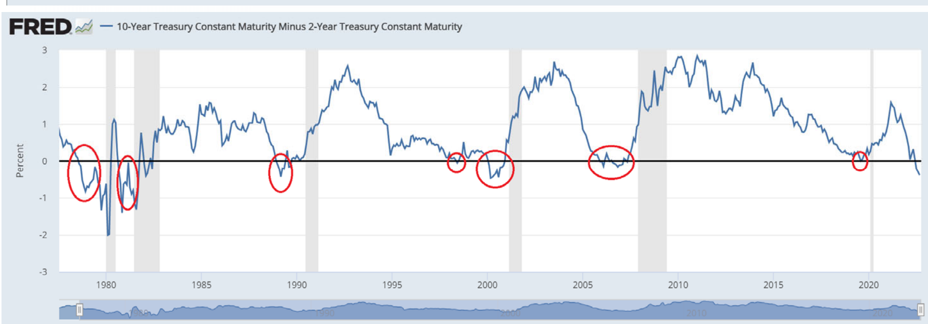
Liberty Sound Financial

09/30/2022
2022 Q3

Focus 5 Report

Yield Curve - Red



These last 2 years remind me of a quote I've heard many times since becoming a parent: "The days are long, but the years are short." The yield curve is once again inverted, and it was only a couple of years ago that I was warning here to be wary of this signal. Despite being 2 years removed from the beginning of the global pandemic, we still seem to be living in a Covid economy marked by supply and demand imbalances. The second chart shows us that hard economic times are not far off after this signal flashes red. Of the last 7 inversions I circled, 6 of them led to recessions.

All is not lost though. Powell recently stated that by crushing inflation now, we will be setting up for a solid investment runway of 7+ years. Once inflation rolls over, the FED will be able to lower the short end rates, which sets us up for a very large spread between the 2- and 10-year treasury yield. After Covid, long term rates were extremely low; and this inflationary environment has pushed those rates significantly higher. Think of this as vaulting the ceiling. Once the FED normalizes their policy rate to the neutral rate of 2-2.5%, we'll have a healthier yield curve.

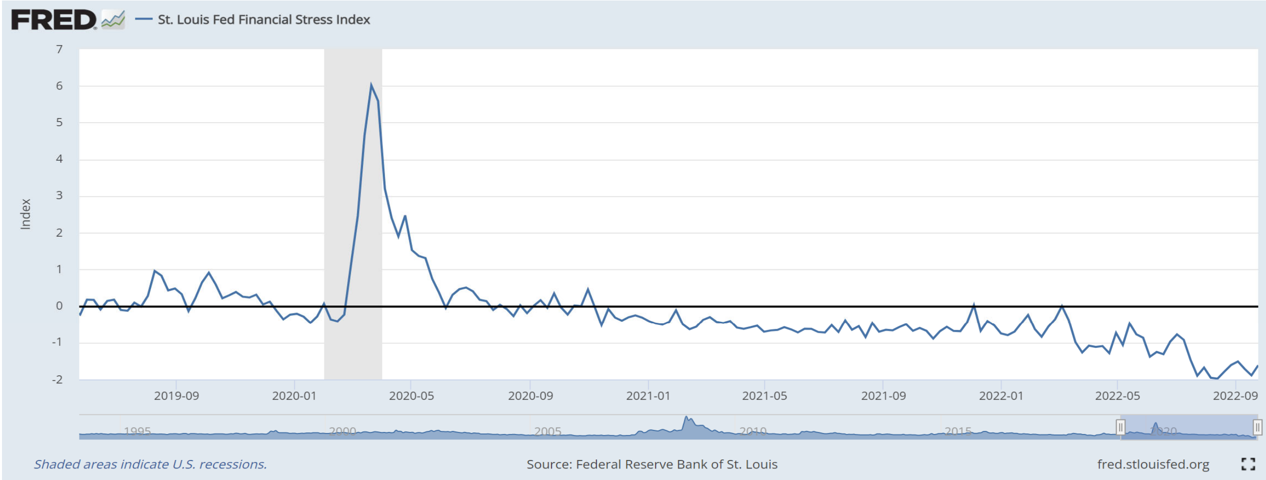
Until then, we will be on watch for a recession, as these elevated short-term rates will eventually slow down the economy.

Indicators

Special points of interest

- Yield curve inversion—Recession looming?
- Financial Stress—Below Avg.
- EPS growth—Downward Revision
- Employment—Strong
- Inflation — Peaking?

Financial Stress Index - Green



This chart continues to show less and less stress in the financial system, despite the headline news we are reading. We'll take that positive news. A strong financial backdrop would greatly reduce the impact of a recession. It feels like we are still shell-shocked from the "Great Recession,", which was greatly exacerbated by a collapse in the credit markets. If the banks and lending institutions remain well-capitalized and the credit markets continue to function properly, we can avoid a severe recession. The FED will have to walk a fine line with rate increases, as this pace has the potential to cause cracks in the credit markets.

One has to wonder...who holds the debt on the office buildings struggling for tenants?

S&P 500 EPS Trends - Yellow

Table 1: S&P 500 Earnings YRI vs. Consensus Forecasts (9/26/2022)

	Yardeni Research		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	**208.53 a**	**49.2**	**208.53 a**	**49.2**
Q1	49.13 a	48.3	49.13 a	48.3
Q2	52.75 a	88.5	52.75 a	88.5
Q3	53.89 a	39.3	53.89 a	39.3
Q4	54.05 a	26.9	54.05 a	26.9
2022	**215.00 e**	**3.1**	**223.83 e**	**7.3**
Q1	54.83 a	11.6	54.83 a	11.6
Q2	57.95 a	9.9	57.95 a	9.9
Q3	51.00 e	-5.4	55.66 e	3.3
Q4	52.00 e	-3.8	57.99 e	7.3
2023	**235.00 e**	**9.3**	**242.22 e**	**8.2**

The revisions are upon us. Analysts are now coming to terms with stubbornly high inflation eroding away profit margins for US firms. Mild inflation can be a great asset to businesses as they can generally pass on the majority of those costs to the consumer. This stubbornly elevated prolonged inflation, however, becomes a hinderance as time moves on because firms are unable to keep passing along cost increases. This leads to margin compression and earnings reductions.

If we consider the factors that drive earnings, sales growth, margins, consumer strength, and production capability, the majority would agree that margins are the main concern right now. Looking at the recent data, production capability is actually normalizing. The cost of shipping containers has come down, the wait at the ports has eased, and the ability to find raw materials is also greater now. The seesaw between inflation eroding margins and consumer strength will be key to earnings in 2023. If inflation eases without the FED having to take extreme measures, then we'll avoid a deep recession, and consumer spending will moderate but continue. On the other hand, if inflation rolls over because the FED squashes it with an iron fist, then a deep recession will cause a severe pullback in consumer spending.

For what it's worth, early calls are for a robust holiday shopping season to end the year.

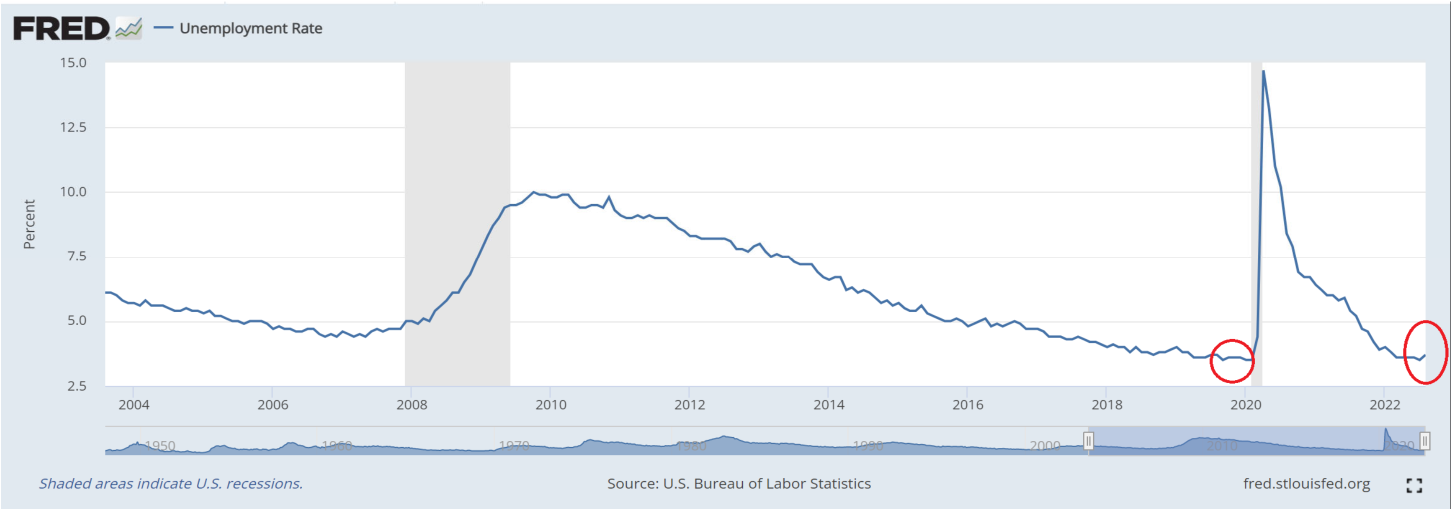
S&P 500 Earnings: YRI vs. Consensus Forecasts (6/20/2022)

	Yardeni Research		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	**208.53 a**	**49.2**	**208.53 a**	**49.2**
Q1	49.13 a	48.3	49.13 a	48.3
Q2	52.75 a	88.5	52.75 a	88.5
Q3	53.89 a	39.3	53.89 a	39.3
Q4	54.05 a	26.9	54.05 a	26.9
2022	**225.00 e**	**7.9**	**229.57 e**	**10.1**
Q1	54.91 e	11.8	54.91 e	11.8
Q2	56.00 e	6.2	55.46 e	5.1
Q3	57.00 e	5.8	59.71 e	10.8
Q4	57.00 e	5.5	61.22 e	13.3
2023	**240.00 e**	**6.7**	**251.99 e**	**9.8**

e=estimate.

* Historical earnings growth rates and earnings are not adjusted for accounting and index composition changes.
Source: Yardeni Research, Inc. and I/B/E/S data by Refinitiv.

Labor Market—Green

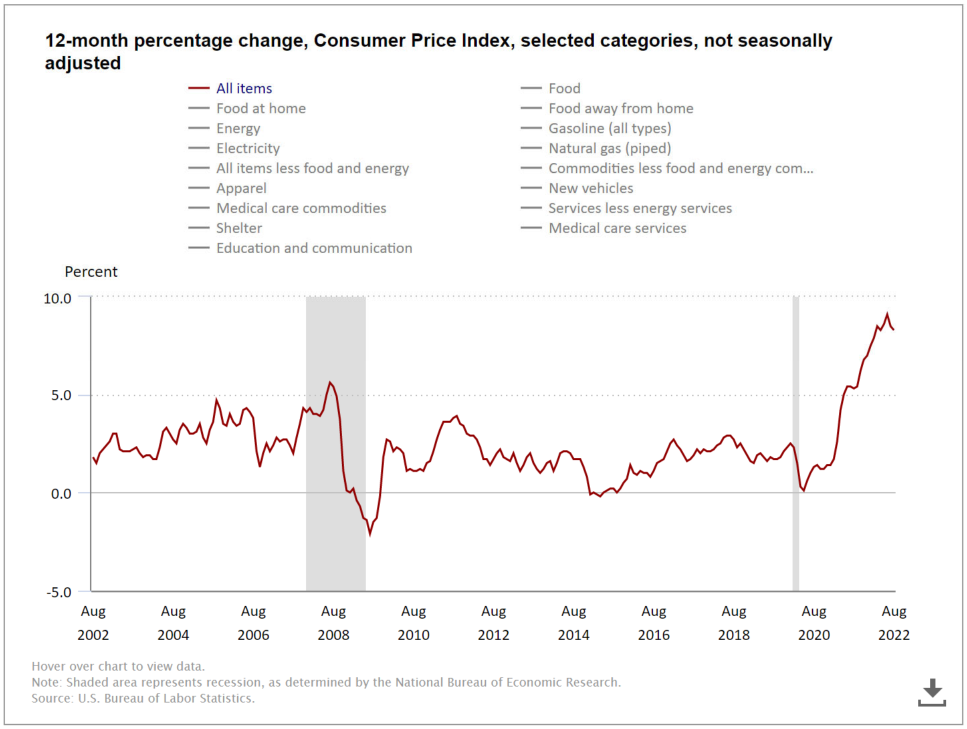


In my opinion, Biden may have spoken too soon. In a recent press conference he reassured the public that the economy was strong by pointing to the labor market. While he is correct, they are also a lagging indicator when dealing with FED rate hikes, as shown in the charts above. The FED will only stop hiking rates when inflation starts to come down, which means we need a weaker economy. That's economic jargon meaning people need to lose their jobs. I expect the unemployment rate to tick up as we move forward. In recent weeks we've seen it happen across the tech sector, firms announcing 10-20% layoffs, the latest being Google shutting down a gaming unit.

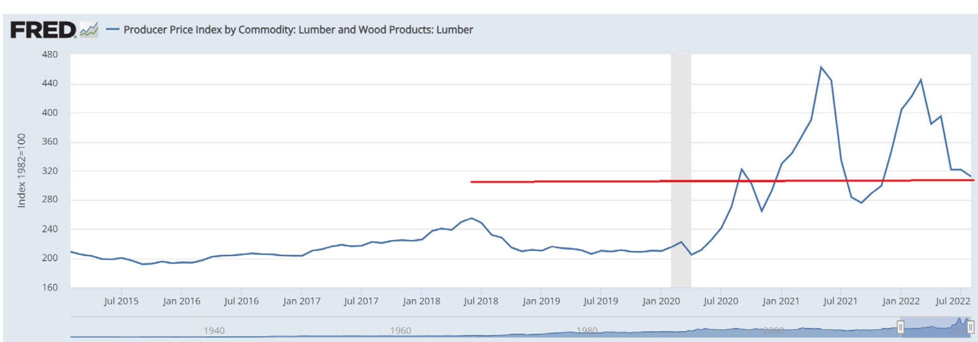
Looking at the glass half full, the labor market should allow the FED to cool inflation without causing a massive crash in the workforce. It's forecasted by some that unemployment has to rise to 5% for inflation to meaningfully cool. In the grand scheme of US economic history, 5% has been considered full employment in past.

The bottom line is that the reason for the hawkish FED comments and rate increases is that they need the public at large to be fearful of losing their jobs, stockpile cash, stop spending on excess, and thus ease demand for goods/ services.

Inflation—RED (slightly improving)



I fell for the first head fake in the beginning of the year, and while this chart shows inflation moderating/peaking, it's too early to call an end. Much like Covid, the virus has spread far and wide throughout our economy after starting in only a few sectors like used cars and energy. I continue to read about positive developments like lumber prices collapsing back to pre-Covid levels, gasoline coming back down, and shipping costs easing; but rent prices are still soaring. Rent prices could take another 3-4 months for the YOY % to moderate as 12-month leases are still coming due in October, November, and December.



Summary

Inflation continues to dominate the signals, as it has eroded the spread in the yield curve and lowered earnings estimates; and probably in the near future will hamper the labor market. This is presenting an attractive long-term entry point, in my opinion, for the equity markets. The investing public is starting to believe that the FED will never lower rates again, and that the whole system is going to collapse. But this inflation storm too shall pass, and set us up for another runway of controlled inflation with lower FED rates. I can see a world 3 years from now where short-end rates are 2-2.5% and the economy is robust. But first we have to endure the tightening and realignment of supply and demand.

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.