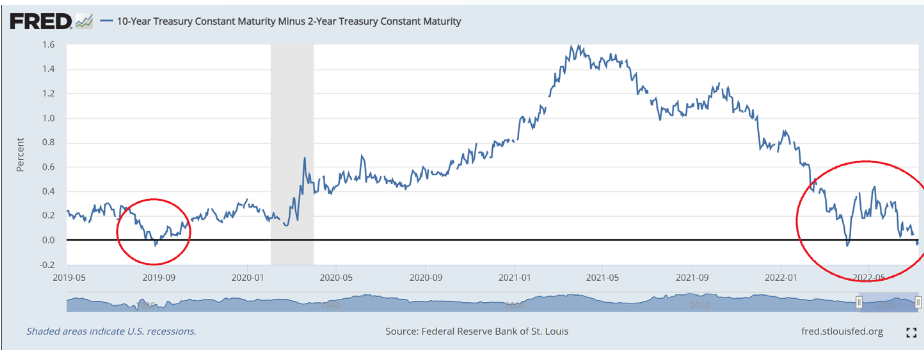
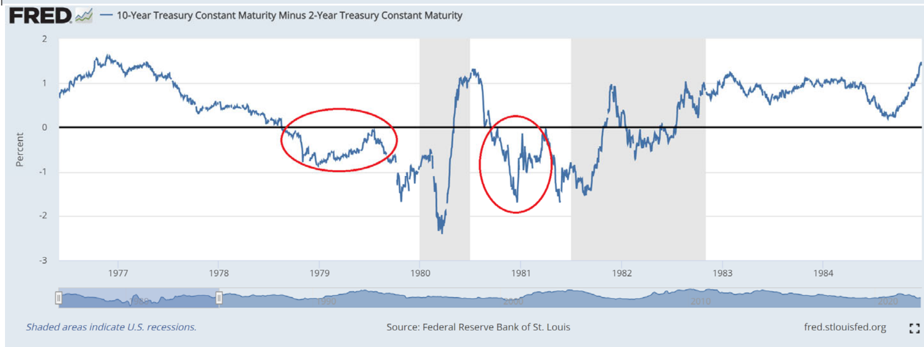
Liberty Sound Financial

06/30/2022
2022 Q2

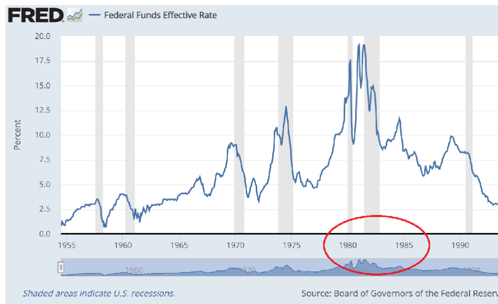
Focus 5 Report

Yield Curve - Red





Unfortunately the yield curve spread remains in question as the FED continues it's aggressive tightening policy. The spread has gone negative again, which in the past has been a solid indicator that a recession is looming. For a comparison, in the second chart, I've selected the 1970s-1980s when inflation was this rampant across the board. You can see that in 1980 and 1982 we had a double dip recession which might be instore for us. From 1980-1981 the FED raised rates aggressively to squash inflation at the expense of the economy. The FED Funds Rate is shown below. In my opinion, a "softish" landing is still possible due to the relative low rate environment. The FED may not have to raise rates that aggressively to combat the exuberances in the market that are magnifying inflationary pressures. Mortgage rates have essentially doubled, which should rapidly cool the housing market, a contributor to inflation.



Indicators

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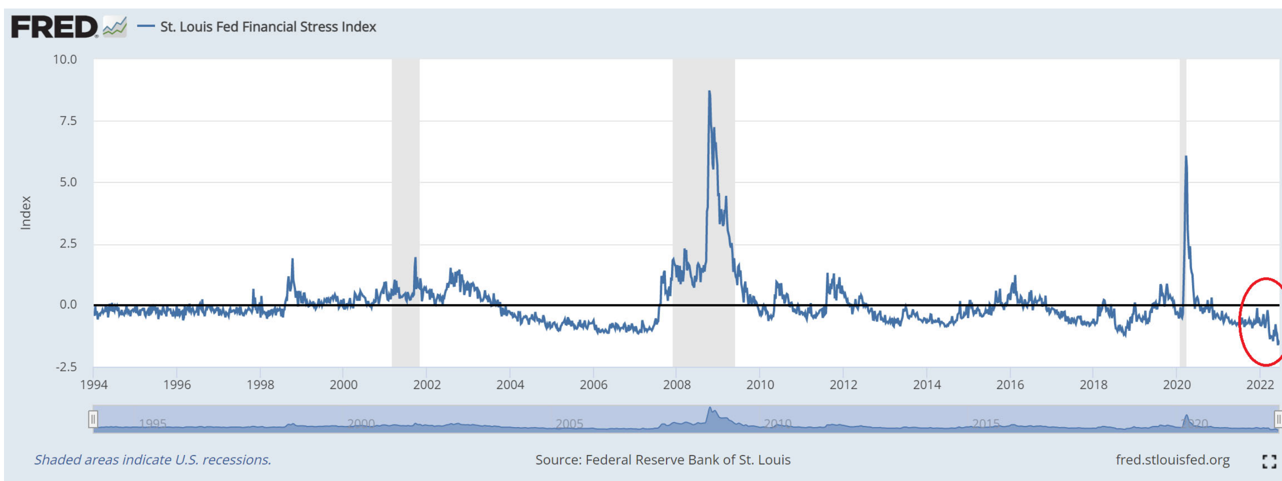
Special points of interest

- Yield curve inversion—Double Dip?
- Financial Stress—Below Avg.
- EPS growth—strong /normalizing
- Employment—Remains Strong
- Inflation — Historic Numbers

Financial Stress Index - Green



This chart might be the most perplexing of those in this newsletter, and perhaps provides some optimism. The economic headlines have been frightening….highest inflation in 40 years, aggressive FED tightening, a 20%+ stock market correction, mortgage rates over 5%, and a war in Europe. All of this and the financial stress index remains well below baseline. The worst case scenario is a situation where the FED has to step in and provide liquidity, because that is in direct conflict with their tools to fight inflation. My belief in the FED to engineer a soft landing hinges on the financial market ability to handle the decrease in liquidity.

S&P 500 EPS Trends - Green

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

	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	**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

Analysts have yet to lower their earnings estimates for a perceived recession setting into the economy. From a pure mathematical standpoint, what's interesting to me is that the S&P 500 is roughly 20% higher than in 2019, and earnings for 2022 are still projected to be up 38%+ from then. There are 2 main factors that determine the price level of the index, the first are the actual and projected earnings and the second is the multiple applied to those earnings. We've seen the multiple applied come down, which is indicative of an expected recession and lower/slower growth in the economy. Broadly speaking, the market is expecting earnings from this year to be around 200, given the current multiple of 19. If earnings hold up we could see a surprise rally later in the year, and if earnings come in below 200, we may have farther to fall. A quick google search will show you that the historical average of the multiple is closer to 15, not 18-20. An important difference though is that the makeup of the index has changed aggressively over the last 20 years. Technology companies like Microsoft and Apple typically have multiples over 20, and given their trillion dollar valuations, heavily skew the average. As opposed to cyclical companies like Banks, Energy, and Industrials, which made up a larger portion of the index decades ago, garnish multiples in the 10-15 range, sometimes even lower. The higher multiple can be justified given the current composition of the S&P 500 index. For now, the earnings projections support a market rally.

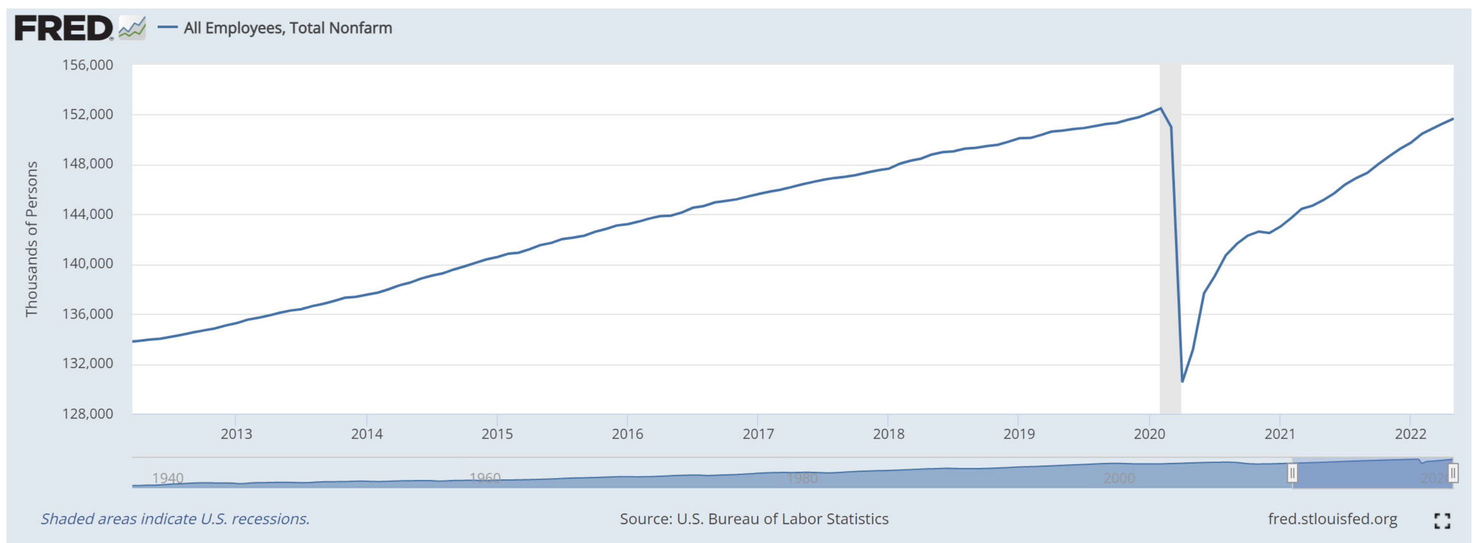
S&P 500 Earnings: YRI vs. Consensus Forecasts (6/20/2022)

	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.

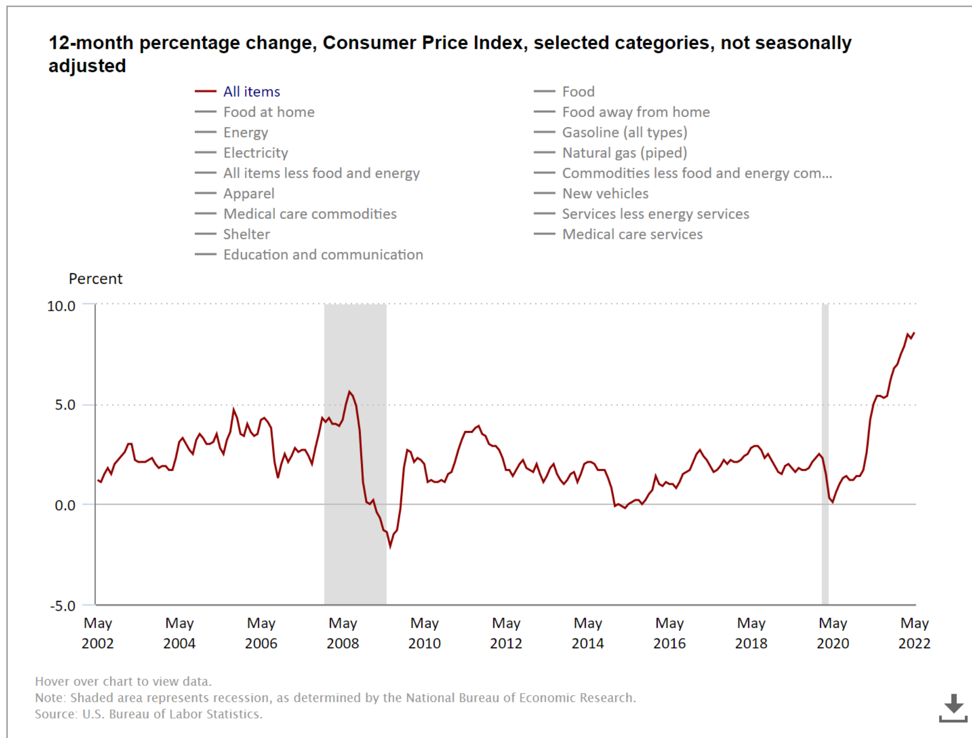
Labor Market—Green



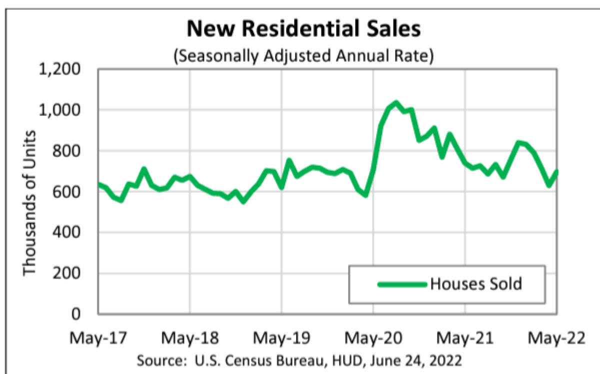
Another signal in stark contrast to the doom and gloom headlines has been employment. The jobs picture still remains robust. But, for this series I included the 1980s as a potential warning of what FED tightening can do. The employment picture was great, and then the FED tackled inflation with substantial rate increases. In the top chart you can see the destruction that took place, with unemployment reaching 10%.

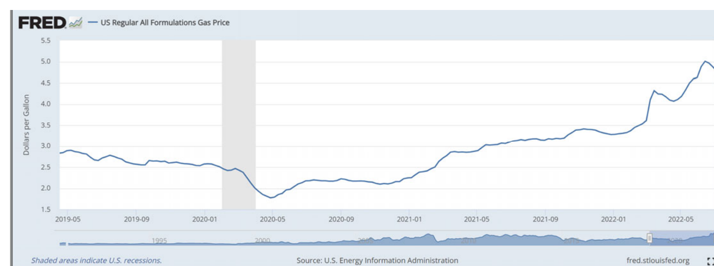
There are 3 potential outcomes with the current tightening cycle: No recession, mild recession, deep recession. A soft landing would include the first 2, with a hard landing being the latter. There's been speculation that the FED won't be able to raise rates as substantially as they would like, leaving room for them to soften their stance if the economic picture weakens. The FED will be paying close attention to the jobs market to gauge how much room they have to tighten. Given how strong the job market is, they may sacrifice the jobs number to tame inflation.

Inflation—RED



Inflation is here, and many of us, included myself have never experienced this kind of inflation in our lifetimes. Another first in a long list of firsts for the younger generations in America. I believe the current data is showing positive signs of slowing inflation. We can see a top forming in the chart, and the housing market, along with gas is showing signs of easing. While we see some softness in inflation, my signal remains in the red because we'll need a few more months to call a top. The spike in mortgage rates has begun to normalize the housing market, with new residential sales falling back towards trend. Gasoline Prices are also rolling-over. If these trends continue, they will have a cooling affect on inflation data, which may allow the fed room to halt rate increases in the fall.





Summary

The dichotomy of my indicators remains with 2 screaming red and 3 all green. The inflation and yield curve overpower the others, and suggest that now is the time to remain out of speculative areas and stick to a core allocation. The FED will not be able to ease until inflation rolls over. As my other charts suggest, the FED will tighten into a recession and kill job creation if that's what it takes to bring down inflation. My hope is that by cooling off the housing market, and bringing down the bubble in house valuations, the FED can engineer a soft landing. An area of interest to watch is technology, long thought by some to be the cure to inflation. The markets are treating it as anything but that.

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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