CORBETT ROAD

MACRO MUSINGS

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Third Quarter 2021 Review: Commodities Surge and Inflation Won't Go Away

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SUMMARY

- The current **micro**cast™ signal recommends an upgrade from an aggressive allocation to the most aggressive allocation. Both models remain positive, underpinning a constructive market outlook for the coming quarters.
- The **macro**cast™ score continues to be positive, driven by upbeat data in the Aggregate Economy and Technical categories. Concerns remain with Inflation, which has yet to show any signs of easing.
- Asset class performance diverged a bit in Q3, with few stock indices performing well. US large-cap stocks led the way, while mid- and small-caps posted negative returns. Emerging markets performed poorly, bonds were mostly unchanged, and commodities surged higher.
- The S&P suffered its worst decline of the year in September. However, the 5% pullback was one of the mildest observed in recent years, with only 2017 having a shallower decline.

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 a low chance of a sustained bear market.

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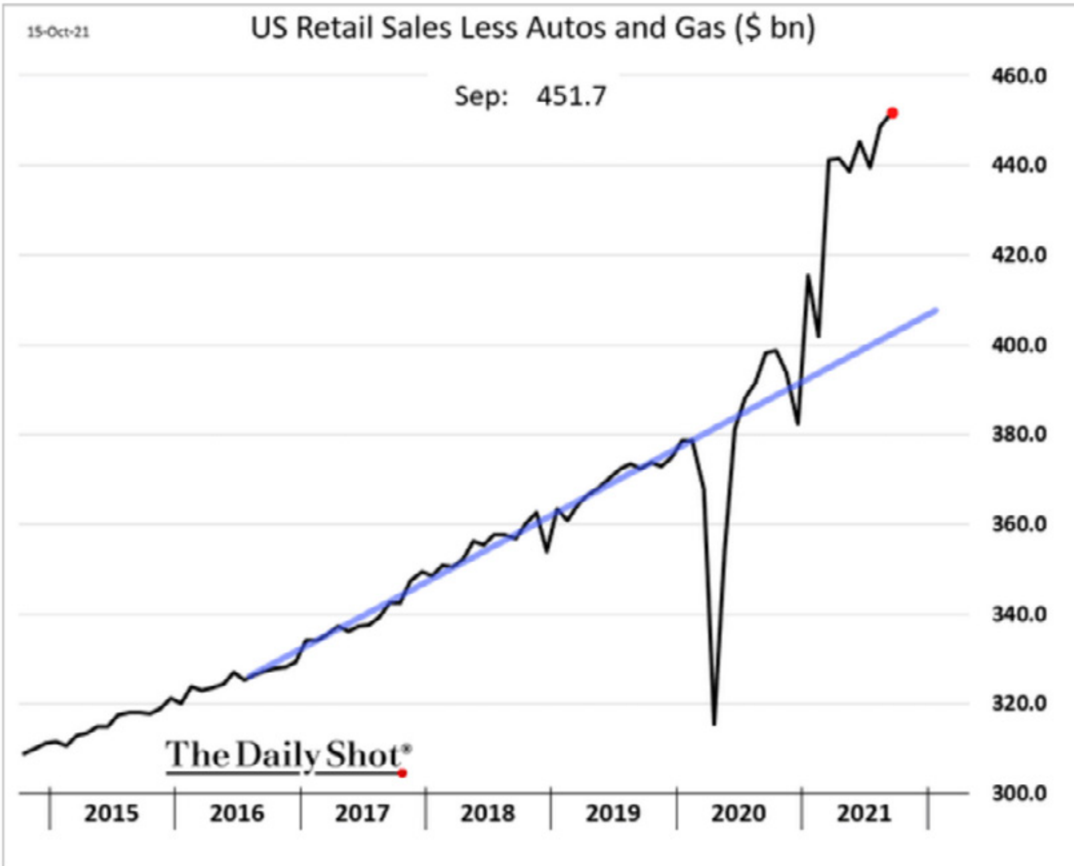
Within the VITALS, **Aggregate Economy** data continues to be positive. While it is clear that economic growth has slowed from earlier this year—due, in part, to supply chain issues, higher home and commodity prices, and reduced travel and leisure activity amid a resurgence in Covid cases—the consumer is still spending (from The Daily Shot):



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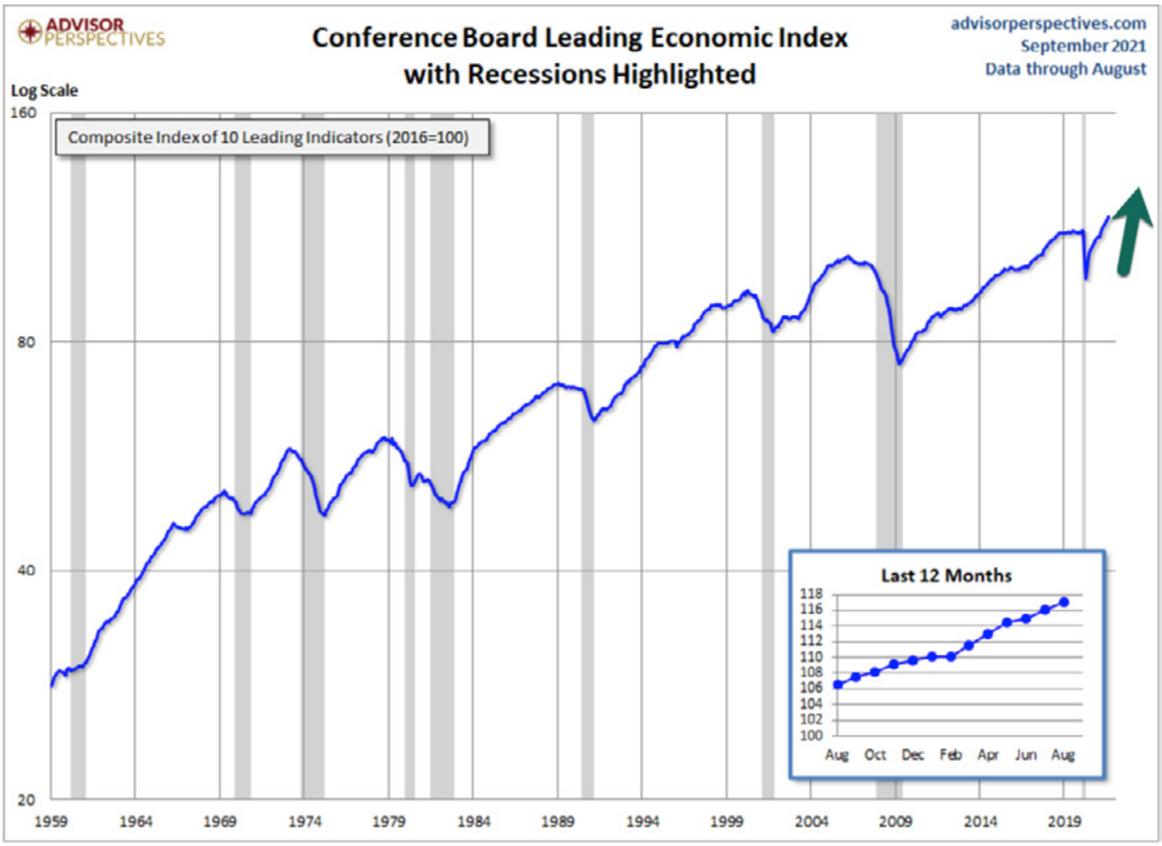
The Conference Board Leading Economic Index (LEI) continued its steady march higher, reaching another all-time high in August (from dshort.com):



Technicals also remain strong, with over 80% of S&P 500 stocks showing a positive return through the first three quarters. This level of breadth has only occurred six times in the past forty years. In each of the five previous instances, stocks finished higher in Q4 (from Sentiment Trader):

S&P 500 after > 80% of stocks show positive YTD return thru Q3

Signals (5)	% Pos YTD	1 Week	2 Weeks	1 Month	2 Months	3 Months	6 Months	1 Year
1989-09-29	83.6%	2.8	-4.4	-4.0	-1.6	1.2	-2.6	-12.3
1995-09-29	82.4%	-0.3	0.0	-0.2	4.0	5.4	10.5	17.4
2009-09-30	81.2%	0.0	3.3	0.9	3.6	6.6	11.4	8.0
2013-09-30	85.9%	-0.3	1.7	5.4	7.5	9.5	12.1	17.3
2019-09-30	81.9%	-1.3	-0.4	2.0	5.9	8.2	-13.2	12.1
2021-09-30	81.7%							
Median	**82.1%**	**-0.3**	**0.0**	**0.9**	**4.0**	**6.6**	**10.5**	**12.1**
% Positive		**40%**	**60%**	**60%**	**80%**	**100%**	**60%**	**80%**

© SENTIMENTRADER Numbers are % return after signal; Risk = avg max loss; Reward = avg max gain; Z-Score +/- 2 suggests significance.

In addition, the market has extended its quarterly win streak and has now risen for six consecutive quarters. Historically, similar bullish momentum tended to persist and generally preceded positive forward returns (from LPL):

Six Quarter S&P 500 Index Win Streaks

Long Quarterly Win Streaks Are Usually Bullish

		S&P 500 Future Returns After 6 Quarter Win Streak		
Quarter	Ultimate Quarterly Win Streak	1 Quarter	2 Quarters	4 Quarters
Q4 1950	7	5.1%	2.6%	16.3%
Q1 1955	10	12.2%	19.4%	32.5%
Q2 1959	6	-2.7%	2.4%	-2.7%
Q4 1963	11	5.3%	8.9%	13.0%
Q2 1996	14	2.5%	10.5%	32.0%
Q2 2014	9	0.6%	5.0%	5.2%
Q1 2017	9	2.6%	6.6%	11.8%
Q3 2021	6*	?	?	?
Average		3.6%	7.9%	15.5%
Median		2.6%	6.6%	13.0%
% Positive		85.7%	100.0%	85.7%

Source: LPL Research, FactSet 09/30/21 * Streak not over yet

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

The modern design of the S&P 500 stock index was first launched in 1957. Performance back to 1950 incorporates the performance of predecessor index, the S&P 90.

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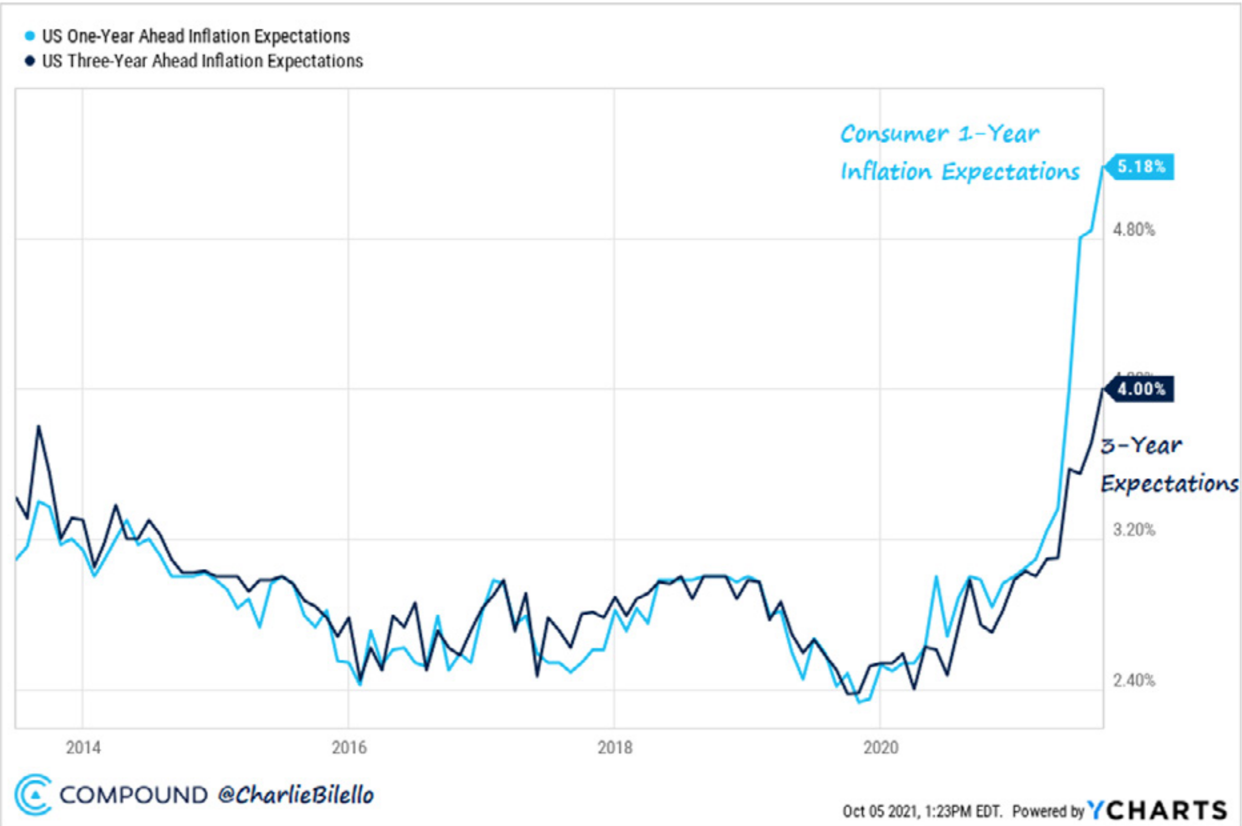
We've written about **Inflation** several times this year, and concerns continue to persist. At this stage, it is fair to say that inflation has shown few signs of being transitory. Price increases remain stubbornly high, and it is beginning to impact long-term inflation expectations (from Compound Advisors):



In addition to lingering inflation concerns, we are hearing more and more talk of "stagflation." Stagflation is a rare economic situation where inflation is persistently high, unemployment remains high, and economic growth is low or negative. The last time the US economy suffered from stagflation was in the 1970s. To be clear, this is not what we are experiencing right now (from The Economist):

The Economist

Rather, the current economy appears to be in the midst of an inflationary boom. Both GDP growth and inflation are above their forty-year averages, while the unemployment rate continues to decline from its pandemic highs. Whether these trends continue remains to be seen. For now, the Fed continues to assert that inflation will cool off once pandemic-related issues are resolved. The problem is economic growth is expected to slow next year while the issues supporting higher inflation continue to persist. There is no telling if another Covid wave this winter will lead to more lockdowns in Asia, which have been at the heart of the supply chain problems that are at least partly responsible for the latest increase in prices.

Our view matches that of the Fed in that we expect inflationary pressures to ease in 2022; however, we think there is a good chance that it will settle at a higher level than what we observed during the post-financial crisis period. Inflation is notoriously difficult to forecast, but we will continue to monitor the latest developments and share our thoughts.

ASSET CLASS **REVIEW**

The following table highlights major asset class returns for the third quarter of 2021:

	Q3 2021 (%)	YTD (%)		Q3 2021 (%)	YTD (%)
Commodities	6.6	29.1	U.S. Corporate Bonds	0.0	-1.3
Real Estate Stocks	1.0	23.1	Non-U.S. Developed-Country Stocks	-0.4	8.3
High Yield Bonds	0.9	4.7	Emerging-Market Bonds	-0.5	-1.5
Non-U.S. Small Cap Stocks	0.9	10.0	Gold	-0.7	-7.4
U.S. Large Cap Stocks	0.6	15.9	U.S. Mid Cap Stocks	-0.9	15.2
Long Government & Credit Bonds	0.1	-4.6	U.S. Small Cap Stocks	-4.4	12.4
Investment-Grade Bonds	0.1	-1.6	Emerging-Market Stocks	-8.1	-1.2

Source: Fidelity Investments

A few notable insights:

1. ***Only commodities saw significant gains.*** The third quarter was weak for most major asset classes. Driven by higher oil and natural gas prices, commodities topped the leaderboard with a nearly 7% return. They are also the best performing asset class for the year.

2. ***US Large-Caps continued to lead.*** Like so many times over the past decade, the largest companies outperformed. In Q3, large caps were barely positive, but year-to-date, the S&P leads among all major equity categories.

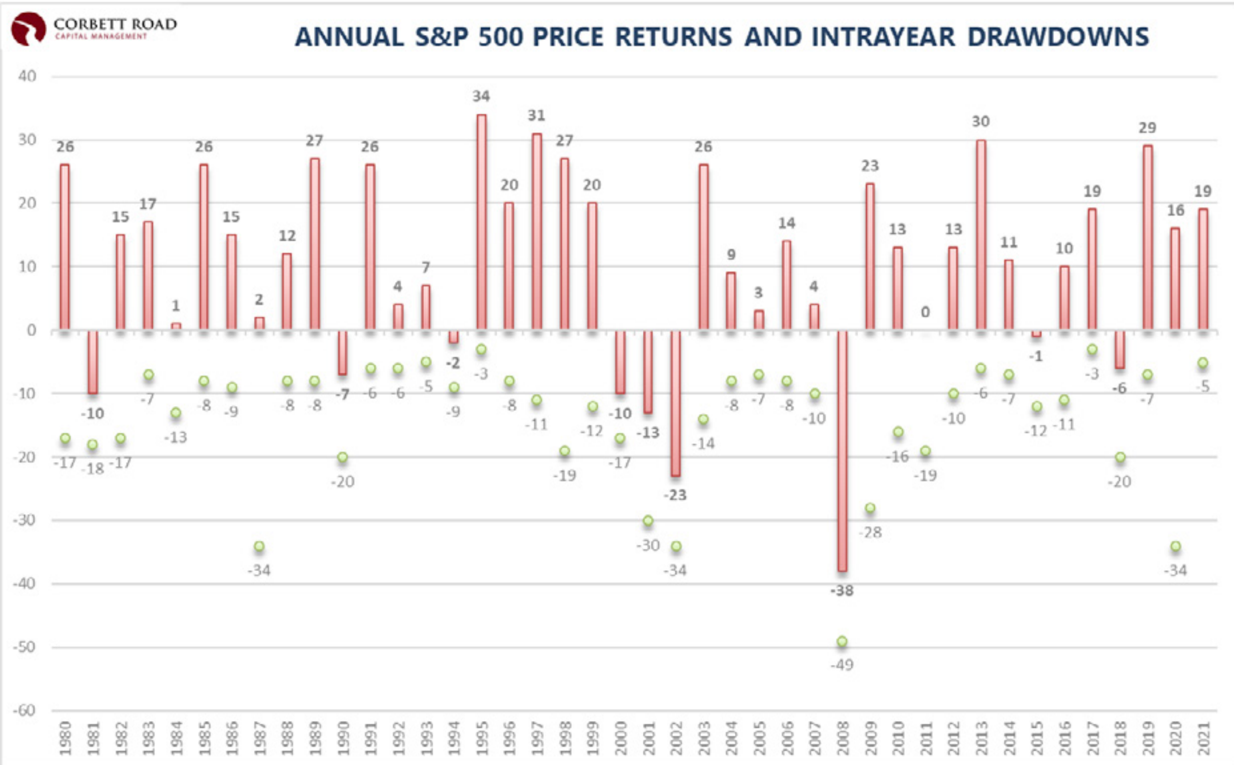
3. ***Small- and Mid-Caps lagged Large-Caps.*** Both small-cap and mid-cap stocks lagged their larger counterpart again this past quarter.

4. ***Emerging Market stock returns were poor, due mostly to China.*** Emerging market stocks were the worst performers in Q3 (declining ~8%) and are negative through the first three quarters. This performance is in stark contrast with the 2000-2010 period when strong commodity performance coincided with strength in emerging market stocks. Historically, emerging markets were more heavily exposed to the materials and energy sectors, whereas today, Chinese stocks and tech make up a larger component of the index and have been a drag on EM returns. This is a good example of how index composition changes over time, rendering previously strong correlations moot.

5. ***Bonds were flat.*** After registering some of the worst quarterly returns in history in Q1, bonds bounced back in the spring but remained mostly flat in Q3.

LATEST PULLBACK REMAINS MILD
COMPARED TO HISTORY

The S&P 500's worst decline this year was 5% from peak to trough, occurring over the month of September. That's mild compared to history. Over the past decade, only 2017 saw a shallower drawdown. Over the past 40 years, the average annual decline has been 14%.



In summary, **macro**cast™ remains positive, which suggests minimal risk for a recessionary bear market. Despite bottlenecks limiting certain industries, the economy is strong, but inflation remains stubbornly high. The data suggests we are in an inflationary boom rather than a period of stagflation. Asset class performance was mixed in the third quarter, but most risk assets have generated positive returns in 2021. Strong, positive breadth and the market's quarterly winning streak have historically preceded continued gains in future periods.

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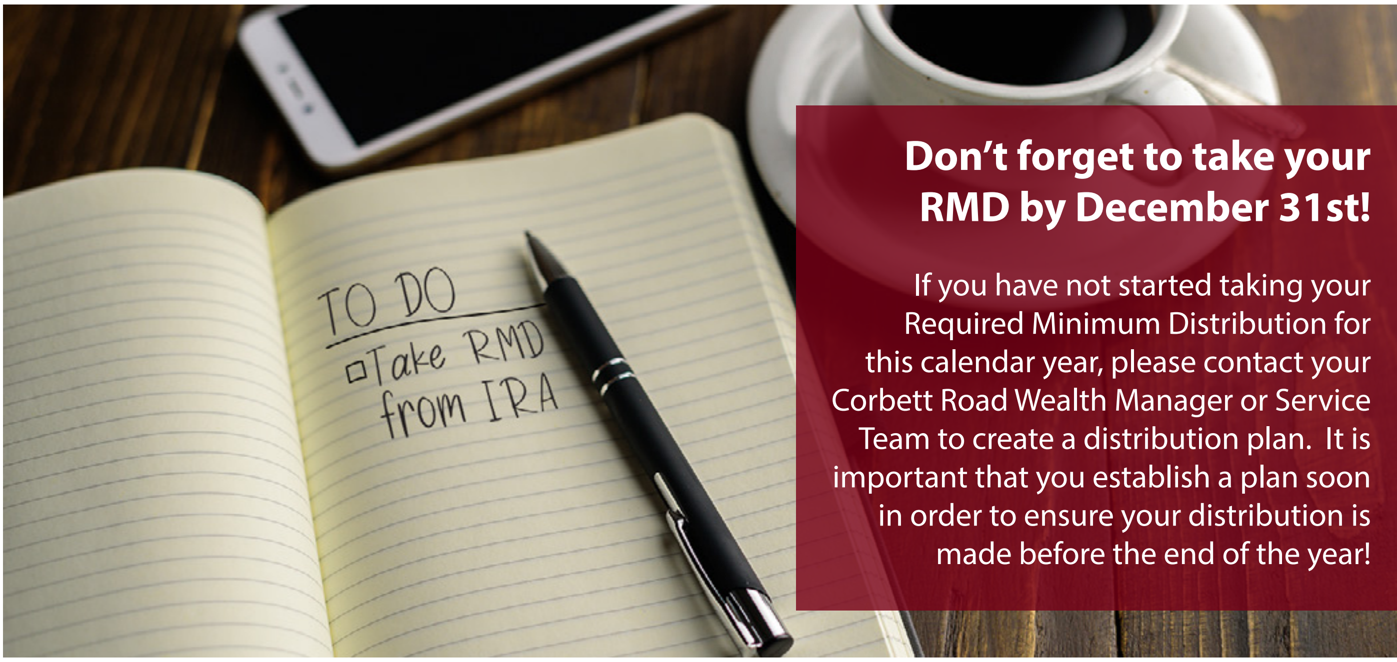
A LOOK AHEAD: **Q4 PODCAST AND OUTLOOK 2022**

Our next podcast episode will be published in early November. We will be covering the timeliest topics of the day, including more on inflationary concerns and how the debt ceiling issue could affect the market into year-end. If you haven't already, please subscribe through your favorite podcast app so you can receive the episode as soon as it drops.

We will publish our next edition of Macro Musings in early December, which will cover our firm's initial thoughts on the year ahead.

Thank you for reading our latest thoughts and analyses. We appreciate any feedback and value your continued relationship and trust.



Don't forget to take your RMD by December 31st!

If you have not started taking your Required Minimum Distribution for this calendar year, please contact your Corbett Road Wealth Manager or Service Team to create a distribution plan. It is important that you establish a plan soon in order to ensure your distribution is made before the end of the year!

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