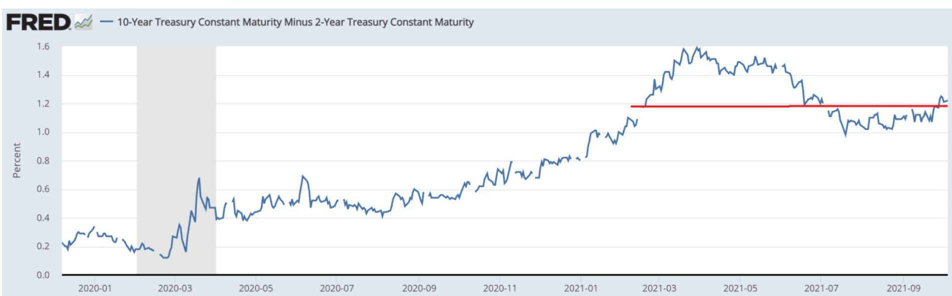
Liberty Sound Financial

09/30/2021
2021 Q3

Focus 5 Report

Yield Curve - Yellow



While most investors are concerned with rising rates, I am actually in favor of a higher rate structure moving forward. You may have heard recently that high growth/technology stocks have sold off due to rising rates. Rising rates!? The 10 year yield stands at 1.5% as I write this. That is incredibly low by historical standards. Before covid, the 10-year yield was hovering around 3%, and growth stocks were holding up just fine. It's important to keep historical perspective when talking about overall rate levels.

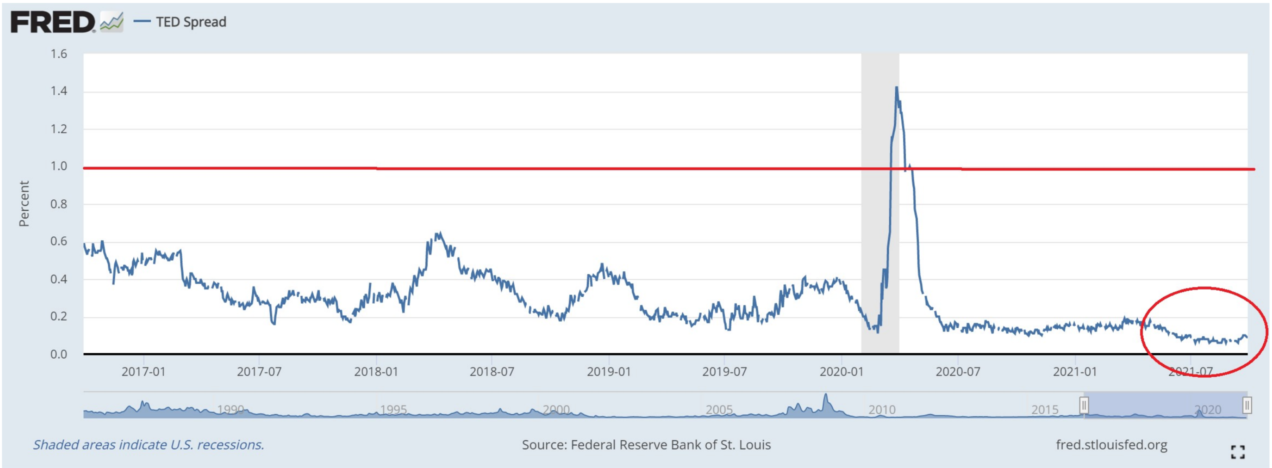
The yield spread's long-term trend is steepening and intact, but the short-term trend is flattening which will prove to be a challenge for a Fed that wants to raise rates. They can only raise the short-end rates, and if the long end rates don't come up, the Fed will run the risk of inverting the yield curve. We need a normalized rate structure, where short end rates are around 1-2% and longer-term rates are around 3%. This will create room for the next recession, as the Fed lowering rates only has an effect if the rate level is elevated to begin with.

Indicators

Special points of interest

- Yield curve Stabilized
- TED spread—No stress
- EPS growth—intact but normalizing
- Employment is back on track
- Inflation moderating

TED Spread - Green



We remain at record low levels on the TED spread, indicating that there is minimal stress if any in the global banking system. The trigger point is 1.0, which we reached in the Covid lock down in 2020 before the Federal Reserve took actions to keep the credit markets from freezing. A point of interest is as global monetary boards pull back their stimulus actions (low rates & bond buying), will the drop in liquidity cause the TED spread to rise? Banks appear to have made it through with few defaults as stimulus checks kept rents paid for the most part. Another important shoe to potentially drop would be commercial mortgages on office buildings as the "WFH" trend is real. These mortgages were written with a certain level of rent increases baked in, that appear to have evaporated in some markets so the tenants could be in the driver seat for lease negotiations.

S&P 500 EPS Trends - Green

S&P 500 Earnings: YRI vs. Consensus Forecasts (7/5/2021)

	Yardeni Research-post tax cut		Analysts' Consensus	
	Level	YOY %	Level	YOY %
Q1	38.07 a	23.2	38.07 a	23.2
Q2	41.00 a	25.8	41.00 a	25.8
Q3	42.66 a	27.5	42.66 a	27.5
Q4	41.18 a	14.3	41.18 a	14.3
2019	**162.97 a**	**0.6**	**162.97 a**	**0.6**
Q1	39.15 a	2.8	39.15 a	2.8
Q2	41.31 a	0.8	41.31 a	0.8
Q3	42.14 a	-1.2	42.14 a	-1.2
Q4	42.00 a	2.0	41.99 a	2.0
2020	**139.76 a**	**-14.2**	**139.76 a**	**-14.2**
Q1	33.13 a	-15.4	33.13 a	-15.4
Q2	27.98 a	-32.3	27.98 a	-32.3
Q3	38.69 a	-8.2	38.69 a	-8.2
Q4	42.60 a	1.4	42.60 a	1.5
2021	**195.00 e**	**39.5**	**191.37 e**	**36.9**
Q1	49.13 a	48.3	49.13 a	48.3
Q2	46.00 e	64.4	45.07 e	61.1
Q3	49.00 e	26.6	47.61 e	23.1
Q4	52.00 e	22.1	49.78 e	16.9
2022	**205.00 e**	**5.1**	**213.76 e**	**11.7**

e=estimate.

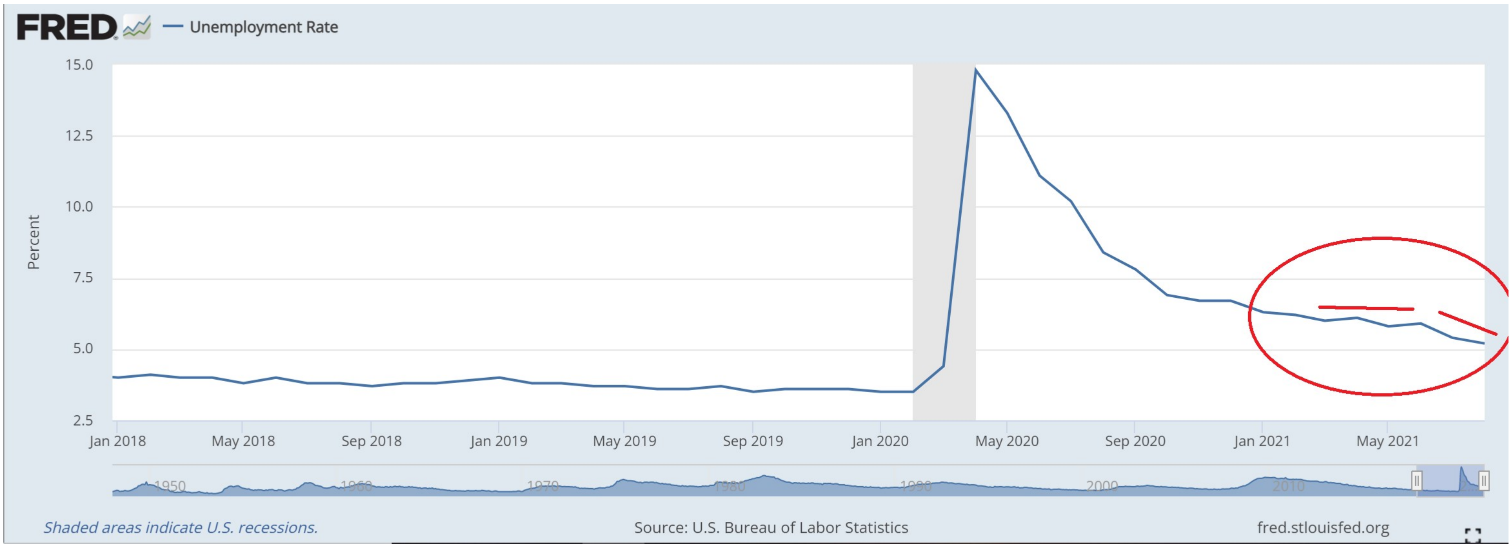
The economy, though it may not always feel like it, is cranking along. The EPS numbers continue to climb higher as we evaluate earnings projections from July to October. One key area of stress are the supply chains, which might dampen these numbers in Q4. CEOs across many industries are citing not a lack of demand, but a lack of product to sell as reasons for trimming EPS estimates going forward. In my opinion this is a good problem to have. Fixing supply chains, while difficult, is not impossible, and requires time and patience….which we know Americans tend to struggle with.

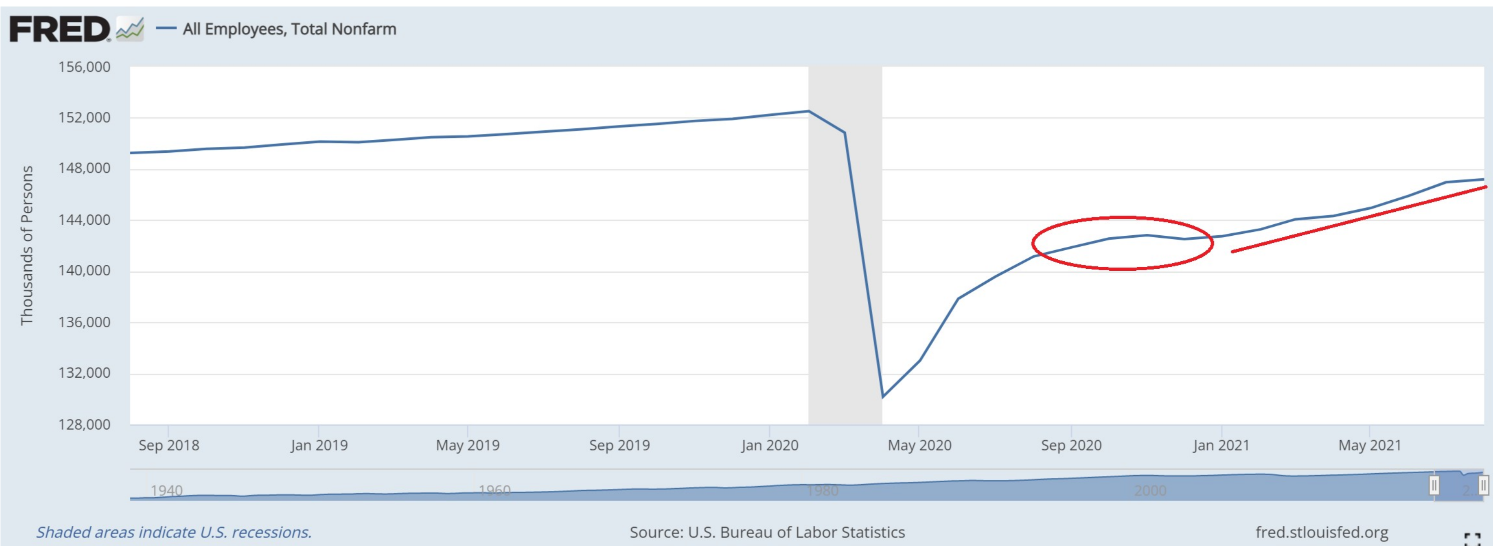
The earnings numbers remain robust, roughly 30% over 2019, which given Covid measures is an unbelievable place to be. As I've said in previous letters, the easy money has been made. Now we begin to look at 2022 numbers, which are flat, with roughly 5% growth expected. Based on that, we are in for a flat 6-8 months, before we see meaningful growth in 2023. Remember, stock markets are forward looking by about 6 months. I would expect that in August/September 2022, we'll get some help from meaningfully higher earnings in 2023.

S&P 500 Earnings: YRI vs. Consensus Forecasts (10/4/2021)

	Yardeni Research-post tax cut		Analysts' Consensus	
	Level	YOY %	Level	YOY %
2019	**162.97 a**	**0.6**	**162.97 a**	**0.6**
Q1	39.15 **a**	2.8	39.15 **a**	2.8
Q2	41.31 **a**	0.8	41.31 **a**	0.8
Q3	42.14 **a**	-1.2	42.14 **a**	-1.2
Q4	42.00 **a**	2.0	41.99 **a**	2.0
2020	**139.76 a**	**-14.2**	**139.76 a**	**-14.2**
Q1	33.13 **a**	-15.4	33.13 **a**	-15.4
Q2	27.98 **a**	-32.3	27.98 **a**	-32.3
Q3	38.69 **a**	-8.2	38.69 **a**	-8.2
Q4	42.60 **a**	1.4	42.60 **a**	1.5
2021	**210.00 e**	**50.3**	**200.64 e**	**43.6**
Q1	49.13 **a**	48.3	49.13 **a**	48.3
Q2	52.75 **a**	88.5	52.75 **a**	88.5
Q3	53.00 **e**	37.0	49.11 **e**	26.9
Q4	55.00 **e**	29.1	51.08 **e**	19.9
2022	**220.00 e**	**4.8**	**219.94 e**	**9.6**
2023	**235.00 e**	**6.8**	**235.66 e**	**7.1**

Labor Market—Green

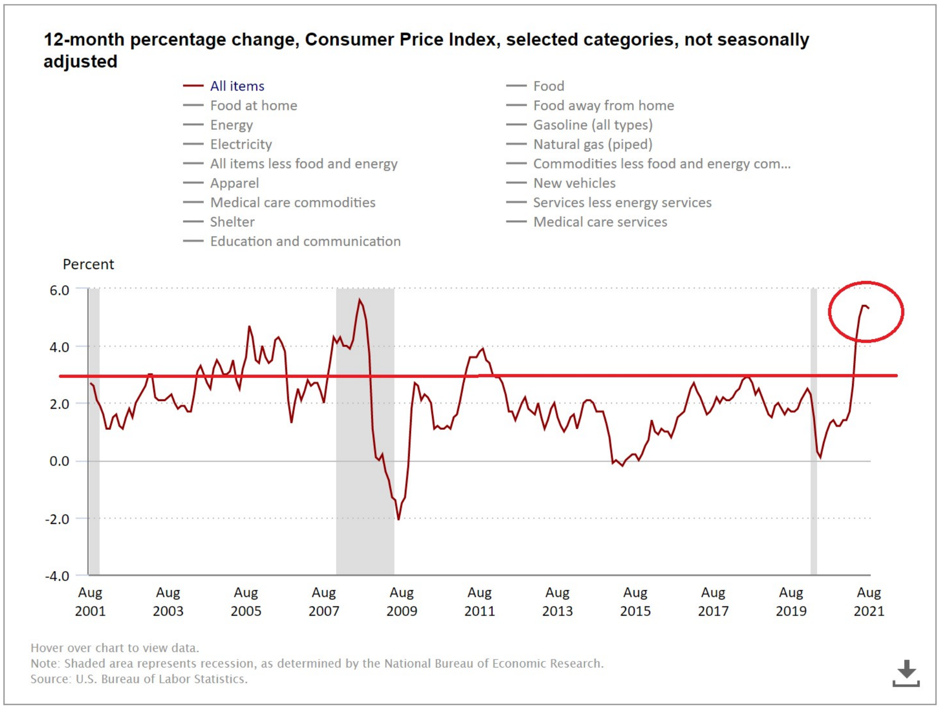




The summer stall fears from Delta are begging to ease. My highlights above recap that the trend lines had gone flat, but have since regained their positive direction. Unemployment continues to fall, and total employed is rising as the economy continues to heal. The U.S. economy, while the greatest the world has ever known, isn't a machine with an on/off switch no matter how great we are. Patience is required as supply chains and the service sector begin to adjust to a new normal; a new economy with new opportunities for capital.

Working parents are still facing childcare challenges, another huge contributor to unemployment. Right now young kids can't be vaccinated, and schools/daycares are struggling to stay open as they try to mitigate outbreaks. When a child has to stay home for 2 weeks due to close contact, how is that parent supposed to work? It's not possible for certain professions. We won't fully heal until we can keep schools/daycares open for working parents. Aside from the politics of the vaccine and mask mandates, the bottom line is that kids are being kept home, and it's hamstringing the labor market.

Inflation—Green



This might be the peak of inflation. The trend line is rolling over, which is a sigh of relief. The average media report would have you believe that we are in a hyperinflation period and the demise of the US dollar is upon us. I can't stress enough. That's nowhere near in the cards right now. The fact remains that we've gone 20 years without any meaningful inflation. Look at my red line at 3%, how many spikes do you see above it? I count 4 in 20 years, and then rates struggled to stay at 1-2%. We need inflation for a healthy economy, and I'd rather be at 3-4% than 0%, or worse, negative.

We'll monitor this inflation report. Anything over 4% long term would be very worrisome, but a return to 2-4% would be a home run for the US economy. Right now supply chains are putting the most pressure on prices, not necessarily the easy monetary policy and fiscal stimulus packages. The cost of shipping goods from overseas has skyrocketed, because of constraints at factories and ports. These issues should correct long term, which would alleviate a major source of the inflation.

Summary

The easy money has been made. Over the last 12 months seemingly every stock shot through the roof as the economy reopened and EPS estimates steadily increased across the board. But that is over for now. A new investment paradigm has begun, one where we have to actually invest in quality companies. There's a tug of war between "stay at home sectors" and "reopen sectors" as the Delta variant delays the broad-based reopening we all hoped for. In my opinion software and work from home technology companies still represent a long-term opportunity as more and more companies announce permanent plans to allow workers to remain home.

References:

https://www.yardeni.com/pub/yriearningsforecast.pdf

https://fred.stlouisfed.org/

https://www.bls.gov/charts/consumer-price-index

The above charts/data were produced by the St. Louis Federal Reserve, Yardeni Research, and BLS.gov.