Luke Gromen: Recession with Rising Yields is Entirely Possible

June 9th, 2022

Erik: Joining me now is Forest For The Trees founder Luke Gromen. Luke, I've really been looking forward to this interview. You know, it's been fascinating to me since that Fed survey came out saying that an unprecedented 41% of respondents had become concerned about foreign divestiture of US assets. I've had just wildly opposing views. David Rosenberg told me just fade that entire report. It's nothing to worry about. That's, you know, just don't even think about that being an issue. Whereas Louis Gave seemed to think it was a huge issue. And I know that you've probably out Louis Gave because I heard you say in another interview that you thought it was on par with the Nixon moment on August 15 of 1971 when President Nixon effectively defaulted on the Bretton Woods agreement. So, talk about what's going on here with the seizure of Russian FX reserves and also the extra judicial seizure of other Russian owned assets in the United States. Is this a big deal? Why is it a big deal and why aren't many people other than crazy nutcases like you and me taking this seriously?

Luke: Hahaha crazy nut cases indeed, right? Thanks for me back on Erik. I think it's a really big deal simply because the US has a supply demand problem for treasuries. And when you have a supply demand problem, you are trying to make your assets more attractive not less attractive. And so to me, I just think it's a big moment, because it had never been done. I mean, it had been done to some smaller countries, but it had never been done to a G8 nation, it had never been done to a nation on the UN Security Council. Have never been done to the world's biggest producer of commodities, to the world's biggest exporter of energy. And I think we're seeing that it is a big deal in markets. And by that, I think we can just look at the ruble dollar rate doing what it is done, since those sanctions were announced. I mean, we saw the ruble go to whatever it was 120 against the dollar. And President Biden pronounced it dead and buried and called it rubble. And, but that was sort of, you know declaring victory. You know at the end of the first quarter, and the second quarter, the game featured Russia coming out and effectively defending the ruble with gas. And people say, well, the ruble is a one-way market, the ruble, you can't I can't buy and trade rubles. Well, the US made it a one-way market sell side only when they put on the sanctions, right. So you sort of can't have that argument both ways. So, the US made it sell side only one way and the Russia came out and said that's fine. We're going to defend it by saying you gotta have it to buy gas. And so, there's sort of this bifurcated reality where, you know, paper FX traders can't buy rubles or the spreads not within you know, the numbers, not what they see on their screen. And I think that's right. I think I sympathize by that.

But the real market, I think that the paper FX market for rubles is a sideshow, the real game is Europe buys $150 billion a year of energy from Russia. And once the US did what it did sanctioning FX reserves and trying to trigger a collapse in the Ruble. It forced Russia to defend the Ruble. And Russia really only has one thing to defend it with and its energy. And so they defended the ruble with energy because of what was done to the FX reserves and we've seen what the ruble has done since it's trading at 60 today. It's up against the dollar, pretty notably on the year. It's the best performing currency in the world on the year. And it's really, it's a two way market. If you need gas, you're buying rubles. If you don't need gas yeah it's still a one way market, but they don't care. They're trying to defend their currency.

So I think when you look at what has happened in the markets as it relates to that, I think that all goes back to this sanction of FX reserves and the implications of that for others which is, now that that weapon has been deployed, everybody else is going to I mean, this is warfare. This is just economic warfare. And so, once your enemy or your adversary deploys a weapon, you immediately if you are smart, if you have a brain in your head, you immediately go about looking to disarm or protect yourself from that weapon. And how do you do that at the very least you stop growing your holdings of treasuries, at the very least, and you look for other alternatives. Clearly, I don't disagree with the point that there are not many other sovereign debt markets... There are no other sovereign markets that are that are as deep and liquid as a treasury market. Of course, Treasury markets had its own liquidity problems in recent years, it's only been deep and liquid at key times or anytime there's been stressed because the Feds been in there injecting liquidity, which is not exactly a great reserve asset characteristic anyway. So to me, I think what we're seeing in ruble, gas, energy geopolitics suggests it was a very big deal. And I think the ultimate outcome is kind of what I lead off with, which is, the US has a structural deficit problem, it needs more buyers of treasuries rather than less, preferably at negative real rates, actually it has to be at negative real rates with our debt levels this high and our deficit levels this high. And the US is out there advertising, hey these aren't safe, we will take them if you are a bad actor. And the reality is yeah Russia is a bad actor. But Japan was a bad actor in the 80s. The Germans were bad actors. At one point, the French were bad actors, the Israelis were bad actors, the Saudis were bad actors three years ago. So there's, you know, who's a bad actor and who's not shifts a lot. And so I think it's just going to touch off, I think, a sort of a slow, steady, relentless bid for physical gold as a reserve asset or a redeployment of surpluses into productive things, right. So instead of the Saudis storing any excess surpluses in treasuries, they'll store them in developing their own country or developing elsewhere, paying Dustin Johnson a gazillion dollars to go golfing, whatever they want to do. But the bottom line is any dollar any surplus that is diverted away from the Treasury market increases the pressure on the Fed to ultimately finance US deficits, because they're the only one with a big enough balance sheet to do it without crowding out the domestic and the global economy.

Erik: Luke, I happen to agree emphatically with everything you just said. But in the interest of good journalism, I'm going to play devil's advocate here and say wait a minute, a lot of people would say look Luke the situation with Russia was a sanctions issue. There is no sane reason for anyone to think that the US can't afford to pay its bills or has to default on its debt because it's insolvent or anything like that. The reason that Russia's foreign exchange reserves were seized was because of Russia's aggression in Ukraine. And people might say it's not completely unprecedented in the sense that after Pearl Harbor, Japanese assets, I don't know about Japanese FX reserves. I'm not that good of a monetary historian but certainly a lot of Japanese owned financial assets in the United States were frozen after Pearl Harbor. So it's not unprecedented. And I guess to my thinking Luke, if I had to try to make the counter argument here, the big counter argument would say look Luke if what you're saying was true, the price of gold would have doubled by now because if we saw other people losing faith in the US Dollar as a reserve asset because they're afraid that what happened to Russia might happen to them. They would be divesting US Treasuries, which is certainly reflected to some extent by the upward pressure we've seen in yields, and they'd be reinvesting in gold or some other reserve assets and gold hasn't budged. So how could that possibly be true?

Luke: Ultimately, you can only watch the flows of gold and you can see, I mean, was it the Czech central bank came out last week and said we're going to increase our gold holdings out on 10x over the next several years, from 10 tonnes to 100 tonnes. You could see the Indian central bank buying more gold. You can see the flows, the price ultimately, think of what we've said in the past is none of this is going to matter for the price of gold till it matters for the price of gold. The only thing you can conceive of is the amount of paper derivatives on gold on allocate paper derivatives is expanding faster than demand in theory, or it simply hasn't really begun in earnest yet it being the shifting from treasuries to gold. I mean, because when you look at the inventories that say Comex of gold, a small hedge fund could go in there and create a hunt brother short squeeze. Alright, so the reason they haven't, everybody likes to make more money. So if there's only a little bit of inventory at COMEX, relative to the amount of dollars out there, and nobody has done it, either. We have to believe everybody in the world with more than a couple 100 million dollars in assets doesn't want the free money implied by creating a Hunt Brother short squeeze in the COMEX Gold market or there's a political reason that they have been told not to try that or someone has tried it and has been told not to try who knows.

But at the end of the day for me, it's less about hey, gold hasn't doubled. So, it's not positive for gold and more about just a structural long term secular positive bid for gold as a reserve asset over time. I will say, I think this is probably what I should have led with, which is, if you look at what US rates have done, and you look at what gold has done, gold should be $400-$500 lower than where it is today. It hasn't budged. So I would say, I think part of why gold hasn't moved is less some of the paper derivative stuff, which is always something to consider as a gold investor all that. And I think it's more that there is still tremendous credibility that the United States is going to raise interest rates and tighten policy and induce a recession. And I think the fact that gold is $1850 today and not you know, where it should be unreal rates which is 1450 or 1300. I think is an early sign of exactly, a big picture of exactly what we described, but more importantly, more acutely. I think there's a lot of people that I think the gold market is calling BS on the US's ability to raise rates and to tighten policy in any real way in any real sustained way.

Erik: Let's come back to Russia defending its currency through energy. It seems to me like you know, this time a year, Europe can get through the summer without needing Russian gas nearly as much as they do for heating in the wintertime. So does that set up a tradable situation that's coming up in the fall where we potentially get Europe being forced to go back to buying Russian energy which Russia might continue to demand rubles for? Does that strengthen the ruble even further or does that trade break down at some point?

Luke: I think, yeah, I think the ruble is gonna keep going up. I don't know whether it's tradable or not, particularly to people in the West either due to shadow or self-banning or actual outright sanctioning of Westerners trading that. I think the ruble is going to keep going up. Because of what that describes, I think the tradable aspect of it is probably short the Euro. I watch it what I watch what the eurozone's doing. I think it was Louis Gave who had the phrase, the Americans are willing to fight the Russians down to the last European. And as harsh as that is, and it's tongue in cheek as is. I'm waiting for European leadership to sort of wake up because I watched what Europe is doing. You've got this debt level that is completely unsustainable. You have followed policies, the encouragement of the Americans to start cutting out your energy inflows, your energy supplies, and the only way you can afford to pay that debt is with more cheap energy not less cheap energy. I mean,what we've been highlighting for several months is that the Europeans are going down a path, the same path or directionally the same path that the Weimar Germany went after World War One, which was Weimar, Germany owed a bunch of debt. And then the French showed up in the Ruhr Valley and seizrf the coal reserves, seized energy, reduced energy into the German economy as a war reparation. And the Germans made up the difference by printing the money. And we all know what happened then famously, and it's not apples to apples purely, but directionally we have a situation where European debts unsustainable, wildly unsustainable, and now they voluntarily are getting rid of their energy, which is sending production. PPI right, I mean, I saw it the other day, German PPI is running I think 30%. The German boon is like 60 basis points, right. So, like, there is no planet that the ECB can raise rates high enough to reduce energy input inflation without blowing up the debt, when they're cutting back their energy inputs from from the Russians.

And so, what's the response you get? Well, you see it in the UK, we're gonna start handing out 400 pounds to everybody because energy costs have gone up, are you insane? Like, they are literally in Europe and UK setting up an energy hyperinflation death spiral with their currencies, which, if I'm looking at it from a very Machiavellian way, there's I think probably certain interests in Washington that would love to see that happen. Watch the Eurozone implode get those German surpluses recycled back into buying treasuries instead of financing, you know, Southern European deficits. But I I think the tradable trade here as we get towards the fall, I think the base case is I think there's two outcomes. I think the first outcome is Europe sticks to their guns, energy inflation goes nuts, and or their economy collapses, their ability to service their debt collapses. And then either that entire market and economy collapse chaotically, which will bid the dollar and US Treasuries for like a cup of coffee, and then that will collapse the US markets in the US economy as well. Or we get to the fall it starts getting cold at night and Europe goes sorry USA, we're done. We can't do this. We can't let people freeze here. We're going with the Russians. And the Japanese go hey America Yen is at 132 keeps rising, our energy costs keep rising. We gotta call the Russians, we got to ask him for gas in yen, sorry, we're leaving you too. And so I think as we go to this fall, what's the tradable possible options are either basically an economic or inflationary, the Euro collapsing against the dollar or a massive reordering of the post war security order as we have all come to know it, which is to say the Europeans and the Japanese say sorry America, we need gas, we need people to not freeze to death more than we need protection from you or the relationship as it's been structured. And I don't know how that is tradable. I think if that happened, that's probably dollar negative I would think but I don't fully, I haven't fully thought about the implications of that from a market standpoint. But that's how I'm thinking about it at this point.

Erik: Luke, French President Emmanuel Macron seems to be the odd man out in Europe where everybody else is banging their fists on the table saying Russia bad guys. Macron seems to be the one saying wait a minute, let's think about what we can afford to do in terms of alienating Russia. Let's think twice before we burn any bridges. Is that just because Macron has a different philosophy than other leaders or is there something about French economics that make France more vulnerable to this energy situation with Russia than other countries?

Luke: You know, and I don't know all of the specifics about who's taken, I thought the Germans were most susceptible in terms of percentage of energy inputs, I thought the French still had a bunch of nuke plants that were running that might make them better off, but I might be missspeaking. So I don't I don't know for sure. I don't know if that is tied to historic French desire to maybe a little more animosity towards the Americans than the Germans say, historically, within the European Union. I don't know if it's that or if there are commercial interests or if it's energy. I don't really know, maybe he's just actually being pragmatic as opposed to the others in Europe that are pretending like it's not going to get cold and that they don't need the gas, which is like believing in maybe skittle shitting unicorns are going to deliver the gas to them. I don't know...

Erik: That actually sounds more likely to me than the other option, which is President Biden already promised to deliver to Europe as much gas as they need using nonexistent export terminals to fill up nonexistent LNG transport ships in order to supply the gas. In any event, let's move on Luke, you and I have talked quite a bit in past interviews about your view that over a longer time period, the US dollar for a lot of the reasons we're talking about the loss of confidence of other nations in the dollar reserve asset, that that would cause the dollar to decline dramatically. Yet, in the tactical timeframe, you just said a moment ago that it's very likely that the Euro could collapse against the dollar, which means dollar up substantially. So I think these are actually compatible views but help our listeners reconcile that apparent contradiction.

Luke: Yeah, I think it's ultimately just an order of sequencing and the pace of that sequencing, where if the Euro collapses against the dollar. The dollar is going to skyrocket, you'll see a flight to safety in the dollar. I think you'll also see as the dollar rises, you'll see Treasury selling around the world to raise dollars, global dollar assets selling to raise dollars. So you, you're talking about a scenario where two things are going to go up. Oil and gas, as one are going to go up, and the dollar is going to go up. So the dollar is going to rise against everything except oil and gas. And the dollar is going to crash against oil and gas. In that scenario in my view. And that then leads to a scenario where as oil and gas go up, Russia gets stronger. And as the dollar goes up, America gets weaker. Because as the dollar goes up, US corporate profits decline, layoffs go up, US deficits go up, US tax receipts go down. And that math will happen. I think the US is betting that at some point on the dollar, oil and gas will fall and they will come out ahead and they can use the dollar to once again as a blunt weapon to beat the world into submission, including the Russians. And then Americans can buy up the world on the cheap, and we restart the whole cycle, etc. I don't think that's how it's gonna go. I think energy prices, as the dollar goes up, and the US economy declines, you're in a sort of stagflationary environment here in the US. US goes into recession. You're gonna and we're gonna go back to the point I made at the start, which is the Fed has never begun tightening with US debt to GDP at 120%. And US deficits at 6 to 7% of GDP. It's never happened, not at least in 80 years. So anyone, sort of applying the framework of the Treasury market and US markets and the dollar of the last 40 years, I would take those without that framework, and I would throw it in the trash bin, because the reality is the Fed has never tightened with debt this high, and with deficits this high as a percent of GDP.

And what that means in plain English is that as that recession happens. As oil and gas spike and as the global economy tanks, and as the dollar strengthens, and the US goes into recession, US Treasury yields are going to rise, not fall. And so there's no playbook anybody has seen where US goes into a vicious recession, and US interest rates go up. And again, that then goes back to okay well we got oil and gas up, we got dollar up, and we've got rates going up. Who's got the better balance sheet Russia or the United States? Who can better weather a rise in interest rates? Well, Russia's rates are at 11 right now down from 20. And they're fine. US couldn't afford 11. US can't afford... I mean, we're seeing it right now. Targets numbers this morning, US can't afford... Where are we at? 75 basis points, 100 basis points on Fed funds. I don't even know where we are. So it really is a balance sheet contest between the US and Russia at that point. And I think Russia wins. So that's I think, when you marry those two up? Absolutely, I think in the short run, it's very bullish for the dollar. To the point only that it becomes apparent to markets that the US has a balance of payments problem, which is what US recession, but rates up is telling you. And I think basically the moment you see the US go into a recession due to the factors we just laid out and they see the treasury yields start to go up. I think that's going to be a dinner bell for people to sell the dollar, to buy gold, buy bitcoin, buy more commodities, buy more inflation hedges. Because once you see the US go into recession, and Treasury yields going up, because of the balance of payments problem I just laid out. That is a message to those with the eyes to see it that one of two things is going to happen. The global economy, the US dollar system is going to go into a debt death spiral, which is, Brent Johnson's hey the DXY goes to 200 and the world collapses. I don't know that that'll happen. But it could if the Fed just stands aside. The more likely outcome and and why I think it is, dollar negative is much more likely as the Fed comes in with some version of yield curve control and actually prints money to contain US Treasury yields in a recession. And the balance sheet goes vertical, instead of the DXY. The Fed's balance sheet goes vertical instead of the DXY and as that happened, I think the dollar goes down probably a lot. So that's I think how I would rectify that tactical and path relative to the sort of how it ends up in the end.

Erik: I want to go back to your comments about stagflation, something that's really surprised me and we get a lot of really smart guests on macrovoices and with the exception of Ronnie Stoeferle last week who's a gold guy, it's not surprising that he's on a stagflation focused message. Just about everybody else I talked to is telling me look, the inflation spike that we saw was a result of the pandemic and supply chains. Oh, it's already peaked. The peak is behind us, you know, we're headed back down to 2% inflation. And I don't agree with that at all but I'm shocked by how consistent that view is. What's your take, Luke? Is it true that the inflation that we've seen was entirely about the pandemic or could this be the beginning of a secular inflation which is my thought.

Luke: I think it's absolutely a beginning of a secular inflation whether you want to... Now within that, are we in a deflationary cup of coffee for time period for stuff you buy at Target? Probably, for used cars, maybe probably. For oil? No. Gas? No. Food? No. Secularly though, you can't get online or go somewhere without saying hey deglobalization or we're going to reshore. If globalization was disinflationary for 20-30-40 years, it's strange credulity to think that deglobalization and reshoring won't be secularly inflationary. So I think that's sort of I think that's point one that secularly I think that's enormously inflationary. And I think that's something that's going to happen, in part based on what we've seen. But I also think it completely ignores what happened here, which was we had a government transfer payment bubble that as a result of, of the backside of COVID right getting sort of trying to, to drive a recovery. And I think you have to go back to again, the US balance sheet, the US government cannot repay its debt without inflation full stop, they need negative real rates. You know, when you have debt to GDP at 120% and you're a twin deficit nation, if you do not have negative real rates, you will mathematically default. It's like third grade math.

And so this is the elephant in the room that I think everybody's saying that, hey you're good. We're gonna go back to 2% inflation, we better not! We go back to 2% inflation. US real rates go positive. That is a your implied bet is that the United States government is going to default. In my opinion, there's zero chance of that happening. So, are we in a brief period in time where stuff at Target goes down in price because their inventories are up 43% of their demand is falling? Yeah, maybe probably. Is it negative for oil and gas? No. Do I think we're gonna have deflation in oil and gas in any real way? Probably not. And I think again, I think the real bottleneck in all this is the dollar is a reserve currency. We are the center of the system and our balance sheet. We literally cannot afford our debt unless US real rates are negative. US real rates negative implies sustained inflation. And so and that's I think ties back to the point I made before earlier as well about why gold hasn't risen it, why isn't gold risen more? Well, it's done really well given what rates have done. But to your point Erik. There's still this widespread consensus view that inflation is going to return to normal. The US balance sheet tells you there's like zero chance that's going to happen. That inflation is gonna return to some normal pre-COVID level. It better not because inflation returning to some free COVID level on a sustained basis implies the US government defaults on its debt. And I think there's zero chance that's happening. So I just think we're in a period of time right now, between sort of two trapezes, right, we've let go of the 2020 through mid-2021 of, hey, we've got fiscal stimulus on top of fiscal stimulus on top of fiscal stimulus and the Feds monetizing the whole darn thing.

And, we've sort of let go of that trapeze after policymakers had the crap scared out of him by how bad inflation got, and now we're in sort of this, well, they're just gonna stop inflating and they're going to tighten, they're going renormalize and we're all gonna go back to normal.

There's in my opinion, virtually zero chance of that happening because of the balance sheet of the United States. That Rubicon has been crossed. The United States debt to GDP is 120%. The deficit is 6 to 7% of GDP. We are as a nation, with record tax receipts, like off the charts record tax receipts, the United States still cannot afford its treasury spending, its entitlement pay goes or its defense spending altogether with record tax receipts. And so unless they're willing to step up and slash one of those three things massively, let alone everything else they spend money on. The balance sheet of the United States is our leading indicator, and it tells you we are going to get inflation for a long time to come. And I don't know when we catch the next trapeze. I think the slowdown we are seeing. This rapid slowdown we're seeing in the US economy as we speak, I think is a sign that the next trapeze is coming towards us and what does that look like? That looks like you know, two months ahead of a midterm with the US heading toward recession. Hey guys so $10,000 debt forgiveness, student loan forgiveness for everybody. There's a huge chunk of fiscal right there. But the bottom line is the leading indicator is the US government's balance sheet. They need that 120% debt to GDP to get back towards 70 or 80% of GDP before they can before the Fed can normalize policy without blowing up markets, without blowing up the US and global economy. And just by way of context, the 8% CPI inflation we saw in 2021. It took it from 129% of GDP to 122% of GDP. So we need double digit inflation for probably five years. And if we don't, then you're going to see what we've seen year to date, which is stocks down, bonds down, and wash, rinse, repeat until either you have a systemic collapse or the Fed is forced to come back into finance US deficits.

Erik: It sounds like our views are extremely compatible, Luke. I'd like to introduce my own thoughts on inflation and get your feedback. I've been calling this or I'm starting to call this an inflation Dipsy Doodle. What I see is, of course, the inflation that we've just seen, there was a transitory effect from the pandemic supply chain interruptions that exacerbated the beginning of what I think is a secular inflation. Well, those transitory forces are coming out of the system now. And that's why we've seen a peak. And that's why almost everybody, except you and I are saying okay, look, that inflation thing was just a scare, it's behind us never to be seen again. So I think that inflation continues to come off for a little while, until it starts to come back in probably led by energy prices. And then I think the next point where maybe there's still another round of people staying in denial, is we get to even higher inflation than what we saw at the peak a month or two ago. But everybody says okay look, that's just because of that stinkin Vladimir Putin, it's all his fault. And it's because of what he's doing in Ukraine and how that's affecting energy prices, but that'll be transitory too. And there will be transitory too, at some point we'll get some resolution to the Ukraine war, and inflation will come off a little bit except it won't go all the way back down to 2%, it probably won't get back down to 5%. And then it goes up and it makes a new high. And I think at some point, you get this oh my gosh moment where it's like, oh, it really is a secular inflation that started around the pandemic bottom. And we've just been kidding ourselves with all of these excuses we're making about why it's transitory when in reality, those are just exacerbating factors that are ignoring a much more important underlying base trend. How does that jibe with your thinking?

Luke: I think it makes a lot of sense, I think some of it will definitely be energy driven or energy exacerbated. Because one of the great underappreciated factors in the inflation debate that's been going on in my view has been this fact, which is, it's been almost four months now since Putin invaded Ukraine. And we saw oil prices rise, whatever they rose, I guess they were up probably what 35, 40, 50%. And consensus overwhelmingly at the time was don't worry, America will step up and will increase energy production. Shale will come through. Last time I checked a couple of weeks ago, US shale production was up 100,000. Excuse me, US total oil production was up 100,000 barrels a day. 100,000 barrels a day. And when I talked to people in the energy patch, it ain't coming. It's you are for a whole number of reasons. you've drilled and fracked a lot of your A and B locations and you're left with C locations. So productivity is declining or non existent. You've got inflation and supply chain problems in all sorts of energy related industrial goods, etc. You've got employment problems, because when you laid a bunch of guys off, two years ago, it wasn't like they were sitting around the phone waiting for a callback. And so you've lost a massive amount of your skilled labor that introduces further inefficiency. So I think when... the message, there's a message that's been greatly underappreciated.

And really, let me let me add even to that, China basically shut down for several of the last month or for a couple of last months. And so you've got a situation where China has been shut down to a significant amount and oil didn't drop. Oil didn't drop and oil ran up, and US shale didn't respond. And so I think one of the sort of still wildly underappreciated dynamics is this peak cheap energy view, which is something we've been writing a lot about, which is just like the marginal barrel of oil, what's the marginal. What's he cost? What's the marginal oil barrel cost? What's the price today, there's your marginal barrel, you know, it's not 40 or 60 or 70. It's 120. And to really grow production, what the last three months four months have taught us is to really grow oil production by 150. Who knows but it's an expensive number that is going to add to inflation at a time when the US balance sheet is in a position where the Fed can pretend they're going to tighten and they can't structurally, the United States government cannot afford positive real rates. They need negative real rates, which means they need inflation well above their interest rate or else they will default on their obligations.

And so I think between this dynamic and I think there'll be an interplay. I think we're seeing a little bit now. But I think there will be a sustained interplay between this dynamic of the US must have significantly negative real rates on a sustained basis to afford its debt just to keep the wheels on the car. And this peak cheap energy dynamic, which is, prices are going up and no one can produce more oil, in part because oh, by the way, the Big Four shale basins are declining, existing production is declining at a 5% per month rate. So just to stay flat, you got to grow production 60% a year. I think those two are going to Interplay back and forth to each other. And I just get the sense that there's a lot of bond bulls out there that just, they're not looking at either one of these two, which I think are, you know, forget elephants in the corner, you have two King Kong's in the corner as a bond investor that I just think are going to sort of, reverberate back and forth and drive secular inflation I think much higher over the next three to five years than most people believe is possible at the moment.

Erik: Let's go a little deeper on your comments about the US having to have deeply negative interest rates in order not to default. What you describe is just third grade math, it ought to be obvious. I'm quite certain that the Congress of the United States and the White House don't understand this. So I don't know if that means it's above third grade or if they're below third grade, but I'm sure that they don't get it. So let's go a little deeper, because when you say they would be forced to default, look, the US can print money in order to not default. Now, you can certainly make the argument that that ought to be inflationary and ought to lead to inflation but they don't have to have the inflation in order to push the button, print the money, and pay off the next Treasury payments. So why do you say that they have to have deeply negative interest rates in order not to default on their debt?

Luke: Well, you can just see what's happening, right? So the punchline is that up until just recently the US tax receipts, total tax receipts, were not covering just the Treasury spending, right? Which is interest and other things treasury is spending on entitlement pay goes. So with tax receipts that are record, I don't know 4.3 trillion maybe. Last year, the US entitlement pay goes just what they wrote out in checks to pay entitlements to keep those entitlement obligations, money good right to pay out what they're owed. They paid 2.8 trillion so nearly 70% of tax receipts alone are going to entitlement pay goes which is you know, health and human services, social security. And then defense, which is 800-850 billion probably not going down now that we're in this thing with this proxy war with Russia and writing checks to Ukrainian like it's going out of style. So those three alone, Treasury spending, entitlement pay goes, defense, with tax receipts, really in a bubble. If you look at the chart, it's incredible. Up enormously year over year with the tax receipt bubble, the US was able to get to 100% of their big three expenditures. Then they have to borrow the money for everything else. And the issue then is the tax receipts if you look at them, they've been very tied to asset prices. So when asset prices, and particularly when stocks fall, tax receipts fall, and just on a slight lag. And so now year to date, we've seen stocks fall, bonds fall, crypto fall, home prices are maybe flattening out we'll see. At any rate, the point is that tax receipts are going to start dropping year over year alongside asset prices, probably within the next few months. But entitlement payments are not going to drop, Treasury spending is not going to drop in fact, it's going to go up because interest rates are going up. Defense is not going to drop because the after mentioned proxy war with Russia. So you're going to get into a rising deficit scenario. And if we have a recession, the last two recessions, US deficit as a percentage GDP rose by 500 to 800 basis points. So you're looking I don't know a trillion to 1.6 trillion more in Treasury issuance. Who's the buyer? With the dollar going up foreigners are sellers on net and certainly not buying anywhere needed enough.

Feds selling allegedly right? Everybody believes Feds gonna tighten away for the next couple years, which is I think wrong but the Feds selling, treasuries selling. They'll sell more as I asset prices fall because receipts will fall, so their expenses won't fall. So issuance will go up. So Treasury selling, Fed selling, foreigners selling because of the strong dollar so who is the buyer? And the answer, of course, is well, there's always a buyer at the right price. Exactly. So now rates are gonna go up to find where that is because private sector balance sheets aren't big enough to finance that number. By the way, they have to sell other assets to raise the capital to buy those treasuries. So what do they sell? They sell stocks, what do they sell other assets, asset prices down, tax receipts down, Treasury issuance up, oops, we have to upsize the auction oops, so you get into this debt death spiral where again, when I say the US would default, that is the ultimate end game if the Fed just stands aside. The reality of it is that way before that, to your point, the Fed can print money, and they will. They'll come in and they will print the difference. We've seen it repeatedly over and over. But what it speaks to is, again, people just aren't considering the US balance sheet because for 40 years, anyone in this business that is under shoot 65-70 years old, has never had to think about the US balance sheet never had to. But if you look at the US balance sheet, it looks like the balance sheet and emerging market except that it issues the reserve currency and it can print money whenever it wants.

So that I think is really where I shake out on why I think it's secularly inflationary. The US balance sheet is where it is they need to get that debt to be able to get out of this predicament, you have to have inflation run higher than your interest coupon for an extended period of time. Once you get debt to GDP back down to 70-80%, then, you can tighten rates, and it doesn't trigger this dynamic of oops, tax receipts aren't covering just our big three. By way of comparison, in 2016, the big three peaked at, I think 130% of tax receipts, and that's when the Fed was monetizing the whole thing, The entire deficit a year and a half ago. In 2016, the Big Three were like 62% of tax receipts. Just to give you an idea in six years how much these things have consumed the receipts. And so it's really along that line of you've got to get nominal GDP high enough to get the debt to GDP low enough so that when you tighten, you don't trigger this shortfall in receipts relative to expenditures that either drives interest rates up, you basically have the free market setting interest rates for a government that owes a lot of money that's not good or the Fed caps rates by growing their balance sheet or or keeps rates politically expedient levels by growing their balance sheet. So that's why... do I think the US dollar is going to default? No. If the Fed stood aside today and did nothing... Would the US government default? Yeah. Would a lot of others default before? Sure. I don't know if it's any consolation, because you know when Brent talks about it, I think he thinks that's a 6, 12, 18 month time horizon. It's like 6, 12, 18 day time horizon. It may be our time horizon. So, that's I think, part of the difference in our views on it. But at any rate, I'll pause there because I've probably over shared.

Erik: Luke, you alluded earlier to the possibility of a recession coming in which interest rates actually go up not down though somewhat unprecedented scenario. I'm going to one up you with that and say, not only do I think that is possible, but I think you could see inflation continue to rise during a recession, as much as that's seemingly impossible. I'm convinced that the current political administration would probably respond to a recession by doing things like forgiving student debt, trying to help and that's going to, as you said earlier exacerbate inflation but particularly, I think, almost everybody is assuming if you had a US recession, then oil prices would collapse in half. I don't think that's true at all. I think that they would dip briefly, but they would then continue to rise. If we saw an inflationary recession, which is punctuated by higher interest rates and higher energy costs and higher gasoline prices. First part of the question is, would you agree with me that that is entirely possible in this environment? And if so, what are the knock-on effects? Because, if you're talking about that situation, it's going to require a major political upset, it potentially is the kind of thing that gets presidents impeached and replaced and so forth. What happens next if we get to that scenario?

Luke: Yes, I agree. It's possible. I think it's probably likely actually and what happens next? I think you actually get gold to move for starters, because I think everybody that thinks we're gonna go back to some sort of pre-COVID inflation thing is going to go oh God I need to own gold and that's a lot of money. So I think it does probably I think that does well, I think Bitcoin rips, etc, I think the implications of it politically, yeah, it's not good, I think we'll get into a whole bunch of propaganda this is, this is I think they'll tell us inflation is seven and it's really 14 or something, which I think they're kind of already doing. It's challenging, and it'll be very challenging in emerging markets in particular. So it's really the Fed's worst case scenario where you're going to have bonds going down, you're gonna have, you're gonna have inflation up well above yields, and you're going to have, basically, they're going to have to be monetizing or growing their balance sheet into that just to maintain the solvency of the government. I mean, the overriding bottom line is the balance sheet of the United States government post COVID means they don't have really any options. The only option they have is inflate the debt away. The only question is the pace at which they're doing it, slowing it down, the way they have with pretending like they're going to tighten for a while is hurting them not helping them. They can do it, they could have done it for you know, negative 6%, negative 10% real rates for three, four years, they probably would have been okay, but now with this, they're extending it out, and they're probably going to have to make it much more pronounced. And I think they need very negative real rates for a compressed period of time. And then they just normalize policy, and that's it and bondholders get screwed, low-end consumers get screwed on a real basis. Everyone gets paid everything they're owed, but it doesn't buy him nearly as much. Commodities do well and the political stuff shakes out however it shakes out and it could be potentially nasty.

Erik: Luke, I can't thank you enough for a terrific interview. But before I let you go, please tell our listeners briefly what you do at Forest For The Trees and how they can follow your work.

Luke: Absolutely. We aggregate macroeconomic data points from a variety of publicly available sources looking for economic bottlenecks that will stand to either benefit or hurt various sectors and try to help our clients position properly accordingly. You can find our work at fftt-llc.com And you can find out I have a pretty active Twitter feed at @LukeGromen.

Erik: Patrick Ceresna and I will be back as MacroVoices continues right after this