as it continued to aggressively tighten monetary policy, the rally at the end of the summer was reversed. After three consecutive negative quarter for stocks, the fourth quarter ended strong with a 7.6% return. The positive end to the year came after the realization that the Fed is getting closer to the end of its tightening cycle.



Source: S&P 500 Index

## Outlook

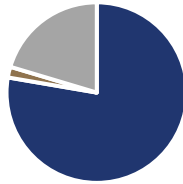
After such a difficult year, there are positive signs for the economy and financial markets. Inflation appears to be moderating which would allow the Fed to stop the rate hiking cycle, and most economic indicators suggest that if there were to be a recession it would be mild.

2022 was dominated by inflation. We believe 2023 will be a transitional year from high inflation and slowing growth to lower inflation and low growth. Inflation in the US is normally driven by services. The pandemic caused goods prices to surge, and Russia's invasion of Ukraine pushed commodity prices higher. Inflation is gradually normalizing – goods and commodities account for less total inflation. This trend would point to inflation coming down and sustaining a lower level of price increases going forward.



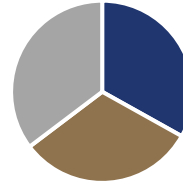
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Pre-pandemic Average



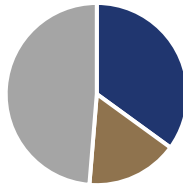
■ Services ■ Goods ■ Commodities

February 2022



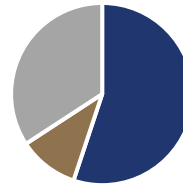
■ Services ■ Goods ■ Commodities

June 2022



■ Services ■ Goods ■ Commodities

November 2022



■ Services ■ Goods ■ Commodities

Source: US Bureau of Labor Statistics, "12-month percentage change, Consumer Price Index, selected categories"

The silver lining of a down year like 2022 is that there has been a reset in valuations. Compared to 2021, most asset classes are considerably cheaper today which presents favorable investment opportunities. For example, P/E ratios for US stocks are much more attractive than they have been in recent years.

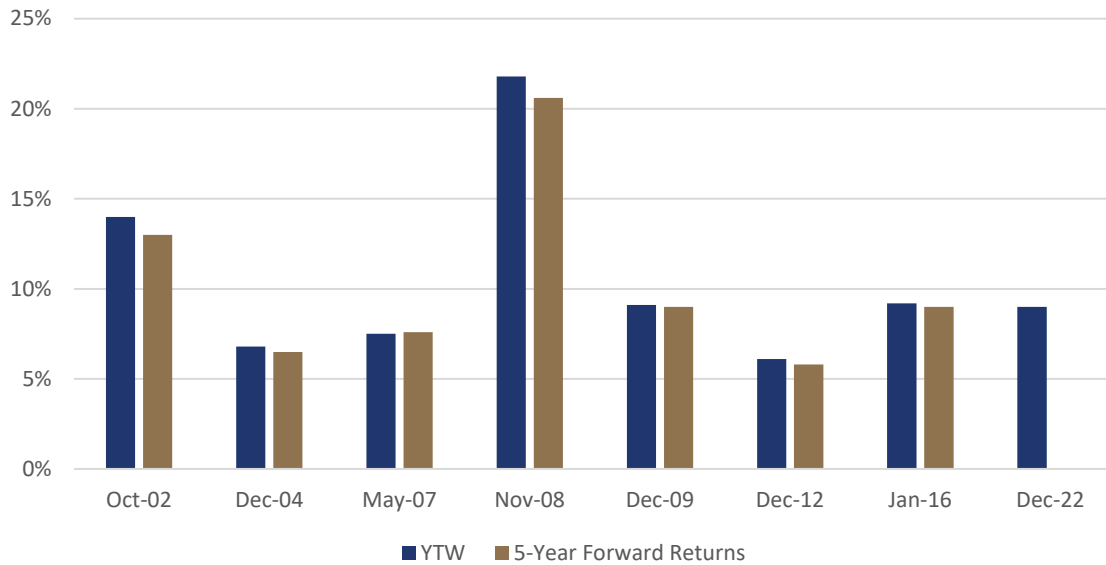
Time Period	P/E	Forward P/E
<b>12/31/2021</b>	24.6	21.4
<b>12/31/2022</b>	18.6	17.5
<b>5-Year Average</b>	22.3	19.7
<b>10-Year Average</b>	20.4	18.4
<b>Pre-Pandemic</b>	21.5	19.3

Source: S&P 500 Index, Yardeni Research "YRI S&P 500 Earnings Forecast"

There are also opportunities in fixed income. Using high yield bonds as an example, elevated yields suggest attractive forward five-year returns. Historically, five-year returns have closely matched the starting point of the bond yield. Below are some examples of similar scenarios to current high yield bond yields.



### High Yield Bonds Starting Yield and 5-Year Returns



Source: Federal Reserve Economic Data, "ICE BofA US High Yield Index Semi-Annual Yield to Worst", "ICE BofA US High Yield Index Total Return Value"

Additionally, a diversified portfolio has historically been resilient after a bad year. Looking at the 10 worst years for a simple 60% stock, 40% bond portfolio, the average subsequent 3-year return was 28%.

Year	Return	Next 12 months	Next 3 Years	Next 5 Years
1931	-27.3%	-1.7%	31.7%	107.2%
1937	-20.7%	19.3%	15.5%	18.8%
2022	-16.9%	?	?	?
1974	-14.7%	23.6%	43.7%	65.9%
2008	-13.9%	11.1%	34.3%	72.0%
1930	-13.3%	27.3%	-6.6%	24.3%
1941	-8.5%	12.4%	46.7%	73.6%
2002	-7.1%	17.2%	32.0%	56.1%
1973	-7.1%	-14.7%	27.2%	27.0%
1969	-6.9%	8.8%	37.5%	8.9%
2001	-4.9%	-7.1%	17.8%	35.0%
<b>Average</b>		<b>4.2%</b>	<b>28.0%</b>	<b>48.9%</b>

Source: NYU, "Historical Returns on Stocks, Bonds, and Bills: 1928-2022"



## **Conclusion**

Last year's shocks to the market were extreme, causing significant selloffs across most asset classes. However, economic numbers are stabilizing which will hopefully reduce volatility. The aftermath of 2022 does present investing opportunities. Valuations have come down in equities, starting yields in bonds are the best in years, and economic indicators do not suggest a major recession.

We will continue to monitor trends that we believe could impact your portfolios, such as the pace of the recovery, earnings growth, valuation, and inflation. Our goal is always to be efficient and selective in portfolio construction to best position clients for success.

If you have any questions, please don't hesitate to reach out to your Academy Financial advisor.

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**CRN-5407744-011123**