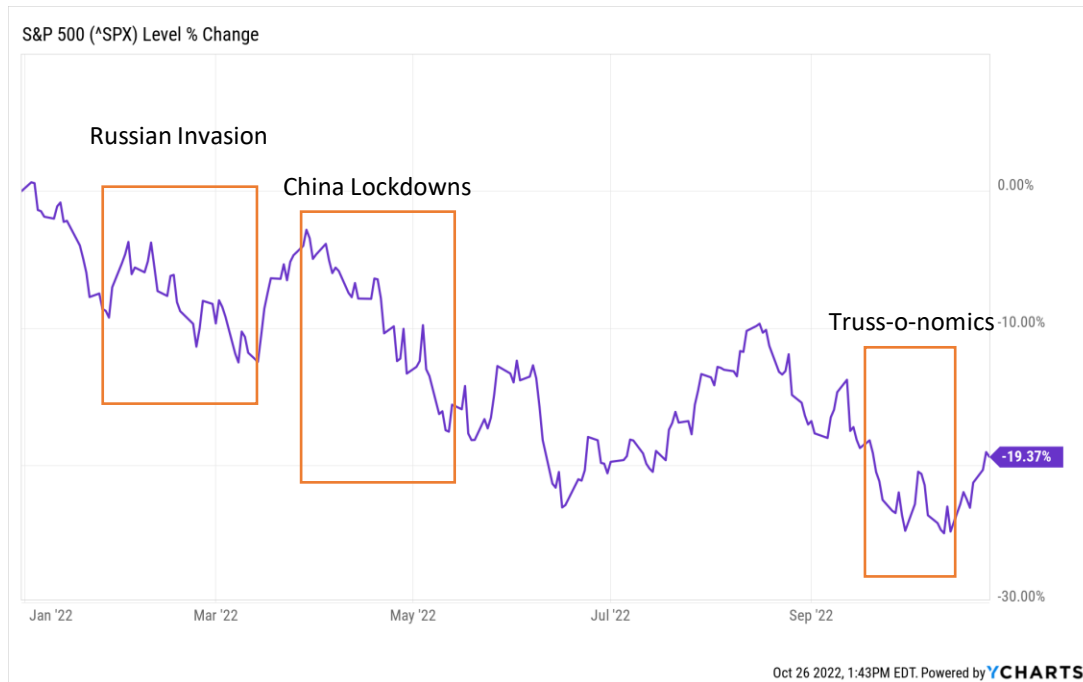


Sevens Report Alpha Webinar – Are We Closer to the End of This Bear Market Than We Think?

October 27th, 2022

Tom Essaye, President Sevens Report Research

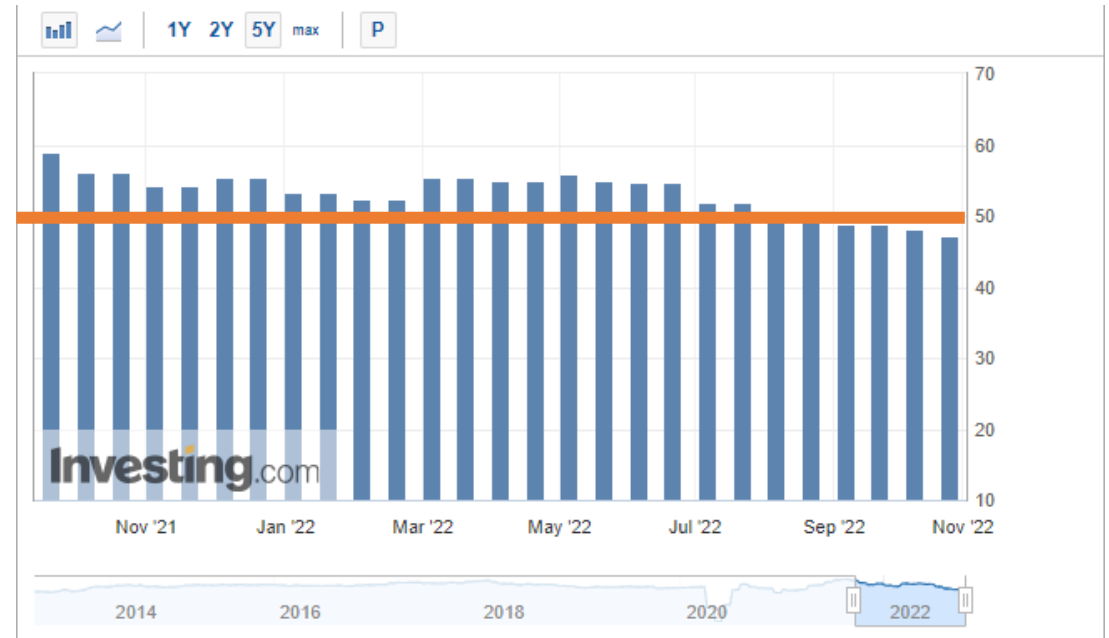
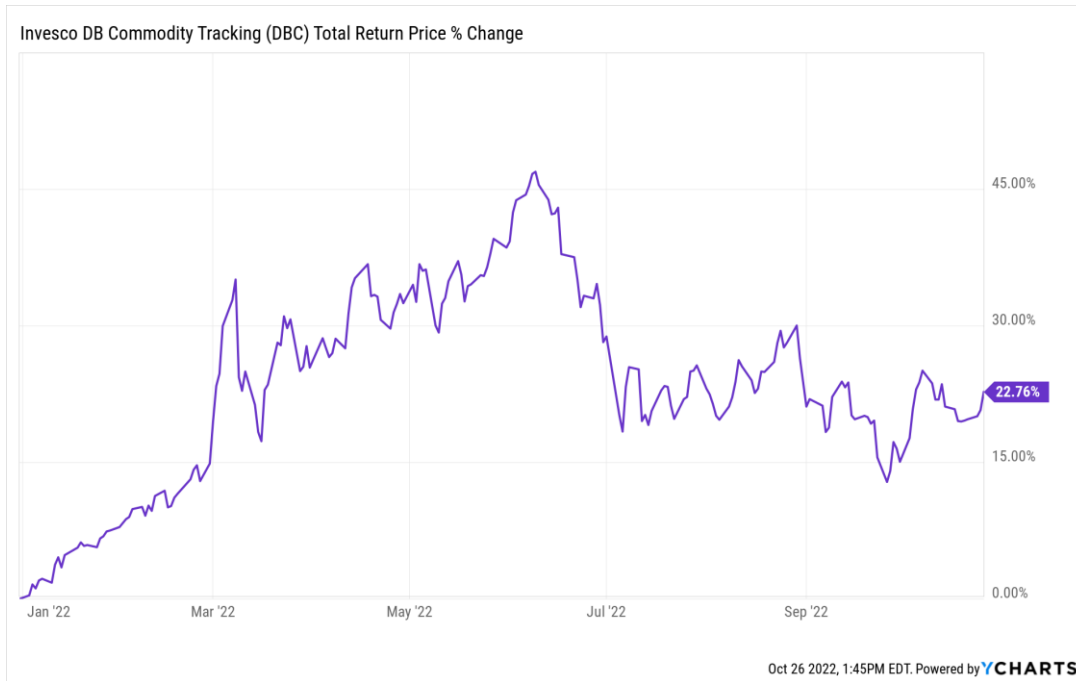
The Story of 2022



- 2022 was going to be a challenging year in markets as more aggressive Fed rate hikes pressure the market multiple.
- But, that consistent pressure has been compounded by three surprises events:
 - Russian invasion of Ukraine
 - China's no COVID policy
 - UK fiscal drama (Truss-o-nomics)
- These surprises have made the declines in the S&P 500 worse than they otherwise would have been.

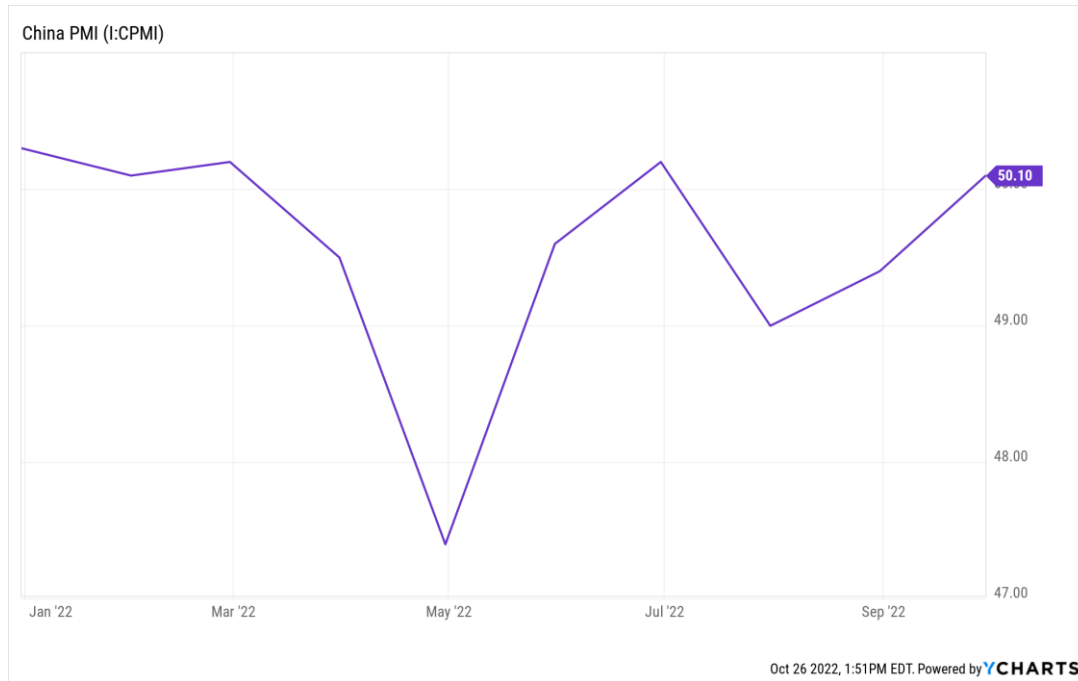
The Story of 2022

No Russian Invasion, No Commodity Spike or Looming EU Recession



The Story of 2022

No “Zero COVID,” no drag on global growth.



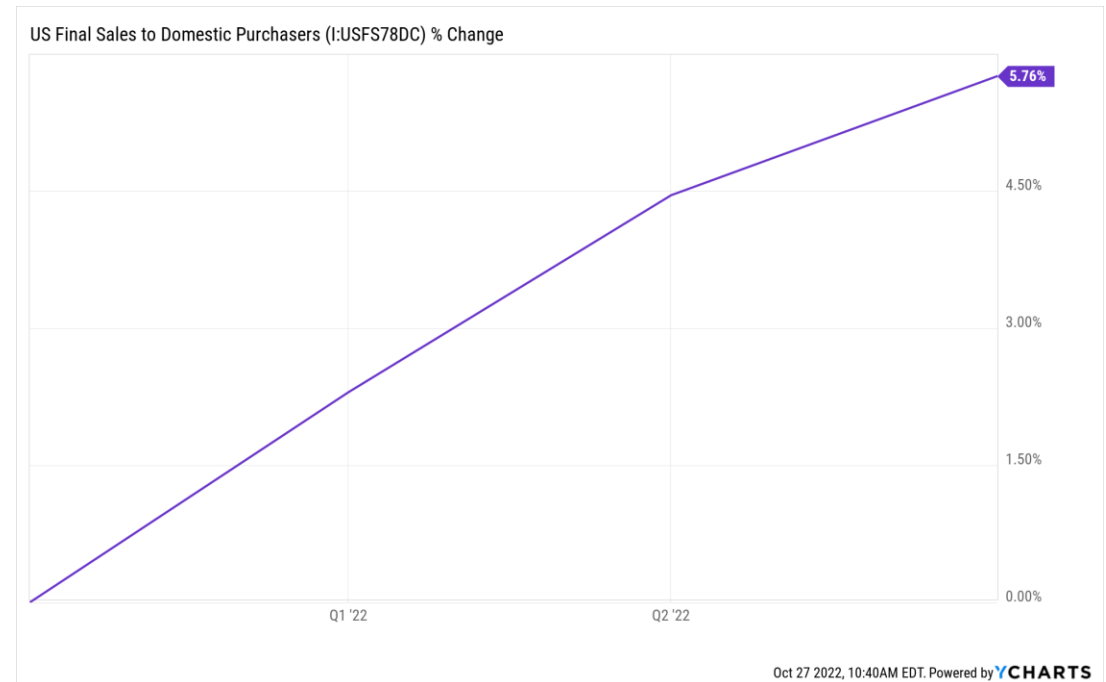
No “Truss-o-nomics,” No Yield spike.

U.K. 10 Year Gilt



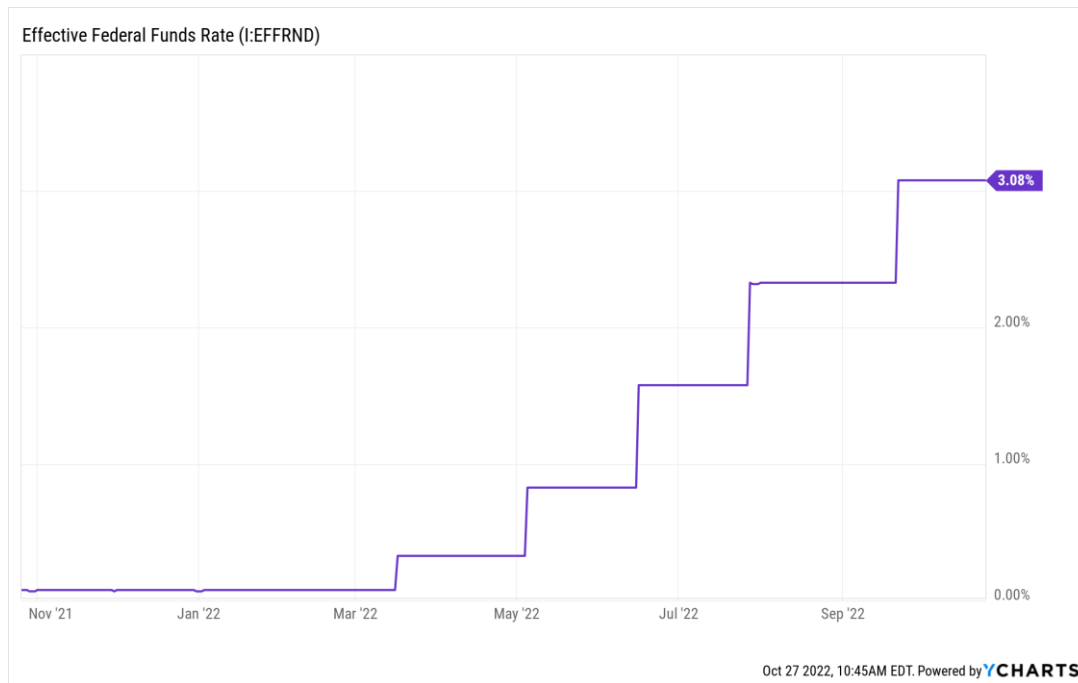
The Story of 2022

- Here's the point:
 - If all this market had to deal with was Fed rate hikes and high inflation, I contend the S&P 500 would not be down this much YTD.
 - That's because nominal U.S. economic growth was very strong.
 - Essentially, there was a lot of “cushion” for the economy to absorb these intense rate hikes.
 - Real economic growth has been strong throughout 2022.
 - Ignore Real GDP
 - Final Sales to Domestic Purchasers, Unemployment, and Personal Savings were all very strong throughout 2022.



So Why Does This Matter?

The Fed Has Now Dramatically Raised Rates.



And Growth Is Slowing, but only barely!



The Path for Higher Stock and Bond Prices

- The Fed will end its rate hike campaign likely in the next few months. Rate hikes are much closer to an end than they are to the beginning.
- Economic growth will slow going forward. But, it's still positive and employment is still solid (not showing signs of deterioration).
- It's possible that, as growth slows in 2023 the Fed does "pivot" to focusing on growth as inflation declines.
- **Just as strong growth has provided an economic cushion against rate hikes, the Fed signaling a "pivot" in 2023 could boost the market multiple just as growth really slows, creating that "soft landing" in the markets.**
- This works given the S&P 500 is already down 20%. A lot of pain has been priced in, and this scenario is possible, and I believe it would lead to positive equity returns in 2023, **as long as there are no surprise crises.**

Potential Crises To Watch (These Could Drop the S&P 500 10% - 20% (or more)).

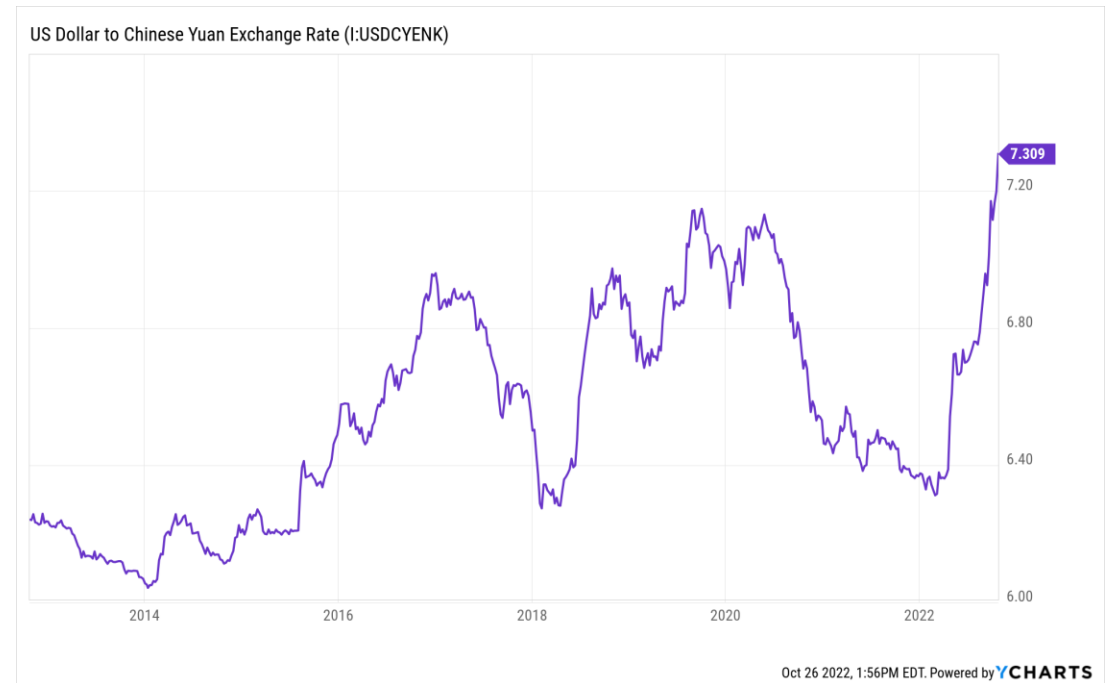
- In order of greatest probability:
 - Currency Crisis
 - Disorderly Yield spike
 - Geo-political crisis
 - Bank liquidity crisis

Currency Crisis

Biggest Candidates: China

- The Chinese yuan has fallen to multi-year lows vs. the dollar as “Zero COVID” guts economic activity and President Xi consolidates power in a fashion that is viewed as unfriendly to business.
- China must support the yuan by buying the yuan and selling dollars. If concerns arise about China’s dollar reserves, it risks China losing control of the yuan, spiking inflation in China, and unleashing a currency crisis in the second-largest economy in the world.
- Second candidate: Japanese yen. The yen is at multi-decade lows and the BOJ is actively supporting it in the currency markets. If they stop, a run on the yen could occur, rippling through markets.
- For evidence of the negative impact of this, just look at the market reaction to spiking GILTs. All of this is interrelated.

Key Indicator to Watch: Chinese Yuan



Disorderly Yield Spike

Biggest Candidates: Japan & Italy

- The Bank of Japan has executed an unprecedented break from the global banking community by pouring on stimulus while everyone else hikes rates.
- The result has been pressure on JGBs, but that hasn't impacted markets because the BOJ has been supporting the market. If they stop, a run on JGBs could occur and we can expect a similar market reaction to the GILT yield spike.
- In Italy, if the recession gets bad enough and the ECB doesn't stop hiking rates, we will be discussing an "Ita-leave" scenario in 2023.

Indicator to Watch: 10-year JGB yield, 10-year Italian BTP yields.

Italy 10 Year Government Bond



Geo-political Crisis

- Most likely candidate: Expansion of Russia/Ukraine war.
- The conflict has been put on the “back burner” by the markets, as the risk of it expanding beyond Ukraine’s borders remains low.
- However, that risk isn’t zero.
- Consistent nuclear threats by Russia, the lack of any clear military progress, and the “dirty bomb” accusation are all keeping alive the prospect of a tactical nuclear deployment by Russia in Ukraine.
- In that instance, many military analysts believe the U.S. and NATO would retaliate by destroying all Russian military hardware in Ukraine and essentially decimating the Russian army.
- Obviously, that would be a direct conflict between NATO and Russia and stocks would drop sharply.

Bank Liquidity Crisis

- Think of this as a 2008 re-do.
- This is very unlikely for numerous reasons:
 - First, bank balance sheets are much stronger than they were in '07/'08.
 - Second, regulations on banks are more stringent than they were pre-GFC (stress tests).
 - Third, consumers do not have the intense leverage they had in '07/'08. Much of the real estate run-up has just resulted in positive equity for homeowners. That equity may go away, but it won't leave them distressed.
 - Unemployment remains low.

Bottom Line

- The S&P 500 is down solidly YTD.
- Yes, the outlook remains challenged and there isn't much hope for material upside anytime soon until:
 - Inflation peaks and the Fed pivots
 - China reopens
 - Geo-politics calm down
- But, as we look to 2023, the almost unanimous negative outlook seems too simplistic. Growth remains resilient and the Fed is almost done. There's a chance the Fed pivots just as the economy slows, and the resulting bounce in multiples results in a rally in 2023 and into rate cuts in 2024, meaning the end of this bear market occurs in the next several months or quarter or two.
- That assumes, of course, there are no more "surprises" or "crises" (we'll be watching for those for you).