First Trust
Monday Morning OUTLOOK

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# Respect the Bear

We became bullish about stocks once mark-to market accounting was fixed in March 2009. We were also bullish after COVID-19 hit. We got called "perma-bulls," but as we look back at the low interest rates and healthy profit growth, we don't see any other course to have taken.

We were still bullish at the end of last year, forecasting 5,250 for the S&P 500 and 40,000 for the Dow Jones Industrial Average for 2022. As always, we used our Capitalized Profits Model to assess fair value for 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. But to be cautious – and because we knew the 10-year Treasury yield was being held back by excessively loose monetary 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.

Yes, we were also forecasting high inflation and knew monetary policy would eventually have to get tight, but we thought the Fed would be very slow in shifting toward a more appropriate monetary policy.

By early May, with the Fed getting more assertive and the 10-year Treasury yield at about 3.1% (well above our "cautious" 2.5%), we reconsidered our stock market forecast and downgraded it to 4,900 for the S&P 500. Our thinking was that although the Cap Profits Model was saying we were already at fair value, that the Fed would still be relatively loose and a recession was further away than most investors thought. In turn, the lack of a near-term recession would allow equities to climb a wall of worry.

But, given the recent hastening by the Fed in the pace of rate hikes and policymakers' lack of focus on what they really need to do — a targeted and persistent reduction in M2 growth — we no longer think equities are going to reach a new high (an S&P 500 north of 4800) until one of two things happens.

The first, and much more likely, possibility is that the Federal Reserve eventually gets monetary policy tight enough to bring inflation down toward its 2.0% target, which, in turn, also induces a recession, probably not this year, more likely in late 2023 or 2024. In that scenario, a new bull market would start sometime during the recession, once investors start to grow more confident about the recession ending soon.

The second, and less likely, possibility is that the Fed pulls off a soft-landing, in which case a bull market would start once investors become more confident the Fed has pulled it off. We'd love to see this second scenario play out, but don't expect it.

Either way, we don't expect the S&P 500 to hit a new all-time high, above the old high of 4,797, anytime soon. Instead, until one of our two scenarios plays out – a recession or the realization the Fed has pulled off a soft-landing – US equities are likely to be in a trading range with potential bear market rallies that come and go. At current prices, equities could easily rally from here, but if a recession is eventually coming that rally will not last.

It's now clear that the Fed is raising short-term interest rates much faster than anyone thought at the start of the year. And the 10-year yield continues to rise. But the problem with simply raising rates to try to tighten monetary policy is that the way the Fed implements monetary policy doesn't directly lead to shifts in the money supply like it used to.

Before 2008, if the Fed wanted to tighten monetary policy it would sell bonds and drain reserves from the banking system. Now the Fed thinks it can control monetary policy by setting the interest rate it pays banks on reserves. In other words, higher short-term rates don't automatically mean slower growth in the money supply. With so many excess reserves in the banking system, the money supply is still more likely to grow than shrink.

The best news we could get is that the Fed starts talking less about short-term interest rates and more about where it would like to see growth in the money supply during the next few years. It's the rapid growth in the money supply that got us into the inflation mess and it's slower growth in M2 that will get us out of it by bringing inflation back down. That's why the most important day in June is not June 15, the day of the last meeting and the 75 bp rate hike decision; it's June 28, when the Fed next reports M2 for May.

| Date/Time (CST) | U.S. Economic Data | Consensus | First Trust | Actual | Previous |
|---|---|---|---|---|---|
| 6-21 / 9:00 am | Existing Home Sales – May | 5.400 Mil | **5.360 Mil** | 5.410 Mil | 5.610 Mil |
| 6-23 / 7:30 am | Initial Claims – Jun 18 | 226K | **224K** | | 229K |
| 6-24 / 9:00 am | New Home Sales – May | 0.590 Mil | **0.581 Mil** | | 0.591 Mil |
| 9:00 am | U. Mich Consumer Sentiment – Jun | 50.2 | **50.2** | | 50.2 |

*Consensus forecasts come from Bloomberg. This report was prepared by First Trust Advisors L. P., and reflects the current opinion of the authors. It is based upon sources and data believed to be accurate and reliable. Opinions and forward looking statements expressed are subject to change without notice. This information does not constitute a solicitation or an offer to buy or sell any security.*