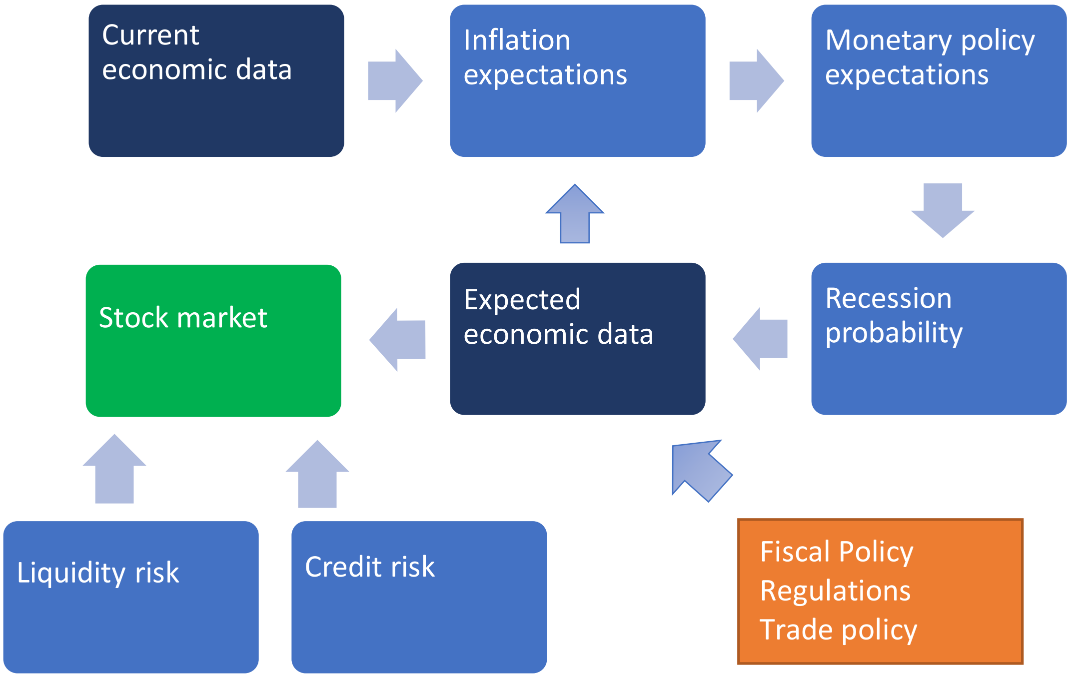
Weekly S&P 500 Outlook



Executive Summary

Current data: New peak in CPI, core peaked in March. Rise in claims, but still strong labor market.

Inflation expectations: Rising for 3rd week, but still below March peak (rising oil).

Monetary policy expectations: Significantly more aggressive – overreaction.

Recession probability: Low probability of an immediate recession, longer term risks rising.

Expected data: Near-term modest stagflation – likely priced in. Longer-term: the Fed-induced recession vs. soft landing?

Trade policy: Biden considering dropping China tariffs – re-globalization. Positive for inflation and growth.

Liquidity risk: Resurfaced – overaction to CPI and sell-off in short term bons.

Credit risk: Still falling – not affected by liquidity risk.

S&P 500: Liquidity shock sell-off in overreaction to CPI to near previous lows 3840.

Short-term outlook: <u>Bullish.</u> Overreaction to CPI. The probability of an imminent recession low, and credit risk falling. Watch for the rising inflation expectations to the new peak as the signal to sell.

Longer-term outlook: <u>Neutral</u>. A deep and prolonged Fed-induced recessionary bear market is likely – especially if there is a credit crunch (housing bubble crash). However, lower expected Federal Funds terminal rate supports soft landing. Uncertainty means volatility, thus, neutral rating.

Weekly Macro Analysis and S&P 500 Outlook

Current economic data	
GDP:	**-1.5%** Q1 2022 (down from 6.9%) consumer spending 3.1% - **strong** **3.5%** Q1 2022 yoy (down from 5.5%)
Unemployment rate	**3.6%** May 2022 (last 3.6%) Weekly claims **229K** (up from 202K) 166K low Mar 20th
Inflation:	**8.6%** May 2022 CPI (up from 8.3% - **new high**) **6%** May 2022 Core CPI (down from 6.2% high **6.5% March**)

Note: Labor market - uptick in clams to 5 week high – still strong. **New high in CPI -** core peaked.

Inflation expectations			
	Nominal Yield (*last week*)	Real Rate	BE Inflation Expectations
5Y	3.26% (2.93%)	**0.09%** (-0.13%)	**3.17%** (3.06%) – **3.59% peak Mar 25th**
10Y	3.16% (2.93%)	**0.37%** (0.17%)	**2.79%** (2.76%) – **3.02% peak Apr 21st**
30Y	3.19% (3.09%)	**0.67%** (0.53%)	**2.52%** (2.56%) **– 2.63% peak Apr 21st**

Note: Inflation expectations **slightly rose** for 3rd week (higher oil prices)– Nominal rates **sharply rose** due to increase in real rates. Peak inflation expectations Apr 21 3.02%

Monetary policy expectations					
Front	Jan 2023	Jan 2024	High	First cut	Jan 27 -terminal
1.10% (1.09)	**3.20** (2.81)	**3.48** (3.05)	**3.66 Jul 23** (3.22 Jul 23)	**3.33 Mar 24** (2.96 Dec 24)	**3.50** (3.22) *last week*
QE ended in March. QT starting in June – June-Aug $47.5 bill/month, after $95bill/month					

Note: Fed significantly **more aggressive** (CPI) – **New Peak hawkishness** (3.20 from 3 in 2022)

12-Month Recession probability: moderate		
10Y-2Y spread	0.10% (0.28%)	**Narrowing** (Inverted week of March 28th)
10Y-5Y spread	-0.10% (0.00%)	**Re-inverted** (First inverted in March, reinverted)
2Y-3mo spread	1.76% (1.52%)	**Widening –** an imminent recession not expected

Note: Recession probability **increased**, but lower chance of an imminent recession (2Y-3mo)

Fiscal Policy, Trade, Regulations
Biden considering dropping China tariffs – should lower inflation expectations (re-globalization)

Note: "The agency is collecting comments from industry participants in two batches, ending July 5 and Aug. 22."

Expected data
Level 1**:** Fed-induced slower growth and still persistently elevated inflation (de-globalization) Level 2: Recession vs soft landing.

Note: Sharp increase in claims – beginning of slowdown in labor market?

S&P 500 pricing: Past performance: 5 Days: -6% YTD: -18.4%

- PE = **19** – Fell from 36 on Jan 4th, 2022 – **still overvalued**.
- The Fed-induced liquidity shock correction (19% total): **Phase 1 selloff**
- **The Latest:** Sharp negative reaction to CPI (more aggressive Fed exp) Phase 1 still active.
- Reacting **positively** to the possibility of dropping the China tariffs (lower inflation)
- Reacts **positively** to less aggressive Fed (lower recession probability)
- Reacts **negatively** to more aggressive Fed (higher recession probability – higher oil)
- **Next**: Pricing of Level 1 expected data: stagflation (slower growth – elevated inflation)

Note: The new peak in Fed hawkishness after the new peak in CPI – negative for stocks.

Liquidity risk – High – Phase 1 selloff – ACTIVE – easing
Expectations of an aggressive monetary policy tightening in the presence of a bubble causes the liquidity shock and bubble burst. The ultra-hawkish Powell IMF speech on 4/21 reduced the market depth in short term bonds, which caused the liquidity shock in S&P 500 futures and burst in speculative bubbles 1) tech stocks, 2) meme stocks, 3) cryptocurrencies. **The new peak in Fed hawkishness – liquidity risk resurfaced.**
• Crypto – Bitcoin**: -38%** (-37%) YTD QQQ: **-28%** (-23%) YTD
• VIX = **27.75**(24) peak vol. May 2 at 36

Note: QQQ sell-off, volatility well below peak, bitcoin stable – **liquidity risk resurfaced in QQQ**

An Imminent Recession risk – Low – Phase 2 selloff – not yet expected
In recessions: 1) corporate earnings decrease – further contraction of PE ratios 2) unemployment increases – lowers consumer spending. Initial claims up – beginning of slowdown? But, labor market still strong. The 2y-3mo widening – Fed expected to be more aggressive means no expectations of an imminent recession.

Note: 10Y-2Y narrowed while 10y-5Y inverted.

Credit risk – Moderate – Phase 3 selloff – not yet expected			
As recession hits and unemployment increases, corporate and individual bankruptcies increase – especially in the presence of a housing bubble, or other collateral value bubble. Systematic bankruptcies increase the credit risk to a high level, which causes forced selling – and the most severe phase of the bear market. Credit risk deepens the recession (Phase 2) and causes the liquidity shock (Phase 1).			
Credit risk	BBB-10Y HYG	**2.07%** (2.10%) -**13%** (-9.58%) YTD	**Decrease** for 3rd week (**2.38%** Mar 10). **Lower** with bonds
Housing	Case-Schiller	**21.2%** (20.1)% yoy	Highest increase ever – bubble?

Note: Moderate level of credit risk, but **decreased** for 3rd week**.**

Cross-asset analysis - signals		
	Pattern	**Note**
Bonds		
Bund	Up-new nigh 1.52% (1.27%)	TY-Bu=1.65% (1.66%) - narrowing
ECB 0%	July 2022 Dec 22 **1.34** (1%) Dec 23 **2.26** (2%)	**More** Aggressive tightening expected
Stocks	Correction – liquidity shock (Fed)	
FTSE100	Near 200dma support – heavily commodity/energy weighted	Strong commodity prices – no global recession
STOXX50	Downtrend – **failed** at 100dma	Aggressive ECB – recession?
EEM	Downtrend – **failed** at 50dma	
Currencies	Strong USD	
EUR	Downtrend – **failed** at 50dma	Fed, war in Ukraine; ECB tightening
AUD	Downtrend **– failed** at 200dma	Hit by the liquidity shock - bounced
Commodity		
Gold	Holding the 200dma - flat	Strong USD, rising real rates negative
Copper	Back below 200dma	Hit by liquidity shock **or global slowdown**
Oil	Uptrend continues to new highs above March 7th invasion	Supply issue – sanction on Russia

Note: higher interest rates, stronger USD (**liquidity shock resurfaced**), weaker copper but stronger oil (inflation, but risk of slowdown), stock markets failed at the resistance.

S&P 500 Technical analysis

- **Correction 19%:** Jan 4th – May 20th – held the 20% level – 3840.
- **Failed Bounce –** Double bottom
- **Support:** 20% correction threshold and previous low - 3840
- **Opinion:** Neutral – will the support hold or another leg lower to 20+ bear market drawdown.

S&P 500 Tactical outlook

Tactical - Fundamental Thematic **Bullish**

- The liquidity shock resurfaced (negative): Phase 1 **– overreaction to CPI.**
- **An imminent recession risk still low (positive): Phase 2**
- **The credit risk still easing (positive): Phase 3.**
- **The peaks in inflation expectations holding (positive)**
- The new peak in the Fed hawkishness and CPI (negative – liquidity shock)
- The pending decision to drop China tariffs – positive catalyst
- Fed's mild dovish turn – questionable ().
- Selling in reaction to the stagflation effect on corporate earnings (negative)
- Expected weakening economic data (negative) but will support the Fed pause in Sep

Technical **Neutral**

- Will the 20% threshold drawdown hold at 3840

Longer term **Neutral**

- The Fed-induced recessionary bear market (recession possibly 2024).
- Alternatively, relatively low FF terminal rate favors soft landing.
- 2Y-3mo inversion to signal a possible Phase 2 selloff – an immediate recession (inactive).
- Spike in credit spreads above 3% to signal a possible Phase 3 selloff (inactive)

Tactical Trades:

- **Bullish:** Buy the 3840 support – **overraction to CPI .**
- Alt: Bearish: Sell the breakdown below **3840** with rising inflation exp. – also **stop loss.**

Long term S&P 500 strategy

- Not recommended to allocate new money.
- Will likely have an opportunity to exit existing positions at higher price.

Expected economic data and inflation variables

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 consumptio**n** 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 (deeper correction needed), 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.