

Episode 33

The Caldwell Hour: Low vibration becoming a quake?

Market indicators are flashing signs of late cycle vibration. Ryan Caldwell and team share their strategic approach to riding this low-frequency wave.

Ryan Caldwell (00:00:00):

Welcome to another episode of the Caldwell Hour, an FS Fireside chat podcast. I'm your host Ryan Caldwell. I am joined by my FS colleagues, Lara Rhame, Scott Sullivan, Brian Cho and Peter Bianco. In this episode of the podcast, we will be discussing the quarterly performance of global capital markets. The fundamental economic and quantitative inputs that all drove outcomes in the quarter and what our views are of the going forward influences that are likely to affect capital markets.

Ryan Caldwell (00:00:49):

I thought, I guess, first to talk about the quarter, there were a couple of things, and I was thinking about it this way. Like the cadence of the quarter was really weird. First and foremost, it was a bad quarter, right? If you look at kind of equity returns, bond returns... and Pete we'll get to commodity returns in a minute, but outside of commodity returns, it was a bad one. And again, as bad as I can remember, early in the year back to 2008 and even like a glimmer of a 2020. And I thought the cadence was actually really different. Because I was thinking about this as I was getting ready for the podcast, which was, January it was all about slaughtering growth stocks, right? Like the real issue in January was, "wait a minute, no, the Fed's really going to have to move and inflation's probably going to run a little bit hot." And so, like the high, multiple stuff, like you didn't want to be in. And there is, again, from a fundamental perspective, I don't know that a lot had gone on other than I think people woke up at the turn of the calendar and realized, "no, I probably don't want to be in the high, multiple stuff". And we talked about in the 3D report, it is shocking to me how fast you rerated all that stuff down. So, I do think one of the takeaways out of the first quarter was this really wide, multiple disparity that existed between like super premium, high growth, non-cash flow, generating growth and value, like eviscerated in a quarter.

Ryan Caldwell (00:02:06):

Like normally, if you think back to 2000, that took 12 months to work all that out. When the market was transitioning out of tech into kind of the next thing, like it took a full 12 months. This was literally in like 30 days, you rip the multiple. So again, back to this discussion we've been having about how fast the market's moving. So, I thought again, January a lot about the multiple compression and again, strategists have been all over multiple compression. The truth of the matter is most of the multiple compression happened in one place. It was really expensive stuff. The cheap stuff didn't see a bunch of multiple compression and we're going to talk about that. February then changed gears a bit because obviously Ukraine became the key point. Were they going to go in? Were they not going to go in? And ultimately, obviously toward the end of the month they did. So I think that changed the characteristic stack. And when I think about the last

month March, which was wild, right? Like you had a terrible first part of the month and then the back half, it rallied, like somebody lit it on fire.

Ryan Caldwell (00:03:11):

And again, I think now, with a little bit of perspective, people are starting to debate, "Why did it rally so hard?" But I think, again, we've talked about on these podcasts, the macro, which we're going to bang on a lot, the positioning of investors, like none of it made any sense. And so we're trying to reconcile through a lot of that.

Ryan Caldwell (00:03:32):

And so, I want to kind of break this down a couple of different ways. I want to start with maybe a little bit on kind of macro and the Fed. So, I'm going to hit Lara, you and Pete, really hard on this and maybe in a little bit roundabout way. And then Brian and Scott, I want to come back to you a little bit on what happened at the company level, right?

Ryan Caldwell (00:03:51):

So, framing the two together, and then I want to get a little bit deeper into kind of where we think this thing's going. Because I think, I can't remember a time in my career where there's this much consternation about the next quarter. So, like, I think even near-term forecasting is become incredibly difficult. Let alone medium-term forecasting long-term forecasting, so I did want to kind of touch on all three of those things. But maybe first to start, so Lara, I'm going to start with you. And I thought a lot about this and I was telling everybody before we started up the podcast, so much of what's being discussed is so consensus it's fairly boring, right? Yes. The Fed is hiking. Yes. We have very high inflation. I think we all now know how we got here. So, like the normal kind of talking points around this, I'm not really sure what to do with because they've become fairly obvious embedded and vetted.

Ryan Caldwell (00:04:56):

So, I wanted to come at it from a little different angle. And a little bit of this as talking offline to Pete, Lara. I want to think about, I want to probe this a little bit. And Lara, like I said, I want to start with you and I want to start with the Fed itself. And the thought I kind of had in trying to prepare for this podcast, and when we were writing our quarterly, is the amount of volatility in Fed forecasting is shocking.

Ryan Caldwell (00:05:16):

And so like, I'm sitting back thinking about the market going, "wow, the market's really been volatile, and rates have really been volatile, and we can't settle." But part of that argument is like, if you think about the forecast vol at the Fed, even going back to earlier in Powell's tenure, to even where we're at today, like the variability shocking. And Lara, so I wanted to start with you and for our listeners who aren't as familiar with her background, and this is why I want to tease it out this way. Lara was at the Fed when she was at Credit Suisse, she was a currency trader. So, I love macro people that were traders and I've got two of them because they're more apt to give you cut through and tell you what really people are looking to trade off in these kinds of macro layouts.

Ryan Caldwell (00:06:01):

And so, Lara wanted to start with you because I thought last week when Brainard started channeling Paul Volcker. You know, I kind of sat back and said, "dear God". Like they are blatantly, or at least she was blatantly saying, we want explicitly tighter financial conditions. Now, again, for all you that are listening, that translation to me is "you need high yield spreads, wider. You need equity prices lower, and you need the dollar stronger". That is what tighter

financial conditions, quote means. Higher rates, wider spreads, again, just less looseness if you will. But Lara when I think about that flip, and again, for those of you that are not as familiar. with Governor Brainerd's framework. So she was the president of the San Francisco Fed. She has been a board member for a very long time. Lara will probably tell me exactly how long she's been a board member, but she's the quintessential dove. Most of the policy framework that's been expunged out of the Fed in the last four or five years has really come from her and John Williams out of the San Francisco Fed.

Ryan Caldwell (00:07:12):

And it's very dovish. And so, Lara, this flip that we saw last week, so what we've been trying to understand for market participants is this: A) do they really believe it? Do they really believe that they are this far behind the curve? They've got to go this fast. If they don't inflation will embed. So you must destroy demand in order to get supply side shock inflation under control. Do they really believe it? Or B) is it really still a political issue because obviously inflation is not polling well. It's polling horrifically, and none of these people are confirmed yet. And again, I'm not trying to be, I'm not trying to be a tin foil hat guy, but they're not confirmed again, this vote hasn't... Brainard, Powell... They have not yet been confirmed, so they are still politicking. And then I guess, Lara lastly, if they do believe it, do you believe that this Brainard laid out soft landing where they tighten enough that, I guess, you get rid of excess job openings while not getting to actually firing people?

Ryan Caldwell (00:08:25):

Is that really achievable given the blunt instrument that's monetary policy? So those were kind of my three. So between you and Pete, I wanted to dive into this, what is politics? What is going on? Why are these people so volatile? And if they can't forecast, how are we supposed to forecast?

Lara Rhame (00:08:43):

Yeah. So Ryan, I, I'm going back, I'm going to go back and hit a couple of the things that you mentioned. because I completely agree. I feel like markets have moved so far. They've swung to a hawkish place pricing now for maximum hawkishness. Something that you mentioned was, calling out the Fed for being bad at forecasting during this environment.

Lara Rhame (00:09:07):

And, none of us are perfect forecasters, they've got like thousands of economic PhDs over there, like what's happening. And, I would almost turn the question around and ask if the only reason they were good at forecasting before is because inflation for two and a half decades was 1.9% plus or minus 0.2%.

Lara Rhame (00:09:36):

In other words, it was low volatility. It was stable, it was steady. It wasn't really going anymore. That's not a challenging forecasting environment. And even in that environment, they still had episodes where they got them wrong. But I feel like they just were lucky. It's like a coach that's middling that has a phenomenal team, you know, they look really great. That's not to disparage, an institution that I think wants to do well, but I think they just got lucky for a long time in, a low volatility economic environment where your forecast was never going to be that wrong. It's a really good, and we're going to get into a little bit of this later when we talk about the great moderation, but Lara, it's a really good point.

Ryan Caldwell (00:09:31):

And again, I want to circle back to it because I want to link together was really all of the stable fed just Bretton woods two. And they were a beneficiary as well, like chicken in the egg and they, to your point.

Lara Rhame (00:09:44):

Yeah, absolutely. Yeah, here we are, forecasts have been wrong. I think inflation. pretty obviously it was not transitory, but it took a long time for, I think the fed to really, because it's a consensus organization to really build that momentum. and we talked, you talked off the top about the Volcker fed and that is the name that really everybody, like there should be a statue of him out in front of the New York Fed.

Lara Rhame (00:10:11):

He was just this like larger-than-life character that I think, you know, really was, deified, and he's still really looked up to as the model for, really coming into the ring with inflation and doing battle. And that's, I think the situation that the fed is in right now, so do they believe it? Yes. You know, I think they believe you've got, especially, you know, if you really look at a lot of the core people who started there in the seventies and eighties, there's a really strong belief that now is their moment now is the time for them, if they fail to address inflation now, and can't get ahead of it, that they've just sort of almost disappointed this big legacy. So, I do think there's belief that they need to do something. is it political? Of course. And I think here's where it's political. Two ways you have the confirmation battles that are coming. You're getting enormous pressure from the white house; this white house doesn't tweet as loudly as the prior white house.

Lara Rhame (00:11:15):

But believe me, there is the back-channel pressure that is at a very high volume. and, but the other side of that is just recognizing that, for all that the fed has talked about, rising income inequality and all of the other, wider, ways that the fed has tried to impact the economy. They've talked a lot about income inequality and, the inflation, especially the food and energy inflation combined index is over 15% now. it's just a punishment to, the lower core tile of income households. So, you have this issue where the fed is, I think really acutely aware. And I think, unfortunately there's just not as much that they can do about that, but they're acutely aware that inflation is, I think now a big risk to a large swath of our economy.

Lara Rhame (00:12:07):

So, there's these, this is politics in the background. And then, there's the talk of the soft landing. And I think this is a place where, they're talking a lot about how they can manage a soft-landing Powell give a long speech about it. You've had Brainard out talking about. how, they, on the one hand, they want to talk tough on inflation. And on the other hand, they want to keep comforting people that they can manage a soft landing. The reality is the probability of them. Actually, achieving a soft landing is low. I think that it's low and whether or not that ends in a recession, it will very likely end in them having to turn around pretty quickly and cut rates. and whether we get, the classic recession or just a quarter of contraction and weak growth, I don't know, but I think the chance of this, it's like trying to find a unicorn, trying to achieve a soft landing is just really, truly difficult.

Ryan Caldwell (00:13:04):

What and that's I just one of the things I want to do, like tickle you and Pete on a little bit, like when you look at the forward rate curve, it's nuts, right? Cause it has all this front-loaded hiking. And then like effectively, it starts to Peter out to cut really quickly. So it's like the market is already assuming there's a policy error.

Lara Rhame (00:13:25):

Yes. and it's the forward curve, it's the yield curve. It's other classic indicators that we look at on the economic side, I look at a ratio of consumer expectations to the present situation that is at the highest level that it usually is that precedes a recession. So there were these little alarm bells going off, and the, it's early in the fed rate hike cycle, but I think it would be irresponsible to ignore the fact that these alarm bells are going off. And the fact that this cycle has been on fast-forward since COVID hit, it has been, a record bear market record recovery. Record profits, recovery record economic recovery. And here we are raising rates aggressively, and we're only two years into the recovery. Usually we're five years into a recovery.

Lara Rhame (00:14:18):

So it's all just been on fast-forward and I that's what I that's how I can't do anything, but take seriously until I see evidence, otherwise that we're still on fast-forward.

Ryan Caldwell (00:14:30):

Yeah. And I think that's probably the salient point for what I was really trying to get at, which is, are you just going to get, are you going to get late cycle, right? Like the market's kind of half telling you that and Pete, I'm going to come right to you cause we're going to go right to commodities and we're going to go right. To the, again, the backdrop, not the, we went to war and commodity prices spike like that part, I think we know, but this has been brewing a bit in the background.

Ryan Caldwell (00:14:58):

For a bit having, commodity imbalances, and now this kind of hyperactive fed when Pete, yesterday, we were kicking around the curve and you had made this point of what the smart money's doing out in like the five-year 10 years and five-year five years and what's embedding there, can you talk a little bit about that because the smart money is telling you, you're going to get again, whether you call it a recession or not the smart, money's telling you you're going to get a late cycle event, whatever that means. You know, we looked yesterday at the fund manager survey, which comes out from Bank of America, which they do a really good job. And what was shocking was at least to me, was the difference between what's priced into the curve, at peak, I think we were talking about 11, 12 hikes or whatever it was.

Peter Bianco (00:15:46):

The fund manager survey, which, is a pretty decent indicator overall. I think they were looking at seven or eight, so there is a big disconnect there and there's always been, there is even a disconnect to where the fed terminal rate sits versus what the market pricing versus the survey as well. So there's clearly a lot going on and we can talk about whether it's, larger, real money insurance types that need to hedge exposure, which, their objectors are very different than, say ours are, or the leverage community. But yeah, it's been a really difficult environment to navigate.

Ryan Caldwell (00:16:17):

And for either one of you or both. So I have a client asked me this question and I gave a very flippant answer and I've been thinking about it a lot ever since. And I still think my flipping answers. But I'm going to, I'm going to pose it to you too. What is the terminal rate? Do we have a clue what the terminal rate is?

Peter Bianco (00:16:36):

I'll leave that to Lara.

Lara Rhame (00:16:41):

Thanks, Pete. so it's lower, I think, than the fed is estimating. And this is, and I don't mean to talk out of both sides of my mouth. And so that's why I just want to explain what I'm about to say.

Ryan Caldwell (00:16:51):

You're an economist that's totally acceptable. It's expected. It's no problem. You don't have the trader hat on your, you can play an economist but on the other hand,

Lara Rhame (00:16:59):

Podcasts where we got the part of the cycle being on fast forward and part of, I think what I was talking about when I was saying that the, for the Volcker crew for the Volcker fan club now is the time to shine. I think this issue of how much do they have to raise rates to actually impact demand, and to actually impact inflation. It may not be as much as it was back. It may not be as much as the markets are pricing in. And it certainly isn't as much as it was back in the seventies and eighties. Thank goodness. But, but by that, I mean, demand's already slowing.

Ryan Caldwell (00:17:38):

Yeah.

Lara Rhame (00:17:40):

Look at what's happening. Potential growth back then was four and a half percent. Now it's 1.75% and we're already there, on the consumer side, and a lot of what's causing prices to rise is not driven by demand. So I don't think you have to hit demand too hard to get some of this, to come back into balance. So I think that is another issue. When I talk about the cycle being on fast-forward, the fed may get to a place where it's impacted inflation. Faster than even markets think. and for that reason, I feel like I sound really pessimistic when I say oh you know, policy mistake, could they go too far? They usually do. That's not me being, wildly out of left field here. That's just what happens. but there's, I think there's going, there's room for them, especially if they're, depending on how active they want to be using their balance sheet there's room for them to be flexible as the rate hike cycle continues. We just can't take the fed funds futures curve in stone. It's not carved in stone. It's not a roadmap. And I think if we've learned anything from the rates volatility, it's that?

Ryan Caldwell (00:18:50):

Yeah. No, I think it's an excellent point and I want to highlight it just to the listener group, because I've had this kind of sneaking suspicion that again, you were going to land where you landed Lara, and I know where Pete's head is on this. You could run this car into the wall pretty quickly and right into the wall out of the wall quickly. Is so I even struggle with and this sounds ridiculous, but bear with me, like the bear market term, the recession term, I'm just not sure you're going to be there long enough to count it. I'm not sure, so sure. You're not going to see it. I'm totally like, you can convince me no problem. We can get there. But as market participants, like duration matters, right? Like the duration of the downturn, the duration of an economic recession, the market dislocation matters. I'm just not sure it's going to last very long. So I'm also not sure, like how do you deal with that?

Lara Rhame (00:19:47):

Is it going to be with the recession? I like to call it my favorite recession in the early nineties, two quarters of weak growth, contraction, but year on year we were positive.

Ryan Caldwell (00:19:56):

Yeah, like that's is. So I just wanted to leave that out for the listeners to say, you got to talk about it now because the market has clearly shifted from when will inflation peak to when will growth bottom. Like we have now done that. Like I think if we talk and we're going to get at this at the company level here in a minute, but there is no question at the macro level, the market's gone. That's peaking when does growth bottom, Two really different environments. All of a sudden, even with kind of inflation doing what it's doing.

Ryan Caldwell (00:20:26):

So Pete, maybe let me roll to you because I want to talk to, I want to talk about. the big contributor, if you will. president Biden likes to call it Putin's price hike. but we can go back to the, the price hike and I want to talk. So for our listeners who are not familiar well Peter Bianco, who is the head trader on our main strategy is also the lead PM on a real asset strategy that we manage. And so he is immersed in all things, commodities, real asset, energy, transition, all those fun topics that are now being written about. And so Pete clearly one Q is a very hot quarter, as you've laid out in the past to us.

Ryan Caldwell (00:21:05):

And I was hoping maybe just to take a minute or two with our listeners to maybe go a bit beyond, look, Russia invaded the Ukraine, right? Energy prices spike because Europe's too path dependent on Russia, for their energy supply, particularly natural gas, the world needs their barrels of oil. As it reopens like all really well kind of socialized. Food inflation, wheat, obviously Ukraine and Russia, big wheat producers. That's now really well socialized, but what I may be wanting to have you lay out underneath, okay, that's the present of what's happening. But one of the things you've been harping on, at least with us for the last kind of 12, 24 months now is that these roadmaps to like COP 26 ESG and sustainability, hydrocarbon investing. You were kind of pulling what little hair you had left in your head. And I can say that, cause I have no hair. You are pulling what little hair you had out left saying, this is madness. Like the way we're approaching this doesn't make any sense. So it was maybe wondering if you can give me like the two minute background on like, how did we get here?

Peter Bianco (00:22:13):

Yeah, no, that's a fair question. So I'll even tie it in with the previous discussion, central banks, the main central banks around the world. in 1919, they came up with this plan to really stoke inflation. that's what John Williams was tasked with and it was presented at the Chicago Fed. ECB took a similar stance. So you had an environment where the Phillips curve was dead and they needed to create inflation. So we had very easy monetary policy and they said, we will allow it to overshoot to the upside. And here we are. So that was sort of the background. It was really, conducive to risk-taking on top of that, there was a dogmatic push toward this decarbonization. Now what that all means is we're all going to go to electric. It's going to be great. Hydrocarbon traditional hydro hydrocarbons are going to go away to do that. you have to spend massively on commodities around the world and folks started to get hip to that. So that did cause a little bit of a bit to the space then COVID happened.

Peter Bianco (00:23:10):

So we had easy monetary policy, which was extended to incredibly easy monetary policy. And all of a sudden this whiff of inflation and it's this discussion of inflation started to, to perpetuate. So that was the setup. My view is that created a perfect storm and a vacuum for where we are now, where it was, hydrocarbons. there was a geopolitical vacuum in Europe and an opportunity for maybe folks around the world, IE, Russia to make a move. And then we have this conflict, which just exponentially accentuated all of those factors.

Ryan Caldwell (00:23:51):

So Pete, when you think like, this is the question, obviously we're hearing a lot and we're discussing ourselves a lot and you, and again, I think you've got some pretty poignant views. So what is the solution to this problem? If I think about the problem is almost like a teeter-totter problem, on one end of the teeter-totter we want to get to, more sustainable, more renewable energy solutions. On the other side of the teeter-totter is hydrocarbons, which have wildly been underinvested in now for a good five years, six years, maybe going back to the shale boom, in kind of 14-15, the kind of it is you've laid out the key materials to get to, sustainable and renewables things like cobalt, platinum, iron, or, lithium, copper, like we haven't done anything there since, the, the heyday of the boom of, materials, energy and industrials back in 2007 and eight, you just haven't invested. So Pete, what is the answer to deal with this? All of a sudden, because again, you know, to Lara's point going into COVID, in 2019, nobody thought we were short commodities, it was starting to percolate that, oh, like this is going to need to do more, but now it's like glaringly obvious we're short commodities. So what is the solution? Because you can't do any of this fast.

Peter Bianco (00:25:14):

No, you can, but you sorta gotta separate what's popular versus what's practical. And, essentially what we've been saying is, price is the best geologists you're going to need traditional hydrocarbons to bridge the gap to a greener future. And I think, I think the traditional, integrated energy companies would say the same thing. Unfortunately it's gonna make for some very unpopular decisions or else we're going to live with these higher prices for the foreseeable future. I think that's pretty insightful.

Ryan Caldwell (00:25:46):

And again, as we've been thinking about it across all our different strategies, and I think, we were kicking around another company earlier today, but you made this point, which is, this is just a long-term investment cycle, right? Whether it's now or later, it's a long-term investment cycle.

Peter Bianco (00:26:01):

It's a durable, sustainable theme that we discussed this morning, like we're going to be dealing with this for the rest of our careers. Like you're going to be able to play this theme cross asset it's durable, through whether it's a growth cycle, whether it's a value cycle, like this is something that, that we're going to be involved with for a long time.

Ryan Caldwell (00:26:20):

Nope. Nope, totally makes sense. Brian, I want to kind of loop you into the discussion now. So again, quarter wasn't great. Again, tons of policy volatility, the Fed's back on the boil commodity price spikes. So Brian, maybe real quick, if you could give the snapshot view. And obviously we lay all this out in great detail in the actual written 3d report that we do. But Brian, if you could give a little bit of an update on the two cycle clocks, cause I want to hit on exactly what Lara was talking about, which is speed. So if you could spend a minute on our, we have two cycle clocks, we've renamed them. This is what apparently I've been told you do. When people think things are too complicated, you just rename them to something simple and then they become very easy to understand.

Ryan Caldwell (00:27:08):

So we've done that. And so we have two cycle clock frameworks. We work under one, we call our tactical domain, which is really optimized for the next kind of three to six months. And then we have a more strategic. Domain, which is again, more medium term optimized kind of 12 to

18 months. So I was wondering maybe if you can give the listeners when you took the snapshot at the end of the quarter, what are the tactical works? say, and what did the strategic work say? And were there any sort of things that jumped out at you between the two when you compared one to the other, that you know, that you observed? Because again, this is all your work, your models, like what did you see?

Brian Cho (00:27:52):

Okay, let me address the easier part first in that question. So let's deal with, our, all the domain, cycle clock. We are now calling it simply domain.

Ryan Caldwell (00:28:05):

This is the strategic domain. Brian strategic is understandable. It is strategic.

Brian Cho (00:28:14):

What we're doing there is trying to identify what will work for the next 12 to 18 month and beyond. And what's interesting about the reading of the outcome on that model is simply all you're going to have to tilt towards value or anything to do with the valuation or cheapness. So it's favor that you take risk and cheaper names and cheaper securities, across the investment spectrum. Having said that that's the theme that we are leaning on. And then we have this tactical domain model, which tries to identify what should work next three to six months. And here's what he says at the moment. First of all, what I felt was very interesting is he likes beta, but he likes cheap beta. And then at the same time, it doesn't like high idiosyncratic risk. So high arbitrage risk or anything to do with, youth workie type of events. So the companies that CMDC likes to talk about a lot, they're the wrong company to think about at this point.

Brian Cho (00:29:28):

So high arbitrage risk is shun. Then the bling that continue to show up is actually free cash flow, margin. Margin is favor again and again, whether it's a growth or value. And then one more thing I want to point out is that tactical domain likes momentum. So another way to say it is, he wants to bend a little bit more or bed on the, your names with the moment growth names with the momentum. There's a big but, right? What it wants is the free cash flow margin. So at the end of the day, it's saying, okay, he wants kind of like of carpi names and a lot of free cash flow production. So that's interesting to me because he think about what's been happening around the world and all this geopolitical risk that's been talking about how are we going to now regionalize versus globalization that occur for past 20 years? What's interesting about that is so far the companies with the durable cash productions are the winners and that kind of shows up this year, especially the cheaper side of the ledger.

Ryan Caldwell (00:30:43):

No, I was just going to say just, picking up on a couple of things just to translate. the factor read to sectors and stocks. So what the shorter term tactical model is saying is it wants the things that have been winning. So on the cheap high beta side it's commodities, right? That's, what's winning. The other thing it wants is effectively defense, right? So it wants high free cashflow margins. It wants a valuation support. And so you think about, what's been leading healthcare utilities, staples, and commodities, right? Everything on the other side of the ledger, in the very short run, the market is repudiating, relatively quickly. So that is just again, to compare and contrast the two. Where are we looking at a more medium-term basis? Like it wants cyclicity, like our sentiment work, our strategic work wants cyclicity over the medium term. It really doesn't want it in the short run outside of commodities, Pete, where again, it's so obvious how short supply we are relative to demand.

Ryan Caldwell (00:31:48):

So it's, that's what I find so interesting to me. And Brian, you brought up just brought up the point about, near term price momentum. Well, if you think about what's worked in the last nine months, it's pretty narrow, right? A lot of things haven't worked and again, a couple of things are working. And again, I'm trying to stitch all this together for the listenership. That's late cycle. If I told you energy utility, staples, and healthcare, we're going to lead, you'd say, oh, the world's about to come to an end. Okay, great. We're a late cycle. So I think again, the short and the medium term I think are in conflict. And so Scott, this is where I wanted to come to you because I'm going to give you the zinger on the quarterly stuff before we launch into kind of a, maybe a little bit bigger topic, but Scott, here's what I wanted to hammer you on, which is this.

Ryan Caldwell (00:32:37):

So what we're now seeing again, outside of Pete spaces, because they don't believe this. And I don't think there's any, any sort of demand issue being priced in at the moment. But Scott, when you look at things like discretionary, semiconductors, industrials, other cyclicals, right? The argument, the market is very quickly seem to gravitate to is I don't care what your numbers are in one case. Or now maybe even to queue. And we've gotten a little bit, it's very early in second quarter earnings. So don't want to over extrapolate or reporting first quarter in guiding second quarter. So I don't want to over extrapolate, but where the market is coming to lining up again with Laura talking about the rate forecast is effectively that by the time we get to the second half, the numbers have to get cut because the consumer is done.

Ryan Caldwell (00:33:34):

Right? So if you're a consumer sensitive business, by the time we get into the back half of the year, your demand is not going to look like it looks today. Again, very rough sort of story, but that seems to be where the market's honing in. So I wanted to kind of grab you on that. Because as many of our listeners now Scott runs our small and mid cap strategy. He also does all the core strategy work on the big fund with Brian. And so we talk a lot about this concept of kind of core versus kind of outside the core. And what's showed up to me. Scott is like the core cyclicals are now under attack. That's the new part. I think recently, as mark said, I don't believe your demand see in the second half, so I'm going to press you. When you think about that starting point, do you buy it? Is it right? is that the most important thing? what are you thinking about now when you're thinking about kind of cyclicals consumer, like what you're looking for, what you're not looking for, do you believe the numbers? Do they need to be cut because it is a big deal now and it does seem the growth argument now seems to be the big argument.

Scott Sullivan (00:34:43):

Okay. Yeah, no, I think that's the right question. and I think, in thinking about the consumer or some of the consumer stocks, I think maybe target is probably the best example. and when they reported about a month ago, the guidance was back half loaded for this year. since then I would argue it probably hasn't gotten a ton better from a consumer standpoint. And that I would argue is amongst the most defensive names, from an earnings perspective in this environment. so you have that and you have, where that stock is trading, which happens to be a little bit cheaper. So to me that's a very important stock to watch regarding the consumer all ends of it because you can argue trade down, trade up, all sorts of different aspects of it. But I think the bottom line is, yeah, the number's got to come down there. Is that one cheap enough could be if it is the others aren't. That's the way you got to think about it. I think on a relative world of okay, who's the best position here? What's their valuation look like, okay. We can all run a Walmart, but Target's probably going to comp better. Why is it like seven, multiple points cheaper? I don't think that makes sense. So I think you're going to come back to this kind of core supply demand or, who can generate demand or who gets the demand, and a more, peer

or historical manner, as opposed to like us arguing about consumers that we get our eyeballs that we captured.

Scott Sullivan (00:36:02):

I think it's going to be a little bit more a fundamental look at some of the demand backdrop. So I think that's one point on the consumer, which makes it a very difficult place to be. I think that all those things that we discussed, geopolitical commodities, that's all going into the consumer. And in addition to that, they've got a demand problem around gas price. So I think that's hard and I think that'll. W it usually is the first to turn, but if it is, I think it needs to turn from a lower point. so that leads you to some other places industrials, were okay. and I would say there again, a narrowing of the market, and the way that I preface that is this. I think the short term is unquestionably become more difficult there. commodity price increases different things on the margin, employment problems, the ability to use the supply chain, shipping problems in China. So I'd be hard pressed to say a bunch of people are going to beat numbers in the second quarter, first quarter, third quarter, it's going to be hard.

Scott Sullivan: (00:36:56):

And those businesses as Pete was discussing our longer cycle, this is going to be a long, it's going to take a long time. so, you know, Freeport or Rio doesn't have to order the mining truck this quarter. They can wait until next quarter or the following quarter. They will order the mining truck, providing copper stays up or goes higher, which is probably likely if there's not enough of it. So, and we need it for EVs and all sorts of different things that are gonna make us green. So I think those things will have to be squared. And at the end of the day, you're going to want to be positioned in things that you think ultimately, the demand will be there out into 23 and 24. Cause that's at the end of the day, that's where the leverage will ultimately come through in the model is when commodity costs will eventually, at least normalize year over year, it may be at a higher level, but once that happens, the margins will normalize and pricing will flow through and economies of scale will be reached.

Scott Sullivan (00:37:48):

So that'll be how the cycle plays. And that's when, in some of these industrials that are in good places, we'll get their leverage. And we can talk about numbers that are \$5 higher than where the street is now in 2025. But so I think positioning and all those things is going to be what you need to do and I would agree. That it is probably more and more late cycle by the day it appears, given what's happened with energy. So, I think it's become tougher and tougher to become narrower and narrower. And, the places that have been safe, are safe for a good reason. the free ports of the world don't necessarily have a massive price increase coming their way. They're in control of that in aa lot of ways in more control than others are because their end market is the commodity. whereas others don't have that same benefit in a lot of cases. The commodity is a piece of the input, so it squeezes margin. So that is just the contrast and business structure that, will be beneficial to those that the commodities will help them. So I think all that stuff makes me think that we are late cycle and things like health. Probably utilities and maybe staples, in addition to, materials, energy and parts of industrial, are the places where you want to be. and with that mindset, it's not all industrials. it's not all utilities and it's not all staples. they'll all have different kind of drivers, but it's going to be nuanced, I think, throughout the sectors.

Ryan Caldwell (00:39:09):

And then Scott, I think the kind of adjunct discussion there is selling to consumer versus B2B, right? So that's the other sort of hot debate in the market and I'll use semi's because it's pretty easy because they do both right in the argument there in the argument that has popped up.

And again, it popped up at the end of the quarter. It's now gotten really loud and prevalent is things like smartphones PCs, consoles, things that were close to the consumer, right? You're likely going to end up in actual glut. Now, supply glut back to this argument that, the consumer is going to slow. You had all these supply chain issues, you had to build a bunch of stuff. You're building all that stuff now. But by the time you get to the second half, like the consumer is going to be slower and you're going to have too much stuff. that's effectively the argument. And so the numbers need to be cut.

Ryan Caldwell (00:40:04):

But when you look at the enterprise, and you look at this B2B spending trends, particularly, and again, if you look at Pete's places, if you look at things like materials and energy that looks pretty durable, right? If you think about again, Pete's right. you don't have to run out and buy the mining equipment today, but you're going to have to go out and buy it. At some point you've got to pull that trigger and then things like, we saw this, overnight out of Taiwan, things like, advanced computing, autos they're booming, For anything that needs content in these transitions. So I use Pete's, going from ice engines to EV you know, EV platforms, you need a ton of chips. And so what's showing up is this is normally the time you'd think the enterprise would start talking about CapEx cuts or like here, we gotta be a little bit more careful demand might slow down.

Ryan Caldwell (00:40:55):

We're not hearing any of that. It, at least the long of these places, Scott, that you touch, like automation. Pete like you touched like materials and energy, all see, and semi's we're again, you've got, some of this stuff's very advanced into data centers and hyperscale and hyperscalers and AI, quantum computing. And then you have basic wafers that like, go in your iWatch where people are saying that's dead. So Scott, that's the other thing I was going to tickle you on. so it sounds like you think consumer related companies need the second half numbers cut and they probably need to be cut for the stocks to work anyway. Right. The market won't believe it until they actually cut the numbers. But do you think you get the same thing in like the enterprise, so do you see that? Do you end up seeing that in like machinery names or semiconductors or guys that aren't just consumer and market demand latent, but have more kind of cap X cycle sensitivity, even in the short run.

Scott Sullivan (00:41:53):

Okay. Two points. One, since I just ripped the consumer, I should also point out that, the consumer in some geographies around the globe, like maybe Indonesia and Brazil will be a little bit better off given that they have the commodity is a key source of income in the country. So that's one point then on your point, yes. so consumer versus kind of enterprise, I think that's an excellent, point and I think what you're going to see like over what you've already seen and what you will continue to see is like the automation of the workforce and the workplace. As we all went through the pandemic and saw how difficult, labor and supply chain issues could be. The investment in robotics and automation makes even more sense, from a return perspective, given the security, it gives you around your supply chain. and so because of that will require more computers, more automation. And that part of the business is probably a little bit less cyclical than you would have had in the past.

Scott Sullivan (00:42:52):

I would argue a more secular driven, market. And what you're seeing now and automation is that it is a little bit like that. Cyclically it actually did a little bit better during the pandemic with orders, and now they're a little bit slower, but still growing year over year. So it's going to grow through its down turn. You know that we have right now is we cyclically reopened, we all go out

for, to cruises and, no one buys a computer and then all of a sudden we'll all need a refresh in three years and we will, and that'll be automated. We'll be able to get them faster, different colors, but you'll also need less people. And the margins for the business will be higher because it's just a better supply chain. so I think that's a good point and, and relevant.

Ryan Caldwell (00:43:33):

Okay. I think again, as we kind of look back at that quarter, I think, and again, we wrap this up in the 3d report by saying wow, a lot happen level changed. Again, I think Lara's salient point about moving fast, which I think continues to be, I think about as an investor, the one thing you've got to just keep front and center is that this thing is moving lightning fast and it's going to price in really extreme outcomes because we're at a pretty extreme place and so I guess more to come on the quarterly, but boy, when I got to look around that all sounds late cycle. yeah. Okay. it looks like my vibration is, might be more than a vibration. It could be like a crack or an earthquake. So that's fun. Hopefully.

Scott Sullivan (00:44:18):

We might have just convinced ourselves.

Ryan Caldwell (00:44:19):

Yeah, I'm sure we did. Hopefully it just comes fast and I like it's over in a weekend and yeah, whatever. The other place I wanted to go, and we went here lightly in the 3d report and I want to kind of tee this up because it does require everybody here, but I wanted to tee this up and I talked about this because I do think you've got to be thinking about this, whether you can invest in it aggressively at the moment or not a little bit different question, but I think you've got to frame this out and start to think about it. Even when you really start to think about medium term portfolio construction and that's a little bit. A little bit where we're going. We talked about on our last podcast, this research series, we are kicking off again, we've co-opted Lara onto the team and just said, this is going to work and so the first kind of spearhead of this was to really piggyback on a piece. Lara had written about a year ago talking about the great moderation and I'm going to have her define it. And what I wanted to do, at least in this research kind of exploration is combine it with quantitatively how we look at the world.

Ryan Caldwell (00:45:30):

And again, given some of the things Pete talked about in terms of geopolitics energy, Scott just talked about we've lightly touched on automation, replacing. But that's a really big deal. and we'll talk about that a little bit more, but this whole notion, and I kinda laid it out this way in the piece I wrote, which was, I think in retrospect, because you get to do this stuff later, the most important event of my career was China's entry into the WTO. And I want to go back and pick on a point, Lara made up at the top of her discussion, talking about the fed and forecasting in the job. And again, like when you talk to strategists, what they tend to tell you is the fed is the only thing that matters. Like they love to talk starts and ends where the fed, if I had to loosening buy stocks, if they're tightening sell, it's basically turned into that easy of an analysis because quite honestly, we haven't had a lot of economic growth.

Ryan Caldwell (00:46:27):

So to Lara's point, you could have kinda penciled in 2% growth and it was plus or minus 20 basis points either direction almost every year. But when you think about the investment implication of China's entry into the WTO, it dropped interest rates substantially, right? It outsourced labor to Asia, it outsourced CapEx to Asia. So 22 years later here, we are sitting at this system and boy, nobody seems to like it anymore. And by like it, I mean, the politicians don't like it, the populations, all of a sudden don't like it either, if you're running a fortune 500

company, you've loved it, but you probably you're a little bit suspect that it can continue. But this notion of kind of the great moderation ending, which is really some sort of, shot at Brenton woods two ending. And the investment implications of that are so big and so important to portfolio construction that we said look short, run, no question. This is a really hard environment.

Ryan Caldwell (00:47:37):

It's really volatile. Things are moving all over. As Lara just said, we, again could get a real, late cycle kind of thing here, but the medium-term change is huge. And again, I mentioned this. some of our internal people a couple of days ago, when I said, look, the most seminal event in my career was China entering the WTO because it changed the profile of everything, but it took the market like a long time to figure it out. It wasn't like, in 2001, everybody figured out the joke that margins were going to skyrocket, and China was going to add all this demand. Like it wasn't until the mid to late 2005 that people was like, oh, okay, China, this is real. And by 2010, it was like, well, demand is real.

Ryan Caldwell (00:48:19):

But the real benefit is we have all these capital light companies and now in 2022, we're staring at it going, oh dear God, if they tear this thing up, it really has big implications. So we were, we started to write about this in 3d because Lara and Brian are going to have some real seminal work on this, going through the great moderation going through what it meant, quantitatively, where we think that's going to take you the things you need to do. So I wanted to use this as a little bit of a tickle tease. If you will, Lara, to maybe set the stage, again, you've written a ton about it. So you know this great moderation. Can you define it for us? Sure. Very simple. it's 25 to 30 years of low volatility, macro life, low volatility, GDP growth, low volatility, inflation.

Lara Rhame (00:49:10):

It is long slow expansions versus coming out of World War Two. When you had wildly volatile, expansions, and then deep contractions. Instead, you get, after the eighties is really the inflation in the Volcker era attains inflation, you get these long, seven-to-11-year expansions where growth is just very stable, very easy to forecast. And it comes from policy, right? The fed and fiscal policy working harder, really, I think arguably the fed to blunt, the, business cycle, it comes from demographics, which slow, growth and bring that down. And then it comes from globalization, which adds to moderating price pressure. And it really gives us this like golden era of free cashflow margin. And it comes from investment, in technology, which really, also allows for businesses to just experience that profitability. And so you've just had this environment that has been, it's been the 30 year bond rally. It's bee all of the benefits that we've seen over the last 30 years now hitting this, you know, crashing into this extraordinary, really epic, I would say volatility, on the growth side because of COVID.

Lara Rhame (00:50:38):

I think we all know, and this is something that, you can say till you're blue in the face, but the globalization piece had started to come off the rails before COVID happened. COVID has made it so much worse. I look at it and I say, I believe that derailing, the globalization trend and walking it back is going to be a structural, multi-decade event because we were already doing it. It's not like COVID is going to go away and it's all going to go back to the way it was, the seas were already there. so that's the great moderation of what it's given us and that's why it's come to an end. You know, you've gotten such a wild and dramatic fiscal response to the wake of COVID households saw governments. They saw their government giving them money straight into their mail slot. This is 15 years after households slogged through, the great recession really,

is it electorate going forward, going to be satisfied with a government? That's not going to react with this really strong, pro-growth reaction, fiscal reaction.

Lara Rhame (00:51:44):

I think you're going to see, not only does higher inflation, make us have these sort of, this more wild pattern of growth and fed overreaction and markets layering onto the fed and adding to that volatility. But you also have it coming from the fiscal world. And I think you see it, this is the corporate profit side that, I look to you and Scottie and Pete to answer, how do you know is the golden era of just blanket profitability turn into something that is far more selective and something that is far more complicated? You can't just capture it with an ETF?

Ryan Caldwell (00:52:28):

No, I look, I think like a really good point. Actually, you just tied, like you just helped me crystallize that. Because if you think about what Lara just said at the stock level, and say, okay, that was great, really good overview. What do you mean? If you look at the S & P 500, the biggest beneficiary of the great moderation and globalization has been the S & P 500, right. Because here, we don't have, we didn't, well we will be going forward. Our cap ex cycles to Lara's point have been wildly blunted. You haven't needed big CapEx cycles. Why? Because they were happening in Asia. If you need to build a plant, you need to build the next widget. You did it there. You didn't do it here. So that actually mutes the economic cycle. So that's a, that is a really big deal. And you start to add some of these things up. Pete saying, we need to actually spend in energy and commodities to get to the next energy and commodities.

Ryan Caldwell (00:53:26):

Got to have a spending cycle there. Scott talked about automation. We've got to spend to automate that suspending cycle. Lara just talked about, again, this de-globalization and again, I know it's topical and I know everybody's saying it however, like the reason everybody's saying it is because we finally hit the intersection where politics, security and economics have all rammed their heads into each other. And we just don't agree. Regionally. We don't agree about the roadmaps going forward. In Europe, clearly the Russians and the Europeans who had been working hand in hand didn't agree on the future. Right? Clearly this relationship we've been in with China, we don't agree on. Right. We got cheap stuff. They got full employment. Nobody wants, they don't want that model anymore. And we don't want that model anymore. So when you think about, and Lara, you hit the salient point, the S & P 500 has seen its free cashflow margins double in the last two decades. I give Brian and his ex-partners at Empirical, a lot of credit for this.

Ryan Caldwell (00:54:34):

They've been writing about Bretton woods two, for 22 years saying, this is a margin story, right? If you figure it out, one thing you figured out the margins were going up and they were going to be way more durable than you thought. so again, back to Lara's point, when you have durable high margins and blunted economic cycles, it's actually not that difficult to manage monetary policy. And the S & P 500, again, the beneficiaries are companies at the top of the S and P 500. So if you look at the cap weighted index and who sits at the top they're Uber capital light. So what I mean by that is when Brian shows us these cuts of margins and he shows us the worst decile and the best decile. To get into the top decile of free cashflow margin now in the S & P 500, you've got to have free cashflow margins that are 20%. That is a shockingly high number, too high. Right? I think what history is going to suggest is that was too high. That got you to the place where you broke things the other way, right? The companies were ripping out too much profitability from the global economy relative to labor, relative to resources in the capital stock.

Ryan Caldwell (00:55:49):

And so now you got to reverse that. So when we kind of think about this, and again, Lara and Brian are writing this piece, when I think about talking about the tails, the first of this, I first want to talk about it at the stock level. Because I think it'll make more sense if I actually talk about it at the stock level. And then Brian, I want to come back to you and talk about it at the factor level. So Scott, I'm going to start with you, right? Cause you're the consumer industrial guy, right? You're a lot of other things. So don't let me sell you short, but you're the consumer, but let's start with industrials, right? Because next the technology, the biggest beneficiary of this trend of great moderation, Bretton woods two has been the industrial companies. And so if I give you a scenario where I told you, you got to invest right. In whether that's automation, whether that's plants and equipment, but you got to invest and you're probably going to be more regionalized like, how do you think about that when you think about analyzing companies? assuming that's true, maybe it's not true and we're smoking something, but assuming that's true and we're going to the great moderations over more swings in the business cycle, more cap ex how do you think about that?

Scott Sullivan (00:57:11):

Yeah, I think it's a good question. And I think, it's a fairly easy answer and the answer is I get in the way of the spend. So like in industrial, yeah. I'm getting in the way automation, I'm getting in the way of defense, and I'm getting in the way of mining. And so I think that's a good point. From the standpoint of, okay, so those, then there's this regionalization point around like defense, different countries will obviously try and use their homegrown defense contractor and different things like that. So there, there could be different, geographies that have above normal growth Europe in this situation that would be better off there. But they're all gonna have to deal with the Bretton woods situation. The tax situation will not be the same over the upcoming years. The ability to take on leverage will probably not be exactly the same. and inflation will probably be higher. yeah, there's, de-globalization all that stuff on the margin. That's certainly as Goldstein and Brian have both highlighted it's certainly, it's been a great call, but it's certainly less going forward than it has been in the past. So I think that's the answer you're trying to get in the way of the spend and it's increasingly narrow. The other side car to that Scott too. And I want to press you and I'm definitely going to press Pete on. This is also when you look regionally, right? So if we were the capital light beneficiary, and E M was the capital heavy panel and they were penalized for it dramatically, right?

Ryan Caldwell (00:58:34):

If you look at it at the end, yep. They got full employment and they moved up GDP per capita, which was all politically really palatable, but it was bad. Right. As an investor, as an equity holder, it wasn't great. Because you had the boom early and then you got all the kind of rescission. So I guess I would go back and say regionally, when you think about some of these regions that make things versus those that buy things like very simple way to break the world up, those that buy versus those that make, like, where are you putting your weight going forward on the makers or the buyers? I guess from that standpoint, you're putting it more in the makers, I think. and I think the reason for that is because their opportunity to move up and from a margin standpoint is better. so on the margin, their margins will go up, as they move into more, like higher cost goods and then they, their society develops further.

Scott Sullivan (00:59:35):

So I think that the answer is that because on the margin, our margin, is artificially high.

Ryan Caldwell (00:59:42):

And Pete you're on the other side of the coin in, in, in this instance, When I look at, the base industries, when we think about traditional commodities, real assets. Like the margins have been under pressure for literally a decade plus. And like we were looking at this, we were looking at this chart the other day, as a matter of fact, I think I threw it in the 3D report because I thought it was so interesting when you now look at the free cash flow margins, at least. And again, I understand the price spike, but when you look at the free cashflow margins today of your sectors, energy materials, commodities, they now rival tech free cashflow margins. So I wanted you to maybe talk a little bit about how you think about like the cash flow and margin progression from your groups. Cause they have some interesting thoughts on this as well. Being penalized for two decades for being the low margin sectors, relative to tech and consumer and industrials, they responded. So can you maybe walk through that a little bit and maybe how you see that.

Peter Bianco (01:00:51):

Yeah. Well you don't really hear about today is, what was it? 18 months ago, oil traded down a negative \$40 a barrel. And it actually put a couple of the wild cutters out of business. And, it was really dark days, for the for the traditional hydrocarbon players. So they took the stance that they want to be very disciplined with allocating capital, and it's going to take a lot for them to move off of that. So whether the price stays at a hundred dollars a barrel, and we'll just talk about oil because it's easy or it goes to 80 or 75, like they're still in a very good place. So I see that sort of, staying put for the foreseeable future and until they get some sort of olive branch from the government. I remember when the whole ESG movement was happening, like it was anathema to invest in, a coal producer, invested a traditional hydrocarbon company. and they have very long memories. I think they're in the catbird seat, like we've been talking about.

Ryan Caldwell (01:01:55):

Yeah. I think that's probably like my best example, easy example on the margin, because it's domestic too, where you look at, like two industries take like comm services on one side. So the, they big social media platforms versus, the Permian. And that they were polar opposites. And again, if you think of that kind of index construction, one, one part of the index got to, darn near, 40 ish percent plus of the S & P 500 rightfully. So they were sucking all of the cash flow out of the economy. But that's just starting to work the other way. So I always like to look at these starting points and I think what energy was like, what 2%, two and a half percent of the index at the low, like it got to like almost non-existent. And so is these trends to your point can last a really long time. And again, we're going to be begging them to invest, which is going to be the weird part, like getting wildcatters to invest. Usually not, it used to not be a hard thing to do, but when you almost kill them, like it does leave a lasting impression.

Peter Bianco (01:02:56):

Oh, absolutely. Yeah. It's going to be, it's an interesting tight rope between the election cycle versus like again, what is practical?

Ryan Caldwell (01:03:05):

Yep.

Peter Bianco (01:03:06):

So we're going to be fighting that battle for a long time.

Ryan Caldwell (01:03:10):

And then Brian, I want to kind of pop you in here because quantitatively, and again, you've been writing about this for 20 years and if we take a look at it, if we take a look at de-globalization,

which is the, I guess it's the new term for this? There's not a lot of empirical evidence yet, Or even at all, if I was looking at this empirically saying, show me the evidence that people are going to near source and hold more inventories and build supply chains locally, it would be, it'd be hard to find the empirical evidence, but Brian, when you look at it, and I think like when you look at the margin deconstruction of what's gone on. And this is, I think one of the most powerful things I think you've done in your career was deconstructing what happened on the plant floor, right? you guys did that work, right? You understood like where the margin, what changed due to rates, what changed due to tax rates and what changed due to globalization? if you think about the three big things that influence margins in the last 20 years, tax rates, interest rates and globalization. So Brian, when you think about this factorially and you think about the starting points and you're observing what's going on, what does that make you think about in terms of what you should look down emphasize going forward? Where are the risks going to be like again, if you had to deconstruct Brenton woods two and I'm not sure it's going to get all the way deconstructed. And even if we're talking about it on the market, what does that mean? You're looking for, what does that mean? You're trying to accomplish and again, from a kind of quantitative perspective, what worries you?

Brian Cho (01:04:57):

Yeah, so here's how I wanna approach it. I think you pointed this out in the 3d report, which is, the biggest beneficiary of globalization has been the technology and manufacturing, manufacturing companies in S&P, or the other way to say it is large cap companies. That's making stuff. And what was interesting about that is their margins had exploded and the way they got there is the biggest thing that happened to margin exposure is because you have the interest rate that. And then on top of that, there was a global, efforts to lower the corporate tax around the world. And so now us is almost at the bottom since 2018 tax con. So you have that. And then the other side is this, globalization hands, you move the wage growth from onshoring to offshore. So March cheaper, right? So wage growth, is almost non-existent in us. And so wage growth it, it has become very efficient wage. So you should think about that and bringing it to was a factor setting. You kind of have to look at DuPont analysis, right? You have to construct how the profit gets generated. First day, when you look at the DuPont analysis is asset term. So companies that turns their assets faster and faster, they will have a higher, margins. But now that has to slow because you kind of have to now build the inventory because of the due to the COVID due to the fact that now you're going to have to regionalize the supply chain probably.

Brian Cho (01:06:37):

And then also there's some uncertainty about, how thin you, cause you can be with the, inventory light approach. So that's going away. So as it turns going to get lower. And then the other part that you have to look at is the financing side, right? So when you look at the financing side, due to the low rate environment, or, almost non existed rate, you could just finance anything. So debt to equity ratios have gone up. Insurance interest rate expense has gotten almost to nothing. So companies are borrowing more, but their interest rate interest expense coverage has been better all this time. So you have that going, that's kind of slow. That's going to have to disappear. And then last week is the actually what happens at the plant floor, right? So you have cost of goods. That's been going down forever, but now we're beginning to see a real, growth in the cost of goods because now your input cost is going up. On top of that, you gonna have to start thinking about onshoring your work first, which is beginning to happen to a degree and they make, but it is happening. So your SGNA has to go up. So all that says to me is when you bring it down to, financial analysis is simply, okay, your margin or free cash flow margin has to decline from current level. So the biggest question then we have to ask from this global line or Eagle globalized world, is that free cashflow margin

should come down. Ultimately they, that should bring down the PE multiples but how fast is that going to happen? And I think that's the one thing that we need to ask. Whenever we look at individual securities, the ones with the durable margins or the ones that can drag this process out the longest they will be.

Ryan Caldwell (01:08:35):

And Lara so if I aggregate all that back together, what I hear is you probably get better nominal economic growth, but you get lower earnings and you get a lower multiple. So like I think, and again, Brian and Laura are going to crystallize this and some really cool research, but like you do get the, you do get this kind of notion of going backwards a little bit to your point, a little bit more volatile business cycles, a little bit higher nominal growth at the peaks. Again, you may run inventory cycles again, like things we just haven't seen in a really long time. And again, economists don't even embed it in forecast anymore. They think you got a quarter of production and like its over.

Lara Rhame (01:09:21):

Yeah. And I think, as demographics have just slowed so much our traditional Phillips curve models have let us down on the inflection point. Yeah. Signals. And that's why, when you get, you're getting right now, you've seen these signals of inflection points coming fast and furious. That's why Brian's tactical domain is so important because we need to be able to decipher all of this noise and understand what's really happening and I think what you touched on really important because if you look at the investment side of things it's not all bad and it's just harder. So that's the, I think that's the, there's still, a lot of growth. The nominal growth really speaks well to company fundamental. It's just that when you get higher volatility and I think greater policy uncertainty, that's naturally going to come from the fact that investors are going to be confused and that happens, we're seeing it right now. You'll curve inverts. that it's, that it is an inverted again, there's just so much happening right now and it is moving so fast. If that continues. you really just get this higher growth, but you get the higher volatility and that's a killer for multiples. that's where I think we all feel it in our, not for the trading floor lens, but from my own statement lens.

Ryan Caldwell (01:10:48):

Yeah. I think that is it's. So that is so well said. And so again, we're going to be, Lara is going to be out evangelizing this. We're going to be writing about it, but like again, when I sit back and think about. Short-term yep. We've got to navigate. This is a very tough environment. It's likely to feel. I, in the very, very short run weeks, months, quarters, lot of volatility, there's again, this horse race of where the terminal rate is and where demand falls. Like the market. Isn't going to believe it one way or another until it sees it because of to Lara's point all the policy volatility, when you step back and try to think at 50,000 feet and go wow, this is a complete reordering. and I'm just absolutely when I, when you step back and look at it and we put this in the 3d report, the margins more than doubled and to Lara's point, the chicken and the egg point between interest rates, globalization tax rates. It's not clear how you untangle, which one led to which one. So it really did all come together in a way. That really benefited the kind of margins particularly of developed market companies that could outsource again, had stable currency, could benefit from the repression of kind of interest rates.

Ryan Caldwell (01:12:06):

And to Brian's point, you see it in leverage on balance sheets, that's going to change. We see it in the number of workers you're going to hold. That's going to change. There's it's so dynamically important to figure out that this is the thing that I'm going to keep trying to hit listeners, clients, anybody that pays attention to us over the head with, because while we're

trying to navigate through the very short-term with one eye on where are you going? This is a really different investment environment. Like Lara said, you got go back to. I would almost argue. And this isn't a great example, but maybe even late nineties was the last time you can even look like this prior to China's entry into the WTO. You had some more regionalization. It wasn't nearly as bad as the seventies or eighties. We were globalized clearly in the nineties, but it went on hyperdrive when China enter the WTO because they were so willing to take on everybody's cap ex and labor. Right. And it benefited them what they pulled the country out of a horrific spot, but boy, that's just, you know, 20 years on, we're heading to a different spot.

Ryan Caldwell (01:13:10):

So again, way more, a lot more to come on this, Lara and Brian will be writing about it. You'll see Lara on TV talking about it. we're going to push to go evangelize this if only because I'm just like, I've said this internally. I think the 60/40 narrative being dead is lazy. Like I think you got to rip up the entire approach to investing because that's how different this is right. Of the old 60, 40 was the biggest beneficiary of this great moderation Bretton woods Two you suppressed interest rates. The country with the most stable currency was the biggest beneficiary in the margins exploded. That's why it worked. That's where you had a sharp ratio that was better than all the macro funds. You know, people were paying two and 22, just dumbly going 60, 40 into U S assets. But that does seem like it's reaching or reached it's Nate here and something new is coming. So again, more to come, Lara and Brian are quarterbacking this. You'll hear a lot more about it, but again, I think it is by far the most important thing to be spending Mindshare on again, while you're going through the process of, surviving through the next couple of quarters or rest of the year. So I think maybe with that, we've stolen a nice hour and 23 minutes of everybody's time.

Ryan Caldwell (01:14:28):

I appreciate everybody's participation today. Really good. We will be back again as we start to publish, I'm going to podcast on top of it. It gives me, another, another lens in which to hit Brian and Lara and Pete and Scott on some of these topics. So again, we'll be a little bit more frequent as the research becomes frequent, but this is the roadmap and where we're going. And so I appreciate everybody helping me set it up. So thank you everybody. And we will be back. Thank you. Thanks Lara. Thanks Pete. Thanks Scott. Thanks Brian.

Ryan Caldwell (01:15:46):

Thank you for listening to this episode of the Caldwell Hour. If you enjoy what you heard, please subscribe to us on Spotify and Apple music as not to miss this or any of the shows from the FS Fireside Chat series.