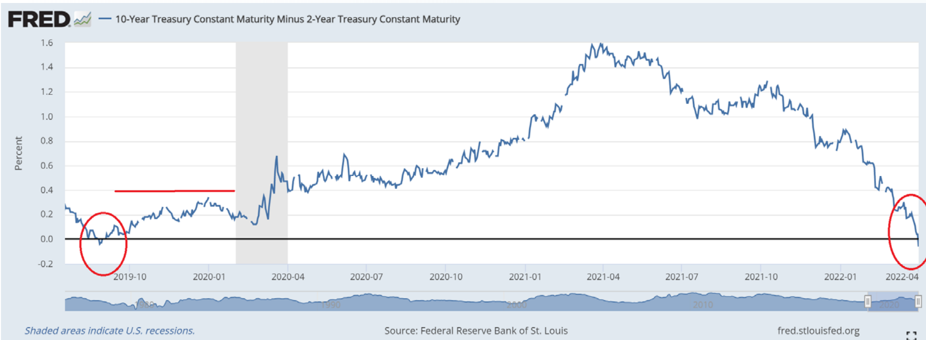
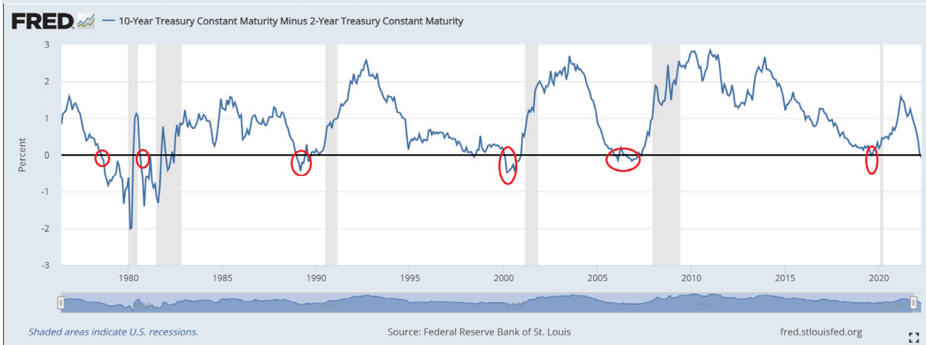
Liberty Sound Financial

3/31/2022
2022 Q1

# Focus 5 Report

## Yield Curve - Red




That was a short lived recovery in the spread between the 10 year and 2 year treasury yield. Unfortunately, not many positive economic events have followed these inversions. If you look at the bottom chart dating back to 1970s, you'll see the red circles precede every recession. The late 1990s is an interesting comparison, at this point the yield curve has only slightly inverted, if we can avoid a significant dip below the break even point, a recession signal may be pushed down the road. Let's keep in mind that historically recessions happen 12-18+ months after the inversion signal.

An interesting dynamic to me is that the long end of the curve, 30 year treasuries, are not selling off. They yield a paltry 2.43% while the 2 year is at 2.46%. With inflation well over 5%. What does this mean? In a normal market, the 30 year bond should be yielding 4-5% at this point to compensate for inflation and rising rates. The fact that it hasn't, could mean there are investors who think a recession is coming and are willing to lock in 2.43% for a long time. It possibly could be foreign investors diving into safety from the rocky geopolitical landscape in Europe. Only time will tell, but this signal is screaming caution.

### Indicators

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### Special points of interest

- Yield curve inversion
- Financial Stress—All Clear
- EPS growth—strong /normalizing
- Employment—Very Strong
- Inflation — Historic Numbers

## Financial Stress Index - Green

I had to retire the TED spread as LIBOR is no longer used as an interest rate setting benchmark. As an alternative I've selected the Financial Stress Index, where 0 is designed to be average conditions in financial markets. It monitors interest rates and yield spreads among other variables. The key take away here is that there is actually below average stress in the financial system. This is key to avoiding long drawn out slow downs. If capital can be quickly and efficiently redeployed to areas generating positive GDP, then the economy can swiftly adapt and recover. Financial stress is the fuel for a severe economic downturn.

## S&P 500 EPS Trends - Green

**S&P 500 Earnings: YRI vs. Consensus Forecasts (12/27/2021)**

| | Yardeni Research | | Analysts' Consensus | |
|---|---|---|---|---|
| | **Level** | **YOY %** | **Level** | **YOY %** |
| 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** | **205.78 e** | **47.2** |
| 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 | 55.00 e | 29.1 | 51.16 e | 20.1 |
| **2022** | **220.00 e** | **4.8** | **222.98 e** | **8.4** |
| Q1 | 53.00 e | 7.9 | 52.21 e | 6.3 |
| Q2 | 54.00 e | 2.4 | 55.11 e | 4.5 |
| Q3 | 55.00 e | 2.1 | 57.64 e | 7.0 |
| Q4 | 58.00 e | 5.5 | 58.35 e | 14.1 |

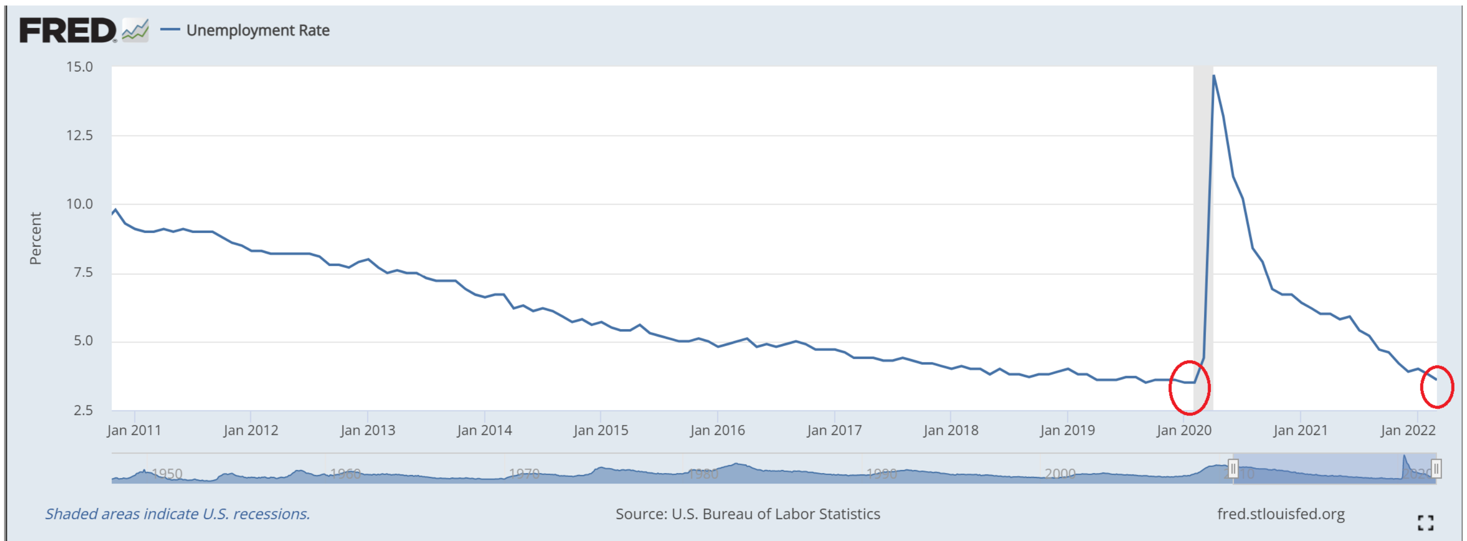
Despite inflation concerns and rising rates out of the Federal Reserve, earnings estimates continue to come in strong for the S&P 500. I've included below the 2019 numbers for a comparison to pre-covid levels of earnings, and we are smashing through those levels. This market reminds me of 2015/16 when earnings cooled off after years of strong gains, before shooting higher in 2018. If you look ahead, analysts are calling for a very strong 2023. Current year estimates are still pretty strong at 8-9% growth, as far as the stock market goes, that might be baked in already.

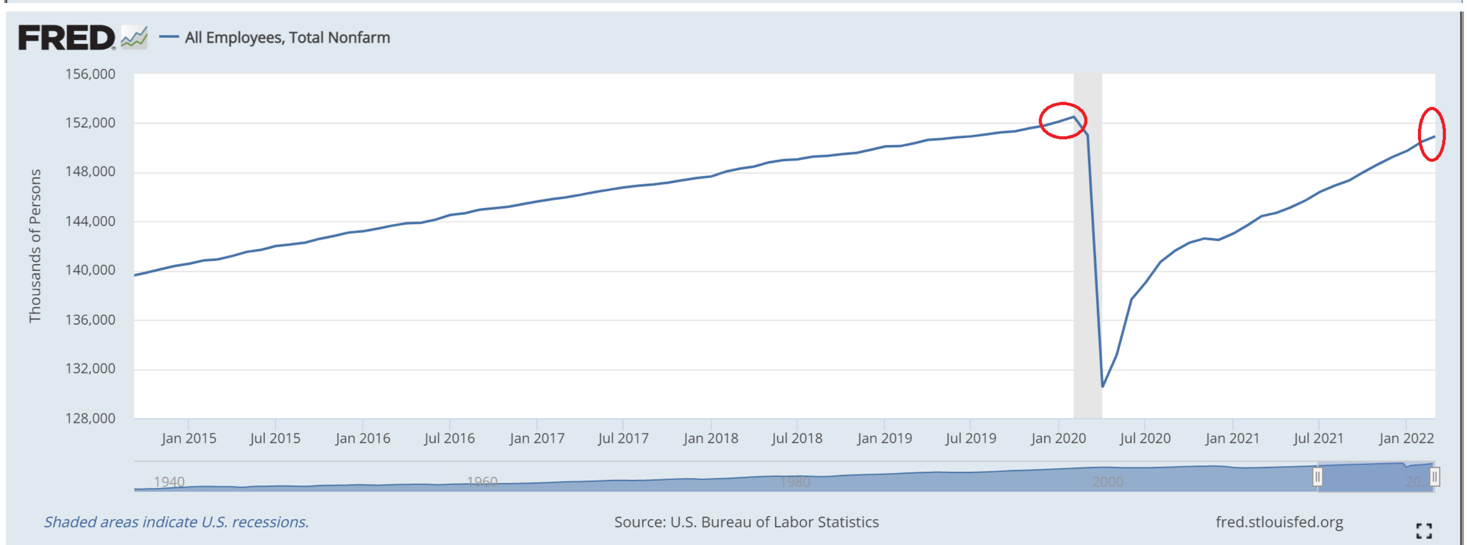
What I take away from this is that the Federal Reserve might be able to raise rates without pushing us into a recession. These earnings estimates are very robust, and should be able to handle a slight increase in rates. Historically speaking having short end rates of 2-3% is still low and actually stimulative by those standards. We'll monitor earnings projections in future reports to see if the rising rates are lowering earnings estimates, that might be our canary in the coal mine.

**S&P 500 Earnings: YRI vs. Consensus Forecasts (3/28/2022)**

| | 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** | **227.30 e** | **9.0** |
| Q1 | 53.00 e | 7.9 | 51.62 e | 5.1 |
| Q2 | 56.00 e | 6.2 | 55.86 e | 5.9 |
| Q3 | 57.00 e | 5.8 | 59.14 e | 9.7 |
| Q4 | 59.00 e | 9.2 | 60.67 e | 12.2 |
| **2023** | **250.00 e** | **11.1** | **249.52 e** | **9.8** |

# Labor Market—Green

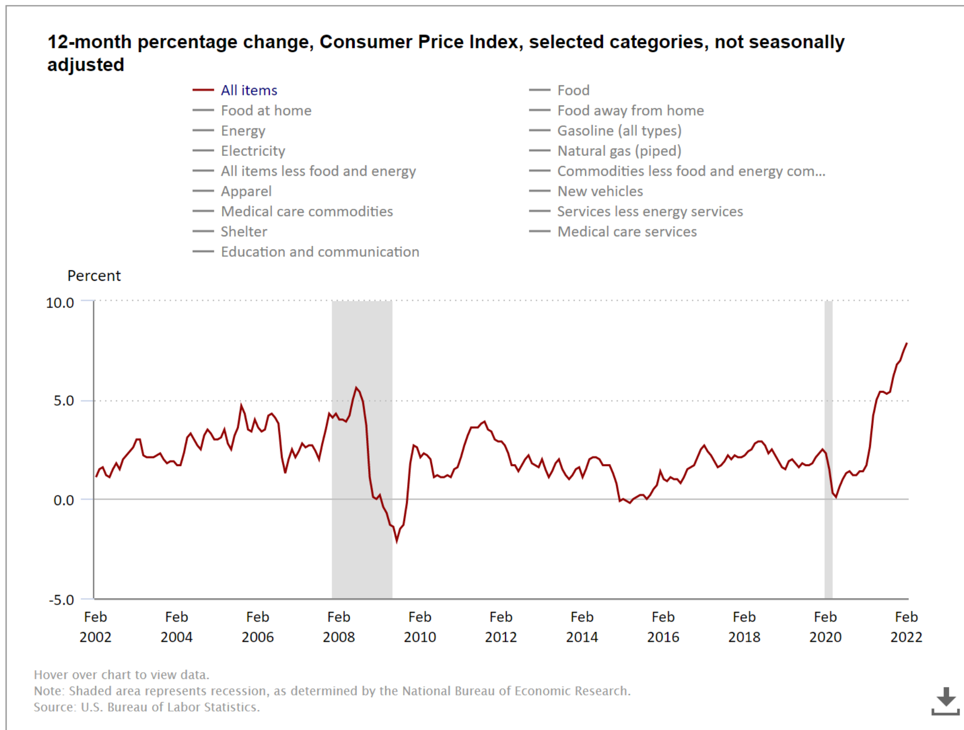


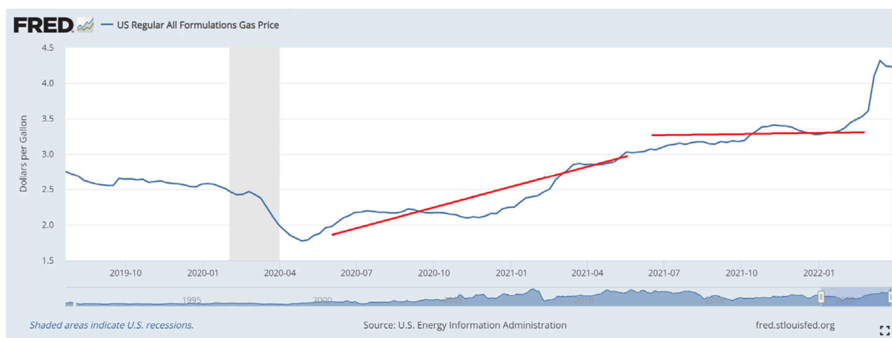

We are on the other side of Omicron, and the labor market is smoking hot. The theme of this newsletter is can the economic system handle the Fed raising rates? So far we've seen strong earnings, zero financial stress, and now a red hot labor market. The unemployment rate is essentially equal to pre-covid levels, and the total payrolls are almost back, with a slight lag. That total nonfarm number I expect to keep climbing as more and more people return to the workforce. What will cause this? There are 11 million job openings, as stimulus money dries up, and covid wanes, more people should return to work.

Rising rates at this point shouldn't destroy the labor market. With this much activity, a ton of available jobs posted, the labor market should stay tight. The only wrench in the short term would be a covid surge that shuts down factories and slows activity in the service sector. At this point, it feels like society is ready to move on and deal with this as the flu…this is merely an observation and not necessarily my opinion.

# Inflation—RED




Scalding hot inflation report. My previous thoughts of a top have been defeated. Exogenous factors are at play in my opinion, beyond the control of the FED. The FED can't fix supply chains, and can't fix gas prices caused by a war in Ukraine. If you look at gas prices, they had leveled off around $3.50, before surging to above $4. Inflation is a YOY% change number, if gas had stayed at $3.50, then the inflation number would look a little softer. The scariest aspect of this reading to me is that it could be a manufactured short term reality exaggerated by the war in Ukraine, which may cause the Fed to over tighten. The calls are loud from Wall Street to tighten fast; but in my opinion they should go slow and steady because their actions are likely to have little impact on energy prices or shipping times.



## Summary

We have an extremely mixed picture, with Rates and Inflation screaming caution, and Earnings, Jobs, and Financial Stress sounding the all clear...which group is right? To me this is the time to grab cash flow positive companies. I prefer not to chase individual sectors, if a company is generating sound cash flows, those are the companies to be with at this time in the cycle. Rising rates present a challenge to growth stocks, especially small and mid sized companies, even if those rates are historically low. The easy money stocks of the covid era are out of favor, as I've called in previous letters, and cash flow positive quality companies have been in favor.

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.

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