Liberty Sound Financial

09/30/2020
2020 Q3

# Focus 5 Report

## Yield Curve - Yellow (+)

The 10-2 spread continues a positive trend; though it's probably engineered by the FED. The curve primarily steepened from the FED dropping near term interest rates to 0%; while the longer durations remained unchanged. The 10 year bond has risen from 50BPS to 70BPS over the last several months. A strong, resilient economy will drive the 10 year treasury up over time.

The best time to invest historically is at the top of the curve. In the last recession, the housing bubble, the spread went from 0 to 2%-3% before going on a 10 year downward trend to here. If you had invested at that peak in 2010, and gotten out in 2019/20 at 0% spread; that would have been ideal.

The battle we are facing is two fold, not only is it a tight spread, but rates are historically low. We could be entering a negative rate environment, which is why It's important for the spread to continue to widen, and the 10 yr treasury to climb higher, at a slow, steady pace.

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## Special points of interest

- Yield Curve steepening
- TED Spread All clear?
- EPS Growth bottomed out?
- Unprecedented Unemployment
- Inflation slightly below target

## TED Spread - Green -

The TED spread, aka the fear gauge, remains at all time lows. Remember, banks are privy to sensitive financial information when issuing credit lines / loans to businesses. So they are able to set rates higher as they see financials deteriorate. As of now, they are not panicking, partly because the FED stepped in and helped backstop money market funds. The FED program appears to be working to keep the credit markets flowing.

The traditional level of concern is 1%, which was breached before the last 3 recessions, and now also in 2020. This period was historically fast given the nature of how quickly COVID19 spread; but the trend holds. Given the lack of overall fear in the financial markets, the indicator is to remain invested.

## S&P 500 EPS Trends - Yellow

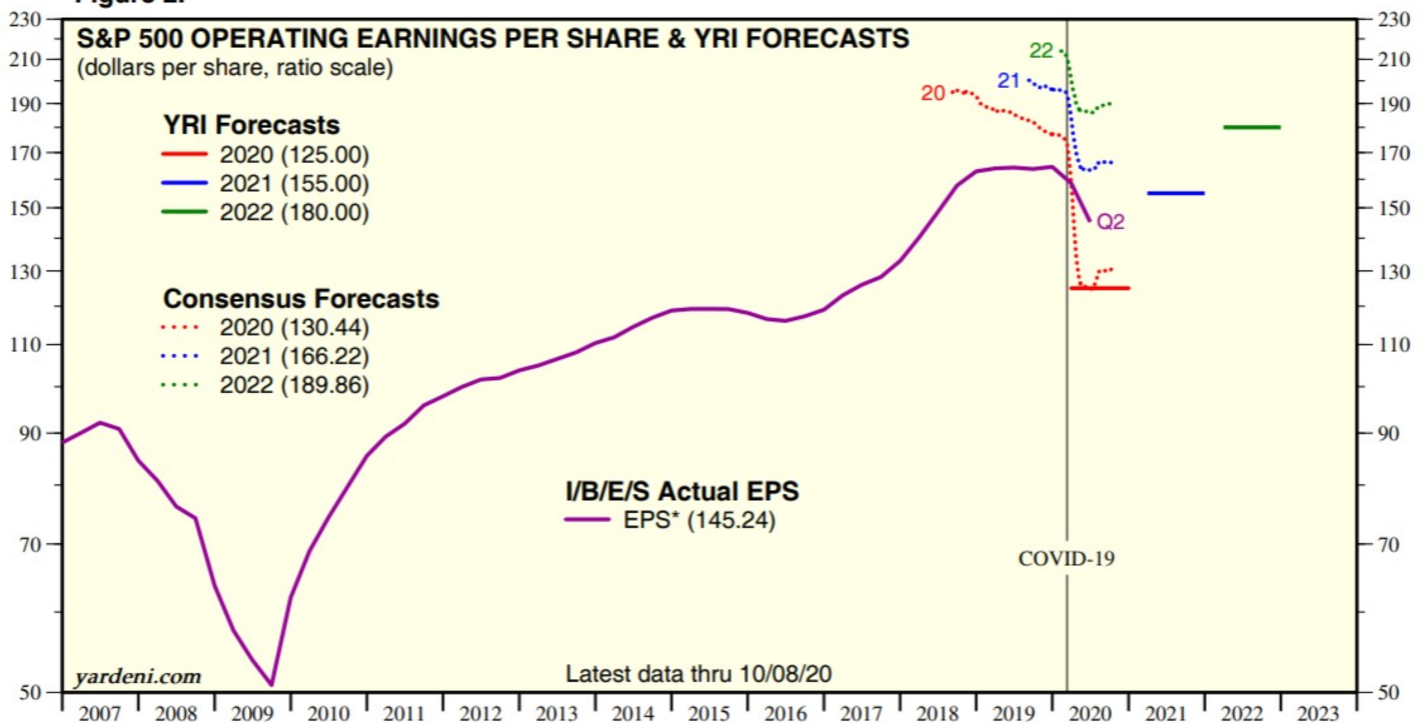
**S&P 500 Earnings: YRI vs. Consensus Forecasts (3/30/2020)**

| | Yardeni Research-post tax cut | | Analysts' Consensus | |
|---|---|---|---|---|
| | Level | YOY % | Level | YOY % |
| **2018** | **161.93 a** | **22.7** | **161.93 a** | **22.7** |
| Q1 | 38.07 a | 23.2 | 38.07 a | 23.2 |
| Q2 | 41.00 a | 25.8 | 41.00 a | 25.8 |
| Q3 | 42.66 a | 27.5 | 42.66 a | 27.5 |
| Q4 | 41.18 a | 14.3 | 41.18 a | 14.3 |
| **2019** | **163.00 a** | **0.7** | **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** | **125.00 e** | **-23.3** | **130.44 e** | **-20.0** |
| Q1 | 33.13 a | -15.4 | 33.13 a | -15.4 |
| Q2 | 27.98 a | -32.3 | 27.98 a | -32.3 |
| Q3 | 30.00 e | -28.8 | 32.97 e | -21.8 |
| Q4 | 35.00 e | -16.7 | 36.09 e | -14.1 |
| **2021** | **155.00 e** | **24.0** | **166.22 e** | **27.4** |
| **2022** | **180.00 e** | **16.1** | **190.67 e** | **14.7** |

The Technology sector is masking a pretty weak year for the overall SP 500 index, while positive for the year, it's down around 20-30% YOY on EPS. The EPS numbers for 2020 are brutal; the spotlight remains on 2021, which is where the market is looking to. The current numbers have come in slightly better than expected by analysts, which is obviously a positive trend for 2021. Next years estimates range from 150 to 170, which is where 2019 was (163). Thus, we see the markets trading at near all time highs, that we saw at the end of 2019, in anticipation of future EPS growth.

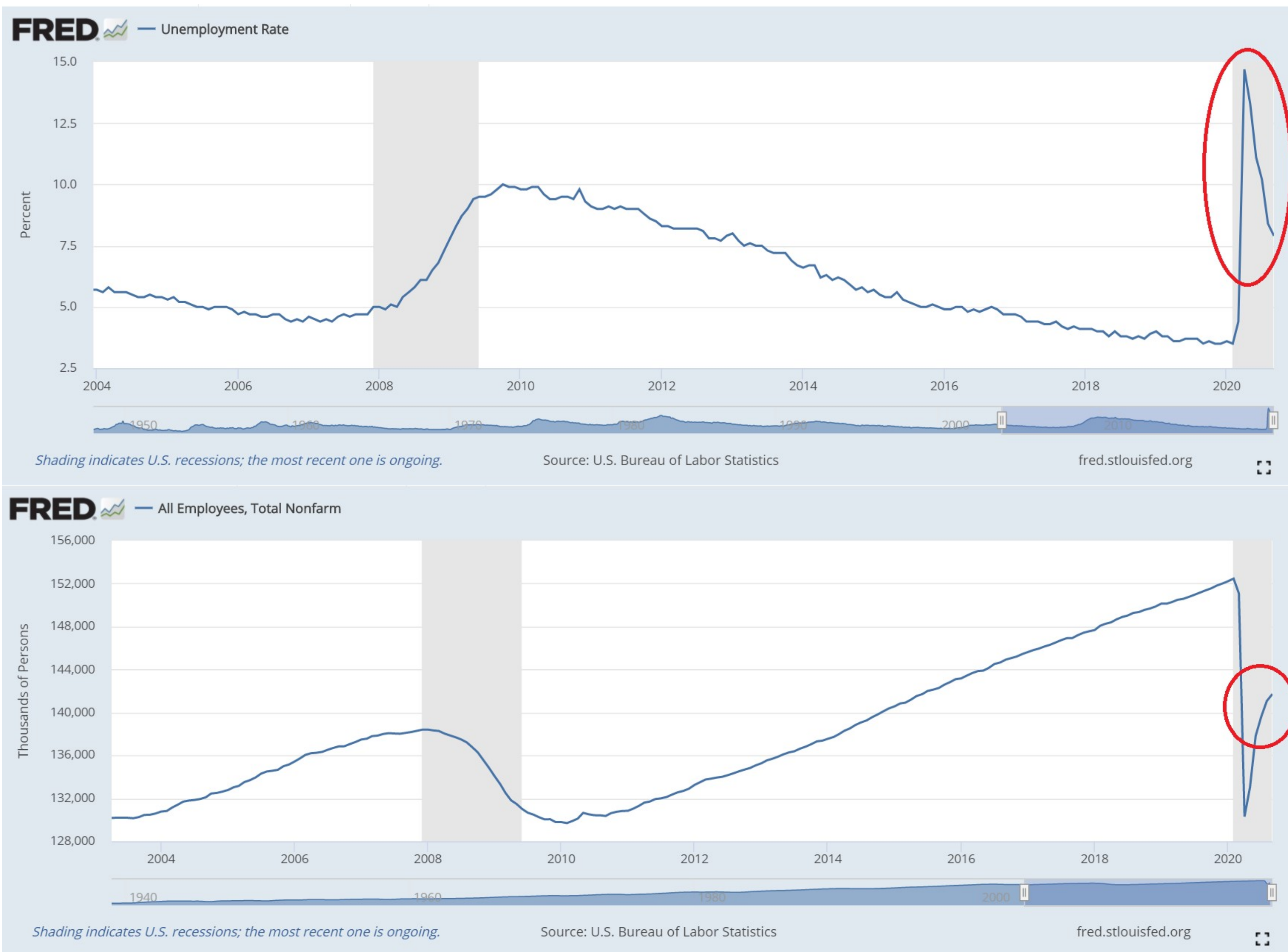
I've bumped my rating from Red to Yellow as we get more clarity on a rebound in EPS. Q2 coming in slightly better than projected is a positive sign. Caution remains as stimulus runs out, and our government has thus far failed to pass further measures. A 2nd stimulus package, coupled with an effective treatment/vaccine will drive 2021 back to normality; with hopeful 2022 expansion.

It is my opinion that the Tech sector will continue to drive the market, and this holiday season with online shopping, will show us what kind of shape the consumer is in. We'll need to watch if Prime Day pulls forward demand from Black Friday / Cyber Monday, or does it add to the overall Q4 numbers.




* Four-quarter trailing sum of operating earnings per share.
Note: COVID-19 = WHO declares global pandemic on 3/11/2020.
Source: I/B/E/S data by Refinitiv.

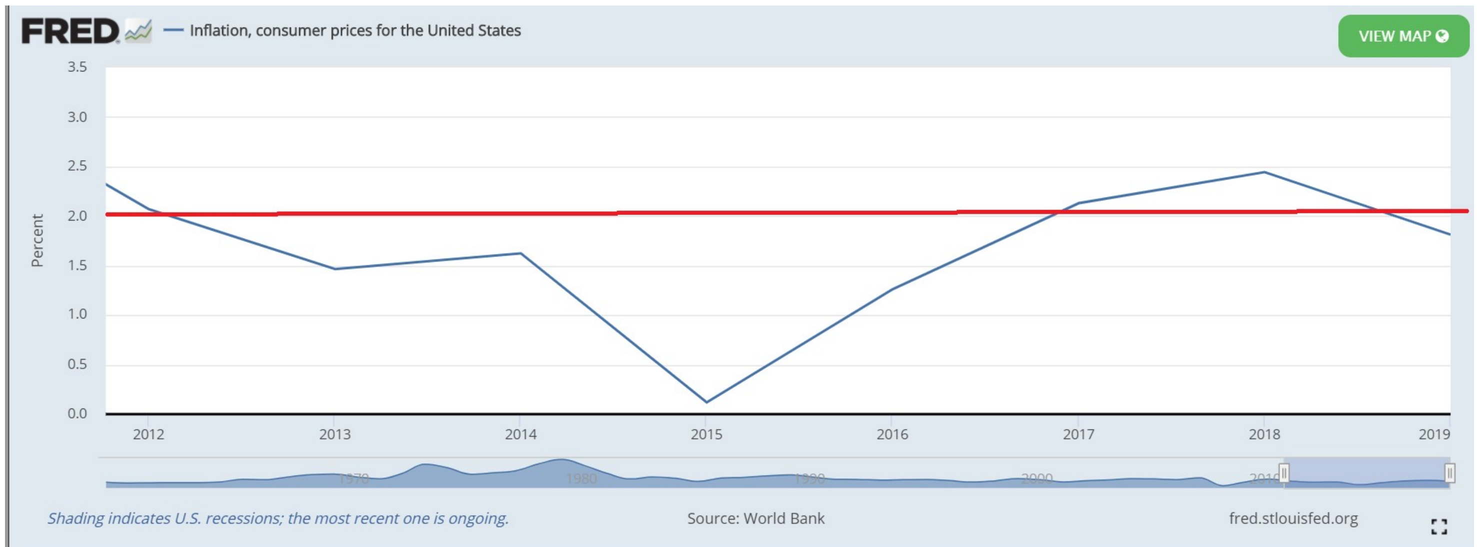
# Labor Market—Yellow




The unemployment picture remains challenged, but is also far from the worst case scenario envisioned by economists. Initial projections had unemployment topping out at 20-30%, while in this figure we peaked at 15% and have cut that number in half since peak COVID19 in March/April. An interesting trend to watch is the 2nd chart, you'll notice that the total non farms are still increasing but at a slowing rate. This could be a function of the PPP wearing off and no new stimulus coming in. The Airlines have announced thousands of job cuts across the board; unless congress passes another airline stimulus bill.

I raised my rating from Red to Yellow, while many industries remained limited and closed, the bulk of the economy has found ways to cope with Covid19. The challenge will come this winter when outdoor activities, like dining, are forced back indoors. Most experts are predicting a second wave in the winter, which might force industries to close back down. That will be a tremendous indicator for the markets. Those looking for a buying opportunity, might have it on a second lock down in the metro areas of the north, such as NYC.

## Inflation—Green




This is a trailing chart, and thus we need to wait for 2020's numbers to officially post to the FRED website. The tone has been that inflation is starting to rollover, as the FED has talked numerous times this quarter about leaving rates at 0% for a substantial time to drive inflation and the recovery. The FED has plenty of room to run to the upside on inflation. In the 70s and 80s everyone was afraid of run away inflation…..some of us remember interest rates being over 10%. But now, we are faced with a world starved for inflation. Inflation last hit 3% in 2011! That's a full 9 years ago. The FED targets 2% as their benchmark. Inflation hasn't been this low since the 1960s! We are truly living in an historic decade that will be written about in economic journals for a century. One of the greatest bull markets in history, failed to deliver any meaningful inflation or interest rates (10 yr yield ).

My indicator remains Green, as there is no sign of run away inflation or disinflation. So far, the 0% FED rate appears to be propping up inflation.

## Summary

The easy money has been made….now is the time for more cautious investing. The +50% or even +400% seen in tech stocks like Amazon, Zoom, Peleton, Apple, etc… are not sustainable when large portions of the country remain underemployed. Though it is my opinion that the "tech" stocks will drive our country and market forward, the outsized returns we have seen in the near term, are likely to be limited going forward.

Key areas I think will drive our markets higher are: Cloud computing, E commerce, 5G, Industrial Automation, and Green Tech. For further discussion on these areas, please schedule a call with me.

References:


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

https://fred.stlouisfed.org/


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