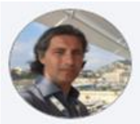
GAV S&P 500 Outlook Report



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LONG TERM S&P 500 OUTLOOK

Very Bearish	Bearish	**Neutral**	Bullish	Very Bullish

SHORT TERM S&P 500 OUTLOOK

Very Bearish	**Bearish**	Neutral	Bullish	Very Bullish

Long-term S&P 500 Outlook

Longer-term, stock market prices will be driven mainly by the unfolding trend of de-globalization, which will cause a stagflationary environment. Inflation will continue to be elevated due to chronic supply-chain issues and commodity shortages, while growth will be lower due to less trade. As a result, recessions will be more frequent. The stock market will likely have a neutral long-term trend with the periods of deep selloffs and sharp rallies. Thus, timing will be important - this is not a buy-and-hold environment.

Where are we now?

The Phase 1 selloff (liquidity risk shock) was signaled with the Fed pivot in Nov 2021, and started in Jan 2022, as the monetary policy hawkishness started in increase – with the peak hawkishness on June 16th (3.66% for 2022). The Phase 1 selloff was possibly completed on June 16th with -24% drawdown. The subsequent relief bounce was based on expectations of the Fed's dovish pivot and reached the key technical resistance at 200dma on Aug 16th. The 200dma resistance held and the new selloff started with the breach of the 100dma support, which appears to be the Phase 1B selloff. Specifically, the market realized that the Fed will not make the dovish pivot, and more importantly, the Fed hawkishness for 2023 is increasing – which is significantly increasing the recession probability (Phase 2 selloff).

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Where are we going?

Stock market fundamentally goes up, unless: 1) the Fed is expected to aggressively increase interest rates, which causes the liquidity shock - more severe in overvalued markets and bubbles (Phase 1), 2) there is a high probability of an imminent recession (Phase 2), and/or 3) there is forced selling or deleveraging due to high credit risk (Phase 3).

- Phase 1: Probability of the Fed-induced Liquidity Shock Sell-off: **Phase 1B in progress**

We have been in the Phase 1A selloff from Jan 1 to June 17th (-24%), as the Fed fell behind the rising CPI inflation and 10Y BE. The market bottomed as the peak Fed hawkishness for 2022 was reached on June 16th (3.66%). The PE ratio decreased from 37 to 21.

The Powell speech on Aug 26, laid the foundation for "higher rates for longer", which ruled out the dovish pivot – and ended the relief rally. The expectations for higher rates in 2023 and the terminal rate are rising – this is possibly starting the Phase 1B selloff, with all eyes on monetary policy expectations for 2023 - the Jan 2024 contract peaked at 3.80 on June 15th.

Currently, the Fed is expected to stop hiking in April 2023 at 3.80, and start cutting in Nov 2023 – this is more hawkish compared to the previous week. The speculation in meme stocks and cryptocurrencies is still high. The liquidity-based selloff is not finished – and the Phase 1B selloff is currently in progress.

Monetary policy expectations						
Front	Jan 2023	Jan 2024	High	First cut	Low	Jan 27 -long term
2.33	3.64	3.45	3.80 Apr 23	3.54 Nov 23	3.12Jan25	3.48
2.33%	3.53	3.30	3.68 Apr 23	3.39 Nov 23	2.95Jan25	3.30 last week
QE ended in March. QT starting in June – June-Aug $47.5 bill/month, after $95bill/month						

BE Inflation expectations			
	Nominal Yield (*last week*)	Real Rate	BE Inflation Expectations
10Y	3.04%(2.97%)	0.45%(0.41%)	2.59%(2.56%) – 3.02% peak Apr 21st

- Phase 2: Probability of an Imminent Recession Sell-off (**Moderate**)

The Phase 2 selloff is based in an imminent recession, which causes the downgrade in earnings and contracts the valuations (PE=22.8, PEx=18.3, EPS Q4 23=232). The 10Y-2Y spread reached the -0.40 level on Aug 5 (lowest -0.48), and first inverted in March. Thus, the probability of a recession within 12-24 months is very high. However, the 10Y-3mo is still positive near 0%, but it's expected to invert in Sep 2022. Thus, the probability of an imminent recession is moderate.

The labor market is still strong (3.5% unemployment rate). However, the Q1 and Q2 of 2022 have been negative due to the slowdown in business investment – so we could be in a technical recession already. The Fed's first cut expected in Nov 2023. The sharp increase in initial clams could trigger the Phase 2 selloff. Housing market is slowing down. However, still not enough evidence to support an immediate recessionary selloff.

12-Month Recession probability		
10Y-2Y spread	-0.36% (-0.26%)	Inverted – Inverted week of March 28th –0.48% peak
10Y-3mo spread	0.22% (0.31%)	Narrow but positive – an imminent recession still not expected
2Y-3mo spread	0.58% (0.58%)	Positive – Fed still behind

- Phase 3: Probability of the Credit Risk Sell-off (**Low**)

The Phase 3 selloff is the forced selling and deleveraging as the credit risk spikes, usually during the severe recessions. The BBB-10Y credit spread is currently at the low-modest level - below 2.50%. Thus, the credit risk selloff is not expected yet. The housing market is slowing down, but no evidence of sharpy falling housing prices.

Credit risk – Moderate/Low – Phase 3 selloff – not yet expected			
Credit risk	BBB-10Y	2.21% (2.21%)	Steady – (still modest)
Housing	NAHM	49 (55)	First sub 50
Volatility	VIX	25.6	Spiked in Phase 1B selloff

- **Implications**: S&P500 is likely to go **down** as the Phase 1B selloff is in progress, while the probability of the Phase 2 selloff is increasing.

Tactical S&P 500 positioning (short term)

- **Existing Short:** stop loss above 200dma and fundamental change (dovish turn and no recession).
- **New Short:** 50dma breakdown, stoploss above 100dma
- **Tight new short:** 100dma breakdown in progress – short with stop loss above 4100.
- **Options strategy:** short call option, Dec, strike 4400

History:

- Short 200dme resistance worked.
- Short 100dma support – in progress.