VANN EQUITY MANAGEMENT

HIGHLIGHTS

- Initial Thoughts on the Iranian Strikes on Israel
- **Weekly Market Preview**: How Bad Was Last Week for the Rally
- **Special Reports and Editorial**:
  - The Most Important Long-Term Indicator for Markets
  - What Does CPI Mean for Markets?

STOCKS

S&P 500

- Technical View: **The medium-term trend in the S&P 500 is shifting neutral from bullish** as the index tested one-month lows last week.
- Dow Theory: **Bullish (since the week of July 10, 2023)**
- Key Resistance Levels: 5210, 5244, 5265
- Key Support Levels: 5070, 4968, 4846

SOURCE: Factset and Vann Equity Management Research Team

"The S&P 500 declined last week as June rate cut expectations plunged following the hotter-than-expected CPI report and as Treasury yields surged to multi-month highs."

- ✓ **What is Outperforming**: Growth factors, tech, consumer discretionary and communication services have outperformed thanks to strong earnings and continued "AI" enthusiasm.
- ✓ **What is Underperforming**: Defensive sectors and value have underperformed recently mostly as Treasury yields have risen, although they are poised to rebound substantially if there is a surprise slowing of growth.

Initial Thoughts on the Iranian Strikes on Israel?

Geopolitical tensions rose even further over the weekend as Iran launched several hundred missiles and drones at Israel, reflecting the biggest increase in tensions in the Middle East in decades. The immediate impact on markets would be as we would expect given rising geopolitical risks: Higher oil prices, lower stocks, higher risk-off assets (e.g., Treasuries). In the short term, the weekend's events can be filed under the "Things We Do Not Need Right Now" category, as a market that has had a quasi-perfect environment for nearly five months must now contend with several disappointments including a hot CPI that pushes back on the idea of declining inflation, reduced Fed rate cut expectations from June to September (which means higher rates for longer) and a dramatic escalation in geopolitical tensions. That will increase volatility in the near term.

However, there is reason to believe that geopolitical tensions will not become a material negative for markets. First, the Iranian attack on Israel was largely ineffective, as the vast majority of drones and missiles were intercepted by Israeli and

U.S. forces. Second, Iranian officials declared after the launches the matter was “concluded,” hinting they did not want further conflict. Third, the U.S. has said it will not support any offensive action by Israel against Iran, reducing the chances of a material, retaliatory strike from the Israelis.

Bottom line: This is clearly a further deterioration in the geopolitical landscape, and it will increase market volatility. However, we would be hesitant to extrapolate this out to a bearish game-changing event. Yes, tensions remain high and the chances of a broader conflict in the region are present, but there remains a path to de-escalation.

From a market standpoint, our investment team views this as making a pullback towards 5,000 in the S&P 500 more likely but does not view it as a fundamental negative shift that requires materially more defensive positioning for anyone other than a very short-term trader.

How Bad Was Last Week for the Rally?

The S&P 500 dropped to a one-month low and experienced the strongest selling we have seen since the first two weeks of the year as inflation ran hot, markets abandoned the idea of a June rate cut and the two ongoing geopolitical crises (Russia/Ukraine and Israel/Gaza) threatened to escalate.

Looking at the events of last week, there were some clear negatives, and the market reaction was legitimate. First, CPI showed the decline in inflation, which had slowed to a crawl in recent months, fully stalled and that challenged the idea of falling inflation which has been one of the keys to this rally. Second, rate cut expectations for June were dramatically reduced and the first rate cut is now expected in September. That challenged the idea of looming rate cuts, which had also been one of the keys to this rally. Nevertheless, were these events material negatives that should make us suspect of this rally? No, not at this point.

As we have said, the key impact of the stall in declining inflation and delayed rate cuts is that it shattered the unrealistically optimistic view/valuation, but it did not change the medium-term outlook. Put in more regular terms, our investment team and others have called this a “Teflon” market, in that no bad news would “stick” and stop the rally. Well, last week, the hot CPI delayed Fed rate cuts and geopolitical tension “stuck” and stocks dropped accordingly.

However, there is a difference between not perfect and bad, and that is the key takeaway from last week. Inflation has stopped falling (not perfect) but it is not rebounding (that would be very bad). The Fed will not cut in June (not perfect), but the Fed is not thinking about hiking rates (that would be very bad).

Bottom line: The market was priced for perfection at 5,200 in the S&P 500 but it was forcefully reminded this week that the environment is not perfect, and stocks are declining accordingly. Given that sentiment and positioning were extended on the bullish side of the ledger, a continued decline towards 5,000 should not shock anyone.

Unless we see more bullish factors deteriorate (meaning growth underwhelms or AI enthusiasm begins to disappoint) or the Fed talks about hikes or inflation rebounds, then any decline towards (or through) 5,000 in the S&P 500 is likely an opportunity to add long exposure at more reasonable valuations.

Bottom line: Last week’s news was bad, but the four parts of this rally remain largely intact (solid growth, inflation declining, Fed cutting rates and AI enthusiasm) and it will take further deterioration to challenge the validity of the rally (although again, a further pullback near term should not surprise anyone).

Economic Data (What You Need to Know in Plain English)

Inflation for the month was the focus of economic data last week and the data sent a clear message that caused stocks and bonds to drop: **The decline in inflation has stalled.**

The key report was Wednesday's CPI, and it came in hotter than expected as headline CPI rose 0.4% vs. (E) 0.3% m/m and 3.5% y/y (up from 3.2%). More importantly, Core CPI rose 0.4% vs. (E) 0.3% and 3.8% vs. (E) 3.7%. The market impact was immediate as the S&P 500 and Treasury bonds both fell sharply. The biggest practical impact of the hot CPI report was the drastically reduced June rate cut chances, which ended the week at just 25% (down from 65% pre-CPI).

Looking at the actual CPI print, it clearly was not what the market wanted and the decline in stocks and bonds was appropriate given the market's aggressive expectation of near-term rate cuts. However, importantly, the CPI number did not imply that inflation was bouncing back. Instead, it just implied the decline in inflation had stalled and that is an important difference as a stall in the decline in inflation is not a material negative. **A bounce back in inflation would be a material negative,** as it would put the idea of rate hikes back on the table.

Bottom line: Markets need inflation to continue to decline to fuel a further rally and inflation stats will remain in sharp focus over the coming weeks.

The other notable inflation report for the month was the PPI and the headline was encouraging as the PPI rose just 0.2% vs. (E) 0.3% and 2.1% vs. (E) 2.3%. That caused a knee-jerk market rally although the details of PPI were less favorable and once they were reviewed by actual people (not algorithms) the market gave back those initial gains as PPI showed sticky services inflation (which is the issue with broader inflation right now).

Bottom line: Last week's inflation data pointed to a stall in the decline in inflation and while that will not undo the five-month-long rally in stocks, it will increase near-term volatility and the sooner that decline in inflation resumes, the better.

Focus of economic data for the rest of the month turns to economic growth, sticky inflation by itself is not a bearish gamechanger for markets **as long as economic growth stays solid. However, if growth starts to roll over, look out. Here is the point: Growth is now more important than ever, and the numbers need to stay Goldilocks to dismiss stagflation concerns and simultaneously not encourage the Fed to get even more hawkish.**

COMMODITIES, CURRENCIES & BONDS

Gold

- Technical View: Gold hit fresh record highs last week as the strong push higher in early 2024 continues with the path of least resistance still decidedly higher.
- Primary Trend: **Bullish (since the week of November 27, 2023)**
- Key Resistance Levels: $2386, $2415, $2448
- Key Support Levels: $2348, $2297, $2259

SOURCE: Factset and Vann Equity Management Research Team

"Commodities were little changed last week as volatile geopolitics were offset by disappointing Chinese economic data, with geopolitical risks elevated, commodities should remain generally supported."

Commodities were mixed and price action was volatile last week as geopolitical headlines saw oil whipsaw between gains and losses before ending the week lower while inflation worries powered gold to new records and copper continued to rally on expectations for a bullish supply-demand imbalance in 2024.

The acts of war by Iran, an OPEC member and major global oil producer, bring the geopolitical seriousness of the conflict/emerging war to the next level and should send oil prices meaningfully higher near term as traders assess the developments overseas and the impact they will have on oil supply and demand dynamics.

Switching to metals, gold was up as much as 4% last week as market-based inflation expectations continued to offset a steadily strengthening dollar and sharply rising yields. Inflation expectations via 5-yr breakevens moderated into the weekend though, and gold ended up just 0.47%. Gold futures may pull back on profit-taking here, but the trend remains decidedly in favor of the bulls with prices in reach of $2,500/oz.

10-Year T-Note Yield Futures

- Technical View: The 10-year yield rose to new multi-month highs to start Q2 leaving the path of least resistance higher.
- Primary Trend: **Bullish (since the week of August 21, 2023)**
- Key Resistance Levels: 4.588, 4.632, 4.725
- Key Support Levels: 4.419, 4.304, 4.248

10-Year Treasury Note Yield Futures Weekly Candle Chart

Hi: 5.013
4.52
5
4
3
2
22
23
24

"Treasury yields rose to multi-month highs last week following a hotter-than-expected CPI report as the 10-year yield has likely broken out of the 3.75%-4.25% 'stock positive' trading range."

SOURCE: Factset and Vann Equity Management Research Team

SPECIAL REPORTS AND EDITORIAL

The Most Important Long-Term Indicator for Markets

What is the single most important long-term indicator in the markets right now? **The unemployment rate**.

Throughout late 2023 and so far in 2024, our investment team has maintained that the one "rally killer" event we all need to be watching for is an economic slowdown. First, a slowdown is nowhere near priced into markets and the resulting price correction if we get a slowdown could easily be 5 or 6 market multiple points. So, the market multiple is going from the current 21X to something like 15X-16X. Given that 2025 earnings are around $240/share, that means a market decline of 1200-1400 points is not unreasonable in the S&P 500. That would put the S&P 500 under 4,000.

That may seem outlandish given the market's resilient nature but anyone who was in this business in 2000 or 2007 knows

it can happen, and much faster than most think.

Bottom line: It is not likely, but it is possible, and risks must be monitored.

While not the most frequently updated metric, the unemployment rate is one economic indicator that will tell us if the economy is slowing. Put simply, it is very unlikely that we will get an economic slowdown as long as the unemployment rate stays near 4%. Sure, there may be a loss of economic momentum or even a cooling of growth; but unless the unemployment rate rises into the mid-4% towards 5%, then the likelihood of a rally-killing slowdown will remain low.

Bottom line: Markets will get more volatile.

They have to, as the past five months are not typical market behavior, and it will not last forever. However, volatility does not mean an end to the rally and understanding the difference is very important (and it is something we are going to make sure we tell you).

What Does CPI Mean for Markets?

CPI ran hotter than expected and resulted in a moderate decline in stocks as expectations for a June rate cut fell to just about 20% and markets priced in just two rate cuts for 2024, undermining one of the four main factors of the 2024 rally (looming rate cuts).

There were a lot of conflicting headlines in markets about what this hot CPI means, so I wanted to cover its likely impact on the market in the short and medium term.

First, CPI did not imply inflation was rebounding. Reports that imply inflation is bouncing back are exaggerating the impact. The bounce in headline CPI was caused by volatile and likely overstated factors, and it was largely expected. Core CPI did not decline, but it also did not rebound, and the 0.4% monthly increase was just 0.359% if taken out an extra decimal place. The point is that core CPI was nine-thousandths away from meeting expectations. The decline in inflation has stalled, but inflation is not bouncing back.

Why This Matters: If Inflation is bouncing back, that is a negative game-changer. If the decline has just stalled, it is not a material negative. The CPI implied the latter, not the former, so this CPI is not a bearish game-changer.

Second, CPI is a short-term negative for this market. We are not trying to be dismissive of the decline, but we are trying to put it in proper context. The key impact of the March CPI is that it demolished the market's unreasonable rate cut expectations present since December (remember we started 2024 with fed fund futures pricing in seven rate cuts!).

Why This Matters: Rate cut expectations have helped fuel this rally so with rate cut expectations dramatically reduced, this market is vulnerable to a pullback, one that can bring the S&P 500 towards 5,000 (a 5% decline from the highs) and that move over the next few weeks should NOT shock anyone).

Third, while markets are vulnerable to a pullback, they can still rally, and the CPI was not a bearish game-changer. Our team said several times that higher rates and elevated inflation are not mutually exclusive to higher stock prices. **The keys are growth and earnings**. If Q2 earnings are strong and economic growth remains stable, then the S&P 500 can move higher despite elevated Treasury yields and no Fed rate cuts.

Why This Matters*:* Downside risks have increased with sticky inflation and if growth data or earnings disappoint, a 10% decline is not just possible, it is reasonable. We need to watch growth and earnings very closely now because the safety net of near-term rate cuts is likely removed.

Fourth, higher-for-longer sector positioning likely works near-term but defensive and slower growth remains our investment team's preference over the medium and longer term. Last week, cyclicals and defensives relatively outperformed. That is an odd combination, but it makes sense. Cyclical sectors such as energy and financials are beneficiaries of higher inflation and higher yields. However, with rates likely higher for longer, the chances that the economy slows will grow as higher rates continue to pressure economic activity and that implies defensive sector (consumer staples, healthcare, super-cap tech) outperformance.

Why This Matters*:* Tech's dominance in this market will likely continue to fade, especially with higher yields. Tactical positioning in financials, consumer staples, healthcare and, for those who can embrace volatility, energy (XLE), is attractive following the hot CPI and reduced rate cut expectations.

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