Episode 54

Market madness 2023

Sit courtside as the Investment Research team evaluates their top picks for the most impactful market event of Q2

Kara O'Halloran (00:00):

The episode that you are about to hear was recorded prior to the events that transpired around Silicon Valley Bank. I hope you enjoy the conversation.

Kara O'Halloran (00:05):

Welcome back to FireSide, a podcast from FS Investments. My name is Kara O'Halloran. I'm a director on our investment research team here, and today is our second annual Market Madness episode. So I am joined by my whole team to go through what we think is going to impact markets the most over the next few months. So I've designed a bracket with 16 teams, and we'll go through head-to-head matchups and fill out the bracket in real time to determine what we think is going to move markets the most over the next few months. So I'm excited to be joined by Lara Rhame, our chief US Economist; Rob Hoffman, the head of our research team; and Andrew Korz. Thanks all. Thank you all for, for coming in today.

Lara Rhame (00:44):

It's going to be great. Yeah, I mean, I won last year, so...

Kara O'Halloran (00:47):

This, it's true.

Lara Rhame (00:47):

I'm feeling really confident.

Kara O'Halloran (00:48):

I'm excited to be doing this because if you know where my college basketball loyalties lie, you know that I'm not overly excited for March Madness this year. So at least we have market madness.

Andrew Korz (00:58):

Yeah, and I think I speak for everyone when I say I hope markets have a better year than, uh, than our Wildcats did.

Kara O'Halloran (01:05):

Yeah, I agree with that.

Rob Hoffman (01:07):

<laugh>

Kara O'Halloran (01:07):

<laugh> All right. So, um, let’s dive right in. Um, so we’re gonna start with our, our first matchup in the east region. Um, we have an up or downside surprise in inflation versus corporate credit defaults. So Rob, I’m gonna have you walk us through this matchup. What are you watching here?

Rob Hoffman (01:29):

Maybe I'll start with corporate credit defaults, because you know, my background, I'm a credit guy, so I can go there first. I think a lot of what's been going on in the corporate credit space, you do see rising default rates without a doubt. Um, both bonds and loans are a little bit over 2% now, which is the highest they've been in a while. However, average annual rates are still three and a half percent or less. And the outlook for this year is while they will continue to slowly climb most, um, market prognosticators don't really expect you to get anywhere near even long-term averages. And certainly one of the things that we've written about a lot in our work is the fairly healthy underlying fundamentals within credit. So while you have slower economic growth, it is causing some increase in defaults On the corporate credit side, I have a harder time seeing that being a major issue, especially when you're going up against up or downside inflation surprises. The impact from that really resonates across the rates, markets and fed expectations. It causes all sorts of impacts and equity markets. We've seen fixed income in the AG put up, you know, returns that we wouldn't have thought possible, uh, both to the downside <laugh>. Yeah,

Kara O'Halloran (02:53):

That's, that's a tough matchup. Yeah. Yeah, I mean, and I think also if we think about corporate defaults, I look at, um, you know, maturity schedules in the market, which look really favorable as of now. So only 16% of the market matures in the next two years. I mean, that's 84% of the high yield and loan market that does not have a near term maturity. Um, I mean, I do think we have to watch, we've started to see a little bit of margin erosions. We do have to watch these fundamentals, um, but I do think it's, as we've seen them kind of slow a little bit, it's more of a mean reversion back to, you know, off of these exceptionally strong levels back towards the averages. So I agree with you, Rob. I don't think that, um, I don't think corporate credit defaults are gonna move markets more than inflation. I actually was looking at some of this data. If you look at C P I, um, the s and p 500 returns on C P I days last year, we averaged a move of 2.6% in either direction on C P I day. Wow. Yeah. Um, so I I, I think inflation, um, it drove markets. I, I'd say it was the Dr. Primary driver last year. I don't think it won our tournament, but I think we all know in hindsight it was the primary driver. And I think it, it beats credit defaults in this

Rob Hoffman (04:05):

One. Something tells me if you looked at the average change in the s and p on days that the corporate credit default rate got updated every month, that it would not have near the same level

Kara O'Halloran (04:15):

Of, I think that's right. I probably should have looked at that, but I think there's a no statistical significance there. <laugh>. Um, alright, well, round one, I think we all agree inflation's inflation is moving on inflation. Yeah. Yeah. All right. All right. Next up Andrew and Laura, we have corporate earnings versus the strong US dollar.

Andrew Korz (04:36):

Yeah, so I away, I can kick us off and I'll, I'll focus primarily on the, on the earnings side. Um, although I would, I would argue that these two things are sort of intertwined. Um, but I I, I think on, on corporate earnings, and I think that was a good, uh, sort of segue from, from your

discussion. I think it's tempting right now to say that, uh, equities specifically are, are, you know, almost trading in a way that it looks like they're not even taking fundamentals into account. It seems like you watch markets day to day, it's really, it's currency, it's rates, um, it's fed, it's, it's all these sort of macro things. Um, and, and, and fundamentals really seem to have taken a backseat. Um, you know, if you look at, you know, the forward earnings expectations, uh, of, of, of analysts, right? The broad kind of consensus of what are earnings gonna be over the next 12 months, that peaked last June, and it's been coming down pretty consistently since then.

(05:29):

But over that time, the s and p of 500 is up over 6%. So I think there's this, there's this narrative in the market that, hey, it's, it's fed, it's it's macro right now. And that's really all that matters. We would sort of argue that maybe in the short term that might continue to be true for a while. Um, but in the medium term, it's really challenging to fight a, a, uh, difficult fundamental backdrop. And I think right now we, we, we recently wrote a note that sort of looks at equity markets and says, Hey, they're, you know, valued at 18 times earnings right now, which is very high historically, and sort of we see them in a bit of a pickle right now. On one side you have margins, which, uh, excuse me, margins, which have soared, uh, over the past couple years due primarily to operating leverage, um, to the significant, you know, uh, surge in, in, um, in revenue growth, uh, and to inflation.

(06:26):

And as that all comes down, that operating leverage gets sucked outta the system, right? And you, and you start to see significant margin pressure. Now what's the one way that doesn't, uh, come to fruition? It's if the economy reac accelerates and, and, um, nominal GDP growth stays hot. If that happens, that's exactly what the Fed does not want to see. And it's, it's, it's just gonna, you know, continue to, to sort of look like what we've seen over the past few months where markets have to push the terminal rate higher and higher and eventually multiples, you know, start to come under, under pressure. And ultimately, that, that I think does raise the, uh, the risk of a recession, you know, maybe not in three months, but in, call it nine to 12 months. So I think corporate earnings, while it may feel like in the short term they are sort of playing second federal to, to the macro stuff, um, I would argue in the medium term that's really gonna be sort of the lever that that is, is, is driving markets.

Lara Rhame (07:21):

It's hard for me to disagree with you there, Andrew, because in our matchup, strong dollar versus versus corporate earnings, I see the dollar over the coming year as being more of, um, a follower than a leader for markets. You know, and this is really after an extraordinary 2022 for the dollar, which, you know, was up. Um, you know, if you look in October of 2022, we were up 20% on the year, and we were at a 20 year high for the dollar index. So, um, you know, that came off. We ended the year up 8% star strong, but like the top of a multi-year range, we'd been there before. And I think, you know, to remind everybody, when we get a really strong dollar, it weighs on the earnings of these large multinational corporations. And it also, you know, I think this is tangential, but strong dollar acts on the economy in much the same way as tighter monetary policy does.

(08:29):

So, you know, October of last year, Kara and I wrote the strong dollar playbook, you know, um, something that got a lot of attention. Um, but I think when the dollar right now is strong ish, but still within the range, it's not really going to be driving markets in and of itself. And, you know, could the dollar reemerge as an enormously powerful strong force in 2023, I'm less worried about that because, um, you know, I think long-term interest rates are probably gonna be a little bit more range-bound. I think us gro US growth right now, everyone's got pretty robust expectations for US growth. I think if there's a risk, it's that we're a little bit too positive about, um, you know, US growth prospects, and then you still have, you know, non-US events. The E C

B looks like they're gonna be a little more hawkish than we'd expected. Things that are gonna keep non-US rates a little bit high, um, as well. So, um, you know, I think if you look at where we're gonna get direction, market direction, I would say corporate earnings are gonna, uh, beat the dollar for really driving markets in the coming year.

Andrew Korz (09:43):

Yeah. And if it feels like the case for the dollar being the a a primary driver is sort of this idea of like the dollar being self-fulfilling, where it gets it, you know, it gets stronger and that puts pressure on the global economy, which, you know, slows the economy down, which makes the dollar even stronger and sort of is, is sort of self-fulfilling cycle. It doesn't feel like we're necessarily close to that

Lara Rhame (10:03):

Right now. No. I mean, China just reopened. Yeah, I think, you know, you get, you have moments where I think you people, you know, people try to write a story for the dollar one way or the other, and I think after a really a year where the dollar really made a lot of headlines this year, it's probably not going to. Yeah.

Kara O'Halloran (10:20):

Right. That was a, that was a great matchup. So, but I think we're, uh,

Lara Rhame (10:24):

I lost, lost that I with that one though. But

Kara O'Halloran (10:25):

You're not

Lara Rhame (10:26):

Taking sides. Well, no.

Kara O'Halloran (10:27):

Yeah, we have corporate no one lost. Yeah. The strong dollar lost <laugh>. Um, mark

Lara Rhame (10:31):

Lost the dollar. Yeah. Love that. I am, I'm

Kara O'Halloran (10:35):

A permanent Windsor too. I know, you're, I know you are. All right. Well, we have corporate earnings moving on. Yeah. Um, okay. It's actually, I'm, I'm gonna toss it back to you guys for what I, this is actually the game that I am most excited or the matchup that I am most excited to watch, um, or to hear, I guess. So we have tech layoffs spreading to the broader economy versus commercial real estate defaults. These are two things that have started that, well, tech layoffs have been in the news for a while now. It feels like. I was just listening to the radio on, on the way in, and Meta is doing more layoffs, and, you know, we're hearing about this constantly. Um, and it's, it's easy if you just hear those headlines to have that cloudier view of the labor market, right? Sure. But remember, we just had that, that payrolls report in February of over 500,000 jobs added. So just a blockbuster report. And then we're, but we're also starting to see on the cre default side, we're starting to see Siri defaults, especially at these higher rates. So, or

CMBS defaults I should say. But anyway, um, I'll let you guys take it away because I, I'm excited. Think, yeah, I,

Lara Rhame (11:35):

I think, I think both of these, um, you know, what is so interesting is both of these tech, you know, tech lab spreading to broader economy and c r e defaults, we have come off of a terrible recession, the great recession where C r E defaults did spread to the broader economy and, you know, and residential housing as well. Um, so I think I, I'm, I'm gonna take the first side of this, um, because I think this is something that I've spent a lot of time talking about. Um, because we need to remember two things. First of all, layoff announcements are upsetting, full stop, and, um, and they make everybody anxious. But, um, remember that our labor force in the US is 146 million people. So when we see layoffs of 5,000, 10,000, we need to put that in the broader context of just really, you know, at the ma at the, again, the most macro level across our entire economy.

(12:34):

You know, there's very l few signs that the unemployment, that the labor market is weak. It has been so strong. You, if you take out a microscope, you can kind of see evidence that it's coming off of its most sort of frothy pace in decades. But, um, but really, you know, the unemployment rates at 3.4%. Um, we initial claims initial this sort of weekly measure of who is being laid off, um, is still below 200,000 every week. That is an extremely low, um, number. And by the way, is one of my favorite indicators for watching this. So that's the first thing. Um, this really does seem to still be, um, focused on tech. And second of all is that we have to remember that these, there are companies that really overhired during the pandemic, and we see this in their stock prices. We see this in their investment spending in their real estate holdings.

(13:31):

They were extremely, um, sort of aggressive about projecting forward the growth that they were seeing in 2020 21, and acting upon that when they made some of these larger hiring and other investment decisions. So they're having to walk that back a little bit. And when we look at the layoff numbers, we really need to remember that they're laying off really a fraction of the workers that they hired during the pandemic. So, um, I'm not, we ne, you know, we need to watch employment conditions broadly. That is absolutely at the top of the list. Uh, higher unemployment rate and broad job layoffs are a hallmark of recession, but tech layoffs in and of themselves are not a leading indicator of that. So the, I'm less concerned, to me, this, my side of this matchup is probably less likely to be the, the key driver in the coming year.

Andrew Korz (14:24):

Yeah. Now, I, just to add on to that, I, you know, when, when you think about tech layoffs spreading to the broader economy, certainly that's, that's ultimately other parts of the labor market as well. But it's also like, to the extent that tech companies not only are laying off a bunch of workers, but they're also, you know, seriously cutting back on r and d and software spend and those types of things. Yeah, we're not seeing that. You know, just recently we've seen sort of the chat G p T craze and you've seen Nvidia stock going crazy because of that. Um, I don't think there's any thought within, you know, economists or, you know, the tech sector specifically that like tech spending is gonna go through some sort of winter here that would spread throughout other parts of the economy. So I think we need to keep that in mind as well. Good point. Um, so in terms of Siri defaults, I, I think this is a really interesting one that's getting a lot of noisy headlines, which we don't normally necessarily see in, in commercial real estate. It's usually sort of the,

Lara Rhame (15:19):

And when we do it makes everybody really nervous breakfast. Cause there's this PTs from 20,

Andrew Korz (15:24):

The last time you saw some conduit cmbs, you know, default on, on, on Bloomberg. It was, you know, it was not a good time. So no <laugh>. So, but I i i, I think it's important to put this into context, right? Um, so we have seen a few larger office buildings, um, sort of go into, into default recently. And they've, they've made headlines because they've been large, you know, large loans, um, you know, that are, that are taken out by significant and, and, and powerful sort of institutional investors who I'm not gonna name here. Um, but they sort of have gotten, you know, headlines and, and it, I I think it has a lot of people asking is, are we gonna see a wave of defaults? Is this sort of the tip of the iceberg? And I think it's, you know, I think it's important to remember, um, that there's been pressure in different parts of the commercial real estate market for, um, for years now, right?

(16:18):

Like you think about the retail space and malls, um, there's been a lot of pressure on regional malls for years now, right? And that's a significant part of the commercial real estate market. Um, but what we saw was not every default ends in liquidation in lots of losses for investors, et cetera. What you get is you get some, um, really poorly located, um, you know, older, uh, types of assets that yeah, have to go through a liquidation process. And investors lose a lot of money. A lot of these assets though, um, you know, the borrower brings the lender to the table and they renegotiate, they extend the loan, um, they put modifications in. Um, I, I think you're gonna see a lot of that in the office space, uh, coming up because yes, the fundamentals are not great in some parts of, of that sector right now.

(17:09):

You know, full stop. We, we can't avoid that, I think. Um, but I also think that there are still, uh, people who believe in this space. There are still people, you know, if, if you look at the fundamentals, actually, we, we are at the, the, the top end of where we've been in terms of office usage over the past three years right now. Right? And there's still plenty of investors out there who think, Hey, I can get a really good deal, um, on a well-located, well amenitized office building. So I think, you know, it's important to be rational about this. I don't think this is gonna go away, but I also don't think that this is something here and now that we need to worry about from a sys from a systemic standpoint. Have

Lara Rhame (17:44):

Borrowers and lenders gotten better about that negotiating process? Was that a lesson learned from the great from the financial crisis?

Andrew Korz (17:54):

Yeah. Well, I, I, that, that's a good question. I, I think there's just more lenders out there. There's more, there, there's more players with capital, right? Like during the G ffc, you sort of had this situation where if banks pulled back and if CMBS pulled back, um, there was basically nobody else out there, right? Um, right now I think there is, there's alternative lenders, there's insurance companies, there's debt funds, um, who are willing to, to put capital to work.

Rob Hoffman (18:17):

Cool. Which can be positive and negative, right? Yeah. Your, your institutional lenders at times may play much harder ball than your traditional banks might have through the financial crisis. But your point about is it's systemic or not, I think is the key point. Like when you think about the financial crisis, you just saw wave after wave subprime blows up and all of a sudden it's hitting SIVs, which nobody knew about, and then the auction rate market seizes up. Yeah. And I, I'm not sure if you have that or, or anywhere near that.

Andrew Korz (18:45):

More circuit breakers in the financial system.

Lara Rhame (18:47):

Yeah. So who wins our showdown then?

Andrew Korz (18:49):

That's a, I'm not a

Lara Rhame (18:50):

True

Andrew Korz (18:51):

One.

Lara Rhame (18:52):

So I'm, I'm gonna, I'm gonna walk that back and say that I think tech layoffs spread to broader economy in this particular situation is probably going to be something that we need to be a little bit more concerned about in the coming year than, yeah, I think it wins the overall tournament, but I do think that it, um, you know, wins this matchup. I agree.

Kara O'Halloran (19:12):

And I also think one point, you know, if we're, if we're gonna get really literal and talk about what is going to drive markets the most, I mean, we're all watching those payrolls da that payrolls data so closely, and we are seeing markets move on that.

Lara Rhame (19:23):

So talk about data.

Kara O'Halloran (19:25):

So we wanna get, we'll get, get super, uh, we'll take it very literally. Yeah. All right. Moving on. Um, <laugh>, all right. This is a, this is gonna be an interesting one for Rob and I. So we have fed rate cuts versus a balloon related incident. Um, this

Lara Rhame (19:40):

One,

Andrew Korz (19:41):

Do you have a birthday coming up or something?

Lara Rhame (19:42):

We're not talking about the balloon arc that you put together for the Eagles. Right. I did

Kara O'Halloran (19:45):

Put together, and I will say my work product probably suffered then <laugh>,

Lara Rhame (19:50):

But, but it

Kara O'Halloran (19:51):

Was great. It was labor of love. Yeah. Um, maybe we'll put a picture of that on social. But anyways, um, so this is a tough one, right? Because I think that, I actually think I have to take balloon related incident here because I don't, I don't see fed rate cuts. I don't think any of us expect any fed rate cuts in the near term. I think if we look at what the market's currently pricing in, we've continued to push out fed rate cuts over the course of this year. Now I think we're pricing in the first markets are pricing in the first cut towards the end of this year. I think our, and you know, Laura, please, please jump in, but our R f s house view is that we're not gonna get these fed rate cuts this year. But I do think if we wanna say the lack of fed rate cuts, you know, I think that could be something that moves markets. I think we are seeing at any time we see some sort of repricing of the terminal rate of the fed's path, um, we are seeing that drive a lot of volatility. So I could take that end of the coin, but Rob, what are you thinking here?

Rob Hoffman (20:51):

I mean, 99 loof balloons is one of my favorite songs of all time. <laugh>. So <laugh>, that being said,

Lara Rhame (20:58):

Jet, I don't even

Kara O'Halloran (21:00):

Know what that song,

Rob Hoffman (21:01):

Don't even know that song is my head.

Andrew Korz (21:03):

I love German techno.

Rob Hoffman (21:07):

Um, I do think the, the second point you were making on fed rate cuts, while certainly it is hard to see the Fed cutting this year, I think one of the most interesting things to just been watching, you know, since June of last year is how the fed rate curve has shifted from pricing in three rate cuts this year to now well, pricing in less than one pricing in just sort of pushing that into say, okay, well, we'll just have six rate cuts next year, and how that has started to change. And so from that standpoint, I think the expectation of when fed rate cuts will happen and how severe they will be, has had a very big impact that has reverberated, you know, throughout, uh, financial markets, you know, perhaps even more so than just, not that we're want to jump ahead to fed rate hikes, but maybe more than the simple action of the Fed increasing is how the expectation of when they would cut and how steep they will cut when they have to start doing it. It's had a very big impact on markets. So if you put that angle on it, maybe fed rate, we'll,

Kara O'Halloran (22:17):

We'll add the word expectations <laugh> to the end. Yeah. Or selection committee, uh, <laugh>. Yeah. Or

Lara Rhame (22:24):

Even reframing it as like fed reaction function, I think is to Rob's point is really critical. Yeah. Because I think markets are used to the Fed at the first sign of trouble, just like zero interest rates, quantitative easing. And I, I think it's a very different, our, our teams

Andrew Korz (22:42):

Have to change their names in the middle of the tournament. Oh,

Lara Rhame (22:45):

I'm not sure. Or maybe not how that works. Okay. Well,

Kara O'Halloran (22:48):

I make the rules around here.

Lara Rhame (22:49):

Yeah, <laugh>.

Kara O'Halloran (22:52):

All right, we'll, we'll go with some sort of discussion of fed rate cuts. Okay. Moving on. Uh, I, I just don't think we can have balloon related incident.

Lara Rhame (23:00):

It can't happen <laugh> again, uh,

Rob Hoffman (23:03):

<laugh>, there's a whole song about it. I'm telling you it's a great song.

Lara Rhame (23:05):

<laugh>,

Kara O'Halloran (23:06):

That's her new intro. Music <laugh>. All right, let's move on to the next match up. We have fed rate hikes versus consumer delinquencies. So Andrew and Rob, I'm gonna have you guys walk us through

Rob Hoffman (23:19):

This. Well, maybe I'll just continue the thought. I mean, fed rate hikes, we've certainly seen the change in sentiment. Were they gonna do 75? Were they gonna do 50 now? Are we settling on 25? You know, that change in sentiment did have some pretty big implications for the market and the Fed seemingly taking a little bit of pressure off the brake pedal, although the foot still on the brake pedal, um, you know, it did cause an acceleration in markets. We saw a really nice run in January, you know, some of that perhaps related to this and, and change and how aggressive the Fed was going to be. Um, so from that standpoint, I think, you know, look, the, if

we can say fed rate, cut expectations, you know, how long are they gonna continue to hike? And, you know, how much pressure are they gonna need to apply, I think is a major event that will continue to move markets, you know, consumer delinquencies, Andrew, I, you've seen them start to tick up in certain places, but I'm not sure it's reached a level of market moving and, and defeating rate hikes in our, uh, in our bracket.

(24:28):

Yeah,

Andrew Korz (24:29):

I think these two things are pretty closely related actually. Um, when you think about

Kara O'Halloran (24:34):

Starting to see there was a method to my madness. Yeah. Yeah. Pun intended. <laugh>.

Andrew Korz (24:37):

Yeah, <laugh>, um, <laugh>. So I, I mean, like when you think about consumer delinquencies, not that that's what the Fed is targeting, certainly. Um, but I think within that, you've seen the lack of interest rate sensitivity in the economy and the difficulty that the Fed is sort of having in slowing down the economy. And, and, and part of that is because what you had over the past decade was consumers and also corporations, um, taking advantage of extremely low long-term rates and financing themselves long-term at these low rates, right? So when you think about consumer, uh, debt, um, the vast majority of that is mortgage debt, right? And almost all of that is, um, is sort of financed at the 30 year long-term fixed rate, um,

Kara O'Halloran (25:23):

To 5% of the mortgage market has any sort of incentive to refinance right now. Yeah. It's it's some absurdly

Andrew Korz (25:28):

Low number like that. It's, yeah, it's essentially zero. I, I, I don't think if I had a home, I would, I would look to refinance right now. Um, so certainly when you think about it that way, that's gonna, you know, really dry up housing activity, which it has. But in terms of the existing homeowners and, and delinquencies, they're good. They're like, I'm, I'm not going anywhere. Um, if rates drop at some point, maybe, but, but you know, as for now, um, the affordability on those existing homeowners is great. When you think about other parts of, of sort of the consumer balance sheet, certainly autos and credit cards are, are something that have gotten a bit more, uh, press recently. And when you think about autos, not only have auto loan rates gone up, obviously as the Fed has hiked, but also you've seen car prices are, you know, almost double, uh, for used cars, at least what they were pre covid.

(26:16):

So people, to the extent people are stretching themselves financially to afford a monthly payment, um, on call it a, you know, a new car that was $40,000 a couple years ago, now it's $70,000, but we need to watch that. Uh, the same with with credit card, uh, delinquencies, you know, uh, uh, credit card lending has gone up recently. Um, you know, delinquencies have started to tick up. They're, they're, you know, barely back to where they were pre covid. But I think this, the auto space and the credit card space are certainly places we need to watch, especially as consumers continue to, to sort of, uh, run down their excess savings from the pandemic period. Um, but I, you know, in, in, in terms of who wins this, I think it has to be fed hikes. I think the market has continuously thought that they've had the fed pinned in terms of

like a, a, a range that will be the terminal rate. And I think we've all seen the charts about, you know, the, the futures market is, is famously bad at, at, uh, predicting what the Fed is gonna do. So if inflation stays, you know, persistent as it's shown over the past couple months, um, who knows, we may get another hawkish surprise. <laugh>.

Kara O'Halloran (27:21):

All right. Fed rate hikes moving on. Um, okay, Laura, we got a good one. Um, US debt ceiling versus a geopolitical event. Start this off.

Lara Rhame (27:32):

Well, um, you know, you were the one who suggested that we do a, a podcast with Jason Cole, our, um, you know, our political analyst here at FS Investments, um, who just started, and I think he has been a tremendous resource about the debt ceiling. And, um, and I have to say I was, I feel like I was not complacent going into that podcast and left, uh, the discussion with him feeling even more anxious Yeah. About, um, the possibility that the debt ceiling is going to have significant market impact over the coming year. Um, and that's not to downplay what are really significant geopolitical uncertainties. And, you know, we're coming off of a year where Russia's invasion of the Ukraine was an absolute, I think, you know, completely rocked the boat, um, in and ricocheted around markets, and we're still feeling that impact. Um, but I think the debt ceiling, um, and here I'll, you know, repeat Jason's concern, um, which i, I really echo, which is that there is a, there is a non-zero probability <laugh> that we accidentally default that we are going to raise the debt ceiling that will happen, but do we experience a tactical default default before that?

(29:08):

And, um, and I think maybe, you know, uh, you know, because I'm not an expert in this realm, I don't wanna place, um, probability on anything. But I think more importantly, just to say that when I see other pundits and I hear people say, oh, it's gonna shake out like it did in 2011 when, you know, we kind of came down to the wire, but we raised a death ceiling in time, I cringe because that was bad <laugh>. I mean, that was not a good market outcome. Yeah, no, it's,

Kara O'Halloran (29:39):

If we think about what happened then, and yeah, it was, you know, thir was that math 12 years ago at this point, we saw consumer confidence really fall by Yeah. You know,

Lara Rhame (29:48):

Equity markets got equity markets

Kara O'Halloran (29:51):

17% in the course of like two weeks.

Lara Rhame (29:53):

It took them four months to recover where

Kara O'Halloran (29:55):

They credit sp spreads widen. We saw the economic uncertainty index reach its highest recorded level existence, surpass that in Covid. But I mean, it was, it was a very, very uncertain time. It was not a, a good time for markets.

Lara Rhame (30:07):

Oh. And I, and I think, you know, a lot of people say to me, oh, well, we were experiencing the European debt crisis back then. That was another reason markets were so volatile. Well, at the time, interest rates were at zero, and the fed was, you know, had just finished sort of the first round of quantitative easing and would go on to do two more. Now the fed is coming off of the most aggressive rate hike cycle in 40 years and is quantitative tightening, right? So, you know, there's never a good time for a debt crisis, <laugh>. And, and, um, and so I think that when we look at the spectrum of outcomes, you know, the kind of the, the more optimistic being, oh, it's gonna be like tw 2011, like that to me is, is a concern. So I really, it, it mo over the last, since we recorded that podcast, it moved up in my rankings of what could impact the coming year. And I have to say, I, I am the opposite of complacent. I'm pretty, I'm pretty nervous about it. And

Kara O'Halloran (30:59):

Just a plug for that podcast, it's on this feed, it's still completely relevant. Yeah, I mean, everything a hundred percent. Jason is a fantastic resource. Yeah. So, I mean, I agree with you. I think the only thing on the geopolitical side, uh, um, last year, obviously geopolitically dominated really by the Russia, Ukraine situation. It's, I, I guess Taiwan is a potential here, you know, things like that. It, to me, this is more of like, this is your left tail event. We've seen a lot of those in the last couple of years. So, um,

Lara Rhame (31:27):

It's hard to dismiss that as well,

Kara O'Halloran (31:29):

You know? Exactly. It's kind of like, this is like your unknown unknown. Yeah. Um, but I agree. I think debt ceiling is, is moving on here. All righty. Um, next up we have China policy versus just Elon Musk as a person doing something. Doing anything. Yeah.

Lara Rhame (31:45):

Yeah.

Rob Hoffman (31:46):

I mean, I, you know, look, if this was a auto industry March madness bracket, I think the <laugh> the chance of Elon Musk moving, you know, deep into the finals could be pretty high because you continue to see a lot of reverberations in what's gone on there. You know, the, the changing of prices of electric vehicles has been really interesting to watch. Um, I think it's brought a lot of competitiveness, you know, back to Tesla for instance, but I think in the purpose of a March madness or market madness bracket, you know, that type of move isn't really a high level market moving type action. And so then it's, does he do something else that's super crazy? You know, probably not. Um, I, I,

Andrew Korz (32:34):

I will, playing devil's advocate, he is simultaneously the head of the most important social media company in the world. The head of the, by far the most traded stock in the world, and the head of the company that is providing, uh, broadband to Ukraine <laugh> in their war efforts. So <laugh>, there's a lot that can go on there. Yeah. Um, but I I I I, I will say on, on China policy, we just got there, uh, their recent annual party meeting that they had, they set a conservative growth target of 5%, which I think some people expected a bit higher. Um, I think when we think about China right now, you know, they ended their covid lockdowns, that's acting as a huge stimulus. But I think it's not the type of stimulus that we're used to from China. We're used to this huge, you know, debt driven surge and investment and real estate spending.

(33:21):

This is much more on the consumer side, which I think is a, you know, sort of, it's not gonna drive the levels of growth we saw, say five, 10 years ago from China. Um, the good news is that it also likely won't drive the type of, you know, commodity centric inflation that is, you know, hurting us, but really hurting Europe right now. So I think those are the things sort of to watch how strong does the economy get? Um, how much, cuz because Europe is so tied to China from a trade standpoint, how much does does China reopening, uh, support Europe? Um, and then certainly there's certain things they can do again with, um, with debt limits, with, uh, their interest rate, which they're currently, um, leaving flat basically. So I, I mean, uh, China policy I think is actually a bit of a weak number one here, but I think it does move on.

Kara O'Halloran (34:10):

All right. Our last first round matchup. Um, so we have long-term interest rates versus crypto. You wanna start with this one,

Lara Rhame (34:17):

Laura? I, I don't know. I feel like I'm gonna take crypto. No, no, I'm, I'm not gonna take, I'm not gonna take crypto to advance. Oh. But <laugh>. But I think, you know, when I'm out there speaking to clients and talking about sort of what keeps me up at night or what I'm concerned about this, you know, I think at the end of the day when we have a fed rate hike cycle like this, any fed rate hike cycle, but this has been so fast, so aggressive, it's the tide going out and I get nervous about, um, you know, like, is there some Ponzi scheme out there or some financial episode that's going to break and it's going to cause sort of broader systemic damage. Um, and when cryptos kind of, you know, we had, you know, the dominoes start falling in the crypto space last year, that made me anxious, like, Ugh, is this gonna be the <laugh>?

(35:12):

Is this, is this the tag going out? A bunch of people are swimming naked with their daytona's and they're, you know, <laugh> like fancy cars, and we're gonna now have to, um, you know, deal with sort of some broader systemic fallout and happily that has not happened. Yeah. So, um, I think all that's to say, and I, I should probably started that off very clumsily, Kara, because I, I don't think that's gonna be the driving. I don't think crypto's gonna be the driving factor, but when I saw crypto on this, that was the talking point that

Kara O'Halloran (35:41):

Jumped out to me. Yeah, I mean, I think that a lot of the, you know, if we think about like the NFTs and like Dogecoin, all of these, these crypto were, you know, elements of crypto, I think they were a lot really like the sy a symptom of all of that excess, all that excess liquidity. Yes. All of that that we had for so many years. Um, and I also think we saw, you know, once we saw FTX collapse and that did not become a systemic event, it really didn't spread to markets. It's really, um, crypto following markets rather than driving markets is what we've seen. I mean, that's just the relationship that we've seen unfold. It trades like a risk asset right now. Um, Bitcoin at least I should say. Um, so I agree with you. I don't think crypto is moving on here. When we think about long-term rates though, you know, I think this year becomes not necessarily those acute rate increases Yeah. Um, or those acute rising rates, but it's really the fallout from a, a steady Yeah. You know, a higher long-term rate environment higher for longer.

Lara Rhame (36:37):

You know, you look at, you look at the last two years, it, you know, it's incredible. In, in 20 we started 2021, the tenure was less than 1%. And if we started last year with the tenure at 1 51, and today it's 4%, it peaked at four and a quarter, you know, end of last year, sort of October of last year. But, um, I think, you know, it's come so far, we have felt that in financial markets, on

consumer budgets and balance sheets, in corporate balance sheets, it's, it's, it's happened everywhere. I think from here, we kind of maintain that three 50 to 4% range throughout the year. Um, but I think really it's again, sort of following the broader employment trends, inflation expectations, and fed rate hikes, um, you know, it's probably not gonna win the tournament, but I think it advances

Kara O'Halloran (37:33):

This one. Yeah. All right. Okay. So that wraps up the first round. I think that we, um, we did a good job of really, you know, setting the stage for all these teams. So I wanna kind of quickly go through the next rounds, um, and our matchups, and if there's anything specific that we wanna call out, please do that, you know, changes if you're looking at a certain matchup. But, so our next, our, uh, is this final four, no elite eight round. I've been here before, I promise <laugh> Elite eight round. Um, we have inflation versus corporate earnings. Andrew, give us, you know, who are you have coming out of here. We talked about it being macro driven environment for the beginning, the next little bit, and then turning in fundamentals. So who wins

Lara Rhame (38:14):

This one in

Andrew Korz (38:15):

Your view? Yeah, I, I feel like this is for the next few months, was driving markets. I, a month or two ago, I might have said earnings. Um, I think now that, especially after the last c p report and after the, uh, sort of revisions that we got, that show inflation didn't come down as much as we thought last year. I have to go inflation, because at some point, if it doesn't come down, the fed's gonna have to really put the kibosh, uh, down and, and then earnings, you know, kind of follow from

Kara O'Halloran (38:37):

That. Follow. Okay.

Lara Rhame (38:38):

Can I take the next

Kara O'Halloran (38:39):

One? Oh, sure. All right. So yeah, so next up we have tech layoffs spreading to the broader economy versus fed rate cuts.

Lara Rhame (38:45):

I am tier, but definitely gonna take the tech layoffs spreading to the broader economy because, you know, as I said in the first round discussion, layoffs broad macro layoffs multiple months in a row of declines in payroll employment, that is the hallmark of recession. That is when you, that is when the referee really starts the clock on a new recession. So I think that is not something that I expect, but it is something that is absolutely the top of my watch list for the coming

Kara O'Halloran (39:18):

Year. All right. Tech be watching it. Tech layoffs are moving on. All right. Fed the next region fed rate hikes versus the debt ceiling. Ooh.

Rob Hoffman (39:27):

I mean, that's a,

Kara O'Halloran (39:28):

That's a tough one. That's tough. Could be a fi this could be a, I mean, if, if at least a final four, if

Rob Hoffman (39:32):

Debt ceiling becomes a real issue and the government doesn't address it, and we default even if only for a day, I mean, it's a calamity, whereas, you know, but like fed rate hikes is a more real tangible, the Fed is hiking. If they hike more than expected, markets will react to that.

Lara Rhame (39:58):

Well, and these aren't independent, right? I mean, right now the Fed is expected to kind of, right now the peak fed funds, the terminal is sort of like June, July, and the X date on the debt ceiling is like, we don't know, but maybe July, August, like does the Fed stop their rate hike cycle? Because this is ki you know, I

Kara O'Halloran (40:19):

Don't know. All right. Oh, so we gotta make, we gotta pick, like, gotta make a call. Oh, it's a coin flip.

Lara Rhame (40:24):

I say fed rate hikes. That's, but sorry, wasn't my bracket. It wasn't my part of that.

Rob Hoffman (40:28):

No, no, no. I think wasn't

Lara Rhame (40:29):

Anybody, wasn't my conference

Rob Hoffman (40:31):

<laugh>. I, I mean, I think we all want to be eternal optimist that the government's gonna find a way to solve the dead ceiling and it doesn't become a big issue <laugh>. And if that's the case, absolutely. Fed rate hikes over dead ceiling.

Kara O'Halloran (40:40):

All right, let's go with fed rate hikes. All right. All right. That's tough. Andrew, how about, um, China policy versus long-term rates?

Andrew Korz (40:46):

That's tough. I feel like China policy people have a decent grasp on at least what they're doing right now. Now any change will be massive, but I don't think people are expecting any huge change, especially after their, their meeting last last week. I'm gonna say long-term rates, just because I think old paradigms kind of die hard. And we're seeing that with this incredible, um, curve inversion right now. And I think as we go throughout this year, more and more people are gonna realize that rates are not gonna go back down to one and a half, 2%. And I mean, you look at, like, again, we're equities are valued right now at 18 times earnings. That's just a

historical anomaly with the 10 year around 4%. So I, yeah, I, I I think markets continue to, to kind of get used to a new world.

Kara O'Halloran (41:29):

Yeah. All right. Long term rates. Moving on. All right, our final four, we have tech layoff spreading to the broader economy fed rate hikes, and long-term interest rates. This doesn't feel that surprising to me. So anyway, Laura, inflation versus the layoffs.

Lara Rhame (41:43):

My answer may surprise you guys, I'm gonna go tech layoff spreading to broader economy is moving on because I think wages are an important piece of the inflation picture that are now underappreciated and are driving fed policy more. So, um, I think that's gonna become a more dominant part of the un I think that's a more dominant uncertainty of the economic landscape over the

Andrew Korz (42:08):

Coming years. Like you think about the, like what in real time is gonna like really impact markets? If we got an upside surprise finally in like initial like jobless claims, that would be, that would set off the alarm bells big

Lara Rhame (42:19):

Time. Yeah, totally. Yeah, I agree.

Kara O'Halloran (42:20):

All right. Fed rate hikes versus long-term rates. How did this happen? <laugh>

Andrew Korz (42:25):

<laugh>, short term rates and long term rates

Lara Rhame (42:27):

Take piss <laugh> yield crew flattening your steeping.

Kara O'Halloran (42:32):

Take this

Andrew Korz (42:32):

One. Oh man.

Rob Hoffman (42:35):

I mean,

Kara O'Halloran (42:39):

Fed

Rob Hoffman (42:40):

Think fed.

Kara O'Halloran (42:42):

Yeah, that is, I mean, I think I, I think that the possibility of a hawkish surprise is would move markets more than like a, the 10 year rising 25 basis points. Yes. It's j I'm trying to think about like magnitude now. Right.

Andrew Korz (42:58):

The, the argument again for I think for I think long term rates is that, is that markets still have not calibrated for a world where the 10 years that's fair is is consistently at

Kara O'Halloran (43:06):

Yeah, it's, it's between

Lara Rhame (43:07):

Three

Andrew Korz (43:07):

And a half and four and

Kara O'Halloran (43:08):

A half. It's, it's not the move in in long term now it's the them staying high.

Lara Rhame (43:12):

Yeah,

Andrew Korz (43:12):

Exactly. Earlier. And it's like you think about economically, like the second to 10 year comes down, mortgage rates come down and the housing market explodes again. Okay. You know, it's like that's really the lever that can drive economic. And, and that's, you know, that's what bar like most corporate borrowing rates are, are based off of. I would go long-term rates. All right.

Lara Rhame (43:27):

<laugh>. Oh,

Kara O'Halloran (43:28):

Personally, I'm fine with it.

Rob Hoffman (43:29):

I mean, what is the propensity that in a no landing scenario and the economy stays strong, that long-term rates go higher? I mean, 10 year we hit, we hit four and a quarter on a fed rate curve that was lower than it is today. I mean, could you not go back to 5%, four and a quarter, four and a half, five all of a sudden? And then you've got a whole host of duration pain all across fixed income and other things like that.

Kara O'Halloran (43:56):

I mean, I guess either way, either way we see the 10 year mo or long-term rates move.

Andrew Korz (44:01):

Yeah, that would be my choice personally, but,

Lara Rhame (44:03):

Wow.

Kara O'Halloran (44:04):

Laura, were you gonna,

Lara Rhame (44:05):

Laura, would you disagree? Just talk about it. I no, I I was gonna say fed, but you know, this is I guess where, you know, we all have our, we all have our different,

Kara O'Halloran (44:14):

I was fed, I was with you tournament.

Lara Rhame (44:15):

Yeah, <laugh>. Sure. <laugh>.

Kara O'Halloran (44:19):

Because I think Andrew convinced me though. I, I,

Lara Rhame (44:21):

I think, I think what you're driving at is, is really important. Um, because over the longer term, if we weren't talking about the next year, I would agree, you know, we've had 40 years of long-term interest rates trending lower. And I think where if you consider that the next five years we could actually see the chance of hitting 3% the same as hitting 5%. And this world where the risks are more symmetric, that is truly, I mean, long-term interest rates haven't been here in 16 years. It's a different world. But I think over the coming year shifts in fed rate, hike expectations are just That's fair.

Rob Hoffman (44:59):

Yep.

Lara Rhame (44:59):

You know, huge driver markets. Yeah, I can buy that. Yeah. What do you do, Kara? I

Rob Hoffman (45:04):

Don't know. I mean, you're the chief economist.

Kara O'Halloran (45:06):

I

Lara Rhame (45:08):

Fed.

Kara O'Halloran (45:09):

Fed. All right. It all comes down to this. It is a national championship. We have fed rate hikes versus tech layoffs spreading to the broader economy. We all knew it had to come down to this.

Lara Rhame (45:22):

Did we?

Kara O'Halloran (45:23):

Yeah. The Fed is, we are wa

Lara Rhame (45:25):

Yeah. The Fed was gonna be there.

Kara O'Halloran (45:26):

Yeah. The Fed was gonna be there and we're, and you know, we're all watching the labor market Yeah. For signs that the Fed can slow down for signs of recession. I mean, yeah, I think it, I think it was coming down to right.

Rob Hoffman (45:37):

I, I think jobs, yeah, I mean, I think I agree jobs, I'm gonna, I'm gonna misstate this, but what would wags the tail? Like jobs is driving it. If the jobs number gets worse, that's going to have a direct impact on what the Fed does. Oh, the Fed, yeah. It's not, well, I guess some people would say maybe the Fed can mess up, which could then impact the jobs market, but I, I think it's, I think as the jobs number goes, has a more immediate impact and, and the market's gonna change quickly if that jobless rate starts going up and

Lara Rhame (46:14):

Expectations change. And, and I, and I agree with you and maybe I'll, I'll rephrase the, the one part and say like the fed rate hike cycle's already very far along. And, um, the, those shifting expectations of where, where we end the fed rate hike cycle and when we end the fed rate hike cycle are going to be massive drivers of the coming year. I think those two things are dependent on the jobs market. And so that to me is why I took at the, at the end of the day, the final core single thing that is gonna dominate the landscape. It's going to be jobs.

Kara O'Halloran (46:50):

All right. Heard it here first folks. Um, all, I think that was fun. Thanks guys.

Lara Rhame (46:55):

It'd be an interesting year.

Kara O'Halloran (46:56):

It, it will be an interesting year. Thanks Kara. Yeah.

Lara Rhame (46:58):

Would you make us think about it like this? It is really fun. <laugh>.

Kara O'Halloran (47:02):

Yeah. We'll, we'll check in. We said we would do it last year, but we need to actually do a, yeah, yeah. Three months from now we'll check back in on our bracket. But

Kara O'Halloran (47:09):

Thanks for the time, everyone. Yeah.

Rob Hoffman (47:10):

Awesome. Yeah.

Lara Rhame (47:11):

Thanks Kara.

Kara O'Halloran (47:15):

This episode was recorded at the FS Investments headquarters in Philadelphia's historic Navy Yard. It was edited and engineered by Aaron Sherman. Special thanks to show coordinator Ellie Zhang. If you enjoy this episode, be sure to like and subscribe wherever you get your podcasts. Thanks for listening.