MACRO Voices

with hedge fund manager Erik Townsend

Jim Bianco: Has the Fed Signaled a Policy Error?

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Erik: Joining me now is Bianco Research founder, Jim Bianco. Jim, it is great to get you back on the program. It's been so long, I want to start with the subject that I know is near and dear to your heart and mind, which is okay, this whole big picture of inflation and the credit market and what's going on with fixed income. And here we are, you know 2% on the 10 year yield. Some people say this is the beginning of the end. The bond markets about to crash. Alex Gurevich told us last week, no, no, no it's actually time to buy bonds not to sell bonds. And there's something kind of fascinating to me, which is I've seen this narrative floating around where people are saying, hey, wait a minute, if you look at what's going on with the stock market's reaction to inflation, you kind of think that inflation is not transitory and about to run away. But if you look at the credit markets, reaction to inflation, then it looks like the credit market is not really persuaded that this is going to be non transitory, secular inflation. Is that right? And a lot of people think the credit markets smarter than the stock market, what's going on here?

Jim: Yeah, so a couple of things. Let me start at the beginning of your question about inflation. So obviously, everybody knows that we've got a seven and a half percent inflation rate, and it's a 40 year high. We also know from the inflation statistics, given where we saw the numbers in March, April, May, June of last year, .6, .9., .6. That unless we continue to put up point .6-.9, we'll probably have a peak in the year over year numbers. Now, that's not a sign that inflation is over. Because I think the story in the second half of the year, is going to be that how fast does inflation descend? And count me in the camp that is not very fast, and that we're going to still wind up with a very elevated number.

Why do we have inflation? I might give you a little different answer as to why we're going to have inflation. Every generation has a financial event. This generations financial event was that we sent everybody home for a year. Last generations was the great financial crisis, the one before that was the tech bust of 2000. Because we send everybody home for a year, I think what we're not appreciating is, a lot of secular changes have occurred in work patterns, purchase patterns, and in the general economy. Now, do not mistake that for saying that it's dystopian, it doesn't have to be dystopian, and I don't think it is necessarily bad. And what I mean by that is, we went home for a year, we showed work from home as a viable alternative, a remote work is a viable alternative. And for a lot of people, it's preferred. And we're having a very difficult time getting people to go back to the office.

In fact, their stories, even this week, HSBC being the latest, that the raising banker pay a lot, because one of the things that New York City banks want is they want you in the office five or six days a week, 10 hours a day. So they have to bribe you to do that. Because a lot of people don't want to do that anymore. And because we working at home, our consumption patterns have changed a lot. We need more stuff, as opposed to services, cuz we're now remote. And that is leading to a general confusion among shippers and manufacturers. What am I supposed to make? What am I supposed to ship? I have this schedule of what it used to be in 2019. But that doesn't seem to work anymore. Obviously, the 2020-21 schedules were lockdown schedules of what people wanted. I don't assume that's going to work. I don't know what they want. So I order everything. And that's why we have this perpetual supply chain problem as well too.

And the reason I bring that up is because it seems like a lot of economists like to say as far as the inflation problem is a supply chain problem. Yes, that's true. So therefore, do nothing, just stand there and wait, and the supply chain will resolve itself. No, it won't. It won't until we have an introspection of what is the post-pandemic economy look like? And I think the answer is it doesn't look like 2019. And so the sooner we understand that, the better we can go about starting to understand what this new economy is. In the meantime, inflation is going to stay elevated. There's a friction in the economy, a mismatch. There's a friction with supply. And we've also overstimulated the economy with too much stimulus checks and too much fiscal stimulus as well, too. So that's why I think that the inflation rate is going to stay up.

As far as bonds go, let me be clear that in this environment, you have to separate short term rates and long term rates. Let me start with short term rates, short term rates are going up. The two year note in the United States was 22 basis points in September. It's 160 basis points now five months later. The bond market is pricing in something like six or seven rate hikes as we go forward from here, and this is brought up an interesting disconnect. The bond market thinks six or seven rate hikes. But if you ask most fund managers... the Feds not gonna go that far, Feds not going to do that much. And the reason that you hear that as far as people saying the Feds not going to go that far, you go wait a minute, if the markets pricing in six rate hikes, is it what the market price is in the consensus but the consensus seems to be something less, because the people that price in those six rate hikes are T0bill traders, Eurodollar traders, repo traders, they're very, very close to the Fed. They think the Fed is going to be more aggressive equity traders, long term bond traders, international global fund managers that are not as close to the Fed, they think something else and what this is, is it's about a priority.

From 2000 actually from 1980. But I'll go 2008 as well too when they started modern QE to the beginning of last year. The priority of the Federal Reserve was growth, it was to make sure that the economy grew as fast as it could. And to that end, they had this thing called the new framework that they introduced in September of 2020, where they were going to put an emphasis on trying to keep employment as high as possible, even if it meant letting inflation run hotter than usual. The growth priority also shows up in what is known as the Fed put, the Fed will never let the stock market fall too much because it created a reverse wealth effect. But now I would argue that the priority of the Fed is shifting to inflation because of the big seven and a

half percent number, the persistence of inflation as well too. And it's going to stay there. And those that think no, the Fed will move less, the Fed will move less because it doesn't want to impair growth, it won't impair the economy, are going to find out that that might not be the priority of the Fed anymore.

Last thing you mentioned was about the credit markets, let me make a quick comment. Credit spreads have widened, they just haven't widened as much as you would have thought given the volatility in the equity markets. So first thing is they have widened. They have shown some concern. Now part of that could be the various mix of what you have in the credit markets. Energy companies tend to be bigger borrowers, so they're weighting in the high yield index or in the investment grade indexes higher than their weighting is in say the S&P 500. So with booming oil prices and booming energy prices, they're perceived to be better credits. And so their bonds are not widening as much as everything else. And with a higher weighting, you'll see them relatively perform a little bit better.

But there's another dynamic that's going on in the credit markets, which I think a lot of people don't realize is occurring. No one sells anymore in the credit markets. It's either you buy or you hedge or you buy your hedge. What has happened since January is two things. If you look at puts on the HYG and the LQD indexes, these are the high yield ETF and the investment grade ETF, the iShares ETFs puts have exploded in volume and open interest since the market started getting a little messy around January 1. Credit default swap volume has exploded higher. ETF volume has exploded higher. ETF volumes right now, if you look at dollar volumes of the HYG and all the junk indexes that trade, it's 80% the sell volume of the underlying cash market, no other ETF sector, whether gold, healthcare, international, whatever you want, nothing is approaching what is happening in the high yield and investment grade ETFs that they trade almost as much as the underlying market.

By the way, speaking of the underlying market, cash market volumes of high yield bonds and investment grade bonds that trade eight year low. They're not trading bonds. You buy bonds when you're bullish. You buy puts and you short ETFs. And you buy credit default swaps when you think things are going messy. So there's an old adage in the stock market. It's a market of stocks, not a stock market. I think that really applies for the bond market. It's a market of bonds. It's not a high yield market. But we trade this like it's a high yield market. We just you know, buy the ETF, buy puts, buy credit default swaps, or not. Wait a minute, just so you know, bonds are not the same as an energy bonds, which are not the same as healthcare bonds, even more than casino stocks, energy stocks and healthcare stocks. But that's the way that we seem to trade it right now. And that's one of the things that might be masking the selloff that you see or the lack of urgency in the credit markets is it trades as one instrument, and when that one instrument decides that now's the time to sell, which it hasn't for many many years because it either buys hedge, you could have real problems moving forward with the market.

And last thought on this for you. Why is it bigger now than it was before, I think this is an echo of the 2020 response to the pandemic. Remember, in the pandemic response, the Fed came in and created facilities to buy investment grade bonds and buy high yield ETFs as well too. And

there was a mantra that went around Wall Street. Buy credit, because you're co-investing with the Fed. As long as the guy with the printing press is buying the same thing you want to buy or refuses to let what you're buying go down, I want to be long it. Okay, the Feds not buying high yield ETFs or investment grade bonds today. But there is a belief that if the markets wobbly enough, the printing press will come back and make sure that everything's okay. So just hedge, just hedge, don't sell. If I'm right about the priority shifting. And a realization comes in, that the printing press, the Fed is not going to show up and start buying investment grade bonds, if they start performing sloppily, because they've got a different priority, then I think you're going to see a whole different type of credit market. So I'd say with the credit market sell off to be continued, because all they're doing is hedging. And they're waiting for the storm to pass.

Erik: Wow, so much to unpack there Jim. Let's go back to one of the first things you said, which was this trend. And I've heard it framed the same way you framed it by other people. They're saying, boy there's going to be this kind of showdown between employers and employees, because the employees are going to want to continue working at home and not have to go back to the office. The employers are not going to want to hear that. I feel like I'm missing something. Manhattan office space is super expensive. If we've learned how to work remotely and it seems to be working for most businesses, especially in finance, where you know, maybe people have to get a couple of extra computer monitors at home, but they seem to be able to do it. Why would the employers not want to save money on office space and just let everybody work at home? Why wouldn't that just become the new trend?

Jim: Well, let's start off with that. Just to put some numbers on this, about a third to maybe as many as half of the employees in United States can work from home. So we're not talking about everybody, right? You know, the great examples I like to use is a surgeon can't work from zoom and a waitress can't work from zoom. And a policeman can't work from zoom. In many other jobs like that is to but about a third to about a half of the jobs. So of those third to half of those jobs, you're right, a lot of them fall into financial services. So why aren't they all excited about the idea to save a ton of money because not only do you save money in real estate, you also take money in support. Because one of the things that happens when you work from home is you're responsible to, you know, support your own technology. If your computer breaks, you have to fix it. You know, they don't send the IT guy to your house. It's your problem if it gets fixed so you save a lot of money on that as well, too.

I think the simple answer is who is the office designed for and who likes the office the most? The office is designed for executives in you know, it is their office managing director types, senior vice president types, they prefer the office more than anybody else. Who are 75% of the employees roughly speaking in the service sector office, they can work from home, their administrative, they're operational, they're maybe clerical as well to. The office is not designed for them. They're the ones that have to take the New Jersey Transit through the port authority, that is not a fun thing to do, even through this day. They would prefer to work from home. So that's kind of the push-pull. Yes, Dave Solomon of Goldman Sachs wants everybody at Goldman Sachs back in the office 10-11 hours a day, five or six days a week, because the office is a wonderful place according to Dave Solomon. And he's right for Dave Solomon It is but for

the clerical staff, the operation staff, you know, the administrative staff, they might have a different view about 200 West Street which is the headquarters of Goldman Sachs, as well. So I think that that's kind of the push pull.

The other thing is a lot of Manhattan office real estate has been signed to very long term leases. JP Morgan, Jamie Dimon wants everybody back in the office why? He just spent over $1 billion building the JP Morgan office tower. He's got a lease that is probably going to go forever, if not a generation. So he just can't say, oh, great, everybody's gonna go home, let's just get rid of the office tower. No it's yours, you own it now, as well. And you are going to fill it with everybody that you have, because you've spent years building this building. So the boomer managers are not ready to make that shift. But the millennial and Gen X staff, that's operation, clerical, and stuff is ready to make that shift. And that's where the friction is. That's why I said to you, I don't think it's a coincidence that at the same time, you're having this friction in that they want to be back in the office, you keep seeing stories all the time that they're raising banker pay to record numbers. They have to... that's the only way to get them to want to get on the New Jersey Transit and go through the Port Authority every day to come to an office. They would prefer to work remotely. And then when they work remotely, they probably prefer to move out of New Jersey as well, too. But if you don't let them work remotely, they can't move out of New Jersey as well.

Erik: Jim, I want to ask you about the Fed and whether or not they're making a policy error. But first, let's start with what's going on with the Fed because there's this story I don't really understand. Who the heck is Sara Bloom Raskin? I know that she's one of the Fed governors, but one of the less well known ones, why is she suddenly in the news, what's happening here?

Jim: She was a Fed governor and now they're trying to bring her back as the vice chairman of supervision at the Federal Reserve. In 2018, there was a FinTech company called Reserve Trust and Reserve Trust applied to the Federal Reserve in order to get a license to use the Feds master account. Now in English, what that means is, this FinTech company was going to be able to transfer money in the financial system without using a bank intermediary. They were denied. They then put Sara Bloom Raskin on their board, a former Fed governor, she made some phone calls to the Kansas City Federal Reserve, and the Kansas City Federal Reserve all of a sudden a year, within a year later, the Reserve Trust got their license to have access to the Fed master account. And to this day, they still advertise that they're the only FinTech firm that has that so they can transfer money by cutting out the intermediary of a traditional commercial bank. She then resigned from the board, and they bought back her stock for a million and a half dollars.

Now, I don't believe she did anything illegal in any of those activities. But two things from the smell test, it doesn't look very good, especially if you're being promoted or being nominated to be the head of supervision, not just any old Fed governor. Second of all, I believe Reserve Trust was headquartered in Denver, which is why the Kansas City Fed was involved in it. Because of Wyoming's forward thinking about recognizing Dows as a legal entity. There's a number of crypto banks headquartered out of Wyoming, that want to also get access to the Fed master

account, which would have to go through the Kansas City Fed as well, too. They're not having any of that. They don't want any of these crypto banks to have master account status. So Cynthia Lummis, the Wyoming senator has been really hammering away. Why do they get a master account because they hired you to put on the board. But then these Wyoming banks that are crypto based, cannot get that. So the Feds in a very difficult position. Now the Republicans are ganging up on her. And they're not allowing as of this recording a vote in the Senate Finance Committee on the five nominations that the Biden administration has put up, which includes Jay Powell to have a second term as Federal Reserve Chairman and includes Lael Brainard to be the vice chairman of the Fed.

So, in essence, they're holding all of this up. Now we'll have to see by the time this recording comes out, whether or not Sherrod Brown, the Democrat head of the finance committee decides to separate Raskin and say, okay well, we'll just vote on the other four because they're not as controversial. If he does that, she's effectively dead. They'll never vote on her, and that'll be the end of her as well. And so we'll have to see, but it is holding this up. And Erik, this brings up another issue as well too. Wait a minute, January 31 that was the end of Powell's term. It's mid-February as we record, why is he still Federal Reserve Chairman, if if they have not voted on him again? Well first of all, Federal Reserve rules say that if the next guy to be the Fed chairman is not been approved by the Senate. The old guy continues in the seat until they get around to voting in the next guy. Well, in this case, the next guy is also Jay Powell. The old guy is Jay Powell. So the Senate didn't see an urgency to kind of get it so they let his technically lapse and let them stay in there until they vote on them.

But here's the problem. I mentioned a second ago that there's a priority among the Fed maybe of switching to inflation. We also know that inflation is the number one issue in the country, according to political polling. It is not crime, it is not COVID. It is not foreign policy like Russia. It is not climate change. It is inflation is the number one issue in the country. President of the United States has on many occasions including earlier in the week we're talking that the Federal Reserve has a plan to rein in inflation. So he said to the American public, yeah, I know, you're very upset about inflation. There's this guy named Jay. And he works in this marble building over here in Washington called the Federal Reserve, he's gonna fix it for you. And so the Fed is under enormous political pressure to do something about inflation. And oh, by the way, it wasn't their plan. But effectively, the Senate is sitting on a veto of the Fed. You know, so that J. fix inflation, J. If you don't fix inflation by say mid year, we could just march down to the floor of the Senate and we don't have 50 votes for your renomination. And we'll throw you out and we'll find somebody else.

Now, again, I don't think that was the plan all along. And I don't even think they think that right now. But effectively, that's what's happened is that he is the Federal Reserve Chairman. He is being asked to bring inflation for the first time in 40 years, and the Senate is holding the sword of Damocles over him. At any point he displeasures the Senate. They just want a 50 votes for him and he's out. So the Fed is in a position of enormous pressure of loss of independence that we've frankly, I don't think we've ever seen right now with the Federal Reserve. And we'll have to see how it plays out. And what I'm suggesting is, it's all about inflation. And it's all about

politics. And that's what cerebral Alaskans about. And that's what this whole thing is about. It's about politics, the Fed is one of the most political or, you know, the Fed likes to say that they're non-political, that is not true at any point in at least a generation. The Fed is intensely political and it revolves around inflation.

Erik: Jim, just summarizing that your position is that the Feds independence has been compromised at least to some extent. Well, that's a perfect setup for my next question. Because if you look back to the end of January when the FOMC meeting occurred, and we had that nosedive in markets, well wait a minute, some people said that can only mean one thing that's got to be that the market is telling us that the Fed has just signaled a serious policy error. They screwed up by being too hawkish, too aggressive, it's clear that their intention is to be very aggressive in raising rates that's going to crash the economy, lead to a recession. And the stock market is of course, a leading indicator of recessions. It means what's coming is a recession.

Now, I think there's another argument, which is maybe the Fed is doing the right thing in terms of responding as they need to inflation. And perhaps it's not so much of a policy error. What is it? Is it is it a policy error? And if it is a policy error, how long does that policy error continue? In other words, if it does continue to crash the stock market, how far do we go before from what you're saying, if their independence is compromised before somebody whispers in Jay Powell is here and says if you want to be around next week, you better do this next whether it's what you want to do or no?

Jim: I think it really comes down to the belief about inflation. And there is a strong belief in the financial markets among fund managers and traders and economists, those that care about this, that it's still somewhat transitory that it will peak in the spring. I agree, it'll peak in the spring, and that it will rapidly decelerate down to around two and a half or 3% by the end of the year. I disagree. I think that with the strong housing market, with the inability to as I explained before, the inability to understand the shift in the economy, the supply chain problem has been lingering and is still an issue, that the descent of inflation will be much slower and will stay at unacceptably high level. So that's where the debate comes in, as well. But I also think that the Fed has already made a policy error. They have another thing that the Fed likes to do, which is called forward guidance. In English what that means is, the Fed wants to tell you 16 times what they're going to do before they do it.

This inflation thing that remember one year ago, inflation was one and a half percent. Today, it's seven and a half percent. It moved up on them too fast. They initially put in their framework for their new framework to emphasize unemployment, dismiss inflation fears, call them transitory, say it was going to go away because remember, the original forecast of the Fed was inflation was going to peak in the spring of last year and come down. And that was when it was at an unacceptably high rate, by the spring of last year was two and a half percent. And it was gonna come back down under 2%, by the end of December of 2021. Instead it shot up to seven and a half percent, as well. So they're now, they've waited too long. Look, we're recording this in February, the Fed is still buying bonds in February, they're still easing. So they've been way way too late in this. Maybe if they had started to taper earlier, ended the taper earlier, maybe have

one or two rate hikes in place now, they would have actually changed the outlook for the bond market, but they are operating so late in this and they are under so much political pressure. Yeah, they're going to have to raise rates. And as I like to say, at this point, the Fed has only got trade offs. They don't have a policy that's going to make everybody happy. Somebody is going to have to be upset here.

They can either raise rates too much, risk inverting the yield curve, risk growth, as well to risk the stock market because they're fighting inflation. Or the Fed can say no, we can't do that much rate hikes, we can't be that aggressive, because we would risk growth. And then let inflation run because one of the other things is let's say the Fed says that all right, look, we'll raise rates a couple of times. But we really can't get aggressive in raising in dealing with this inflation thing and raising rates too much, the economy will put the stock market at risk. We could wind up having a reverse wealth effect. Go read the left wing publications. Mother Jones, Xers and stuff. What are the economists in those saying? Look if the Fed can't get inflation under control. Let's just bring back price controls. Let's just bring back wage and price controls. Yeah, they didn't work in the 70s but they're desperate right now. The day we're speaking, the Washington Post has a story. The Democrats are the ones that love taxes, want to see fossil fuels usage reduced to save the planet, they're getting ready to cut the gasoline tax for the rest of this year because they're so panicked about what's going to happen in December as well too.

So if the Fed doesn't get this under control, there will be I think, talk about price controls before the end of the year. I think the Fed also knows this. And this is another reason why the J saying don't go there with those price controls. Let me handle this. I'll move 50 in March. And I'll just keep hiking every meeting until we slow the economy enough to bring down inflation. So as I've tried to say here, there's only trade offs is who gets screwed here? You screw the people that are upset about inflation. Why is inflation the number one issue in the country. According to the Federal Reserve's survey of consumer finances 40% of the American public has less than $1,000 of savings and they rent. Every day, they see prices going up. And they see their paycheck buying less and less. According to the latest CPI number goods, which is about 30% of CPI was up 18% year over year. Stuff was up 80%. 70% of CPI is services and they're up about four and a half or 5%, which is still unacceptable, which is how you wind up with an average of seven and a half or there abouts. So they're really seeing every time they go to the store stuff is going up. Food prices are going up.

Why do you think the President is screaming about Big Beef, you know trying to manipulate the price of hamburgers. And of course, gasoline prices again hit 3.50 a gallon nationwide, which is another eight year high the day we're recording. So you're seeing that those are the people that are tremendously upset. 40% of the country that doesn't own assets. I don't have a stock portfolio or own a house to watch them zoom up in price. Yeah, okay, I'm paying more at the grocery store. But who cares? Look at what my Spiders did, my S&P ETF or look at what the price of my home is right now like the other part of the people are. So the Feds got a choice. Do they help those 40% or they help the 10% that own equities. And that's where like I said there's no policy that makes both of them happy. That ship sailed long ago, I think they're going to lean

towards the 40%. And that's why I think that there's going to be a rude awakening in financial markets that they're not the priority anymore.

Erik: Let's come back to this question of whether inflation is transitory or secular. Because, you know, I've been in the secular camp and frankly I'm no expert on this. A lot of people I look up to who are much more expert than me are more in the transitory camp as Alex Gurevich was last week. But you know, all those guys in the transitory camp if I'd asked him six months ago what do you think of the possibilities that we're going to get a January print? It's seven spot 48%, they would have laughed in my face and told me it was impossible.

So I guess my question is, how do we draw a line in the sand and say okay, if this happens, it's decided we know that this is not transitory, it's actually quite a bit more than that. I mean, I'm hearing that inflation, according to all the experts who think it's transitory is supposed to peak in February or March, sometime in the spring. So how long do you wait after that, to see that the trend has stopped in order to conclude that that really happened? And if we continue to see inflation persist through the summer, say it into Labor Day, American Labor Day, the one that happens in the beginning of September. Does that mean that the transitory group was wrong and the secular group was right, or is it still too early to tell? How do you decide? Who do you how do you know when it's right?

Jim: Well I think the short answer is it's going to take years for us to decide which side is going to be right. And let me start with this. Dan Tarullo was a Federal Reserve Governor from 2008-2017. And I like to joke the Federal Reserve governors, you really want to listen to are the ones that recently leave, because most of the job of a Federal Reserve Governor is your hand at talking points and go out there and read them and read them like you mean it. But once you leave, you get to tell everybody what you really think. And Dan Tarullo went to the Brookings Institute in October of 2017 and gave a speech. And this speech was the Federal Reserve really has no framework for inflation, we really don't understand why it goes up and why it goes down. There was an economist at the Federal Reserve, Jeremy Rudd. He put out a paper in September of last year and the paper was essentially designed, why do we think there is such a thing as inflation expectations and he basically argued the Fed always talks about inflation being well anchored. That's not a thing. It's kind of a made up thing that we don't even know what anchored inflation is or unanchored inflation is as well to.

That paper kind of slipped in under the wire. The Fed probably didn't want to publish it, but he'd been there for 20 years and figured out a way to get the paper out. So let me start with the premise. We don't know what causes inflation. I know you're gonna get people oh, yes, it's monetary, its supply chain. It's this or that. Yea go ahead and correlate that over a long period of time and the answer is zero. So this is what makes inflation so difficult. All we have are opinions about inflation. All we have are theories about inflation that eventually get, you know, disproven and the theory that we're disproving now in 2022 is modern monetary theory. Uh, you know, first it was monetarist that got disproven then it was rational expectations that got disproven. And now it's modern monetary theorists. You know, the Stephanie Keltons of the

world. You're on the firing line now that you're going to be defrocked as the next theory as to what causes inflation.

So let me start with that premise. We don't know what causes inflation. We think we do. We like to dismiss it as being this or that. And so therefore, the transitory crowd can do exactly what you said. There is no possible way we're going to see seven and a half percent inflation six months ago. And when we see it, they just plow straight ahead and say it's still transitory. And there is a nonzero chance they could be right, that you know, that inflation could peak and dramatically accelerate-decelerate into the two and a half percent range within a year. Now, I think the only way that's possible is if you had a dramatic deceleration of the economy to. You want to get 2% inflation back, throw in over tighten, have a policy mistake, have the economy go into recession, guess what, you'll have 2% inflation within a year, but they think you can have it without a recession. So it is a difficult question to answer. And I think people need to understand that. If it wasn't a difficult question to answer, here's the theories. We all agree on it. This is what causes inflation, then we wouldn't be having this debate.

So I think we're going to continue to have this debate. But what I think is changed the dynamic that people have a hard time understanding is the political aspect of this debate. Panicky Democrats over what's going to happen in November. Willing to cut the gas tax right now, telling the American public this guy named Jay is going to fix it. He's going to fix it right now. Not voting on him, so that we've got like a veto over the Federal Reserve. Again, that wasn't their plan, but it's effectively become what they have right now is a veto over the Federal Reserve Chairman, and his new role in a second term. As well to putting tremendous pressure on the Federal Reserve to address 40% of the public doesn't own stocks, doesn't own a house and is very very upset about what they're seeing in terms of at the grocery store, at the mall, and at the gas pump. And even if you want to argue whether the Fed can't print ships, the Fed can't print barrels of oil, and stuff, the President has already told the public Jay is going to fix it. And Jay better start acting like he's going to fix it. And that means get aggressive with raising rates.

Erik:
Let's take that notion of get aggressive with raising rates and talk about what it's really going to mean then for the stock market. Because if I summarize kind of the gist of what I'm getting from almost everybody, it goes something like this. Look, the Feds going through this thing. They're gonna raise some rates for a while. But we've seen this movie before. We know what happens is you get to 20% or so down on the stock market and the Fed changes its tune, the Fed put kicks in, and you they change their tune. And you know, that everybody just looks past and says don't worry, the Feds got our back. I agree with you that I think there could be a lot of not so much from the Fed itself but political influence changing this as you see more and more people that have a very different view that favor that 40% as opposed to the 10% really saying, you know, we don't need to save the stock market, we need to take care of that 40%. And I think what we eventually get to I'm surprised, Jim, that it sounds like you think MMT has somehow been discredited or disproven. It seems to me that the MMT crowd is still got the political ear. And I would anticipate that as things start to get bad, where you've got a real problem with

inflation, the 40% is in real trouble. You do exactly what the President of the United States prescribed as the solution for inflation, which is pump more money into the economy.

Now, that is obviously completely at odds with anything that anybody who understands inflation knows to be the right prescription. But that is what President Biden said is we're going to pump so much money into the economy, that inflation isn't going to matter. And I would imagine that the Fed can let inflation run hot, while the MMT crowd says look, let's support that 40% with a whole bunch of universal basic income, new transfer payments, new support, so that the people who are getting run over by inflation have extra money to pump into the economy, which of course, just exacerbates the inflation and starts to get it to the point where it runs away. I'm certainly not suggesting what I'm describing is desirable or anything that I would advocate. But it seems to me that the political backdrop right now is for the MMT crowd to continue to have a lot of influence and for there to be a lot more stimulus. I think is we have to withdraw COVID stimulus, the politics are gonna say, well, we got to replace it with some new kind of stimulus so that we can keep getting votes and handing out stimulus. The idea of withdrawing all the stimulus and letting the economy crash. That's not popular. We're not going to go there might change if there's a change in politics after the November elections. But for now, I'm not sure why you see this is the MMT crowd has been discredited. It sounds like you see it differently.

Jim: Yeah, so let me let me be clear on what I think they're beginning to be questioned on the road to being discredited. And as I said, every other theory before MMT as to how the economy works, what causes inflation, ultimately had been discredited. At one point or another. Remember everybody focused on money supply 40 years ago and money in monetarists and then all of a sudden, the monetarist stopped working as well too, because ultimately, inflation is a very very difficult animal to understand. So yes, the questioning is begun with MMT. It started with a big New York Times Magazine article about two weeks ago talking about whether or not MMT is one, but it had an asterisk on it. And it was all about, you know, explaining the inflation. And it's been an enormous debate. So the debate is begun. And I think it ultimately ends with them being just the next theory that goes down the drain. And they'll be replaced by another theory, it could be another pro government type of theory that comes along as far as when inflation goes. The other problem with politics. Let me draw it. Let me go back to politics.

Okay so if the MMT crowds argument is, we need more stimulus in order to, you know, to do what Europe has said, I mean, Italy and France have both come out in the last six months and said, I understand petrol prices are high and you can't afford petrol. You know, it's already high enough as it is in Europe. So here, we're gonna mail your money so you can afford gas. You can afford but more petrol. Well, that just keeps the price high. You know, the reason the price is high is because we need demand the slow and if you're going to keep subsidizing demand, then the price is going to just stay up. Well, if MMT wants to say that here is their two problems. Problem one, Joe Manchin of West Virginia 50-50 Senate, Joe Manchin of West Virginia was a Democrat. He said no way. He's not gonna vote for any more stimulus. So you're not on to 49 senators. Kirsten Cinema of Arizona is probably not going to vote for it as well too. Let me throw out a third one that a lot of people don't really focus on a lot. There's a Democrat Senator Ben Ray Lu John from New Mexico. He had a stroke two weeks ago. And he had surgery, and he's

been in the hospital, and his staff is not releasing a medical update on his status. Now, he's still the senator from New Mexico, he's a Democrat, he's probably not going to be around for several weeks if not months to vote on anything because of his health considerations.

You're down to 47 senators right now. You're gonna have to find three Republicans, at least three Republicans in order to vote for any kind of stimulus package. By the way, they voted for none of them last year. So there's going to be no stimulus. I don't care what the argument is about MMT, there's going to be no stimulus. And then if the Democrats lose the house and or the Senate November, there's going to be no stimulus plans from this point forward. So what you're left with is how do we, you know, get the anger of the 40% away and that is we're going to have to aggressively tackle inflation. So yeah, you're right. MMT has not been discredited. I may have misspoke earlier. But what I am saying is, the beginning of the questioning of them has begun. And this I've seen this pattern for 40 years, starting with the monetarists in the early 1980s. And that they all kind of go, they all have their moment in the sun. And then they're all kind of defrocked. And then we move on to the next theory. And that's kind of where we are right now with MMT.

Erik: Okay, so let's finish talking through what happens with the stock market, you're saying that the stimulus really does get withdrawn, and it is in fact stays withdrawn. That sounds to me like it probably has to lead to a recession. And certainly the reaction of the stock market to the last FOMC is indicating a policy error and a move toward recession. But all the stock traders seem to just want to tell themselves, don't worry, we only got about 20% down and then you know, it's Jay to the rescue, it's gonna be fine. Are they going to be disappointed as the Fed put about to expire?

Jim: Yeah, so I think what you know, they need to what you need to understand about what I'm saying and I'm gonna agree with Alex last week a little bit on this as well too. I think what you're going to see in financial markets is you're going to see relentlessly rising short rates. You're gonna see the long interest rates trend sideways. So the 10-year note might get, you know, it's over 2% as we talk right now. It hit 177 last March. So it's a grand total of 30 basis points higher from its peak last March. And you might get to two and a quarter. I think that's all you're really going to get out of long rates as long as the Fed stays aggressive. Short rates will start to head higher as the Fed stays aggressive, the yield curve will invert. And when the yield curve inverts, that's a market signal that something's broken. And, you know, we might not be apparent the day that the yield curve inverts that something's broken. Now, that can be financial markets plunge, that could be an economy that goes in recession, it could be the plumbing of the financial system, the repo crisis of 2019. What you could see out of it but something will have broken.

Now you transfer that to the equity market. Where is the equity market right now? Well, by most valuation measures, forward P/Es, market cap-to-GDP, Shiller P/E ratio, take your pick, price-to-book, price-to-cash flow, price-to-EBITDA. Throw them all in the mix and say, in general, where is the state of the stock market? It's fully valued if you want to be charitable, it's overvalued if you want to probably call it what it is. And it's been that way for many years. And that's worked

because we've been in a zero rate environment with no inflation and very accommodative central banks. Well, if you're now going to be in an inflationary environment, inverted yield curve environment, and hostile central banks, and think that equity prices with full valuation are going to provide you a place to be that's going to be a tough call, I think its going to be tough.

Now that doesn't necessarily mean that equity prices have to plunge. You know, there is arguments to be made that inflation beneficiary stocks could be the place to be like energy or industrials or basic materials. Yeah, but the only problem with that is that they make up like 5 or 6% of the S&P. But long duration assets like technology, healthcare, which have been, you know, where the money has been made. They're really struggling the most and will continue to struggle from here on out. So yeah, I think that, you know, as far as equities go, everything's working against you. You've got inflation, you've got a flattening yield curve come and maybe an inverted yield curve, and you've got a hostile fed that about to begin in March.

Yeah, if you told me you had a P/E of eight, I might say the stock market can handle that. But when you tell me that the forward P/E is still over 20, which is a very rich number, which is still high even relative to the 2000 peak, as well in the market, that's where the valuations are. That only works to buy a 20 P/E, if you've got zero rates, no inflation, and everybody's pulling for the stock market and the Federal Reserve's priorities growth. Well, it's not growth anymore. You've got everything working against it. So I think it's going to be a very tough haul. Yeah, you might find some places to hide in beneficiary of inflation, beneficiary stocks, energy stocks, industrials, that kind of stuff, basic materials, but they're a very small percentage of the overall stock market.

Erik: Jim, I want to shift gears completely, because we've only got a few minutes left, and I want to touch on a subject I know I can talk to you about, and frankly, not many other people because when I talk about decentralized finance, and how I see the biggest thing that's ever happened to the finance industry, bigger than the internet, you know, bigger than the personal computer, the biggest thing ever is going to be the tokenization, not just of currencies but of all financial assets over the I think it'll probably take 20 to 30 years to fully play out. When I try to have this conversation with almost everybody in finance and say let's really talk about tokenized assets. And let's talk about where this trend is headed and what it ultimately means long term. And particularly, I have a lot of ideas. In my book, I wrote a whole chapter about my vision of a digital sovereign bond market, which fundamentally changes the playing field in terms of the ability of smaller countries to finance their borrowing needs, and so forth and how it could really change the playing field for equitability of humanity, and I think this is a very fascinating topic.

And every time I try to have it with anybody, they say, oh, yeah, interesting topic. Do you think Bitcoins putting in a double bottom here, you know, 30 whatever thousand. It's like, dude why are you bothering to look at a Bitcoin chart? Why is that even an interesting topic? I don't get it. It seems like nobody wants to look at the long picture here. I know, you're one of the few people I know who does. And I'm going to suggest to you that is I've looked at the entire financial landscape. And I look at the technology that's coming in tokenization. I think fixed income is the low hanging fruit. I think that bonds are basically the most antiquated part of the financial

system, they're the ripest thing to completely reinvent and replace with something much better. We don't have time here to get into all the details of why I think that but what do you think and as a fixed income guy, what do you see on the horizon? How do you interpret this whole DeFi trend?

Jim: Oh, man, I mean, we could do a whole hour on just this one subject right now. But I agree with you. A couple of thoughts. Let me start with one thing you threw out there. First of all, in the crypto space, there's a term that they use called Degen, and Degan is short for degenerate gambler. And it seems like all the traditional financial people are a bunch of degens. They just want to buy a token and watch the number go up. And I've gone the other way, you know, I try to look at the protocols, and I try to understand how they work. I've tried staking. I've tried lending. You know, I've put my tokens in a liquidity pool. I've traded them on automatic market makers. I mean, I'm trying to understand this space for how it's designed and what its purpose is. Instead of just opening a coin base account, buy some BTC and just pine for number go up. And that seems to be where the problem is, with a lot of people. So they they think it's just magic money or magic beans that they're trying to trade up and down. But if you go the next step, and you understand what decentralization means, what a decentralized autonomous organization, a DAO means. What it means to stake a coin, either in a liquidity pool, or borrow against it or lend against it in a borrowing or lending protocol, buy insurance against it and do all of this other stuff.

What comes into focus is your absolutely right, a whole new financial system comes into focus, a whole new capital stack comes into focus. What is you know, the capital stack now at the high end is senior debt then Junior debt. And then at the low end is equities, as well as, and you're starting to change the whole idea of the capital stack, and I agree with you, you could start changing that capital stack at the fixed income end of it. The idea of a token, and then issuing a token and trading a token could be a replacement for fixed income. A lot of people aren't there yet. And part of the reason that they're not there yet, is this gets very uncomfortable for a lot of people in traditional finance. What do you mean we're going to replace my job? We're going to replace what I do? We're gonna replace my company as well. And so they get very nervous about that kind of talk, or the you know, and that comes up being very dismissive in while regulators will never allow it. Why won't regulators really allow it, and then they'll mumble something about investor protection. And I always like to say, you mean incumbent protection is what you're hoping that the regulators are going to wind up doing.

So I would argue to you yes, that what you're seeing is a whole new way of doing things. And it's almost flipped on its head. Because what's interesting that's happened, because of all of the rules we have. You've got these protocols that allow you to borrow and lend and stake your coins and trade your coins and automatic market makers and stuff. And that's open to you and me and everybody else. Anybody can go open an account, move your money to an unregulated wallet like a Dharma or Metamask. And you could start, you know, connecting with these protocols and doing all this stuff. But institutional investors can't. So some of these protocols are creating different levels, which are institutional levels with know your customer and anti-money laundering rules and saying, okay, institutional investor, you could come in here, and we're

going to have a special institutional investor place for you. You're fundamentally at a disadvantage. So we've kind of flipped the script, you're better off in this world, this crypto world, being a retail investor, you've got access to everything, you've got the edge.

If you're an institutional investor, you're hamstrung with all these rules, you're put at a disadvantage. That's kind of the opposite of what the current financial system is right now. So yeah, I agree that this whole world is going to open up something. And I agree with what you said, many years down the road, there is no immediate change coming right now. But over the next generation in a generation, what we consider to be investments and how we invest, and how we think about the way that we raise money, and we allocate money is going to be completely different than it is now. And that also leads to another issue. When I say that oh, yeah, it's going to take a generation. A bunch of people over the age of 55 or 60 you know, that's my age group as well too. You know, oh, okay, good, good, then I don't have to do anything. I just have to sit here and just continue on cause in 5 or 10 years or so I'll just retire. And that poor guy that works for me over down over there. He's 38. He's the guy that has to figure it out. I don't have to figure it out. And the only thing I've always said to them is be careful on that, because this stuff tends to sneak up on you a lot faster than you think. But yeah, I wish we had a whole hour to talk about this because it is a very fascinating subject.

Erik: Well, Jim, the single most compelling thing that you just said, at least to my ear was that you could do a whole hour on this because frankly I would love to pitch to you. This is in my book, the reasons that I think it's not about crypto or tokenization of fixed income assets. It's about re-engineering the 500-year old fractional reserve banking system. If you look at the securitization of mortgages we've been doing since the 80s. It proves that FRS is not the only way to orchestrate credit. And I contend there's much better ways to design consumer credit, commercial credit, everything else, you don't need fractionation of assets, you don't have to have this crazy broken system that we've had for 500 years. There is a better way. And every time I try to talk to anybody about it, they want to talk about the price of Bitcoin. So I'm going to put this out to our listeners as a poll.

Jim: I was just gonna say, I 100% agree with you just real quick, the fractional reserve system in the in the idea of a corporation with equity in a corporation that was invented in the Renaissance 300 or 400 years ago. And now that we're moving into the digital age, they're not really good models for the digital age. And what we're talking about is a whole new financial system to meet the needs of the digital age.

Erik: And here's my contention. When you talk about those 55 to 60 year old guys. Look, the crypto kids know way more than us about cryptocurrency and digital assets and so forth. When it comes to why the fractional reserve banking system is inherently flawed and needs to be better. It's us old guys who have a lot of insight and I think a lot of us are missing the opportunity to learn all about DeFi and tokenized assets and start putting our fundamental knowledge of how the financial system works, which most of the crypto kids have no idea about to work and say how do we apply this new technology in order to make the system much better. Nobody

wants to talk about it. So I'm going to put it out to a our listeners as a poll, let us know on Twitter or send us an email at requests@macrovoices.com.

Erik: Tell us if you want us to get Jim back to do an hour just on that subject a little bit outside of our usual charter of macro but I think it's an absolutely fascinating topic. We're gonna have to leave it there in the interest of time but first Jim, just give us a real quick rundown. What do you do at Bianco Research and how can people follow your work?

Jim: We are a subscription service for macro research. You could follow me at Bianco Research on Twitter. That's probably the place I'm most active on social media, maybe LinkedIn under my name Jim Bianco or visit our website Biancoresearch.com.

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