MACRO Voices
*with hedge fund manager Erik Townsend*

# Luke Gromen: The Fed Is Headed For Difficult Decisions

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***Erik:*** Joining me now is Forest for the Trees founder, Luke Gromen. Luke, it's great to get you back on MacroVoices, it's been way too long. Obviously the talk of the town is, is it a bear market rally or is the bottom actually in? We got above the 200-day moving average, stayed there for a couple of days but on Monday, we saw a big correction to the downside. Is this all over or is this just a pause?

***Luke:*** It's great to be back on. Thanks for getting me back on, Erik. I think it is probably a bear market rally still. I think it is probably still a bear market rally. But I don't have high conviction on that.

***Erik:*** And what is the source of that hesitation? When you say you don't have high conviction, it sounds like you think maybe it's not a bear market rally. Is that contingent on Fed policy or what makes you question that?

***Luke:*** Yeah, it really is contingent on Fed policy and Treasury policy, right. So if you look at a couple big things that have grabbed our attention in recent weeks, so back on October 31, Treasury came out and US Treasury came out and doubled essentially, their estimate for the deficit that the United States is going to run in the fourth quarter of 2022 and in the first quarter of 2023. And it's pretty noteworthy in that fourth quarter alone, they took the net borrowing estimate from $400 billion up to $550 billion in just a three-month span. So back on August 1, they thought they would need to borrow $400 billion in 4Q22. And they're actually going to borrow $550 billion in 4Q22 to keep TGA consistent. So, borrowing needs rose 37% in three months. And so all else equal, if you hold everything else equal, and you effectively double the deficit nearly. So, you're taking the US deficit from 1.3 trillion to 2.6 trillion in an annualized bait rate over the next six months. If you don't do more QE, if you don't otherwise inject dollar liquidity into the system, that's going to be positive for the dollar. And I think it'd be negative for everything else. And I think we're going to see, we're going to see sort of a continuation of the market regime, we've had really since call it February of this year. January, February of this year which is dollar up, everything else down, maybe oil up to.

This deficit and the issue is ultimately the sort of the second big thing we noted there, which is had a chart recently for clients where we showed that any time the US deficit was more than I

believe it was 20% of the projected global GDP growth in nominal terms over the last 25 years, the Fed every single time that that US deficit was more than 20% of global GDP growth in nominal dollar terms. The Fed did QE basically, to help finance it. The one exception to that rule was 2022, where I believe it was a 32% of global GDP growth based on IMF GDP growth estimates for the world. And you saw what we got, which was dollar up, everything else down, and oil up and really oil flat. And the point here is that with what Treasury just announced on October 31. Right now, assuming that global GDP growth is not taken down further from what the IMF is looking for. For 2023, the US deficit as a percent of global GDP growth is going to be like 68%. So, the point is that this deficit increase, there's no balance sheet, there's not enough balance sheet globally to finance this without either selling other assets, like we've seen this year without driving the dollar up, it's going to continue this dollar squeeze and without probably driving down the price of treasuries, yields up. Which is exactly the regime we've seen. So, if that's the regime we're going to get. That's why I say I think it's a bear market rally is the amount by which the US deficit or the relative size of the US deficit relative to global GDP growth is one of the highest in 25 years and if there was not excess dollar liquidity supply by the Fed from somewhere. I think we're on pace for another pretty ugly year to start the year.

Now when I hesitate, what am I looking for? Well, we were seeing this play out through September. We saw things start to break, you saw increasing stress in the treasury market, you saw rising rates in a recession or in a global slowdown. Recession is too strong a term. But you saw the Treasury market not performing... actually performing worse than equities in a global sell off, which was unprecedented going back 60 years. Great chart that Michael Gayed had a couple of weeks ago. Then all of a sudden, in October, we've seen really what's quietly been a massive injection of dollar liquidity. You saw the reverse repo balances come down. I want to say, I believe that numbers 240 billion. You've seen the TGA, the Treasury General Account come down quite a bit as well. And then more recently, the Fed running operating losses ends up leading to a short term injection of liquidity as well, by virtue of the Fed effectively paying banks. They're paying banks, by virtue of running operating losses.

So, you've had sort of this dollar injection of liquidity that has you've seen in the markets, it's sort of been the opposite of what we had year to date, dollar down, yields down, and treasuries, yields down across the bond market, risk assets up, gold up, Bitcoin has stabilized. But the amount of the deficit is so big and now tax receipts are starting to roll over for the US, which is likely going to get worse in the first half of next year. So, you're just faced with this really big gap between what the deficit is projected to be in the US and what the world's ability to finance that deficit is, which is global GDP growth in dollar terms. And though there will be a big crowding out impact even bigger than what we saw in 2022. Unless you get much more dollar liquidity injected or continue to be injected.

***Erik:*** Let's talk about inflation next. I've been kind of surprised for quite a while on MacroVoices, most of my guests were telling me they thought we were at the beginning of a significant secular monetary inflation. Lately, a lot of really smart people are telling me no, look, what's really been going on here has all been pandemic effects. Oil demand recovered faster than oil supply was able to recover to match it. Because of the pandemic shock. The supply

chains caused a lot of increased consumer prices. But it's not according to Jeff Snyder, for example, it's not monetary inflation that's driving the price inflation. That has not been my view. But I'm starting to question myself with a lot of smart people saying that. What do you make of both that view and just the topic of inflation generally?

***Luke:*** I think there's a tactical view and I think there's this secular view. And I think tactically, I would tend to agree with Jeff, that we probably whenever we saw that 8.4-8.3% print CPI, whenever that was, I guess two-three months ago, maybe four months ago. That was probably the local high, you've seen a number of different data series that have rolled over, used cars, home prices, lumber, certain industrial commodities, etc. And so I think from a tactical perspective, I think that's right. I think, I do think there was monetary inflation at the same time, I think that has been reversed up until, you know the October-November, sort of injection of liquidity that we just referenced, you'd see that monetary inflation reverse on some level and a peaking in that from a local perspective.

Now secularly to me, it continues to be underappreciated that inflation was the only way the US government was squaring the circle from a fiscal perspective. The US as a reserve currency issue of the world. It's why I focus on it, they have a balance of payments problem. And when the reserve currency of the world has a balance of payments problem, everybody has a balance of payments problem. And that's what I was just referring to before about this. There's not enough private balance sheet globally to fund U.S. deficits next year, at anywhere near current rates, or current dollar price. You know, dollar-dollar level. And so, when we talk about tactical versus secular inflation. Tactically, I think it's probably rolling over for a bit. Secularly, when you look at the US fiscal position where entitlements we're going to spend probably $2.9 or $3 trillion of cash out the door and entitlements next year. We're going to spend probably 900 billion on defense cash out the door next year. So we'll call it 3.8-3.9 trillion. And then you're going to spend probably pro forma certainly at a run rate basis, probably close to 3.5 trillion in treasury spending all in. So you're going to be what's that? 4.1, 4.2 to 4.5 just in the big three expenditures. We call the big three expenditures, entitlement pay goes, treasury spending, and defense.

And so when we compare that to tax receipts. Tax receipts in the United States in fiscal 22 were an all time record. I believe it was 4.6 trillion or something like that. Well, everyone has been very very quick to point out how silly the everything bubble was. Crypto, housing, stocks, everything bubble great. Not as many people are pointing out that the everything bubble drove a tax receipt bubble. Tax receipts were up like 40% in fiscal 21-22, you can see it on a chart, it's an absolute spike. April 2022, which is usually your biggest tax receipt month of the year, for obvious reasons, right? April 15 tax filing date for individuals. The United States collected I believe was $863 billion in income taxes, in total tax receipts in April 2022. Well, what was that from? Well, that was from the everything bubble in 2021. That amount was up I believe, $430 billion year over year versus April 2021. And it was up $350-$380 billion versus pre-COVID, April 2019. So everyone is looking, do we have any inflation debate. And I think it's an important debate to have but I think they're also missing the Forest for the Trees on this, which is the US fiscal position is in deep trouble without that inflation. And so to the extent that inflation comes

down, tax receipts are going to come down, that's already happening. And you're going to end up in this position where we were in 2019, all over again early 2020, I suppose it was where your big three expenditures are going to go back to being 110-120% of your tax receipts. And that is just sort of comes to the same conclusion as before, from a different angle, which is, you get that deficit needs to get financed. And either the Fed prints it, in which case we get dollar down, risk up, like we had in the sort of the April 20 through I would call it January 21 monetary regime. Or the Fed stands aside and says we're not financing these deficits, in which case, we go back to the point I made about the insufficient global balance sheet to finance this. And we're going to find out in markets, what the clearing rate for treasuries is on that and that yield we will have is a slowdown in we'll have a much stronger dollar, which will drive a global slowdown. A growth slowdown in corporate profits and you're going to see the Treasury markets probably continue to sell off even with that global slowdown. And you know that's going to sort of drive a wash, rinse, repeat deflationary cycle until the Fed steps in.

So I think there's a story really of two, a tactical yeah, it's slowing down. Secularly I think we're in the early stages of a massive secular inflationary regime for a number of reasons. Number one, the Fed is ultimately going to have to finance this one way or another, whether they call it QE or they call it swap lines, or they call it reduction of the ERP, however they do it... They're going to have to inject the liquidity at some point next year in my view. Number two, you get into things like deglobalization. If globalization disinflationary, reshoring and deglobalization is going to be inflationary secularly. Peak cheap energy, we're seeing this all over. It's getting harder and harder for shale to grow production. US shale has been the marginal oil producer for the last 15 years. China has been offline and U.S. shale is peaking. China comes back online in a bigger way. I think peak cheap energy is a very important secular inflationary driver. You've had workforce reductions, yes, some of its temporary bottleneck stuff, some of it. The Fed did a paper on long COVID a couple months ago. You've got millions of people out of the workforce that may not be coming back anytime soon, that's inflationary.

So there's a number of different things that I think are very secularly inflationary from a supply chain perspective that aren't going to change. They're going to get worse in terms of driving inflation. And I think on top of that, you've got this U.S. balance of payments, which in the short run, the Fed can play tough guy, but they can only play tough guy until, you know, until it comes time to call the US Marines and say sorry we've got to stop sending you know, you guys can't spend, you guys have to come home because we don't have the money. And when that happens, they're going to print the money.

***Erik:*** Okay Luke, let me play that back both to make sure I got it straight, but also because I want to talk about what happens next. So we had in 2020, a global pandemic that results in an obscene amount of liquidity being injected by central banks into the economy that leads in 2021 to an everything bubble, including tax receipts. In 2022, governments including the US government are spending beyond their means and we're running up deficits. Of course, the attitude of policymakers is deficits don't matter. There's always a market for US Treasury paper. We'll just print up some treasuries and you know, sell them off, and the world will finance our deficits. And what you're saying is, wait a minute, the picture is not what it used to be... Look at

what's going on in Europe right now, it's not exactly like, there's a huge appetite for buying up US Treasuries, other than the Fed itself could buy it. But as you know and I know, the Feds ability to buy treasuries as it did with QE for years and years was enabled by a deflationary backdrop where they could get away with doing with that, because there was no inflation that they had to risk exacerbating. Now there is inflation to risk exacerbating.

So first, did I get the chronology approximately right? And if so, let's just talk about what the choices that we're left with are because it sounds like we've got governments continuing to deficit spend, or at least the US government is spending away. There's no sign of restraint in sight and you're questioning where the heck the money is going to come from? And it certainly sounds to me like if the Fed is called upon to step in and bail things out, bail out the Treasury market. It's going to blow up a bunch of other things, isn't it?

***Luke:*** Absolutely. No, you got you got this the chronology, much more than approximately right. And to me, that's the elephant in the room that nobody wants to talk about when you say. Well, everyone just assumed the politicians always assume there's plenty of demand for treasuries. Of course, there's plenty of demand for treasuries the question, it's really a function of two things. Number one, we've never seen the deficits this big relative to global growth, number one. And number two, with US debt and deficits this high, it's not a question of will there be demand for treasuries at a certain price? Of course, there will be. The question is, can the US government afford that price without going into a death spiral? I mean, look 10%-12% sure they can afford the treasuries or sure they can place that paper. But the problem is, is to your point, that's a world where everything else is imploding. You're going into a debt death spiral again because we have never gone into a slowdown with US debt to GDP at 120% of GDP. We've never gone into debt to a slowdown with U.S. deficits at 7 to 8-9% of GDP. I mean it's unprecedented since at least the end of World War Two, and there are things that are very different now versus then. So I think you've got it exactly right, which is we're running headlong into a situation where the Fed's is going to be forced to make a choice and that's going to be an interesting moment.

***Erik:*** It seems to me there's more to it than just the governmental death spiral of debt that you talked about, because pension funds around the world have already taken a hit that they didn't think was possible. You know, the whole idea of risk parity was you're supposed to do the portfolio construction so that when you're losing big on equities, you're making it back in bonds and didn't work out that way. We're losing on both. Now that you're losing on both a lot of people are kind of feeling like okay, we can't go any lower than this, because that would really break the system. Luke, I think we're going lower than this on both stocks and bonds. How does this system break and you know, is it a government death spiral that we need to worry about first or do other things like a wholesale failure of pension systems around the world lead the way before we even worry about something like that?

***Luke:*** I would say you've already probably started to see it in the more sensitive things right? So you saw it in the British LDI, the leveraged gilt pension scheme right that needed to be bailed out. Let's call it what it is back at right at the end of September. You've seen obviously FTX and

crypto, this blow up has happened. And Wall Street I think generally is that well, it was a levered scheme, it shouldn't of happened. It was unique to British financial system, it's not systemic... okay. Crypto is crypto, haha. You know, they can't afford Lamborghinis anymore and it's not systemic. Okay, now you're starting to see some interesting things in the last couple of weeks right? I mean, I heard some credible rumblings recently that commercial real estate is starting to freeze up. Those markets are starting to freeze up, right? Bid-ask is blowing out. Then last week, you had the Blackstone right? You know, we're freezing redemptions. Today, you had Starwood follow up. We're freezing redemptions. And this is, you know, this is how this kind of a thing starts, right? Because if they gate redemptions, that's fine. It is what it is, right? We don't want to mark-the-market. We're funding short, we're lending long and our lungs are illiquid. And what they're really saying is, is we're just going to sort of, you know, we're going to extend and pretend until the Fed comes and saves us or we're going to try to hold out for a bit longer. That's what they're really doing. which again, is fine. It's exactly what I would do. But of course, in free markets. What happens then is people that need liquidity are going to go somewhere else to source that liquidity. You don't necessarily sell what you want to, you sell what you can.

And so I think to answer your question directly. I think you're starting to see some of the symptoms go sort of from the periphery to more core systemically important markets. I mean, it was even a great article last week in the FT. The court documents just came out for the nickel trade. That nickel trade chaos back in March during the sanctions. And it turns out that the LME basically pulled a Hunt Brothers on Elliot and Jane Street, which is hey, we were going to go broke. Six or seven market makers clearing firms might have gone into default. This had the chance to be systemic. And so yes, you were supposed to be up a couple 100 million dollars Elliott, but sorry, we're breaking your trades. And Elliott is suing them and understandably so. And I don't have any legal thoughts or perspectives on it. But my point is that I think you're already starting to see the sort of the rule changes put in place when these systemic pressure start to build, which is hey, we're going to gate redemptions, hey we're going to break trades. And I don't think these are going to be the last things we see for no other reason than look at the Fed's operating loss, right? Look at the Fed. Now, does it matter for the Fed? No, the Fed can't go bankrupt. But the Fed is down like a 1.2 trillion on its bond portfolio and it's running these massive operating losses. There's a great chart you can see, it's remittances to the Treasury and it's a most incredible chart. It's sort of like Nicolas Nassim Talibs, you know, the 1000 days in the life of a turkey, right? Which is, you know, for like 1000 days, the Fed just predictably, you know, prints money and clips a coupon and mails it to the Treasury and then all of a sudden, one day, it falls off the table. And like the Fed's book is there's a lot of books out there that look exactly like the Fed, right? Borrow short, lend long and other upside down. And so I think you're we're starting to see the symptoms of this borrow short, lend long, where you know, the first thing is gate, extend, and pretend, hold on... Hope the Fed comes in with more liquidity. The Fed has given a little more liquidity. You know, to our earlier point over the last couple of months but unless it's sort of explicit and big, I think it just bought time. I think it just about time.

***Erik:*** Luke, it seems to me there's another dimension to this that I think is very relevant, but most people don't seem to have picked up on yet, even though it's obvious, which is, I think that

the bifurcation that's being created by this war cycle, is here to stay. In other words, I don't think this is just about Ukraine. I think that the United States, China, and Russia are pitted against one another in a long term, ongoing change of the global power regime. If that's true, you know, let's go back to what you said a few minutes ago about how there's this complacency in Washington, we'll just deficit spend, it doesn't matter because there's plenty of buyers for US Treasuries. Well hang on a second, historically, the biggest buyers of US Treasuries have been China and Russia. I kind of got a feeling they're not buying anymore. So does that, do people realize that the game has changed? And I guess first of all, would you agree with me that this bifurcation and deglobalization of the global economy is going to be a thing? And if so, what are the other knock on effects and consequences of it?

***Luke:*** I absolutely agree, it's a thing. And you know, it's interesting couple of weeks after we talked last back in early June Erik, Vladimir Putin gave a speech. And it was arguably one of the most important speeches in years. And of course, it was absolute crickets on the speech from the Western media because they never say anything. But there was one point in his speech in particular that I thought was really really important. Which just says look, you want us to use these FX reserves in dollars and euros depreciate at 8% per year. He flat out said that and it was really interesting because 8% per year is the compound annual growth rate of US Treasury issuance since 2008. 8% a year, 8% more treasuries, 8%... Now, if I'm an oil seller, if I'm the world's gas station, as John McCain call them or gas station masquerading as a country or however he phrased it. If I'm Russia, and I'm big in oil and gas and commodities, all of which deplete. Every oil field has at some point depleted. I know I have a finite resource base. And so if I'm going to sell my energy, and oh by the way knowing that the world's biggest marginal producer of energy shale is peaking. So sort of like the cap on oil prices has been shaled to some big extent over the last 10 to 12 years and that cap is now getting removed because we can't produce much more not at these prices.

So if I'm Putin, the Americans want me to sell my oil and then store it in debt, whose supply is going to grow 8% per year CAGR. Who's yield has never able to get above 3% without something blowing up and the Americans having to print money to prevent the whole thing from coming unhinged. And it's likely that oil is probably going to rise secularly with U.S. shale production rising. So in oil terms, the value of US Treasury bonds is probably the supply of treasuries is going to rise eight. Say that, you know, oil rises 5% to 8% per year if shale peaks just sort of smoothed, and it's a terrible deal for him. So what is he done? He stopped buying treasuries back in 2008 or 2010 and he bought gold instead, a lot of gold. Because you look over time, gold and oil tend to move over time, they could separate but all in all, for long spans of time, gold holds its value versus oil, treasuries at sub 3% cannot and the US can't raise rates enough to compensate you for that.

So there was this really important speech that he gave. He flat out talked about the real issue and I think that Ukraine is really just a symptom of which is the Russians and the Chinese and the world's creditors more broadly, cannot afford to store their surpluses in Western financial instruments broadly, but US Treasuries specifically at negative real interest rates because they will end up with a pile of paper, that is fallen drastically against energy. And then they will go run

into financial crises. They won't be able to afford oil, their economies will collapse. And they'll have political problems. And that's a matter of national security, that is a red line for places like China and Russia. On the flip side, going back to the point we were just talking about with the US debt level and the US deficit levels. We cannot afford to float this without negative real interest rates for a sustained period of time. And so it's a matter of US national security that we get somebody to buy these at negative real interest rates. And we can have the Fed do it but that then impacts the dollar as we've repeatedly seen. When the Fed when the Fed finances deficits, the dollar goes down, and that's fine when the dollar is high, but there's the limit to how much we can do that. It's inflationary over time, we've seen that. We now see that with inflation over the last couple years.

So I think we are absolutely at a huge moment of deglobalization. And I think it is very much an impasse that extends far beyond Ukraine, which is, there is this fundamental disagreement, which is the US needs China and Russia and Saudi and everybody else to finance US deficits at negative real interest rates. And it's a matter of national security and China, Russia, Saudi and everybody else, it's a matter of national security, that they don't finance US deficits at real interest rates because they end up importing the inflation. So I absolutely think we're seeing a fracturing, I absolutely think it's inflationary, I absolutely do not think it's likely to be resolved anytime soon. Even if we had a you know, peace in Ukraine tomorrow, because the real I think underlying fundamental issue is the debt is who's going to buy the debt, and we want the foreigners to buy it at a negative real rate. And the foreigners saying no, you buy it Americans if you like it so much.

***Erik:*** Let's talk about what investors should do in reaction to all of those views Luke. Because back in the day, the pretty common view was, if what you're worried about is government's are going to debase the currency and they're going to deficit spend beyond their means, and they're going to get into a debt trap. What you want to do is you want to buy gold in order to protect yourself and hedge against that exposure to the government's Fiat money system. I would say, though, that what we saw up until the first of November, was pretty darn clear evidence that even as inflation is really taking off even as we're seeing all of the gold bugs, you know, greatest fears realized which is the currency has been debased, inflation is starting to run away. What gold actually responded to was the Fed being forced to raise short term rates, basically, you know, was bearish for gold, even though the reason they were forced to do that was actually the realization of what all the gold bugs have been worried about for so many years.

Now, something changed dramatically at the beginning of November. I'm assuming that it must have been the perception that inflation has peaked. With that, you know, we had an inflation print which was finally substantially lower than the previous one. And you know, inflation is a famously noisy series. So I'm not necessarily persuaded that was the final and last peak. Is it time now that the gold market has just figured out reality or is this a false breakout in gold? Because we're really going back to whatever that regime was that lasted until November as soon as the Fed is forced to raise rates again. How should we think about where gold is going from here?

***Luke:*** Well, it's interesting because I agree, you've seen all of the things you'd want to see as a gold bug, and you also didn't see price move, the way you would think. Now with that said,,,

***Erik:*** And it was actually inflation coming down, which resulted...

***Luke:*** Hahaha, Exactly right! So it tells you there's still that huge impact on financial, the financial, you know, financialized gold market, right? It's still trading is still very influenced on real rates. Now, a couple things... Number on, central bank buying of gold in the third quarter even as we're in this absolute dollar spike, this dollar shortage, foreign central banks somehow found the money to buy the most gold in a quarter that they'd ever bought, ever. I think it was 400 tons in a quarter, incredible! You can see in a chart, it's a spike, which I think is interesting. I think it's interesting that gold prices fell when central banks did that... curious... Particularly when you saw physical buying of gold elsewhere around the world. You know, the source was a lot of the sources came from ETFs. So basically ETFs were unloading gold to retail into central banks, and at lower prices. So I thought that was number one interesting which suggests to me that the fundamentals lead to gold buying, it just didn't show up in the price at that point as it was overwhelmed by what real rates did.

Now I'd also say, given what real rates did, the fact that gold only got down to whatever it did, 1630 or 1650 at the lows. And it's really, really encouraging for gold. I mean, gold should have gone with what, with the fastest rate hikes by the Fed in 40 years and all they could do is knock gold down to 1630 or 1650. Like, wow, you know what happens when something breaks? You know because really if the Fed really wants to beat deflation. If they really want to, they're gonna have to stand aside and let some really big important things go bankrupt. And, you know, does Powell really want to go to the Christmas party or the Fourth of July party 2023 and go see his buddies, after he just let one of them go bankrupt? Hmmm... I don't think so, I don't think he's going to do that. I don't think he can do that. So to me, it was interesting that gold, not just on that inflation print, but that also coincides with that point I made earlier where that was October 31st that the US government came out and said, or the US Treasury came out and said oops, the deficit for the next six months is not going to be 1.3 trillion run rate, like it was the last six months, it's at 2.6 trillion run rate.

And that to me, I think it might have had something to do with waking gold up as well which is, you know there's been this credibility that the Fed is going to do whatever it takes, and they're going to get inflation down. Like I think gold really is going to do well, once it dawns on everybody that not only is inflation going back below 6% for the next five years, like it might be 8% to 10% this time next year because the only way the Fed's going to avoid that outcome is if they're willing to let some very systemically important people go bankrupt and I don't think they're willing to.

***Erik:*** Let's talk about the Feds policy going forward. Let's suppose that it's not 8% next year but it's 4.5% next year. At that point, maybe I'm crazy but I would like to think okay, the Fed should still be learning a lesson. Their target was 2%, it's more than double that. Obviously, their previous policies of bailing out financial markets left and right have led to inflation that they

didn't anticipate. They ought to learn a lesson and they ought to get their act together and not do that anymore. I suppose the counter view would be hey from 8%, we came all the way down to four and a half, it's getting better. You know, it's okay to print money like it's going out of style again. How do you think the Fed is going to behave in terms of you know, when we were sub 2%, it seemed like every time the market crashed, the Fed was there. The so called Fed put was very much in force to bail out the financial markets anytime there was a significant problem. If we got back down to a steady 4.5 to 5% inflation but not 2%. Do you think the Fed would change its ways and realize you know, we're still at double or what we originally intended or you think they would just adjust their target level to 4% to match actual and declare success and not worry about it too much.

***Luke:*** I don't think they're going to change their target just because I think they would see that as defeat. I think they would jawbone and say, we've made a lot of progress. And they probably ask for help from the BLS or whoever it is that calculates inflation to try to get the number lower and sort of Jawbone it but I think they are ultimately beholden to the fiscal situation. They can play tough guy, but the market is going to set the price of borrowing for the US government. And that's, I think going to be a real sensitive issue. Given that dynamic we talked about before, which is, right now, projected deficits are running at 68% of projected global GDP growth next year. And that's assuming like two and a half percent global GDP growth, right? Like, as the dollar goes up and rates go up, as things slow, that growth will slow and, you know, then this won't happen linearly. You'd get a nonlinear rise in the dollar, nonlinear rise in Treasury yields, global yields. Nonlinear decline in sort of everything else until something systemic snaps. So I don't how they would spin that.

I don't think they're going to raise the target, I think they would try to jawbone it. But I think ultimately, I don't think they're going to have a choice. Like whether it's four and a half, or five, or six, or, you know, three and a half, when the US government's fiscal situation or when something systemic goes. They're going to have to make a really hard decision, which is I'm going to let this system collapse. I'm going to let one systemic thing go. And once one systemic thing goes, as we saw with Lehman, all these notional derivatives start to become net when you take one systemic player and put them into bankruptcy. So they're going to have to decide what you know, at that point. Do they want to be tough guy or do they, you know, and I don't think they can afford to be tough guy. I think ultimately, I think they will ultimately step in at that point. And so I think they're going to have to loosen into still elevated inflation at some point in 2023.

***Erik:*** Luke, I think that's really fascinating because frankly, I don't think it's a question of them even having the option of playing tough guy. If they try to play tough guy, higher authorities in macroeconomic theory such as Maxine Waters are going to step in and say you're fired. We're the Congress, we're going to spend money, whether you like it or not. And if you're not ready to print money in order to buy the Treasury paper in order to let us spend beyond our means, we'll get somebody who will. So I think that they're forced to. What does that mean, when it happens because it seems to me like regardless of whether you think we've got a secular inflation now or not, they can create one if we get to a point where there are no natural buyers to support the amount of deficit spending that's going on, and the deficit spending continues. And the Fed is

forced, either by policy or by having the the principal players of the Fed replaced by somebody who's willing to play ball with them. You get to a point where it seems like you do get into that Rudolf Havenstein moment where the Fed is just printing money, like it's going out of style and it really is fueling a runaway inflation.

Am I right to think that's where this could be headed and how long does it take for something like that to play out? Because the biggest mistake I've noticed with people who concern themselves with hyperinflation and such things, is they first conceived that it is theoretically possible, and then they convince themselves that it's coming tomorrow morning. This stuff takes a while so how long would it take to get to the point where the Fed is in such a pickle, that they really have to just print money like it's going out of style and fuel a runaway inflation?

***Luke:*** And I would argue that and we've done the math that the 5% Fed Funds terminal rate that fed fund futures or Eurodollar futures have been discounting right around there. And people are thinking like, I don't think the US government can afford five, not on a sustained basis. And that's a problem because of the US government really can't afford five, and certainly not six on any sustained basis. And we know that because tax receipts are already starting to roll over and deficits are starting to rise again. Then how are they going to stop inflation? That is seven, right? Yeah, the studies have shown, Druckenmiller is on the tape talking about this... Once you get, what did he say? Once inflation is over five, you've got to raise Fed funds over inflation to get it down. Like that's the problem and there was a great study by Research Affiliates we quoted last week in one of our reports, which know that once inflation gets to eight, it takes on average, I think 7 to 10 years to get it back to 2. And it takes you raising rates nearly that high like that, to me is sort of the elephant in the room that nobody wants to talk about and that people pretending they don't need to own gold that need it.

I don't think you're there yet. I mean, I think there's always going to be buyers for treasuries. It's just that this is the part that everyone keeps leaving out visa vis the Volcker move is oh well, the Fed can just be Volcker. Well US debt-to-GDP was 30%. U.S. deficits were never more than 3% at the depth of the 80-82 recession. So like that's 120% now, and that's 7 to 9% deficits as a percent of GDP. And you know, you've got these off balance sheet liabilities that are coming on in a massive way that just wasn't the case with entitlements. You know, it wasn't the case back in the 70s due to demographics. So there will be demand for the treasuries. The problem is not well, the question is not whether there will be demand for treasuries... The question is, will the rate at which there will be sufficient demand for treasuries given the global balance sheet situation to describe earlier... at what rate? And can the US government afford that rate?

But once that realization comes and it's not that there won't be Treasury buyers but the rate at which there will be Treasury buyers, because again that global balance sheet isn't there with the dollar at 114 where it was and it's maybe a little bit more there with the dollar 104. The rate will bankrupt will cause that spiral to happen, right? Where now interest goes up, okay, they have to finance at higher rates. Okay, that means the deficit goes up, which means that you know, and that gets very nonlinear very quick. Now, we're not there yet but that is ultimately the dynamic. Politically, you know, I'm waiting for Congress to wake up and go wait a minute... You, Mr.

Powell are telling the US people that you want to raise unemployment which he is... That you are willing to take a recession and possibly a painful recession to the American people. And you're currently going to pay in 2023, you're going to print money in hand it to the banks to the tune of $200 to $300 billion to keep their money in reserves, which is what the Fed is doing. That is a potential, you know, I'm waiting for Elizabeth Warren or Maxine Waters or somebody to go wait a second, why is he putting the economy in a recession and paying the bank $200 to $300 billion. Now, we all know in the financial markets why he's doing it. But oh, my goodness, does it look ugly from a political stand. It is a hot button issue. And I could see that becoming a hot button issue to your point of when does the Congress start to squawk about that? And I suspect once their constituency squawks about it, they'll start squawking about it, which they're not squawking that much yet.

***Erik:*** Well Luke, I can't thank you enough for a terrific interview. But before I let you go, please tell our listeners a little bit more about what you do at Forest for the Trees and what they can find at fftt-llc.com.

***Luke:*** Absolutely! So we're a macro thematic investment research firm. We aggregate a large amount of data points in an unconventional manner looking for developing economic bottlenecks to help our clients make money. So we've got different institutional and mass market products they can find out more information about at fftt-llc.com.

***Erik:*** Patrick Ceresna, Nick Galarnyk, and I will be back as MacroVoices continues right here at macrovoices.com.