Liberty Sound Financial LLC

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Q3 2026

Focus 5 Report

Executive Summary of Market Conditions & Outlook

We are living through one of the most paradoxical market environments in recent memory. On paper, the headwinds are formidable: yields sit at multi-decade highs, energy costs have re-accelerated, and inflation remains stubborn enough to keep the Federal Reserve on high alert. Yet, despite this wall of worry, equity markets continue to demonstrate remarkable resilience and grind higher. What is actually driving this persistent strength behind the scenes? The answer lies in an unprecedented wave of capital expenditure powered by AI hyper-scalers. Technology giants are pouring hundreds of billions of dollars directly into physical infrastructure, generating an immense real-economy stimulus that is actively counteracting monetary tightening and providing a powerful floor for corporate earnings.

While this expansion might be hard to perceive from coastal financial hubs, the American Heartland is experiencing a genuine blue-collar and industrial awakening. I was reminded of this dynamic at a recent First Trust luncheon, where a lead bond manager shared a telling anecdote: family members of his who own a regional water and sewer contracting business are currently seeing record demand, driven largely by massive utility infrastructure contracts with Amazon Web Services. This is real, ground-level stimulus building the backbone of the future economy. At the same time, the manager highlighted that mid-duration bonds are currently offering real yields 2% to 3% above expected inflation—one of the most compelling entry points for fixed income in decades. This structural yield cushion reinforces the market's underlying conviction that core inflation will continue to cool over time.

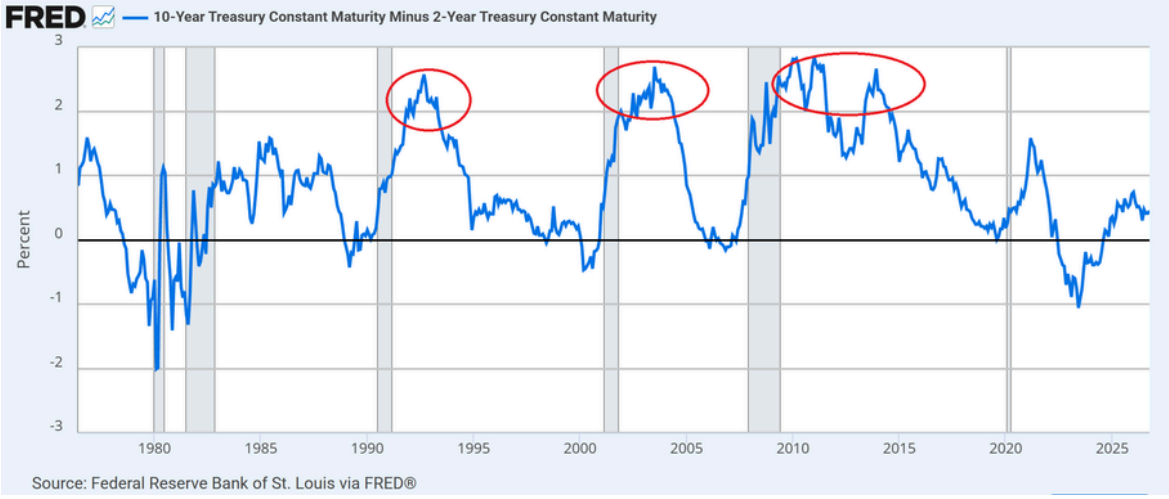
Like every major economic cycle throughout history, this capex boom won't last forever. However, the timing of this infrastructure spending serves as a crucial economic bridge through a tight monetary environment. The ideal scenario—and one that is increasingly taking shape—is that by the time this initial hardware and data center buildout matures, headline inflation will have fully settled, interest rates will be lower, and energy supply constraints will have eased. That combination would allow the economic torch to be passed smoothly from heavy industrial buildouts to broader market productivity, fueling the next leg of sustainable expansion.

Indicators

Yield Curve.....2
Financial Stress.....3
Earnings.....3-4
Employment.....5
Inflation.....6

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Yield Curve—Positive



The current 10-2 Treasury yield spread sits at roughly +45 basis points (0.45%) as of early October 2026, signaling that the curve has fully normalized after its historic 2022–2024 inversion. The fact that this prolonged inversion never materialized into a recession suggests the indicator's once-flawless predictive power misfired in this economic cycle.

Why the Signal Misfired

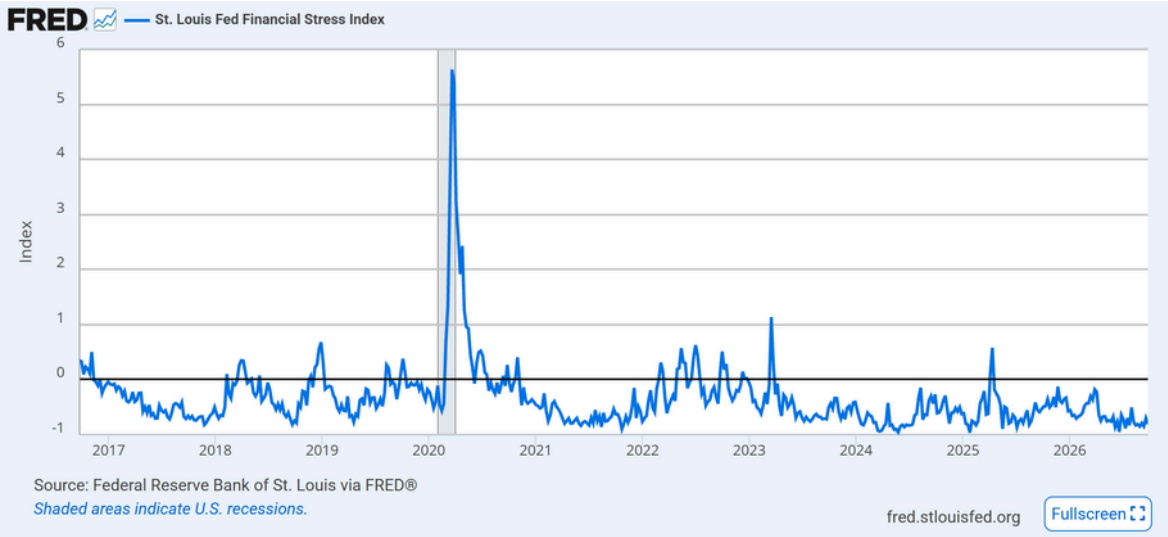
Market analysts largely agree that structural market changes distorted the yield curve's traditional signal over the last few years:

- Term Premium Compression: Years of quantitative easing (QE) and heavy global demand for safe-haven assets artificially anchored the 10-year yield, keeping long-end rates lower than they historically would be.
- Inflation Dynamics, Not Credit Crunches: The inversion was driven by the Fed aggressively hiking short-term rates to fight post-pandemic inflation, rather than the bond market pricing in an imminent economic collapse.
- Corporate Resilience: Companies locked in ultra-low, long-term debt in 2020 and 2021, insulating them from the Fed's short-term rate hikes and preventing the default cycles and mass layoffs that usually force a recession.

The Verdict: Bullish

In the current macroeconomic environment, a 50-basis-point positive spread is bullish. Instead of steepening because the Fed is panicking and slashing rates to save a dying economy (a "bull steepener" that often precedes recessions), the curve has normalized alongside robust economic activity—the textbook definition of a soft landing. A positive, upward-sloping yield curve restores the traditional banking model of borrowing short and lending long, supports credit creation, and generally provides a highly favorable backdrop for equities and growth assets.

Financial Stress Index—Positive



The STLFSI specifically tracks core financial plumbing—such as yield spreads, interbank lending rates, and institutional credit availability—rather than standard equity volatility. While the Iran war introduced temporary inflation spikes and elevated defense costs, it did not restrict commercial liquidity or seize up credit markets, allowing the systemic stress index to remain firmly in negative territory throughout the year. Behind the scenes we are watching for signs of distress from the SAAS sector, which has yet to materialize in a meaningful way.

S&P 500 EPS Trend—Positive

S&P 500 EARNINGS FORECASTS: YRI VS ANALYSTS' CONSENSUS (10/2/2026)

Year / Quarter	a / e *	Yardeni Research - Level	y/y%	Analysts' Consensus - Level	y/y%
2025	a	271.3	11.8	271.3	11.8
Q1	a	63.1	11.5	63.1	11.5
Q2	a	66.7	10.4	66.7	10.4
Q3	a	72.8	15.1	72.8	15.1
Q4	a	72.9	12.1	72.9	12.1
2026	e	375.0	38.2	363.5	34.0
Q1	a	75.0	19.0	75.0	19.0
Q2	e	100.5	50.7	100.3	50.3
Q3	e	96.0	31.9	89.8	23.4
Q4	e	105.0	44.0	93.4	28.2
2027	e	425.0	13.3	419.3	15.4

* a = actual / e = estimate; ** 2026 earnings includes MTM gains from Alphabet and Amazon during H1.
Source: LSEG Datastream and © Yardeni Research.

The S&P 500 Priced to Perfection

Financial conditions are remarkably loose, geopolitical shocks have been absorbed with minimal systemic damage, and corporate earnings forecasts look extraordinary. Wall Street consensus—led by aggressive targets like Yardeni Research's $375 EPS for 2026 and $425 for 2027—paints a picture of unstoppable corporate execution. Profit margins are projected to expand toward record levels of 16.7% to 16.9%, fueled by AI infrastructure build-outs and sustained tech sector dominance.

However, for investors, a critical question emerges: If the market already expects perfection, how much upside is actually left?

Key Risks on the Horizon

If the market is priced for flawless execution, what breaks the narrative?

- AI Capex ROI Fatigue: Hyperscalers continue to spend hundreds of billions on semiconductor and data center infrastructure. If monetization timelines for AI applications slip from 2026 into late 2027 or beyond, profit margins will face immediate downward revisions.
- Sticky Capital Costs: While financial stress indices (like the STLFSI at $\approx. -0.80$) show low systemic fear, 10-year Treasury yields hovering above 4% mean capital remains significantly more expensive than during the pre-2022 era.
- Asymmetric Risk/Reward on Earnings Days: In a "priced to perfection" environment, companies that beat earnings estimates receive modest bumps, while those that miss or offer slightly conservative guidance face severe single-day selloffs.

The Bottom Line for Investors

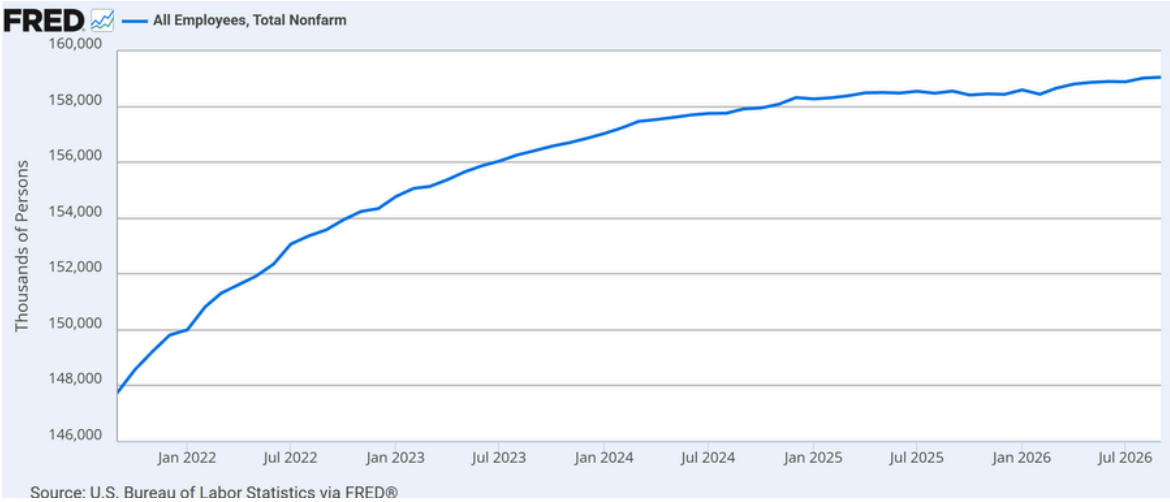
A strong economy and record earnings are undeniably positive, but a great company is not always a great stock if you pay too much for it. With forward growth already reflected in current index levels, market upside from here will likely depend less on multiple expansion and more on strict operational execution. **Investors should consider prioritizing quality balance sheets, sustainable free cash flow, and disciplined risk management over chasing high-beta momentum at peak valuations.**

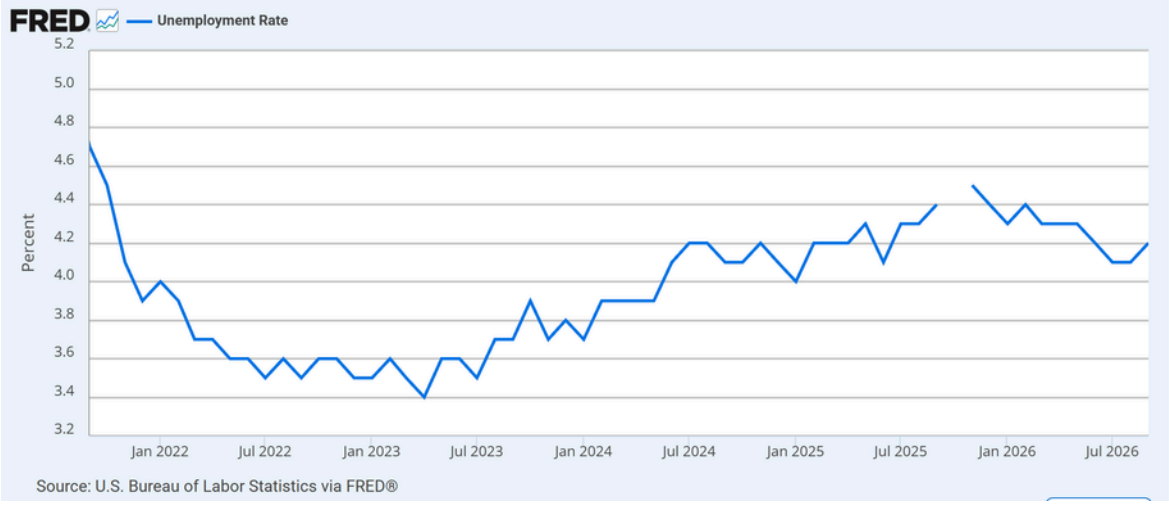
S&P 500 EARNINGS FORECASTS: YRI VS ANALYSTS' CONSENSUS (6/26/2026)

Year / Quarter	a / e *	Yardeni Research - Level	y/y%	Analysts' Consensus - Level	y/y%
2024	a	242.7	9.7	242.7	9.7
Q1	a	56.6	6.6	56.6	6.6
Q2	a	60.4	11.3	60.4	11.3
Q3	a	63.2	8.2	63.2	8.2
Q4	a	65.0	13.7	65.0	13.7
2025	a	271.3	11.8	271.3	11.8
Q1	a	63.1	11.5	63.1	11.5
Q2	a	66.7	10.4	66.7	10.4
Q3	a	72.8	15.1	72.8	15.1
Q4	a	72.9	12.1	72.9	12.1
2026	e	330.0	21.6	339.8	25.2
Q1	e	75.0	18.9	75.0	19.0
Q2	e	80.0	20.0	80.9	21.3
Q3	e	85.0	16.8	87.8	20.7
Q4	e	90.0	23.5	91.1	25.0
2027	e	375.0	13.6	398.9	17.4

Source: LSEG Datastream and © Yardeni Research. * a = actual / e = estimate

Labor Market–Neutral

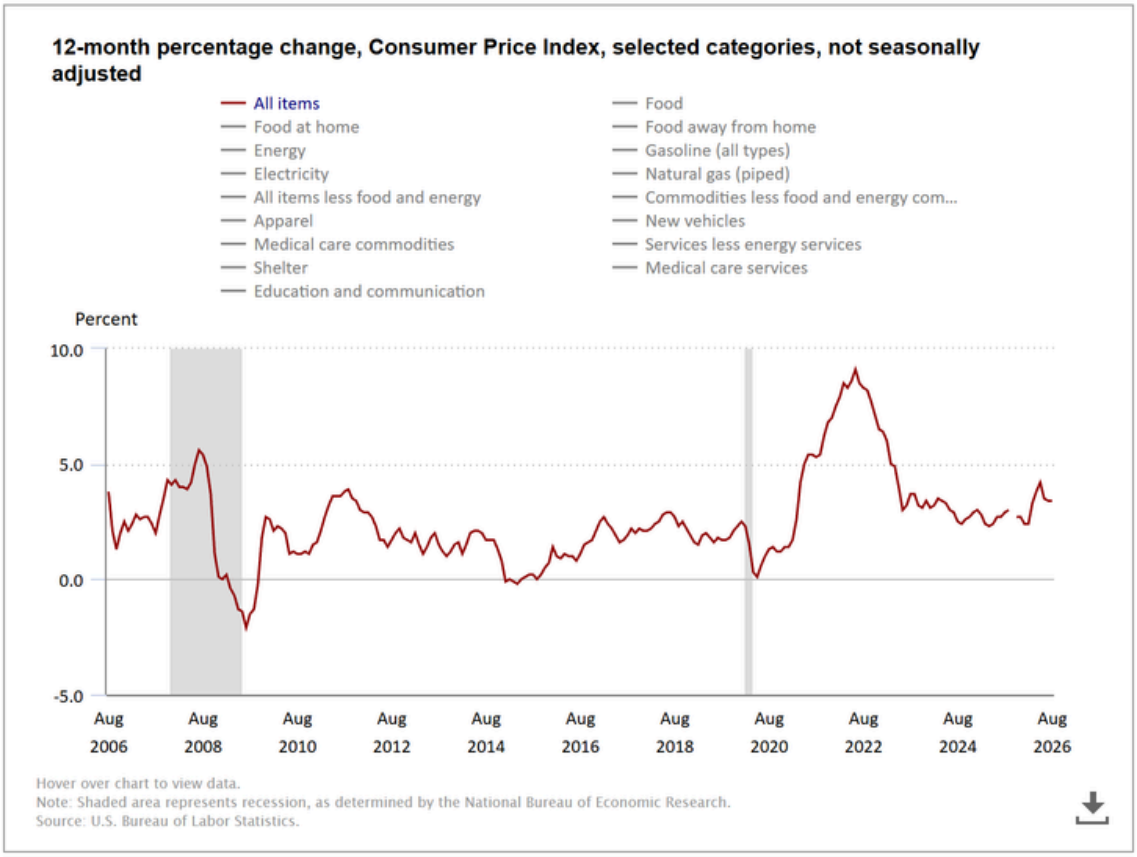




The steady rise in unemployment to 4.2% alongside a flattening total employment trendline signals a labor market settling into a "low-hire, low-fire" equilibrium rather than an acute economic collapse. Businesses are largely hoarding existing talent while sharply curbing new hiring, keeping job creation near replacement levels. While this reflects underlying economic stability rather than a structural breakdown, the lack of employment expansion naturally caps top-line volume growth across the broader economy.

For the Federal Reserve, this labor market deceleration should effectively closes the door on further monetary tightening, forcing a tactical pause. Trapped between sticky headline inflation driven by elevated energy prices and a clearly cooling labor backdrop, the Fed has little runway for additional rate hikes without risking a sharper contraction. In this environment, corporate earnings growth will increasingly depend on margin expansion and operational efficiency rather than broad economic momentum, favoring high-quality, cash-flow-resilient companies.

Inflation-Neutral



Cooling Disinflation: Headline and Core Trajectories

Recent Consumer Price Index (CPI) data confirms that the broader disinflationary process remains on track. Both headline CPI and core CPI—which strips out volatile food and energy components—have continued their downward drift. This cooling trend is being driven by a combination of declining core goods prices, easing vehicle valuations, and the ongoing, albeit gradual, deceleration in shelter inflation. While short-term energy fluctuations can introduce noise into headline figures, the underlying core trajectory shows clear evidence that price pressures are continuing to abate across the economy.

Implications for the Federal Reserve

For the Federal Reserve, the steady downshift in core inflation is a welcome development that provides significant policy flexibility. When paired with a cooling labor market—where the unemployment rate has drifted up to 4.2%—moderating inflation strips away the hawkish justification for further monetary tightening. As nominal inflation declines, passive tightening occurs because real (inflation-adjusted) interest rates become increasingly restrictive. This shifts the Fed's focus away from aggressive rate hikes and toward protecting the labor market, setting the stage for a more neutral policy stance or eventual rate cuts.

Perspective: A Far Cry from 2022 Highs

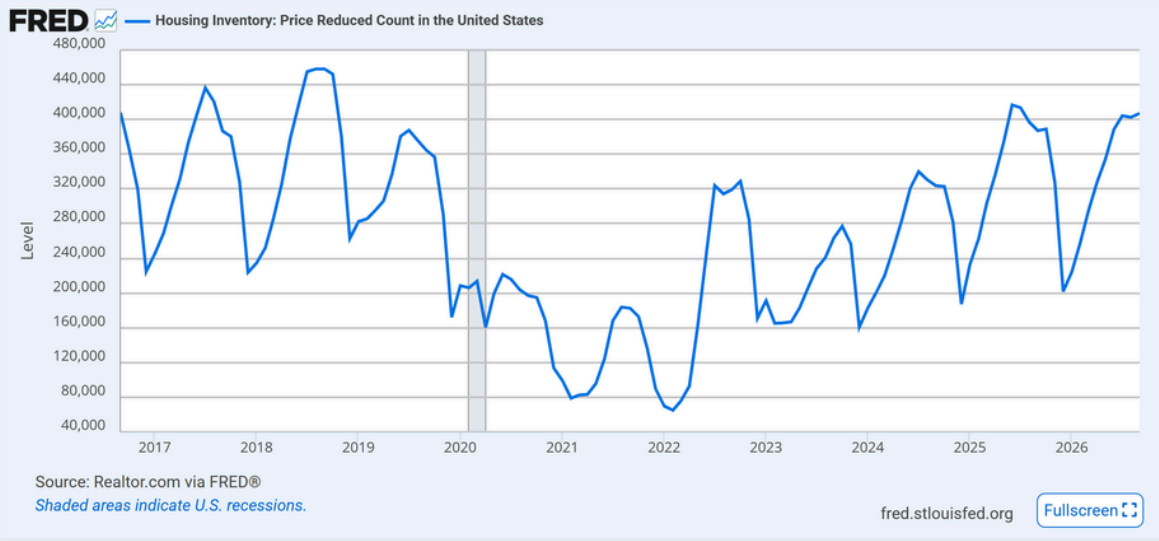
While inflation has not yet fully settled at the Fed's 2.0% target, it is critical to keep today's numbers in historical context. Although current price levels remain somewhat elevated, they are a far cry from the multi-decade spikes seen in mid-2022, when headline inflation peaked above 9.0% amid severe supply chain dislocations and global energy shocks. Today's macroeconomic landscape reflects a vastly normalized supply-demand equilibrium rather than the acute inflationary crisis of recent years.

Summary

Over the short term, the macroeconomic setup continues to favor a market that grinds steadily higher rather than experiencing a sharp valuation breakdown. The primary structural tailwind remains the clear disinflationary trajectory at the core level. As real-time softening in housing—particularly across Sunbelt and secondary markets where heavy multi-family supply has driven down asking rents—continues its mechanical roll into official CPI shelter prints, core inflation should keep cooling. This persistent easing in core price pressures effectively neutralizes the threat of additional Federal Reserve monetary tightening, establishing a stable policy backdrop for risk assets.

At the same time, the underlying economic engine remains remarkably durable, anchored by the relentless buildout of AI infrastructure. Massive, committed capital expenditure from major hyperscalers is providing a powerful floor for corporate earnings and broader economic activity. Far from being a localized tech phenomenon, this historic capex cycle is generating broad multi-industry spillovers across memory, semiconductor equipment, power generation, and industrial hardware. With core inflation trending downward to give the Fed breathing room and hyperscaler spending reinforcing economic growth, the path of least resistance for equity markets remains upward.

I included a chart below, which demonstrates that the housing market data is beginning to soften. The inputs the Fed uses lags by 9-15 months. The chart depicts that price reductions on active listings are significanlty higher than past years, and the trend line is tilted upwards.



References:
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