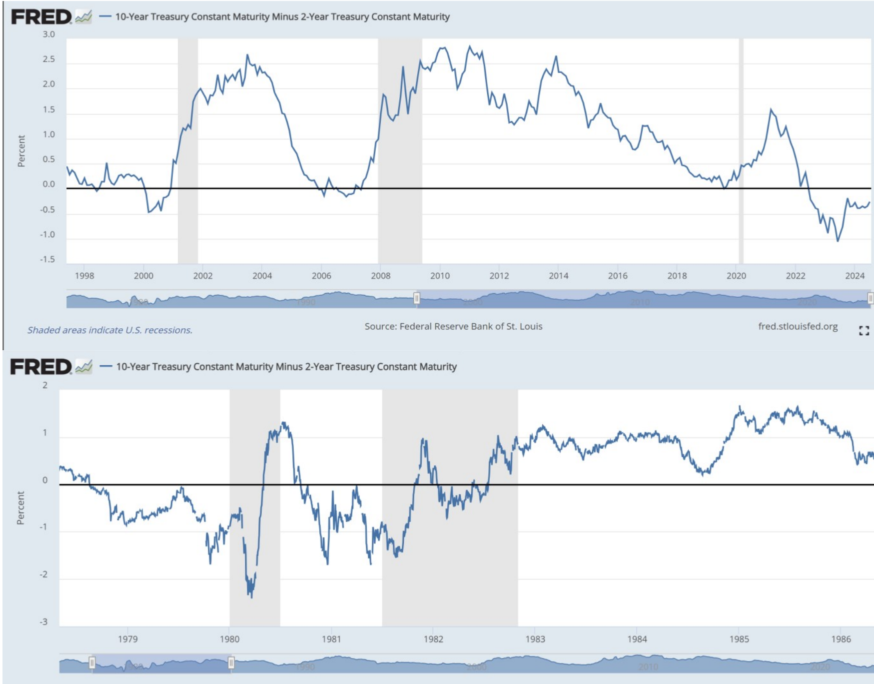
Liberty Sound Financial

07/01/2024
2024 Q2

Focus 5 Report

Yield Curve - Red



The yield curve is playing out very similarly to the late 1970s into the early 1980s. That period was marked by high inflation, which the FED tamed with higher rates, but only after failing to keep rates elevated long enough. There was an initial mild recession, which was followed by a more severe recession after the FED raised rates again to finally quell the high inflation.

Here we are at the current time...we've experienced relatively high rates which has brought down inflation, but we have not experienced a recession...yet. The decoupling of the global manufacturing system, given tensions with China/Russia, and in the middle east, will put upward pressure on shipping/production costs. The FED has said it will take some time to achieve their 2% target for inflation. A key area they are concerned with are the transportation of goods given the geopolitical tensions impact on shipping lanes. In regards to the yield curve, will the FED be able to keep rates high enough and long enough to stomp out inflation before they have to cut rates to protect the economy? That is the million dollar question. I'm hopeful that they can begin to ease without inflation reaccelerating. A major help would be a reduction in spending from the Federal Government, which would keep the M2 money supply in check.

Indicators

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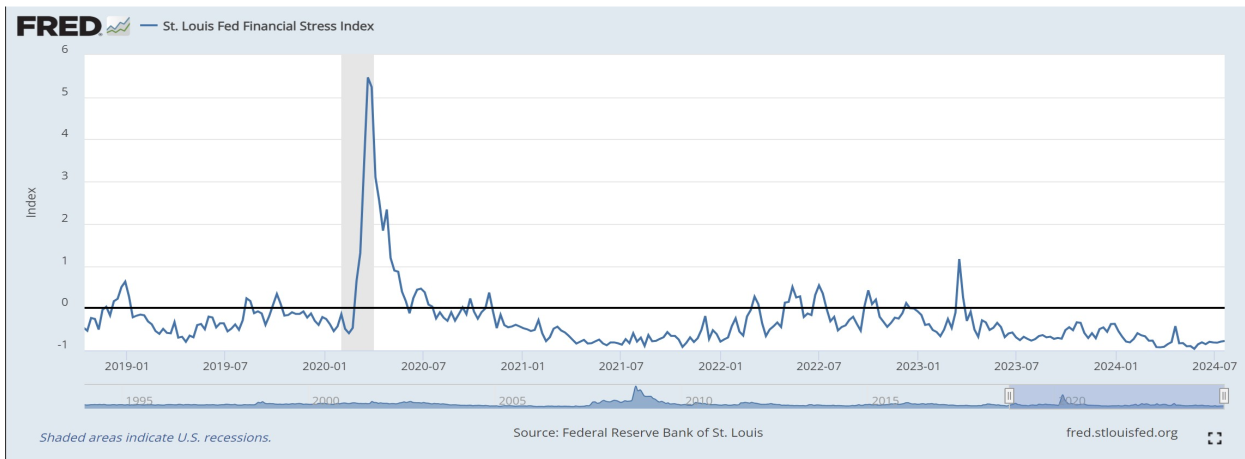
Special points of interest

- Yields—Inversion Persists
- Financial stress—All Calm
- EPS growth—Strong
- Employment—Strong
- Inflation —Stubborn

Financial Stress Index - Green



Even with rates elevated, there appears to be ample liquidity in the financial markets. Though some of the friction could be hiding out on the balance sheets of banks and mortgage companies who have yet to take losses on their loans or treasuries. There is no negative noise to report here. Time and accounting practices will determine if that is so.

S&P 500 P 500 EPS Trends - Green

S&P 500 EARNINGS FORECASTS: YRI VS ANALYSTS' CONSENSUS (6/28/24)

Year / Quarter	a / e *	Yardeni Research - Level	y/y%	Analysts' Consensus - Level	y/y%
2023	a	221.4	1.5	221.4	1.5
Q1	a	53.1	-3.1	53.1	-3.1
Q2	a	54.3	-5.8	54.3	-5.8
Q3	a	58.4	4.3	58.4	4.3
Q4	a	57.2	7.5	57.2	7.5
2024	e	250.0	12.1	243.4	9.9
Q1	e	57.0	7.4	56.6	6.6
Q2	e	61.0	12.4	58.9	8.1
Q3	e	63.0	7.9	63.1	7.9
Q4	e	66.0	15.5	65.2	14.0
2025	e	270.0	8.0	278.6	14.5
2026	e	300.0	11.1	316.4	13.6

* a = actual / e = estimate

Here we stand, more than half way through 2024, and there is very little evidence to suggest that we are in or will be in a recession within the next few months. The major banks and highly touted analysts have been very wrong in calling for a recession at the end of 2023 or even mid-way through 2024. The earnings are coming in strong, even with the large cap tech companies spending on building out their AI infrastructure.

My stance continues to be that since there was such an explosion in the M2 money supply, and thus savings accounts, that it will still take time for those extra dollars to work their way through the system. From what I see on the ground, I believe earnings can hold up relatively, but consumer spending will be reigned in. Consumers are just now seeing their car insurance premiums spike upward 20%, their home owners insurance going up 20%, their property taxes either shooting up or services being cut, and the list rolls on. The delayed impact of inflation is being felt by the middle class now. The immediate rise in living cost, really hurt the "working class", but now the delayed impacts of inflation are being felt by the "middle" class.

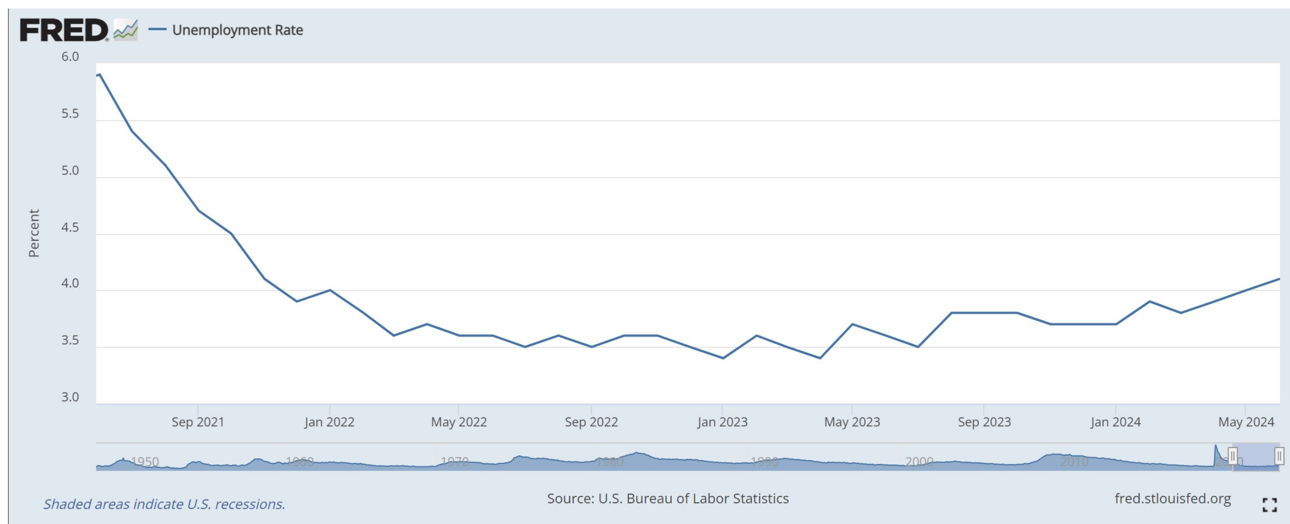
In my opinion, I don't think we are in a bubble, but there are pockets of excess that have eased, which will hopefully drag down inflation, and allow earnings to remain intact for the most part. There would need to be an outsized shock to employment to drive a huge drop in spending and thus earnings. At this moment there are too many people working, locked into low rate mortgages, to allow for a substantial drop off in spending.

S&P 500 EARNINGS FORECASTS: YRI VS ANALYSTS' CONSENSUS (3/31/24)

Year / Quarter	a / e *	Yardeni Research - Level	y/y%	Analysts' Consensus - Level	y/y%
2021	a	208.1	49.0	208.1	49.0
Q1	a	49.1	48.3	49.1	48.3
Q2	a	52.6	87.9	52.6	87.9
Q3	a	53.7	38.8	53.7	38.8
Q4	a	54.0	26.7	54.0	26.7
2022	a	218.1	4.8	218.1	4.8
Q1	a	54.8	11.5	54.8	11.5
Q2	a	57.6	9.6	57.6	9.6
Q3	a	56.0	4.3	56.0	4.3
Q4	a	53.2	-1.5	53.2	-1.5
2023	a	221.4	1.5	221.4	1.5
Q1	a	53.1	-3.1	53.1	-3.1
Q2	a	54.3	-5.8	54.3	-5.8
Q3	a	58.4	4.3	58.4	4.3
Q4	a	57.1	7.5	57.1	7.5
2024	e	250.0	12.9	242.9	9.7
Q1	e	60.0	13.0	54.9	3.5
Q2	e	61.0	12.4	59.2	9.0
Q3	e	63.0	7.9	63.5	8.7
Q4	e	66.0	15.6	65.3	14.3
2025	e	270.0	8.0	276.1	13.7
2026	e	300.0	11.1	302.7	9.7

* a = actual / e = estimate

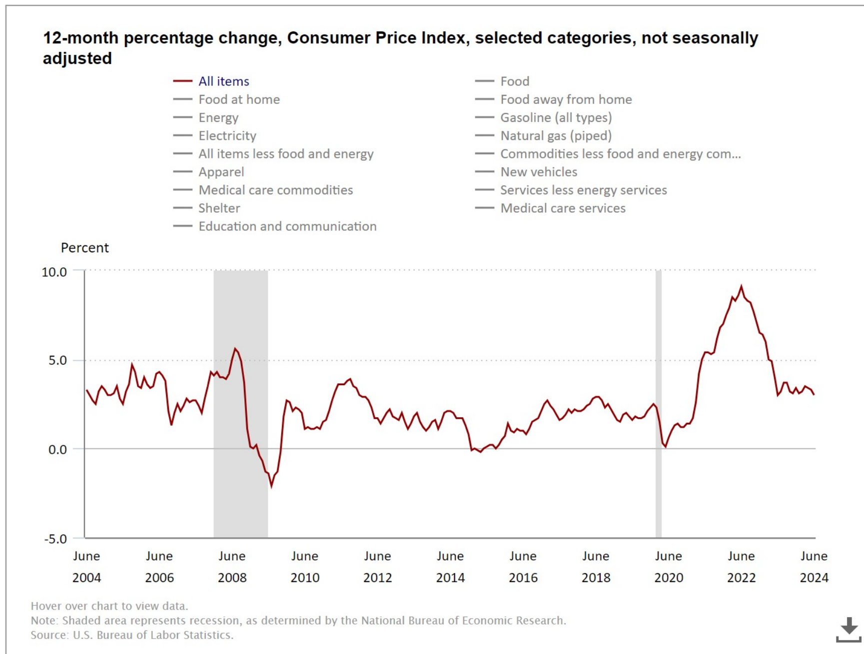
Labor Market—Green -



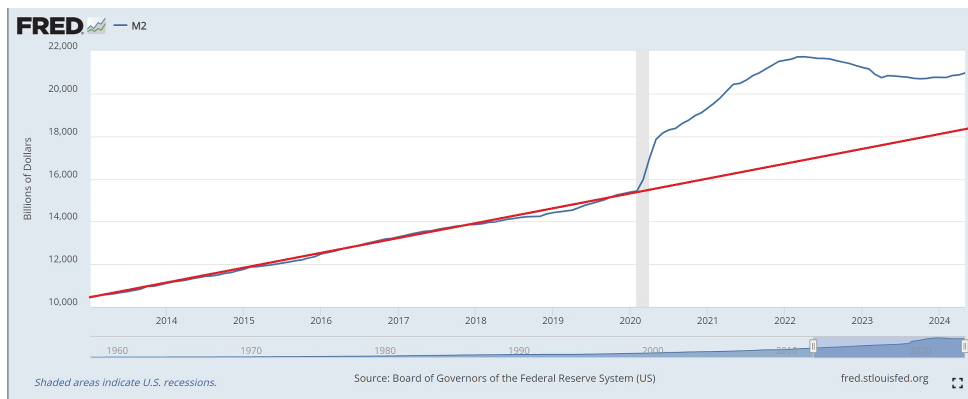
There is weakness creeping into the unemployment level, as we now have a steady trend line upward established. Another aspect not shown here, is that the employment numbers are being helped by part time jobs and not full time jobs. That's typically a trend we see established before a slowdown/recession. What's worth remembering is that 4-5% employment is considered full employment, and we are just at 4.1% right now. Part of the inflation equation was not just overprinting of money, but a labor market that was overheated. This slow down we see happening is a return to more normal levels of employment.

My repeated theme through the rate hike cycle has been...can the FED lower rates before a recession? We can clearly see the labor market cracking and slowing down, but when will the FED lower rates? If we slide to over 5% unemployed, they will have gone too far. I agree that the FED to avoid making drastic cuts later, should start lowering now, to produce a gradual rate decrease cycle.

Inflation—Yellow +



We are at the precipice of winning the war on inflation. Certainly there are pockets of inflation that remain, like car insurance and home owners insurance, but overall inflation has moderated. That doesn't mean that prices aren't increasing….they are increasing at a more normalized pace. The piece of the puzzle that gives me angst is pictured below. The M2 money supply is still drastically higher than the trend line before Covid. My fear is that with lower rates, we will see a reacceleration of that money supply, and thus inflation. The housing market may help with that, as the high cost of homes from a lack of inventory, and elevated mortgage rates, might act as a sponge to soak up extra liquidity.



Summary

My view is very the much the same from my last report. Inflation has almost always been brought under control by a recession, engineered by higher rates from the FED. Right now we are in the sweet spot, where inflation is coming down, and the economy is still strong/stable, but if the FED doesn't adjust rates at the precisely right moment we could slide into a recession.

I would continue to lean on AI tech plays that are building out the next phase of the “internet” revolution, and energy players that will power that next phase. Stay within a risk budget, and don’t chase here as the market has run up.

References:

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https://fred.stlouisfed.org/

https://www.bls.gov/charts/consumer-price-index

https://www.federalreserve.gov/monetarypolicy/fomc.htm

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