Harley Bassman: Inflation, Bond Yields, VIX vs. MOVE, Demographics & More

July 21st, 2022

Erik: Joining me now is Harley Bassman, famously known as the Convexity Maven and more recently managing director for Simplify Asset Management. Harley prepared a terrific slide deck to accompany today's interview. I encourage you to download it as we will be referring to the graphs and charts it contains throughout the interview. Listeners, you'll find the download link in your research roundup email. If you don't have a research roundup email, just go to our homepage at macrovoices.com. Look for the red button above Harley's picture that says looking for the downloads.

Harley, it's great to get you back on the show. I think the subject that's on everybody's mind is okay, inflation, bond yields WTF over what is going on here. Because it seemed for a while like we really were seeing a breakout well above 3% on the 10 year yield. A lot of people were concerned, okay, this is the beginning of the end. The 35 year bond bull market is clearly over. We had a blow off top and it's all downhill in price, uphill in yield from here. But then we got this recent upside surprise on CPI inflation which normally you'd expect that to spike treasury yields much higher, and it didn't. So does that mean that the bottoms in on price and the top is in on yield and we're back to a bond bull market and is inflation really transitory or not? How do we tie this all together? You pick whether you want to start with inflation or bond yields and how do we make sense of those two things together?

Harley: Erik, thank you glad to be back on the show. You know, I've been in the non-transitory camp, the inflation camp for a while. That's a simple U of Chicago grad who believes in monetary policy, you know, Milton Friedman, and you print a lot of money, you print money faster than the growth of the overall economy, you're gonna get inflation and thus we have this. You know, the transitory people, they will be right. Okay. It's just a matter of when. I mean, in the grand scheme of things, we'd like this transitory so they're not wrong. They're just, you know, a bit early. I think you've hit on an interesting concept, which is mentioning inflation and interest rates in the same sentence. I think what's different this time is maybe they're not linked as in the past, for a variety of reasons and the guests might be scratching their head. I think it's possible to say that we're going to have continued inflation that's maybe not nine print, but certainly six till the end of the year. That's pretty easy to to go and say that. The question is well will rates move anywhere near that point? And the answer might be no for that, for a lot of stuff. But not, not least, which is the Fed is happy with a negative real rate. Negative real rates are great for the economy and great for the stock market. So the Fed might well keep that. And the uncertainty of course of this. I'll join everyone else. If the yield curve, that's what we can't figure out. You know, usually the yield curve inverts. And luck spent a lot of time on this because all your guests talk about it, it usually inverse before the second to last fed hike right at the end, here it inverted basically before the first hike. And that's what we can't figure out and the curve is right, we will have a recession. Are we in one right now? Unclear but it's gonna come. And so the market basically is trying to digest this cognitive dissonance of the curve versus your lying eyes of inflation.

Erik: Harley help me understand the relationship between interest rates and inflation, because everybody says when inflation goes up, it makes interest rates go up. And I kind of think, well, wait a minute. In the past, when inflation goes up, it causes central banks to raise policy rates because they need to fight inflation. But we have a situation now where it's very difficult for them to raise policy rates very much, because we've got so much national debt to contend with. So let's assume that central banks are not going to aggressively raise policy rates, does inflation still cause long rates to go up just because there's inflation? Or does inflation only cause long rates to go up because central banks are fighting the inflation by raising policy rates?

Harley: Well, I mean the rate you're talking about is the 10 Year rate or mortgage rates, things like that, which is, in theory linked to policy rates, but they're not really. The Fed controls the front end and they can do what they want to do. Back end is supply and demand. The idea that the two of them are linked I guess kind of makes sense in the idea that, why would you want to own an asset earning 3% when inflation is running at six or greater, you're losing. It's a negative yield when everything's said and done. And so logically, you think that wouldn't make sense, but it can be different. I'd also say that I would push back very hard on the notion that the Fed can't go hard. I think they can and I think they will for a lot of reasons. Not the least of which is Jerome Powell's legacy. If you really think about it, you know, what do we as human beings do? We still read the Greek tragedies, we read Shakespeare. Why is that? Because these guys have zeroed in on the great human frailty of hubris, of ego and that always drives people. That tends to be the Great destroyer of mankind is your ego harming you. What's Jerome Powell looking at right now? He's looking back at history. And he sees Arthur Burns, who was the Fed Chair of the 70s who was bullied around by Nixon and other politicians, who did not raise rates, who left the inflation genie out of the bottle. And we had the huge inflation in the 70s, which was unpleasant. He's not thought of kindly now. We have Paul Volcker, who we could push back and forth about how much of the reduction of inflation was him versus demographics, there was other things going on. But nonetheless, he's well known as the guy that fought inflation. And he's thought of well now, although at the time, he was not a hero.

So Jerome Powell is sitting here and he's late to the party. We had inflation starting a year ago and for reasons I would describe as political, which is, they did not announce his renomination in August like they usually do. They did it in November. They did put him up for the vote quickly, they waited longer than that. And I think he was paralyzed from raising rates, or reversing QE because he wanted to go and get the job. And he was concerned that if he took strong actions, the politicians would not reconfirm him. So I think he was hung up by politics for nine months. I think he would have gone earlier. And now he's been, you know, at least cracking, he's out there, he's talking about fighting inflation as a primary idea, more important than unemployment in the economy. And he's looking at saying, what do I want to be remembered as, what do I want my tombstone to say? Is it you know, Jay Powell, you know, Arthur burns Redux inflation runs wild during his term, or, you know, Jerome Powell, the hero who slayed inflation. I can guarantee you, it's the latter. And therefore, he's gonna go and fight inflation however he can. The only tool he really has is interest rates and that is what he's gonna go and do. And so I think that the market is looking at the curve, looking at recession and all this stuff, but I think they underestimate what Powell is going to do to go and, you know, try to spear inflation. And I think rates can go a lot higher than what the market is pricing in or what people think.

Erik: Well let's talk about how high rates can go because if you read the doomsday bloggers, they would tell you oh, look, you know, if the Fed tries to raise rates at the short end of the curve, it's going to bankrupt the US government, because already, we're spending almost 100% of tax receipts on interest payments. So if the interest payments double, you know, it kind of creates a problem, or you have massive more deficit spending and a need to really invoke modern monetary theory. How far can this go? How far can the Fed raise rates to fight inflation before you get to a situation where the federal government can't pay its bills?

Harley: Now, the government can always pay their bills for God's sakes, they can print money. They've already been printing money for a decade, what's gonna stop them?

Erik: Isn't that part of what's causing the inflation, though? I mean haven't we gotten to a situation where if they print money in order to you know, to deal with this, that it's just going to make it worse?

Harley: He'll raise rates until something breaks, something breaks being the economy. Well, I mean, inflation is a supply demand disequilibrium. They can't push down supply or push up supply. So they'll push down demand. They will throw people out of jobs. And think about it in the grand scheme of things. If we break down the world into quintiles for the US. The bottom quintile is 0 to 27,000 roughly income. Top quintile is 141,000 and above. Bottom guys, they'll get you know, government support, top guys they don't care. So 60% in the middle, these guys actually care about inflation, it actually is significantly impacting their lifestyle. That's a lot of people. If we take unemployment from 3.6% to 5.6% or 6.2% to where it was for the last recession. Okay 2% of people lose their jobs. That's pretty bad. Losing your job is worse than having inflation but we're talking about 2% versus 60%. I think the Fed's gonna go and balance things out and say We'd rather go and reduce the damage to the entire 60% than for these small amount of people who lose their jobs and you know what, they're not wrong. So I think they could take this as high as they want. They will stop I mean, they will slow the economy down. We will go to recession, and we've already got! You know, the housing market is already gonna go into the tank. You know, simple math. And I've written about this before when rates went down from five and change to three and change a few years ago. That basically accounts for 85% of why housing prices went up by 22.

Now you're seeing the reverse, taking rates from three and change to five and change. I've posted the math on my last commentary. In theory, all else equal, housing prices would drop by 21%. Will they go up by that much? No, but that's a big number. And therefore, and you can see this on, like chart seven shows the monthly mortgage cost holding everything else constant takes the cost of a mortgage up by 60 odd percent. Remember, the average person does not buy a house. He signs up for a 30 year payment plan. And what he can afford is what he can afford, okay. They are not some Wall Street gizmo who is gonna go and get a huge bonus. His incomes is gonna move by 2. 3, 4 percent at best, and therefore what he can pay is what he can pay. And therefore, you know, if rates go up, he'll buy less house or take on more debt, I suppose. But and housing is 15, 18% of the of the GDP. Okay, so you're gonna go and slow down the housing market by a lot. It's not going to crash, it will not have a repeat of 08'- 09'. We have much tighter credit standards now. And people tend to pay their house before they pay anything else, you're just gonna see a slowdown in the market. Let's turn over lower prices and that will slow down GDP.

Erik: Harley, let's talk about what's causing the inflation because some people would make the argument that look, this has been brewing for 10 years. All of this easy money policy from the Fed had to eventually lead to inflation, somehow they managed to avoid it, then we really, really overstimulated into the pandemic, that was the straw that broke the camel's back and that's what did it. And I could easily make the opposite argument that it had nothing to do with monetary policy and the fact that energy is an input to everything. And people who understand the energy markets understand that we've got a real supply driven crisis, that's only going to get worse and that's driving the inflation. So what do you think is driving this?

Harley: A little of both! You know, I mean, the federal government mailed out checks to people and they spent the money. They were locked up for two years, and now they want to travel, they want to do stuff. And you know, other things have wrinkled supply. I think the more interesting idea is how are the markets processing this concept right here, and the uncertainty of how it's going to play out? I think everyone knows we're gonna have a recession. And everyone knows that we have a supply problem that's gonna resolve in a year or two, one way or the other. It could be bumpy but we know that. What's happening here is along the way, readers let's just care about is how do you invest? How do you make money? What you've seen in the interest rate market is it's been vastly more volatile and uncertain than the stock market. So if you look at slide two, the MOVE, it got up to 155. It's now about 127 and what drove that? The front end! We had no idea where to pin front end rates.

Slide three is kind of interesting. It's the European MOVE, that's gone even crazier than the US move, because they've gone from negative rates to positive rates but we're not gonna go about that. Slide four is the more interesting one. And this one seems to be you know, so popular on every website. It is the relative movement between the MOVE and the VIX. The VIX is vol for stocks and the MOVE is vol for bonds, and you can see how the move has gone definitely higher. Why is that? I think two things. Number one is that there is more uncertainty of bonds and stocks. But more important, let's remember this... short dated options, one month options on liquid assets, stocks, bonds, commodities, oil, whatever it might be, is driven by realized vol. That is the number one prime driver. And what you tend to see is implied volatility trades, 8% to 12% over realized and when we had these very high vols of 155 on the MOVE, it was realized at 140. What you're seeing right now is the MOVE has come off to 127 and the one month realized is 120. On the VIX at 24 and the realized number is 21.5. It's just following the movement of the market. So there's no magic here per se about something's the wrong price. It's just that rates have moved relatively a lot more than stocks have so it's not crazy.

Erik: Harley, I know you're a regular listener to the show so you're heard my comments last week, which were echoed by a Goldman Sachs flow trader who penned an article saying essentially the same thing which is the most common question that he got from clients last week was what the heck is going on with rapidly worsening macro data, not causing the stock market to sell off. In fact, stocks are up strong as we're speaking on Tuesday morning. And really they got through last week where everything else was in big trouble. What's going on? and it's reflected here in your slide on page four, where the VIX showing much much lower equity volatility than bond volatility when bonds are supposed to be the more stable asset. Why is the stock market not crashing?

Harley: Well I mean, this too is not rocket science. I mean, what's the stock, it's money you're gonna get some day, just kind of batch today. And if you look at the big texts by the Amazons, or the Netflix or the Facebook, we can stipulate they're gonna make a trillion dollars 30 years from now. So the only question really is, what's it worth today? When you get inflation in the early stages, that is very bullish for stocks. And the reason why is, by definition, if you have inflation, prices are going up. And if prices are going up, who's ever selling you the goods at higher prices, is making more nominal dollars, their nominal revenues are increasing. So that's good. On the other side, you have to discount that back. And so early on when you get the inflation, that's good for stocks, good for earnings, but as rates go up, you have to discount them at a different rate. And that would lower the P/E because the PE is nothing more than the discount rate, the cap rate for a cash flow. We have not seen rates go up. And therefore stocks really should not be going down that hard. If we got I mean, as I said before, negative real rates are good. If you could have inflation at you know, five, and rates at three. I mean, what's wrong with that? I mean, the Fed was like negative rates, because negative rates basically is positive for animal spirits. That basically means that someone's starting a business or building a factory or whatever you want to call it can basically borrow money at negative rates. That's a good thing. So I think the Fed would like to go and pull that off. They just want to get inflation from nine down to like, you know, four.

We keep circling back to why would the bond market allow a negative real rate? Why would the bond investors want to get a negative, you know, net yield when it is all said and done? I think the question for that comes down to is, why is that back end not going up? I'm gonna guess what's happening here is you have a who buys 30 year bonds? I mean, you have hedge fund speculators, but let's get rid of them. You're talking pensions, and what the stock market having gone up by so much and bond rates have come down by so much. Most of the defined pension plans are actually positive. Even the other pension plans are looking pretty good right now.

They've been underwater for years. Now, I'm not talking the states, they're still, you know, screwed. But other pension plans are doing well. There's nothing wrong with taking your chips off the table once you finally one. Imagine you buy a stock, it goes down and it goes back up again. But you're thinking I want out, I want to get in. So I think you're seeing long liability managers reducing risk in the stock market. And they're buying bonds to lock in their asset liability mix. Nothing wrong with that. And so, you know, I think the simple is that it's a supply-demand disequilibrium between the back end or the front end.

Now this is where, I want to go diverge for one second and talk about forward rates. I don't think we really appreciate that forward rates are not a prediction okay. They are just the back end of a discount model. So in simple terms, if you're you know, some big hedgy running a billion dollars, you could turn your radio off for a second. If the one year rate is 2% and the two year rate is 3%. And Grandma has to decide what she wants to do, should she take the two or the three. Well, the idea is basically she's making a bet is what is the one year rate a year from now, if she thinks the one year rate a year from now is going to be 4, that means she gets 2% for the first year, 4% for the second year, 3% for the entire two year horizon ignoring some of the details of compounding. That's it, nothing more, nothing less. So when you get a spot yield curve that goes two to three, the forward is 4%, nothing more, nothing less. It's not a prediction per se. It's just a breakeven number. And so we start looking at Euro dollars or other you know, instruments out there and the Eurodollar is nothing more than a three months forward. It's strictly you know, the back end of the spot yield curve. Is it predicting the Fed to cut rates? Eh not really. Is it predicting a recession? Eh not really. But they are interesting numbers when you get these curves to go up and go down. So the more interesting question is not that the front end is peaking in December or March, it's why is the back end hooking on down? I guess it could be people thinking we're going to recession. But I think it's more than that. I think there's a need for long duration assets from people who are asset liability managers and it creates this illusion that, you know, of fear but maybe it's not as complicated as that.

Erik: Harley, we're taught that the asset that's supposed to benefit the most from negative real yields is gold, but gold is just barely managing to hold 1700 here, down a few 100 bucks from its high. And this is at a time you know, the other thing that affects gold is geopolitical tension. We've got a conflict between nuclear superpowers and you know, big threats on the table. What's going on there?

Harley: Gold is an alternate currency. Nothing more, nothing less and should you own gold? The answer is yes, it's a diversifier. It's a non liability asset that you can pick up in your hand. So owning that is pure diversification. I think gold works over a very long horizon like 20-30 years. The old expression was an ounce of gold could buy a fine man suit or a fine Man's armor pr find man's toga. I think that's still the case today. So, yes, it's good to wrap a story around it. But it's a very long lead time instrument. And I think to try and trade it as a short term idea is foolishness. That's it. It's like the euro or the yen or something else. It's just a currency.

Erik: So you don't see it as an effective speculation. A lot of people say you want to hold gold, because look at what's going on with central banks, debasing the currency. Surely it has to mean gold explodes to the upside. You know the doomsday bloggers say it's $5,000 an ounce by next year? Of course I don't believe that's going to happen. But the underlying thesis is that flawed or what's going on?

Harley: I think right, they're just early. I mean will gold be $5000 someday? Yeah of course it will. I just don't think it's gonna be tomorrow. I think what's gonna drive gold, more importantly, is going to be the ultimate denouement of how we process the baby boom generation. I mean, that is by far the number one problem we have in the world right now. If you look at social security 1936, the equivalent of age 62 back then is like 84. Right now, can you imagine retiring at age 84? I mean, you know, and we've made promises that, can we keep them unclear? I'm much more worried about processing the baby boomer generation, which is barely halfway into retirement. That's a much bigger deal than caring about whether the funds rates at 4% or 5%, because that number can move around pretty quickly. And I think it's a public policy challenge to how we're going to do it because the boomers still vote, they still control the purse strings, the Millennials don't vote, which is foolishness. And so dealing with that, that's also an interesting concept because people talk about how income, the demand side of the equation is going to slow down for various reasons, then they point to the economy or jobs for that. I would look at page 18, which I kind of like a lot, which is the boomers have amassed a massive amount of wealth, the housing, stocks, bonds, other various assets, and they're gonna pass them along. And if they're passing along X trillion per year, as I always say predicted, but they're gonna die, and they're gonna give it to their kids, I presume that mostly gets spent. And this occurs to me as I think about as I sit here in New York City right now. You know how do millennials I have four kids. How do they how do they buy an apartment in New York City? How do the kids go to private school? High class problems for sure. But nonetheless, the apartments are still full and the schools are still full. I'm guessing that grandpa and grandma are funding this. And that's just a way of transferring wealth. So maybe Millenials don't need to have incomes that are exploding like the boomers did. Maybe the transfer of wealth over the next 10-15 years will be enough to keep the demand side of the equation higher than we expect.

Erik: Harley, while you're on the topic of mortgages, and housing, and so forth, I noticed back on page six, you've got an MBS chart here. Is there a trade with how do we think about these things in terms of translating them into trading opportunities?

Harley: Am I comfortable saying buy bonds here? Eh not really. I guess I'm more bearish than bullish on bonds. I think that rates are gonna go up but within the sector of the bond market. I think the mortgage backed security of Fannie Freddie, Ginnie bonds are the cheapest thing on the planet. There is no credit risk. So if we get the recession and lack of a problem with high yield or even, you know, investment grade getting down, pushed on down, you know, the mortgage security is nothing more than an advertising bond with a call feature to it. It's a covered call that's it. And right now, you're seeing the spread, that's what's on page six, between 10-year rates and mortgage rates at about 130. That is crazy wide. We've only seen this a few times in the past and usually during panic scenarios. They just don't stay here. And why it's here is we've had a lot of volatility and also a lot of fear. Fear that, you know, mortgages are going to go and you know widen out. Their duration will lengthen, that's already happened. If you look at slide eight, most mortgage bonds have already gone down a lot in trading, you know, high 80s, low 90s. They've already extended to be able to go and get a effectively triple A credit at 130 over strikes me as being, you know, rather fancy number. I think people are worried they're kind of front running, maybe the Fed who's gonna stop buying mortgages, and effectively sell them, the Fed would prefer to go and sell mortgages before treasuries, they'd like to get rid of those off their balance sheet first. So yes, there's a good reason to be concerned. But the mortgage pipeline, the supply of mortgages, it will come to a grinding halt. There will be no refinances. All you're going to have is new issue mortgages coming out. And that's gonna slow down, as I noted before, because you know, rates are higher. So the supply of mortgages really got to crunch down. It takes like three months for this to happen, because the mortgage pipeline, you know, between the time the guy signs a contract, when they close the mortgage is easily three months, and you're so here's your window right now. So if you have assets in investment grade or Treasury securities, I'd be moving them into the mortgage market right now. And with the move coming down from 150s to 120s, things kind of stabilize as a value it is the best thing I see on the planet. I also am interested in some of the, I guess, the mortgage REITs at a 130 spread. And by the way, this thing was trading at a 40 spread last year or 130 spread levered up seven to one. That's a pretty interesting, the only real risk for for this kind of trades is how high the Fed takes the front end up, because they have to borrow money for the leverage at that rate. But in theory, bigger mortgage REITs know what they're doing, and they hedge out that financing risk. So as investments go, I kind of feel comfy with putting money there.

Erik: Harley the slide you've got on page 12 really jumps off the page. Just look at that gigantic spike on the green line there, which is the GDP index and look at the red line that has historically followed it. Which way does it go? Because we saw a spike down and a spike up what comes next?

Harley: Well, this is the interesting topic over here is technically a recession is back to back quarters of negative real GDP. We had negative in the first quarter. And looking at the Atlanta GDP now, we're gonna get another one in a few weeks. Back to back, so we're in a recession technically. Is that really the case? I kind of don't think so. Because what we have here is that nominal GDP is running very high at 6%. We have inflation at eight, therefore we have a real of negative two or there abouts. But is that really a recession when you have nominal GDP growing at six? I kind of don't think so. It's this idea of saying we're in a recession right now. I don't know the economy is growing a lot nominally, which is good. But there is an MBA finance concept, that nominal GDP and nominal 10-year rates should be kind of linked. The idea being that nominal GDP is what the factory makes for a profit and the 10 year rates that would cost to go borrow to fund it, and therefore they should be linked together. And we've had that linkage more or less, up and down forever. I don't see how we could have nominal GDP up at you know, eight, and rates at three, something's wrong with that. And maybe the answer is we're gonna get the recession and drag nominal down. That requires inflation to come down also. I don't buy that. I kind of think this is kind of like, you know, a lot of things I'll propose what, when you see a wide gap, you know, it's got to come in, but it's unclear which way. I'm still gonna believe that we're gonna see, I think longer rates rise, we're not going to get crazy long rates, but they're going to rise IOC inflation going away anytime soon. And so therefore, nominals has stayed pretty high.

But I think that the bigger idea is looking more on a macro basis is what's driving all these things. And I tend to think that notwithstanding supply-demand, its demographics. Slide 17 shows the suggests the idea that what drove the inflation of the 70s was the baby boomers picking the Python. People who were born they come in they get to be age 25-30 and they get married, they buy a house, they buy a car, they buy a washing machine. And they're buying all these goods as they form households from the prior generation, the World War Two generation, which was smaller for a few obvious reasons, a war, but also was just depression baby, so fewer of them. We're seeing now a bit of growth in the millennials. It's actually a bigger group than the boomers is just smaller by percent. And I also think that what you're seeing right now is these millennials, they get married later. Mike had just gotten married last year, which is four or five, six years later than they used to do. I think these boomers, the millennials are going to be buying assets, buying goods, they're buying them from boomers who are retiring. I think the magical missing 5 million people. I don't think they're missing. I think they made a lot of money in the stock market and they just quit. So you have a mismatch here as households are formed by millennials, boomers are retiring. And that's gonna go and keep inflation, you know, supported on the demand side. On the supply side, I think slide 16 is actually the most the scariest thing that I see. Five years ago, when after the first election, you know, I opined that I was not worried about taxes, or about regulation, or other things like that my concern of the unintended consequence of bad things happening was immigration. The reason why the US has outperformed Europe and Japan and everywhere else is net, net, net, we have had a positive labor force growth rate. That's it. And if you think about GDP at the end of the day, number of people, how many hours worked, how productive they are. We've had that growing by slamming the door on immigration, which in slide 16 you see, this is gonna be very problematic. Our birth rate, number of kids per childbearing woman has been declining. We've been making it up in the past by immigration, to the extent we just keep this door closed. That's going to be the biggest problem we face. I think if we have net emigration, positive immigration to make up for everything else will probably be okay. But if we keep seeing this over here, things don't end well. Then we start to look like Europe, as opposed to the US.

Erik: Now this is a Census Bureau chart. So should we assume that this accurately reflects the legal immigration or the illegal and illegal immigration aggregated?

Harley: Well, I suspect it includes iillegal and this whole idea of illegal immigration. I mean, I'm not gonna dig into the politics. But the reality is, however, they get over here, I don't care. They come here, they work, they pay taxes, they've got income taxes, but when they rent a house to stay in, that landlord pays taxes, when they go to a store to buy goods, they pay sales tax, so they're engaged in the economy. I'm not gonna dig into you know, medical care or education, you can go fight that battle somewhere else. The reality is they are contributing to the economy when they come here, legal or otherwise. And we know for a fact that has been reduced. Yeah, we have border issues right now but at a macro level, we've been reducing immigration for five years now.

Erik: And is that a result of the clampdown during the Trump administration on illegal immigration or is it also a reduction of the number of visas authorized for legal immigrants?

Harley: All the above. I mean, why are we not offering more, you know, the various visas for people is beyond me. There are certain people who have skills to go be productive in science, there's people who can be productive in terms of agriculture. And really, I mean, I'm not sure where you live, but everything I see is help wanted everywhere. Look at what they said Heathrow Airport is limiting the number of passengers that can come through to 100,000 per day. They are at 104,000 right now. So they're requesting the airlines go move people around to reduce people, they do that because they don't have enough baggage carriers or pilots or everyone else. I think it's across the economy, that this disruption of the economy, because of the lockdowns was a good public policy or bad we could debate that, but we know what the result is right now, is that we eliminated a lot of people who aren't going to come back. And that's once again I think add to supply problems, where they're not going to be work, and the only way to get people to come back, you got to pay them more. So that is just gonna keep on going. This idea of I think was runaway, you know, Venezuela inflation, we don't need that. All we have to do is inflation coming in at 4 or 5%, which is I think is pretty easy to do, to go and kind of, you know, make it a quandary as to what to rates do in the long run and what's the Fed do. I think the Feds gonna go look at a five number and say I don't like that. And they're gonna take rates up to go and deal with it. I mean, you go look at a slide 10. You know, CPI versus the Fed funds rate. Is it different this time? I suppose so. No, disagree. It's not it's never different this time. And I think the Feds gonna go look at things like this and say we gotta get rates up enough to go and just pull the kettle off the boil.

Erik: Let's go back to what you said earlier about demographics and the millennial generation is as big as the baby boomers in terms of the number of people involved. But the thing is, they're nowhere close in terms of assets. And I do see your point that some of those baby boomers are going to give their kids, you know, inheritances that will include both money and homes. But still Millennials don't have a lot of savings. So I guess what I'm not seeing is if the millennial generation is the new baby boomers, you know, the Echo Boom, or whatever you want to call it. They're not very well capitalized. So how do we continue to see the asset price levels, particularly in housing that we're used to, as you said earlier, you know, the place that housing numbers come from is either you've already got an expensive house, and you trade up to another one. And you know, you sold the first one, and that gives you a bunch of money. And then it's based on what you can afford from your income. As we see now we got all the way to almost zero interest rates, we're coming off of that now. So the amount of money people can borrow based on their income is going down. I don't see a big trend in baby boomers being super generous and giving all of their assets over to their kids, a lot of them are spending it and not giving really large inheritances. So where does this baby boomer generation get rich? And if they don't get rich? How do they continue to support the asset prices that we're used to particularly in real estate?

Harley: I mean, get rich is a different concept than cover the payments. All they need is income to cover the payments? So are we going to have assets increasing in value? Probably not. But can they afford a house? Yeah, probably. And you're probably gonna see continuation of people migrating out of the blue states to the red states. That's not political. But I mean, you know, selling California or New York or Connecticut moving to, you know, Texas or Florida, and especially now that you can do this, because zoom exists, it didn't exist before. The company I work for, [Simplify Asset Management](). This company doesn't exist before COVID. Right? I mean, we have people in San Fran, and Vegas and Newport Beach and LA and Virginia and Boston and New York, like, how do you go and have a company built like that before zoom. And so all of a sudden, people are able to go and work from home. Obviously, they become very mobile, and then they're not stuck in the expensive states. Now, does that mean that California and New York City go down in price? Maybe but you can certainly afford if you're getting paid a reasonable salary, you could afford some kind of dwelling in a less expensive area. I do think that what you're really hitting on here is the public policy concept that the boomers have basically stolen from the millennials. And I agree with that. I think that's a great wrong, how to fix that. It's unclear, we've made promises that we hope to keep, but I suspect we're gonna go and do some income targeting for Social Security and other things. The government can't pay for everyone to go and retire like princes. So there'll be limits put on that. But yeah, I think the biggest public policy struggle right now is pressing the boomer generation, as they get older, and they retire.

Erik: Harley, final question, I want to make sure we cover slide 15 where you've got the correlation between the S&P 500 and the 10 year Treasury yield. Tell me about this chart?

Harley: Well they're all linked actually. A 14 and 15 are linked together. And is the concept I've been, you know, hammering on for a while now, there has been a very strong correlation between stocks and bonds that last 20 years, where they hedge each other stocks up, bonds down or vice versa. That really was the underpinning of the 60/40 portfolio. That seems to be looking at chart 14, a correlation that is linked to rate level or inflation level. Those two were the same thing before, they're not the same thing now as I spoke about earlier. My great worry is this. If we get rates or inflation up high enough, you're gonna start to see that stock to bond correlation flip over and go back to what it was 30 years prior, which is stocks and bonds go up and down together. We're not there yet, I think you got to go and get rates up to about 4% to go and do that, because that's a level where you start to go change the P/E of a stock, where the discount rate impacts it. We're not there yet, but you can see already that we've really kind of turned down and slide 15 to having no correlation or negative correlation in some places.

If this occurs, this is the Achilles heel for the market. We've had it twice before, where the stock-bond correlation has flipped over where they go up and down together. This is November-December of 18 and March of 2020. Both times the Fed stepped in to go and save the day. If we get stocks and bonds down together, that means everything goes down together. Anyone who's levered all of a sudden gets margin called, or at least, gets very sad. And I think that's where you got to be concerned about longer term rates. That's why we have created various hedge products at my firm for interest rates, not because we believe that rates are going to four.

But if they do, it'll be really, really problematic. And I think that people should be looking at ways to go and just be covered. If those ratios start to go higher, because that's going to kick up, kick the stock market down hard. We're not there yet. And if the Fed can manage to go and soft land us, then I guess we'll be okay. But um, I think the correlation, flipping is the greatest risk to financial assets.

Erik: Well Harley, I can't thank you enough for a terrific interview. First time we interviewed you, you heard technically in retirement, but you've actually gone back to work with Simplify Asset Management. Tell us about what took you back where the opportunity is that brought you back into the industry and how people can find out more about what you do there at Simplify.

Harley: Well, you know, I call myself the Convexity Maven because I like to focus on risk assets that have convexity optionality put into them. What we do at Simplify which is totally unique, is that we create ETFs that have long optionality, long convexity, long option like features. So your gains are accelerated, your losses are cushioned, reduced in a way that is relatively clever and so it doesn't cost that much. And a few things, I mean, some of the products are geared to making money if things happen, others are geared toward cushioning your loss. So if you think about March 2020, the real risk in March 2020 was not that prices went down, because they all came back. The risk was you sold, it got stopped out and did get back in. If you buy a product that has a cushion to it. It'll stop you from getting out when it is scary and I will tell you, even for myself when we are at the bottom I am under my desk crying and when we're at the top I am in euphoria also. We are social animals, we all feed back with each other. And so having products that will self insure themselves is a pretty clever idea. We've gone from zero to 1.4 billion in short order. And it's a very exciting thing for me, we were able to do this because of changes in regulation. And we have some great guys on the team. One of them is Mike Reid is always on your show as a guest and we're both like loving this, this new venture over here.

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