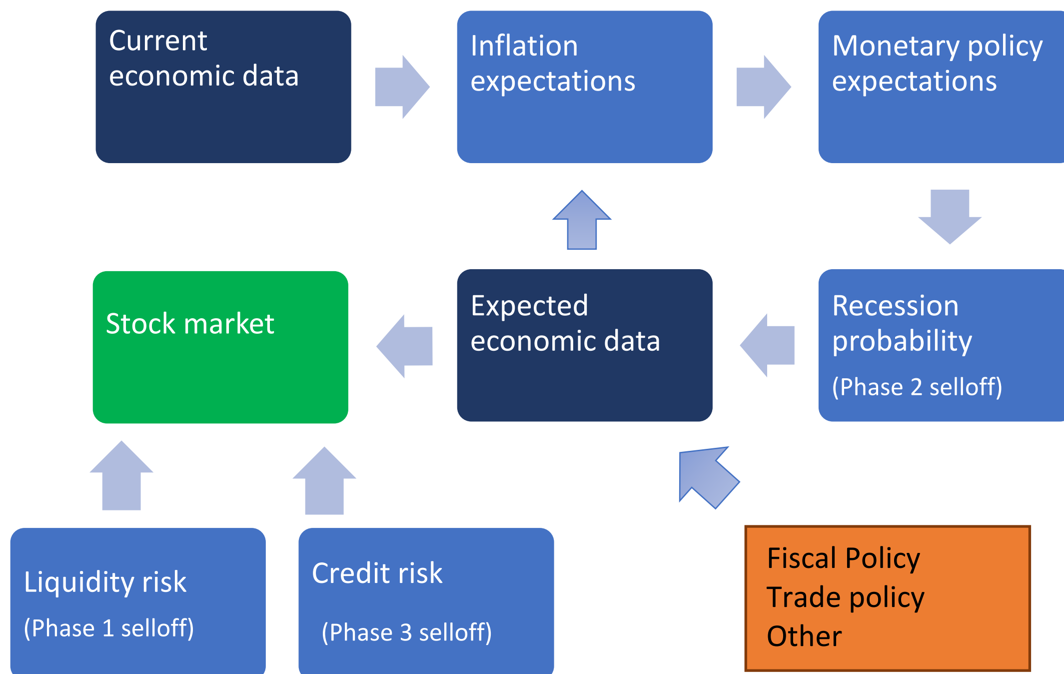
Weekly S&P 500 Outlook



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: Neutral - Rising credit risk - market could be starting to price The Bearish Thesis. (Downgrade from Buy)

Tactical considerations:

- Strategy 1: Neutral – observe what market is pricing – slower growth (bearish) vs less aggressive Fed (bullish).

Weekly Macro Analysis and S&P 500 Outlook

Current economic data	
GDP:	**-0.9%** Q2 2022 (up from -1.6%) **1.6%** Q2 2022 yoy (down from 3.5%)
Unemployment rate	**3.6%** June 2022 (last 3.6%) – non-farm payrolls above expectations Weekly claims **256K** (down from 161K) – **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 are **still** climbing. **Second negative GDP Quarter.**

BE Inflation expectations			
	Nominal Yield (*last week*)	Real Rate	BE Inflation Expectations
5Y	2.68%(2.84%)	**-0.12%(0.26%)**	**2.80(2.58%) – 3.59% peak Mar 25th**
10Y	2.65%(2.75%)	**0.09%(0.40%)**	**2.56%(2.35%) – 3.02% peak Apr 21st**
30Y	3.01%(2.97%)	**0.72%(0.81%)**	**2.29%(2.16%) – <u>2.63% peak Apr 21st</u>**

Note: Inflation expectations **increased,** real rates **<u>sharply</u> <u>decreased.</u>**

Monetary policy expectations						
Front	Jan 2023	Jan 2024	High	First cut	Low	Jan 27 -long term
2.33%	**3.30**	**2.31**	**3.30 Feb 23**	**3.02 July 23**	**2.32Jan25**	**2.68**
1.68%	**3.36**	**2.77**	**3.36 Feb 23**	**3.06 July 23**	**2.46Jan25**	**2.82 last week**

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

Note: Fed less **aggressive** in 22, stops earlier in Jan 23, cuts July 23, by 100(90)bpt by Jan 25. Recession July 2023? Peak hawkishness Jun 17th (3.67% for 2022).

12-Month Recession probability: low		
10Y-2Y spread	-0.23% (-0.22%)	**Inverted – deeper** (Inverted week of March 28th)
10Y-5Y spread	-0.03% (-0.09%)	**Inverted -** (First inverted in March, reinverted)
2Y-3mo spread	0.56% (0.59%)	**Narrowing –** an imminent recession still not 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 (July 2023)** or Soft landing?

Note: Recession in July 2023.

S&P 500 pricing: Past performance: 5 Days: 4.25% YTD: -12.91%

- PE = **21** – Fell from 36 on Jan 4th, 2022 – **still modestly expensive**.
- **The Bounce –** back out of the Bear market territory
- **The Latest:** the bounce continues – short covering
- Reacting **positively** to the possibility of dropping the China tariffs (lower inflation)
- <u>Reacts **positively** to less aggressive Fed (lower recession probability) – **Fed in Neutral**</u>
- Reacts **negatively** to more aggressive Fed (higher recession probability)

Note: Market is possibly looking past Fed tightening, and pricing easing in 2023 with soft landing.

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**: -38%** (-37%) YTD	QQQ: **-20%** (-23%) YTD
• VIX = **21(**23) peak vol. May 2 at 36	
Note: VIX dropping, QQQ rising, BTC 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	**2.42%** (2.20%)	**Rising – cycle high (still modest)**
Housing	Case-Schiller	**21.2%** (20.1)% yoy	Highest increase ever – bubble?
Note: Moderate level of credit risk **– but rising.**			

Cross-asset analysis – signals		
	Pattern	**Note**
Bonds		
Bund	Down **0.81%** (1.03%)	TY-Bu=**1.84%** (1.88%) – narrowing
ECB 0%	Positive 0.38 Dec 22 **1.21** (1.26) Dec 23 **1.23** (1.40)	**Positive**
Stocks	The Bounce	
FTSE100	Downtrend **– bounce 100 breakout**	Weaker commodity prices? – global recession?
STOXX50	Downtrend – bounce **100 breakout**	
EEM	Downtrend – **bounce near 50**	Resembles EUR chart – strong dollar
Currencies	The bounce	
EUR	Downtrend – **bounce from parity**	Fed more aggressive than ECB, Ukraine
AUD	Downtrend **– bounce at 50dma**	Global recession
Commodity	The bounce	
Gold	Sub 200dma – bounce towards 50	**Falling real rates**
Copper	Sharp selloff **– bounce**	**Global recession**
Oil	Bottom of channel – bounce at 100	Supply – sanction on Russia vs recession

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

S&P 500 Technical analysis

- **Bear market 24%:** Jan 4th – Jun 17th (current -12%)
- **The bounce continues –** back out of the bear market territory, above 100dma
- **Support:** 1) 100dma 4130
- **Resistance:** 1) 200dma 4341
- **Opinion: Neutral** – **top of the channel**.

S&P 500 Tactical outlook

Fundamental Thematic	**Neutral**

- **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:** Rising credit risk, market could be starting to price **The Bearish Thesis.**

Technical	**Neutral**

- Top of the range

Tactical considerations

- **Neutral** – observe what market is pricing – slower growth (bearish) vs less aggressive Fed (bullish).

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: