CORBETT ROAD
WEALTH MANAGEMENT

MACRO MUSINGS

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Peak Worry?

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SUMMARY

- Our models suggest markets will be more volatile in 2022, but declines are unlikely to result in a recessionary bear market.
- Three issues that have been a hindrance to the market should start improving over the next few months. Inflation concerns, uncertainty about the aggressiveness of Fed tightening, and geopolitical tensions should all be nearing peak levels.
- Geopolitical events get a lot of coverage, but unless these events trigger a recession, they typically only impact stocks in the short term. We do not believe the current Russia and Ukraine crisis will have a broad enough impact to jeopardize domestic economic growth.
- Both bonds and equities are down more than 5% from their prior peaks. This is rare, with only six occurrences in the past fifty years. While the sample size is small, bonds rebounded in the year ahead all six times and stocks were higher in five instances, with only one small loss.

INFLATION WILL LIKELY PEAK
IN THE COMING MONTHS

We expect inflation will peak in the coming months, thanks to improving supply chains, less fiscal support, and a shift in consumer spending from goods to services.

While certain components that haven't seen large price increases (shelter costs) may rise, some of the key contributors to the high inflation readings (used cars) will likely fall, perhaps substantially. This should lead to a deceleration in the headline inflation rate (table from Bloomberg):

Pandemic Inflation

24-month annualized percentage changes:	Dec. 2021	Feb. 2020
Headline CPI	4.1%	1.9%
Food	5.1	1.9
Energy	9.5	-1.4
Core CPI	3.5	2.2
Shelter	3.0	3.3
Used cars and trucks	22.9	-0.1
All other items	2.7	1.5

Sources: U.S. Department of Labor, Bloomberg

Bloomberg

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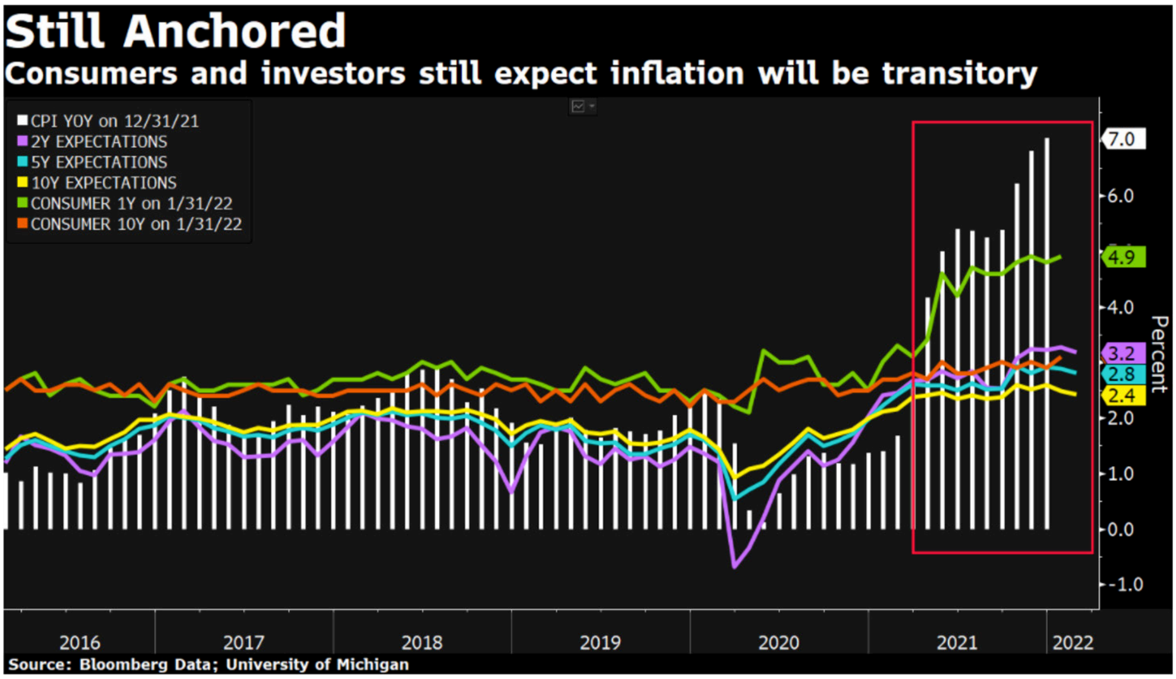
Despite the higher levels of inflation, we've experienced over the past nine months, it's important to note that long-term inflation expectations remain anchored. This is critical since the belief that prices will continue to rise can lead consumers to front-load their purchases, causing prices to increase further and creating a vicious, self-reinforcing cycle of higher and higher prices (chart from Bloomberg):



While we expect inflation to peak, that doesn't mean it will immediately revert to pre-pandemic levels. Our view remains that once the effects of the pandemic and its aftermath wear off, inflation will settle at a higher level than the 2% average we've witnessed over the previous decade. Whether the Fed will tolerate an inflation level of 2.5-3.0% remains to be seen, but it is likely that monetary policy will be less accommodative than it has been in a long time.

BUT CURRENT FED HAWKISHNESS **MAY BE AT ITS APEX**

Late last year, the market was pricing in only three rate hikes for 2022, but as inflation proved to be more resilient, forecasters rapidly increased their expectations for more aggressive policy action. For example, both Bank of America and JP Morgan are now calling for seven rate hikes this year.

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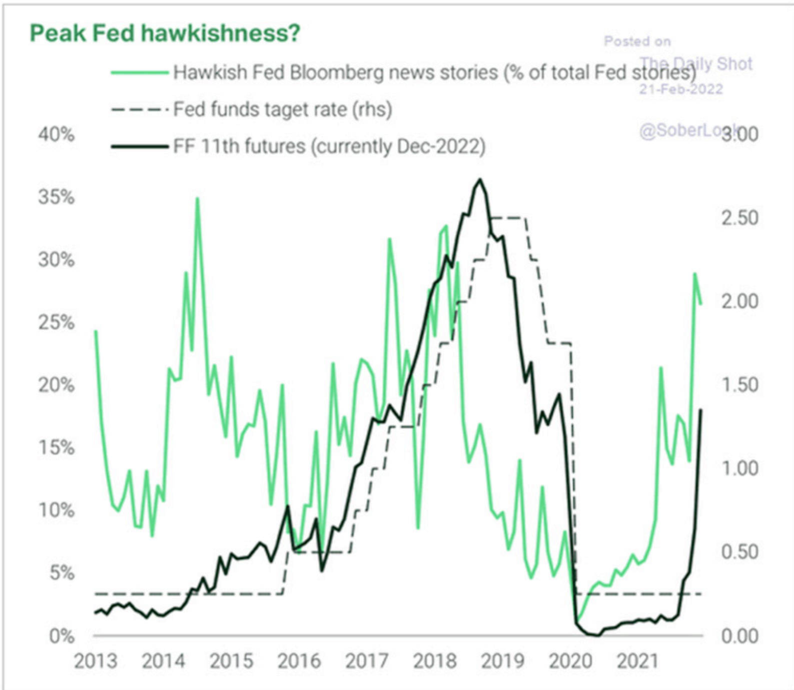
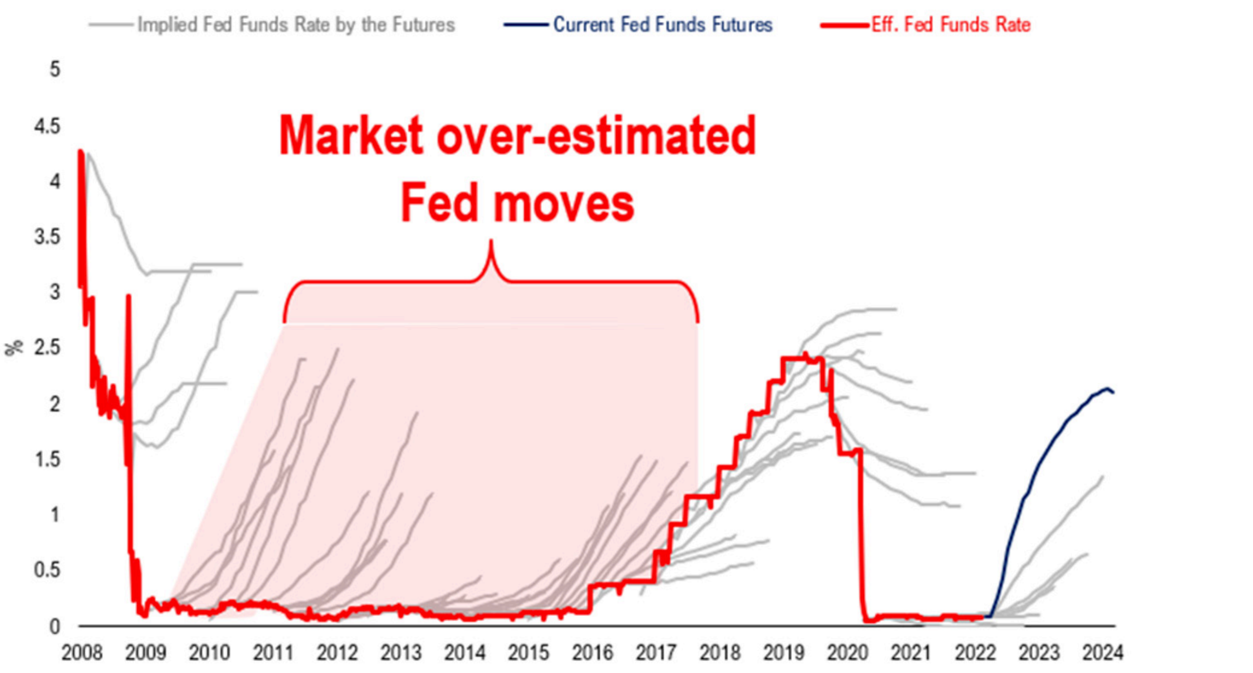
At this point, it seems that market expectations—either inferred through the futures market or explicitly stated in Wall Street forecasts—have overcorrected while news stories referencing Fed Hawkishness may have peaked (chart from TS Lombard via The Daily Shot):



Source: TS Lombard

While the Fed is almost certain to raise rates multiple times this year, historically, the market hasn't been good at pinpointing the exact number of hikes. Fed fund futures frequently over- and underestimate the pace of rate moves (chart from Fundstrat):



Source: Fundstrat, Bloomberg

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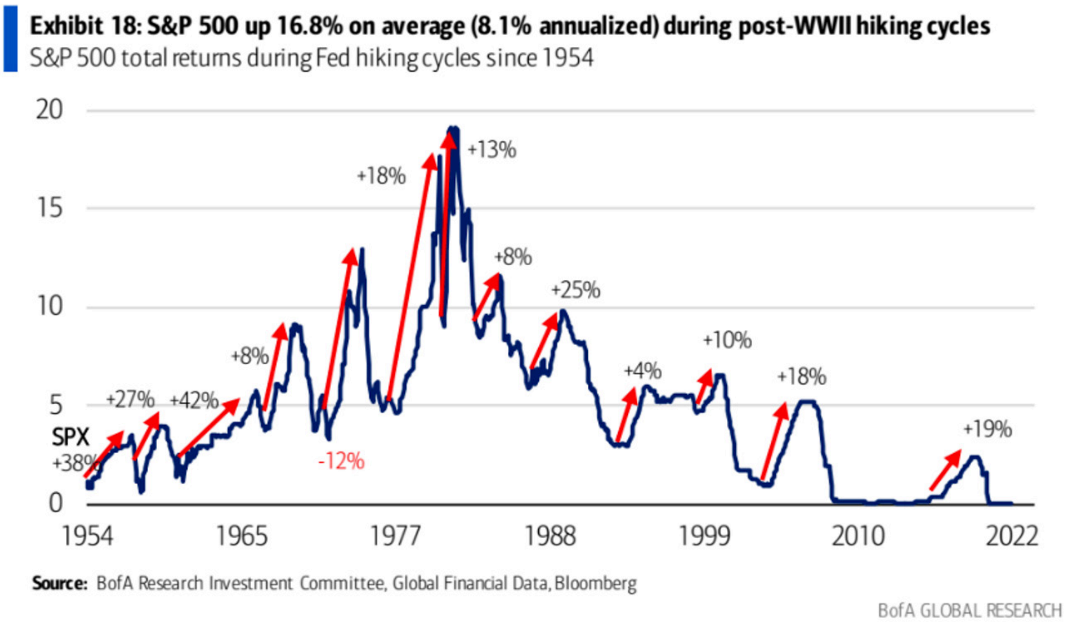
Lastly, while the exact number of rate hikes remains unknown, there is no evidence that rate hikes in general are bad for the stock market (chart from BofA):



Returns are more muted when the Fed is raising rates, but they have only been clearly negative one time.

So, while the Fed has yet to raise rates, we think concerns over how aggressive their actions will be has reached maximum levels.

GEOPOLITICAL TENSIONS HISTORICALLY **LACK MAJOR MARKET IMPACT**

Tensions remain high in the Russia/Ukraine situation, but we believe this is a less significant factor for the market than inflation trends and Fed monetary policy. Historically, geopolitical events have had little impact on stock performance, unless those incidents either contributed to or coincidentally occurred during a recession (table from Truist):

S&P 500 performance around select geopolitical/military events

Date	Select geopolitical/ military events	1-month later	3-months later	6-months later	12-months later
12/7/1941	Pearl Harbor	-3.4%	-12.7%	-9.1%	0.4%
10/31/1956	Suez Canal crisis	-2.8%	-3.8%	-0.1%	-11.5%
10/20/1962	Cuban missile crisis	8.7%	17.7%	25.1%	32.0%
10/17/1973	Arab oil embargo	-7.0%	-13.2%	-14.4%	-36.2%
11/3/1979	Iranian hostage crisis	4.2%	11.6%	3.8%	24.3%
12/25/1979	U.S.S.R. in Afghanistan	5.6%	-7.9%	6.9%	25.7%
8/3/1990	Iraq invades Kuwait	-8.2%	-13.5%	-2.1%	10.1%
1/17/1991	Gulf War	15.2%	23.5%	20.6%	33.1%
8/17/1991	Gorbachev coup	0.0%	3.0%	7.0%	8.9%
2/26/1993	World Trade Center bombing	1.2%	2.5%	4.0%	6.4%
9/11/2001	9/11	-0.2%	2.5%	6.7%	-18.4%
3/20/2003	Iraq War	2.2%	15.6%	17.4%	28.4%
	Average	**1.3%**	**2.1%**	**5.5%**	**8.6%**
	% Positive	**50%**	**58%**	**67%**	**75%**

Data Source: Truist IAG, FactSet. Grey shading represents down markets where the economy was in recession at some point during the measurement period. Past performance does not guarantee future results

While further escalation or resulting conflict would be unwelcome developments, we do not believe it would put significant enough stress on the US economy to drive us into a recession.

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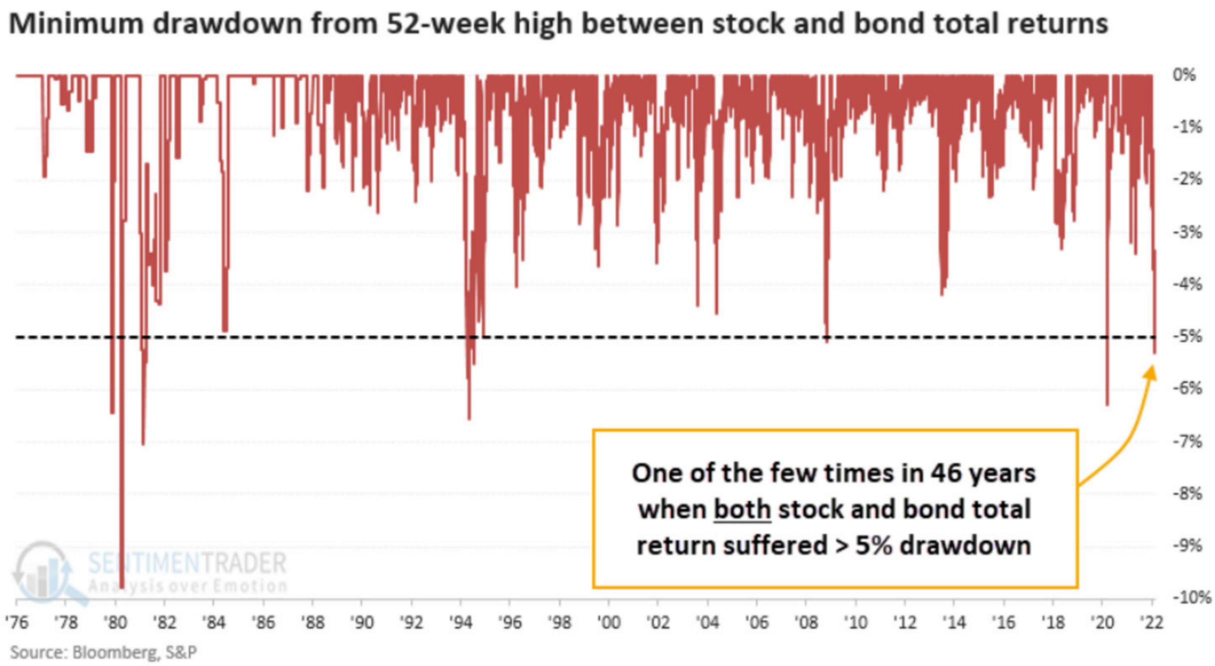
BOTH STOCKS AND BONDS ARE DOWN 5%
A RARE OCCURRENCE

Given all the worry, it is no surprise that the market environment remains negative. What is surprising is that bonds are not acting as the safe haven they typically provide during periods of uncertainty (chart from Sentiment Trader):



It is rare for both stocks and bonds to decline more than 5% simultaneously; this has only occurred on six occasions in the last 50 years.

The good news is that in previous instances, both bonds and stocks saw better returns in the months ahead.

A year after these events, the Bloomberg Aggregate Bond Index was higher all six times, with a median gain of 7%.

As for the stock market, the S&P 500 was higher in 5 of 6 instances with an average gain of 23%. The only decline was a modest 2%.

In summary, concerns over inflation, Fed hawkishness, and geopolitics should subside soon. As these worries diminish, we expect to see a more constructive market environment.

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