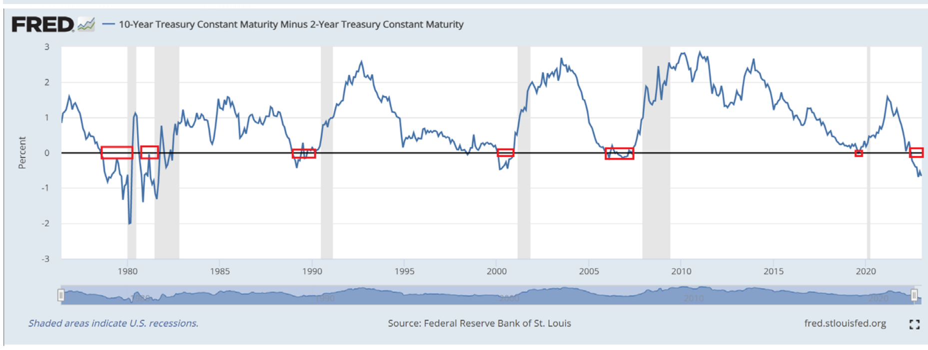
Liberty Sound Financial

12/31/2022
2022 Q4

Focus 5 Report

Yield Curve - Red



According to the yield curve, it's not a matter of *if* we get a recession, but when and how deep? There's a battle going on in the yield curve over the 10-year rate. As the FED has continued to push the short-end rates higher, the market initially bought in and moved the 10-year note up accordingly. But as of late, the 10-year note has reversed course and fallen back under 4%, sitting at roughly 3.6% as I write this. What is the market trying to tell us?

In my opinion, the market doesn't believe the FED can keep rates up this high for as long as they intend to, without crashing the economy. Investors are willing to lock in 3.6% for 10 years with the expectation that the FED will have to drastically cut rates this year to combat a deep recession. The FED has told us that the neutral rate is 2.5%. The longer they stay at 4-5%+, the greater the odds are that they'll send us spiraling into a recession instead of a soft landing.

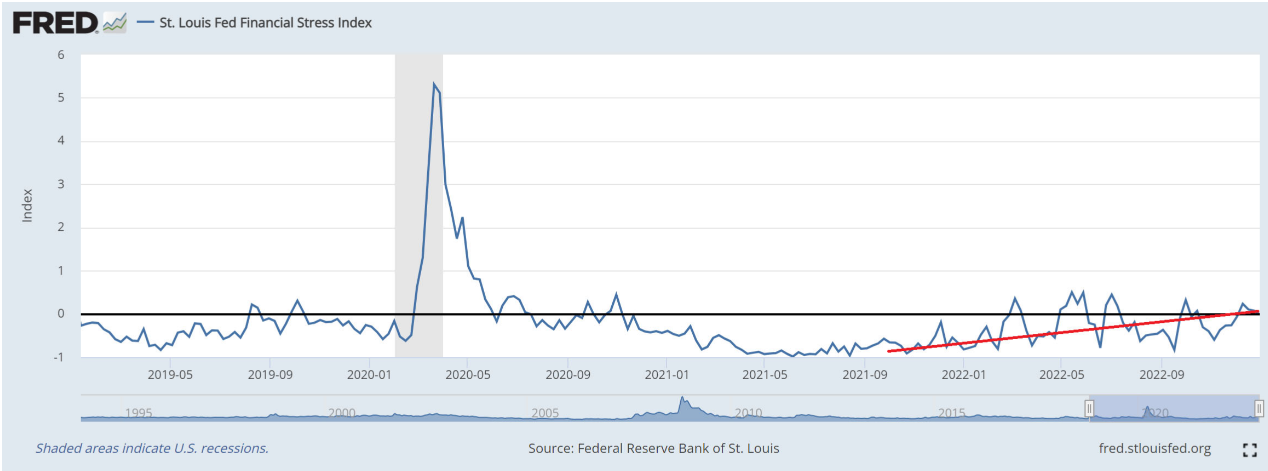
Inflation is like a fire; you can't ease up until all the flames are extinguished. The FED knows this: They have to "talk a big game" and be stern, otherwise they risk sparking too much optimism, and a rebound in inflation. Hopefully they can thread the needle into a soft landing.

Indicators

Special points of interest

- Yield curve inversion—Soft landing in play?
- Financial Stress—Below avg.
- EPS growth—Downward revision
- Employment—Strong
- Inflation — Peaking?

Financial Stress Index - Yellow



The stress index is trending in the wrong direction, and this should appease the FED to some degree. Financial tightness will help drive down inflation. This is the "threading of the needle" that the FED has to accomplish: We need tighter financial conditions to drive down inflation, but not so tight that they completely stall out the economy, driving us into a deep recession. Hindsight being 2020, clearly financial conditions were too accommodative during 2021, and there was room for the fed to tighten last year (2021) without creating undue stress.

S&P 500 EPS Trends - Yellow +

Table 1: S&P 500 Earnings YRI vs. Consensus Forecasts (1/9/2023)

	Yardeni Research		Analysts' Consensus	
	Level	YOY %	Level	YOY %
2022	**215.00 e**	**3.1**	**219.87 e**	**5.4**
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	53.81 e	-0.4
2023	**225.00 e**	**4.7**	**229.24 e**	**4.3**
Q1	53.00 e	-3.3	53.97 e	-1.6
Q2	55.00 e	-5.1	56.40 e	-2.7
Q3	58.00 e	3.5	58.50 e	4.4
Q4	59.00 e	8.3	59.51 e	10.6
2024	**250.00 e**	**11.1**	**253.37 e**	**10.5**

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.

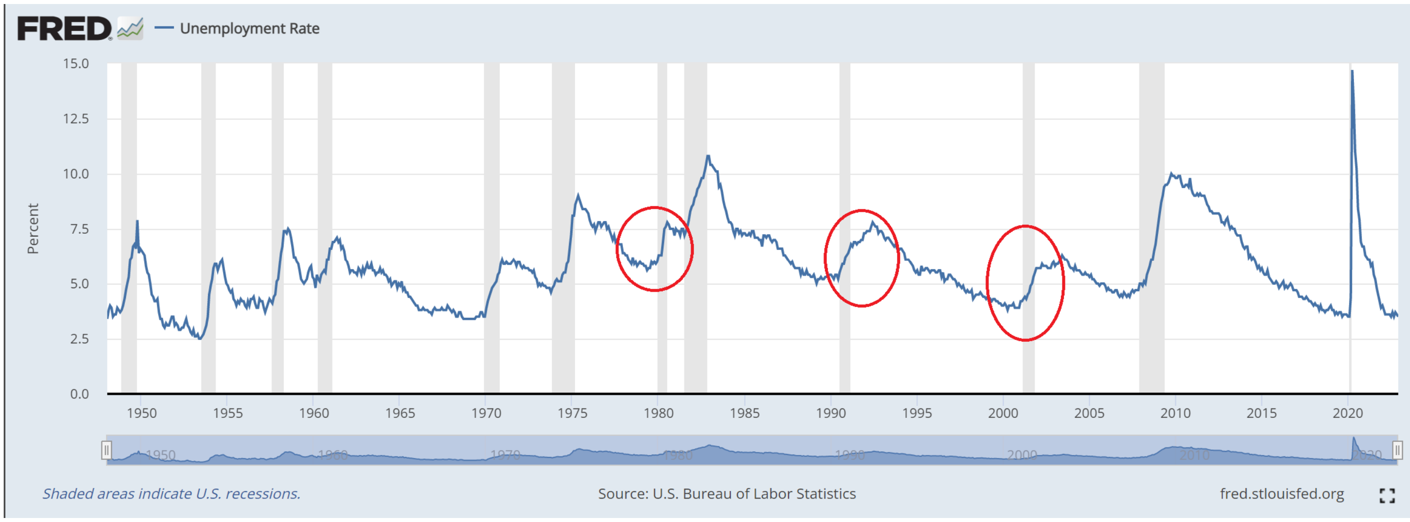
The earnings picture remains a mystery on Wall Street. Recently, as shown in the charts, estimates have come back up, after seeing steady decreases. In my opinion, the 2023 estimates are rather bullish compared to most estimates I have heard and read about. The key will be the $210 -$220 range. If earnings can hold that mark, then current market valuations make sense. But if earnings in Q1 are revised downward to below $210, then the market may have further to fall. The market multiple is a complicated discussion. Simply applying a long run average from previous time periods doesn't make much sense to me given how greatly the components of the index have changed over that course. I like to use 16-18 as a multiple with a bear case of 14 and bullish limit of 20. If you start extrapolating the numbers, one can see that 200 x 15 = 3000 , and currently the SP 500 Index is around 4000. That would be a 25% drop from these current levels.

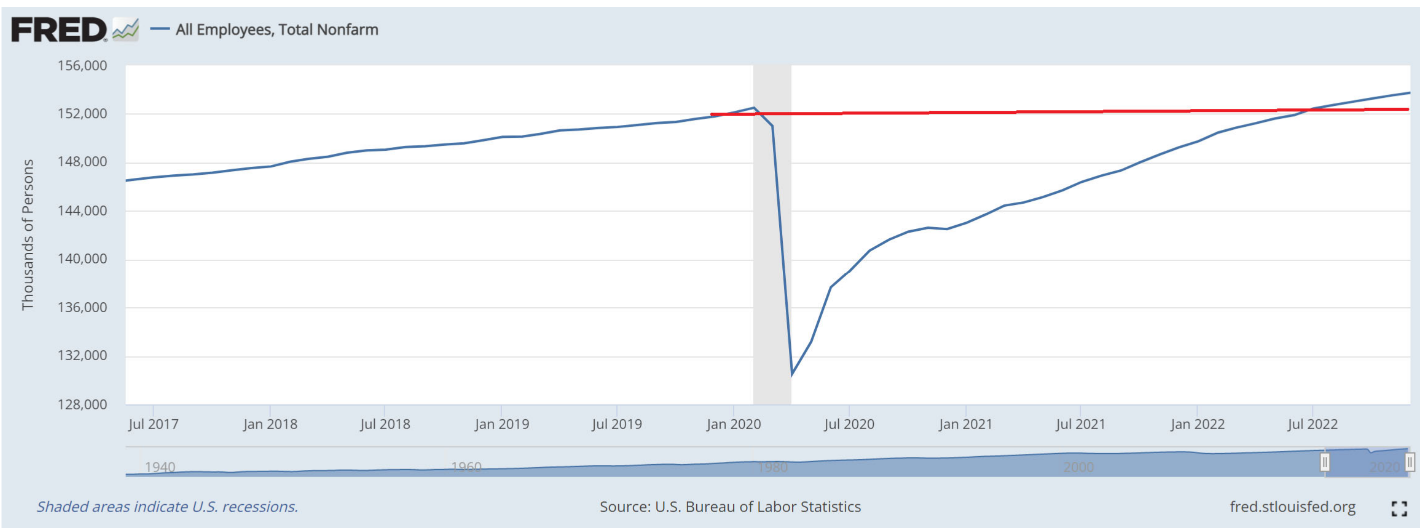
Given recent news on inflation and price stability, I am optimistic that companies will be better able to navigate 2023. Normalization of consumer behavior will play a major role, as will the cooling housing market. The demand strain on supply chains has simply been too great, and hopefully we will see a better balance in 2023. I concur with most analysts that the first half of 2023 could be rocky as the FED wages their war on inflation, but the 2nd half could see a robust surge if the FED declares the war on Inflation a victory.

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**

Labor Market—Green -

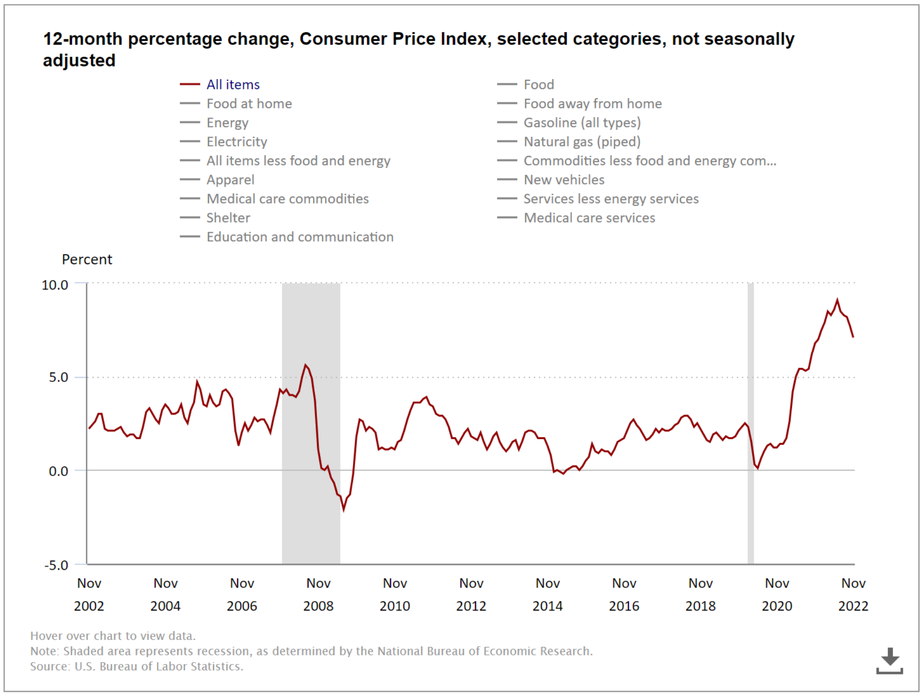




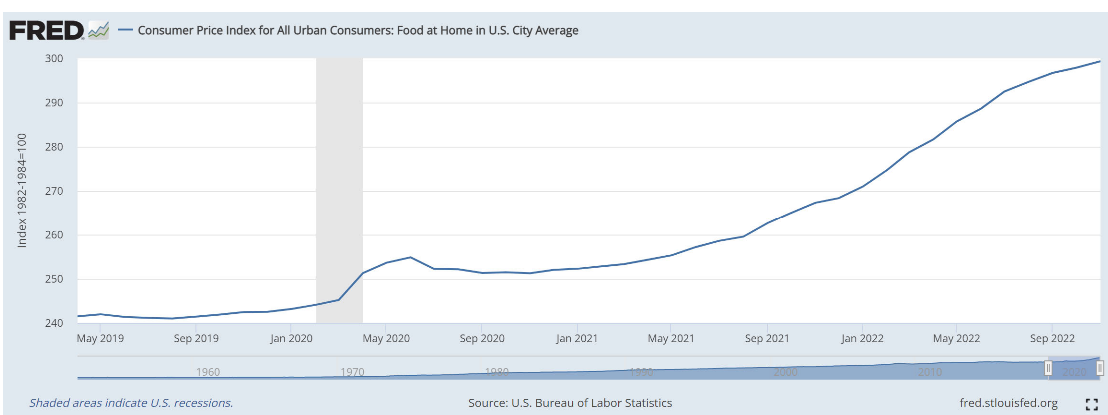
The employment numbers remain strong, but the headlines are softening as technology companies lay off thousands across the board. A lot of banks on Wall Street are forecasting negative numbers in the job market at some point in Q1. In a recent inflation report there was softening in wage gains, which makes sense when you think big picture. Here you have thousands of high-paying tech jobs being eliminated and replaced with service sector jobs that don't pay nearly what big tech pays. The big picture is we are seeing demand at the high end of the wage spectrum cool, while demand for lower paying service jobs remains strong. We'll see how that dynamic plays out. Another aspect is that tech employees are frequently compensated with stock options and when your stock is down 50% that's a large dip in wages as well.

While a strong jobs market is a problem for inflation, underneath the curtain we are seeing destruction in the higher paying tech jobs that will hopefully help bring inflation down.

Inflation—Yellow



This is the rollover in inflation data we have all been waiting for. It's too early to declare victory, as the FED keeps reminding us that current levels are still above their targets. There is encouraging anecdotal evidence that inflation is cooling. The NYC rental market is finally seeing prices level off and even come down in some areas. We've all seen energy prices level off with oil and gas coming down off their highs. But there is still sticky inflation in food, as I continue to see reports on bread, eggs, chicken, and dairy that highlight the struggle of price stability. Some of these issues are exacerbated by the war in Ukraine, and others made worse by climate change. It will be up to the Fed to determine just how helpful higher rates are on cooling food inflation.



Summary

Will 2023 be the year that the FED declares victory on inflation? The entire investment thesis for 2023 will depend on taming inflation. Without price stability and a balanced demand/supply dynamic, businesses can't function properly, and thus can't plan for growth. Investment themes for early 2023 include staying neutral/core, investing in high-yielding short duration treasuries, and avoiding falling knives. There are many companies who have been greatly devalued by the inflation battle, and the likely scenario is that only a handful will roar back to life. Just like the tech bubble of 2000-01, some companies made it but many others never regained those heights.

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.