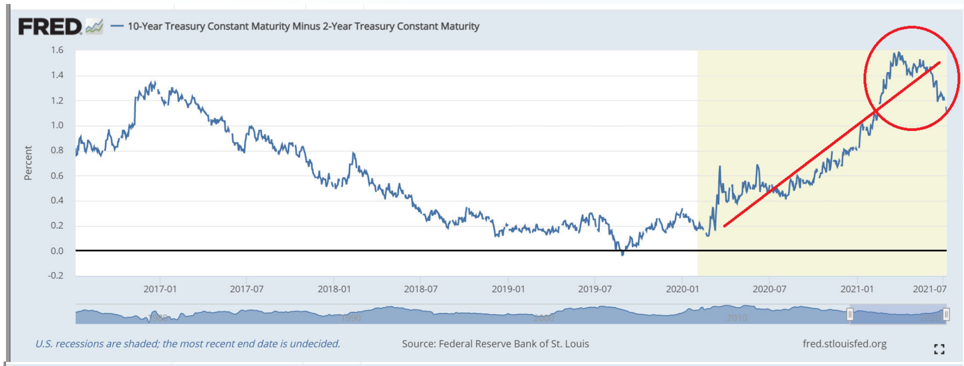
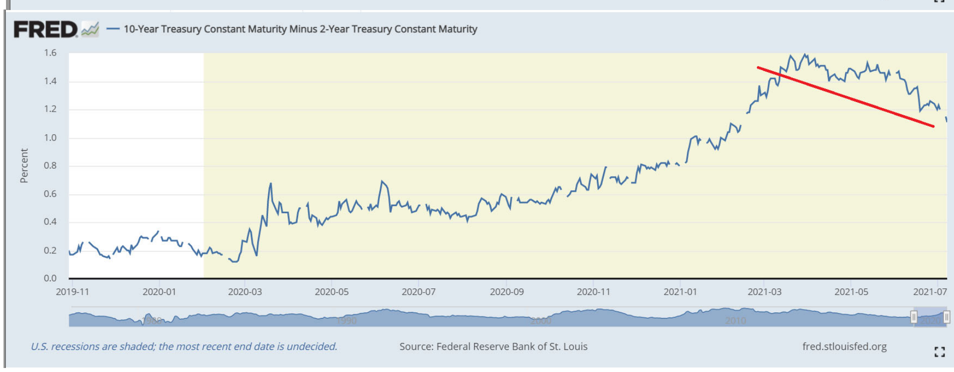
Liberty Sound Financial

06/30/2021
2021 Q2

Focus 5 Report

Yield Curve - Yellow





Houston, we have a problem! Rates have stalled out, and the 10-2 spread is tightening. How quickly the tables have turned from runaway, rampant inflation, to stalled global economic growth. Poof! Just like that, the value trade has faded and growth stocks are all the rage again.

I am not a professor of global economic forces on treasury bonds, but I do know that a jittery, whipsawed bond market ,is not a plus for equity markets. Equities like calm status quo bond markets that drift upward or downward slowly allowing market participants to adapt.

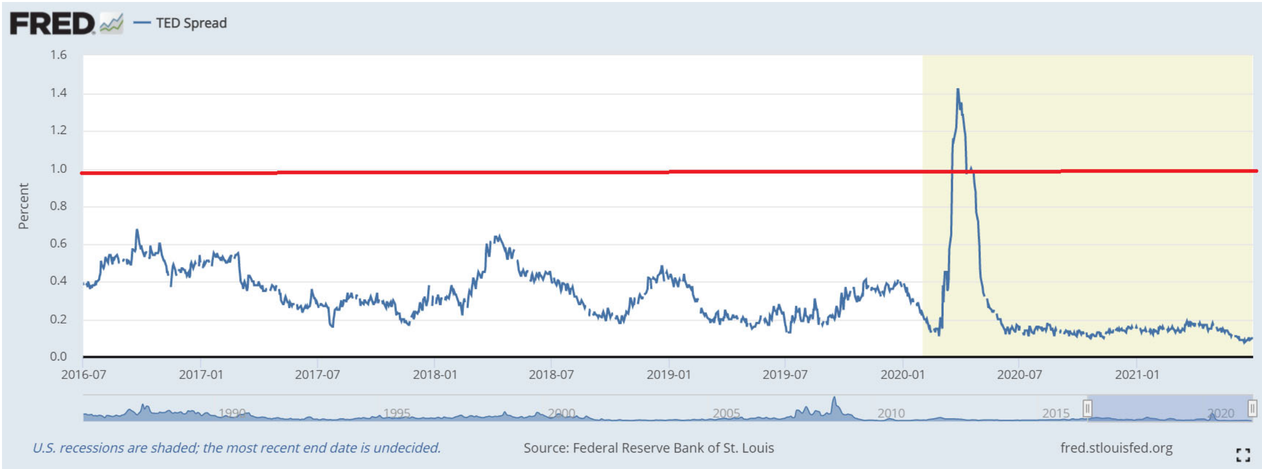
The good news is that the upward trend is still intact despite this pullback. In my opinion, the first chart shows the recent pullback is perhaps a balancing of the rapid increase preceding this drop. In economic terms, I would like to see a more robust widening of the 10-2 spread before it reverts lower. In an ideal world the spread will widen to a healthy peak before slowly drifting lower as the economic cycle wanes.

Indicators

Special points of interest

- Yield curve reverting?
- TED spread—No stress
- EPS growth—Exploding
- Employment is rising
- Inflation topping?

TED Spread - Green



No alarms here, the TED spread remains at historically low levels. Easy monetary policy and assistance programs have calmed fears of massive bank loan defaults. Though I can't help but wonder if commercial real estate, especially office buildings, will begin to struggle as workers shift to hybrid models full time. Rents could be pressured downward as firms utilize less space. This might reflect in the TED spread down the road if banks begin to experience defaults on office building mortgages that no longer make sense given the potential for permanently reduced rents. Building owners who refinanced in 2016-18 based those appraisals on rents that may not exist anymore, and thus the mortgages might not make sense.

S&P 500 EPS Trends - Green

S&P 500 Earnings: YRI vs. Consensus Forecasts (4/12/2021)

	Yardeni Research-post tax cut		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	**180.00 e**	**28.8**	**176.51 e**	**26.3**
Q1	43.00 e	29.8	40.11 e	21.1
Q2	43.00 e	53.7	42.24 e	51.0
Q3	46.00 e	18.9	45.88 e	18.6
Q4	48.00 e	12.7	48.39 e	13.6
2022	**200.00 e**	**11.1**	**203.10 e**	**15.1**

Up, up, and away! The earnings keep rolling in higher and higher each quarter. Last quarter EPS estimates were around 180, and now they're between 190 and 195.   We are on pace to explode past the earnings from 2019, which would be a huge milestone for the post covid stock market. There is still a chunk of society that is reeling from Covid, and still not back to work, as they return this could propel us even higher. EPS is firing on all cylinders and we are doing it at less than full employment.

A derailment in earnings could come from a Delta variant spike in the fall; though states seem very hesitant to issue lockdowns/restrictions, especially in the southern states. The economy is very flush with cash, so it has the ability to sustain a shock. The black swan events that concern me are a covid surge in the fall; and financial asset bubbles in crypto/meme stocks. The latter has the ability to rock the trust in the financial system and potentially freeze credit markets if it's large enough. Especially crypto scams, we could very well be in a Ponzi scam mania, we just don't know it. There already have been several large crypto Ponzi schemes that thus far have been small enough to be absorbed.   Time will tell.

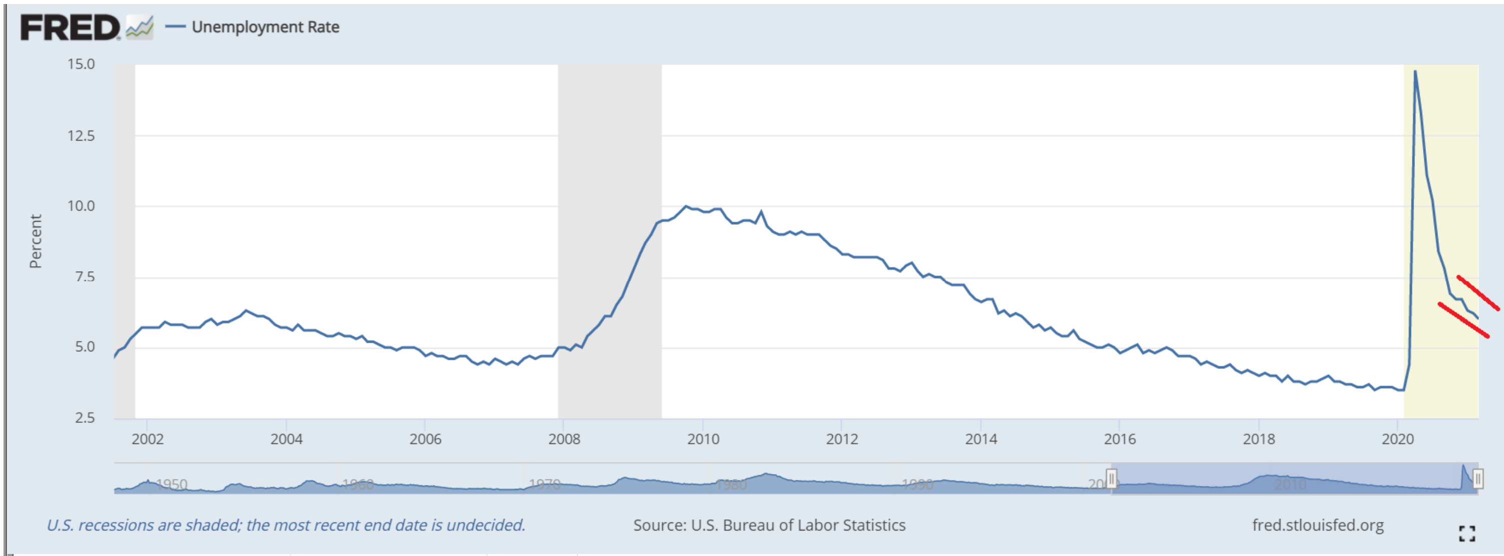
S&P 500 Earnings: YRI vs. Consensus Forecasts (7/5/2021)

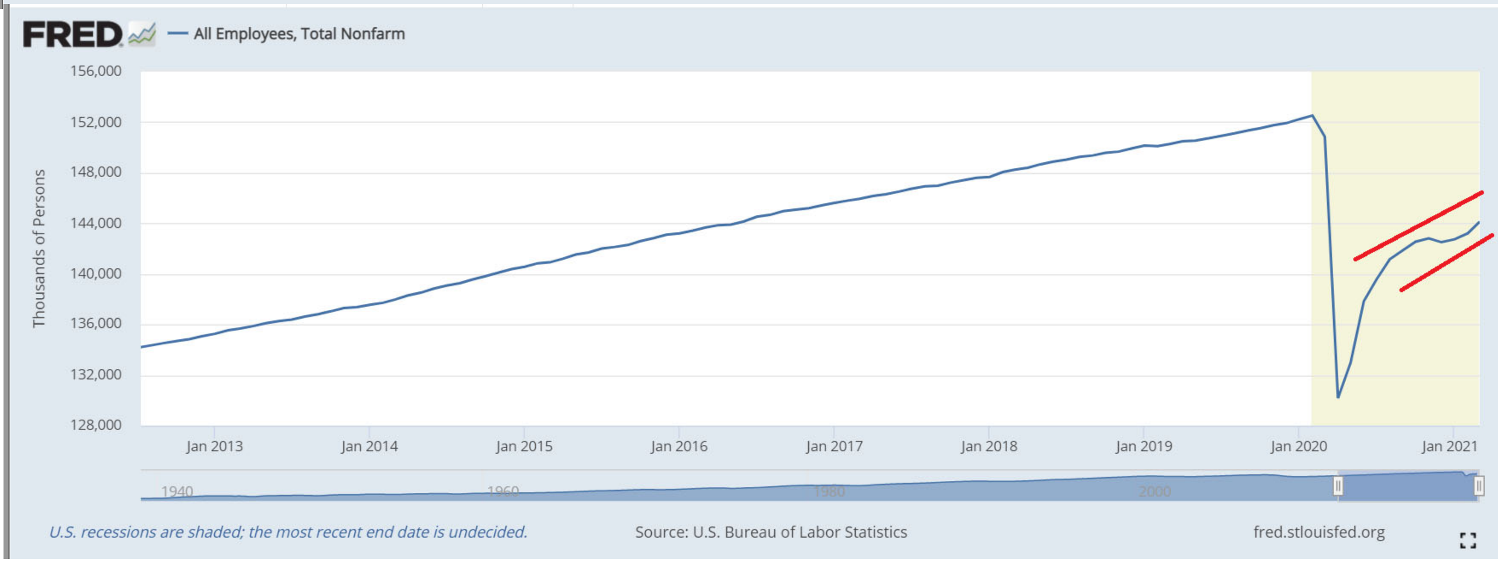
	Yardeni Research-post tax cut		Analysts' Consensus	
	Level	YOY %	Level	YOY %
2018	**161.93 a**	**22.7**	**161.93 a**	**22.7**
Q1	38.07 a	23.2	38.07 a	23.2
Q2	41.00 a	25.8	41.00 a	25.8
Q3	42.66 a	27.5	42.66 a	27.5
Q4	41.18 a	14.3	41.18 a	14.3
2019	**162.97 a**	**0.6**	**162.97 a**	**0.6**
Q1	39.15 a	2.8	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	**195.00 e**	**39.5**	**191.37 e**	**36.9**
Q1	49.13 a	48.3	49.13 a	48.3
Q2	46.00 e	64.4	45.07 e	61.1
Q3	49.00 e	26.6	47.61 e	23.1
Q4	52.00 e	22.1	49.78 e	16.9
2022	**205.00 e**	**5.1**	**213.76 e**	**11.7**

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

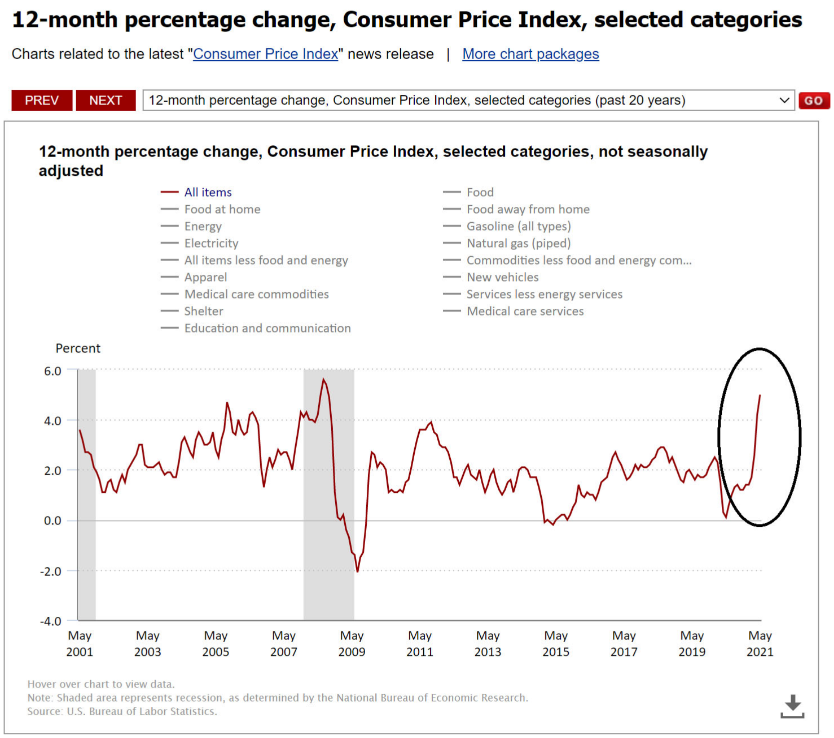




The south is open for business. I just got back from a family trip to South Carolina, and they are humming as if Covid never was. Political and scientific beliefs aside, their restaurants are full, their beaches are packed, their attractions are buzzing. The southern economy is in full swing. That momentum should carry over to the northern/coastal states as the reopening expands. The slowdown in jobs recovery, in my opinion, is the reluctance of the northern/ coastal states to fully re-open. When they do, we'll see the jobs recovery ramp back up. Technically there aren't many restrictions left in these states, but as a society, many people are reluctant to dine out and participate in activities on a pre-covid scale. We need that to fade as covid fades to resume a full jobs picture.

The employment picture is the key for our economy to return to normal and be sustainable. The training wheels, such as the expanded unemployment assistance, are coming off, and for us to ride on two wheels, we need people to be willing and able to work.

Inflation—Green



Inflation continues to climb higher, but this is a lagging indicator. I expect this chart to moderate in the next reading and that's because commodity prices have topped out. The huge one in the news has been lumber prices at Home Depot and elsewhere. Well the lumber futures price has come down 50%! The lumber futures index peaked at $1,500 in May and is now sitting around $750. That will reflect in building prices soon. China also released commodities from their strategic reserve to help moderate other prices, like copper. For the reasons mentioned above, I believe that supply chains will continue to reopen at 100% and drive prices back down to meet demand. Runaway rampant inflation in my opinion is off the table, and it's looking like the FED will be proven right on transitory inflation.

Remember, we want inflation around 2% or slightly higher. Looking at the chart, we have struggled for years to maintain that 2% mark. Running hot for a bit should not concern us. Though a tick up to 6% on the next reading would begin to make me nervous, and the FED might have to tighten sooner.

Summary

I am still worried about bubbles in Crypto currency and meme stocks. We've seen some stories billion dollar Ponzi schemes in crypto but they haven't been large enough to rock the system at large. A sizeable scheme has the potential to wreak havoc in the system. In other assets classes I remain bullish on tech stocks as we realize that the 5 day, 9 to 5 work week is gone. The hybrid model is here to stay, and so is the tech that goes with it. Value stocks will probably heat back up with the cyclical business cycle, but my base case remains that tech stocks will remain the winner long term, through a full business cycles. My reasoning is simple: They have a global customer base (borderless), and they already pay high wages (less wage pressure).

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.