

Episode 66

3D Report: Q2 2023 Recap—An exuberant upside surprise

Ryan Caldwell and Lara Rhame review the 3D Report for Q2 2023

Ryan Caldwell (00:00:01):

This is the 3D Report, a podcast from FS Investments and Chiron. I'm your host, Ryan Caldwell. Welcome to the FS Chiron third quarter 3D Report podcast with our special guest, Lara Rhame.

Lara Rhame (00:00:34):

Good morning.

Ryan Caldwell (00:00:35):

Lara. How are you?

Lara Rhame (00:00:37):

I'm great. It's the day after the FOMC meeting and it's the peak of summer and there's nothing that I'd rather do than try to clarify the swirl of what's happening right now. Cool. And we need to flush it all out. So...

Ryan Caldwell (00:00:58):

By the way: I love summer solstice, so this is great. And I agree, I did say to Lara before we kicked off, what a perfect day to do this podcast because we had GDP, the Fed was yesterday, earnings is basically over for the most part—yeah. You got the ballast of them last night. So, what a wonderful time to discuss this brilliant piece of writing. One of the things I will say to our listeners: I'm a terrible writer. Like, I know I'm a horrific writer. I should not write anything. Lara is an amazing writer, and we laugh about this all the time because she does an incredible job of taking really complex stuff and making it digestible in a way.

(00:01:41):

Because she has to. She doesn't obviously just work with us at Chiron—she deals with all of our products. So in your seat you have this really hard job of like, “I have to touch on all these points, but like, I have to do it in a way that's connective.” So she's a really good writer. Long story short, listener, she's an awesome writer. So what I thought I would do is, instead of talking about my less than par writing in the 3D report (which again, at some point we'll get out of the bowels of FSS to our listeners) I thought what we would do, Laura, is maybe go through this excellent piece that you wrote—titled Sailing Into the Slowdown—which again, I think from a timing perspective, just couldn't be more, more topical given where the markets are. So if you'll allow me, I'd love to kind of go through that piece with you and maybe pick your brain and help me walk myself off a cliff of a first half that was less than stellar from a returns perspective from the Chiron team.

Lara Rhame (00:02:46):

First of all, you're too kind because I always enjoy reading your writing. But second of all, I think this where..

Ryan Caldwell (00:02:54):

I'm terrible.

Lara Rhame (00:02:55):

This is where I feel like you always pull the thread that brings us to the relevant and really unique piece of the forecast. So I'm interested in where you're going to drive the conversation, given my meanderings of the Q3 outlook.

Ryan Caldwell (00:03:14):

Well look, I thought maybe where we would start is right at the top of what you wrote because I always think weirdly, really smart people give you the conclusion upfront and then you can take the time to read how they got to their conclusion. If you so think it, and you kind of did that without being obnoxious in the way I am when I say, here's the conclusion. You can ignore me from here. But I do think maybe to start with this kind of the point I thought of the piece was look, up until now things have been resilient, maybe a very good term. But that doesn't mean that what comes next isn't less than resilient. And when you look forward, many of the things that you look forward to look slow downish, not acceleration.

(00:04:06):

And I actually always believe in capital markets. It's always about that, right? It's about the rate of change. It's not about the level. It's about the rate. Because the market adjusts the levels pretty succinctly. It's about the rate of change. And Lara we are now, it feels like this at the summer solstice year, you know, July twentieth, seventh or eighth or whatever the date is today. What was believed in the first half seems to not be believed anymore. And I thought you wrote a really excellent piece talking about slow down maybe these are some of the things you should worry about. So maybe let's start with, what's changed in the narrative with Wall Street economists and the market for maybe where we started the year to maybe where we're at. And then I want to pull some threads going forward on why you're maybe slow your role a little bit on changing the narrative. But what have you seen? Because again, we haven't talked. There's been so much narrative change in like eight weeks. It's crazy to me.

Lara Rhame (00:05:09):

So let me let you off the hook when you feel you're kind of on the lunatic fringe because I think something that we talked about, you and I have talked about it a lot. When I saw the Fed raising rates so aggressively, my thought was, and I stand by this. This is going to lead to a recession at some point, but I never had expected it in the first quarter for the simple reason that the Fed was still clearly actively in a rate hike cycle at that time or in the first half of the year. And I think what I got right, we both got that right. But here's what I got wrong and I guess this is where it is you can never underestimate the power of the herd.

(00:06:02):

Because I think I didn't appreciate how broadly markets and other Wall Street analysts had expected a recession in the first half of the year. And so for everybody else, it was this big surprise when the data was coming in stronger than expected. So the data in the first quarter was very strong. Data the second quarter has been normal. But when we didn't get a recession and we got solid economic data, it was this exuberant upside surprise for markets. And it's given us this valuation lift I think. And that to me, I'm not trying to double talk because I want to be clear that as everything was lining up at the end of last year, we've had all this momentum, you know, the title sailing into Minnesota. I'm like, we're sailing along, there's tailwinds, right?

(00:07:02):

That's what sailing is, it's like harnessing tailwinds. And so we've had all this momentum. It's why the fed had to be so aggressive. To me this is as obvious as the nose on your face. But when we actually look at the market reaction, there was so much I had not understood how much pessimism was built in. And so I think that is what has surprised me is markets just turning back flips over the fact that we didn't have a recession that I never expected in the first place. And I don't think I had convinced you also into not, you know, separately or I convinced you, I don't know, but that we weren't going to have a recession. And so now it feels like somehow, even though we got it right, we still got it wrong. I don't know.

Ryan Caldwell (00:07:44):

No. Look, and just for our listeners, I would say Lara has in her piece, which I would encourage everybody to read, she has this awesome chart and I want to speak to this looking at economic surprise relative to S&P 500 multiples. And so I want to crystallize this argument because I think it's brilliant and I hadn't thought about this until kind of I digested the chart right? And thought about the point and your point's exactly right. Which is, oh dear God, everybody was in the recession camp of March of 2023. The ball had moved that far. Yes. And to your point back to rate a change. So when you look at Bloomberg's surprise, which by the way we'll get into because it's starting to roll over. But when you look at Bloomberg's surprise for the entirety of 2023, for the most part it's just been beat, lowered expectations. When you look at these diffusion indexes, it's always like, what are the numbers? Are they better or worse? Now the numbers got really low because everybody expected a recession.

Lara Rhame (00:08:51):

Right?

Ryan Caldwell (00:08:51):

Right. And then you started beating them, which is the upside.

Lara Rhame (00:08:55):

Compared to what was expected. Absolutely. We were getting these strong upside surprises.

Ryan Caldwell (00:09:00):

Yes, yes. So, when you look at five multiple points of expansion. So when you think about all that's gone on this year. And I think this chart is just brilliant because what it tells you is, yeah, all that's happened is the multiple is just following economic surprise. Yeah. So we priced in the recession that was supposed to happen in the here and now, no evidence of a recession. In fact, the opposite, you got a relatively strong first half versus maybe what expectations were. Yeah. And the market just completely revalued. Yeah. Right, under the guise that well no recession. So therefore, and again, there I think there's some other contributing things that we'll get to later in your paper.

Lara Rhame (00:09:39):

Well, AI.

Ryan Caldwell (00:09:40):

AI.

Ryan Caldwell (00:09:43):

Inflation key AI, right? Yeah. And, but I do think baselining this, to get back to the going forward, the baseline was no recession happened. In fact the opposite, generally speaking, pretty good outcome relative to maybe where the consensus was in the first half of the year.

Lara Rhame (00:10:02):

Yeah. And I think that is really to me the importance of the outlook for the second half of the year. Because markets now are not, you know, there's been the exuberance. We've somehow avoided a recession that everyone's expecting in the first half. This is the market narrative. And now, we're going to get a soft landing. And I would push that even further and say markets are not even looking for any kind of slowdown in growth. And that to me is what is probably the biggest vulnerability because what is the economic catalyst in the second half of the year to drive valuations even higher than where they are today? Because when I look ahead, the backward looking data right now are great. It's the forward-looking stuff that is turning problematic and, again, timing matters. I think, you know, I don't have a perfect crystal ball recession's out a foregone conclusion. I expect one in the first part of 2024. But the path from here to that is slower. The second half of the year is going to be slower than the first half of the year. And I don't think that's price in at all.

Ryan Caldwell (00:11:21):

No, look, I want to touch on that and I want to pull on that string because you just made, I think the key point for anybody that's in it, we'll get to the economics of this and I want to pull at this. But from a market perspective, our belief system is built around starting points. So like to your point, I think what we missed was that the starting point was wrong to be betting recession in March. Because everybody was betting it. But now when I look at the starting point, and I look at you, I thought did a brilliant job laying this out in the piece. When we look at PE and I pull apart the P and the E, what you now have to believe at these multiples is not soft landing. That's not enough. Right, recession off the table, soft landing, not good enough. You have to believe 2024 big earnings re-acceleration. So that's the thing.

Lara Rhame (00:12:23):

Second half of the year, right? Second half of the year we even have an acceleration.

Ryan Caldwell (00:12:27):

Yeah, if you look at the cadence of earnings build now sequential quarter every quarter now goes up into the right.

Lara Rhame (00:12:36):

Yeah.

Ryan Caldwell (00:12:36):

And it has to, right? Like you would have to believe that. To believe that you can grow into this forward multiple, right? Because again, all kidding aside, when you look at the forward multiples, we're at 2021, 2000 and nifty fifty highs on forward. This is not a good starting, this is not what beginning of cycle normally looks like is all I'm saying from a starting point perspective. Yep. So to grow into it is what you got to believe. I've got to grow into it. So what you just said, Lara, I think is critical and salient. Maybe let's play with that is does it accelerate from here? You have it slowing, but the market's saying accelerating. So can we play with that a little bit? What do you see slowing? Yeah. And I want to pull on that relative to the narrative of acceleration. Because I don't think the market's defined what's accelerating. It's just, again, imputing from this multiple something's got to accelerate.

Lara Rhame (00:13:37):

Totally right. Because, and I think when I read your 3D report, we have different lists that are sort of forward-looking indicators that are slowing. And there's some overlap. But here's my list. Okay, my list is that bank lending standards are still tightening.

Lara Rhame (00:13:58):

And this is a classic channel of monetary policy tightening. This is the purpose of fed rate hikes. Well, so here's my list. So bank lending standards still tightening. Banks are going to need more capital. They're putting loan loss reserves aside, that is all in motion and it's going to continue.

Ryan Caldwell (00:14:19):

And you sit on bank boards. I just want to call that out always for our reader.

Ryan Caldwell (00:14:23):

Lara is a practitioner, this is not Ivy Tower economics. She's a practitioner. Definitely. So I just want to make sure I call that out.

Lara Rhame (00:14:29):

And I think it's a discussion that we're really having, more discipline. The loans still significant loan demand, but you got to price them higher. You got to be way more disciplined and still really paying attention to what deposits are coming in. So, there's a balancing act right now with banks and it's only I think, going to get more pronounced. So, yield curve's still inverted, right? That is a signal that we cannot ignore and more inverted than it has been ahead of prior recessions. We have corporate profits peaked in the fourth quarter of last year, and that typically peaks two to four quarters before a recession begins. And then initial claims have come down a lot, which I'd like to talk about labor. Let's put a pin in that one. But I think most importantly the business sentiment surveys, the ISMS, all of these are quite downbeat. And I think, to finish where I started, the Fed is still trying to slow the economy down.

Ryan Caldwell (00:15:42):

Yes, yesterday.

Lara Rhame (00:15:42):

Markets are convinced that that's going to be the last one. You know, this has been something that markets have tried to sell to the Fed and the Fed just has kept ratcheting higher. Before the banking crisis, we had sort of priced terminal fed funds around 5.65. That's another rate hike at least. Yeah. Like another one and a half. And I think you were kind of moving back towards that. I think it's a bold statement to say yesterday was the last one that the data keep going the way they were this morning. I think they probably do go again. That is their policy, it is a policy choice to slow the economy. So, you know, all of those together at least mean that we are going to see slower growth. And I think then you add back, you added in some of the other stuff, the fading tailwind, the excess savings.

(00:16:41):

It was two and a half trillion dollars. Took us a long time to spend that down. But we have done it now. We are through it. And interest rates have had impact. Housing is a different story, but autos, credit cards, that is having an impact on household balance sheets. And I think you're starting to see it. And then the student loan payments coming back in. I mean it all this is, you know, a hundred million here, a hundred million there, and all of a sudden, you're talking about growth decelerating from two and a half to one. And that is a significant slowdown.

Ryan Caldwell (00:17:20):

Can we pull apart some of the, I just want to go down your list actually. Yeah. This is perfect. So let's start, I want to start with banks. Because maybe back to March, that was the epicenter of for sure we're going to get a recession. Since March, and we saw PAC West in Bank of California yesterday. Again, that's why I love doing these podcasts on seminal events. Orchestrated by everybody's savior, Jamie Diamond. So once again, JP Morgan, the new GSE saves the day. But maybe starting on the transmission mechanism of the banking system to the economy. And again, you know this, this is why I don't sleep at night. Because I am convinced we're going to get a left tail event out of this process.

(00:18:10):

And I don't know when, and I don't know what it is. Right. But I've kind of been railing on, when you see this, it always happens because you got to understand the transmission mechanism. So I want to go through that for a second. So you indicated, look, when you sit on bank boards, you got to adjust the cost of financing, right? Yep. Even if you're grade at underwriting loans, at this point in the cycle, I have to imagine your CFOs are saying, eh, uh, eh, cost of funding has gone up if I've got. So I want to pull apart both sides of the balance sheet here, because I think they're really meaningful. So first on the deposit side. So the first part of the year was about this deposit cataclysm that caused all these asset sales and capital shortfalls. And that quote has gone away.

(00:18:58):

But to your point, the Fed just raised yesterday. Yeah. Right. So when I look at short term rates. Even over above the fed rate, they haven't gone down at all. No. And so, if I'm a depositor or a short term, you know, parker of money, I have all the incentive in the world to be parking in money market funds that are now 30 basis points, 20 to 30 basis points higher than the overnight rate. Yeah. All of a sudden well again, that is not maybe some massive contraction of liquidity from the economy. It is a slow drip of funds leaving the system to go park in the risk-free rate. That's what the Fed intends. We are pulling excess liquidity from markets over here to fund over here the risk-free rate,

Lara Rhame (00:19:55):

I think yes. And that is exactly the squeeze.

Ryan Caldwell (00:20:01):

Yes.

Lara Rhame (00:20:01):

Because I think the deposit beta, we know it ramps up significantly at the end of a rate hike cycle. And we've seen it. Everyone's awake now, everyone wants their 5% on their checking account. Click go. Yep. And so we've seen a couple of things. I think we've seen banks have to really carefully manage the deposit side, which is just a type of prudence banks are expecting there, there hasn't been new regulation written about this, but in anticipation that there's going to be regulation requiring banks to carry more capital. They're already imposing that on themselves.

Ryan Caldwell (00:20:38):

Of course. Regulatory arbitrage of course.

Lara Rhame (00:20:42):

And I think, when you think about, okay, if last year we made ten loans this year we're only going to make eight. Yeah. And we're only going to make the eight that will take a higher rate or we're only going to take the eight that can guarantee us a million dollars in deposits. And a lot of them are writing in clauses that if the deposits from that are related to that loan dip below a certain level, the rate on the loan goes up. Checks up. So there's very much, these two pieces are deeply interlinked and construction is still booming. The home builder equities, those equities are at all time highs. They're ripping.

Ryan Caldwell (00:21:25):

We got a lot of stuff in the ground that's got to come out of the ground, I totally agree.

Lara Rhame (00:21:28):

But you look at these construction loans, they're getting good yield on those, the banks are, and then here's the inverted yield curve part because it used to be you flip into permanent and it was just beautiful. And now you flip them to permanent and they have to take 150 basis point hit on that because the five year yield, the five year loan is going to get them a lot less. So this is the problem with the inverted yield curve and the slow grind. It just grinds down the bank margin and all they do now is protect margin. I will say it's interesting you started this by saying that it keeps you up at night. And I hope you're wrong.

Ryan Caldwell (00:22:15):

I do too. I don't want to be right on that. I don't, because I know what it means actually and that's not good.

Lara Rhame (00:22:22):

I think that when you talk to a lot of the folks on the bank boards, they're like, listen, I'll take a margin, squeeze over bad loans any day of the week. That's what they're like. They see it coming and to them that's like the better case scenario than like the bad loan.

Ryan Caldwell (00:22:42):

Look, it's the rational response, right. And that's what the responsible management teams are going to do.

Lara Rhame (00:22:51):

And not all of them are.

Ryan Caldwell (00:22:53):

No, but you go I need to survive. So that is margin squeeze. Yeah. Right. Like margin squeeze. Okay, I live bad loan, I die. That is correct. Exactly. Right. Like it's very basic framework. Yeah. So I agree with that. But you have to then start to make the argument that in mass, bank management are going to act rationally and that you are a rational actor and those around you are rational actor. And if they act rationally, that's credit contraction.

Lara Rhame (00:23:25):

Absolutely.

Ryan Caldwell (00:23:26):

So, what bothers me, again, I'm going to pull this back to equities for our listeners, because I know people love looking at the S&P 500. I've gotten this argument a lot from clients, which is, well Ryan, there's five trillion sitting on the sidelines. That it's going to make its way back to the equity market. And I say time out, right? That five trillion that's sitting on the sidelines, that's not dry powder, right? That is earning a return of six risk free. Your hurdle rate, Mr. Equity investor whose equity risk premium is now zero. Is that.

Lara Rhame (00:24:07):

Yeah.

Ryan Caldwell (00:24:08):

So rational actors would say at the risk-free rate, I'm getting six, I'm not looking. Again, along the efficient frontier, you're going to have to provide me ten, twelve, fourteen, fifteen taking risks to move off the efficient frontier of 6%. So I no longer see deposits at money market funds as all of a sudden dry powder to come back to the equity market. No, the Fed wanted that money out of the system.

Lara Rhame (00:24:40):

They wanted out of the system. Yes.

Ryan Caldwell (00:24:44):

This is accomplishing the plan.

Lara Rhame (00:24:47):

Exactly. Exactly. I think that is really important. This is not an unwanted side effect of monetary policy. This is a point of monetary policy.

Ryan Caldwell (00:24:56):

Absolutely. So yeah. If rates collapse and all of a sudden, you've got to deploy that capital because rates collapse. Well my guess is you're going to have a bigger problem in the equity market than you have in kind of bank deposits.

Lara Rhame (00:25:09):

Yeah. I think the other side of that is, if you look at the long term interest rate market, I think from the Fed's point of view, if the tenure tomorrow we woke up and it was down a hundred basis points and mortgage rates are down a hundred basis points, the Fed would tighten further. I mean I think that that to them is the worst case scenario because to them that just reignites the housing market, it reignites the small part of the economy that they can touch with their rate hikes. You got it. And they need to keep their thumb on the scale, on the long part of the curve, which is why one more rate hike, two more rate hikes, done here. I think that debate is intellectually fun, but it's missing the point, which is that we've got to keep longer term rates higher for a little while longer because the reality is that they know that they are only able to impact economic growth and slowing things down.

Ryan Caldwell (00:26:10):

And by the way, it's a big deal. Housing is kind of driven even the back to economic surprise and upside and longevity to the numbers and, but it was housing. Yeah. Right. At the root of it, what turned right in the spring and was housing and prices and all of a sudden it shores up

balance sheets. So your point here is massive, which is their response function is non conducive to the market's reaction to the data.

Lara Rhame (00:26:40):

Exactly.

Ryan Caldwell (00:26:41):

Right. If you keep driving the equity multiple up and keep the long end inverted, you have easier financial conditions, which does not create the condition set in which the Fed is hoping to. So you're right, it's this circular problem that has not gone away.

Lara Rhame (00:26:54):

The way high yield spreads down to 375. It depends on what you look at, but sub 400 basis points.

Ryan Caldwell (00:27:03):

Yes.

Lara Rhame (00:27:04):

Financial conditions are as easy today as they've been in a very long time. So this is just I think another way of saying that when they're tightening, they are only able to influence a very small amount of the economy and their signal of tightening is what influences markets. And markets have, they're like 2022 in the rear view mirror. We digested it, we're fine. And I think that is where there is this vulnerability in the second half of the year.

Ryan Caldwell (00:27:42):

And I want to give you some credit here because you wrote about this last year and it was incredibly salient to where we are today, which was careful guys, the economy is likely to be much more resilient to a rate hike cycle than previously because of the construct of the consumer, the construct of mortgage debt, the construct of the Fed's transmission mechanism and the actual tools that they have. So like I give you a lot of credit for the resilience comment of the economy to rate hikes and shock. What I am worried about is that the financial markets are not as resilient to that shock as maybe the multiples believe today. Yeah. That's my concern is that I get you, you're exactly right. The boomers are entrenched, they have a strong balance sheet. You can jack the front end up as high as you like, they're not moving. And that's created this weird feedback loop in housing where there's no supply. Yeah. Prices are going up and like brilliant call. That's absolutely correct.

Lara Rhame (00:28:48):

I appreciate that you really only call out the things I said right.

Ryan Caldwell (00:28:53):

I think when I think about 2023 and what mattered. I think there's only been a couple of things that mattered so far this year. The resilience of the economy to rates has got to be top of the list. Yes. Right. Because of the point you made about where everybody got in the first half. Yep. I think the other kind of salient point that Mike Goldstein made was the margins of the big growers and fang, which we'll get to, got to the market multiple and like that ended up being cheap. So like those two things in combination probably explained like 99% of the returns of

this year. Yeah. The economy was more robust and I could buy the margins, the best margins at the market multiple at the beginning of the year and it worked out for me.

Lara Rhame (00:29:36):

Yeah. As we were talking, I pulled up a graph of financial conditions. And I think it was probably already in your head, but I had to look it back up because, you know, we had this crushing deterioration in financial conditions in late 2022 as the Fed was like hammering markets with like, not only are we going to raise rates more than you think, but we're not going to cut any time soon. And since then, literally since they mentioned we we're going to stop, we're going to take our foot off the brake a little bit. Our foot's still on the brake, it's just not like lead footed emergency break anymore. Yep. Financial conditions have been recovering and today they are as easy as they were in August of 2022, which is, you know, whatever 175 basis points of Fed rate hikes ago. So, the market has really, I fee like has bought the Fed. Yeah, I agree. That's a good way to put it. You always so succinctly summarize.

Ryan Caldwell (00:30:45):

No and Lara, so next step of this argument and I want to get to it because it's on your list and I think it matters and we're at the point of the cycle where we're starting to get people right about why it doesn't matter, which always gets me to jump up and down and go, ah, charlatan, there you are. Right. Which is yield curve. So, the inverted yield curve and you make an excellent, excellent point that the depth and the duration of what's going on in the yield curve are troubling the go forward growth rates.

Lara Rhame (00:31:18):

Yeah.

Ryan Caldwell (00:31:18):

So I know, and I'm not naming names, but I want to maybe pull at this thread a little bit about does the yield curve matter? And we had a prominent house write a piece again saying, I don't care about the yield curve because the term premium because of QE has become so low that it's very easy to tip into inversion and therefore the signal no longer matters. My old buddy at Hyman at ISI is screaming about this. This is the old guys jumping up and down going. It's not about inversion, it's about to your point, it's about the depth, it's about the duration. Because what it does to the financial system, not the signal, but what it does. So can we pull on that a bit? And where's your head with the yield curve and does it matter and does it predict anything and do you care and why should you care?

Lara Rhame (00:32:10):

I do care. And I literally remember writing a piece in 2006 when by the way the economy was still looking really solid. And we were, as we now know on the precipice, trying to explain why this time the yield curve didn't, the yield curve version didn't matter. And sure enough it mattered. I think that this is just law of gravity and we underestimate the magnitude of trillions of dollars of liquidity being pumped into the system and how long that takes to come out. But it matters because we have just for 15 years been reaching longer and longer and longer in duration in our portfolios. Yes. And I think that it's hard to retrain behavior. Aside from the fact that we've had to make a fast pivot, go short duration, I think people have not truly worked that through their portfolios.

(00:33:15):

They've kind of done it at the margin and tried to make a little bit of a change. But the longer that this stays inverted, the more we're going to see this rolling over into shorter duration investments that is going to continue to take liquidity out of the system. And I'll add onto that

the fact that, you know, this is a more macro part of the story, but the government debt financing, we've snuck through because interest rates were so low. We were like issuing debt with our eyes closed and debt service payments were really low. But as you get into 2024, you get more corporations needing to refinance at higher rates. You have the government now having to roll at interest rates that are 400 basis points higher, 300 basis points higher than it was, it is really going to build. And that is, you know, I think yield curve inversion is going to take longer to have an impact simply because of when we fixed floating rate vulnerabilities of the last of the two, early 2000s we kind of broke some of the key mechanisms of monetary policy. It's going to take longer for the brakes to slow the machine, but they are absolutely going to slow the machine. It's just going to take longer. And I think that it's going to be a different channel. It's not going to be the household, it's going to be corporate and it's going to be government.

Ryan Caldwell (00:34:49):

Lara, if you're bullish, how from here, and I can't answer this question. I've been asked it and I have no good answer, so I'm throwing it to you. How do you get to a steeper yield curve? How do you get a gentle bull steeper?

Lara Rhame (00:35:07):

Gentle, the problem is the gentle part.

Ryan Caldwell (00:35:14):

That's why I said it that way. Yeah. I wanted to, because you have to believe it's gentle, right?

Lara Rhame (00:35:18):

Yeah, I see it as a neutral, neither bullish or bearish. Okay. I see it as, I think the Fed is going to fight any return to the zero lower bound. Yep. Because I don't think they're comfortable there. I think they want to see the Fed funds rate more like two, two and a half, where like it never really is. They just, that's their neutral rate and they never managed to live there. They always had to live either way above or way below. But I still think that, that's where they would like, and then I think the long end, and I was just having this discussion today because I keep having people say to me, especially some of our younger colleagues, oh, you know, interest rates are really high and I'm, you know, gob smacked because the ten years at 375, 385.

Ryan Caldwell (00:36:11):

Well, relative to zero.

Lara Rhame (00:36:12):

Relative to two or one and three quarters, it's high. But if you think of long run inflation between two, two and a half and then some kind of normal term premium on top of that, you're looking at long-term rates at four to five. And I mean, that would be ideal. That would be healthy. The bankers would love it. Sure. So to me it's a neutral steepening. It's not a bull steepening.

Ryan Caldwell (00:36:40):

So you, I want to just touch on a quick thread and then move.

Lara Rhame (00:36:43):

But that to me is the best case scenario. That's the goldy locks.

Ryan Caldwell (00:36:45):

So like what you brought up. So Danielle De Booth has been making this point, I think she's dead on that Jay does not want to go back to Zurp. Yes, I agree. Think what you want about Jay and hate Jay, love Jay, whatever you think about Jay. But like the message the market is not gleaming from this Fed is they are trying to break zero and Zurp.

Lara Rhame (00:37:09):

Yes. I would agree with that. And I think that if the Fed is making a mistake, it's not being more explicit about that.

Ryan Caldwell (00:37:17):

Okay. Okay. Okay. I just wanted to tease that out for listeners. I think that's huge.

Lara Rhame (00:37:21):

Because I think that is a huge communication mistake. Yes, I agree with you. And I think if I were them, I would be hammering that, like this was an emergency. We did it after a once in a hundred year financial crisis, and then we had like a global pandemic. And now going forward, if we have a recession, and I think this is where I may be out on a limb, but I think if we have a recession, they are going to take the stairs down, not the elevator to zero and try to get us at a landing place that's more like two.

Ryan Caldwell (00:37:58):

Like I think look salient point, like put a big star sticker on that and circle it. Right. I agree with you. The lack of communicating that is what's allowing this curve to so deeply invert because the market's saying you're going to zero at the first problem, you're going to zero. We'll have a curve that's 200 steep because you're at zero. And it works out that way.

Lara Rhame (00:38:21):

That never occurred to me. And I think this is why I find these conversations so valuable, Ryan, because I feel like you bring it to the financial market so clearly. And I think you're exactly right. I think that's it. Because you know, when I look at long-term rates that I know that you and I, and you know, we have an ongoing discussion about this,

Ryan Caldwell (00:38:40):

Which you're winning by the way. Well, I mean I don't know what winning is, but I feel like I'm going to end up watching the movie and Aaron, we won't make you edit it out this time. Yeah, but right now, I'm more on track to watching the movie than you are if we were.

Ryan Caldwell (00:38:56):

I think if we were settling the bet July 28th or seventh and for our listeners, just as a joke, I obviously had when we started the year, you know, we found a very awful movie to watch. And the bet was like if rates were substantially lower long rates at the end of the year, or Lara had to watch the movie if long rates were not lower at the end of the year, I had to watch the movie.

Lara Rhame (00:39:18):

Well what is going to happen? They're the same. They haven't moved. And we started the year at 385. Now that it's still 385.

Ryan Caldwell (00:39:24):

I still feel like that's a win relative to my forecast. Right. So I am just saying.

Lara Rhame (00:39:29):

This is mean we both got out of watching the movie.

Ryan Caldwell (00:39:31):

Yes. Maybe can I settle that bet now and I just parlay that into something else.

Ryan Caldwell (00:39:39):

But I think it's just a key point. It's a key point to back to 20 times forward earnings, Mr Equity market. You got to believe that, Lara, you have to believe that to hold the multiple.

Lara Rhame (00:39:50):

Yeah. Well, so Q2 was supposed to be the trough in earnings. I know. I mean, this is where I get to ask you questions about earning season because I keep my eye in the headlines, but I'm not in the weeds. And it seems there have been story and story again about how companies are having to cut price if they want to maintain the sales volume and from there, so that's the margin compression and margins have stayed pretty generous. I mean, we're starting at a high level of margin. But if earnings, if this is the trough, what is the accelerant for the second half of the year and what is the guidance looking like?

Ryan Caldwell (00:40:33):

So, no, really good question. And here's, I think here's the dilemma. I actually want to section off AI for a minute to make the point more explicitly.

Lara Rhame (00:40:42):

That's what people, well probably really want to talk about.

Ryan Caldwell (00:40:44):

Well, no, but what I would say so far, Lara under the hood is a little bit like your Bloomberg economic condition surprise index, which is the numbers got cut enough, you know, into kind of the second half companies are over the bar, but not by much. And they're not by much because they beat a little bit on the margin with cost discipline and supply chains loosened up. And you wrote about this as well and the piece critical point, right? I have never seen in my career the number of supply chain driven misses and really good management teams over the last year. People that really know what they're doing got surprised left and right. So there is less of that now because it does feel like with China open and global trade kind of moving through the pipe that there's less of that.

(00:41:36):

But here's what you are seeing, Lara, the top line's not accelerating. Yeah. Right. So, for listeners, I was telling Lara this before we got on the podcast, Microsoft's a great example, and again, I'm not picking on Microsoft, but I want to frame the argument. The argument around Microsoft is can the company grow the top line at ten next year? And you go hmm ten, okay, there's a debate about ten now remember ten was supposed to be in the bag because they had AI, this is why I wanted to section off AI for a minute. Yeah. Right. To talk about the numbers underneath the surface. Every business line's decelerating, everyone is slowing down,

they're not accelerating. So again, they report, you know, the stock was up, now it's down. But like the business lines are all decelerating. The management team is talking about cost, discipline, and yes, cloud's growing, but it's slowing. So again, you go from 50 to 40 to 30 to 20, it's still 20, but it's not 30 and it's not 40. And so if the debate around the company is, can the top line grow nine or 10 find debate, but the stock is trading 35 times forward. You don't get 35 times for kind of high single digit top line growth that's decelerating.

Lara Rhame (00:43:00):

It's hard to justify.

Ryan Caldwell (00:43:01):

It's very hard to justify. And in Microsoft's defense, they didn't upside that. The forward guide was kind of right on the number. What we keep seeing out of the guides are rate on the number, rate on the number one quarter out with no length and duration. The only companies where we've seen some lengthening duration of the forecast, it hasn't been good. Right. Like semiconductor companies, that's a really good bellwether for the global economy. Lara, they keep pushing out the recovery in things like cell phones and PCs and now even auto and industrial that's slowing down. It was rip roaring for the first cut.

Lara Rhame (00:43:41):

It's absolutely slowing down.

Ryan Caldwell (00:43:42):

It's absolutely slowing down. You look at auto production and go, well of course it's slowing down. It should be slowing down. So I think to your point, that's why I'm so I think kind of flummoxed at the forward multiple because it's assuming from here that the E is going to accelerate. So I can't get my head around the problem of it's either margin or it's top line that accelerates that. So Lara, are the margins going to get better or is the top line going to accelerate? That's the bet you've got to make. And they're not telling you either one of those.

Lara Rhame (00:44:19):

Yeah. And I think layer onto that, the fact that this assumption that things are going to accelerate from here is a scenario in which the Fed holds rates where are or even continues to have to kind of like every other like chip away, chip away, chip away at that liquidity. And those two don't reconcile. So again I think that both sides of the market narrative right now are vulnerable to what I think are the, the tectonic plates of how tightening works and the time that it takes to work through the system. It's going and to other headwinds that are just gathering for the economy.

Ryan Caldwell (00:45:10):

Well, and Lara, and again, maybe now to pull the AI piece back into this discussion. Yeah. Just look, it's kind of colored everything we look at and even economically, you're going to get sucked in I'm sure to having to write some paper about what AI means to the productivity of the economy and how do we think about that? You're going to, I know it's coming. Here's the thing that's so interesting about this. So, Microsoft, everybody was positioned in Microsoft for their Nvidia quarter. So repositioning our listeners last quarter, Nvidia had a blowout on all the chips they sold to all the big hyperscalers that are built for AI, large language model training or what we call training. So, we revalued a large part of the market around the benefits to this and of course there will be benefits, but Microsoft comes out and they say, yeah, we had a great quarter in AI, it went from 1% of our revenue, 1% of the business to 2.

(00:46:05):

TSMC the largest foundry in the world. All they do is chips. All they do is alien technology, advanced chips. If you want the stuff that you can fit on, you know, a pin needle to drive you, it's TSMC, they said that AI was 5% of their business in the quarter it's growing 50 and in five years it'll be about 15% of the top line in five years. So when you look at the pull forward to the story, the early conclusion is really good for Nvidia. They have the chips, the people need to build these large language models and train them. But the deployment of this is see you in five years. Yes. And I think the smartest kind of commentary I've seen around this in regards to the economy I got from Mark Andreessen and Andreessen Horowitz and he said look Ryan, here's how we think about this.

(00:47:01):

Making a more efficient model for search who caress Google search is really good. He is like what is it you can't find on Google search that chatGPT is going to find for you? Probably not much. He's like, look where the renaissance in this is going to be is he is like, and this is how we're betting at an Andreessen Horowitz and he's been very vocal about this is, you take your average doctor. And their diagnosis and the inefficiency inside the healthcare system, you go, wow, AI can do a lot there, but like in terms of making your social media feed better, eh.

Lara Rhame (00:47:43):

Right.

Ryan Caldwell (00:47:44):

Right. It's already about as good as it's going to be. So his point in that is saying the market revalued all these big social media companies micro and said, these are the winners. And his argument is they're not going to be the winners weight rate here. The winners are going to reside in places that you don't see yet and it's going to take a long time to manifest.

Lara Rhame (00:48:05):

I mean, I buy that because I think we've just been watching this evolve ever since the tech boom of the mid nineties. Remember telecom stocks couldn't fail. I mean that was all about telecom and, and we saw the shakeout and some of them live and some of them are amazing and some of them die. So I think I go back to the work that we did with Brian Cho, your partner about the power of capital spending and the impact that it has on markets. Because I think when I hear talk about AI and all of the opportunity, what it sounds like to me is dollars that are going to have to be invested in putting the hope into practice and that markets punish that those management choices and the investment choices. And there's a rocky road from here to like the dream come true five years from now of harvesting all these gains.

Ryan Caldwell (00:49:13):

I think brilliant point. I'm glad you made it because I do think that's the joke. Is to get from here to there, the market is pulled ahead, all the benefit with none of the cost.

Lara Rhame (00:49:27):

Yes, exactly and when I hear, oh, we're going to be implementing this, we're going to be implementing that. I mean, I know we had, you know, again, COVID has caused so many fascinating waves and then counter waves. So we had all the tech hiring in 2020, 2021, 2022 was, you know, finally I think was some right sizing of that. There were tech layoffs. Those have really, you know, largely stopped.

Ryan Caldwell (00:49:52):

Kind of go the other way.

Lara Rhame (00:49:53):

Right. And now they're hiring again. Yeah, exactly. Don't tell anybody on don't say that's on ring's call.

Ryan Caldwell (00:50:01):

I totally agree.

Lara Rhame (00:50:02):

I think from here to there, and I think the days of dropping hundreds of millions of dollars into the metaverse maybe, I don't know, I don't mean to pick, I'm not a stock analyst, so I don't mean to call it any particular firm, but I think there were some heavy spend dream projects that were punished in the equity markets. I think it'll be more rational than that. But, you know, as Brian Cho's work showed, markets don't like investment spending and it's not good for free cash flow margin. And I think that is how you're going to have to look at this as an equity. I mean, I put it to you, you're the man behind the curtain pulling the strings on the portfolio.

Ryan Caldwell (00:50:46):

Look Lara, it is a perfect discussion into a second half slowdown argument because what went on with those stocks in the first part of the year was cost cutting. Yes. It wasn't some magnanimous re-acceleration in the top line. It was that they got CASP capital DI Zuckerberg stopped spending on the metaverse. Right. Yes. To your point, Google, Microsoft, all these guys had excess labor. They over hired they shed the excess labor, they didn't fire all, they didn't cut to the bone. But what they did was they sent the signal to Wall Street that we're going to protect the margin. We hear you, you took the stocks down 60, we're going to protect the margin, we're going to slow down CapEx, blah, blah, blah. Where they didn't slow it down was obviously in hyperscale chips for large language models. But even yesterday, Lara, as meta reported, you know what everybody was looking for in the report, it wasn't ad spend. Yeah, ad spends got to be okay. And it was, but it's single digits, Lara, this is not the Facebook. Of three years ago that was growing ads 20, 25%. You're growing like five, six. So coming back to GDP as you would expect. Whatever nominals are to of these businesses tend to be revert. Everybody was looking at CapEx. Are they going to accelerate CapEx? Yeah. And they didn't so the stock's up.

Lara Rhame (00:52:11):

Yeah, there it is.

Ryan Caldwell (00:52:11):

There it's, but that is such a different argument than the business is booming and they're guiding up into the. They're not, so to your point, the minute this is sort of revealed that like, oh, we actually have to hire some programmers and we got to spend on this and we got to put things on the ground and CapEx can't come down to the degree that Wall Street wants it to come down for the free cash flow margins. What do you pay for that? It's all back to like the forward multiple starting point. You are saying slower these things are grind. It's not a linear, you know, easy path where you just get all the margin with none of the cost. I think that's exactly the argument of like, it's just friction costs. It's hard. It's not easy. And I think Mark's point is salient in this regard. I don't know how much faster or better you're going to deliver me an ad on Instagram to make me do something that I'm not already doing. It's really efficient.

Lara Rhame (00:53:06):

And this has been the perennial productivity conversation. That I get into all the time.

Ryan Caldwell (00:53:14):

Yes, that's it.

Lara Rhame (00:53:14):

Oh, technology is going to make us so much more productive. And there are clearly ways where that's happened, but then you look at other, you know, every time that I'm at the grocery store, checking myself out at self.

Ryan Caldwell (00:53:26):

Do you feel like technology helped you?

Lara Rhame (00:53:27):

Is this really a productivity enhancement? I have to question that, you know? And you look at how much more time we spend on our phones because already the algorithm is so good at making me stay on my phone. That's not productivity. You know, me looking at cute puppies for hours is not productivity enhancing.

Ryan Caldwell (00:53:47):

No, and by the way, back to Marxism, you just became Xi Jinping on our podcast by saying this is non economically productive. Which by the way is entirely their argument, right? Yeah. Which is why they rip those companies apart and said this is non-productive to GDP. And they're probably somewhat right in that argument.

Lara Rhame (00:54:07):

Yeah. I mean I get into this discussion a lot about productivity enhancement. And I, that's not to disparage the innovation because there's clearly advancement there, but it's to make the broader point that AI sounds great. There's going to be some applications that are going to be radically productivity enhancing and others that are probably just going to cause us to waste even more time than we do right now looking at our phones or whatever.

Ryan Caldwell (00:54:38):

Absolutely, all that to say Lara, like AI does not lead to numbers going up in the next 12 to 24 months. And I think just to land the plane, to say that's evident. You can now say that with certainty to go it's not in the here and now.

Lara Rhame (00:54:53):

Yeah, exactly. I mean there, there is no doubt that there was an euphoria. I think that was kind of a perfect storm of a sigh of relief that inflation's, you know, off its tippy top and is did that disinflation is more broad that we didn't have a recession and you sprinkle on, you know, the innovation and markets love a tech rally. It's comfortable, it's what we've had, you know, it's what gave us. Nothing's feels better than a tech rally.

Ryan Caldwell (00:55:25):

Totally agree.

Lara Rhame (00:55:26):

Yeah. So, it's kind of this perfect storm of euphoria in the first half of the year, and I think second half of the year is where reality bites to use a Gen X to throw back of our.

Ryan Caldwell (00:55:37):

I love it.

(00:55:39):

So, sticking down on your list, and I want to pull at this one, and you said consumer savings rate, balance sheet back half of the year liquidity. I just made that one big blob, but look when you look at the global economy now in our, in our esteemed colleague Troy Gayeski, who I love, keeps making this point, it's all about the US consumer now. China is not going to save you, Europe's not going to save you. It's all about the US consumer. And it's kind of is. I would laugh and go, okay Troy, but it's like, yeah Troy, you're actually right. It's now been out down to the US consumer. Because the Chinese aren't going to help you. And look, the European rally will look like, you know, a bunch of weather related nonsense because they're in a recession.

(00:56:23):

Yes. And like sideways and China's in again, whatever the official numbers are, it's a recession, right. Or pushing on the string or it's Japan or whatever you want to call it. Yes. So consumer. Like what are the signposts? I get unemployment, right? And if the unemployment rate goes up, people are going to get very nervous and if it goes up in an uncontrolled way, they'll panic outside of employment and employment's, if you want to wrestle employment, let's get into it. What are you looking for in the consumer for flashpoints? What's the, because the bulls are saying ah, gotcha. Right, because you said you were going to have a recession if you get one. It's got to be the consumer. If you look at the consumer, they're holding in even through high rates and housing prices and all these things and they're still employed and it doesn't look like there's going to be massive employment. So you don't get your slowdown. So what are you looking for in consumer? What should we be looking for? And then I've got a sidecar question I got to ask you on the high end. That doesn't make sense to me.

Lara Rhame (00:57:23):

So I think we have travel and leisure I think is really an important leading indicator. I think you know, emerging from the pandemic, that was clearly a place where we have spent a significant amount of money. And so I think that is going to be an important leading indicator because that's something people really plan for.

Ryan Caldwell (00:57:45):

Yeah, that's right. That's a good point. Yeah that's forward.

Lara Rhame (00:57:47):

Have really budgeted. I think they have spent a lot on travel and there may be, I would expect, you know, when I see airline fairs down and I see airlines slashing, you know, airfare and giving special offers to me it's like, oh, people aren't expecting to travel over the next year as much as they were over the last year. And that's, to me has a cascade impact.

Ryan Caldwell (00:58:12):

Which sounds exactly what American Express said on their call back to earnings. Yeah AmEx they guided down volumes in travel. They guided down volumes in corporate travel like Vegas travel. I always struggle how to, you know what I mean? Convention travel forward bookings. Sure. That stuff all slowed, right? They whacked the stock that day, but they talked exactly about that point about travel and leisure slowing forward booking slowing.

Lara Rhame (00:58:40):

Yeah, I think that, so to me that is something that I'm watching really closely and I think I just wanted to spend a minute talking about housing because.

Ryan Caldwell (00:58:48):

Please. Yeah it's absolutely critical.

Lara Rhame (00:58:52):

Yeah, because I get asked this a lot and I just want to be very clear about it. Because a lot of people are like, oh look at, you know, and actually we just got GDP numbers this morning and housing did detract again a little bit. But I want to talk about how housing hits the GDP numbers. Because remember, if you buy or sell an existing home, that does not impact GDP, that does not show up at all. What shows up is if you buy furniture that new home or if you remodel the kitchen, those things show up. But housing, residential construction, which is new homes is a very small part of GDP. Very small. I mean talking like 3% give or take. And so we do, after two years of that being negative, we do, you know, I was surprised it wasn't a small addition to GDP, we expect it to start adding to GDP soon.

(00:59:47):

It's not going to move the needle very much on growth. And the reality is that because we're still seeing this extremely low number of existing homes sold, low inventory, it's a story we're all familiar with in our local communities. It is just slowing the flywheel of all the activity that comes with buying a home. The jobs for the, on the refinancing side, the finance, the mortgage, you know, guys, the jobs for the realtors, the jobs for all of the economic activity that comes after you buy a home. So I think there's still going to be a drag from this. And I think, you know, right now there still is a little bit of like, people are going to stay in their homes so they're remodeling their homes to make them nicer. I think we have to look at that and see how that progresses. Because, the home builders right now are still really, you know there's a ton of demand and that doesn't seem like it's going to slow down anytime soon. We'll see if eventually interest rates kind of, you know, again, a lot of these guys we're still building off of loans that they had, you know, a year and a half ago. We'll see how that keeps going. But it's still looking strong just given supply constraints.

Ryan Caldwell (01:01:03):

Look Lara, and I mean one of the things when I look at housing that looks interesting is like, look, I used to cover my first job at the old place was covering home builders, right? So that was my first like, oh you're an equity analyst, you get to cover something. Because nobody ever wants to cover home builders because they're really hard. The thing that's interesting about what's going on in this cycle is there's a ton of rate buydown going on in those, right, in those companies at the moment. The Lenar, the ess, the tolls, right? They're doing a ton of rate buydown to get people in because there's so much margin in the land. What people don't ever realize about home building stocks is it's not what happens above ground, it's the ground. And again, these guys had land banks that were six, seven years old. So when you reprice the asset, like all of a sudden their margins exploded. So they've been able, as they've turned, been able to turn community to buy down rate to get people in.

Lara Rhame (01:01:57):

A really good point.

Ryan Caldwell (01:01:58):

Even now looking at that though, in some of these markets like Florida, California, California maybe its own little issue. Texas, you're starting to see big price reductions and bigger rate buy downs even of the DR Hortons and the pultes. And again, these guys are going, but Right. You're seeing some price sensitivity even at the beginning of front end construction because you probably drug the people into the housing market that you are going to drag, right. With new homes. And like, and for now you have like inertia. What I was actually, what I wanted to tickle on, I made this note to you is do you believe this narrative that's starting to creep around that lower rates will lead to lower housing prices because of the supply reintroduction. If rates actually did come down that it wouldn't be good for housing prices because all of a sudden that latent supply is going to hit the market and there's not nearly as much demand if existing supply comes back to the market relative to what it looks like today. It's, again, I have no idea, I haven't put my thumb on the scale here.

Lara Rhame (01:03:04):

Yeah. I think we're still, so for as much building as we've seen Yeah. And as much I think concern about an oversupply of multifamily of homes.

Ryan Caldwell (01:03:16):

That's where I was going.

Lara Rhame (01:03:18):

We're still so behind in housing.

Ryan Caldwell (01:03:20):

Yeah. That's where I was going.

Lara Rhame (01:03:22):

And I think this will be something that, you know, again, I'm fascinated to see how this plays out over years. I think we'll look back Ryan at this Covid period and feel like we've witnessed one of the biggest migrations in our country.

Ryan Caldwell (01:03:40):

Yeah, that's very right.

Lara Rhame (01:03:41):

That we've in our generation, at least in our lifetimes. And I still think that, you know, if you look at the places that have exploded in population, they don't have the number of homes. Inflation there's higher. Rents have skyrocketed. There's going to be waves, counter waves. I mean I just think it's going to really take a long time to play out. Because you can see a pandemic and want to move to Florida, you know, Asheville, North Carolina, right. Or to the sunbelt state. And then you maybe get there and like two years in you're like, it's still too expensive. I still can't find a, a place to rent and it just takes time to find these new equilibriums.

Ryan Caldwell (01:04:22):

Yeah, I mean I think the really thing when I kind of pull apart the income cohorts, and this was kind of my closet question to you of weirdly, I'm a bit more concerned on companies that are more tied to the high end than the low end. Because I think if we had pull forward, and here's my anecdotal, right? When I look at supply, we'll started housing and I'll end at handbags, because I think I can probably pull that together.

Lara Rhame (01:04:52):

I love both of those subjects.

Ryan Caldwell (01:04:53):

When you look at four and five star housing supply, we're building a lot of it. A lot of it. Yes. Right. And that requires a lot of income. Again these aren't the per square foots are going. And even in multifamily, what worries me about multifamily is not multifamily because I think you probably do need a lot of entry level to first time buyer in a lot of places. We're just building it. The problem is they're building a lot of four and five star units that are at really high rents that people that have money would go, I'd never do that. If I can afford rent that's six grand. I'm going to wait it out for a house. I'm not moving into your five star luxury apartment unit. So what worries me is and you hit me over the head with this offline and you said, I just don't know if it's a national issue or if it's a regional issue. And I was like, aha, that's the answer. It's going to be a regional issue. Sure. We're going to get someplace like Bentonville, Arkansas where everybody was like, I love Arkansas and I'm moving out of the city to Bentonville and there's trails and I'm going to climb mountains. And two years later they're like, what am I doing here?

Lara Rhame (01:06:01):

Right, I can't get a job or my company want me back now.

Ryan Caldwell (01:06:05):

So, I think like your point, and then so I wanted to tie that back was to say, Ooh, it's probably a regional issue, which means it's a rolling issue. It's not a one-time issue like 08. And so if there's an issue, it's likely to be regional enrolling. And then my question to you is back to the high end. When I look at the high end, I don't get it right because stock prices are up, housing prices are up and the most acute slowdown I see is at the high end. You've seen it now at remort, LVMH the other day American Express talked about it, the high end is all of a sudden not spending. And so, that was my big podcast question to you was, why? Right? Why is that consumer the first one to stop spending?

Lara Rhame (01:06:52):

Well I think there's a lot of international consumption in there, right? Okay, sure. Even slower economies in Europe and this is even US.

Ryan Caldwell (01:07:00):

Just looking, so if you look at Lou, so let's take Louisie, right? Because they just reported LVMH was growing us only business mid-teens a year ago this quarter flat.

Lara Rhame (01:07:12):

Oh wow.

Ryan Caldwell (01:07:13):

Missed a Lot.

Ryan Caldwell (01:07:14):

Same thing. Growing 20 in high end watches. Is this quarter flat?

Lara Rhame (01:07:18):

Yeah.

Ryan Caldwell (01:07:19):

That's a huge slowdown given that, again, global economy, they're still travel, right? The Asians are out spending, the Europeans are out spending, everybody's out traveling and spending. But when you looked at U.S. only it just stopped.

Lara Rhame (01:07:35):

I mean I think that this, I chalk up completely to covid fatigue. You look at like, I mean my other is the Rolex Daytona price index is the down pretty significantly.

Lara Rhame (01:07:50):

Yeah. And I think, you know, it's a combination of people that probably shouldn't have been buying those things, got stimulus checks and bought those things. And a combination of, you know, we bought five handbags in one year. And so now you're like, okay, I'm done for a little while. Yeah. So, I think that that I chalk up and I think again you look at growth, you think about the small decisions made in every household that combine to an economy of less aggregate demand. I think that is a big piece of it. There's some spend exhaustion and some I think going to be some right sizing of household balance sheets that have realized that we need to now be a little more reasonable with our spending expectations.

Lara Rhame (01:08:39):

Excess savings are gone too. So that's going to add to it.

Ryan Caldwell (01:08:41):

It's just at a minimum it's then I'm just writing the note, it's just mean reversion, right? We've just got to have some balance, consumer balance sheet mean reversion.

Lara Rhame (01:08:50):

I think that's what is, I think the mean reversion is the second half of the year and I think Fed tightening is going to tip and is going to cause mean reversion to overshoot.

Ryan Caldwell (01:09:04):

Gotcha. Okay. You just landed the plane. Perfect. Yeah. Like that's it. Perfect. Okay.

Lara Rhame (01:09:10):

To together we got there.

Ryan Caldwell (01:09:12):

So, okay. So last one out of this brilliant piece, and again, nobody wants to talk about this and I get it, but Washington and rates and what's happening and the financing costs of all that's gone on and honestly Lara, it's the Stan Druckenmiller gorilla in the room that nobody will talk about, which is what do we do about this? And if you got to stay higher for longer, how does this bite.

Lara Rhame (01:09:43):

It's the other inconvenient truth.

Ryan Caldwell (01:09:45):

Can you give the functional because I think people shove this in the corner and say it doesn't affect me day to day, so therefore it does not exist. But it clearly exists. And your point I thought earlier was brilliant, which is yeah. You know, we've done a lot of funding on the front end and one might argue why you're doing that and next year you're probably not going to be able to do that. So when you think about Washington and you think about the interest load that's coming, and you did a great job in the piece, like the visual of like debt interest payments exploding that chart you have on page four, bottom right. It's a little bit of the deficit hawk, it's like porn for them. It's like see told you there it is.

Lara Rhame (01:10:31):

Yeah.

Ryan Caldwell (01:10:32):

I'll know it when I see it and there it is.

Lara Rhame (01:10:34):

And there it is yeah.

Ryan Caldwell (01:10:35):

So can you talk through that just for a minute? How does it actually impact the consumer, the economy, the markets? How does it bite? Because it's real.

Lara Rhame (01:10:46):

You know, when I am out talking to advisors and when I'm talking to their clients, it's probably one of the biggest things that I get asked all this time. And I think for years the answer was, yeah, we're issuing, you know, hundreds of billions of dollars of debt, but interest rates are so low that we're just, you know, that you're not seeing the interest costs rising. And that just has complete, first of all, we actually did issue so much debt that even if you assume that rates stay low or sort of return to a very, very low rate. And what I did actually in that piece was I proposed three different yield curve scenarios. And one of them is the congressional budget office baseline, the other one is a very low interest rate profile, very low. Which should scare us if that comes to fruition because that is a stagflation scenario, which would be terrible for equity markets.

(01:11:45):

And in that scenario you still get interest costs rising enough to be, you know to chip away meaningfully at discretionary government spending. That's how high our budget deficit now is. And, and then if you get kind of just a continuation of where we are right now, which, you know, as we've already discussed, I don't even consider interest rates high against a historic context and where inflation is to be high. If you even get them, get it to stay where it is. The implications for discretionary spending are very painful. And I talked to clients, to advisors and to clients about this and it's like, what do we do about it? And the answer is prepare for higher interest rates. And if you're worried about it, you need to be saving more, which is also not good for economic growth. Because you're going to have to offset what the government can no longer give you. And you know, I mean, just go down, I don't know how far you want to look. It seems, because you talk about the next generation and it just keeps going.

Ryan Caldwell (01:12:53):

Do I get to stop at, it's still a massive fight between the beneficiaries of the grandpa versus grandson, right? Yeah. Is it still spending versus taxing? You either got to raise taxes or cut spending or some combination of both. Because once you realize the interest load and maybe more importantly the world who's the borrower understands the interest load, they're going to call charge you more.

Lara Rhame (01:13:21):

They are going to charge us more.

Lara Rhame (01:13:23):

And I think, you know, you could even bring it back, you know, even outside of this deficit conversation, when you just look at the fiscal impulse, which has been, again, such a tailwind. Yep. Next year it is likely going to detract and if the appropriations isn't passed part of the debt ceiling agreement, they could just let that fall into place, which is a 1% cut across the board, across the board of government spending. And you know, I think some would argue that that's not enough.

Ryan Caldwell (01:13:59):

Well of course its not enough, but rate of change. But back to rate of change.

Lara Rhame (01:14:04):

Yes. It is certainly going to be a headwind for, for growth, into next year a pretty powerful

Ryan Caldwell (01:14:10):

Wow. So for our listeners, what I would say is, look, I don't recommend reading a lot of stuff. And I would recommend reading Lara's piece because she very succinctly goes through economy Washington, you even got markets in there. I mean, you even have the concentration of the market, right? What's gone on with bang, it was really well put together for kind of a, you know, just in general, but for a time and place where I've seen so many people flipping and the only reason I think they flipped is because the price is telling them to flip. Right? The prices that they see on the screen, as you said, spreads, contracted, poor, forward multiples, all these things have kind of forced people to change an opinion. And you've been pretty steady. Like I said, you beat me over that in the first half of the year and said, you're too early buddy. Careful with this massive recession call you got out there because maybe not yet. And right maybe a little early on that. And so I've taken it to heart, but the point is I'm not sure the condition set has changed at all. The only thing that kind of changed was the expectations around how the cake would come out of the oven have changed.

Lara Rhame (01:15:28):

To say the checks in the mail and I'm not quite sure when it's going to get here. Yeah. But I think the check's in the mail.

Ryan Caldwell (01:15:35):

Okay. So I think we end on the checks in the mail and like I said I am not a good writer. Please read all of Lara's stuff because she writes incredibly eloquently.

Lara Rhame (01:15:45):

It's a labor of love.

Ryan Caldwell (01:15:45):

Yeah. And look it really helped to pull this podcast together for me. So I appreciate all the work, so thank you as always. I love doing this. I always learn something. Really, really good work. I appreciate it. It's great. Thank you.

(01:16:03):

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.