CORBETT ROAD
WEALTH MANAGEMENT

MACRO MUSINGS

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Focused on Fighting Inflation

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SUMMARY

- The **macro**cast™ score suggests the probability of a recessionary bear market has increased, and the defensive position of **micro**cast™ indicates market conditions remain volatile. The combination of both risk models reflects a challenging market environment.
- Central banks across the globe continue to raise interest rates in an effort to bring down inflation. The European Central Bank announced rate hikes coming next month, and the Federal Reserve is expected to raise rates by 1% over the next two meetings. Fighting inflation remains the top priority.
- Anticipated Fed action is already having an impact on the economy, with mortgage rates at 13-year highs, and housing affordability seeing the biggest drop ever compared to the previous year.
- In a follow up to our most recent podcast, we highlight every major bear market since the Great Depression. Historically, once a bear market ended, returns over the following 1-, 3-, and 5-year periods were all positive, and often, well above average.

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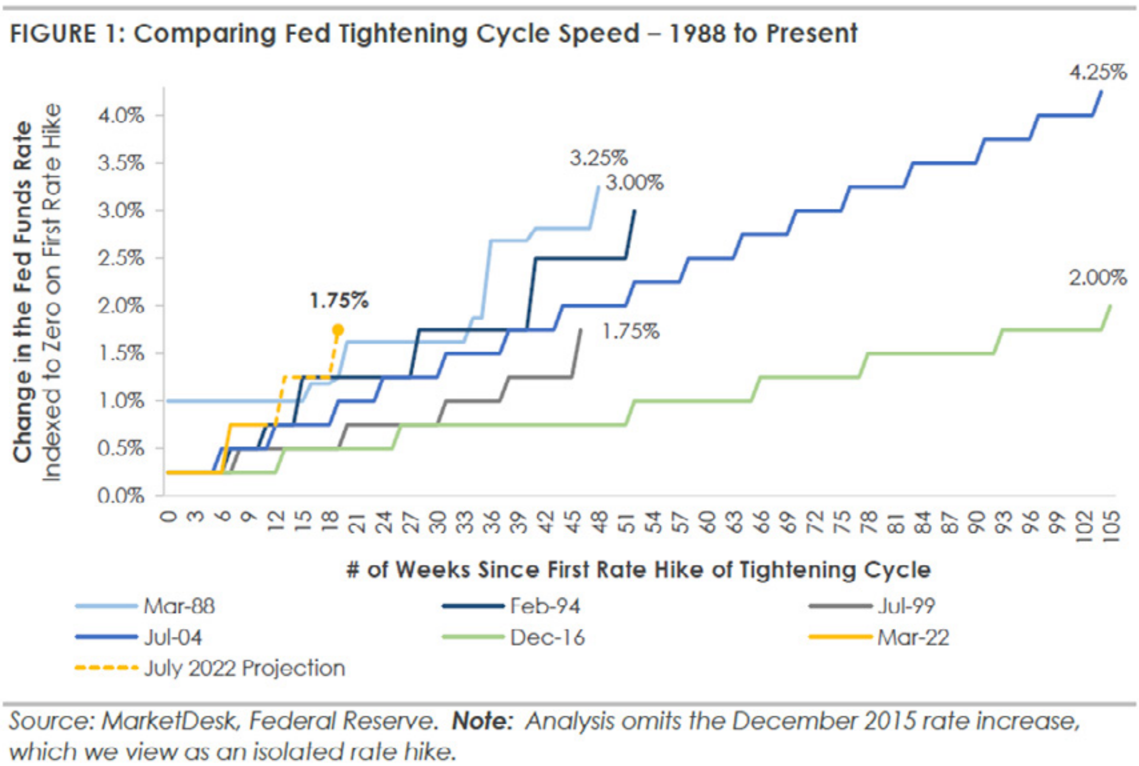
CENTRAL BANKS **ARE STILL TIGHTENING**

Central banks across the globe are focused on fighting inflation, and that means more rate hikes ahead.

The Federal Reserve increased the benchmark federal funds rate by .25% in March and .50% in April. With another .50% hike expected after both the June and July meetings, the central bank is on pace for the fastest rate hike cycle since 1988 (chart from MarketDesk):



Similarly, central banks abroad are tightening monetary policy. The European Central Bank recently announced they are ending their own quantitative easing program and raising rates next month, with further tightening expected in September. The Reserve Bank of Australia, the Bank of Canada, and the Bank of Korea have all raised rates over the past two weeks.

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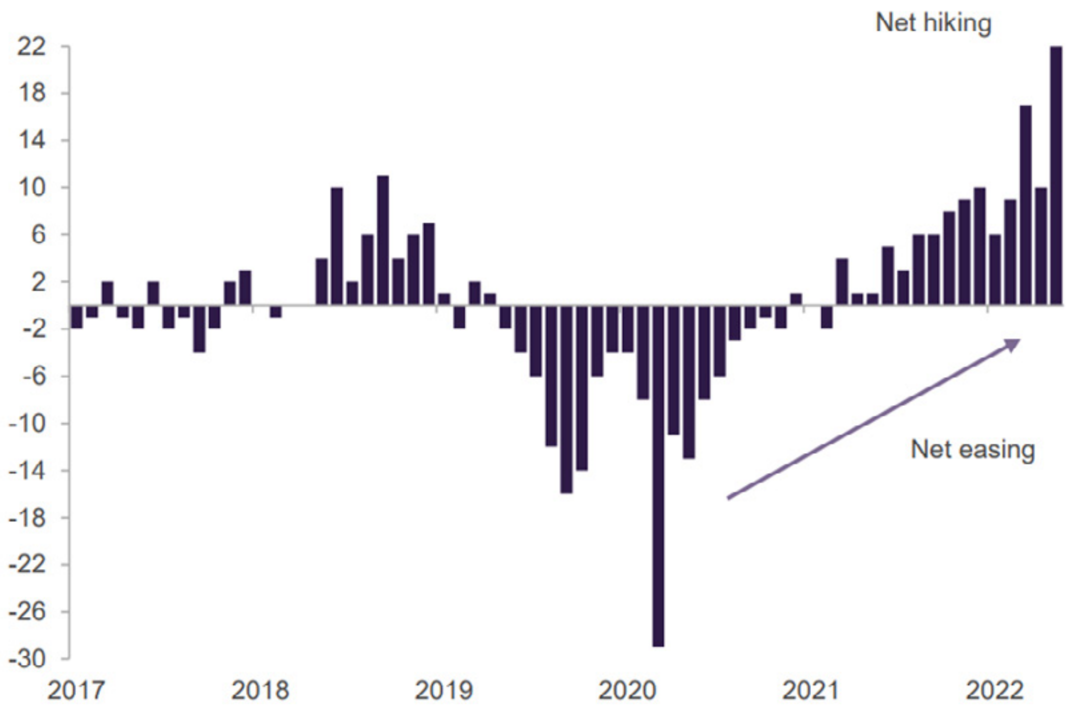
The net effect of central bank action over the past five years is clear. After providing a record amount of liquidity in 2020 to help ease the economic fallout from the COVID-19 pandemic, they are now reversing course to fight inflation (chart from Truist):

Number of central banks hiking minus easing

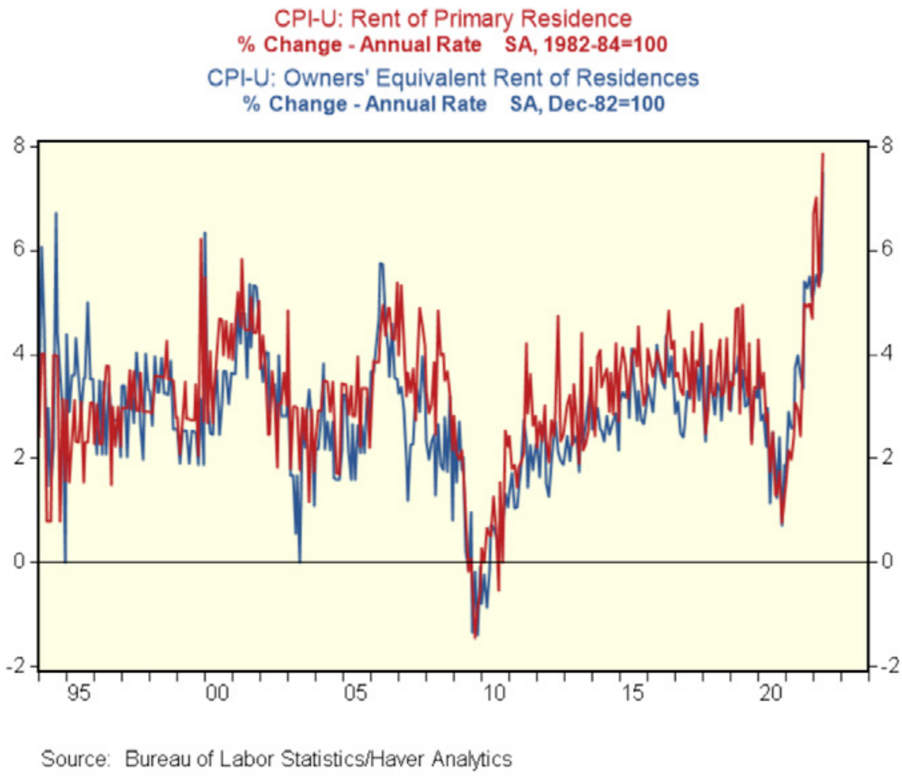


Data Source: Truist IAG, Haver. Series constructed using predominantly countries in the MSCI All Country World Index.
Past performance does not guarantee future results.

INFLATION **HASN'T SLOWED DOWN**

The latest inflation figures for the US were released last week on June 10th. The 12-month increase in the headline number for May matched the March increase of +8.6% y/y. The Core CPI index (which excludes volatile energy and food prices) came in at +6% y/y.

Last year, inflation was driven by reopening categories and supply-constrained segments, such as new/used vehicle prices. This year, housing is a driving force behind inflation as indices within the shelter category (rent and owners' equivalent rent) are seeing prices increase at the fastest pace in over 25 years (chart from Renaissance Macro):



The latest inflation print is disappointing. We had hoped to see a clearer sign of peaking, which wasn't the case in the May data.

If inflation continues to come in higher than economists are forecasting, we expect central banks across the globe to remain "hawkish" and continue raising rates until the data improves.

TIGHTENING OF POLICY **IS ALREADY HAVING AN IMPACT**

In the United States, even though the benchmark rate has only increased by .75% since March, the effects of tightening monetary policy have already begun reverberating throughout the economy. For example, mortgage rates have roughly doubled since January 2021, with

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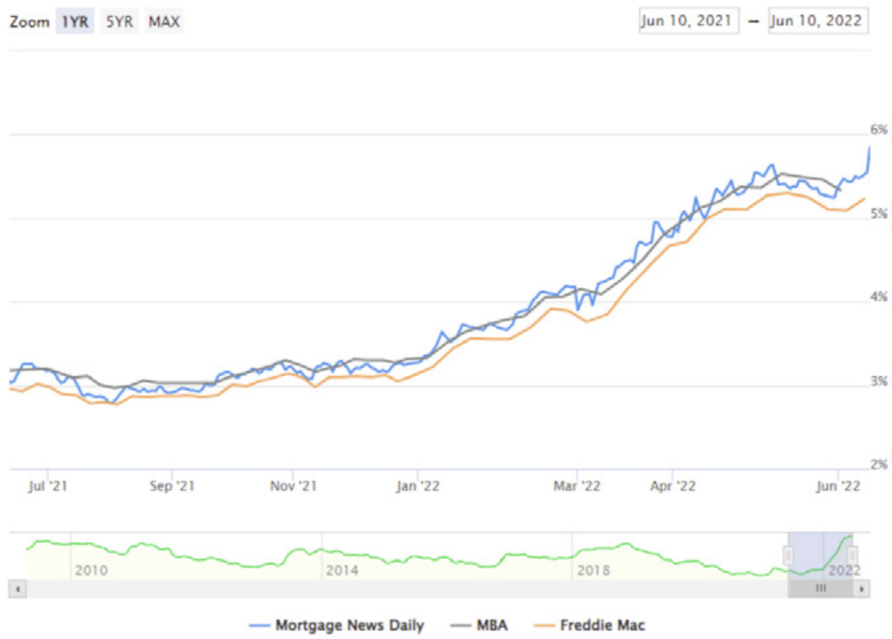
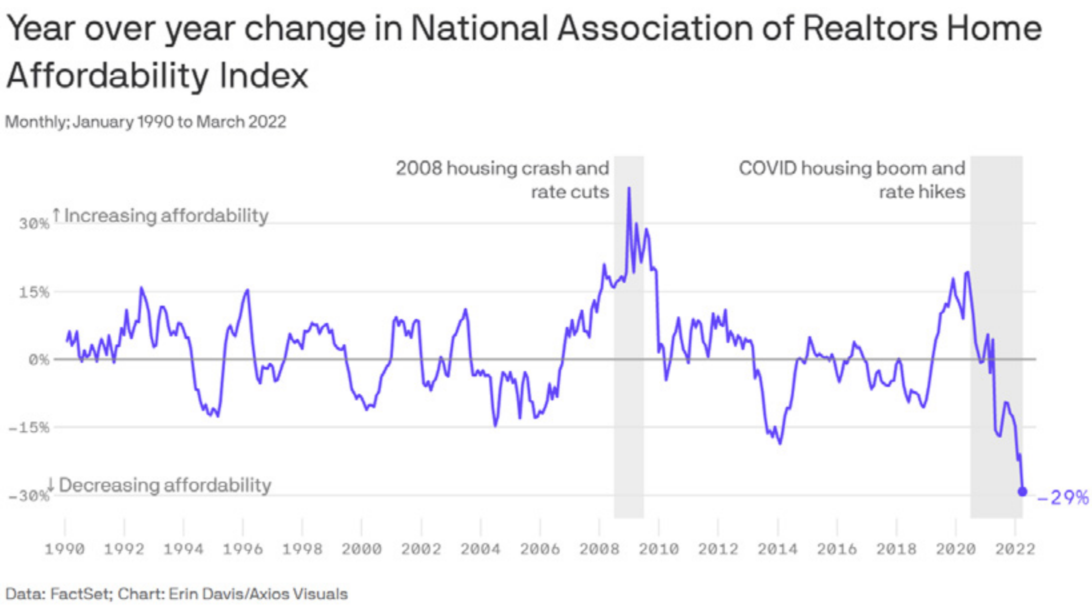
most of that increase occurring this year. As of Friday, June 10th, they are nearing 6% (from Calculated Risk):



This is the highest level since 2009.

The combination of higher mortgage rates and higher home prices have had a major impact on housing affordability. Year over year, the Home Affordability Index has dropped the most in history (chart from Axios):



Housing prices are an important component of inflation. As housing becomes less affordable, it could lead to weaker demand for other goods and services, pressuring prices lower, and ultimately, helping to lower inflation through lower rental rates.

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IN CASE YOU MISSED IT,
PODCAST ON CORRECTION AND BEAR MARKETS

Our latest podcast is available **here.** We discussed the history of bear markets and corrections, as well as their implications.

Discussing market performance isn't always the easiest in audio format, so we wanted to supplement with one chart we discussed during the show. The chart below illustrates the drawdowns of historical bear markets, as well as their subsequent returns (data originally compiled by Ben Carlson):

Returns After the Bear Market Ends

Drawdown	Peak	Trough	Number of Days	1 Year	3 Year	5 Year
				Forward Returns		
-86.2%	9/3/1929	7/8/1932	1039	162.9%	170.5%	344.8%
-56.8%	10/9/2007	3/9/2009	517	53.6%	97.9%	181.6%
-54.5%	3/6/1937	3/31/1938	390	35.2%	38.2%	84.5%
-49.1%	3/24/2000	10/9/2002	929	24.4%	59.0%	105.1%
-48.2%	1/11/1973	10/3/1974	630	38.1%	72.7%	117.5%
-40.6%	9/7/1932	2/27/1933	173	98.7%	194.5%	154.6%
-36.1%	11/29/1968	5/26/1970	543	34.7%	50.6%	42.2%
-34.5%	11/9/1940	4/28/1942	535	61.2%	128.6%	144.9%
-33.9%	2/19/2020	3/23/2020	33	62.8%	???	???
-33.5%	8/25/1987	12/4/1987	101	23.2%	55.5%	121.7%
-31.9%	10/25/1939	6/10/1940	229	8.0%	59.7%	118.8%
-31.8%	2/6/1934	3/14/1935	401	83.8%	16.3%	84.9%
-29.8%	7/18/1933	10/21/1933	95	2.9%	120.1%	87.3%
Averages			432	52.2%	88.6%	132.3%

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The beauty of this study is the perspective it provides. Investing in equities comes with risk, volatility, and periodically, market corrections. Each drawdown feels worst than the last, but it's important to remember a few key facts about bear markets.

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1. On average, bear markets have lasted approximately 14 months. While they've ranged from as short as one month (during the Covid shutdown) to as long as three years (the Great Depression), the average bear market typically lasts for a little more than a year.
2. Stock returns after a bear market are typically very strong, averaging over 50% in the year following the bear market bottom and over 130% over the next three years.

While past outcomes help to provide context to the current environment, the best way to handle market volatility is by having a plan. There are numerous ways to manage risk, and one of the most effective, time-tested methods is through diversification.

For instance, consider the worst years ever for a 60/40 portfolio compared to the worst years ever for the US stock market (since 1928) (chart from Ben Carlson):

The Worst Years Ever For the U.S. Stock Market

Year	S&P 500	Reason
1931	-43.8%	Great Depression
2008	-36.6%	Great Financial Crisis
1937	-35.3%	1937 Crash
1974	-25.9%	1973-74 Bear Market
1930	-25.1%	Great Depression
2002	-22.0%	Dot-Com Crash
1973	-14.3%	1973-74 Bear Market
1941	-12.8%	WWII
2001	-11.9%	Dot-Com Crash
1940	-10.7%	WWII
1957	-10.5%	1957-58 Recession

The Worst Years Ever For a 60/40 Portfolio

Year	60/40 Portfolio	Reason
1931	-27.3%	Great Depression
1937	-20.7%	1937 Crash
1974	-14.7%	1973-74 Bear Market
2008	-13.9%	Great Financial Crisis
1930	-13.3%	Great Depression
1941	-8.5%	WWII
2002	-7.1%	Dot-Com Crash
1973	-7.1%	1973-74 Bear Market
1969	-6.9%	Nifty Fifty Crash
2001	-4.9%	Dot-Com Crash
1966	-4.8%	1966 Bear Market

Source: NYU

Whether diversifying investments across different asset classes or investment strategies, diversification has historically helped to dampen the volatility of equities.

In summary, central banks across the globe are raising rates to fight inflation, which continues to persist, but the tightening of monetary policy is already starting to have an impact on areas of the economy like housing. The Fed hopes to pull off a soft landing, whereby the tightening of financial conditions lowers demand and inflation without causing a recession. While the outcome remains uncertain, it's helpful to look at the current market environment through a historical lens. Bear markets and corrections are common in equity investing, but they're typically short-lived and resolve in above average market returns in the years that follow. We've been here before, and we will continue to monitor the conditions and act accordingly while communicating our viewpoints.

We hope everyone has a safe and happy Independence Day!

If you have other vacations, events, or home improvement projects that you need to plan for financially, please don't hesitate to contact your Corbett Road Wealth Manager to discuss them.

Enjoy the holiday!

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