What Could Cause Stocks to Hit New Lows?

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Our View of the S&P 500: Rangebound Between 4300-4600

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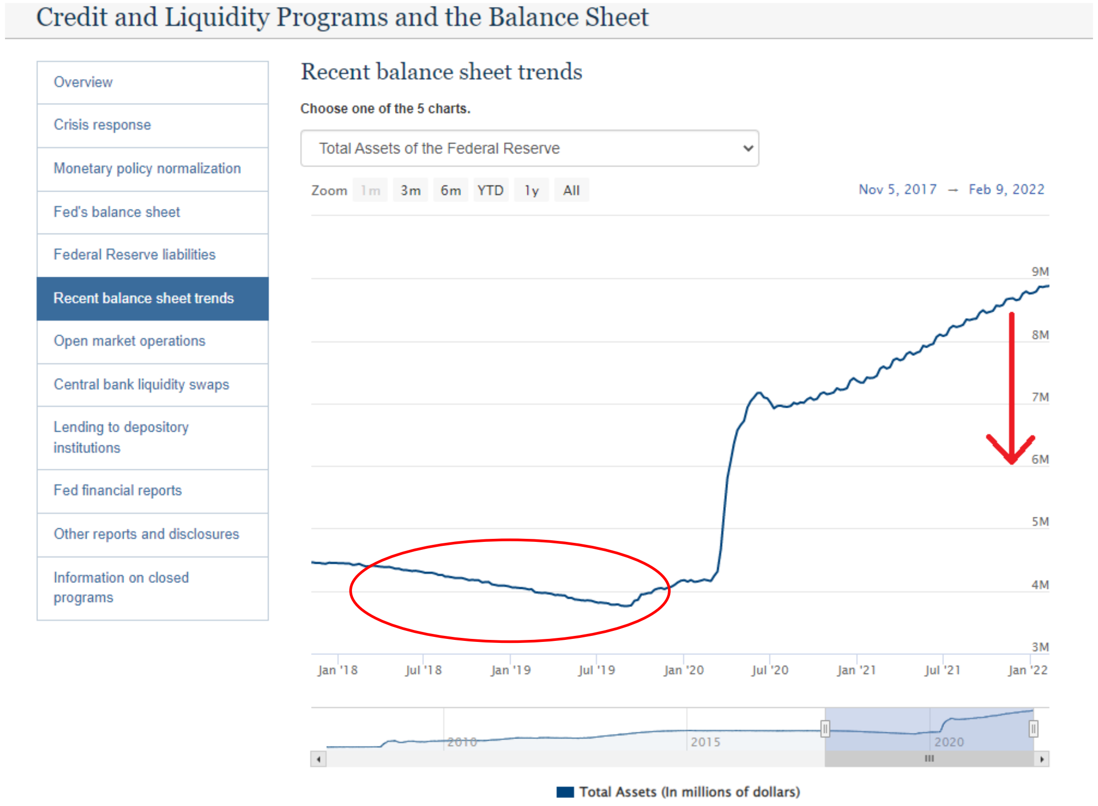
- Given this market reality, what could make the S&P 500 breakdown through that support?
  - A more hawkish Fed
  - Corporate earnings growth stalls
  - Economic growth stalls

Scenario One: The Fed gets too hawkish (this is about the balance sheet, not rates).

- Balance sheet reduction (aka Quantitative Tightening) is the major issue for markets, not rate hikes.
- QT History:
  - Fed announced details of QT in June of 2017. A gradual ramp up occurred over a year to $50 billion/month ($30 billion Treasuries/$20 billion MBS).
  - Began in October 2017, was ended in September 2019 due to slowing growth.



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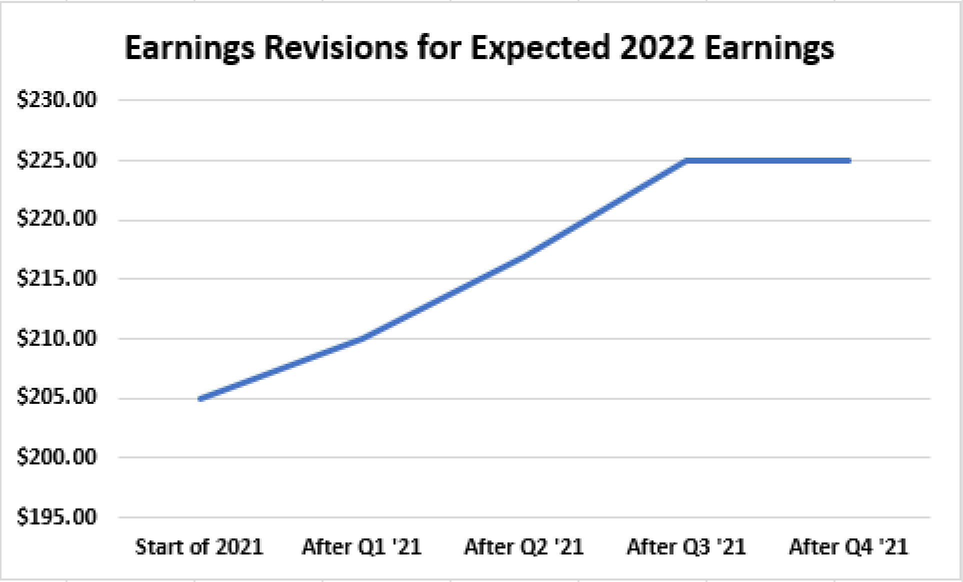
- Key QT questions to be answered (perhaps at the March meeting):
    - When will QT begin? June, July, August?
    - How big will QT be?
        - QE was much bigger this time, so it reasons that QT will be much bigger also. $50 billion/month? $75 billion/month? $100 billion/month?
    - How long will it last? Fed balance sheet pre-COVID was $4T. Now it's nearly $9T. Where's the end target?
    - Will the Fed sell assets?

- Negative scenario: QT > $100 bln/month with asset sales.

Scenario Two: Corporate earnings growth stalls

- Positive earnings revisions helped to turbo charge 2021 gains in the S&P 500.
- But, Q4 earnings have resulted in a “halt” of the positive 2022 earnings revisions.
- That leaves estimates at just 8% EPS growth from 2022 to 2023.
- If that reverses and earnings growth threatens to turn negative, it will be a new headwind on stocks.

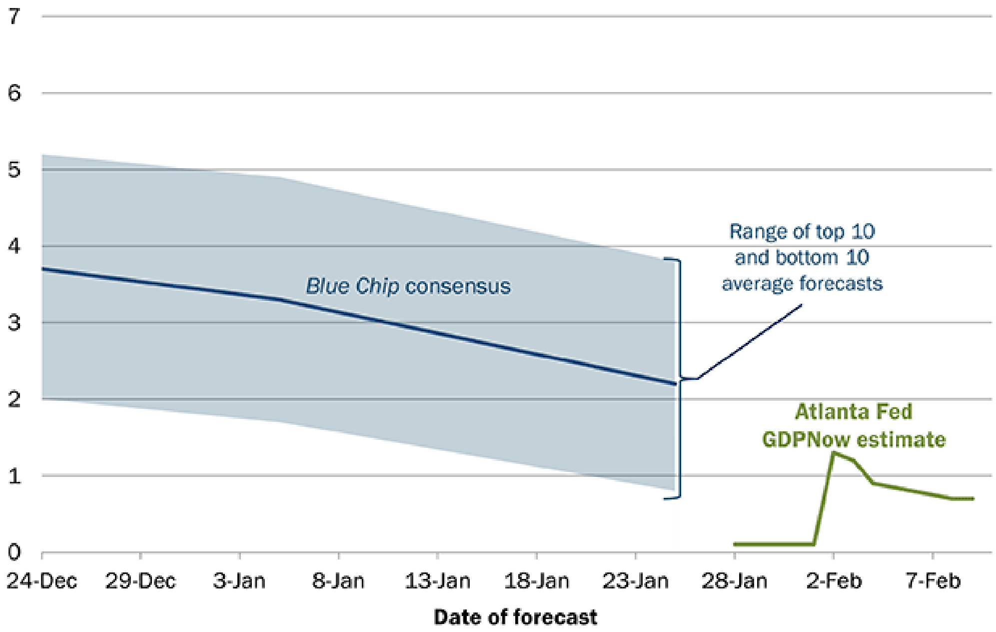


Scenario Two: Corporate earnings growth stalls

- This matters for 2023 also:
  - Aggressive bulls are starting to try to value the market by 2023 S&P 500 earnings.
  - Currently, expected 2023 S&P 500 EPS are $243/share. That's 8% earnings growth over 2022 expected S&P 500 EPS of $225/share.
  - Bottom line: On 2022 EPS, the S&P 500 is very fully valued at these levels. But, on 2023 EPS, it's borderline cheap. The key is that 2023 earnings estimates don't decline because if they do, that's a valuation headwind.
  - Negative Scenario: Earnings growth stalls.

Year	Expected S&P 500 EPS	Current S&P 500 Level	Valuation
2022	$225	4435	19.7X
2023	$243	4435	18.3X

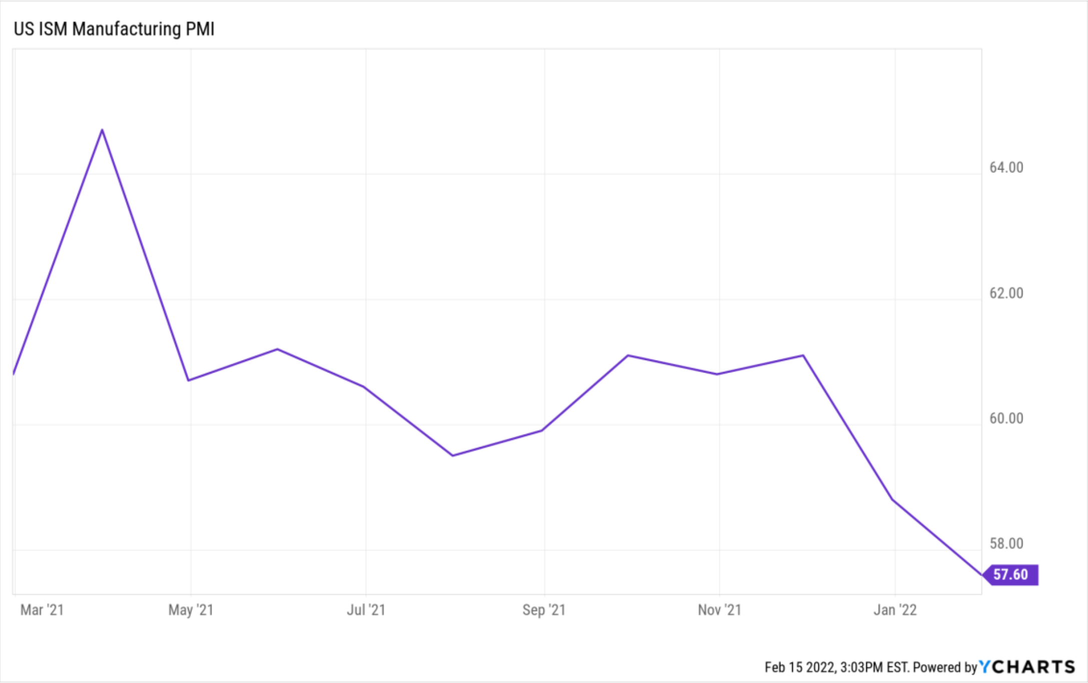
Scenario Three: Economic growth stalls (Stagflation)



Sources: *Blue Chip Economic Indicators* and *Blue Chip Financial Forecasts*
Note: The top (bottom) 10 average forecast is an average of the highest (lowest) 10 forecasts in the *Blue Chip* survey.

Scenario Three: Economic growth stalls (Stagflation)

- Economic growth is going to naturally slow.
  - Inflation will begin to curtail demand.
  - Rising rates and QT will become headwinds on growth.
  - The key will be whether growth slows and stays positive, or whether growth stalls.
  - Negative scenario: Economic growth stalls (PMIs drop below 50, GDP falls back towards 0%).



So, What's It All Mean?

- Current market set up:
  - Market Multiple: Fair value 19.5 2022 expected S&P 500 EPS.
    - That factors in:
      - Fed hiking rates gradually
      - On going economic recovery
      - High but soon receding inflation
      - Not aggressive balance sheet reduction.
      - Stable 2022 and 2023 EPS.
    - Fair value = $225*19.5 = 4,387.50 in the S&P 500.

- Negative scenario:
  - Fed aggressively reduces balance sheet. Impact to multiple: 18X-19X (18.5X average).
  - Earnings peak (so 2023 estimates not $243, drop closer to $225).
  - Economic growth slows. Impact to multiple, another full digit reduction, so 17X – 18X (so 17.5X average).
  - That equals $225 * 17.5X = 3,937 fair value or a more than 11% decline from current levels.

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Three Strikes We're Out

- Negative Scenario 1: QT> 100 bln/month and/or asset sales.
- Negative Scenario 2: Earnings growth stalls.
- Negative Scenario 3:   Economic growth stalls.

Alpha Strategies for This Environment

- Low Volatility Sectors. 12/28/2021. XLU/SPLV.
- “Old Economy” Names. 1/26/2021. DLJ/FDL/RPV.
- Hedged Equity ETFs. 3/10/2020. DMRL/CCOR/JHEQX.
- Minimum Volatility ETFs. 5/21/2019. USMV/SPLV/EEMV/EFAV.
- Short Duration Bond ETFs. 10/16/2018. MEAR/LDUR/MINT.