MACRO MUSINGS

September 15, 2023

Beyond Inflation, Signs of Market Resilience

Rush Zarrabian, CFA®
Corbett Road
Managing Partner, Portfolio Manager

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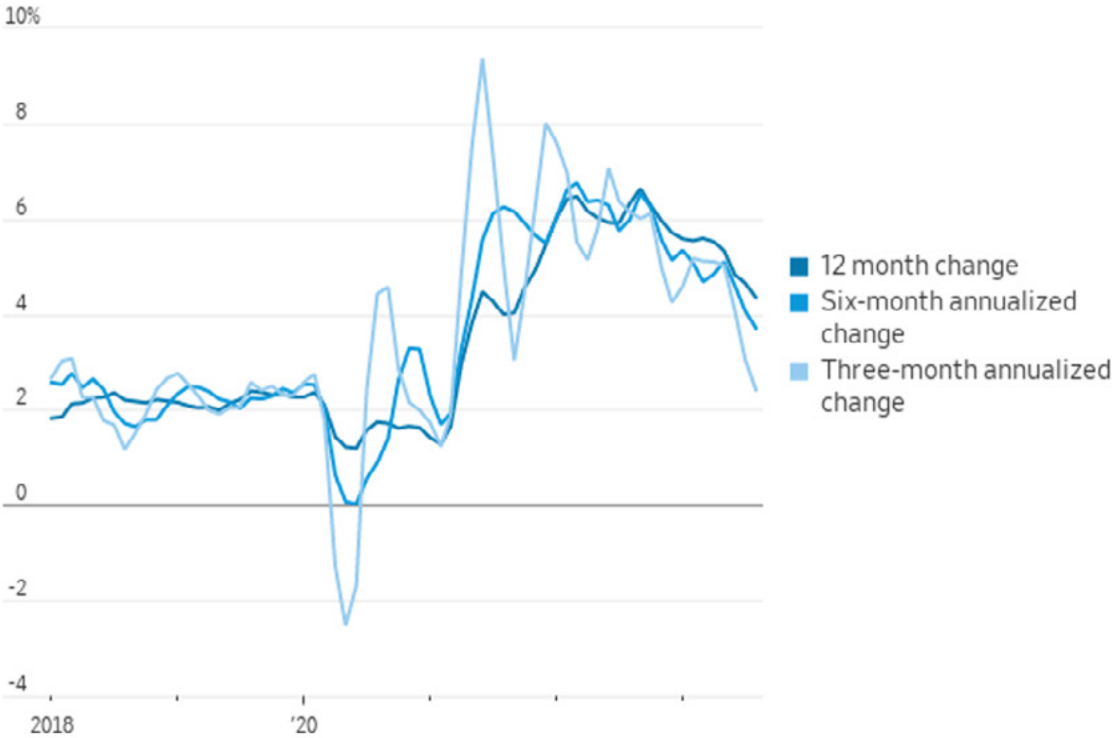
SUMMARY

- The **macro**cast™ score is unchanged from last month's figure. Similarly, our **micro**cast™ signal maintains its aggressive allocation stance from August. While the **macro**cast™ score suggests the risk of a sustained, recessionary bear market remains elevated, the **micro**cast™ model's positioning reflects a more optimistic picture of the market environment.
- In August, headline inflation—influenced by rising gas prices—accelerated to 3.7% year-over-year growth, up from 3.2% in the prior month. On the positive side, core inflation continued to slow, dropping to a rate of 4.3% year-over-year. While the trend in core inflation is encouraging, there is still work to be done in achieving the Federal Reserve's 2% target, and another rate hike is still possible before year end.
- While both **macro**cast™ and The Conference Board's Leading Economic Index continue to advise caution, we have yet to see signs of credit stress in the bond market. Corporate bond spreads, which typically spike higher in economic downturns, have been declining since March.
- Despite the stock market's usual late-summer slump, robust performance through August typically results in positive returns for the rest of year. This is especially common when equities pullback in August, as they have this year.

HEADLINE INFLATION JUMPS IN AUGUST, **WHILE CORE INFLATION CONTINUES TO TREND LOWER**

Headline inflation accelerated in August, largely driven by rising gas prices. The year-over-year inflation rate reached 3.7%, an increase from 3.2% in the preceding month. Excluding volatile food and energy prices, the core inflation rate decreased to 4.3% from 4.7% in July. Overall, the trend in inflation is heading in the right direction, as depicted in this chart from the Wall Street Journal:

Core consumer-price index



Note: Core inflation excludes food and energy items. Three- and six-month annualized change uses seasonally adjusted figures.
Source: Labor Department

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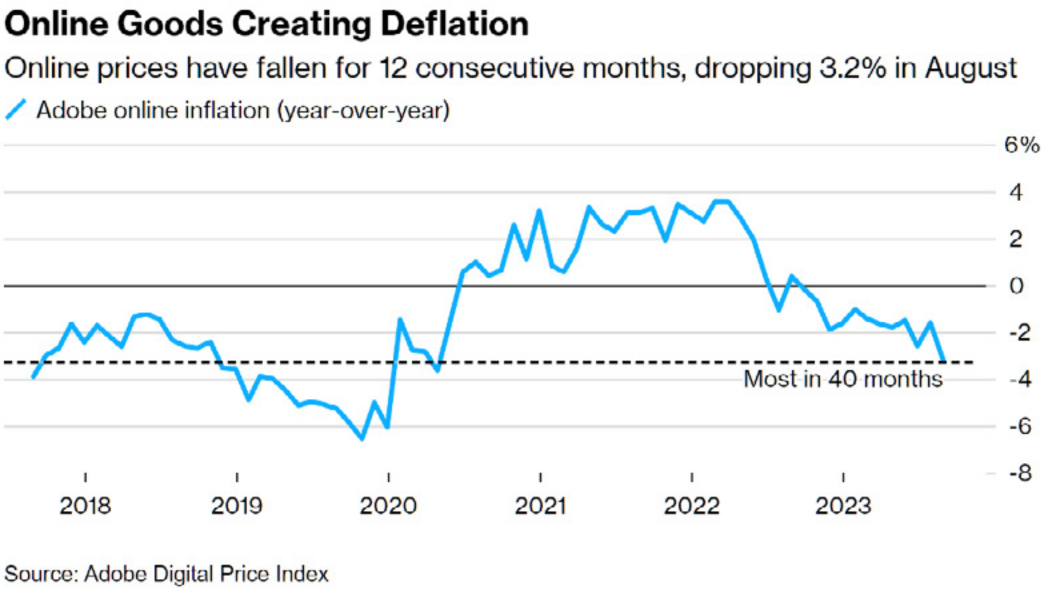
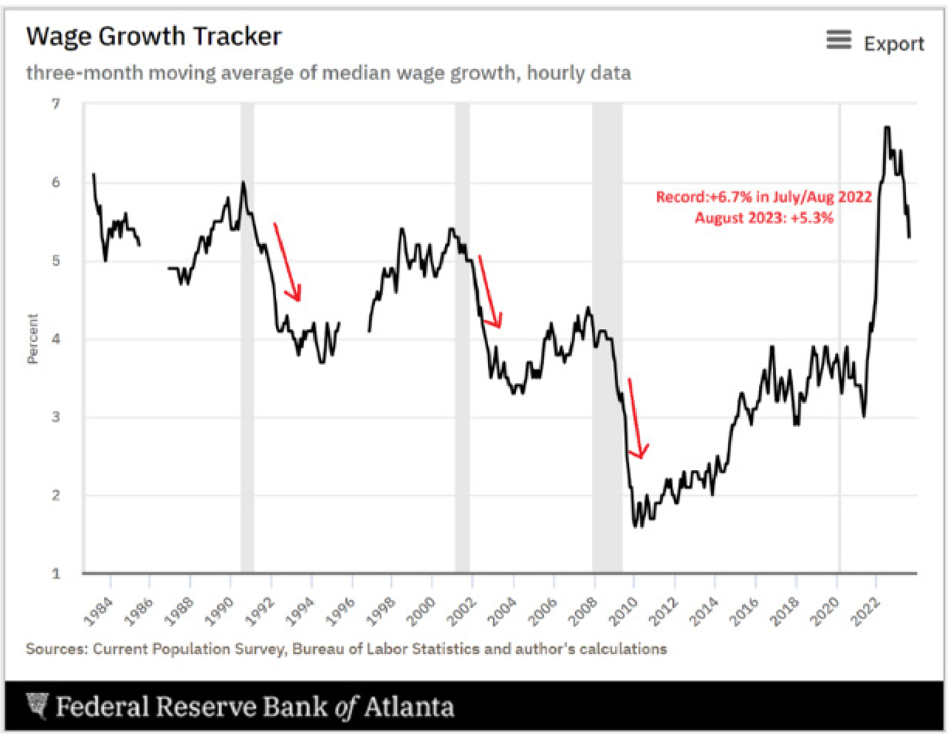
A significant driver behind the decline in core inflation is the drop in the price of goods. Adobe's Digital Price Index—a model that tracks online prices to gauge inflation in the digital economy—highlights this downward trend (chart from Bloomberg):



While core inflation remains high, the downward trend is positive and further declines are expected in the months ahead. Shelter inflation, which operates with a lag, should continue to come down to reflect the slowdown in the cost of rent while slowing wage growth is also encouraging (Chart from Atlanta Fed, via DataTrek):



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Even with current inflation rates trending below last year's figures, there is still work to be done before inflation reaches the Federal Reserve's 2% target. While the Fed is likely to keep rates unchanged after their meeting next week, the Oct. 31-Nov. 1 meeting might still bring about a rate hike. The next employment report and CPI print will hopefully provide members with more clarity.

CORPORATE BOND SPREADS REMAIN UNFAZED **BY ECONOMIC UNCERTAINTIES**

While both **macro**cast™ and The Conference Board's Leading Economic Index signal caution amid elevated recession risks, there are few signs of concern in the corporate bond market.

Credit spreads, which compare the yield on a corporate bond to that of a risk-free Treasury, are a reliable indicator of stress in credit markets as they reflect risk sentiment and investor confidence in corporate earnings. Amid periods of rising economic uncertainty, bond spreads typically widen as investors sell riskier, corporate bonds in favor of risk-free Treasuries. A widening spread indicates higher perceived credit risk whereas tightening spreads reflect the opposite.

The following chart shows investment-grade credit spreads over the past decade (Chart from Federal Reserve Bank of St. Louis):

Shaded areas indicate U.S. recessions Source: Federal Reserve Bank of St. Louis myf.red/g/18Mfo

While spreads rose in 2022, they remained below 2.4%—well off the levels reached during the onset of the pandemic and during the 2015-2016 global economic slowdown, which was driven by China's faltering economy and the oil price crash. They were even lower than levels reached in 2018 when investors worried about the Fed overtightening.

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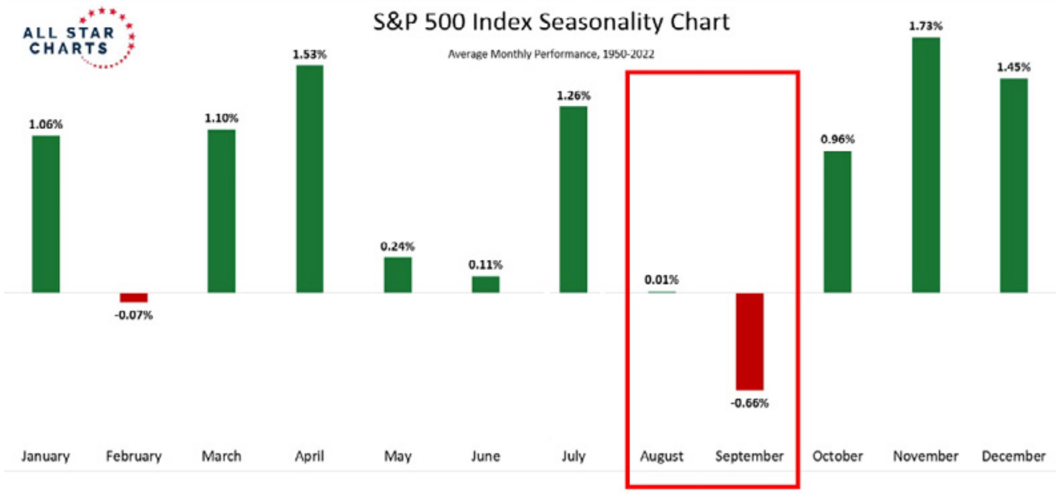
Although we saw a brief spike earlier this year during the regional bank crisis, spreads have drifted lower since, despite economic indicators signaling an impending recession.

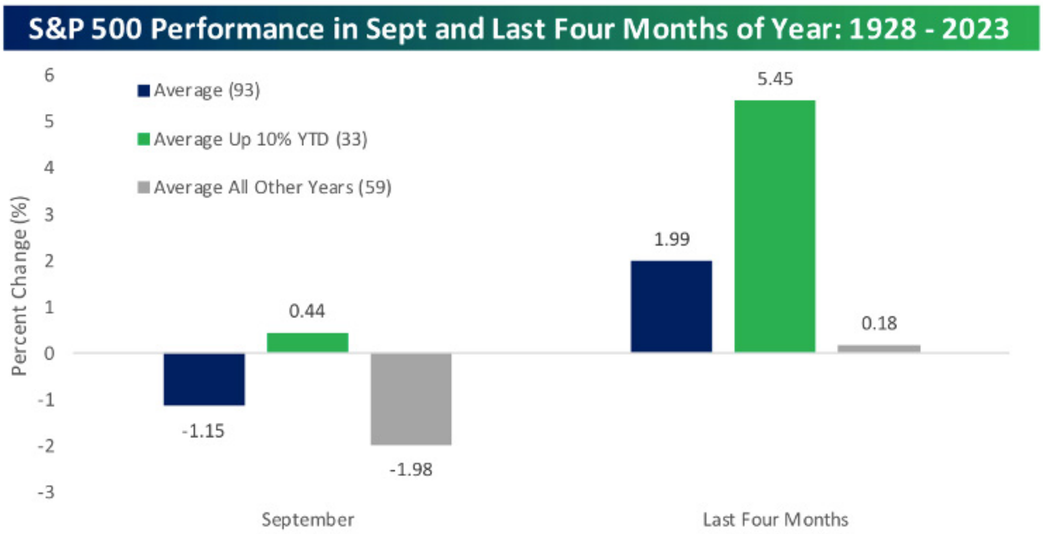
While credit spreads aren't definitive predictors of the stock market, the current trend in this measure of credit risk is not reflecting the risk of an imminent recession.

HISTORICAL PRICE STUDIES POINT TO **A POSITIVE YEAR-END MARKET OUTLOOK**

The stock market has experienced a slight pullback since the beginning of August. It is not uncommon to see a dip during the late summer; historically, August and September have posted weaker equity returns than other months (Chart from All Star Charts):

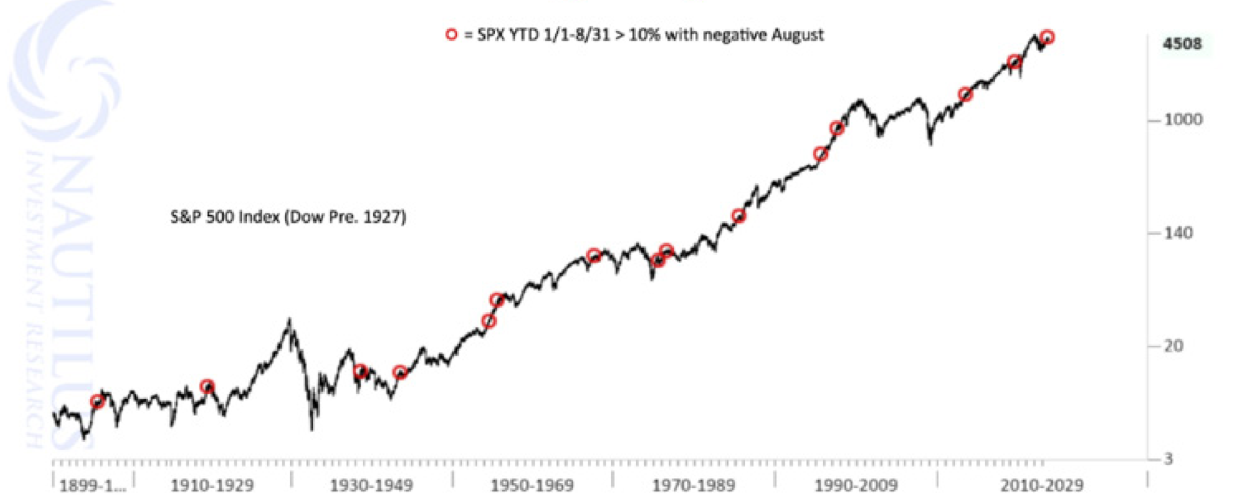


Seasonally, September stands out for its notably weak performance. Yet, there's a silver lining. When the market has surged by at least 10% leading up to August, September typically sees positive monthly returns. Moreover, the gains for the remainder of the year have averaged over 5%, as illustrated by a chart from Bespoke:



Further, when August records a decline, as was the case last month, the subsequent returns tend to be even more promising. Historically, average gains have risen to 8% for the rest of the year, and perhaps more importantly, it has only registered negative returns once (Table from Nautilus):

S&P 500 YTD Through August Greater Than 10%



SPX_NAUT Multiple Condition Analysis

SPX_NAUT forward returns after 15 events 12/29/1899 - 8/31/2023

Event Dates	YTD Return	-1Mo	1Wk	1Mo	2Mo	3Mo	Rest Of Year	1Yr
08/31/1905	15.10%	-1.31%	-1.05%	1.91%	3.89%	11.15%	19.76%	16.59%
08/29/1919	27.43%	-2.25%	1.68%	6.08%	13.53%	0.95%	2.37%	-17.58%
08/31/1938	14.31%	-2.19%	1.91%	1.49%	8.62%	2.82%	8.96%	3.90%
08/31/1943	20.78%	-0.42%	-0.17%	2.37%	1.02%	-4.83%	-1.10%	9.07%
08/31/1954	20.23%	-3.40%	2.85%	8.31%	6.20%	13.95%	20.62%	43.88%
08/31/1955	20.01%	-0.78%	1.62%	1.13%	-1.95%	5.03%	5.33%	8.71%
08/31/1967	16.57%	-1.17%	0.77%	2.86%	0.28%	0.92%	3.02%	9.56%
08/29/1975	26.72%	-2.11%	-1.14%	-3.46%	2.89%	5.02%	3.81%	16.80%
08/31/1976	14.10%	-0.51%	1.97%	2.26%	-0.01%	-0.41%	4.42%	-5.97%
08/30/1985	12.79%	-1.20%	-0.20%	-1.89%	0.76%	7.18%	12.01%	34.09%
08/31/1995	22.34%	-0.03%	1.92%	3.53%	3.49%	7.74%	9.62%	17.00%
08/29/1997	21.43%	-5.74%	3.53%	5.32%	2.19%	6.22%	7.89%	6.43%
08/30/2013	14.50%	-3.13%	2.37%	3.80%	7.98%	10.58%	13.19%	22.62%
08/30/2019	16.74%	-1.81%	1.78%	0.47%	4.11%	7.33%	10.40%	19.61%
08/31/2023	17.40%	-1.77%						
Avg after Signals		-1.86%	1.27%	2.44%	3.79%	5.26%	8.59%	13.19%
Average All Periods		0.67%	0.14%	0.60%	1.22%	1.84%	2.41%	7.69%
T-Statistic		-6.76	2.97	2.27	2.33	2.54	3.65	1.35
# Events Up/Down		0 / 15	10 / 4	12 / 2	12 / 2	12 / 2	13 / 1	12 / 2
Significance		-100%	99%	98%	98%	99%	100%	90%

NAUTILUS INVESTMENT RESEARCH — Daily 12/29/1899 - 8/31/2023 — Data Source: FactSet 9/1/2023 23:51

In summary, headline inflation showed a slight uptick last month, primarily due to rising gas prices, posing challenges to the Federal Reserve's 2% inflation target. However, core inflation, which omits volatile food and energy costs, demonstrated a continuation of its promising downward trend. Despite economic caution flags raised by **macro**cast™ and other leading economic indicators, bond market sentiment remains optimistic, as evidenced by the behavior of corporate bond spreads. The stock market's recent dip aligns with typical late-summer patterns, but strong performance leading up to August often precedes positive year-end returns, especially after an August decline.

We appreciate your time and interest in our latest insights.

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CORBETT ROAD
WEALTH MANAGEMENT

Washington, D.C.
7901 Jones Branch Dr
Suite 800
McLean, VA 22102
Local: 703.748.5836

Boston, MA
101 Arch St
8th Floor
Boston, MA 02110
Local: 617.600.7930

Los Angeles, CA
1901 Avenue of the Stars
Suite 200
Century City, CA 90067
Local: 310.591.5674

Fort Lauderdale, FL
2598 E. Sunrise Blvd
Suite 2104
Ft. Lauderdale, FL 33304
Local: 954.507.6028

Knoxville, TN
800 S. Gay St
Suite 700
Knoxville, TN 37929
Local: 865.444.4520

Phoenix, AZ
2375 E. Camelback Rd
Suite 600
Phoenix, AZ 85016
Local: 602.807.1145

St. Louis, MO
7777 Bonhomme Ave
Suite 1800
Clayton, MO 63105
Local: 314.463.0132

Toll Free: 844.688.4955
info@corbettroad.com
www.corbettroad.com
linkedin.com/company/corbettroad