Episode 84

3D Report: Q1 Recap—Effectively valuing the Mag Six

Ryan Caldwell:
This is the 3D report, a podcast from FS Investments and Chiron. I'm your host, Ryan Caldwell. I would like to welcome everybody to the FS Chiron 3D report. Today I'm joined by my colleague Lara Rhame as always and we will go through first quarter ruminations and where we think the market may go and the economy may go in 2024. So, Lara, good morning.

Lara Rhame:
Good morning.

Ryan Caldwell:
How are you doing?

Lara Rhame:
I'm great, I'm excited. Excited to be back on this podcast.

Ryan Caldwell:
I'm sure.

Lara Rhame:
I keep earning my invitation back. That's my goal every time, I earn my invitation back.

Ryan Caldwell:
Well look without you, I'm not sure anybody's really listening to the meat. So again, you've got to have some things to talk about here. And boy, again, there's always so much to talk about. I know I've begun to love this environment. There's so many things moving around.

Lara Rhame:
So much better than the 2010’s where the economy just grew 1.8% every year forever. It's like we're really moving and shaking now.

Ryan Caldwell:
So I thought maybe what we would do, I wrote our quarterly obviously the 3D report. And I tried to maybe take a little bit of a look back and look at what were the misses. Because again, I think last year as I sort of talked about in the piece, there was a whole lot to look at, but there turned out to be from a market returns perspective, really just one thing that ended up mattering and so far almost to start the year, it feels a little bit similar to where we maybe…not tailed off because we kind of had this big pivot rally at the end of the fourth quarter that now seems to be reversing, which we'll get into. But again, I think what sort of the underlying drivers were, at least for equity markets last year so far, looked like they've held together.

And in some instances you might argue they're being exacerbated relative to trend. But I thought in your piece, and again Lara's going to publish here really quick and I've been lucky enough to get the preview because we figured it might make some sense. And what I wanted to do is sort of match together what I was looking to highlight in the 3D report with sort of your economic update. Because quite honestly, and not, again, we don't collaborate on these before we write them. I was kind of stunned to go, oh, okay, this fits actually pretty well with how we thought at least the other, I'm going, I'm going to parse the equity market for a little bit on this podcast, the kind of other 4 93 and credit and sort of what that looks like, the more economically maybe reflective parts of the economy versus the big seven in what's happening.

And then obviously, Lara's sort of this cycle, right? Because I think what I've picked up from you, rightly so, there's been a couple of things I think that you've got really right, that I think people need to start baking into forward expectations. And I want to touch on those because we're going to come back to multiples and what we're paying for things and what we're growing and ultimately allocating capital and sort of how we see that. So, if that works, I thought maybe I'd try to do a little mashup and kind of use you to do it.

Lara Rhame:
No, sounds good. Sounds good. Put me in coach.

Ryan Caldwell:
Alright. So maybe let's start here, Lara, maybe I think, and again, I think you kind of put a dagger through this a little bit on our last podcast, but I wanted to maybe kind of circle back on it because I think it's pretty important, which just kind of the growth call. And I wanted to start with growth because this has been, is it a recession? Is it not a recession? It seems to me particularly the world has kind of pivoted from a year ago, believing there was almost a hundred percent certainty of recession to now. I think the softer landing or not a disaster, maybe I'll start there, is sort of manifested if you will. And the economy stayed relatively strong. Headline inflation is cracked, although we're going to spend some time on inflation. So maybe table that or put a pin in that one for a minute. But as you pointed out, and you pointed out at the end of the year and emphatically you've sort of been behind the scenes saying this is the growth is pretty good. And I think we maybe I want to spend a minute on the big compositions, business spending inventories, consumer, and maybe just kind of touch on that for people and sort of where you're at in February 29th of ‘24.

Lara Rhame:
And listen, guilty as charged. I was one of the people who a year ago was very worried about the possibility of a recession. Yeah, I know. Well, and I think we shouldn't beat ourselves up over it like 2022. We had 425 basis points of rate hikes within nine months. Just really not comparable to anything except for the 1980s. And I would argue even more aggressive because back then they were starting from 16% fed funds rate and we were starting from zero. So, in terms of magnitude, I think it was full, the most aggressive. And then in March we had the regional bank failures and a lot of us were like, oh boy, here it is, here we go. And there are times when it is good to be wrong. Nobody ever wants a recession or roots for it. So, in that sense, I could not be happier that we avoided one, recessions never a good outcome.

And what we really saw last year was truly, I think you look quarter by quarter, it can only be described as an economy firing on all cylinders. And I think it's important to appreciate as we go sector by sector, I'll knock off two of the smaller ones first, that business investment is going to be also sensitive to interest rates. But I don't think we saw that emerge last year for two reasons. Obviously massive incentives for businesses to invest. I think coming off of truly 15 years of underinvestment, I could not be happier that we are finally seeing business investment. Some people would point out that it kind of slowed towards the end of the year, but the fact that we've had now nine quarters of positive business investment in a row to me is of strong positive. It's only 15% of the economy, only 15% of GDP, I call it a swing factor.

But boy, it is swinging in the right direction. And I think it gives us all of the things that we love investment for. It's the productivity growth eventually it's more jobs. It's all of those things that really I think are our good and our positive. And then we look at government spending, which again, quarter by quarter last year added five to eight tenths every quarter to GDP growth. And another way to say that is if we averaged over 3% GDP growth last year, that would've been 2.25 if we didn't have the government just pouring as much money as they still are into the economy like it or lump it, it's not a state, it's just stating the facts. This is really added to GDP growth and if you look at hiring, it's added to job growth too. So, these are the powerful tailwinds that have given us just blockbuster GDP growth of 3.1% last year. Very strong and are still I think powerful positives.

Ryan Caldwell:
So Lara, I want to maybe stop there just for a second because I think there's a whole bunch of very important things I want to pull out of that stream of a really important consciousness. First, when you think about the fiscal spend plus BI or business investment, they tend to also have some correlation. So managements are willing to invest if the government will subsidize them, is maybe a nice way to say that. One of the points you made to me emphatically at the end of last year swinging into this year, and I think we talked about on a podcast last quarter, was that there was still a pretty big fiscal impulse at least through the first half to three quarters of this year.

Not last year, between the CHIPS act and parts of build back better. And we're seeing that, right? So I think that's a very important point or almost counterpoint to the bearish argument, which was right, there's all this deficit spending yet we don't have, we're not getting the kind of bang for the buck. But that was sort of my point in looking at the ROEs of the market. Like, no, you're actually getting good returns and it's got a longer tail, but you're getting those returns that supposedly weren't going to come. So I just wanted to maybe tease that because to your point, well BI is not a big part of GDP. It is a massive informational signal to the market about where capital is being allocated to what sectors are growing and what sectors are. So I just wanted to stop there. I think it's such an important point.

Lara Rhame:
It really is. And I think you and I talked a lot and we've written a lot together our teams about how markets interpret investment and I think for so long, investment was a dirty word and hit individual equities hard. If you errs call, they're like, we're going to invest. It was like, oh, sell that. It's terrible for free cash flow, right? That's right. Margin that was a sell signal. And I think as that dynamic may not have completely gone away, but we have to recognize that it's also overshadowed by a lot of the advancements that we hear about. You can't talk about the world at all. I feel like you can't talk about getting a cup of coffee without mentioning ai. And although my coffee, I would just want to mention my coffee order was still messed up this morning, so I'm not sure. I think we're not there yet. They haven't turned

Ryan Caldwell:
The robots on yet at Starbucks, it's coming.

Lara Rhame:
We haven't implemented it. And that brings us to full circle to this investment conversation because when you have these big innovations that have captured the imagination and the hopes of markets, you need to spend dollars to implement them. And so I think it's one reason why we've seen the investment numbers now be, I think viewed very or more positively. And listen, if it adds up to GDP growing at six to 7% on a nominal basis, that aligns with your earnings and it's also just a good fundamental economic story. So while I think a lot of the price action would show that growth expectations have been pulled forward, we're going to need spending to implement this stuff. I think that is a huge determinant of the coming year is that spending viewed negatively by markets or positive because it's going to enable us to really actually put a lot of these new innovations into place.

Ryan Caldwell:
Well, I thought it was interesting, Lara. So we were scrubbing numbers now that four Q is mostly in. And so for the year it looks like you're going to grow earnings two for 23, about 2% X energy. It's like six, right? Got to remember energy was down like 30, 35 in the year. It's a huge negative swing. And then Q4 rate to your point, which is again why I think this is such an interesting discussion coming into 24, you grew six all in X energy 11. So you did start to see this bottom line acceleration for again as much focus as there has been on kind of ai, the big seven, you did see acceleration everywhere else too. You got X energy, those numbers look pretty good. So to your point, we're coming into a year where the market's kind of got eight and a half to 9% earnings growth. That doesn't seem crazy to me. Right? Again, given your numbers and backdrop, if the nominals can be somewhere around three to four, you can bang out eight to nine I think. And if they're better, you're going to do better for sure. Yeah.

Lara Rhame:
Yeah. I mean the Q4 numbers, that was a significant earnings beat. I mean we just keep Yeah, it was a big deal.

Ryan Caldwell:
Yep. It was a big beat. Yeah, it was a big beat. Other thing I wanted to maybe touch on just inside of growth before we get to, I think the main dish inventories is the other thing that we've been paying a lot of attention to because you clearly have this big bull whip effect in the economy both up and down across sector. And I think one of the things that we talked a lot about last year and still actually starting to show up or it's starting to show up I should say in some of the production numbers and some of the PMI was that it looks like inventories are normal, which is a very good thing. It looked like we got over inventory last year was a huge inventory drawdown looking at the company level and now all of a sudden, it's the discussion, at least at the sector level.

And I am curious about what you're thinking about at the macro level is hey, even if we don't have some massive order growth, we're now at you got to replenish at least what's going out the door versus just running down inventory. And that's another big earnings swing sort of sentiment swing when you think about sort of markets, which is once I get easy comps, particularly if you're a retailer and you had too much inventory and so sell through is really hurting your margins and now you get to a place where you've burned up inventory the next sale, all of a sudden your incremental margins are much higher. So, it does look like, again, from an economic perspective, maybe it does look like we balance inventories and we might get some production uplift as the year goes on, which has been clearly missing in the growth forecasts and outputs. As you said, lots of government, right? Consumer good,

Lara Rhame:
Consumer good.

Ryan Caldwell:
But again, the inventory drag was pretty big. Yeah,

Lara Rhame:
No, I think you bring up such an important point because this has just been a nightmare for those of us trying to add up to quarterly GDP DP numbers. You can get the consumer pretty close and you can get business investment pretty close and then you just get a 5% swing on inventories and your headline is just completely off. So that has really just been this extraordinary volatility coming from that inventory sector. And so the fact that it's REN normalizing I think is really going to give us just a better platform from which to get production been really I think another place where it's been hard to understand what's going on, the sentiment, all the purchasing managers indices, all the manufacturing sentiment surveys have been dismal and they've been dismal for a long time, which is really hard to square with what we see from the stimulus data and the investment data.

So, I think one caveat I would add that is I think going to be a dynamic that this year is China, and you're the one that really brought this to my attention. And so I'm just going to parrot you for this entire audience that when China's economy is weak, and it is make no mistake, very weak right now, they sort of run home to the way that they know they can grow and that is just turn on the machines and they produce and they manufacture. So they're going to be flooding the world with cheap goods. And while I think trade restrictions are rising and they may not all flow straight into the US if they're flowing into markets that our goods are also competing with, then we'll put downward pressure on our goods as well. So this is something that we can put a pin in for the inflation discussion, but I think that, I hope that it doesn't fully constrain US production and I know that when we produce, we're not exactly competing with China for necessarily the same goods, but I think there will be, this will have some, it will be in the mix when we look to try to forecast production in the rest of the year.

Ryan Caldwell:
Yeah, look, and I mean just to put a fighter point on that, the easiest sector to dive directly into what Lara is talking about is the EV sector or the US auto sector, the European auto sector, given what China's doing with units in Europe, and again, they're keeping the lights on with BYD and flooding markets with low cost EVs because Delore's point, they've got to take share somewhere in order to keep capital flows from really getting negative. And so I do think keeping a keen eye on are they able to stabilize that economy domestically is going to be a critical point for the rest of the world because of just that behavior, Lara, which I think is such an important point to make because they will do that and again, to the sectors that are strategic to them where they feel like they've got some runway they've already started. So I think, and again, we'll put a pin, I think the inflation discussion's pretty important. Maybe the last thing I was maybe going to touch on the growth outlook because look, I think this is important too, and this is more of a market.

Lara Rhame:
I love that we haven't really talked about the consumer. It's like the biggest piece, but they're fine. They're fine, they're fine.

Ryan Caldwell:
No, look, I think I was going to go there, but I keep just stealing your line, which seems to work, which is if the unemployment rate has a three or a four or even a five handle on it, you probably don't have a consumer problem. Now again, going from three and a half to five and a half would be painful, I understand that. But the point you've continued to hammer people over the head with is the unemployment rate is far too low and the forward leading indicators to employment are far too strong to be making some big horrific consumer slowdown argument.

Lara Rhame:
Yeah, I think,

Ryan Caldwell:
And that seems to be playing out, but again, is there any impeachment to that argument that you see?

Lara Rhame:
I think the one thing I'll say, and we're recording today on leap year, February 29th was a lot of, I think there were some rumors bubbling up about seasonal problems. January, remember we had this blowout employment number, 353,000 jobs at it was higher than the entire top range of the consensus estimates. And when we think about the initial jobless claims, totally different data source, we're just not seeing those weekly layoffs rising. And that is I think an independent verification of the fact that the labor market's really tight.

Ryan Caldwell:
I think that is such a critical point to make because that has been sort of the anchor of the bear cases. Just because you haven't seen it doesn't mean you won't see it. But I go back to this kind of fun fact of just putting markets and economy back together with behavior. I've never known management teams to fire people when earnings are accelerated. Exactly. It just doesn't happen. It just doesn't happen.

Lara Rhame:
And I

Ryan Caldwell:
Think that's not when you see it.

Lara Rhame:
Totally. And we keep hearing about tech layoffs and I appreciate that those headlines, those headlines get a lot of attention, but the reality is that tech employment is still so much higher

than it was pre pandemic. I think that's the human side of your inventory correction. We're still working a lot of that out.

Ryan Caldwell:
And look, as we get into, look, as we get kind of further into the markets discussion, the thing that is critically clear, particularly out of four Q into four, one out of the valley, the platform companies, the AI darlings is this, they are more than willing at this point to trade opex people for CapEx, more ai. And to Lara's point, back in 22, those companies got eviscerated for hiring all the people that they hired. So Wall Street disciplined that dog. And so the trade off to Wall Street was, we'll give you your margin because we'll get rid of these people that are now working in places. For anybody that was paying attention, apple the other day, apple shut down their car unit, what are they doing with all the people in the car unit? They're going to reassign most of them to ai, AI generative, and others will leave the company. Well, their deal with Wall Street is this, we won't screw up the margins, but you let us spend on AI and everybody seems to have shaken hands and they agree.

Lara Rhame:
Yes, I couldn't agree more. That's well put.

Ryan Caldwell:
So I think that's not the place to look, in my opinion, to see for the early cracks in sort of unemployment if that's what one's looking for. But I wanted to highlight that point because again, one of the things I love about you is you come back to core principles and you're like, look, I've been doing this forever, Ryan, you're not going to have some nasty recession. If the unemployment rate's at 3.5%, the consumer's employed, they're likely going to have real wage growth. It ain't that bad. Whatever you think is out there can't get bad until they start losing jobs. So I just want to make that point. It's been so durable. Yeah.

Lara Rhame:
Yep.

Ryan Caldwell:
Alright. I think now maybe Lara, if you want to swing, because I do still think when I look at markets and economy, there's still a very, very big disconnect. So when we are having this economic discussion and the debate around the economic discussion seems to be what is the right level of interest rates, we're really going to dive into this. I think it's pretty important because you've heard a lot of, at least I have anecdotally, rates are too high for X to happen. Rates are too high for housing to clear, rates are too high for charge offs not to go up. There's lots of these reasons of rates are too high and what's happening in the market. Again, going back to last year, and this was kind of the point I tried to make in the 3D report, which is look for the big seven, which may be six because Tesla's got the LoRa, BYD, China dumping cheap things, problem affecting them.

So put them out of the cabal for a minute. But maybe think about the big six or the big platform companies, what jumped out of us in a really hard, what did you screw up was this, the margins there are unassailable. And what I mean by that is empirically the metas, the Nvidia, the Googles, the Microsofts, we've empirically never seen this before. So I'm always prone to hyperbole, but this is weirdly not hyperbole. When you look empirically, you've never, ever in the history of markets had companies this big, this profitable growing this fast. And I put the profitable thing on there as a really big tag because this is not ‘99, 2000.

Lara Rhame:
It's just not so important to differentiate that.

Ryan Caldwell:
And let me just like to give you the example Nvidia, which again, people are sideways about. It's done so well, but I'll use it because it's the bellwether. Nvidia has 50% free cash flow margins. It's

Lara Rhame:
Extraordinary.

Ryan Caldwell:
So every dollar of revenue is giving you 50 cents of cashflow and they're growing 250%. So trying to value that is like you trying to put together an economic forecast in this environment. The market just doesn't know how to do it because normally we fade things and say there's a terminal rate, you fade it, but you're so profitable so fast that this long duration asset has weirdly gotten a really short duration because they're delivering you so much cashflow so quickly. And so what's happened is people look at the s and p 500 and go, well, that's the economy that's represent and it's not at all. And we've sort of been having this debate and when you look back at 22, which was again an economy that was very good, but the market hated the construct of the growth. And so everything x, the kind of big seven didn't work.

So we come into this year, so we start the year and this is where I wanted to set up into inflation, and it seems to me that we're having the same debate. So the big six or seven are not rate sensitive. And I would agree with that because they're so cashflow generative that the higher rates are the more valuable they are because they're generating so much of this cashflow. And so the market said, you know what, if real rates go up, it's really not going to affect them. And if real rates go down, it's probably good for them. So you know what? I'm just either going to neutralize it or overweight it and forget about trying to analyze it because this is really difficult to try to peg the right growth rates so profitable. But Lara, the other 4 93,

Lara Rhame:
We do have other stocks out. It's hard to remember,

Ryan Caldwell:
Seem to have a really high sensitivity to the point I think, which is maybe your seminal point you're going to make for 2024 to the level of rates and where is the right level, not monthly inflation and did we beat CPI this month or PCE this month? But what is the right level to balance the economy and then create a curve and then create valuation metrics around some sort of medium term rate forecast. This one's been so volatile and I thought what was so important about what you said, and again there's a couple other people that have really started to say this, but I maybe wanted you to dive into this on look, the level of rates is going to change and if it does, what does it mean to the other 4 93? Because every day real rates go down the other 4 93 rip higher like, oh, we're going back to zero rates, we can buy everything else again. And everyday real rates go up, they sell that stuff off and go, can't ever grow again because rates are never going to normalize.

Lara Rhame:
And I

Ryan Caldwell:
Think, so I wanted to dive into that.

Lara Rhame:
When you look at today and sort of even some of the big changes and expectations from the beginning of the year, markets are changing fast only two months ago, but we talked about the economy. I feel like the economy still, people haven't been as worried about that. And I think the big change that we've made is at the start of the year markets, were expecting seven fed funds rate cuts. And today it's now only three to four. But that to me and the interest rate, all of the cascading interest rate implications of that are the real sort of expectations shift that we've been forced to swallow at the beginning of the year. And I think I say forced to swallow because I think a lot of us, and I in particular wrote my year ahead Outlook saying, this is nuts. I didn't say that I was more diplomatic.

Ryan Caldwell:
I said the same thing, stealing it from you doesn't

Lara Rhame:
Make any sense.

Ryan Caldwell:
I said, the only way you got seven was with economic calamity,

Lara Rhame:
A big economic problem. And so I think today where we are, the inflation is a piece of this story. The other I think call that I feel confident and passionate about is that inflation is not going to fit back into that neat 2% lane that it occupied for the 20 years before the, and I want to be clear, I'm not saying inflation can't hit 2% again because it absolutely can, but it's not going to. It is a lane, right? You think about you're on a highway, you are in a lane for 20 years. That is pretty much what core the core PCE Deflator did. And maybe we even drifted a little bit to the low side, but it stayed in that lane. Low volatility, dependable, we stopped talking about inflation. It was so dependable, right? Mean, so now this is a higher volatility world for a variety of reasons, and it is now I think going to be a more volatile inflation picture.

I think it's going to take a lot longer to fit back into that, to hit 2%, but I don't think we're going to see a return to that 2% lane for you could take a decade where we're in a higher volatile inflation environment. So you think about what that means for interest rates and you add in all of the other pieces of this, the higher growth, the unmoored inflation expectations, you peel back the lid on inflation and you see that we have goods price deflation again, but services prices are significantly higher. Wages are still too high, too high. I mean, I say that when inflation's high, you need the wage growth. When I say too high, I mean inconsistent with the fed's, 2% target and you put it all together. And then you have the supply side dynamics. You have the reduction in global appetite for US treasuries.

You have the Fed stepping back from quantitative tightening, and it really is a story now of multiple factors which are pointing to interest rates. And I am going to fight the phrase higher for longer. I would say they are really normalizing back to where we were before the financial crisis. And my punchline to all of this is that doesn't have to be some negative pessimistic viewpoint because you and I have been doing this for a long time. Remember decades where we had robust housing markets, robust m and a activity, robust credit markets and interest rates were core interest rates. That core government yield curve was at a higher place. And I would argue that actually as we over the next year or two renormalize the yield curve and it's maybe anchored at a fed funds rate, that's around 4% on the short end. Long-term rates, if you want that to be positively sloped, are going to be between four and 5%.

And that's a good thing. How happy would the banking sector be to have a positively sloped yield curve that wasn't anchored at zero? I mean they would be thrilled. So this isn't necessarily a negative outlook, but one of the hallmarks of last year was rates moving so fast. Think about 2023. We started the year with the 10 year treasury at one 50 and by October we'd hit 5%. That's a really fast move that felt very, it felt like a gut punch for a lot of interest rates, sensitive sectors and interest rate sensitive markets. And so just absorbing that fast rate of change is difficult going forward. I don't want to be cavalier. We're going to have refinancings that are going to take a bite. We're going to have a lot of debt that refinances at higher interest rates with corporate fundamentals and the economy sound. I don't see a problem getting that done, but there's going to be some friction there that we are going to feel for investors. Hey, it's an opportunity that I think is my core message that with these adjustments and absorbing this higher interest rate environment and coming to rest at a place that feels more familiar to what we were before the financial crisis, it is going to take some adjustment, but I don't think it has to be a negative thing at the end of the day at all.

Ryan Caldwell:
I think it's really important point to underline for a couple of different reasons for market participants. One, there has been so much consternation that from clearly sectors that were financed when rates were zero, that you need zero to function. And the response to that is that's ludicrous. Yes, you might need a massive price adjustment for the asset that you financed

at zero, but that doesn't mean that rates need to come down because you missed financed an asset or mispriced an asset at very low rates. And so what we've been trying to think about when we look through US sectors, this applies also in Europe. Japan's a little bit different, and again, that we could side note that. But one of the things that you clearly see is this is, look, when you're looking at cyclical sectors, and again, I'm going to take tack out for a minute because it looks different, but if you look at cyclical sectors, this is what we've argued, which is look in the places that are rate sensitive, you're going to need two things to compensate you for what Lara just pointed out, I'm going to need more free cashflow yield, so I'm making a valuation point.

I need cheaper for those cash flows because there are going to be more headwinds with a structurally higher real rate environment. So how do I adjust for that? Well, again, if rate up price has to come down, so how do I compensate for that? I look for better free cashflow yields, right? That's giving me a cheapness to say, okay, this company, this sector is accounting for the fact that rates are likely to stay higher. The other thing that we're trying to look for at the company level is again, back to this margin point to again, looping that glory. If I have a higher rate debt to which I have to embed into my financial corporate structure, can my margins grow around that? If they cannot, and again, I don't have some very cheap valuation buffer, then just ignore it to Lara's point, those things will adjust themselves.

The market will adjust you and grind your multiple down, your earnings down to adjust for the fact that rates are higher. That doesn't mean calamity. Now again, if you went and financed an office building at a two and a half percent cap rate in 2021, you are likely going to have a price problem. But that doesn't mean that caterpillar is wildly mispriced because rates are at, rates are at five instead of at zero. So I think this is such an important point for investors to get their arms around, which was there is another leveling mechanism in this argument, which is price. And so if your prices have not adjusted to Lara's reality, then ignore, move away, get away from likely going to be realized years. And

Lara Rhame:
Some of that may be coming, right? I mean this throughout the next year and a half I think. Yeah,

Ryan Caldwell:
Of course. But to Lara's other point, there are going to be many. As a matter of fact, a lot of businesses that will adjust their inventories have moved. They weren't pricing things on zero rates or very high asset prices. So they're likely going to move rate through this fine. Again, we've already seen earnings, I would argue last year 2% earnings growth is far below trend, but you usually get an up 10 or down 10, you almost never get flat, right? So you got to kind of pick one. And again, maybe when you sort of add up all the pieces, again, I just think that point is so important that it's not so much rates at five. It's what price did you buy things when they were different, when they were at a different, were at a different level.

Lara Rhame:
And the real rate discussion is so sensible with this go there. And again, something that when inflation was 2% and the fed was holding the fed funds rate at zero and the tenure was 2%, you're talking about zero to negative real rates for 12 years, 12 out of the last 15 years. And I think this is a piece now that people are starting to have to think about again, like, alright, there's an interest rate, but with inflation, the difference between inflation at 2% and inflation at three and a half percent is massive, massive. When you're thinking about real rates, massive. And again, the 10 year can be at 4% and if inflation's at 2%, your real rate's 2%. If inflation's at 3%, your real rate's 1%. So this is the piece that I think the Fed has done a bad job of messaging because when I get into this debate about how much is the fed going to cut and why are they going to cut?

On the one hand you could say, look, the economy is strong. There's no urgency for the fed to cut rates. I see the best argument for surgical rate cuts in the second half of the year because they can adjust given inflation moderating down, even if it doesn't fit neatly into the 2% lane, it can moderate down and they can surgically cut rates to maintain the same level of real rates. That to me is not easing, it's not easing policy, it's not sort of turning back on the liquidity gusher and giving us accommodated monetary policy. It's just really, I think, accommodating the fact that real rates can still be managed. And I think that is something that they've done a bad job of messaging because when they talked about stopping the rate height cycle, I think that's done and turning to when they would cut rates, markets just go back into, oh, they're going to ease. They're going to ease policy. There's room for them to cut rates and not ease policy. And I think that's where they haven't done the work to explain that. And I think it's caused this whipsaw of fed rate expectations that I think is going to continue to add volatility to that core fixed income piece throughout the year.

Ryan Caldwell:
Critical point, and maybe for listeners, I want to put my market guy hat on for a second and just crystallize why that debate has been so important for the market. So real rates to Lara's point in sort of post-crisis era we're about zero for a very, very long time. Prior to that, and this is why I her forecast of sort of where we're going, real rates in the first part of the decade were about 150 basis points. Prior to that they were about 2%. So again, back to Lara's point that you don't need zero to make the economy go, one might argue zero doesn't make the economy go. We kind of learned that lesson maybe in the last decade. But again, when you think about this argument, and again, this is why this is so important to market guys because they are trying to parse exactly what Lara is pointing out is where are real rates going to end?

Are we just going to try to hold one and a half to two real rates? So to Lara's point, they can follow inflation down without ever easing policy that is not loosening, that is not go give me high multiple stuff. That is not a mean reverting environment, which is what the value crew always looks for. The fed will cut under, they'll cut real rates, and then we can mean revert. What I find so interesting about these two arguments together, Lara, when I think about real rates in the inflation argument and fed policy, it then gets you into the argument of, gee, what other assets do I want in this environment? Well, we're figuring this out. So I sort of bluntly laid claim to the big margin growers and said, look, until their margins blow up, you better own them. You've never seen anything like them. I don't care what real rates do. Obviously if we went into a big nasty recession, that would impact them as well. But talking about 50 basis points here and there of real rates for those companies is just not impactful when the margins are that big. However, for everything else, it's

Lara Rhame:
Critical.

Ryan Caldwell:
So when we think about how much value to own or in cyclical spaces or credit or even talking about credit spreads, credit spreads are really tight. So when I think about these,

Lara Rhame:
But that's the difference when your base rate is 5% and your credit spreads on top of it, we've come from a world where the only thing you're buying is the credit spread, but now credit spreads can stay where they are and you're still earning eight to 12% depending on where you are. Actually, that's not good at all. Pretty good. Yeah, it's pretty good. Take that. It's pretty good. Yeah,

Ryan Caldwell:
No, so I think the lesson, or at least the inference to our listeners and investors is look, we are probably in a period where you have really got to do the work into what you are going to own. Yes. Right? And one of the benefits I think that I have sitting inside of FS with a firm that has really good views into what's happening in private credit and private real estate and private equity and secondary is private equity. What we're seeing is there's a lot of opportunity because of what you just suggested. There's been so much price dislocation because of the rate discussion that, and again, some of it's going to go bust and be bad, some of it isn't. And the job is going to be parsing through the good and the bad to figure out what can survive in a real

rate world that's not zero, it's probably one and a half to two. And if you can do that work and you can find assets that are appropriately priced for that sort of outcome, God bless, I think you're going to do pretty well. If you have assets that are unfortunately not going to do well at a one and a half or 2% real rate, then that is probably time to really evaluate what was in your portfolio, why you made the investment when you made the investment, the

Lara Rhame:
Vintage that were the

Ryan Caldwell:
Vintages. The vintages in this stuff are critical, critical. When was it made at what prices? At what cap rates? So that work is going to be critical. And again, Lara, you've had a pretty good message, which is look, there are alternatives, there are things to be doing that aren't just passive equity investing. And again, I would not shy away from passive equity investing, and as an active guy, I'm saying the top of it's so good and you're getting it for free, don't give that up because it's pretty good. But over here, when we talk about the other 4 93 and we talk about credit and where things are priced, I do think you can have a really good debate on alternatives versus that liquid universe because I don't think that is universally accepted and priced. When we look at liquid markets today, your view that no real rates are probably stuck one 50 to two or we'll see, you're not going to get your zero party again. And if that's not the case, you got to really think differently.

Lara Rhame:
Well, for the first time in a long time, it feels like it's fun to be an asset allocator again, because you talk about it like, Tina, there is no alternative. That was our lives for so long. It's actually okay, I don't pick a number. You think stocks are going to up 15% this year. It's like, okay, well, you can also get a similar return in so many other places because core yields are higher. And in my opinion, I think they are going to stay there. And that really actually opens up a lot of opportunity investments that may not have been attractive for 15, 20 years. Or to your point, you look at some of these spaces were just not available. Full private credit was just not a thing 20 years ago, and now these are massive markets. So it's good because I think it makes our financial markets stronger to have these diversifications of pools of capital, but as an asset allocator, it makes it fun again for the first time in a long time. It's good news.

Ryan Caldwell:
Hire

Lara Rhame:
States don't have to be bad news. There's one thing I want to hammer home to everybody today. That's it, because I feel like I'm having trouble selling this as a positive when I'm out there talking with advisors, just, maybe it's just because they hear it from their kids. High interest rates. I can't buy a house right now. And I think this is a supply side that's very different from the fact that you and I probably both bought our first homes when interest rates were significant, mortgage rates were significantly higher than they are today.

Ryan Caldwell:
Well, it's funny, Lara. And again, this is where I go back to this big divorce, if you will, in psychology between how the consumer perceives inflation and how Wall Street perceives inflation. So again, I don't think housing has a rate problem. I think it has a price problem.

And I go to those advisors whose kids are saying, I can't buy a house and go, they could buy a house if you'd cut the price 30%. They have no problem buying a house with a 7% mortgage rate. If prices reflected 7% mortgage rate. You have been unwilling to accept the fact that rates have gone up, therefore the price needs to adjust. Now that being said, so Lori, and that's like the other thing we see a lot of even, and I want to kind of make this point, which is look, we look at inflation on a, we look at the level, but we are rate of change people because Wall Street pays us to be rate of change people. So you're right, this baseline of inflation that was so low going into 2020 had a massive level jump through the pandemic. I mean, it was massive generational jump in the price level of thing. Now that is no longer accelerating at the rate it was accelerating a couple years ago, but it's not going down.

Lara Rhame:
That is so we're not

Ryan Caldwell:
19 prices, were not even close.

Lara Rhame:
And the difference between 2% inflation and 3% inflation sounds like, okay, yeah, it's better. Everyone's like, Lara, what are you talking? It's better than nine. Sure. But over years, that is a huge difference in real rates, a huge difference in erosion of returns that I think markets are just still, they really need a lot more work to shake off the complacency because I think I still hear it when it comes to inflation. Everyone's like that. That was last year. That was so last year, Lara, we're not worried about it anymore and I'm still quite worried about it.

Ryan Caldwell:
Yeah, look, I think it's such a good point because to your point, when you have changed the base and then you're talking about compounding a hundred basis points higher, yeah, it's not 900 basis points higher. That was toxic. But even compounding a hundred basis points higher off a bigger level are going to run. I mean, you wrote this so well last year about the stickiness of inflation. This is the stickiness of the price level. And so you go, well, how does that manifest itself in me, the investor? Well, when I go listen to Proctor and Gamble, talk about the fact that they can't raise price now. And again, they took a lot of price in the pandemic.

Lara Rhame:
They took a lot of price because they

Ryan Caldwell:
Can't take price anymore and their volume growth is down.

Lara Rhame:
And it may not be good, but it's services. I think that's, you talk about the overall inflation number, but you lift up the hood and you were just seeing this massive divergence and services. Now it's not just rent. There's a big insurance component to this. There's a medical care component to this. And it starts to feel, to me, a little bit too much like 2021 when everyone's like, oh, Lara, that's just a one-off. Oh, that's just a one-off every month. I know. I know. We're not worried about inflation anymore because whatever is erupting this month is just a one-off. And I'm like, well, yeah, add it all up. And you get a year of inflation that is worse than 2%, it is higher than 2%. And that's where I just don't think you can dismiss inflation costs are higher. That's a one-off. Well, guess what? When I hear everybody talking about it and it's impacting household budgets to the degree that it is, it's no longer a one-off. I think this is the continued issue that is going to have people going back and asking for higher wages. And there it is. It doesn't have to be a massive explosion, but it's a grind, and I think it's a grind that's going to leave us with higher inflation, and we're going to see that throughout the interest rate and return expectation, price expectation piece over the next, for the foreseeable future.

Ryan Caldwell:
Look, I think that's a perfect landing spot for the plane. And look, I would just highlight to our listeners, look, this is why the big seven are acting the way they are because the margins keep going up and the market has put its arms around and said, look, the rest of this is hard. It's really hard, but their margins keep growing, and if they keep growing, I can sleep at night. So I do think it's a really important point when you're looking at capital markets to understand that, look, this is, and again, I don't like getting into hyperbole about you've never seen this before, but in this instance, it is that odd that, look, the only thing I do think that matters there is do the margin stay sustainable? If they do, you're going to own them in your portfolio. But for everything else, what Lara just highlighted absolutely is the key. Can you survive in that

environment and thrive in that environment? If so, you're going to get a big gold star. If not, you're in a lot of trouble. So I think as much as I'd a great thematic easy story for 2024, and I know we're in an election year and that creates all sorts of narratives

Lara Rhame:
Loud, that can be the next podcast.

Ryan Caldwell:
Yeah, that're way outside the podcast. We'll get to that probably in June or September. But I would just say that I do think that is, and I wrote in a 3D report, you got to understand the really big thing, and I made the point about margins of the big guys. I do think for the other 4 93, Lara, this is the really big thing. Can you live in that environment or can you not? And if Ken, great, thumbs up if you can't move on.

Lara Rhame:
And I think that evolves throughout the year as the refinance has come up and as, yeah, sure. I think we're still work in progress there.

Ryan Caldwell:
Yeah, for sure. And again, I don't think it's some easy straight wide path. There'll be winners, there'll be losers, but that's the point, right? Five point a half percent short rates are not the end of the world as last year proved so dramatically, the market's going to have to readjust to this. And to your point, Lara, the one-off discussions already on inflation to start the year are concerning. They're really concerning. So I know what the market lathered itself up into in December, which was big pivot. Lots of cuts. It's probably going to look different than that. We'll obviously be on guard to work through it, but like I said, I highly appreciate you coming on because I think the point you've made about inflation and growth and real rates is the takeaway for our listeners. You're not out here expunging like forecasting. It's just the point of what happens to the base rate and how do you build a book around a base rate that's changing. And if you think about the world that way, you're likely to be Okay.

Lara Rhame:
Love it.

Ryan Caldwell:
Yeah, so thank you. It's always great to have you, and again, probably exhaustively too long for our listeners, but that was a ton of fun for me.

Lara Rhame:
Well, I think I just try to lob up the economic ideas and you actually frame it all out so well. I feel like together we always get there.

Ryan Caldwell:
Yeah, no, it's a wonderful partnership. And again, it's been one of the things that really, again, we have a great quantitative view. We have a great fundamental view, but this has been generationally different in economic analysis. And so, finding your footing here is critical. So again, I always appreciate you joining and look to doing it again in a quarter. 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. If you enjoyed this episode, make sure to follow and the podcast, wherever you stream.