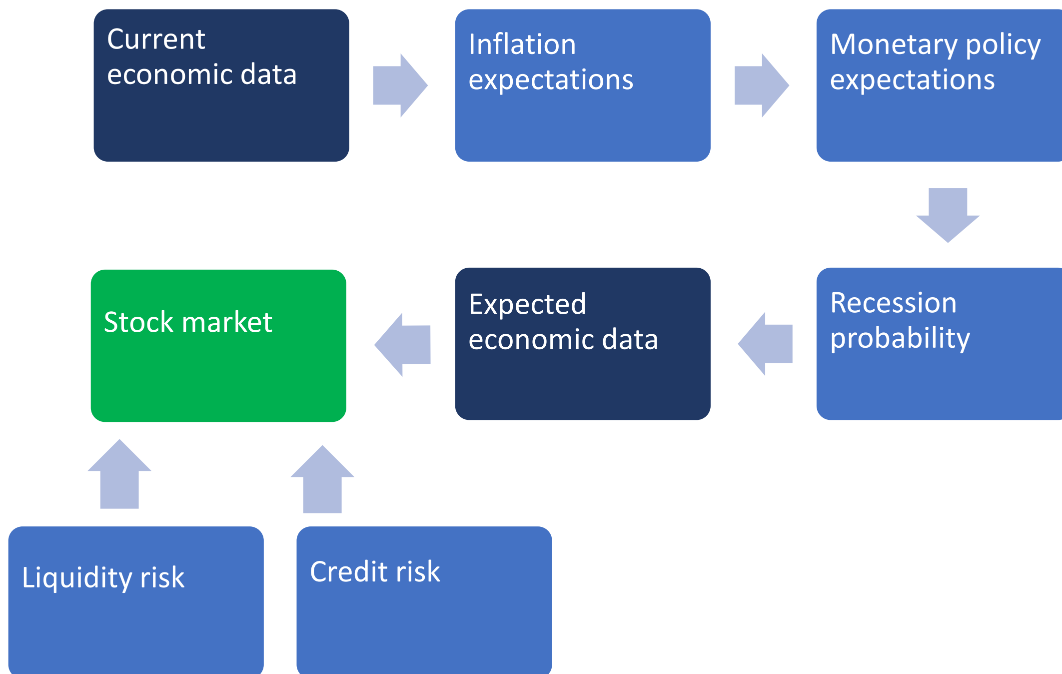
Weekly S&P 500 Outlook



Executive Summary

Current data: Labor market still remains strong, inflation possibly peaked in March.

Inflation expectations: Still falling – the peak inflation expectations hypothesis.

Monetary policy expectations: Less hawkish – the peak Fed hawkishness hypothesis.

Recession probability: Yield curves narrowing– the probability of an imminent recession still low.

Expected economic data: Ultimately the Fed-induced recession, possibly late 2024.

Liquidity risk: Possibly peaked with the blowoff of stablecoins on May 12th, bond prices stabilized.

Credit risk: Slight increase, still moderate level.

S&P 500 Outlook:

- The 19% correction was primarily due to the Fed's liquidity shock – the phase 1 selloff.
- Expect the bounce rally as the liquidity risk eases – the peak Fed's hawkishness.
- Technically, May 12th was possibly the liquidity shock capitulation.
- Short-term outlook: **buy the bear market rally** (until an imminent recession).
- Longer-term outlook: the Fed-induced **recessionary bear market**.

Weekly Macro Analysis and S&P 500 Outlook

Current economic data	
GDP:	**-1.4%** Q1 2022 (down from 6.9%) – *Consumption 2.7% (strong)* **3.4%** Q1 2022 yoy (down from 5.5%)
Unemployment rate	**3.6%** April 2022 (last 3.6%) Weekly claims **203K** (up from 202K – **still** strong but rising)
Inflation:	**8.3%** April 2022 CPI (down from 8.5%) **peak inflation in March** **6.2%** April 2022 Core CPI (down from 6.5%)

Weekly note: **Inflation peaked**; labor market still strong – supporting the strong economy.

Inflation expectations			
	Nominal Yield (*last week*)	Real Rate	BE Inflation Expectations
5Y	2.87% (3.08%)	**-0.22%** (-0.16%)	3.09% (3.24%) – **still falling** - above 3%
10Y	2.92% (3.13%)	**0.18%** (0.26%)	2.74% (2.87%) – **still falling** sub 2.75
30Y	3.08% (3.26%)	**0.55%** (0.65%)	2.53% (2.58%) – **still falling**

Weekly note: Inflation expectations are **falling**, for the **third** week – **peak inflation expectations**? Nominal and real yields fell – **flight to quality – liquidity shock.** Stock market selloff = lower inflation.

Monetary policy expectations					
Current	Jan 2023	Jan 2024	High	First cut	Jan 27 -terminal
0.768%	**2.73**	**2.95**	**3.06 Aug 23**	**2.70 Jan 25**	**3.05**
(0.34%)	(2.80)	(3.19)	(3.33 July 23)	(2.93 Dec 24)	(3.24) *last week*
QE ended in March. QT starting in June – June-Aug $47.5 bill/month, after $95bill/month					

Weekly note: Fed **significantly less aggressive** about 25bp across all maturities, high in Aug 23, first cut Jan 25. **Peak hawkishness**? Stock market selloff causes less aggressive Fed. **Liquidity shock.**

Recession probability: Phase 2 selloff – not expected		
10Y-2Y spread	0.34% (0.40%)	**Narrowing** (Inverted week of March 28th)
10Y-5Y spread	0.05% (0.05%)	Positive (First inverted in March, reinverted)
2Y-3mo spread	1.64% (1.92%)	**Narrowing –** but an imminent recession not expected

Weekly note: Recession probability increased; still no an imminent recession. **Note narrowing of 2Y-3mo**. – stock market selloff – liquidity shock.

Expected data	
Fed-induced recession (late 2024?)	De-globalization related higher inflation

Weekly note: Stagflation with an ultimate recession. Outlook unchanged.

S&P 500 outlook: Past performance: 5 Days: -0.99% YTD: -15.91%

- PE = 20 – Falling but still moderately overvalued.
- Cyclical outlook: **The Fed-induced recessionary bear market** (higher rates = recession)
- **Current:** Fed-induced liquidity shock correction (19% total): **Phase 1 selloff.**
- Inflation expectations are falling – **peak inflation** (should cause less aggressive Fed)
- Monetary policy tightening expectations are less aggressive – **peak hawkishness.**
- The peak hawkishness should reduce the liquidity risk **– the correction is completed.**
- The probability of an imminent recession is **low**: the Phase 2 sell off not expected**.**
- The credit risk is **modest –** the Phase 3 selloff not expected.
- Thus, the probability of a sustained intra-phase **bear market rally** is high, until recession expectations increase (2y-3mo inverts) sometimes in 2023.
- **Short term strategy: buy the bear market rally (current level on SP500: 4000)**

Weekly note: The correction deepened, but it possibly found the short-term bottom at 19% total drawdown.

Liquidity risk – High – Phase 1 selloff – ACTIVE

Expectations of aggressive monetary policy tightening in the presence of market bubbles causes the liquidity shock and the bubble burst – this is Phase 1 selloff of the bear market.

During this cycle, the uncertainty about the aggressiveness of interest rate hikes and quantitative tightening QT (post Powell IMF speech on 4/21) reduced the market depth in short term bonds, which caused the liquidity shock in S&P 500 futures. As a result, the bubbles busted in: 1) big tech stocks, 2) meme stocks, 3) cryptocurrencies. Forced selling due to margin calls and the increase in fear deepen the liquidity shock – S&P500 total drawdown 19%.

The peak inflation expectations should reduce the expected monetary policy uncertainty and restore the market liquidity.

- 10Y Bond (Fed's bond bubble) – nominal and real rates fell **in flight to safety** (3.14 peak?)
- Crypto – Bitcoin: **-38%** (-23%) YTD QQQ: -25% (-23%) YTD

Weekly note: Bitcoin crash of 14% and blowoff in some stablecoins – possible bottom in QQQ selloff. Real rated decreased – is QT priced in? **Stablecoin blowoff was the capitulation?**

Credit risk – Moderate – Phase 3 selloff – not expected

As recession hits, unemployment increases, and earnings decrease, some indebted companies/institutions/individuals default. Systematic bankruptcies increase credit risk to high or extremely high levels, which causes the forced selling – this is ultimate Phase 3 of the bear market.

Credit risk	BBB-10Y	**2.20%** (2.10%)	**Increase** to moderate. (**2.38%** Mar 10).
	HYG	-11.68%(-10.83%) YTD	**Still falling**

Weekly note: Moderate level of credit risk.

S&P 500 Technical analysis

- **Correction 19%: Jan 4th – May 12th**
- Liquidity shock – SP500 is not trading based on technicals (forced selling, margin calls)
- Notable reversal on May 12th – **capitulation?** (the 3850 level – 20% drawdown)?
- **Expectation:** Short covering /bottom-picking rally: target levels: 1) 4100 (breakdown), 2) 4300 (reversal), 3) 50dma (after 100dma, 200dma)
- **Strategy: Buy the bounce rally**.

S&P 500 Tactical next-move outlook - summary	
Fundamental Thematic	**Buy**
• The peak inflation expectations/peak Fed hawkishness trade – Phase 1 selloff completed. • The liquidity shock culminated with the blowoff of stablecoins – correction competed.	
Technical	**Buy**
• Possible capitulation with the reversal on May 12th.	
Longer term	**Sell**
• The Fed-induced recessionary bear market (possibly 2024). • 2Y-3mo inversion to signal Phase 2 selloff – an immediate recession. • Spike in credit spreads above 3% to signal Phase 3 selloff - credit crunch.	

Expected economic data assumptions

Expected economic data is the function of:

- Whether the monetary policy is as expected, or more/less aggressive, which depends on the inflation-path (and the incoming economic data).
- The effects of the expected monetary policy, which is designed to affect the demand-side of inflation dynamics.
- Note: There were 13 Fed's interest rate hiking cycles since 1945, which caused a recession 10 times. Exceptions: 1994-95, 1983-84, 1965-66

Key inflation drivers	
Demand shock:	Supply shock:
*Extraordinary pandemic-related monetary stimulus causing higher credit consumption. (Higher rates to lower credit consumption.) *Extraordinary pandemic-related fiscal stimulus - direct cash, benefits. (Fiscal benefits expiring - less consumption) *Investment gains and wealth effect: rising stock market, housing, cryptocurrencies caused higher consumption. (Rising real rates designed to deflate bubbles – QT) *Pandemic-related labor shortage causing rising wages 5.6%, which leads to more consumption. (Lower consumption to increase unemployment rate.)	*Pandemic-related labor shortage - low participation rate 62.4%. (Needs to increase labor participation – **end of pandemics**, increase immigration or productivity.) *Pandemic-related supply chain bottlenecks - China 0-covid policy (End of pandemics and globalization to improve supply chains.) *Pandemic-related material shortages – such as semiconductors. (End of pandemics and globalization to improve shortages.) *Commodity shortages: **Russia sanctions**, geopolitics (long-term problem – economic war) *Longer term: **de-globalization** reduces supply (Russia/China block developing)
Monetary policy works with a lag: labor market still strong, asset prices still inflated, consumption still strong, wages still rising.	End of pandemics could improve supply-chains and some shortages – but still lockdowns in China. De-globalization will keep supplies tight for longer-term – implying higher long-term inflation expectations.

Weekly note: Demand is still strong and supply is still tight.