CORBETT ROAD
WEALTH MANAGEMENT

MACRO MUSINGS

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Fed Hikes Rates .50%, More to Come

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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 suggests we are in the most challenging market environment since the onset of the pandemic.
- The Federal Reserve raised interest rates .50% last week. Further hikes of similar magnitude are expected at the next two meetings in June and July, and potentially beyond, should inflation remain stubborn. Chairman Powell noted that a hike of .75% is not currently being considered, but it would be unwise to assume the Fed won't change its mind if inflation data does not improve over the next several months.
- We continue to view recession as a potential risk for 2023, not this year. If a recession does occur, the impact could be dampened by the strength of households and businesses, which are in a much better financial position than prior downturns.
- Despite a hawkish Fed and challenging macro environment, several indicators suggest the recent market sell off may be overdone and conditions for a relief rally could be coming together.

THE FED RAISES RATES BY .50%
EXPECT MORE OF THE SAME GOING FORWARD

As expected, the Federal Reserve raised short-term interest rates by 50 bps (.50%). This was the largest single rate hike since 2000. Looking ahead, they signaled for another 50 bp increase in June and July, and Chairman Powell said further rate hikes, starting in September, would depend on the path of economic growth and inflation.

In addition, the Fed will begin reducing its balance sheet next month. The combination of higher rate increases and the reduction of bond holdings makes this Fed arguably the most aggressive since 1994.

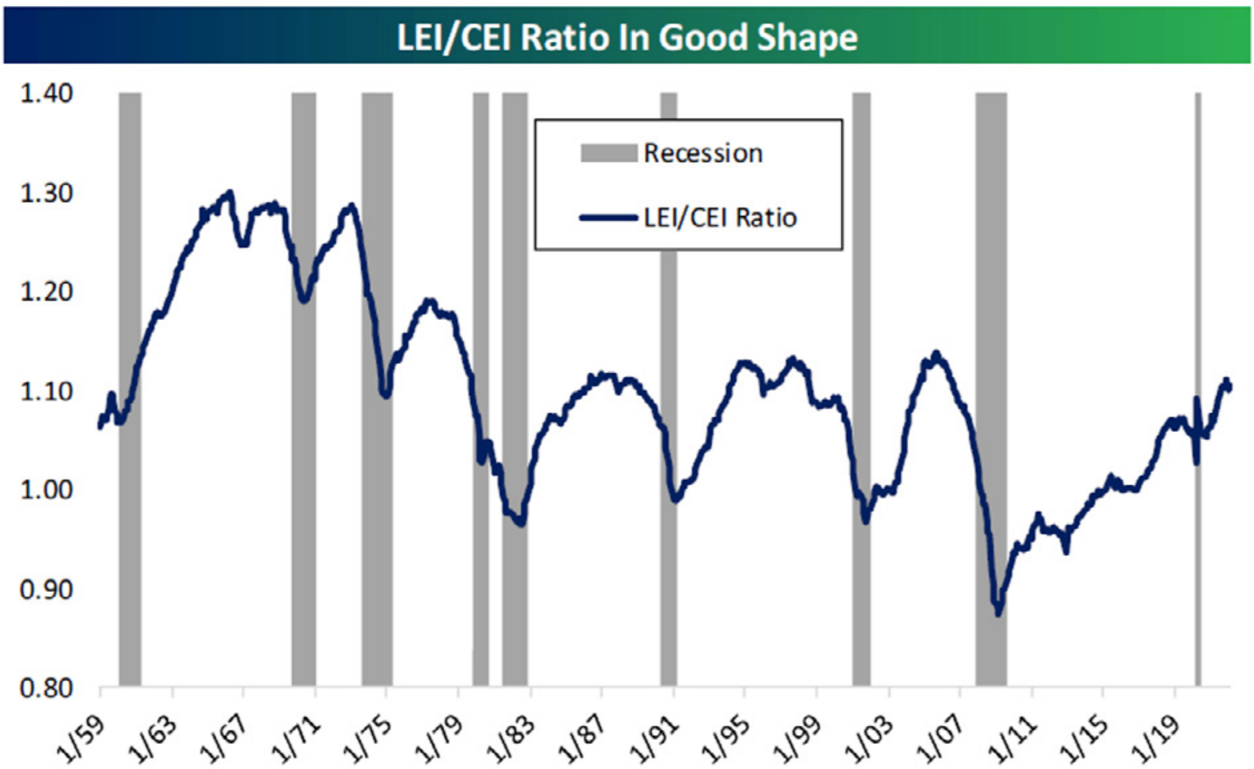
While Powell said 75 bp rate hikes were not being "actively considered," that doesn't mean a rate increase of that magnitude is completely off the table in the future. If inflation data does not show signs of slowing to the Fed's target rate, members can change their minds, as they have multiple times over the past year.

This also means that easing inflationary pressures could result in a less aggressive pace of tightening. If the data shows inflation normalizing as expected or faster than expected, the Fed will slow down and return to the more traditional pace of 25 bp rate hikes later this year. While that would likely be a welcome development for markets, our view is a change in tone is more important than a simple slowdown in hikes. Right now, that tone is very hawkish, and we expect it could be many months before inflation moves decisively lower or economic growth weakens to the point where the Fed adopts a more dovish tone as it faces the possibility of a recession.

LACK OF MARKET IMBALANCES
REDUCES CHANCE OF SERIOUS DOWNTURN

Recessionary risks have clearly increased. Our **macro**cast™ score is at zero after dipping to -2 late last month. Commodity prices have spiked, and the Fed is aggressively tightening; however, we believe a downturn in the economy is likely a 2023 story.

One indicator we follow is the ratio of Leading to Coincident Economic Indicators. This compares a basket of leading indicators, which tend to turn down ahead of the economy, to coincident indicators, which focus on the economy as it is today. The ratio typically rolls over and declines several months before a recession (Chart from Bespoke):



While the ratio may have peaked, history suggests it could be several months before it moves meaningfully lower.

Several factors suggest that the base of the economy is much stronger today than it has been in past periods leading into recessions. Notably, the two most recent pre-pandemic downturns (2000 and 2006) showed significant financial imbalances in the private sector, i.e., the private sector was heavily reliant on external financing during these periods (next two charts from Goldman Sachs).

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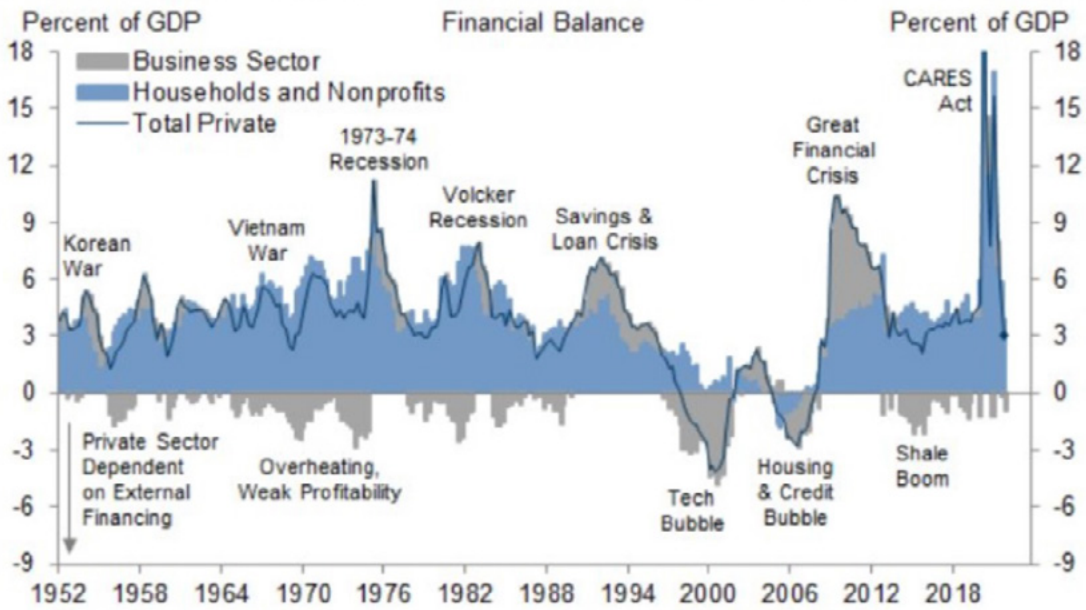
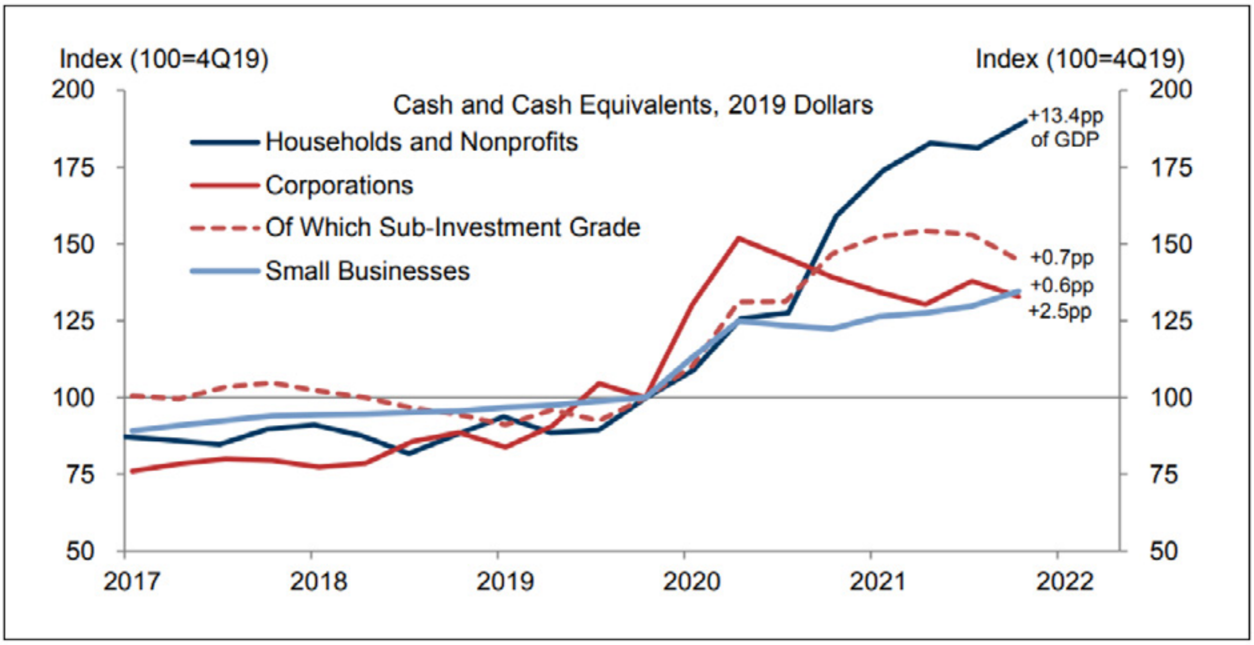
The following chart shows the financial balance among households and businesses:

Exhibit 1: No Obvious Imbalance in the Household or Business Sector—Unlike in 2000 and 2006



Source: Department of Commerce, Federal Reserve, Goldman Sachs Global Investment Research

Digging deeper, the next chart shows the amount of cash held by individuals and businesses now compared to 2019:



The above charts show that the balance sheets of households and businesses remain in good shape. This is a far cry from the overleveraged environment leading into the Global Financial Crisis and the over investment that accompanied the Tech Bubble.

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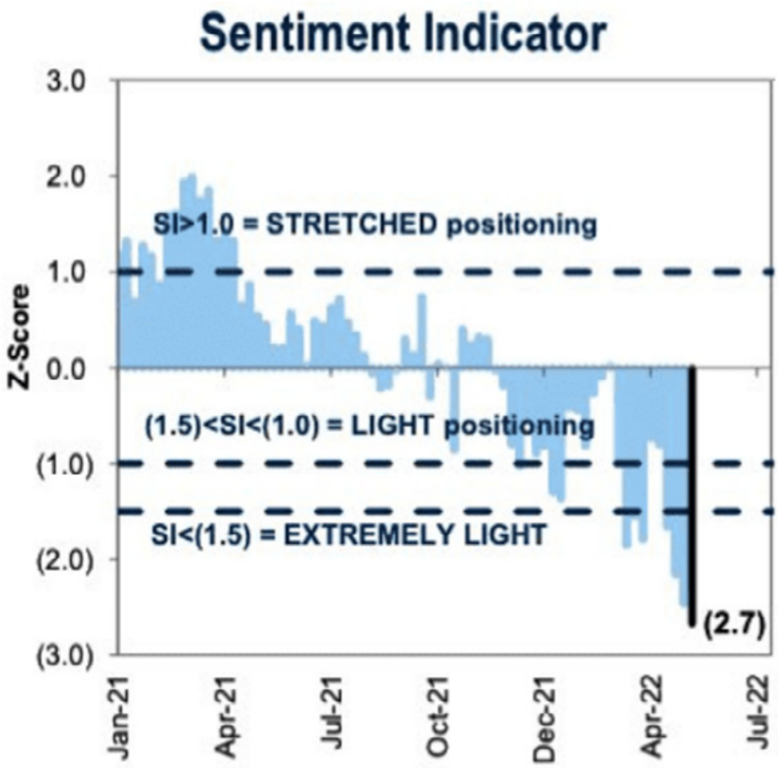
This doesn't mean a recession won't occur. In fact, there have been several recessions over the past 70 years where households and corporations held similarly healthy balance sheets. But, it does suggest that the private sector is better positioned and able to cushion the blow from rising rates and a mild recession if it were to occur.

SENTIMENT IS EXTREMELY POOR, **WHICH COULD SPARK A RELIEF RALLY**

The recent market decline has been unyielding. As of May 11, the S&P 500 is down 17% from its all-time high in early January. Other indices such as the Nasdaq and small-cap Russell 2000 are down even more.

The magnitude and speed of the decline has contributed to negative sentiment, and extremely negative sentiment is often a contrarian bullish signal for equities.

First, the Goldman Sachs Sentiment Indicator compares the current positioning of market participants to last year's positioning.



Note: Sentiment Indicator measures stock positioning across retail, institutional, and foreign investors versus the past 12 months. Readings below -1.0 or above +1.0 indicate extreme positions that are significant in predicting future returns.

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The chart shows stock positioning is extremely light. Since 2010, whenever the indicator dropped below -2.2, stocks rose an average of 8% over the next three months and an average of 19% over the next six months.

In addition, the lack of bullishness in the American Association of Individual Investors (AAII) survey has historically been followed by positive market returns over the next several months (table from LPL):

Where Did All The Bulls Go?

AAII % Bullish Less Than 20% Is Usually Bullish For Stocks

		S&P 500 Index Returns		
Date	% Bullish	3 Months	6 Months	12 Months
5/13/1988	19.0%	2.2%	6.6%	22.2%
7/22/1988	16.0%	7.4%	8.8%	27.5%
8/19/1988	19.0%	1.7%	14.0%	33.0%
9/2/1988	18.0%	2.8%	11.5%	33.7%
9/9/1988	17.0%	3.6%	9.8%	30.7%
10/7/1988	13.0%	1.0%	6.8%	29.0%
11/25/1988	17.0%	7.7%	20.3%	28.7%
12/2/1988	19.0%	8.5%	18.5%	29.0%
12/9/1988	17.0%	6.6%	17.8%	25.9%
3/10/1989	13.0%	11.5%	19.1%	15.4%
3/31/1989	18.0%	8.4%	18.2%	15.6%
2/2/1990	15.0%	2.3%	4.2%	3.7%
2/9/1990	19.0%	5.5%	0.6%	7.7%
8/17/1990	18.0%	-3.3%	12.6%	17.6%
9/14/1990	16.0%	3.9%	17.9%	21.1%
9/21/1990	13.0%	6.0%	18.0%	24.6%
10/5/1990	15.0%	1.3%	21.6%	22.4%
10/19/1990	13.0%	5.9%	21.9%	25.6%
11/16/1990	12.0%	16.5%	17.4%	20.7%
11/21/1990	16.0%	15.7%	18.7%	19.8%
12/21/1990	16.0%	11.5%	11.8%	16.7%
9/4/1992	14.0%	3.6%	9.0%	10.6%
7/2/1993	18.0%	3.5%	4.6%	0.1%
4/14/2005	16.5%	5.5%	1.3%	10.9%
1/10/2008	19.6%	-6.2%	-12.7%	-37.3%
3/5/2009	18.9%	38.1%	45.7%	66.8%
4/11/2013	19.3%	5.1%	4.0%	15.0%
1/14/2016	17.9%	8.3%	12.0%	18.4%
2/11/2016	19.2%	12.8%	19.2%	26.6%
5/19/2016	19.3%	7.2%	6.1%	16.7%
5/26/2016	17.8%	3.9%	4.4%	15.6%
2/17/2022	19.2%	?	?	?
4/14/2022	15.8%	?	?	?
Average		6.7%	12.6%	19.8%
Median		5.5%	12.0%	20.7%
Higher		29	30	30
Count		31	31	31
% Higher		93.5%	96.8%	96.8%

Source: LPL Research, AAII 04/18/22

All indexes are unmanaged and cannot be invested into directly. Past performance is no guarantee of future results.

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In summary, we expect the Fed to remain aggressive in their attempt to rein in inflation. Recession risk continues to rise, but it is more of a concern for next year, not 2022. While the market sell-off has been significant over the past few weeks, investor sentiment and positioning are poised for a potential relief rally in the intermediate-term.

We expect a challenging market environment until our indicators improve.

Look out for the release of our smart**life**™ Monthly Newsletter towards the end of May. This will highlight financial and life planning topics on a monthly basis. As always, if you have any financial or life planning questions, please don't hesitate to contact your Corbett Road Wealth Manager to discuss them.

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