Today's Market

Hotter Inflation Data May Put The S&P 500 On A Path To 3,300

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Summary

- The CPI data came in hotter than expected, and real wages continue to plunge.
- The odds of a recession just increased dramatically following the report.
- This means the current PE ratio for the S&P 500 at 16.5 is too high, and will need to contract further.
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CPI data came in much hotter than expected, killing the idea of peak inflation. It also should kill any hopes the bulls have that the Fed will pause in September or anytime soon, for that matter. Ultimately this will put pressure on the Fed to tighten even more and downward pressure on the S&P 500 index (SPX), potentially sending it to around 3,300 in the coming months.

On top of inflation rates remaining north of 8%, the consumer continues to fall behind, with real wages and weekly earnings dropping by 3.9%, the lowest reading in the cycle. More importantly, this was the lowest reading since the series has had data going back to 2007.

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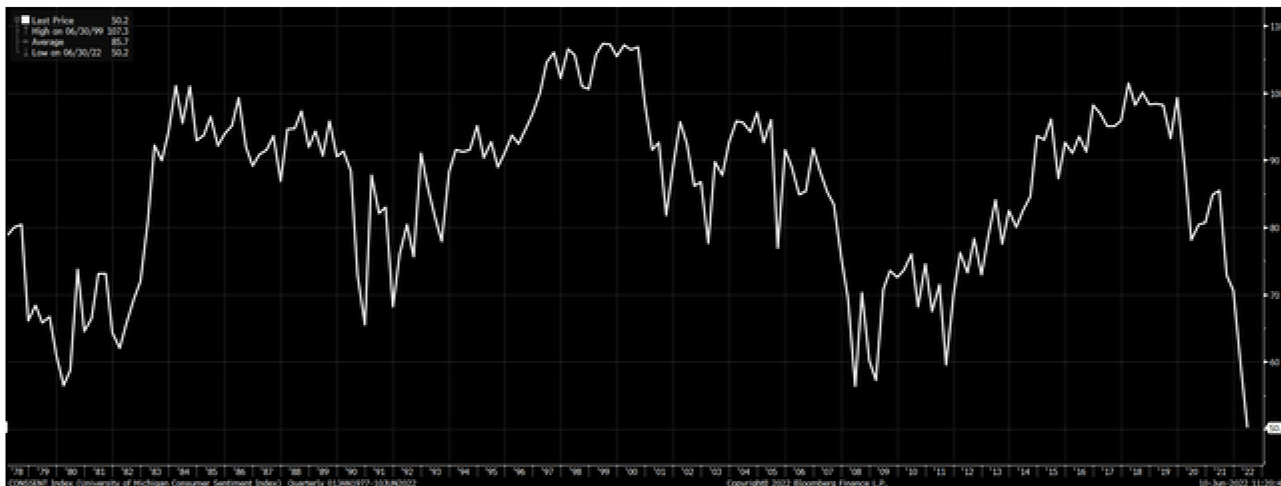
The high inflation rates and weak wage growth has resulted in the University of Michigan's consumer confidence falling to its lowest level ever, going back to 1978. The reading came in at 50.2.



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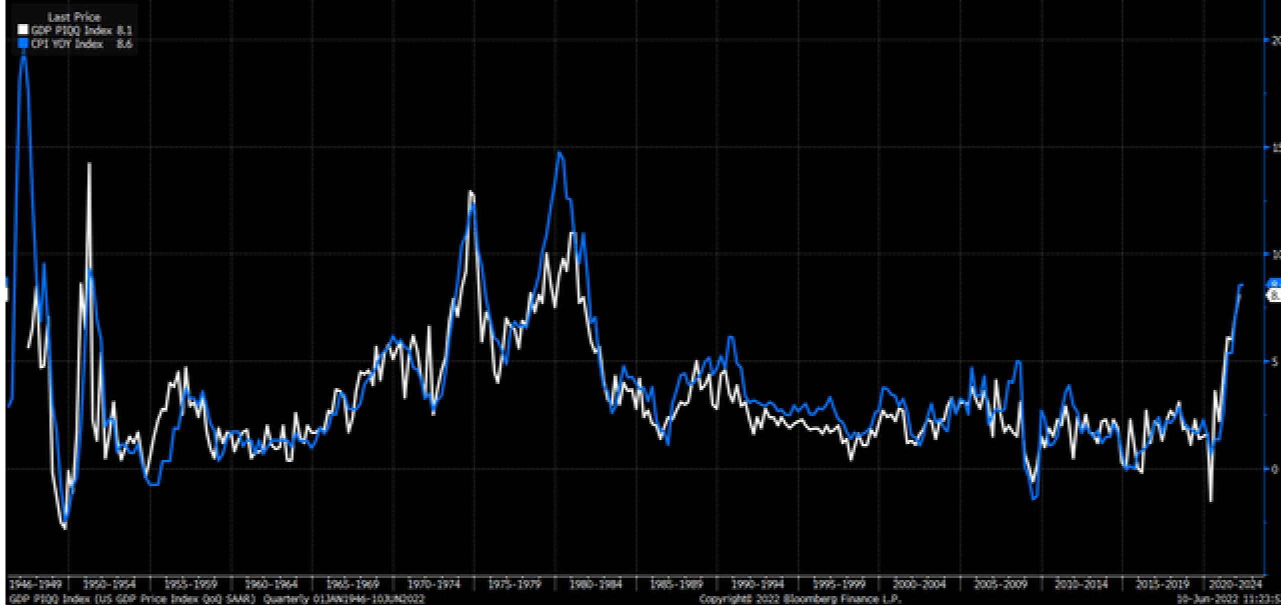
Recession Risk

The odds of recession increased dramatically following the CPI report because the odds of a GDP price index reading north of 8% for the second quarter have increased considerably. The GDP price index and the CPI track each other very closely, and unless GDP nominal growth is going to be north of 8%, then the odds for a negative second-quarter *real* GDP report seem very probable, in my opinion.



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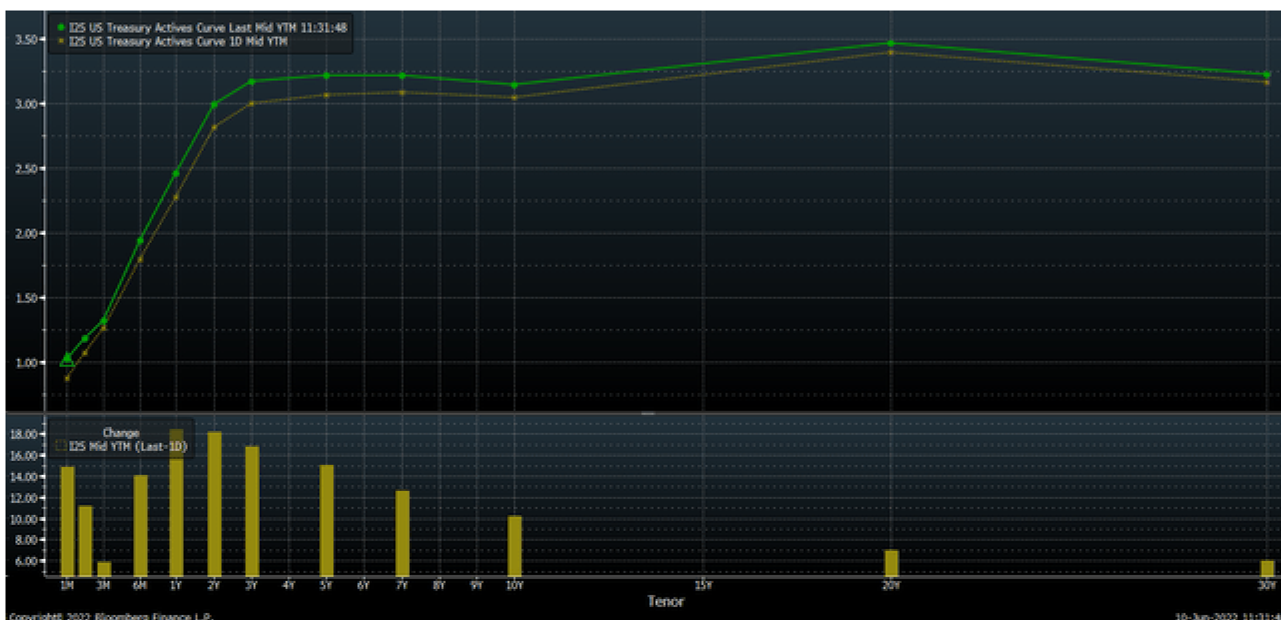
That, in essence, is the problem for the Fed, high inflation, with the potential for negative real GDP prints to come, and this time the Fed will not be able to back off hiking rates because it is *nominal* growth that the Fed will need to target to pull down inflation. It means that the Fed isn't going to back off this time as quickly as it has in the past, even if *real* GDP is negative for a few more quarters.

Markets Reprice

The bond market is, of course, repricing across the curve right now, and that's sending equity markets sharply lower. Treasury yields are seeing the most significant gains at the front of the curve as markets price in more rate hikes, with the two-year now trading up almost 19 bps today to just about 3%.



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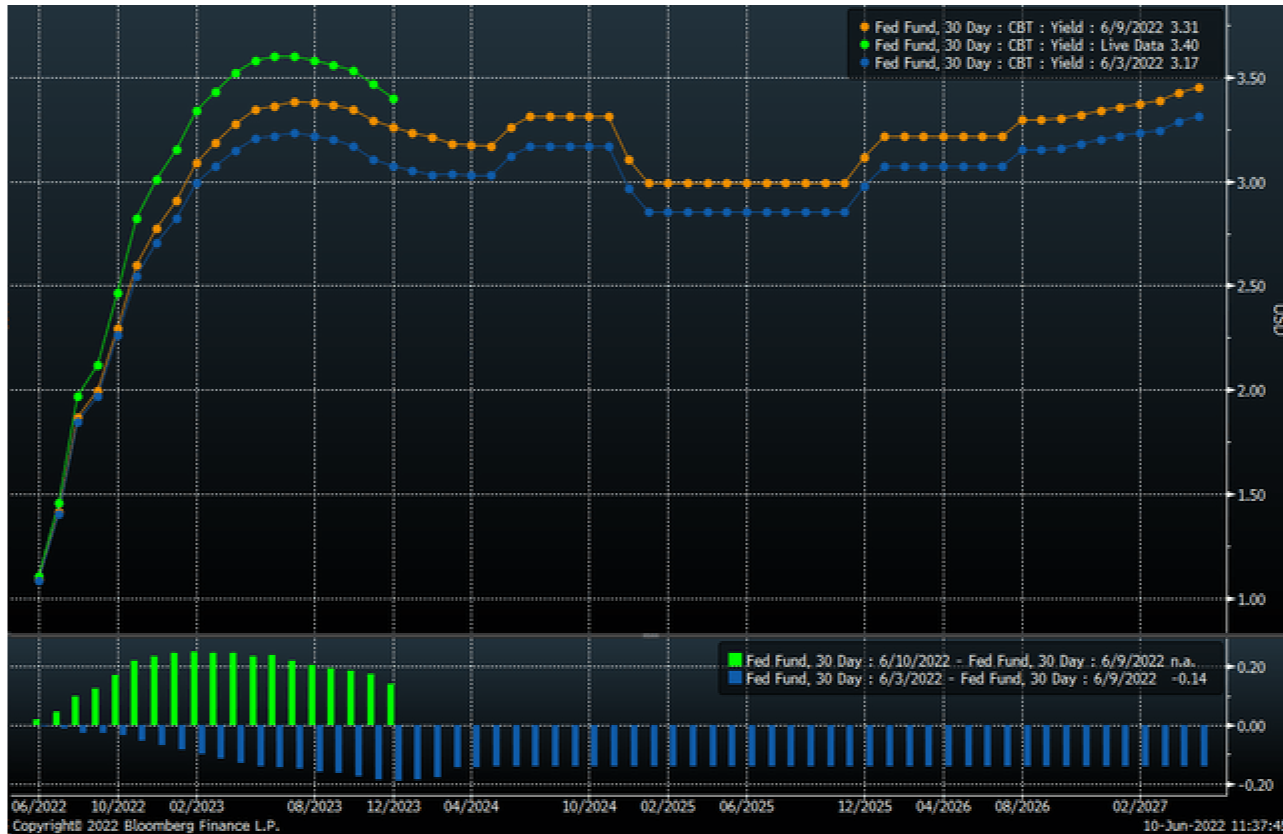
The Fed Fund futures curve has moved sharply and is now showing peak rates of 3.6%, from 3.36% just yesterday and 3.2% just a week ago. That is a massive repricing in the Fed fund futures in short a period and an indication that the market believes an even more aggressive Fed is coming.



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Of course, it's also spilling into real yields, which are repricing, causing the 10-year *real* rate to break out and now trade a new cycle high, at 36 bps. The technical breakout puts the 10-year *real* yield on a path to reach 65 bps.

Bloomberg

The higher rates in the US is resulting in spreads widening with yields globally and sending the dollar sharply higher, with the dollar index now trading over 104. The stronger dollar is just another headache for the S&P 500 on top of rising rates, which centers around falling PEs and lower earnings estimates.

Trading View

Valuation Resets

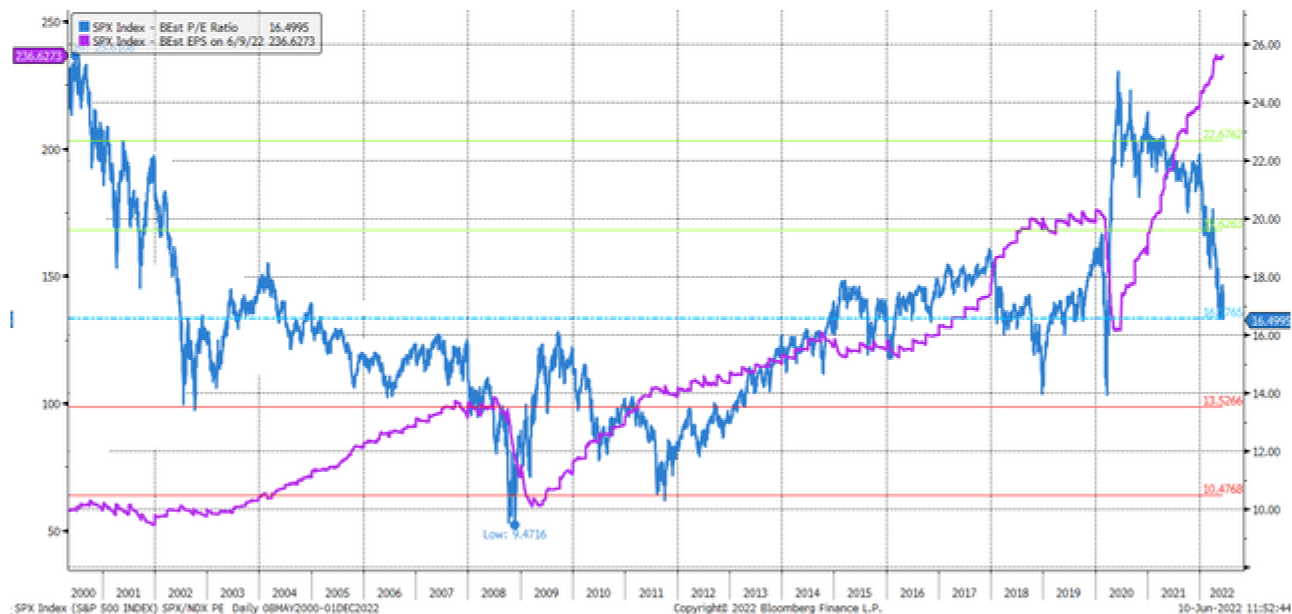
The higher rates climb, the more the earnings yields of the S&P 500 will need to rise, which in turn puts downward pressure on the PE ratio of the S&P 500, compressing multiples. The higher rates go, the less the S&P 500 is worth.

On top of that, a strong dollar will work to put downward pressure on corporate revenue and earnings. For example, Microsoft (MSFT) just recently warned the strong dollar would negatively influence its quarterly results.

Plus, a Fed that continues to work to tighten financial conditions in an attempt to slow the economy is going to weigh heavily on earnings prospects for the S&P 500.

All of this has created a disastrous outcome for the S&P 500 because there's the problem of higher rates working to compress the PE ratio for the index and the strong dollar working to lower earnings estimates. Again, given the uncertainty of the rate hiking cycle and the potential impact on S&P 500 earnings. The multiple on the S&P 500 will have to contract to a below-average PE ratio on a historical metric.

Currently, the S&P 500 is trading at a fair valuation of 16.5 based on its historical average since 2000 of 16.6. But the problem is that the market needs to anticipate where earnings are going, and as of right now, earnings estimates for the S&P 500 are too high at $236.63 per share NTM, assuming a recession is coming and growth slows.



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The market can anticipate the changes in earnings estimates by lowering the multiple it pays for those earnings, as it did in the 2008 and 2020 recession, with the PE dropping sharply ahead of the earnings estimate cuts. Where the PE bottoms are tricky, but given the rising risk of recession, the significant rate hiking cycle to come, and the earnings risk, the current multiple of 16.5 is just too high. It will need to reset, and at this point, a reset to around 14 seems reasonable, given that was the bottom of the range for 2018 and 2020.

Assuming that earnings of $236.63 and a PE ratio of 14, the value of the S&P 500 would be around 3,300. That doesn't mean that we go straight down to 3,300. It probably means we grind lower over the coming weeks and months. That should allow investors the time to digest the environment and the Fed's rate hiking path.

Unfortunately, many investors have been brainwashed to believe that the Fed will back off because that is what the Fed always does. But this time is different. The Fed has a real problem on its hand with inflation running too high and the average person falling behind. The *real* wage data show that if the Fed doesn't bring inflation under control, wages will have to start rising faster than the inflation rate, which means the Fed will have completely lost control.

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