MACRO Voices
with hedge fund manager Erik Townsend

Lyn Alden: Energy, Inflation, The Dollar & More

July 14th, 2022

Erik: Joining me now is Lyn Alden, founder of Lyn Alden Investment Strategy. Lyn produced a terrific slide deck to accompany today's interview. I strongly encourage you to download it as we will be referring to the charts and graphs that it contains throughout this interview. Listeners who find the download link in your research roundup email. Apologies if it may be delayed a couple of hours after the podcast this week due to some production issues. Please bear with us there. Once you've got it though, I think you're gonna love the graphs and charts that it contains. If you don't have a research roundup email, just go to our homepage macrovoices.com and click the button that says looking for the downloads. Lyn, it's great to get you back on the show, I know you've been writing quite a bit about a subject that's very much near and dear to my heart, which is crude oil and energy in general. Why don't we start with the big picture. What's on your mind with respect to energy. I don't want to taint it too much with my own views. And we'll get into some of those other views a little bit later on.

Lyn: Thanks for having me and happy to be here. And so energy is obviously one of the key things affecting all markets, not just obviously energy markets, but also impacting everything else, because energy touches pretty much everything in our lives, financially, and otherwise. And so you know, my view of the energy market over the past year or more has been that supply side issues are starting to come to the forefront. And that this is obviously going to cause significant inflationary pressures both for the energy sector directly and then also for the broader economy. And so, generally speaking, commodities go through these very large CapEx cycles. There's periods of time where you know, commodities are structurally over supplied, prices are low, nobody wants to invest. There even you know, in more recent terms, there could be other reasons why they don't invest like an ESG overlay onto those financial reasons. But for a variety of reasons, nobody wants to invest in the space. But then over time, if that not occurring, eventually you work down the existing supply, right? So wells start to run dry, demand starts to slowly creep up over time, until you go back above equilibrium. And so then you start to get rising prices and then more and more supply comes online. And some of those take many years, you know, for the bigger projects to bring online, until eventually they over build, you know, cause a period of oversupply and low prices again. They start the whole cycle again, and this is a pretty long term cycle. And so my contention for a while now has been that we're entering, you know, a decade of much tighter commodity supply in general and energy supplies specifically. And we're starting to see that manifest this year. And my view is that it won't be a straight line. So I'm not trying to say, you know, chart oil on a week by week basis and make

those specific calls. It's more about the fact that, you know, in the years ahead, through ups and downs, that we're looking at structurally higher energy prices, most likely.

Erik: Lyn, another topic that you've written quite a bit about is inflation. Now, to what extent is this oil price event that we're having about inflation in the economy and to what extent is it about the Russian war, President Biden has of course described this as the Vladimir Putin price hike. Is that what's going on here or is there more to it?

Lyn: Great question and I actually look back to the three times I was on your show before. We centered the conversations around inflation. So my first appearance in mid-2020 was called the road to inflation. And then the next two appearances after that were really about how the, you know, inflation is being driven in large part by the fiscal side. And so it's not just bank reserve creation, this time around unlike the 2008 crisis. This is actually, you know, significant fiscal stimulus that actually increased the money supply and broad circulation among most economic participants. And that, you know, people can take that extra money go out and buy things with it. And so now, even though we're getting a pullback in terms of that money supply growth, and that fiscal stimulus, those effects are still working their way through the system. And so my view is that is the combination of the monetary inflation with that we've seen. As well as that commodity cycle. And so, you know, if we look at slide three for example, we can see over time, you know, there's very significant persistent growth of the broad money supply. And that is, of course, the unit of account that we're looking at when we're measuring oil prices. But then when you combine that with the fact that, you know, you have these big commodity cycles, you know bull market in the 1970s when you had shortages. Bull markets in the 2000s when you had shortages. Bull markets recently when we've had shortages. These represent these huge stepwise increases in the price of energy and then you go through a long consolidation phase. So my view is that it's both the unit of account going down significantly, basically significant, you know, monetary debasement, broad money supply increases, as well as where we are in the commodity cycle. And when we look at the order of events, we started to get rising energy prices before the war. That obviously added a lot of extra volatility and uncertainty onto energy prices. But it wasn't as though this was not happening before that war occurred.

And then specifically when we look at European natural gas prices, which are arguably the craziest energy charts out there at the moment. Those also broke out in late 2021, which was again before any sort of a conflict began. And so I think what we're looking at structurally is that the increase in the broad money supply is part of what contributed to the breakout of energy prices, because we basically increased people's demand to buy more energy intensive things. But then as that supply constraint exists, that will be a persistent inflationary pressure going forward. And so for example, if you look at slide five. That shows the five year rolling cumulative changes in both oil and CPI over time. And that chart goes back well over a century. And what you generally see is a very strong correlation between energy prices and broader inflation with the notable exception being the 2000s. That was the biggest decoupling we've had. We had basically rather high energy prices without the level of inflation we'd expect from those high energy prices. And that was because our other disinflationary factors were so strong. That was kind of at the at the peak rate of globalization. So we were aggressively pushing jobs out to

China. We were tapping into this large untapped pool of labor throughout the developing world. And so we had these big offsets that we could offset inflation with. You know, it didn't necessarily translate into sharply rising domestic wages. It didn't translate into sharply rising manufacturing costs because we had all these offsets, as well as just rapid technological growth. But I think that we're going to be unable to repeat that this time around the basically, we know, we're no longer have, you know, China's already quite developed, they already have, you know, potentially a working population peek in place. They're already rather, you know, developed in that sense. And we don't have a lot of other levers in to basically offset some of this inflation with. And so I think going forward, we're going to see a tighter relationship between money supply growth and CPI, because we don't really have those offsets to work through.

Erik: Lyn as we're speaking on Tuesday midday energy markets are outright crashing. Crude oil literally down over $7 on the day. We haven't quite tested that 95 spot 10 level that we got to last week. But as I'm speaking now, we're just above $96 so about $1 away from it. Now it was OPEX announcement that they increased their production by 234,000 barrels per day in June that seems to have been the proximal catalyst for this but bigger picture, what we're seeing here is a tug of war between increasing recession fears, which are causing the macro traders to really say, okay sell crude oil, recessions coming! You gotta sell crude oil, we don't want to own it anymore. And the other side of that is the physical market as indicated by the time spreads is just screaming out a bullish signal, which is the time spreads are really tight, the physical market is tight. We don't have enough physical oil, recession or no recession. How do we make sense of this Lyn? It's clearly a balancing act but if you're trying to trade this, what do you do? Because you don't know when the next headline is going to come out as happened this morning, that causes the market to drop by $8 or $9 in a matter of a few hours. On the other hand, I think you and I agree that there's a very, very bullish longer term picture. How do you weigh that recession risk and the perceptions in the marketplace about that recession risk against the supply situation that you and I both see is really getting critical?

Lyn: That's a good question. I think the way to manage it is to basically try to run a conservative book, right? Because we are at a period where headlines can sharply influence the price up and down. And so my energy thesis is less based on what it could do it in any any given multi month period. Basically, if you suppress demand enough for a short period of time, you could potentially reach you know, kind of a pretty low energy prices briefly. I think the bigger picture thing to focus on is as we go forward, where's the brand new supply going to come from? So, as you point out, we have some variables from OPEC for example. We also have variables related to the war. We also have variables related to the Strategic Petroleum Reserve. We also have variables related to Chinese lockdowns right? So the two biggest countries in the world, the United States and China are basically affecting the oil price in different ways. The United States is releasing oil into the market and China is reducing its consumers oil demand, basically less jet fuel, less gasoline usage. Basically, by having those pretty extensive lock downs, they're kind of holding their demand suppressed. And so those two big impacts are, you know, temporarily bearish and then there are you know, there's always these like marginal spare capacities that can come online, but I think that as we look out past this period, basically

when we get into recession, the Fed unable to keep tightening. I think basically we'd have energy come back pretty quickly.

So the way I described it in the recent newsletter is it's kind of like, you know, if you've run away from a Monster and hide in the closet. That monster can just wait outside the closet until you come back out. And I think that's essentially what we're doing by reducing demand in the face of a supply problem, right. So basically by China reducing their own demand. By the Fed trying to tighten policy and cut demand off, this can temporarily suppress energy prices, maybe doesn't make them go down sharply, maybe it makes them go sideways and choppy for a period of time. You know, that can that can do things in the near term that are not very bullish. But basically, I think that whenever major central banks, you know, a counter recession tries to stimulate again, we would have energy prices come back pretty rapidly because the supply side problems are still there. And so I think until those supply side problems are addressed, we're going to be basically in an inflationary situation. So even in inflationary decades, like say, the 1970s, you still had disinflationary periods within an otherwise inflationary decade. Because there always are attempts by policymakers and things like that, to fight back against what's happening, I think that's what we're seeing now. And I think it's important for investors to realize it's not just the production of oil and gas, it's also the transportation of oil and gas to where it needs to go based on, you know, pipelines, or LNG capacity, and things like that, as well as refining capacity in order to turn it into the products we actually use as the end user and where we need to use them. And so basically, it's the whole energy complex, for the most part that is under invested in, and that this is going to be a constraint for, I think, years to come. And trading that I think is basically you know about risk management. Because there when you have such strong variables both to the upside, and the downside, you can get these uprising breaks up, you can get surprising breaks down. And I think it will reward investors that kind of stick through it, and maintain that kind of cautious long exposure as we look out into the years ahead.

Erik: Lyn, I really want to drill down on what you just said about until those supply concerns have been addressed. Because what I don't see is how they're going to be addressed. Because we've got a situation where OPEC has admitted that they're basically out of spare capacity. The US shale industry is doing its very best and is amazing everyone with how well they're doing given the uphill battle that they're fighting with respect to their government policy, not really supporting them. But it's still not enough, and I don't expect it to become enough. And the problem is that producing resources will continue to decline. That's just the way oil wells work, they don't continue to produce the same amount of oil, it's always going down. And you always have to drill new oil wells in order to replace the old ones. And as you said Lyn, investing in this stuff, it's almost uninvestable because of the ESG movement, because people are concerned about the longevity of the industry. And obviously in the long term, we will eventually as a civilization will solve this problem by electrifying the economy, getting rid of internal combustion engines and so forth. But that is a solution that will occur in a timeframe measured in decades, not months or quarters or years. So in the sense of months, quarters and years, how is the supply problems going to be addressed? What can be done to solve it?

Lyn: So the short answer, I think, is that it's going to take years and years to solve the problem. I think this is going to be a story that lives with us for most of this decade. It's not something we're going to solve by next year or the year thereafter. Basically, nothing short of large CapEx expenditures on a persistent basis will be able to solve this. And, you know, when something gets bad enough, you start to get feedback loops, right. So if you go into severe stagflation, or types of recessions, eventually, people, you know, rotate out some of the policies that contributed to that until they find leaders putting a new policies into effect. And so for example, I think the United States will eventually up tick its energy production, at least to a mild degree. And I don't think that's, you know, necessarily right around the corner. But I think that as you look at a number of years, I think that as the situation goes more and more untenable we will eventually bring some more supply online. I also think that there are more unconventional things that they can draw into over time, for example, in Canada, or they can also go offshore. I think right now, we're seeing that as you point out, a lot of private entities don't necessarily want to put a long term capital into this, right now. You know, the markets, basically telling them like, you know, oil prices high now, but this is all transfer, it's gonna go back down. And so there's not a lot of incentive to go out and spend billions of dollars on these long term objects to bring long term supply online, as well as transportation and refining capacity.

So basically I think that the longer the prices persist in these big high choppy levels, the more it will dawn on private entities that yes, that this is a longer term problem, and that you can safely put, you know, long term capital at work, once you start to see that jurisdictions are shifting their view due to voter backlash and persistence, that inflationary pressures. So, you know, I think Rick Rule is the one that you know, often says that bear markets are the authors of bull markets and bull markets are the authors of bear markets. And right now we're kind of suppressing the ability of markets to come in and address the price pressures that we're seeing. But I think that the longer that grinds out over time, eventually that will change politics that will change public perception, and then that will change private investment at least at least in a number of jurisdictions where it starts to matter. But again, I think that's a multi-year story. I don't think that this problem can be addressed anytime soon.

Erik: Lyn as we speak here in July of 2022, open interest in crude oil futures is crashing like it's March of 2020. And I don't say that figuratively, I'm looking at a chart courtesy of our friend Ole Hanson at Saxo Bank, who tracks the commitment of traders reports very actively, and we're literally seeing the abandonment of speculative interest in crude oil futures. So all of that speculative, long interest is coming out of the market. Does that mean that we're close to a bottom in energy prices or are there more factors that could drive us even lower? Particularly, I know, you follow the recession cycle very closely. Are we about to get even more bad news recession wise?

I think we're going to be in a period of economic weakness for a while. So in a recent report I even talked about I mean, oil could go down to 70 or 80 potentially. I mean, I wouldn't be shocked to see a sharp dip in energy prices. It's not something I'm calling for. But basically, if they do manage to destroy enough demand, there's variables that are outside of our current say, forecasting capacity. You know, what if China goes even stricter on certain lock downs?

What if the US and Europe doesn't counter an absolute severe recession, and policymakers push that as hard as they can on the demand destruction side. You can certainly get these, you know, brief periods of wild price swings in either direction. I think the situation then becomes what is the feedback loop from there, and I think that there'd be another reversal, another response, because you start to get breaking financial markets, breaking Treasury markets, you know, basically a collapse in tax revenue, resulting in all sorts of liquidity problems in some of the core markets of the financial system. And so I think they'd end up reversing course, again, if they were to encounter something that severe.

Lyn: And so I think that there's really no headlines I'd be surprised on that can drive oil below 80 or above 120 next week, right? There's all sorts of things that can they can adjust where oil goes in the short term. I think the bigger story to focus on is where does have to go long term, and what levels of depth to stay at long term in order to ever bring new supply online and to change policies around allowing new supply to come online. And so I think it's a great thing, that speculation is being washed out in the industry. You know, as kind of an inherent contrarian, I always get concerned when something I've been talking about becomes consensus. I get concerned about locally overbought periods. And so I do like it when a market gets flushed once in a while because that basically helps price discovery happen again. We actually see where the fundamentals are. So if a lot of macro people are looking at recession signals, and they get out of their position. Well, we can still see what's happening in physical markets, and then over time that drives the price. And so I think that basically when we look past this period of turbulence, I'm so bullish on energy prices. And if you look at oil equities, for example or transport equities like you know, the midstream sector. I still think that area is pretty attractive, when you look at long term. I mean most of those prices didn't go up to reflect, you know $100 plus oil and they're basically still pricing in as though it was going to come back down and natural gas, we're gonna come back down, and we're gonna go back to the normal we had over the past five years. And I think that's the part that's quite unlikely. So I think that basically, if we have somewhat of a counter cyclical approach, you know, careful cash management level leverage management. I think as we look out, this is still plenty of bullish opportunity either in directly in oil and natural gas themselves, or in some of the equities that are involved in their production and transportation.

Erik: Let's move on to the recession cycle because you study that quite actively. I've been telling our listeners for months now that I thought a recession was nearly certain because the Fed basically needs one in order to fight inflation. Well how close are we in terms of the recession actually happening? You know, when I first started saying that it was a nutcase, conspiracy theorist view. Now it's getting a little more consensus, but it's certainly not mainstream in the sense of people expecting that a recession is a near certainty, which has been my view for, you know, a couple of months now. How close are we to the mainstream really realizing this and particularly, how deep do you think this recession is likely to be? How long do you expect it to last in comparison with where we are now, in terms of consensus expectations.

Lyn: So if you're looking at leading indicators and coincident indicators. You know, it's arguable that we're in the early phases of recession already. I mean we've had potentially two negative quarters of real GDP growth. A number of the forward looking indicators are very very soft, especially when you look at things in real terms, rather than nominal terms. You know, people are basically buying fewer goods, when you factor out the fact that the prices of those goods are much higher. So basically, the amount of stuff that they're taking home from the store is diminished compared to where it was a year ago. The part of the economy that's still pretty sticky, that's still pretty strong is the labor market. And, you know, a bunch of factors that go into that. But it's important to realize that that's often a lagging indicator, that that's something that, you know, basically rolls over once you're pretty much already in a recession, or, you know, bout to enter one. And so I think that we're seeing early signs of some softness in the labor market, we've obviously seen a lot of layoffs by tech companies specifically, we've also seen, you know, a reversal in the trend. We had, you know, a long period of lowered lower initial jobless claims. And now we're starting to see kind of a mild rise in jobless claims. And so I think we're encountering a somewhat softer job market that has not rolled over yet. I also think it's important to look at the real wage component. And so for example, you know, jobs have not really started shedding yet. But if look at the median worker, their wages went up more slowly than inflation over the past year. So instead of kind of like firing people, we basically have given everybody a pay cut in real terms, right? So it often in that sense, feels like a recession, even though you don't have the job losses yet. And I think that's one thing to kind of look at this is through that inflationary lens. I think that a lot of analysts are used to looking at nominal numbers, because inflation component was not a very large part of the nominal number over the past several decades. But now that inflation is such a big component of the nominal number, I think that can disguise some of the problems that we're seeing in the real numbers, the inflation adjusted numbers.

And so I think that many workers, you know, they've already gotten a real pay cut. I think the job market is showing some signs of weakening. And I think that, you know, by the end of the year, we're in what is basically a recession. As to the severity and length of it, that will partially depend on what policymakers do, and it'll partially depend on what happens with headline factors like wars and what happens with some of these, you know, severe energy bottlenecks. I think that this is going to resemble a more of a stagflationary type of recession where you know, instead of a big deflationary bust, you get more of a grinding malaise, something like we saw in the 70s or something like, you know, people experienced in the hardship of the 1940s where it's different than to say the recession of the 2008 crisis or different than the recession of the early 2000s and more along the lines of that inflationary, it's kind of scarcity driven mindset type of recession. And so I think that a lot of things could chop along nominally sideways, right? So for example, you can get a, you know, 9% reduction in real corporate earnings, and still have flat nominal corporate earnings because you have such a large inflation component, basically, the money supply itself is so much larger, and so the unit of account that you're measuring things in has diminished. So I think that we're in probably a large choppy, kind of, you know, malaise going forward for a period of time until you start to see a reversal of some of the supply side constraints, which I don't think is happening anytime soon. So I think right now we're entering what is kind of like a disinflationary move within what is otherwise a very inflationary situation.

So some of the supply bottlenecks have been addressed. Demand in some areas have been destroyed enough. We've seen the housing market cease up, we've seen durable goods cease up. And so some of that should be somewhat disinflationary, even as things like, you know, the housing component of CPI still coming up with a lag and even though as we've discussed, we still have severe problems on the energy side. And so I think that this is going to be one of those longer and more stagflationary types of recessions.

Erik: Lyn as we're speaking on Tuesday, commodities are outright crashing, which seems to very strongly confirm the recession expectations that you and I both share. But hang on, the stock market is really hanging in pretty well as I look at S&P futures right now. They're basically flat on the day and just a hair above their short term moving averages, the chart is really not looking that bad, but commodities are crashing. So if the reason commodities are crashing is because a recession is coming, why not equities?

Lyn: Well, equities often take their time and then factor everything in at once. And so for example, you know, in the run up to COVID, equities were kind of like last to get the memo that this virus is actually going to be a pretty serious factor. Globally, we saw it expressing in commodities first. And then it took, you know, equities a while to see it. And then of course, once equity saw it, they pretty much saw it all at once. And I think that equities are getting a partial reprieve from the perception that, you know, rates might be topping, or at least they're going up, you know, longer term rates are going up more slowly than they were before. Basically, that they're, you know, some of the forward expectations of Fed hawkishness. Some of the most hawkish expectations are probably being taken off the table even as the Fed itself is still hiking. And so the equity market is kind of balancing those factors. It also went down pretty sharply in the first half of the year. And so sometimes you just get a natural bear market, sideways move or bear market rally until you have further weakness. And also I've been separating OpEx commodities from CapEx commodities. So basically, you know, OpEx commodities would be once we need on a regular basis, you know regardless of what we're doing and oil and other energy commodities would be in that basket. Basically, even in recession, we're still driving, we're still using the majority of the of the energy we need. Whereas we look at a CapEx commodity, like copper that is heavily involved in the construction cycle, you know, I've been a lot less bullish in the tactical sense on those CapEx type of commodities, because that's where you see that really show up in the recession data. You know, copper to gold ratios for example have always been a really good proxy for economic growth globally. If you kind of overlay a copper and gold chart on a PMI, purchasing managers index chart, they're basically the same chart. You get this like sideway economic acceleration and deceleration. And just about every indicator we look at suggest a deceleration across the board. And so I think that we've already seen part of the equity move in the sense that valuations compressed as we saw the sharp rise in rates and I think the second leg to be aware of is the earnings weakness that is likely coming at as basically businesses are facing cost pressures. And then due to the weak, low sentiment consumer, they have trouble passing those price increases on to the consumer. And so they face squeezing margins and weaker earnings. And that could translate into another much lower low in equities, or it could it could cause like, multi-year choppy sideways action that basically, you know, bleeds out in real terms. While being say, you know, this kind of big

sideways band in nominal terms. It's always hard to predict where sentiment is going to push things around. But I think that the whole second leg to follow that the equity markets not really touched yet, is that weaker earnings side?

Erik: Lyn, let's drill down on copper as you mentioned that just a minute ago. It seems to me like, you know, we got a recession coming, Dr. Copper always sells off when there's a recession coming, I think the recession is going to be longer and deeper than most people expect. That would suggest that copper has farther to go to the downside from here. But hold on, when I stop and think about the longer term view, you and I both share an inflationary, longer term outlook. And I'm convinced that long term I mean, we really do need the electric vehicle movement. You know, climate change is a real issue. I think that the priority that was placed on the climate agenda is going to be diminished as a result of the pain that it's causing at the at the gas pumps. But at some point, we are going to need to make the investment and electrifying the economy. And demand for copper is going to be off the charts. So I passionately want to buy, you know, back up the leverage truck. And buy the very bottom of this move in copper which I'm sure is not here quite yet. How do I know when it is here?

Lyn: Well, it's always hard to time the exact bottom. But I think that, you know, with copper, as you point out, we have to keep in two separate timeframes. So long term, I'm very bullish on copper. You know, when we're looking back 5-10 years now, I think copper is much higher in dollar terms than it is now. But, copper is a pretty discretionary metal. It's heavily involved in construction, and it's heavily tied to economic activity. And so I'm, you know, I'm neutral or bearish on it in the sort of like near term sense until we start to see a reversal in some of these indicators. So in order for me to want to buy copper or copper producers again, I'd be more aggressive long. I want to see a turnaround in the PMIs right? So I want to see that this period of economic deceleration gets behind us. And then we start to see that early signs of turning around and moving back up. We can also look at things like the copper to gold ratio. And then you can use that ratio chart. And you can similarly look at reversals and momentum. So you know, if you're looking at the longer term chart, like the weekly chart, you're basically looking for these, you know, more structural shifts, where we've been in Copper has been going down compared to gold in recent months. And you know, when you get to kind of that bottom of that trend, you start to see a reversal. That's when I think you can more aggressively go long copper. And these cycles can always surprise you to the upside and downside. I mean, back in mid-2020, I was analyzing copper producers and buying them pretty aggressively. And I expected them to hold them for a number of years. But then copper and the copper producers rose so quickly, and became so euphoric that I ended up trimming them a lot earlier than I you know otherwise would have. And now we've seen this big pullback, I would absolutely love to get back into that trade longer term. And, you know, as I point out, I just want to see signs that I don't think we're pretty much anywhere near close to the bottom of the PMI cycle and the bottom of the, you know, the kind of the copper to gold ratio chart.

Erik: Lyn, we've talked about recession and inflation. Recessions tend to bring lower interest rates, inflation tends to bring higher interest rates, what should we expect here?

Lyn: So that's the normal pattern that investors are used to expecting. And the exceptions to that pattern tend to be so long ago that they're outside of most people's radars. And so for example, I have on slide two, it shows the inflation's of the 1940s and the 1970s side by side, as well as the short term interest rates of the 40s in the 70s, side by side. And what you saw the 70s is pretty much what you'd expect logically that interest rates generally followed inflation levels, especially by the end of the decade as Paul Volcker tried to break the back of inflation. But even prior to him, there was still this pretty tight correlation between rates and inflation. Whereas we look back in the 40s, you saw complete detachment where you had super high inflation, but you still had low interest rates. And that large part comes down to debt levels. Basically, when societies are heavily indebted, like they were in the 1940s, but they were not in the 1970s. That's when you're likely to get that decoupling of interest rates and inflation. And that leads to, you know, kind of structural currency devaluation. We're already seeing that to some extent in Europe and Japan. So for example, Japan right now is doing yield curve control, despite the fact that they have inflationary pressures. When you have 250% sovereign debt-to-GDP, they didn't really have a choice other than to have persistently negative real yields.

And then we look at Europe for example, they're facing acute energy crisis, high inflation. But when they have countries like Italy with 150% debt-to-GDP again that's basically untenable in real terms, right? So bondholders in those types of countries are going to get defaulted on one way or another. It could either be nominally, which is unlikely to happen when an entity can print its own currency or it can happen in real terms where everybody takes a haircut, it's kind of like a restructuring, except everything gets paid back every currency unit that they're owed, and just those currency units are worth a lot less than they used to. So you know, holders of those bonds, will be able to buy less energy, less food, less house, whatever you want to call it in the future of the long run. And I think that the Fed is basically gonna encounter a similar situation pretty soon when they have, you know, roughly 103% debt-to-GDP. And you have pretty high private debts, pretty high corporate debts, and the economy itself is so financialized. And tax revenues are so tied to rising asset prices, I think they're also going to run into a situation where they're unlikely to be able to raise rates as high as they want to in the face of this inflation. We also see these kind of negative feedback loops, where if you have a big decoupling between the Federal Reserve's policy, and then policies from other major central banks then obviously that leads to dollar tightening. And so for example, the recent dollar strength we've seen is less about the dollar specifically.

So for example, we don't see a massive breakout in US dollars vs. Canadian dollars. You know, the dollar versus the Renminbi is still below its 2020 highs. We don't see huge breakouts across the board. But we do specifically see a breakout against the Euro and the Yen because those are currently being unusually weak currencies due to their circumstances. But nonetheless, when you start to see significant dollar strength, which in part is what we're seeing now. You generally start to see less buying from foreigners of treasuries. Basically, they're squeezed in various ways, and they're unable to keep cycling their trade surpluses back into US capital markets. And so on slide seven there, I show on the left chart there, you have the broad Dollar Index in blue. And you have foreign treasury holdings at the Fed, which is the most rapidly updating data we have on that subject that's in red. And you see a pretty strong inverse

correlation. So when you have $1 move up, especially if it's disorderly, $1 strengthening environment, you generally get less foreign buying. And the feedback loop there is that that means that the US domestic economy has to absorb more of the fiscal deficits. So the US banking system, you know, pensions, US households, or the Fed. These entities end up having to absorb more of the fiscal deficits. And at the current time, in the middle of this year, there was not a lot of net Treasury issuance. And so the Treasury Department is in pretty good shape at the moment, even though we're seeing rising illiquidity and rising volatility in the treasury market, from some of these lack of buyers. But I think as we look out into 2023, when weak as a prices translate into weak tax revenues, and as we likely see a persistently, you know, lack of foreign bid for treasuries, I think they're going to run into more acute liquidity problems in the treasury market. And then in order to solve that, there's basically a number of things they can do. So for example, the Fed can stop raising rates, they can turn to QE. That's obviously pretty bad optically if inflation is still you know a problem at that time. They can also do things like adjust SLR requirements for banks to allow the commercial banking system to buy more treasuries as actually, you know, something they really did in the 1940s. The US commercial banking system was a big financier of the high federal debt. So were they were done during World War Two. And I think we'll probably see a similar thing this decade. And so basically, as we kind of call this right now, the Fed is doing their best to push back on inflation. But essentially due to how high debt levels are, I think that by next year, regardless of what inflation numbers are, they're going to have trouble to continue tightening. And that's when you could get say the next leg up in oil prices or potentially, that's when you could see bottoming in copper prices and another round up. Those are the types of environments I'd be looking for to be be more structurally long, some of those CapEx types of commodities.

Erik: Well Lyn I can't thank you enough for a terrific interview and a terrific slide deck. But before I let you go, please tell our listeners a little bit more about what you do at Lyn Alden Investment Strategy, what services you offer to investors and how they can follow your work and find out more about what you do.

Lyn: So I'm active at lynalden.com. I have a variety of public articles and newsletters and then also have a research service pretty low cost and it covers macro and individual investment opportunities. That's mainly both for a sophisticated retail audience and for an institutional audience. And I'm also active on Twitter at @LynAldenContact if they want to follow for charts and kind of just observations throughout the week.

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