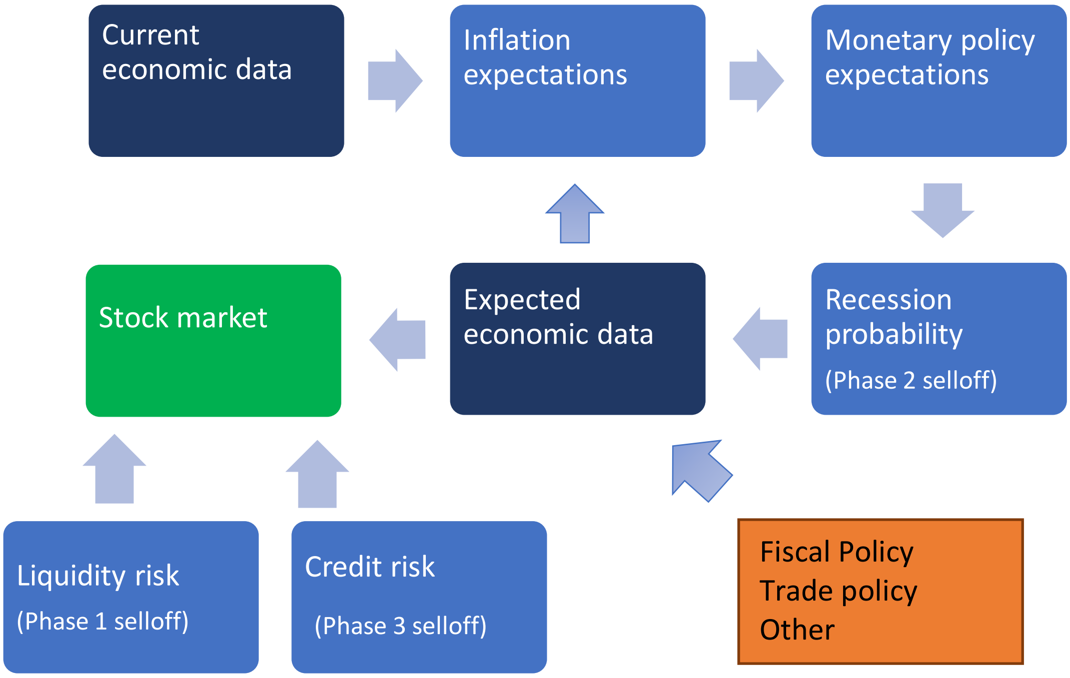
Weekly S&P 500 Outlook



Executive Summary

Fundamental Theme: Inflation expectations are falling because the Fed is still expected to be very aggressive in 2022 and invert the 10Y-3mo spread, which is expected to cause the recession by Aug 2023.

Key drivers last week: S&P500 went down by 2.12% for the total drawdown of -20.18% YTD – back in the bear market territory after the failed bounce. Low liquidity markets combined with growth worries (selloff in Bitcoin, AUD).

Expected drivers next week: Hints about the Fed's policy action (FOMC minutes) and more evidence on growth worries (employment report). The Phase 1 liquidity shock selloff is still active, but easing.

The Bullish Thesis: Falling commodity prices will produce a lower headline CPI reading, which will allow the Fed to be less aggressive in 2022 (end of Phase 1 selloff). The Fed will not have to invert the 10Y-3mo spread and induce the recession (reduced expectations of Phase 2 and 3 selloffs). Also, note easing Covid lockdowns in China – positive for supply chain disruptions.

The Bearish Thesis: The Fed-induced recession in 2023 will be deep (increase in unemployment rate) and, thus, cause the down revision in earnings (Phase 2 selloff). Further, the housing market collapse will cause the increase in credit risk to a high level (Phase 3 selloff).

S&P 500 Outlook: The bullish thesis is more likely – **BUY**

Tactical considerations: The probability of a sharp liquidity-based selloff is higher while S&P500 is in the bear market territory (>-20% drawdown) near the level 1840 – current 1825.

- Strategy 1: buy with the confirmation of the bullish thesis: CPI report July 13th.
- **Strategy 2: buy above the -20% threshold (the 1840 level) – anticipation of Strategy 1.**
- Strategy 3: buy after the sharp liquidity selloffs – if the bullish thesis is still more likely.

Weekly Macro Analysis and S&P 500 Outlook

Current economic data	
GDP:	**-1.6%** Q1 2022 (down from 6.9%) ISM new orders sub 50 **3.5%** Q1 2022 yoy (down from 5.5%)
Unemployment rate	**3.6%** May 2022 (last 3.6%) Weekly claims **231K** (down from 233K) 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%) **Core PCE May 4.7%** (last 4.9%)

Note: Labor market still strong. Economy slowing. PCE confirms peak inf. for March.

BE Inflation expectations			
	Nominal Yield (*last week*)	Real Rate	BE Inflation Expectations
5Y	2.88% (3.19%)	**0.24%** (0.35%)	**2.64%** (2.84%) – **3.59% peak Mar 25th**
10Y	2.88% (3.13%)	**0.52%** (0.56%)	**2.36%** (2.57%) – **3.02% peak Apr 21st**
30Y	3.10% (3.26%)	**0.89%** (0.82%)	**2.19%** (2.44%) **– 2.63% peak Apr 21st**

Note: Inflation expectations **sharply fell** and real rates also **fell**. Peak inflation: Apr 21 at 3.02%.

Monetary policy expectations						
Front	Jan 2023	Jan 2024	High	First cut	Low	Jan 27 -long term
1.67%	**3.33**	**2.75**	**3.37 Feb 23**	**3.05 Aug 23**	**2.23Jul24**	**2.82**
(1.21)	(3.41)	(3.16)	(3.52 Apr 23)	(3.22 Nov 23)	**2.57Jul 24**	(3.11) *last week*

QE ended in March. QT starting in June – June-Aug $47.5 bill/month, after $95bill/month

Note: Fed sill **aggressive** in 22, stops Jan 23 cuts Aug 23. – **Recession Aug 23 (1% cut)**? Peak hawkishness Jun 17th (3.67 for 2022).

12-Month Recession probability: low		
10Y-2Y spread	0.05% (0.07%)	**Flat-stable** (Inverted week of March 28th)
10Y-5Y spread	0% (-0.06%)	**Flat** (First inverted in March, reinverted)
2Y-3mo spread	**1.19%** (1.43%)	**Narrowing* –** an imminent recession not expected

Note: Still low chance of an imminent recession (2Y-3mo) – but the spread narrowing fast*, expected to invert by the end of year. Recession summer 2023? (Commodities selling off)

Fiscal Policy, Trade, Regulations

Biden considering dropping China tariffs – which should lower inflation (re-globalization)
Seems like China is reopening after the covid lockdown – supply chain bottlenecks are easing.

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 (Aug 2023)** or Soft landing?

Note: ISM new orders sub 50 – GDPNow says Q2 also negative GDP – technical recession?

S&P 500 pricing: Past performance: 5 Days: -2.12% YTD: -20.19% (-18.37%)

- PE = **19** – Fell from 36 on Jan 4th, 2022 – **still modestly expensive**.
- **The Bounce failed –** back in the Bear market territory
- **The Latest:** Pricing-in sill aggressive Fed in 2022 and recession in Aug 23.
- 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: Back in the bear market territory.

Liquidity risk **–** High – Phase 1 selloff – ACTIVE but 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 peak Fed hawkishness Jun 17th – peak liquidity risk?	
• Crypto – Bitcoin**: -59%** (-55%) YTD	QQQ: **-30%** (-27%) YTD
• VIX = **26**(27) peak vol. May 2 at 36	
Note: BTC and QQQ sold-off, but VIX slightly decreased – liquidity shock is easing	

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 is expected to **invert by the end of 2022**.
Note: Recession expected in summer of 2023.

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 credit risk to a high level, which causes forced selling – and the most severe phase of the bear market.			
Credit risk	BBB-10Y	**2.31%** (2.20%)	**Increase – near 2.38% high**
	HYG	-**14.9%** (-13.7%) YTD	Down, TBonds Up
Housing	Case-Schiller	**21.2%** (20.1)% yoy	Highest increase ever – bubble?
Note: Moderate level of credit risk – increase **to the near cycle high.**			

Cross-asset analysis – signals		
	Pattern	**Note**
Bonds		**US bunds drops more* US recession?**
Bund	Down **1.23%** (1.43%)	TY-Bu=**1.65%** (1.70%) – narrowing*
ECB 0%	Aug 2022 Dec 22 **0.95** (1.21) Dec 23 **1.67** (2.01)	**Still Less** aggressive tightening expected
Stocks	The Bounce failed.	
FTSE100	Downtrend **– bounce stopped at 200** – heavily commodity weighted	Weaker commodity prices? – global recession?
STOXX50	Downtrend – **tripple bottom 3400**	Less aggressive ECB – recession?
EEM	Downtrend – **tripple bottom 39**	Resembles EUR chart – strong dollar
Currencies	Strong USD	
EUR	Downtrend – **trupple bottom 1.04**	Fed more aggressive than ECB, Ukraine
AUD	Downtrend **– 0.69 breakdown**	Global recession
Commodity		
Gold	Sub 200dma – dropping	Strong USD, rising real rates negative
Copper	Sharp selloff **– now low**	**Global recession**
Oil	Selloff to 50dma – still holding	Supply – sanction on Russia vs recession
Note: 1) lower interest rates (**recession**), 2) Stronger USD (liquidity shock continues), 3) **weaker** copper and dip in oil (**recession**), 4) stock markets bounce failed.		

S&P 500 Technical analysis

- **Bear market 24%:** Jan 4th – Jun 17th (current -20%)
- **The bounce failed –** back to the bear market territory
- **Support:** Low point at 3650
- **Resistance:** 1) the 20% 3840 level, 2) the previous high 3940, 3) 50dma 4006
- **Opinion: Bullish** - possible **higher low** – bounce of the **bottom of the channel**.

S&P 500 Tactical outlook

Fundamental Thematic **Bullish**

- **The Bullish Thesis:** Falling commodity prices will produce a lower headline CPI reading, which will cause the Fed to be less aggressive in 2022 (end of Phase 1 selloff). Thus, the Fed will not have to invert the 10Y-3mo spread and induce the recession in 2023 (reduced expectations of Phase 2 and 3 selloffs). Also, note easing Covid lockdowns in China – positive for supply chain disruptions.
- **The Bearish Thesis:** The Fed-induced recession in 2023 will be deep (increase in unemployment rate) and cause a significant earnings revision (Phase 2 selloff). Further, the housing market collapse will cause the increase in credit risk to a high level (Phase 3 selloff).
- **S&P 500 Outlook:** The bullish thesis is more likely – BUY

Technical **Bullish**

- Higher low – bottom of the channel.

Tactical considerations:

- The probability of a sharp liquidity-based selloff is higher while S&P500 is in the bear market territory (>-20% drawdown) the level 1840 – current 1825.
- Strategy 1: buy with the confirmation of the bullish thesis: CPI report July 13th.
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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: