Sevens Report Alpha Webinar #116 – Identifying the Bullish Scenario

May 12th, 2022

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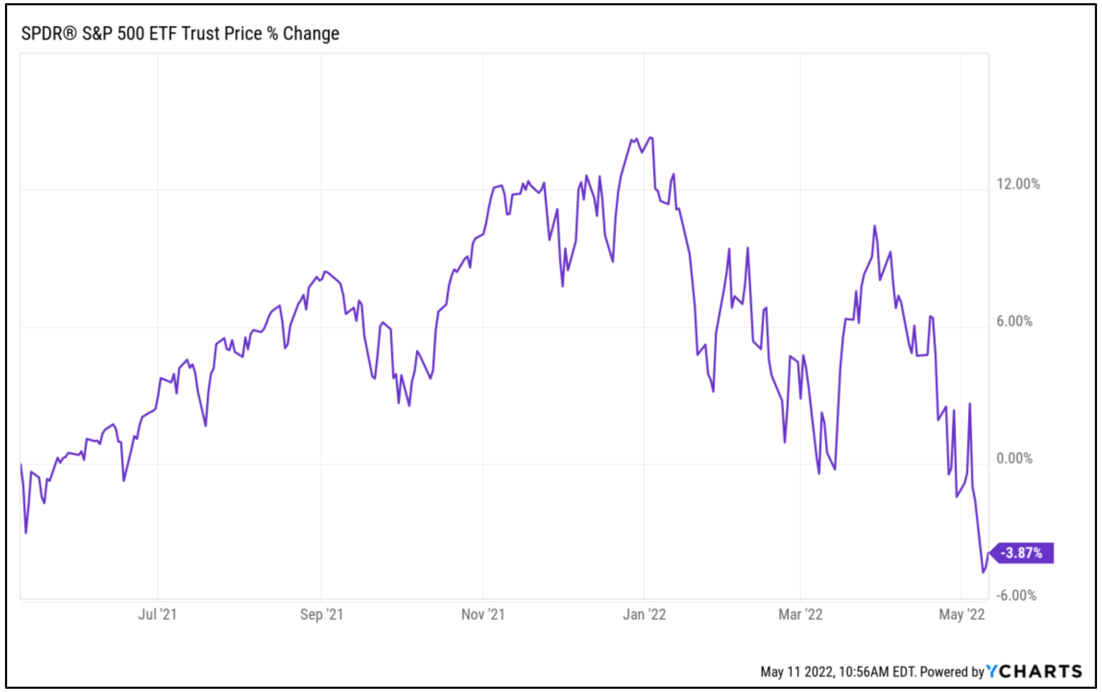
Current Situation: Painful and Negative



- Sentiment is extremely negative:
  - Investors Intelligence Advisors Sentiment:
    - 27.6% bulls (fewest since ’16)
    - 40.8% bears
    - Bulls-Bears spread -13.2%. Only two times lower was ‘16 (-14.5%) and ‘08 (-25%).
  - AAII Investor Sentiment
    - 26.9% bullish (well below historical 38%).
    - 52.9% bearish (way above historical 31%).
  - CNN Fear/Greed at Extreme Fear (24).

Negativity Is Well Founded

- Fed set to hike rates more quickly than anytime since the 2000's.
- Quantitative Tightening will begin in June and reach peak ($95 bln/month) by September.
- China is continuing with "Zero COVID" policy and crushing its economy via lockdowns and extending supply chain problems.
- Inflation remains near multi-decade highs.
- Russia/Ukraine war will not end anytime soon (meaning growth headwinds on Europe, high geo-political premium in commodities).

But – a negative outcome and further declines in stocks is <u>not</u> a foregone conclusion, and we want to identify the positive scenario for stocks.

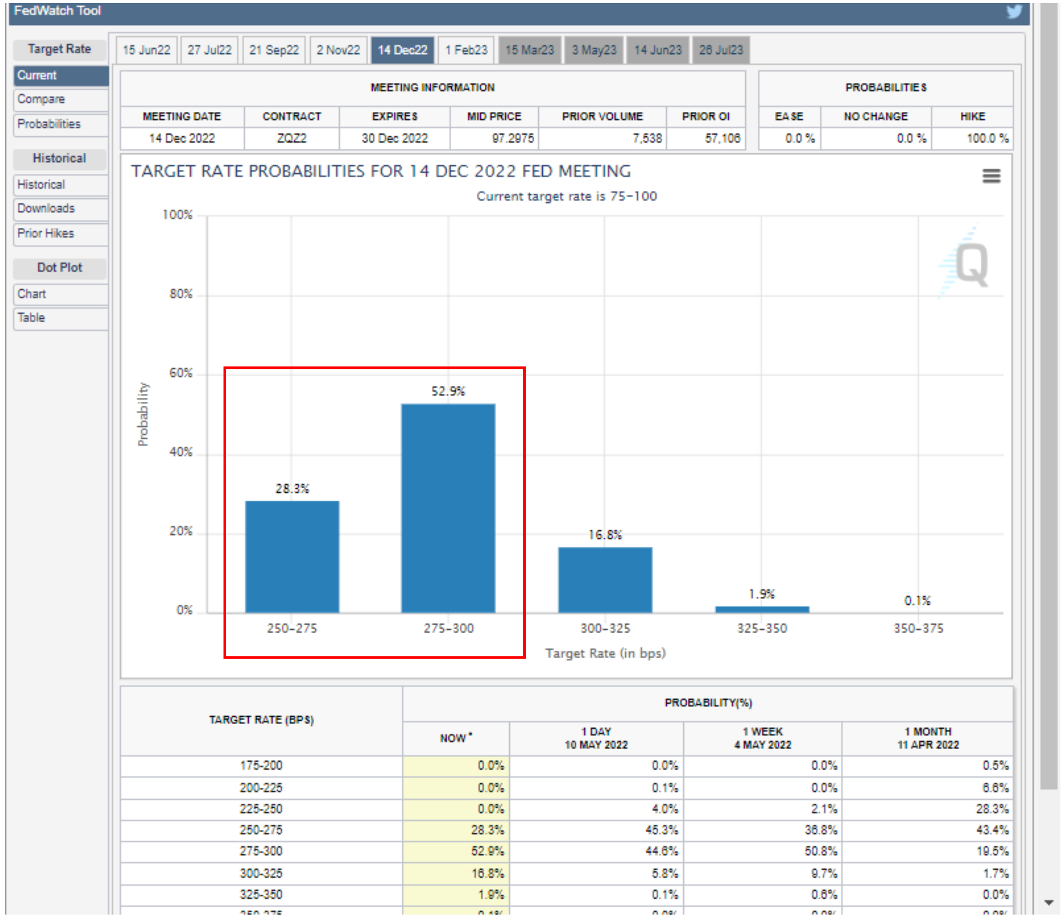
Problem 1: Fed Tightening

Why this is a problem:

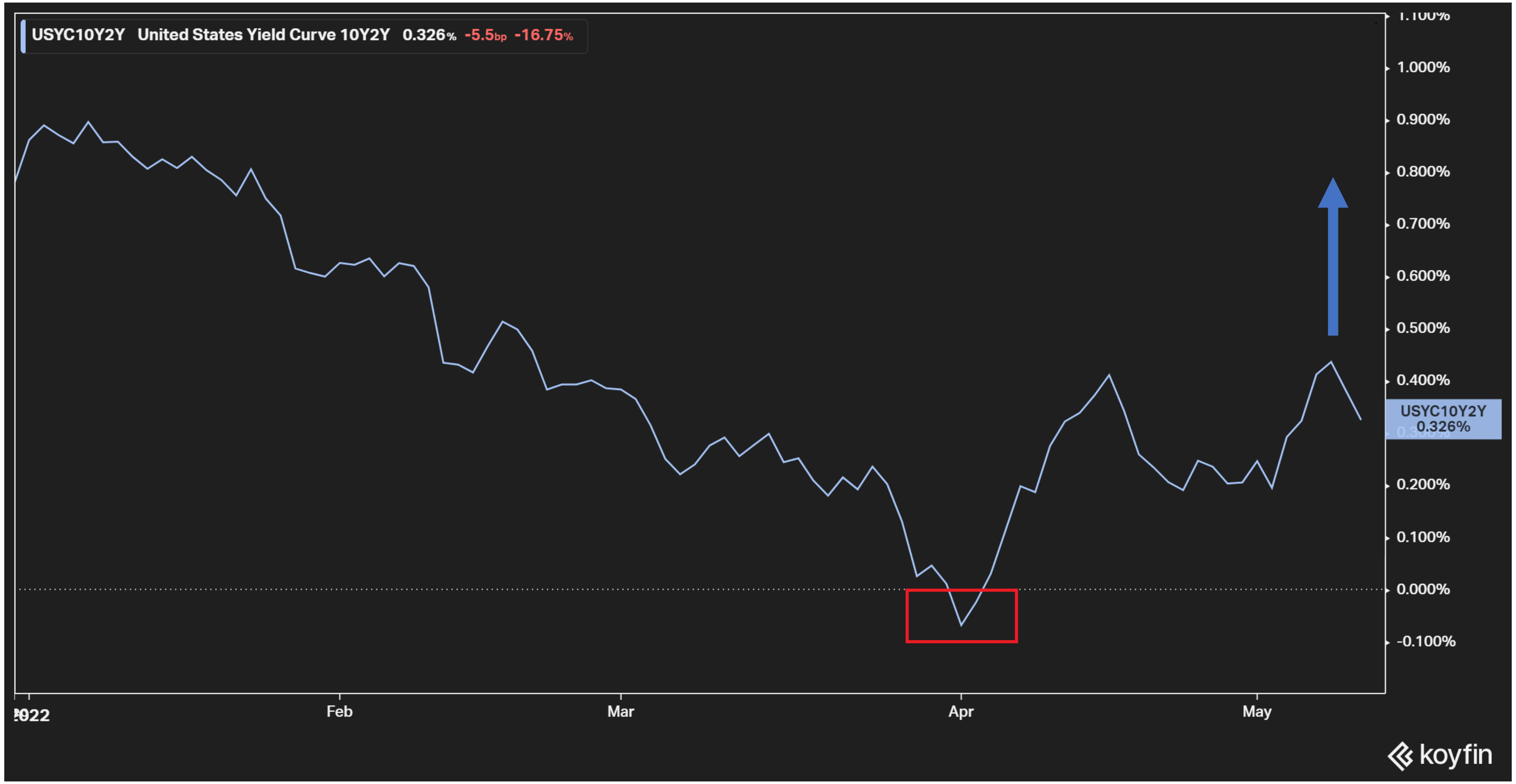
- Because Fed rate hikes and QT could cause a recession.

But, on balance, the Fed has become *less hawkish* since the last FOMC decision.

- Powell rules out 75 bps rate hike.
- Fed notes some initial peak in inflation pressures (still true despite today's CPI).
- Fed Fund futures now forecast Dec. Fed Funds between 2.50% - 3.00% vs. 2.75% - 3.25% previously.
- The yield curve is starting to call the Fed's "bluff" on rate hikes.
- Positive outcome: The Fed's hawkish "bark" is worse than its policy "bite."



Problem 1: Fed Tightening

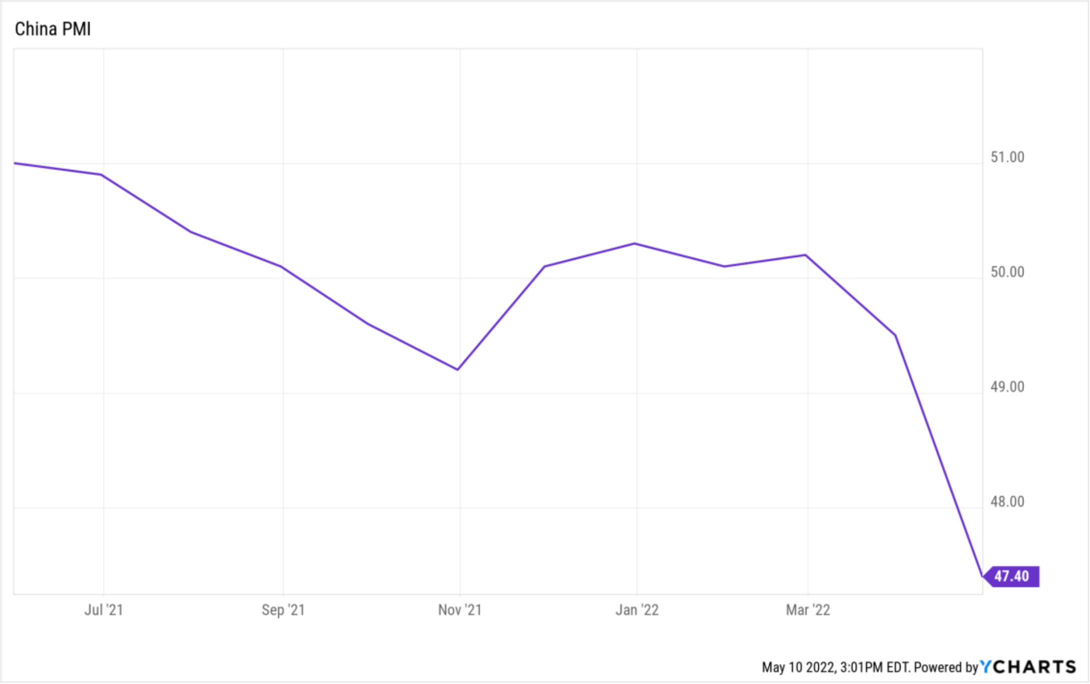


Problem 2: China COVID Lockdowns

Why this is a problem:

- Chinese economic growth is collapsing as major cities are in lockdown in response to COVID cases.

- That, in turn, is increasing global recession risks.



Problem 2: China COVID Lockdowns

But, Chinese authorities are responding.

- Multiple reserve ratio cuts over the past several months.
- New infections in Shanghai have dropped 50% to 1,487 over the past 24 hours.
- Global pressure is increasing on China to abandon "Zero COVID" policy (most recently WHO).
- Positive outcome: COVID wave in China ends in May, allowing for full reopening of the countries economy while stimulus helps rebuff inflation risks.

Problem 3: Earnings

- Why this is a problem:
  - Rising rates are already causing market multiple compression, which is the main force behind the drop in stocks YTD.
  - If earnings growth slows or turns negative, that will add an additional headwind on the market.

- But, Q1 earnings season wasn't bad
  - There were some high-profile blow ups, mostly in tech: NFLX, GOOGL, AMZN, SHOP.
  - But, in general results were more solid than those results imply:
    - According to Fact Set, 79% of companies in S&P 500 reported better than expected EPS.
    - 74% of S&P 500 companies reported better than expected revenues (above 69% average).
    - Q1 EPS growth is tracking towards 9.1% (lower than during 2021 but still solidly positive).

Problem 3: Earnings

- Why does this matter? Valuations!
  - 2022 S&P 500 EPS is still approximately $226/share.
  - With the S&P 500 at 4040, that equates to a multiple of 17.87X. That's a multi-year low and decidedly "reasonable" given current fundamentals.
  - Even more importantly, though, expected 2023 S&P 500 EPS (referred to as "Next Year's earnings) are still around $245/share.
  - Based on the S&P 500 at 4,040, that's a multiple of 16.48X. Typical "slowdown/recession" multiples range between 15X – 17X – so based on next year's earnings, the market has already priced in a partial slowing.
  - Positive outcome: 2023 S&P 500 EPS stay above $240, creating a valuation floor not too far from current levels.

So, What's It All Mean?

A Game of Multiples (Updated 5/9/2022)			
Market Influence	**Current Situation**	**Things Get Better If...**	**Things Get Worse If...**
China Lockdowns	Chinese authorities are implementing lockdowns in major manufacturing cities such as Shanghai and that's hurting Chinese economic growth and extending global supply chain issues.	Covid cases decline throughout May or, more importantly, China backs off the Zero-Covid policy, which reduces the risk of future lockdowns.	Covid cases remain elevated in China, and we continue to get rolling lockdowns of major cities.
Inflation	Inflation remains at multi-decade highs although there are some potential hints that inflation pressures may be peaking.	Inflation begins to back off the recent highs (specifically CPI begins to moderate m/m and y/y).	Inflation pressures continue to accelerate higher, fueled by surging commodity prices and more supply chain disruptions.
Fed Tightening	The Fed decision wasn't as hawkish as feared. The Fed did hike 50 bps and Quantitative Tightening has started as expected. But Powell noted some mild improvement in inflation and importantly, guided to two more 50-bps hikes (no 75 bps).	The Fed further backs off the idea of numerous 50 bps rate hikes, and the year-end Fed funds rate falls towards the 2.00%-2.50% range.	Inflation doesn't subside and the Fed gets more aggressive, reintroducing the chance of a 75-bps rate hike, multiple 50-bps rate hikes, or increased Quantitative Tightening.
Russia/Ukraine War	The war is now largely stalemated with Russia concentrating on seizing the eastern part of Ukraine, but they are being met with stiff resistance, ensuring an extended conflict.	A cease fire is reached, which will reduce part of the geopolitical premium currently priced into commodities (especially oil and wheat).	The conflict extends beyond Ukraine, with Russia invading Moldova and expanding territory and increasing the risk of a larger conflict (possibly with NATO).
Economic Growth	Economic growth is stable but showing early signs of a loss in momentum and stagflation concerns are rising.	Economic growth remains strong and doesn't materially slow, refuting stagflation concerns.	Growth begins to slow quickly and fears of a global recession increase.
Expected 2022 S&P 500 EPS	**$225**	**$227**	**$215**
Multiple	18X-19X	19X-20X	16X-17X
S&P 500 Range	4,050-4,275	4,313-4,540	3,440-3,655
S&P 500 Target (Midpoint)	4,162	4,426	3,548
Change from today	**3.7%**	**11.2%**	**-11.5%**