Capital Markets Outlook
4Q 2022

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Summary

Outlook

- Inflation remains the primary issue – it is showing few signs of near-term moderations which is causing central banks to aggressively hike interest rates.
- The Fed appears to be steadfast in its plan to keep interest rates above neutral for a significant period of time. At this point, policy has been focused on combatting inflation without concern for economic growth.
- A sustained economic slowdown is likely, whether or not it is labeled a recession. However, the economy is in good shape in several ways – unemployment is low, household finances are strong, and corporate balance sheets are not over leveraged.
- Attractive valuations in both equities and fixed income present good investing opportunities and potential for strong forward returns.

Key Risks

- Economic growth could be slower than expected if inflation does not come down enough for central banks to stop raising rates.
- Geopolitics have kept commodity prices elevated. Should the war in Ukraine intensify, commodity prices could push inflation higher even as monetary policy tightens.

Third Quarter Review

The third quarter had the same themes as the second quarter, which will probably continue through the fourth quarter as well. This is the year of the Fed vs. inflation and the third quarter presented more evidence that central bankers intend to continue tightening aggressively to fight rising prices. As of now, the Fed appears to be solely focused on inflation without considering economic growth. At the Jackson Hole symposium in August, Federal Reserve Chair Jerome Powell outlined that strategy:

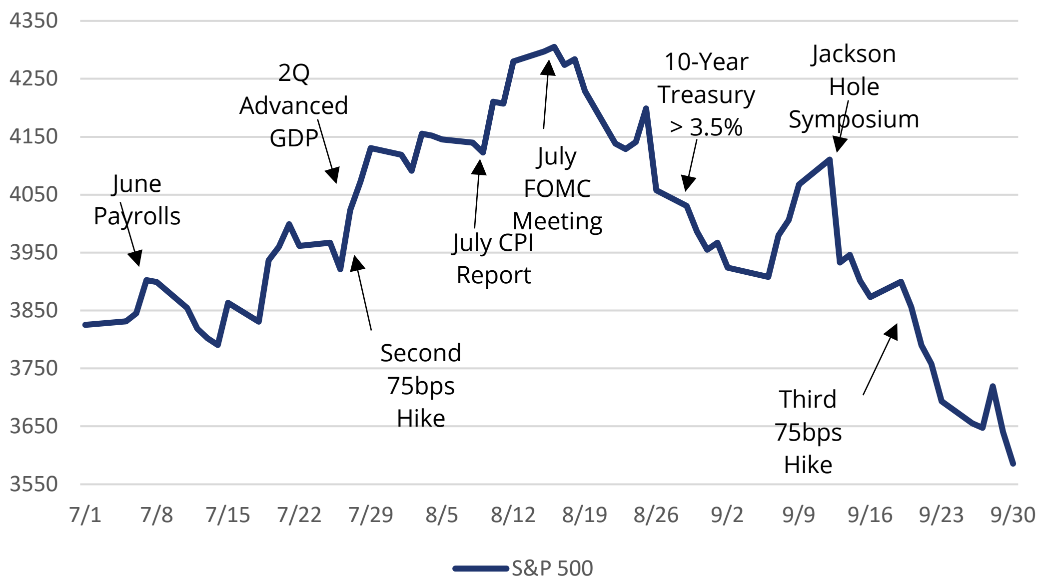
"Reducing inflation is likely to require a sustained period of below-trend growth. Moreover, there will very likely be some softening of labor market conditions. While higher interest rates, slower growth, and softer labor market conditions will bring down inflation, they will also bring some pain to households and businesses. These are the unfortunate costs of reducing inflation. But a failure to restore price stability would mean far greater pain."

The Fed's determined strategy along with persistent inflation numbers continued market volatility. However, the downturn towards the end of September made the quarter feel worse than it was.

	September	Q3	YTD
Large Cap	-9%	-5%	-24%
Mid Cap	-9%	-2%	-22%
Small Cap	-10%	-5%	-23%
International	-9%	-10%	-27%
Emerging Markets	-12%	-13%	-28%
1-3 Year Treasuries	-1%	-2%	-5%
7-10 Year Treasuries	-5%	-6%	-16%
20+ Year Treasuries	-8%	-10%	-30%
Aggregate Bond	-4%	-5%	-14%
TIPS	-7%	-5%	-14%

Source: YCharts

Stocks rallied through mid-August on optimism that inflation had peaked and would start to meaningfully change directions. In August and September the Fed made clear that it would continue to aggressively tighten monetary policy, possibly at the expense of the labor market and economic growth.



Source: YCharts

Although the third quarter along with the rest of the year has been volatile and investment returns have been negative in almost every asset class, the drawdown in stocks has been relatively mild. Through September 30, this bear market was the fourth smallest in terms of price decline.

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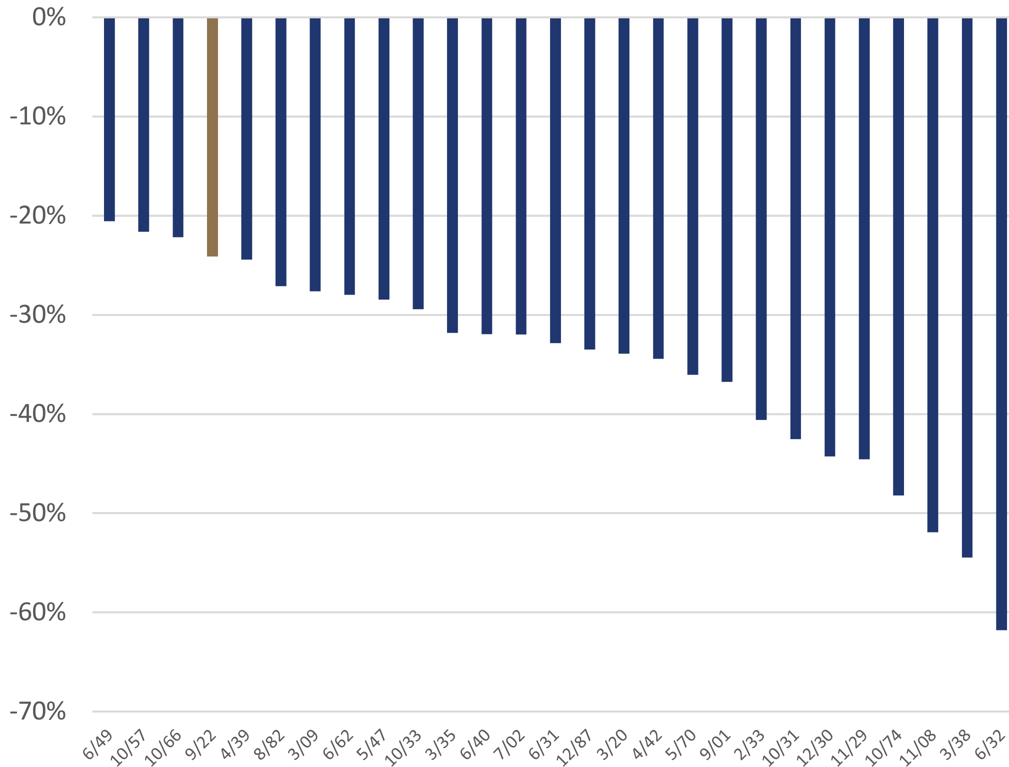
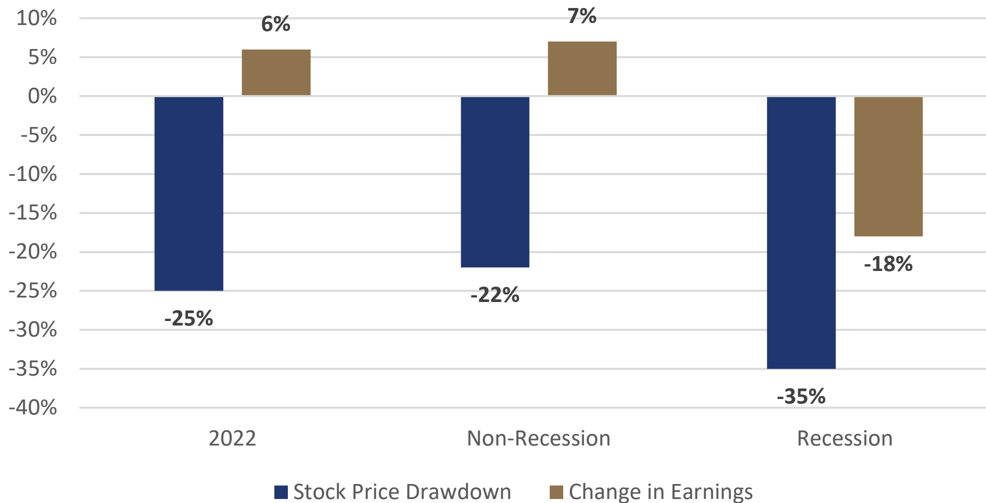


Source: Bespoke Investment Group

In fact, 2022 stock prices and earnings have more closely resembled historical non-recession bear markets. Most bear markets coincide with recessionary contractions in the economy and corporate profits. Sometimes bear markets occur without recession, which typically accompanies positive earnings growth and shallower stock declines.



Source: NBER, YCharts

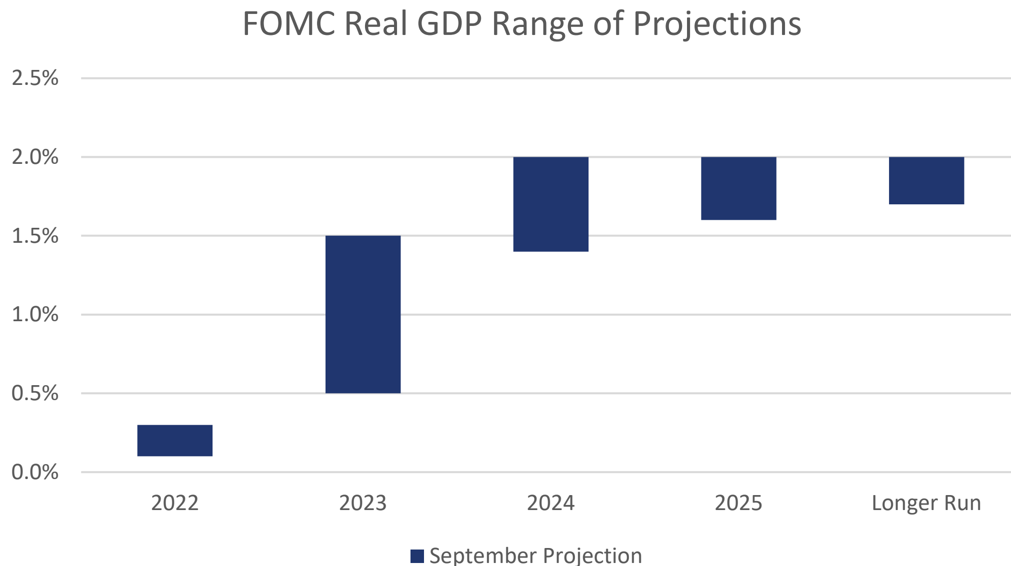
Economic Outlook

The Fed is projecting that rates will stay above neutral until at least 2025. The below chart shows where each member of the Federal Open Market Committee (FOMC) believes the Federal Funds Rate will be in upcoming years.

	2022	2023	2024	2025	Longer Run
5.25	—	—	—	—	—
5.00	—	••••••	—	—	—
4.75	•	••••••	••	•	—
4.50	•••••••••	••••••	••	—	—
4.25	••••••••	—	••	—	—
4.00	•	•	••••	—	—
3.75	—	—	•••	••	—
3.50	—	—	•••	••	—
3.25	—	—	•	••••	—
3.00	—	—	•	•••	••
2.75	—	—	•	•••	•
2.50	—	—	—	••••	••••••••••
2.25	—	—	—	—	••••••
2.00	—	—	—	—	—

Source: Bloomberg, US Federal Reserve

The Fed is intentionally slowing growth and wants unemployment to rise because the committee believes that is the best way to combat inflation. Central banks do not have any control over the supply side of the economy – they cannot unclog supply chains, make natural gas flow, or produce more oil. Instead, they raise rates in an effort to cool demand. As such, the FOMC projections of GDP growth do not go above 2% for the foreseeable future.

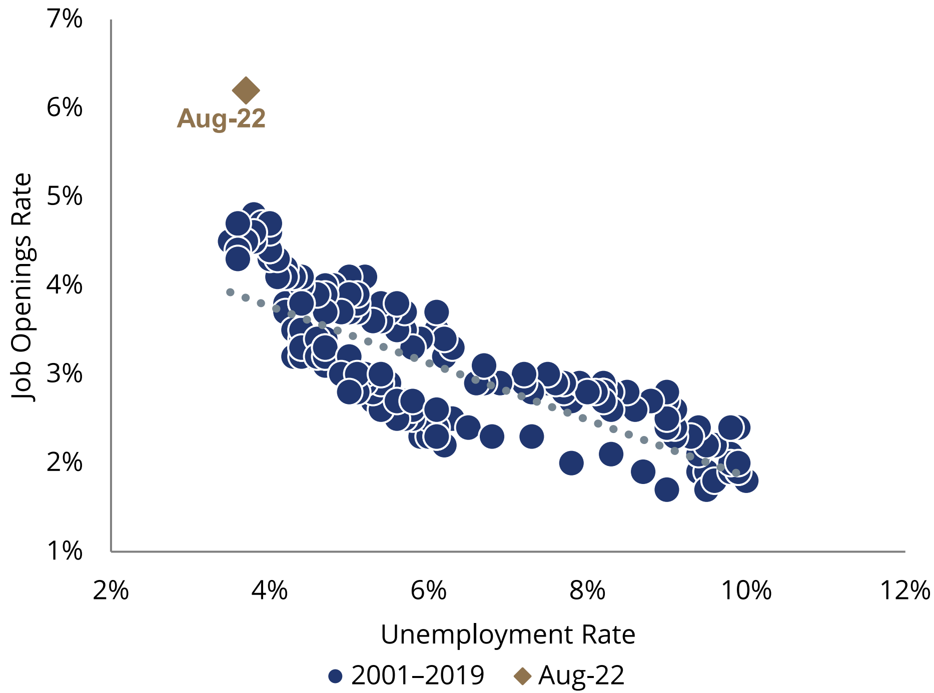


Source: Federal Open Market Committee

There are already some signs that demand is slowing – retail sales growth has cooled, manufacturing surveys have started to slow, and the housing markets has had significant decline. The full effect of changing monetary policy tends to lag several quarters. For example, in the last cycle there was a 16-month lag between the peak in housing prices and the peak in inflation. The first rate hike this cycle was in March so it is not surprising that we are just now seeing signs of slowing growth.

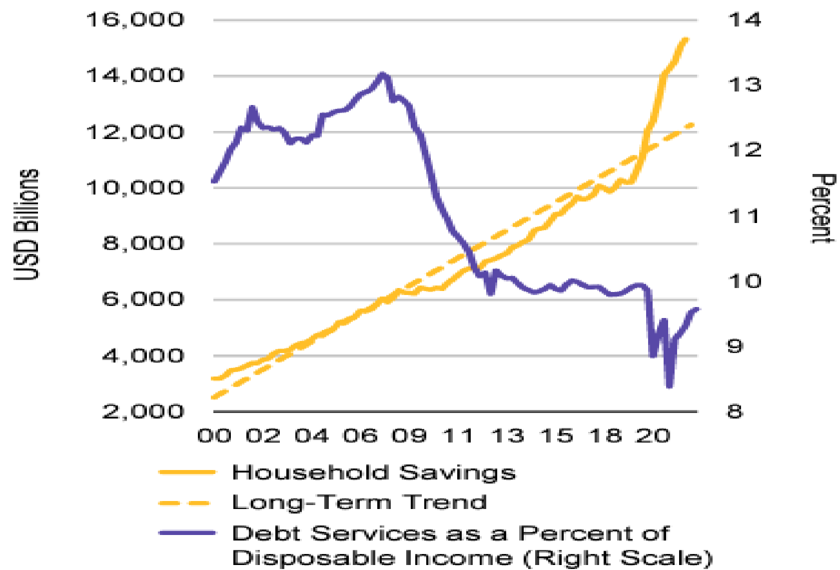
The good news is that if the US economy were to enter a recession, it would likely be shallow in comparison to other recent recessions. The labor market is very strong, with job openings near record levels and the 3.7% unemployment rate near multi-decade lows.

US Unemployment and Job Openings



Source: Bureau of Labor Statistics

Household finances are strong – personal savings remain high and consumers are not overleveraged.



Source: AllianceBernstein

Despite rising costs, corporate profits have stayed positive, with market expectations for 2022 earnings growth remaining around 10%. Estimates for 2023 profit growth have been revised lower this year, but they remain higher than recessionary averages which are negative.

Source: Fidelity Investments

Asset Class Update

Equities

The first nine months of 2022 were the 4th worst start for stocks in market history. On average, the 12 months following a bad start for stocks has been a positive 10%.

Year	First 9 Months	Next 12 Months
1931	-34.3%	-9.6%
1974	-32.8%	38.1%
2002	-28.2%	24.4%
2022	-23.9%	?
2001	-20.4%	-20.5%
1962	-19.4%	31.7%
2008	-19.3%	-6.9%
1937	-17.3%	-5.5%
1966	-15.1%	30.6%
1946	-11.3%	6.5%
Average	*-22.2%*	*9.9%*

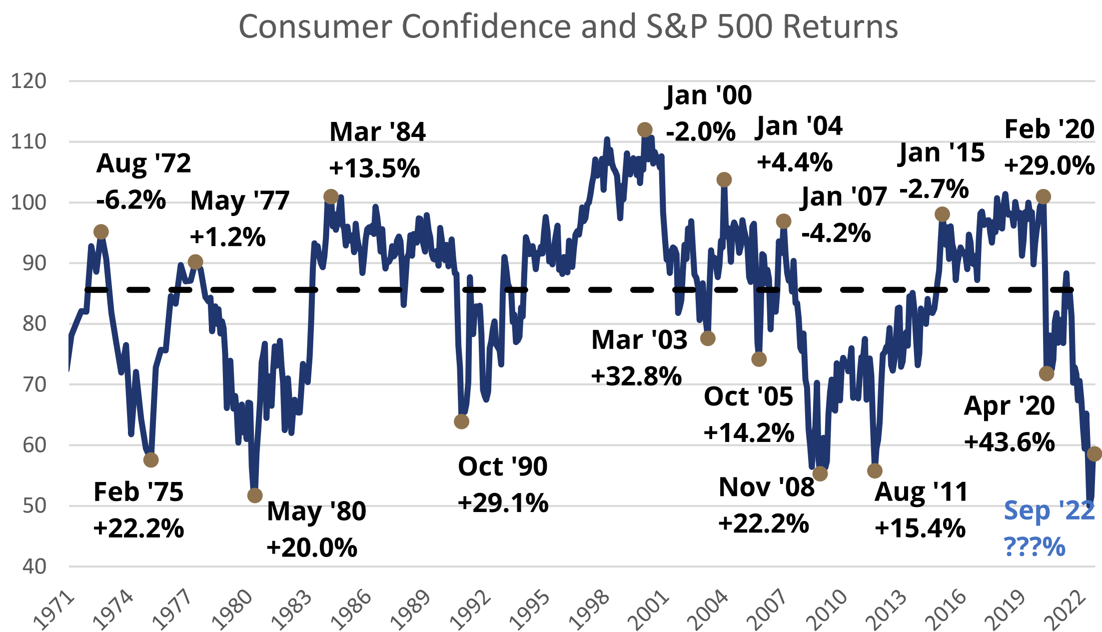
Source: Morningstar

Persistent inflation, slowing economic growth, and greater monetary policy uncertainty raise the odds that market volatility will remain elevated. However, the broad equity sell-off caused valuations to fall further and now look relatively attractive. Current P/E and Forward P/Es show stocks are priced cheap compared to long-term averages.

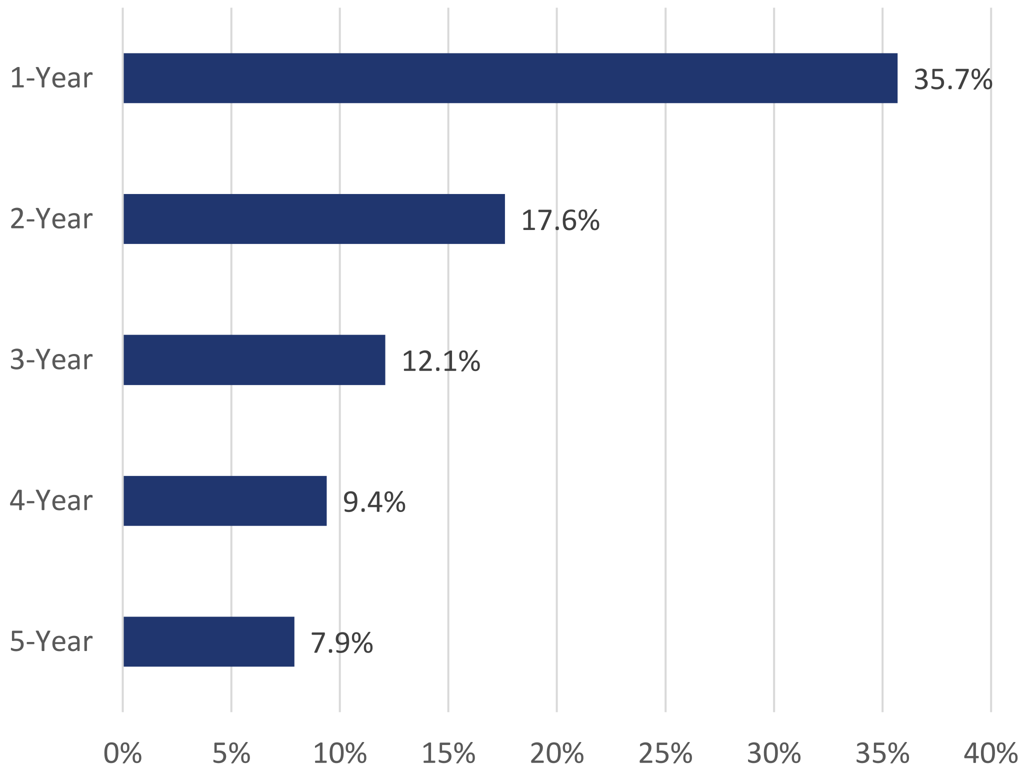
Time Period	P/E	Forward P/E	Forward P/E 2023	Forward P/E 2024
12/31/2021	24.6	21.4	21	19.2
3/31/2022	22.8	19.4	18.3	16.7
9/30/2022	17.6	15.2	14.8	13.6
5-Year Average	22.4	18.6	17.5	15.8
10-Year Average	20.9	17.7	16.7	15.0
Pre-Pandemic	21.5	18.8	17.3	15.5

Source: Bloomberg, S&P

The current economic and market environments have driven consumer sentiment to historically low levels. 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%.



Forward looking returns should be attractive, even if new highs are not seen in the short-term. Assuming that the stock market eventually returns to the all-time high set in January, annualized returns could be double digits over the next several years.



Source: YCharts

Fixed Income

Bonds have had by far the worst start to the year in market history. The almost 15% decline is unlike anything the bond market has seen in the past. However, much like stocks, the forward returns after a market drop have been strong with an average of 9%.

Year	First 9 Months	Next 12 Months
2022	-14.6%	?
1981	-3.9%	35.2%
1994	-3.2%	14.1%
1987	-2.9%	13.3%
1958	-2.0%	-0.3%
2013	-1.9%	4.0%
2018	-1.6%	10.3%

1969	-1.6%	-14.6%
1959	-1.0%	11.0%
Average	*-3.4%*	*9.3%*

Source: Morningstar

Returns have been negative across the board, primarily due to the quickest rate-hike sequence since the 1970s.

US Treasuries	Yield (12/31/21)	Yield (9/30/22)	YTD Return
TIPS	1.68%	-1.04%	-13.61%
2-Year	4.28%	0.73%	-4.59%
5-Year	4.09%	1.26%	-10.79%
10-Year	3.83%	1.52%	-16.85%
30-Year	3.78%	1.90%	-31.49%
Sector	**YTW (12/31/21)**	**YTW (9/30/22)**	**YTD Return**
US Aggregate	4.75%	1.75%	-14.61%
Investment Grade Corporate	5.69%	2.33%	-18.72%
High Yield	9.68%	4.21%	-14.74%
Municipals	4.04%	1.11%	-12.13%
MBS	4.83%	1.98%	-13.66%
Leverage Loans	10.52%	4.60%	-2.66%

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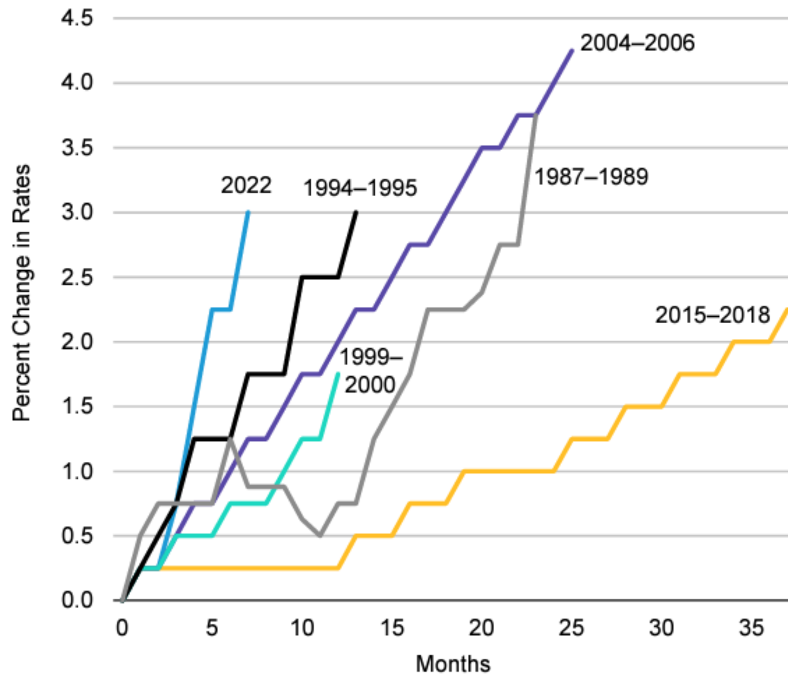
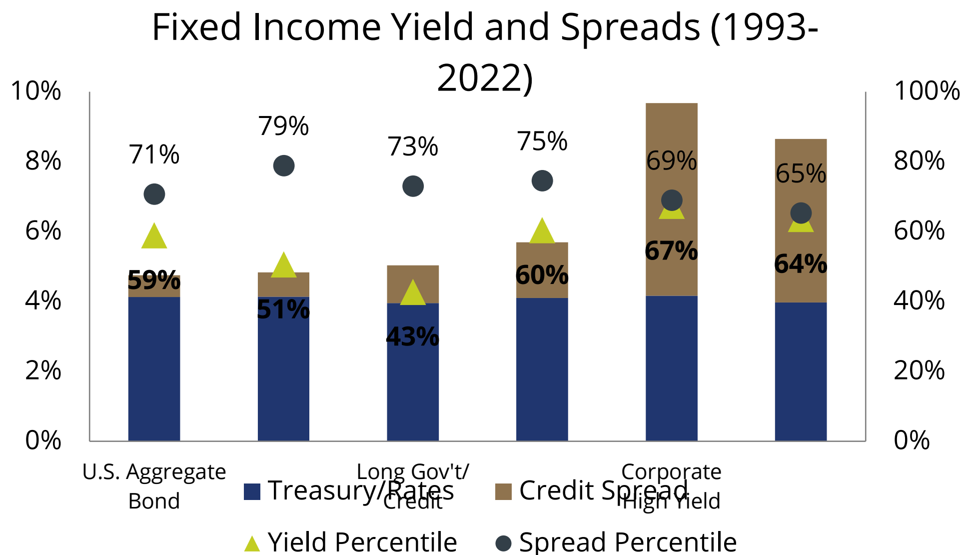
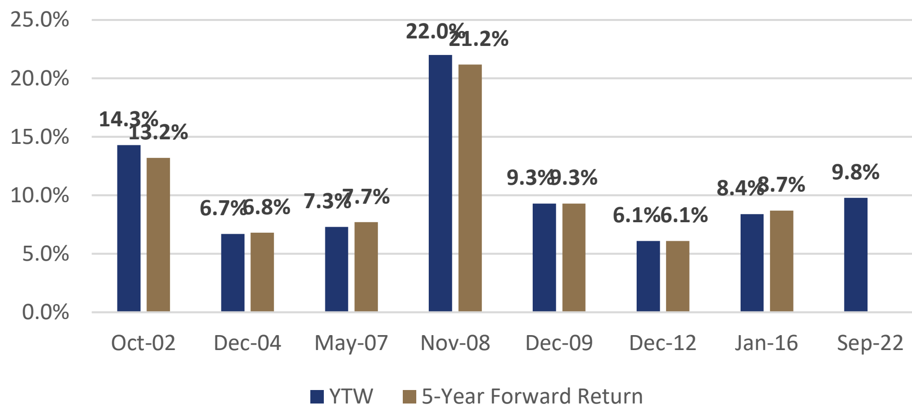


Source: AllianceBernstein

Although the volatility has been painful, it does present the most attractive investment environment for fixed income in decades. Credit spreads in all major bond categories are now above their historical averages. After years of extremely low bond yields, fixed income assets now offer relatively better income with more attractive valuations.



Long-term bond returns are driven more by starting yield than interest rate moves. For example, 5-year high yield bond returns very closely match the starting yield-to-worst.



Source: Bloomberg

Conclusion

The Fed's aggressive approach to fighting inflation has led to significant market volatility and widespread negative returns. Rising interest rates and slowing economic growth naturally lead to fears or economic recession. However, the labor market, household finances, and corporate finances remain strong which would point to slowing economic growth without a recession or a very shallow recession.

It is important to remember that although investing can be volatile over shorter periods of time, over longer time horizons return ranges condense. For example, 60/40 portfolio has never lost money over a 10-year time frame.

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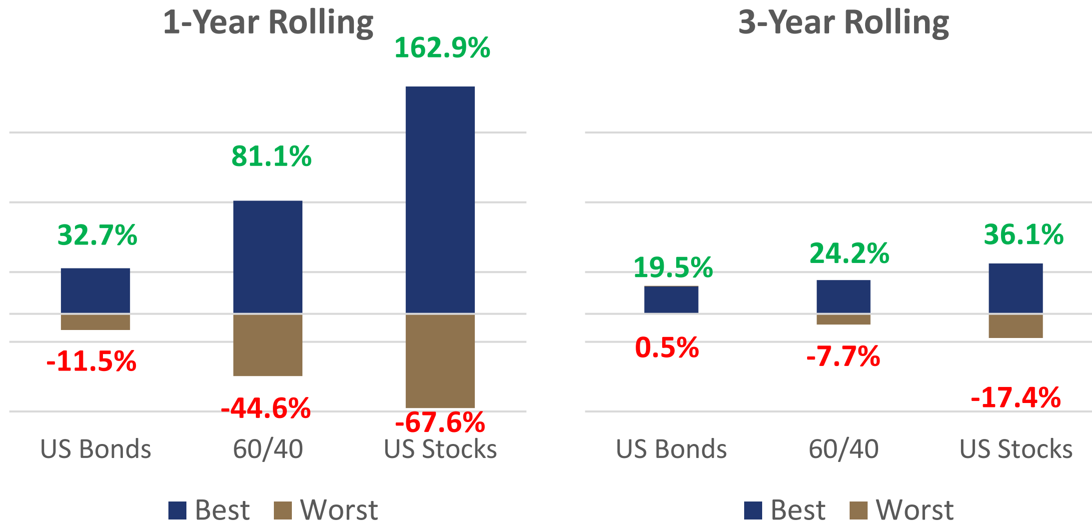
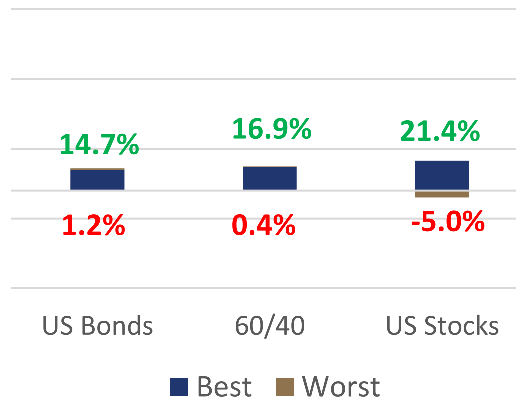


10-Year Rolling



Source: Morningstar

This market presents its own unique investing opportunities. Valuations have come down in equities and corporate profits remain positive, starting yields in bonds are the best in years, and the drawdown in most asset classes presents opportunities for tax loss harvesting in taxable accounts.

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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