CORBETT ROAD

MACRO MUSINGS

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INFLATION FIXATION

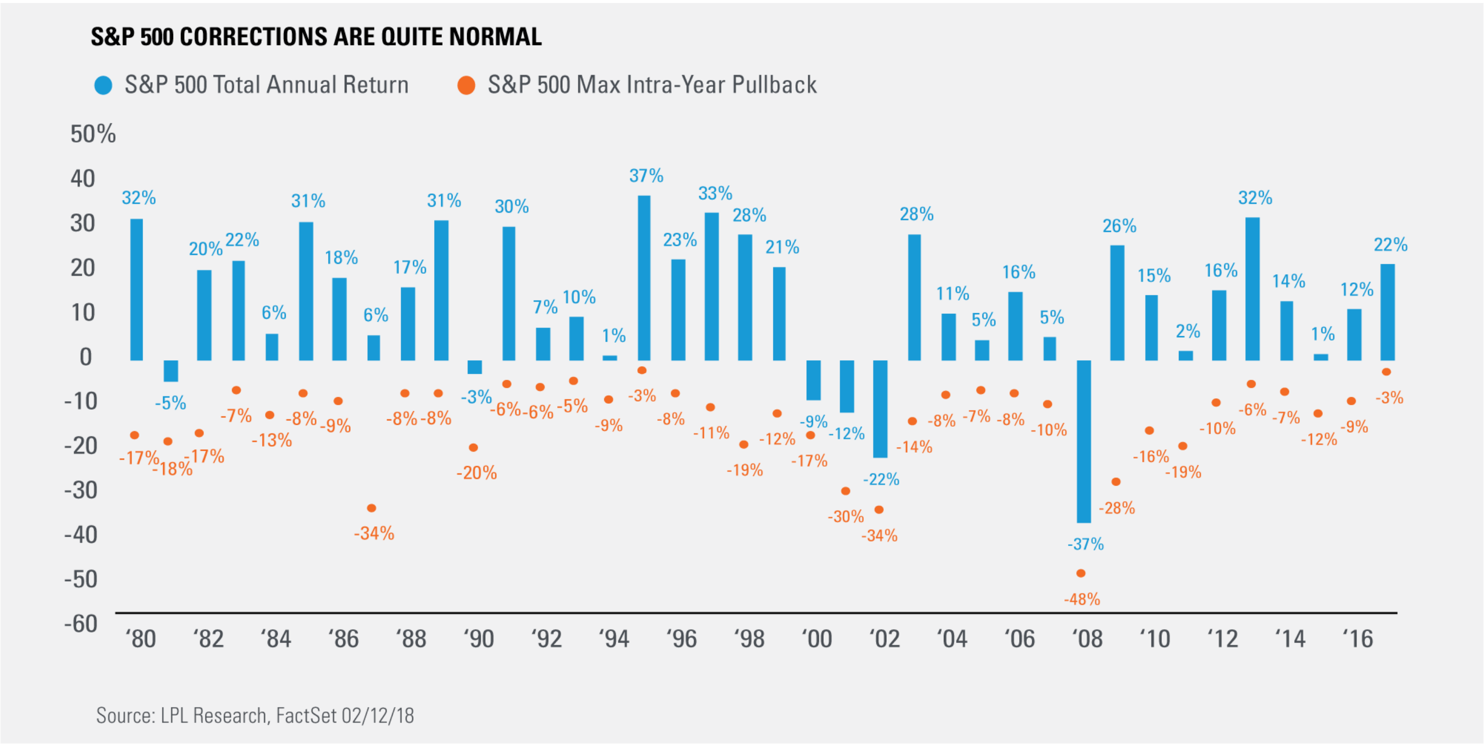
SUMMARY

- MACROCAST™ continues to suggest that the risk of a major bear market occurring is low.
- The recent 10% decline in the market was the first since February 2016. The amount of the correction was typical of a market correction, but the speed in which it occurred was historic.
- Jerome Powell has officially taken over as Chairman of the Federal Reserve, but policy expectations have not shifted with the changing of the guard. We continue to expect three rate hikes in 2018.
- One possibility given for the market sell off was inflation worries. Currently, inflation is 2.1% year over year. History suggests the market does not falter under most inflationary conditions, and is less concerning until it gets above 5%.

MARKET DECLINE WAS TYPICAL IN PRICE MOVEMENT, BUT ATYPICAL IN SWIFTNESS

On January 26th, the S&P 500 reached an all-time high of 2872. The market then proceeded to lose 10% over the next 9 trading days. It was the first 10% decline since early 2016, and the fastest decline from an all-time high in market history.

It was arguably the pace of the decline and not the amount of the decline that caught many investors off-guard. It's been almost two years since the last 10% decline; that is unusual. As a reminder, double-digit declines in any calendar year are the rule, not the exception (chart from LPL):



In terms of volatility, 2017 was a true outlier. The peak-to-bottom decline during the year was less than 3%. 1995, which also saw a 3% drop, was the only other year to come close to this lack of volatility in the past 40 years.

As is often the case during a correction, the focus was on how much money was being lost, as opposed to how much was gained before the drop. The following data highlights market performance from key dates in the past two years. The returns below are for the S&P 500, from the dates listed through the all-time high of January 26, 2018.

- From the beginning of 2018 until January 26th, the total return was up 7.5%. This is a huge move for the market, and not far from the average *annual* gain for any given year, which is around 10%.
- Since Thanksgiving 2017, the market went up 10%.
- Since August 2017, the market was up over 18%.
- Since the U.S. Election in November 2016, the market was up 34%.
- Since the selloff following the decision to leave the European Union ("Brexit") in June 2016, the market rose 43%.
- Since the oil crash finally bottomed in February 2016, the market rose an astounding 57%! That equates to an annualized gain of over 26%.

When viewed from this perspective, the question regarding the market drop shouldn't be "Why is this happening?!", but instead, "What took so darn long?" The real head scratcher was not the decline we just experienced, but that markets rose with barely a drop.

The Fed Will Likely Stick to the Plan

We still think three rate hikes is the most likely outcome for the Fed this year. This would put the Fed Funds rate somewhere between 2% and 2.25% by the end of the year. Note that a Fed Funds rate just over 2% is still low by historical standards.

There's been concern that the Fed will be forced to increase rates at a faster pace due to increasing inflation. Fed analyst Tim Duy thinks that is not going to happen. Duy believes that the Fed is focused on intermediate term inflation and not short-term moves. In an article for Bloomberg, he cited Fed policy in 2017 as the guidepost on how they might handle recent inflationary pressure:

...central bankers continued tightening in 2017 despite inflation that was well below forecast. Why move forward with tightening in a low-inflation environment? Because policy makers believed their medium-term inflation forecast and did not want to be put in a position of accelerating the pace of rate hikes when that inflation emerged.

Just as they were focused on maintaining rate hikes even though inflation was low, the base case is that they stick with three rate hikes even if inflation comes in higher than expected over the next few months.

Even if Inflation Rises, That Doesn't Spell Doom for Stocks

Worries over inflation have been cited as a reason for the recent rise in interest rates, and as a catalyst for the initial decline in the market at the end of January. Specifically, higher than expected wage growth in the latest employment report, triggered the first big drop in the market on February 2nd.

The most recent measure of the Core Consumer Price Index (CPI) was 2.1% when compared to a year ago. If inflation is set to rise well above 2%, the focus then turns to what that means for the market. How have stocks performed during various inflation regimes in the past? The table below shows market returns during various levels of inflation, and the results may surprise you. Over the past 90 years, inflation hasn't had a negative impact on stocks until it reached much higher levels (table from Charlie Biello of Pension Partners):

S&P 500 Ann. Total Returns at Various Inflation Levels (1928 - 2017)					
Inflation Quintile	Inflation Range	S&P 500 Nominal (Ann.)	S&P 500 Real (Ann.)	% Positive Nominal	% Positive Real
Quintile 1	-10.3% to 0.9%	4.6%	6.5%	56%	61%
Quintile 2	0.9% to 2.1%	15.8%	14.2%	83%	78%
Quintile 3	2.1% to 3.0%	11.5%	8.7%	83%	78%
Quintile 4	3.0% to 4.7%	12.1%	8.3%	89%	83%
Quintile 5	4.7% to 18.1%	4.0%	-3.5%	56%	39%

There appear to be two situations when inflation had a clear negative impact on stocks:

1) When there was deflation, or falling prices, as is often the case during recessions. During these periods stocks were up an average of 4.6%.
2) When there was inflation above 5% (which often occurs during wartime) and most recently in the 1970s and early 1980s. During these periods, stocks were up 4% on average, but returns were *negative* after adjusting for inflation.

When inflation was between 1%-5%, stocks have done quite well, showing higher than average returns and positive returns about 80% of the time. Stocks have done okay during periods of deflation. It has only been during extreme inflationary periods that equities turned negative.

MACROCAST™ REMAINS STURDY, DESPITE INCREASED VOLATILITY

After a strong market run over the past two years, the market finally dropped a noticeable amount. Even with the decline, MACROCAST™ remains positive, and in fact rose through the decline. Increased volatility may stick around, but our model suggests staying the course at this time.

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