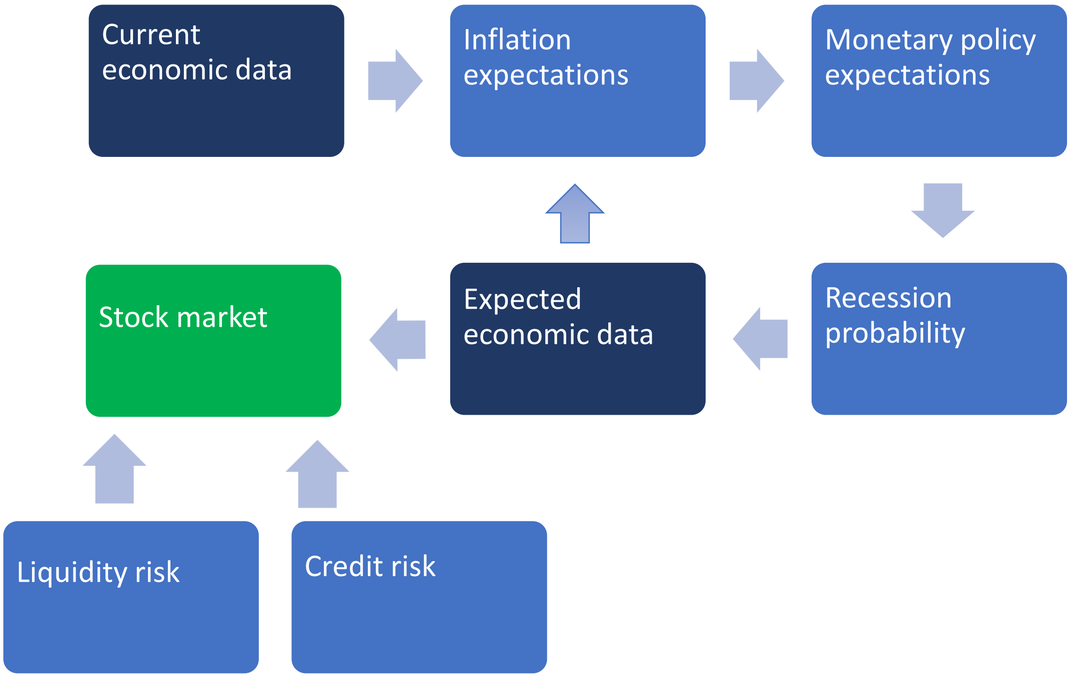
Weekly S&P 500 Outlook



Executive Summary

The peak in inflation expectations and the peak in monetary policy tightening expectations has been reached. But, stagflation is starting to show in the corporate earnings, and will likely start showing up in the expected economic data – this is not priced-in in the stock market. The pricing of the stagfaltionary effect on corporate earnings is within the context of the low liquidity, which is adding to oversized selloffs.

Yet, S&P500 is still holding the 3840 level (20% bear market threshold), with the range resistance at 4100. Short term outlook on S&P500 is neutral within this range. The resistance breakout could lead to the bear market rally, while the support breakdown could lead to the bear market continuation with the 3400 level target.

The long term outlook is still bearish – the Fed induced recessionary bear market.

S&P 500 Outlook:

- The 19% correction is 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.
- The stagflation effect on corporate earnings is adding to the liquidity risk.
- Technically double bottom range (3840-4100).
- Short-term outlook: **Neutral**
- 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%) – Retail sales *0.9% mom (strong)* **3.4%** Q1 2022 yoy (down from 5.5%) – past peak growth
Unemployment rate	**3.6%** April 2022 (last 3.6%) Weekly claims **218K** (up from 197K – strong but **rising**) 166K low Mar 20th
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	2.80% (2.87%)	-**0.12%** (-0.22%)	2.92% (3.09%) – still falling **- below 3%**
10Y	2.78% (3.92%)	**0.19%** (0.18%)	2.59% (2.74%) – still falling **sub 2.75**
30Y	2.99% (3.08%)	**0.63%** (0.55%)	2.36% (2.53%) – still falling

Weekly note: Inflation expectations are **falling** (4th week) – **peak inflation expectations April 21 3.02%.** Nominal interest rates fell, real rates stable – all about falling inflation: pricing slowdown?

Monetary policy expectations					
Current	Jan 2023	Jan 2024	High	First cut	Jan 27 -terminal
0.768% (0.34%)	**2.75** (2.76)	**2.86** (2.95)	**3.07 Jul 23** (3.06 Aug 23)	**2.77 Dec 24** (2.70 Jan 25)	**3.02** (3.05) *last week*
QE ended in March. QT starting in June – June-Aug $47.5 bill/month, after $95bill/month					

Weekly note: Fed **less aggressive**, high in July 23, first cut Dec 24. **Peak hawkishness May 4th** (3% 2022) Stock market selloff causes fall in inflate on exp and less aggressive Fed. **Liquidity shock.**

12-Month Recession probability: moderate		
10Y-2Y spread	0.20% (0.34%)	**Sill Narrowing** (Inverted week of March 28th)
10Y-5Y spread	**-0.02%** (0.05%)	**Reinverted** (First inverted in March, reinverted)
2Y-3mo spread	1.57% (1.64%)	**Narrowing –** but an imminent recession not expected

Weekly note: Recession probability **increased**; but low chance of an imminent recession (2Y-3mo)

Expected data
Stagflation with an ultimate Fed-induced recession (possibly in late 2024)

Weekly note: Outlook unchanged.

S&P 500 pricing: Past performance: 5 Days: -02.84% YTD: -18.44%

- PE = 19 – Falling from 36 on Jan 4th, 2022 – still moderately overvalued.
- Cyclical outlook: **The Fed-induced recessionary bear market** (Fed hikes = recession)
- **Current:** Fed-induced liquidity shock correction (19% total): **Phase 1 selloff.**
- The first leg down (Jan 4) – negative reaction to rising long term rates (**peaked**) and real rates (QT) – speculative bubble burst – revaluation of PE multiples.
- The second leg down (Apr 21) – negative reaction to extreme Fed hawkishness (**peaked**)
- The third leg down (May 18) – negative reaction to corp. earnings (Target) – pricing the expected data: stagflation - **story to continue – possibility of Phase 2 selloff.**
- Volatility driver: the liquidity shock (low market depth – buyers strike) – **still active**

Weekly note: The correction deepened, but still sub 20%. Consider the possibility of further negative reaction to corporate earnings and stagflationary date (growth slowdown and elevated inflation).

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 full bear market – usually sub 20% selloff (1987 -33%)

The 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 burst 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.

- Crypto – Bitcoin: -39% (-38%) YTD QQQ: -28% (-25%) YTD
- VIX = 29 (peak May 2 at 36)

Weekly note: The selloff in QQQ continues - Bitcoin more stable. Stablecoin blowoff during the week of May 14th was possibly the first sign of capitulation. **Peak volatility May 2nd**.

Immediate Recession risk – Moderate – Phase 2 selloff still not justified.

In recessions corporate earnings decrease, which requires further downward adjustment of PE rations. – this is the Phase 2 of the full bear market.

Labor market is still strong, and consumer spending is still strong. Recession requires increase in unemployment. Initial claims leading indicator – uptick, but still strong. 10Y-5Y spread inverted.

Weekly note: Currently, high inflation is shrinking margins – stagflation but no recession.

Credit risk – Moderate – Phase 3 selloff – not expected

As recession hits, unemployment increases, and earnings decrease, and 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 deepens recession (Phase 2) and causes the liquidity shock (Phase 1).

Credit risk	BBB-10Y	**2.37%** (2.20%)	**Increase** to moderate. (**2.38%** Mar 10).
	HYG	-12.08%(-11.68%) YTD	**Still falling**

Weekly note: Moderate level of credit risk. **Rising - reached the previous high.**

S&P 500 Technical analysis

- **Correction 19%:** Jan 4th – May 20th – holding the 20% level – 3840.
- **Double bottom**: support 3840 – resistance 4100 **(range)**
- **Breakdown** (3840) – target 200wma – 3420
- **Breakout** (4100) – target 50dma - 4300

S&P 500 Tactical next-move outlook - summary	
Tactical - Fundamental Thematic	**Neutral**
• The peak in inflation/inflation expectations/Fed hawkishness trade (positive) • **Unfolding** - Selling in reaction to the stagflation effect on corporate earnings (negative) • The liquidity shock continues – but peak VIX possibly reached (positive)	
Technical	**Neutral**
• The 3840-4100 range	
Longer term	**Sell**
• The Fed-induced recessionary bear market (recession 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.	
Outlook: Hold. The effect of stagflation on earnings vs. the peak Fed hawkishness.	
Tactical Trade: Buy support (3840) – sell resistance (4100)	

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 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, 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.