CORBETT ROAD
WEALTH MANAGEMENT

MACRO MUSINGS

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Third Quarter 2022 Review: Volatility Persists

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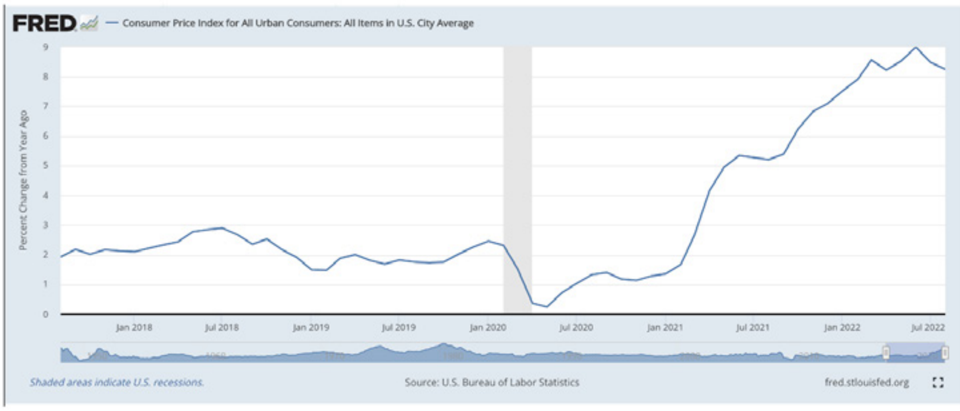
SUMMARY

- The **macro**cast™ score suggests that the probability of a recessionary bear market remains elevated, and the defensive position of **micro**cast™ reflects the volatile market conditions. The combination of both risk models suggest we remain in a challenging market environment, which we expect to persist through the rest of the year.
- Inflation—and the Fed's fight against it—remains the driving force behind market action. While inflation has likely peaked, the Fed is focused on reducing wage growth to slow inflation further, and history shows higher unemployment may be needed to achieve that goal.
- Asset class performance remained volatile in the third quarter. Equity markets rallied early in the quarter, only to give it all back and finish with a negative return. Bonds struggled as rates rose, and the 2-year Treasury bond yield reached its highest level since 2007.
- The S&P 500 finished down for the third consecutive quarter—a rare occurrence. Historically, when the market was down three quarters in a row, future performance was mostly positive, but forward returns were much stronger if no recession followed.

THE MESSAGE FROM **macrocast™**

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.

Within the VITALS, Inflation remains at historic highs. However, after rising for the past two years, headline inflation appears to have peaked in June:



While easing headline inflation is a welcome development, price changes in the underlying components show inflation remains persistent in the stickier, services categories like shelter. Core CPI, which excludes the volatile food and energy categories, increased in August:

June +5.9% year over year

July +5.9% year over year

August +6.3% year over year

The divergence, with core CPI rising and headline CPI falling, led the Fed to step up its tightening efforts to prevent inflation from becoming entrenched.

A key focus for the Fed as they combat inflation is the labor market. Simply put, they believe that inflation won't fall without a slowdown in wage growth.

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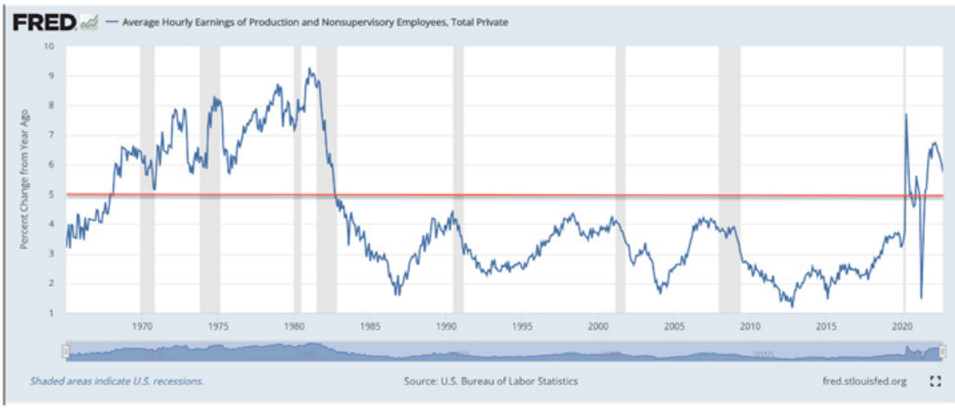
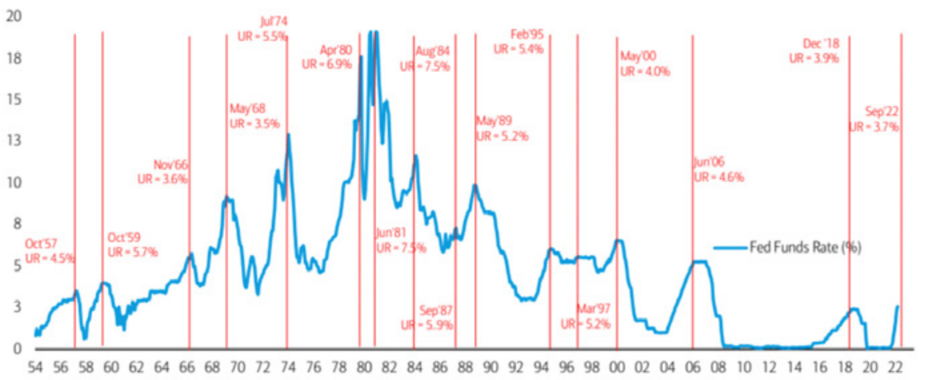
History is supportive of this view. In the inflationary period of the 1970s, wage growth remained above 5% throughout the entire decade. It took a series of aggressive interest rate hikes and a deep recession in the early 1980s for wage growth to fall back below 5%, where it remained for the following four decades:



What causes wage growth to slow? In the above chart, you can see that wages often decline after a recession. Recessions are characterized by slowing or contracting economic growth and rising rates of unemployment. The combination of weakening corporate profits and a greater supply of available labor lead to lower pay increases. With less cash available for spending, consumer demand falls, inhibiting businesses from raising prices further and putting downward pressure on inflation.

The Fed will likely continue to raise rates until joblessness rises. Looking back historically, the level of unemployment where the Fed stopped raising rates has varied over time, with the unemployment rate ranging from 3.5% to 7.5% before the Fed pivoted (chart from Bank of America):

Chart 2: In past 16 cycles average U-rate when Fed hikes rates for last time = 5.7%
Federal Funds Rate (%)



Source: BofA Global investment Strategy, Haver.

BofA GLOBAL RESEARCH

It should be noted that hiking cycles have only ended when the unemployment rate was below 4.0% three times: 1966, 1968, and 2018. In each instance, inflation was much lower than it is today.

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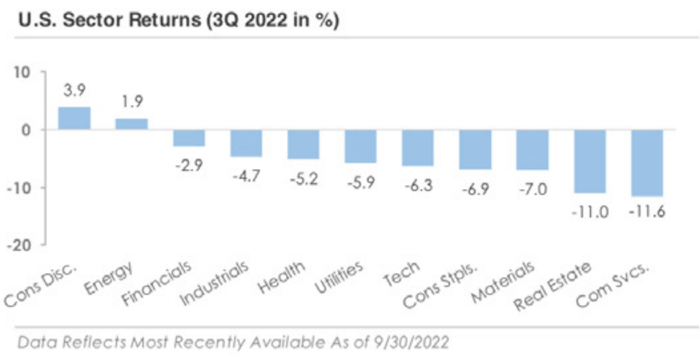
ASSET CLASS **REVIEW**

The following table and chart highlight major asset class returns through September 30th:

Stocks	Level	1 month	3 months	YTD
S&P 500	3,586	-9.2%	-4.9%	-23.8%
Dow Jones	28,726	-8.7%	-6.1%	-19.6%
Russell 2000	4,137	-9.7%	-2.1%	-25.1%
Russell 1000 Growth	1,400	-9.7%	-3.5%	-30.7%
Russell 1000 Value	827	-8.7%	-5.6%	-17.7%
M SCI EAFE	1,137	-9.2%	-10.4%	-26.9%
M SCI EM	54,180	-11.5%	-13.0%	-27.9%
NASDAQ 100	10,971	-10.5%	-4.5%	-32.5%

Fixed Income	Yield	1 month	3 months	YTD
U.S. Aggregate	4.75%	-4.1%	-4.7%	-14.3%
U.S. Corporates	5.74%	-6.0%	-6.1%	-21.1%
Municipal Bonds	4.33%	-2.8%	-3.0%	-10.6%
High Yield Bonds	9.61%	-3.7%	-1.7%	-15.0%



A few notable insights:

A Boom-and-Bust Quarter. The third quarter was an up-and-down quarter in the equity market, literally. The S&P 500 Index returned -4.9% during the third quarter; however, the slight loss obscures the market's two extremes. The S&P 500 started the quarter by rising ~14% through August 16th as expectations for a shorter tightening cycle and a potential interest rate cut in 2023 propelled stocks higher. The August CPI report, highlighting inflation's persistence, followed by hawkish Fed commentary threw cold water on the market's initial advance, sending stocks lower. At the end of the roller-coaster ride, the S&P 500 closed the third quarter slightly below where it started.

Sector performance had no clear trend. U.S. sector returns were varied with no clear leadership trends during the third quarter. Despite soaring inflation and pressure on household budgets, Consumer Discretionary was the top-performing S&P 500 sector, with the gains primarily driven by Tesla. Energy was the only other sector to produce a positive return. The remaining sectors were mixed with no clear defensive or cyclical trends. Communication Services and Real Estate both traded down more than -11.0%. The middle-of-the-pack sectors included three defensive sectors (Utilities, Health Care, and Consumer Staples), three cyclical sectors (Materials, Industrials, and Financials), and one growth-style sector (Technology).

International stocks went back to underperforming. International markets underperformed the S&P 500 during the third quarter. The MSCI EAFE Index of developed market stocks returned -10.4% during the quarter, while the MSCI EM Index of emerging market stocks returned -13.0%. International markets faced a variety of headwinds during the quarter, including Europe's energy crisis and China's struggle to reopen and return to growth after its zero-Covid policy. In addition, a strong U.S. dollar, which produces currency translation losses when investments are translated back into USD, weighed on international stocks.

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Treasury yields continued to rise, sending bonds lower. Bonds continued to trade lower during the third quarter as Treasury yields rose to decade-plus highs in anticipation of tighter Fed policy. The 2-year yield sits at the highest level since August 2007. To put this year's spike in yields into perspective, the 2-year yield was just 0.73% on 12/31/2021 but was 4.20% at the end of Q3. The parabolic move higher in Treasury yields this year provides a visual depiction of the Fed's aggressive interest rate increases.

THREE STRAIGHT NEGATIVE QUARTERS **ARE RARE**

The S&P 500 has fallen for three consecutive quarters for only the ninth time since WWII. Market performance going forward was mixed in previous instances and was heavily influenced by whether the US economy entered a recession (table from Truist):

S&P 500 price returns after 3-straight down quarters

Date	Cumulative price decline over 3 quarters	3-months later % change	6-months later % change	9-months later % change	12-months later % change	Recession period
Sep-53	-12%	6%	15%	25%	38%	Yes
Sep-66	-17%	5%	18%	18%	26%	No
Sep-69	-10%	-1%	-4%	-22%	-10%	Yes
Jun-74	-21%	-26%	-20%	-3%	11%	Yes
Mar-78	-11%	7%	15%	8%	14%	No
Mar-84	-5%	-3%	4%	5%	13%	No
Dec-00	-12%	-12%	-7%	-21%	-13%	Yes*
Sep-02	-29%	8%	4%	20%	22%	No
Jun-08	-16%	-9%	-29%	-38%	-28%	Yes
Sep-22	-25%					
Average		**-3%**	**0%**	**-1%**	**8%**	
Median		**-1%**	**4%**	**5%**	**13%**	
% periods positive		**44%**	**56%**	**56%**	**67%**	

Data source: Truist IAG, FactSet. *Recession started March 2001
Past performance does not guarantee future results.

If the Fed can reduce inflation without tipping the economy into recession, that bodes well for future stock performance. Stocks were higher a year later in each instance when no recession ensued.

If a recession occurs, negative returns are more likely, but given how much stocks have declined already, a milder decline like the ones that occurred after 1969 or 2000 might be a more likely outcome than the decline we saw during the global financial crisis in 2008.

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Finally, below is an update to a table from our last quarterly review. This was the 14th worst nine-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 the longer-term performance was particularly notable. 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 9 Months Periods & Forward Returns (1971 - 2022)									
	Worst 9 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	-46.7%	Jun-08	Feb-09	26%	42%	56%	102%	189%	372%
2	-39.3%	May-08	Jan-09	8%	23%	35%	73%	147%	309%
3	-37.0%	Jul-08	Mar-09	17%	36%	52%	91%	167%	341%
4	-34.5%	Jan-74	Sep-74	9%	36%	41%	84%	153%	392%
5	-32.3%	Mar-08	Nov-08	-16%	6%	27%	53%	132%	288%
6	-30.6%	Apr-08	Dec-08	-11%	4%	28%	52%	134%	246%
7	-29.7%	Aug-08	Apr-09	14%	20%	41%	72%	142%	315%
8	-28.6%	Feb-08	Oct-08	-14%	-7%	11%	41%	108%	250%
9	-28.1%	Nov-73	Jul-74	-5%	1%	21%	50%	90%	255%
10	-27.2%	Mar-74	Nov-74	19%	35%	36%	65%	123%	334%
11	-27.2%	Sep-08	May-09	12%	20%	23%	53%	135%	268%
12	-27.0%	Apr-74	Dec-74	25%	46%	38%	70%	135%	356%
13	-26.6%	Jan-02	Sep-02	8%	4%	26%	66%	115%	129%
14	-25.9%	Jan-22	Sep-22						
15	-25.0%	Dec-73	Aug-74	-1%	18%	29%	62%	121%	333%
16	-23.7%	Feb-74	Oct-74	7%	22%	26%	51%	100%	318%
17	-22.0%	Oct-73	Jun-74	-25%	-18%	19%	41%	75%	236%
18	-21.8%	Feb-01	Oct-01	8%	5%	-13%	18%	53%	58%
19	-21.6%	Apr-02	Dec-02	-3%	13%	32%	58%	93%	113%
20	-21.2%	Jul-00	Mar-01	7%	-10%	3%	9%	33%	55%
Average Worst Periods				4%	16%	28%	59%	118%	262%
Average All Periods				3%	6%	12%	41%	79%	218%
Differential				2%	10%	16%	18%	40%	44%
COMPOUND		Data as of 9/30/22				@CharlieBilello			

In summary, while inflation has likely peaked, the Fed would like to see wage growth fall and unemployment rise before they feel comfortable enough that inflation is moving towards their goal of 2%. The continuing uncertainty around Federal Reserve policy, the weakening economic growth outlook for 2023, and the signals from both **macro**cast™ and **micro**cast™ suggest caution towards risk assets.

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