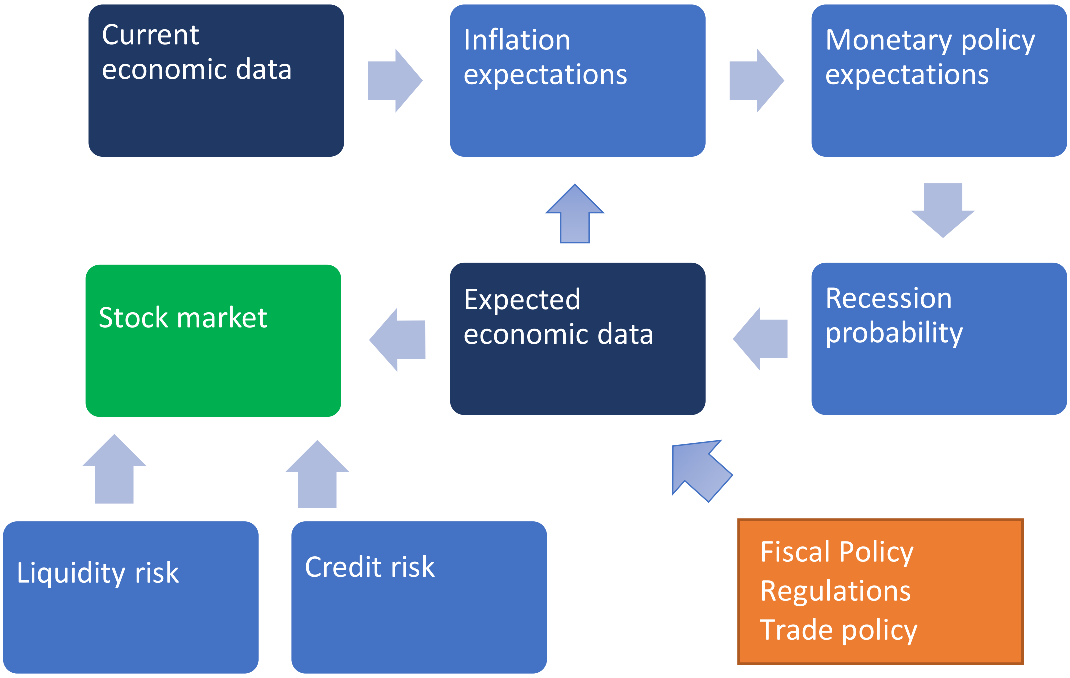
Weekly S&P 500 Outlook



Executive Summary

Key drivers last week: S&P500 went down by 3.81% for total drawdown of 23.41% YTD (bear market). This is still the Phase 1 sell-off due to the Liquidity Shock – sharply higher real rates, and more aggressive monetary policy tightening expectations – new peak in the Fed hawkishness.

Tactical SP500 outlook: Neutral. The liquidity shock likely to continue until the data shows the trend of falling inflation and we get more clarity of the Fed's policy tightening. However, the probability of an imminent recession is still low (too early for Phase 2 selloff), and credit risk is still low/moderate (no support for Phase 3 selloff).

Strategic SP500 outlook: Neutral. Bear market is a buying opportunity for long term investors. However, no clarity yet on how deep the bear market will be. The liquidity risk can lead to a much deeper selloff – and it's still uncertain whether the Fed will induce a recession, whether the recession will lead to a credit crunch.

Weekly Macro Analysis and S&P 500 Outlook

Current economic data	
GDP:	**-1.5%** Q1 2022 (down from 6.9%) **retail sales May -0.3%** **3.5%** Q1 2022 yoy (down from 5.5%)
Unemployment rate	**3.6%** May 2022 (last 3.6%) Weekly claims **229K** (down from 232K) 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 still strong but clams stay high. Retail sales negative – beginning of slowdown?

Inflation expectations			
	Nominal Yield (*last week*)	Real Rate	BE Inflation Expectations
5Y	3.34% (3.26%)	**0.51%** (0.09%)	**2.83%** (3.17%) – **3.59% peak Mar 25th**
10Y	3.23% (3.16%)	**0.63%** (0.37%)	**2.60%** (2.79%) – **3.02% peak Apr 21st**
30Y	3.28% (3.19%)	**0.84%** (0.67%)	**2.44%** (2.52%) **– 2.63% peak Apr 21st**

Note: Inflation expectations **sharply fell** and real rates **sharply increased** – pricing the official beginning of QT. Peak inflation expectations Apr 21 3.02%

Monetary policy expectations					
Front	Jan 2023	Jan 2024	High	First cut	Jan 27 -terminal
1.21% (1.10)	**3.67** (3.20)	**3.45** (3.48)	**3.77 Apr 23** (3.66 Jul 23)	**3.51 Nov 23** (3.33 Mar 24)	**3.51** (3.50) *last week*
QE ended in March. QT starting in June – June-Aug $47.5 bill/month, after $95bill/month					

Note: Fed significantly **more aggressive (**2nd week) – **New Peak hawkishness** (3.67 from 3.2 in 2022)

12-Month Recession probability: low		
10Y-2Y spread	0.05% (0.10%)	**Narrowing** (Inverted week of March 28th)
10Y-5Y spread	-0.11% (-0.10%)	**Re-inverted** (First inverted in March, reinverted)
2Y-3mo spread	**1.62%** (1.76%)	**Narrowing –** an imminent recession not expected

Note: Recession probability **increased**, but still low 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: Fed-induced **Recession vs Soft landing?**

Note: Claims stay high – beginning of slowdown in labor market? Retail sales negative.

S&P 500 pricing: Past performance: 5 Days: -3.81% YTD: -23.41%

- PE = **18** – Fell from 36 on Jan 4th, 2022 – **still modestly expensive**.
- The Fed-induced liquidity shock selloff continues: Phase 1 **–** official Bear market
- **The Latest:** Pricing sharp increase in real rates and the new peak in Fed hawkishness.
- 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)

Note: The new peak in Fed hawkishness as real rates increased – negative for stocks.

Liquidity risk – High – Phase 1 selloff – ACTIVE

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 for 2nd week – the liquidity shock continues.**

- Crypto – Bitcoin**: -59%** (-38%) YTD QQQ: **-32%** (-28%) YTD
- VIX = **35**(27) peak vol. May 2 at 36

Note: Major crash in bitcoin, QQQ sell-off, volatility near the peak – **liquidity shock resurfaced in Bitcoin**

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.

Key indicator **2Y-3mo spread** still indicates the low probability of an imminent recession. But the Fed is behind the curve and the spread expected to significantly narrow by the end of 2022.

Note:2Y-3mo at 1.62.

Credit risk – Moderate/Low – 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	BBB-10Y HYG	**2.13%** (2.07%) -**14.8%** (-13%) YTD	**Increase – still low** (**2.38%** on Mar 10). **Lower** with bonds
Housing	Case-Schiller	**21.2%** (20.1)% yoy	Highest increase ever – bubble?

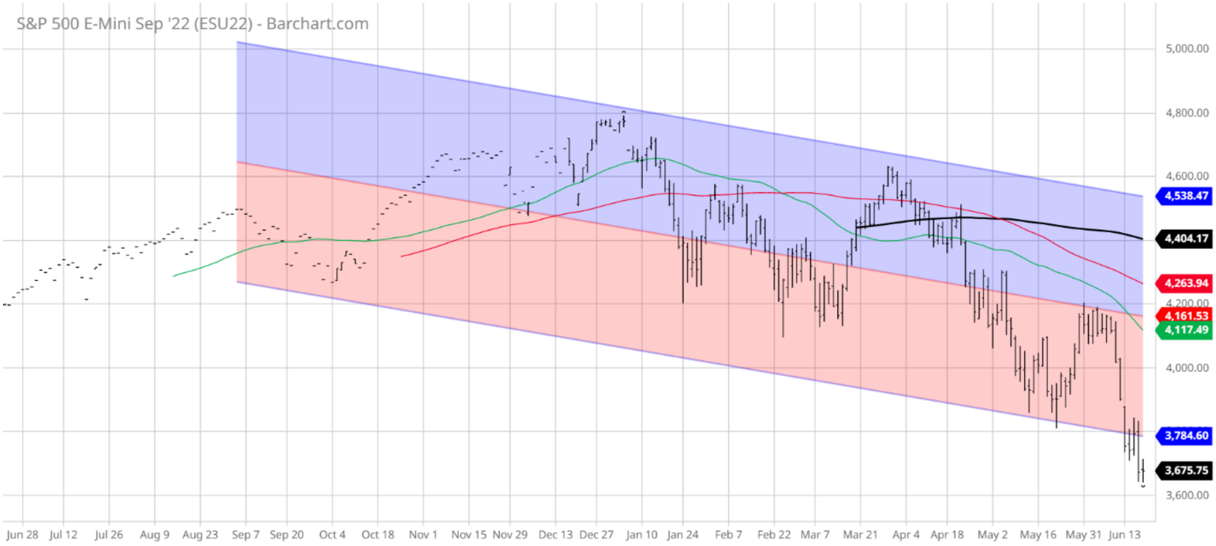
Note: Moderate/Low level of credit risk – slight increase**.**

Cross-asset analysis - signals

	Pattern	Note
Bonds		
Bund	Up-new nigh 1.66% (1.52%)	TY-Bu=1.57% (1.65%) - narrowing
ECB 0%	July 2022 Dec 22 **1.5** (1.34%) Dec 23 **2.45** (2.26%	**More** Aggressive tightening expected
Stocks	Bear market – liquidity shock (Fed)	
FTSE100	**Breakdown** to new low – heavily commodity/energy weighted	Weaker commodity prices? – global recession?
STOXX50	Downtrend – **at previous low**	Aggressive ECB – recession?
EEM	Downtrend – **at previous low**	
Currencies	Strong USD	
EUR	Downtrend – **near previous low**	Fed, war in Ukraine; ECB tightening
AUD	Downtrend **– near previous low**	Hit by the liquidity shock
Commodity		
Gold	**Still** Holding the 200dma - flat	Strong USD, rising real rates negative
Copper	Below 200dma **– new low**	Hit by liquidity shock **or global slowdown**
Oil	Selloff to 50dma - holding	Supply issue – sanction on Russia

Note: 1) higher interest rates, 2) stronger USD (**liquidity shock continues**), 3) weaker copper and dip in oil (**global slowdown**), 4) stock markets sold off including the FTSE.

S&P 500 Technical analysis



- **Bear market 24%:** Jan 4th – May 17th.
- **Breakdown – 1840 level** (correction turned into bear market)
- **Next Support:** 3500 (200wma).
- **Opinion:** Bearish

S&P 500 Tactical outlook

Tactical - Fundamental Thematic **Neutral**

- **The liquidity shock continues (negative): Phase 1 – reaction to QT, and CPI.**
- **The new peak in the Fed hawkishness (negative – liquidity shock)**
- An imminent recession risk still low (positive): no support for Phase 2 selloff
- The credit risk still moderate/low (positive): no support for Phase 3 selloff.
- The peaks in inflation expectations holding (positive)
- The pending decision to drop China tariffs – positive catalyst
- Fed's mild dovish turn – difficult to implement as long as CPI is not falling.
- Possible selling in reaction to the stagflation effect on corporate earnings (negative)
- Expected weakening economic data (negative) but could support the Fed pause in Sep (positivr)

Technical **Bearish**

- The 3840 level breakdown

Longer term **Neutral**

- Bear market is a buying opportunity for long term investors.
- However, no clarity yet on how deep the bear market will be – the Phase 1 selloff still active.
- The 2Y-3mo curve inversion to signal a possible Phase 2 selloff – an immediate recession (inactive).
- The Spike in credit spreads above 3% to signal a possible Phase 3 selloff (inactive)

Tactical Trades:

- Bullish: The data must show the trend of falling inflation. Wait for the 3500 level.
- Bearish: The bet on further downside is the bet on the deep recession and the rising credit risk – not there yet.
- **Neutral: Avoid tactical trading until the Liquidity shock passes.**

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.