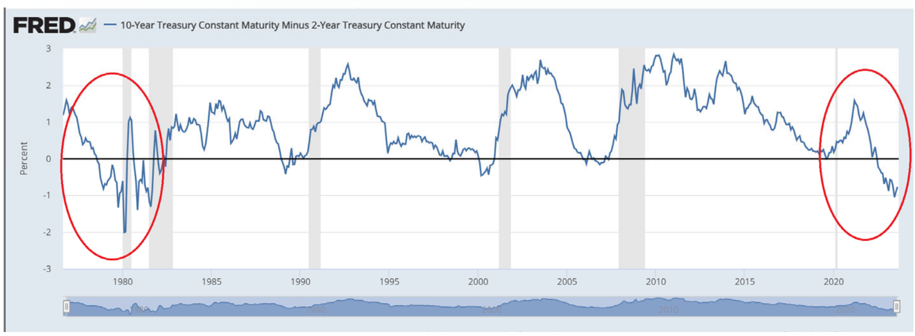
Liberty Sound Financial

09/30/2023
2023 Q3

Focus 5 Report

Yield Curve - Red



The good news is that the yield curve is setting up exactly like 1980. The bad news is that the yield curve is setting up exactly like 1980. That's why, in my opinion, the FED has said again and again that they don't want to repeat the mistakes of the past. The upside is that the first recession in 1980 was mild in duration, but most likely that's because the FED abandoned their fight on inflation, which is the mistake they don't want to repeat. Instead of one recession to correct the inflation problem, we experienced a double dip recession.

It's my view that the FED has the tools and the foresight to tame inflation without crippling the economy if they learn from the mistakes of 1980. Does that mean we won't have a recession? No, but it means the FED will make sure the inflation fire is out before they restoke the economy, and we get a clean new runway to take off on.

The FED has been battling to drain the excess cash from the system, which creates inflation. But if their timing is just right, they'll lower rates before the cash is drained below what's required to keep the economy going.

Indicators

Special points of interest

- Yields—1980 repeat?
- Financial stress—All clear
- EPS growth—Stagnant
- Employment—Strong
- Inflation —Improved

Financial Stress Index - Green

With the banking crisis behind us….for now…there appears to be very little stress in the financial system. Though one wonders just how many non-performing commercial loans are on the books at various institutions. Extend and pretend loans to ghost town office buildings can only continue for so long before they have to be shown as a loss on the balance sheet. That might create another run on banks as they have to sell bonds at a loss to cover the losses in real estate.

S&P 500 P 500 EPS Trends - Yellow

Table 1: S&P 500 Earnings YRI vs. Consensus Forecasts (10/2/2023)

	Yardeni Research		Analysts' Consensus	
	Level	YOY %	Level	YOY %
2019	**162.93 a**	**0.6**	**162.93 a**	**0.6**
2020	**139.72 a**	**-14.2**	**139.72 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	42.58 a	1.4	42.58 a	1.4
2021	**208.12 a**	**49.0**	**208.12 a**	**49.0**
Q1	49.13 a	48.3	49.13 a	48.3
Q2	52.58 a	87.9	52.58 a	87.9
Q3	53.72 a	38.8	53.72 a	38.8
Q4	53.95 a	26.7	53.95 a	26.7
2022	**218.09 a**	**4.8**	**218.09 a**	**4.8**
Q1	54.80 a	11.5	54.80 a	11.5
Q2	57.62 a	9.6	57.62 a	9.6
Q3	56.02 a	4.3	56.02 a	4.3
Q4	53.15 a	-1.5	53.15 a	-1.5
2023	**225.00 e**	**3.2**	**220.83 e**	**1.3**
Q1	53.08 a	-3.1	53.08 a	-3.1
Q2	54.49 p	-5.4	54.49 p	-5.4
Q3	58.00 e	3.5	55.92 e	-0.2
Q4	59.00 e	11.0	58.14 e	9.4
2024	**250.00 e**	**11.1**	**247.49 e**	**12.1**
Q1	60.00 e	13.0	57.80 e	8.9
Q2	61.00 e	11.9	61.09 e	12.1
Q3	63.00 e	8.6	63.13 e	12.9
Q4	66.00 e	11.9	65.58 e	12.8
2025	**270.00 e**	**8.0**	**277.03 e**	**11.9**

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.

Though we still have a quarter to go, it appears that we have avoided an earnings recession. The holiday shopping season will determine if we finish slightly above or slightly below last years EPS number of 218.09. The real key here is to analyze the 2024 number as markets tend to trade based on data 6 months from now (forward looking). With a robust growth of 11% forecasted for 2024, there is still hope for stocks in the 12-18 month window. Though the yield curve would say otherwise, typically we see a recession 18-24 months out from an inversion. If next year's number holds true, then $244 x 20 = 4880 on the SP 500 index, indicating a possible 16% upside in the index from here.

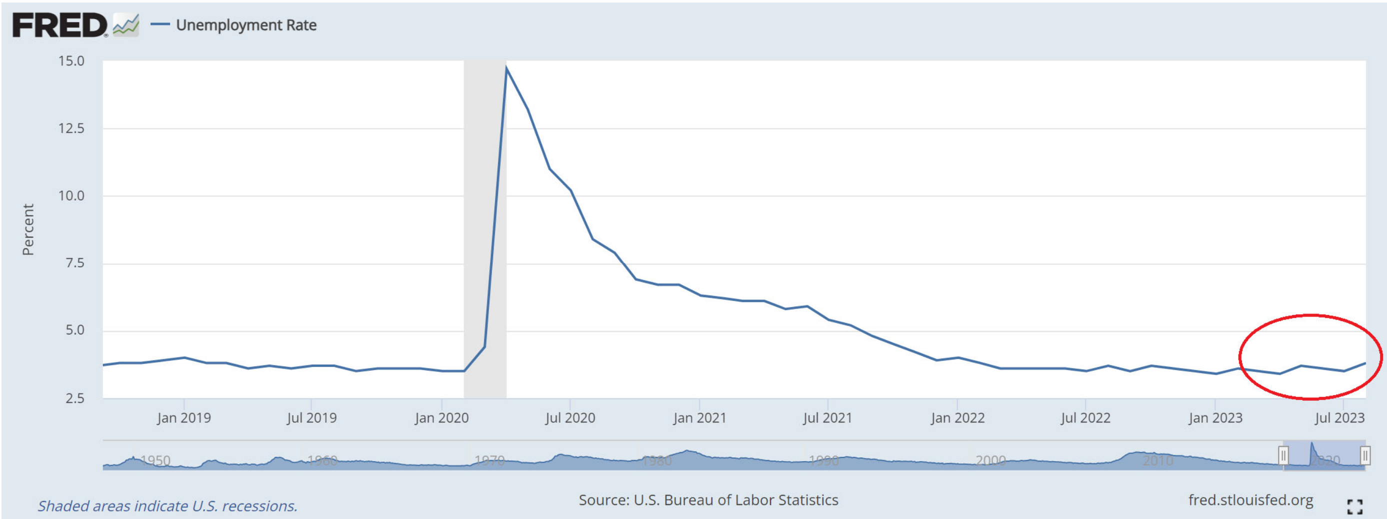
In my opinion these estimates will come down as the year rolls on, as we see the excess cash drain from the system, as noted in charts like the M2 money supply. The destruction of excess cash is precisely what the FED wants, but when do they stop? That is the soft landing conundrum you hear about in the news. When do they lower rates and allow the M2 money supply to grow again? If they keep rates elevated for too long, they risk stalling the economy into a deep recession.

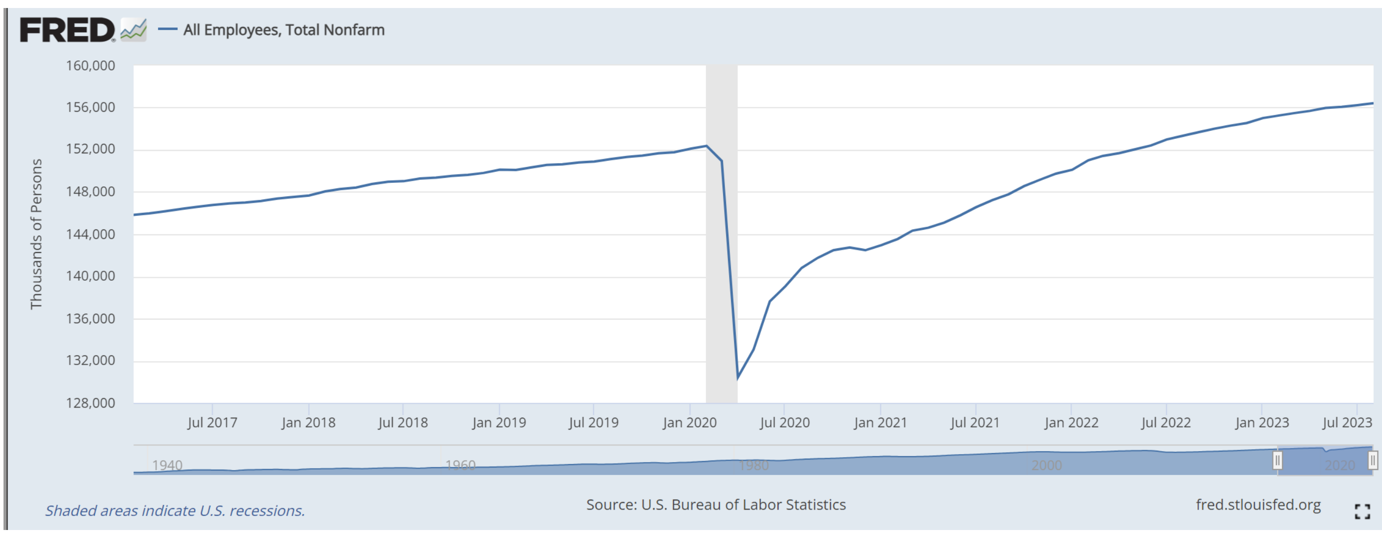
Table 1: S&P 500 Earnings YRI vs. Consensus Forecasts (7/10/2023)

	Yardeni Research		Analysts' Consensus	
	Level	YOY %	Level	YOY %
2022	**218.09 a**	**4.6**	**218.09 a**	**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	53.16 **a**	-1.6	53.16 **a**	-1.6
2023	**225.00 e**	**3.2**	**219.14 e**	**0.5**
Q1	53.28 **a**	-2.8	53.28 **a**	-2.8
Q2	55.00 **e**	-5.1	52.81 **e**	-8.9
Q3	58.00 **e**	3.5	55.76 **e**	-0.5
Q4	59.00 **e**	11.0	57.58 **e**	8.3
2024	**250.00 e**	**11.1**	**244.88 e**	**11.7**
Q1	60.00 **e**	9.4	57.45 **e**	7.8
Q2	61.00 **e**	5.3	59.47 **e**	12.6
Q3	63.00 **e**	12.4	62.35 **e**	11.8
Q4	66.00 **e**	24.2	64.93 **e**	12.8
2025	**270.00 e**	**8.0**	**273.33 e**	**11.6**

e=estimate.

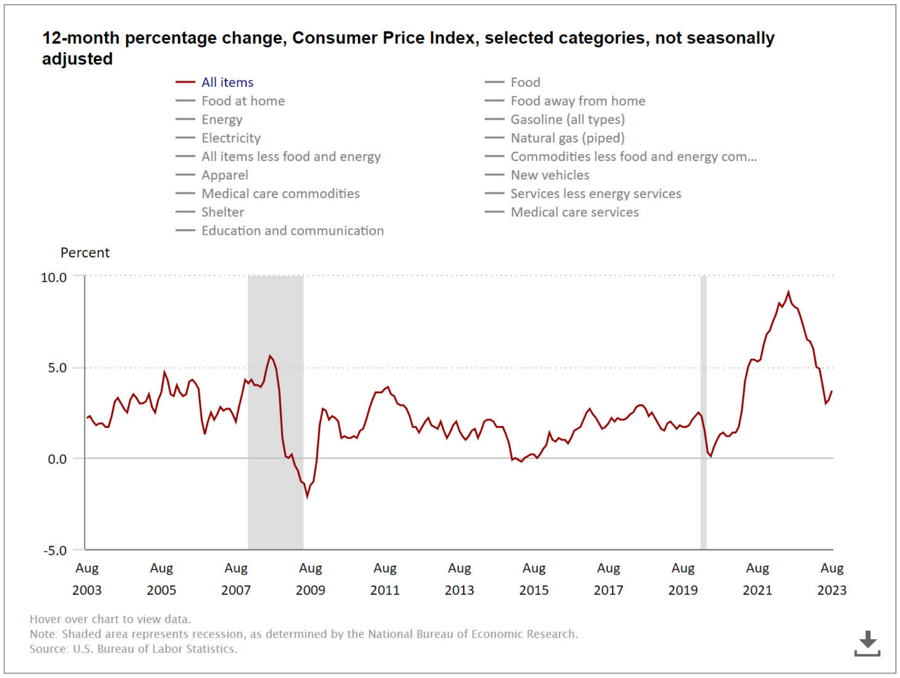
Labor Market—Green





This chart and the financial stress index have been resilient and strong for a while despite the "bears" out there screaming that a recession is on the way. So what's the deal with the charts remaining so bullish? Typically we would see cracks in the system before a recession, with signs such as unemployment rising and defaults creating financial stress. This could be another Covid anomaly, where we have seen exaggerated charts from massive recalibration due to the bluntness and speed of the closing and reopening of the economy. In my opinion the next recession may not be preceded by rising unemployment, but a drastic, seemingly overnight, destruction of the employment type chart. When the excess cash runs dry, if the FED hasn't lowered rates, certain industries could stall out overnight, creating widespread unemployment. There's a saying, "Stocks take the stairs up, and the elevator down." I believe the same holds true for unemployment: The labor market has been slow and steady, but if it stalls unemployment might sky rocket quickly.

Inflation—Yellow +



12-month percentage change, Consumer Price Index, selected categories, not seasonally adjusted

The level of inflation has come down greatly, which is a relief; though there is much work to be done to reach the FED's objective of 2%. The slight uptick in the chart is concerning, and if I were to include the M2 money supply chart, you would see a corresponding bump-up there too. Overall, the M2 money supply is decreasing, which gives us hope that inflation will continue to lower over time as excess cash is removed from the system.

The FED recently announced that they wouldn't raise rates, but that they were thinking of keeping rates higher for longer. Which in my opinion is more bark than bite, so to speak. They can't project any weakness in their fight on inflation. If the market senses weakness, stocks and inflation might take off again before the job is done. The FED is starting to realize they can't raise rates much further without breaking the system, so their tactic is to keep rates elevated for longer. Now begins the game of wait and see. Will the FED lower rates before or after the economy stalls out? Hopefully they manage it just right after learning from past mistakes. One positive effect of high rates is that there is plenty of room now for stimulus. If the economy crashes, assuming inflation is lower/fixed from a recession, they can lower rates and drastically stimulate the economy.

Summary

In my opinion, these high rates are not sustainable, not because they are historically high, but rather because they come on the heels of a decade of ultra low rates. The many financial markets that comprise our economic system are not repriced for such a sustained level of high rates. With that in mind, my overall take on this report is to remain with high quality companies that have cash on the balance sheet. High-flying growth stocks typically require a stabilized environment, a core characteristic being low inflation.

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.