Capital Markets Outlook 2Q 2022

Blake Gaulden, CFA, CFP®
Chief Investment Officer

Home Office
1447 York Rd
Suite 801
Lutherville, MD 21093
410.825.0034

Sykesville Office
7520 Main St
Suite 102
Sykesville, MD 21784
410.730.9786

York Office
600 N Hartley St
Suite 160
York, PA 17404
410.372.3232

Richmond Office
9 South 5th St
Suite 101
Richmond, VA 23219
804.253.1437

Vienna Office
8219 Leesburg Pike
Vienna, VA 22182
301.296.6278

ACADEMY FINANCIAL, INC.
EVALUATE • ENVISION • EXECUTE

Summary

Outlook

- The war in Ukraine doesn't have a large direct impact on the US economy. However, it does increase the likelihood that commodity prices will stay elevated, and supply-chains will recover more slowly. These factors will keep inflation higher for longer than initially expected.
- Rising prices for daily necessities leave households with less disposable income. That suggests slower growth ahead, though a significant amount of savings built up during the pandemic should allow for a gradual decline in growth rather than a sudden stop.
- Monetary policy decisions will likely have an increasingly large influence on short-term investment returns, especially when combined with more persistent inflation.

Upside Risks

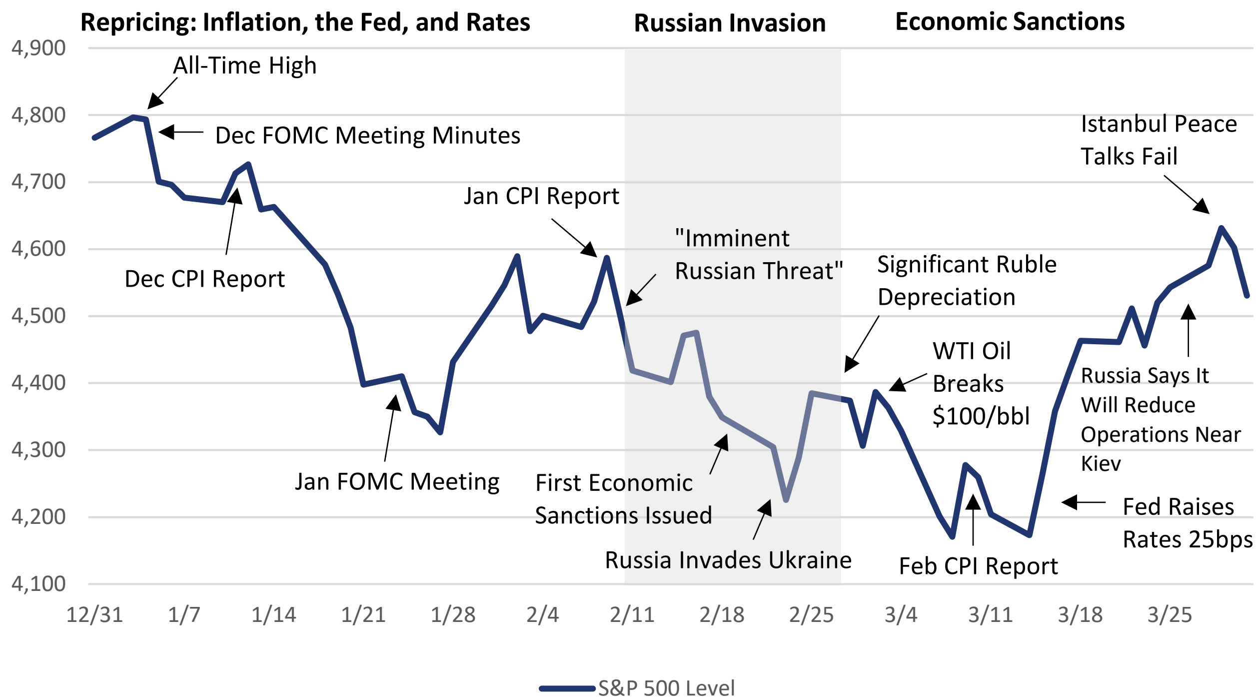
- A quick resolution of the war in Ukraine could lead to decreased commodity prices.
- Fiscal support could provide relief to consumers facing higher prices.

Downside Risks

- Continued Russian aggression in Ukraine could dampen sentiment and keep inflation at elevated levels.
- Inflation expectations could surprise to the upside further and force more aggressive monetary policy tightening.

First Quarter Review

Stock markets fell in the first quarter as Russia's invasion of Ukraine cast uncertainty on the growth outlook and amplified concerns about inflation and rising rates. In the first half of the quarter, investors were grappling with what price they would be willing to pay for moderating earnings and rising rates. In the second half, geopolitical conflict dominated the news. The combination of these factors led to increased volatility.



Source: YCharts

Although there was some market recovery following economic sanctions of Russia, the result was a negative return for the S&P 500 after seven straight quarters of gains. US stocks were not the only investment to suffer, almost every asset class produced negative returns to start 2022.

Asset Class	1Q 2022	1-Year Trailing
US Large Cap	-4.6%	15.5%
US Small Cap	-7.5%	-6.2%
International	-6.0%	-2.7%
US Bonds	-5.6%	-4.3%
US High Yield	-4.9%	-1.7%

Source: YCharts

Economic Update

Just as the global economy was on the cusp of recovery form the COVID-19 pandemic, the world faced a second shock from the Russian invasion of Ukraine. As with any geopolitical event, the situation can change rapidly, making forecasting the economic outlook particularly difficult. However, most geopolitical events do not have a long-term impact on the economy. You'll notice that historically, most of the large declines coincide with an economic recession and are not directly caused by the geopolitical climate.

S&P 500 Returns After Select Geopolitical Events

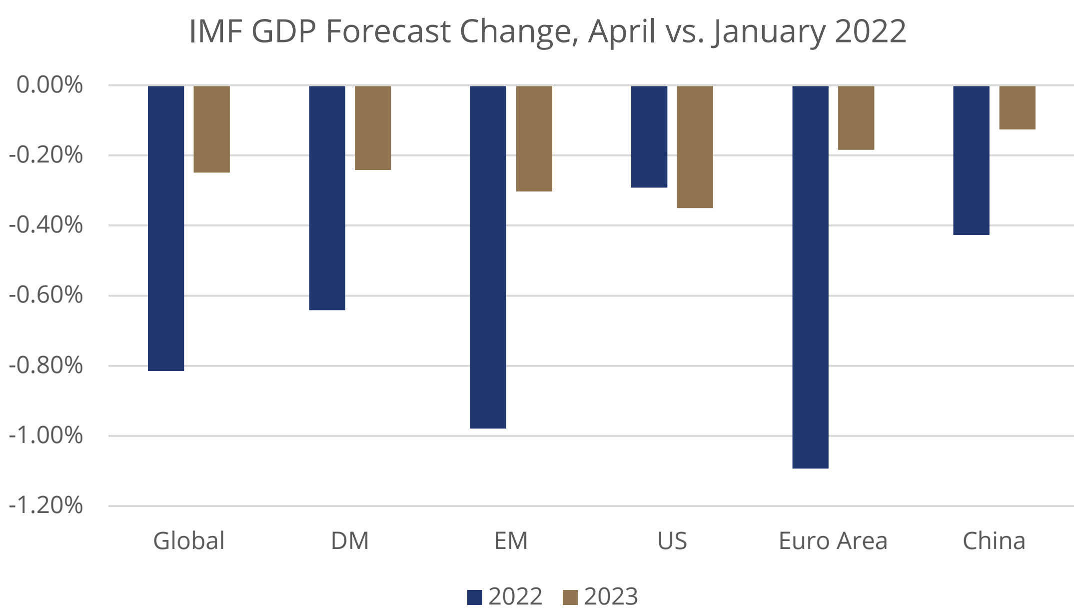
Event	1st Trading Day	1 Week	1 Month	1 Quarter	1 Year
Watergate	6/19/1972	-0.1%	-1.4%	0.4%	-3.0%
Yom Kippur War*	10/8/1973	1.4%	-3.9%	-10.0%	-43.2%
Three Mile Island Accident	3/28/1979	-0.1%	-0.7%	-0.2%	-4.2%
Iran Hostage Crisis*	11/5/1979	-1.0%	3.6%	12.3%	24.3%
Reagan Assassination Attempt*	3/30/1981	0.6%	0.6%	-1.6%	-16.9%
Challenger Space Shuttle	1/28/1986	3.2%	9.3%	16.8%	32.0%
Iran-Contra Affair	11/3/1986	0.7%	2.1%	12.3%	3.2%
Iraq Invades Kuwait*	8/2/1990	-4.7%	-8.9%	-12.8%	12.8%
Desert Storm/First Gulf War*	1/17/1991	4.5%	17.2%	23.6%	36.6%
LA Riots	4/29/1992	2.0%	2.3%	2.8%	10.2%
WTC Bombing	2/26/1993	1.2%	2.1%	2.2%	8.3%
Oklahoma City Bombing	4/19/1995	1.4%	3.1%	11.3%	30.5%
Centennial Olympic Park Bombing	7/29/1996	4.3%	4.6%	10.8%	50.6%
Kenya/Tanzania Embassy Bombings	8/7/1998	-1.3%	-0.5%	5.1%	21.0%
USS Cole Bombing*	10/12/2000	-1.6%	0.2%	-2.5%	-18.5%
Bush v Gore Election*	11/7/2000	-5.6%	-5.5%	-5.3%	-20.9%
9/11*	9/17/2000	-4.9%	-0.9%	4.7%	-15.5%
War in Afghanistan*	10/8/2001	1.9%	3.0%	9.8%	-24.2%
SARS	2/11/2003	-0.1%	-3.2%	12.2%	39.5%
Second Gulf War	3/20/2003	-0.5%	2.4%	14.3%	29.2%
Madrid Train Bombings	3/11/2004	0.0%	1.5%	1.5%	9.5%
Orange Revolution - Ukraine	11/22/2004	1.1%	2.2%	3.1%	8.6%

Asian Tsunami	12/27/2004	0.3%	-3.4%	-2.7%	6.8%
London Bombings	7/7/2005	2.4%	2.7%	0.2%	8.6%
Hurricane Katrina	8/29/2005	1.1%	1.0%	5.7%	9.5%
Arab Spring	12/17/2010	1.2%	4.2%	1.6%	0.2%
Hurricane Sandy	10/29/2012	1.1%	0.0%	7.0%	27.3%
Boston Marathon Bombing	4/15/2013	-2.1%	3.0%	6.3%	16.7%
Russia/Ukraine/Crimea	2/27/2014	1.6%	0.5%	3.5%	16.8%
Greek Referendum	11/5/2015	-1.2%	-0.3%	-8.4%	1.4%
Brexit	6/24/2016	-0.7%	3.1%	3.0%	17.8%
Trump Surprise Election Win	11/8/2016	1.6%	5.4%	8.1%	24.0%
Hurricane Harvey/Irma/Maria	8/25/2017	1.4%	2.8%	7.2%	20.2%
US-China Trade War	1/22/2018	2.2%	-2.6%	-3.7%	-3.1%
COVID-19 Outbreak	2/19/2020	-7.1%	-28.7%	-13.3%	15.9%

***Denotes the event occurred during a recession or six months prior to the start of a recession**

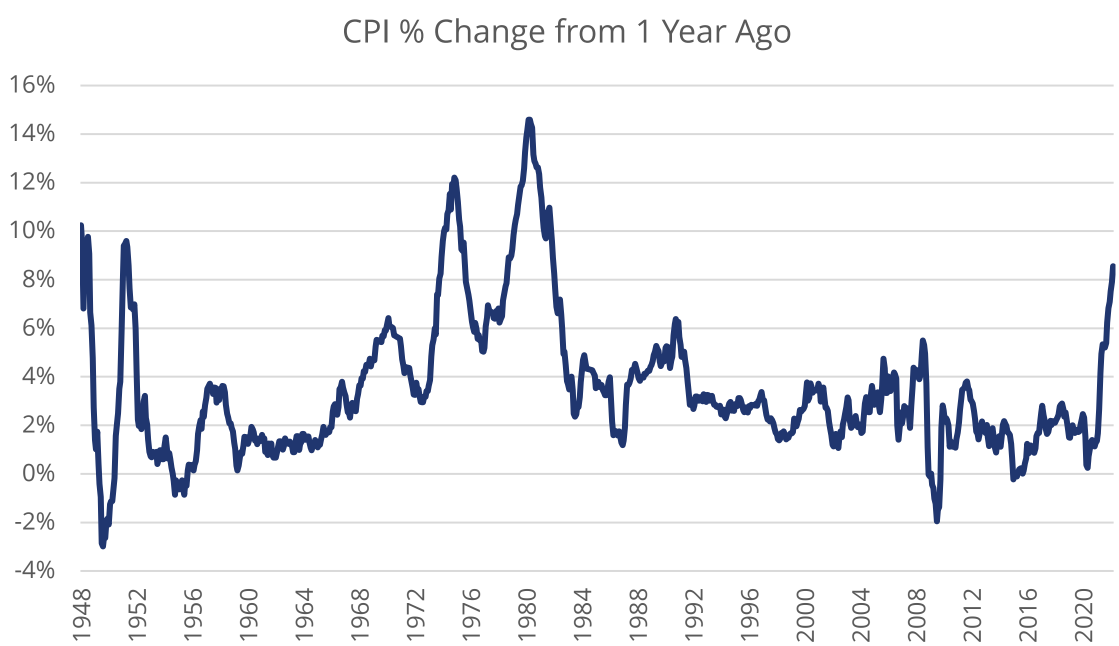
Source: AllianceBernstein, FactSet, National Bureau of Economic Research, S&P, and WHO

That being said, it is becoming clear that growth will be lower and inflation higher than originally expected. The International Monetary Fund (IMF) has downgraded its global growth forecasts by 0.8% for 2022 and 0.2% for 2023. Note that positive growth is still predicted, just at a lower level than earlier forecasts.



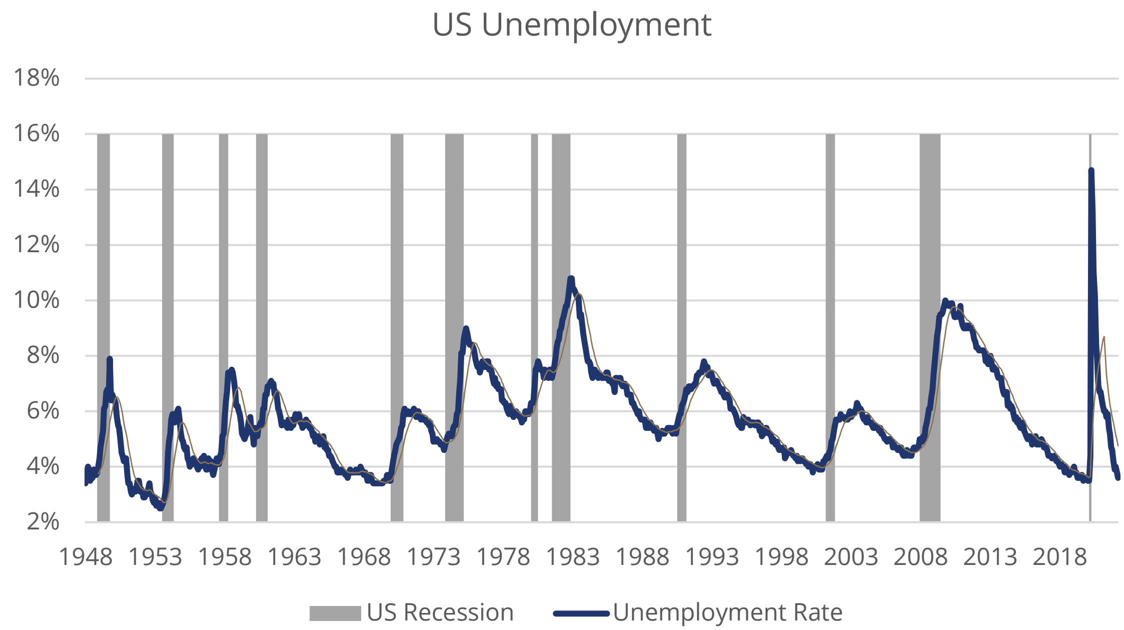
Source: IMF World Economic Outlook

Year-over-year inflation has increased 8.5% which is the highest number in over 40 years. The magnitude of the impact on growth will be determined by how much energy prices rise and how long they stay high. Consumer demand for food and energy is largely inelastic. Higher prices for food and gas won't reduce demand for those items. However, consumers will be forced to make decisions on other goods and services which could slow growth more broadly. The longer inflation remains above trend, the more growth will be stifled.



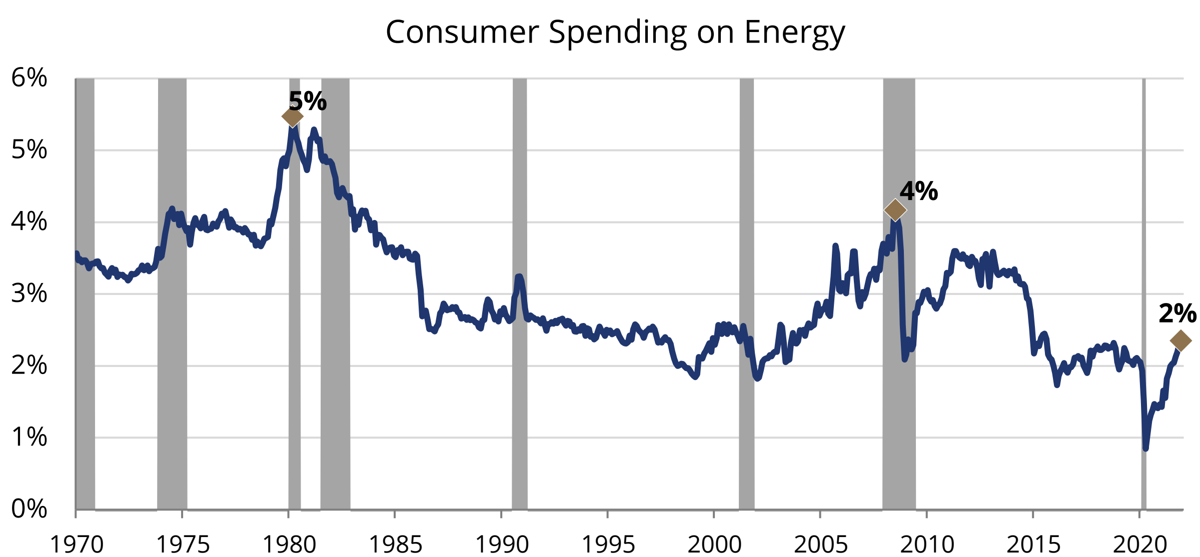
Source: US Bureau of Labor Statistics

Changing Fed policy in the face of rising inflation has led some to speculate about an economic recession. While the odds of a recession have increased, the risk is still low in our view. One positive is the labor market – the unemployment rate is at a historically low level and trending down. Historically, the unemployment rate has started increasing before a recession starts.



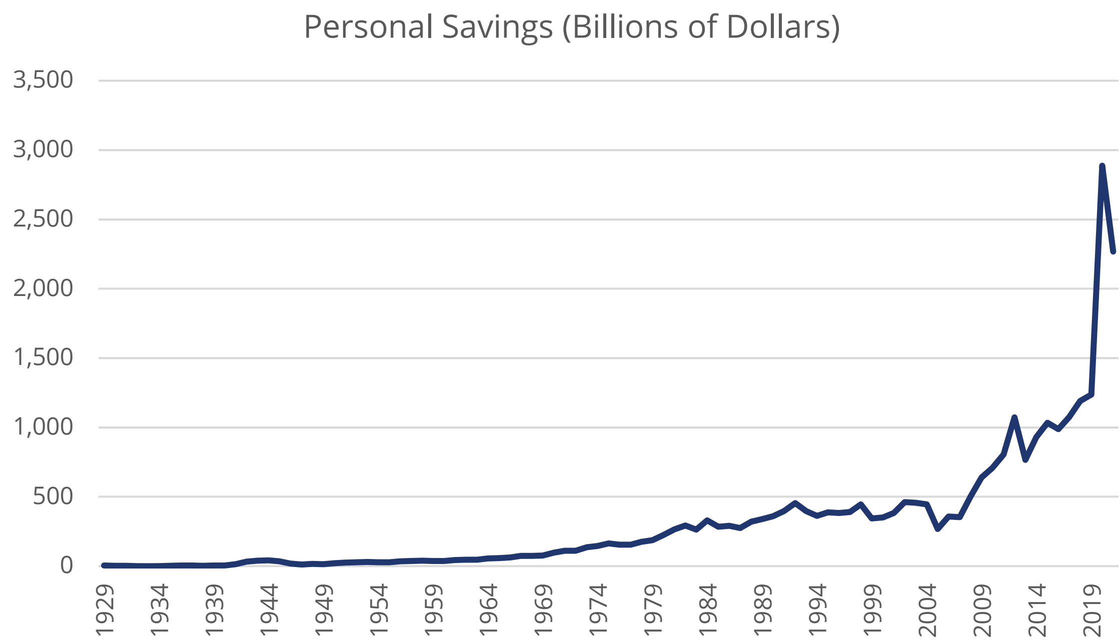
Source: YCharts

With energy prices rising, US consumers are spending more to drive cars and heat their homes. Despite the dramatic increase in energy prices, consumers are spending less on energy as a portion of their incomes relative to prior oil-price shocks.



Source: US Bureau of Economic Analysis

The reopening from COVID-19 pushed growth well above its long-term trend globally, and US households have accumulated more than $2 trillion in savings. This should allow consumers to smooth consumption during this time of uncertainty.



Source: US Bureau of Economic Analysis

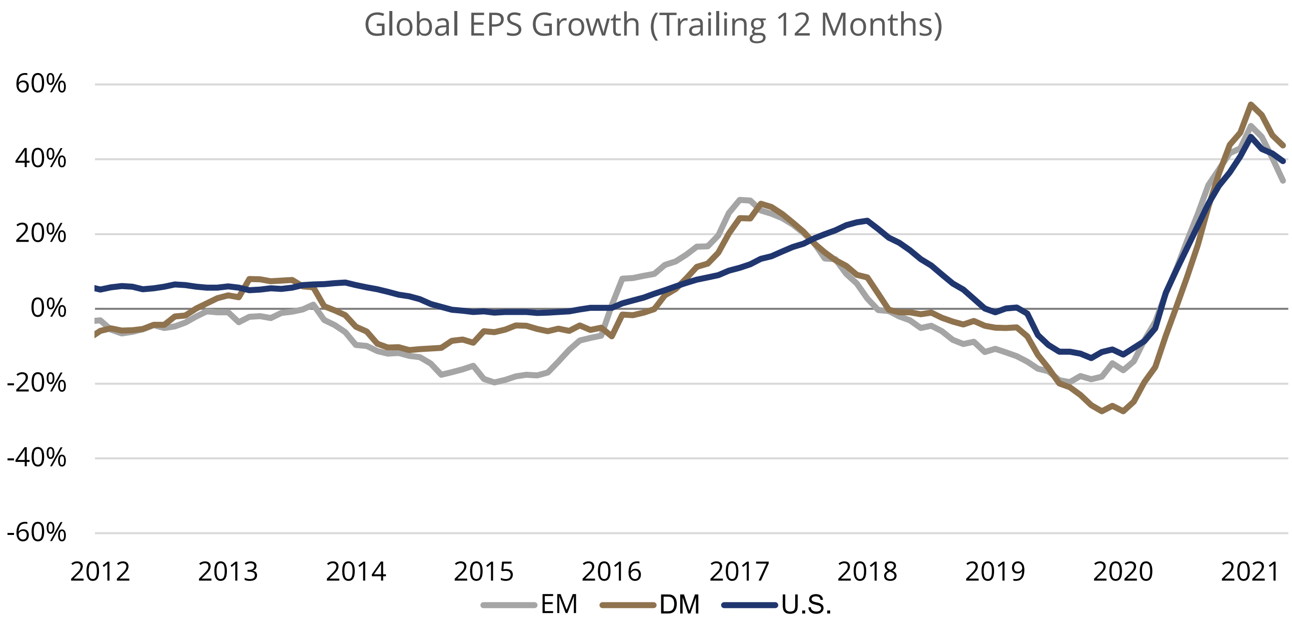
With the information we have today, the economic outlook is more uncertain than a few months ago but is still trending positive. As long as the Russia-Ukraine situation is resolved in the coming months, the hit to growth is likely to be temporary rather than permanent. However, we are closely monitoring relevant economic indicators to look for any changes, whether they be positive or negative.

Asset Class Update

Equities

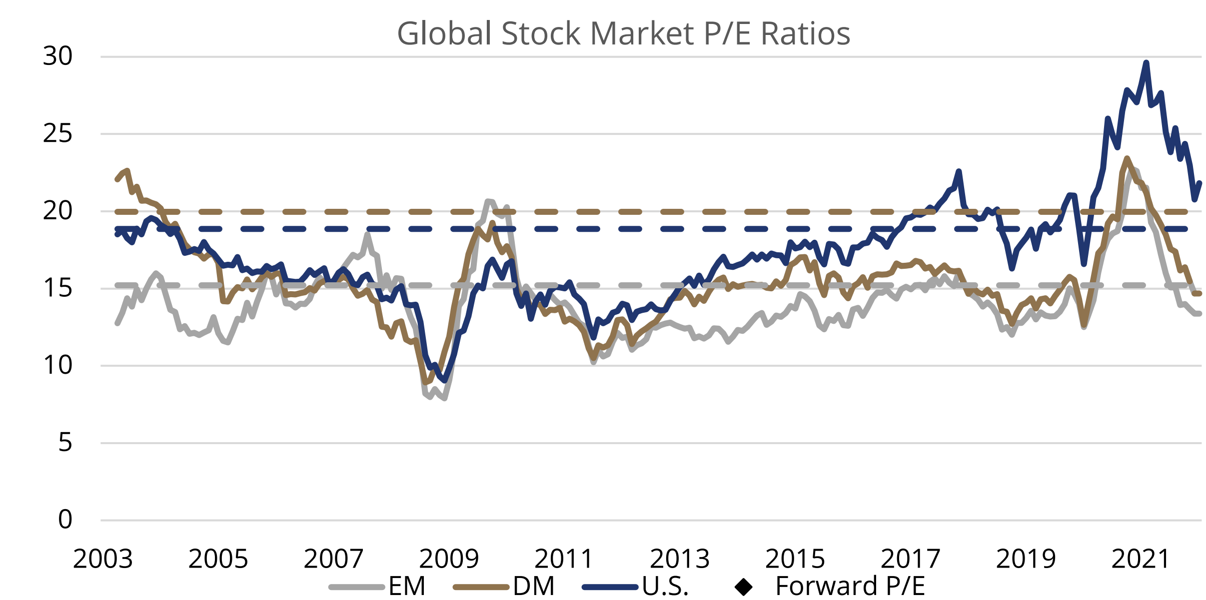
Global earnings slowed to start the year, which was expected coming off the record-high levels achieved in 2021. More moderate growth is expected across global equities with forward estimates in the single digits.

ACADEMY FINANCIAL, INC.
EVALUATE • ENVISION • EXECUTE



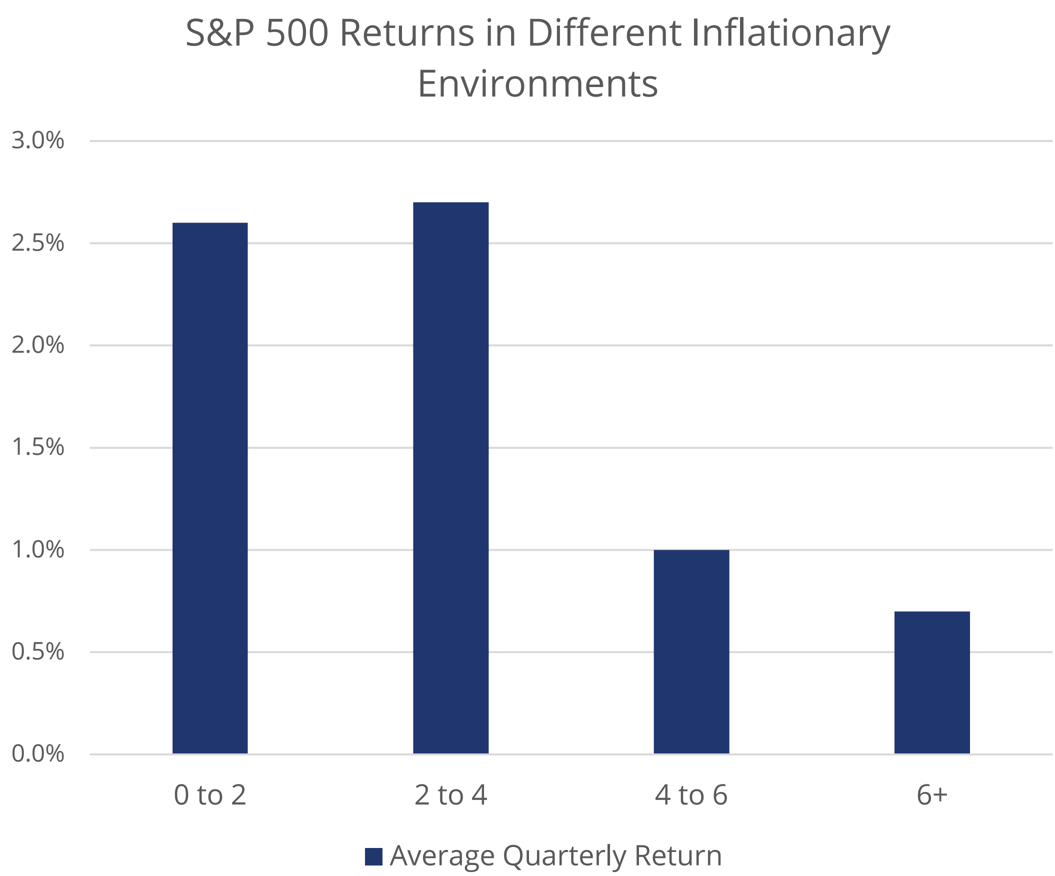
Source: MSCI, Bloomberg, Fidelity Investments

Although earnings numbers are expected to be lower, there are still opportunities in stocks. The broad equity sell-off caused valuations in global stocks to decline. The P/E ratios for both Developed Markets and Emerging Markets are below their long-term averages, while the US remains slightly above its long-term average.



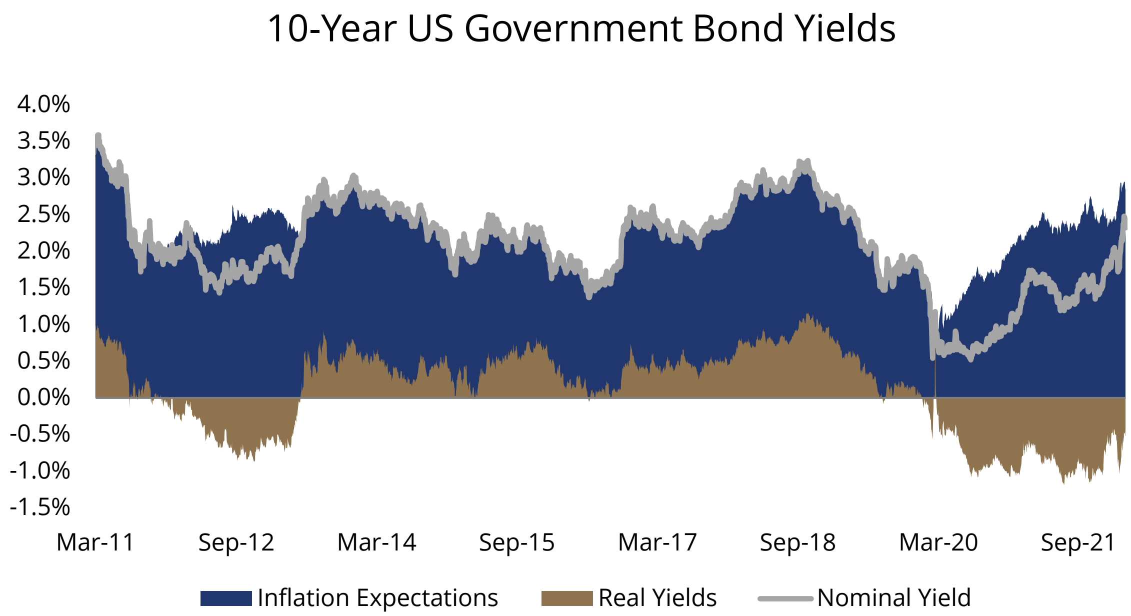
Source: Bloomberg, Fidelity Investments

Equities have historically performed well in many different inflationary environments. If supply-chain issues are fixed and inflation comes down below 4%, that could be an ideal situation for stocks.



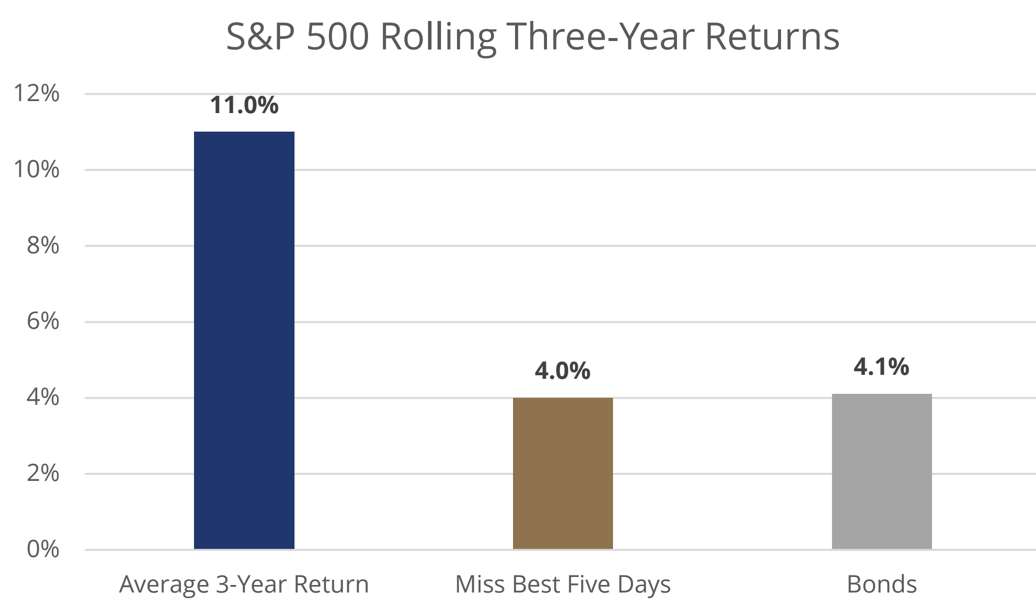
Source: AllianceBernstein

Real bond yields still remain negative, which is supportive of equities. When interest rates are low, investors receive less income on bond investments which incentivizes them to consider higher risk investments such as stocks. Additionally, lower interest rates make borrowing less expensive which can help boost economic growth.



Source: Bloomberg, Fidelity Investments

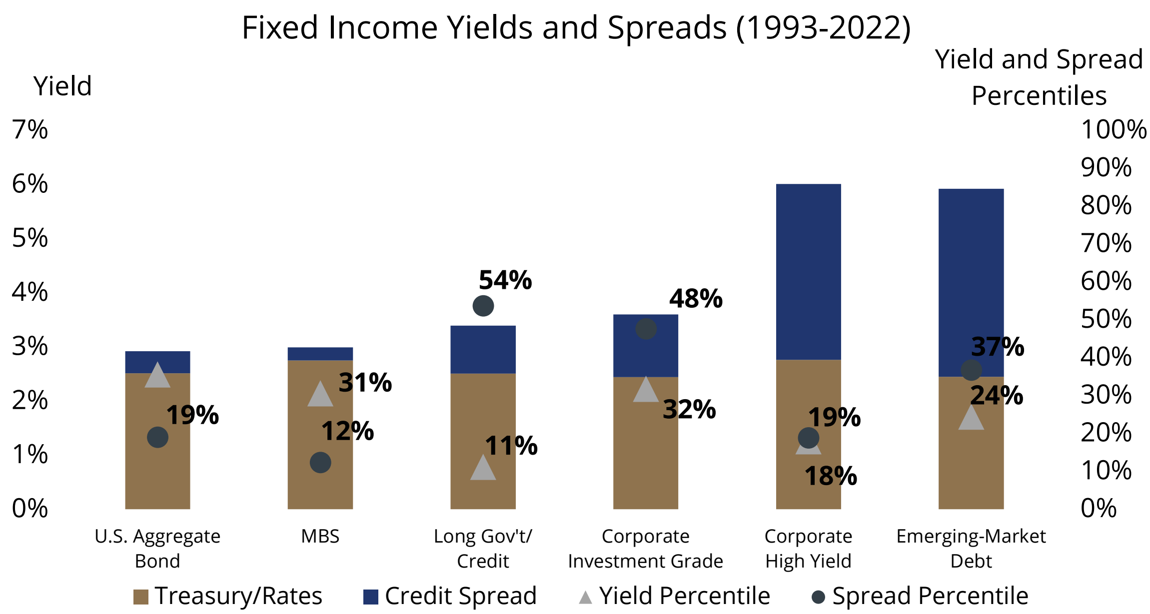
When there is an increase in volatility or uncertainty in markets, it is important to remember the value of staying invested and the consequences of attempting to time the market. Missing the best days of market returns can have significant impact on long-term returns.



Source: Bloomberg, Morningstar

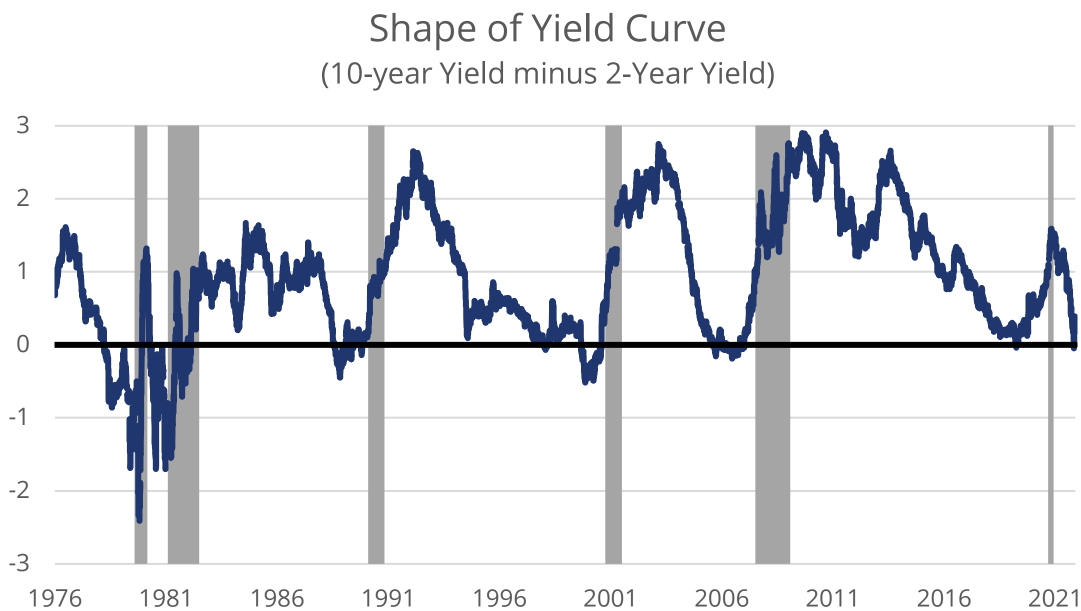
Fixed Income

We previously forecasted that this would be a difficult year for fixed income with inflation, fiscal and monetary tightening, and rising rates presenting headwinds for bond returns. However, the sell-off and changing economic conditions may present a more favorable environment moving forward. Both interest rates and credit spreads increased during the first quarter across most bond categories. Although higher rates and spreads caused yields to move up, they remain at the low end of their historical range.



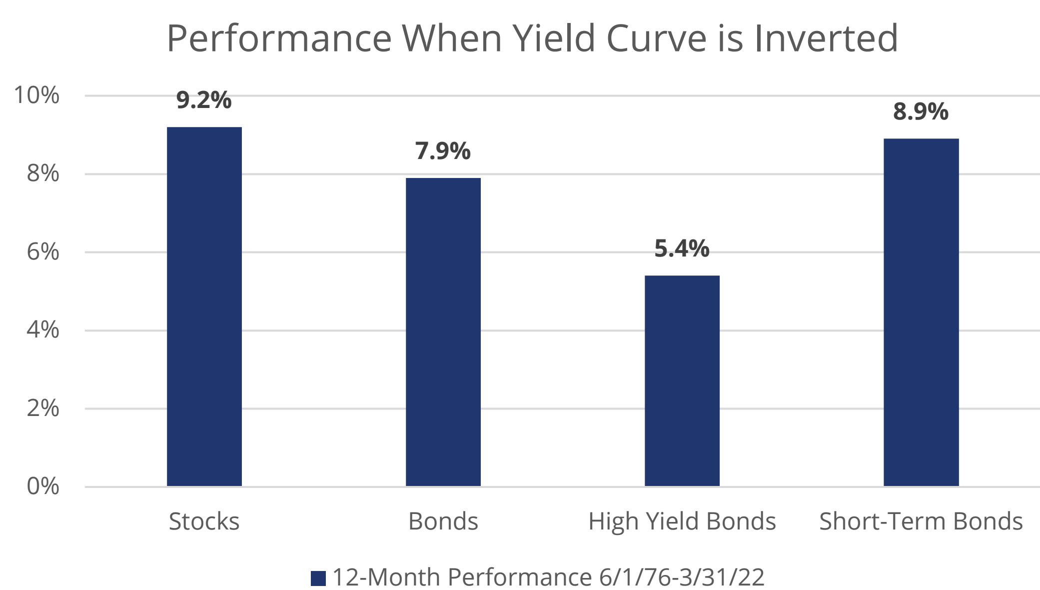
Source: Bloomberg, Bank of America Merrill Lynch, JP Morgan, Fidelity Investments

The yield curve very briefly inverted at the end of the quarter (the yield on the 10-year Treasury was less than the yield on the 2-year Treasury). This is sometimes used as an indicator to predict an economic recession. However, this metric has very bad track record of the timing of a recession. The yield curve has inverted anywhere from months to years before a recession starts.



Source: Federal Reserve Bank of St. Louis

Although an inverted yield curve often precedes an economic slowdown, it is not necessarily bad news for investments. Both stocks and bonds have historically had positive returns in the 12 months following a yield curve inversion.



Source: Morningstar

Using the past as a guide, the segment of fixed income that performs best varies based on the shape of the yield curve.

	Inverted (<0)	Flat (0><1)	Steep (>1)
Stocks	9.2%	16.5%	11.1%
Bonds	7.9%	6.8%	6.3%
High Yield Bonds	5.4%	7.5%	9.6%
Short-Term Bonds	8.95	6.0%	4.4%

Source: Morningstar

The fixed income landscape has been changing quickly and we will be monitoring conditions and valuations to prepare changes as conditions warrant.

Conclusion

This year started with an upswing in volatility and negative returns for most asset classes. Changing monetary policy combined with multiple other sources of uncertainty mean that the volatility is likely to persist further into the year. Although growth has slowed slightly, the economy is still strong, and we continue to favor stocks over bonds on a relative basis. 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.