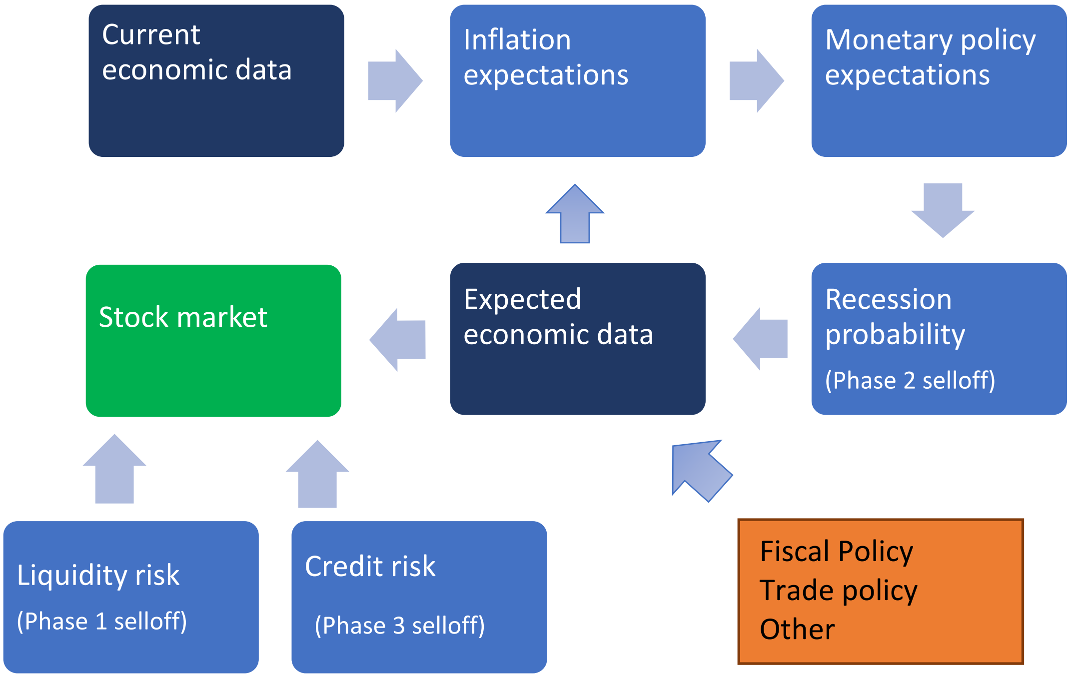
Weekly S&P 500 Outlook



Executive Summary

The Bullish Thesis: Falling commodity prices will produce lower headline CPI readings in July and August, 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).

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:

- 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.
- **Strategy 4: buy in anticipation of short covering as the liquidity risk eases.**

Weekly Macro Analysis and S&P 500 Outlook

Current economic data	
GDP:	**-1.6%** Q1 2022 (down from 6.9%) **3.5%** Q1 2022 yoy (down from 5.5%)
Unemployment rate	**3.6%** June 2022 (last 3.6%) – non-farm payrolls above expectations Weekly claims **244K** (up from 235K) – **new high** (166K low Mar 20th)
Inflation:	**9.1%** June 2022 CPI (up from 8.6% - **new high**) **5.9%** June 2022 Core CPI (down from 6%)

Note: Labor market **still strong**, but claims **still** climbing. Inflation still high – new high for CPI

BE Inflation expectations			
	Nominal Yield (*last week*)	Real Rate	BE Inflation Expectations
5Y	3.03% (3.12%)	**0.43% (0.49%)**	**2.60%** (2.63%) – **3.59% peak Mar 25th**
10Y	2.92% (3.08%)	**0.54% (0.70%)**	**2.38%** (2.38%) – **3.02% peak Apr 21st**
30Y	3.08% (3.24%)	**0.85% (1.02%)**	**2.23%** (2.22%) **– 2.63% peak Apr 21st**

Note: Inflation expectations **unchanged** **stay low** but real rates **decrease.**

Monetary policy expectations						
Front	Jan 2023	Jan 2024	High	First cut	Low	Jan 27 -long term
1.69%	**3.51**	**2.99**	**3.55 Feb 23**	**3.25 Aug 23**	**2.76Jul24**	**3.00**
(1.68)	3.49	(3.06)	3.60 Apr 23	(3.35 Aug 23)	2.82Jul 24	(3.15) *last week*

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

Note: Fed still **aggressive** in 22, stops earlier in Fed 23, cuts Aug 23, by 75bpt by Jul 24. Recession Aug 2023? Peak hawkishness Jun 17th (3.67% for 2022).

12-Month Recession probability: low		
10Y-2Y spread	-0.20% (-0.02%)	**Inverted – deeper** (Inverted week of March 28th)
10Y-5Y spread	-0.11% (-0.04%)	**Inverted - deeper** (First inverted in March, reinverted)
2Y-3mo spread	0.83% (1.22%)	**Narrowing* –** an imminent recession still expected

Note: **Higher** chance of an imminent recession (2Y-3mo) – the spread narrowing fast, expected to invert by the end of year. Probability of recession in 18-24 months very high*.

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.
Biden visits Saudi Arabia – effect on oil?

Note:

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: Recession in Aug 2023.

S&P 500 pricing: Past performance: 5 Days: -0.93% YTD: -18.56% (-17.8%)

- PE = **19** – Fell from 36 on Jan 4th, 2022 – **still modestly expensive**.
- **The Bounce –** back out of the Bear market territory
- **The Latest:** Failed selloff despite 9.1% CPI
- 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) **NO last week**

Note: Market is possibly looking past Fed tightening, and pricing easing.

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: **-41%** (-40%) YTD QQQ: **-26.6%** (-26%) YTD
- VIX = **24**(24) peak vol. May 2 at 36

Note: BTC,QQQ and VIX stable – **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 18-24 months.

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%** (2.33%)	**Stable**
Housing	Case-Schiller	**21.2%** (20.1)% yoy	Highest increase ever – bubble?

Note: Moderate level of credit risk

Cross-asset analysis – signals

	Pattern	Note
Bonds		**US bunds drops more**
Bund	Down **1.13%** (1.34%)	TY-Bu=**1.79%** (1.74%) – widening
ECB 0%	Jul 22 (July 22) Dec 22 **1.23** (1.15) Dec 23 **1.54** (1.68)	**Slightly More** aggressive tightening expected in 22, less in 23.
Stocks	The Bounce	
FTSE100	Downtrend **– triple bottom** – heavily commodity weighted	Weaker commodity prices? – global recession?
STOXX50	Downtrend – **bottom channel 3400-3500 range.**	
EEM	Downtrend – **new low**	Resembles EUR chart – strong dollar
Currencies	Strong USD	
EUR	Downtrend – **new low – <u>parity</u>**	Fed more aggressive than ECB, Ukraine
AUD	Downtrend **– new low - bounce**	Global recession
Commodity		
Gold	Sub 200dma – selloff cont 1700	Strong USD, rising real rates negative
Copper	Sharp selloff **– new low**	**Global recession**
Oil	Selloff to 200dma - breakdown	Supply – sanction on Russia vs recession

Note: 1) lower interest rates (**real rates**), 2) Stronger USD (**liquidity** shock continues), 3) **weaker** copper and dip in oil (**recession**), 4) stock markets bounce (**short covering**).

S&P 500 Technical analysis

- **Bear market 24%:** Jan 4th – Jun 17th (current -18%)
- **The bounce continues –** back out of the bear market territory
- **Support:** 1) the 3800 (**held**) 2) low point at 3650
- **Resistance:** 1) the previous high 3940, 3) 50dma 3938
- **Opinion: Bullish** - possible **higher low** – **range** – bounce of the **bottom of the channel**.

S&P 500 Tactical outlook

Fundamental Thematic **Bullish**

- **The Bullish Thesis 1:** 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 Bullish Thesis 2:** The Fed policy priced in – liquidity risk easing: short covering.
- **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 1 is more likely – BUY

Technical **Bullish**

- Higher low (range) – bottom of the channel.

Tactical considerations:

- 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.
- **Strategy 4: buy in anticipation of short covering as the liquidity risk eases.**

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: