First Trust
Monday Morning OUTLOOK

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630-517-7756 • www.ftportfolios.com May 9, 2022

Reducing Our Stock Market Forecasts

At the end of 2021, we set out our projections for the stock market in 2022: 5,250 for the S&P 500 and 40,000 for the Dow Jones Industrial Average. Those projections were based on our expectations for both profit growth in 2022 and the yield on the 10-year Treasury note. At that time, given interest rates, the US stock market was still under our estimate of fair value.

This is no longer true. Given the surge in long-term interest rates this year, the US stock market is now fairly valued for the first time in over a dozen years, dating back to the Panic of 2008. During many of these past twelve years, with the US stock market well under fair value year after year, we often lifted our year end forecast during the year.

We use our Capitalized Profits Model to assess fair value on the stock market. The model starts with the government's measure of economy-wide corporate profits and uses the yield on the 10-year Treasury Note to discount those profits.

The yield on the 10-year Treasury finished last year at about 1.5%, which made the stock market look extremely attractive and undervalued. But to be cautious – and because we knew the 10-year Treasury yield was being held back by excessively accommodative Federal Reserve policy – we used a 2.5% yield to discount profits, instead. Using a 2.5% yield suggested fair value for the S&P 500 was 5,250, which became our forecast for the market at the end of 2022.

But here we are in early May and a vicious sell-off in the bond market has pushed the 10-year yield to 3.1%, substantially higher than the end of last year and above our 2.5% estimate. This higher yield makes a world of difference in how our model sees the stock market. Using a yield of 3.13% and fourth quarter profits suggests we were already at fair value as of Friday, with the S&P 500 closing Friday near 4,100.

This is a good point to stop and discuss our model. Our capitalized profits model ***is*** ***not*** a trading tool. It is a valuation tool. Just because the model says we are over-valued, does not mean stocks will automatically fall. Nor, if under-valued, do they automatically rise. The odds change, but we cannot use this model to trade. For example, from 1996 to 2000, our model showed US stocks grew increasingly more over-valued, but the markets did not peak until early 2000. At that time of the peak, the over-valuation was 60% and the subsequent dot.com crash was significant.

When we say the stock market is fairly valued – as it is today – that means there is an equal chance that it goes up or down from here. And the prime factor determining the outcome is whether the economy experiences a recession or not.

A stock market at fair value should be expected to rise over time as long as profits tend to rise. Recessions typically drag down profits, and with that the stock market as well.

We think the outlook through year end suggests a larger gain than normal when stocks are at fair value. First, some investors are already pricing in a recession for this year or early 2023. But we don't see a recession starting that soon. As the most pessimistic investors realize they were wrong, that's an adjustment that should drive equities upward. It's a classic wall of worry that can help boost stocks, with bad news in the near term already over-priced in.

One way to think about this is to look at the yield curve. When the Fed gets too tight, the bond market starts to signal that the Fed will need to reverse course, and short-term rates rise above long-term rates – an inverted yield curve. That is not happening today. Long-term rates have been rising faster than short-term rates, and the yield curve has steepened. The reopening of the economy following the pandemic is still underway, and we still expect profits to rise this year.

Second, some investors are concerned about a wider war in Eastern Europe, perhaps triggering NATO's call for mutual defense, which could lead to World War III. We think the conflict is more likely to be contained to Ukraine and as the weeks and months pass without a widening of the conflict, that's another wall of worry for stocks to climb.

Third, we think the stars are aligned for large Republican gains in the House and Senate, even after factoring in what appears to be an overturning of Roe vs Wade. Our best guess is that the GOP ends up with a solid House majority near the post-World War II high-water mark of 247 seats (of 435 total) set in the 2014 mid-term election. In addition, it looks like the GOP is heading toward about 53 Senate seats.

This is not to say Republican wins are always good for equities; they're not, far from it. It is to say that in the current political situation a Republican Congress creates a divided government where the odds of tax hikes would be dead at the same time the Judicial Branch is taking a tougher line on federal regulations.

Put it all together, and we think there's a recipe here for an equity rally into year end with the S&P 500 ending the year at 4,900 and the Dow at 39,000.

However, assuming some modest increases in interest rates from here, such a rally would also put the stock market in overvalued territory. So the rally we're projecting would be something for equity investors to enjoy, but not a reason to become complacent.

For now, our best guess is that the next recession starts in the Spring or Summer of 2024. If so, equity gains from our projected year-end level would be limited and it might be time then to think about a significant, albeit temporary, shift in the investment outlook.

One issue making the current environment even more uncertain is that the Federal Reserve is trying to reverse course for the first time under a brand-new monetary regime. Quantitative easing/tightening, along with the payment of

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interest to banks on the reserves they hold at the Fed, has never faced a test like it does today.

Under monetary policy before 2008, interest rates and bank reserves were connected. The Fed operated with a "scarce reserve" model. If they pulled reserves down, the federal funds rate would go up. If they added reserves, the rate would fall. But now, interest rates and bank reserves are decoupled. In other words, the Fed can push rates up without changing the amount of money on its balance sheet.

In fact, that is what it has done in recent months. The Fed has lifted interest rates twice (by a total of 75 bps) but has not done any quantitative tightening. In other words, the Fed has not become tight, just moderately less loose.

We do not know, and neither does the Fed, whether the interest rate it pays banks on reserves will actually slow down the growth of the money supply.

The bottom line is that recessions typically happen when the Fed tightens too much. And with inflation well above current interest rate levels, the yield curve positively sloped, and the money supply still expanding, the Fed is not tight.

It would take a recession for us to believe that a true bear market, not just a correction, would occur. Right now, we do not expect a recession in 2022.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
5-11 / 7:30 am	CPI – Apr	+0.2%	**+0.3%**		+1.2%
7:30 am	"Core" CPI – Apr	+0.4%	**+0.5%**		+0.3%
5-12 / 7:30 am	Initial Claims – May 7	192K	**194K**		200K
7:30 am	PPI – Apr	+0.5%	**+0.6%**		+1.4%
7:30 am	"Core" PPI – Apr	+0.6%	**+0.6%**		+1.0%
5-13 / 7:30 am	Import Prices – Apr	+0.6%	**+1.4%**		+2.6%
7:30 am	Export Prices – Apr	+0.7%	**+1.3%**		+4.5%
9:00 am	U. Mich Consumer Sentiment- May	64.0	**65.0**		65.2

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