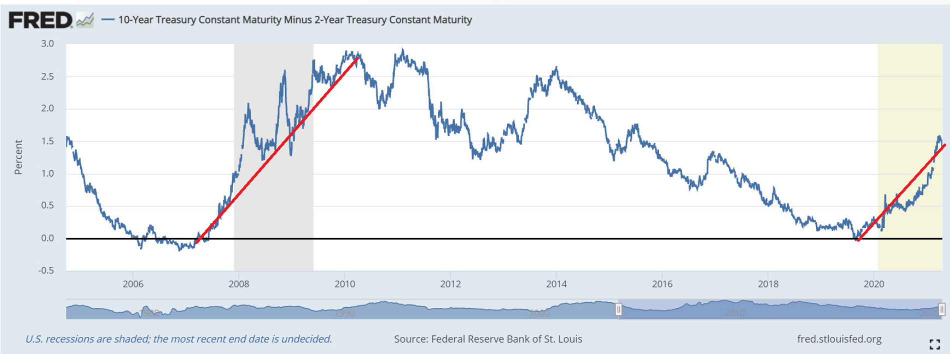
Liberty Sound Financial

12/31/2020
2020 Q4

Focus 5 Report

Yield Curve - Yellow (+)



For historical perspective, I've included the yield curve from the housing crash of 2008, where in hindsight every investor wished they had bought in at the top of the curve. In theory, in tough economic times the Federal Reserve pumps in liquidity via lowering short-term interest rates, and purchases in the bond market, thus spurring an economic recovery. Once the economy has found a footing, the Fed eases off their accommodative stance and begins to tighten. The easy money policies usually provide room to run for the economy to grow until there's another exogenous shock to the system. The conversation for another time is if whether removing the "punch bowl" creates a double dip recession, or if the Fed's actions are too much and create hyperinflation. There are many concerns, but as John Maynard Keynes once said, "In the long run, we are all dead."

My greatest concern continues to be overall low level of interest rates. The 30 year rate is still hovering around 2.25%, and the short end is essentially 0%. My caution on yields is that they are still too low and present a challenge to the market when they move higher towards more normalized levels…unless this is the new normal.

Indicators

Special points of interest

- Yield curve has steepened
- TED spread—No stress
- EPS growth—Above 2019
- Employment is rising
- Inflation has heated up

TED Spread - Green +

The TED spread remains at historically low levels, and the banking sector looks strong given the recent earnings reports. We've come a long way since this time last year when money market funds were beginning to freeze and credit spreads were widening even on high-grade corporate debt. There doesn't appear to be any stress in the banking system, which bodes well for financial markets given their ability to absorb small shocks.

The longer term questions for banks are how are the office building properties financed and who holds those mortgages? With employees working from home, some now permanently, those buildings were built with a perceived rent level that I'm sure does not exist going forward.

S&P 500 EPS Trends - Green

S&P 500 Earnings: YRI vs. Consensus Forecasts (1/11/2021)

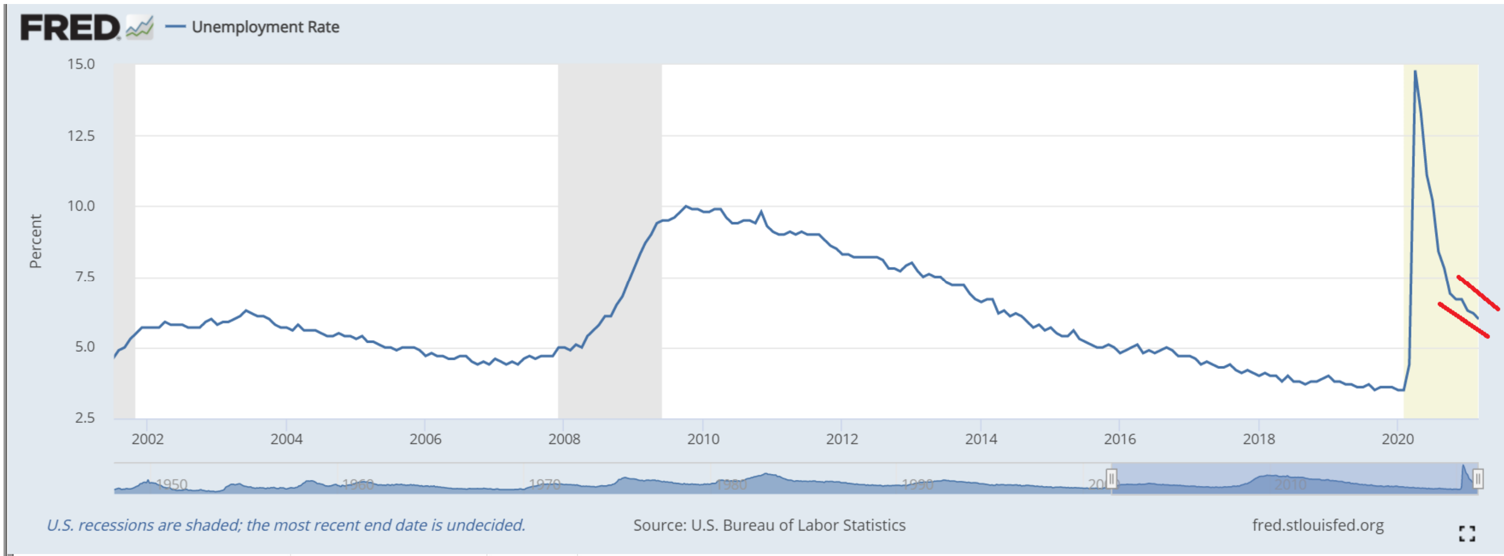
	Yardeni Research-post tax cut		Analysts' Consensus	
	Level	**YOY %**	**Level**	**YOY %**
2018	**161.93 a**	**22.7**	**161.93 a**	**22.7**
Q1	38.07 a	23.2	38.07 a	23.2
Q2	41.00 a	25.8	41.00 a	25.8
Q3	42.66 a	27.5	42.66 a	27.5
Q4	41.18 a	14.3	41.18 a	14.3
2019	**163.00 a**	**0.7**	**162.97 a**	**0.6**
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	**140.00 e**	**-14.1**	**135.79 e**	**-16.7**
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	39.20 e	-6.7	36.92 e	-12.1
2021	**170.00 e**	**21.4**	**167.61 e**	**23.4**
Q1	39.00 e	17.7	37.64 e	13.6
Q2	40.00 e	43.0	40.45 e	44.6
Q3	45.00 e	16.3	44.22 e	14.3
Q4	46.00 e	17.3	45.28 e	22.6
2022	**195.00 e**	**14.7**	**195.51 e**	**16.6**

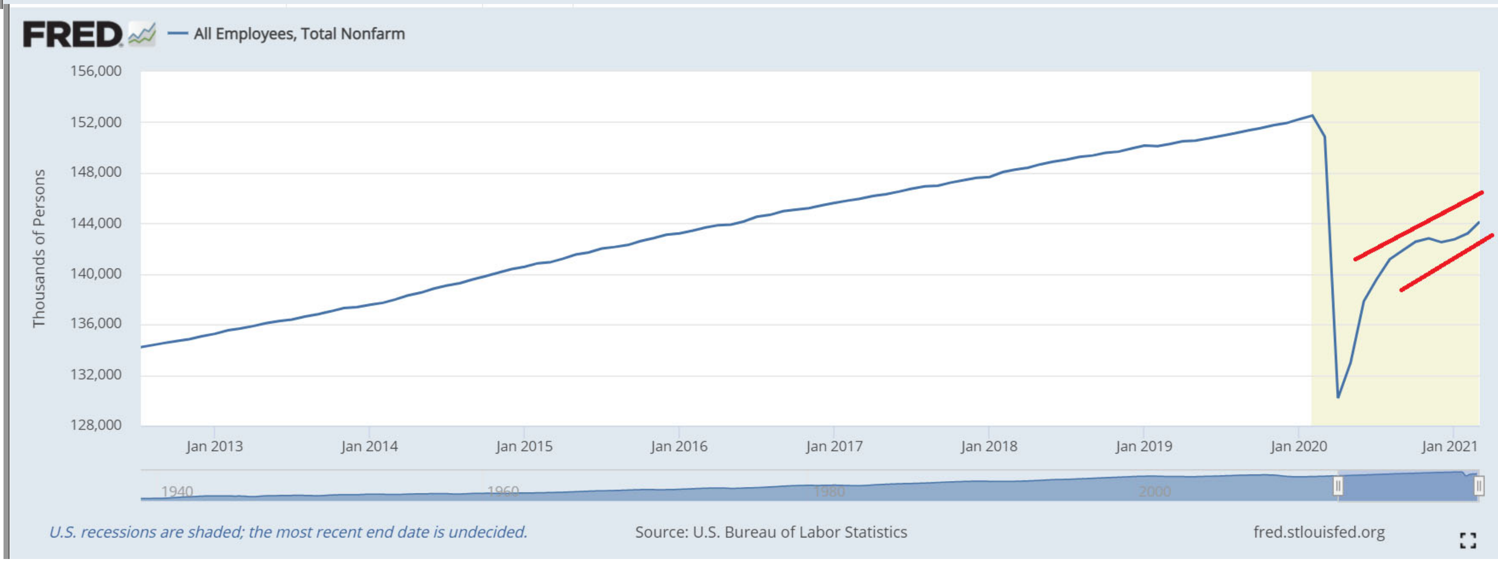
Earnings estimates continue to increase, even amongst the bears. What I'm keying in on are levels relative to 2019. Starting last quarter, Q4 2020, we reached and surpassed quarterly levels from 2019, and that's with the service sector still severely impacted by indoor dining restrictions. The bears will say that these numbers are inflated from the stimulus bills and Fed actions, which is true to some degree, but remember 80% of the workforce remained employed and accrued extra savings from gas, parking, dining out, etc. These funds are now surfacing as the economy reopens. The question we have to ask ourselves, is the American consumer flourishing? The answer is yes. Our economy is based heavily upon the American consumer, 70% so! Unfortunately there is 20% of the employment pool who have suffered greatly, and continue to do so, which is why fiscal and monetary policy will stay accommodative despite a strong initial recovery. Before Covid became a global pandemic, the Fed showed patience in tightening because they wanted to pull those left behind with the rest of the recovery. This is the path I expect moving forward as well. They will let the economy and inflation run hot in an effort to pull up those hurt most by the pandemic. I am very bullish on earnings because as vaccines take hold and the Fed remains accommodative, global business will return to a more normal pre-pandemic level….justifying levels bears call inflated.

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**

Labor Market—Yellow+

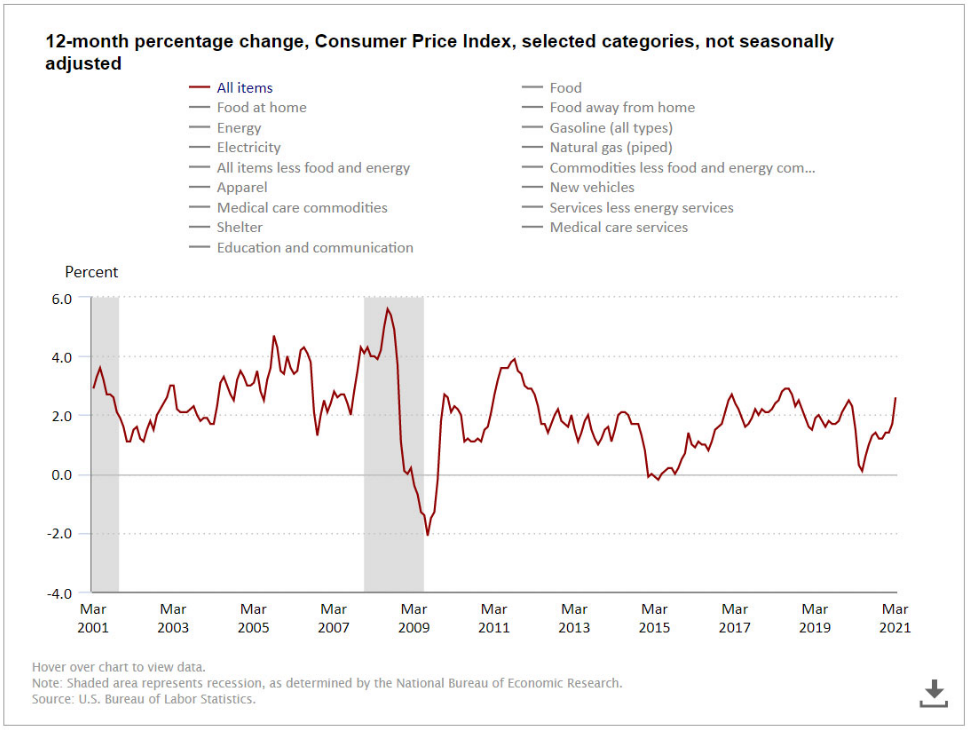




There was stagnation in the recovery efforts in my last writing, as the employment sector had leveled off. As you can see from the red channels above, the labor market has thawed and more people are getting back to work. What's interesting is that earnings are back to pre-pandemic levels, but employment is far from it. We've made a strong comeback, but we are only at employment levels last seen in late 2016. The trend shows potential for a full employment recovery by year end. Financial markets are forward looking, and I believe the optimism for the labor market recovery by year end is baked into the stock market.

I have this signal at yellow and not green beacuse I am worried about Covid variants that will dampen the recovery and postpone the leisure travel so many desperately want to resume. The UK strain is now the most dominant in the USA, but it's the South African variant which has shown resistance to the vaccines that worries me the most. My baseline is that we all need a booster shot in the fall to cover variants, which would slow down our recovery but not stop it.

Inflation—Green



Inflation is here, and it's back in a big way. As a consumer you may not see it yet, but everything tied to the housing market is experiencing rapid price increases (lumber, appliances, HVAC, etc.) I view this a positive. We as an economy and as a nation need inflation to be at 2% or even slightly above to prevent us from sliding into disinflation. Just like every other aspect in this recovery there is a rapid snap back, which makes the numbers appear rather large, but in reality they will taper back down to a long-run average. The Fed has been echoing this sentiment every chance they get. While they are seeing high inflation data now, they view it as transitory. The Fed for the last several years has tried to get inflation to rise above 2% and remain there. Having failed to do so, they are prepared to let inflation run hot. "Perma-bears" always point to our exploding debt as a negative, but that debt is financed at ultra low rates, and they forget inflation has the ability to combat that. I believe that our current inflation is healthy, and needed, and should have a watchful eye on it, but that no real action is needed right now.

Summary

My fears from the last newsletter played out as “mini bubbles” burst in the Electric Vehicle space, fueled by the boom in SPACs. I still have concerns in the “easy money” areas of the stock market, as investors pour their stimulus checks into meme stocks not based on fundamentals. While I personally believe in the potential of crypto currencies, their sizable position and variability could create a market correction on a “bitcoin crash”. That being said, there’s a famous saying, “Don’t fight the fed.” With easy monetary and fiscal policies in place, we are setup for an economic recovery.

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.