Episode 59

3D Report: Q1 2023 Recap—You can run for a long time, but sooner or later...

In this episode of FireSide, Ryan Caldwell and Lara Rhame discuss the timing of a possible recession and assess macroeconomic trends and global investment opportunities.

Ryan Caldwell (00:01):

This is the 3D report, a podcast from FS Investments and Chiron, I'm your host, Ryan Caldwell. Welcome to the podcast Lara Rhame. Another quarterly 3D, quarterly podcast update. How are you?

Lara Rhame (00:32):

Second quarter 2023. I'm great. I'm great. Markets are keeping me on my toes. Economic data keeping me on my toes, and springtime, everything's blooming...

Ryan Caldwell (00:43):

This springtime. Time for all the seasonal adjustments to go the other way.

Lara Rhame (00:47):

That's right.

Ryan Caldwell (00:48):

Just kidding. No, we'll get into that. So, I thought maybe what we would talk about, and we do some planning but not a lot. And I do that because I want kind of Lara's, off the top of her head, what she's thinking without a lot of time to analyze and be moderate. And for our listeners, I like to kind of think of Lara as really the voice of reason. She is really the most kind of grounded and reasonable, and I've said this in the past, but I'd love to talk about her background because it's so unique. Not only being an economist but also being an FX currency expert. She sits on the board of banks, so she's got this really wide purview and sees a lot of the things that we as market participants talk about. So, in terms of being kind of an ivory tower economist, that's not what she is.

(01:33):

So, it's very functional. So, I love to kind of throw these extreme positions at her and just kind of see how she walks me off the ledge or where to stake out a different opinion. When, in 3D I kind of staked out this extreme position, which was that for all the broad strokes, effectively the economy was likely to be wildly more resilient to the Fed than the market. And if I kind of crystallized one queue, right? The thing that's probably the seminal market economic event was SIVB, the deposit bailout that all of a sudden sort of threw a wrench in this kind of smooth trajectory of Fed policy and things going smoothly. And I think, you know, when we did our last

podcast in Philly, we had kind of tongue in cheek made this point that like the Fed's going to keep going until they break something and then they'll probably stop. And the market somewhere in there and here is tried to figure out if they've indeed broken enough things to go ahead and stop. Or, if you know there's more that needs to be done for kind of the inflation boogeyman and what that might mean six, 12 months from now.

(02:43):

Um, if they do pursue policies to kind of break the inflation boogeyman since I don't see a ton of like new awesomely interesting economic ground to break in the first quarter. I mean generally first quarter was pretty good. Right? And we had talked about that back in January, like the consensus that like first quarter was going to fall off a cliff and you're doing all these earnings revisions and the market was going to bottom and it was going to be new lows, obviously none of that came to fruition. And you just said, and I've kind of written it 25 times now, the nominals are just too good for this and they have been. Right? The world doesn't fall apart at 3.5% unemployment and inflation running at five. The top line's just too good.

(03:25):

But I thought maybe where I would start with you again since I'm staking out this position that I think the Fed broke things and ultimately we're going to end up in what is not going to be a soft landing at all. It's likely to be something much worse than a soft landing. But I figured like I wanted to start here and wanted your kind of opinion on the thought process and where your head's at because there seems to be kind of two camps that are staking out, right? And kind of economic bill, which is not a term but one I just threw out there, which is you have kind of a group of economists that tend to be more monetarists that are kind of staring at leading indicators going this is a disaster, it's going to be awful. Right? And this is where like the OA crowd starts to rev the engine a little bit saying that be shocked rates monetary growth is contracting leading indicators, which we got another look today and they are bad, right?

(04:19):

Leading indicators are awful. The economy ends up in this really big ugly recession six to 12 months from now, pick your date and then you've got kind of the other camp that's staked out that's kind of looking at the coincident and lagging indicators and not just the coincident lagging indicators but the composition of them. Because I think that's the part that maybe the monetarists like like to ignore when they look at leading indicators as well. Like wait a minute, there's a whole lot going on under the surface and labor composition and CapEx spending and like all the things that look coincident or lagging, but it seems to me that's where the fight's brewing, right? And the market's fighting somewhere along those lines, right? You might argue the bond market's staring more at leading indicators, at least the rates market and credit and equity multiples are a little bit more focused on the here and now saying, well it's not falling apart, right?

(05:12):

So maybe there's this kind of thread to kind of surf. So when you kind of think about that and it's really the growth versus inflation argument that we've been kind of batting around for a while. Like where do you come out on either camp or neither camp and kind of when you frame your own thoughts and having to forecast this and think about not only the endpoint but the travel like rate of travel and how we get there. Like what are you seeing given it does feel like both sides are really extreme, leading indicators are bad, but lagging indicators are really hot.

Lara Rhame (05:47):

Yeah, I think as always, right, when I think I have things figured out the way you phrase the question I'm like ugh, that's really probably the exact right question because the, the one you phrase it as growth versus inflation, I think that it's a much tougher trade off this time around

and I, I've been saying this for a long time, the economy just had a lot more momentum than everyone appreciated. We saw growth rates that were supercharged from C O v, um, from the bounce, from the reopening, from the trillions of dollars of fiscal and from the monetary easing, the quantitative easing and all of that has just made our economy so resilient. And I think you added to that the fact that like you fixed the problem of the last crisis, which was the emphasis on floating rate debt and the over-leveraging of the household balance sheet.

(06:43):

Like you fixed that problem and you broke monetary policy <laugh> because you made, you made us have to have to push like we pulled the emergency brake but this time it's only sort of hitting two of the wheels on the 18 wheeler. Yeah. It's not hitting the other 16 wheels that are still going. And so to me the growth versus inflation trade-off is much, much more challenging. You are going to have to hit growth harder to get inflation to really come under control. And I think that trade off is not clear to me because I could envision a situation where the Fed does not fulfill the job on inflation and stops. I think we have another rate hike coming early May. We're going to have this prolonged pause and I think we're going to end up in a place that nobody feels good about because it's probably still going to be a little bit too hot.

(07:40):

And yet we're all going to be feeling the impact, we're going to be feeling the inflation that's decelerating but it's not decelerating enough to fit us back into the 2% target box. And I think that's a tough place because guess what? You don't get the big deceleration, you don't get the big earnings bump in 2024 that everyone's expecting. I wanna be clear, a recession is in my forecast. I think my timing on that has been sort of fourth quarter 2023. Sure. Ryan, if you today told me like no Lara, I feel very strongly that that's going to happen this month or next month or in the second quarter. Let's have that debate. I think the timing is up for debate but to me that's where we're headed. I think the question is how we get there and whether it's sort of coasting into a couple quarters of contraction or it's just more of a, of of a hard sort of a crash landing into a recession.

Ryan Caldwell (08:42):

Yeah, I, I mean I think I want to emphasize that point because you've made this kind of over and over again to me. You've also made it in your in in sort of the research you publish, which I encourage everybody that listens this to read Lara's research. I do. And like what dawned on me was the point you made that was effectively, and I'm going to paraphrase it because it's what I do, which was look, there's no outcome where you don't club growth to hit 2% and so the terminal rate ends up higher or longer or higher for longer. Would however you want to now describe this terminal rate argument of what's the right level and how long do you need it, it almost doesn't matter to your point, which I think probably for Wall Street guy like me who wants everything to come fast, right?

(09:34):

I need it to come fast because if it comes fast I know how to like position for mean reversion and the good stuff or if it's going to come fast I can position for the bad stuff but this cycle doesn't lend itself to that. Right? And so you've been making that point really for a year and a half really since the Feds started lifting off of like, hey look like the timing that Wall Street wants equity speak, credit speak is very unlikely to come to fruition. And whether it's like kind of, and you made this point on our last podcast, like what is a soft landing is no earnings growth soft landing like that doesn't really feel soft landing when the multiples 19 times, right? Like if it was 14 times, we all might do a back flip and say, okay, flat is the new up, great, let's go.

(10:24):

But at 19 times you're like, uh, if my best case or highly probable case or most probable case is flat 24 numbers, I'm paying a whole lot for this experience at the moment. And so like I, I wanna reemphasize the point to the listeners about timing because timing has gotten everybody or it's gotten the bulls, it's gotten the bears, it's gotten everybody the bears wanted to come too. The bulls have said look, if I, if it doesn't come, that means that like the Feds soft landed it. So your point is salient to me and look what we don't know yet is like the pain point of realization for the Fed of like do they get inflation to three but the unemployment rates at six and the tradeoffs are just too hard, right? Are you really going to crank rates a hun another hundred basis points to ring out another a hundred basis points of inflation if you risk sending unemployment to 7 89?

(11:17):

Probably not but like we don't know those tradeoffs yet. It's way too early to understand those tradeoffs. But your rate of travel I think is what sticks out at me. So again, when I have my highly bearish staked out position into your point, like you can have a real pushback debate with me for probably the next two quarters, right? If I said no Lara, it's tomorrow. Like the only way it's probably tomorrow is if you break something else in the financial system, which we'll get to in a minute. But like if you just follow the rate of travel of unemployment, how companies actually hire people, how they actually fire people, right? How quickly CapEx actually gets cut, like all the things that look like contraction and look, we're about halfway through one Q earnings and right now I would tell you they're not good but I also don't have managements guiding you off a cliff for the end of the year either.

(12:13):

So like this debate seems to me like it's going to be here with us for a minute and you keep making the point about timing and I keep have to making a note about it to say like step by step you've gotta watch this trade off right? And probably not get too bearish too early or too bullish now. Yeah because of your point I and I think it's a salient one. You've got a recession in your forecast which means there's no earnings growth. Like that's my translation of Lara has a recession at some point in the future in her numbers it means Ryan, you get no earnings growth. So like we can deal with that. But again, the market doesn't love zero earnings. It either wants down 20 or up 20 because it's a much easier thing to digest.

Lara Rhame (12:59):

You said something which I wrote down because I think when you think about inflation at 3% the Fed sort of stopping there, I think it's the fundamental side, it's the macro side of what you expressed from the incomplete answer that markets are are looking for and aren't going to get <laugh>, which is the training of like now the economy sells a little bit, you get zero interest rates, you get quantitative easing, we're going to back up the dump truck and give you everything that you want. My urine forecast is 4% for inflation. Say we get to three. And that is a world where sure if the, if we have a recession the Fed's going to have to cut some but they're not going to be all the way back to zero. And I think that is another big problem for market expectations. It's not going to feel nearly as good as what markets have gotten used to.

(14:00):

That's the reward that they get on the other side of the pain of a recession is usually really fabulous. It's a lot of liquidity and they're not going to get that this time around. And I, I leave it to you to trade that cause I think it's going to be a lot of disappointment from people who are who now look at what happened after Silicon Valley Bank, the biggest bank crisis since the financial crisis. You get treasury yields down a hundred basis points across the curve. That makes total sense to me. And you get large growth multinationals, you get the, the the margin monsters up. Wh when did Google and Nvidia become safe havens like the 10 year treasury? I don't know apparently it happened or not <laugh>. No, that's what markets went to. That was what happened. It was stunning to me.

Ryan Caldwell (14:52):

No and look it is an excellent point because like the note I just made when you just made that statement was that is multiple compression. Yes. Right? If I don't get the kitty right, if I don't get massive monetary policy reaction, I don't get a bunch of rate cuts and QE and fiscal stimulus and like all the rewards of living through a down cycle. Yeah. If I don't get them then how do you trade? Like you can't trade the forward multiple at 19 times earnings. Like you can't, so like either way you have a multiple problem and the other argument I guess just following that trajectory is that's a terrible environment for cyclicals, right? Because you don't get to reset all the things that you need in early cycles cyclicals to go jump up and down and go woo-hoo. Now I can go by materials and automakers and home builders and all the early cycle stuff because like I don't have a big acceleration to look forward to.

Lara Rhame (15:54):

Yeah it it's the, it's the mirror image of the last five rate hike cycles where they raise and then they end up cutting almost twice as much as they've raised and it's just driven rates to zero. And now I think you're going to get the, the flip side of that and I think you still, at the end of the day you still end up with an inflation problem. Inflation's gone from nine peak of nine middle of last year down to five. That to me is pretty easy and understandable easy work. Yeah it's really inflation had had exploded out of every sector of our economy to get to nine and as it's come down you just needed a couple of those to correct. But to get it all to fit back in the box to me requires everything to go perfectly and I just don't think we're in that world anymore.

Ryan Caldwell (16:46):

No, and you bring up a really good point. It's not only that you're left with an inflation problem, you're left with a growth and inflation problem and

Lara Rhame (16:52):

Inflation problem. Which is why when you started with the trade off, I was like that's tough usually because that's the way the Fed is trained. They've trained themselves on this trade off and I think the Fed's job only gets much more difficult in the second half of the year. I have no idea what they're going to do when the economy slows more, they're already muddling themselves by offering a liquidity solution to the banking system while they're still quantitative tightening. This is a problem of their own making. I don't mean to do the easy thing which is a sling shade at the Fed <laugh>, it's too cheap. But I wanna be a little more nuanced and just say that um, throw the <laugh>, am I allowed to <laugh>? Oh of course. Um, that I think the job only gets much harder at the second half of the year.

Ryan Caldwell (17:44):

So this is the perfect transition then into the next topic which is I'm going to bite down on your economic forecast and say okay that's right. Like base case 70% probability you end up with better inflation than you started the year but not at the target. And growth is definitely worse and it's feeling numbers are looking recessionary, it's not cataclysm, right? It's what it is. It's you know, contraction of inventory and some labor and pretty normal cyclical contraction without the kitty to get better. So let's put that aside and say okay that's right. Sure. The second part of the discussion, and again this is where I kind of wrote with a sharper pen, was when I step back and look at the system and you just kind of highlighted it and this is the other place I really want to pick your brain cuz I know you know it, which is you took the financial system and you put a boatload of leverage on it at zero, right?

(18:44):

So while back to your point, the structure of the economy doesn't easily lend itself for inflation mean reverting quickly, right? Particularly coming out of covid, the labor mismatches, the

supply chain mismatches all the things. So the economy has a little bit different structure to it post covid than it did pre covid. But I look at the financial system, you just pointed this out, this is a problem of the Feds zone making because you did take rates to zero for a very long time, pushed real rates really negative for a few years and you created like leverage on top of the system. So like when I really wanna like turn up the bear argument, this seems like the easiest place to do it, right? Which is to say, well when you take a system that's highly levered and we don't know how highly levered yet and I want to get into S I V B because I'm shocked that this one was missed, right?

(19:42):

Or that this risk could be missed. But if you take the basic structure and say it's just hyper leverage on zero rates that was endorsed by the regulators, right? So I, if you take to your point the floating rate credit problem and make it a high quality duration problem, right? It's still a problem. And we clearly did that when you look at the system Lara and go okay, right the hickey e brake and two wheels on the economic 18 wheeler seized up and the other 16 kept flying. But on the financial markets 18 wheeler, maybe this is a 36 wheeler but like the market wheels like seem like when you pulled the e-brake all 16 of those can lock up real quick and right, you just made the point about S I V B and you go, oh, like there's issue one with pulling the e-brake and shocking rates 500 basis points in a year with quantitative tightening ripping in the background and you can see the liquidity pullout in the market, right?

(20:48):

Sure. Lisa, you've talked about this, it is clear, you look at bid as spreads and currencies, fixed income equities, everything's wider. So it's clear as day do you worry that the butt end of the 18 wheeler that might have another trailer called the market seizes up wildly earlier than the economy does and the spillover effects to the front of the 18 wheeler or 36 wheeler overwhelm you. Cuz like that's I think really the bare argument, right? Because you don't have the economic data at all empirically to say it's over, right? You've got leading indicators and inverted yield curves but you don't have anything else, right? You don't even inside of earnings, they're not disastrous. Do you think that position of the market is wildly too levered to rates in the system and that gets the Fed? Like where do you land on that? How do I think through that and how do I like mentally not like jump out the window with the thought process of yeah you pulled the e-brake and the economy keeps pushing but the market seizes up on you so fast you don't know where to go.

Lara Rhame (21:54):

I think, I think to talk you off the ledge on one side of things, you know the issue of these unrealized losses being carried by banks, you Fed rate hikes devalued the largest asset class in the world by, let's call it 15% o over the course of a year. Yep. So every single bank out there, I don't care every single one is carrying some kind of unrealized loss from this rate hike cycle. And I do think that, I mean S I V B I was had a ton of red flags, but I think what troubles me is the broader trading that we're seeing in treasuries. And you and I have talked about this separate from this specific, I think clear mismanagement of the asset liability. Yeah. Matt, so I am, I think my personal opinion and I'm not a banking analyst, is that the financial system, the, the core of the banking system remains healthy.

(23:03):

Ironically now the yield curve shifting down has helped mitigate a little bit of the unrealized losses that these banks are carrying. That said, and I think the Fed's reaction has blunted some of the pain this feature has caused. But I do think that in the background there's a troubling drumbeat and it is the problem of liquidity in the treasury market. And I don't even think that's associated with the Fed rate hike cycle. I think it's associated with regulatory changes that they made in the wake of the financial crisis. And people ask me what keeps me up at night and it's the fact that through the lack of depth from the primary dealers, the fewer market makers, the

disincentives even carry off the run treasuries nowadays. Yeah. We saw the biggest swing and the biggest implied volatility in treasuries since the pandemic broke out close to what it was during the financial crisis. That's just unacceptable. This is supposed to be our oasis. It's supposed to be the most liquid market in the world. And I think you have two events coming up that we really need to think about a lot. We have the debt ceiling, I don't wanna call it a crisis, I wanna just say we have the death ceiling. But it's hard to, to not, I want you in

Ryan Caldwell (24:28):

Pocket, I definitely want you to talk through this because you wrote a great piece on it and entering this pocket where like when you look at the move index, and again, I'm trading treasuries, I'm trading treasury futures and it's frightening. Yeah. Frightening to be trading treasury futures, looking at the bid asks and like where you're getting lifted. It's crazy. So like I do want you to touch on, okay, now we've got this pocket of illiquidity and treasuries and we're heading into this debt ceiling wrangle. Yeah. Right. Risk, can you risk that it's, I know rabbit hole but like let's go.

Lara Rhame (25:02):

No, I, I think, I think it's a, I think it's a significant risk. Here are my three takeaways. When people say, oh, it's going to be like 2011, we're going to kind of muddle through at the end, it'll be fine. 2011 was bad <laugh>,

Ryan Caldwell (25:17):

It was

Lara Rhame (25:17):

Awful. We had, we had the equity markets down 14 to 17% and they stayed down for months. It took the months to recover to where they'd been. We had consumer, it's two weeks we, we

Ryan Caldwell (25:28):

Two weeks to go down 17, I remember. Yeah. Like it was awful. Yes. And,

Lara Rhame (25:32):

And and consumer confidence got hit. Sidebar. Right now, despite robust consumer spending, which the data are probably artificially inflated by the cost of living adjustments that we got, I think first quarter we're going to have quite a significant slowdown in consumer spending. So all that's to say second key takeaway about the debt ceiling is that in 2011 it really did impact the real economy because consumer sentiment fell. And right now consumer confidence is fragile. Mm-hmm. <affirmative>, it's more fragile than it should be given where jobs and where spending is consumer confidence is already fragile. So that's a real vulnerability to meet the economy. And finally, I think that both sides, and here I am shamelessly quoting Jason Cole, who is our political analyst. He's fantastic and co-authored with me said that in his view, and I agree with this, both sides took away the wrong lesson from 2011 at the end of the day then Vice President Biden was the one doing the final negotiations on the death ceiling change.

(26:47):

And he feels like he could've held out for more and made all these concessions that he didn't have to make. And on the Republican side, I think they ended up with a very incomplete solution on their side. They feel like they could've gotten more if they just held out. So at you have both sides coming away with the wrong take away. And I think here's the problem, at the end of the day, we will probably get an increase in the death ceiling. It's just that we may very well inadvertently stumble into a default because they negotiate at the last minute. There's too

much intransigence and everybody's on Twitter, which wasn't a thing back in 2011. And you start all of the real genuine negotiation too late, it increases the chance that there's a mistake. And that to me causes a tarp moment where markets truly crater and then the next day policymakers come back and oh no, no, we, we were kidding.

(27:44):

We were really vo voting, voting. Now it'll be fine. I think it's a situation where we have explosive financial market volatility. I think yields actually fall in that environment. But, but it's a huge risk off rotation and I think we need to be really careful about that given the, the backdrop of this poor liquidity in treasuries. It could just amplify all of this, it, it makes it acutely painful for all of our other fixed income asset classes which trade off of treasuries and which you're doing fine otherwise, corporate fundamentals to your point, we have the cyclical headwinds, but balance sheets are generally speaking solid. This is the kind of thing which this is the undertow, which can suck a lot of things under with it.

Ryan Caldwell (28:35):

Yeah. Y you, so there are a couple of things I wanted to touch on there. Like some really,

Lara Rhame (28:40):

But that wasn't, that wasn't, I didn't do a good job talking you off the ledge with that <laugh>.

Ryan Caldwell (28:43):

That was a little <laugh>. No, I, I mean look that maybe you remind me of some dynamics. And again, like I said, I think like the thing as a market participant I think I spend the most time about is like the rate of travel to this end point of what recession looks like. Right? Because effectively those contours are where you make money, don't make money, right. In general grand scheme of things. Mm-hmm. <affirmative>, I remember 11 and it's interesting because after 11, and this was, I don't know, three or four years ago I was on the road in Europe with UB s with John Boehner and I remember had all these like dinners with Bayner and one of the things he acutely talked about was the debt ceiling negotiation in 11 with Obama and Biden. Right. And if you remember at the time he was managing the tea party and that was his struggle. Right. And again, president Biden has openly said that he, he feels like he left things on the table actually talking to Bayner. Right. His argument was they were always pretty close. Yeah. Like it wasn't like the Biden Boehner Obama discussions weren't that hard. It was when they had to go back to the parties and say like, here's where we're at. And that was 12 years ago. Yeah. Right. This is the, these the McCarthy Biden negotiation is not going to be pleasant.

Lara Rhame (30:03):

No. And Bayner didn't survive.

Ryan Caldwell (30:05):

That's right.

Lara Rhame (30:06):

That dead ceiling resolution, that was it. And I think McCarthy sees that that's a pretty clear roadmap.

Ryan Caldwell (30:13):

Yeah, no that's, that is the nuance I wanted to tease out of what you just said because it's hard regardless.

Lara Rhame (30:20):

Yeah.

Ryan Caldwell (30:21):

But this, the dynamic is so much worse. It's

Lara Rhame (30:23):

So much worse.

Ryan Caldwell (30:24):

It's so much

Lara Rhame (30:25):

Worse. And we're not going to mint a trillion dollar coin. We're not going to invoke the 14th amendment. We are going to have to solve this through a negotiated political solution. So for me, the banking system I think needs to be addressed. I think it's something that every bank is now immediately looking at their uninsured deposits to liquidity ratios and actively actively managing those. But I think that there is another problem out there. And I think our economy wants to grow. That's what it naturally does. A lot has to go wrong to push us into recession. And again, timing asking me why, eh, why what really why you think end of 2023. Well I think that this exactly, this kind of market political disruption, um, could easily impact to the consumer at an already fragile time and get us there in the fourth quarter.

Ryan Caldwell (31:24):

No, I, I think that's a really salient point. So Lara, like the one last kind of topic I wanted to just peek on around this system leverage and kind of get your thoughts on, because you said on the board of a bank, you're incredibly bank savvy. I was a banking analyst and when I think about sort of the banking issue, right? I I, I think at this point the deposit flight issue is going to resolve itself almost anyway given the backstops that are in place. And to your point, the Fed's got one more hike probably at most, right? So the amount of money that's going to leave bank deposits for money market is probably, if it hasn't moved by now, it's probably not moving for the last 25 basis points. And so like yet you have this kind of timing issue where the funding of de deposit beta, which I love these terms, that Wall Street deposit beta, that just means top money, right?

(32:14):

Deposit beta picked up. Well of course it picked up and all that really meant was that you could get 5% in the money market when the banks were wildly lagging deposit rates at like two or 3% because they were trying to keep their margins high. That's all that happened. But when I think about the old banking analyst thing, and this is a thing like again, I'll send Lara these charts at like the middle of the night passive aggressively like, ooh, this is bad <laugh>. Like knowing she won't respond, but I know she knows what I mean, like when I look at like things like senior loan officer surveyor, I think about the asset side of the bank balance sheet. So as an old bank analyst, like that's the thing that scares me to death is that all of a sudden once you put bank managements in the position of having to manage the asset side of the balance sheet, they always manage it down, right?

(33:02):

Like they shrink. Like that is always the response. So if I think that like the small and mid-size banks, like we probably don't have a bunch of deposit led failures from here, but collectively, like everybody tightens the belt and they get tighter on lending standards even more and they already were. Right? And you run that through the model, like what it looks like is small business contracts because they're the big borrower from the banks, right? And not the big banks. Like the big banks are going to be just fine through this. Like there's almost no question about that. But when you contract lending to small business, and we go back to this kind of labor discussion and I think, you know, the one thing you keep hitting me over the head with and I think it's right, is that the realization point where the cowbell ring for everybody Fed market participants is when labor cracks, right?

(33:52):

That's when people are going to get nervous is when they really see labor crack because that's the consumer and that's all the tales that go to consumer. So back to bank balance sheets, if the small and mid-size mid-cap banks are contracting the balance sheet, therefore you're contracting liquidity into small and medium businesses who are the places where excess job openings are still hot, right? They, they we never quite got that match of labor and openings. Correct. If that's where it echoes through, right. If that's the outcome, not that we have a whole bunch of more bank failures, which I don't think we do, but if they all contract together, right. And this is kind of the the point I was going to ask you about. Powell said this at the presser at the last rate hike and now it's become like the echo of the Bullard and the Wallers and even Mester said it today, which is why we look at kind of the contraction of, of credit conditions as like a rate hiker too. And like that scares me to death, right? Because in my experience when the banks kind of contract together, it's not a raid hiker too. It tends to be like a cycle ender. So like I wanted to kind of throw that at, because again, I know you know banks, I know you know how the management teams operate. I know you know what the issues are. Like how do you spend that like thought process and like, do I get to sleep at night and stop sending you senior loan officers?

Lara Rhame (35:18):

<laugh>? I look, I look forward to those <laugh> charts <laugh>. So what I think we start talking about is the tipping point where these reactions become really asymmetric and that is the labor market. And I think there's no doubt that that's the psychology. It it's what you, I think it's what keeps you and I engaged in markets in the economy cuz for all of our quantitative models, there's such an animal component to all of this and a behavioral component. And there's no doubt that it's a driver in the banking sector. Deposits have fled the system. There's still deposits to be had. It just depends on how much you're willing to pay for 'em. The cost is going up and every banker is sitting there right now saying, oh it's fine. The economy's strong. We just need to make sure to protect our margins and ask for more as we refinance or as we roll things or as we make new loans.

(36:17):

And I think the problem is on a dime that turns to, to needing to actually be more stringent because there's only so much that you can get, you start pushing on the string of asking for higher yields. The, the very fast flip side of that is the deterioration and loan quality. And that's what we have to be so careful about. So to me it's that really asymmetric response where very quickly they start to button down or you're going to see regulators be stricter as well. So I think that is a vicious cycle that's going to enter the psychology. And I just wanna make one final point on the labor front because that is also where, you know, you see very little firing at a macro level. I'm not talking about company by company layoffs. Um, and my favorite economic indicator, I stand by it weekly initial claims.

(37:11):

Claims and it's been creeping higher. I just wrote that two 50 a week. Mm-hmm. <affirmative> is my, that's sort of about 20% off of the low. And when it crosses that threshold, you start seeing claims rise a lot faster. And then you usually get a recession a a quarter or two after we were at 2 45 <laugh>. So we're getting there. It's not necessarily the start of the recession, but it's, it's the asymmetric movement higher that starts the broader machine rolling over. So I, I don't think we're that far off. And I absolutely think that lending behavior is, is another piece y it's never just one thing that causes us to have a recession unless that one thing is covid and then it is just one thing, right? Then it was just that one <laugh>. But normally the world Yeah, that'll do her, that'll do, that'll that will happen. But, but otherwise it's usually a confluence of events and there's no doubt that the banking system is just a huge, that that to me, when I saw that news and the, there is a direct correlation between tightening and lending standards and lending standards don't move in small increments. They move in massive swings. Yeah. Yeah. And I think we're, we're still just seeing the start of that and it's a lagging indicator. That's also another problem for people who like to see it in a chart. It is a lagging indicator. It's slow. Yeah,

Ryan Caldwell (38:41):

No, i, i I think, no, I think that's the finer point on it. And and that's, I I did want to tease that out with you a little bit because it's, like I said, I think that one's been just a percolating and we'll see. And you're right, it is, it is probably the most behavioral action is once the mass of them start to tighten down standards, they all go together and they all, it goes real fast. Yeah. And you're right, it's a really laggy thing and like ultimately it's predictive and you're right. I was thinking about you this morning cuz I saw the claims number at 2 48 and I'm like, oh man,

Lara Rhame (39:12):

Was it 2 48? Yeah. Yeah,

Ryan Caldwell (39:14):

He was so two whatever, 2 45, 2 48, somewhere in there. But I was like, ooh, 2 50, 300. Like that's always the magical swing, right? Yeah. Like once you start to push up through there. Yep. No,

Lara Rhame (39:25):

It goes fast.

Ryan Caldwell (39:26):

It goes real fast. All right, so last thing I wanted to take away with you and then I'll, I'll let you go back to the day job and not having to deal with me, which is, I was thinking about this topically and I don't, and and I think it was a bit of our discussion sort of around the Fed being like between Iraq and a hard place with growth and inflation by the end of the year, again, following your forecast and saying, okay, somewhere in the vernacular of right is your forecast next year's an election year. I think this plays back into your discussion about what you get, like the kitty discussion. Like how good are the goodies on the other side of like weaker growth? And like again, I don't expect you to have some perfect answer at all and it's more just kind of a speculative discussion around like how Fed policy moves. Boy, how do they navigate that if your forecast is right? Cuz dear Lord, that seems hard.

Lara Rhame (40:22):

A absolutely and the Fed is, is just coming under enormous fire from both sides of the aisle, from one side on the banking regulation side and on the other side from the, the extraordinary packages that the extraordinary measures that they put into place like overnight with no legislation <laugh>. So they're really coming under fire from both sides. I think it's a misnomer that they don't do a lot in election years. They very often are active in monetary policy in

election years. I think something else, a tale event that is very hard to invest around. But you wonder when or if we do ever come to a point where politically there's power drawn away from the Fed. Again, I'm, I'm, I'm not here to to forecast that, I just wanna discuss it, but I think really one of the bigger issues is the quantitative easing that the Fed put in place.

(41:27):

They did it once and it kind of worked and calmed the markets down when the problem was a financial crisis. They did it a second time around Covid and I would argue that it was a failure and it added massively to volatility in the economic cycle. And that is absolutely the hard opposite of what they're supposed to be doing. And you've heard me say before on your podcast that I see a world now of faster, shorter, more volatile economic cycles that stems from more volatile policy cycles and I think it will lead to bigger financial market swings and more financial market volatility. But I think there's, I think that there is a moment where there may be, maybe it's just purely for the drama, for the political drama, but we do see power being clawed away from the Fed. And I, i i, I don't want anybody to mistake that for me forecasting that for next year, but it's something that I think in as, as long-term macro investors that you and I are, we need to think about it going forward.

Ryan Caldwell (42:35):

No, so this is funny and listeners won't believe me when I say this. We did not coordinate this discussion, but exactly where you went was exactly the thought process I'm worried about, which is if these people have to be cutting rates next year, oh boy. Yeah, right. That's a problem, right? If they don't cut rates and the unemployment rates going up, and again, back to this marginally attached argument that was percolating back in 2019 before covid, that's a problem. Yes. Right? So like you look around the spectrum and go, oh, exactly to your point of do we get to a point where the Fed becomes an election cycle issue because to your point, you've overmanaged the washing machine, right? You were too aggressive both directions and like you screwed the whole thing up. And and again, Congress has oversight of this, but they advocate that oversight pretty materially.

(43:33):

And so yeah, like where I was kind of heading was, do you call Fed credibility into question next year just because of the confluence of events of the way this cycle is unfolding with the politic around it. Right? And again, I don't know who's going to be running Biden runs on the democratic side and like by all accounts it look like Trump's running on the Republican side. Who knows if he wins, but if it's those two, like you can see it becoming an issue very, very quickly. And so I I I'm glad you that's like we, I wasn't in left field kind of thinking through it, but again, that's why I said like if I left them with your forecast, I think they'd be like, oh, uh, don't give us that. Well, I'd rather have it much worse or much better. Don't give me the in the middle because like then the whole thing looks bad.

Lara Rhame (44:22):

Yeah. And I, and I think it just speaks to the fact that number one, like you said, their, their list of friends grows thin.

Ryan Caldwell (44:30):

Yeah.

Lara Rhame (44:31):

And, and this is the problem when you take credit for decades of low slow inflation and sort of calm, steady long expansions, you get blamed when when that doesn't happen. And you could argue that they should share some of that blame, but there are other factors that have

impacted it. And I think de-globalization would've happened with or without the Fed. I think that's just going on in the background, but it's, it's a problem when you take, what is the expression when you take credit for the rain? You can't get upset when you're blamed for the drought. I think that's kind of the experience that they could be in for next year.

Ryan Caldwell (45:14):

Yeah, no, I think that is incredibly well said. And I'll put a bow on it and then there Yeah, I think it's this, like me again, it becomes a currency, credibility issues. There are all sorts of things that percolate around that argument that we can get into if that argument does indeed rear its head. But yeah, just in again, thinking about trajectory of things and operations and look, and I I I will say this, when, when the Wall Street Journal's writing books about how you save the world using taxpayer dollars, like the irony gets really thick and like I do think there is a little bit of a ground swell against like, wait a minute, like this is trillions of dollars overnight and nobody's voting these people in. Like who, like who's watching this? So again, no more to be said. I think you hit the nail on the head and like I said, that was not pre-planned, it was just sort of floating around in the back of my head. So I totally appreciate that as a topic and one maybe we will tease out in further podcasts. So I think with that, Lara, I can't thank you enough. This was great. Again, I love your thought process. I love being able to kind of wrap through things with you and again, stake out some of these positions and kind of see where we go. So appreciate it once again

Lara Rhame (46:26):

And I know, I know you'll trade us through it.

Ryan Caldwell (46:29):

Yeah, we'll see, I'm doing the Hail Mary for those of you. Yeah, I hope so. Seems tough. Got

Lara Rhame (46:37):

This.

Ryan Caldwell (46:38):

Yeah, we got it. So thank

(46:40):

You very

(46:41):

Much. And again, I want to thank our listeners for lighting off about 53 minutes of time to listen to us. So thank you very much and we'll

(46:48):

Be back.

(46:55):

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.