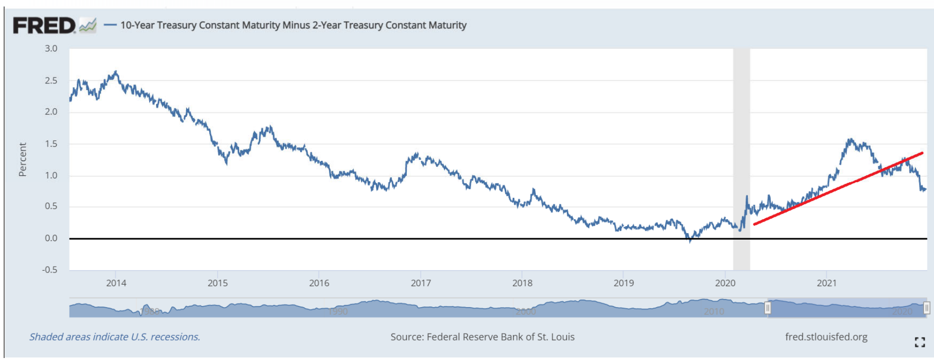
Liberty Sound Financial

12/31/2021
2021 Q4

Focus 5 Report

Yield Curve - Yellow



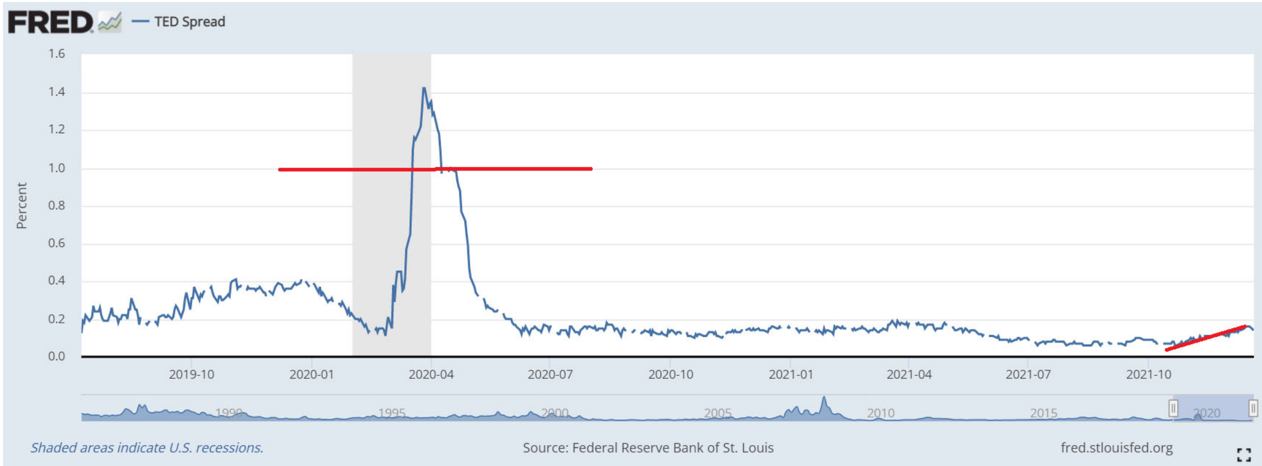
The reason that I include the yield curve as a signal is that a negative spread between the 10-year and 2-year treasury bonds has often been associated with an impending recession. It was correct this most recent time; whether that was COVID-19 or not, we'll never know. My concern over the last several years and recently is our relatively flat yield curve, which has kept us in the danger zone. A healthy, steep yield curve gives us room for policy errors and bond market jitters. When the yield curve is flat, there's very little room for error. As we emerge from this recession and global pandemic, the FED will begin to normalize their rates and stop their bond purchases, which they recently conveyed to the market, in turn putting pressure on the flat yield curve. The problem we are seeing is that the long end of the curve is stuck at 2%. The Fed wants the short end to be at 1-2% in 12-18 months. This creates a very flat environment. Why is the long end of the curve stuck at 2%? With inflation this hot, and consumer demand strong, there shouldn't be an appetite for a 20-year treasury bond paying 2%. But here we are. Many investors are worried about "sky-high stock prices" but for me the real concern is the long end of the treasury curve. The curve doesn't make sense to me given the economic back drop.

Indicators

Special points of interest

- Yield curve flat
- TED spread—No stress
- EPS growth—strong /normalizing
- Employment back on track
- Inflation — running hot

TED Spread - Green



There was a recent increase in the TED spread with the Omicron variant, but we are well under the threshold for concern. Again, this indicator is a fear gauge amongst the banks. A healthy credit/ financial market helps backstop complete collapses. The key difference between the Dot Com Bubble and the Great Recession is that the former involved one sector (technology), and the latter involved the credit markets. There's very little here to indicate any stress in the banking system and thus the credit markets.

It will be interesting to watch what happens here as the FED stops buying bonds as part of their monetary tightening program. The buying provides extra liquidity in the credit markets, which banks thrive on. As that spigot is closed, we'll get a better idea of the true TED spread.

S&P 500 EPS Trends - Green

S&P 500 Earnings: YRI vs. Consensus Forecasts (10/4/2021)

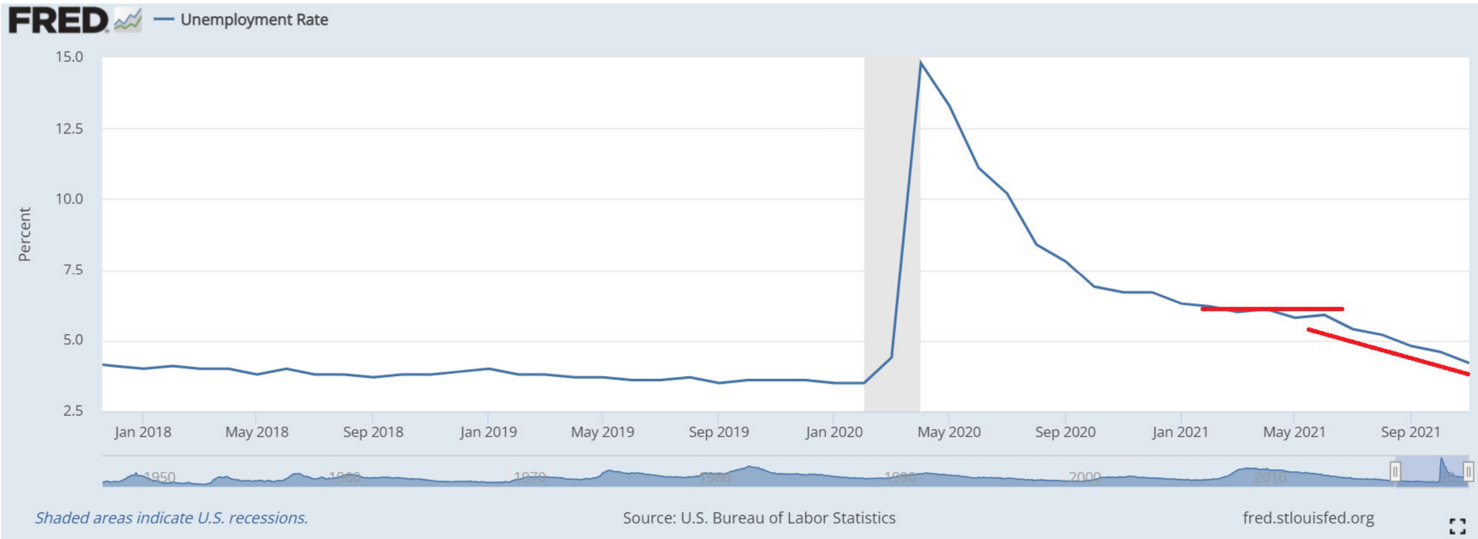
	Yardeni Research-post tax cut		Analysts' Consensus	
	Level	YOY %	Level	YOY %
2019	**162.97 a**	**0.6**	**162.97 a**	**0.6**
Q1	39.15 a	2.8	39.15 a	2.8
Q2	41.31 a	0.8	41.31 a	0.8
Q3	42.14 a	-1.2	42.14 a	-1.2
Q4	42.00 a	2.0	41.99 a	2.0
2020	**139.76 a**	**-14.2**	**139.76 a**	**-14.2**
Q1	33.13 a	-15.4	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	**210.00 e**	**50.3**	**200.64 e**	**43.6**
Q1	49.13 a	48.3	49.13 a	48.3
Q2	52.75 a	88.5	52.75 a	88.5
Q3	53.00 e	37.0	49.11 e	26.9
Q4	55.00 e	29.1	51.08 e	19.9
2022	**220.00 e**	**4.8**	**219.94 e**	**9.6**
2023	**235.00 e**	**6.8**	**235.66 e**	**7.1**

Earnings estimates continue to come in strong as analysts are looking for 8-9% growth in 2022, and even more importantly for robust growth in 2023. I would caution against taking this to mean that the stock market will continue to show 20%+ gains. Earnings are just half of the equation, the other half being the earnings multiple, which is at the upper range of what historically has been normal. The PE ratio is sitting at around 30, with the historic average having been close to 16; but for the last 20 years the average multiple has been between 20-25. While earnings look like they'll increase going forward, I'm expecting a multiple compression when the FED starts to raise rates next year. If this happens, the increase in earnings will be offset by the multiple compression. Most analysts expect a choppy 2022, earnings should end up higher than in 2021, but what multiple will the market assign those earnings is the key.

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

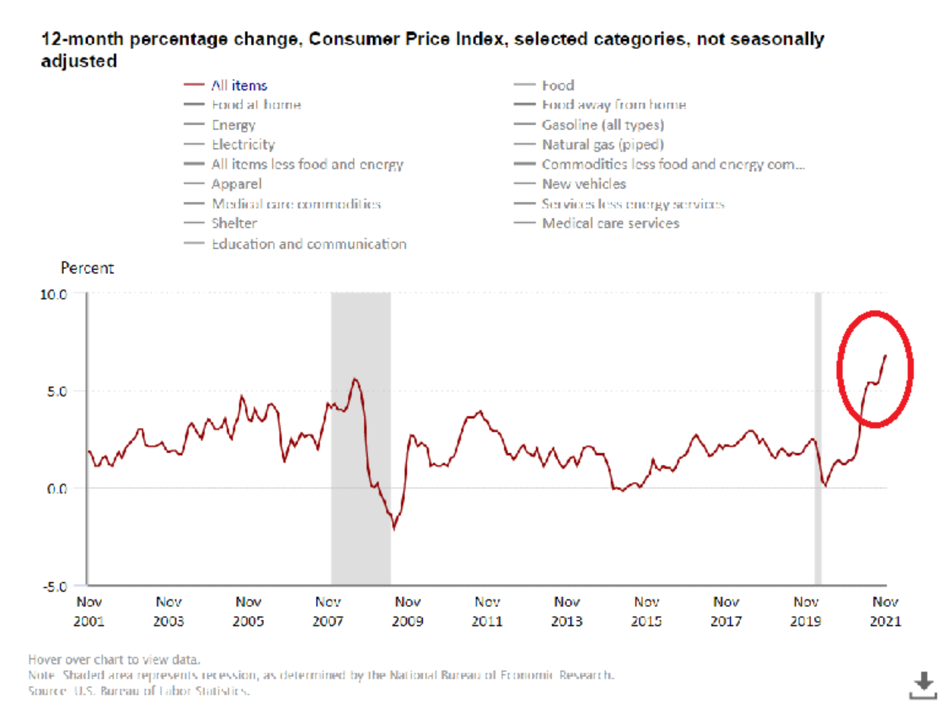
	Yardeni Research		Analysts' Consensus	
	Level	YOY %	Level	YOY %
2019	**162.97 a**	**0.6**	**162.97 a**	**0.6**
Q1	39.15 a	2.8	39.15 a	2.8
Q2	41.31 a	0.8	41.31 a	0.8
Q3	42.14 a	-1.2	42.14 a	-1.2
Q4	42.00 a	2.0	41.99 a	2.0
2020	**139.76 a**	**-14.2**	**139.76 a**	**-14.2**
Q1	33.13 a	-15.4	33.13 a	-15.4
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	**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
2023	**235.00 e**	**6.8**	**245.27 e**	**10.0**

Labor Market—Green



The Delta surge didn't impact the labor market as we feared it would, and so far the Omicron isn't having a significant effect either. We saw a leveling off over the summer and early fall, but that downward trend in unemployment has returned. In fact, we are approaching pre-COVID levels. Another area to look at is labor force participation. Those dropping out don't count towards unemployment, but we continue to see a steady rise in total nonfarm employees. The number of total nonfarm employees is also close to the pre-COVID high. The employment picture as a whole looks robust and widespread across sectors. The service sector might experience a setback as Omicron dampens the mood for indoor dining in cold weather states. The variant, while exponentially spreading, should also exponentially decrease in the coming weeks. By February/March, states could be experiencing low COVID numbers, which should keep the service sector strong.

Inflation—Yellow



The previous peak has extended, and while I'm confident this peak too shall pass once YOY comps come in, it has caused me to reevaluate my outlook on inflation. This recent increase has caused the FED to act and put forth a timeline for interest rate increases and to draw back the bond purchases. These actions should eventually dampen inflation as well as strengthen supply lines. The most important dampening might be due to basic mathematic principles. Measurements in 2022 will be based on high 2021 numbers, hopefully producing smaller percentage change recordings.

The last 10 years of inflation has actually struggled to stay above 0%. Looking at my yield curve analysis, I would prefer inflation to run slightly higher than expected rather than at 0 or below. Contrary to what is being reported by keyboard warriors and certain news outlets, the US dollar is not being destroyed; and inflation, while hot, is not hyper. But inflation is starting to reach levels that will start to impact the economy negatively if they don't crest and level off. Over the next 3-6 months we need to see key inputs like energy stabilize. I don't need to cite stats on oil; just look at gas prices.

Summary

The easy money has indeed been made. With the FED raising rates, the squeeze will be on high-flying growth stocks. We've seen this trend play out over the last couple of weeks. I believe this will ultimately create good long-term buying opportunities in companies who benefited from COVID and are now being tossed aside as if we are going back to normal. The 9-5 work week in the office in my opinion is dead, and that means the companies that facilitate working from home will benefit long term. With robust spending by consumers and easy money still floating around, it's hard to imagine a stock market collapse here; but a tired market is more likely.

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.