CORBETT ROAD
WEALTH MANAGEMENT

MACRO MUSINGS

September 15, 2022

Fed Not Deterred

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CORBETT ROAD
WEALTH MANAGEMENT

SUMMARY

- Our current **micro**cast™ signal remains at a defensive allocation. The **macro**cast™ score suggests that the probability of a recessionary bear market has increased and that 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 rest of the year.
- In recent speeches, members of the Federal Reserve have reiterated that they want to see inflation come down and stay down before they are ready to slow rate hikes. With the latest inflation figures coming in higher than expected, that view is likely to remain in place for at least the next few months.
- The recent rally in the market pushed traditional valuation measures like the P/E ratio to levels where stocks have historically stalled. This suggests that even if stocks were to rally, earnings growth would be required to push the market higher. With expectations of a recession increasing next year, earnings estimates are more likely to continue on a downturn.

A FED POLICY PIVOT IS **UNLIKELY ANYTIME SOON**

Members of the Federal Reserve made it clear in recent speeches that they will continue to raise rates until they believe inflation is fully under control, even if that means a recession.

At the annual Jackson Hole Conference in August, Jerome Powell, Chair of the Fed, used his speech to forcefully push back against the notion that the Fed will pivot and cut interest rates if economic data starts to weaken. Powell emphasized the central bank's "overarching focus right now is to bring inflation back down to our 2 percent goal." He cautioned, "Reducing inflation is likely to require a sustained period of below-trend growth … [and] will also bring some pain to households and businesses."

A more recent speech by Fed Governor Christopher Waller suggests a persistent decline in inflation is needed before stopping rate hikes. Waller cited last year's policy mistake as evidence the Fed does not want to get burned again (emphasis ours):

To sum up, while I welcome promising news about inflation, I don't yet see convincing evidence that it is moving meaningfully and persistently down along a trajectory to reach our 2 percent target. I keep in mind that a year ago we saw similarly promising evidence of inflation moderating for several months before it jumped up to a high and then very high level. Those earlier inflation readings probably delayed our pivot to tightening monetary policy by a few months. ***The consequences of being fooled by a temporary softening in inflation could be even greater now if another misjudgment damages the Fed's credibility. So, until I see a meaningful and persistent moderation of the rise in core prices, I will support taking significant further steps to tighten monetary policy.***

Investor hopes for a Fed pivot were one of the primary catalysts that propelled the stock market higher during July and August. Chair Powell's speech dashed those hopes and sent the S&P 500 down more than -3% on the day of his speech. Why? Two lines from Chair Powell's speech underscore the Fed's goal: "There is clearly a job to do in moderating demand to better align with supply. We are committed to doing that job." This focus on lowering demand for goods and services may increase portfolio volatility during the months ahead as investors debate how long it will take the Fed to achieve its goal, as well as the impact tighter policy will have on the economy.

These comments, along with another high inflation report this month, suggest rates will rise for the foreseeable future, and rate cuts are a long way away.

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INFLATION NUMBERS CAME IN HIGHER THAN EXPECTED
HERE ARE SOME POSSIBLE PATHS GOING FORWARD

While August inflation data was higher than expected, we believe inflation numbers should continue to fall in the coming months.

This handy table from Bespoke Investment Group lays out the possible paths based on various scenarios. For example, if there is zero inflation over the next eight months, the annual Consumer Price Index (CPI) will reach 3% by springtime. If, however, inflation is closer to the last decade average of .2% per month, then CPI won't fall below 3% until June. Month-to-month inflation will have to remain historically high for the Headline number to still be above 5% by next spring:

Potential Paths for YoY CPI Based on Constant MoM Changes

Month		Actual CPI YoY %	Fed Funds Rate (%)
Jun-21		*5.39*	*0.08*
Jul-21		*5.37*	*0.07*
Aug-21		*5.25*	*0.06*
Sep-21		*5.39*	*0.06*
Oct-21		*6.22*	*0.07*
Nov-21		*6.81*	*0.07*
Dec-21		*7.04*	*0.07*
Jan-22		*7.48*	*0.08*
Feb-22		*7.87*	*0.08*
Mar-22		*8.54*	*0.33*
Apr-22		*8.26*	*0.33*
May-22		*8.58*	*0.83*
Jun-22	*Already past the peak:*	*9.06*	*1.58*
Jul-22		*8.52*	*2.32*

Future YoY CPI w/:	0.0% MoM	0.1% MoM	0.2% MoM	0.3% MoM	0.4% MoM	Fed Fund Futures:
Aug-22	8.30	8.41	8.52	8.63	8.73	2.33
Sep-22	8.01	8.22	8.44	8.66	8.87	3.02
Oct-22	7.12	7.44	7.76	8.08	8.41	3.02
Nov-22	6.59	7.02	7.45	7.88	8.31	3.52
Dec-22	6.27	6.80	7.33	7.87	8.41	3.77
Jan-23	5.38	6.01	6.65	7.29	7.94	3.77
Feb-23	4.43	5.16	5.90	6.64	7.39	3.90
Mar-23	3.05	3.88	4.71	5.55	6.40	3.96
Apr-23	2.48	3.41	4.34	5.28	6.23	3.96
May-23	1.36	2.38	3.41	4.44	5.49	3.96
Jun-23	-0.01	1.09	2.21	3.34	4.48	3.93
Jul-23	0.00	1.21	2.43	3.66	4.91	3.89
Aug-23	0.00	1.21	2.43	3.66	4.91	3.89
Sep-23	0.00	1.21	2.43	3.66	4.91	3.80
Oct-23	0.00	1.21	2.43	3.66	4.91	3.80
Nov-23	0.00	1.21	2.43	3.66	4.91	3.71

CPI YoY is below projected Fed Funds Rate as early as March '23 or as late at July '23 based on 0.0% to 0.3% MoM CPI readings.

One thing to note is the table does not account for possible negative month-to-month readings. Another consideration is this table refers to **Headline** CPI, which includes volatile food and energy prices, while the Fed is usually focused on **Core** measures that exclude those categories. The Fed believes core inflation better represents the underlying trend. Regardless, barring an unforeseen event, inflation is expected to continue lower as we move into 2023.

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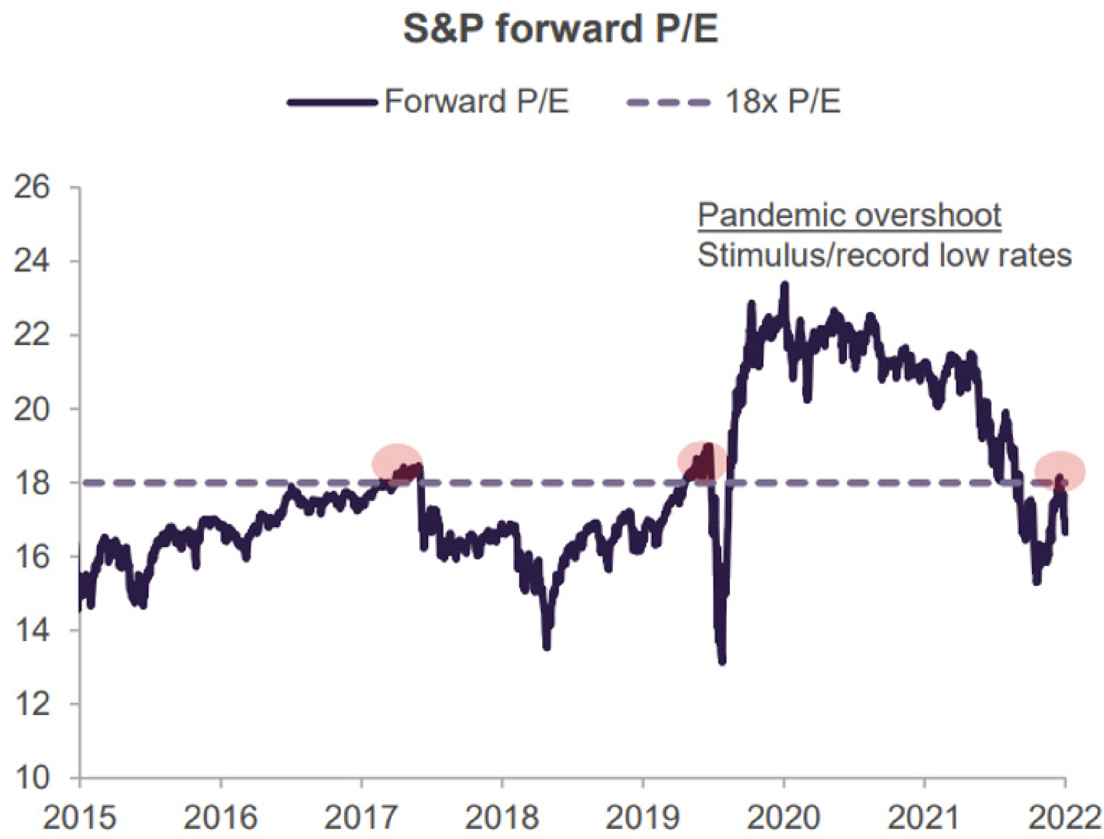
VALUATIONS REMAIN
A HEADWIND TO MARKET UPSIDE

The rally off the June lows peaked on August 16th. This recent top occurred with the S&P 500 trading at 18 times their expected earnings over the coming twelve months (chart from Truist):



A P/E of 18 for the market has been an area of key resistance over the past several years, outside of the post-pandemic period. The higher valuations we observed during that stage were supported by record high fiscal stimulus and significant monetary accommodation, which are no longer the case. In our view, it is highly unlikely that either the Fed or government will provide support in that manner in the near future.

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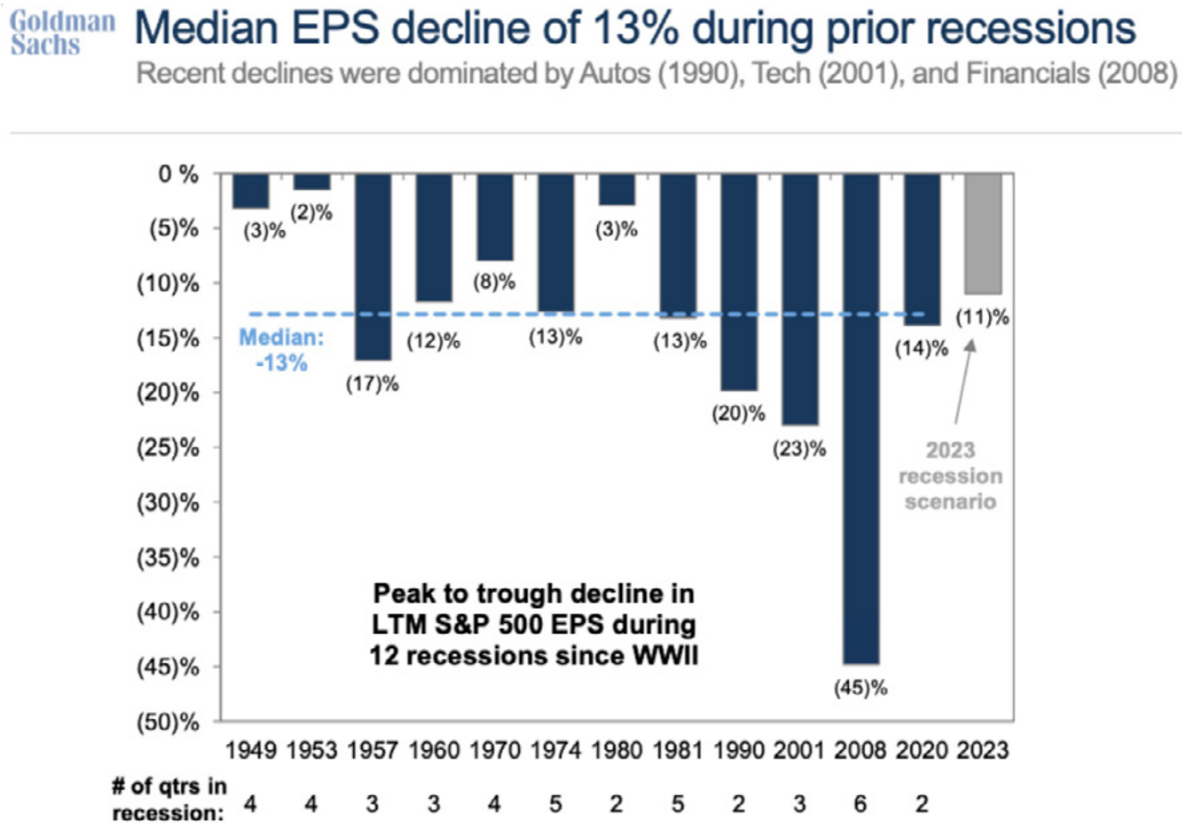
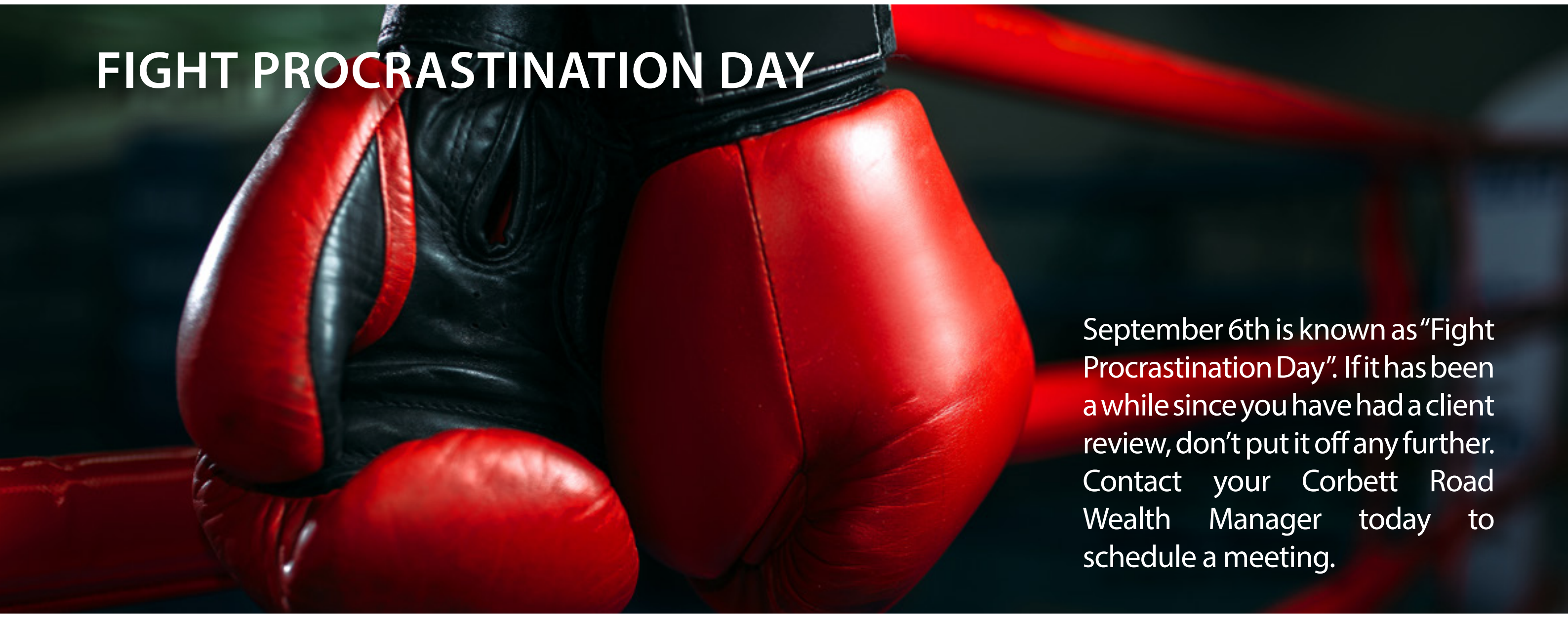
It should also be noted that consensus earnings estimates for 2023 have not meaningfully been reduced yet. If the US economy goes into recession next year, then earnings estimates will likely drop, pressuring valuations further (chart from Goldman Sachs):



In summary, the Fed remains committed to lowering inflation, even if that means a recession is needed to get the job done. The latest inflation figures came in higher than expected, but scenario analysis suggests it should still be much lower by next May. Even if we avoid a recession, current market valuations indicate the upside is somewhat limited from recent levels.

Thank you for taking the time to read our latest thoughts and for your continued trust in Corbett Road.

FIGHT PROCRASTINATION DAY



September 6th is known as "Fight Procrastination Day". If it has been a while since you have had a client review, don't put it off any further. Contact your Corbett Road Wealth Manager today to schedule a meeting.

IMPORTANT DISCLOSURES

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