SEVENS REPORT

Sevens Report Alpha Webinar – There’s No Fed Pivot – So Now What? (Updated Market Outlook)

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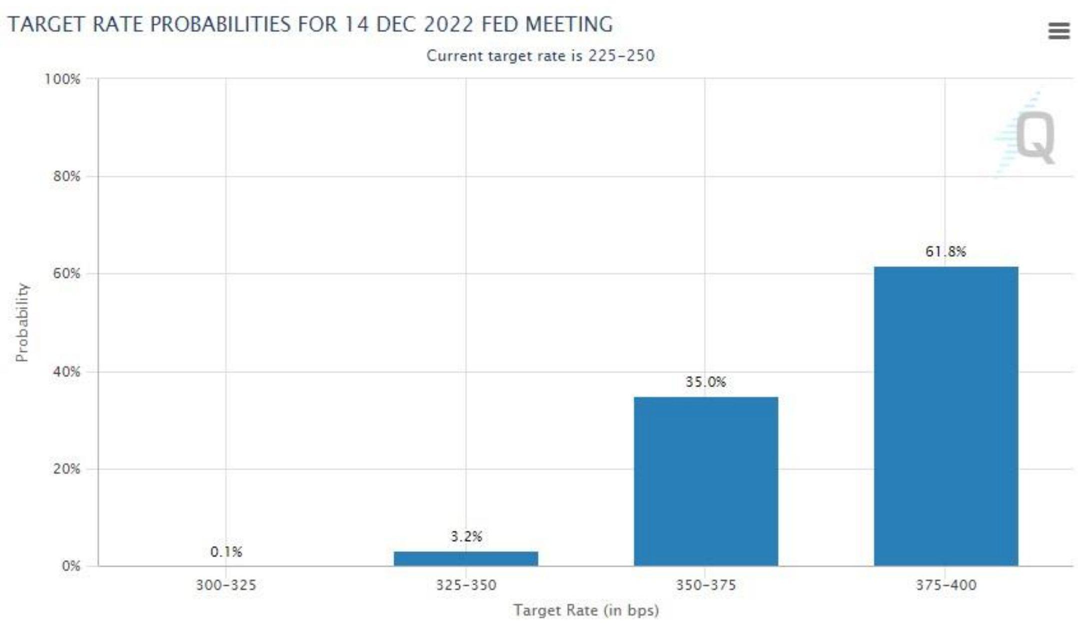
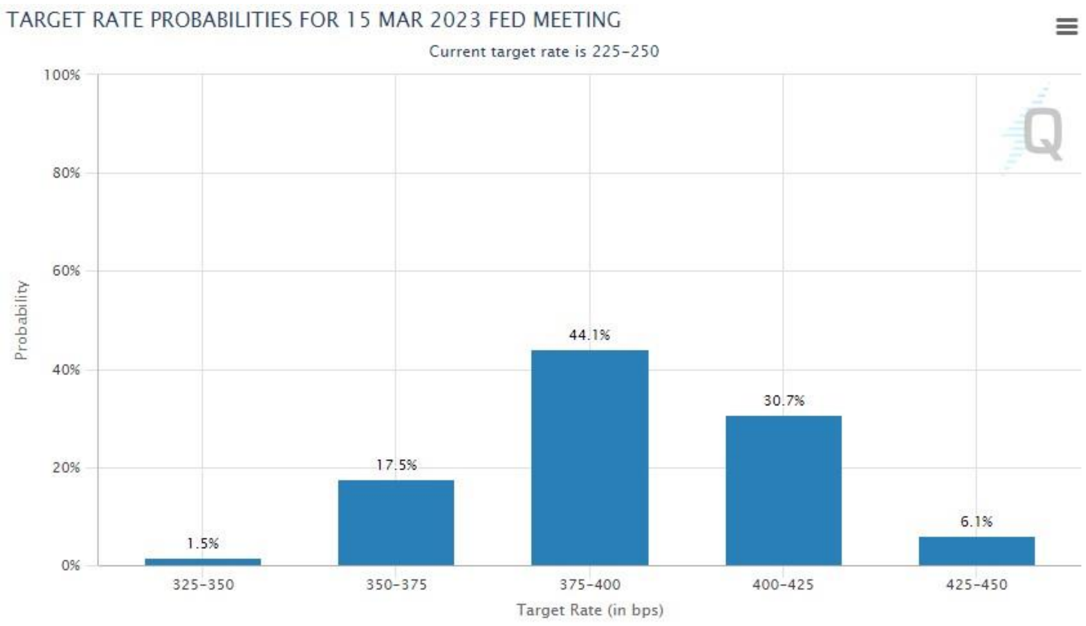
Current Fed Expectations

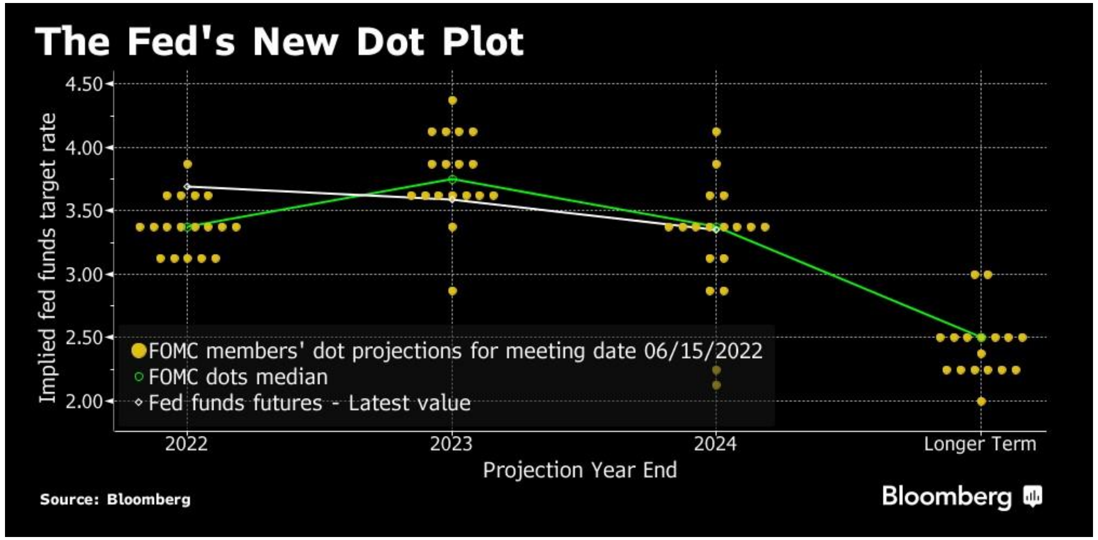
Rate expectations for the end of the year have risen with the consensus FOMC rate of 3.875% (meaning another 150 bps).



The "Terminal Rate" however remains unchanged, at 3.875% (meaning no hikes after December).



How Does That Compare with Fed Projections?



- The median "dot" in June was 3.375% while the median "terminal" dot was 3.50%.
- We should expect both of those "dots" to rise at the September meeting.

What Would Make the Fed Outlook Positive or Negative for Stocks?

- Inflation has peaked but remains very high, while the labor market remains strongly out of balance.
- We expect the "dots" to rise for year-end Fed Funds to between 3.5% to 4.0%.
- We also expect the "dots" to reflect a terminal rate close to, or slightly above, 4.0%.
- The major issue for markets going forward isn't by how much the Fed hikes (it's not going to be materially over expectations – maybe a hike or two).
- **Instead, the key question is "Do the "dots" forecast a rate cut in 2023?"**
  - **If "yes," positive and a relief rally.**
  - **If "no," negative and further weakness because that means higher rates for longer and an increased chance of a meaningful economic contraction.**

Are Stagflation Risks Rising?

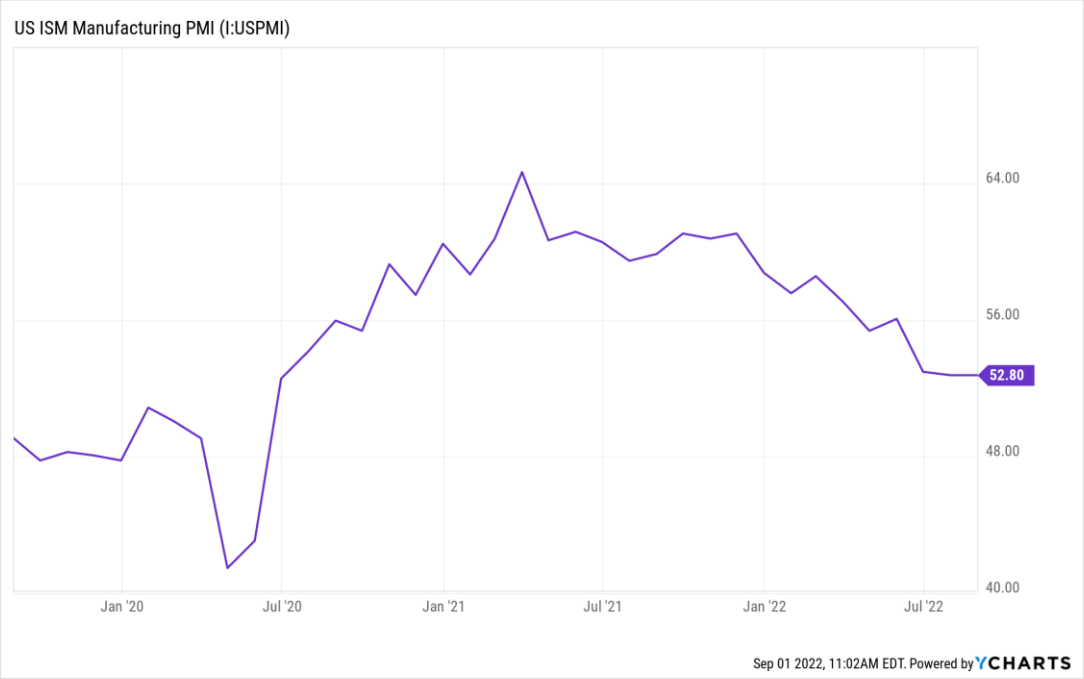
- Inflation has likely peaked (the ISM Manufacturing Price Index earlier today likely further confirmed that) but with the Fed sticking to rate hikes through year-end, and with Quantitative Tightening accelerating, focus will turn towards economic growth, not inflation.
- Growth matters because if we see a material economic contraction, that will impact the market in two ways (both negatively).
- First, multiples will decline. Right now, stocks are trading at a 16.5X 2023 multiple. That should fall to 15X in a contraction (if not lower).
- Second, and more importantly in the near term, earnings expectations will fall.
  - One of the biggest positive surprises of 2022 was 2Q earnings, which kept 2023 EPS expectations at $240. But, the economy is not contracting right now. If it starts to contract, there is zero chance earnings stay at $240, and discussion about how far earnings will fall ($230, $220, $210) will be back on, and that will further weigh on stocks.

So How Do We Know If the Economy Is Rolling Over?

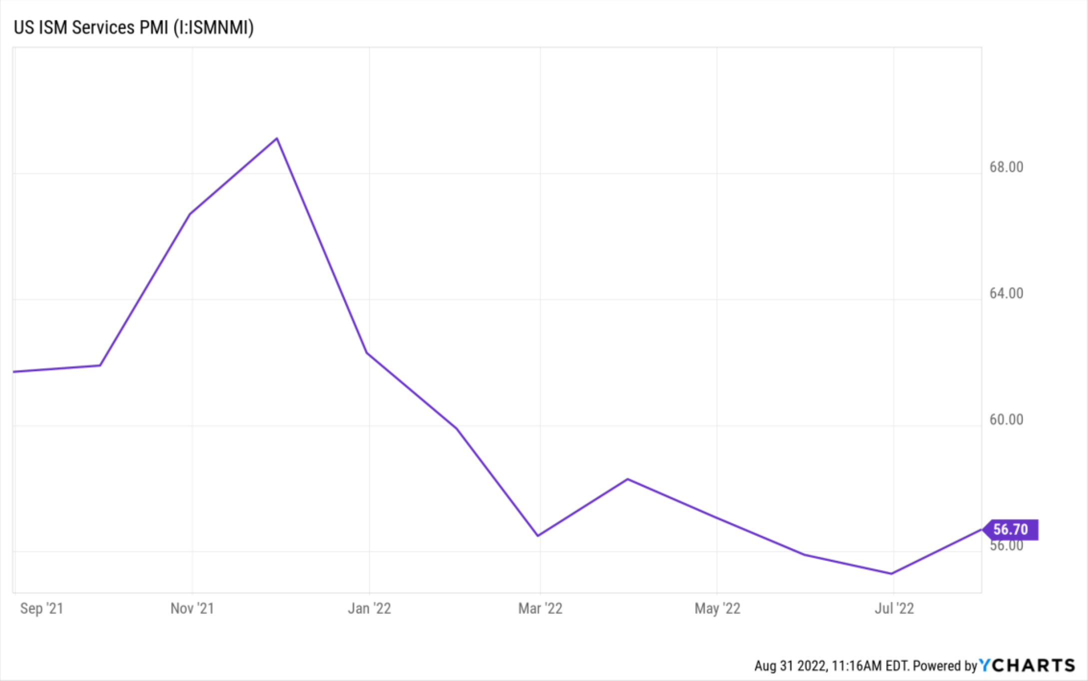
- Key indicators to watch:
  - ISM Manufacturing PMI
  - ISM Services PMI
  - Consumer Spending (Retail Sales, Mastercard Spending Data)
  - Weekly Jobless Claims
  - JOLTS
  - Unemployment Rate

ISM Manufacturing PMIs

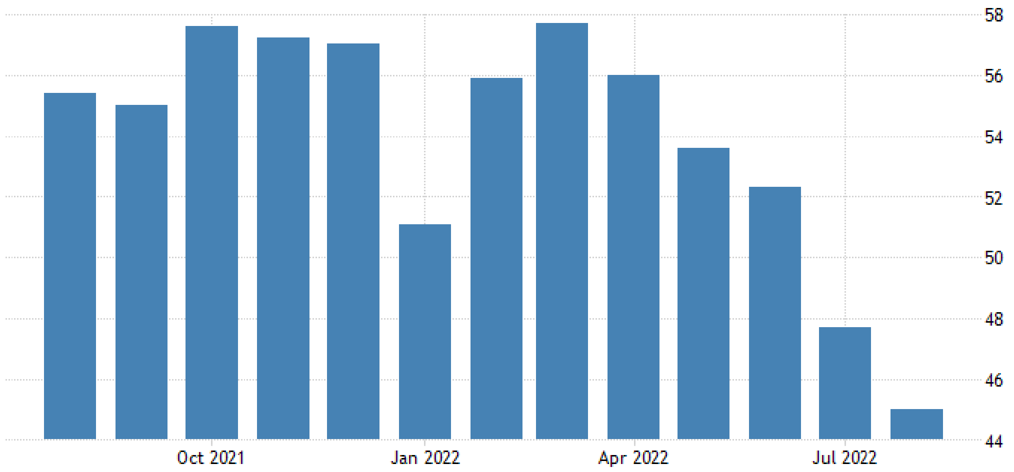
ISM Manufacturing PMI is holding above 50 (still expansion) and in stark contrast to the rest of the world.



ISM Services PMI is also holding comfortably above 50, signaling expansion.

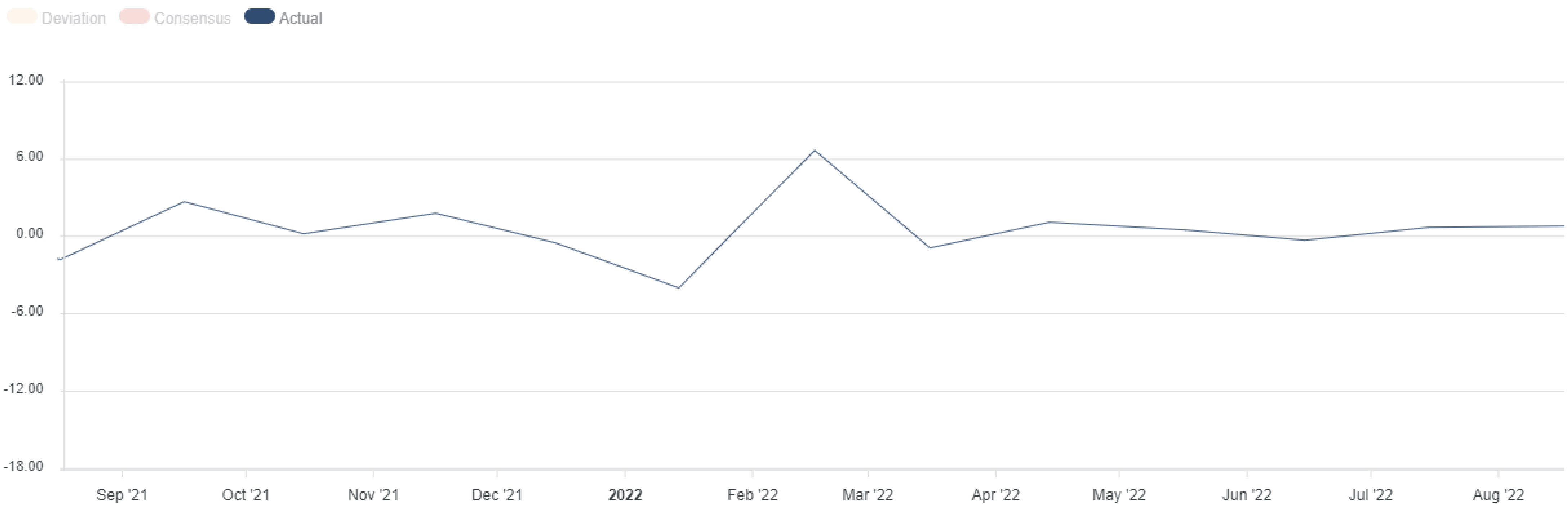


Markit PMIs - Much Weaker



- There's confusion in the monthly PMIs (which outside of the jobs report are the most important monthly economic reports).
- The ISM Manufacturing PMI is strong, while the Markit Composite PMI is weak (sub 50).
- One difference may be in company size, as Markit sources from smaller companies, while the ISM sources from larger companies.
- While not conclusive, in the initial phases of an economic downturn, we'd expect smaller companies to be impacted initially.

Retail Sales – Control Group



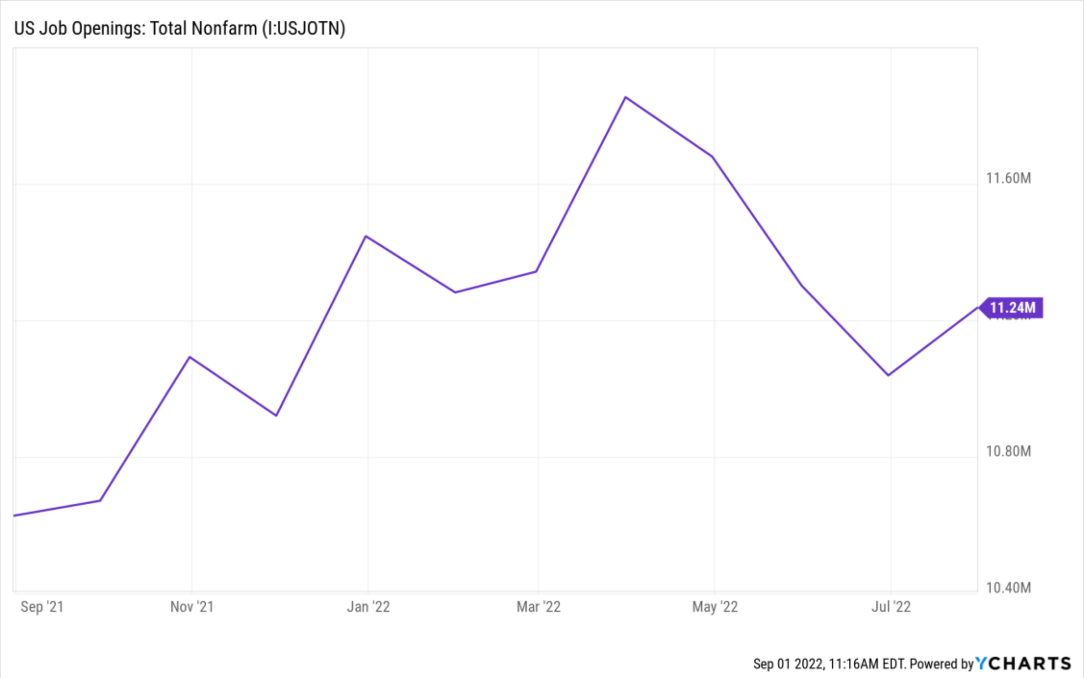
Weekly Jobless Claims

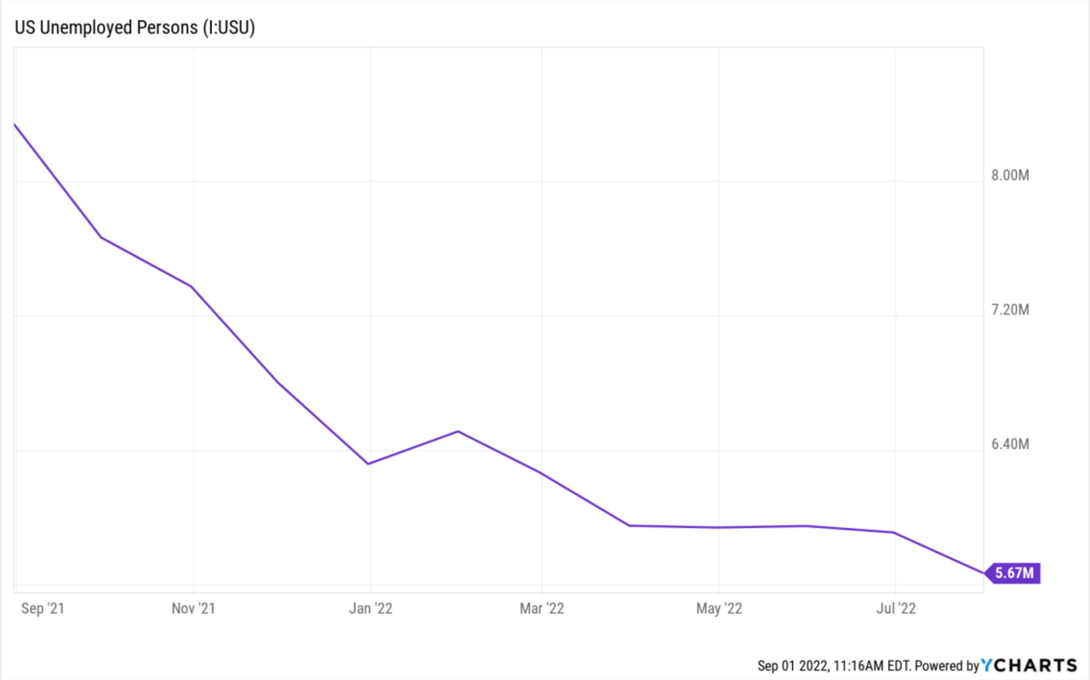
- Weekly jobless claims remain under 250k.
- That is far below the number it needs to be for there to be "balance" in the labor market (likely solidly over 300k).
- No evidence of stagflation.

JOLTS and Unemployed – The Picture of Unbalanced

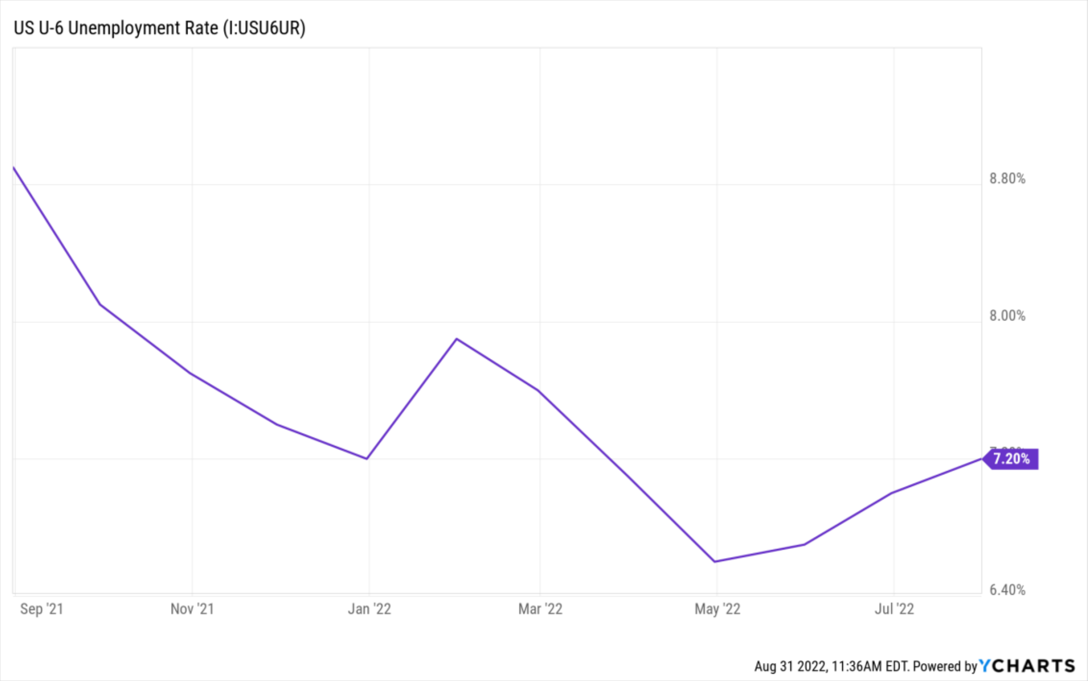
Job Openings are > 11 million.

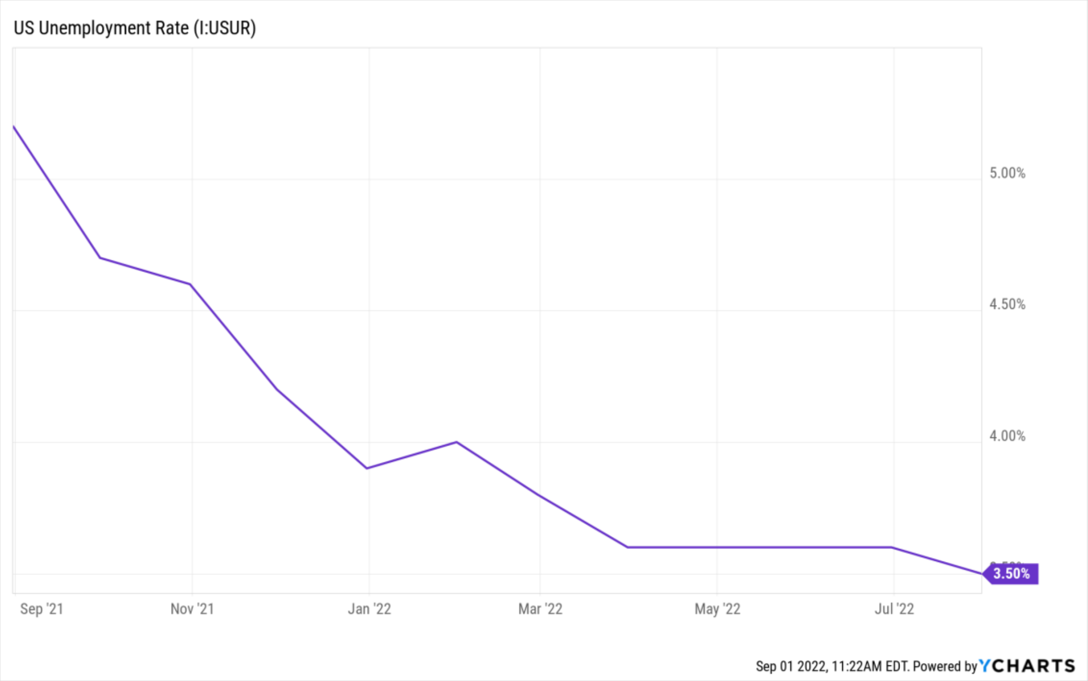
The number of unemployed persons looking for a job is 5.7 million.





Unemployment Rate





So, Where's Fair Value?

- The current macro environment:
  - Peak but still high inflation.
  - Not peak Fed hawkishness.
  - Growth positive but risks of a future slowdown.
  - Geo-political unrest.
  - Earnings stable but risks.

- Appropriate market multiple:
  - 16X-17X.
  - Reflects the current "ok" economic state, acknowledges the risks and makes allowances for a soft landing.
  - 16.5X*240 = 3,960.
    - Question is can $240 2023 earnings hold?

Takeaways

- Key Fed Questions:
  - 50 bps vs. 75 bps isn't the key issue for markets (although the financial media will focus on it in the coming weeks).
  - The much bigger issues are:
    - "Terminal" Fed Funds? Below 4% (Bullish) or Above 4% (Bearish)
    - Rate Cuts? 2023? (Bullish). 2024? (Bearish)
- Economic Data:
  - Is the economy rolling over?
  - If "yes" then that will pressure the market multiple and 2023 expected EPS, and a decline to (and through) the June lows shouldn't be a surprise.
  - What to do:
    - Read our monthly Economic Breaker Panel
    - Watch the key reports each month.
    - So far, "no" the economy is not rolling over.
- Fair Value for This Market
  - Inflation peaked, no Fed pivot, China still "Zero Covid" and Continuous geo-political unrest.
  - At 16.5X and current earnings expectations, S&P 500 is "fairly" valued here. Risk comes if growth rolls over, or earnings expectations fall.