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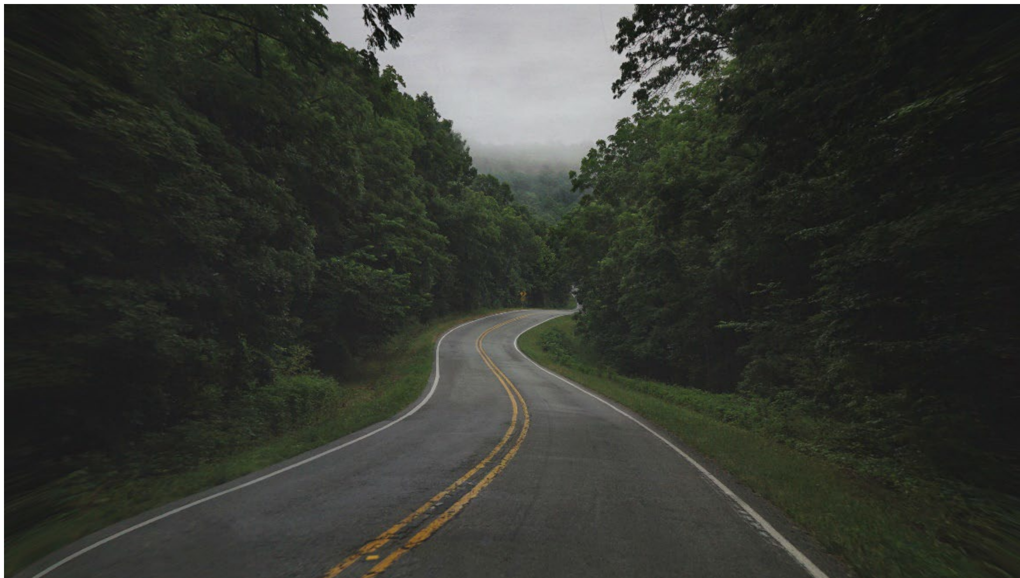
Capital Markets Outlook 2Q 2023



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Summary

Outlook

- Inflation remains the key driver of markets and the economy. Although inflation has likely peaked, recent data suggests that it will remain elevated compared to recent history.
- Aggressive tightening by the Fed does appear to be slowing economic growth, which should pave the way for a pause in rate hikes.
- Many asset classes are still attractively priced after a broad-based downturn in 2022.

Key Risk

- As the Fed likely approaches the end of its rate hiking cycle, tighter financial conditions could make it difficult to engineer a soft landing.

First Quarter Review

The US economy proved to be more resilient than many expected to start the year, as some cracks began to appear in the first quarter. Stronger than expected economic data and a tight labor market raised the risk of a policy induced recession during a historically aggressive rate hiking cycle by the Fed. Additionally, the failure of Silicon Valley Bank contributed to an increase in market volatility and raised investor concerns about the potential for more widespread issues that would lead to a recession.

On March 22, the Fed raised the federal funds rate by 0.25%, a move which was widely anticipated. Moving forward, the Fed faces the difficult task of balancing the recent regional bank crisis with combatting inflation. Despite some of the twists and turns presented to start the year, many asset classes have posted positive returns in recent months.

	Q1	1 Year
Large Cap	7.5%	-7.8%
Mid Cap	3.8%	-5.1%
Small Cap	2.5%	-8.9%
International	9.0%	-0.2%
Emerging Markets	4.1%	-10.5%
1-3 Year Treasuries	1.6%	0.2%
7-10 Year Treasuries	3.9%	-5.8%
20+ Year Treasuries	7.4%	-17.4%
Aggregate Bond	3.2%	-4.6%
TIPS	3.6%	-6.2%

Source: 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 Protected Securities Index

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Outlook

As the year progresses, more uncertainty has been added to forecasts. In addition to ongoing issues with inflation, the recent bank failures have added more volatility to markets. However, we do not believe this will lead to a major disruption. There are some key differences between the bank failures in 2023 and those in 2008.

- The US banks that came under pressure in March are much smaller and less systemically important than the institutions that failed during the global financial crisis. The small size of the banks made it much easier and less costly to resolve the issues.
- In 2008, deteriorating asset quality and investor flight from those assets led to a rapid downward spiral in asset values. The assets that declined in value in 2023 were US Treasuries, which have much less downside risk. Additionally, instead of their value falling further, their value has risen.

Inflation has been a key driver of capital markets and the economy for the past two years. There is now a sustained downtrend with lower inflation numbers coming in over the past eight months. After Russia's invasion of Ukraine caused a spike in commodity prices, energy prices have been declining. Improved supply chains and lower consumer demand has allowed core goods inflation to slow down as well.

Consumer Price Index, components

m/m % change, seasonally adjusted

		2021										2022												2023	
	Weight	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Jan	Feb
Headline CPI, y/y	100.0	2.6%	4.1%	4.9%	5.3%	5.2%	5.2%	5.4%	6.2%	6.9%	7.2%	7.6%	8.0%	8.5%	8.2%	8.5%	8.9%	8.4%	8.2%	8.2%	7.8%	7.1%	6.4%	6.3%	6.0%
Core CPI, y/y	79.5	1.7%	3.0%	3.8%	4.4%	4.2%	3.9%	4.0%	4.6%	5.0%	5.5%	6.1%	6.4%	6.5%	6.1%	6.0%	5.9%	5.9%	6.3%	6.6%	6.3%	6.0%	5.7%	5.5%	5.5%
Core svcs. ex-housing PCE, y/y*	-	2.9%	4.3%	4.3%	4.2%	4.4%	4.4%	4.3%	4.4%	5.0%	5.0%	4.9%	4.8%	4.7%	4.5%	4.5%	4.6%	4.0%	4.2%	4.5%	4.7%	4.4%	4.3%	4.7%	4.7%
Headline CPI, m/m	100.0	0.5%	0.7%	0.7%	0.8%	0.4%	0.4%	0.4%	0.9%	0.8%	0.8%	0.6%	0.7%	1.0%	0.4%	0.9%	1.2%	0.0%	0.2%	0.4%	0.5%	0.2%	0.1%	0.5%	0.4%
Core CPI, m/m	79.5	0.3%	0.8%	0.7%	0.7%	0.3%	0.2%	0.3%	0.7%	0.6%	0.7%	0.6%	0.5%	0.3%	0.5%	0.6%	0.6%	0.3%	0.6%	0.6%	0.3%	0.3%	0.4%	0.4%	0.5%
Core svcs. ex-housing PCE, m/m*	-	0.6%	0.5%	0.4%	0.4%	0.5%	0.3%	0.2%	0.2%	0.6%	0.5%	0.2%	0.3%	0.5%	0.3%	0.3%	0.6%	-0.1%	0.5%	0.5%	0.4%	0.3%	0.4%	0.5%	0.3%
Energy	6.9	3.5%	0.2%	0.3%	1.5%	1.7%	2.8%	1.5%	3.6%	2.6%	2.4%	0.8%	2.7%	8.2%	-1.0%	3.4%	6.9%	-4.7%	-3.9%	-1.7%	1.7%	-1.4%	-3.1%	2.0%	-0.6%
Gasoline	3.2	6.3%	-0.6%	-0.1%	2.5%	2.5%	4.5%	1.5%	4.1%	4.2%	3.8%	-0.3%	4.7%	13.2%	-3.1%	3.2%	10.3%	-8.1%	-8.4%	-4.2%	3.4%	-2.3%	-7.0%	2.4%	1.0%
Electricity	2.5	-0.1%	0.9%	0.4%	0.0%	0.2%	0.7%	1.0%	1.6%	0.7%	0.9%	2.7%	-0.3%	1.7%	0.9%	1.3%	1.5%	1.5%	1.2%	0.8%	0.5%	0.5%	1.3%	0.5%	0.5%
Utility Gas	0.9	2.4%	1.6%	1.1%	1.2%	2.0%	1.6%	2.2%	6.7%	0.5%	0.1%	0.5%	2.0%	0.6%	2.5%	7.2%	7.5%	-3.8%	3.5%	2.2%	-3.7%	-3.4%	3.5%	6.7%	-8.0%
Food	13.5	0.1%	0.3%	0.4%	0.7%	0.6%	0.4%	0.9%	0.9%	0.8%	0.6%	0.8%	1.0%	0.9%	0.8%	1.1%	1.0%	1.1%	0.8%	0.8%	0.7%	0.6%	0.4%	0.5%	0.4%
Food at home	8.7	0.1%	0.3%	0.3%	0.8%	0.5%	0.4%	1.2%	1.0%	1.0%	0.6%	0.9%	1.3%	1.3%	0.9%	1.3%	1.0%	1.3%	0.8%	0.7%	0.5%	0.6%	0.5%	0.4%	0.3%
Food away from home	4.8	0.1%	0.3%	0.6%	0.7%	0.8%	0.4%	0.5%	0.8%	0.6%	0.6%	0.7%	0.4%	0.3%	0.6%	0.7%	0.9%	0.7%	0.9%	0.9%	0.9%	0.5%	0.4%	0.6%	0.6%
Core goods	21.4	0.1%	1.9%	1.7%	1.9%	0.3%	0.3%	0.3%	1.3%	1.1%	1.4%	0.9%	0.3%	-0.4%	0.1%	0.6%	0.6%	0.1%	0.4%	0.0%	-0.1%	-0.2%	-0.1%	0.1%	0.0%
Apparel	2.5	0.1%	1.0%	0.8%	0.6%	0.0%	0.3%	-0.5%	1.0%	0.7%	0.9%	0.7%	0.6%	0.3%	-0.1%	0.4%	0.7%	-0.1%	0.3%	0.0%	-0.2%	0.1%	0.2%	0.8%	0.8%
New vehicles	4.3	0.0%	-0.1%	1.1%	1.6%	1.4%	1.2%	1.3%	1.5%	1.6%	1.8%	0.3%	0.1%	0.1%	0.4%	0.6%	0.5%	0.5%	0.8%	0.7%	0.6%	0.5%	0.6%	0.2%	0.2%
Used cars	2.7	0.6%	9.6%	7.7%	9.1%	-0.4%	-1.3%	-0.5%	3.1%	3.2%	3.9%	1.4%	-0.6%	-3.6%	-0.7%	1.9%	0.5%	-0.8%	-0.2%	-1.1%	-1.7%	-2.0%	-2.0%	-1.9%	-2.8%
Medical care commod	1.5	0.1%	0.6%	0.0%	-0.4%	0.2%	-0.2%	0.3%	0.6%	0.1%	0.0%	0.9%	0.3%	0.2%	0.1%	0.3%	0.4%	0.6%	0.2%	-0.1%	0.0%	0.2%	0.1%	1.1%	0.1%
Core services	58.2	0.3%	0.4%	0.4%	0.3%	0.3%	0.1%	0.2%	0.4%	0.4%	0.4%	0.4%	0.5%	0.6%	0.6%	0.6%	0.6%	0.4%	0.6%	0.8%	0.5%	0.5%	0.6%	0.5%	0.6%
Shelter	34.4	0.3%	0.4%	0.3%	0.4%	0.5%	0.2%	0.4%	0.4%	0.5%	0.4%	0.3%	0.6%	0.5%	0.5%	0.6%	0.6%	0.6%	0.7%	0.7%	0.7%	0.6%	0.8%	0.7%	0.8%
Rent of primary res.	7.5	0.2%	0.2%	0.2%	0.2%	0.2%	0.3%	0.4%	0.4%	0.4%	0.4%	0.5%	0.6%	0.4%	0.6%	0.6%	0.8%	0.7%	0.7%	0.8%	0.7%	0.8%	0.8%	0.7%	0.8%
OER	25.4	0.2%	0.2%	0.3%	0.3%	0.3%	0.3%	0.4%	0.4%	0.4%	0.4%	0.5%	0.5%	0.5%	0.5%	0.6%	0.7%	0.6%	0.7%	0.8%	0.6%	0.7%	0.8%	0.7%	0.7%
Medical care services	6.7	0.1%	0.0%	-0.1%	-0.1%	0.1%	0.2%	0.0%	0.6%	0.5%	0.5%	0.5%	0.1%	0.6%	0.5%	0.4%	0.7%	0.4%	0.7%	0.8%	-0.4%	-0.5%	0.3%	-0.7%	-0.7%
Transportation services	5.8	1.1%	1.3%	1.9%	0.9%	-0.8%	-0.7%	-0.9%	0.0%	1.2%	0.5%	0.7%	1.1%	2.1%	2.2%	1.6%	1.8%	-0.4%	1.0%	1.9%	0.6%	0.3%	0.6%	0.9%	1.1%

Source: JPMorgan Asset Management Guide to the Markets as of 3/31/23

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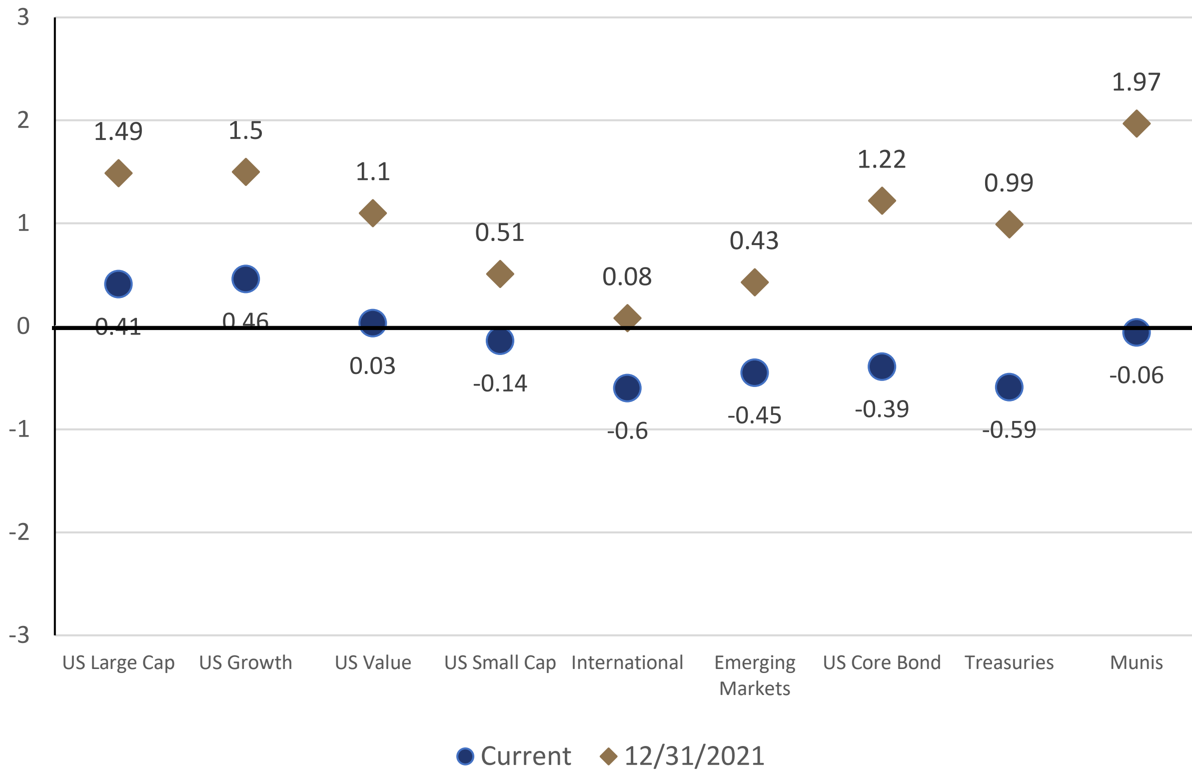
If inflation has peaked, that could signal good news for both stocks and bonds. Historically, the 12 months following a peak in inflation have led to positive asset returns. The average has been 18% for stocks and 8% for bonds. Eight months after the inflation peak last June, stocks have returned 6% and bonds have returned -3%.

Peak Inflation	Next 12 Months	
	Stocks	Bonds
May 1934	4.8%	6.3%
May 1942	57.6%	2.0%
March 1947	5.3%	0.9%
February 1951	13.6%	0.3%
December 1969	4.0%	16.9%
December 1974	37.0%	7.8%
March 1980	40.1%	13.1%
November 1990	20.3%	14.4%
July 2008	-20.0%	7.9%
Average	18.1%	7.7%
June 2022	6.1% (8 months)	-2.6% (8 months)

Source: US Bureau of Labor Statistics. U.S. bonds represented by the IA SBBI US Gov IT Index from 1/1/26 to 1/3/89 and the Bloomberg U.S. Agg Bond TR Index from 1/3/89 to 2/28/23. U.S. stocks are represented by the IA SBBI U.S. LrgStock Tr USD Index from 1/1/26 to 3/4/57 and by the S&P 500 Index from 3/4/57 to 2/28/23.

Those historical numbers pair well with the current valuation environment. Last year, elevated inflation and tighter financial conditions caused a widespread downturn in most asset classes. Even though equity markets have recovered to a degree and bond yields fell in the first quarter, the current landscape still presents good opportunities in many asset classes. The below charts shows valuations for different asset classes relative to their 25-year average. A value above zero would be more expensive than average, a value below zero is less expensive than average. Compared to the end of 2021, all these asset classes are more attractively priced, with many trading below their long-term averages.



Source: JPMorgan Asset Management Guide to the Markets as of 3/31/23

Conclusion

Although there continues to be economic uncertainty, there are many data points that suggest the global economy may slow but ultimately recover. Economic growth remains positive, inflation is slowing, and many asset classes are attractively priced.

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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