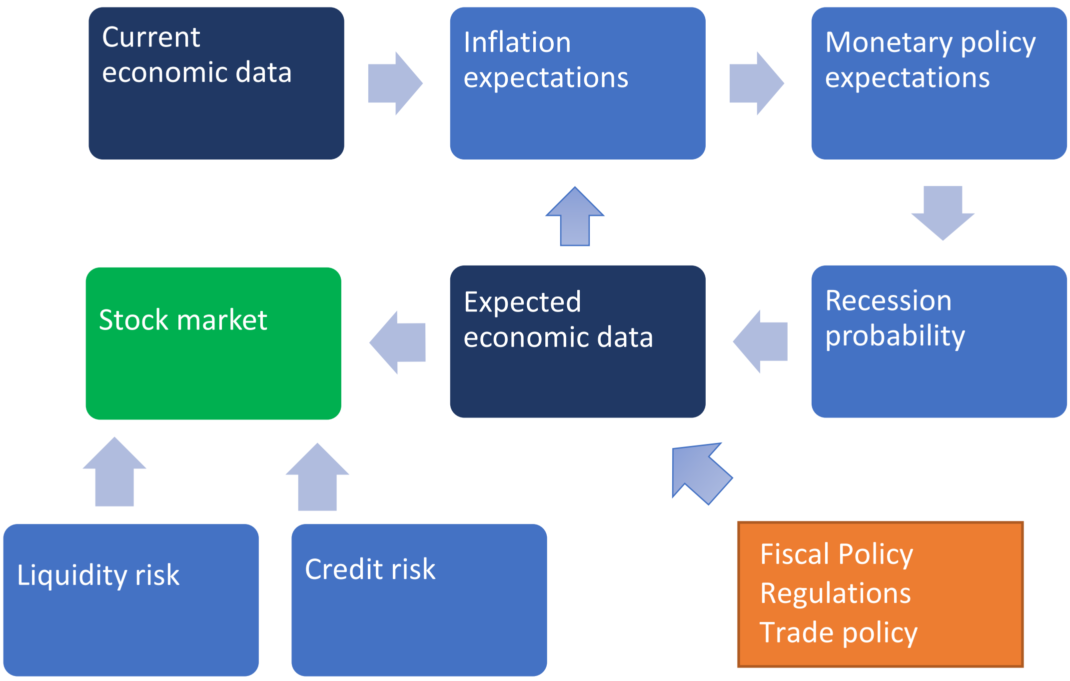
Weekly S&P 500 Outlook



Executive Summary

Current data: Employment still strong, downtick in claims. Supports strong economy.

Inflation expectations: Rising after 4 weeks – within the normal range.

Monetary policy expectations: Significancy less aggressive (but notice inflation expectations rising)

Recession probability: Falling. The expected monetary tightening less aggressive – mild dovish turn.

Expected data: Near-term modest stagflation: dovish turn = higher inflation, modest growth. Longer-term: the Fed-induced recession vs. soft landing? Lower terminal rate supports soft landing.

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

Liquidity risk: Mild dovish turn = lower liquidity risk.

Credit risk: Falling due to mild dovish turn.

S&P 500:The 20% correction and the 6% Bounce. Mild dovish turn - lower recession risk, lower liquidity risk, lower credit risk – but higher inflation expectations.

Short-term outlook: Bullish. The bounce to continue to the 50-100-200dma levels. Watch for the rising inflation expectations as the signal to sell.

Longer-term outlook: Neutral. 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%** April 2022 (last 3.6%) Weekly claims **210K** (down from 218K) 166K low Mar 20th
Inflation:	**8.3%** April 2022 CPI (down from 8.5%) **PCE 6.3 (6.6) Peak in March** **6.2%** April 2022 Core CPI (down from 6.5%) Core PCE 4.9 (5.2)

Weekly note: Labor market still strong – supporting strong economy. Inflation peaked in March.

Inflation expectations			
	Nominal Yield (*last week*)	Real Rate	BE Inflation Expectations
5Y	2.72% (2.80%)	**-0.27%** (-0.12%)	2.99% (2.92%) – **sub 3%**
10Y	2.74% (3.78%)	**0.08%** (0.19%)	2.66% (2.59%) – **sub 2.75%**
30Y	2.96% (2.99%)	**0.60%** (0.63%)	2.39% (2.36%) –

Weekly note: Inflation expectations are **rising** – Real rates and nominal falling. Peak inflation expectations Apr 21 3.02%

Monetary policy expectations					
Current	Jan 2023	Jan 2024	High	First cut	Jan 27 -terminal
0.76% (0.76%)	**2.64** (2.76)	**2.78** (2.86)	**2.95 Jul 23** (3.07 Jul 23)	**2.70 Dec 24** (2.77 Dec 24)	**2.95** (3.02) *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** (**dovish turn**) - Peak hawkishness May 4th (3% 2022)

12-Month Recession probability: moderate		
10Y-2Y spread	0.26% (0.20%)	**Widening** (Inverted week of March 28th)
10Y-5Y spread	0.02% (-0.02%)	**Widening** (First inverted in March, reinverted)
2Y-3mo spread	1.45% (1.57%)	**Narrowing –** but an imminent recession not expected

Weekly note: Recession probability **decreased**, low chance of an imminent recession (2Y-3mo)

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

Weekly note: Negotiations underway.

Expected data
Modest stagflation. Longer term the Fed-induced recession (possibly in late 2024) vs soft landing?

Weekly note: Outlook unchanged – under watch the China tariffs policy

S&P 500 pricing: Past performance: 5 Days: 6% YTD: -13%

- PE = **21** – Fell from 36 on Jan 4th, 2022 – **still overvalued**.
- **Current:** The 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, Snap) – started to reflect the expected data: stagflation. Nvidia bounced after neg. guidance (**peaked?**)
- **Latest:** The 6% Bounce – short covering (meme stocks up), possibly China tariffs, mild dovish turn by the Fed, and falling real rates.
- Reacting **positively** to the possibility of dropping the China tariffs.

Weekly note: The Bounce – after 9 weeks down.

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. **Mild dovish turn – lower liquidity risk.**

- Crypto – Bitcoin: -39% (-39%) YTD QQQ: -23% (-28%) YTD
- VIX = 25(29) peak vol. May 2 at 36

Weekly note: QQQ bounce, volatility down, bitcoin no bounce – **liquidity risk receding**.

An Imminent Recession risk – Moderate/Low – Phase 2 selloff – still not justified.

In recessions: 1) corporate earnings decrease – further contraction of PE ratios 2) unemployment increases – lowers consumer spending.

Labor market and consumer spending are still strong. Initial claims downtick - strong. The 10Y-5Y spread positive.

Weekly note: Stagflation showing up in corporate earnings. Slowdown expected to show in data.

Credit risk – Moderate – Phase 3 selloff – not 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	**2.25%** (2.37%)	**Decrease** moderate. (**2.38%** Mar 10).
	HYG	-7.80%(-12.08%) YTD	**Bounce**

Weekly note: Moderate level of credit risk. **Decreased.** Mild dovish turn.

S&P 500 Technical analysis

- **Correction 19%:** Jan 4th – May 20th – held the 20% level – 3840.
- **Double bottom**: support 3840 – resistance 4100 **(range)**
- <u>**Breakout**</u>: the Bounce- target 50dma – 4372 (2nd target 100dma, 3rd target 200dma)
- **Support**: the 4100 level.

S&P 500 Tactical outlook	
Tactical - Fundamental Thematic	**Bullish**
• **Mild dovish turn** – but note rising inflation expectations • The peaks in inflation/inflation expectations/Fed hawkishness (positive) • Selling in reaction to the stagflation effect on corporate earnings (negative) – peaked? • The liquidity shock eased (positive) • The pending decision to drop China tariffs – positive catalyst • Weakening economic data – negative catalyst	
Technical	**Bullish**
• The 4100 level breakout	
Longer term	**Neutral**
• The Fed-induced recessionary bear market (recession possibly 2024). • However, lower terminal rate favors soft landing. • 2Y-3mo inversion to signal a possible Phase 2 selloff – an immediate recession. • Spike in credit spreads above 3% to signal a possible Phase 3 selloff - credit crunch.	
Tactical Trades:	
• **Bullish:** Buy the breakout above 4100 (dovish turn). **Bias.** • Bearish: Sell the breakdown below 4100 (rising inflation exp).	

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.