Episode 42

The 3D Report: Q2 2022—Mapping the Economy's Rapid Movement

FS Chiron Funds CIO Ryan Caldwell is joined by Chief U.S. Economist Lara Rhame to analyze the many macroeconomic uncertainties that lie ahead.

[00:00:00] Ryan Caldwell: Welcome to the 3D Report, a podcast by FS Investments. My name is Ryan Caldwell, and I am the CIO of the FS Chiron Funds. On today's episode, we are discussing the third-quarter economic and market outlook with the Chief U.S. Economist here at FS, Lara Rhame.

[00:00:23] Ryan Caldwell: What we thought we would do is maybe just a little bit of one-on-one time. Normally what we've done in these 3D podcasts and Caldwell hour is to have the whole team on. And I thought, Lara, maybe what we would do, is maybe have a little bit of a scrap. So, for our listeners, I have not, I've read some of Lara's writings as of late, but we have not had sort of a pre-, if you will, podcast hash-out on sort of where her current thinking is, where her numbers are and sort of what she's thinking about. Again, broad strokes. I know where her head is, but not specifics. And quite honestly, we haven't shared a bunch of what's going on in the portfolio, very, very short term, with her as well. And the reason I wanted to kind of frame it this way, actually Lara, was because so much of this year, and even I think so much of what's likely to be the rest of the year is all actually just being driven by macro factors. Right? So really at this point, when we isolate down the world, and this is probably, will be part of the discussion, what’s interesting is most things fundamental. Quite honestly, aren’t driving the tape so much anymore.

[00:01:31] Ryan Caldwell: It’s really coming down to macro factors and this, you know, kind of intersection that the world is very succinctly staring at. Inflation versus growth and can Fed thread the needle? Do we soft land? Do we hard land? And quite honestly, everything seems to be a bit of a slave to that outcome. So, what I thought maybe we would do, because I know Lara has hardcore dove into her numbers, kind of put things together and her thoughts for the back half of the year. So, I just wanted to kind of kick it off and go through it with her. Well, like I said, the audience will get it with me a little bit real time. And maybe some of this back and forth of maybe where the macros meeting, the equity tape, and the credit tape and some of the rates tape because we'll go through all of that. So, Lara, that's what I thought we'd do. I thought we'd just have a conversation. I want to see where your heads at.

[00:02:23] Lara Rhame: Sounds great Ryan. Happy to share what’s going on.

[00:02:28] Ryan Caldwell: So I guess let's kick off and tell me if you think I'm crazy and maybe framing it this way. And a little bit of cheat for our audience. We actually had a little email string going back and forth today as some numbers were coming out. But Lord, do you think this is an appropriate framing of the discussion to say. Either the bond market and particularly the rates curve has the outcome mostly. Right. And the Fed will be hiking here, you know, still relatively aggressively to somewhere around three and a half percent, maybe a tad higher and then very quickly.

[00:03:04] Ryan Caldwell: And I believe, and you'll correct me if I'm wrong. I believe the rate curve has cuts now occurring. I believe in May of 2020. It's been as recently, they had cuts in the first quarter. Yeah, it was almost March, right? Yeah. So like you have this very sharp cliff up and cliff hook up and then cliff down. So that's effectively, so in the Ray curve, when we have these discussions with clients and we say, well, you know, the Ray curve is anticipating, you know, the Fed to hike and then ultimately cut. We have to remind some of our, you have to remind listeners is, "hey, actually three and a half, maybe, you know, 3.75 is somewhat already priced in." So we're at 2.50 today and right. So you've got about a hundred and to 125 priced in short run. And then to the point somewhere starting early next year, late first quarter, early second, the market then believes the Fed's gonna have to start cutting. So that's one view of the market, the other view of the market.

[00:04:07] Ryan Caldwell: And. I'm a little bit glad we're a little bit late in doing this podcast. Normally we're pretty quick, right? Outta the quarter to jump into the 3D report. This time we waited and I'm glad we waited a little bit because the market kind of did what we thought it was gonna do, which was bounce out of really bearish positioning. Really bearish. So if you think about sort of where we were end of June, middle of July, the world was coming to an end. And quite honestly, everybody believed it. Everybody was absolutely on the same side of the boat. And now obviously we've had a potent bounce, very potent bounce, and Lara will talk about peak inflation and growth rates and all that stuff.

[00:04:43] Ryan Caldwell: But the markets effectively take peak inflation, peak rates, maybe peak energy prices to say peak inflation. Bond volatility has come down. And what we've seen in the last eight weeks or six and a half weeks, I guess, is actually the equity risk premium has fallen, right? Actually pretty, yeah, pretty materially. So when we think about the equity market is effectively saying that earnings estimates for 2023, you know, up here around 4,200 are probably okay. So by, okay. I mean, you know, consensus to start the year was 2.50. I think consensus is bled down to like 2.40 now, which, you know, if you look at the comparator for 2022 is now like 13, 14% growth, cuz we're looking like something like about $200 this year, maybe 2 0 3, 2 0 4 and the market's still got a pretty hefty 2 35 number next year.

[00:05:44] Ryan Caldwell: If indeed the bond market's right. There's no possible way that earnings number is right. If the earnings number is right, there's almost no way the bond market's right. So I wanted to kind of kick the discussion off their Lara with the somebody's lying or wrong. And so when you kind of think through everything, you've looked. Which side are you leaning as more right or more wrong? Because this is all now about economic growth. It's right. Does nominal and real growth hold up or do we have to have something more severe than that to kind of reset inflation expectations to the Fed target?

[00:06:27] Lara Rhame: All right. thanks for teeing that up because I. You know, feel like all of the challenges with the market begin and end with inflation. And one of, I think I'm gonna reframe something you said, which is that markets are imposing peak inflation and, you know, they imposed a bottom on price action. And there's this market reflex to go to a place where we fit a neat cycle in an environment where the reality is. We may experience a more so, sideways pattern for a while. And I just think markets. Are almost completely unmoored by that concept markets like a direction they like thinking that things are gonna, you know, be clearly in the rear-view mirror, inflation's clearly peaked. So I let me do a round Robin on my economic outlook because I feel like that can really help underpin our discussion going forward.

[00:07:28] Lara Rhame: And if. If you don't agree with any of this, I want you to, I know you're quite why. No, I'll jump in. yeah. You'll yeah, I get to hear is great. OK. Yeah, no, let's do it. So inflation may very well have peaked at 9.1%, you know, with the huge caveat that the commodity complex may have another bout of significant volatility, particularly over the winter driven by geopolitics, but, Likely we have seen this peak and I think the problem, and this is really in particular, an issue for markets is that we're not going to get this significant dissent.

[00:08:08] Lara Rhame: My year end GDP forecast is still 6% and, a year from now, it's probably going to be 4%, ending 20, 23, between three and a half and 4%. Which is high enough that the Fed will not be able to spike the ball that they have, achieved victory or, that they have brought inflation back in line with their, stated inflation goal of average inflation targeting at 2%. So, let me just unpack that a little bit, because just as it was a perfect storm of factors, which, caused inflation to break out of its long run trend of around 2%, that it held for decades, it is really going to take a similar confluence of good news and frankly luck to get us back down to 2%. And here I wanna be clear because we could easily get, you know, a real plunge in energy prices.

[00:09:02] Lara Rhame: Or some headline volatility that causes inflation to dip, but there's a difference between that and really sustained stable, low inflation. And, when I break it down, the reality is for the next three to two to three quarters, rents are going to stay persistently high, rental. Inflation's probably gonna remain around four to 5% energy prices. Even if they stay where they are and you project out zero energy inflation, you still get, all. Inflation remaining high. And what I mean by that is that to get inflation, to come down meaningfully, you need deep energy price deflation. That's a cleaner way to phrase that. And so energy price is staying where they are, is not gonna do it for you.

[00:09:55] Lara Rhame: And then the third piece of that is durable goods, [00:10:00] price deflation. And I hope that we will talk later on about deglobalization, but we will, but. Yeah, I think it is so underappreciated. the extent to which globalization gave us an umbrella of cheap. Goods price imports from Asia and allowed the Fed to really, I think pat itself on the back for managing low inflation for decades, when really they were just getting a huge amount of help from this pulse of cheap durable goods.

[00:10:40] Lara Rhame: So that is really a huge part of, and a huge uncertainty going forward on inflation, whether or not. You know, and that's really is going to be an auto story. And again, here we have another big change, right? Electronic vehicles constructing. These is going to be a lot more expensive and it's going to come. It's gonna inject a lot of volatility into durable goods prices. you know, there's no doubt that now Walmart has too many. Cabinets. So they're gonna have to sell those at a discount

[00:11:12] Ryan Caldwell: They're in the aisles marked up and marked down. Exactly. but outside of that, and again, on a sustained level to me, the durable goods piece is very uncertain.

[00:11:20] Lara Rhame: So, inflation ends the year around 6%. It's not significantly lower than where it's not sign. It's not lower enough from where we are to, give the Fed really any political ability to go soft on, on inflation. Now let's talk about growth. you know, I don't wanna rehash the, are we in a recession? Are we not in discussion? The reality is growth is slowing. And it's going to be a grind going forward. the expectation consensus has around 2% growth in the third quarter. I put it more around 1%. and that's because the piece that I really am focusing in on is that final sales component. That is really just an extremely weak level of growth, and I think for the full year, you're gonna get a very weak, outturn probably again, around 1% for the entire year. And that really means that we're hopefully going to get a, even more relief on the growth front in the fourth quarter. and then finally, I just wanna address what's happening with the low growth.

[00:12:33] Lara Rhame: We're experiencing and the high rate of hiring that we're still seeing because we're throwing tons of bodies at the economy, but we're not getting an acceleration and real growth out of it. And I think what we're experiencing now is a productivity recession. Yes. And yes. This is important because, markets. And really households, right? That are driving this engine of our economy. They are missing out when you have no productivity gains or you have negative productivity, you're missing out on all of the standard of living gains. That's what productivity really gives you. And I think it is reinforcing this sense that the economy is totally stagnant and that is something we could attribute it probably to several factors.

[00:13:29] Lara Rhame: One reason that we're having such poor productivity growth is because a lot of the jobs that we're adding are just by nature, low productivity jobs. If you add, you know, twice as many waitresses, they really only deliver twice as much food or waiters. you're not getting a benefit of scale there. I we've underinvested as we know for decades and that's really coming home to roost.

[00:13:52] Lara Rhame: We see that in places like the energy sector. Where we are really having trouble harvesting productivity gains from the rigs that we [00:14:00] have. We just haven't really invested in that infrastructure. And the third thing is probably some measurement error. sure. You know, just given how rapidly things move during the pandemic. It's hard to capture that our economy is very large. It's very complicated. You can't distill it into one number. But at the end of the day, this falling productivity, this, productivity recession is just amplifying the feeling of stagnation of slow growth and of weak growth prospects.

[00:14:35] Ryan Caldwell: Okay. So Lara, wow. So again, the audience, we haven't gone through that, but when I digest. I guess here's my flip thought. This is exactly what we're worried about. And we kind of see a bit of this quantitatively and just for our listeners, maybe to give you the earnings interpretation of what Lara just said, this is a massive margin problem. And we're already seeing that show up. Right? So if you look at sort of 20, 22 margin numbers, like originally the street had margins actually up a bit. Then about halfway, you know, kind of May, June, they had 'em down, just a touch. And when you actually cycle through what happened in the second quarter, and I know we're having this, oh, you know, praise God that the second quarter earnings were okay.

[00:15:22] Ryan Caldwell: And okay. is an interesting dynamic. They were better than disaster. but Lara, the mix you just laid out is almost exactly what we're seeing a top line that's okay-ish with margins that are under a ton of pressure because there's no productivity coming out of any of the spend that you have to spend to get, you know, workers back in the building. Step one. Yep. Yeah. And the other thing you touched on and it's true is this kind of lead, lag effect too, right? When you think about all the things that are running hot, That put the Fed in motion to the degree that it put the Fed in motion. There's no resolution on those [00:16:00] things, right? As you pointed out, owner's equivalent rent in, just for our listeners to, to give you a little of a sense of, Lara’s feistiness.

[00:16:08] Ryan Caldwell: We were having a debate, I don't know, about a month ago. And she was like, I'm running the numbers. I'll send you the model you play with it. I can't get the numbers to come down. We model everything here. So the point all the point, the point being.

If you put that stew in a mix, you have a stew that is really actually bad corporate. It might be economically. Okay. Although to Lara's point, it's gonna feel very stagnant, but from a corporate perspective, The way I would say it is this ensures there's no V right wall. Street's addicted to the V and that's why wall street is building the forecast the way it's building the forecast. It wants them to raise so much.

[00:16:47] Ryan Caldwell: They break it to create a brand new cycle to which we can go load in a bunch of beta. Right. You've already seen a little of that so far in the last month. And Lara, if I just even like, if you're half, right, like if I just half assume. You get this kind of real growth deceleration while productivity is unwinding a little bit underneath you. Ultimately, what managements will do is start firing people. So let me get right to the punchline. If that's what it looks like by December, then when we do budgeting into 2023, managements are gonna look at each other and say, we have too many people because the first place you go to get productivity better is to fire.

[00:17:28] Ryan Caldwell: Right. That is the low hanging fruit of productivity gains is to get right size labor relative to wherever you think the top line is. And I think Lara's point is Sali. Again, much of the labor that's being added right now is labor that was taken out relatively early in the pandemic. It was very service oriented and related. So couldn't come all the way back till the economies were reopened. And now the reopen in this labor has come back. But to her point, when you look sort of, you know, if you want to think sort of mid midway earners to high end wage, earn. They never left the work. They never went anywhere and now they've had big wage gains.

[00:18:09] Ryan Caldwell: So all of a sudden, when you're looking at managing a P and L it starts to feel upside down. So even companies like a Microsoft, which are not particularly capital intensive, are already talking about lightning up headcount and getting cost under control. And so Lara, the cocktail you just put out is actually. Neither curve is predicting effectively. What you're talking about, which is the Fed can't really cut until it's a disaster. It doesn't really get to disaster as fast as you want it to. So we're gonna lumber through a cycle to your point that for the first time in a while might take a minute.

[00:18:47] Lara Rhame: I think you said something. So I actually haven't thought about it like this and my eyes lit up when you said it. Wall street almost likes the traditional Fed rate hike cycle, where they RA, where they do not give us a soft landing. right. You know, they it's easy. It's easy, right. Wall street takes their lumps when the Fed is raising rates and when the recession starts or the Fed clearly when the Fed is clearly able to declare victory and say, we're done raising rates now, you know, we all kind of hang on expecting maybe some shoe to drop with the economy, but...

[00:19:26] Lara Rhame: For markets, it's a green light to rip higher. They've taken their lumps during the rate hike and they can safely assume that financial conditions are gonna get way easier. And these traditional asset classes just rip higher and what we're not used to is the Fed actually. Achieving a soft landing, right. They don't do that very often and they don't do it well in the last six rate hikes. They've only done it once. And that was, you know, the mid nineties. We still managed to have a financial crisis in the middle of all of that. and, you know, I think wall street truly is not pricing correctly. This idea that it could just be a grind. Consistently lower growth. We get some layoffs. You get the unemployment rate up to five, 6%. It's three and a half right now. but it's not a situation where there's this neat peak in a Fed funds rate. They come in, they're cutting three quarters later because they're, they can't with inflation, persistently higher.

[00:20:37] Lara Rhame: And, you know, I think that is, to me, that's what markets are mispricing and the range of outcomes is so wide. Right now you have some pundits calling for 6% Fed funds rate. And some people are calling for rate cuts in February. you know, this is a market that is wildly divergent in views.

[00:20:58] Ryan Caldwell: Perfect. Bow on the discussion like I, to, and like maybe the other thing I would say too, Lara is this is an outcome that can be okay. Economically. Right. If you're a policy maker, it's okay. Economically, but it's actually net bad wall street, which we have not had in almost two decades. Right? The issue of you said it earlier, globalization allowed everything to kind of slide a little bit easier. And so, Hey, even if the nominal weren't good, corporate profits were great, right?

[00:21:32] Ryan Caldwell: Because you were compounding these very high margin capital I businesses under globalization. And now you're saying, well, there's some friction costs that have popped up in this globalization mess at the same time. You're not gonna have the productivity tailwind, whether, you know, whether whoever was causing it, whether it was low rates, whether it was outsourcing, whatever was really was whether it was really innovation and return on invested capital. Like a, you know, some of that is yet to be kind of feathered out. But if you're giving me a scenario where look, the nominals are high enough, they can't cut. Right. They softish land the economy. Well, productivity's under pressure and margins are under pressure. Like that's not a great market.

[00:22:16] Lara Rhame: Right. and it's probably not a good enough economic outcome either, you know? Sure. Like, just because, you know, if we don't, we, I don't think we're gonna have a classic recession. but the probability of a more employment led Fed rate hike, driven recession sometime in 2023 has risen significantly.

[00:22:38] Lara Rhame: Yeah. But it's probably not going to be very deep or severe there's, you know, a lot of reasons why it may be a more mild recession or it could just be like the first half of 2022, where we get a couple of quarters of negative growth, but it doesn't. Check all the boxes either [00:23:00] way. It is a grind. And I think to your point, it's not a, it's not an ideal economic outcome and it's not a good enough economic outcome to give wall street the relief on the growth side.

[00:23:13] Ryan Caldwell: Yeah. That's what I mean, it's not good enough or bad enough. And I look…

[00:23:16] Lara Rhame: Right…

[00:23:17] Ryan Caldwell: …in your point. Exactly. Wall street, 1000% wants them to go fast and break things to reset the margin structure to dive back in. Right. There's no question that like easy. Yeah. And even back to the point, if you think about this is, I, I think maybe to frame this for the listeners, Think about how hard the first part of the year was because you had no convexity out of the bond market.

[00:23:43] Ryan Caldwell: And Lara talked about this a ton in 2021, you're gonna lose convexity. Here's why, so you lost convexity, right? And once you lost convexity, you lose like 60% of the assets. You can, you know, roll into a portfolio to kind of help create diversification. [00:24:00] So the first half of the year is a mess. But as soon as bomb ball was quote under control, the market was like, oh great, 60/40 works just fine. But what Lara's laying out the case for is 60, 40 is not fine in that environment. It doesn't work right. You don't get enough to get the convexity you need and you don't get enough on the growth side to get the cyclicality that you need to really go load up on data and risk. So it gets really hard.

[00:24:27] Ryan Caldwell: So I, I, thinking in, in, in sort of my chair in managing the fund where this really kind of sets the mindset is, boy, you're gonna have to be concentrated. Boy, you're really going to have to be disciplined in risk because Dolores point the forecast air is going geometric, right? Because there's so many outcomes that could come. There's just so much forecasting error that could pop into your numbers. And then ultimately. You have to focus on companies where the margins can hold up. So if I had one maybe piece of advice in this environment, make sure there's a margin and make sure it's durable to whatever, regardless of country sector, make sure that it's durable.

[00:25:16] Ryan Caldwell: Like the thing we're gonna have to turn up in our own quantitative work is margins because you just told me we have a margin problem. That is, I think that is where this secular shift given de-globalization is going to be so important because when we think about the need to. Sh, you know, either bring production back to the us friends short, I mean, you just have seen announcement after announcement that companies are now going to have to engage in more investment it's act.

[00:25:52] Ryan Caldwell: That's actually not a bad thing for the economy, we've needed that's for a long time it's economy. Yeah. And, and, but for margins, it puts them deeply under pressure. And I think it'll be interesting, you know, and you've pointed this out. I think this is something that I always enjoy hearing you talk about. Companies that are used, that companies that provide the. Inputs for companies that are investing are also an important place to look because that's also an area where, you know, articles about steel manufacturers saying, oh, we haven't seen any slowdown in demand. Right. We haven't seen any sign of slowing, you know, there are all there's the, there are huge sectors that are going to benefit from better investment trends.

[00:26:37] Ryan Caldwell: Well, and that's actually something I wanted to pivot to and add back into the discuss. Because you and our partner, Brian Cho have been doing a lot of work in, in, in a couple of areas. And one of 'em I want to touch on, which is capital spending. And I, because I wanna bring this back into your nominal economic growth discussion as well, because we've seen this now, embed, I would argue and we'll see, you know, CapEx growth has been extra.
[00:27:02] Ryan Caldwell: Right. If you look at CapEx in the first two quarters of this year, it's been extraordinary relative to the last 15. I mean, it really does look like an early cycle kind of CapEx, boom, which is another reason back to like the nominals are holding up and the enterprise has been holding up because quite honestly, the enterprises are spending and Lara, this is kind of tying this together to your point about inflation, which.

[00:27:30] Ryan Caldwell: When managements have to invest because they think they have to either hold inventory. And I would argue probably most management teams. We talk to now think the baseline of held inventory has to go up. Now. There's a huge. Again, divergence among management teams, even in the same sectors about how much inventory you really need to hold. But almost uniformly across the board. Companies are saying, look, global supply chains turned out to be a big point of vulnerability. That probably means we need to layer at least, you know, some number of days, outstanding of inventory on the balance sheet. I was actually laughing the other day, Lara for the first time in like seven years that I started looking at DSOs.

[00:28:10] Ryan Caldwell: And thinking, my God, like we're actually back to an economic cycle because the amount of inventory outstanding on the balance sheet people care about. Yeah. But your point about the friction costs that causes is enormous, right? When you don't have to carry inventory, you get this nice free load through the P and L, which keeps your margins nice and high.

[00:28:30] Ryan Caldwell: And then something like Invidia, which we saw, you know, what a week ago just came out and wrote 1,000,000,005 of inventory right off the top line. That's the other risk here too, to lo that Lara in Lara's forecast is you have a big mismatch between inventory and where demand is. When that happens,what companies do at first, they will try to discount and see if they can incentivize you to buy stuff via price.

[00:28:56] Ryan Caldwell: But when that doesn't work, they just straight write it off the balance sheet, right. It comes right out of the top line, which again, back to the numbers being realistic, if you think there's gonna be inventory cuts and or there's gonna be inventory, write offs. Some of the retailers. There's almost no question. They're gonna be writing off at minimum, some seasonal stuff. And even the semi guys have started to write down inventories. That's a knock to numbers. And to Lara's point, it's not an economic problem. As a matter of fact, like it weirdly can be beneficial down the road economically if you start to bring that inventory back. So again, another instance where real bad for margins real bad for wall street, but economically it's a net neutral. It doesn't do anything to your economic forecast.

[00:29:42] Lara Rhame: Yeah. I think, you know, we've had head fakes on the investment side before thinking that now we were finally going to get some investment going. You know, I think it was six years ago. We had new tax policy that, tried to incentivize companies

[00:29:56] Ryan Caldwell: Yep.

[00:29:57] Lara Rhame: To invest through changing depreciation schedules. The big difference today. Is inflation. That's exactly right. Cannot you understate how much of a game changer that is for companies? Because again,

[00:30:11] Ryan Caldwell: Can you explain that for listeners why that changes the mindset deflation to inflation?

[00:30:16] Lara Rhame: It's incredible. This is where it begins and ends because when you have capital goods, price, deflation companies can just wait. And the machine that they wanna buy, keeps getting cheaper. There's no incentive for them to pull the trigger on that purchase because the crane or the tractor or the cloud computing or whatever it is just getting cheaper and cheaper going forward.

[00:30:42] Lara Rhame: And so you get this delay and we've seen that for 15 years. Now, suddenly with inflation and the expectation that. Part of the goods market is going to continue to see prices rise. Suddenly. Now companies are incentivized to buy today, cuz it's going to be more expensive tomorrow. It has just been a complete change in attitude, towards investment. And that is to me driving a significant amount of what you're seeing and then you layer on right. You've had the automakers announce. Hundreds of millions of dollars to retool factories towards electric vehicle manufacturing. you know, the, you just had Congress passing the chips. budget, you know, to, help incentivize spending on semiconductors energy.

[00:31:34] Lara Rhame: Clearly I don't care whether it's ESG or the need to invest in existing, weak infrastructure in old energy. you're going to be spending there. You can really see over the next to me. It's not even a one year. Outlook Ryan it's years where deglobalization is going to, unwind slowly and at the margin, we're just going to see higher capital spending.

[00:32:02] Lara Rhame: And hopefully, you know, this is the glass half full side of me. Hopefully that will engender productivity gains down the road. The productivity burst that we had in the 2000s was directly related to all of the investment spending that we did in the nineties on technology. There's there are ways to harvest, not just growth today, but productivity enhancement going forward. It's getting it right on the investment side. That's way trickier.

[00:32:33] Ryan Caldwell: No, I think that is incredibly well said. Our medium-term thesis has been, that's the only story that matters as much as it feels like the Fed matters. And it does, obviously the inflation matters. But I think tying that back to the point you made earlier, Lara, the Fed had a really G easy time managing interest rates in a highly globalized environment, because it was just inherently to your point, durable goods, deflationary coming out of Asia every year, all the time. And all my labor was there. My capital was there, so I never had the kind of capital squeeze. And now to your point, I've gotta spend. Right. Most of these big industries where we've seen this capital spending, let's go right into semis, right. Semis and autos are the two big ones. Right? You can just pick them right off as easy targets to your point.

[00:33:22] Ryan Caldwell: We passed the chips act. Well, not two days later, global Foundry east puts out an announcement that they are gonna put a fab in Vermont. Well, that's great for Vermont and it's great for the us economy that we're gonna build a fab in Vermont. Now here's the problem. It's not good for global foundries. There is no question that the fab in Vermont is going to be their lowest productivity, lowest margin fab in the world. Right now they have to do it. And again, when we think about these redundancies and things, right, has to be done. And again, in the short run, investors rewarded it like the next day stock goes up and they say, this is great.

[00:34:02] Ryan Caldwell: They're gonna build a fab and there's capital spending, but to Lara's point medium term, Right. They have sky high margins. Those margins will start to erode down over time.

[00:34:12] Lara Rhame: Yeah.

[00:34:12] Ryan Caldwell: So you would create, you know, the value, if you will, of an economic dollar from the corporate margin to the employee, to the plant, to the equipment, to the dirt, it's just a different view of how a dollar is used.

[00:34:26] Lara Rhame: Yeah. And it's the upside down of what we've experienced…

[00:34:30] Ryan Caldwell: of what we just lived though.

[00:34:31] Lara Rhame: …over the last 15 years where you had the economy, you know, think about the 11 year expansion that we had was incredibly low growth, actually. I mean, the average growth rate during that expansion was 1.8% very low. And what did equities do over that exploded period?

[00:34:48] Ryan Caldwell: They exploded.

[00:34:49] Lara Rhame: Yeah. So...

[00:34:50] Ryan Caldwell: And the margins tripled...

[00:34:51] Lara Rhame: This is, yeah, this is the upside down of that.

[00:34:54] Ryan Caldwell: So, so that's again, that, so that sets us up for a tough tape. Maybe one that's bottomed, maybe one that hasn't probably a lot of whip, which we've seen a lot of.

[00:35:08] Lara Rhame: Right.

[00:35:09] Ryan Caldwell: And I would probably say again, broadly, beta exposure is gonna be really hard, cuz this is a really tough broad environment. Little bit more concentration, a little bit more, probably active relative to passive, at least here in the us. Now the other thing, Lara, I wanted to make sure that we got to, and again, for our listeners, I know I point this out on every podcast I get Lara on. So Lara is absolutely a wicked currency trader with opinions and like, I do think like the last, like big we haven't gotten, we've talked a bit about de globalization and as you know, like it's like, I think it's like my Waterloo, like I do think this is the really big thing that we'll be dealing with for like a decade, like the fall out of these nasty geopolitical divorces and security. And Lara knows a lot about this. It's hard, right? When these things start.

[00:36:04] Lara Rhame: Yeah.

[00:36:04] Ryan Caldwell: They're they really do kind of tug at the strings of what. Lara, when I think about, and again, this is a big investment point. So for effectively, again, this whole period of globalization. And low economic growth yet really strong profitability. It's been a dollar boom, right? The dollar has sucked all of the capital out from the rest of the world. Like this has been the place to land your capital. And you're telling a story that's a little bit different than what attracted all the capital here.

[00:36:41] Lara Rhame: Yeah. I think, you know, this is... You're not just seeing volatility in equity markets. The treasury market has been incredibly volatile and currencies have broken out of ranges that we haven't seen in a decade as well. And I think going forward that this is another pain point. Where the economy is going to bash markets around a bit, because you're going to see currencies in and of themselves become a flashpoint for additional geopolitics and, you know, real conflict, you know, people would point to like, oh, the strong dollar policy, China would push back against that.

[00:37:24] Lara Rhame: And you know, some little. there have been skirmishes throughout the last 15 years, but, you know, look at what's happening with the yen right now. you know, again, some of these things have, you know, these over bands stretch. So they're GL, far right over the first half of the year.

[00:37:38] Lara Rhame: They've come off a little bit, but you've really seen. You know, when gr when global growth slows, you get countries, greedily doing whatever they can to capture whatever growth they can. And Japan was a, just a great example. As the rest of the world's been tightening, Japan was easing, really [00:38:00] gobbling up every possible jGB quantitative, easing doing whatever they could weakening the yen. to somehow keep their economy going and keep their long-term interest rates low. All of this is by way propping up their bond market. Basically, all of this is by way of saying we've seen. I don't. I just think we've only seen the beginning of what countries are gonna be willing to do to maintain trade share, and to maintain capital and to maintain growth in a world where it is an increasingly rare commodity. At least for the next couple of years, it seems.

[00:38:35] Ryan Caldwell: No, no, that's a, again, another sort of important point when constructing portfolios, right? When you think about...

[00:38:44] Lara Rhame: Yes.

[00:38:44] Ryan Caldwell: And again, you've had a fairly easy ride last decade of effectively being able to just belong S and P 500 Barclays ag and us dollar and you won materially like relative to history in a way that you've never won before. And particularly when you look at sharps, you just couldn't have done better. And so almost everything you've kind of pointed to Lara is some reversal of that, even if just on the margin, but as investors, we live on the margin, right? These rates of change and living on the margin really do affect how dollars flow.

[00:39:18] Ryan Caldwell: So that does tell you that. As these kind of currency wars, which is effectively what starts to happen here to kind of maintain trade share, like as these unfold, it has real implications. and again, let's come back to the us. I will tell you, and we B were surprised how much currency headwind. Absolutely. And again, for second quarter, everybody, they weren't as bad as they could have been. There was a lot of this talk about looking through currency and again, as an investing for a very, I understand people like to look through currency and say, well, you know, they missed, but it was currency. And you know, if you normalize currency, it'd be fine.

[00:40:00] Ryan Caldwell: Totally rational investment point. But where it's not rational is when you're sitting in the C-suite. And what I mean by that is these losses are real losses off of the top line, right? So like Microsoft doesn't hedge their currency. They're not in the currency hedging business, but they lost 600 basis points of revenue in the second quarter because of the dollar they have to manage to that. That's real revenue that is lost through currency translate. And like may, maybe it normalizes, maybe it doesn't, but it doesn't normalize on a path that's comfortable for management. So my argument has been, yeah, wall street can look through it, but if management doesn't look through it, then it becomes again, back to being a margin problem because it's affecting my top line.

[00:40:49] Lara Rhame: I'm laughing. Cause that's like a trucking company saying they're looking through energy prices, that's what all X energy, like we'd have been fine. Right? Exactly.

[00:40:57] Lara Rhame: Yeah. You know, huge amount of your sales are coming in non-dollars. It really matters if the dollars, if you're gonna be repatriating that into a weaker currency or a stronger currency, it matters enormously for your bottom line. And I think, this is a place where, you know, we haven't. Again, you know, I don't wanna go too far down the rabbit hole because I know you and I both have a, what I would say is a very healthy piece of conspiracy theorists in us. I'd like to think about things, but, you know, we haven't even talked about quantitative tightening, right?

[00:41:29] Lara Rhame: The Fed, reducing the balance sheet, the impact that's going to have on long-term interest rates. The lack of volatility in the treasury market is one of the more scary aspects of the way that financial pricing has gone in 2022. and you think about the impact, you know, rates and currency go hand in hand and, should the dollar weaken significantly. What that would add into treasury market volatility, I think is something that could really take us all by surprise. You know, it's hard for me to, at the end of the day, be a real bear on the dollar. I am sort of a consummate dollar bull

[00:42:12] Ryan Caldwell: But with your forecast, I can't get too bearish on it. Right. Like, that's not a super bearish dollar forecast. It isn't...

[00:42:20] Lara Rhame: No, because it's, you know, it's always against the rest of the world. and certainly against developed Europe, you know, where it's hard to make an argument to leap in and buy Euros.

[00:42:32] Ryan Caldwell: Can we, can we just shift gears for a second? Cuz I want to pick up. Because I don't wanna leave this podcast without talking about it. Cuz we haven't talked about this and I'm dying to kind of get your thoughts on it as we get post-labor day. Like right now, it doesn't matter. But my guess is post labor day, this ramp discussion's gonna get louder. And you know, the, these zultan posenars of the world will be out in full force, probably come post labor day, but can we talk QT and balance sheet?

[00:42:59] Ryan Caldwell: And how you think there's been so much debate about, will they do it? Won't they do it, the pace and everybody marking the pace relative to what they're saying. So how do you think that does flow through and the debate about the R P versus bills and does it really affect the market and does it not? Boy, it's a big discussion and boy, it feels like it's gonna get loud. So yeah, I would not wanna leave here without talking about.

[00:43:27] Lara Rhame: No, I agree with you and I do think it matters. I do think it's more of a 2023 story because let's face it, the pace of quantitative tightening. Isn't even really gonna sort of hit its stride and become more systematized until October and the Fed rate hike expectations for 2022 really haven't changed very much. They're sort of locked in. It's the early 2023 where, there's still more uncertainty and where you're seeing more literally week by week a rate hike gets priced in a rate. Hike gets priced out. That's a pretty big change in. You know, the three-month treasury in one week, that's a move of 30 basis points, you know, even intra day sometimes.

[00:44:15] Lara Rhame: So I think it's, this is to me, something that is, could have more impact in 2023. And I think, you know, again, the low level of volatility and treasury markets, is really going to have an impact when we. sort of past that initial trillion dollars out of the balance sheet. I know trillion here, trillion there, you know, but, we hit a level during the last round of QT where everything was going really calmly until suddenly the repo market exploded.

[00:44:46] Lara Rhame: And there's a big difference in that happening when inflation's low and the Fed has a lot of options and they can come in and cut with no problems. Their path is so much more [00:45:00] constrained by persistently higher inflation. They just do not have the wiggle room they've made such catastrophic blunders. On the way up with inflation, they are going to be hypersensitive to not repeating that. And I think I wanna just add one more thing, which I was just at a conference with a bunch of the Fed folks. And I think there was some open frustration that they don't have an P plan. Yet , you know, they still don't, you know, they've been talking about this and they sort of have this one year exemption.

[00:45:36] Ryan Caldwell: Yeah.

[00:45:36] Lara Rhame: And then they rolled it back and a lot of people thought they'd make it permanent, which would be at least

[00:45:41] Ryan Caldwell: Yeah.

[00:45:41] Lara Rhame: Some stop gap until there's something more formalized. Come on. This is critical plumbing. Every real big blowup that we have financially starts with a, some kind of a leak and then an explosion in this plumbing. This is the circulatory system of our financial markets. And when there is a little blood CLO can cause catastrophic damage.
[00:46:06] Ryan Caldwell: No, that's really what really well said. And you're right. If you kind of think about now that you say it out loud and lets me process it. Just given the way the RRP works.

[00:46:18] Ryan Caldwell: This isn't an issue until you're into 2023. Right? The real question is when do you start hitting bank reserves? Right? Like when do you work through the excess slash liquidity account at the R P, which can be replaced with bills, but once you start cutting into the bone of excess reserves, that's where the liquidity and the tape really can start to get wobbly on you. So that's a really good point, Lara. Thank you, cuz that'll help me mark that a little bit. It's really not that this year's issue it'll get talked about.

[00:46:45] Lara Rhame: It doesn't mean it shouldn't be on our radar.

[00:46:46] Ryan Caldwell: Sure. You're right. It'll get talked about in October, but the mechanics of the math are more feed through by mid-year next year, you know, kind of third quarter next year.

[00:46:56] Lara Rhame: Yeah.

[00:46:57] Ryan Caldwell: Okay, well, that's...

[00:46:59] Lara Rhame: The blow up will not be televised.

[00:47:00] Ryan Caldwell: Great. That's awesome. We get to push that off a year. Okay. We talk about QT next year. I guess last one, I guess the last one, maybe to land the plane. I mean, geopolitics here. clearly China, and again, we've talked a lot about deglobalization so I'm not gonna hammer the us China relationship too hard, even though I have lots of opinions on it.

[00:47:22] Ryan Caldwell: But I think Lara, you know, as you know, we've gotten relatively nervous about this relationship and the way it's going to operate and you know, what it really means for sort of the globe and who's the hedge on, and who's not. but your point, I think about policy makers is also relevant to Congress and the white house as well. In that this globalization gave you a lot of license to do a lot of stupid things for a really long time, without really doing a ton of damage. And now you don't have that, right? At least for the EC, the economy, the economic portion of the argument. And again, I'm not to get political here, but as the economy sits as a tool, or not a tool for the politicians to your point, as much as if it was a tailwind of the Fed.

[00:48:16] Ryan Caldwell: It was a tailwind here too, because you can run monstrous deficits at a, at absolutely no penalty. Right. and keep the wheel spinning and keep margins high. And again, that all came at the expense of kind of labor at the end of the day. And boy that's coming unglued. And so, yeah, I mean, medium term, I have really pretty doer kind of thoughts on where the us China relationship's gonna go. And I almost think it's politically not even path dependent anymore. We're just heading that way, regardless of who's in power, right. It's become sort of the issue to be worried about. But most importantly, Lara, the policy makers have to, you said it either get lucky or start making some better decisions.

[00:49:00] Lara Rhame: Yeah. you know, this is something that is, you know, we're gonna get through the midterms. We're probably not gonna see a lot of really significant more fiscal spending on the us side. But when we think about coordination of global policy, it, you know, As that unwinds, we're just going to see so much more volatility. And I think, you know, you have this spacing where you have these really large economies that don't have election cycles every four years. you have ours that, that do. Yeah. And, or ever...

[00:49:36] Ryan Caldwell: They just have because...

[00:49:37] Lara Rhame: And right, exactly. And so this also adds to. The need for policy for us policy makers to look more long, run, at least on the China side. There does, that seems to be the one disliking China seems to be the one thing that both could agree on right now. so that maybe gives some hope for some slightly more strategic thinking, because boy, we let ourselves get into a pretty ugly chess match. we're down a lot of pieces. so, but at the same time, I think we have to acknowledge that in the us, we do have a lot of strategic advantages, geographically, natural resources, because I think we are entering a world where that is just going to continue to matter more and more. So, yeah, I know. I see. It's another place where we can hopefully get some benefit.

[00:50:43] Ryan Caldwell: Absolutely. Right. Right. At the end of the day, we have all the raw materials. If you will, to fix the problems, it might, it's going to probably take some smarter decisions, directed into some places that deal with these friction costs. I think that you, so aptly identified, right? Interestingly enough, again, what did people agree on? The chips act actually had pretty wide. Yeah, right. I think it's, we're starting to at least get some understanding that some of these industries are strategic and therefore should have some sort of support and that might actually make some economic sense and regional sense. So again, it's one marker. It's early, but again, those are things like watching for. Can you make some smart decisions after maybe making some stupid one?

[00:51:30] Lara Rhame: Right. You know, the, I think to some degree and it has you know, complacency happens that we shouldn't beat ourselves up about it too much, but I think we viewed ourselves as a monument to operational efficiency. And boy, we are experiencing the downside of that now.

[00:51:45] Ryan Caldwell: Yeah, that's exactly right. And I look, I also think, I also think just as in any complex system, when you build a complex system, Like you're reliant on that system and particularly the key parts to effectively be rational actors. [00:52:00] And I think what we figured out in 2022 is some of the cogs in the global wheel may not exactly be rational actors.

[00:52:07] Lara Rhame: Yes.

[00:52:07] Ryan Caldwell: And so you can't build the system on top of it. And so you've just gotta rethink your systems and processes.

[00:52:14] Lara Rhame: Yeah. And happily, I think actually for. The us economy still being the largest in the world. We're better at flexing and changing than many other economies out there. I mean, I, when we had the initial supply chain issues, my answer was that's something, the U.S. is good at...

[00:52:30] Ryan Caldwell: Yeah, we're great. There,

[00:52:31] Lara Rhame: private industry wants their stuff off the boat. They'll figure out how to get it off the boat.

[00:52:34] Ryan Caldwell: And low and behold, they got it off the boat they did. And you were right.

[00:52:38] Lara Rhame: So those that's resolving.

[00:52:41] Ryan Caldwell: Well, I think we've, I think we've exhausted. And again, this is about topically Lara, where about I would've covered. I would just say, I would just say to our listeners a couple of things, one Lara's doing a lot of really good work. I would actually say. You know, the research that she has cranked out. And again, yes, she's an economist, but she's a markets economist and I love markets economist. And again, she's got a lot of markets experience.

[00:53:07] Ryan Caldwell: So being able to kind of write economy to markets is an art. And so I would encourage people to read the research. And again, there's some really interesting stuff. She did some really interesting work on the great reset. Did some really interesting work on capital spending has done amazing work on inflation.

[00:53:27] Ryan Caldwell: So again, I would tell our listeners, you know, time to start reading, and again, it's been relatively a relatively. Straightforward run the last 12 or 13 years, but you got to understand this because the world is changing and all these things that Lara sort of pointed to, like when you see them in graphs and numbers. To me, it's almost a little bit more vivid, right? We talk about it almost a little bit. Willy-nilly on a podcast, but when you look at some of her work and some of the charts and you go. Like the visuals are very impactful and the words are impactful. So I would encourage our listeners to be reading the research again, Lara does a great job there.

[00:54:05] Ryan Caldwell: And the other thing that, I would leave our listeners with is. Again, I think if you're thinking about portfolio construction, and again, I'm, we're not here to give you names or asset allocation recommendations. This is really more of a discussion about what we see affecting markets and economies. I think what Lara just laid out for you as a case is what is in front of you is very different than what is behind you and what is in front of you, you are going to have to change the way you. About allocating capital and it's very painful and we see it still, right. Again, the market's reflexive action is to always go back to what worked before.

[00:54:47] Ryan Caldwell: Right? So again, even this bounce, right? What did the market go back? It went right back to technology, right? As soon as it got an air to breathe, that went back to the air that it used to breathe, but just like in 2000. Right. It took about three or four years for people to figure out the tech was no longer the thing to do it wasn't until the mid-2000s that the bricks became the big story and it became socialized on wall street. And then ultimately. You know, became the narrative. So I do think this is a really important moment in time. And again, the reason we did this podcast this way and look, Lara's on every one of our podcasts, but I wanted to strip the team down and just get at the macro because it is so different relative to what we've been living under.

[00:55:32] Ryan Caldwell: Again, for most people's recent investment history. So again, I do think it's probably time to think more and listen more and read more and probably be a little slower to act. So that's at least the way I think we're thinking about it. So, Lara, I can't thank you enough. I love grabbing your time. I've grabbed a lot of it, you know, we will be back. our producer, Aaron has told me that we will be going monthly. So we will be coming back to our listeners with more frequent content and probably a little bit shorter form, but for the longer form.

[00:56:03] Lara Rhame: Thanks so much Ryan.

[00:56:03] Ryan Caldwell: But for the longer form stuff, Lara, like, again, we want you all year, so can't thank you enough for being here. An awesome discussion. I very. Appreciate it helps me kind of frame out what we're thinking about as well.

[00:56:17] Lara Rhame: Yeah. Thank you so much. Really appreciate it.

[00:56:19] Ryan Caldwell: Thank you.

[00:56:25] Ryan Caldwell: Thank you for listening to this episode of the 3D Report 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.