CORBETT ROAD

MACRO MUSINGS

June 22, 2020

Rush Zarrabian, CFA
Portfolio Manager
Corbett Road

FED PROMISES LOW RATES WHILE ECONOMIC DATA IMPROVES

SUMMARY

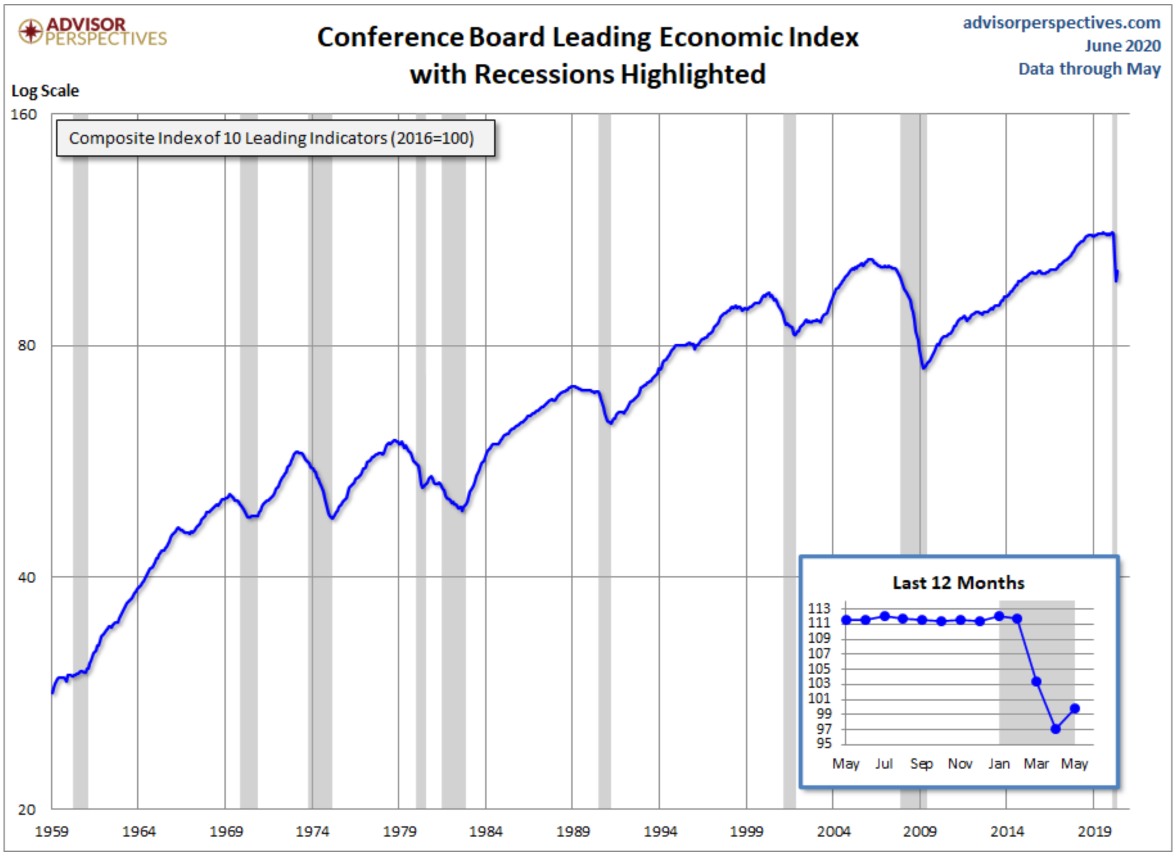
- **After grinding to a halt in March and April, economic indicators rebounded in May. The economy is still deeply negative but appears to be heading in the right direction.**
- **The Federal Reserve indicated that they will not raise rates any time soon and will do everything in their power to keep credit markets from freezing up.**
- **The market's recent rally is one of the fastest in history. Large gains in such a short period are rare, and often pause or correct over the short term, but historically, they have averaged double-digit returns a year later.**

THE REBOUND IN MACROCAST™ WAS DRIVEN BY IMPROVING ECONOMIC DATA

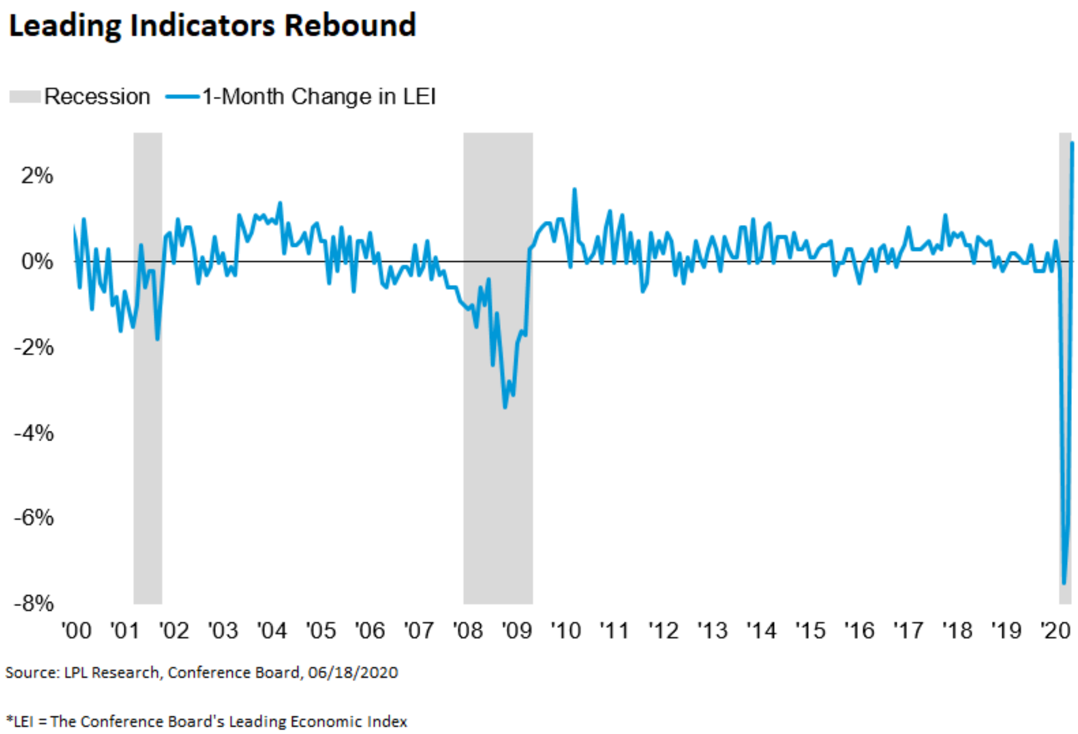
We will do a deeper dive into MACROCAST™ in next month's quarterly review, but we wanted to highlight the main drivers that resulted in a positive MACROCAST™ score. Most of the economic indicators we look at bottomed in April, but began improving significantly in late May. While they are still weak on an absolute basis, the magnitude of the rebound has been similar to readings that have historically only occurred at the end of recessions.

A SHARP JUMP IN LEADING INDICATORS

That rebound is clearly reflected in the latest release of the Conference Board's Leading Economic Index (LEI). The chart below shows that after the sharpest decline in history, the LEI bounced back last month (from Doug Short):



That does not look like much of a rebound on the long-term chart, but here is the same indicator showing the monthly change:



Sentiment Trader identified time periods when leading indicators rallied as much as they did while the overall level remained depressed.

Similar declines of this magnitude and sharp rebounds occurred on the following dates:

1. April 1975 – After the '73/'74 recession triggered by the OPEC crisis
2. June 1980 – After the brief recession of late 1979/early 1980
3. June 2009 to September 2009 – After the recession caused by the global financial crisis

In each case, markets were higher a year later with a median gain of 13%.

WHY DOES THE MARKET CONTINUE TO RALLY? WE THINK IT'S MOSTLY ABOUT THE FED.

Though the economic data is improving off record lows, we do not believe this to be main reason the stock market has rebounded so strongly. Jerome Powell has been the fastest acting Chairman in modern history, taking swift and aggressive action in the face of the worst collapse in the economy in 90 years.

We believe this is the number one reason markets have rebounded as quickly as they have. We agree with the analysis of PIMCO's former Managing Director, Paul McCauley, who said in a recent interview that he thinks the market has rallied because the Fed removed the worry that the economy was no longer a "going concern."

In mid-March (when MACROCAST™ went negative), there was a real concern that the entire system would freeze up and the economy would not be able to function, a scenario like the Fall of 2008 after Lehman Brothers was forced into bankruptcy. When the Fed signaled it would do everything it could to boost liquidity and keep financial markets functioning, the market began looking ahead to corporate profits rebounding in 2021 and 2022.

The aggressive stance taken by the Fed and other global central banks stopped a widespread meltdown in access to credit, effectively putting a floor on equity markets.

And **it does not appear they are ready to pull back that support anytime soon**. While Chairman Powell again cautioned that the economic recovery would take time, he was unequivocal on the Fed's outlook for interest rates:

"We're not thinking about raising rates. We're not even thinking about thinking about raising rates."

We still believe Congress will have to act if more stimulus is needed to support businesses, states, and the unemployed, but by making sure liquidity is ample, the Fed has effectively reduced the probability of another credit freeze.

WHAT HAPPENS WHEN THE MARKET RALLIES 30% IN 3 MONTHS? A PAUSE IN THE RALLY WOULD NOT BE SURPRISING OR CONCERNING AT THIS STAGE.

A study by Nautilus Research shows when the market has risen 30% over three months, in all instances, the market has pulled back one month later but only by an average of 2.5%. **The good news is, in each case, the market was higher three months, six months, and twelve months later with average gains of 6%, 10%, and 14%.**

It is also notable that three of the four examples occurred right after final bear market lows were in place. The first occurred in 1975 after the OPEC recession, the next in 1982 after the Fed raised interest rates to stop inflation, and the last in 2009 after the global financial crisis. (The fourth example was in 1999, a year before the Dot Com bubble burst.)

THE MAJOR RISKS HAVE DIMINISHED BUT NOT DISAPPEARED

As we noted in last month's Macro Musings, these are indeed challenging times, and there is still considerable uncertainty around the pandemic, the likelihood of additional stimulus, and the U.S. presidential election.

Despite MACROCAST™ turning positive, we still believe the market will be volatile, but the improvement in the data is clear, and we expect further improvement into next year.

We will be keeping a close eye on these developments, will continue to monitor the situation, and will update our thoughts and positioning when necessary.

Thank you for your enduring trust in Corbett Road.