Capital Markets Outlook
1Q 2024

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Summary

Outlook

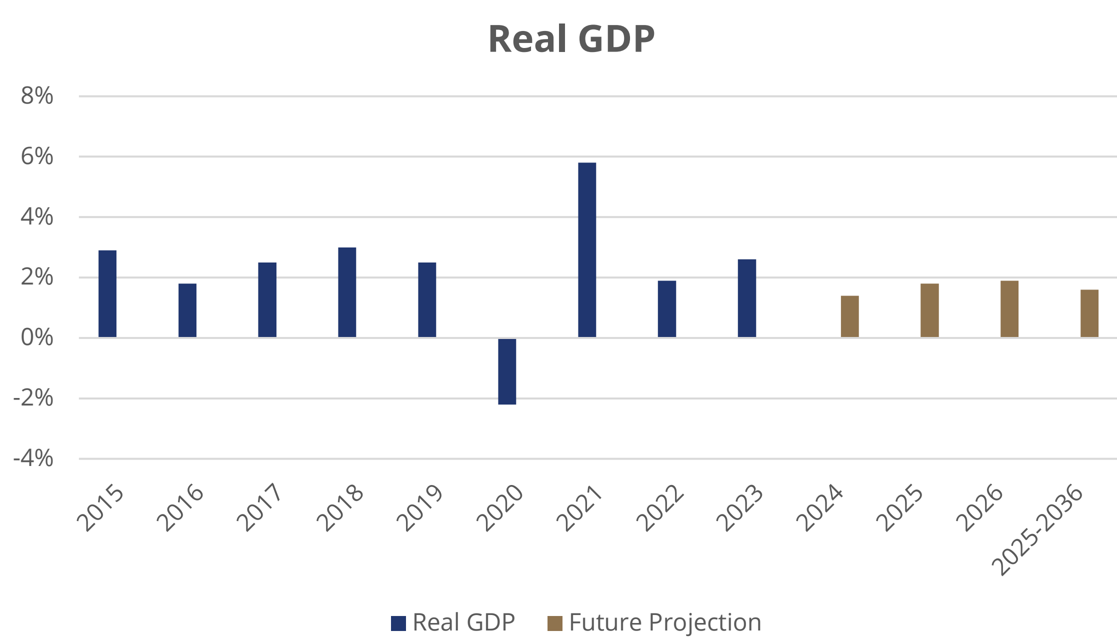
- Easing inflation and economic growth that surprised to the upside point to a soft economic landing.
- Whether or not the economy can remain resilient through eventual rate cuts will likely play a large role in market performance.
- Fixed income yields remain high, offering favorable future return opportunities.
- Slowing economic activity and the end of the Fed tightening cycle favor high-quality stocks and bonds.

Key Risks

- A soft economic landing is possible, but the range of potential outcomes is wide.
- Higher rates increase pressure on businesses that rely on loans. Households face more costly debt with mortgage and credit card rates.

Review

At the beginning of last year, many investors were concerned that 2023 would be a difficult year for both markets and the economy. Instead, 2023 showcased further economic resilience with real GDP numbers coming in stronger than expected.



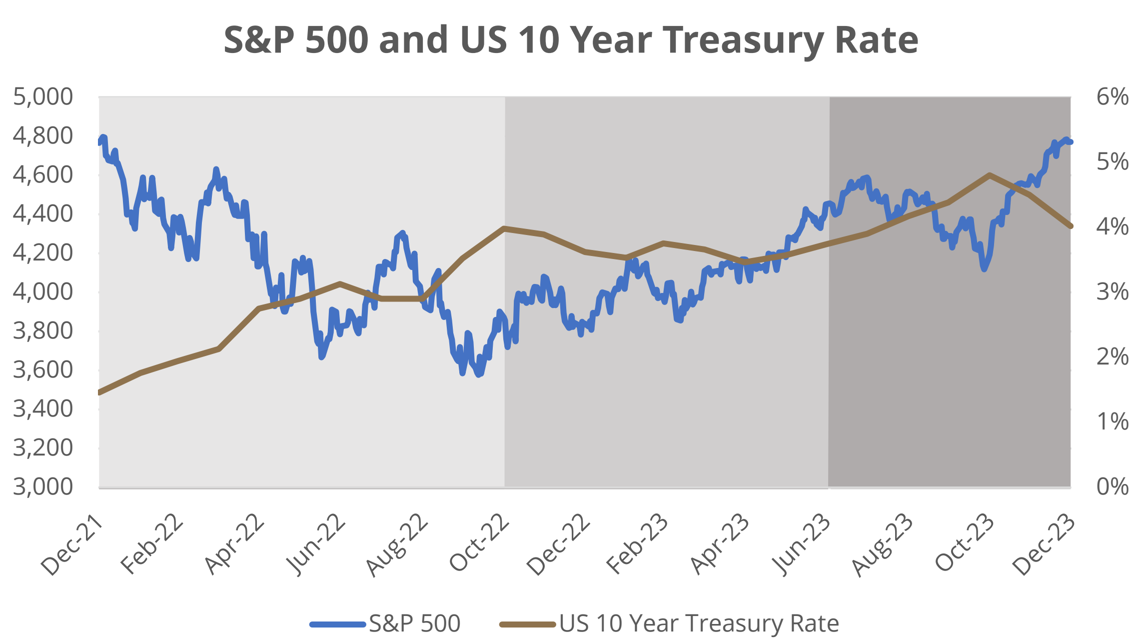
Source: Federal Reserve Bank of St Louis Economic Research, Federal Open Market Committee, The Conference Board. Future projections as of 12/31/2023.

Although there were some intra-year drawdowns, strong GDP growth and easing inflation led to positive returns across asset classes.

	3 Months	6 Months	1 Year
Large Cap	11.6%	8.0%	26.2%
Mid Cap	11.6%	7.0%	16.4%
Small Cap	15.1%	9.5%	16.1%
International	10.7%	5.2%	18.4%
Emerging Markets	8.0%	3.6%	9.0%
High Yield Bond	7.2%	7.0%	12.4%
1-3 Year Treasuries	2.5%	3.2%	4.2%
7-10 Year Treasuries	6.4%	1.6%	3.6%
20+ Year Treasuries	12.9%	-1.9%	2.8%
Aggregate Bond	6.8%	3.3%	5.7%
TIPS	4.5%	1.7%	3.8%

Source: YCharts. 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-Linked Bond Index[1]

In equities, the sharp decline in rates helped boost returns to finish out the year. This pattern can be seen over the past two years as stocks declined during the sharp rise in rates in 2022, showed positive returns as rates were relatively flat through summer 2023, then got a final boost with the rate decline to close out the year.

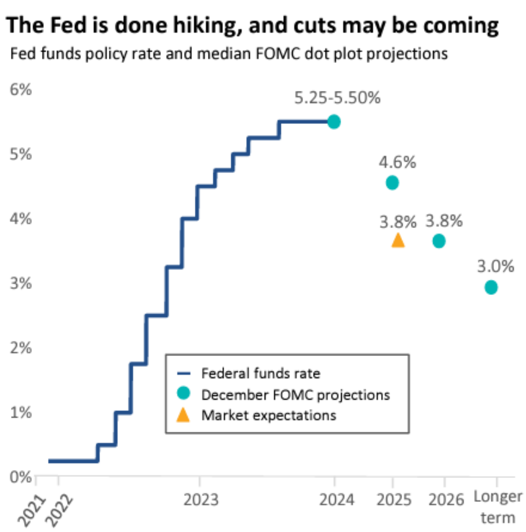


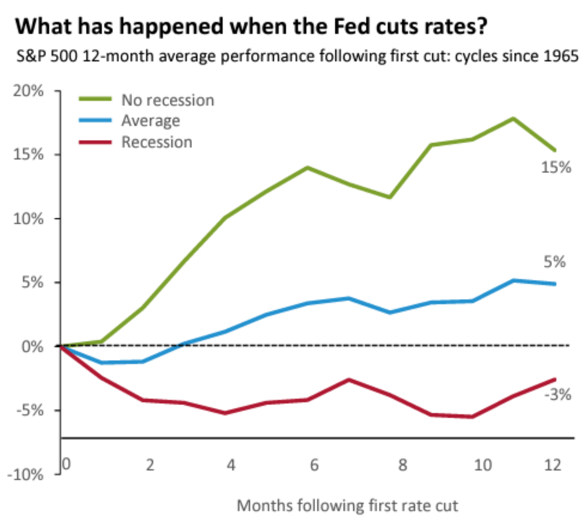
Source: YCharts. S&P 500 Index, US 10 Year Government Bond Interest Rate.

Outlook

Unemployment remains historically low and inflation pressures eased in 2023, reducing headwinds to economic growth. Yet central banks are still cautious – policy rates and bond yields remain high and are likely to stay elevated for some time. The economy is expected to continue to grow at a moderate but slowing pace. While a slower growth environment should help keep inflation down, it does leave the economy susceptible to shocks, so investors should be prepared for a range of outcomes.

For example, declining inflation points to a change in FOMC policy in the future. When the Fed decides to start cutting rates, the outcome for markets will likely be tied to the strength of the economy. On average, the S&P 500 posts positive returns after the first rate cut. However, the historical difference in returns if the economy enters a recession or avoids a recession is significant.

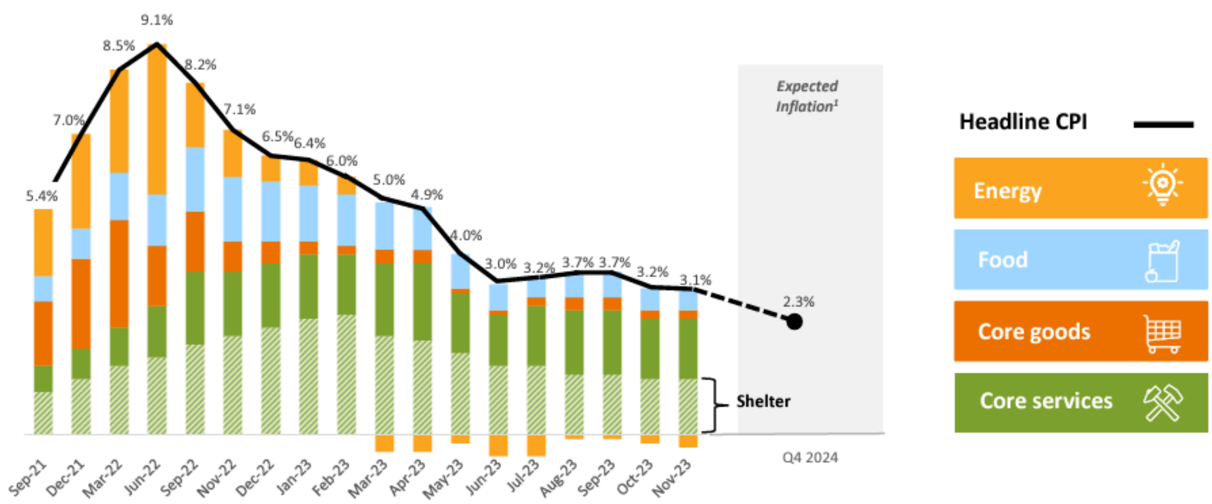




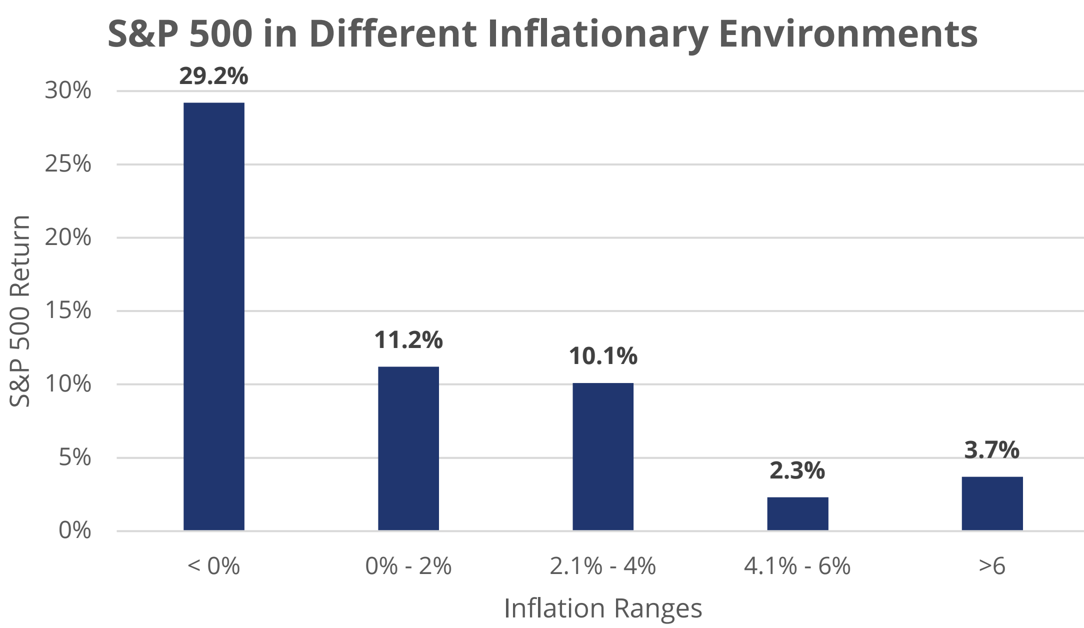
Source: Lincoln Financial Market Intel Exchange. (Left): Federal Reserve, Federal Reserve Bank of St. Louis, Bloomberg as of December 29, 2023. Projected rates listed for 2025 and 2026 represent values as of year-end of the previous year. I.e. 2025= 12/31/2024. (Right): Federal Reserve, NBER, Bloomberg Finance L.P. Analysis provided by J.P. Morgan as of December 11, 2023. Analysis incorporates cutting cycles that began in: Nov '66, Aug '69, June '74, May '81, Oct '84, Jun '89, Jul '95, Sep '98, Jan '01, Sep '07, Jul '19, and Mar '20. Recession is determined by an NBER-defined contraction that occurred within 12 months of the first cut, excluding the 2019 cycle preceding the COVID-19 pandemic.

While there are downside risks in the current environment, Inflation settling down could be good news for equities. At the current level of inflation, returns have historically been favorable. The average return for the S&P 500 when inflation was between 2.1% and 4.0% was 10.1%, which easily outpaces price increases.

Headline CPI and components of CPI inflation (year-over-year)



Source: Lincoln Financial Market Intel Exchange, U.S. Bureau of Labor Statistics. [1]Inflation expectations for Q4 2024 represent median analyst expectations compiled by Bloomberg as of 12/31/2023.



Source: YCharts, Federal Reserve Bank of St Louis, S&P. As of 12/31/2023.

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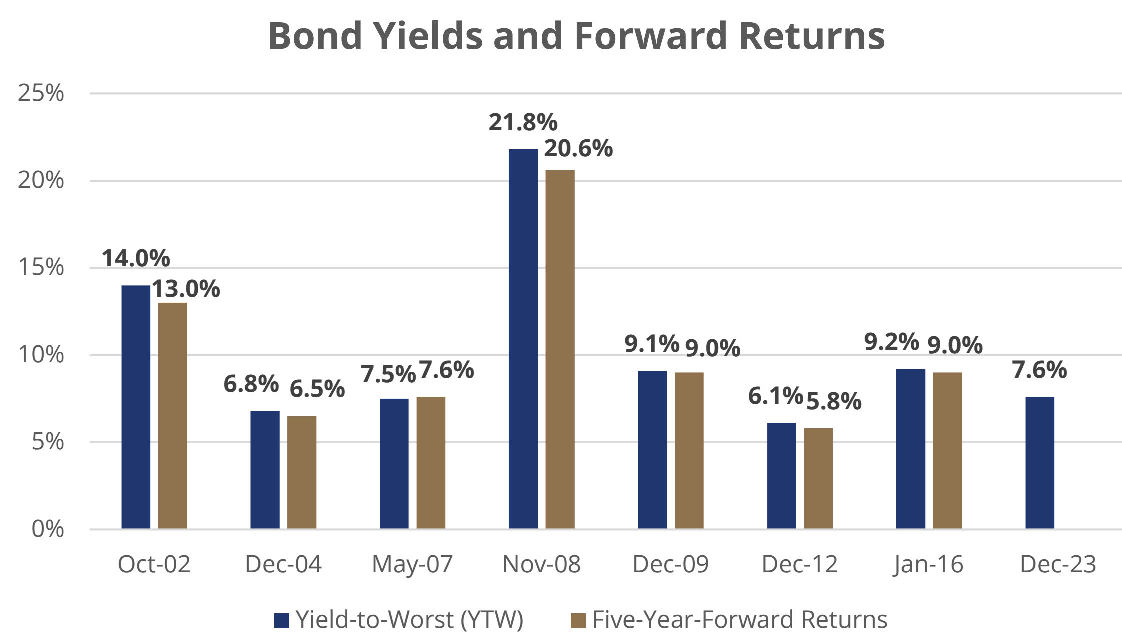
For bonds, rates remaining elevated is a good sign for future returns. The starting interest rate is often an excellent predictor for longer-term total return in fixed income. For example, the Bloomberg US Corporate High Yield index ended 2023 with a yield of 7.6%. Using history as a guide, this starting yield suggests strong future returns for the asset class.



Source: YCharts. YTW and forward returns are represented by Bloomberg US Corporate High Yield Index. Yield to worst is a measure of the lowest possible yield that can be received on a bond that fully operates within the terms of its contract without defaulting. As of 12/31/2023.

At least some of the decline can be attributed to fears of recession as investors became concerned with the uncertain economic outlook. However, investor sentiment souring has often been a contrarian indicator of stock market performance. The S&P 500 has averaged 24% in the 12 months after a sentiment trough, while only returning 3.5% after a sentiment peak.

Conclusion

There are positive trends for both stocks and bonds, but investors should be prepared for a range of outcomes. Improving economic data has reduced the probability of a recession. Most analysts believe there will either be a mild recession or no recession at all in the near term. If the economy does falter, it is not necessarily detrimental to investments. The average return for the S&P 500 during a recession is -1%, and the average return 1 year after a recession is +16%.

S&P 500 Index Price Return

Recession Start Date	*Duration (Months)*	*Return During Recession*	*Return 1 Yr. After Recession*	*Return 3 Yrs. After Recession*	*Return 5 Yrs. After Recession*
July 1953	10	18%	30%	62%	101%
August 1957	8	−4%	33%	50%	61%
April 1960	10	17%	10%	23%	44%
December 1969	11	−5%	8%	10%	5%
November 1973	16	−13%	23%	7%	22%
January 1980	6	7%	8%	34%	57%
July 1981	16	6%	20%	46%	66%
July 1990	8	5%	8%	19%	72%
March 2001	8	−2%	−18%	3%	23%
December 2007	18	−38%	12%	48%	113%
February 2020	2	−1%	44%	43%	N/A
Average return		−1%	+16%	+31%	+56%
Number of positive periods (%)		45%	91%	100%	100%

Source: Lincoln Financial Market Intel Exchange. Morningstar, NBER. Cumulative price return of the S&P 500 Index. Past performance is not indicative of future returns. Recession duration is measured from the first day of the month following the peak month, to the end of the trough month.

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.

[1]The S&P 500 index covers the 500 largest companies that are in the United States. These companies can vary across various sectors. The S&P MidCap 400 Index, more commonly known as the S&P 400, is a stock market index from S&P Dow Jones Indices. The index serves as a barometer for the U.S. mid-cap equities sector and is the most widely followed mid-cap index in existence. The S&P SmallCap 600 Index is a stock market index established by Standard & Poor's. It covers roughly the small-cap range of US stocks, using a capitalization-weighted index. The MSCI EAFE Index tracks large cap and mid cap companies in developed countries around the world. The index primarily covers the Europe, Australasia, and the Far East regions. The MSCI Emerging Markets Index represents securities that are headquartered in emerging markets. An emerging market is considered a country that has not yet become developed because of economic characteristics. The ICE U.S. Treasury 1-3 Year Bond Index is part of a series of indices intended to

assess the U.S. Treasury market. The Index is market value weighted and is designed to measure the performance of U.S. dollar-denominated, fixed rate securities with minimum term to maturity greater than one year and less than or equal to three years. The ICE U.S. Treasury 7-10 Year Bond Index is part of a series of indices intended to assess the U.S. Treasury market. The Index is market value weighted and is designed to measure the performance of U.S. dollar-denominated, fixed rate securities with minimum term to maturity greater than seven years and less than or equal to ten years. The ICE U.S. Treasury 20+ Year Bond Index is part of a series of indices intended to the assess U.S. Treasury market. The Index is market value weighted and is designed to measure the performance of U.S. dollar-denominated, fixed rate securities with minimum term to maturity greater than twenty years. The Bloomberg USAgg Index is a broad-based flagship benchmark that measures the investment grade, US dollar-denominated, fixed-rate taxable bond market. The index includes Treasuries, government-related and corporate securities, MBS (agency fixed-rate pass-throughs), ABS and CMBS (agency and non-agency). The Bloomberg US Treasury Inflation-Linked Bond Index measures the performance of the US Treasury Inflation Protected Securities (TIPS) market.