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Capital Markets Outlook
3Q 2022

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Summary

Outlook

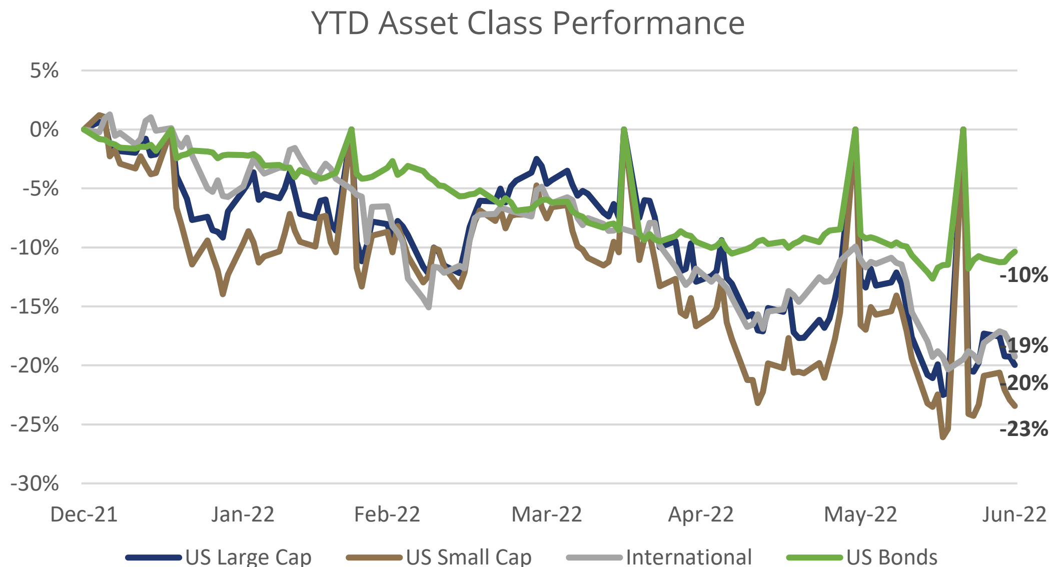
- Inflation continues to run above target and is likely to remain elevated for some time.
- Higher prices push growth lower as households reallocate income towards necessities like food and energy and away from discretionary purchases that have a large impact on the economy.
- The Fed is raising rates aggressively, which is likely to contribute to slowing growth, possibly through 2023.
- Although the risk of a recession has increased recently, we do not believe it is imminent. The US consumer is the main driver of the economy and households, on average, remain in strong financial positions.

Key Risks

- Constructing monetary policy in an unprecedented environment increases the potential for error – policy that is too easy could further cement inflation, policy that is too tight could cause a recession.
- Geopolitics have kept commodity prices elevated. Should the war in Ukraine intensify, commodity prices could push inflation higher as monetary policy tightens.

Second Quarter Review

The first half of the year was difficult for investors with prices declining across asset classes. While the drawdown in the S&P 500 was not catastrophic, the simultaneous decline in stocks and bonds resulted in diversified portfolios falling more than in the 2020 bear market in many cases.[1]



Source: YCharts

While the impact of COVID-19 on the economy has lessened, new challenges emerged. Russia's invasion of Ukraine and China's zero COVID policy have contributed to sustained inflation. Those geopolitical issues combined with lingering pandemic supply-chain issues have led to more persistent inflation than originally forecasted. In response, the Federal Reserve started an aggressive rate hiking cycle and has increased its target rate buy 1.50% this year, including a 0.75% increase in June. The FOMC has signaled that it will continue to hike over time, raising rates another 1.75% by the end of this year.

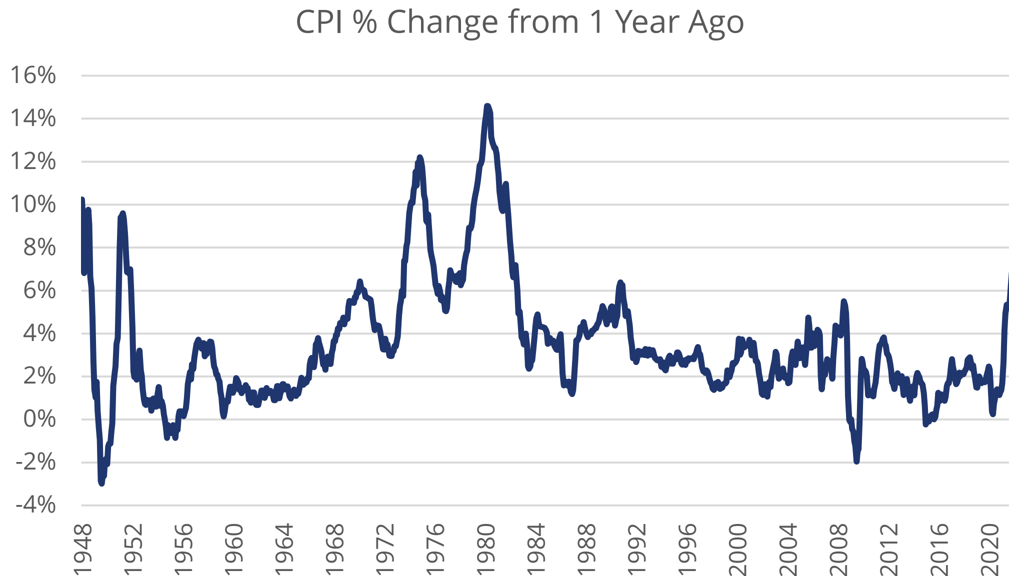
High inflation and Fed tightening have led to rising mortgage rates, US dollar appreciation, record-low consumer sentiment, and one of the worst starts to the year in both stocks and bonds.[2]

It is important to examine the current environment relative to the economic outlook and fundamentals. While the volatility in the first half of the year significant, there are reasons to be optimistic for future returns.

Economic Update

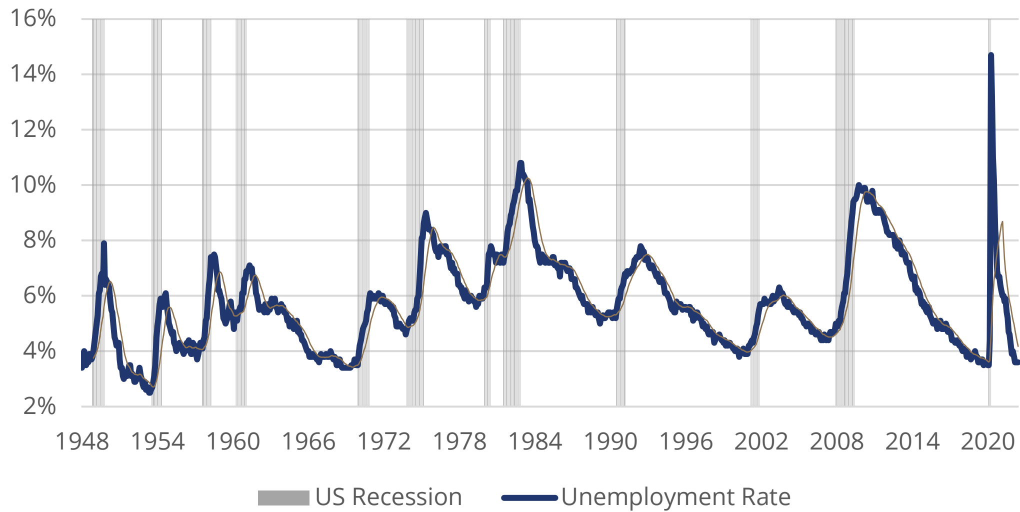
Through much of 2021, the FOMC believed that strong inflation was transitory and kept policy very accommodative. But the committee started changing its tone late last year and since then has been more aggressive in trying to bring inflation down. The FOMC has

already increased rates 1.50% and has signaled that it will hike an additional 1.75% this year and 0.25%-0.50% next year.[3] Despite these efforts, inflation has continued to surprise to the upside and inflation expectations have moved higher.



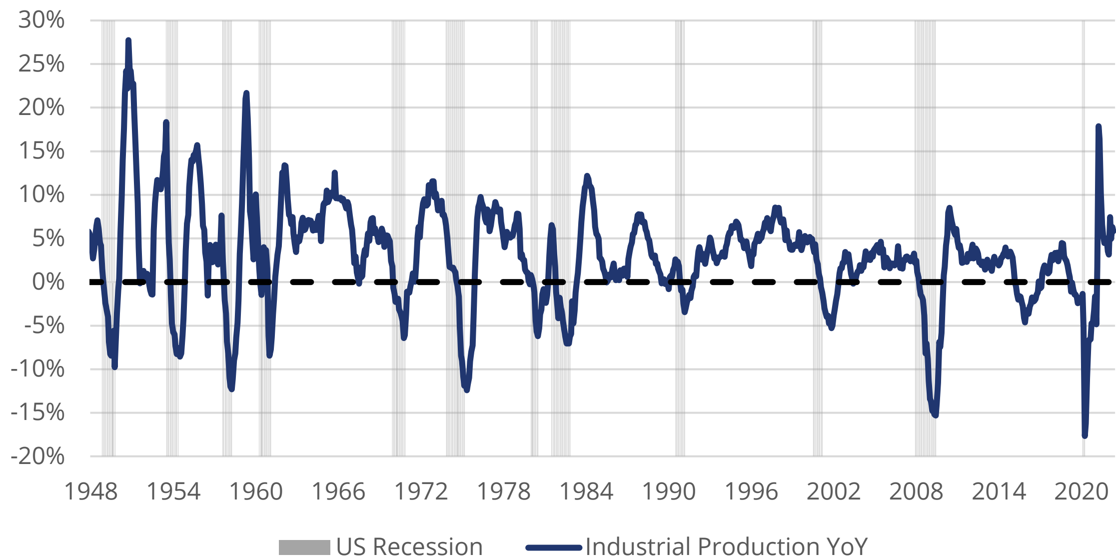
Source: Ycharts

The hawkish shift from the Fed has contributed to a tightening in financial conditions, including dollar appreciation, an increase in mortgage rates, and a drop in equity prices. However, the economy appears to have maintained decent momentum despite these changes. The unemployment rate is at a historically low level and trending down. Historically, the unemployment rate has started increasing before a recession starts.



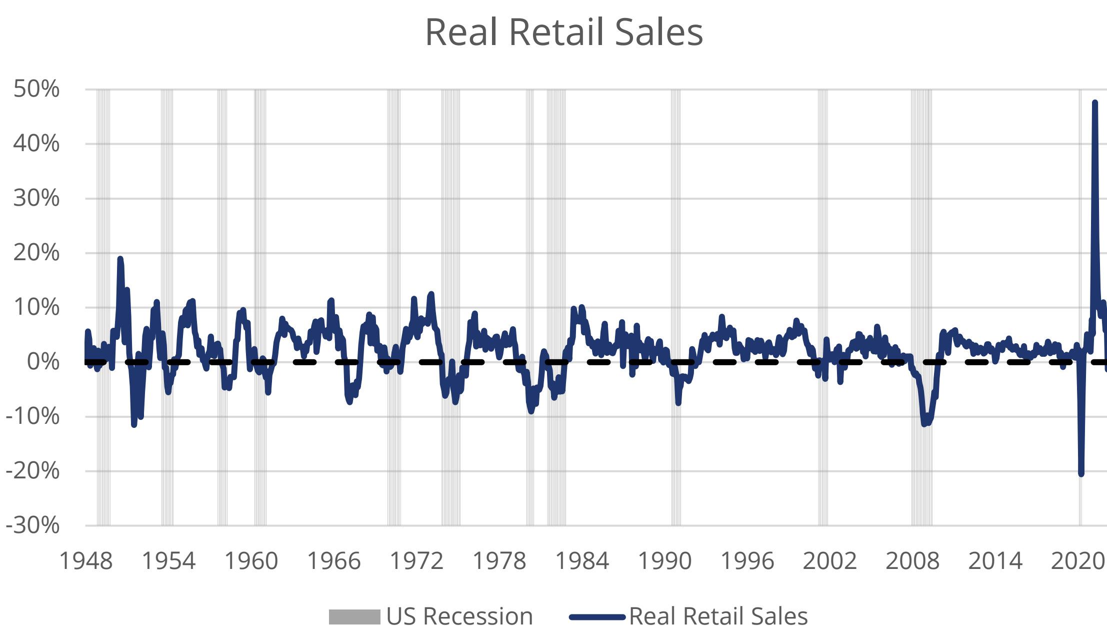
Source: Ycharts

Industrial production growth, which measures the output of manufacturing, mining, electric and gas utilities, has remained positive after coming back to earth following a huge surge in 2021.



Source: Ycharts

Inflation has started to show in retail sales numbers. Real retail sales measures looks at sales at retail and food services stores and adjusts for inflation. This number typically trends negative before a recession starts. Real retail sales dipped to -1.3% in March but has recovered to -0.4% as of May. Although it is a data point to keep an eye on, it has held up remarkably well considering the sustained uptick in inflation.



Source: St. Louis Fed

The previous three economic indicators look at different aspects of the economy – employment, production, and consumption. The unemployment rate and industrial production look positive for the economy, while real retail sales is negative but trending in the right direction. While economic growth is slowing, a recession is not a foregone conclusion. Inflation is expected to moderate and additional slowing of the economy could further ease those pressures. GDP forecasts remain positive and if the Fed has a good chance of engineering a soft landing.

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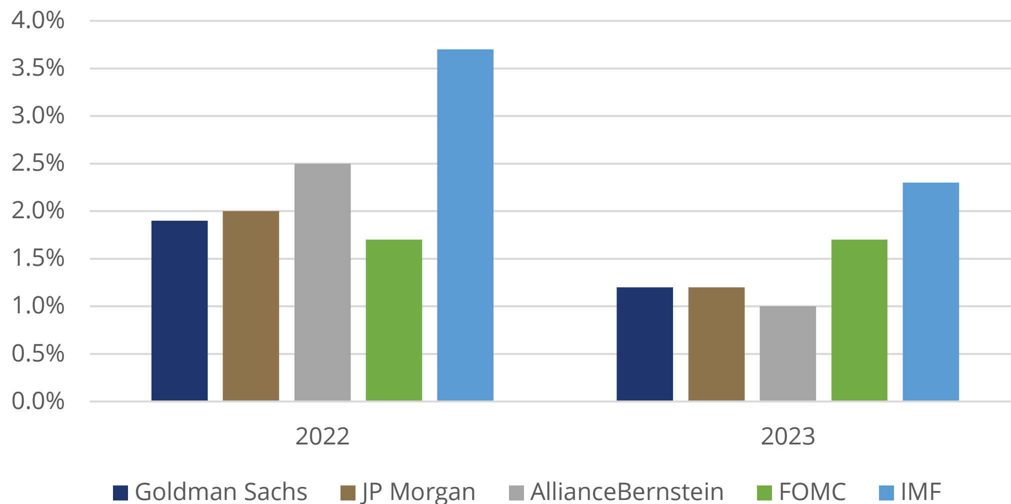


Source: Goldman Sachs, JP Morgan, AllianceBernstein, Federal Reserve, IMF World Economic Outlook

Asset Class Update

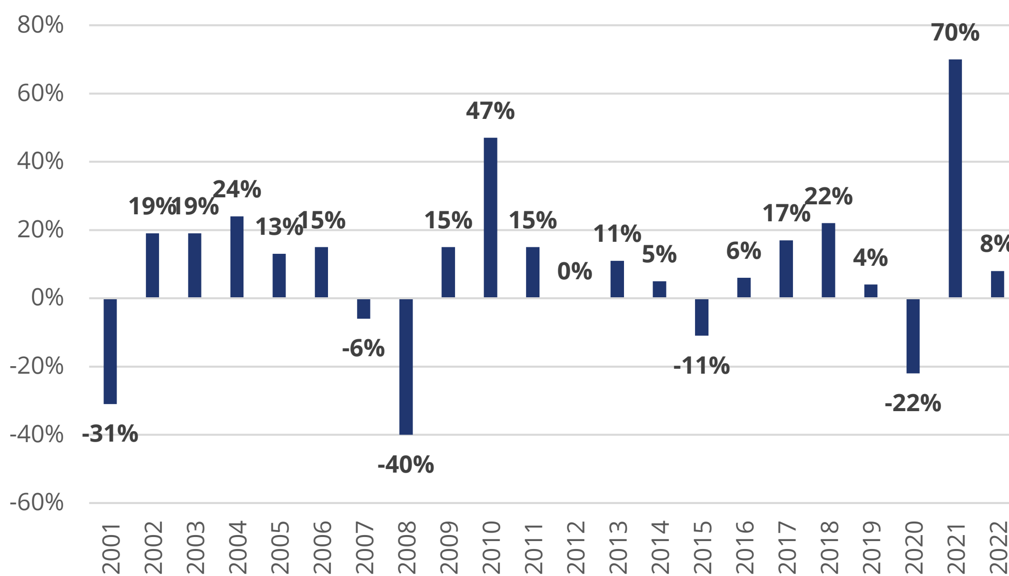
Equities

The first half of 2022 was the fourth worst start for stocks. Rising interest rates, inflation, and geopolitical risks led to significant selling. However, returns have typically been positive after such a bad start.

Year	First 6 Months	Next 6 Months	Next 12 Months
1932	-43.5%	43.0%	117.8%
1962	-22.5%	12.6%	26.0%
1940	-21.8%	8.9%	0.9%
2022	-19.0%	?	?
1970	-17.0%	19.1%	31.9%
2002	-11.4%	-11.3	-2.6%
1982	-11.4%	27.1%	51.7%
1973	-10.8%	-9.6%	-14.3%
1931	-10.6%	-39.1%	-65.6%
1939	-9.9%	8.2%	-15.4%
Average	*-17.8%*	*6.5%*	*14.5%*

Source: Morningstar

Earnings slowed to start the year, which was expected coming off the record-high levels achieved in 2021. In the first quarter, EPS rose just 4.2% year-over-year and analysts expect 8% growth for 2022. Given the many headwinds markets are facing, it is positive to see earnings growth remaining close to its long-term average of 9%.



Source: JPMorgan Asset Management

Continued earnings growth is paired with valuations that have come down to their long-term average. This should set up investors for better returns in the long run, particularly if interest rates and inflation numbers moderate.

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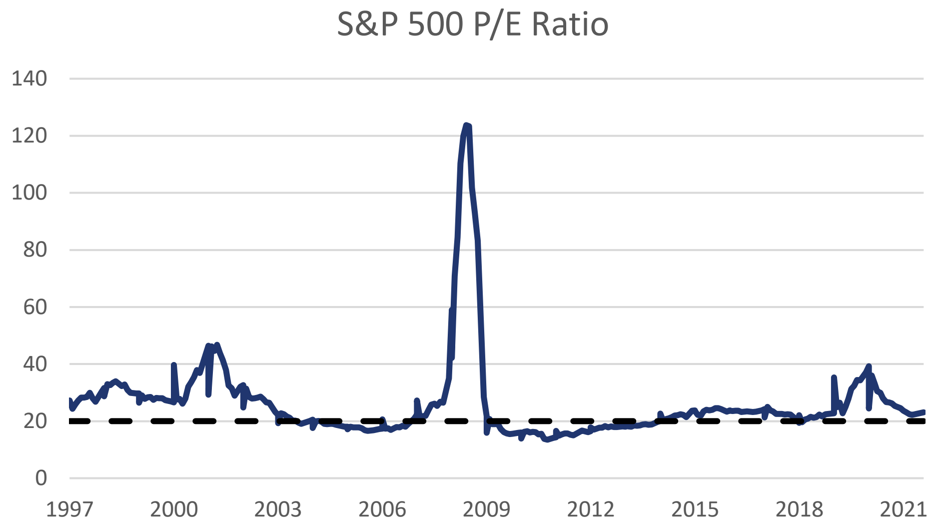
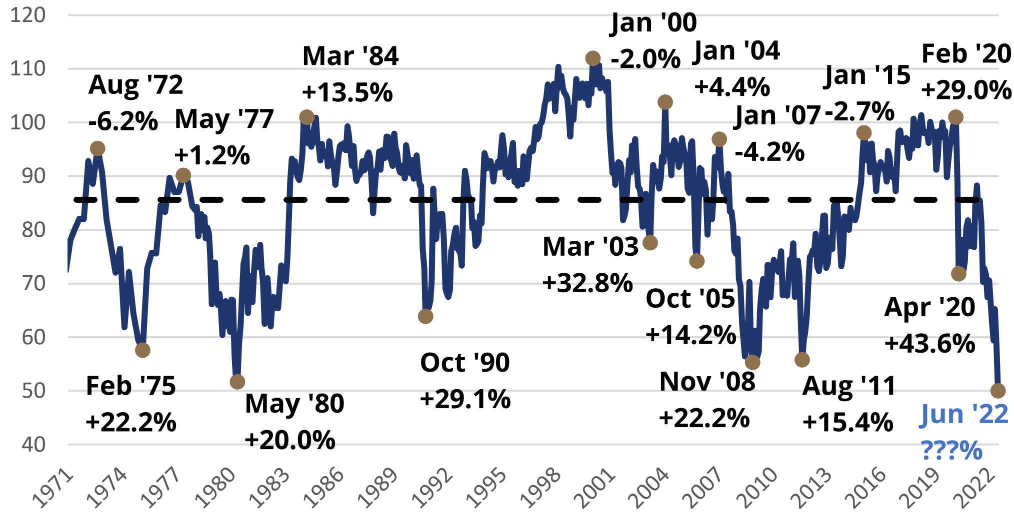


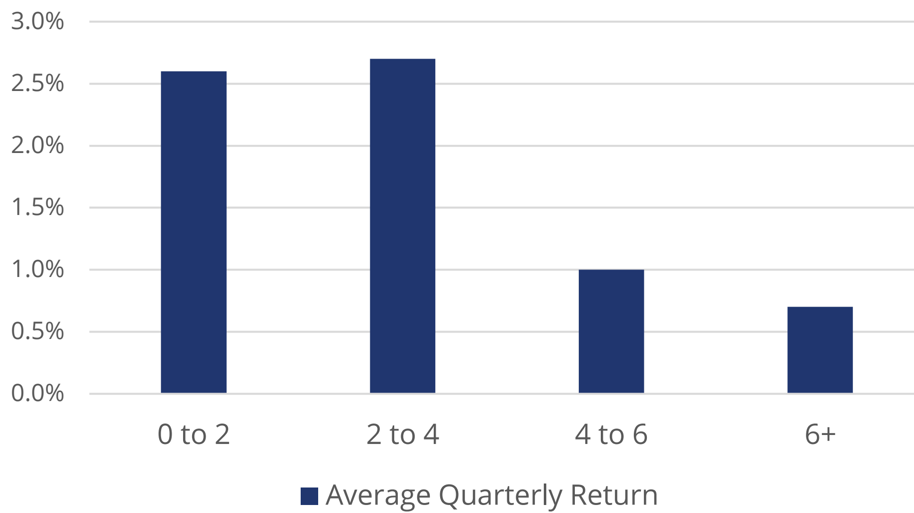
Source: Bloomberg, Fidelity Investments

The current economic and market environments have driven consumer sentiment to its lowest level on record. Although this may appear to be a negative data point, history suggests that the average consumer is a poor predictors of future stock market returns. The below chart shows the University of Michigan Index of Consumer Sentiment with several peaks and troughs labeled. It also highlights the return of the S&P 500 in the 12 months following the peaks and troughs. On average, buying at a confidence peak yielded a return of 4.1% while buying at a trough returned 24.9%.



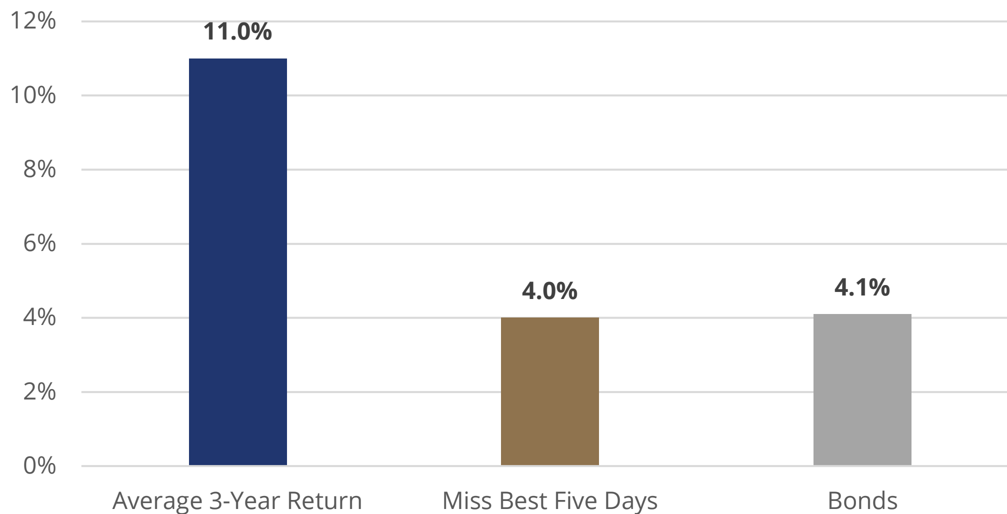
Source: Ycharts

What could be the catalyst for positive future equity returns? The most likely scenario is inflation moderating and the Fed taking a more dovish stance. Lower interest rates would be more supportive of stocks and calm investor fears. 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

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

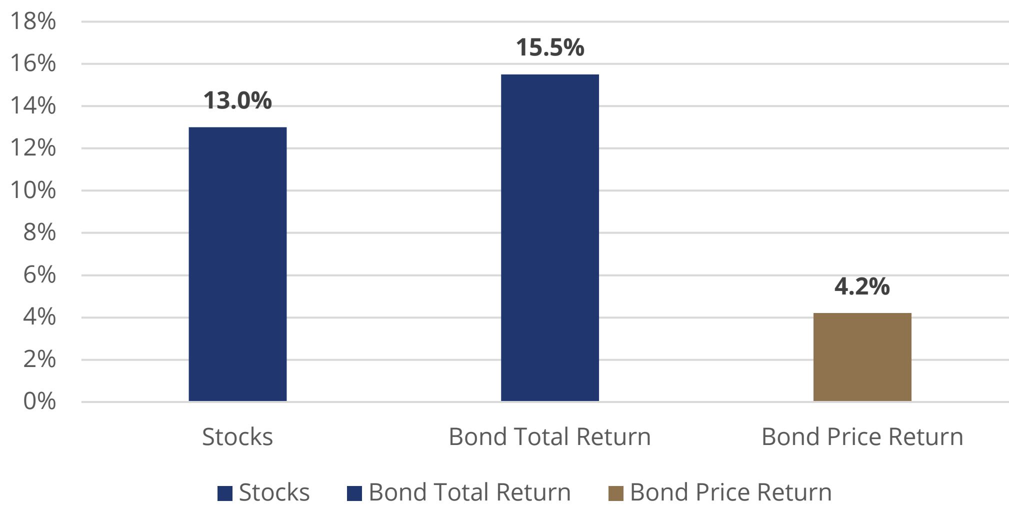
Fixed Income

High inflation, falling unemployment, and the Fed's hawkish stance led to one of the worst 12 months of bond performance in market history. This is the worst start since the early 1980's when the Fed raised rates as high as 20% (compared to the target rate of 1.75% today).

	Bond Price Return	Stocks 1 Year Later	Bond Total Return 1 Year Later	Bond Price Return 1 Year Later		Bond Price Return	Stocks 1 Year Later	Bond Total Return 1 Year Later	Bond Price Return 1 Year Later
Mar '80	-17.3%	40.1%	13.1%	1.6%	**Oct '94**	-10.0%	26.4%	15.7%	7.6%
Feb '81	-16.4%	21.6%	10.5%	-0.5%	**Nov '80**	-9.6%	-5.4%	13.4%	50.0%
Jul '81	-15.3%	-13.3%	20.5%	6.1%	**Nov '94**	-9.6%	37.0%	17.6%	9.6%
Jun '81	-15.2%	-11.5%	13.4%	-30.0%	**Dec '94**	-9.5%	37.6%	18.5%	10.4%
Aug '81	-14.2%	3.2%	29.9%	14.3%	**Jun '84**	-9.5%	31.0%	29.9%	16.0%
Sep '81	-13.5%	9.9%	35.2%	19.2%	**Sep '94**	-9.5%	29.8%	14.1%	6.1%
May '81	-13.2%	-10.7%	14.9%	1.2%	**Oct '79**	-9.4%	32.1%	3.4%	-6.7%
Apr '81	-12.1%	-7.4%	17.1%	3.2%	**Sep '69**	-9.2%	-6.2%	11.1%	3.1%
Jan '80	-11.3%	19.5%	6.0%	-4.6%	**Jan '95**	-9.1%	38.7%	17.0%	9.1%
Sep '80	-11.2%	-2.7%	-2.6%	-13.5%	**Apr '84**	-8.7%	17.7%	19.9%	6.7%
Aug '80	-11.1%	5.4%	-3.6%	-14.2%	**Sep '87**	-8.2%	-12.4%	13.3%	3.5%
May '84	-10.5%	31.7%	30.2%	16.1%	**Jan '00**	-8.1%	-0.9%	13.8%	6.2%
Jun '22	-10.26%	?	?	?	***Avg***	*-11.3%*	*13.0%*	*13.9%*	*4.2%*

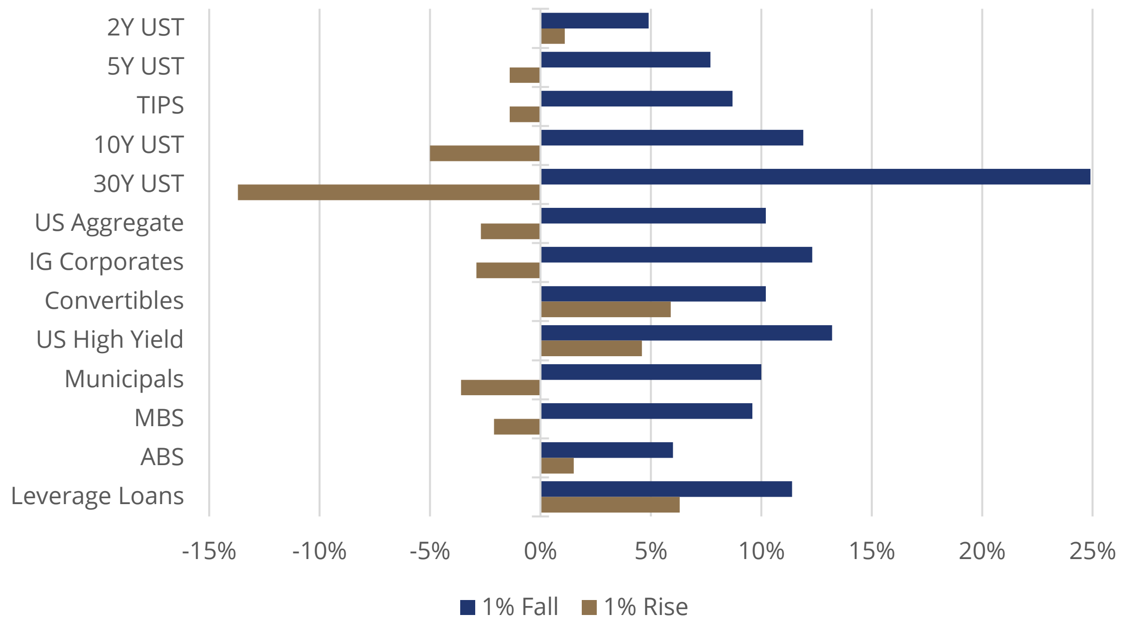
Source: Morningstar

However, both bond and stock returns have historically been positive after these down periods for bonds. On average, bonds have returned 15.5% and stocks 13.0%. Given that bonds do not have double digit yields like they did in the 80s, we can also look at the price return of bonds (excluding interest payments) and see that on average they have returned 4.2% after a large drawdown.



Source: Morningstar

The rise in interest rates has led to potential opportunities in bonds not seen in years. Historic drawdown levels combined with higher yields provide an appealing starting point for fixed income. If inflation stabilizes and the Fed moves away from raising the federal funds rate, interest rates could fall which would be positive for bond total returns.



Source: JP Morgan Asset Management

The yield curve very briefly inverted at the end of the first quarter and the start of July (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.

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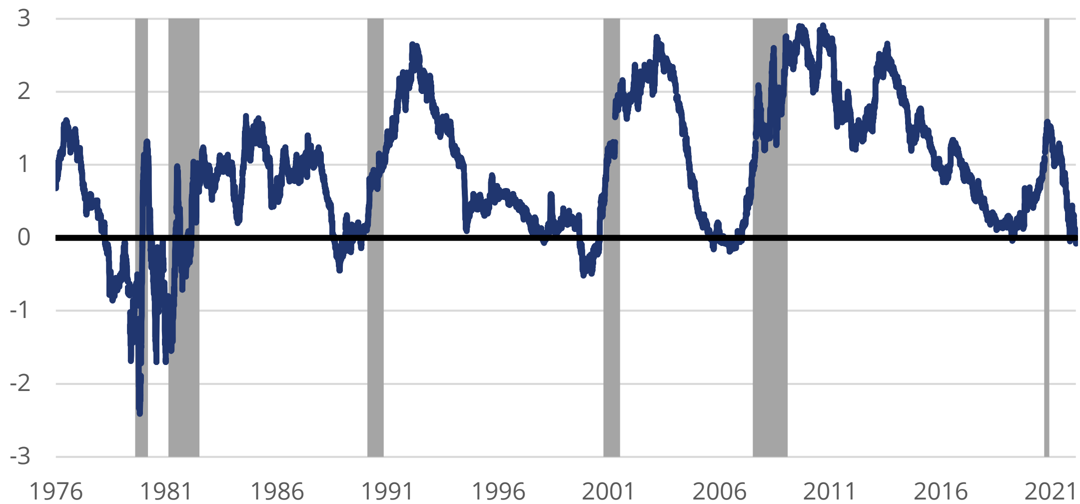
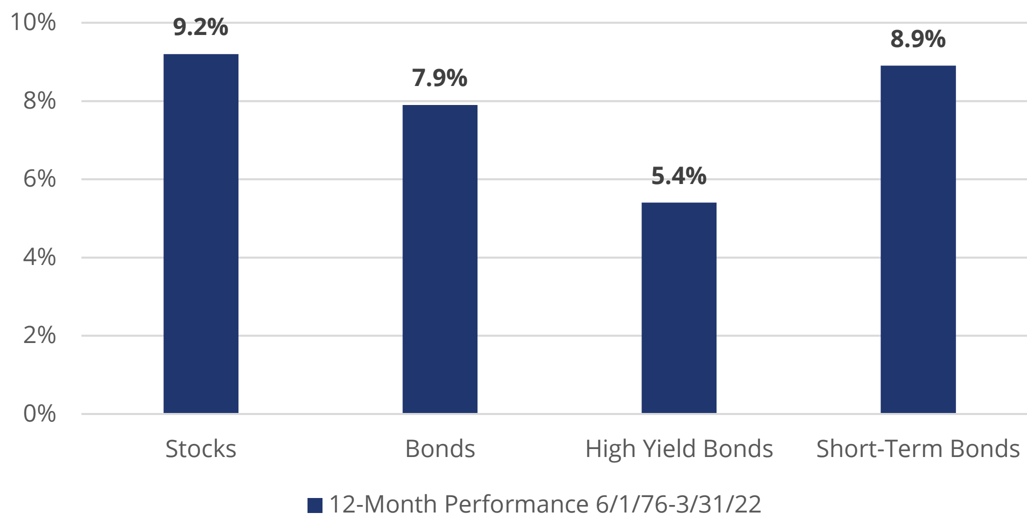


Source: Federal Reserve Bank of St. Louis

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	8.9%	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

The first half of the year has featured an increase in volatility and negative returns for most asset classes. There are many economic data points that would otherwise point to a strong economy, but rising inflation and interest rates have led to the possibility of a recession. If there is no recession, then many asset classes are likely undervalued and have good forward return potential. If there is a recession, it will hopefully be short-lived as the average US consumer is well prepared and there are many positives for the future of the economy. 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.

During times of increased volatility and economic uncertainty, it can be helpful to review finances and investment options.

1. Consider rebalancing investment accounts to take advantage of downturns (Academy Financial already does this for many client portfolios).
2. Review your contributions to retirement and other investment accounts. There may be opportunities to buy into a down market.
3. Assess your risk tolerance and talk to your advisor to see if there are investment products you should consider to reduce downside risk.

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

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[1]JP Morgan Global Research
[2]JP Morgan Global Research
[3]FOMC Summary of Economic Projections