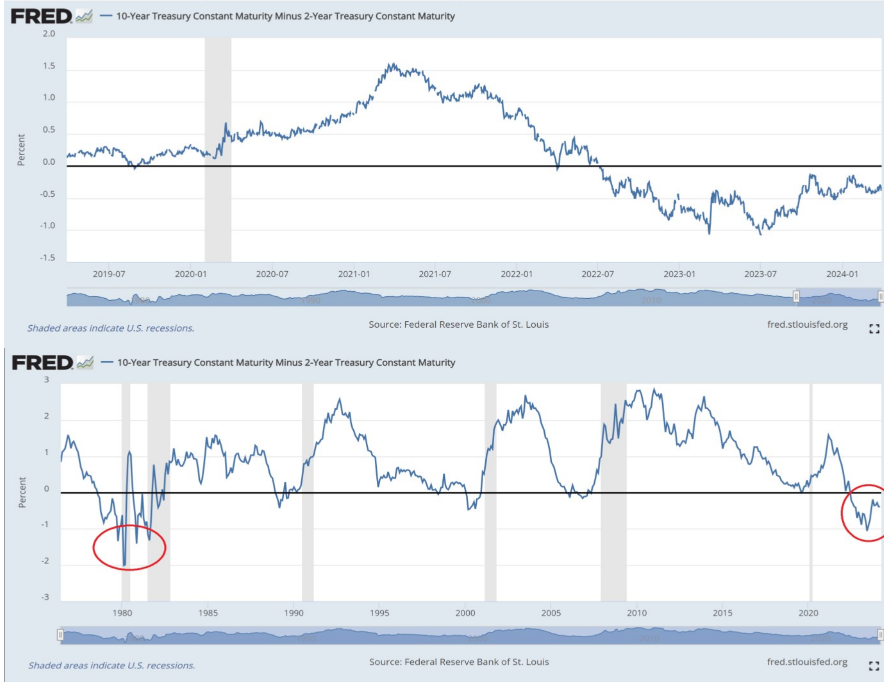
Liberty Sound Financial

04/01/2024
2024 Q1

Focus 5 Report

Yield Curve - Red



When the dust settles, this will go down as one of the most remarkable yield curve trends in our history. We have not seen this deep an inversion since 1980, which sadly is not 20-30 years ago, but over 40 years ago! The duration of this inversion, coupled with a strong economic backdrop, has bewildered even the best forecasters. While employment and job creation have remained strong, we all see the impact of inflation around us, and know that it's a black swan lurking in the background. If inflation surges again, that might be the straw that breaks the camel's back. The FED would have no choice but to hold rates steady for longer or even nudge them higher.

To reiterate, we haven't seen an inversion like this without having had a recession. Just look at the chart above: every dip is followed by a gray recession bar. In my opinion, we probably will get a recession in the short term, because the FED will keep rates too high for too long. I remain hopeful of a shallow recession from a quick reaction from the FED to cut rates when they see the economy rolling over.

**Quick note, the FED did quietly announce they are slowing the pace of reducing the balance sheet, which is an easing of quantitative tightening.

Indicators

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Special points of interest

- Yields—Inversion Persists
- Financial stress—All Calm
- EPS growth—Strong
- Employment—Strong
- Inflation —Stubborn

Financial Stress Index - Green

No noise to report here. I might have to search for a new chart that weights the inputs differently. There is obviously some pressure on the smaller regional banks, as we have seen NYCB decline by 70% + in the last month or so. The larger banks with the bulk of the assets remain strong. According to the index, all is well. But underneath the surface there are clearly cracks in the foundation of some of the financial institutions in this country.

S&P 500 P 500 EPS Trends - Green

S&P 500 EARNINGS FORECASTS: YRI VS ANALYSTS' CONSENSUS (3/31/24)

Year / Quarter	a / e *	Yardeni Research - Level	y/y%	Analysts' Consensus - Level	y/y%
2021	a	208.1	49.0	208.1	49.0
Q1	a	49.1	48.3	49.1	48.3
Q2	a	52.6	87.9	52.6	87.9
Q3	a	53.7	38.8	53.7	38.8
Q4	a	54.0	26.7	54.0	26.7
2022	a	218.1	4.8	218.1	4.8
Q1	a	54.8	11.5	54.8	11.5
Q2	a	57.6	9.6	57.6	9.6
Q3	a	56.0	4.3	56.0	4.3
Q4	a	53.2	-1.5	53.2	-1.5
2023	a	221.4	1.5	221.4	1.5
Q1	a	53.1	-3.1	53.1	-3.1
Q2	a	54.3	-5.8	54.3	-5.8
Q3	a	58.4	4.3	58.4	4.3
Q4	a	57.1	7.5	57.1	7.5
2024	e	250.0	12.9	242.9	9.7
Q1	e	60.0	13.0	54.9	3.5
Q2	e	61.0	12.4	59.2	9.0
Q3	e	63.0	7.9	63.5	8.7
Q4	e	66.0	15.6	65.3	14.3
2025	e	270.0	8.0	276.1	13.7
2026	e	300.0	11.1	302.7	9.7

* a = actual / e = estimate

A lot of analysts have been extremely mistaken in their calls for a recession in the back half of 2023 or even the early part of 2024. The earnings picture remains very robust, and is reflected in reported EPS and forecasted EPS. In fact, the consensus EPS on the SP 500 Index is now slightly higher for 2024 at 244 vs. 242 in December.

Here is where the argument comes in on valuation. The "Old Guard" prefers to use a multiple of 15-17 times earnings because that's the historical average over long stretches. But those who actually dig into the numbers see that the SP 500 is no longer dominated by banks, energy, and telecoms, which never command a high multiple. I think a more natural EPS multiple should be around 20 given that technology companies dominate the index, and their ability to scale and grow earnings has been exponentially higher than the old economy businesses.

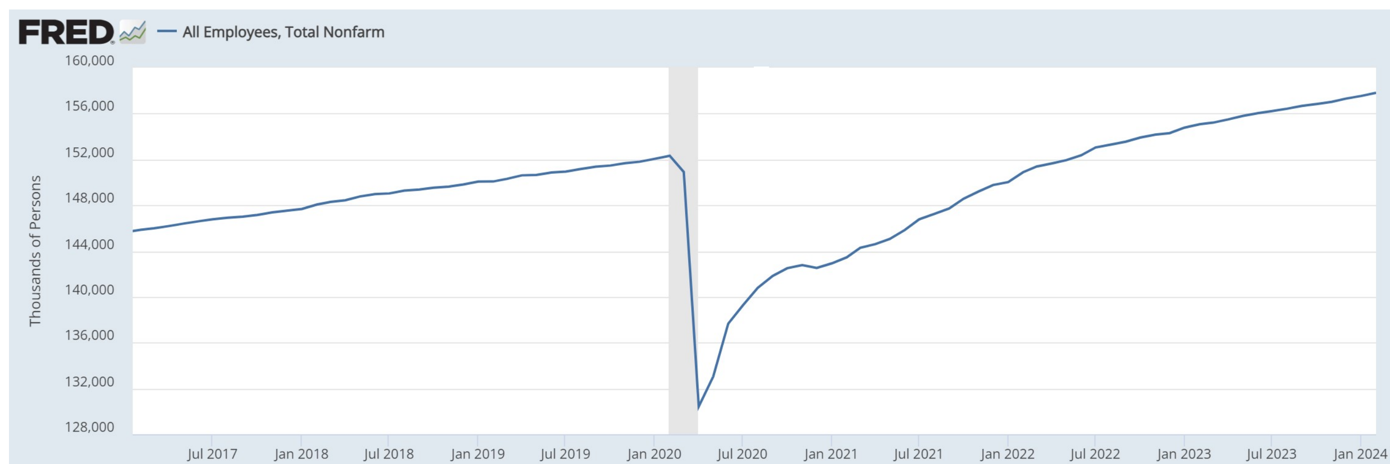
Given that 2025 EPS is forecasted to be $270, if we multiply that by 20 we get 5,400 as a target for 6-12 months out. With the SP 500 around 5,100, that implies about 10% upside to go. If you use 17X as the "Old Guard" prefers, you get 4,600, which implies the market is 10% too high. Only time will tell which version of math proves correct, but as time marches on, the multiple is getting priced higher on average.

S&P 500 EARNINGS FORECASTS: YRI VS ANALYSTS' CONSENSUS (12/26/2023)

Year / Quarter	a / e *	Yardeni Research - Level	y/y%	Analysts' Consensus - Level	y/y%
2022	a	218.1	4.8	218.1	4.8
Q1	a	54.8	11.5	54.8	11.5
Q2	a	57.6	9.6	57.6	9.6
Q3	a	56.0	4.3	56.0	4.3
Q4	a	53.2	-1.5	53.2	-1.5
2023	e	225.0	3.2	219.7	0.7
Q1	a	53.1	-3.1	53.1	-3.1
Q2	a	54.3	-5.8	54.3	-5.8
Q3	a	58.6	4.6	58.6	4.6
Q4	e	59.0	11.0	54.7	2.9
2024	e	250.0	11.1	244.0	11.1
Q1	e	60.0	13.0	56.3	6.1
Q2	e	61.0	12.4	60.0	10.5
Q3	e	63.0	7.5	63.6	8.5
Q4	e	66.0	11.9	64.3	17.6
2025	e	270.0	8.0	274.6	12.5

* a = actual / e = estimate

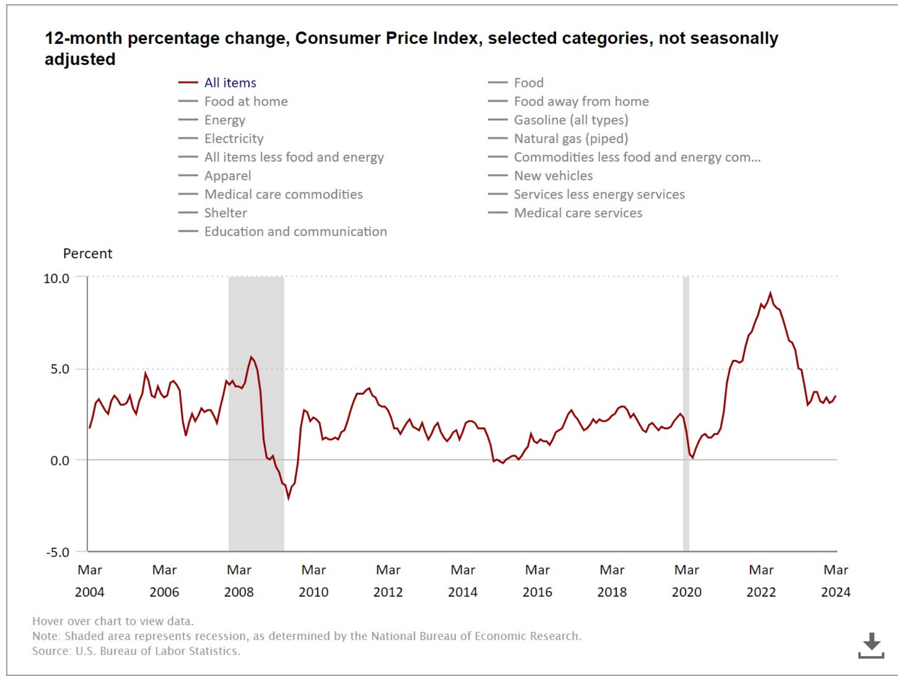
Labor Market—Green -



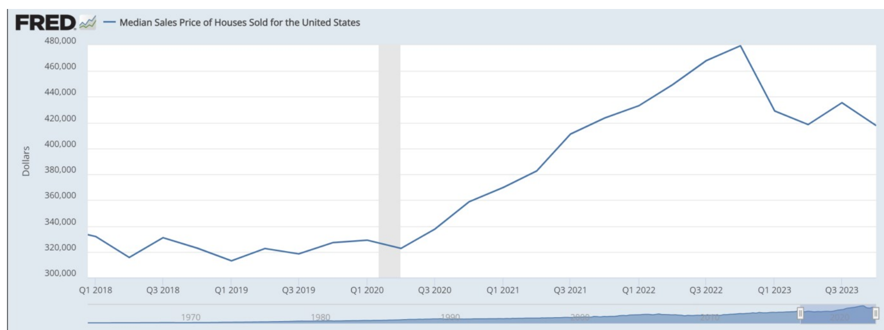
Still no negative print in sight as the labor market remains very robust. In the last reading, there was a little weakness in the number of full-time vs. part-time hiring reported. We'll have to monitor that to see if that trend accelerates into an issue of under employment. The unemployment rate is rising slightly, and as I've mentioned in previous writings, I was always taught that 5% unemployment was considered full employment. If we can move from 3% to 5% unemployment without a recession that would be the dream scenario.

Clearly we have all seen now that if you let the labor market run hot with extremely low unemployment, you get a very inflationary environment. Unfortunately for a few million people, it would benefit inflation to see them laid off and re-employed. The idea is not to have 5% sitting at home, but rather have this turnover effect where we are cycling through. That will bring down pressure on the wage price spiral that we are clearly in. It's not as drastic as the 1970s, but people are expecting 5% plus annual increases in compensation, to compete with inflation, and that's a never-ending cycle.

Inflation—Yellow



Here is where the FED has been spot on. Getting from 9% down to 3-4% was the easy part of the ride to end inflation. We have stalled here at 3-4% as various elements seem to be stuck in the mud. Containing shelter costs remains a very big challenge for the FED. One aspect that doesn't align for me is that the median home price in the U.S. has clearly come down, and yet the FED says that the shelter inflation is still too high. If you see the chart below, home pricing is dropping. In the coastal cities, we are not seeing this effect, but clearly there is moderation in the heartland. Even those who locked in 2-3% mortgage rates are now seeing the delayed effects of cost of services via their property tax bills, which was noted in the inflation report. Michigan property tax increases averaged 5% last year and it was reported that they will again average 5% increases. Perhaps only a recession can force municipalities to cut services and lower taxes? This is why inflationary periods typically end in a recession, because behavior is very hard to modify, and it can take a strong economic force like a recession to fix it.



Summary

I remain wary of a soft landing. Consumer behavior is very unpredictable, and without a recessionary force to change it, I don't know how we get out of this inflationary spiral. The headline inflation of 3-4% is not itself very high, but we all see in our daily lives that clearly there are pockets that remain elevated, like our property tax bills, auto and home insurance, along with countless food items.

Now is the time to stay within one's risk tolerance, and I would lean towards large cap tech, cloud computing, and AI companies, coupled with energy companies and a good mix of fixed income.   In fixed income, I would recommend starting to increase duration to lock in these rates for longer.

References:

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

https://fred.stlouisfed.org/

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

https://www.federalreserve.gov/monetarypolicy/fomc.htm

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

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