Episode 76

3D Report: Q4 2023 Recap—The economy has to normalize

Ryan Caldwell and Lara Rhame review the 3D Report for Q4 2023

Ryan Caldwell (00:01):

This is the 3D report, a podcast from FS Investments and Chiron. I'm your host, Ryan Caldwell. Welcome back to the FS Chiron 3D report podcast. This is Ryan Caldwell, and today I'm joined by my colleague, an esteemed economist, Lara Rhame. Lara, how are you doing?

Lara Rhame (00:37):

I'm good, Ryan. How are you?

Ryan Caldwell (00:38):

Well, it's been a quarter, that's for sure.

Lara Rhame (00:41):

It sure has. I think upside surprises, downside surprises. We got to figure out what it all means for next year.

Ryan Caldwell (00:48):

Yeah, yeah. So I thought what we might do, Lara, is as opposed to the unstructured mess of a podcast that I normally throw at you, I thought maybe what we would do is maybe hit some of these sort of flash issues that have really set the table to end the year and are probably kicking off, will probably be the issues that kick off the year next year. And I have a little bit of a cheat code I get to sort of hear and see what you're writing and saying because you're out there quite a bit. And this was a little bit of a weird quarter actually for me because I feel like I spent a lot more time on companies than I did on macro. It kind of felt like I had the macro figured out and lo and behold, come November, December...

Lara Rhame (01:36):

That third quarter of growth just walloped us all. I mean, nobody had that in their forecast.

Ryan Caldwell (01:40):

Yeah, no. So I thought maybe I'd use you as a tool to dig back into some of these things that I think have become somewhat consensus and maybe feel around where you think kind of the ball moved to and maybe where you think it ought to be versus maybe where it's moved to, if there's any difference and maybe go through the issue. So that was what I was hoping to do, set up into '24 as to what's grinding on you and I'll lay out what's grinding on me.

Lara Rhame (02:07):

Okay. So here's my list, in no particular order, let's start with growth because I think looking ahead to next year, I find myself in much the same place that I was this time last year where I

look ahead, I'm like "growth is probably going to be slower." And as you recall, I laid out a lot of really thoughtful reasons for that. And these include inverted yield curve putting outside of the clear signal that it sends about high probability of recession. It just puts inherent pressure on the banking system and gives us that credit, that slow credit squeeze. So that's one. Two is that we are growing and we were this time last year well enough above potential that it is just unlikely to continue at that pace. And that may sound like a cheap answer, but over time we really do trend around our potential. And so given that so much consumption was fueled by excess savings, it made sense that consumers were going to pull back after such exuberance in 2021 and then in 2022, so think of this last year, it was 2022 and yada yada...

Ryan Caldwell (03:22):

The COVID period as it's affectionately called out.

Lara Rhame (03:26):

Right, exactly. Yeah, as we lovingly remember it. And then I think finally the third leg of the growth story is the fact that higher interest rates don't just impact the banking sector. You're going to see businesses feeling the pressure. We saw really the Fed raising rates so fast when I think in March the regional banking crisis happened. That was a lot of our worst fears realized. When they go that fast, they usually break something and they did break something, something broke, two banks broke, and third, if you count Credit Suisse, which was more of a slow meltdown. But those three things together really had made me expect slow growth this year. And what we have just seen is just momentum. And I won't even believe it. We all are in it. This momentum coming from really I think all cylinders of the economy, government spending, the infrastructure package has really just given us this significant tailwind.

(04:23):

It has also helped to power business investment, which has been really robust. And finally, households just have not skipped a beat. They have just kept spending. And the third quarter was really exceptional. We had just this supercharged consumer and it's been services, it's been good, it's been everything, and it just shows no signs of stopping. So I find myself today looking ahead to next year thinking this can't continue. It has to rationalize, it has to normalize. And in the back of that is last year me thinking we were going to have a recession this year. Not only did that spectacularly blow up my face, I'm not beating myself up about it too much, Ryan, because I wasn't alone. But I think next year I'm trying to focus less, even though I still, I'm doubling down. I still think there is a significant risk of at least one quarter of negative growth, if not a more sort of classic version of a recession, mild, but recession. So I still think that is a heightened risk, but slower from here is still the forecast. My GDP numbers one and a quarter for next year. That is not far from the consensus at all, but it is definitely slower from what 2023 is likely going to be, which is around 2.8%, almost 3%. So just an incredibly strong pace of growth.

Ryan Caldwell (05:45):

Yeah. Lara, I thought and I mean, maybe a couple of things around that. I want to poke on a few things that you brought up, which I think...

Lara Rhame (05:53):

And I didn't even get to the Fed, so...

Ryan Caldwell (05:55):

Look, we'll do a lot of laps on that. But I think you kind of pointed out I think three legs of the stool. I just wanted to pull on just for a minute, consumer government spend. Because look, if I wanted to say what did I miss? And I think generally speaking, a lot of people miss this year, and

you rightly pointed out the consumer was wildly stronger than everybody thought. Given where rates went right after the kind of deluge of spend in 2021 and 2022. Although now all of a sudden maybe that's starting to slow down a little bit. So I'm giving you a little bit of relief here in December because it does feel like some of the slow down metrics are starting to show up a little bit. We'll maybe get into some of those, but consumer definitely that's the one that all of a sudden I think there's more debate about. Do the higher rates continue to bite into the consumer?

(06:50):

You burned up excess savings and maybe there's some rationalization of labor. So a little bit to kind of lean into your argument, government spending. That would be the other thing. I would jump up and say, I'm an idiot, right? If you kind of look back and you look at how much fiscal was in the pipe still, yes. And to your point, I missed the CapEx business investment point, right? Massive point. And again, the interesting thing is you look at a lot of these programs and they're not even spent up yet. As a matter of fact, ships act has barely been budged. Some of build back better, like half of it's still to come. And again, I know we'll get into kind Washington dysfunction, but boy, there's so much spending that was baked in the pipe that again, I just looked through because of the yield curve.

(07:37):

But boy, that was a big part. And as you pointed out, three QGDP had a ton of government spending in that number. So you can't discount what's going on the fiscal front even into 24, right? You'd think this is starting to be over, but there still seems to be a tail. And then the last kind of thing I had just in terms of 24 was we had a massive inventory drawdown last year. And again, we talked about this a bunch on the podcast through the year when you talked about retailer inventories, industrial inventories, they were all out of whack with demand. But you kind of look at the numbers now as you exit the year and at least at this level of demand, right? Inventories are really clean.

Lara Rhame (08:20):

I literally was looking at this. It's so funny. Inventory sales ratios are right back at all time lows, and that's across eight decades. So it's really extraordinary to me that we were a monument of operational efficiency going into covid and we seem like we're comfortable running inventories that lean again, we'll see if that lasts, but certainly maybe it's from protection, maybe it's for profitability or because it makes the markets happy, but companies have really drawn down their inventories again.

Ryan Caldwell (08:52):

Well look, and I think that's a key point because there are a couple of things I want to touch on because look, I think there were a couple of narratives too that were in the ether. One of them was deglobalization and what would that mean to company income statements and balance sheets? And the answer was not a right. We all, even we did had prognostications the yeah, you're probably going to hold a little bit more inventory. The margins are going to be under pressure. And none of that happened, right? To your point, managements went back to the ruthless, if I don't have margin, wall street's going to fire me and effectively managed right back to 2021 margins. Which again, I think if you were going to put a gun to my head and say, what do you miss outside of government spending? I would've said, if you would've told me the free cashflow margins of the market, we're going to end the year at 21% for the core of the market, I would've said, you're nuts. It's not possible. And man, that was a story. So to your point, growth plus corporate efficiency gives you big number in s and p. And again, and to your point, you had good economic underpinnings of growth. I don't want to dismiss that point because it was not, to your point, nobody had that, right? When I look back at kind of where forecasting was to start the year, generally speaking, it was pretty doer. And to your point, the upside economic surprise was evident all year. It just got you all year

Lara Rhame (10:12):

Again and again and again, again and

Ryan Caldwell (10:14):

Again and again. So

Lara Rhame (10:15):

Including this acceleration into q3, we saw that from

Ryan Caldwell (10:19):

The

Lara Rhame (10:19):

Growth August. We saw that from growth, we saw it from the monthly numbers from the, I mean it wasn't even just strong. It was an acceleration again. So

Ryan Caldwell (10:29):

Yeah, the summer,

Lara Rhame (10:30):

The late, that's where we find ourselves today.

Ryan Caldwell (10:32):

The late summer was so strong, and again, maybe if we can fast forward a little bit now talking about December into the first quarter, I had that thought too. Well is some of just what we've seen. We saw the Thanksgiving numbers and it was come in pretty good just for our audience. Laura and I are on a weekly research call and Laura made a really good point on our Monday research call where she was like, everybody keeps burying the consumer and then you throw out an event and they show up. So they hadn't been spending, hadn't been spending, everybody had their credit card data for November out. It's terrible. Here it is. And then you see the Thanksgiving retail sales and they just hooked up massively. I think what I was going to just kind of prompt you on is again, back to 24, it's a little bit of waiting for gado. Do you get it? And if you get it, how late in the year does it need to be that the consumers used up all their excess savings and the unemployment rate starts to affect them, which I want to get into the unemployment rate with you too just when we get there. But that was my first thought for you with consumer is like, when does GADO show up? When you think about even the quarters, does anything jump out at you?

Lara Rhame (11:45):

So nothing right now jumps out at me because at the end of the day when we have full employment and there is solid real income growth the consumer will spend and it's just a matter of degrees. And so I think today you're still at a broadly healthy consumer balance sheet, positive income growth, which has finally caught up to some degree from, I think one of my key themes into next year is this sort of seesaw pivot away from consumers relying on excess savings to consumption now being more tied to income growth and yet it's hard to utilize that or to lever, use that as a lever into any kind of weak consumption. Again, slower to me is the answer, but I just go back to the idea that the economy wants to grow and as the consumer is experiencing that income growth, there's no reason for them to just one day decide to contract

their spending. And I don't expect that given what the other fundamentals are. Something needs to happen to get them to move. And usually it's the job losses.

Ryan Caldwell (12:59):

So can we pick on that one for a minute? Can we go right there? Because one of the arguments again, as we get into the current here and now thinking, right, that wall street's I think coalescing around, and you'll correct me if I'm wrong, is that like, look, the unemployment rate's going to bleed up, but there's not a great case that it's going to explode higher. So if you're using kind of mean reversion, can it normalize but to explode higher? And this point was made to me by somebody much smarter than me is Ryan, if the free cashflow margins are 21%, why do they need to fire a bunch of people? And it's a really good point. It's not like the margins aren't great. So you would need a new leg down in demand almost, right, to really drive the UE rate to something that's goes from annoying to that's a big problem. How do you think about that?

Lara Rhame (13:58):

Okay, I feel like this is another where I'm just tripping myself back into talking about a recession because I keep trying to talk myself out of it and then I keep talking myself back into it. And this is the problem with the unemployment rate. It is one of the classic statistic examples of an asymmetric response that we have in economic data. Full stop. It goes down very slowly and then it shoots higher. If it goes up more than 0.7 and we've gone from 3.4 to 3.9, it's five tenths. If it goes up seven tenths, it goes up another two and a half percent and you have a recession. And so this is really one of the most important, most classic indicators and the job losses do not signal that a recession could be starting the job. Losses are the recession right now have seen this movement in the unemployment rate without any job losses.

(14:58):

I'm not trying to get fancy. I would expect right now what we've seen with the data very soon in this month, next month to see either the unemployment rate stop rising or to see job losses start coming. You really don't get that big of a move separately from each other. But this to me is something that is really important to watch and needs to be watched very closely because we're getting close to thresholds at which it does usually jump higher. And this is the animal spirits that take over again, it would be so astounding for it to happen without a real reason we've made it this far. Even corporations, I think they're staring down next year to higher refunding costs an enormous amount of corporate debt matures next year and in 2025, there are lots of reasons to look at high and fed policy and think it hasn't had an impact this year yet. It may still have an impact next year. If that's an incomplete answer, it's because I am gun shy to stand up and say, this time is going to be different. We're going to see this rise in the unemployment rate and not get a recession.

Ryan Caldwell (16:09):

No, and I absolutely appreciate that point and I'm not really either, right? I think what tickled me about the comment and the point was yeah, just looking at management behavior. When did they get nervous and fire people when profitability sucks and when the stock prices are getting destroyed and you actually don't have either one of those at the moment. And the other one I was going to hit you on a little bit because you talked about this Monday and I thought it was important, but this whole move that look, everybody that has been bearish has been sitting around waiting for initial claims to spike, right? Because the key to there, it's right. Once you see initial claims going, you can start to kind of pencil in your x plus to recession. And we've had absolutely none of that. Now what we have had is continuing claims stacking, and I think I could make the argument that yeah, if you lost your job, I see getting a new one might be harder, but I also don't see the mass rush to fire a bunch of people IE initial claims.

(17:13):

So I don't know how much of that again is symptom or byproduct of a really weird cycle or we just haven't seen it yet. To your point, and monetary policy kicks in, right? The higher for longer kicks in next year you have debt problems. The top, we haven't talked about inflation, but I am also in the camp of, I don't know how you don't think the top line slows. I don't know how you take inflation from nine to whatever it's going to land at two and a half, three, whatever. And think that doesn't impact the top line. It has to.

Lara Rhame (17:44):

Yeah. So let me just also again start with that jobs with last word about the job numbers because there are certainly signs that things are cooling down and normalizing, which is great. I mean, it's just been, so some of these labor supply demand mismatches have been enormous and very hard to reconcile. So as those normalize, I think it'll be just clearer to look at the data and understand what we're working with. But I do think that we are seeing companies be a little bit slower, and I think I might argue, Ryan, that if we were in a different business cycle, they would've already been laying off more people. But today I think there still is that little piece in the back of their minds where they're a little more worried about getting the butts back in the seats because of their difficulty with that immediately after the pandemic ended. So as we look ahead to that, to the top line, that's been I think one of the most extraordinary parts of 2023 for me as well. When I look back, it is very hard to square the fact that we've just kept these margins because inflation has come down so much. And nominal growth is probably at one of the most radical decelerations and nominal growth since the 1980s.

Ryan Caldwell (19:03):

No, well said. Switching gears, but not really. I mean, I wanted to touch on inflation and I wanted to wrap it into the Fed, and I really wanted to kind of pick your brain on this. This is probably from a market participant standpoint, the most volatile thing I think I can remember in my career. And I want to go back to the last time we talked when the SEP was out and for our listeners, the SEP is the statement of economic projections that the Fed puts out, I can't remember what cadence, Laura every other meeting or four times

Lara Rhame (19:43):

Every other meeting. Yep. Four times a year, every meeting.

Ryan Caldwell (19:46):

And so from the September SEP to today might be the most radical change in fed expectations up, down, up, down that I think I can remember in my career. And I wanted to kind of go through it with you to understand the setup into 24 because the market looks radically different December 5th than it did September 5th, at least in its view to 24. So maybe to set the table for listeners. So the September SEP, what was important about that was that the Fed effectively took rate cuts out of their projections for 2024, which really caused the market to say, oh, they really do mean higher for longer. And what you saw is a radical repricing of the yield curve, both of the short end, you parallel shifted up and the market finally said, I'm not sure that five to five and a quarter to five and a half the number, they may need to go more.

(20:48):

But maybe more importantly, Laura, at the same time, there was some consternation about funding the government. So there are two things that happened, the heavy third quarter funding calendar, and then you had this sort of parallel shift in expectations. And for those of our listeners that remember Bill Ackman coming out jumping up and down saying at four and a quarter, if you didn't short the 10 year treasury bond, you were an idiot because it was going to 5% because the Fed was serious this time, it was higher for longer, and there was a big funding calendar. So when you think about October, most of the drawdown in October was directly linked to this massive move we saw in real interest rates being repriced. And I thought finally

sort of the market giving Powell in the Fed the credit of saying, okay, they're serious. They're going to hold rates up for a very long time.

(21:41):

They're very serious about breaking inflation. And obviously in October we had very poor capital markets. It was a really bad month across the deck. It was one of those 20, 22 months where bonds got killed and gold got killed and equities got killed. Nothing really jumped out. It is a real rate move. And what we figured out if you haven't figured out to date is that when real rates go up, nothing goes up. That's effectively been what's happening in liquid markets. Then you fast forward to the CPI print of a few weeks ago then Governor Waller last week, and then the PCE print and continuing claims, and there was some data in between. And Laura, the radical repricing of the 2024 curve, so again, no fed cuts in 2024. By the time I went home and was perusing my Wall Street research over the weekend, we had now moved the first cut to March with something like 80% certainty. And there was somewhere between 102 hundred basis points of cuts being debated amongst the Wall Street talking heads. And again, one firm who'll leave nameless, but I've talked to Laura about they have fed funds at like two and a quarter by September.

Lara Rhame (22:53):

Unbelievable. So just a

Ryan Caldwell (22:54):

Shocking, shocking change. And again, bonds have rallied, equities have obviously rallied, gold has rallied, crypto's rallied. So again, real rates down, everything rallied.

Lara Rhame (23:04):

And let me just say too that when we look at the futures curve, we recognize that there's a range of sort of options that expresses if the futures curve says they're going to cut five basis points at a meeting, it doesn't mean we really think they're going to cut five basis points. It means some people think they're going to cut one and most people think they're not going to cut at all. And yet, I looked it up before I came down here, 130 basis points today of great cuts priced in. Wow. Wow. Even what you're talking about, some of the folks who are thinking of the 200 and the 200 base split camp, most of their narrative is non-res recession. It's not like that's a weighted average of non-res recession and deep recession. That's a lot of people saying, I don't think we're going to have a recession and we're still going to get these massive rate cuts, which to me is just very difficult to square.

(24:00):

I just wanted to also highlight when you talked about how fast these expectations moved, we actually didn't get that much data. We had a red hot employment number in September. We got a pretty cool one in October. I wouldn't even call it cold, I would just call it cool. And we got a bad CPI number in September. We had a very well behaved one in October, but we're still in this choppy data background and we really didn't get significant, any headlining piece of data that really caused us to wake up with a fresh set of eyes on things and just this massive rate move in the background has to me really defied expectations. And I think there's no way to me, you could tell a story where the Fed without seeing a very significant slowdown in the economy, significant rise in the unemployment rate from here to think they're going to cut so much. You have to think that there's going to be a pretty significant hit with growth and equities aren't pricing that in at all. So we've still landed in this place, and this is the problem, when expectations move so fast, the markets move in different directions, they don't catch up to each other. That's going to have to close. And that gap closing, that gap's going to be painful.

Ryan Caldwell (25:20):

Well, you just hit the ball out of the park because the thing that bothered me about that is exactly about the movement and expectations rate expectations. To be clear, what bothered me about it was exactly what you pointed out. There was no growth penalty. So when I looked at the same firm who's forecasting heavy rate cuts to get to two and a quarter by September, they had one quarter I believe of growth at point, negative point, 0.1. They're like, so it might be a negative quarter, but it's not really a recession. It's not going to last long. And ultimately, Laura, it seems to me, and we've talked about this a lot, the equity market never believed higher for longer. I never thought the equity market believed higher for longer.

Lara Rhame (26:07):

Is this them still not believing it? I mean, I think that's my

Ryan Caldwell (26:09):

Question. Yeah. I think there's no question

Lara Rhame (26:11):

That what this is. Yeah.

Ryan Caldwell (26:12):

And I think as soon as Governor Waller gave the green light of, Hey, if inflation happened to crater with no hit to growth, of course we would cut rates and the market said, see, we knew it. There it is. Right? You're not waiting for growth to slow down. If inflation miraculously dis inflates and we're back at trend, well then you can cut the front end really quickly. Soft landing, no landing, revalue out earnings in the back half of the year. That's absolutely what happened.

Lara Rhame (26:41):

The market definitely has what I call happy ears. Meanwhile, you got fed chair Powell out there saying, whoa, hold on. Weird. It would be premature to start timing near term easing of policy. And nobody's listening to the guys. Well,

Ryan Caldwell (26:58):

I mean, look, chair Powell, I think for 30 seconds on Friday affected the bond market, but it was literally 30 seconds, 30. The market said, Nope,

Lara Rhame (27:05):

You're going to cut blink. You missed it.

Ryan Caldwell (27:06):

Yeah, you're going to cut. We don't believe you. So Laura, weirdly, all of a sudden we're trying, it seems like all year the market has wanted the feds finally done trade. We've done it like eight times,

Lara Rhame (27:20):

And the Fed futures expectations have lagged the dot plot have lagged what the Fed is saying, this whole rate hike cycle.

Ryan Caldwell (27:29):

So weirdly, I feel like here we are again, maybe they really are done and maybe they don't need to do anything else.

Lara Rhame (27:36):

I'm comfortable they're done. Okay, I'll buy that.

Ryan Caldwell (27:40):

Okay. And now the argument is they're done to when is the first cut and now it's like the first cut is not that big of a deal because it's likely to be an inflation induced cut. And I guess what I hear you saying is pump the brakes. We'll see, but you haven't had a consistent run of data that would've told you the trend is broken, right? It's not going to re-accelerate mission accomplished job done, and now you can normalize restrictive real rates, whatever that means.

Lara Rhame (28:16):

Yeah, no, no. I think to me, this is probably one of the places that I'm more off consensus because I think part of, again, this miraculous rate cut cycle, this non-res recessionary rate cut cycle, which would also by the way be totally unprecedented is the huge piece of that is inflation. And again, this is such a critical nuance, not just hitting 2% energy could crater again and headline could hit 2% year on year, but core headline at 2% or below and staying there for a back in the lane that we maintained for 20 years. And to me, that is really the piece that I struggle with for multiple reasons. I think that we have seen the durable goods deflation, and that has been helped by several things. The inventory clear out, it's been helped by the housing market ironically, has really crushed the demand for durable goods.

(29:24):

So obviously you don't buy a new house, you don't need to buy new furniture, you don't need to buy the new, you don't redo the kitchen. And then finally, the rising interest rates I think is also much more likely to hit durable goods than it is to hit anything non durable or services. So that's really the pain point there. So I think those three things have hit durable goods prices. Those are back in deflation for now. But you look at the rest of it, not only is it not in that what we need it to do to fit into the 2% box, it's still far above. And I think rents to me, are the very clear example of this. We've talked a lot about how rents have come down. We know that the short-term indicators, near-term indicators of rents take a really long time to filter into the overall CPI numbers, but that works both ways.

(30:12):

Those have bottomed, they've reversed. And importantly the divergence, and this is something that we look at a lot, the divergence between what it costs to rent a square foot versus buy a square foot has never been wider. Meaning that it is much cheaper to rent a square foot than it is to buy a square foot. And when you think about landlords who are going to have to refinance next year, some multifamily is going to refinance, they're going to have to pay more. Landlords are rational, they see this and they are going to be raising their rents. So this is all coming in the pipe and it's all going to hit Q2 of next year, and it means that we are just going to have a real devil of a time getting this services aside, which is a larger piece of the economy back into the 2% box.

Ryan Caldwell (31:04):

Yeah, I mean I think the sali, and we've talked about this online, so I'll get you to put it on the record too. The thing that is really interesting to me is when you think about the back end of the curve, ultimately how steep of a curve do you get? Because the market, the equity market is starting to try to tell you you're going to get this typical one 50 to 200 steep curve, and boy, it just doesn't look like that's coming. I mean, I'm really skeptical of that without something really

gnarly coming through economically to get that kind of front end movement out of the fed next year, given again what you've laid out both on the inflation and growth side. So that's what I mean everybody wants, not everybody. The market has said here recently with all the movement in small and medium banks here recently, the big banks, you're going to end up with this steep curve. And it's like maybe, but if you get there, it's usually because you had a credit cycle and that's no good. You get really steep curves off credit cycles the rest of the time they're like a hundred wide and it's like, it's okay, right?

Lara Rhame (32:18):

Or very flat for years. Thank you. This can go on for years. And one of the things that you have said, I think you hit it very clearly when you said it was that if fundamentals stay solid and they have been solid, and let's say that you and I here together agree that even if we have some slowing fundamentals in and of themselves today look like they may very well stay solid next year, it's the multiple that really is then the big question. And that to me relates directly back to the interest rate issue. And when I say hire for longer, I mean that we are coming off of this truly, we have been trained, we have been really taught over the last 15 years to expect interest rates to be low, to stay low, to stay below nominal growth, to stay real interest rates at zero.

(33:15):

This is not the norm. The norm is positive. 200 basis points we're there today. And we could move tenure could go between three and a half and five. The five year could go between three and a half and five a couple of times and just really beat you up on the fixed income side. And I think really take equities along for the ride because another thing you pointed out to me is the equity market has just completely responded to rates this year. It's really been a massive, it has been the tail that's swagged. The dog rates have

Ryan Caldwell (33:50):

No, I mean there is no question in my career this year has been the biggest rate influenced factor market I've ever seen. I mean even for all the talk about the magnificent seven in ai, yes, it was some ai, but what it really was is it was a really big defensive trade because the market was terrified of cyclicals all year because of higher rates. You weren't bidding up Apple because it was some awesome growth stock. You were bidding up Apple because it's a way better bond than a bond. And so when you look at the cashflow production relative to anything, I get why it all happened. But to your point, Laura, it tells a little bit of a lie because yeah, the s and p is up 20, but most of that came at a really monstrously profitable companies that got more profitable and had a little bit of a story. The cyclical side of the economy has been dog meat really all year, to your point, it's just following rates, right? Real rates down. You rally cyclicals and small caps real rates up, you take 'em down 50. I mean it's really, to your point, the market sensitivity to rates, I think as you predicted to start the year was wildly more sensitive than the economy was wildly more sensitive than the economy

Lara Rhame (35:12):

And this bear steepening that we had in October, September, October, that just caught everybody wrong footed. I think to me, as I look ahead to next year, okay, I'm willing to take some of the risk of recession off the table, the risk of the bear steepening is absolutely out there and still of clear and present danger I think to this multiple story.

Ryan Caldwell (35:34):

Well, and look, the other thing, we didn't talk about this a lot, but I'll plug it in there because I do think it turned out to matter, which again fits a little bit of my market guy hat on with your economic view, which is look, one of the kind of hedge fund the inside baseball sort of happenings in the fourth quarter was the fourth quarter first quarter treasury funding announcement. And the reason that was so important going to our listeners, if you remember

back and we actually wrote about this in our last 3D in July, which set the market on tilt, is once it saw how much coupon had to be issued in the third quarter, it said, oh my God, that's actually financial conditions tightening, right? If you're issuing coupons, you're moving bank reserves. That's not the RRP, that's bank reserves. And then in October you had, or late October, you had treasury come out and the funding calendar for the fourth quarter and first quarter was exceptionally like coupons and very heavy in T-bills, right?

(36:43):

And I think Treasury Secretary Yellen and tac, who is the committee that kind of looks at how do you put together the funding calendar for the treasury, it has market participants. And so it's a little bit more market sensitive. Basically the message to the treasury was we can't handle all that supply. And right now there's all this demand for money market, so there's plenty of demand at the front end of the curve and we can draw down another trillion out of the RRP. So why don't we do that? But to your point, by mid-year next year, there's no RRP to draw and you're not going to be able to fund the government at the front end. You're going to have to

Lara Rhame (37:21):

Issue, right? Well, T-bills, you're going to have to issue bills debt. And

Ryan Caldwell (37:24):

So Laura, I get what the Fed and treasury are saying that their hope is that inflation's much lower next year and they can fund the government at a lower rate of interest because inflation came down. But my God, there's a lot of issuance to do. And to your point, I just don't know how much relief you're going to get in the kind of belly to the long end of the curve.

Lara Rhame (37:46):

And I mean, I think this is work that we did a little bit ago. We actually need to refresh it for next year. But one of the number one questions I get when I'm out there talking on the road is, well, we've been issuing debt for so long and building up this deficit and no one seems to care. And my answer is they care now and they're going to care a lot more going forward because from here, the dynamics are truly horrible and we modeled out a higher for longer, which sidebar is actually lower than where the yield curve is today. So that was our most expensive scenario. And then we modeled the CBOs expectation and then we modeled a STA nation stagnant environment where we had a very low yield curve and even that scenario took interest payments from two and a half percent of GDP up to three and a quarter.

(38:39):

The worst one was up to four in change as a share of GDP over seven years. This is not productive government spending. This is money out the door. It is the dynamics from here get very difficult very quickly, and that's even in a low rate environment. So this is a huge issue for next year, for the next 20 years, and it's going to increasingly just cause us to have to make some really tough decisions and it's going to start to be a real problem for the economy. It's a lag on growth, a drag on growth.

Ryan Caldwell (39:10):

I think so well said. I mean, I've tried to describe this as we had a $13 trillion party and now the bill is due. The bill wasn't due over the last three years. It's now due. And I'm with you. I'm not in the camp that it didn't matter because again, you think about that bear steeper you had in September, October. I'm going to tell you right where that came from. It was all around how are we going to fund this growth, even if growth to your point, if growth ends up being just, okay, you have a yield curve problem, so this whole multiple versus growth rate, I do think that issue's going to sink with us or sit with us for a while. And again, having seen the numbers as you've

laid them out, and again, doing back envelope math, the problem just for listeners to square the circle, this is a productivity margin problem long term like a big one. This isn't a small problem. This is a crowding out problem that becomes very real

Lara Rhame (40:10):

And at the margin hit, it's everything. This is money we're sending abroad. It's dollar negative everything. Yes, there's a lot of different angles to this that I think it's relevant today because clearly it was part of the carnage that the bears deepening caused in October. It's not going to be resolved in 2024, and I think it's only going to build into a bigger issue going forward.

Ryan Caldwell (40:32):

So Laura, maybe last one to get us kind of teed up into 24, what is the one thing you might leave listeners with to think about that you think they may not be thinking about given all that's gone on? And again, look, and again, here's what happens. Returns tend to set the narrative. So very quickly, once we put a bow on this year, it'll be like, what a great year it was, blah, blah, blah. And everybody will revise what they said. So I thought about a little bit about for you in this, what keeps you up at night or what are you worried that people aren't thinking about? Or maybe it's something obvious they are thinking about and you just think they're dead wrong. But what is that thing that as you think about 24, that's kind of the hitch and the crawl?

Lara Rhame (41:19):

Here's what I think is something that I'm already seeing from a lot of these 2024 outlooks that I'm reading. This idea that the Fed may cut, some think they're going to cut a lot, still a lot of people more reserved once, maybe twice in the second half of the year. Sort of this surgical rate cut philosophy. And the forecast that comes out of that is like the tenure today at four and a quarter, and then the tenure kind of moves down 50 basis points to 3 75. So they just had this neat line from one the start of year to the end of the year. Look at the, you don't have to look at the last year, look at the last four months, we have just seen enormous volatility in bond yields. I may even agree with that starting an endpoint, but I think you could easily hit three and a half paying back up to 5% back down to three and a half. This two-way risk, which sounds really boring, but can have devastating mark to market consequences, market depth volatility. Again, the vol that the rates injected into equities should not be underestimated. And I think that people who are kind of have this neat fed forecast that they're applying or painting what that brush to the rest of the yield curve are really missing powerful dynamics that are at play that are getting worse. Liquidity in the treasury market's terrible, terrible. And it's just I think really has the possibility of impacting markets across all of these different asset classes.

Ryan Caldwell (43:03):

No, I love it. Let's leave that there because it's a good one. And look in my column that I didn't torture you with to go through of left tail risk, that's at the top of the list, right? Treasury market's getting a liquid quick QT keeps running in the background. We're going to get down to fractional reserves. We got a bunch of debt to roll over. I don't know. I don't know. I don't know. That's a lot.

Lara Rhame (43:31):

And there's even more debt to roll in 2025, which people are going to start worrying about in 2024 because of course that's what we do with markets. Of course,

Ryan Caldwell (43:39):

Of course.

Lara Rhame (43:39):

It's going to be an interesting year, Ryan, I'm glad.

Ryan Caldwell (43:42):

I glad we'll

Lara Rhame (43:42):

Be through it together.

Ryan Caldwell (43:45):

Well, I can't thank you enough. It's always awesome to have you on our podcast. Again, you've been just a fountain of information this year. I can't thank you enough. I love doing these and look forward to sitting back down next year and getting after it. So as Zoe Flora, thank you. It's always helpful. And I want to thank all of our listeners again, you all make this podcast go. The FSS Fireside series has been incredibly successful, so we thank you all for that. And Aaron, great year on the mic. We appreciate all you do for us. So thank you very much,

Lara Rhame (44:23):

Aaron, our man behind the curtain. Yes

Ryan Caldwell (44:24):

Can't do it without him. And again, we look forward to getting back after it next year.

Lara Rhame (44:29):

Happy new everyone.

Ryan Caldwell (44:29):

Happy New Year.

Ryan Caldwell (44:35):

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.