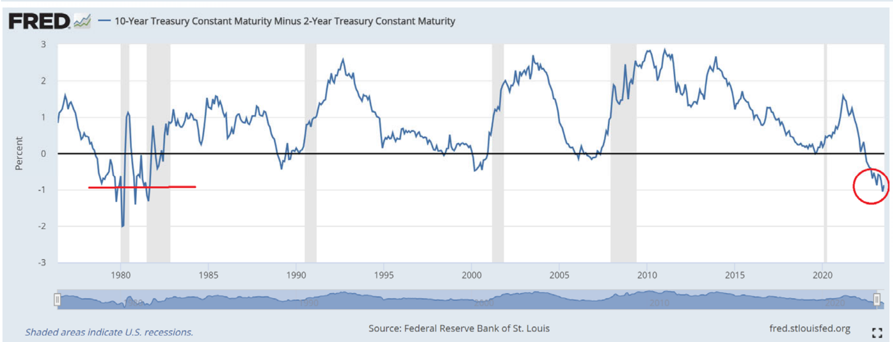
Liberty Sound Financial

6/30/2023
2023 Q2

Focus 5 Report

Yield Curve - Red



We are approaching historical territory as the yield curve remains severely inverted. This deep of an inversion, as you can see above, hasn't happened since the 1980s, which is already 40 years in our rear view mirror. The best investment periods have typically been after a recession and when the yield curve slope is the steepest. Look at 1991, 2002, and 2011.

What does this mean for today's investment environment? In my opinion, now is the time to stay balanced and stay true to a well-diversified core portfolio that is within your risk tolerance. Typically, a growth allocation would be 80% in equities; that could deviate +/- 10%. Now would be the time to stay true to the 80% or even slightly less. I would advise waiting until the FED can lower the short end back to a neutral rate of 2-3%. This will allow the yield curve to steepen, sending the chart into positive territory. Whether or not it takes a recession to get there remains to be seen.

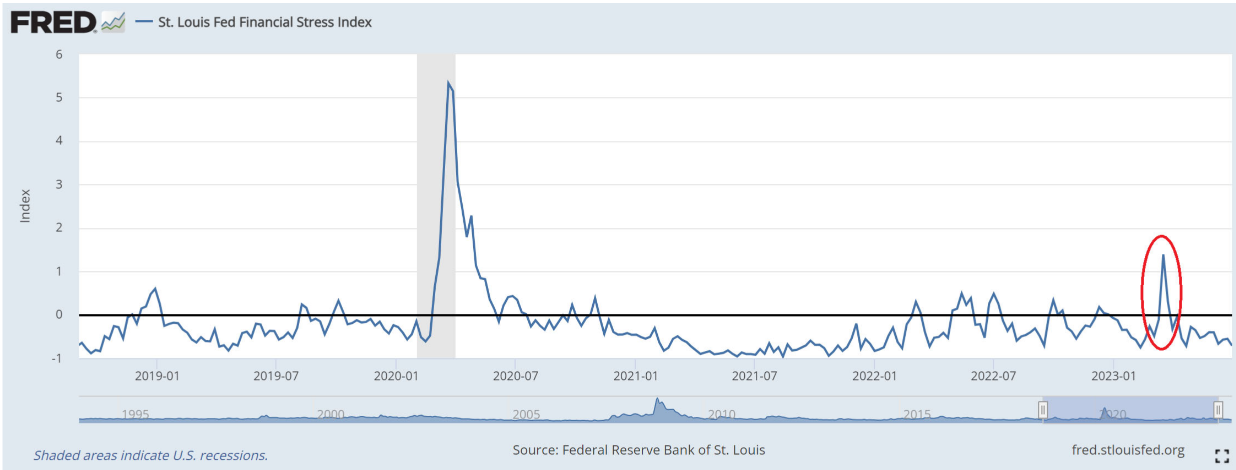
I'm focusing on the signal, and the signal says, "Be patient for lower short-end rates."

Indicators

Special points of interest

- Yields—historical inversion
- Financial stress—clear sailing
- EPS growth—flat
- Employment—strong
- Inflation — moving downward

Financial Stress Index - Green



What banking crisis? Apparently the regional banking crisis is over, or is it? If the FED keeps moving short-end rates higher and overshoots to the upside, the t-bills/notes on the balance sheets of banks decrease in value. Larger banks can weather that storm, but smaller regional banks who experience outflows have to liquidate t-bills at a loss to cover those outflows, realizing huge losses in the process. The higher the rates go, the larger the potential hole grows. Regional banks have loans on the books in commercial office real estate that haven't been exposed yet. Office real estate is experiencing a bear market that no one is talking about....yet.

S&P 500 EPS Trends - Yellow -

Table 1: S&P 500 Earnings YRI vs. Consensus Forecasts (7/10/2023)

	Yardeni Research		Analysts' Consensus	
	Level	YOY %	Level	YOY %
2020	**139.76 a**	**-14.2**	**139.76 a**	**-14.2**
2021	**208.53 a**	**49.2**	**208.53 a**	**49.2**
2022	**218.09 a**	**4.6**	**218.09 a**	**4.6**
Q1	54.83 a	11.6	54.83 a	11.6
Q2	57.95 a	9.9	57.95 a	9.9
Q3	56.05 a	4.0	56.05 a	4.0
Q4	53.16 a	-1.6	53.16 a	-1.6
2023	**225.00 e**	**3.2**	**219.14 e**	**0.5**
Q1	53.28 a	-2.8	53.28 a	-2.8
Q2	55.00 e	-5.1	52.81 e	-8.9
Q3	58.00 e	3.5	55.76 e	-0.5
Q4	59.00 e	11.0	57.58 e	8.3
2024	**250.00 e**	**11.1**	**244.88 e**	**11.7**
Q1	60.00 e	9.4	57.45 e	7.8
Q2	61.00 e	5.3	59.47 e	12.6
Q3	63.00 e	12.4	62.35 e	11.8
Q4	66.00 e	24.2	64.93 e	12.8
2025	**270.00 e**	**8.0**	**273.33 e**	**11.6**

e=estimate.

* Historical earnings and growth rates are frozen when the reporting periods are complete. Annual EPS is calculated independently of quarterly EPS, and may not equal quarterly sum due to estimate coverage and index constituent changes.
Source: Yardeni Research, Inc. and I/B/E/S data by Refinitiv.

Here we are at the halfway point of the year, and earnings are teetering on the brink of going negative. While not the worst outcome to have, it's not great for valuations in the markets, as EPS is a key metric along with the PE multiple. However, there is cause for optimism in the numbers as 2024 is projected to rebound by 12% off this year's number.   Remember, markets are forward looking, so while there might be an EPS speed bump here in 2023, if 2024 is setting up for a nice rebound, the valuations will start to trade off of that.

My baseline assumption is that within the next 6-12 months, we will get a resolution on inflation and rates. In my scenario, inflation continues to move lower and reaches a point where the FED can begin to soften on rates and perhaps lower them. We may or may not get a recession in that time frame, but I think the back half of 2024 could be promising for businesses as we begin to see an end to the war on inflation. It's nice to see that as it stands today, inflation is moving lower; but it's still elevated and no one can really see the finish line yet. Once we have that clarity, and an end in sight to inflation, then I think EPS will start to tick up meaningfully.

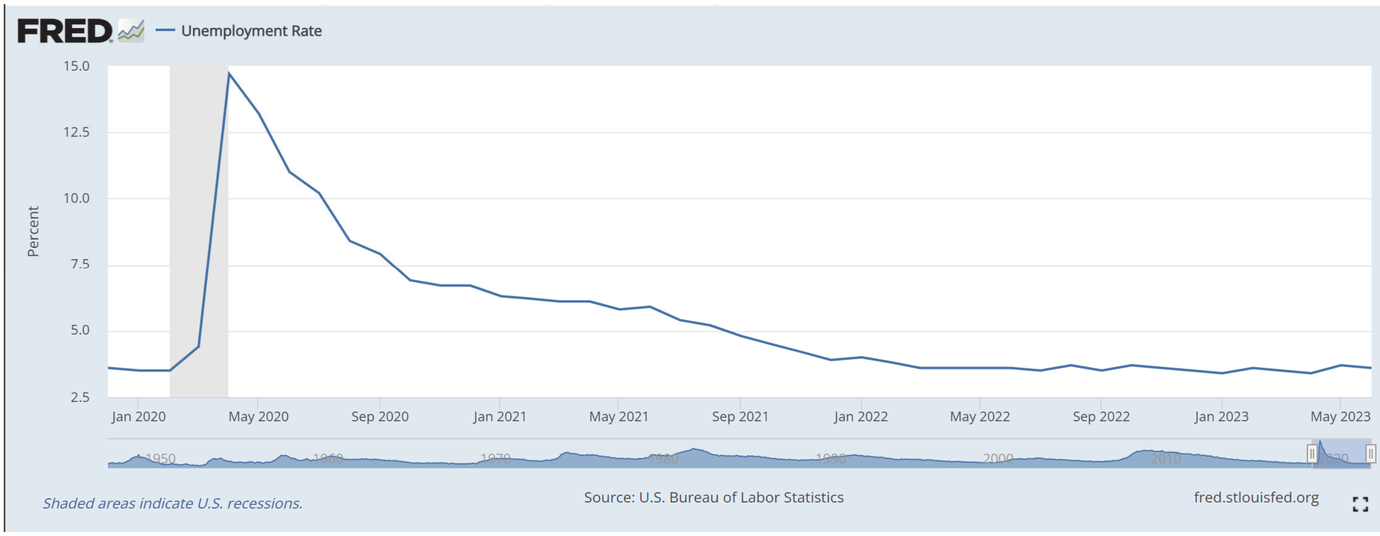
Table 1: S&P 500 Earnings YRI vs. Consensus Forecasts (3/27/2023)

	Yardeni Research		Analysts' Consensus	
	Level	YOY %	Level	YOY %
2021	**208.53 a**	**49.2**	**208.53 a**	**49.2**
2022	**215.00 e**	**3.1**	**218.09 e**	**4.6**
Q1	54.83 a	11.6	54.83 a	11.6
Q2	57.95 a	9.9	57.95 a	9.9
Q3	56.05 a	4.0	56.05 a	4.0
Q4	54.50 e	0.8	53.15 e	-1.7
2023	**225.00 e**	**4.7**	**221.40 e**	**1.5**
Q1	53.00 e	-3.3	50.79 e	-7.4
Q2	55.00 e	-5.1	54.56 e	-5.8
Q3	58.00 e	3.5	57.25 e	2.1
Q4	59.00 e	8.3	58.74 e	10.5
2024	**250.00 e**	**11.1**	**248.03 e**	**12.0**

e=estimate.

* Historical earnings and growth rates are frozen when the reporting periods are complete. Annual EPS is calculated independently of quarterly EPS, and may not equal quarterly sum due to estimate coverage and index constituent changes.
Source: Yardeni Research, Inc. and I/B/E/S data by Refinitiv.

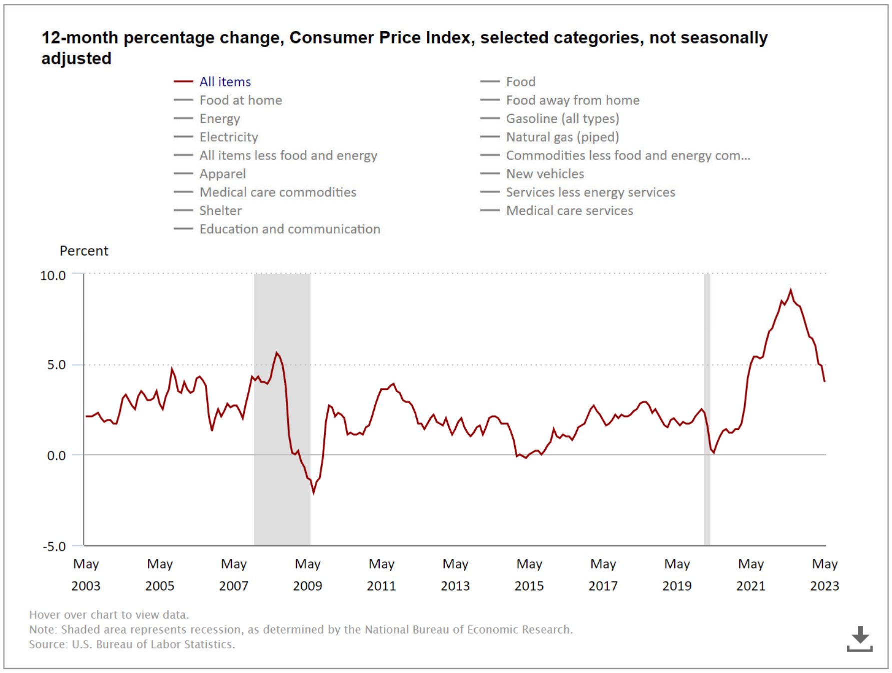
Labor Market—Green



At the start of this year, analysts/banks on CNBC stated that by the 2nd half of this year we would be seeing negative job growth (job losses), and a recession starting to set in. Well, given the recent data it doesn't feel like we are going to be losing jobs anytime soon. While this is great news for employees, it could spell trouble for the economy. I have always been taught that 5% is considered full employment. Having it lower than that would indicate overheating and inflation. That's a simple overstatement of the reality today as there are many factors such as the aging population, the definition of employment, etc., that move the target. In any event, the unemployment rate being under 4% gives the FED cover to continue to raise rates even higher to push down inflation. In a classic FED move, they could take rates too high, and crash the economy sending unemployment above 5%.

Given the strength in the labor market, it's hard to imagine a deep recession even if the FED does take it too far. At the point when the economy starts to roll over, hopefully inflation is also lower, and the FED will be able to lower rates to ease conditions necessary to avoid a deep economic recession.

Inflation—Yellow +



The economy doesn't really work for anyone without price stability. Those in the lower economic brackets are seriously hurt by inflation on necessary items. Even capitalists at the top are hurt by inflation as they struggle to develop and undertake business ideas. Businesses like calm, steady, predictable conditions so that they can map out a financial plan. It is welcomed news for all to see inflation continuing to cool as we are now a full year into the FED's decision to start aggressively raising rates.

One area to pay attention to is home ownership costs, and unfortunately I haven't found a suitable chart for this topic. But municipalities around the country are now beginning to struggle with inflationary costs which will be passed onto middle class America via property tax increases. Home insurance premiums are skyrocketing in large swaths of our country, given the large scale wild fires and storms we've experienced. I believe this tandem, while hurting middle class America, will provide inflationary relief as excess cash is drained from the system.

Summary

Taking a broad view of the signals, the investment landscape isn't that terrible. Earnings and the yield curve continue to be the largest sources of angst. The labor market remains strong, inflation is trending lower, and there's very little financial stress, for the time being. My question is what will happen when all these office buildings have to be refinanced? Up until now, banks/lenders have been kicking that can down the road.

My overall advice is to remain balanced and diversified within one's risk tolerance and to wait for lower rates before taking on added risk.

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.