Episode 24

The Caldwell Hour: Navigating this new market

Ryan Caldwell, Scott Sullivan, Brian Cho, Peter Bianco and Lara Rhame share their outlooks for 2022.

Ryan Caldwell (00:00:04):

This is the FS Chiron FireSide chat hosted by Ryan Caldwell. And today I am joined by all of my colleagues live here in Kansas City. So today we've got Scott Sullivan, who is a co-portfolio manager, Brian Cho, who runs our quantitative group and Peter Bianco, who is a portfolio manager and as always our key, not only guest, but permanent member, the FS chief economist, Lara Rhame.

Lara Rhame (00:00:48):

It's fun to be doing this from in Kansas City.

Ryan Caldwell (00:00:51):

Yeah. We even made Lara come to Kansas City to do our-

Lara Rhame (00:00:52):

Happily.

Ryan Caldwell (00:00:54):

... started here podcast.

Scott Sullivan (00:00:55):

And economic review.

Ryan Caldwell (00:00:57):

Oh yeah, had economic review. Yeah. Oh, that's right. We had to do work. Okay. So, we thought maybe what we would do today in early year tradition is maybe do a recap look back quickly of what 2021 was, and maybe set the table for what we are thinking about in 2022. And off the top, one of the things that I wanted to lay down for our listeners, we are going to be a little bit more active on the research side this year. We do think we're at some incredibly important paradigm shifts that are happening in global capital markets. And we actually think there's much more to write about. Lara sort of kicked this off last year in her economic series. First talking about the great moderation, and then lastly, very recently talking about inflation and its impacts.

Ryan Caldwell (00:01:51):

But we want to get more robust with this. So one of the things that you will see from us this year is a pretty consistent cadence of what is happening, why we think it's happening and ultimately what we think you ought to be doing about it when you think about portfolio construction. So much more to come this year, but again, this podcast is really set up to do a

little bit of backward look. A little bit of kind of forward foreshadowing and dig into maybe some of the topical issues.

Ryan Caldwell (00:02:20):

So maybe let me start with '21. And look. '21, guys, as we all know was a really weird year. And one of the things, as I was thinking about prepping for this, I hearken back to, Lara, on our December of 2020 podcast had made this outrageous statement that, "One of the left field ideas could be that people are starting to think about the U.S. being in a recess by the end of 2021." And we all kind of looked at her cockeyed and said, "Yeah well, we'll see." And interestingly, we never got close to a recession, but the market sure thinks we did.

Ryan Caldwell (00:02:55):

If you kind of look at the cadence of 2021, and that's where I wanted to start, which is just, one of the things that we do a lot of at Chiron is kind of looking at levels and where we're at. Like the market, at least in my career has become a bit of a rate of change market. And what we do at Chiron is much more based on where are the levels and maybe particularly where provocative starting points, or unprovocative starting points. And '21 was a really weird one, because you kind of got all of the market phasing in 12 months with an economy that again, doesn't look like anything we've seen in a very, very long time.

Ryan Caldwell (00:03:34):

And one of the things that we see in our work is this fight, if you will, between sort of shorter term price and macro metrics relative to more medium-term fundamental starting points. And we think 2022 is going to have a lot to do with that fight. So again, if I kind of summed up '21, it would be, we started the year really early cycle, very optimistic, roaring '20s, I think was the mantra to start the year. And by the end of the year, we were trying to figure out if we were going into a recession or not, given the leadership and how the year unfolded.

Ryan Caldwell (00:04:12):

And again, 2021 was a year of growth one again, which I never would've predicted quite honestly. Again, given our fundamental view, given our quantitative starting points. I don't think we would have thought starting 2021, the growth would've been such an outsized winner when we all looked back. But again, I think as Lara was kind of foreshadowing, what happened is the thing ran so hot that the market kind of jumped to the conclusion. And was maybe already starting to jump to the conclusion that policy makers are going to have to move fast, act fast. Again, this COVID cycle's really odd. And so when we start 2022, I think the thing that we are all kicking around is A, where are we in this cycle clock, shorter term, longer term? B, what is the reaction function of the policy makers now? Because they so widely missed their forecast.

Ryan Caldwell (00:05:04):

I think that would be the other thing I would talk about in 2021 is how bad everybody missed the forecast. If you think about the inflation forecast, I think the Fed missed it by 500, 600 basis points. I mean, shockingly big miss. When we look at things like earnings estimates, so that's another place, the street was just wildly wrong, right? S&P 500, IBES estimates to enter the year, I think we're about 170 bucks. We ended the year we think, and Scott's going to talk about, somewhere like 215, that's a massive miss from the strategists. So when you think about the why of how '21 unfolded, again a lot of it has to do with an economic environment, quite honestly, people haven't operated in for a very, very, very long time. And so I think that's a key kind of thing to put in front of you as you think about entering 2022.

Ryan Caldwell (00:05:56):

So when we kind of think about these transitions and maybe where I want to start is I want to start with you Lara, because I want to set the macro table. Because I can't remember a period in my career where the macro and policy and positioning is so intertwined. And so, maybe to kind of start the conversation, when we exited 2021, what was incredibly evident was the correlation between growth stocks and 10-year bond and the amount of market cap that is now assigned to it has skyrocketed. So the equity market is just as, and we're starting to argue maybe more so rate sensitive than the underlying economy in which it's supposed to represent.

Ryan Caldwell (00:06:42):

So maybe, Lara, if you could maybe start and set the table, and again, I know you've written a lot recently again about the end of this great moderation, what inflation's doing. Can you maybe set the table a little bit for what you're thinking about inflation, nominal growth, because it's such a big deal. Real growth, even bigger deal, and kind of what you see underneath the table to maybe start the discussion for 2022? Before we even get into Fed, what are the numbers telling you?

Lara Rhame (00:07:12):

Sure. And something that I really ... Looking back at 2021, you covered it really well, incredible year. It's really extraordinary that this time last year, January 2021, inflation was 1.4% year on year. We had the 10 year around, right around there, right around one and a half, one and a quarter. But so your real rates right around zero and inflation, just if there's one sort of dominant feature of 2021 it's inflation came on like a freight train. We're going to get the December CPI number in tomorrow, but it's going to be 7% year on year. I mean, that's just a number that we haven't seen in 40 years. And you may hear me say that several times, Ryan-

Ryan Caldwell (00:08:02):

No, it's shocking.

Lara Rhame (00:08:02):

Like we haven't been here. If this feels different, it is because it is completely different. And that is something that underpins really, I think, every facet for investment, for policy, for the economy. And what does that mean for growth? We talked in the middle of last year about growth estimates that were so strong, and this is the critical difference between real and nominal growth. Growth estimates in the middle of last year for the economy in the third quarter were 7%. That was the consensus. Incredibly strong relative to sort of our underlying potential relative to our historic growth rates. Well, what did you get? You got real growth that actually was quite disappointing, real GDP. The number that we reflexively go to, sort of the broadest measure of growth that we just are used to looking at. And most of our audience really is familiar with, that was only 2%. Nominal growth was 7.9%. So that is the difference between the real and nominal growth in a high-inflation environment.

Ryan Caldwell (00:09:12):

And I just want to interject the point out. That was the exact moment where the market started to go late cycle.

Lara Rhame (00:09:19):

Yes.

Ryan Caldwell (00:09:19):

Right, exactly where defensive's stopped underperforming, core growth stocks took off, was exactly at that point when the real number went, oh no.

Lara Rhame (00:09:30):

Long-term interest rates plunged anew.

Ryan Caldwell (00:09:32):

Plunged.

Lara Rhame (00:09:32):

Yes.

Ryan Caldwell (00:09:32):

Yes.

Lara Rhame (00:09:32):

Yes, yep, exactly. And so, I think when I look ahead to this year, I think it's still something that most people I speak to have not internalized, because we've seen in 2005, 2008, inflation jumped, we had a big energy price run up, empathetic dissipated immediately. And now I just don't see that happening. Looking ahead to 2022, the first quarter, we're probably going to see inflation continue to edge up. It may get as high as 7.3, 7.5 in the first quarter. Throughout the year it may only come down to three and a half or 4%. That implies really, really strong nominal growth, but it becomes a headwind for real growth. And it impacts virtually every part of the economy and financial markets as well. So, if this time feels different, it is really different. And of course, the impact to policy is going to be high answer.

Ryan Caldwell (00:10:35):

Yeah. And that's where I wanted to take you, which is, because I think what's so critically important from an investment standpoint, Lara, is the point you just kind of touched around, around what is happening and what could happen with real rates? So again, real rates, not nominal rates and sort of, again, we've seen the market have a very reflexive reaction to real rates coming off the floor. So it maybe for our listeners, if you could just spend a second on why real rates are important, why all of a sudden the Fed sounds like they're paying close attention to real rates and what that means for their policy going forward?

Lara Rhame (00:11:19):

Sure. I mean, at the end of the day, these negative real rates are a reflection of so many factors, really low international rates. The fact that we're just still seeing very low potential growth in the U.S., the fact that the rates complex and yield curves across the globe are so, so flat. And when we think about the extraordinary quantitative easing at the Fed through at the markets as the pandemic unfolded, it really just caused rates to just fall everywhere. And I think when we think about real rates being negative, that's also caused a lot of confusion because inflation is so high, it seems like rates should be higher. And that's the disconnect that we're going to be struggling with for 2022.

Lara Rhame (00:12:17):

People are going to be looking at long-term rates and thinking, "Oh, they should be going straight up." And that is going to, I think that's far from certain. My expectation is that long-term rates still stay relatively, very close to historic lows. And I said 2% for the bulk of 2022, historically you look at Fed rate hike cycles, long-term rates only rised 75 basis points. And they tend to really peak early in the cycle, which is, I think what we're going to talk about a lot today is where we are in the cycle.

Ryan Caldwell (00:12:52):

Absolutely.

Lara Rhame (00:12:52):

And this is as the Fed ramps up, what we start to really clue into. And for the Fed, I mean, I cannot, they are so behind the eight ball, they're so behind in trying to now manage inflation, their forecast has been so wrong. Their messaging on this has been clumsy. It's been wrong. And because of that, they're now having to really just all line up in a proactive arrow that is just heading towards quantitative tightening and monetary tightening, policy tightening.

Ryan Caldwell (00:13:28):

No, I really want to emphasize a point you just made, because it's critical to think about, because I think, look as we enter today, and again, real yields have jumped and post the Fed minutes early in the year, this year, like we've had this kind of seminal change in, I guess, seminal, we went from negative 1% to negative 80 basis points. So let me slow down with how seminal it really was. But the point being, again back to being rate of change. The rate of change and Wall Street obsessing about rate of change. It's been impactful. But the point I wanted to tickle is exactly what you said is that there could be a real GDP growth problem that the long end sniffs out early as the Fed starts to go fast. So there is a condition set, and I know this will sound hair tickle almost if you will, to the market right now, where you actually need to be long duration at some point this year.

Lara Rhame (00:14:24):

Right. Right. And I think that it's extraordinary and that is all going to be confused by the fact that they may really start to shrink the balance sheet-

Ryan Caldwell (00:14:37):

Yes.

Lara Rhame (00:14:37):

... at some point.

Ryan Caldwell (00:14:38):

Yes. Yes.

Lara Rhame (00:14:39):

And which, by the way, I mean, if Fed policy is now trying to dictate a long-term rate and use that to control the economy, I think they've lost their minds. We really have [crosstalk 00:14:51]-

Ryan Caldwell (00:14:51):

No, I, will-

Lara Rhame (00:14:51):

We have to state this-

Ryan Caldwell (00:14:53):

Wait right here. Wait right here, we'll see. Because the currency will matter in this equation, right?

Lara Rhame (00:14:58):

Absolutely, absolutely. And I think, to your point, you sort of think about where we were before the pandemic. We had inflation around 2% and we had 10-year yield around 2%, real rates around zero. So when we think about where we're going to get back to, I think the forecast

naturally guide us back to zero real rates, but for investors that's just, it couldn't be less satisfying, couldn't be less satisfying outcome. So, the Fed this year, they're behind the eight ball they've rapidly pulled forward rate hikes. The market has so far easily absorbed three to four rate hikes in 2022. And I think, I remember a time when sort of rapid rate hikes were once every meeting, not once every quarter. So I just want to remind everyone that there's a lot of room for them to go faster than markets are saying.

Lara Rhame (00:15:58):

And I think the other key difference this year, and this is where I'm interested in what you and the team is thinking. In 2018, we really have seen in 2014, '15, we really saw the Fed flinch when market volatility erupted because of policy tightening or the threat of policy tightening. This rate hike cycle is different. In those episodes we didn't have inflation, we didn't have wage inflation. They were, I think we could now consider preemptive rate hike cycles. This time around the Fed may very well stand up to the markets in a very different way. And with their eye on their credibility, which has been just demolished over the last six months as inflation has surged and they've got it wrong, they need to recapture that.

Lara Rhame (00:16:51):

And even dovish Fed members have turned very hawkish. So I think that to me is the huge question for 2022, we're going to have inflation. Long-term interest rates may very well respond to your point to continued hawkishness by sort of being mired at these historic lows. But what will the market make of a Fed that is just, I think at this point really on its heels and needs to recapture credibility?

Ryan Caldwell (00:17:22):

And I think, just to put a bow on that, because it was such a good comment. The market has started to discuss the fact that the put is lower, whatever you think that means, the put is lower.

Lara Rhame (00:17:34):

That's right.

Ryan Caldwell (00:17:35):

And so that's why, again, when we look at, and I'm going to try to weave this in a bunch of different places. And I want to be very clear. We are looking at two cycle clocks, one, we think that has made it up to this COVID disruption liquidity cycle that started in March of '20. We think we're coming to the end of it. So we think you could very well get a normal end of cycle vibration.

Ryan Caldwell (00:18:02):

Right now, again, I think Lara's point is salient. When you tie back to the real economy, it's a little bit different story. The real economy is in a different place than where we have been during kind of other recent post global financial crisis type of environments. So I think Lara's point's so spot on. Because the real economy could continue to chug along, while the equity and rates markets are throwing a fit.

Lara Rhame (00:18:28):

That's right.

Ryan Caldwell (00:18:29):

And again, they're going to respond, they're going to be focused on that. Now it is a political year. All of those things come into focus, but if the political issue is inflation, which the administration has pivoted to, both parties have grabbed onto it. If that's the issue, then they

may think they're doing, to quote Lloyd Blankfein, "God's work." So right, maybe they're doing God's work by dealing with inflation. So we'll see.

Lara Rhame (00:18:54):

Yeah. I think one thing I just wanted to wrap up, this backdrop for the economy is just touching on ways that inflation can impact growth, because as you said, the economy's in good shape. I mean, our growth rates have been strong, real growth has been really healthy. Every wave of the pandemic our economy gets better at dealing with it. And all of that is really good news. Household leverage levels are low. Wages are rising, real wages are rising for some of the lower income households for the first time in decades.

Ryan Caldwell (00:19:32):

That's a long time, yeah.

Lara Rhame (00:19:32):

I think we just have to remember that over time inflation can really erode, significantly erode the purchasing power of the lowest income households. And we've already seen it impact consumer confidence. We have two measures that we look at. One of them is highly sensitive to labor markets, those are great.

Ryan Caldwell (00:19:53):

Ripping.

Lara Rhame (00:19:53):

Booming.

Ryan Caldwell (00:19:53):

Ripping.

Lara Rhame (00:19:54):

And one of them is highly sensitive to inflation and that is at its lowest level at any time during the pandemic. So this isn't, as inflation, midterms is really going to be, I think, a really important point for this year because I think, as it continues we could really see concerns about inflation leech into aggregate demand. And just give us enough of a headwind to bring us from growth that's way above potential, around 4%, down to something that feels more pre-pandemic-like too.

Ryan Caldwell (00:20:27):

I think it's a great point to kick off with. And again, when we start to talk at about cycle clocks and positioning, really, really interesting point. Because again, I think economically you would look, and Lara and I have this discussion a lot, because even internally we get a lot of confusion when we talk about this, which is, "Look, the economy in and of itself looking in isolation, more midcycle-ish probably." But the Fed is acting late cycle. And the reason the Fed's having to act late cycle is because of investor positioning and where their liquidity went. So we're going to put a fine bow on this, but again this cycle, I think to Lara's point may dictate being broken in order to get to better growth going forward. So again, that's why I want to put a flag in the ground to say, we're going to write a lot about this. We're going to talk a lot about this.

Ryan Caldwell (00:21:19):

But I have been front footed about cycle within a cycle, and you still have to deal with the end of this one. So that is a little bit top of mind. When we get into more medium term forecasting and discussions, we think there's places to go. But I wanted to really turn the dial up on this

discussion, Lara, because it matters. We've got a Fed that's now engaged. They may have to go faster as we talk about international here in a second. Some of the other factors that could kind of blend in here in the first half. And if they go fast, capital markets don't like fast.

Lara Rhame (00:21:52):

Right.

Ryan Caldwell (00:21:53):

So I think that's just, I want to leave that there. We'll come back to this here in a second as we digest sectors and leverage and all that stuff. So now maybe I want to go a little bit more international on the economic front and positioning front. I see my colleague Peter Bianco down there, one of the cogs, big cogs in the wheel here. So, Pete, one of the things I wanted to dive into with you.

Ryan Caldwell (00:22:24):

And again, a little bit on this kind of cycle clock thought process, but also I wanted you to maybe give a little bit of the setup on what's going on in Europe, what's going on in Japan and then you and I can do a little banter about China. But I wanted you to set the table in Europe and I wanted you to set the table in Japan, because these are forgotten places, EFA consistently underperforms the S&P 500. Nobody's there by virtue. Again, of even looking at last year, EFA was fine up 13. If you look at the acqui, I think it was up 13, S&P was up 25. So again, why bother?

Ryan Caldwell (00:23:01):

But when you think about the setup, Pete going into 2022, can you talk a little bit about Europe? Where they're at with COVID? Where they're at in the cycle clock? What do you think growth's going to be? Or even over and above growth? I don't want a growth forecast. Give me the policy setup. Give, no forecasting, just give me the setup going in and maybe kind of unveil the map a little bit, because again, we think it's going to be important again, for the first time in a long time. But I want to kind get to the setup of why kind of EFA and EM are maybe turning the corner relatively?

Peter Bianco (00:23:40):

You bet. Yeah, and I'll leave the forecasting to Lara. Because-

Ryan Caldwell (00:23:42):

That's what she does.

Peter Bianco (00:23:43):

Yeah.

Ryan Caldwell (00:23:43):

That's why we have her, somebody had to do the forecast.

Peter Bianco (00:23:46):

Yeah, I feel we start a lot of these sort of beginning of year with being bullish on Europe or bullish on Japan. So spoiler, this is no different. Europe's been interesting because what the market's trying to do is it's trying to extrapolate and look through this sort of COVID light lockdown period that we've entered. Sort of this fall and they're still kind of dealing with, but there's some other really interesting things going on in Europe right now, which actually provide a provocative setup from an investment standpoint. One, the big news over the fall was like, Chancellor Merkel is no longer. We now have a new chancellor, Olaf Scholz, which is not

necessarily a known quantity. So we could get some movement from Germany on getting off the black zero and maybe get some fiscal spend and some monetary policy easing coming down the pipe from Europe. Another interesting-

Ryan Caldwell (00:24:46):

And again, maybe just to pause you just to make this point, big rate of change difference.

Peter Bianco (00:24:52):

Well, that's exactly right.

Ryan Caldwell (00:24:53):

May not be a big level difference when it's all said and done, but from a rate of change perspective, again, I just want to call out that nuance, big.

Peter Bianco (00:24:59):

Absolutely. I think this is, not to steal your word, but this is a seminal moment, I think for Europe, an important moment for Europe. And one other thing that we're seeing, or that is happening rather is we have a new Bundesbank president, Jens Weidmann, who is a notorious hawk on the ECB, he's out. We have a new gentleman, Joachim Nagel, who is an executive on the BIS, but that's a new quantity on the most important central bank, maybe second in the world, but most important obviously in Europe. And then there was an article over the weekend, which is interesting, from Isabel Schnabel, who's also a ECB board member talking about this concept of green inflation from the Germans. A and from the Northern Europeans.

Peter Bianco (00:25:50):

So I think this shift to decarbonization, which is a theme obviously we've talked about quite a bit on the real asset side, that may give the ECB sort of cover to potentially stay ahead of this inflation problem. And when we talk about the rate differentials, which has been so important, not just in the front end, but in the long end in the burn market versus treasuries and JGBs. The relative rate of change, like we've talked about, the relative spread is what really matters to these markets.

Ryan Caldwell (00:26:18):

Yeah, it's funny you actually bring that up and we'll talk about this later with Lara. But I was actually going to ask you, is there any risk given the new Fed appointees to replace given some of their agenda around green and decarbonization that we don't get some fluff at the Fed level as well around tolerating inflation that's around energy transition?

Peter Bianco (00:26:41):

Yeah. I think-

Ryan Caldwell (00:26:42):

Later, I don't think that's today. But to Lara's point, if we end up with a baseline that's a point and a half to two higher, at the end of all this there could be some explaining to do. And that might be again, I agree with you when I look at what's coming out of Europe, we're laying an excuse to run a hotter book.

Peter Bianco (00:27:00):

I agree with that. And if you think about, there is a sort of changing the guard globally within the central banks, within governments, but also from a population standpoint, millennials are getting older and the-

Ryan Caldwell (00:27:19):

Finally.

Peter Bianco (00:27:20):

Finally yeah, we may not be getting smarter, but society is developing and progressing. And there are these changing dynamics that are happening, which may not affect stocks today, but we just have to kind of think about. So Europe's interesting, we're there. And what's interesting about Europe is they're selling all stuff to China and we're getting more constructive on China. So there's incredible amount to do in Europe.

Ryan Caldwell (00:27:49):

Well, and the other point I want to make, just before we leave Europe, because this is going to be salient when we get to Japan and China, which is you still have reopening shutdown sluggishness in the numbers?

Peter Bianco (00:28:02):

Yes.

Ryan Caldwell (00:28:03):

Lara's point was really important to me. The U.S. economy has gotten more efficient with each and every wave in which has come in dealing with this and economically the divots have been smaller. Europe, and as you get closer to Asia, have been much more draconian in the way they've dealt with it. So every wave has led to a really hard stop in the economy.

Peter Bianco (00:28:23):

Yes.

Ryan Caldwell (00:28:24):

So if you talk about where you can get economic momentum, even if it's fleeting, even if it's more kind of storage business, not live-in business, that's a place where again, growth could be accelerating, even though the Fed's under a bit of a tightening cycle.

Ryan Caldwell (00:28:42):

Now again, that may mean nothing for positioning in the short run, but medium term, you do have a COVID tale that is much bigger in Europe and gigantically bigger when we get to Asia. In terms of kind of the reopening momentum that we've been enjoying here in the U.S. economy. So that was one point I wanted to kind of tickle out of you as well is, we look to me somewhere six to 12 months behind what's going on in the U.S. in terms of economic progression. And heck, given this many shutdowns, it may just be worse.

Peter Bianco (00:29:15):

Exactly.

Ryan Caldwell (00:29:15):

We just don't know.

Peter Bianco (00:29:15):

Yeah, that's a really important point. You get this sort of coiled spring once, they drop the rope and they say, "Okay, you can go, travel restrictions are off. Are we going to get that?" And given that Europe is such a service-driven economy, it's so important. And on top of that, they're also a major energy importer. So they have a couple things coming down the pipe. I think the ECBs

going to have to shift their tone to address these because we all know the Germans and the Northern Europeans are allergic to inflation. So this is going be tad amount and front and center for them.

Ryan Caldwell (00:29:54):

Yeah, no, I want to flip you to Japan and then ultimately, good luck.

Peter Bianco (00:29:59):

Oh God. Yeah. I think I've said this on previous podcasts but you're not a true investor unless you lose money in Japan. So I've hit that wicket, so we can talk about it, absolutely.

Ryan Caldwell (00:30:09):

I mean, I think again, just from a starting point perspective, I think back starting with Lara with a nominal forecast of the U.S., particularly in the U.S. running hot, here's the kind of thread I want to pull on, which is, again, back to your point about the rope drops. Economic activity picks up. You've got some stimulus in the pipe. One of the things that's been helping this, I don't know helping's right, because supply chain inflation's been so weird, but one of the things that's maybe kept a lid on global economic growth is all the shutdowns and reopening. So back to this momentum, if we get reopened, and again, I want to point to Japan because it is probably the most, at least in developed markets, sensitive market to global economic growth.

Peter Bianco (00:31:01):

And yield curve.

Ryan Caldwell (00:31:02):

And yield curve.

Peter Bianco (00:31:03):

Right.

Ryan Caldwell (00:31:03):

Absolutely. A yield curve that could steepen, which again, we're not so sure of, but shift, parallel shift higher.

Peter Bianco (00:31:11):

Exactly.

Ryan Caldwell (00:31:11):

Sure. Inflation running hot, global growth being good, Japan.

Peter Bianco (00:31:16):

Yes, yeah.

Ryan Caldwell (00:31:17):

So that's why I wanted to tickle it in the sense of how it's constructed, what's in there? And again, you're running this real asset fund. You're cavorting the world for these opportunities for new things and old things. So you see the old industrial complex plus energy and you see all the new stuff plus decarbonization. So I wanted to just tickle on Japan and kind of, okay, they ran a zero case for a while. They seem to be buckling little bit on that. How do you kind of think about Japan in terms of starting point and what you're seeing?

Peter Bianco (00:31:48):

Well, yeah, it's so interesting because like, Japan's, it's had its fits and starts, but it's really been a non-quantity for a while.

Ryan Caldwell (00:31:57):

It's been, yeah, ignore it.

Peter Bianco (00:31:57):

And I think it's almost generational because previously, folks that are much older than I am-

Ryan Caldwell (00:32:04):

Shout-out to Marc Spilker who made money in Japan in the '90s.

Peter Bianco (00:32:07):

Exactly, those guys-

Ryan Caldwell (00:32:08):

That's my guy, yep.

Peter Bianco (00:32:09):

And the old JGB basis and yen futures. But yeah, if you look at, here's the thing, the Nikkei [inaudible 00:32:19] it's been roughly flat for the last four months, meanwhile there's so much else going on. So I haven't had to spend a whole lot of time, but where it gets interesting is, you haven't been able to say Japan and inflation in the same breath for like 35 years.

Ryan Caldwell (00:32:34):

40.

Peter Bianco (00:32:35):

Yeah, since they own Rockefeller Center. Or Pebble Beach, everything else. So that dynamic will be key. Now, when looking at the data, Japan did host the Summer Olympics. So I'm not quite sure what's distorted, what's not distorted. We don't really have a clean look, but that's another economy where you're saying, you're sort of extrapolating this reopen trade that's not really reopening. So we think it's going to go here. We're not quite sure. We just don't know.

Peter Bianco (00:33:05):

But for me from a starting point, I think there's just so much ... The great thing about our strategy is like, we can go anywhere in the world. We can trade any instruments anywhere, anytime. Japan, we don't have to be there. We don't necessarily have you there. So I'm sure there's stuff to do. Some of the stuff screens well in the work, but I just think there's so much else going on. I want to see how that battlefield unfolds before I-

Ryan Caldwell (00:33:29):

Well, and look, I'm going to walk you into this header.

Peter Bianco (00:33:31):

Oh God.

Ryan Caldwell (00:33:32):

Which is, look, I mean, so much of it, at least, in the last decade, plus for Japan has weirdly been China.

Peter Bianco (00:33:38):

Yes, very important.

Ryan Caldwell (00:33:39):

The region needs to be going right. If the region's spinning, then Japan catches some of the flywheel effect.

Peter Bianco (00:33:46):

You're a 100% right.

Ryan Caldwell (00:33:48):

So I mean, the big elephant in the room's China.

Peter Bianco (00:33:50):

Exactly right. And they are a China and China proxy. They can be, they do have a lot of input into that economy. The other thing is Japan's a big energy importer.

Ryan Caldwell (00:34:00):

Yes.

Peter Bianco (00:34:00):

So I want to kind of see how that feeds through to the economy. So again, I think there are certainly fine things to do in Japan. There's plenty to do, but I just see so much else around the world, specifically in China that may be more-

Ryan Caldwell (00:34:16):

So look, let's go right to the heart of the matter, right? So if I look again at the other big and anomaly in 2021, and we as a team talk about this all the time, is just this mismatch if you will in kind of policy cycles, again, COVID being part of it for sure. But China was the stark standout. They tightened like a drum last year. If you look at monetary growth, I think it peaked somewhere in the first quarter, close to 19. And by the end of the year, if you look at total social financing, it was like eight. And the economy for all intents and purposes, forget what the printed numbers was, was in a recession. The market is in a bear market. And again, we all know the issues around big tech and common prosperity.

Ryan Caldwell (00:34:59):

But Pete, I want to get down to economic nitty gritty. And again, I want to wrap this back into this kind of shorter term phenomenon COVID cycle clock, the big, I think news in my mind, there's two big things. One, China went from tightening to loosening in December of last year.

Peter Bianco (00:35:18):

Yep.

Ryan Caldwell (00:35:19):

They put the flag in the ground and said, "We have probably overdone it, property market's wobbly. Consumptions falling apart, we're too tight." So that was one. And we needed to see that signal to start the level out. Now again, interestingly enough, if you look year to date, EM, if you look at EM relative to EFA or S&P, particularly NASDAQ, if you look at the ETFs, EM is leadership this year. Now again, it was a laggard, but so far in this, which you would not guess given the Fed rate tightening cycle.

Ryan Caldwell (00:35:53):

So I just want to point out the contrast there. And then, Pete, the other thing going on in China is obviously this zero COVID strategy, which is proving to be a death blow to their economy.

Peter Bianco (00:36:03):

Yeah.

Ryan Caldwell (00:36:04):

So as important as it is for them to stimulate and try to get some sort of basis for economic growth, the other side of this equation is they're running a zero COVID strategy at all times.

Peter Bianco (00:36:14):

Right.

Ryan Caldwell (00:36:14):

And so the economy can't reopen. So again, Pete, when you think about that, give us a little foreshadowing into what you're thinking in that market, given that's sort of the setup, went from tightening, probably not loose, yeah, tightening to loosening, big paradigm shift and then zero COVID strategy plus the Olympics start in two weeks.

Peter Bianco (00:36:36):

Yeah.

Ryan Caldwell (00:36:36):

Three weeks.

Peter Bianco (00:36:37):

I mean, it's a mess and that's why I love it. I think it's really, really hard, but that's what we're paid to do is to kind of look through that and do the work. I think we're going to see a very different China post Olympics than we are right now. The zero tolerance. I don't even know what that really means. I don't know if they're enforcing it, we read the news stories, but we're not there. So I guess it's working for them but this-

Ryan Caldwell (00:37:04):

Not really.

Peter Bianco (00:37:05):

Not really. And you're right, the data does show their in recession, but China is very focused on saving face. And this Olympics is a very important event in the history for the country. So they're going to make sure that everything is dialed. There's no sick people. They're going to host athletes from all over the world. And after that, we're going to kind of get a ... Then after that they can sort through whatever this real estate situation. And they're clearly sorting through it now. I mean, but we're probably going to hear more about it, maybe a bad bank and their plan either fiscally or monetarily to tackle this recession. But make no bones about it. China is day trading their economy and it's incredible. You have the second largest economy in the world and they're sitting there, it's like a tennis match back and forth. So it's hard, but I think it's so bombed out that it's starting to get interesting and we're doing the work.

Ryan Caldwell (00:38:00):

Okay. So generally speaking, we think we get a little tailwind from reopening globally, probably comes right at the time where nobody wants it. And ultimately, and again, look not to be tied this back, but at the end of the day, we've tested this and over and over and over and over again. And Brian will be here in a second to beat me over the head with it one more time, which

is at the end of the day, if the Fed is tightening, real rates are going up and the dollar accelerates, there ain't a whole lot to do till you get through that.

Peter Bianco (00:38:34):

I agree. And I will caveat that with one point, again, back to that relative point. If we see, and I would, I probably look for the Bank of England first, because they traditionally are first. But if we start to see those guys get over their skis for whatever reason and they feel they have to catch up, and mind you, those economies are a lot easier to "control than ours." I would maybe say dollar down, but I don't know, but that's how I'm positioned, so I'm talking about-

Ryan Caldwell (00:39:02):

Yeah, no me also, nice to be seen. I mean, that's why I keep going back to this short term long term dynamic.

Peter Bianco (00:39:09):

Exactly.

Ryan Caldwell (00:39:09):

I can paint you a case where we get a big dollar ripper to start the year that gets faded the rest of year.

Peter Bianco (00:39:15):

That's exactly.

Ryan Caldwell (00:39:16):

So totally, again, we can pontificate. But again, this cycle within a cycle framework, I want to keep reinforcing because we think it's roughly right.

Peter Bianco (00:39:26):

Right.

Ryan Caldwell (00:39:28):

So that queue right into Brian Cho, the king of the cycle within a cycle and predicting cycles. So Brian, where I wanted to kind of go with you, and again, I wanted you to set the table for where we're going with our research lens over the next six months, which was, and again concise, in this vein of what, and maybe I'll start here and you take off which it is, Brian again is incredible at engineering when we need things built.

Ryan Caldwell (00:40:03):

One of the things that we were attuned to coming out of 2018 in 2019 was that some of these shorter term signals, because of who's now trading them are far more impactful than they've been through history. And so Brian being Brian, engineered us, we have this kind of cycle clock framework that we call domain that's optimized to 12 to 24 month holding periods. It is really good, it works, it is incredibly potent, but it's also optimized for 12 to 24 months. And the problem is, we are seeing cycles unfold much faster than that. So Brian, built us a faster cycle clock that looks to optimize six month holding periods.

Ryan Caldwell (00:40:49):

Now, what I would tell you is we sort of, we started this model back in, we call it our domain 2021 model. We started this model back at the end of 2020. And I will tell you it was lights out in 2021. It caught the inflections early. It caught the inflections late. And again, it's very price

and macro input driven. So Brian, I want to start with you and looking at the two cycle clocks that you build, and tell us what you are seeing and why you're seeing it?

Brian Cho (00:41:30):

Thank you for that introduction. So let's first think about what we have done with our original domain indicator. That was optimized for 12 to 24 months because before financial crisis and before the zero bound policy, what used to happened was factors took a while for it to express itself. Another way to say it is, when you see something, it actually had performance drag associated with it that you can bribe.

Ryan Caldwell (00:42:04):

It's exploitable.

Brian Cho (00:42:05):

Yeah. It was quite exploitable, especially with the valuation metrics and even momentum metrics works up to 12 months. That's what we used to see. And then come, we went through the great financial crisis and then one thing that happened was the level. Now we're going to talk about the interest rate level, right? It went to basically zero and it stayed there. And what it created is that when you have base level that's small or basically zero, anything that changes off of that becomes extraordinary, right?

Brian Cho (00:42:43):

Because you're dividing by zero. Another way to say it is, you could have infinite potential to any change. And so that's what we began to see, right? So all of sudden the macro factors that used to matter less in the equity investing have become greater and greater and greater influence. So what was interesting to us in 2018 and '19 is the fact that, well, our longer term indicators were fine if you are to buy and hold. And if you have that window and holding period, it was fine. However, when you look at our strategy and if you look at mutual fund complexes in general, and then having to deal with all the hedge funds and day traders and all these other parties involved in the market, you have to move faster. And it became a battleground where you have to move faster and faster because the macro factors that influence the market has became faster environment.

Brian Cho (00:43:51):

So what we did is okay, instead of looking at next 12 month and 24 months, why don't we look at shorter terms, three to six months. And then, instead of looking at fundamentals or bottoms of fundamental data, which we use in the longer term forecast, we say, "Okay, let's take them out because it takes while for them to work itself out." So let's just concentrate on looking at the faster moving metrics, which is the market reaction and all the macro factors typically yield curve, volatility, how they move around and all those things. And what we did is we looked at those numbers and we transformed them in our work to see how the latest number look compared to last 12 months. And I think that was the important distinction of how we used to look at the numbers and how we're doing it now, because keep in mind, we're zero bounded, meaning that the small movement in the number has a greater rate of change.

Brian Cho (00:44:57):

So you have to account for that. So one thing we did is we say, "Okay, what if we are to look at latest number compared to the last rolling 12 month?" And then we incorporate all the data and we looked at what should work going forward next three months and up to next six months. And what we did is actually was quite eyeopening, because what it said was we're in a situation where the longer term domain indicator that we have follow the economy, general economy,

much better. It finds that path. However, because the macro environment is so whippy and its bifurcated, you have to have a faster look, right? So this is what this is. So this lens allows us to look at how we should position ourselves on the shorter term.

Ryan Caldwell (00:45:51):

So talk to me about what you see today between the two, the shorter acting model and the longer acting model. And then that's going to kick us off into a little broader discussion, but I wanted to just lay down to start 2022. When you look at the shorter term model, again, to account for the next three to six months versus the 12 to 24 month optimized model, what do you see?

Brian Cho (00:46:17):

Yeah, so let me start with the longer term forecast. So when we look at our longer term numbers, it basically says we're in value domain. Especially in U.S. Japan, we're looking at devalue.

Ryan Caldwell (00:46:36):

So the market wants, so the market, the model wants, cyclicality.

Brian Cho (00:46:41):

That's right. Cyclical value is what it wants. And only exception to this is, even in the emerging market is mostly value, right? There's only two real exception, which is, if you look at Europe, it's value tilt environment, which is right above devalue. So it's right below the neutral. And then when you look at EM, it's just devalue across the board. And only exception in EM would be Taiwan.

Ryan Caldwell (00:47:14):

TSMC.

Brian Cho (00:47:15):

That's right.

Ryan Caldwell (00:47:15):

Semiconductors.

Brian Cho (00:47:16):

Semiconductor industry dominates that mark, so it looks a little different.

Ryan Caldwell (00:47:17):

It looks like '70s.

Brian Cho (00:47:19):

Yeah. So now let me talk about the shorter term. So in shorter term indicator, we have done one more thing, which is, instead of looking at just simply value versus growth, we decide to look at, okay, how are these macro factors impact the factor exposures right on a shorter term basis? And what it says now is this, avoid controversy, avoid high beta, buy high margin, buy free cash for yield. In fact, buy maybe devalue. But on top of that, what was interesting to me was, you want price trend. So you want value where the price trend is what it's saying. And so I think that's actually the key thing, where it says, buy value, buy free cash flow, buy with something with a margin, but you got to have market's endorsement. And if market is conflicted about it, this is a really, really slippery slope.

Ryan Caldwell (00:48:18):

And that's the point I wanted to key on, on the short term numbers, which is, there is one metric that jumps out at me when we look at our short-term modeling work, that looks as late cycle as I can remember in my career, which is the model does not want, and I want to be really clear about what it doesn't want, it does not want any controversy, none.

Brian Cho (00:48:42):

That's right.

Ryan Caldwell (00:48:43):

It wants directional. It wants trend. It wants no controversy. The problem with that is positioning is such that we are ripe to have some controversy. So I go back to Lara's point about, "Look, the Fed may need to go faster." Oh, that'll be controversial. When I look at again, we're going to get with Scott here. We're going to talk about earnings and sectors and leverage to kind of wrap that up. So again, some of the things you point out are so odd. The shorter term more, yes. Emphasize valuation. Why? Because the really expensive stuff is horrid. That's the thing you also didn't say, the model is flat out repudiating the most expensive stocks.

Brian Cho (00:49:30):

That's right. What's also interesting about the latest numbers is actually, let me put it this way. There's two things, which is, first of all, what I said about what it endorses have little alpha. Positive, yes, but not that much. But what's interesting about that is the flip side, right? It hates expensive stocks. It says, "Stay away." And then the other thing it says is, when it comes to controversy, while you want quiet, you want consistency, you want the endorsement, but the controversy old names, you got to stay away. The model does not want anything to do with it. The punishment that's associated with those names is the biggest number I've seen for past two years since we implemented this model.

Ryan Caldwell (00:50:23):

Yeah. And also maybe just, for our older listeners, those of you that remember cycles, this looks again, if I just showed you the factorial expression of what we're looking at, this looks as similar to 2000 as any other peer where you go from a really extreme growth rotation into a really extreme value rotation, which was then met by recession. And then ultimately you cleared the decks and you got into a more cyclical cycle. But again, that was another period where again, very different setup, again, very different circumstances. But again, if I just showed you the two periods and how the factors rolled in '21 versus 2000, it was the same year, in a really weird, again, the S&P wasn't up 25 in 2000, but again, really weird year from a factor expression exposure, because effectively the market took that layer of speculative growth and started to shoot it at the end of the year.

Brian Cho (00:51:25):

That's right.

Ryan Caldwell (00:51:26):

And that's what we see when cycles end.

Brian Cho (00:51:28):

Yep. Yep. What's interesting is, to me the fact that the longer term outlook and shorter term outlook is conflicted or disagreeing, and I have never seen it disagreeing this much. And what's interesting is, market is about to enter controversial period, has nothing to do with internal, let's say equity market, but everything that's outside. All this macro dynamic is coming down the

pipe. So obviously the model to me is saying, "Okay, there's all this stuff that's going on. And you need to find places where it's less controversial." And as you pointed out, what was interesting for past couple of days is, when you look at value versus growth per se, the market went down as hiccups. And then when you see what was happening on those days, although you had down days, values were outperforming on a relative basis.

Brian Cho (00:52:29):

This is somewhat scary. And at the same time it also wants stability. Which also says, "Okay, on a shorter term basis, it's clearly later cycle, maybe even close to the end." While the economic data and the longer term indicators are saying, "Well, we're still kind of early to mid, not yet, but that's what we're seeing."

Ryan Caldwell (00:52:53):

So I want to take this now over to Scott, because I think, look, if we think about what we've just said, just to kind of give the sort of a halftime reset. So if you think about what we said, Lara kicked off saying, "Look, we are likely to have stronger growth, higher inflation to start, and growth that might roll over toward the back end. Fed going to maybe have to move faster." Pete, again, kind of in the endorsement camp, we're going to get a little bit of a reopen trade. Europe might be a little hotter if you look at nominal GDP relative to the U.S. So maybe some things to do there. Brian just gave us the cycle clock summary saying the short term one wants no controversy wants you to be careful. Wants you to avoid extremes.

Ryan Caldwell (00:53:39):

And again, put some emphasis on valuation, quality and sort of low vol, low idiosyncratic risk, not easy defined, by the way. Cyclicals don't tend to have easy price trends. So it's a hard mix. And again, when you actually look at what's been working, it's been some mix of cyclicals, like energy and financials, with actually staples and utilities. So again, if I really call out what's happening in that framework, it's this barbelling of, give me some cyclical protection and yield curve sensitive stuff like energy and financials, if rates are going higher. But on the other side, give me all the stability of staples and utilities, because this is hard because the Fed's raising rates and late cycle, this is what you should do.

Ryan Caldwell (00:54:24):

So that let's me jump right into Scott, because where I want to go with Scott is okay, we've talked a ton about the PE. We've talked a ton about the inputs to the PE when you talk about PE. We've talked a little bit about what's going to go into earnings, given Lara's nominal forecast, but where I wanted to kind of get you to kind of drill down or at least talk a little bit about is, where are the places where you see earnings leverage can get better or sustainable. If Brian's point is like, "The market doesn't want trend, not vol." So, where do you see good to stable?

Ryan Caldwell (00:55:01):

And then I want you to kind of talk a little bit about, because again, Scott has probably one of the cooler lenses in the firm. Like what are you seeing when you're looking at small, mid, large, globally? When you think about this weird cocktail, kind of pull together for me what you're thinking about earnings, where you're thinking it comes through, and then ultimately kind of big, small, indifferent, seeing across cap structure and where's your head?

Scott Sullivan (00:55:32):

Gotcha. Okay. Well, I'll do what I was always taught to do as an analyst, and that is give my conclusion first.

Ryan Caldwell (00:55:39):

Good, because everybody stops listening after it. That's what Hank used to tell me too, "Nobody cares. Just tell them what to do."

Scott Sullivan (00:55:45):

And so my conclusion and that is I think probably midcaps end up being the best place to be over the next let's call it year. But there's some nuances to that. And then I think on all the things that Lara and Brian and Pete just said about all the things that you're looking for, they're obviously exactly right and do a lot of in-depth work in that area so then it's my and Ryan's job to find the stocks that match up with that. And I'd say there's two things that have been the most important, and we look at all the year end reports and this and that, and the other thing, all the sector stuff. And you end up coming to just a few ideas, really, of how you're going to think about the book.

Scott Sullivan (00:56:28):

And I think what's going to be the most important thing for 2022 is the CapEx numbers. And if you sort of look at them, the growth rate for CapEx, this is a summary of sort of a bottoms up analysis from Citi, their universe. But they sort of look at overall CapEx by the sectors. And basically their conclusion is CapEx is up 15 this year. It was up eight last year and it was down 10 in 2020. So that's kind of where we're at. From an overall level it's about 730 billion, I guess, and the previous peak was 650 in 2019. So, we have that element where there's some CapEx and then it's like, "Okay, what is this CapEx all about?" And it breaks it down by sectors, but what's most interesting in here is the sectors with the highest CapEx, growth rate, industrials, strange 20%, materials 20%, energy 18%, and comm services 20%.

Scott Sullivan (00:57:30):

And then you go to staples or healthcare. Healthcare is eight and utilities are seven and discretionary is actually five, because they don't need any capacity because they already have too much capacity. So this comes to a level discussion of where we're at on that CapEx and what that sort of looks like by a sector perspective. Because I have to find all these things that are valued, that don't have ARB that I believe in, I mean, it's a very small bucket at the end of the day that stocks that check that. And so I think our conclusion is that all the things that we've all heard about, whether it be EV or the metaverse or copper or Bitcoin, all these things are, that's where the CapEx is going. Comm services is the metaverse, materials is largely copper and gold and some different things.

Scott Sullivan (00:58:25):

Industrials is all about automation. In addition to that, and this is the last point I kind of want to make on the overall CapEx is the level comment that Ryan made earlier. And I've covered industrials for a long time, so this is boring, but for me, I've covered Caterpillar for 10 years. So this is what's most striking to me about Caterpillar, In 2012, 2012, 10 years ago, they did 65 billion in revenue. In 2018 they did 55 billion in revenue. Last year they did 40 billion in revenue. And this year they'll do 50 billion in revenue, blah, blah, blah. Point being, Caterpillar did more in revenue in 2012 than they were going to do in 2022. And guess what? They're going to make a new peak in revenue. I don't know if you know what they do, but they do energy, like green energy more or less. They have a solar division that pipes natural gas all over the place.

Scott Sullivan (00:59:25):

They do mining. So anything related to copper and gold, they make the machines, those are going to be autonomous. And then they do fracking around energy and then they do construction around roads. So those are all in my opinion, things that we're going to spend money on over the next five years. So, those are the kind of ideas we're looking for, where the

level of revenue is low. The outlook on CapEx both is accelerating and makes sense to us, and then it can't have high ARB or be expensive. So those are all the things that you sort of think about from a book positioning and what that sort of leads us to is it kind of an overweight and industrials and energy, which are probably the two highest conviction places from a cyclical perspective.

And then you've got a little bit in tech and comm services, which again, we talked about comm services. I know it's a growth area for the most part. We think there's some interesting things around what could happen there in terms of the next generation of whatever it is that we're going to use to control our lives. Now it's the phone, next it's, I don't know, but it could be that, it's interesting. So I think that's sort of the way I think about the book. And then I think Lara's point is very pressing around like, "Okay, this isn't going to be easy. So you're telling me all these things about cyclical, cyclicals aren't easy. They haven't worked for 10 years for the most part, how are you going to manage that?"

Scott Sullivan (01:01:07):

And the real thought is there, if you look at, I went through the Caterpillar example and then you can go through the Proctor example on the flip side of it. I mean, that stock's expensive right here. It trades at 30 times earnings, they grow the top line four. By the way, we talked about level like Proctor is all time sale. Everyone in the world bought all the things from Proctor they possibly could in the last year, like who doesn't have like extra wipes at their house? Everybody does. So in that situation the level's too high. And so, these businesses don't grow 7%, they grow like four. And in addition to that, they have to price on top of these commodities that I talked about that are increasing and things like Proctor for tissues, you don't just double the price, you can't do that.

Scott Sullivan (01:01:53):

With a machine, like a Caterpillar machine where you put on autonomous and put on all sorts of different features, it's called price pack architecture and consumer staples, you get a 20% price increase. So at the end to the day, it's just a lot of companies that happen to be in different groups that are all adopting to this new world. And for the last five years we sort of had tech as the centerpiece of that. Google, Facebook, Amazon. And I think what you've seen over the last year, even 18 months is that is expanded. There's tons of opportunities in industrials. There's tons of opportunities and materials. There's a fair amount of opportunities in autos, discretionary, comm services, financials. So there's lots of stuff to do and we'll have to move a lot throughout the year. But I think the idea is to be cyclical.

Scott Sullivan (01:02:40):

Now, when Brian tells us things are a go, I feel comfortable with the names that we have in there that had fit into the things that Brian has told me to look for. And we'll see how it goes. If the stocks move exceptionally to the upside, which they've started to a little bit at the beginning of the year, we'll certainly get price targets on things. So we'll trim them and reposition into a more balanced book as that transpires. But as of now, the positioning is sort of cyclical with the weights that we sort of described with an overweight to EM, in Europe.

Ryan Caldwell (01:03:18):

I think the last thing I wanted to kind of banter about with you and draw out just is the earnings leverage point, which is look, I mean, as I kind of said earlier in the year, I mean, one of the big misses from strategists last year was getting the E right. They were wildly wrong and they were wildly wrong back to Lara's point is because most of them don't understand how gross profit works. So we saw this massive kind of, we saw big margin expansion, despite all the supply chain disruptions, even as late into the third quarter. Now we'll get fourth quarter numbers here

in a couple weeks. So we'll see, there's already maybe some buckling in that. We've had a couple of people that have, started to say and supply chain's tough again. And demand was tough into the four, so we'll see.

Ryan Caldwell (01:04:01):

But I think the message on whole, if you looked at the E was that the amount of earnings leverage in the system is just gigantic. If you look at kind of incremental margins and leverage, incremental margins are running three times the base and the base is high. The S&P 500 put in a new peak base in the third quarter of about 12,5% operating margins, that's a high number. Now here is the joke. And this is back to Scott's point about Cat. The incrementals were something like 30. So Lara's making the point, "Inflation's coming for your margins." And that's going to start to bake in the first part of the year and you're going to have to figure out where that is.

Ryan Caldwell (01:04:46):

Because in some places you're going to have a cost problem. In some places you're going to have a demand problem. And in other places, like to your point about CapEx, and I want to tie these two things together, the reason I think Scott's point so important about CapEx is because that gives you earnings leverage. And if you think of the sectors he just called out, energy, materials, industrials, even comm services, because that spending's going to be in semiconductors and data center. There's massive earnings leverage in the places where CapEx is double digit. So again-

Scott Sullivan (01:05:24):

Let me throw this out, because I should have tied this up in a little cleaner fashion, but yeah, we talked about Cat and the revenue level. So I said, "It's 50, it was 65 before." So in a way, what that means, if you compare that to whatever you want to compare it to, Amazon or Facebook or whatever, it doesn't matter. Those revenues are for the most part already at peak. So what we have with Caterpillar in this particular situation, only because of the cycle, only because it's a long, long cycle, you also have it in aerospace, it's a long, long cycle. Right now the revenues are depressed. So the way we're looking at it on apples to apples basis is 2021 earnings. We just had them, they're finished, the 2021 earnings for Cat versus whoever you want to compare it to.

Scott Sullivan (01:06:08):

And the bottom line is, yeah, they're not that great. However, you're at a cyclical inflection in the business, as I just talked about. We can go through all those business lines, and for the most part they're all going up for multiple years. Not really much of an argument there. And you're already at a level below where you were before, so your base margins are low, but your incrementals are really, really, really high, off the charts high. From covering the stock for, and I don't want to get too much into one stock, but what ends up happening with this versus a consumer staple, an industrial versus a consumer staple when they really have leverage at the OEM level is large, large earning speeds. And that's what you need. You need it, you need it. You absolutely got to have it.

Scott Sullivan (01:06:52):

And so any of this Omicron supply chain slow down, we can't have it for too long. It can be a little bit, but we to get some numbers into the year. We need to hit the revenues, we need to beat the revenues and all that needs reopen as Pete discussed. So all these things are sort of tied up together, but that's sort of the way we're thinking about it, I think.

Ryan Caldwell (01:07:10):

Yeah, and I think it's incredibly well said. And I think, look, the reason I wanted to draw that out is because quite honestly, you haven't had to worry about cyclicals for a decade.

Scott Sullivan (01:07:20):

No. Well, we just talked about-

Ryan Caldwell (01:07:22):

We just talked about it.

Scott Sullivan (01:07:22):

... 2012 for Cat was the peak and revenue.

Ryan Caldwell (01:07:24):

Right.

Scott Sullivan (01:07:24):

It's 2022.

Ryan Caldwell (01:07:25):

Yeah, we're 10 years later. You could have-

Scott Sullivan (01:07:27):

Down 15 billion from there.

Ryan Caldwell (01:07:28):

Yeah, you could have ignored it.

Scott Sullivan (01:07:30):

All right.

Ryan Caldwell (01:07:30):

Like legitimately ignored it, and that was the right thing to do. I think what we're trying to say is, the competition for investment dollars for where they've gone, whether it's Facebook, Amazon, Netflix, Google, Microsoft, core growth, concept, finance, whatever.

Scott Sullivan (01:07:47):

Which were all right at the time.

Ryan Caldwell (01:07:48):

Correct.

Scott Sullivan (01:07:48):

All that time period, Amazon and Facebook and all those outgrew Caterpillar and deserved to go up, absolutely.

Ryan Caldwell (01:07:54):

No question.

Scott Sullivan (01:07:55):

Today, right now, which one deserves to go up? And I think there's a pretty good argument for Cat over those.

Ryan Caldwell (01:08:01):

No, and that's where I wanted to leave the fundamental argument, is to make that point. Competition for investment dollars is going up. And so again, when we wrap this all up, and again, we've bludgeoned you from top to bottom, from macro to down to the sector level. But one of the reasons I'm so adamant about doing more research and publishing more and more podcasting is, I believe this is a seminal change in the backdrop. We saw one of these at the end of the global financial crisis. Again, at the time, if you remember, it was everybody needed [inaudible 01:08:35] for the next 20 years, dead wrong, dead wrong, absolutely dead wrong. Had to get to the U.S. had to get to growth stocks.

Ryan Caldwell (01:08:42):

Now the argument is, disruption, cloud, concept, finance, secular trends, blah, blah, blah, probably going to be dead wrong. Like, we'll see. But the condition set is setting up to be a bit of uh-oh, that's not really right.

Ryan Caldwell (01:08:57):

And again, I want to pull macro. And so we're going to write about this. We're going to talk about it. We'll give this to you in more bite size chunks. But the thing we tried to do in the 3D report was go through the cycle clock work, go through some of the quantitative work, but I kind of titled it this way, and I want to leave here. Look, 2021 I titled the 3D report from diamond hands to diamond eyes. 2021 was the year of diamond hands. It was the meme stocks. Everybody loved them. Elon was texting out a diamond in hands saying they have, and again, for those of you that are running indoctrinated, diamond hands means you'll buy, regardless.

Ryan Caldwell (01:09:38):

Any volatility, whatever, doesn't matter, you're holding your position, you're buying every dip. We think that's dead wrong. We think you actually need to change your book. So it's not so much about diamond hands and back to Lara, hey, Brian's model of work is saying, "No controversy." Lara's saying, "We're going to get a controversy from the top level of the stack." Different book. And when I talk about having diamond eyes, it's pulling your head up from the table and not having tunnel vision and saying, "Where are we really?" And I think that's a little bit about Lara talking about the Fed's realization of, "Oh God. We're really, really, really behind the curve." Pete's commentary about the Europeans are going to have to change the behavior a bit. And maybe that catalyst is there. China, China's a mess. The second largest economy in the world is a mess.

Ryan Caldwell (01:10:29):

And again, investors kind of whistle past that graveyard and say, "Well, it's not that big of a deal because I'm not all in China." Yes, you are. In every facet of your portfolio you are. So I think all of these things to us are critical. And again, when I think about kind of this short cycle versus long cycle debate, give up your diamond hands, be a little bit more flexible, because we do think you're going to get some controversy. We do think we've got to end this weird cycle we're in, in order to get to something else. So shorter term I would say, we're watching this thing closely. We are worried about a first half. I keep saying late cycle vibration, because I'm not sure you're going to get the typical down 30 that you get in a recession. So I'm not sure we quite see that, but can the market give you half of one? Can the market give you a taste? Sure.

Ryan Caldwell (01:11:19):

And I think that's a little bit of what we're seeing out of our work a little bit. So as Scott pointed up, yep, we're cyclical for now. It's working great. Market's rotating. Economy's fine. We think we get some reopen. We keep a real tight eye on this into the first half of the year, because my

guess is you're going to have to do something very different. And ultimately we think looking at our kind of medium term work, you're really going to have to do something different relative to the last decade. So we think we're there. We've been talking about this cycle clock concept. Cycle within a cycle for a good year and a half. And I would tell you it's as vivid to me as it has been, and we're going to be pretty close to following that model.

Ryan Caldwell (01:12:01):

Again, we rely incredibly heavily on our fundamental team, from Lara and macro to Scott, Brandon, Pete, all of our guys and myself and fundamental. We're looking at Brian's quantitative work. And again, what we're trying to figure out is where we're at in this mess. And again, this is likely going to be a volatile cycle. It probably needs a ... Take a WWE reference, a top of the rope elbow to kind of get the thing over with. And then we likely move on to something that looks a bit different. So all of that we'll see how it unfolds. Unfortunately, it's all been way faster than I would like it to be, given I'm getting older and fast things when you're older are disruptive. So again, I would just say, we're focused on this. We're going to write a lot about it. We will get it out to the market. I really appreciate the team putting this all together.

Ryan Caldwell (01:12:52):

Again, you can read it in our 3D report, it'll be out quickly. I see Phil back there nodding his head as if yes. So we will have this out to the market quickly and we will be back with updates. So like I said, you're going to feel a very consistent cadence of research on this through the first half of the year, because we do think it's so important. So I think with that, guys and gals, thank you all. We appreciate it. Nice long one to start the year, we will be back. Thank you all.