MACRO Voices
with hedge fund manager Erik Townsend

Julian Brigden: There's Behind the Curve and There's This

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Erik: Joining me now is MI2 Partners founder Julian Brigden. Julian prepared a terrific slide deck for today's interview, registered users will find the download link in your research roundup email. If you don't have a research roundup email, it means you're not yet registered at macro voices.com. Just go to our homepage macrovoices.com Click the red button that says looking for the downloads.

Julian, it's great to have you back on the show. It's been way too long. The inflation-deflation debate rages on. Just last week, I had David Rosenberg on telling us that the three Ds those being debt, demographics, and disruptive technology assure a disinflationary backdrop for years to come. And that this inflation will be transitory, what say you and feel free to reference your charts as we get into it.

Julian: Well, here's the thing - look, I'm not going to answer that myself. I'm going to lean on the world's oldest central bank, the Bank of England, and they wrote a piece which we picked up on and we discussed with our clients the other week, and probably other month, and we said, the title of the piece was, it's always transitory, a 700 year history, Because I think there's a real temptation for us to get lost in a very short term perspective. And by short term, I mean, you know, 20-30 years, right, that's our kind of our frame of reference. I mean, even if you're an old geek like me, right? He's been in markets, you know, for 30 odd years. Right? I mean, it's very easy to just get my optically focused on those last 30 years and lose the longer frame of reference. And what the Bank of England discovered, was that basically, when they look at the risk free asset, and they look at returns and inflation. That basically since the mid 1460s, we've been in a disinflationary world, David, so I like to kind of use that word, as opposed to deflation.

And, you know, the drivers are pretty consistent, right? I mean, productivity, you know, demographics, etc, etc. And I think there's always this tendency to get very, very excited about developments, you know, that are sort of today, right? To think that the technology we have today is just so utterly transformative. And, you know, I was reading this piece by Barry Ritholtz, who's the sort of equity guy, and he's very, very good. And he wrote this thing and said, sort of, you know, it's all really changed since the mid 80s. And I was like, really, you know, if you actually look at productivity since the mid 80s, it's actually not the case. Right? Actually, arguably it's been lower than it than it was in the 60s in the 70s. And also, we shouldn't forget,

you know, the world quite transformative events historically. I mean, even in a relatively short period of history. I mean, you know, penicillin, the aeroplane, right? The internal combustion engine, the light bulb, right? I mean, all these things have been bloody transformative, right? So just to assume that, that Salesforce or cloud computing, all these things are just so much greater. You know, is that really, right?

So what the Bank of England did was, they look at all these trends. And they say basically, even though we've been in this disinflationary period, since the mid 1400s, they've actually been eight periods. And this would be the ninth, where we've had extended what they call real rate depressions, so incredibly low levels of real rates. Now, they come up with some reasons as for that, but what's interesting is what causes those 10. And, and the point is, what causes them to end is essentially two things typically. Firstly, some sort of geopolitical shock. And then secondly, and this is quite remarkable, particularly some sort of pandemic some sort of big shock. And you can understand why I mean, you basically rejig the world, particularly after a pandemic, you actually reset expectations of workers, you've obviously, certainly in cases, things like the Black Death, right? You've wiped a lot of your workers out, right? So, you know, wages tends to rise. But there's all these sorts of factors that are remarkably consistent over this hundreds of year period. And I think we tick that box now. Ultimately, even these bouts of inflation proved to be transitory when we go back to that long term, disinflationary trend. So I think the disinflationists are ultimately going to be right. But let's say this bout is typical last seven years, right? And we're two years into it, maybe. Do you really want to be long fixed income for the next five years because you're gonna get hosed? I mean that's a life, that's a career. Right?

Erik: So you're saying that the disinflationists have it right, we are going back to disinflation, but we could have something like the 1970s happened between now and then.

Julian: Yeah, it's not. I mean, I think personally, I think the analogy right here right now is the late 60s. But I can construct the 70s.

Erik: Let's dive into page two of your slide deck and take a look at the core PCE and final demand charts that you've got what's going on here?

Julian: So I mean, just these are sort of some short term plays. Right. We've been, you know, as you alluded to, at the beginning of the interview, we've been in the inflation camp for a long, long time, not just in this iteration, Erik but we really started talking about it when Trump came in, right? And he did that unnecessary procyclical stimulus that you got, and I think, absent COVID, that would have been the low in bond yields back in 2016. But what this is talking about is just how much more pressure is in the system right now. I think it's important that finally the Fed is beginning to wake up to this because I actually think we're at a very, very pivotal point. So we kind of got lucky in timing this interview. But this is just an illustration of what could be still in the pipeline. Right? So to say, it's all about to peak, this is the peak, we're at the highs, I'm not sure that's the case. In fact, my bet that we're definitively not. So this is looking at the new final demand PPI that they produce. Conveniently, it's back two percentage points lower than the old

PPI. But it's actually very good at because it is a final demand metric at looking at what happens in feed through into CPI.

And you can see at this point that we have basically the best part of 500 basis point divergence between PPI and core PCE. Now, what happens in that scenario? Well, there's a couple of scenarios. Firstly, you know, maybe those PPI prices just evaporate? Well, if you go look at the ISM's, that is not happening, right? I mean, businesses are definitively not seeing significant reduction in input costs, right? Their prices are still feeding through, they still planning to put through price increases. I mean, Kellogg's, for example, planning, I think 20% price increases next year. So the PPI isn't going to run away. Fine, what do they do? They can eat them? Don't think they're going to do that. I'll go through why I don't think they're going to eat those price increases, and then they pass them through. So if they pass them through, what does it mean for CPI? Right? Well, the typical spread, even if we're very generous, like the highs of the spread that we saw in 2017-2018, was 125 basis points. Okay. So let's say that that's what happens that PPI sits here, CPI just core PCE so plays catch up. Then you're looking at core PCE of seven, seven Erik. I mean, Powell has already told us that what's going on in already with core PCE in fours is inconsistent with price stability. Seven, these numbers are insane, right. And the number is actually even worse in Europe, because their PPI increases are really off the charts.

Now, at some point, I would guess probably in February or March, when we start to get the January or February data, we should start to see some of these numbers start to peak there some relatively robust base effects. That should they bloody better start to weigh on these headline numbers. But even when those drop away, the core pressures are going to be acute. So for example, if you look at owner equivalent rent, which you know is about 30% of CPI. Our models somewhere and this is a very conservative one I've taken here shows the lows, fours, I've got one that show five and change. It's a little bit more erratic which is very good. The Dallas Fed one and this is probably not a surprise why Kaplan, the Fed governor was so hawkish, they had almost 7% by the end of 2023. I mean, these are swinging numbers, you are not going to get core inflation down if your rents are increasing anywhere close to these sorts of levels. And I think the Fed are beginning to realize they're playing a very dangerous game, right? Because we do have rising inflation expectations.

If you look on slide four, whether it's longer, I mean, sure, the short dated stuff is more elevated than the long dated stuff. But even the long dated stuff has starting to push to some pretty heady levels. Okay, some pretty heady levels. You're looking really at 4% for the sort of three year and longer stuff. And this is dangerous because the Feds own work Erik suggests that in the late 1960s, and we'll talk about that at the end of the presentation. It may have only taken two years, for as they would term it for inflation expectations to become unanchored. So you really, really, really playing with fire here. And I think it's one of the reasons why the Fed has been pivoting so hard. And we'll come back to what the ultimate reason I think they've done it, and the implications to that in a second. But the fundamental problem, I think, that's caused this is we just overcooked it.

So if you look at slide five, one of my clients has done an awful lot of work on this. And, and they have data I dream of having access to. So they went and looked at 28 countries, they looked at 120 years worth of data for each one. And they looked at the impact of fiscal and monetary stimulus and the feature into inflation. And what they discovered is, if you fire one of the barrels, fiscal or monetary, not really that much relationship, when you pull both triggers, though, particularly with a certain degree of ferocity, then the feed through to inflation is nigh on perfect. And they asked us to go and construct a model, which we did. And that's what we call this excess stimulus modeling. Great. And what you can see is, it's a very, very good leading indicator, it leads by about 18 months for inflation. Now, there are some base effects in there. And that's why I've split the graph up, you can see it worked very well in the 70s works very well into the mid 2000s.

And then you go look at slide six. Now. That's now! The couple of things to bear in mind, Erik. So the first thing is, look at the size of the stimulus compared to the post GFC stimulus, each just utterly disproportionate. And the thing is, it doesn't just happen, right? We spend all this money. There are you know, I've got some clients who've got a big Muni portfolio. Okay and they tell me that the states is still sitting on money from the prior handouts that they got, you know, earlier this year. They're still working through how to spend them. Right, so there's plenty of money. And by the way, we've got a big fiscal stimulus, we've got an infrastructure stimulus package we're working through, right? Which come 20, beginning of 23, we'll start adding about and this is just the federal bit. Remember, the states tend to chip into these projects, when you do infrastructure spending by almost the lion's share, right? The federal ones worth like three quarters of 1% on GDP, right? So these numbers could be big. And this thing is still feeding through. It's like the boa constrictor has swallowed the sheep, right? It doesn't just dissolve overnight, right? This thing could sit in this stomach for ages and get metastasize. Right, and that's exactly what's happening, this stimulus is working through the system.

Now, the final thing to bear in mind in this chart, is this uses detrended CPI. So you really have to think about it is kind of like an incremental model additive to where CPI is at the time, as opposed to just showing you a level. What it basically tells you is close to 10% Core by the end of this coming year and into 23. I mean, these numbers Erik are inordinate! Inordinate! We just blew out end to at almost 30% per annum. Where does that money go? It doesn't just disappear overnight. It's still growing at like 13%, which by the way, would be the highest number bar this in the postwar period. I mean, these numbers are ginormous, we just overcooked it. And if you want another example of this, look at slide seven, right? We are trying to push through 34% higher goods demand than prior to COVID. We'd have bloody supply problems in a normal world. There is to much aggregate demand. I would either by this way this thing that Yellen is telling us Don't worry, right? We'll be all satiated when it comes to physical goods right? We'll go and spend it on services. Well good luck with that love, because demands already 4% higher. If you think you've just got to find the workers who are going to all feed us at McDonald's and every single restaurant. You and I all know and everyone else listening to this all knows that that is not the case. Not for the wages that you're trying to pay.

What we've done is we have created too much aggregate demand. Because we thought this was the GFC. We thought this was going to be how we'd play out. We had to support aggregate demand. It was kind of the right thing to do, but we just did too much. This is not a stagflationary environment, right? Stagflation is, when really the definition is when prices destroy aggregate demand. In the old definition, when demand when there's too much money chasing too few goods, that is, by definition, inflationary. I mean just look at the demand for labor Erik, right? And this is the one that's really causing the Fed conniptions on slide eight, right? So the Fed had assumed, maybe correctly, that the participation rate would recover, right? It dropped about two points during COVID to I think, like 63 to 61 and they assumed that people would come back, right? Well, you know, was it a realistic assumption? I don't know, maybe they didn't see that survey that 4% of Americans have decided they could retire because they made so much money in crypto, right? God help us.

But the point is they assumed that it was coming back. And so if you assume that participation rate was coming back, you could run this thing a little hot? Well, unemployment actually, if you tend to look at this chart, once it gets going, it's a pretty linear relationship, right? If you look at the relationship in the fall of unemployment, between sort of 2010 and 2019, it's pretty much a 45 degree line. Right? You know, one job begets another begets another begets another begets another begets another, okay? Look at what we're doing now. Right? A, they have just miscalculated how quickly this thing is falling and B, they just miscalculated even if everyone came back into the labor force. Even if those 4% of of crypto retirees decided that they really wanted a part time job working at McDonald's. Even if they all came back into the labor force, there is so much aggregate demand out there, that the level of jobs that it supports would drive unemployment to 1%. Insanity, cause there's no way that 1% isn't way below full employment, what I'm told, is this current crowd within the FOMC believe it's like 3.8% is full employment. Now, that's quite a big drop from the prior level. It's about 1%. So it's quite a woke, you know, in this sort of woke-y world that we live in, right? That's quite a loose and easy definition for full employment.

But the point is, is there's so much demand out there that you're actually trying to create jobs are full, almost 3% below that. I mean, this is nuts and then, you know, hence sort of JP's dismissive of oh, we haven't, we don't have a wage spiral is ridiculous. But we've got Atlanta, which is the better of the metrics, running, you know, we're going to be running at close to 5%, which is where we were in 2000. Right, and the guys on the ground tell you definitively we have a wage spiral going on. I mean, I love listening to what the ISM guys tell you in their various interviews, and the one that just stood out to me from last month actually was from the chairman of additive manufacturing. He said well people are chasing wages. 27% of my employment comments were related to attrition, and that was the largest component of anything. He said you hire two people on a Monday only to see others leave on a Friday to the factory down the street. It's not clear when this wage spiral stops.

Erik: Julian, I want to go back to something you said at the very beginning, which is that there are these periods of essentially real yield depressions that end with pandemics. Well hang on a second, we've got a whole bunch of listeners who see this inflation coming just like you and I

see this inflation coming who think that gold is the hedge for that inflation? Now gold doesn't usually do well, when real rates are recovering. And you just said it's a pandemic that tends to mark the bottom of those real rates. So what does that mean for precious metals?

Julian: Oh, now you're gonna ask me on the market stuff. I haven't got to that bit. Yeah. look, I'm not I mean, I've been toying around with it. It's, you know, technically, and don't get me wrong. I'm not sure that in this world that we live in that we can see a significant rise in real rates, right? Does the market do it for a while and the pain that it cause for central banks? That's my gut. And that's when you really, really want to buy your precious metals but I'm not sure it's now. This is I think that what we have seen over the last, or certainly since his reinauguration is a much more defined Fed. A Fed that has pivoted extraordinarily hard. Right, from, oh, we're going to taper, you know, no rate hikes in 22' to we're going to taper over the next. You know, we'll be done by June. Well, now, they will be done by April and they're bringing in potentially 100 basis points rate hikes into 22'. I wouldn't be surprised to see from the dots. And so that's not the time that you want to be long well, probably any risk asset, frankly.

Erik: So you think the time for gold is not yet?

Julian: Not yet, no. And neither silver nor, as I said, not really any risk asset. Just a very, very dangerous time. You've just had a central bank for all the reasons who's finally the Penny has dropped with these guys. They've had that kind of epiphany moment. Oh, my God and this is what I'm literally told, they finally realized that that participation rate is not going back up. And if it isn't going back up, Erik, and you already have way too much demand, even assuming it were, then the risks of a sustained overheating of wage spiral or getting out of hand is real. Because look, look at slide 10, this is all happening boss in an economy. We've you've already closed the nominal GDP gap, right? And according to the ISM guys, and you know, the GDP now is even higher than this. We're already growing this coming quarter, it's six. So you can put another 6% onto this thing. Right? We didn't manage to close the GDP gap, nominal GDP gap in a decade. We've done it in 18 months.

Erik: Enclosing a GDP gap during a pandemic no less.

Julian: Yeah, I mean, and the point is Erik, is, and this is what risk markets haven't, the penny hasn't dropped yet. If you've closed your GDP gap, right, look, inflation is one thing we can say, you know, and as I said, I mean, there will come a point early next year where you should start see some of these headline rates start to peter out. But the problem is, is if you're running an economy, too hot, those core rates, those wages, those core CPI, those rents will keep pushing through and that that's the real enemy. Right? Not headline, okay. The real enemy is those core underlying prices. Okay. And that's because the will being no spare capacity. Okay. So what does that mean? You have to raise rates, not just to tackle inflation, but to actually slow the economy down.

Erik: Now, what happens when that raising of rates effectively bankrupts the federal government with increased cost of borrowing?

Julian: Oh, I mean, that's, that's the third iteration. We're not there yet. Right. We haven't even started. I mean, look at look at slide 11.

Erik: Maybe the way I should have asked the question is, how far can that backing up of rates go before it breaks the system?

Julian: Well, I mean, I don't know. I mean, it's a difficult, you know, because you could have a situation where nominal rates rise and real don't rise as much. Right. Right. Real could be suppressed still. I mean, could we go to yield curve control? Maybe, but that's not now. Right? That to me, is a is an outcome that occurs after the next risk off event. Right, what has to happen now is pretty much laid out in light slide 11. Right, given everything that I've discussed, that there is too much aggregate demand that is still working through the system that boa constrictor is still absorbing that last meal, okay. It hasn't manifested itself yet it truly in inflation. Okay. It hasn't manifested itself yet truly in the labor market, which almost certainly means it hasn't manifested itself in terms of wages, okay. In an environment, we've already closed the output gap in nominal terms. Okay. Ask yourself, absent some sort of miraculous event, you know, in almost another nasty wave of the COVID would be to some extent, helpful. I had a really nasty, why not? Not, you know, what Omicron looks like is an actual fact that Fed said, and I was surprised by this.

I mean, one of the things that I always makes me laugh is the honesty of central bankers when they retire right? And so Bill Dudley, ex New York Fed President has gone to work for Bloomberg. And his utterances have been spot on. Okay, so for example, there was one in February where he came out and he said, stage three of the inflation process will arrive when the economy reaches full employment, and inflation is reached 2% is expected to keep climbing. Okay, I will tick that box. At this point, the Fed will start increasing short term interest rates. The tightening process will probably have to happen quite briskly, perhaps at a rate of two percentage points a year. Given that we have a long way to go from near zero to a level that would make monetary policy restricted to 200 basis points. Let's say starting in April, a year well, we're not even close to that in the Eurodollar market. Okay.

I was surprised how hawkish Powell was in the face of this new variant, but it appears that they've come to the conclusion that the longer that the pandemic lasts, with this aggregate demand still in the system, the greater the risk that people don't come back to work right? To the greater the risk this, these price inflation becomes embedded, particularly via wages. Okay, but ask yourself, everything that I've laid out here, is it right that we have the easiest financial conditions in 38 years? And it's only 38 years? Because that's as far as the data goes back? And ask yourself, What does it mean? You know, because remember what financial conditions are made up of, right? There's basically five metrics in a financial conditions index, to rate metrics, short term rates, let's call them two years. Long term rates, let's call them 10. The currency, the dollar in, in our case, credit spreads, and the equity market. So ask yourself, despite the fact that we've seen quite big moves, which have been very profitable for people like ourselves, right, in the short term, and belly of the curve, right, sort of, you know, DEC 23, Euro

dollars and this sort of stuff, right? How is it the financial conditions haven't bloody moved yet? And I think that's a significant problem, right? I think that's a really significant problem. And if you don't, and this is what I think the Fed is waking up to and we've been told this.

The market actually is assuming that somehow we're only going to go through what the terminal rate roughly, you know, the top of the rate cycle of roughly 175. And it occurs kind of around the end of 23. If you look at the Eurodollar market, okay, if 2023. But he goes on and he's right. So how high will rates need to go? Well, that depends on how easy higher rates will tighten financial conditions and cool off the economy. So in other words, how high rates will raise the dollar, raise 10-year bond yields, not lower them, raise them because you want to slow the housing market down. Okay, widen credit spreads and slow if not lower the equity market. Okay. So far, he said there is little sign they've had much effect. All this suggests that the Fed will have to raise short term interest rates by considerably more than is currently anticipated. The last time the central bank faced unresponsive markets between 2004 and 2006. It had to increase rates to five and a quarter percent from one. This episode may be a better template than the last business cycle.

Erik: Bill Dudley said that just on the third of November, yeah. Well, that's a recent quote, and certainly timely.

Julian: Yeah. And this has been this, we've shifted from, you know, betting that I mean, in January, in February of a lot of this last year, we were selling Eurodollars and we switched to selling short Sterling, then we switched to selling Euribor, which is the European equivalent of the Eurodollar notes. These are all three months, you know, interest rate futures. And they worked out very profitably. But I just don't think that we've got it yet. And in a way, Erik, and this is the point other markets have to respond. It's like the old adage, if the tree fell in the woods, or the forest and no one hears it, did it fall? Right. So I listened to all these equity guys saying, Oh, we can cope with, you know, 175 in rates. And I'm sitting there and going, but you don't get it. Because you can cope with 175 on REITs ,175 can't be the top because you have to stop you the equity market going up. You have to drive credit spreads wider. You can't have a scenario where rates only rise to the point that the equity market doesn't care because that's the tree falling in the woods that no one hears. The Fed doesn't change Fed funds to affect Eurodollars in isolation. They do it to tighten broad financial conditions because nothing hangs off three months money. Really, right? They do it to tighten to raise the price of a mortgage, they do it to slow down asset prices. They do it to make it more expensive for companies to borrow money and do buybacks, right? If you've got to slow the economy down, because you've already closed nominal GDP, and the demand caused by this massive, historically, almost unprecedented stimulus is still damn well feeding through the system. Then you may have to go a lot a lot further than people realize.

And this just isn't even built into the fixed income markets. When you look at say slide 13, right. Let's say, you know the dot plot is right. And I think the dot plot will show two and a half percent for 24. Right? We've got five year yields nominal yield at 125. So literally half of that. When you look at breakevens, you've got, you know, essentially what the market is pricing for real yields.

This isn't really real yield. But essentially, what the market is pricing at close to historic lows. I mean, certainly why, you know, as where they were just before the taper tantrum, right, which is why I wonder whether we have that coming to the bond market. I don't know whether it'll be this meeting from the Fed or the January meeting. But I just don't think people realize, essentially, how rapidly the Fed has moved to go back to, you know, an interview that I did with Grant Williams a couple of months ago, and I just tweeted out something about the you know, what are the checks central bank saying because they just raised? I think it's 75 basis points. So the ECB isn't saying the answer is nothing. They just have the ability to move quicker, because it doesn't really matter. Right? So what is what did the Bank of Canada see, when they literally ended QE, not just taper ended, the thing that the Fed isn't seeing? The answer is nothing. Just the Fed has to give it a bit more time because they're a much more pivotal Central Bank, because what they do has much larger implications for assets and risks, etc, etc, around the world. And the answer is nothing, they are beginning to see exactly the same thing.

Erik: Let's go back to this Bill Dudley quote, where he says that they could have to raise rates from 1% to 5.25% in a short period of time. What would break if they did that?

Julian: I mean, that was he's talking about the period 2004 2006. And I think actually, it's, I think that's actually pretty reasonable. Right? I think, you know, not the amount. But to draw that analogy, I think there are some pretty strong analogous situation between then and now, in some respects, but just think of it this way, you know, the Trump's spending, right, a trillion dollars, it took the Fed 225 basis points plus QT to finally crack the equity market, which, by the way, is what you have to do a bare minimum, you have to stop it rising. And we all know, once it stops rising, it tends to become quite unstable, okay, to tighten financial conditions. Right? And that was on a trillion dollars of spending, we've arguably done six times that, right, so who the hell knows what it's going to take to get this equity market to realize that? Right, but that's basically what has to break it has to be the equity market. And, you know, I think we're quite vulnerable. I generally have said this, Erik. You and I have talked many times over, you know, the last five, six years. And we've talked about, you know, the Fed creating this crack addict to whom they are now beholden, right? This liquidity junkie that they've created.

And, you know, just look at slide 14, for just, this isn't really economics anymore. This is like flow mechanics. You're putting X amount of liquidity and the other element goes up by Y. In 2013, I did a projection of where the S&P was going to be based off the price action of the the of the S&P for every 100 billion dollars of liquidity in QE two and the end of QE one. And at the end of QE three, I was 25 points shy. I mean, this is mechanics, right? So if you look at it now, and you maybe eke it out until April, maybe, maybe 20, you know, what are we looking at? We're looking at 4850. So the 150 points on the S&P. It's not much. You're kind of running on fumes here. And then things start to get a little dangerous at that point. Like, typically, the crack addict doesn't like it, when you take away his crack, it tends to throw a bit of a wobbler. And particularly if you're going to have to start to pricing, very rapid rate increases to slow this thing down. Maybe, you know, he doesn't crack straightaway because the earnings numbers are just too great. And because wage growth is enough that Americans can keep consuming, and I do think Americans

are in America is in kind of the sweet spot when it comes to funding inflation of around, you know, 5% or 6%.

I mean, if you look at aggregate weekly payroll, which is kind of like the hours work times the amount of pay that you earn, for every hour, it's rising at nine and a half percent. So essentially, if you're working, that's what you're earning. So we can fund 4% and 5% inflation. We might not like, you might bitch and moan about it. But we can do it. And this is the point I mean, this will eventually you have to crack the equity market and you're getting closer, when you've turned the tap off. This is what I illustrated here with these purple arrows. When the balance sheet goes flat, the risks rise. And what I'm told is that the Fed, if they'd have had their data change so much. And now that Powell was confirmed, reconfirmed their option was basically to bring form forward rate increases or to end QE, instantly. They were worried about the market of ending QE instantly. So they pulled it forward as fast as they can ending of QE. And that basically means it's done by the end of March.

Erik: Moving on to page 15, you've got junk bonds here truly, and I've been telling myself for like five years, surely it's gonna be time to short junk bonds any day now. But it seems like that day never comes.

Julian: I'm actually sure. We shorted them a few weeks ago, we got a technical signal that suggests that it hasn't really failed ever. I need another week to totally and utterly confirm it. But it's worked every single time since sort of 2006-07 and I have a signal to sell and we're using it as a hedge for shorts that we have on in fixed income. So we're kind of bar belling our risk. We're saying look, you know, we know, you know, these rates have to reprice. But of course, at any point of risk assets crack. You know, we know that those fixed income shorts will swing badly against this. So how do we hedge it? And one of the things that we've had is a short on HYG but you could use it for percent equity long, right? It's kind of the same thing. Because it's a really clean as you can see in this Erik. If and it is my conclusion that financial conditions at 38 year lows as I said only 30 year lows because that's as far as the data goes back are just too easy given this macro backdrop and they need to tighten well credit needs to widen, HYG needs to fall. So I think it is something you should watch very carefully. It's obviously had a nice bounce over the last few days is actually had a perfect technical retracement 61.8% retracement from the most recent highs. So it's a perfect area, I think actually to kind of slot this market and I think it's a great tail risk age.

Erik: Well, let's talk about those tail risks though because it seems to me like the real tail risk is not the very big tail risk, but the most of the way out in the tail where the market starts to blow up. And then the Fed changes their tune and says yeah, we didn't really mean that tapering stuff. We just Joshin you guys there. What do you make of this situation Julian? What's going to happen? Are we really going to taper this time or is it just another round of the Feds saying what they need to say politically?

Julian: Look, I never like to say it's different this time. And it isn't ultimately it won't be ultimately. But it is a little more nuanced this time. And the reason for that Erik is this is really the

first time that we've had a little bit of inflation in 17, right? 16 and 17. But this is really the first time that we've had to deal with high inflation, high wages, high wage growth, and so it is a little bit more difficult for the Fed. I think it just makes the putt. I don't think it ultimately takes the put away. But I think your bloody dreaming if you think that puts at 10%. I know the equity boys on CNBC will just be loaded with the rah rah rah merchants in their short skirts and pom poms going you know, buy buy buy! It's down 10%, I'd sniff if it was down 20%.

Erik: Now on page 17, you've got a warning about the 1960s. What's going on here?

Julian: So, you look, I think the Fed's trapped. And in a way, it's pointing towards Central Banks. I think to your point in it, you know, and as I said, it's never going to be ultimately different. Ultimately, we're going to have to do probably a rinse and repeat, you know, so we get our crisis. We put more money in, etc, etc. But they're very, as I said, they're in a very difficult situation now, because and I think it was hoped that they just hope inflation would go away, right? Because now what they've got to do is ugly. So they've got to tighten to tackle this overheating economy. But, you know, that is going to cause frictions with government. It's almost certainly going to undermine asset prices and because of hyper financialization, right? I haven't put the chart in here, but you can go in, you guys can pull it up. If you look at JOLTS, and you look at it against the broad US equity index, you'll see it's the damn, same chart. Right? So basically, as soon as the equity market goes down, your jobs growth will just dissipate. So I do truly think to use a British expression, their snookered. So it's very difficult, though it's impossible for them to kind of hit the ball straight on, they've got to try and, you know, play some special shot. It's incredibly difficult.

So I think that makes policy reactive which is exactly what I think we're seeing now. It's you know, the Czechs saw it, the Canadians saw it, the RBA saw it, the Bank of England saw it right. Why haven't the Fed and ECB seeing it? Well, because there's just so much more stake for these guys right? But it's not even go down the rabbit warren that the ECB is going to be potentially forced to go down if indeed they have to start to tighten, right? And what that means to Spain and Italy, etc, etc. Okay, so they are reactive, by definition. And I think that sets us up in this world. And I'm in the process of formulating my thoughts on this. We originally talked about this kind of accelerative oscillation back in early 2017 when Trump comes in and there is a tendency, Erik, because that's basically how the world works to assume that everything just reverts to the norm. Right? That we kind of work in this world of this sort of nice, benign sine wave. Right? So we get to the top of the cycle, and we kind of get, you know, if you think of it in economics, we kind of get an inventory overhang, right. And so companies start to slow down, you know, because prices and maybe isn't enough and people back off buying. It makes slow down production in the economy rolls over. And then, you know, they work off the excess inventory. And then we're at the other end of the cycle, and prices have dropped and people demand, you know, comes back and then they start to build it up again. So you get this kind of nice benign kind of sine wave.

And, you know, policy ends, you know, plays its part right to easing is on the way down, it's procyclical. It's like positive gamma, right, it's easing on the way down, and it's tightening on the

way up. And it all stays in nice uniformed check, right. And that's what we've had the great moderation, it's been lovely. Okay. And the oscillation of the economic cycles drops, you're going to look at PMIs, and you can take them back into the 40s, you can see that the world which is much more volatile, right? Well, there's a reason why you kind of get there. And it's in part because you policy becomes reactive, is no longer. You no longer have positive gamma, you're not selling into an up market and buying into a down market. You're, you know, buying in an up market and selling in a down market. And that can get you really screwed up incredibly quickly. And that's kind of what happened in the 60s. So if you think about it, and look at this chart on slide 17. So there's three things here, you've got CPI on the top, your unemployment, average hourly earnings in the middle, and then you've got government spending. So the world was great. Okay, in the early 60s. How soon period for assets, both bonds and equities, super low, super stable inflation basically oscillating either side of like, 1.3%. Back then, we didn't have the debt. So we weren't concerned about disinflation or deflation, right. No central banks were running around waving their hands in the air. Okay. It was just perfect.

In fact, the Fed thought, when initially Johnson came and started spending all this money post Kennedy's assassination, where he won both houses. He was able to push through these big spending plan. Kind of sounds familiar, we can make the comparison to Donald Trump back in 2017 when this happened. Came along, and he hit the economy with this unnecessary, right? We didn't need it, but politically driven pro cyclical stimulus, and far from the cycle, just rising up a little bit and then rolling over it truly kicked it out of phase. Okay. And the reason why we came up with this physiology of this accelerative oscillation was I was talking to one of my quants, who's a mining engineer specialized in explosives. And he said, I was looking at this chart just the top bit. And he said, Boy, boss, that's an accelerative oscillation and I said what do you mean by that, Steven? And he said, Well, if you think about an explosion happening, right, it just radiates blast waves out. And those blast waves in a void would just go on at infinite in some sort of nice, predictable sine wave. So the problem when modeling an explosion is when they hit a wall. Now, if they hit it straight on, the blast wave goes into the wall and is ultimately slowed down at some point. But it's relatively predictable. He said, the really nasty stuff is when it hits some obstacle and it glances. Because it either can slow it down, the friction can kind of slow it down completely. Or rather than that it can actually accentuate the volatility of the cycle. And that's exactly what happened.

So the Fed sitting there in ‘64, everything's great. They think they can let unemployment drop. You know you go back, and you can read the minutes. It thought it could drop a little bit further when the fiscal stimulus comes out in ‘65. And they overestimate it, right, and they start to get wage inflation and inflation, and they start to panic. And they initially raised rates 275 basis points. The end result is stock market crash at the same time, actually, you had a housing crisis, unrelated, but they had to deal with a big sell off in housing. And the effect was a much greater slowdown in the economy that anticipate. They panic, right. Once again, they reacted just as they were in ‘65 to two inflation breaking out, they become reactive. So they behind their game, they're no longer anticipating, they're reacting, right. So then they panic again. And then they cut rates really dramatically. They cut them out onto the ongoing fiscal spending. And the economy doesn't go back to the lows Erik right. It doesn't go back to the lows, it rises again and wage

growth continues to keep pushing higher. And their own work suggests that it only took this is why I said it's very dangerous for the Fed to be playing with these inflation expectations and dismiss them because we're already 18 months we've had rising inflation expectations. And the Feds own work suggesting late 60s may have only taken two years for those inflation expectations to become unhinged. Okay. And then they really hit it hard, or they think they really do and the stock market drops 36% this time and then they panic again.

And the point is, is this reactive policy response, right? Remember, we got more fiscal coming in 23-24. That's when all the infrastructure will get spent. Right. So it may slow from the absolute peak now, but it still will be ongoing. I think could set us up for something that looks like the 60s in terms of inflation. So we won't go back to the lows. As I said, I think all other things being post COVID, it probably would have absent COVID, we probably would have seen the lows in 16. Right? There are all sorts of reasons to think this societally, we needed to move into a higher fiscal spending environment, like COVID just accelerated that inevitable tipping point, right. It's just like the ends of those real rate depressions we saw over the last, you know, many hundreds of years where you ended those real rate depressions because of the end of a pandemic or geopolitical thing, which this time could easily be the US-China, right? The breaking down of those supply chains, etc, etc. Right?

But the point is, is once policy becomes reactive, okay? There is a risk, Erik that because it's late, rather than snatch really slowing rather than just dampening down those nice sine waves, right? That it hits it at the wrong point and it accentuates the cycle. And that's how things get out of whack. Right. And if you've at the same time, if you're moving to a just in case from a just in time supply chain, where you build up much bigger inventories. I mean, I'm not dismissing the fact that we could have a recession the second half of next year, I can easily construct a scenario where that happens. Okay, that we've actually built up too much inventory, right. And the Fed starts to hike really aggressively in the first half of next year. They run down that balance sheet right? Suddenly all these chips arrive, all that manufactured in between there's a lot of semi-finished manufacturing inventory sitting out there ends up on dealers for courts or onto shelves of stores, right? We go from famine in terms of supply to feast in terms of what's in front of actual consumers, just as the Fed's reaching, you know, cruising speed in terms of tightening that we could crash down again.

But that's back to that very volatile kind of world that we weird because you the big thing that used to throw us off whack in the past were those inventory cycles, right? And then you get into all these sorts of games right? You know, What does the Fed do then if we get another crisis? Right, what does the Fed do then Erik? I think we know the answer, boss. So look, I think at some point, they will do what they've always done. They will subsidize the bond market, and they will support the equity market. And I think it's exactly what happened in the 60s. The dollar will ultimately get thrown under the bus. We're not there yet. Got to get the crisis to get there, the response function to deliver that, okay. You know, but if they go down the road of they decide that suddenly, you know, real rates shouldn't be higher, and that they need to come in and do either accelerative QE or YCC, or something like that. I can easily see the dollar get thrown under the bus. I don't have the position on now. You can see on the last chart, the dollar

is nowhere as far as I'm concerned. Okay, at this point in time, but I think it's getting, I think he's getting very interesting. I think it's getting very interesting. I think people are grossly underestimating. And certainly the equity market is grossly under estimating the risk presented by the central banks at this point, because I think finally, the Fed is beginning to see what we've been talking about for a year now.

Erik: Well Julian, I can't thank you enough for a terrific interview. Before I let you go, though, please tell us a little more about what you do at MI2 Partners.

Julian: So MI2 Partners is, has been open for over 10 years now. We're an institutional research provider. And most of our clients are sort of hedge funds, big mutual funds, family offices, etc, etc. And if you're interested in getting in touch with us, you can get in touch with us at support@mi2partners.com If you are retail and you'd like to follow us, then you could also use that same address support@mi2partners.com and we'll put you in touch with the guys at real vision so Raoul, Paul and myself have a joint product called Macro Insiders and it's more geared towards that type investor. And then finally, if you just want to follow me then follow me on Twitter at @JulianMI2.

Erik: Patrick Ceresna and I will be back as MacroVoices continues right after this message from our sponsor.