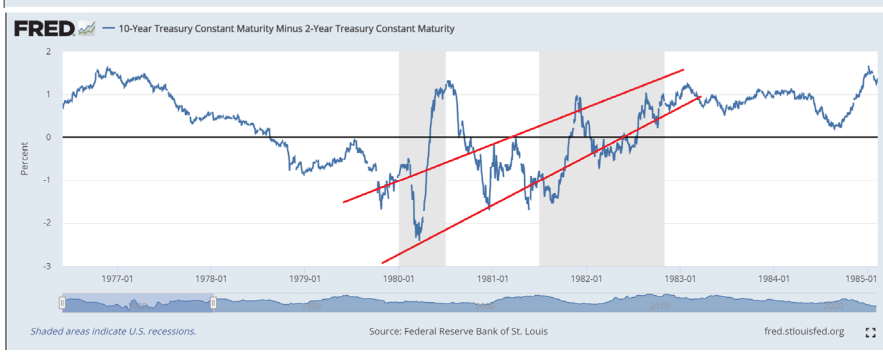
Liberty Sound Financial

3/31/2023
2023 Q1

Focus 5 Report

Yield Curve - Red



The market wins again! In my last email I wrote that the market was trying to tell us something with the 10 year yield dropping, despite the FED projecting rate increases. That message was banking stress! We saw SVB fall apart, and the other regional banks requiring a liquidity bailout from the FED and other larger banks. The "market" and the FED both realize that they've reached an upper limit on rates here. Many called for the FED to pause, but they still pushed through a small 25 BPS rate increase while acknowledging that they might have to pause. On a positive note, we didn't have a large scale banking collapse, and we've seen inflation trending lower, which could allow the FED to pause without losing their credibility.

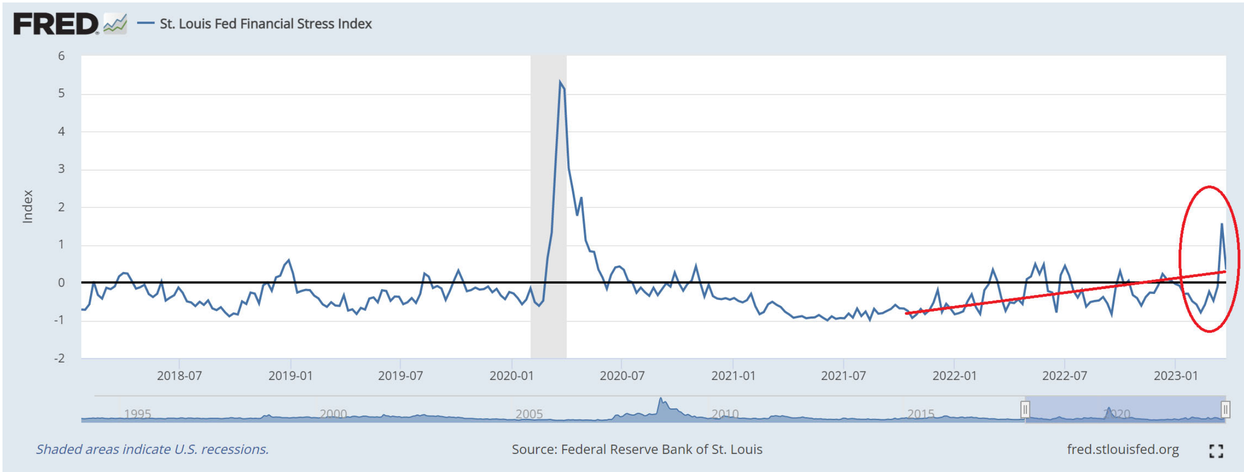
The charts I've shown for this newsletter demonstrate the mistake this FED doesn't want to repeat. In 1980 we got a recession, and they cut rates despite elevated inflation, which only prolonged the core problem, creating a double dip recession, and the extreme rates the baby boomer generation remembers of the early 1980s. By squashing inflation for sure, the FED hopes that we can get by with one mild recession (perhaps none), and not a long drawn out process that lasts 3-4 years.

Indicators

Special points of interest

- Yields—The Market Was Right
- Financial Stress—Bank Stress
- EPS growth—Stabilizing?
- Employment—Strong
- Inflation — Downward Trend

Financial Stress Index - Yellow -



The recent spike in stress has receded for now, as we saw banks struggle to deal with mark-to-market accounting of their treasury holdings which have gone down in value because of rate increases. Normally banks hold their treasuries until maturity and can record their full value. In SVB's case the simple fact is their growth company clients were burning through cash on hand, forcing SVB to have to shift those assets to a held for trading account. On paper it looked like they had billions in losses, when in fact, if allowed to hold those treasuries to maturity they would get back the full value. The FED broke something as they almost always do when increasing rates. Hopefully this is the worst of it, and will help tame inflation so the FED can lower rates.

S&P 500 EPS Trends - Yellow -

Table 1: S&P 500 Earnings YRI vs. Consensus Forecasts (3/27/2023)

	Yardeni Research		Analysts' Consensus	
	Level	YOY %	Level	YOY %
2021	**208.53 a**	**49.2**	**208.53 a**	**49.2**
2022	**215.00 e**	**3.1**	**218.09 e**	**4.6**
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	53.15 **e**	-1.7
2023	**225.00 e**	**4.7**	**221.40 e**	**1.5**
Q1	53.00 **e**	-3.3	50.79 **e**	-7.4
Q2	55.00 **e**	-5.1	54.56 **e**	-5.8
Q3	58.00 **e**	3.5	57.25 **e**	2.1
Q4	59.00 **e**	8.3	58.74 **e**	10.5
2024	**250.00 e**	**11.1**	**248.03 e**	**12.0**

e=estimate.

* Historical earnings and growth rates are frozen when the reporting periods are complete. Annual EPS is calculated independently of quarterly EPS, and may not equal quarterly sum due to estimate coverage and index constituent changes.
Source: Yardeni Research, Inc. and I/B/E/S data by Refinitiv.

Thus far the earnings cliff has been avoided, which is part of the reason for the recent market stability. I wouldn't sound the all clear just yet, but earnings estimates seem to be cementing around the $220 level for the S&P 500 2023 forecast. The fear remains that we might see earnings drop to 200 (or even lower), which would all but guarantee a retest of the lows. Markets tend to be forward looking by about 6 months. Come June/July we will be assessing the accuracy of the lofty 2024 EPS projections which remain at $250. If these projections hold true that would imply an SP 500 of 4200-4500 depending on the multiple used.

The average retail investor can sometimes struggle to understand why the market is trending upwards when the current climate is negative. It's precisely these forward projections of 6-12 months out that can buoy a current negative climate. This is also why retail investors often sell at the worst time and miss the rally going forward.

Having the proper allocation is of utmost importance so that as an investor you can remain invested throughout the ups and downs of the earnings revisions. Those who don't often suffer from investing whiplash.

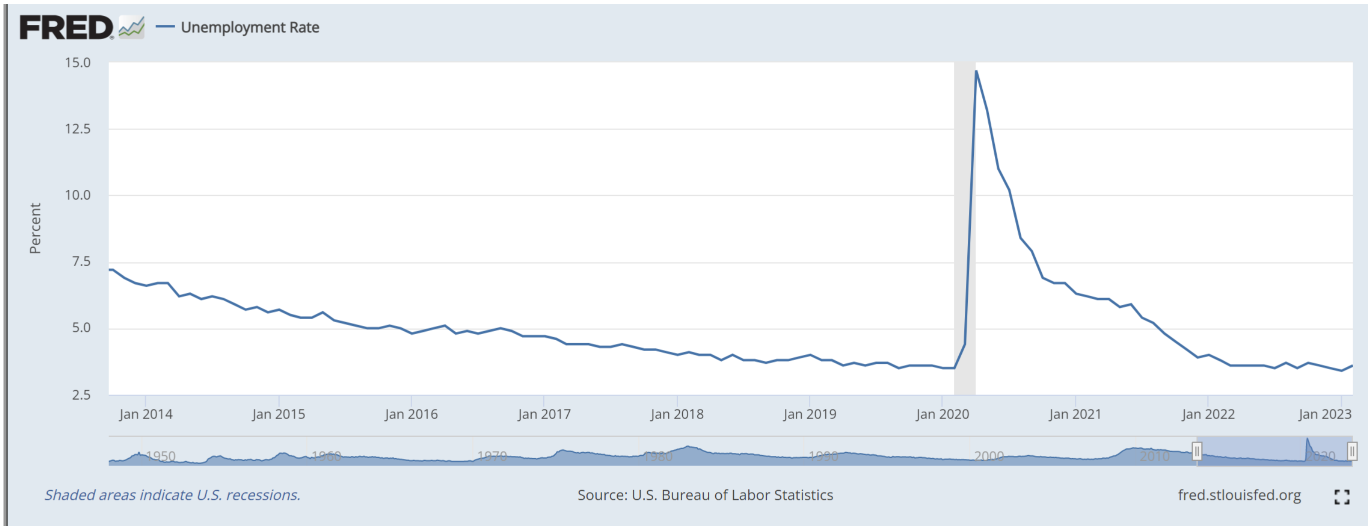
Table 1: S&P 500 Earnings YRI vs. Consensus Forecasts (1/9/2023)

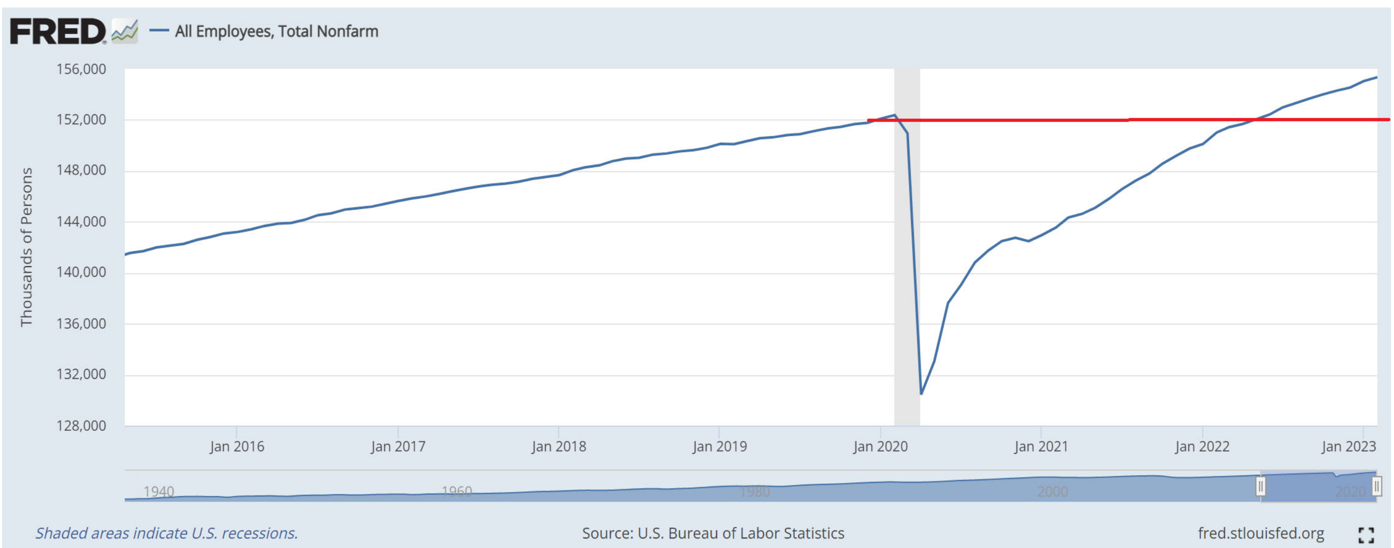
	Yardeni Research		Analysts' Consensus	
	Level	**YOY %**	**Level**	**YOY %**
2022	**215.00 e**	**3.1**	**219.87 e**	**5.4**
Q1	54.83 **a**	11.6	54.83 **a**	11.6
Q2	57.95 **a**	9.9	57.95 **a**	9.9
Q3	56.05 **a**	4.0	56.05 **a**	4.0
Q4	54.50 **e**	0.8	53.81 **e**	-0.4
2023	**225.00 e**	**4.7**	**229.24 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.

Labor Market—Green -

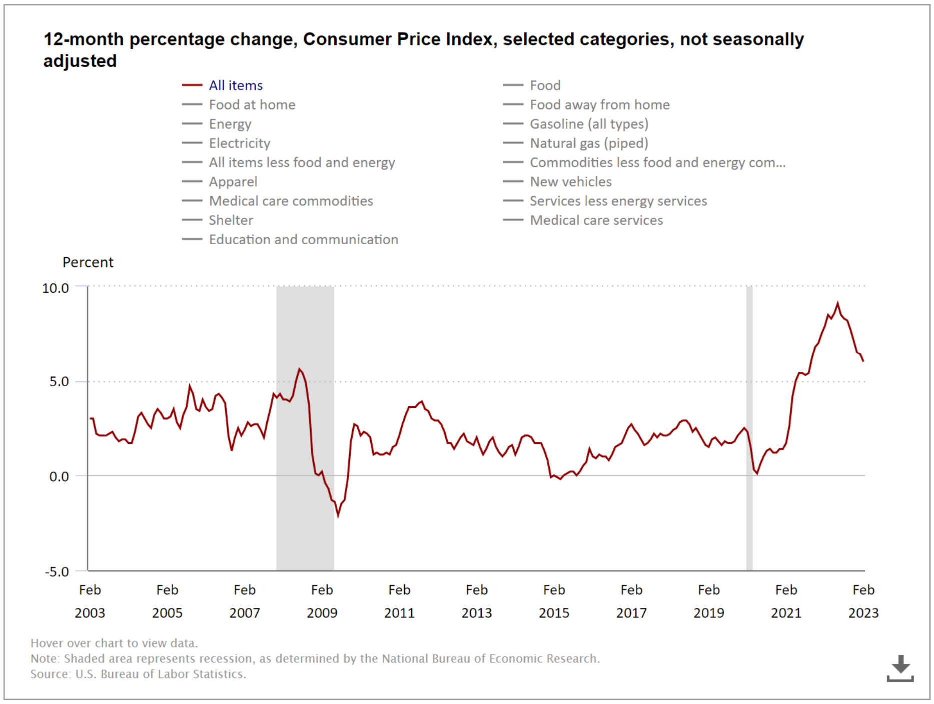




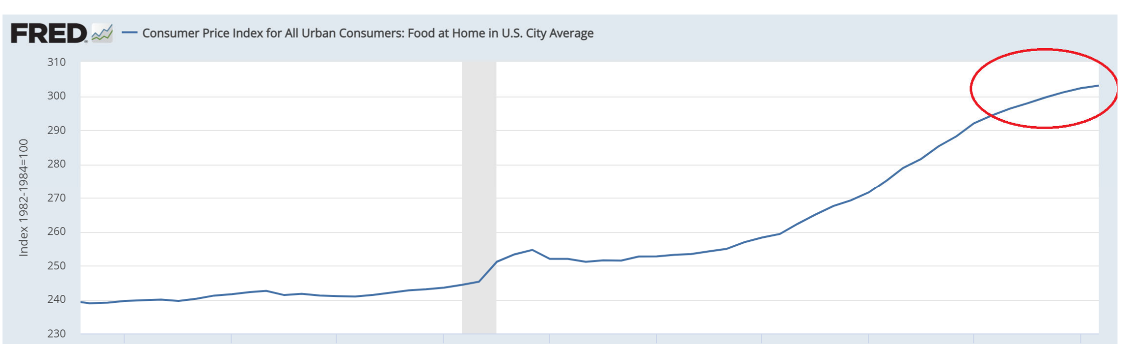
There's a saying in the financial world, "Good news is bad news." In this case, I think it applies. We have a historically strong jobs market, where we have been under 5% unemployment for years. Only the Covid era of lock downs caused the unemployment to drift above that level. This strength has become a problem, as the FED needs to cool inflation, and a tight jobs market will not help in that endeavor. People have tried to explain away this historically low unemployment rate with how it is calculated, pointing to a shift in demographics / participation rate. There are some truths to those arguments, but the total jobs chart shows a significant increase in the total jobs.

Our definition of full employment is fluid, and was always taught to me as 5%. The FED has said that they would like to see unemployment back at those levels, and unfortunately that implies millions of people losing their jobs, as pointed out by Elizabeth Warren during chairman Powell's latest testimony. A strong labor market can fuel a wage-price spiral leading to a very prolonged period of inflation, which arguably would be worse than 1-2% losing their jobs.

Inflation—Yellow +



While most of my indicators are troubling to some degree, this is perhaps the most important indicator among them, and is showing great improvement in the FED's war on inflation. Financial normalcy and confidence cannot return without price stability. The financial stress we've seen, the erosion of consumer purchasing power, and diminished corporate earnings potential, will struggle until we have a stable price market. Last quarter I wrote about food inflation at home, notably egg prices, which appear to be forming a top in the chart below. This is all welcomed news on the inflation front, but the war is not won yet.



Summary

At the end of the 1st Quarter, round 1 goes to the FED on taming inflation. They are battling to lower inflation without wreaking havoc on the financial system, which we saw cracks in recently with SVB being taken over. Even lower liquidity is coming via tighter bank lending standards, and increased regulation. A decrease in liquidity doesn't bode well for stocks, especially those without consistent positive cashflows. Input costs are still elevated (Interest Rates, Liquidity, Energy), which is a strain on growth stocks that flourish on cheaper inputs. Companies who have positive cash flow and cash on hand will fair better in my opinion.

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.