Darius Dale: Reflation Will Give Way To Deflation

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Erik: Joining me now is 42 Macro founder Darius Dale. Darius has prepared an outstanding chartdeck to accompany this week'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. Just go to the homepage macrovoices.com, click the red button above Darius's photo that says, looking for the downloads. I want to let our listeners know, this particular slide deck is a lot longer than we're going to have time to cover in the podcast. We're doing this intentionally because there's so much value that is contained in this particular slide deck, which I wanted our listeners to see even though we won't have time to cover all the slides in the podcast.

Now, Darius works from a systematic approach to macro investing where he tracks what growth is doing, what inflation is doing. And he kind of makes a grid that says okay, when inflation is going up and growth is going down, okay, these circumstances are going to exist. So there's four different possibilities there. Darius, most of our MacroVoices listeners already know your system, but for the benefit of newcomers, what's the best place to learn about the basics of that system before we dive into the meat of it?

Darius: Yeah, absolutely Erik. I appreciate you guys having me back on. Happy New Year and all that stuff even though Larry David tells us we can't say this past the 7th. I'm violating the rules here. But in terms of finding that presentation, we put that together on our YouTube channel, we'll make sure the link is included in this week's Research Roundup.

Erik: Fantastic. Now the last time that we had you on talking about not how the process works but applying the process, you told us look, you believe that we're going to see secular inflation over the next several years. But you put in a really big caveat. You said look, the signals are telling me we're going to go the opposite direction. A little bit of a pullback before that inflation trend resumes. How did that call workout? And are you still on the deflation call or if you flipped back to an inflationary outlook?

Darius: Yeah, that's a great question. So I would start with maybe slide 26 is probably the first place to answer that question. So we did get the pullback in terms of unwinding the prior reflation regime we obviously saw some pretty material drawdowns in a lot of physical commodities and a lot of digital commodities throughout the summer months, but then we actually had a sort of bounce in reflation, as the world really pulled out of Delta. And now we're actually having a secondary bounce in reflation as the world is really sort of pricing in this dynamic whereby Omicron crowds out more dangerous variants of COVID and effectively ends the pandemic. This is something obviously, you've been talking about in your show for quite some time. Ultimately, we see this sort of kind of tertiary reflation bounce fading into a sea of deflation that we show on slide 10 that we ultimately think asset markets will be forced to move to price in in a few months.

Erik: Darius, I want to go back to something you just said about Omicron crowding out the other strains, because when I go back to page 3 of your deck, you say here, specifically Omicron crowding out the more virulent strains and effectively ending the pandemic phase of the COVID-19 crisis. Darius, I know you understand this subject very well, and I am in agreement with you. But I've also learned from the feedback I've gotten on Twitter and email in response to our podcast coverage of this subject, that a lot of people are not following it. And what they're saying is, wait a minute, you're saying that Omicron, because it's so transmissive is going to crowd out the prior strains? Well, what if the next strain that comes after Omicron? If we don't run out of Greek letters first, that is, what if the next strain is much more dangerous than Omicron and even more transmissive, and it crowds out Omicron? What's to stop that from happening? Why wouldn't that be the next thing? Please help our listeners understand this.

Darius: Indeed, indeed, first apply the quick boilerplate language that hey, I'm obviously not an epidemiologist, it's not something I've studied. But certainly from listening to smart folks like you and Dr. Chris Martenson and even my former colleague, Neil Howe, at the onset of the pandemic, you know, this was always going to be the likely phase, or sort of the likely progression of how this would play out. Which is we're going to see increasingly less virulence from subsequent variants, because that's what viruses do, they want to stay alive, they want to keep the host alive so that the virus can reproduce and find new hosts. If the virus is too deadly, then obviously, that process is obviously culminated early, so we're going to continue to see more and more mild variants. And ultimately, that's why we believe the pandemic phase is sort of ending in the near term.

Erik: Darius, something I noticed in the feedback I got on Twitter and email. I think there's a key concept that people are missing, which is they're saying well, wait a minute, you know, omicron, the next variant that could come after Omicron might be even more transmissive really think about this, like a competition, like prize fighters. Omicron has an R-naught of 6.0 or at least it's estimated at that. There's almost nothing except maybe measles that's more transmissible and more contagious than Omicron. People are saying, oh, but look having Delta didn't save you from getting Omicron so having a Omicron is not going to save you from getting whatever comes next. The point they're missing is they're looking at the wrong data. The growth of Omicron has completely defeated the growth of Delta. The case counts are showing that delta is less than 3% of new cases now, because Omicron has crowded it out, what it would take to crowd Omicron out is something much more transmissible than Omicron. For something to become more transmissible to Omicron, while it's killing a substantial percentage of the hosts that it's in, is almost impossible.

Now, I don't know the science any better than you do. But everything I'm reading jives with what you're saying Darius. And what I've just described, which is you don't want to look at whether or not getting Delta saved you from getting Omicron. You want to look at whether the breakout of Omicron ended the breakout of delta, which it very clearly has. And then I'm going on faith from there that the what the epidemiologists and experts tell us is that for something to be more contagious than Omicron, and much more deadly is almost impossible, not completely impossible, but profoundly unlikely. Anything else that you want to add before we move on from this subject? Because I think it's a really important one.

Darius: No, the one thing though, the final thing I'd add on this entire discussion topic goes back to where we started, which is the fact that your feedback loop in terms of Twitter, your inbox, and etc. There still is large contingent of investors out there that don't necessarily buy into what you and I are discussing and agreeing upon right now tells me that this sort of nascent reflation regime that is sort of perked its head up here, in the recent weeks has it certainly has legs, I mean, it certainly could have legs for a few months until we ultimately get into the market having to price in the cyclical decelerations and growth and inflation.

Erik: Well, now I want to hit you with the hardest question or what I think is the hardest question. Let's suppose that you and I have this exactly right. And that what's about to happen is that Omicron is going to basically turn the COVID crisis into a common cold crisis. Everybody's going to get it, the Omicron wave is going to be the one that just about everybody got that darn thing. But most people didn't get very sick over. It becomes endemic, it's a new form of common cold, it's a real nuisance for society forever. But the pandemic phase is over. And let's suppose that that means that we're going to return to rapid growth of the global economy, we're going to get rid of all of the travel restrictions and lock downs and so forth and reopen everything.

Okay, simple question but I would argue, incredibly difficult to answer. Is that good or bad for the stock market? That we're coming out of this horrible, horrible global pandemic crisis in into good times? And the reason I asked that question there is look at what happened in the other direction, everybody assumed it was going to be a horrible news for the stock market. But then we figured out that actually, with all the stimulus the government throws in, it was good news that we were having a global pandemic, at least in terms of asset prices. So does that mean that the recovery is bad news for asset prices?

Darius: Yeah, I tend to think that the sequence of events really does matter. So if you start on slide 28, and sort of look at what we call our cross asset correction risk Indicator, I won't get into sort of how it's calculated, you guys can come check out our site on that. But the reality is we sort of gotten to a place where investor consensus was sort of peak fearful, kind of a heading into the middle of, you know, December. And the unwind of that, that sort of, you know, consensus fear has perpetuated the reemergence of a reflation regime, which in our opinion, is being predicated on this sort of Omicron ending the pandemic dynamic. And so to the extent that investors, you know, sort of have to re-lever up and kind of chase that, that should perpetuate a positive asset market response, you know, kind of into throughout Q1, and maybe even as late as the early part of Q2.

But to answer your question, we would argue that the sort of the ending the pandemic phase of the economy is coming at precisely the wrong time, as it relates to asset markets or financial conditions because you're talking about a sort of a fiscal and monetary policy tightening or dual contraction if you will, not just in the US economy. But this is a pretty broad base throughout the global economy if you look at most parts of the developed and emerging world. And the reality is it's very unlikely we meet consensus growth expectations in that process and that's certainly something I'd like to unpack.

Erik: Okay, let's talk this through then. Because it seems to me that where we're headed is we're going to see this reflation where there's a recovery in the economy. At some point that causes governments to say it's time for us to withdraw stimulus completely. And as soon as they do that, markets start to panic and governments say, oh, boy, we started a fire we can't put out we got to keep at least some of this stimulus going in order to not crash the market. Is that the right way to think about what's coming and how do we know which phase we're in?

Darius: No, no, I think to be honest. And Frankly, I think that's precisely the wrong way to think about what's coming in our opinion. The Fed is it not only behind the curve, but increasingly falling behind the curve. You know, in our opinion, the last two labor market reports, you know, the November jobs report and the December jobs report really sent a really sort of sent a signal from our perspective to asset markets that the labor market was much further along in really the Fed is acknowledged that it realizes. Kind of looking through kind of a few slides on that starting with slide 99, just looking at labor supply, it's at a pretty material recovery if you think about the improvement in the employment-to-population ratio and the female labor force participation rate. And you know, if you look at slide 100, the kind of improvement in the total number of people who are unemployed, and the total number of people in the labor force both really accelerated markedly post the expiration enhanced unemployment insurance. And really, the key takeaway of what I'm saying here is on slide 101 and 102. If you sort of parse the labor market out by education cohort or on slide 102, if you parse it out by ethnic cohort, you're seeing some really, really material step function increases and improvement in the sort of cohorts that are most impacted by the pandemic, whether it be those without a high school diploma, those with a high school diploma, you know, Hispanic workers, African American workers.

And so that leads me to where we are on slide 103, which is if you sort of take our models, forecasts at face value, and our models forecast for core PCE are a little bit more sticky than the consensus forecast for core PCE. It's very likely we've been arguing this since early December, it's very likely that the Fed has to hike four times in 2022. And more importantly, now that they've interjected this sort of quantitative tightening metric into the equation, it's very likely we see even more policy tightness then investor consensus expects at the current juncture. And again, this is a function of the labor market being extremely robust and tight, jumping back a few slides on slide 98, where we show employment cost index relative to the quit rates in the JOLTS data, you know, the Fed is sort of moving, the Fed was right in terms of, you know, the tradable goods, inflation being transitory, and we're already seeing that if you look at the NFIB survey data, the consumer confidence survey data, if you look at the ISM so both the manufacturing and non-manufacturing. The percentage of respondents reporting slower supplier delivery times those are crashing in both surveys now.

So they were right on that call, but what they're missing is the wage pressure that's building up in the economy. And so ultimately, to answer your question Erik, sorry about the long winded answer. Slide 104 is kind of all you really need to know, which is the blue line just shows regressing in the global growth cycle. And the black line shows kind of the relationship between high beta stocks relative to low beta stocks. And the red line shows the relationship between Bitcoin and Treasury bond prices. And as you've seen the last few cycles, and I can pull this chart back as far back as we get the data, you know, whenever we roll off the peak of the global growth cycle, and the US is a real key contributor to that. At the current juncture, at least in the few months, they will be it's been, you know, sort of, for lack of a better word is quite that been a lot of pain, there's been a ton of pain and a high beta risk assets and commodities in particular, whenever the global growth cycle peaks and rolls as we are projecting it it sort of really starting in earnest in Q2.

Erik: Okay, Darius. So it sounds like what you're saying is in your view, the Fed is late to tighten and has lots of tightening that it needs to do in order to catch up. If that's your view, does that mean you expect the Fed to actually do those things? Or you just think they should and regardless of what that answer is, tell us kind of how you see this playing out. Let's assume that you and I approximately have this right that either Omicron ends the pandemic or at least ends the pandemic phase to where we still have a COVID problem. But it's not shutting down the economy anymore. If it goes in that direction as you and I think it will talk us through how this plays out.

Darius: Yeah, absolutely. So it's our view that the Fed is very serious about this sort of sort of policy tightening dynamic. And if anything, you know, it's really just a function of there you go back to August of 2020. All we're seeing is really just the other side of their policy framework adjustment. They've adopted a sort of, you know, average inflation targeting framework to allow for, you know, sort of the improvement for their maximum inclusive, the revised maximum inclusive employment mandate to be accomplished. And now, not only are we accomplishing it, we're accomplishing it much much sooner than I think anyone at the Federal Reserve, or quite frankly, any of us investors would have thought, you know going back to that August of 2020 timeframe.

And so to answer your question, I do believe they're very much in line to see a decent amount of tightening. Because again, if you think about where we're coming from. the starting point, is pretty astronomical if you think about kind of where inflation is relative to its longer term time series. We show that on slide 8. Now we show slide eight on terms of headline CPI, but I think a more kind of important inflation metric would be on slide 92, which is median CPI. Median CPI on a SAR basis is coming off its all time high rate in the month of November and the reality is, you know, even though it's ticked down in the most recent month, the reality is it's still extremely elevated relative to the longer term time series. So there's a tremendous amount of inflation pressure brewing in the economy.

So you know, to answer your question, I do believe that once they get going and to be frank, I believe they've already kind of gotten going in terms of, you know, doubling the pace of tapering, and really putting march out there as a legitimate policy tightening likelihood. And also introducing quantitative tightening into the mix, I wouldn't necessarily say they're on a set it and forget it path like they were in 2018. But I do believe the Fed put is significantly lower than we've kind of become accustomed to as investors, because it's very unlikely that the Fed will have any data, particularly coming out of the labor market for at least a year, if not more, to allow them the sort of pivot back in a direction, that's dovish,

Erik: Let's try to reconcile what you're saying with what the stock market is doing. Because back in 2013, we had this big taper tantrum where the markets said look, if the Feds really serious, and they're actually going to taper their asset purchases, and they're going to, you know, start maybe even shrinking their balance sheet. That has to be bad for the stock market. So everybody panicked, but the learning experience from 2013 was well, yeah, the Fed says they're going to do this stuff until the market starts to collapse, and then they change their mind. And next time, we'll just ignore it and look through it. And it feels to me like that's what's been going on, is there's lots of reasons, there's been plenty of warning from the Fed that they're getting ready to taper. Nobody seems to sweat it. Asset prices just keep melting up. So do you see this as there's an awakening moment where all of a sudden we have a market crash because everybody realizes the Fed was serious or does the Fed turn on serious on us like they did last time?

Darius: Yeah, I think I think to answer your question, I think it starts on slides 94 and sort of ends on Slide 95. Starting with slide 94, I do believe a market crash in 2022 is a reasonably probable scenario. And the reason I say it's a reasonably probable scenario, just sort of looking at kind of attacking that the question twofold. One, here on slide 94, we show the real S&P 500 earnings yield, you know, this is something we've had the deck for quite a while now, which is hey you look every time the S&P 500 earnings yield i.e. the stock market's valuation has gotten so pricey relative to inflation dynamics, you typically what happens is the Fed has to respond to that on the lag, and really sort of perpetuate a material tightening financial conditions. You know, the back test on the real earnings going negative, you know, in the last sort of 50-60 years has an end size of six. And there's been two 10% corrections from that threshold breaching. There's been a one 20% correction from that threshold breaching and there have been three 50% corrections from that threshold beaching. So obviously, the median is a lot closer to 20, than it is to down five as we've come accustomed to really since kind of late 2020, early 2021.

Second chart is on slide 95. And this sort of takes me back to the point you made with respect to 2013 and that taper tantrum. You know, the reality is and what I'm showing in this chart on this slide on slide 95 here is how we calculate net liquidity, which is simply the Fed's balance sheet minus the Treasury general account, because obviously, those two levers have a pretty outsized influence on either tightening or easing financial conditions. And so what we found is that whenever the slope of this line, the blue line, which is the net liquidity line, as we calculate it, whenever that slope flattens out, you typically have some pretty material sort of drawdowns in the stock market, you know, kind of isolating 2010 as a good example, you know, we had 16% drawdown then. 2011 would be a good example, 20% drawdown then. 2012, I think we had a couple of 10% draw downs with that flattening. Obviously, you can barely see the taper tantrum on the chart here on slide 2013. And part of the reason for that is that we had a pretty massive shift higher in net liquidity provision out of the Federal Reserve, and that really didn't stop until you got into the sort of middle of 2015.

And that's when we saw the China de-val really have material market impact. But we would argue this as more of a bigger factor that the risk was already there, the China Deval. If anything really just amplified the risk and sort of allowed the market to correct. And these had another one at 15-16% decline at the start of 2016. And then obviously 10% decline in early 2018, 20% decline in late 2018. And lastly, they stopped fixing the repo market in early 2020, which is precisely the wrong time to stop doing that. So, obviously saw 35% decline. So that was a long winded way of saying, hey, whenever the blue line in this chart flattens out as we expect it to do, irrespective of Qt and Qt will only make that matter worse, we're going to come into some pretty bumpy time. So investors should be really thinking about managing a tremendous amount of risk kind of starting in early Q2 and potentially persisting throughout the end of the year.

Erik: Now talk to me a little more about this blue line on page 95, because it's obscured a bit by the red line. And it's a little hard to read, but it looks to me if I kind of squint and I can talk myself into the idea that maybe it's peeking out and starting to reverse. Normally, I would say that that little blip is not big enough to really tell me it's topping out. It's not a big enough blip but if I put the rest of the story behind it, it sounds like maybe that blue line really is topping out. Is that your view?

Darius: Yeah, that is absolutely our view. I mean, our view is that you know that the blue line is slowly approaching it's sort of crescendo as a function of sort of wind down in QE. Don't forget, the Fed is still buying bonds and adding liquidity to the system through, you know, sort of through February. And so you know, we have at least another month of them sort of, you know, accumulating assets and perpetuating that. But the reality is, you know, now that we're on the other side of sort of the budget deficit being passed, which is on slide 96, you look at the Treasury general account, that balance is now starting to go up. And that's obviously a negative value or sort of has a negative influence on the on the blue line going back to slide 95. And so, you know, the reality is, if quantitative tightening gets introduced into the mix, which again, we think that sort of a, you know, at the earliest maybe late Q2, early Q3 dynamic was sort of in line with Goldman on that one, if that does get introduced into the mix, at the same time, the Treasurer general account balance is continuing to tick up, you're going to start to see a more material decline in the blue line.

But the reality is, you don't I don't think you need to see a decline in the blue line. I think the confluence of a sort of faster than expected growth, slowdown, the confluence of a cyclical deceleration and inflation, but particularly remaining sticky in some certain pockets of the market, like shelter CPI and wages, and also sort of the starting point of asset market valuations, those three factors alone could coincide and perpetuate a 20% decline in something like the S&P 500, which obviously, it'll be much worse in higher beta risk assets.

Erik: Now, this is just my personal view. But it seems to me like what's most important in that scenario, where you're seeing, let's say, a 20%, correction and asset markets, it's going to be the posturing and the messaging from the Fed. Because if they're saying, look it, we're not in the business of bailing out markets and we mean it even at 20% down, we still mean it! We're not in the business of bailing out the stock market, I think that could lead to a collapse of confidence or of complacency rather that could really really, you know, take us down to 40% really quickly. On the other hand, if the Fed starts to cave again, and say, oh, well, you know, It's 20% down, maybe we're gonna change our story and be a little more accommodative. I think that just sets up the next generation of moral hazard, if you will. How do you see this going down? Is this the time when the Fed finally is going to put their foot down and say they made it?

Darius: Yeah, no, I do believe this is the time where the Fed has to put their foot down, because I think one thing that is different in this cycle that is very different and unique, relative to the most recent, you know, set of iterations on the inflation and labor market front, which is, we actually have legitimate wage pressures. Going back to slide 98, we have an all time high in the quits rate. If you go to slide 99, the sort of the labor force participation rate for prime working age individuals, that's the middle chart in those three panels hasn't improved at all in the last sort of six months. And the reality is, we've seen a structural reduction in the total available labor supply, not just domestically, but also internationally. And that's obviously feeding back into the wage pressures that are ultimately sort of, you know, really amplifying a lot of the sort of tradable goods inflation that we're seeing from supply chain disruption.

And so the reality is, if you go back to slide 103, it's like hey where will inflation be relative to their targets, relative to the mandate, and relative to their stated objectives at various intervals throughout 2022? Because I think 2022 is the real big issue as it relates to financial markets. I don't think the market cares about, you know, the Fed hiking rates three or four times in 2023. To me, the financial market risk is all concentrated in this 2022 timeframe. And the reason I say that not to be cute with the calendar. But the reality is, is we have some pretty, I think funky would be the best word to use to describe some of the growth dynamics in the economy that could actually come home to roost in a material way to the downside for asset markets, just as the Fed is sort of kind of locking itself, if you will, by the data. Again, this is a data dependent Fed. The data are locking the Fed into a very tight policy setting. And so if you don't mind, I'm happy to unpack those.

Erik: Darius unpack away.

Darius: Yeah, absolutely. So, you know, let's start with slide 80. We're just showing the yield curve flattening, obviously, we've seen a cyclical bounce in the in the sort of the flattening of the yield curve, and I do believe that it has duration through however long this reflation regime we're currently in, is likely to last and to persist. But the reality is, ultimately, we're just going to make a lower high in all these yield curves. And part of the reason I think we're making lower highs on yield curve terms starts with 81 and 82, which is, you know, if you think about the income that consumers are actually receiving, you know, from the labor market, and you know, ex-government transfers, you know, we're actually contracting at a minus 3% annualized pace in the most recent month. That was the November PCE data, and you actually saw that have a pretty material impact on consumer spending. That's on slide 82, the third panel there shows the seasonally adjusted annualized rate of consumer spending basically grind to a halt in November. Now, clearly, there was some pull forward in terms of demand in the month of October, but again, citing the chart, the prior chart, you know, wasn't just demand, it was very clearly that income growth on a real basis. Ex-government transfers is actually contracting at a pretty material rate.

And so that brings me to my next series of slides, which I think are important for investors to spend some time on, which are, you know, starting with 83. You know, we show the delta between the goods consumption line, obviously, we've been over consuming goods in this pandemic, relative to consumer services. And there's this expectation in the market that service assumption once the pandemic is over, it's going to come and be a real big panacea in terms of supporting growth. And I don't disagree with that, I think that's a very reasonable assumption. The problem is we are over consuming goods to a degree that sort of dwarfs the size of the under consumption in services. And that actually nets out to a negative number. And that's important if you think about slide 84, which is, you know, Bloomberg consensus, and this goes back to the point of market risk. Bloomberg consensus is expecting above trend growth meaningfully above trend growth in 2022. In fact, that 3.9 estimate is 170 basis points north of the five year trend line through 2019. Right, like if you think about that, okay, what is Bloomberg consensus looking at in the context of a consumer spending a consumer that's already starting to stall out in late Q4 of 2021. Well, the reality is, there's obviously the kind of the consensus view is, hey, well, there's a lot of excess savings in terms of our calculations on, you know, the amount of checkable deposits and currency assets households hold is roughly about $2.6 trillion in excess savings. But then you think about the excess budget deficits, the US government has sort of piled on, it's really supported growth in the last couple of years. Our math on that is around $2.3 trillion in excess budget deficits relative to the kind of the legislation associated with the tax cuts and Jobs Act, which is, you know, effectively law. Now the law governing the land in the absence of the build back better agenda, which we always thought had a really low percentage chance of passing, particularly once we saw that October inflation reading.

And so the kind of] the key takeaway on all this is, if you assume the kind of the rise on slide 86 here, if you assume the rise in the net worth of the bottom 50% of households by wealth distribution is all cash, which obviously it's not. There's some stocks, there is some crypto, there's, you know, housing assets, there's all this other stuff. But if you assume it's all cash waiting to be spent into the economy, it's, you know, just shy of $700 or $800 billion. Well, that $800 billion is roughly in line with the total amount of inflation households are expected to experience in the year 2022. So you kind of the bottom half of the income and wealth distribution in the US economy has already been priced out of the economy, is what we're effectively saying. And so kind of taking it back to slide 84, you know, those growth expectations are pretty materially elevated, relative to kind of where trend growth is in the US economy. And so in our opinion, the balance of risks is very much skewed to the downside with respect to growth. And the reason I bring that up is because we have a federal reserve that won't have any data for a really long period of time. Data from the labor market and live data from the sort of inflation readings, that'll tell it to back off, that will tell it that it's tightened financial conditions too much. And that's a real big problem if you can go back to slide 104, in terms of where we are in the market cycle.

Erik: Darius, we've been talking about a lot of your cyclical views. I want to talk bigger picture, longer term secular views. This whole inflation debate that you and I talked about this last time, we had you on the program, and you said, you really think we are headed towards secular inflation. But I don't think we really quantified what that means. And what I'm finding as I talk to a lot of people is different people have very different ideas of how much inflation is a lot of inflation. Some people are saying no, we're not going to get nearly as much as the 1870s. It's only going to be 10 or 12%. Other people are saying we're going to get huge inflation of 3 or 4%. So it really depends on your perspective, what are we talking about in terms of what's coming for this secular inflation that you and I see ahead? Is it bigger than 1970s or is it much smaller than the 1970s?

Darius: Yeah, that's a fantastic question. And you said a word that really struck a chord with me in a very positive way, which is quantifying. I mean most investors that are familiar with me and familiar with my work over the last sort of 12, 13, 14 years, you know, goes back to, you know, kind of my time and my prior shop Hedgeye, you know, developing, you know, their regime base economic and asset allocation system called the quads and ultimately sort of developing what we call our Grids here at 42 Macro, which is quantify everything that can be quantified. You know, reduce this sort of, you know, narrow the range of probable outcomes, so that we can make better investment decisions as investors. And so, you know, as it relates to sort of this secular inflation narrative, which I you know, emphasis on the word narrative, because that's what I see from a lot of investors, which is, inflation is going to be much higher, therefore, you must do this from an asset allocation perspective. And I don't necessarily disagree with the kind of premise of that, but I do think it's important to sort of put some bands around that and ultimately reduce the size and kind of the frequency of observations on the tail, so that we can actually be in the right assets and at the right particular moments in time to take advantage of that theme, of that view. And so starting with slide 57, this 57 and 58 are two of the four sort of secular drivers of economic risk in our framework and you know, starting with slide 57, that's politics. And how we quantify political risk is through the lens of the Gini coefficient, which we show on the x-axis. And the y-axis shows the prime working age employment to population ratio. And very clearly, if you look at where the United States sort of data is on the scatterplot, it's very clearly that we're much more akin from a political risk perspective to our emerging market counterparts than we are with respect to our developed market counterparts in Europe and Japan, and obviously in Canada and places of that nature.

So you know, that, in our opinion, is on slide 58. That's why the US responded so aggressively to the COVID 19 pandemic. There's a sort of zeitgeist of inequality and frustration out there among the US voter base that is really catalyzed kind of a sea change left a jump condition left among both parties with respect to their willingness to sort of, you know, blow holes in the budget deficit in order to appease the various sort of cohorts in their voter basis. That takes me to slide 59. And so we can spend a decent amount of time on here in this slide in the subsequent slides kind of going through, you know, 59, all the way through kind of 77 really summarize our longer term views on inflation. But the key takeaway here is that, you know, we built a dynamic factor model that takes into account all of the major drivers of inflation, both to the up and down over the last few decades. And ultimately, our math in terms of that model is suggesting that the stationary mean of CPI of inflation time series in the US economy is transposed itself around 60 to 100 basis points higher. That's somewhere around sort of 40 to 70 basis points for PCE, and that that has a material impact as it relates to your asset allocation. That has a material impact as it relates to, you know, sort of, you know, your longer term sort of portfolio construction within the equity and credit markets as well.

But the key takeaway is that we're not headed for runaway inflation. If you think about kind of looking towards the bottom of this table, you know, the stationary mean of CPI using headline CPI is kind of the easiest sort of metric to observe. It was only 1.8%. in the prior decade. Our model was, you know, in terms of where all the factors are currently ranking now we don't adjust the factors and weight them relative to their impact with respect to predicting inflation. And the reality is we're talking about inflation, really the stationary mean i.e. the level with which inflation oscillates around. We talking about a stationary mean of somewhere around 2.4 to 2.8% as it relates to the latest data, and this is taking into account all the different changes of things that have happened in the pandemic. If you look at you know, kind of just quickly going through the slide, slide 60 automation has come down a little bit, consumer demand has come up slightly a bit, demographics have gotten more disinflationary. At 62-63, the Fed reaction function has gotten much more inflationary. Slide 64 of the fiscal balance has gotten inflationary. Slide 65, globalization has actually gotten inflationary. A lot of people just say globalization as a longer term factor in terms of perpetuating disinflation. But the reality is, we've been moving in the wrong direction on that scorecard for almost a decade now. And in fact, it's actually gotten more inflationary in terms of the lack of global reduction in globalization in terms of how we calculate it through the imports of goods and services as a percent of GDP.

On slide 66, household formation is materially higher, it's inflationary. (slide) 67, income inequality is materially higher. That's disinflationary. Slide 68, money supply is obviously much more inflationary, but money velocity on 69 is actually quite disinflationary. All time lows in money velocity. Slide 70, monopsony power that's disinflationary, we have much more concentration in market cap and share of income both domestically and globally. In the larger sectors of the economy, larger firms relative to smaller firms. Slide 70, public debt that's obviously extremely inflationary. That's one of the most commonly cited metrics in terms of why we are likely to have an inflation problem or deflation accident over the next few years. Slide 72, technology's gotten significantly more disinflationary, if you look at sort of our proxy for that is the market cap of the NASDAQ 100 relative to the Russell 3000. And then wages, obviously extremely inflationary if you think about kind of where we are in terms of employment cost index, but then when you kind of back into it from a wealth effect perspective, that's even more true. But lastly, wealth, it's actually gotten significantly disinflationary, and that takes us back to that analysis we did on slide 86, which shows you know, the consumers plan to lower 50% of the households by wealth distribution only have about 2.3% of total wealth. So that's obviously moving in the wrong direction, or at least in terms of the wealth that's being concentrated among households here on slide 75 that are unlikely to spin that wealth. You know that that is disinflationary. So taking it back to slide 59, you know, we kind of walk you through all the various puts and takes in our dynamic factor model, and we're happy to sort of debate investors on you know, what needs to be weighted where and what but the reality is, we've jumped conditioned in inflation, but we have not jumped conditioned in inflation from a secular perspective in terms of the trending rate of change of inflation and the trending level that we're likely to see over the next few years.

Erik: Darius, on the bottom of page 59, you're showing 2020 through 2029, your mean projection for the weighted Z-score model of 2.8%. Now, how does that translate to an expected inflation rate during that same period?

Darius: Yeah. So that 2.8% is our models estimation of the stationary mean of inflation, which is sort of the neutral level of inflation that the periodic function will sort of oscillate around. And so if you think about kind of, you know, going back to the prior, if you look at slide eight, kind of real quick, you think about inflation kind of bottoming around, let's say, you know 1% in recent cycles, kind of get up to 3%. And that the reality is stationary mean for that hope function was really somewhere around 1.8%. Or effectively we're arguing is that, you know, if you take everything into account that actually matters in terms of projecting and influencing inflation dynamics here in the US economy, the reality is we've only transposed ourselves higher in terms of that stationary mean around 60 to 100 basis points in terms of our math on that. Now, obviously, our math can be debated. But the reality is, I haven't seen anyone really try to quantify inflation. I've seen a lot of quantification on okay, there's structural deficits here and there. And this is why you need to belong this commodity or that commodity.

But the reality is, if we're not talking about a 1970 style runaway inflation, that obviously has material implications from an asset market perspective. If you think about kind of risk parity, the 60-40 portfolio, and things of that nature, you know, that we show that on slide 76, which is based on our model's estimation, again, based on our quantification of these dynamics, it's very unlikely that we've achieved or cross into the death of the 60-40 portfolio or risk parity, obviously, that's been, you know, not the best place to be, you know, in terms of the backup and duration risk we've seen in recent months, in recent quarters. But the reality is, inflation needs to average a lot more than sort of 2.4 to 2.8% on a headline basis to kill sort of the inverse correlation, in our opinion, between stocks and bonds. That's what the blue line in this chart shows, which is a persistently positive correlation between stocks and bonds, the long bond relative to the Dow Jones Industrial Average, you know, that persistently positive correlation was during a time where inflation the stationary mean of inflation was 5%. Or basically, you know, nearly twice is what we're talking about, it's likely to average in the ensuing decade or really throughout the 2020s. And so if you talk about it, the stationary mean, of inflation being roughly half of that 5%. In our opinion, it's very unlikely the dynamics, which really perpetuated the sort of the build up of the inverse correlation between stocks and bonds, that really began in earnest, kind of in the late 90s, it's very unlikely that those functions, those features have really kind of changed in a material way that will perpetuate a return to a more persistently positive correlation. So, you know, for a lot of institutional asset allocators out there listening to this, I know, they're sort of, you know, kind of relieved to hear me say this. I'm sure other investors are doing similar work on this, but the reality is, in terms of our conclusions on it, it's very unlikely that these things have died.

But I say but! If you look at slide 77, you know, the kind of the key takeaway is that, you know, investors, you're thinking about asset allocation from a longer term, from a strategic perspective, you're obviously really quite focused on what to, you know, substitutes for the 40% for the fixed income portion of the portfolio. And the reality is, you know, on a real basis, if you hold bonds to maturity, you're going to lose money. That's clear, I think we know that. I think everyone gets the joke on that. But the reality is, that doesn't necessarily mean you're going to lose the inverse covariance between stocks and bonds that allows it to be the reasonable beneficiary in your portfolio. And Chris Cole at Artemis has talked about this as well.

So the reality is, you know, in terms of alternative asset classes, you really got to focus on the 60. If your goal is to make money in a higher inflation regime. Now, again, this higher inflation regime means the Fed put is lower, which obviously means stock prices are likely to be are not likely to be as supportive as they were in the prior decade, which likely means you should be as an investor trying to find some more juice in areas that have better fundamental stories like crude oil, like certain pockets of the physical commodities, markets. And so that's exactly the lesson we learned in 1970, which is, it wasn't necessarily the 40, it was partially the 40. But more importantly, it was the 60 or 70, and reconfiguring your asset allocation within that. that portion of the portfolio as it relates to increasing your exposure to commodities from a longer term perspective.

Erik: I want to talk about the portion that doesn't fit in the 60-40 conventional portfolio. And that's the portion that a lot of our listeners have put into a speculative trade. That's all about inflation, which is gold or other precious metals. And the argument there, I want to make sure we keep this in perspective because you are describing what you think is a coming secular inflation period, but it's nowhere close to a 1970s double digit percentage points. You're saying that inflation is going to persist for a long time and might even get as high as 3%. That's kind of your story. That's not anything close to the 1970s runaway inflation situation. A lot of people made a speculation myself included saying look, we know governments are going to take the easy way out. And they're going to do the wrong thing long term in terms of risks they're taking in order to do what they think is going to work in the short term. That means they're going to print money, they're going to debase the currency, that can only mean that eventually the price of gold goes to the roof. Well, guess what? We kind of got all of those predictions right except the price of gold hasn't really gone through the roof yet? What's going on there and does that mean that we're just not headed toward the secular inflation and price a gold's never going through the roof and that speculation is a dumb idea?

Darius: Yeah, no, I think gold, I'll be the first to tell you that gold, you know, we do a lot of work in terms of quantifying things and understand a lot of these dynamics, I think, as well as most, but the reality is gold has confounded a lot of investors in Year to date. We actually recently sold our gold exposure as a function of it not really behaving the way we thought kind of in the prior sort of, you know, inflation-deflation regime that we kind of saw in late 2021. So the reality is on gold, it's, you know, it certainly should behave reasonably well and kind of this sort of stagflation airy dynamic that you could potentially see as a function of a lot of the inflation variables in the economy having taken a step forward, but not necessarily a lot of the growth dynamics in the economy, having taken a step forward. If you think about kind of the main drivers of economic growth, which obviously are population growth, and capital and things of that nature. So, you know, the reality is gold should be a favorable asset class from a longer term strategic perspective. And if you sort of, you know, you run any type of relative valuation model on gold, it's obviously extremely underpriced. But, you know, in terms of our model in terms of how we think about managing macro risk, it's not about valuation, it's not about relative valuation, absolute valuation, those things really matter from a longer term perspective.

But if you're trying to get the next, you know, 1. 2, 3, 4 or 5 quarters right. Valuation really has no basis in terms of that decision making process, certainly not for us. And, you know, empirically, it tends to not really work on that short term timeframe. And then lastly, you made one quick comment that I'd like to sort of correct, which is going back to our secular inflation model, we're not saying inflation is likely to peter out at 3%. We're actually saying that stationary mean of inflation is somewhere shy of 3% in sort of in this decade. And so the reality is, you could get inflation readings much higher from a higher lows and higher highs perspective relative to the prior decade. But the reality is, in terms of where we settle and oscillate around, it's likely to be 60 to 100 basis points higher, which again has asset allocation implications in terms of, you know, sort of forcing investors out of, you know, sort of digital economy thing type exposures, out of duration, risk, and ultimately further into physical commodities, further into digital commodities, and things of that nature. And that's exactly what we show on slides 110 and 111.

In 110, we show the relationship between the US dollar relative to cyclicals and defensives in the equity market. And clearly what we're arguing for is, you know, US dollar from a real basis. Inflation that's higher should actually perpetuate a lower dollar from a longer term perspective. If you think about sort of real interest rates and those dynamics relative to the rest of the world, and ultimately, that lower dollar should perpetuate a persistent outperformance of cyclicals relative to defensives, and it should perpetuate persistent sort of appreciation in physical commodities. That's what we show on slide 111. But the reality is, all those things don't need to be priced in in a linear straight line. The reality is we're probably going to approach some sort of crescendo here in the early part of 2022.

In terms of both cyclicals relative to defensives and commodities relative to the dollar, and ultimately, that crescendo in our opinion should be sold and perhaps sold pretty forcefully, as it relates to a potential larger than expected normalization process with respect to economic growth. And again, that's not just a US phenomenon. Slide 87 and 88 will tell you it's a global phenomenon as well, but then also a potentially sort of more persistent normalization process with respect to fiscal and monetary policy. If you look at, you know, our estimations for how fiscal policy needs to contract over the next, you know, several quarters on 85 and then ultimately the Feds reaction function on slide 103, you know, the normalization process. The summary of 2022 and when it's all said and done, in our opinion, it's going to be normalization, normalization in growth, normalization in inflation, normalization in monetary policy, normalization in fiscal policy and then ultimately normalization in asset markets, you know, out of some pretty lofty valuations for high beta cyclical exposures relative to their defensive counterparts.

Erik: Let's talk that about the asset classes that have moved big time in this reflation such as copper and crude oil. Are you saying in the end of the year that those correct substantially to the downside?

Darius: Yeah, absolutely. I mean that's, you know, slide 104 is kind of the key takeaway on that I keep going back to it because it's one of the more important slides in the deck, which is, look, whenever we roll past the peak in the US and global growth cycles, it has material market impact in terms of forcing investors to book gains or out of for whatever reasons. If you think about VaR targeting and volatility targeting, there's a lot of technical reasons in terms of how asset markets work from a supply-demand perspective that will force investors out of those higher beta exposures. Now, again, we're long, you know, crude oil and uranium and things of that nature. So, you know, we ultimately understand that, hey, look, we're playing a dangerous game in terms of trying to time the market, you have a cyclical peak in asset markets in terms of you know, eventually having a price and all that normalization that we just discussed. But the reality is that we're buyers of that dip. You know, again, who knows what the ultimate lows will be in this market cycle.

But again, from a longer term strategic perspective, we know the dollar is overpriced, we know commodities are under supplied. We know cyclicals are under owned relative to their defensive counterparts, you know, particularly the mega cap FAANG type exposures. And ultimately, we know that values significantly lower than it has been in prior inflation episodes. If you look at slide 116, we know small caps are lower than where they've been in prior sort of growth or inflation episodes. And ultimately, you know, high beta on slide 114, you know, is lower than where it's been in prior inflation episodes and prior cycle. So we ultimately think there's longer term strategic appreciation. And there's also some shorter term strategic appreciation as it relates to the current reflation regime we're currently experiencing. But the reality is, if you go to slide 27, we're showing the dominant market regime, which is currently again, it's currently reflation, having, you know, kind of had a narrow, brief stint in deflation in late 2021.

The reality is we've seen a lot of sort of volatility in our dominant market regime now casting process. And you know, that's neither function of the model, neither function of myself. The reality is it's just what markets are doing. They are having a hard time showing trending sector and style factor leadership in the equity and credit markets. They've had a hard time showing trending leadership in the fixed income markets and in the commodity markets. And as a result of that, you know, taking a look at this slide, and also looking at slide 26, we've seen a lot of sort of back and forth between the market regime, and now casting in that in that process. The reason I bring it up goes back to slide 27, which is the last time we saw this kind of dispersion is kind of volatility in our market regime now casting process was the summer of 2018. And obviously, we all know how that ended as it relates to sort of pricing in a material normalization and deflation, normalization in growth, a normalization in inflation after effectively two straight years of both growth and inflation were accelerating simultaneously. And obviously monetary policy was just really starting to catch up to that in that timeframe. And obviously, we saw a 20% decline in stocks and pretty sharp decline in high beta risk assets, commodities in general, and a pretty material outsize excess returns and things like fixed income, the dollar and gold and that's effectively the scenario we're arguing for most likely commencing late Q1 early Q2 and potentially persisting throughout the middle of the year.

And again, it's very similar to what we outlined on slide 10, which is, hey, look, a couple of years of reflation was reflected in asset markets. It was aided and abetted by monetary easing record, fiscal easing and now all those dynamics are reversing, We have sort of potentially a record fiscal contraction, we know it's very likely we have a pretty material monetary policy normalization process ahead of us, certainly relative to a lot of asset market valuations and risk premia. And ultimately, the growth and inflation dynamics, particularly from an expectation perspective just remain out to launch with respect to the kind of the potential economic growth, the potential GDP in the US and global economy. So that to us is an issue.

Erik: Darius, let's bring this all together market views. We're talking about the potential for stock market downside that you're describing. How much downside are we talking and what other views can you share with our listeners in terms of the let's quantify, as you put it. Darius what are we looking at?

Darius: Yeah, so I mean, you know, going back to what I just said, which is, hey, look, we saw a 20% decline in Q4 ‘18. As a function of all that normalization we saw then. It's very conceivable, we could see a 20% decline here if not longer because the normalization that we're likely to experience in growth, inflation, and monetary and fiscal policy over that intermediate to longer term is likely to be even more steep. That decline is likely to be even more steep in terms of normalization. So, you know, what we've put together here and slides 34 through 42 are some handy sort of back tests that incorporate a lot of what we're talking about from a near term perspective, that's slide 34. And then from a medium term perspective in terms of what we think asset markets are likely to have to price in and kind of the, you know, kind of real quickly on slide 36 Just showing you hey, look, if you're long certain some of the things that should work in the current reflation regime that do not work in the sort of pending disinflation regime or the pending deflation regime rather, those are the kinds of things that you need to think about booking gains in here and you know, at the bare minimum hedging for you know, protection material downside kind of into the middle of this year. And so, you know, obviously if you want to think about this from a fresh capital perspective, you want your longs to be concentrated at the upper left side of those charts and your shorts to be concentrated in the bottom right. So those are all things we put together for investors every week, every day, every month here at 42 Macro. So hopefully, if investors enjoyed the presentation will come check us out.

Erik: Well Darius, I can't thank you enough for a terrific interview. I'm going to encourage our listeners to do exactly that. Check you out at 42macro.com. And I really encourage you to peruse the entire chart deck. We didn't have time for all of it, but there's a lot of great content there. We've run out of time, so we're gonna leave it there. Kevin Muir and I will be back as MacroVoices continues right after this message from our sponsor.