Episode 52

Q4 2022 3D Report: We won't get fooled again

Ryan Caldwell and Lara Rhame reflect on the events of 2022 and how they'll continue to impact the financial markets in the new year.

Ryan Caldwell (00:01):

This is the 3D report, a podcast from FS Investments and Chiron. I'm your host, Ryan Caldwell. I mean, this is, this is amazing. I'm in studio with the, you know, the infamous Lara Rhame. Like, we're actually in the same spot. Like this is... Wow.

Lara Rhame (00:32):

It's gonna be, it's gonna be even better. Yeah. Our podcasts are already great.

Ryan Caldwell (00:36):

It's, how can you not do anything but get more animated? So it's gonna be great. Happy New Year, by the way. I haven't even said Happy New Year.

Lara Rhame (00:42):

Yeah. I've...

Ryan Caldwell (00:43):

I've seen you. I mean like, yeah. 24 hours. No, Happy New Year.

Lara Rhame (00:46):

You can keep it going through January. Happy New Year.

Ryan Caldwell (00:48):

Yeah. Happy New Year. I know this is what happens when you do year-end meetings, like in January,

Lara Rhame (00:53):

Like, and we can say goodbye to 2022. I mean...

Ryan Caldwell (00:55):

Yes, which is good. I, that's probably where we ought to start. Yeah. Actually like saying goodbye to 2022. I mean, I do actually actually think like that's a reasonable jump off point, right? Like, one of the things that I know our listeners have been hearing us banter about and like when we peel off and talk about business cycles is like, how bizarre this one was, is. I shouldn't say was, we're still dealing with it and Lara, like we've talked about this a little bit. Like the compression of this whole thing is maddening.

Lara Rhame (01:25):

Yeah. It's going so fast. Policy's going so fast. Inflation obviously, the number one topic was just, just ramped up so quickly from everywhere. And now obviously it seems like it's just plummeting as fast as it rose, which is, I know something we're gonna talk about. But from a business cycle point of view, you know, the housing market, you know, you've just had these core parts of the economy, the ramping up of hiring, and now the ramping down. All of these things just moved at lightning speed. I can't remember a business cycle where we achieved employment prior, you know, back to the pre prior cycle low in, you know, record time. Yeah. In less than a year, which is an extraordinary. So it's just everything has just been on fast forward. It's really extraordinary.

Ryan Caldwell (02:17):

Yeah. And I think like when you put the market participant hat on, like the thing that is the hardest part about managing through this is that all is like really behavioral inducing, right? And so, like you've gotten all these like muscle groups in the body to react to the stimulus, the cycle, covid, shutdown, reopen, cadence of all that, right? All the sort of psychological sort of, IM, you know, almost like inversions you went through with just, just a pandemic cycle. Then you threw this massive monetary cycle on top of it, which again, got everybody to react like it worked. Oh yeah. It induced management moved. Yeah. Consumers moved. Everybody moved, right? And then you're taking away that punch ball about as fast as you gave it. And so the market's trying to sort out like, and, and we talked about this on our last podcast cuz it's one of my favorite topics of like, the market just wants what it wants and it wants it all in the cadence in which Right.

(03:23):

It expects it. Yeah. And when it doesn't get it, it, you know, we have all these gyrations and so Lara, maybe like starting, like, I wanted to maybe start here, which is kinda the last time we talked, we started to tickle this point about like, is it growth or is it inflation that you should be more worried about? Right? Like if you think about the two big things, and you made the exactly the right point that like 21 and 22 were about like the destruction of an inflationary cycle and what that does and all the kind of second and third derivative effects which have all now come home to roost. But by the time we started to get to the end of the year, and I think, you know, our last last podcast we started to have this debate about the terminal rate, right? Which can it really be, you know, can it really go above five?

(04:10):

Like at the time I think you had Jim Bullard out talking about six. Yeah. Larry Summers could be eight. Like the numbers were like people were feeding on each other for how much work needed to be done. And now, like, fast forwarding into January, right, what seems to be evident is the inflation fear has peaked. Again, I won't, I'm not gonna even go to inflation's peaked. What I'm gonna go the first order of inflation is peaked is, is getting pretty consensus. We've had a couple of prints both in C B I and PPI that are starting to indicate that the sequentials are slowing to a degree that like it's coming down in, in the right direction. And I'll stop there. Now, the other side of that coin has been, right, this looming discussion about earnings revisions and margins and demand, consumer demand, particularly since, again, you've made this awesome point all year last year, the consumers way stronger than you would possibly expect to be forecasting recession.

(05:19):

Like this is not what the base of a jump off into a deep recession looks like traditionally. And so the growth argument kind of went in and out last year and the market was wildly more sensitive to, is the Fed gonna hit us over the head again with a higher terminal rate? Like that was the thing that seemed to drive markets both in equities and fixed income. You fast forward this

year, inflation looks a little better, Peaky, you know, the sequentials look a little better. And in the same breath you've gotten China kind of completely reversing policy. That was something we talked about last quarter and my god, you want to talk about a policy 180 from three years of draconian lockdown to in a week it's all over. Everybody get outta the house and go spend some money. Like it just wildly turned on its head.

(06:06):

And, and when I think about kind of the last global piece, Europe, the war again that fed this whole kind of strain of inflation shock. Again, one more thing on this kind of pile of mess that we got in 22 and like lo and behold you luck into this really warm winter in Europe, right? Natural gas prices go from 10 bucks to two bucks. And all of a sudden, like the discussion about the European revival, even though the ECB doesn't seem to be so in tuned with the European revival, but at least like there's been some narrative and I think to start the year that I kind of wanted to kick off with you about like, well maybe the Fed just engineered a soft landing, maybe inflation's just gonna fall now from here back to 2%. But the unemployment rate doesn't have to skyrocket because inflation's already falling. And so maybe you just looked through, you know, so whatever the earnings degradations are to start the year because the back half of the year in 24 could be pretty good if the fed, you know, doesn't have to go above five cuz inflation's naturally falling. How much do you buy that? Like, I wanna start there. Yeah. With like soft landing, like where's your head on kind of both sides of the soft landing inflation growth equation?

Lara Rhame (07:22):

Okay, so I, I think at the core of my outlook, there are two very different statements. One statement is we could have a year of fairly stagnant growth and the unemployment rate could rise and we could get components of a recession hit us at the end of the year. And as a statement, the Fed has engineered a soft landing <laugh> because I think we could, we could have a soft landing. We could have a a and I'm not even gonna say a landing because that implies you know, like, like a, a trained pilot landing a plane,

Ryan Caldwell (08:01):

It's like core stability, right? Right. You just softly put the wheels down Yeah. And it pulls into the gate, no

Lara Rhame (08:07):

Problem. Right? I I, I, so I think my outlook is for a soft economy. Okay. my outlook is that the economy driven by solid consumer momentum maintains positive growth in the first half of the year. That's not making anybody too happy. You know, it's growth of 1%, one and a half per quarter. Yep. And that by the end of the year we have decelerated further. You know, the arc of my forecast is negative G D P growth in the fourth quarter

Ryan Caldwell (08:42):

Q4.

Lara Rhame (08:42):

Yeah. but it gives you like a, it gives you like a 2023 growth rate of positive a half percent, a little less than where we were in 2022, which is also probably, I dunno, we'll get the numbers in a couple days, but probably 1%. So this is a, when I am asked to describe the economy in a couple of words, my answer is it's a grind <laugh>, we are grinding along. So what concerns me most, and I'd I'd like to, for us to dig into this more is this idea that for markets, a goldilock scenario is a soft landing because I would reframe that is in the kind of the best we can hope

for is lackluster growth. That to me is the same, it implies the same GDP forecast, but it has a very different connotation spin on it. Yeah.

Ryan Caldwell (09:38):

<Laugh>. Well, and, and I think like, so really good point because I think the market's interpretation of soft landing is find you put the plane down at, you know, a percent zero to a percent. You don't contract the thing hard enough,

Lara Rhame (09:54):

Painfully

Ryan Caldwell (09:55):

Painfully enough to break anything. But, but 24 has gotta be better, right? Like it can't be soft landing lay at the gate and the plane never leaves again. Right? Right. Like the plane's gotta take off again for that to work out. And so I I I do think you raise a really good point that just because you landed the plane doesn't mean the plane takes off again vigorously. Yes. And you need that as an ec as an equity guy or gal, you need 24 reac acceleration. Right. So that's why I almost think the market would prefer

(10:35):

Something harder that creates an easier 24 comp, right. Because then I can say, well, okay, if you contract earnings, you know, 5, 10, 15, well, geez, 24 can grow double digits and then it's off of different base and that's great. And like Wall Street loves that. Yeah. But if you tell me, eh, Ryan, like you kind of, you kinda walk this thing down to nothing and it kind of stays around nothing. Well, what we know and, and we've talked about this a bunch and you and our quantitative group actually wrote a paper on it, which was brilliant, talking about the margin structure, margins can't rele if there's no like re-acceleration and top line. Yes. Then I got no earnings in 24, then I got a slog. So like is that soft landing? Like, is is that what we're hoping for?

Lara Rhame (11:27):

Right. And here's where we need to have a broader conversation about the fed's relationship with markets. Yes. <laugh>. Yeah.

Ryan Caldwell (11:39):

That's, it's, it's like topic.

Lara Rhame (11:40):

Let's

Ryan Caldwell (11:41):

Just that's go there. Like this is, I think that's,

Lara Rhame (11:43):

Yeah, because because what do we have right now? We have like a current fed funds rated for 25, it's gonna go up another quarter point Yep. This week. And you know, we can have this like really to me almost meaningless debate of like, is it 4 75 they kept out? Is it five? Is 5 25 it's 25 after all that they've done. That is a meaningless

Ryan Caldwell (12:06):

Change. It almost doesn't

Lara Rhame (12:07):

Matter Tinker at the bat. Yeah. The back of this. So the battle over the market expectations of the rate hike to me is, is close to over the battle now is over <laugh> what happens next. Right. do they stay, do they hold, do they cut and the markets have priced in, you tell me how many rate cuts they've priced in by the second half of the year.

Ryan Caldwell (12:31):

Like you're Yeah, you're getting into like three and a half. Yeah. Three, three and a half, right. Like you were two and then like after you get these prints, the market kind of backed down the two year and backed in and inverted deeper. So Yeah. Somewhere between Yeah. Like th let's say three. Right? But like three to four and that's like not unmeaningful.

Lara Rhame (12:51):

Right? And, and, and as you and I both know the Fed over decades long business cycles Yeah. Falling long, you know, falling interest rates across the curve. The markets have been trained to expect the Fed at the first sign of market disruption and almost, I was gonna say economic disruption, which is true, but really in the mid nineties we kinda had it kick off with the economy doing fine. It was a market disruption. Yep. That's right. The, the market's been trained to, you know, sort of throw a temper tantrum and have the Fed come in and just back up the truck with 500 basis points of rate cuts. Now we know that is zero <laugh> erp Right, right. Quantitative easing now. Yep. and I think to me, this is where we need to really have the important discussion about the fact that when we say every business cycle's unique and we talk about how fast this business cycle's been, the fact that the, to me the fed's reaction function is going to look totally different and it's because of the inflation going into this. Yep. and I don't know who's gonna win the battle of wills, but that makes me nervous for the last half of the year and for what's priced in. Yeah.

Ryan Caldwell (14:10):

And, and I want to so I want to really tease on that actually before it tease on that though, I want to go sidecar back to soft landing for a discussion. Okay. Yes. And just sort of get your thought process on the other like newly kind of minted Wall Street trade of, and again, all, every big house is sort of done the same thing now, which is this whole non non-US versus us. So if your definition of soft landing is achieved, which I agree, I think it's a great definition. You've gotta kind of like, you gotta frame that out and I've got this easy compare non-US where I am stimulating. Right. And IT and Europe not yet, but likely gonna need to when we think about just reconstructing Europe, whatever post this, the invasion issue, Asia clearly stimulating mm-hmm. <Affirmative> like clearly, I mean China's both guns bearing, reopened again, Korea stopped hiking and basically said we're done likely to cut.

(15:15):

So is that, if you think we're stagnant, let me just use stagnant because I know it well and it, and the reason I want to kind of tickle this is cuz you made me think about this the last time international did great. The US was stagnant. It wasn't a disaster, it was stagnant. Yeah. Right. It wasn't like we were grinding through the end of sort of the 2000 period we got through oh three Andron goes sideways, WorldCom goes sideways, we pop out of that recession. But till housing really got going oh 5, 0 6, 0 7, the US economy was terrible. Sure. Right. Like the s and p returns were terrible. Yeah. I remember cuz that was maybe the point in my career where I raised the most money, but non-US was kind of booming. Right. China was the

Lara Rhame (16:00):

Story that was booming.

Ryan Caldwell (16:01):

Yeah. And we're not gonna get that again. So I don't like, I don't want to color it as exactly the same because that was also a moment in time where you had another easy story to go to. Right. So, sure. But when I think about like what can make that work Well, and I hadn't thought about this one outcome would be a stagnant outcome here. Not too, you know, not hot, not freezing, but like kind of blah. Yeah. Where I have this moment where maybe like Europe can comp Okay. And China was closed for four years, so you would think like a 6% g d P print shouldn't be that hard. So like do you kind of think like that when you kind of put on your this again global? Yeah. She's got a very, very good global hat and used to wing around a lot of currencies. Sure. So she knows where I'm going with this <laugh>. So like do you think you can carry again, I guess is what I'm asking, like do you think you get the environment to carry again? That

Lara Rhame (16:52):

Is, that that is a really important to me. You know, when the US goes into recession, it is, it is a twice out, it is a direct gut punch to all of these emerging market countries that to some degree and that's where, you know, you're the expert when you are investing in these countries to some degree rely on us demand for their export market.

Ryan Caldwell (17:12):

For sure.

Lara Rhame (17:13):

I think the real issue is you, you're gonna need the dollar to be weak enough Okay. To to, to get any sort of positive ricochet effect back to the US <laugh> to get the global momentum going of, of that Yeah. Spinning back positively to the us. So you know, but, but a I think, you know, one of the ways that I probably am off consensus is having a more positive outlook for business investment. Okay. And I think the US consumer to me directly pulls from Southeast Asia, from China. But when you look at business investment, I think there's real room there for, for our demand to stay, I think surprisingly resilient. Of course they're cyclical headwinds Of

Ryan Caldwell (18:00):

Course, for sure. Yeah.

Lara Rhame (18:00):

Yeah. But but I think that, and that's a longer investment cycle. Yep. I have been in more round tables with more CEOs recently who talk about that need to see down the road. And these aren't, you know, CEOs, unlike consumers, unlike you and I, we don't make investment decisions year by year. We, we look longer term and we've underinvested for 15 years. So for that reason, I am more positive on, on that aspect. And I think there could be some lift there in a soft stagnant US environment.

Ryan Caldwell (18:29):

Well, no, look, I think that's like we both, I I think I completely agree with that. Like when you think about a, where some of the fiscal incentives are likely to come, right? It's likely to come in sort of productive places, production places in the US or our allies or new allies where you're

supporting to get these managements to continue to invest your effectively corporate welfare. I mean that was the semiconductor act, right? Yeah. It's clearly just corporate welfare now you gotta argue needed. Yeah. Right. Like needed corporate welfare because you

Lara Rhame (19:08):

Could separate discussion, but it is what it is.

Ryan Caldwell (19:10):

Yeah. It is what it is. So like really good point. And it is a longer cycle. Oh, and by the way, if that is true, if true, then the answer is, ooh boy, that's not great for margins and cash flow like Right. For the business. Sure. Right. For c e o making a five year

Lara Rhame (19:31):

Decision. Right. For us, productivity,

Ryan Caldwell (19:33):

Economic growth. Sure. Right. All good. All kind of net earnings bad.

Lara Rhame (19:38):

Yes.

Ryan Caldwell (19:39):

Exactly. And, and if the market, and we saw this a lot last year and we talked a lot about it in our work. You talked about it in the margin paper. The thing that was so surprising last year to me while there were a lot of surprises was the degree in which the market penalized capital spending. Yes. Right? Because the market, again, back to this like petulant child, which we're gonna get back to the petulant child, the petant child doesn't believe the top line.

Lara Rhame (20:06):

Right.

Ryan Caldwell (20:07):

It doesn't believe it's sustainable. So if manager a and I make widgets and I've gotta invest in production to keep making those widgets and shorten my supply chain and maybe change where it is like, yeah. Like I gotta spend, but if my revenue starts to come down, the market's gonna say your margins collapse, your earnings collapse, you can't buy back stock. You. And again, the market is very petant child when we talk about what it wants from companies, right? Yes. Again, you've disciplined this market for a decade to be very capital light and very high return of capital, right? So the market's gotten its duration shortened for it for a decade. Right? So back to the easy thing to do. So if you just reverse that on the margin a little bit, right? It creates this whole different dynamic. So your point about like what is a soft landing, I think like, and again, I hadn't thought through this until we started bantering around. I was like, oh boy. Like, ugh.

Lara Rhame (21:10):

Right.

Ryan Caldwell (21:11):

Ugh. Like that, like, I don't know, I might be with the market, I might want it to go down 20 and wipe the thing and then, you know, they, they come in and Right. Have to overstimulate to re because like I, that model's somewhat of an easier model. I hate to, and

Lara Rhame (21:25):

It's, it's familiar.

Ryan Caldwell (21:26):

It's very maybe familiar is a better term. Yeah. As opposed to easy. It's like, oh, I know what to

Lara Rhame (21:31):

Do. Yeah, exactly. And I think, you know, how many charts do we see? They're like, oh, when the market, you know, once earnings gets get revised down 20% Yeah. Then you buy, right? I mean we, we have been, I, you know, I, I don't, I don't wanna talk about a lot about high yield, but I do think it's, you know, and we all have this chart that's like spread when spreads blow out over 600, they always go to 900 and then you buy, then

Ryan Caldwell (21:55):

You buy them and

Lara Rhame (21:55):

They come back down to 316%. Yeah, that's right. <Laugh>. And that that's the chart that we all have. And it's like, well at this point everybody's looking at the same chart. It, it's harder to get a group, group thing. You know, it's harder to get. So I think that, you know, that was a side example, but it speaks to the fact that when you have a, a shortened business cycle, still a lot of positive momentum. You and I have talked about, you don't get a recession with the unemployment rate at three. It's impossible. It's I percent it's nonsense. It's impossible. You know, you get, it's your point. You get people worried about inflation, but that's coming down. Now you get people, you know, wishing they maybe had a better job. Sure. Try to get one that's important. Sure. But but consumer confidence is recovering and consumer sentiments recovering in line with inflation and with this unemployment rate of 40 decade low.

(22:45):

So you know, when I look ahead, I see one of the things that I think will be very unique about this business cycle is the fact that we had business cycles. And, you know, we had a recession in 19 90, 91, we had a recession in 2001. They were very shallow from the output side. Yep. But but the employment side was huge, decimated huge. And that was globalization. Yes. Right. All those jobs just shipped them right over to Asia, close all those factories. That was globalization. Well, we are to some degree unwinding that sweater now. Yep. <laugh>. Oh yeah. And hard, yeah, hard. And to me, what we've experienced during the pandemic companies may be more guarded with their labor. And we may get this, you know, we may get a situation where the output is just more stagnant, but we don't get the job losses that we've had in prior episodes. And here I wanna differentiate tech and I I just wanna go out and say you had companies that literally doubled their tech workforce, now they're cutting 5% of it. It's, they're nasty headlines. That's not good news. But come on, at a, at the national level trying, you have to use a microscope to find it finds signs of job weakness, labor

Ryan Caldwell (24:06):

Market. No, I mean, look, it is such a, it is such a good point. And again, back to like what do you always do in these big upcycles? And clearly we had a massive tech upcycle, right? You always spend too much, hire too many people. Sure. And you, and you put the cherry on top in 21 with

everybody jammed at home and all these companies that were benefited from people being jammed at home globally thought like, well this is sustainable. Sure. Yeah. And they, they invested and hired that way. And as we've talked about on the podcast before, oh, and by the way, 3 million people just bombed out of the labor force.

Lara Rhame (24:45):

Exactly.

Ryan Caldwell (24:46):

And like, you can't, even if you go well, they're gonna automate it. Well you can't automate that fast.

Lara Rhame (24:50):

Right. E exactly.

Ryan Caldwell (24:52):

So like there are these kind of push, there are these bush pulls. So now I want to go back to the petulant child. Yes. So, okay, soft landing could be in the mix, it could run hot. We know what that looks like last year. That seems like that's coming down less likely to run hot just given all the, all the restriction that's in the pipeline to keep it from running hot. The petulant child, however, back to your point, wants something. Right. And what it wants, and you can see it in the forward curve. So back to this discussion, is it wants the fed to realize that a 5% terminal rate was probably a hundred basis points too high and therefore something nastys coming. And because that something nastys coming, the child's gonna throw out the toys and say what? Fix it. Yeah. So I think my question to you is, and and, and we were, we were having this discussion kind of in a couple of different ways across the firm.

(25:52):

And I think Lara kind of nailed it for me in this kind of vein of like what is point of recognition, right? So again, if we've been talking about inflation versus growth and when do you get to this point of recognition where clearly right now the market and the Fed are in a fight about what the fed's gonna do. Guess my question to you is, under your forecast, the Fed isn't in a hurry to do a lot of anything. Yes. Right? Like again, they're gonna watch the inflation rate again. I don't think they wanna see like, you know, 10 year forward spreads collapse in a big deflationary impulse from keeping rates at 5%. But you're, if you're in the soft landing, I'm gonna keep using this word scenario. Yes. You don't get that

Lara Rhame (26:34):

Right. I think the fed's reaction function is probably one of the most important pieces of my forecast. It's

Ryan Caldwell (26:41):

The, it's probably the only thing that matters quite

Lara Rhame (26:43):

Honestly. And I think the pre-question or you know, the, the the, the lead in question is, you know, is 5% a like break it level? Yeah. Because hey, look at 2017, 18. Yeah. We got to two and a quarter and was like, market was like, you're breaking it, you're breaking it. Wheels went properly. Right. And we're, and we're now like we almost money markets somehow, right? Like

no, I know, right? And, and we're almost twice that. Yes. So I think critical to this discussion is, you know, a a couple of points that, and I offer this up for consideration, right, because, because because I think we need to recognize that you know, there is a certain degree of like they raised rates so fast, there's no doubt that they need to just take a hot minute, <laugh> <laugh> and figure out what the impact has been.

(27:42):

Yep. But you, I think you could argue that our economy is right now less interest rate sensitive than it was you know, prior. I think, you know, when you look at the balance sheets of corporations, I think companies, I think households were op very opportunistic when interest rates were incredibly low and did refinance. Yep. Oh yeah. Clearly. Yeah. So that's also helping this like create this sort of insulation. Yeah. On the interest rate sensitive piece of it, we will see my, my job is not played out in days and weeks and quarters. It's played out in years. Yeah. but I do think that the the labor market has fundamentally changed. There's still certain key pieces of it, which will probably be the same there at some point is a deep asymmetric reaction when the unemployment rate rises. But I do think that companies are viewing labor differently as a, as a more scarce commodity than they have in prior cycles because the pendulum of globalization is, is swinging back.

(29:00):

It's still hard over <laugh>. True for sure. But, but it's swinging back. So so for those three reasons, yes. Cpis coming down fast, we will see what happens with the labor numbers. Yep. We still have wages that are also moving in the right direction. So everyone's got their eye on the wage numbers too. But they are, you know, wage growth at 4% is fundamentally inconsistent with inflation of 2% <laugh>. So, you know, there's still a lot of more room to go there. But for those reasons, I think, you know, I I would stand here and argue 5%, like we're 40, they haven't broken anything yet. Like the 10 years coming down, the housing market's gonna reignite. There's people are waiting to just go out and buy homes. Again, you know, the financial, the easier financial conditions get the more the Fed is like, you wanna play this game, you wanna, you wanna 15% rally inequities. Sure. And you can take 75 more rate hikes, you know, <laugh> more basis, basis points of rate

Ryan Caldwell (30:03):

Hikes and, and look, I think that is, so that's the salient point of the fight, right. Which is the fed saying, I'm not gonna let you ease financial conditions cuz we cannot let inflation reignite. And the market is saying, huh, wait right here. Yes. Right Wait, right wait right here. Cuz you wanna impose that type of discipline. Right. The problem is going to be the yield curve's not inverting because of easing of financial conditions. It's inverting because you're withdrawing liquidity and growth is slowing. Yes. And you won't recognize it and we will. And so I think my question is again, what I think about the two, like you said, two really potent things right there. Yeah. Right. From a Wall Street guy's perspective and a guy that's having to allocate capital, right? If managements are viewing labor relative to capital and capital return differently, they have to retrain Wall Street because Wall Street is gonna bludgeon them with that view.

(31:11):

Right. And we saw that again back to the 2022 point about, right? About like what underperformed the biggest spenders and the biggest hires the market punished because again, you ran a decade plus where the nominals were bad and Wall Street trained management to say, your top line's just gonna be bad. I don't want you investing just milk everything for cash flow and send it back to me and I'll allocate your forecast. Is 180 of that Yeah. Where managements go, sorry guys, I gotta take share, maintain, share. Right. I've gotta be, I've gotta change my cost structure to the worst to have more security in that cost structure going forward. That's a fight, right? Yeah. That's a disciplining fight. Like that's putting the dog collar on the dog and shocking it and, and and and saying to Wall Street, look, you can penalize

the stock but, and this is a little bit what Zuckerberg did, whether you know, misguided or not at Facebook, it doesn't matter what you think Wall Street, I'm just gonna build the metaverse cuz that's the only way I can grow.

(32:16):

So like that's fight one. That's more of a me a micro fight of the macro fight. Number two, back to your point about the Fed and the terminal rate, and I agree, I think at this point like this, this argument about whether it's 4 75 or 5 25 is just irrelevant. Sure. Yeah. The question, the question I have back is, does the market, because it's been trained to be a Petant child, say, eh, you just broke it, it's already broke. Yeah. We're gonna force it wider Right. Managements we're gonna shoot fed, like we're gonna get, we're gonna widen spreads to an uncomfortable level. Like, because back to like, back to the earlier point, like Wall Street says I have to generate investment returns, right? Like stagnation and stock is hard to generate investment returns. I'd rather break something cuz then it's easier to compound and create investment returns going forward. So do you think that's the fight, right? Does the market, I

Lara Rhame (33:15):

Think that's exactly

Ryan Caldwell (33:16):

Like the Fed and say like, the point of recognition is we're gonna keep doing this dance until something breaks.

Lara Rhame (33:22):

Yeah. Like you won't let me have the Barbie doll watch how big of a temper chanter I throw in the middle of the mall. Yes. We both have, I know we both have had small children. Yes, we have children are both grown now, but they're Yes. I

Ryan Caldwell (33:31):

Remember my daughter whacking me with Barbie doll that I wouldn't buy her in the store. So Yes. Is the market gonna whack me

Lara Rhame (33:37):

With the Barbie

Ryan Caldwell (33:38):

Doll?

Lara Rhame (33:39):

Right. I think that to me is the more, if you said to me, Lara, write me a short story that ends with the Fed cutting a lot, that to me iss it, the story's okay. It's not okay, you know, a big recession. It's not, you know, this a more classic sort of recession unemployment up a lot you know, fed, you know, sort of housing driven, I don't know, whatever sort of economic it's, it is the market fighting having a standoff with the Fed and the Fed blinking, which it has done so many times before. That to me is the more that is how I would write it. And I think that's what we all need to be prepared for. And so it's a left tail that's hard to manage around's.

Ryan Caldwell (34:23):

It's a left tail financial event.

Lara Rhame (34:24):

Right.

Ryan Caldwell (34:25):

That sucks.

Lara Rhame (34:26):

Well, <laugh>,

Ryan Caldwell (34:27):

I mean no,

Lara Rhame (34:28):

I like, yeah, well, you know, we had, we had cr you know, we've had, we had crypto already and that's seems, seems

Ryan Caldwell (34:34):

Big enough. Not

Lara Rhame (34:35):

Big enough seems to be well contained. Well, and there's still so much, you know there's so much liquidity still in the system. I think it's easy for us to write something in our, in our quarterly outlooks or in our podcast and say, oh, this is happening. And people think, oh, well they talked about it last quarter. It's like, no, no, this is gonna be happening for quarters. Wow. You know? Yeah. You don't add $4 trillion into the financial system and take it out in one quarter. It takes, it takes six quarters for that to happen. And we've only been doing it for three quarters, so it's gonna take a while longer.

Ryan Caldwell (35:07):

Well, and that's what I think, like, I think this massive inversion, right? In every spread that the Fed looks at, is the market starting to throw the toys at them? Yes. And saying, these are your indicators. These are the indicators you say make you stop doing what you're doing. Okay.

Lara Rhame (35:29):

Right. And that's where you ask yourself, you know, when you look at the 75 basis points of rate cuts that are priced in, you and I both know that's not the market saying, oh, the fed's gonna really just cut 75 base splits. No, that's the market saying they're going to zero. That's the market saying there is a significant chance they're going to zero.

Ryan Caldwell (35:49):

That's agreed.

Lara Rhame (35:50):

And yeah, yeah, yeah. And that's just a another way of saying what you're saying <laugh>. But I think, I think that is, you know, as we see that long end come down, I think that is the, that is where, to me the discussion is the more interesting that we've had today. No,

Ryan Caldwell (36:07):

I totally, no, look, this is like, I think this is the year Yeah. Right now. Like Yes. Again, kind of us non-us, like we've been kind of teasing out maybe more to do there just again, comps and behavior like a hundred percent I don't need. Yeah. Like you don't need to be a genius. I just need bad comps and a little bit better behavior and like maybe I look smart, but this fight to me is the year. Yeah. Right. And like that's sort of like, I, I struggle so mightily with it because I agree generally, like from a forecast perspective, I got nothing to shoot in your forecast. Nothing. Yeah. Right. There's nothing I see given, again, three and a half percent unemployment rate, business investment and some key big sectors that likely is gonna happen whether you like it or not. Right. And again, you've got incentives to do it. Right. That's the thing. Like again, it might not be a Wall Street incentive, but like, hey, T S M C has incentives to build a bunch of stuff in the US might not be good for their margins, but they're incentivized to do it.

Lara Rhame (37:06):

Well and I think, and I think, you know, we've talked about this a lot too, and I think this is something that we do a great job with Brian Cho flushing out in the paper on margin free cash flow is still gonna dominate. That's still gonna be what we're chasing. Its

Ryan Caldwell (37:20):

Gonna

Lara Rhame (37:20):

Be scarcer, right? Yes, yes. Scarcer. Yeah, <laugh>, it's, it's still gonna dominate. It's just gonna come from totally different places, different places that we're used to finding it. Yes. And that is again, the, the painful retraining. Yes. You know, I'm an old dog, I don't like to be retrained. It's hard. Yep. But but it's gonna be that is the, gonna be the tough part of the year. It's not that, it's not that the incentives have changed, we just have to look for them in different parts of the market and it's not gonna come from the set it forget it Yeah. That we've had

Ryan Caldwell (37:54):

No look

Lara Rhame (37:55):

Under the quantitative easing regime.

Ryan Caldwell (37:57):

I think that is the salient point, which is, and like we can think about this a bunch of different ways, and I'm not gonna pull this apart, but I kind of like it as a topic. I mean, you sort of wrote this like, hey, 60 forty's got like long-term problems. I couldn't agree more. It's got long-term problems because in this context we're talking about an s and p 500 allocation and a Barclays zag allocation in 60 40 and saying like, what worked will continue to work. Everything you described is like, that ain't right. Right. Not over any, again, back to not days, weeks and months, but years it's not. Right. Yeah. Right. And all you have to do is like open up like a, open up a history book or just watch the news globally to understand how this is all kind of pulling itself apart and why like what went on in the last decade of globalization just can't go on. Right. And so if that's coming, so if that's coming apart, which means you kind of gotta think about things differently, right? Like I think that is like the salient point for everybody listening. It's like, look,

you're gonna have a lot of places to make bets or not make bets avoid or, but it's not gonna be the same. Right? Like it can't be the same, but

Lara Rhame (39:18):

Even, but you're talking about, you know, needing to look to Europe for the comps, needing to look to, when was the last time you said that

Ryan Caldwell (39:25):

Never <laugh>, like feels like pre pre like talking

Lara Rhame (39:29):

About a new cliff. Right? Like

Ryan Caldwell (39:31):

And, and we've had like again, like I think look a lot of what went on in passive allocations last year was the 40 going pear shaped. Like when you study it and you look at the numbers and you go, why did this on a risk adjusted basis blow sky high? Yeah. And it did. Yeah. Right? And the answer was because you had a five standard deviation move in the 40.

Lara Rhame (39:59):

Yes.

Ryan Caldwell (40:00):

Right. And like no market participant had like lived through that. Yeah. Like even in the seventies, like it took you to sh this was a shock. And so when like when you think about that, you go, okay, wow. Like, and I agree like, and I I was kind of joking, I was joking with a couple of people on your team af team after, because Lara wrote a really good piece talking about like, hey, like it's kind of time to think about divorcing this as a core framework, <laugh>.

Lara Rhame (41:08):

That is, but that entirely other podcast <laugh>, I think I I think, you know, the, the move in long-term interest rates was incredible over the last year. Yeah. And you have, you know, this like 25 year long like downward channel <laugh> in in, in rate and rates and we just popped, you know? Yep. You know, in retrospect you're like, yeah, I really couldn't have gone any further. Right. you know, know, we were literally, the tenure wasn't 0.5 like Right. It was going to go up. So I think the, the speed with the death that happened was remarkable. And to your point just de you know, was so so far outside of what could be statistically expected that it really decimated a lot of portfolios. I think it speaks to how abusive our relationship has been with yield hundred percent. Right. We're really excited about, you know, investment grade debt at, you know, 5% and, you know, inflation's still over 6%.

(42:07):

I might add year on year. We're really excited about that. Everyone's telling me, oh, inflation's coming down, it's so great. I'm like, what's not 10? It's not Yeah. Right. You know, it's, it's, and it's not two. So, you know, you know, you're looking at still today negative real yields. Yes. Yes. That speaks to how beaten up we've become on our expectations for getting income. And I this is more not for you as a money manage. I mean, obviously yields matter for you as a money manager, but for a lot of the folks that I'm talking to every day, they're thinking out about it from the investment side and for, you know, their clients. And I think the message I take to them is

you know, you may have gotten now, you know, yields that are a little bit higher and do they come down to 3%?

(42:52):

Do they, you know, do we revisit for, I don't think that's outside of the realm of possibility. Yep, yep. But you know, we haven't, we'll we'll save the debt ceiling conversation for the next podcast, but you know, there's, we're in here. Yeah. We, we got, we got a couple, we got a couple problems to deal with in 2023 on the, in the bond market still. Yeah, we do. Yeah. we do. But at the end of the day it, to me it speaks to just how sort of we've just been beaten into submission with low interest rates on the investment side and on the money, you know, for you Yeah. How still addicted we are to low

Ryan Caldwell (43:27):

Interest rates. Well, I look that's a really, I mean that's a really good point. It's like, you know, maybe it wasn't her, it was us <laugh>. Right. Like seriously may like maybe you made her do too much. Like she got tired. Like she's, I can't, can't carry the weight of this anymore. And like, so like Yeah. Now it's like eased up a little bit. Yeah. No. Okay. Like maybe can carry some, some wood.

Lara Rhame (43:48):

Sure. Absolutely. I think it's, I think it is, you know, there's the, the scenarios that we're talking about and the expectations that Wall Street, rightly or wrongly are putting on the Fed trajectory in the second half of the year absolutely imply that rates could go down from here. I think the question is how ugly does it get when the Fed fights back and tries to actually discipline the petulant child?

Ryan Caldwell (44:12):

So look, I I think we end there. Yeah. Like I don't have anything else to say. Yeah. Like, I think that's, that's it. Yeah. Right. Like how hard is that fight? How long does it last? How hard does it go? And in the process, do you, do you create a left tail financial event? Yeah. That the market, you know, as a forcing mechanism. Yeah. Or does the dog get retrained and all of a sudden it's a little bit more passive. Yeah. That it's a new world and you gotta act differently. Yeah. Yep. So awesome. No, it was great. This was great. Like, I'm gonna come here to Philly and do these more. Love that. Yeah. It's better being. Yeah, it's good being in person. So as always, thank you. Like thank you. Love these podcasts. We will be back, I think more frequently. Aaron's, you know, Aaron's been looking at me like, we're gonna do more, we're gonna talk more. So we're gonna come back with maybe some, you know, maybe monthly, some shorter form stuff. Excellent. But now Lara, on the quarters, these are great. Like I love your view, love the debate, love kind of teasing all this stuff out and we'll get at it. Next score. Absolutely. Thank you.

(45:17):

This episode was recorded at the FS Investments headquarters in Philadelphia's historic Navy Yard. It was engineered and edited by Aaron Sherman. Special thanks to guest Lara Rhame. If you enjoyed this episode, make sure to follow and like the podcast, wherever you stream.