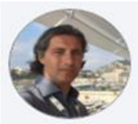
September 3, 2022

GAV S&P 500 Outlook Report



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NEAR TERM S&P 500 OUTLOOK

Very Bearish	**Bearish**	Neutral	Bullish	Very Bullish

Current theme – the Fed induced growth recession

- From Jan 1st, the market was pricing an increasingly hawkish Fed monetary policy tightening, which produced the Phase 1 liquidity selloff of -24%.
- The Phase 1 selloff bottomed on June 16th, at the peak of Fed hawkishness (3.80% for 2022). Also, the CPI and 10Y BE inflations were assumed to have peaked.
- From June 16th, the market was pricing a less aggressive Fed, which produced a 17% rally. The assumption was that the Fed would not cause a recession by hiking deep into the restrictive area.
- The Fed Chair Powell ruled out the dovish pivot on Aug 26th, and set the new theme: **growth recession**, which ended the rally and restarted the selloff.
- The growth recession theme means: the Fed will increase the FF rate to the restrictive level, and leave it there for a long time, until inflation returns to the 2% target. The implication is that growth will be very low for a "long time".
- The goal of the growth recession policy is to ease the demand shock by increasing the unemployment rate and reducing the speculative wealth – housing, crypto, and stocks.

Immediate effect on stock market – bearish

- Growth recession means a low or no growth in corporate earnings – this requires the S&P500 earnings downgrade, which is bearish for stocks.
- The growth recession policy significantly increases the probability of a recession and the Phase 2 recessionary selloff, also bearish for stocks.
- The expectations of a more aggressive Fed particularly for 2023 and the terminal rate, in addition to the doubling the size of QT in September, supports more Phase 1 selling – particularly given that the goal of the growth recession policy is wealth-destruction (the Fed call).

Key risks to the outlook

- The Fed dovish pivot – where inflation falls more significantly due to the supply-side shock resolution.
  - The positive turn in the Russia-Ukraine war, and the immediate effect on oil prices (unlikely).
  - Any policy that favors re-globalization, such as reduction of trade tariffs on China (unlikely, given the recent China-Taiwan-US flare up – deglobalization is progressing, which longer-term favors stagflation, or elevated inflation with low growth).
  - Improvement in covid-related supply chain bottlenecks, particularly in China (likely, but overshadowed by de-globalization, for example in the semiconductors market).
- The Fed dovish pivot – where the Fed allows higher inflation to support a slowing economy (unlikely, until the recession and the stock market crash – that would form the bottom).
- The market reaction when the Fed signals the slowdown in hikes and the eventual stop in the hiking cycle, currently expected in April of 2023 (might not be positive if the 10Y-3mo is deeply inverted).

Technical indicators:

Strategy

- 200dma resistance held, 100dma and 50dma breakdown, downtrend in place – supports the outlook
- **Short:** stop-loss above 100dma.
- **Options strategy:** short call option, Dec, strike above 200dma – 4300.

Data

Phase 1: Probability of the Fed-induced Liquidity Shock Sell-off: **High (in progress since Jan 2022)**

Monetary policy expectations						
Front	Jan 2023	Jan 2024	High	First cut	Low	Jan 27 -long term
2.53	3.67	3.46	3.83 Apr 23	3.56 Nov 23	3.15Jan25	3.51
2.33%	3.64	3.45	3.80 Apr 23	3.54 Nov 23	3.12Jan25	3.48 last week
QE ended in March. QT starting in June – June-Aug $47.5 bill/month, after $95bill/month						

BE Inflation expectations			
	Nominal Yield (*last week*)	Real Rate	BE Inflation Expectations
10Y	3.19%(3.04%)	0.72%(0.45%)	2.47%(2.59%) – 3.02% peak Apr 21st

Phase 2: Probability of an Imminent Recession Sell-off: **Moderate**

12-Month Recession probability		
10Y-2Y spread	-0.20% (-0.36%)	Inverted - Increased as the real rates increased (–0.48% peak)
10Y-3mo spread	0.32% (0.22%)	Positive – Increased: an imminent recession still not expected
2Y-3mo spread	0.52% (0.58%)	Positive – Fed still behind

Phase 3: Probability of the Credit Risk Sell-off - **Low**

Credit risk – Moderate/Low – Phase 3 selloff – not yet expected			
Credit risk	BBB-10Y	2.22% (2.21%)	Steady – (still modest)
Housing	NAHM	49 (55)	First sub 50
Volatility	VIX	25.5 (25.6)	Spiked in Phase 1B selloff