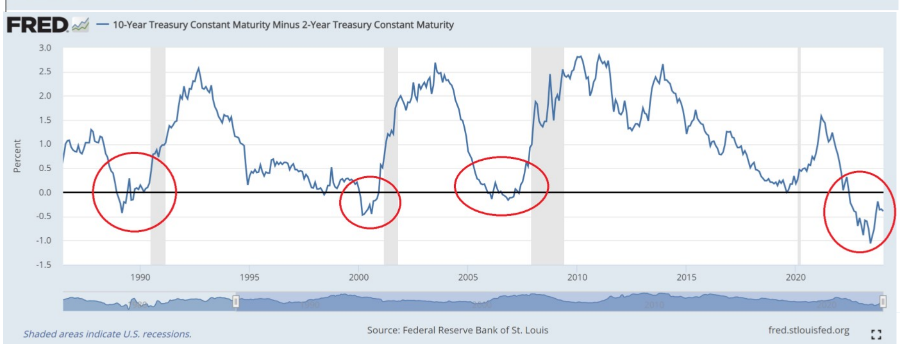
Liberty Sound Financial

12/31/2023
2023 Q4

Focus 5 Report

Yield Curve - Red



An interesting aspect of the yield curve is that we often see it normalize before a recession takes hold. The last three recessions were preceded by normalizing yield curves. There's still a pretty descent chance we avert a technical recession in 2024, but according to the history shown above, we are within a window of 1-2 years. The "market" is calling for 2-3 rate cuts this year, though the FED has yet to confirm if that is so. In fact, their dot plot doesn't seam to confirm that. If inflation continues to fall, and the FED doesn't respond by normalizing the short end of the curve, then the economy could fall into a recession.

In my personal opinion as I write this today, I envision a "soft landing" in the mid to latter part of 2024, whereby we do encounter a mild recession. Today's economy responds rapidly to changes in policy, which is why I believe that if the FED does indeed hold rates too high for too long, that when they do announce cuts to prompt economic growth, it will keep the recession shallow.

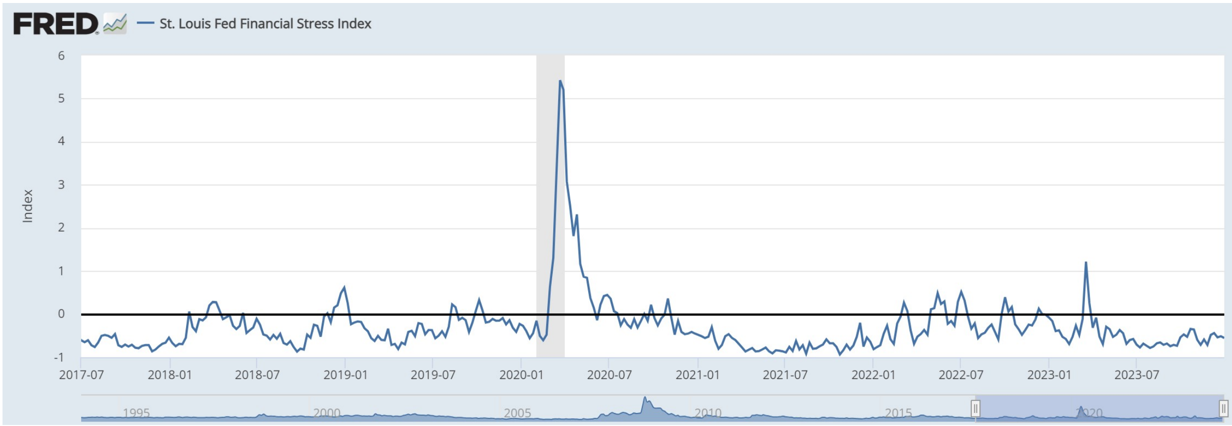
Some might ask what makes me think a recession is in our future? For me, it's the inverted yield curve, and the M2 money supply being restricted. The M2 money supply when healthy, grows at a gradual clip...right now it's stagnated.

Indicators

Special points of interest

- Yields—Normalizing?
- Financial stress—None
- EPS growth—upward
- Employment—strong
- Inflation —Normalizing

Financial Stress Index - Green



With all the talk of a potential recession looming, where's the stress in the financial system? The M2 money supply exploded upward from all the excess printing of cash during the pandemic, which is potentially masking issues under the surface. As a basic economic principal, people will not reduce their life style until forced to do so.....until the cash runs out. Financial stress might be looming under the surface of an over stimulated money supply.

S&P 500 P 500 EPS Trends - Green

S&P 500 EARNINGS FORECASTS: YRI VS ANALYSTS' CONSENSUS (12/26/2023)

Year / Quarter	a / e *	Yardeni Research - Level	y/y%	Analysts' Consensus - Level	y/y%
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	e	225.0	3.2	219.7	0.7
Q1	a	53.1	-3.1	53.1	-3.1
Q2	a	54.3	-5.8	54.3	-5.8
Q3	a	58.6	4.6	58.6	4.6
Q4	e	59.0	11.0	54.7	2.9
2024	e	250.0	11.1	244.0	11.1
Q1	e	60.0	13.0	56.3	6.1
Q2	e	61.0	12.4	60.0	10.5
Q3	e	63.0	7.5	63.6	8.5
Q4	e	66.0	11.9	64.3	17.6
2025	e	270.0	8.0	274.6	12.5

* a = actual / e = estimate

Here's where I have trouble with analysts calling for a recession in the first half of 2024, the simple math requires a massive black swan event. To have a recession you need 2 quarters, or 6 months of declining GDP, which normally translates to stalled out growth in EPS for the S&P 500 index. It's very difficult for the economy to be in a recession and the 500 largest companies are increasing their profits. For the USA to be in a recession by the summer, we have to be in a recession right now. The jobs picture, which you'll see on the next page is strong, earnings forecasts are positive, both indicating we are unlikely to be in a recession as I write this.

I do believe longer term forecasts for the EPS might be in jeopardy. Given that interest rates are still high, with no clear indication of cuts to come from the FED, the economy is likely running on fumes as the excess cash is drained out of the system, as evidenced by the M2 money supply. The primary question I hear get asked is, "If rates are too high, why aren't we in a recession yet?" The answer is simple...borrowed time. An overwhelming abundance of cash was printed during Covid, which fueled inflation, and is supporting the continued economic expansion. Will the FED be able to lower rates before stalling the economy? That's the million dollar question.

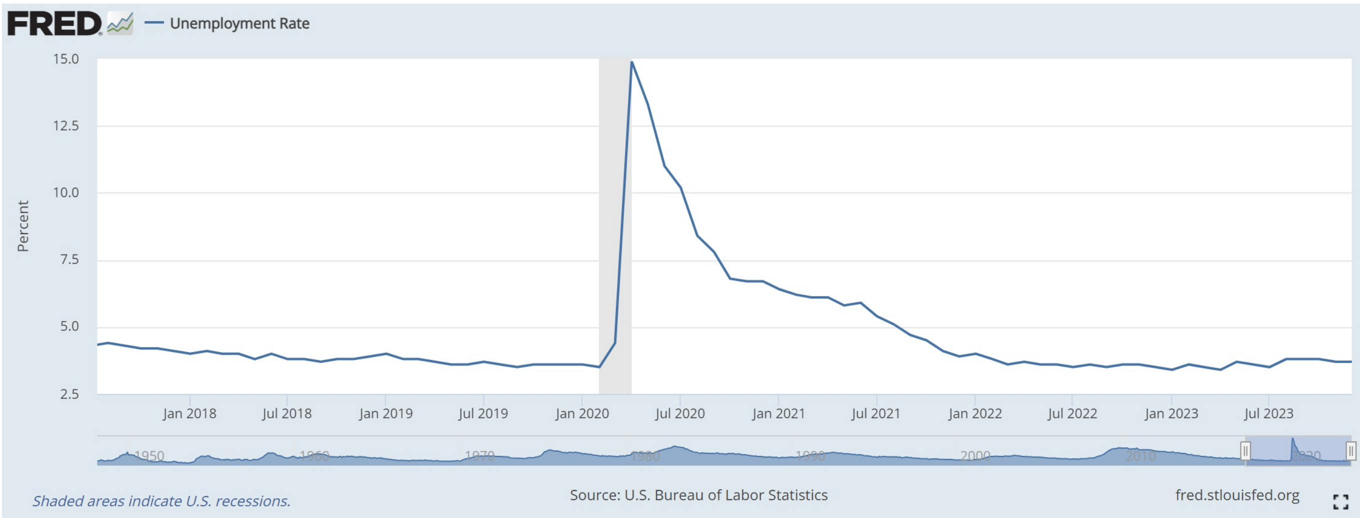
Table 1: S&P 500 Earnings YRI vs. Consensus Forecasts (10/2/2023)

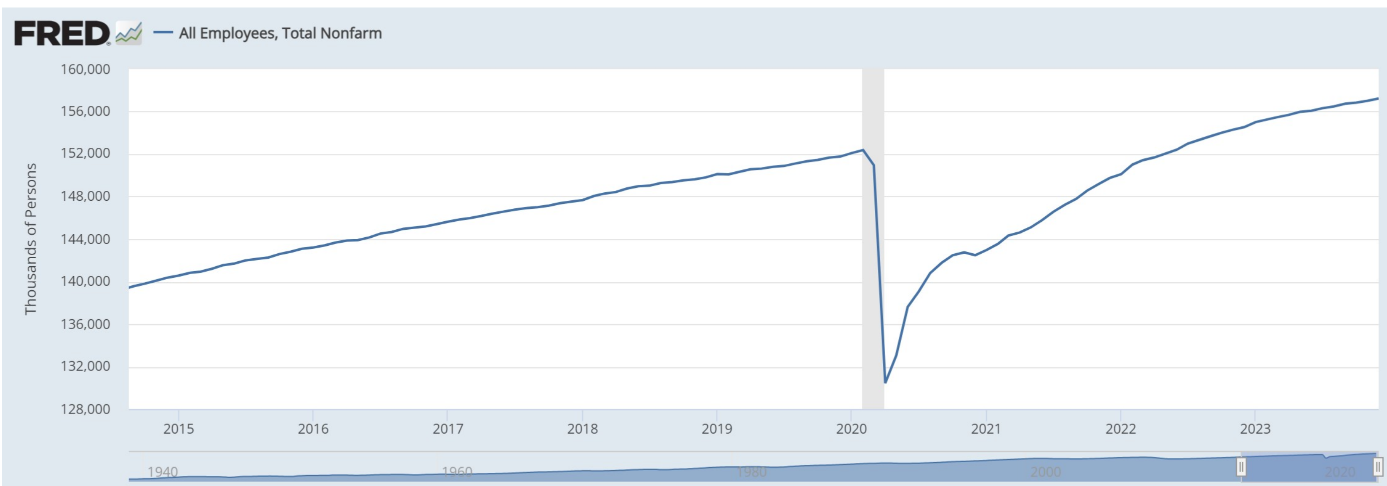
	Yardeni Research		Analysts' Consensus	
	Level	YOY %	Level	YOY %
2019	**162.93 a**	**0.6**	**162.93 a**	**0.6**
2020	**139.72 a**	**-14.2**	**139.72 a**	**-14.2**
Q1	33.13 a	-15.4	33.13 a	-15.4
Q2	27.98 a	-32.3	27.98 a	-32.3
Q3	38.69 a	-8.2	38.69 a	-8.2
Q4	42.58 a	1.4	42.58 a	1.4
2021	**208.12 a**	**49.0**	**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.

Labor Market—Green

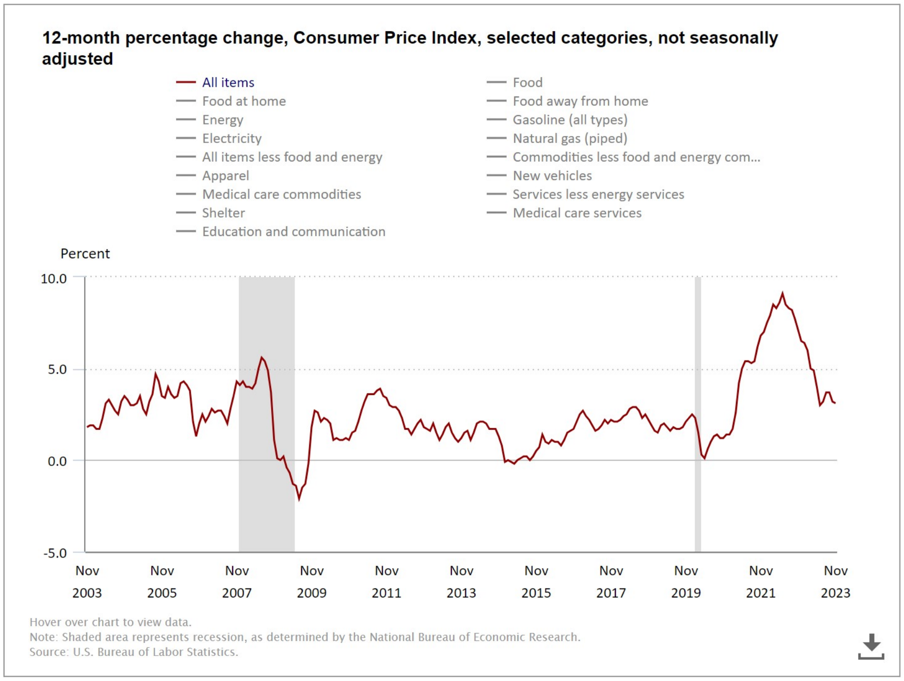




There's a bit of an interesting dynamic going on in the labor market. We haven't had a negative print yet on the jobs number, and yet the unemployment rate is slowly ticking up. This coupled with lower wage inflation is a positive sign that we are returning to the FED's desired 2% inflation target. A strong labor market is a solid sign that if we do get a recession it will remain shallow. Typically what we might see is a weakening labor market where unemployment spikes upward to 7-10% in the more severe downturns, and in the more mild recessions only reaching 5-7%. I could envision a scenario where we enter a recession and see unemployment increase from these levels to 5-6% before regaining a footing on economic stimulus via lower rates.

Keep in mind that 4-5% unemployment has long been considered full employment for the FED. Having this measure inch back towards that level is yet another sign that we are leaving overheated territory and approaching normal economic conditions.

Inflation—Yellow



Is the great inflation ride over? The chart and economic data suggest that the bulk of the inflation storm is behind us (fingers crossed). The easy part for the FED is over, and now begins their important work of "threading the needle" on rates. They will try to leave rates above normal to slowly bring inflation down to 2%, but leaving them elevated for longer than necessary could plunge us into a hard landing recession. Assuming this year we see inflation continue it's downward path, the FED should respond by lowering rates into the 4% range, and by 2025 they should be at a neutral rate of 2.5%-3.0%. If you look at the Dot Plot from the FED, the bulk of the dots for 2+ years out are indeed in that range.

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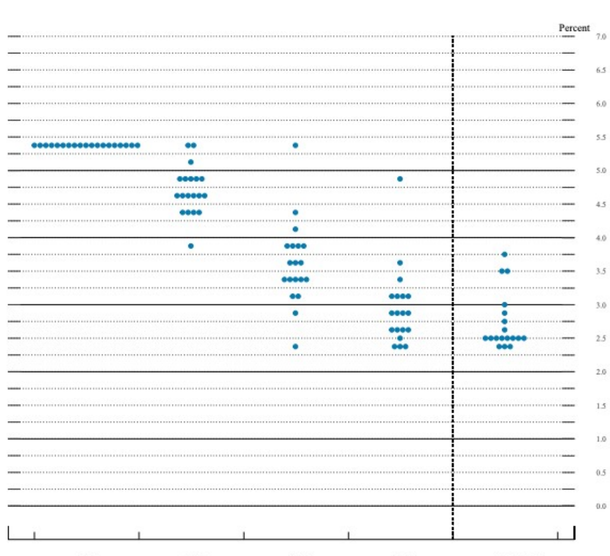
Figure 2. FOMC participants' assessments of appropriate monetary policy: Midpoint of target range or target level for the federal funds rate



Summary

I'll echo my previous comments that these high rates are not sustainable on the heels of a decade of ultra low rates. Underneath the surface there are many markets trying to recalibrate valuations which don't make sense at these high rates. Example being commercial office buildings financed with mortgages that have to be refinanced at rates double to triple the original. Given this sentiment, an area of interest to me is real estate ex office space. High rates have driven investors out of real estate in general when there are several areas with sound fundamentals like e commerce warehouses, data centers, cell towers and other smart infrastructure plays. If rates do eventually come down this year, this sector could benefit greatly.

References:

https://www.yardeni.com/pub/yriearningsforecast.pdf

https://fred.stlouisfed.org/

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

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

The above charts/data were produced by the St. Louis Federal Reserve, Yardeni Research, and BLS.gov.