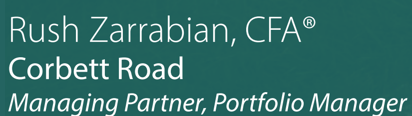
CORBETT ROAD
WEALTH MANAGEMENT

MACRO MUSINGS

July 13, 2022

First Half of 2022 Review: Worst Start in Decades



Rush Zarrabian, CFA®
Corbett Road
Managing Partner, Portfolio Manager

SUMMARY

- The **macro**cast™ score suggests the probability of a sustained recessionary bear market has increased, and the defensive position of **micro**cast™ indicates market conditions remain volatile. The combination of both risk models suggests we remain in a challenging market environment, which we expect to persist through the second half of the year.
- The weakness in the **macro**cast™ score is primarily driven by data within the Technical indicators category, as the market remains in a clear downtrend. The other VITALS indicators, such as those within the Aggregate Economy category, remain mixed, with leading indicators moving lower but not suggesting the economy is in a recession just yet.
- Most major asset classes saw negative returns in the second quarter. Equity markets around the globe were down double digits, and bonds continued their sell-off from the first quarter.
- The S&P 500 finished the second quarter down 15%—its worst three-month return since the first quarter of 2020 and its worst first half of a calendar year since 1970. Historically, when the market saw a similarly weak performance, future returns improved over the next two quarters and the following three- and five-year periods.

THE MESSAGE FROM **macro**cast™

As a reminder, **macro**cast™ is Corbett Road's proprietary investment model. **macro**cast™ measures the appeal of risk assets by looking at the **VITALS** of the market—**V**aluation, **I**nflation, **T**echnical Analysis, **A**ggregate Economy, **L**iquidity, and **S**entiment. By looking at multiple factors, we seek to better gauge market conditions and the probability of a sustained, recessionary market decline.

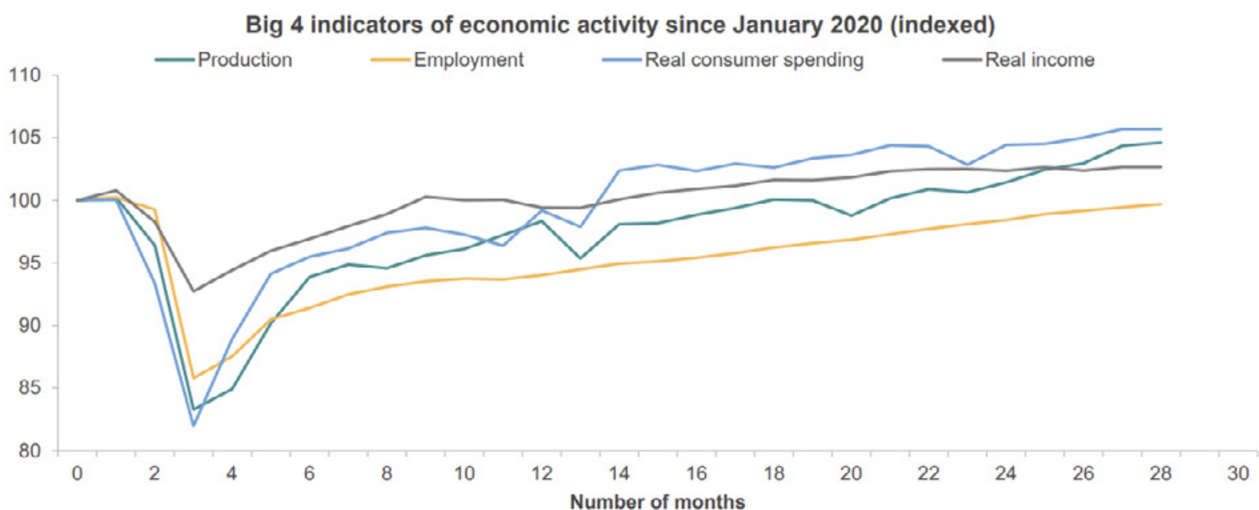
The current score suggests an increased risk of a sustained bear market.

Within the VITALS, **Aggregate Economy** data is mixed. While leading indicators we follow have weakened in recent months amid rising risks and tightening financial conditions, it is not yet clear if the level of deterioration will be enough to tip the economy into an "official" recession.

One thing is clear, the data is not reflective of an economy that is *currently* in a recession.

Although GDP contracted in Q1 and there is a possibility that the upcoming report for Q2 GDP is also negative, that does not mean the US economy is in a recession. Contrary to popular belief, two consecutive quarters of GDP contraction is <u>not</u> what determines a recession. Recessions are formally declared by the National Bureau of Economic Research (NBER), which assesses the trend in economic activity across four key factors of the economy: Production, Employment, Consumer Spending, and Income.

None of the four categories are showing a clear decline yet (chart from Truist):



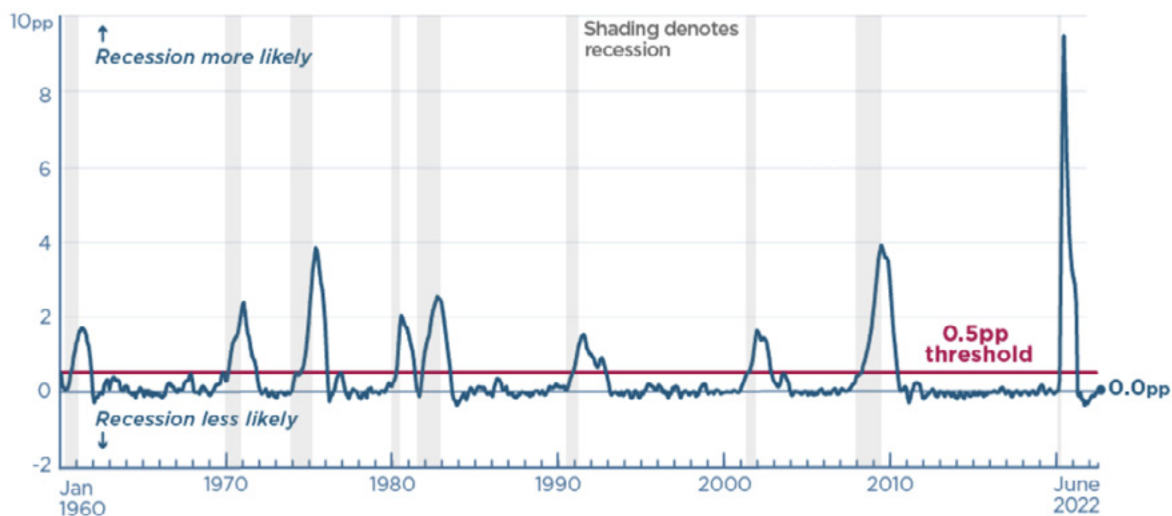
Data source: Truist IAG, Bloomberg. Monthly data through May 2022.

Employment numbers remain notably strong. Although employment data is one of the last economic indicators to roll over, there is typically an uptick in the unemployment rate at the beginning of a recession. The Sahm Rule Recession Indicator signals the start of a recession when the three-month moving average of the unemployment rate rises by 0.5% or more relative to its low during the previous 12 months (chart from the Peterson Institute):

Figure 4

The US labor market is not showing signs of an imminent recession

Monthly recession indicator and actual recessions, Jan 1960–Jun 2022



pp = percentage point

Note: Recession indicator is the real-time Sahm rule recession indicator.

Sources: Federal Reserve Bank of St. Louis and Bureau of Labor Statistics via Macrobond; authors' calculations.

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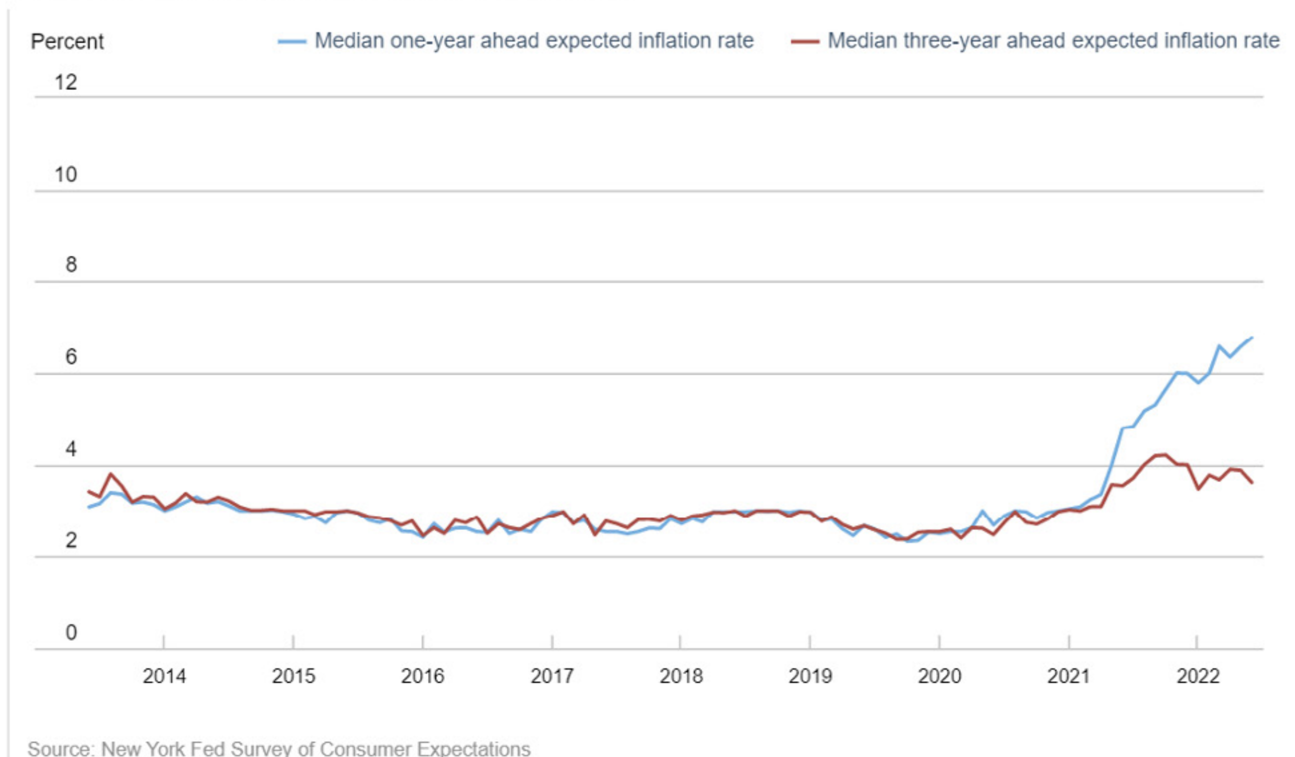
Meanwhile, the latest **Inflation** data was just released, and the results were disappointing.

Both Headline and Core CPI (which excludes Energy and Food prices) came in higher than expected, increasing 9.1% and 5.9% year-over-year, respectively. These figures continue to be at four-decade highs.

The increase was broad-based, with gasoline, shelter, and food prices being the largest contributors. Energy contributed to nearly half of the increase in headline inflation, with gasoline prices rising 11.2% in June.

The latest numbers suggest the Fed will likely remain aggressive in raising rates in the near term, until inflation shows clear signs of declining. Our concern in recent months has been the Fed overtightening into an economic slowdown, but with inflation remaining stubbornly high, they have no choice.

While consumers continue to recognize the near-term inflation problem, the New York Federal Reserve Bank's monthly survey suggest longer term expectations remain subdued. This is a critical and positive development, as the Fed aims to prevent consumer expectations of higher inflation from becoming entrenched. Such expectations can become self-fulfilling, creating a vicious cycle where prices continually increase at a rapid pace because everyone expects them to.



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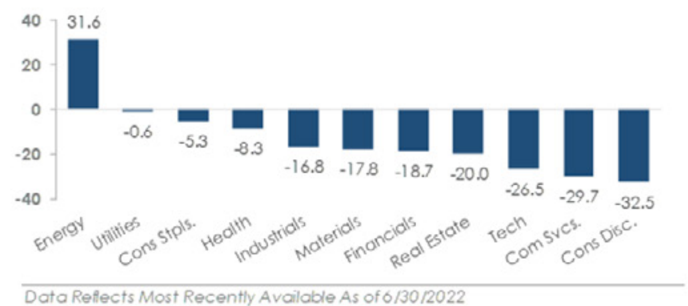
ASSET CLASS **REVIEW**

The following table and chart highlight major asset class returns for the second quarter of 2022:

Stocks	Level	1 month	3 months	YTD
S&P 500	3,785	-8.3%	-16.1%	-20.0%
Dow Jones	30,775	-6.6%	-10.8%	-14.4%
Russell 2000	4,245	-8.3%	-17.3%	-23.5%
Russell 1000 Growth	1,456	-8.0%	-21.1%	-28.2%
Russell 1000 Value	881	-8.7%	-12.3%	-12.9%
MSCI EAFE	1,188	-8.6%	-13.1%	-18.7%
MSCI EM	59,621	-5.1%	-10.4%	-17.2%
NASDAQ 100	11,504	-8.9%	-22.5%	-29.3%

Fixed Income	Yield	1 month	3 months	YTD
U.S. Aggregate	1.94%	-1.6%	-4.6%	-10.1%
U.S. Corporates	2.75%	-3.6%	-8.4%	-16.0%
Municipals (10 yr)	1.89%	-1.5%	-2.5%	-7.8%
High Yield	4.83%	-7.0%	-9.4%	-13.6%



A few notable insights:

The second quarter was another challenging period for equities. The S&P 500 Index declined -16.1%. It was an especially difficult quarter for growth stocks as rising interest rates continued to pressure valuations. The Russell 1000 Growth Index traded down -21.1% and underperformed the Russell 1000 Value Index's -12.3% return. The Nasdaq 100 Index, which investors view as a concentrated growth index due to its outsized exposure to tech stocks, fell -22.5% during the second quarter.

Energy and Defense led. Energy and defensive sectors, such as Consumer Staples, Utilities, and Health Care, outperformed as investors favored inflation-sensitive commodities and risk off assets. Growth-style sectors, which include Consumer Discretionary, Communication Services, and Technology, underperformed the broad market as rising interest rates weighed on longer duration stocks. Cyclical sectors, including Materials, Industrials, and Financials, performed in line with the S&P 500.

International markets, which have lower exposure to expensive growth stocks, outperformed US equities. The MSCI EAFE—an index tracking international developed market stocks—returned -13.1% during the second quarter, while the MSCI Emerging Markets Index (MSCI EM) returned -10.4%. Despite international stocks' outperformance during the second quarter, uncertainty remains elevated abroad as rising energy prices impact Europe and emerging markets face tightening financial conditions (i.e., higher interest rates & lower liquidity).

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Bonds provided no respite. Fixed income traded lower during the second quarter as Treasury yields continued to rise in anticipation of tighter Fed policy. Corporate investment grade bonds produced a -8.4% total return, slightly outperforming the -9.4% total return generated by corporate high yield bonds.

A BAD FIRST HALF HAS SURPRISINGLY BEEN BULLISH IN THE PAST

The S&P 500 declined over 20% in just two quarters, something that has only occurred eight times since WWII. In each previous instance, the market rebounded and was never lower a year later (from Bespoke):

20%+ Two Quarter Drops for the S&P 500: Post WW2

Quarter	2-Qtr Drop (%)	Next Quarter (%)	Next Half (%)	Next Year (%)
Jun-62	-23.48	2.78	15.25	26.70
Jun-70	-21.01	15.80	26.72	37.10
Sep-74	-32.39	7.90	31.19	32.00
Dec-74	-20.28	21.59	38.84	31.55
Sep-02	-28.94	7.92	4.04	22.16
Dec-08	-29.43	-11.67	1.78	23.45
Mar-09	-31.59	15.22	32.49	46.57
Jun-22	-21.10	?	?	?
	Average	**8.51**	**21.47**	**31.36**
	Median	**7.92**	**26.72**	**31.55**

Similarly, this was the 11th worst six-month period for the Wilshire 5000, one of the oldest broad-based indices covering the entire US investible market. In previous instances, returns were mostly higher 3 and 6 months later, but most notably, the index was always higher over the next 3-, 5-, and 10-year periods, with greater than average returns across all time periods (table from Compound Advisors):

Wilshire 5000 - Worst 6 Months Periods & Forward Returns (1971 - 2022)

Worst 6 Month Periods				Forward Total Returns					
Rank	Total Return	Start Month	End Month	3-Month	6-Month	1-Year	3-Year	5-Year	10-Year
1	-42.4%	Sep-08	Feb-09	26%	42%	56%	102%	189%	372%
2	-36.4%	Jun-08	Nov-08	-16%	6%	27%	53%	132%	288%
3	-34.7%	Aug-08	Jan-09	8%	23%	35%	73%	147%	309%
4	-33.3%	Apr-74	Sep-74	9%	36%	41%	84%	153%	392%
5	-31.0%	Oct-08	Mar-09	17%	36%	52%	91%	167%	341%
6	-29.5%	Jul-08	Dec-08	-11%	4%	28%	52%	134%	246%
7	-29.4%	May-08	Oct-08	-14%	-7%	11%	41%	108%	250%
8	-27.3%	Apr-02	Sep-02	8%	4%	26%	66%	115%	129%
9	-26.3%	Mar-74	Aug-74	-1%	18%	29%	62%	121%	333%
10	-21.4%	Oct-00	Mar-01	7%	-10%	3%	9%	33%	55%
11	-20.9%	Jan-22	Jun-22						
12	-20.4%	Jun-87	Nov-87	18%	17%	24%	49%	120%	432%
13	-19.6%	Sep-00	Feb-01	2%	-7%	-8%	2%	22%	44%
14	-19.3%	Feb-74	Jul-74	-5%	1%	21%	50%	90%	255%
15	-18.5%	Aug-87	Jan-88	5%	10%	21%	44%	103%	387%
16	-18.3%	Jul-87	Dec-87	8%	15%	18%	43%	109%	405%
17	-18.2%	Jul-74	Dec-74	25%	46%	38%	70%	135%	356%
18	-17.9%	May-74	Oct-74	7%	22%	26%	51%	100%	318%
19	-17.9%	Feb-02	Jul-02	-3%	-5%	13%	51%	85%	98%
20	-17.8%	Jun-74	Nov-74	19%	35%	36%	65%	123%	334%
Average Worst Periods				**6%**	**15%**	**26%**	**56%**	**115%**	**281%**
Average All Periods				**3%**	**6%**	**12%**	**41%**	**79%**	**219%**
Differential				**3%**	**9%**	**14%**	**15%**	**36%**	**62%**

COMPOUND @CharlieBilello

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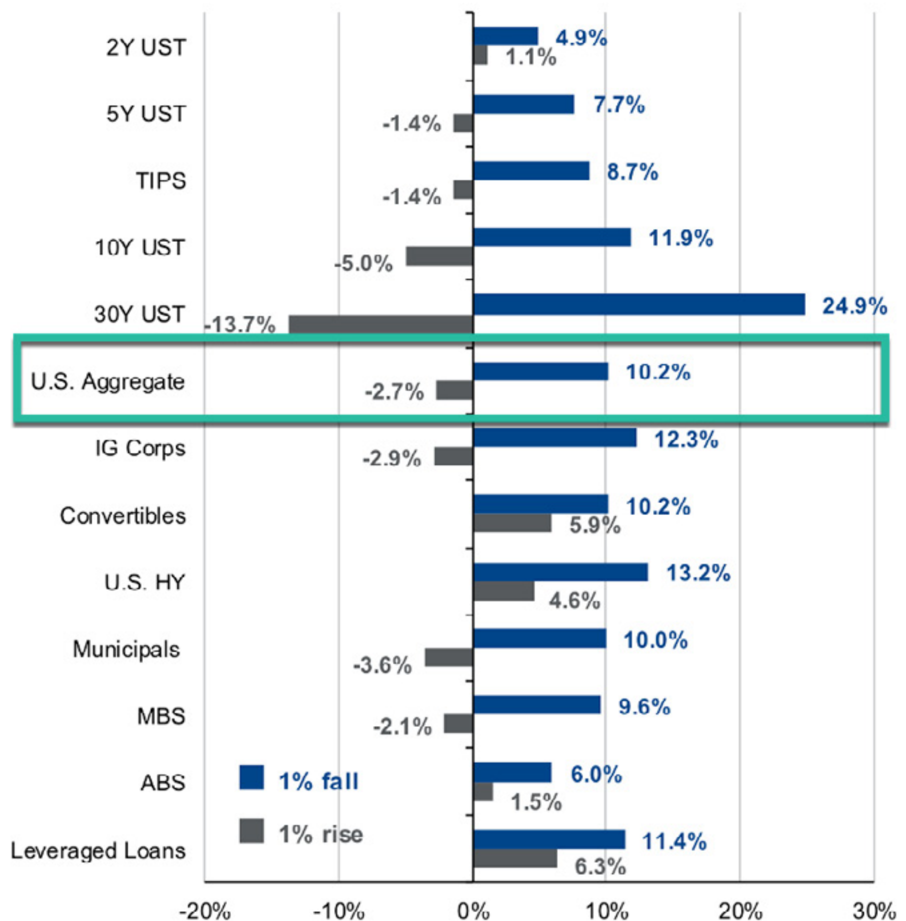
What about fixed income? After a relentless move higher in rates and the worst first half for the Aggregate Bond Index in its history, the risk/reward for bonds has improved meaningfully.

Focusing on the US Aggregate Bond Index, a further 1% increase in interest rates would result in additional losses of just under 3%, while a drop in rates would see the index rebound 10%, all else being equal (from JP Morgan):



RECONCILING RECESSION RISKS **WITH POSITIVE PRICE STUDIES**

There is little doubt that the Fed's actions could dramatically slow economic growth and push the U.S. economy into a recession. However, there remains the possibility that the U.S. economy may be strong enough to withstand the Fed's actions. The labor market remains healthy and corporate profits may prove to be more resilient. If that is the case, it would suggest the market has corrected enough and that the worst is behind us.

This uncertainty is reflected in **macro**cast™, moving neither decisively positive nor deteriorating further.

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We think the fluctuations in the score are likely to continue until some of the most pressing questions facing markets are answered. Specifically, we're monitoring the path of monetary policy and how the Fed reacts to new inflation data, as well as the resilience of corporate earnings growth and the trajectory of forward earnings estimates.

We will continue to make adjustments based on the incoming data and expect to have additional clarity on these questions in the coming weeks and months.

Conversion to a Roth IRA?

Periods of market volatility may present opportunities to convert your Traditional/Rollover IRA over to a Roth IRA at a lesser overall tax rate. If you have considered doing this in the past or have questions about Roth conversions, please contact your Corbett Road Wealth Manager.

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CORBETT ROAD
WEALTH MANAGEMENT

THANK YOU

Washington, D.C.
7901 Jones Branch Dr
Suite 800
McLean, VA 22102
Local: 703.748.5836

Boston, MA
101 Arch St
8th Floor
Boston, MA 02110
Local: 617.600.7930

Los Angeles, CA
10100 Santa Monica Blvd
Suite 300
Los Angeles, CA 90067
Local: 310.591.5674

Fort Lauderdale, FL
2598 E. Sunrise Blvd
Suite 2104
Ft. Lauderdale, FL 33304
Local: 954.507.6028

Knoxville, TN
800 S. Gay St
Suite 700
Knoxville, TN 37929
Local: 865.444.4520

Phoenix, AZ
2375 E. Camelback Rd
Suite 600
Phoenix, AZ 85016
Local: 602.807.1145

St. Louis, MO
7777 Bonhomme Ave
Suite 1800
Clayton, MO 63105
Local: 314.463.0132

Toll Free: 844.688.4955
info@corbettroad.com
www.corbettroad.com
linkedin.com/company/corbettroad