

Episode 14

The Caldwell Hour: Inflation, interest rates and international affairs

Ryan Caldwell (00:00:04):

This is the FS Chiron FireSide chat for the month of August. This is Ryan Caldwell. And today I'm joined by my colleagues, Scott Sullivan, Brian Cho, Lara Rhame and Peter Bianco. Good afternoon, everybody.

Scott Sullivan (00:00:22):

Good afternoon.

Peter Bianco (00:00:24):

Good afternoon.

Lara Rhame (00:00:25):

Hey, how's everyone doing today?

Ryan Caldwell (00:00:28):

Well, Lara, I thought what we would do today for our listeners, it's been a minute since we podcasted. A whole lot has gone on, I would argue over the last quarter. And where we last left our listeners off I believe we were in the middle of the roaring 20s hyperinflation cycle. And we were trying to gauge just how high interest rates were going to go, before the end of the world came.

Ryan Caldwell (00:00:56):

And much to form, that's all reversed. And so here we are sitting in August, with markets that have been actually quite good. If you look at the cap weighted indices globally, they've actually been pretty good. Underneath the surface, however, it's been actually a pretty rough quarter. I would argue it's been fairly analogous to spots in 2019, spots in 2018, spots in 2017. And we're going to try to dive into that a little bit today.

Ryan Caldwell (00:01:27):

And where I wanted to start off with our highly esteemed chief economist was with the economic outlook, and the inflation outlook. Because quite honestly, outside of again, a couple of pockets over the last three or four years, I can't remember a tape that is as macro driven as this tape. It really is, it's all about sort of where growth rates are going to land, and where inflation rates are going to land around those growth rates. And it's gotten quite controversial.

Ryan Caldwell (00:01:57):

So I thought maybe to kick off the podcast where again, we will talk a bit about economics, we'll talk about geopolitics, we're definitely going to get into our own quant work. And then ultimately, Scott and team kind of what they're seeing on the fundamental side. But Lara, I

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wanted to kick off with you, because you've just come off writing a piece kind of talking about these issues, particularly about U.S. growth rates, into the next six to 12 months. Which were in that kind of critical window, and then partnering that with the inflation call, because those seem to have been the two big calls that Wall Street's wanted to make.

Ryan Caldwell (00:02:34):

And so maybe, Lara, can you kind of kick off for us this dilemma, if you will, if you had just dropped in from another planet, which, by the way, it looks like you very well could have given all the evidence we're getting recently on UFOs. If you just dropped in from another planet, and you said consensus growth for 2022 is somewhere a touch under 6%, maybe right around 6%. Yet, here we are with a 10 year bond at 125. And that seems to have caused a lot of consternation for market participants, policymakers and politicians. And so maybe can you kind of kick us off as to what's going on?

Lara Rhame (00:03:18):

Yeah, sure. I mean, I think that is... So I see three sort of systems right now that a lot of people feel are internally contradictory. And I think that's where the interest rate picture gets so interesting. And people are getting it so wrong. Because you've got on the surface are the numbers, certainly would tell you have this incredible, incredible growth rate. 2.6%, more than three times our underlying potential growth rate.

Lara Rhame (00:03:53):

So zooming economy, still, even with this, sort of beginning of mild deceleration. Zooming economy. You had inflation, obviously shockingly, high, 5.5%, that's not going to last, it will just year on year come back down. I think what we're seeing on the inflation front, where there's such a spirited discussion right now is it's kind of bubbling up from all these different places. From supply side shock, from just simply too much demand, too many goods. Too much money chasing too little goods.

Lara Rhame (00:04:26):

You're getting inflation from commodities, you're getting it from wages, you're getting it from all these different fronts. So while it won't stay 5.5% it will likely settle at something higher than the 2% decade average we've all grown to love as investors over the last 20 years.

Lara Rhame (00:04:44):

And then the third system is this interest rate system and which is still negative real rates. Negative 100 basis points, you got the ten year, whatever it is today, 125. And you've got the 10 year breakeven, the breakeven at 2%, 2.5%. So that interest rate picture is the one that is so seemingly out of whack. And a lot of people look at these three things and they say interest rates have to adjust higher. That's the narrative.

Lara Rhame (00:05:18):

And I push back on this for the following three reasons. One, we're looking at a global environment of wildly uneven growth rates. And I know Ryan, you've got a lot to say about that. So I'll just say that increasingly, any headwind to global growth is quite a hit US rates first.

Lara Rhame (00:05:39):

Second of all, you see these negative interest rates from around the world, anytime US interest rates rise a little bit, you're going to have just international interest in those higher rates. So it's a naturally correcting mechanisms. And third, you have policy, not just in the US, but globally, that is specifically keeping interest rates low. That is, these high negative real rates are a policy choice by the Fed. And that I think is probably going to continue longer than most investors

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expect. So that's the framework, those are the three systems I'm looking at. And where I say markets are getting it wrong in the interest rate front.

Ryan Caldwell (00:06:19):

There's a couple of things I wanted to grab onto there that you pointed out and maybe talk a little bit about the price action, if you will, in the quarter as well. And Lara, you highlighted the really negative real rates. And that really came back into the forefront in this quarter. And one of the things that we tried to do is tie together some of the macro outcomes with what gets priced.

Ryan Caldwell (00:06:43):

And what was so interesting in the quarter is, and I think Lara brings up a really good point. On growth rate relative to what's transitory versus sticky inflation, the market's really unconvinced by the growth rate. And the only reason I say it's unconvinced by the growth rate is back to Lara's point about once, it was pretty clear, we were going to stay in pretty negative real rate, the market went right back to carrying growth stocks, instability.

Ryan Caldwell (00:07:12):

So it went from again, roaring 20s, hyperinflation to the points Lara brought up. That a lot of that just wasn't realistic over a longer period of time. And so whether you want to call it transitory, or supply shock, or whatever, we have this excess rate of growth, this excess rate of inflation. They're both going to come down. To Lara's point, we're likely not crashing back to pre-COVID like rates of inflation, but the market is pretty negative, that we're really changing the trajectory of the growth rate.

Ryan Caldwell (00:07:51):

And like I said, how do I observe that because I look at stable versus cyclicity. And when I say immediately the tape went back to rewarding the Googles and Facebooks and Apples, the big mega cap cash compounders, that to me, tells me the markets very skeptical of the growth rate. And again, if real rates are going to stay negative, it's an easy carry. You carry negative real rates, you go by growth stocks. So that's been the thing to do for three or four years.

Ryan Caldwell (00:08:20):

So Lara, we're back to that model again, if you will. Pete, I want to bring you into this discussion, too. Because the other side, the other issue, that's also kind of weighed on the macro outlook over the last four or five months has been our friends in Asia, the Chinese. And again, the second largest economy in the world, with what now looks like really hard deceleration.

Ryan Caldwell (00:08:47):

And you'll never get the CCP to admit that they had a policy error. But if you wanted to look at policy errors one might look at how fast that economy in China is sequentially decelerating. So again, if you kind of look at it, and again, China a very macro policy driven market. M2 peaked a touch over 14% in the first quarter, the CCP, the Chinese government was very adamant that they were going to slow the growth rate, they did. Today, I think the last print we got, Pete, was what something a touch over 8%, I think in M2.

Ryan Caldwell (00:09:23):

And you're looking at the sequential growth rates in China just plummet. And again, I saw some forecasts out today, looking for something like 2% sequential growth in the third and fourth quarter out of China, which is really slow for them. And so you've got to put that into this equation on what the global growth rate is. And I think Lara brought up a really good point

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when she said as soon as there's a growth scare it hits US rates first right because we are worried because we are the reserve currency.

Ryan Caldwell (00:09:52):

And so you saw the dollar strength and immediately as China started to weaken, the ASEAN region slowed very quickly. And again, that kind of deflationary impulse that we've gotten out of China, when they slow multiple times in the last four or five years popped its head up again. On top of obviously, all of the, depending on if you're along them the draconian measures that the government has been taking to real and things like social media platforms, education, property, luxury, wealth, wealth disparity.

Ryan Caldwell (00:10:28):

So again, big campaign by the central government. So Pete, maybe can you talk a little bit about when you look at the intersection of kind of Chinese growth, commodities, and sort of Lara's point about this kind of sticky-ish inflation, that's not hyperinflation, but it sure isn't going to be to the US growth rate that's peaked, but the market still has, or at least economists do have some view that it's better in '22, than it was in '19. And then, obviously, China just destroying sort of the emerging market's growth, particularly out of Southeast Asia, in the last little bit here. So just a little bit of if you could kind of tie it all together, and kind of what the markets thinking what you're saying, and then obviously, with the macro forecast.

Peter Bianco (00:11:18):

yeah. So China's been an incredible pain point, I think, for the investor community. Am I better now? Okay. It's been an incredible pain point-

Ryan Caldwell (00:11:32):

Joe Rogan would be proud.

Peter Bianco (00:11:34):

There we go. For investors, really over the last year. And I think what we're dealing with China is they are just really transitioning their economy. And we are just feeling sort of the lasting effects of that happening. Really, things started kind of kicking off with Huarong Asset, when we started noticing that the government is cracking down on MPLs, and loan growth and the housing market. Then the beginning of this year, when China got really focused on the steel industry and cutting back on pollution, that was sort of the shot across the bow in the commodity markets.

Peter Bianco (00:12:22):

And then we had the pulling of the Ant IPO, and then DD and everything else and the situation with Jack Ma. So when we're dealing with capital markets, folks are asking themselves, is this a place that is investable, and a place that we can put our money? Especially when you have the opportunity around the world to allocate capital. So I think for us, kind of, you have to really think going forward, will China be the growth engine for the rest of the world? Will they continue to put up solid growth prints, 6, 8, 10 percent? Or are they going to sort of focus on themselves and have a more moderate growth going forward? That obviously has ripple effects, the commodity complex, and us as consumers of Chinese goods.

Ryan Caldwell (00:13:24):

And the one maybe more controversial topic, I wanted to throw it the two of you because obviously, it will matter for these things called growth rates and inflation is one of the things I've been kind of tossing around and as I tend to do, sometimes irresponsibly, is this whole notion of de-globalizing. And are we de-globalizing? Since when we think about the last decade or the

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last two decades, 20 years, which has really helped to form capital markets, as we know it. As we think of Bretton Woods 2, and again, for those of you that aren't really familiar with Bretton Woods 2.

Ryan Caldwell (00:14:00):

Look, when China entered the WTO, in 2001, and they entered under a favored nation status, it gave them the ability to A, send goods our way. Our market effectively became open to them while, their market was protected. And if you think about that, from a very high level, it allowed them to accumulate a massive amount of currency reserves. Which is going to be strategically important here for a minute.

Ryan Caldwell (00:14:28):

The benefit to the US was obviously we got to outsource supply chains. That was good for margins, and consumers got cheap goods. So like, what did we get out of it? We got higher, more profitable companies and we got cheap stuff to buy. What did they get out of it? They got trillions of dollars of currency reserves, as you had this massive market open up.

Ryan Caldwell (00:14:49):

Now, again, as everybody is well aware, at least on the margin, there seems to be some cracks in the notion that this all worked out as well for everybody is maybe the technocrats thought it would. And I would argue the last administration argued that quite honestly, we gave up massive strategic advantage this way. And we didn't even understand the game that the Chinese were playing, in terms of revealing their intentions.

Ryan Caldwell (00:15:18):

That being said, again, when we look in a post-COVID world, one of the things that kind of tickles me is this point that well, if we're going to have to re-regionalize up some of these supply chains. And in the US, it's a bit more about security over supply chains being able to get... If you look to Lara's point, all the supply chain disruptions, a lot of them have to do with how uneven the world has reopened under COVID. And again, a lot of these supply chains don't reside close to the US.

Ryan Caldwell (00:15:49):

So there's been a lot of discussion from politicians, management teams about doing more near-sourcing of critical supply chains. Things like semiconductors is one I'll easily pick on. And then when you go to China, there's clearly this notion from the government. And they've been very, very clear about this, about redirecting the thrust of their economy away from kind of, and I won't use the right term blatant consumerism, into something that is more strategic in terms of manufacturing, in terms of supply chains, and in terms of advanced technologies.

Ryan Caldwell (00:16:26):

And so effectively, if you believe the government, they're telling you, there's a big capex cycle coming. But it's not in any of the places where people are invested when you look at market caps. And as a matter of fact, a lot of those things are getting reined in. So I guess I would pose to the two of you. Is this the ungluing of Bretton Woods 2 and de-globalization? Or is it just a crack in the ocean because of COVID. And as COVID normalizes, we'll be back to doing the same things that we've been doing for the last 20 years.

Ryan Caldwell (00:16:57):

Because I do think that's a significant thing one way or the other, if this is breaking apart, our growth rates and inflation are going to look different, there's are going to look different, the rest of the global will look different. If we're going to play the same movie we've played, then Lara is

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going to tell us that bond rates are going to be kept and that kind of demographic, deflationary dividend will continue to wash over us and keep inflation in check. So where do we think we are on that? Or am I overthinking it, or putting too much emphasis on what seems to be a decoupling of the two largest powers in the world?

Lara Rhame (00:17:39):

[inaudible 00:17:36] start with you, I'll hop in. I do think, something you touched on Brian, or Ryan.

Ryan Caldwell (00:17:46):

I wish you'd call me, Brian, I'd feel smarter.

Lara Rhame (00:17:52):

I think one of the things that I've been reminding people of is that for all of the headlines in the US and all of the rhetoric flying around about masking and vaccinations. We are actually handling reopening and we are handling living with COVID better than any country right now. Except for maybe New Zealand and I don't know if they count, sorry. Love them.

Ryan Caldwell (00:18:15):

They don't.

Peter Bianco (00:18:17):

And Singapore.

Lara Rhame (00:18:19):

So just in terms of vaccination rates, in terms of openness of our economy. And when you look at... I specifically draw that through right now, because when you look at China, boy, I think you're really seeing how a pandemic that's still very much out there could impact an economy when we're all still probably vulnerable to it in some way. But Asia right now and China, in particular, is really going to I think, have to take a step back, given the renewed pandemic. But as far as [crosstalk 00:18:52].

Ryan Caldwell (00:18:53):

And really, really good point, Lara that I should have brought up, which is Asia... If you look regionally, this zero case strategy in Asia is unworkable. And I know over the weekend, the Australians came out and actually capitulated and said, they're going to have to move the goalposts away from cases, to hospitalizations, and death. Because it's an impossible bogey to try to hit. So it's a really good point, in the sense that most of Asia from Japan, Korea, China down to Australia, New Zealand, they have been running a zero case strategy. And so anytime you get a case or two, they shut everything down. And that has absolutely contributed to this unevenness and inflation and supply chains and growth. It's a really critical point.

Lara Rhame (00:19:40):

Yeah, yeah. And I think when we think about... I mean, it's clear when we think about the giant push for globalization that really came in the 80s in the early 90s, that the free trade economists really missed something. Which is that if one market is the free market, and the other one is a controlled market, it doesn't work. And I think the US is just right now, we're staring at a really ugly chessboard, when it comes to our strategic options, and our economic options, our political options.

Lara Rhame (00:20:14):

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It's clear that just some kind of decoupling has to happen at some level. And I think the question is, how right will we get it? How wrong will we get it? Are we going to focus just on manufacturing, which I think is the thin end of the wedge. What you've really gotten is trying to now leading the curve on productivity enhancing processes. The US like, we love to think that we really create the IP and China just execute.

Lara Rhame (00:20:42):

But that's kind of come full circle. Now, they're creating the IP around really pivotal manufacturing processes that we are highly vulnerable to because they're not located here on our soil. So semiconductors, I think, is the one that we all think about. So there's no doubt that it's going to happen. It's a long process. I think it's one that when you think about trading about, trading around it, I'm sure you're thinking in very long term trends. And I think for inflation, it means that, actually the higher inflation goes in the near term, because of these supply chain disruptions, the faster will accelerate some of this to try to even the game.

Peter Bianco (00:21:32):

Yeah, I think one interesting aspect is China, I think it was like 2013, they debuted their One Belt, One Road initiative. And that was an incredibly important and strategic plan by the Chinese Communist Party. Where you have a country that's completely playing the long game like we say, here internally. They're playing an eight quarter game, and we're playing essentially election cycles in the US. And even in Europe. But you can see the seeds were planted then that they were strategically positioning themselves to be not only a player on the world stage, but to procure important raw materials, rare earths, and really position themselves for the next 10, 20, 30 years. And we're, at least in United States dealing with election cycles, excuse me, me every two to four years, whether it's midterms or presidential elections.

Ryan Caldwell (00:22:33):

No, it's a really good point. And the other thing I found kind of interesting over the last eight to 12 weeks as we've gotten more clarity on China's regulation of their technology sector. What really kind of jumped out to pay or jumped off the page to me. And actually, Pete, one of the economists you recommend in China actually wrote this piece. And I thought it was quite compelling, because I think we're dealing with some of the, this is where I want to bring Lara back in on this point as well. We're dealing with some of the same things here. And I hadn't kind of thought about it this way. But it made some sense.

Ryan Caldwell (00:23:14):

Which is, if you look at these big technology platform companies, so for China, obviously Tencent and Alibaba, Baidu, BitDance. Pick your big platform companies the argument out of the CCP, is that these companies are actually crowding out productivity gains, they're crowding out efficiencies in the economy, they're crowding out resource allocation. And I actually, again, when you kind of think about it from a high level, at first, you kind of shake your head and go, "Well, that sounds like a very Marxist Leninist thing to say."

Ryan Caldwell (00:23:49):

But then you come back, and you look here, and you look at Amazon, Apple, Facebook, and Google, and you look at some of the same dynamics of the amount of market cap, the amount of productivity, the amount of influence. All these things that when you look at the size of those companies in our economy, one could argue that like, how many ad dollars does an economy need to trade around to get consumers to buy stuff, relative to, again, the size and scale of these companies?

Ryan Caldwell (00:24:17):

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So again, by no means am I a communist looking to shut down companies. But some of the things that they're talking about, like redirecting investment out of property, makes some sense. In this closed capital accounts that they have, like property has been the bubble catcher. And it's a huge problem that they've never been able to really get their hands around. And so they do need to direct capital away from property.

Ryan Caldwell (00:24:42):

So it probably makes some sense but horribly painful for global growth. Because when you think of the knock on effects of property and investment in property and building stuff, it's got a huge... It's why we always talk about infrastructure. It's got huge knock on effects to the economy. And so they're pivoting there.

Ryan Caldwell (00:24:59):

And then the other thing I wanted to grab, Scott just to talk about this for a minute, too. Because one of the places where you're seeing a huge divergence in roadmap is industrial automation and industrial technology. And again, this is a place where China has historically lagged. As Lara said, we're thought to be the IP, they're thought to be the maker of stuff once we hand them off the IP. And boy, that's changing quick.

Ryan Caldwell (00:25:28):

And again, that's got real implications for supply chains, and growth and inflation. And because again, we're back to making stuff. If you're efficient, making stuff productivity goes up. So I think Lara's point about like, who's leading some of the productivity gains is interesting. Because ultimately, that should feed back through to returns and growth and all that stuff. So Scott I was just going to have you maybe touch on a little bit about what you're seeing, and like local Chinese automation and decarbonization, and some of those trends. Because it's been a very different market than looking at something like KWEB, or FXI or even EM.

Scott Sullivan (00:26:07):

Yeah, I think that what you're seeing there is China sort of move up the value added spectrum. And I think what has happened there, is they've obviously been sort of the manufacturer of widgets for a long period of time. And that process of manufacturing, so whether that be vision systems, or automation related to the cutting of metal, are parts that they would often procure from outside of their own borders.

Scott Sullivan (00:26:36):

And what is happening now is that area has become a key area of focus for the government. And it makes sense because their ability to not only manufacture industrial goods, but other goods is going to be increasingly important. And controlling, sort of the automation or the technology around developing or making those products is obviously increasingly important for everybody.

Scott Sullivan (00:27:01):

So as we've sort of talked about de-globalization or the end of Bretton Woods, obviously, it doesn't happen all at once. But I think that as we've kind of gone down this geopolitical path of a little bit separate supply chains, it's kind of critical for national security, there are other elements within that chain that are also important. And you kind of mentioned automation being one. I would say also the procurement of materials, whether it be rare earths, or even copper or different things along that magnitude.

Scott Sullivan (00:27:33):

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So the elements of the supply chain and the manufacturing of the goods, the technology around that has become really, increasingly important. And what you've seen, specifically in China, is they've kind of denoted who they are kind of going to highlight as sort of their national champions or their leaders in that field. And as I said before those leaders would largely reside in Japan or a little bit in the US, and you're seeing China kind of move up that chain a little bit. And really try and develop their own national champions. So I'd say that's just sort of one example. I think you see it in a lot of other places as well.

Ryan Caldwell (00:28:13):

It's getting tougher. And again, sort of we're at this sort of nadir, if you will, between where growth rates are likely to kind of flutter out over the next year or so and kind of where inflation is going to go. I'm going to come back Lara and Pete, because the one of the things I want to definitely have a discussion on is geopolitics and the Fed, and how that's going to roll back.

Ryan Caldwell (00:28:37):

But before we do that, Brian, I wanted to flip to you for a second because, look, one of the things I think that has become quite bothersome to us looking at markets, globally, very recently is your quantitative work, which again, is quantitative and empirical. It's not based on any of our forecasts or opinion, is increasingly flashing what I would call yellow lights. And those yellow lights look to us, and I'm going to have you explain what the yellow lights are, but increasingly look to us, like the market looked a little bit before COVID. Sort of tail end of 2019, beginning of 2020.

Ryan Caldwell (00:29:19):

Definitely kind of third quarter-ish of 2018. And then even going back to maybe kind of 2015, where again, we got some of these same sort of yellow lights flashing and ultimately we ended up getting vol events and all of those. Again, varying degrees of vol in each of those, but the setup was very similar. So I was wondering if maybe you could take a minute and just kind of talk through quantitatively what you're seeing on the dashboard and maybe for our listeners, what you've been jumping up and yelling at us about to do with the portfolio and kind of what you're thinking and doing and seeing. But if you could give a roadmap, that would be great.

Brian Cho (00:30:03):

Okay, so actually, I want to just touch on a couple of things. So first of all I'll touch on Chiron dispersion indicators. So we're here, we're looking at valuation dispersed, from cheapest to most expensive. And we talked about this indicator many, many times in the past. What was interesting to me in recent quarter, especially from COVID high, 10 standard deviations, the middle of that, and then subsequently collapse.

Brian Cho (00:30:38):

And as it collapsed it gained more and more momentum, per se. And then what was interesting to note is, May of this year, at the end of May, the dispersion has reached its trough. And since then it's been increasing. And now it's getting to a place where, typically when equity markets don't do well, per se.

Brian Cho (00:31:02):

So if you were to look at just US dispersion for now, is hovering near one standard deviation. And then if you look at other markets, let's talk about other markets, dispersion has gone up in tandem. Yes the degree in which they went up or the way it got there is a little different. But the when you are to look at equity market, or dispersion perspective, U.S. is an anchor. So the fact that U.S. is moving up, bodes unwell, I should say.

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Brian Cho (00:31:35):

So that's one, I want to point out. The other point I want to make is this thing about correlation. One thing that we do is looking at a whole bunch of different kinds of correlation. And here, what I'm talking about in particular, is we're looking at correlation between NASDAQ's calculated index, and equally weighted. And what's interesting about these two numbers and how they correlate is this. If they're correlated, generally one thing is happening. They're all moving together. And when they move together, usually, that's not a good thing.

Brian Cho (00:32:16):

That means they're catching downwards. They never really catch up. So it bodes poorly for the NASDAQ stocks. So here's what I want to depict for you. So NASDAQ's correlation has been shrinking and shrinking and shrinking, and meaning that they've been decoupled. So the large cap stocks have moved away from the small cap stocks. Now they got to a place where it's usually where they hook up again. So we're near that level right now. Which bodes unwell, I would say is at least a yellow to orange flag.

Brian Cho (00:32:57):

And then finally, one other thing I want to point out is our sentiment indicator. And a sentiment indicator that we use is actually a short term indicator where we look at breadth of the market, momentum of the market, we also look at options and all whole bunch of different indicators to gauge what CTA traders or all these fast movers tend to do in the market. And we catch the data from different sources. Equity market, to the options market and so forth.

Brian Cho (00:33:25):

And what's interesting about that index is it has been going sideways since May, and it started to go down further and further and further. So it's gotten to a place where I would say this. Since the COVID the sentiment is by far the worst. So it's pretty bad. The other way to think about it is okay, what about you compare the latest reading to that entire history? That's only okay, to negative. Meaning compared to last year, it's terrible. Compared to the entire history of the index it's barely okay.

Brian Cho (00:34:05):

So again, it's yellow flag very least. So put it all together, what I've been shouting per se to our team members, is that when I look at the market I'm not... All the things that Lara, and, Pete and whole team's been talking about. These numbers really, in a way, if you think about it, they don't really care about geopolitics. All they're doing is picking up what's coming into the numbers.

Brian Cho (00:34:38):

What's coming into the numbers basically said, okay, market is predicted one way, which is right now, it seems to think that it's looking for slower growth, and then when you have a slower growth, it had to pivot to the playbook they've been playing from past 20 years. So growth is prefer, high margin's prefer. So what's seems to indicate to us is you have to have free cash flow market. You have to have a cash flow that's growing faster that the market seems to think. So you have to have the setup where the quality of the cash flow must be robust.

Ryan Caldwell (00:35:22):

So Brian a couple of things I want to tease out there. So I think first, when we talk about our dispersion spreads, again, and we do talk about this one a lot. And I want to tie it back to something Lara said. As soon as the market got worried about global growth, international spreads started moving quick.

Ryan Caldwell (00:35:45):

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So again, back to like the world... US gets a cold, the world gets a flu, it kind of went the other way around. Like the world got sick first. The US was ripping, and then China started to slow, but those spreads started moving out, as you point out, sort of back in April and May. And they didn't start moving out into the US till more recently. June, July, you start to see those move out. So what does that mean, as Brian pointed out. Small caps are underperforming big caps.

Ryan Caldwell (00:36:12):

If you look at the NASDAQ, the Apples and the Googles and Facebooks are really outperforming the smaller cap tech stocks. That's his point about correlations. So one of the reasons we talk about yellow flags, is this is a market that all of a sudden is lacking in breadth. If you think about how good the tape was, from really middle of last year through March or April of this year, it was really a broad tape. There are a lot of ways to win.

Ryan Caldwell (00:36:41):

And again, the tape was very healthy. And it leaned out incredibly quickly. That's what I can say, with fairly high confidence, the market is far more worried about growth than it is inflation, by virtue of the fact that the Apples and the Facebook's are making 52 week highs, those have become stable companies, utilities are breaking out. Right, that tells me the markets worried about growth.

Ryan Caldwell (00:37:05):

So back to Brian's point. It wants high margins, it wants stability, it does not trust. So again, it's a tougher setup as that relative to where we were even six months ago, and particularly where we were 12 months ago. And so again, from here, you kind of got to get the growth thing right, you've got to get the inflation call right. Because you're not just mean reverting. Again, the market understands that at some point COVID goes away, and you're reopen. And there's normalization, although, again, we're not pricing that in Asia.

Ryan Caldwell (00:37:38):

So the dashboard, to Brian's point doesn't look the same. And so we've really tried to kind of deal with okay, our dashboard change really fast relative to history. The other thing Brian didn't bring up, but I will bring up because he does the cycle work for us. This has been by far the most potent return cycle we've seen since the Great Depression. Again, you're up 100% in 16, 17 months. This is a really fast recovery from a market perspective, relative to history.

Ryan Caldwell (00:38:09):

And again, that last thing Brian pointed out talking about sort of the CTAs and the trend followers. Again, that sentiment is not retail sentiment. Those are the momentum traders that are trading futures, and what they're saying, they are sending a bearish signal. And again, I think again, the way this market is constructed, when you think about sort of who the participants are and how they operate. Unfortunately, because the CTA is risk parity, these strategies are so big, they tend to set you up for grinding higher markets and crash downs.

Ryan Caldwell (00:38:47):

And what have we seen really, since kind of February, March is a grinding, trending market driven by a small cohort of stocks. And it's getting more narrow and more narrow and more narrow as we go along. That's traditionally been a sign to us to be careful. Because that can set you up for a vol event. And again, that doesn't mean that how big the vol event's going to be, how long it will last. They've tended to be pretty quick.

Ryan Caldwell (00:39:14):

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But again, it's a little bit more perilous than it's been. And I think back to Pete, Lara, Scott, market's got a lot more to figure out today than it had to figure out three months ago, six months ago. A year ago, all you had to figure out the world wasn't coming to an end and that some way, shape or form we'd be through COVID. Much different set of a set of circumstances today.

Ryan Caldwell (00:39:38):

So maybe Brian kind of moving from the quant scoring. Over to you Scott, I wanted to talk a little bit about fundamentals. Again, we just got through earnings season. Again, this is another case where earnings have been really, really good across the board, so good that the market, I would argue, almost didn't care. That's how good they were.

Ryan Caldwell (00:40:02):

And so a little bit maybe from the fundamental side, when you think about some of the things that you're looking at. Kind of what you're looking for. What's worked, what hasn't worked, and then maybe particularly too, when you think about next year, and 2023. How you're thinking about earnings growth, kind of where you're poking around, what you're thinking, and kind of the backdrop that you're having to do all that in. And so is there anything to glean from the fundamentals?

Scott Sullivan (00:40:31):

Thank you. Am I good on volume?

Ryan Caldwell (00:40:35):

Yes, you are good on volume. Just Joe Rogan your face rate into that microphone.

Scott Sullivan (00:40:41):

I'm right in there.

Ryan Caldwell (00:40:42):

Atta boy.

Scott Sullivan (00:40:44):

So I think all the things that have been mentioned here prior about geopolitical risks, and Bretton Woods, are all very relevant from the standpoint of unlike a year ago, when I think we all sort of felt like we needed to grow off the bottom or kind of had to happen, or else there was going to be a real disaster. At this juncture, now in a lot of cases, we have rebounded quite a bit, and it's just a matter of what is the sustainable growth rate off of the levels that we're at right now.

Scott Sullivan (00:41:15):

And I think that gets a lot more difficult when you're just playing in straight cyclical areas without any sort of story or any sort of secular aspect to what you're talking about. So we kind of discussed briefly earlier, automation within industrial. But it's a GDP kind of plus type of growth rate. Where beyond the next couple years, where you sort of know that different geographies are going to need that technology. And I use the word technology there, and I think it permeates through multiple sectors.

Scott Sullivan (00:41:47):

So when we traditionally think of industrial, we think of sort of old and stodgy. And that's really been transformed amongst a number of different specific sub-areas within the sector. So

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whether or not that's an industrial, which we've kind of already highlighted. In materials, obviously there's things like battery material and rare earths and different aspects there.

Scott Sullivan (00:42:10):

Within discretionary there is obviously kind of a new consumer here, that tends to be a little bit more likes to go outside or likes to use their at home devices in different manners, that tend to be a little bit more secular in nature. And so those are sort of the ways I think... And a healthcare, a little bit more of robotics. So those are sort of this sort of micros within the macro that I think you really have to focus on. I think it's becoming increasingly important.

Scott Sullivan (00:42:43):

And I also think that to your point earlier on the positioning, and the crowding, as people kind of glom on to these areas, or realize what they are, obviously, more and more people get into them and creates problems around positioning, particularly in the short term. As people are trying to move out of the more very cyclical kind of names.

Scott Sullivan (00:43:08):

So I think, to me, that was the biggest takeaway from kind of the earning season. And I think that given what we've said about the supply chains, there will be inflationary pressures within the supply chain. For a number of reasons, for a number of years. And I think you're going to need particular aspects to offset that, one of which is pricing power, which everyone always talks about. But I think those areas where you've got consumer demand, that also enables productivity are going to enable pricing power from the supplier of that particular goods.

Scott Sullivan (00:43:42):

I think it all sort of melds into a very similar thing to what Lara and what Brian, and what Ryan and what Pete were saying. Where it's just it's definitely more difficult to find things that are going to move in the immediate term. And so you're taking a little bit longer term 18, 24, in some cases, multi-year view that the sort of end market or technology will be a beneficiary of what we've kind of just discussed.

Ryan Caldwell (00:44:07):

That's a really critical point. And one of the things that Brian's old shop, Empirical Research pointed out and we've adopted because I find it staggering. But it dovetails completely into the analysis Scott just provided. Which is that if you look at the S&P 500, today 43% of the market cap of the S&P 500 is now in the highest decile of correlation to the 10 year bond. So another way of saying when you think about this game plan, if you will have negative real rates, as Lara pointed out.

Ryan Caldwell (00:44:49):

Once the market understood real rates were going to stay negative, it was very easy to go back to do this. But you saw incredible correlation back to the 10 year bond. Again, in the things that are high margin good compounding growth rates tends to be the mega cap companies, for sure. Up the tech stack parts of consumer discretionary, where there's tech, parts of automation, again, that's another place.

Ryan Caldwell (00:45:17):

So you saw this huge correlation to the 10 year bond. The other thing that's surprising about that, or at least should catch your attention is that 43%, that's now highly correlated to the 10 year bond is now trading at a 70% premium to the rest of the market. So this is another way of saying, look if we get into an environment where the markets wrong on the growth rate, and again, the growth rate doesn't fall apart next year.

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Ryan Caldwell (00:45:46):

And to Lara's point, inflation turns out to be a little bit stickier than transitory you do set yourself up for this, again, really reflexive move in the other stuff. The stuff trading at a 70% discount that is negatively correlated, and that's the other side of the coin, you look at the other 57% of the S&P 500, you've got about 35% of it, that is now severely negatively correlated to the 10 year bond.

Ryan Caldwell (00:46:16):

So you have these two really extreme outcomes. One of the things that when Lara and I catch up, and it marvels me is that the economy is not as rate sensitive as the stock market is now. The economy's just not moving to the degree to rates that the equity market is particularly. So again, over the course of some period of time, year or two years. These are brilliantly profitable companies, as Brian's quantitative work will point out.

Ryan Caldwell (00:46:46):

What scares you though, is that they become sort of bond proxies. In a world where again, the 10 year bond is sitting at 125. And Lara's point's salient here, that doesn't mean the bonds are about to go to 4%. So they don't have to. But you do go the starting point of rates were to back up a little bit. Not that provocative for the top of the market cap. As a matter of fact, you'd probably feel a little bit more comfortable in your FAANG plus Microsoft stocks, if they weren't so positively correlated to the 10 year bond, because again, a lot of this move here recently came on the 10 year bond falling from 177 to 125. And those stocks took off like a rocket.

Ryan Caldwell (00:47:28):

Again, they've had very good numbers. They're great. They have high margins, all that stuff. But this is a pretty potent starting point. So that was something I wanted to tie into what Scott said. And then maybe guys, all of us, for kind of this last little segment, I want to go back to go back to the Fed, I want to go back to rates, I want to go back to policy. Because there's two massive elephants in the room. The first one is fiscal policy.

Ryan Caldwell (00:47:58):

And again, the market in January post the Georgia runoffs where you had the democratic sweep, kind of priced in a number that was in the kind of \$5 to \$6 trillion range of fiscal that was going to get done. And as the year has gone on that numbers, bleeding lower and lower and lower. And now as of this weekend, we have a group of nine moderate Democrats that have said that they will not sign off on this three and a half trillion dollar infrastructure package, human infrastructure package, and that they want two votes.

Ryan Caldwell (00:48:34):

So you've got one... We have what's fiscal going to be? That's a question I'm going to pose to the group. And then a second one and this is probably a little bit more Lara and Pete, when you think about the Fed. So we have this Fed framework change Lara did an awesome job on our last podcast at the beginning of the year, end of the year talking about what this FATE or forward average inflation targeting framework was going to mean.

Ryan Caldwell (00:49:01):

We had our first test of what at least the market thought it was, a test back in June. And when it in when the Fed put the dots on the plot, the market reacted incredibly violently and basically said there is no forward average inflation targeting. The Fed is going to move, they're going to be preemptive. They're going to move. And even into last week. And Lara and I were talking about this, you had obviously a lot of commentary around the Fed minutes around tapering.

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And how fast are we going to taper? Are they going to start Jackson Holes this week? That's another hot topic.

Ryan Caldwell (00:49:36):

And then lastly, the Fed Chairman, that's going to be up for debate. And there's a lot of cross currents from the progressive side of the democratic party that wants Jay Powell gone. There's a lot of people down, the more moderate democrats and moderate Republicans would like to see him stay. So we have again, a bunch of balls in the air on fiscal and monetary, that just didn't seem like they were there at the beginning of the year. And now it's about to be September and they're there. So I don't know, maybe Lara, Pete, when you guys think about kind of the fiscal and monetary, how we think this goes. I know, I just threw that bomb at the two of you.

Peter Bianco (00:50:18):

I'll let Lara tackle that one first.

Ryan Caldwell (00:50:22):

Back to the chief economist.

Lara Rhame (00:50:25):

Ever brave. So I was almost answering in reverse. I wonder if Powell becomes some kind of bargaining chip, because Biden wants to get an infrastructure passed. So we'll see. If you need the moderates more at that moment, if he needs the progressives more at that moment. I think that's my only insight and I think, as far as infrastructure spending goes. Seems like Biden's position right now is very weakened, given other geopolitical events. The disaster unfolding in Afghanistan, all of those things seem to have put him on the defensive, certainly, in terms of doing anything really sort of pulling everyone together for infrastructure.

Lara Rhame (00:51:20):

Seems like that's just getting more unlikely every day that goes on. But I think we can expect something. The issue is that, of course, infrastructure packages, spending initiatives never hit the economy, it's not going to be like the trillions of dollars of direct transfers to household which literally hit the bank account in that quarter. This takes time to implement. And it's often uneven. Look at simple things like the eviction moratorium.

Lara Rhame (00:51:49):

Where they've given rent relief to localities, but it's still taking a long time to filter through to actually get to renters, get to landlords all that stuff. So at the end of the day infrastructure, I would say, I'm interested what number he puts on it. A trillion, that's too optimistic, even right now.

Lara Rhame (00:52:14):

I think two observations I would make about the Fed and their upcoming policy decisions. One of them is directly to your point. And Brian, I love the way you phrased this a while ago, to me when you said this whole, flexible average inflation targeting, it's a total jumble right now. Market studies, I don't even know I don't know if anybody really knows quite what to make of it yet. And how it will be actually implemented into practice.

Lara Rhame (00:52:40):

But to the extent that they're worried about inflation, supply-side driven inflation, supply shock, inflation, their models specifically do not tighten in the face of that. Actually, given their orthodoxy, we should be cutting or easing into inflation that's like that. We all know, that's not

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going to happen. But I don't think that... I think it would need to be more for them to really get worried about inflation enough to raise rates.

Lara Rhame (00:53:08):

And I just continue to be much more gradual on the Fed rate trajectory, than most people out there. I would easily push the first Fed rate hikes to 2024. If you made a hard argument to me that 2025 was your year that you see lift off, I could pretty easily be talked into that too. So I think it's all going to be gradual, I think it's going to be cautious. And I think inflation would have to get really catastrophically bad and stay there for them to feel the need to cut interest rates to slow our economy down. I don't think that's the inflation dynamic they see that's concerning them right now.

Ryan Caldwell (00:53:47):

No. And I want Pete to jump in. But it's a really interesting point you just made Lara, which is again, I've been a little baffled that in the same breath, the market has tried to say, inflation is a problem, therefore pull forward Fed. Oh, and there's a growth problem.. We have no example of that, where... I mean, we had one maybe at the end of a term that the Fed got disciplined really quickly. Tightening into the trade war slow down was a disaster and they had to reverse course, incredibly quickly.

Ryan Caldwell (00:54:23):

It seems really unlikely that again, if we're getting a growth scare COVID, China, whatever, the numbers are decelerating harder, that they're pulling anything forward. But boy, the market on a day to day basis will have that argument with you. And you can kind of see it playing out in stocks. It's like, oh, today the risk is inflation's too high. Tomorrow, the risk is growth is too slow. That doesn't seem particularly rational.

Ryan Caldwell (00:54:47):

And look, your point about fiscal is a big one, too, which is, depending on how big fiscal is that tells us how much the Fed is going to have to finance and we don't know. And so back to kind of squaring up rates and growth. I think the markets kind of parked at toward the lower end and said let's wait and see what all these numbers look like. And we can go from there. I don't know, Pete, where your head's sitting with your favorite entity in the world, the Federal Reserve and their communique?

Peter Bianco (00:55:17):

Yeah, I think first thing is infrastructure. The notional number is becoming increasingly less important. And we've been talking about really, since they've sort of announced it what's the multiplier, what's the GDP multiplier. And it just continues to be more and more unimpressive. Regarding whether they get it done they say, when your opponent is making a mistake, don't interrupt him. So you can see that as the president and the White House becomes more and more quote, unquote, nuclear, I think people are going to sort of run away from using their political chips to support them. So I don't know what the probabilities are like inside the beltway right now. But it just seems like increasingly, it's going to be an uphill battle for him.

Ryan Caldwell (00:56:07):

Well, and I think Lara brought this up. And you just reiterated the point to me a little bit is you also are starting to run into a timing problem. Like, this is not a this year thing. Like if this thing gets done, it's at the back end of this year for something into next year. And I think you both make a really good point about the magnifier effect. The market figured that one out pretty quickly and said like there's no there in this thing.

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Peter Bianco (00:56:33):

Exactly. And then I guess more so on the Fed. And you sort of insinuated this in your previous comments. The world is increasingly long duration, whether you have a mortgage, whether you have a car payment, or whether you do own Treasury or government bonds. In that same vein, the Fed has sort of painted themselves as having a more socially responsible bent. So it's I were a betting man, I would-

Ryan Caldwell (00:57:02):

Oh you are. Well, I think we pay you to do that. I'm not sure.

Peter Bianco (00:57:06):

That's what I do for a living, but you can vision that the Fed will be and central banks globally will be increasingly more dovish. It does seem like Jay is gaining a bit more popularity in keeping his chair and Janet Yellen had a, I think it was an op-ed or comments over the weekend that she is supporting him. But the cast of characters around him will certainly be different. I think his focus will certainly be different. And when push comes to shove, it's going to come out more dovish, at least that's what it seems.

Ryan Caldwell (00:57:43):

And I think Lara made a really, really good comment, which is the comment about bargaining chip. And I just don't know what the dynamics are going to be between the moderates, the progressives, and look the Fed. And like, it's increasingly clear that if you can't get this three and a half trillion soft infrastructure done, then the progressive's agenda is nuclear. I mean, it's wasted. So you kind of have to have Treasury and fed on board, if you want to then try to do it, quote that way, relative to kind of straight quote infrastructure, which ultimately, the Fed would have financed.

Ryan Caldwell (00:58:27):

But it does become more important than to have a more progressive Fed, if you're not going to get any... If you're not going to get this done. So I think her point about bargaining... I don't know there's no reasonable reason to fire Powell. But we've seen all the comments about there was no reasonable reason to fire Yellen either. And again, it became political. And Lara keeps making the point to me having experience at the institution that look, it's political. And so it's a political hot chip.

Ryan Caldwell (00:58:56):

So I think it's a great debate. And again, it's one that could interject some volatility into the tape. If we do get a change or your point Pete, if we don't change the chairman, but maybe we change others. And Lara is going to comment I can see her ready to come through the Zoom at me. So yeah, go. I mean, this is the debate.

Lara Rhame (00:59:15):

I think something else that I know we're all going to get a chuckle out of. But you read the Fed minutes. I think it's really... The Fed is working hard to try to communicate in their own buried into 18 pages of minutes way that the taper conversation and the taper process is different from any interest rate type process. But there's a funny line in there that says, "But members recognize that markets will not interpret it as such."

Lara Rhame (00:59:46):

Well, it's self fulfilling guys. [crosstalk 00:59:47] connected, guess what? They're connected. So I think that's another... That's going to add to the confusion to potential volatility. If they taper

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relatively quickly, does that imply that they're doing that to raise rates? I think all of these things get totally commingled, despite the Fed's sentence buried whatever page it is in the minutes.

Ryan Caldwell (01:00:16):

No, that's a really, really funny point. Which is the market is leading their discussion. There's no question about that. And to not connect the two is not... I mean, you have to connect the two. The tapes, absolutely connecting, what is taper, when is lift off. The two have to have some congruency, otherwise the world just doesn't make any sense. So I totally agree with that, Lara, there's just got to be some connecting and the markets obviously already connecting those two things together.

Ryan Caldwell (01:00:48):

So look, I think with that we've already abused our listeners for about an hour now. I think we should probably wrap that up. I want to thank everybody for taking some time to listen to us today. And, guys, I want to thank my team for time spent. So everybody have a wonderful month, we will be back on a more normal recording schedule going forward back to sort of quarterly outputs. And I would also recommend our listeners also read our quarterly 3D report, which was just published at the beginning of August. So thank you very much.

Speaker 6 (01:01:30):

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