Capital Markets Outlook
4Q 2021

Blake Gaulden, CFA, CFP®
Chief Investment Officer

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

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

Vienna Office
8219 Leesburg Pike
Vienna, VA 22182
301.296.6278

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

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

Summary

Outlook

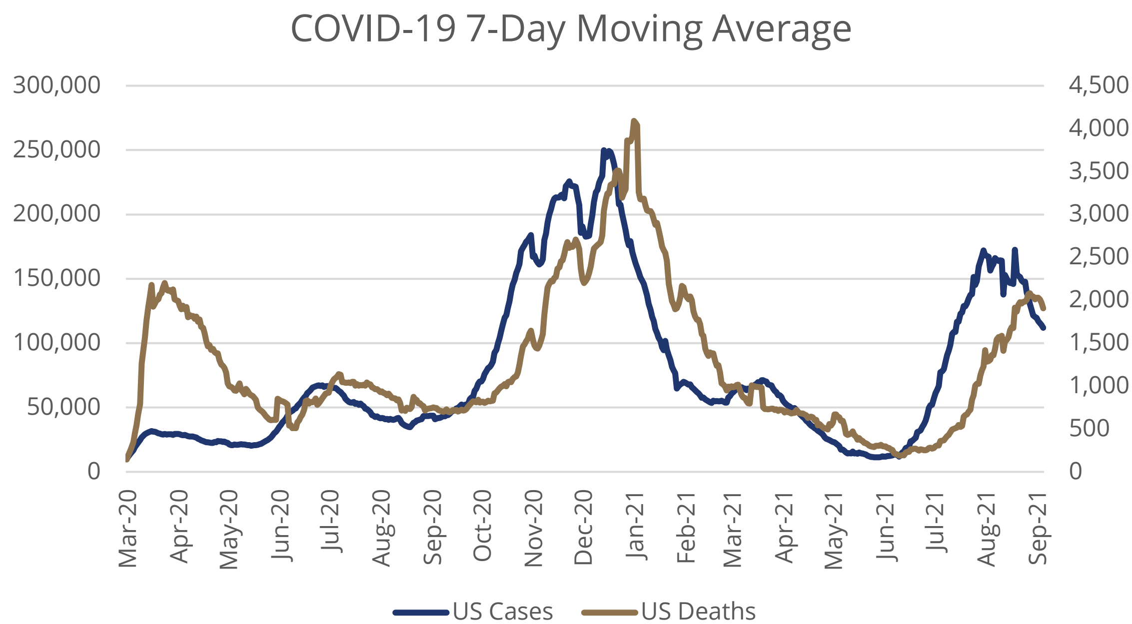
- The widespread economic optimism from earlier this year has moderated. However, there are still many positive economic signs.
- The economic recovery is broadening to other regions of the world, which creates additional investment opportunities.
- Central banks are reducing accommodation in many cases, but financial conditions remain extremely easy. Interest rates remain at historical lows which is supportive of risky assets such as stocks.
- There has been a meaningful increase in inflation for the first time in years. Increases in prices are likely to slow down in 2022.
- The US Federal Reserve will remain a key player in market outlooks. As of now, a rate hike is not expected until the end of 2022.

Risks

- COVID-19 variants slow down economic recovery.
- Inflation forces central banks to tighten policy as growth slows.
- Supply chain disruptions could be more pervasive than originally expected.

Third Quarter Review

Entering the fall of 2021, the American economy is continuing to rebound from the pandemic recession. The recovery has hit some speed bumps recently, particularly with the Delta variant causing a resurgence in COVID-19 cases and deaths. There are now signs that the latest wave of the pandemic is subsiding. When combined with strong growth in the equity markets, pent-up consumer demand, and fiscal stimulus, the economy should be able to reaccelerate.



Source: YCharts

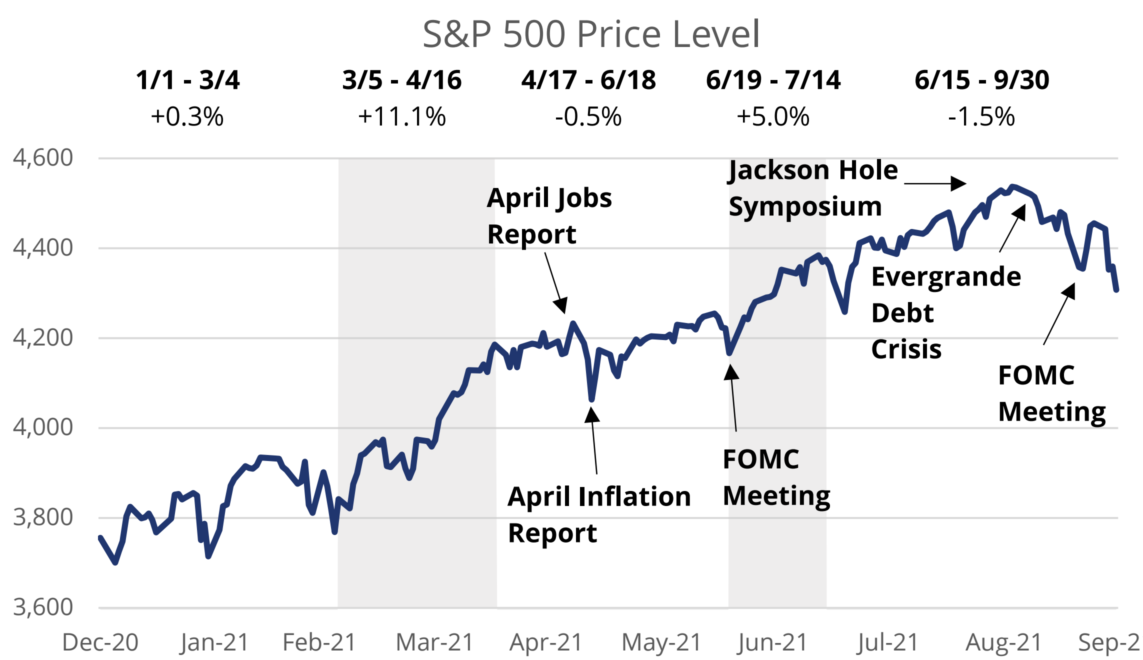
After a very optimistic summer, returns were challenging in most asset classes during the third quarter. When compared to the strong rebound following the lows of March 2020, the recent returns appear relatively muted. Global equities rose through most of the quarter but gave up their gains during a volatile September. Fixed income returns also struggled, with high yield bonds barely ending the quarter positive.

Asset Class	**3Q 2021**	**YTD (9/30/21)**	**March 24, 2020 - September 30, 2021**
US Large Cap	0.6%	15.9%	80.5%
US Small Cap	-4.3%	12.3%	104.8%
International	-3.7%	5.6%	60.9%
US Bonds	0.0%	-1.7%	4.1%
US High Yield	0.5%	3.3%	33.8%

ACADEMY FINANCIAL, INC.
EVALUATE • ENVISION • EXECUTE

Looking at the S&P 500 price movement gives some insight into how the market has responded to changing news and forecasts throughout the year.

- January and February returns were relatively flat.
- As vaccination rates picked up in March, investors became more confident in the recovery and stocks rose 11%.
- In April, the jobs report came in lower than expected and inflation numbers were high. This data led to some more volatility in markets.
- The FOMC meeting in June, combined with continued strong earnings, preceded another move higher.
- In the third quarter, more news including the Fed's Jackson Hole summit and the Chinese Evergrande debt crisis caused an increase in volatility and ultimately a negative return for the three-month period.



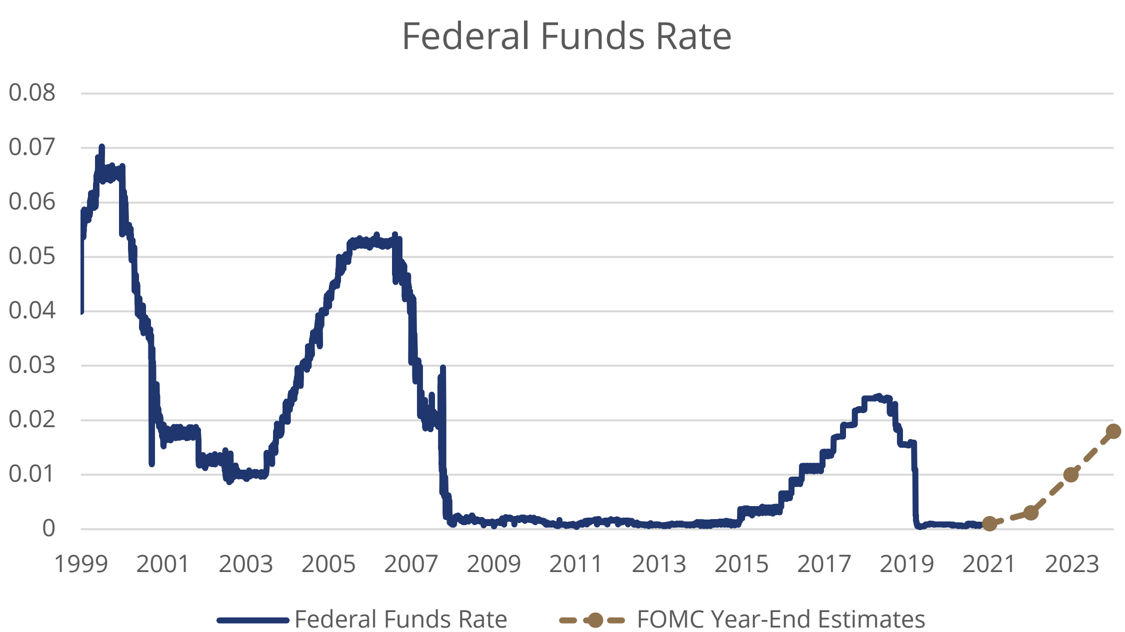
Source: YCharts

None of these events or data points are overly concerning, but they demonstrate that the recovery is unlikely to be a straight line up. We still expect strong global GDP growth this year and in 2022, but cautions remain. As market conditions continue to change, proper portfolio construction will be key.

Economic Update

Federal Reserve Policy

Since the beginning of the pandemic, the Fed has provided significant monetary support, including cutting the federal funds rate and making $120 billion in bond purchases each month. The decline in returns during September was due in part to unease regarding change to the monetary policy landscape. Central banks in South Korea, Hungary and Norway moved official rates up from historic lows and the European Central Bank is preparing to retire its Pandemic Emergency Purchase Programme. In the US, the Fed said it is likely to begin tapering asset purchases in November and signaled that rates may rise next year.



Source: Federal Reserve Bank of St. Louis

The rationale for a change in policy was laid out in the September FOMC meeting. Chairman Powell noted that the Delta variant has slowed economic progress, but that labor market metrics have been all but met and that inflation may be somewhat stickier than originally forecast. As a result, the Fed updated its economic projections to lower its 2021 growth estimate from 7% to 5.9% and increased its inflation estimates. The Fed remains optimistic and expects GDP growth, inflation, and employment to re-accelerate in 2022.

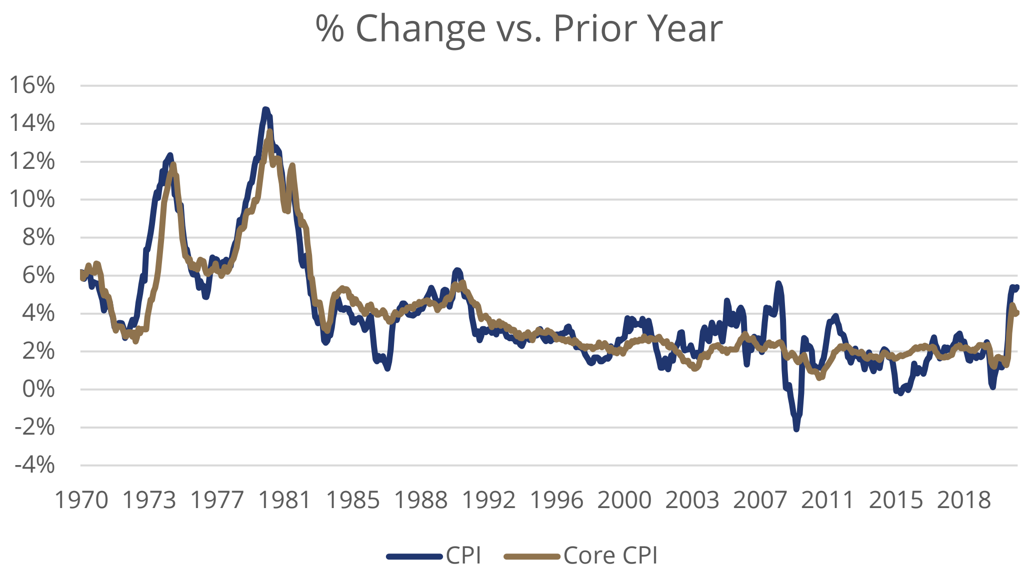
Federal Reserve Projections

	2021	2022	2023	2024
Real GDP	5.9%	3.8%	2.5%	2.0%
Unemployment Rate	4.8%	3.8%	3.5%	3.5%
Core PCE Inflation	3.7%	2.3%	2.2%	2.1%

Source: US Federal Reserve

Inflation

Inflation has been on the mind of many investors. Most measures of inflation are at multiyear highs, including the most recent CPI reading of 5.4%, which is at a level not seen in decades. Core inflation, which strips away some of the more volatile components, is up about 4.0% over the last year.



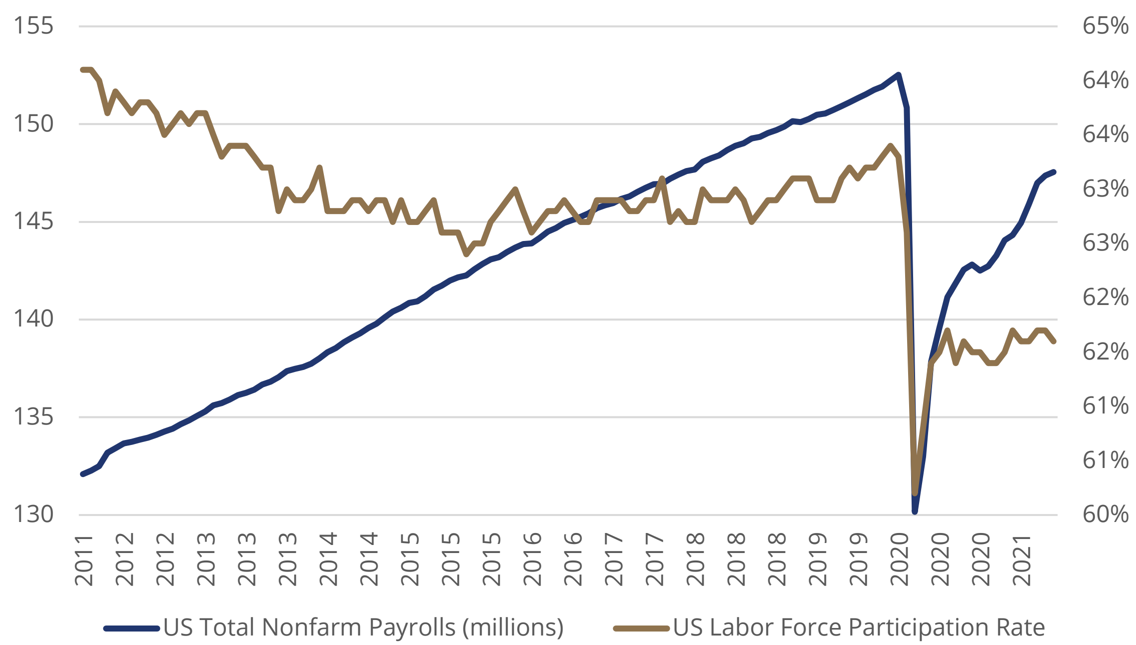
Source: YCharts

The increase in inflation has been more sustained than most analysts expected. Consumer demand has recovered with a boost from government programs. However, it has been difficult for the supply-side of the economy to reboot. There are supply chain bottle necks and shortages in commodities that have caused a mismatch between supply and demand.

A main driver of inflation has been goods pricing and the transportation costs associated with those goods. As supply chains are able to catch up to demand, inflation numbers should start cooling. Even so, there are less transitory numbers that are starting to show up in the data. Rent of primary residence jumped 0.5% in September and owners' equivalent rent rose by 0.4%. Further increases in the cost of housing could create a more durable tailwind to inflation. While it currently appears unlikely that the elevated numbers we see today persist, it is possible the long-term trend could be slightly higher than it has been in recent history.

Employment

The surge in economic growth has been mirrored by a rebound in the labor market. After losing over 22 million jobs in the spring of 2020, the economy has recovered roughly 17 million jobs. However, it is not clear what full employment will look like in the future. There are currently 5 million people not working due to COVID—19, whether it be due to unemployment benefits, higher costs of child care, or lingering pandemic fears. The Fed will have to consider how the labor market progresses from here. If the labor participation rate stays lower than pre-pandemic, wage inflation may be more persistent. If more workers come back to jobs, then inflation numbers may come down.

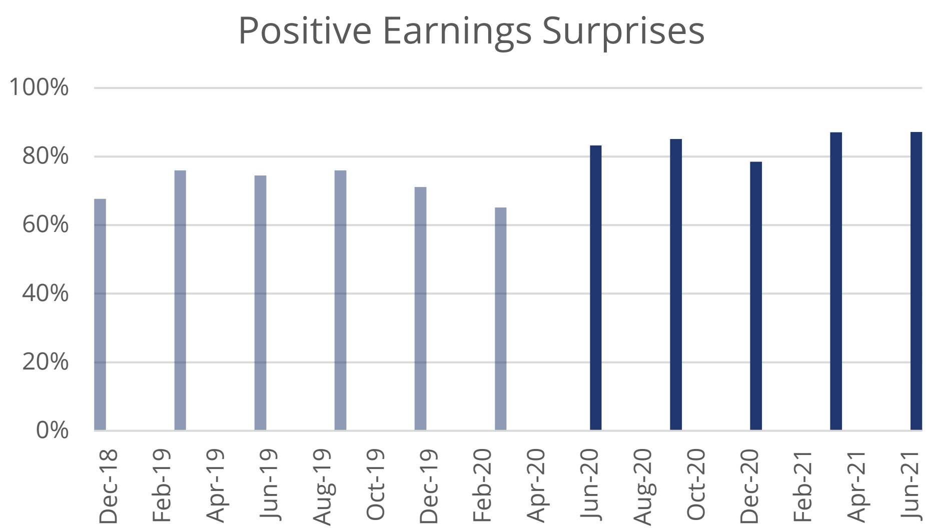


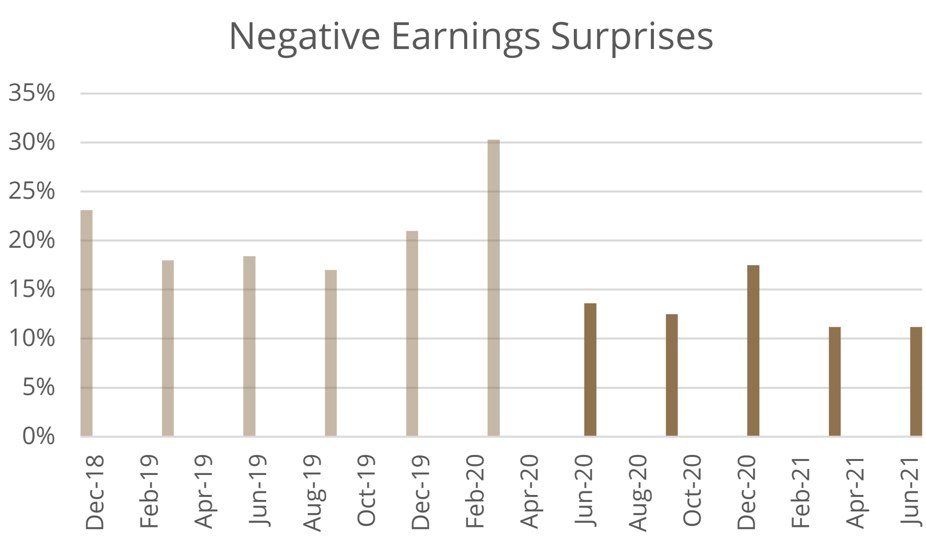
Source: YCharts

Asset Class Update

Equities

During the economic recession last year, corporate earnings in the S&P 500 had large declines. Earnings have recovered quickly since then, with both record positive earnings surprises and negative earnings surprises (an earnings surprise is when reported data beats analyst expectations).

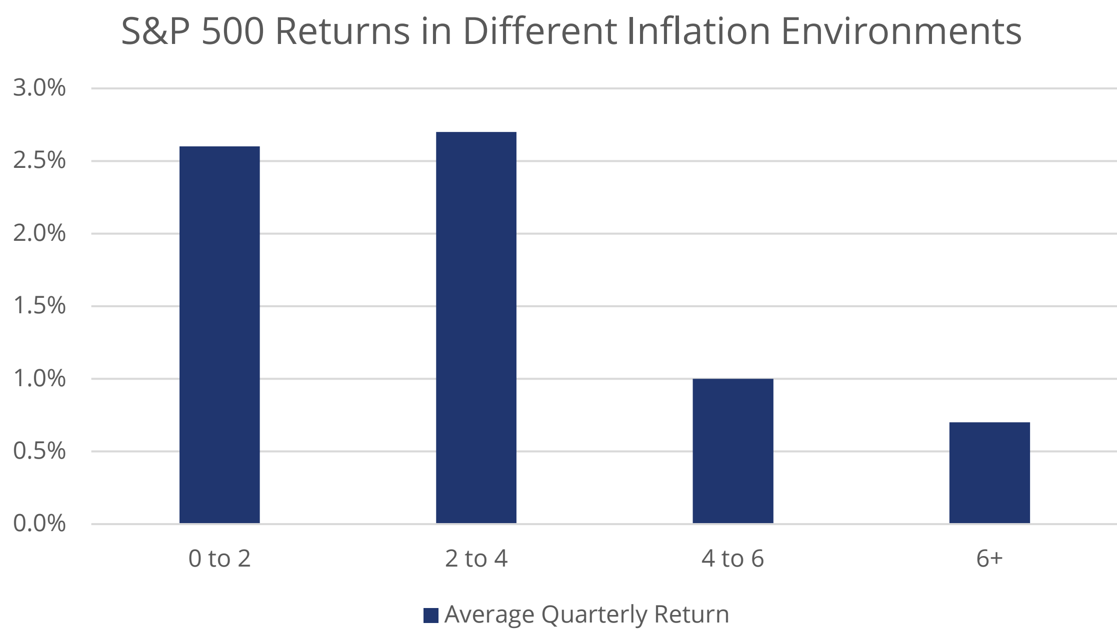




Source: AllianceBernstein

There are several components to the earnings recovery. Some sectors such as Technology, Communication Services, and Health Care did not suffer major impacts to earnings during the pandemic. The other major piece is the increase in consumer demand. Moving forward, many analysts expect earnings to grow at a slower pace due to a combination of elevated valuations, fewer growth tailwinds, and more headwinds from interest rates.

Although the growth trends in equities may be moderating, we still favor stocks over other asset classes for several reasons. Inflation is a concern, but equities have been resilient in many different inflationary environments.

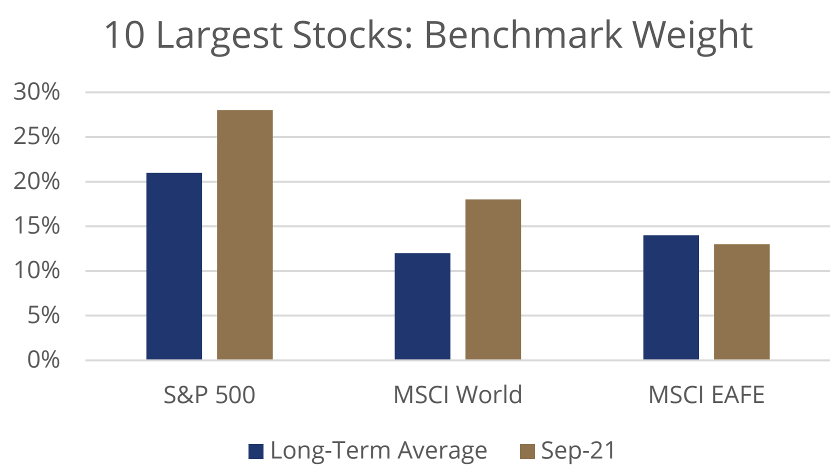


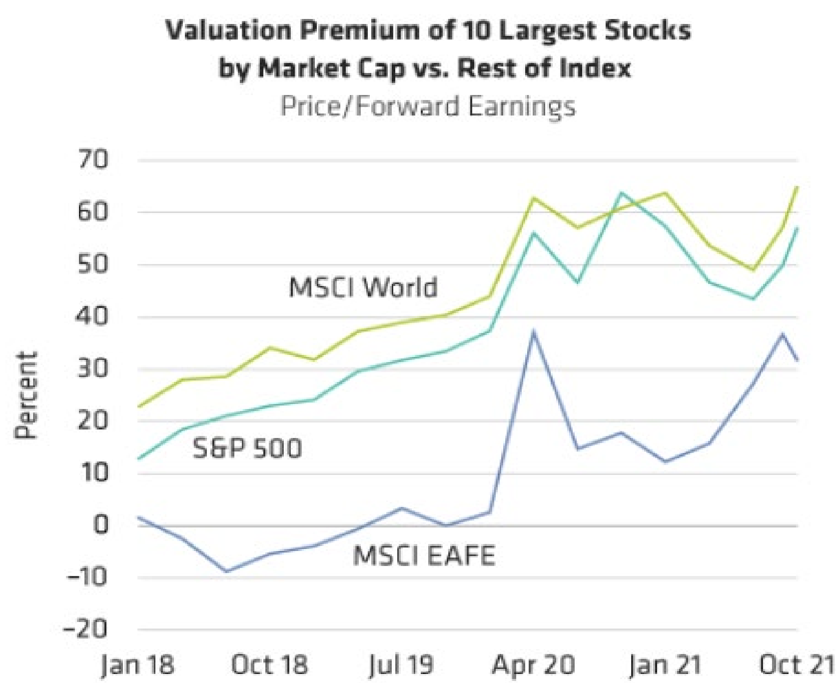
Valuation is another common concern. At the end of the quarter, stocks were selling at 20x forward earnings, well above the long-term average. In fact, many measures of valuation remain elevated.

Valuation Measure	Latest	25-Year Average
Forward P/E	20.31	16.78
Dividend Yield	1.47%	2.01%
Price to Book	4.09	3.07
Price to Cash Flow	15.28	11.05

Source: JPMorgan Asset Management

Continued earnings growth could bring valuation numbers down closer to long-term averages. Additionally, digging further into valuation numbers reveals an interesting trend. Index concentration is also above long-term averages. By the end of the quarter, the top 10 largest US companies made up 28% of the S&P 500 and were 57% more expensive than the rest of the S&P 500 companies. The same pattern can be seen in international markets too.

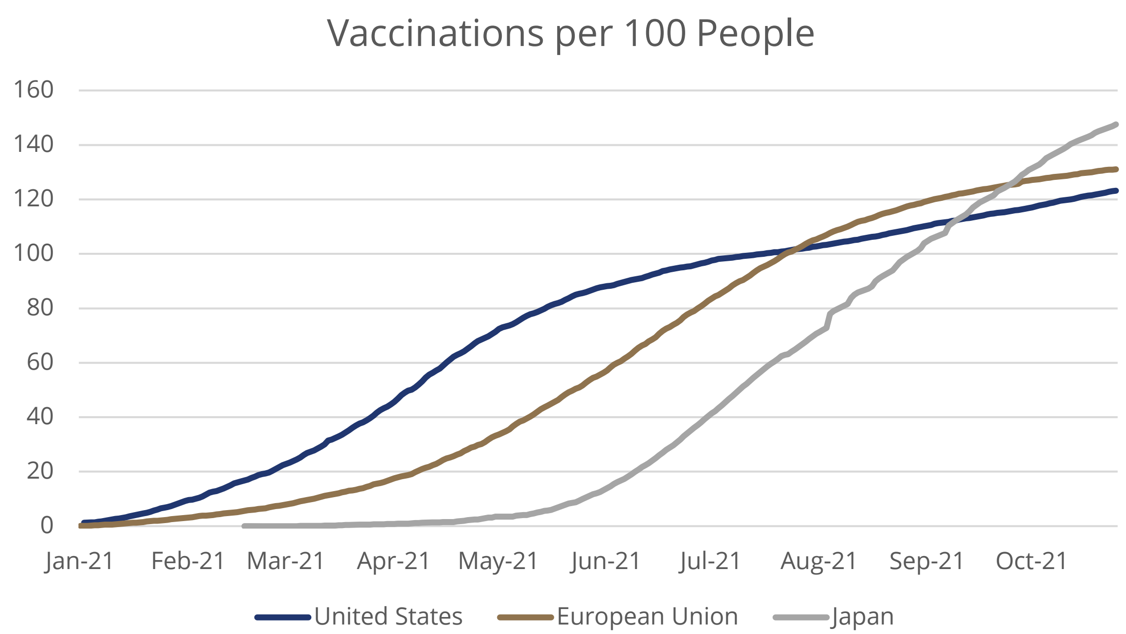




Source: AllianceBernstein

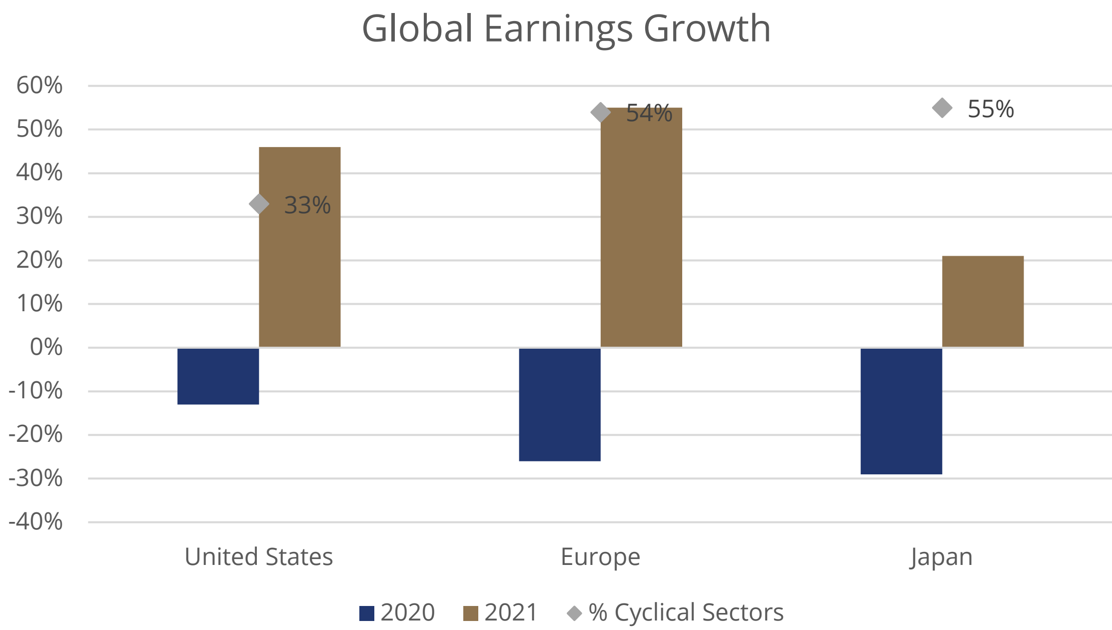
While mega-cap companies such as Apple and Amazon are often an important piece of a portfolio, the valuation and concentration data suggests that there could be investment opportunities outside of those top companies to invest at more attractive valuations and add diversification to portfolios.

International equities have also become more attractive as the recovery continues. While initially lagging the US, many countries are beginning to show signs of growth. Vaccine rollouts in Europe and Japan have accelerated and surpassed the United States.



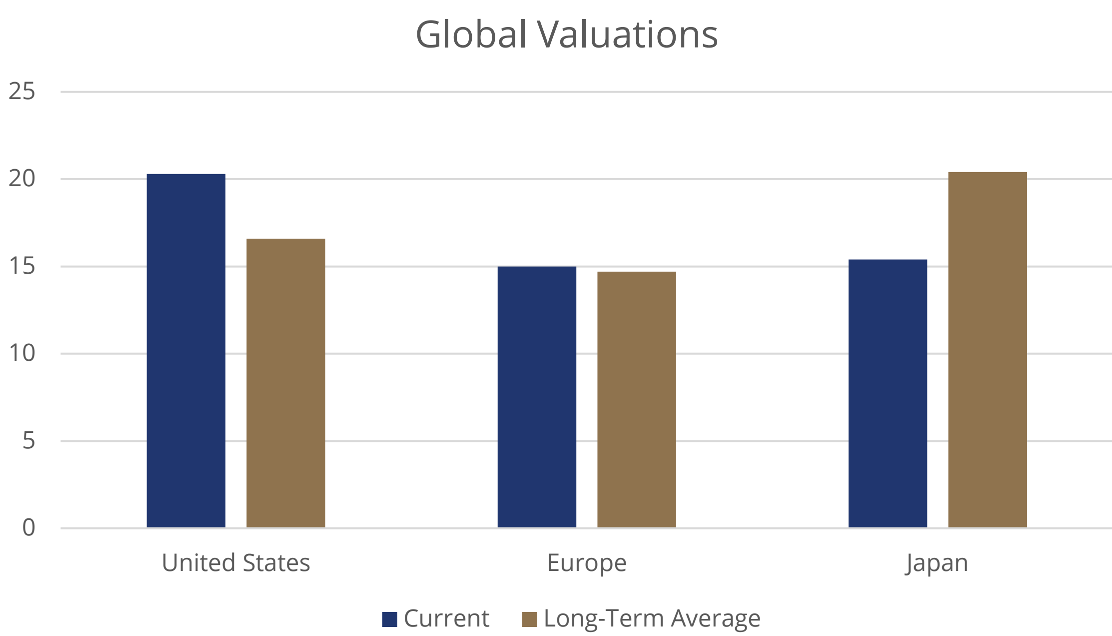
Source: Our World in Data

Much like in the United States, a broader recovery from the pandemic has allowed economies and corporate profits to resume growth. Stocks in Europe and Japan have had strong rebounds in earnings. Additionally, international equities have a larger percentage of cyclical sector companies, which have been more sensitive to the economic rebound from the pandemic.



Source: JPMorgan Asset Management

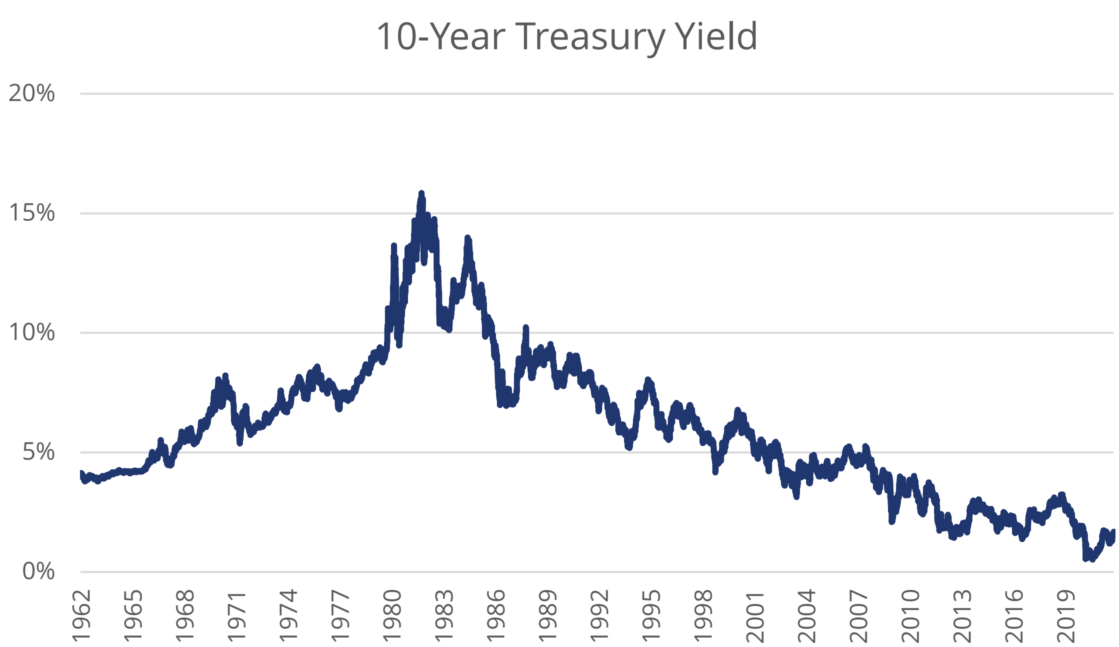
Valuations in international equities are also more attractive compared to the United States.



Source: JPMorgan Asset Management

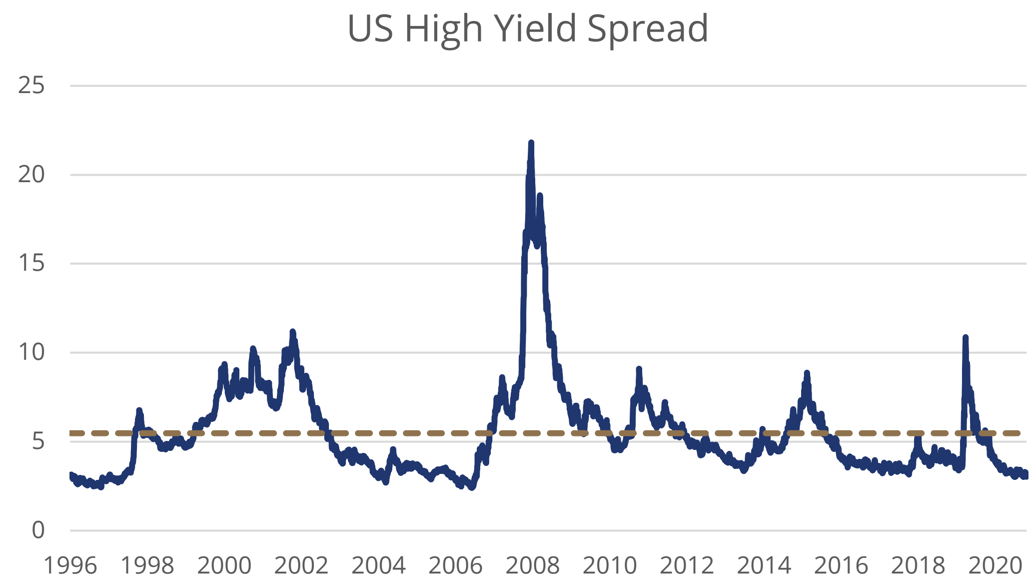
Fixed Income

Bonds remain a challenge for investors. The combination of very easy monetary policy and a recession has left 10-year Treasury yields very low. This dynamic makes generating positive returns difficult – investors are currently receiving low yields on their investments. If interest rates rise, bond prices fall, which offsets some increase in income. In our view, the increased likelihood of rising rates diminishes the attractiveness of government bonds. They will continue to play a role as a portfolio ballast during market volatility but are unlikely to produce strong returns.

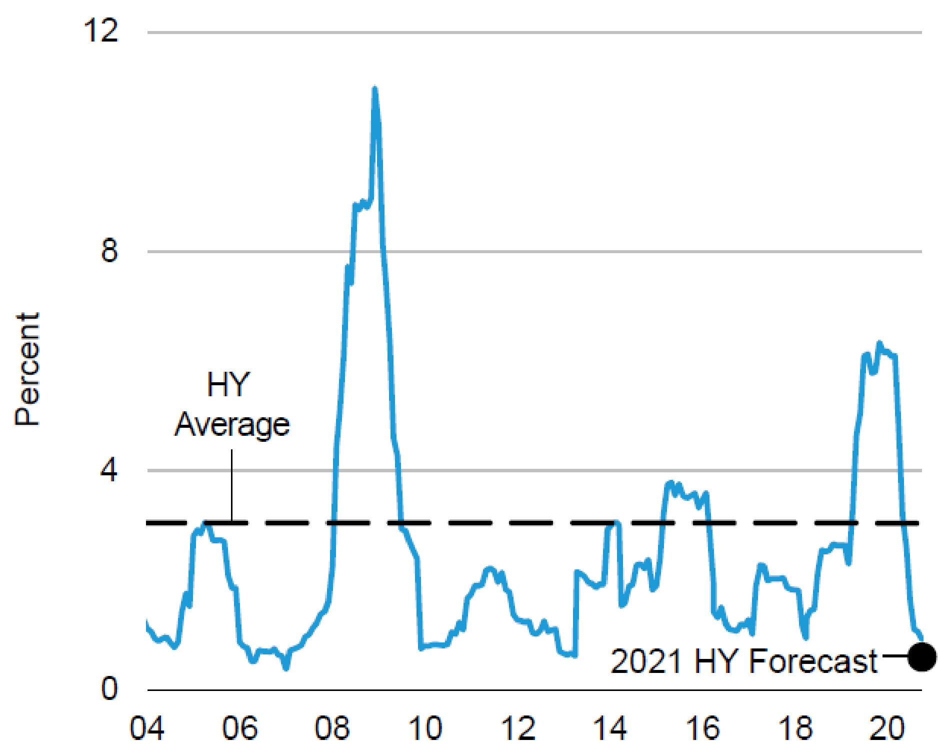


Source: YCharts

Investment grade and high yield corporate bonds have higher income opportunities, though they carry more risk than government bonds. However, the economic recovery has allowed corporate fixed income to remain relatively attractive. Although spreads are extremely tight, default rates are at records low. Continued demand for corporate debt should allow the asset class to maintain low spreads and for investors to receive income.



Source: YCharts



Source: AllianceBernstein

Conclusion

A lot happened in the third quarter. The S&P 500 had its first 5% drawdown in 45 weeks, Treasury yields briefly dipped before ending the quarter up 10bps, and economic data shifted some forecasts. The net result is continued optimism for economic growth though the range of potential outcomes has probably widened. We will continue to monitor trends that we believe could impact your portfolios, such as the pace of the recovery, economic growth, jobs, corporate profits, 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.

CRN-3890980-102821