# Darius Dale: Blow-Off Top Coming Before Bears Get Validated

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***Erik:*** Joining me now is 42 Macro founder Darius Dale. As always, Darius has prepared a terrific slide deck to accompany today's interview, I strongly encourage everyone to download it. Registered users will find the download link in your research roundup email. If you don't have research roundup email, it means you're not yet registered at macrovoices.com. Just go to our homepage macrovoices.com, click on the red button above Darius his picture on the homepage that says looking for the downloads. You will notice that some of the pages are blurred in this slide deck. The reason is that out of respect for Darius' paying customers we normally use the previous month's deck for these interviews. This month Darius wanted to use this month's deck because he's got some slides he wants to show you that have current up-to-date information. In order to respect for paying customers, we had to blur out at least some of the slides of the deck. So the ones that we're not talking to in this interview, please don't be alarmed if they're blurred out when you get the download. Darius, it's great to have you back. What I want to do is set the Way-back Machine to January of 2022. That's 18 months ago. You came on everybody else is saying okay, $4,800 on the S&P just about to hit 5000. We're headed much higher. Everybody's buying the dip and you're saying no. 2022 Could be a crash year were your words. I'm going to say you got that 99/100% right. The only nitpicky thing I might say is it wasn't actually a crash. It was actually fairly orderly the way that the market sold off, but you totally called that bear market. When we brought you back January of this year, everybody was convinced that the US was about to fall into imminent recession. You said no, I think that's coming, but not till the second half. And then you went on to emphasize we've had the growth event, but we haven't had the credit event yet. It's not till we get the credit event that the rest of this story unfolds. Well, Darius, I was thinking about you as I watched the news come out about first Silicon Valley Bank, First Republic, Credit Suisse. And I thought that must mean the market is about to crash. But wait a minute, the market didn't crash. But we got the credit event, or at least I think we did. What's going on?

***Darius:*** Hey, Erik, thanks again for having me back. I'm very grateful to be a regular contributor to this program. Wonderful program. So I'll start by answering your question directly. No, we do not think the Silicon Valley Bank incident and the First Republic bank incidents was the credit event. Recall that we were sort of calling for a phase two credit cycle downturn, which is what happens to the markets when the economy is trying to price in the non-linearity of a recession. That process is still very much ahead of us. But we do not believe that process is imminent. And we still believe that there's right tail risk left to price in the equity market and credit markets.

***Erik:*** Right tail risks to price in so you think there's more upside before this is over. Now, how does that jibe with I realized you do some pretty fancy math in your analysis. But going back to us simpletons who think about Fibonacci analysis. We're already past the 61.8% fib retracement of the overall bear market. Seems to me like if this is just a bear market rally that's gonna roll over, it's kind of overdue for rolling over, it's getting pretty long in the teeth. How much longer do we have before this plays out?

***Darius:*** Yeah, so that the answer to that question really is derived from understanding where you are in the business cycle. Historically, what we found is that the degradation in the market cycle tends to be fairly coincident, if not slightly leading ever so slightly leading with the degradation in the employment cycle. So if you look at slide 65, and it actually even before we get to slide 65, I just want to take a step back and say, one, thank you for the very kind intro. You know, one of the things we talked about the last time we were on the program was the fact that we were going to have a recession that was most likely to commence in Q4 of this year, Q1 of 2024. So obviously that call was, you know, prescient, but you know, the reason I bring that up is because that resilient US economy theme has been the overwhelming driving force of the stock market this year, and of credit markets and credit spreads, tightening. And so, you know, we were actually you know, if we go back to our the listen to our discussion this January. I was actually bearish in that discussion. I think we recorded on January 3, and it was released on January 5, it wasn't until January 12, until we actually pivoted bullish as a function of that theme. So, definitely wanted to explain why we made that call in terms of pivoting from bearish to bullish in mid-January and ultimately where we kind of are in that process. So jumping into slide 65, where we show a compendium of indicators in and around US recessions, you know, the labor market, the markets itself, and then how the equity market relates to the labor market leading up to recessions.

I'll draw your listeners eyes to the column that says S&P500 max drawdown. And so this is the max drawdown the S&P500 in and around recessions. And this is all postwar recessions that we have in the US economy. What you see is that on a median basis, the max drawdown is minus 24% with an interquartile range of minus 19% and minus 39%. In our view, that process is still ahead of us. But what is also still ahead of us in our opinion is the columns that suggests, you know, one year ahead of peak, six months ahead of peak, and three months ahead of peak. And you know, partially, you know, while we knew that we didn't know no one knows anything about the future so I'll be humble but one of the things that gave us an indication that 2023 could see some right tail risk, when we pivot to that column was that you typically see very strong markets leading up to the start of a recession. In fact, if you look at the S&P500 performance one year ahead of its peak prior to a recession, it's typically up on a median basis plus 16%, with an interquartile range of plus 14% to plus 20%. And there are no non-double digit values in this 12 business cycle sample. And you can see that the performance tends to accelerate towards the end. And the S&P500 performance, three months ahead of its peak is a median basis a plus 9% with an interquartile range of plus 5 to plus 11%. And so that's obviously well above, you know, your standard rolling three month return in the equity market. And so why does this happen? That tends to happen as a function of the positioning cycle. You know, positioning is one of these big cycles that we have to get right as investors. It's not just what the macro fundamentals are, but it's how everyone is positioned relative to the likely distribution of outcomes and how those outcomes play out. And so jumping to slide 76, where we show a couple of our, you know, our aggregated positioning metrics, one for the most recent CFTC report, and one for the CFTC report that was just predated the October 22, S&P 500 trough. And as you can how we track aggregate positioning as we look at non-commercial net length as a percent of total open interest, and we amalgamate each of those for all the markets that represent US equities, US rates across the entire curve, US dollar across all major currencies, and all the commodity markets that the CFTC keeps track of. And what we can see right now is that aggregated positioning, so non commercial netlink, speculative net length as a percent of total open interest is only in the 26th percentile of all readings dating back to, you know, the beginning of I want to say of late 1998. When we have the first equity futures and options data. That number was in the 21st percentile at the October 2022 lows. And so what that tells me is that, despite seeing the sharp rally that we've seen in stocks, year-to-date and the tightening of credit spreads, etc. We have not seen too much participation on behalf of institutional investors and and is somewhat concerning for anyone who's bearish in the context of what we just talked about on slide 65 in terms of the crescendo of short squeezes leading up to ultimately that phase two credit cycle downturn that we still see ahead of us.

***Erik:*** Tell me more about why you still see the phase two credit cycle downturn ahead of us. To your credit, you completely predicted that you told us all about it back in January, but then we had Silicon Valley Bank and these other things but you're saying that's not the credit event you were looking for. So it must be that you're expecting a very specific kind of credit event and that one didn't qualify. Tell me more about exactly what you're looking for and why the one that just happened didn't qualify, and what you think might be coming?

***Darius:*** Yeah, absolutely. So in terms of why the one that just happened does not qualify in our view, we had already seen a pretty substantial degradation in credit standards, or, you know, degradation in lending standards, etc. from the senior loan officer survey report that was released in January. When we updated the data for the month of April, which is post-Silicon Valley Bank, post-First Republic Bank, etc. that it deteriorated at the margins, but we didn't see a significant degradation. And so that was our first indication in April, that hey look, this is getting worse, but it's not going to get worse at the same pace. And we've also been religiously tracking every week for 42 Macro subscribers, you know, the growth rate of credit, particularly amongst the sort of small banks or whatever they call small banks, which are any bank outside of the top 25 in assets. And we did see a significant downshift in the growth rate of their total assets. And part that was primarily driven by them continuing to to puke treasuries off their balance sheet, but we also saw them, you know, really start to rein in and lending particularly through the lens of CNI lending, or the most recent data is down some around 1.5-2% three-month annualized, but that 1.5-2% through with any wise in terms of the contraction that we're seeing in CNI lending, you know, the slowdown in overall loan loan growth right around, you know, plus 1-2% every month annualized. Those numbers are actually higher than they were a few months ago. And so, you know, you don't want to make the definitive call that we're actually accelerating in terms of bank credit growth, particularly by some of these beleaguered you know, small banks, regional banks, but it certainly is the case in our view, that this is not the boogeyman that a lot of investors believe it is. And we had an inclination that it might not be the boogeyman, you know, as early as April in terms of that senior loan officer survey data, because one thing we find in terms of, you know, under trying to understand the credit cycle broadly on, you know, cross geography basis is that the US economy is among the world's leading economies as it relates to this sort of the proliferation of non-bank financing throughout the economy.

If you look at the share of overall credit that is actually on bank balance sheet in the US economy. That number is only 30%. That compares to right around 50% for the eurozone economy, right around 80+ percent for the Chinese economy. So we know that the shadow banking sector, which tends to take its cues from things like the dollar from things like the S&P, the VIX, and the MOVE index, you know, these kinds of market based measures of stress. These market based measures of stress have reflexively fit bet upon themselves, and kept the credit machine going for some of these shadow market participants or non-bank lenders. So that in our view is something that has contributed to the resiliency of the US economy that we called out, and is likely to continue to contribute to the resiliency of the economy, at least until we get into the fourth quarter when I think the probability of the economy actually commencing into a recession or tipping into recession is actually, you know, pretty elevated.

So you asked me you kind of what is the main driver of the sort of business cycle, the credit cycle that we see coming in, and I'll direct your audience to slide 60, where we sort of expound upon our hope plus I framework. And so on this chart, it's somewhat of a busy chart but it's important to explain. This is the median trailing 10-year Delta adjusted Z-score of a basket of indicators in months before after a recession starts that represent each of these five cycles. There's the housing cycle, there's the order cycle, there's the production profit cycle, and there's the employment cycle, and the inflation cycle. We've added the inflation cycle to our buddy Michael Kantrowitz over Piper Sandler, he's got this whole framework. And so we've expanded upon that and added inflation to the mix. And so what we find is very similar to Michael's work is that housing tends to break down very long leading indicator of the business cycle. So at around 18 months ahead of recession, orders tends to break down right around 8 to 10 months out of recession, production and profits tend to break down right around four to six months out of a recession. And employment tends to break down right around at the start of a recession and inflation is a much a very much a lagging indicator to the business cycle breaking down right around six to eight months after recession. Well, if you go to the current data, if the next slide on slide 61, you see that we're basically just falling this long term pattern of behavior in the US business cycle, you know, kind of to a tee, housing broke down a long time ago, then we got orders breaking down, and then we got production profits breaking down. Employments is on its way to breaking down, but it hasn't broken down quite yet. And so, you know, that's kind of a boring answer to your question. I know this isn't sexy, but you know, making money financial markets should not be sexy, if you're doing it right. This is a very regular stereotypical business cycle, as defined by the previous slide, which encompasses all 12 of those postwar business cycles. You know, every business cycle that we talked about on slide 65, is represented in the collection of data that we feed into each of these cycles. So this is a regular run of the mill business cycle. It is going to have likely a regular run of the mill phase to credit cycle downturn. And ultimately, we just have to be patient in terms of respecting the x-axis on all these processes.

***Erik:*** Okay Darius, let me summarize what I think I'm hearing. And you can tell me if I've got it straight. With respect to the recession that a lot of people started predicting in Q4 of last year, which you told us not till the second half of this year. You are saying it's still coming, it's still not until the second half of this year, more likely it's actually pushed out a little bit further to the fourth quarter of this year, or maybe even the first quarter of next year. You still think that it is a stage two credit downturn that brings on that recession. But so far, we don't know exactly what the details are going to be. And it's not the whole Silicon Valley thing. It's something else that's still coming. Is that the gist of it very much?

***Darius:*** You mentioned one thing in terms of the you know, just kind of timing the recession. So we run a variety of models that try to time where we are in the business cycle. Obviously, you know, you can't have an entire investment process based on, you know, is it a recession or is it not a recession. You're not going to make any money for the, you know, 95% of the time that we're not in recession so very clearly, you know, it's more than you know, investing is more than just understanding, you know, these kinds of huge business cycle inflection points, but in and around, you know, these business huge business cycle inflection points, you better have a good idea on what a recession is, what a recession looks like, how it gets priced in, how ultimately markets, you know, what causes markets to recover from that. And I think we have a pretty good handle on that at 42 Macro. One thing that gave us a pretty good indication that a recession would be a Q4 for 2023 or Q1 2024 incident is the yield curve, which I think we would all agree, you know, signing on Campbell Harvey's work. In terms of where we are in the business cycle. I think we can all agree that the 10-year three month Treasury yield curve is the best leading indicator for a recession. It certainly is. And from my perspective, if you go to slide 62, where we show the long term time series of the three month 10 year Treasury yield curve, or black dotted lines in that time series correspond to the initial inversions. And if you look at the next slide on slide 63, this is where the math begins and me and me understanding, you know, really starts to take off, which is our math suggests that you know, a recession is most likely to commence in November 2023 through April 2024, when we perform this analysis when the yield curve inverted last fall.

And so what we're looking for in terms of making these determinations, is what we're looking for is okay, well, let's identify the interval of time that has the highest probability of seeing a real GDP contraction and a rise in the unemployment rate based on you know the historical patterns of yield curve inversions. And what we find is that it's the 13 to 18 month forward interval that has the highest percent likelihood of seeing a contraction GDP, these would be the percent negative ratio down there on the table, and the highest probability of seeing a rise in the unemployment rate, which is in the percent positive ratio in the table. So that suggests that q4 to q1 of this year was always going to be the highest probability outcome for recession for those who took the time to do the work. So that's kind of one point I'll make on that. And another thing that there's a compendium of reasons why the economy has resisted recession thus far. And on balance, I think the compendium of reasons of why the economy has resisted recession thus far favor a soft landing more than they favor a recession starting in the very near term. If you think about a distribution outcomes is okay, recession here the Q3, recession Q4-Q1 or no recession are significantly delayed relative to Q4-Q1. And I think clearly, the modal outcome of that distribution is Q4-Q1. But I think the second highest, you know, hump in that curve would be no recession or significantly delayed relative to Q4-Q1 as opposed to a recession commencing in the third quarter, and we can unpack why those features of the economy are persistent.

***Erik:*** Okay Darius, so most likely scenario is the recession still happens Q4 or Q1. But the second most likely scenario is the recession doesn't really actually hit us completely and it's more of a soft landing type of thing. First of all, is that correct and second of all yes please elaborate on unpacking those details you alluded to?

***Darius:*** Yeah, absolutely. That's, that's a great question. And the answer is yes, that is correct in our view. There's still a compendium of factors ongoing in the US economy that would suggest that. You know, the resiliency that we highlighted dating back to last fall, and it's discussed at the beginning of the year with you that resiliency is likely to persist for at least another quarter, perhaps another couple of quarters. So we'll start on slide 48 with reason number one of six. We have record cash on household balance sheets. So this is something that's been in my bonnet for months now which is this concept of excess savings on Wall Street. And, you know, for the life of me, I think, do as much research as anybody on global Wall Street as a single human being. And I can't for the life of me get to anything that looks like, you know, a negative value for excess savings or even you know, remotely close to being a negative value. When you look at the amalgamation of checkable deposits and currency on household balance sheets, we are now tracking at 4.5 trillion. That number is up from just around 1 trillion prior to COVID. If we were to talk about excess savings, the excess savings are obviously very plentiful as opposed to having dwindled to a very threatening state. Another way to kind of look at this is the checkable deposits and currency as a percent of total household assets. And so consumers not only have a lot of cash sitting in terms of their ability to spend into the economy, they probably feel very rich, because that amount of cash is very high relative to the total amount of assets they have. That liquidity at 3%. You gotta go back to the late 1960s to see a share of checkable deposits and currency on household balance sheets. That is as high as it is today. A couple final things I'll make on this other than the slide on 48 is household debt to nominal disposable personal income is actually quite muted relative to previous cycles. So that's, you know, it certainly hasn't been growing in a way that would suggest capital, misallocation in any broad form across the economy.

**Darius Dale** then you have the household debt service ratio, which is essentially at an all time low. Still it's going to rise in subsequent quarters but essentially it is coming off a very low base. And it's certainly not rising at a speed that would threaten a recession. Shifting to slide 49, we show the same metrics for the corporate sector in the US. You know, we're at a record level of cash on corporate checkable deposits and currency on corporate balance sheets as well. And right around 3% as well as total corporate assets, you gotta go back to the mid or sort of early to mid 1960s to see a ratio of checkable deposits to total assets. So corporates probably feel pretty rich as well. Corporate debt as a percentage of nominal gross domestic income is pretty elevated. So that's a bit worrisome, but clearly not growing at a pace that is indicative of broad capital misallocation. And then you look at the corporate debt service ratio, it's at a very middling level, it's going to continue to rise in the coming months. But as we all know, corporates have termed out their funding. If you look at the percentage of corporate debt that's shorter term relative to longer term. It's right around 33% so that number is obviously way down from where it used to be in previous business cycles.

Number three reason why we've seen so much resiliency, that we were able to make that call back then, which is that key measures of private sector income on slide 50 and wealth have outpaced inflation since the start of the pandemic. So obviously inflation has been an issue, but we have not seen inflation be enough of The issue that measure all these measures of income and wealth have really been, you know, kind of gone negative on a real basis. So the blue line, and this chart shows the household assets. If you look at their checkable deposits, plus their money market fund exposure, so amalgamating the total amount of cash they have on their balance sheet, that number is up 127%, since the end of 2019. If you look at household net worth, the red line in this chart, that number is up 27%, since the end of 2019. Corporate assets cash so again amalgamating their checking of checkable deposits, plus their money market fund exposure, that number is up 47% since the end of 19. Nominal employee compensation is up 21%, since the end of 2019. And then you also have CPI only up to 17%, since the end of 2019. So, when you kind of add it all up, it's like inflation is going to catch up eventually, in terms of, you know, kind of dragging consumers into this negative real income state, and ultimately kind of perpetuating a business cycle downturn, but it just hasn't happened yet. And so that's something we call out as well.

Reason number four kind of alluded to this on slide 52 Is that we have limited credit cycle vulnerabilities. So in this chart, I'm showing private non-financial sector credit to GDP, that's the blue line in the top panel. The red line shows the private non financial sector debt service ratio, that's the red line on the top panel, and I show it on a five year Z score basis in the bottom panels. And as you can see the blue line at a minus 0.7 Sigma. You know, we're clearly not growing credit in a way that suggests capital misallocation or adverse selection which is what you typically see just looking setting the time series ahead of the red bars throwing up. You know, obviously, we're just not seeing that. We are seeing a sharp enough rise in the private non financial sector debt service ratio, and that number is going to continue to go higher, as you know, kind of long and variable lags and monetary tightening catch up to the economy. But you got to do a whole hell of a lot of you know, financial tightening if you don't have the kind of capital misallocation vulnerabilities that you have historically had in previous business cycles. So it ultimately means that the terminal Fed funds rate which is another call we made back going back to the fall of last year. The terminal Fed funds rate is actually you know going to be much higher because the neutral rate in this particular business cycle actually gravitated much higher.

Reason number five on slide 53, we have limited exposure to the volatile manufacturing sector in the US economy. The blue line in this chart shows manufacturing share of total non farm payrolls, the red line shows manufacturing share of nominal GDP. And as you can see 14 and 18% respectively were well off prior highs in previous indicator. And what that ultimately means is that the more cyclical aspects of the US economy are actually just significantly smaller shares in recent business cycles. And so ultimately, you know, the reason that's important is because, you know, if you look at the manufacturing sector, as a you know, kind of as a share of total job loss and recession, we show that on slide 89, which show a compendium of indicators in the US economy in and around recession, and what we see is that, if you kind of go to the towards the middle of that table, manufacturing sector share of the total nonfarm payrolls drawdown is at 98%, which means that you tend to see, you know, services sector on on in terms of the net drop loss that we tend to see in the US economy on immediate basis only 2%. And so, you know, what drives the services sector, things like population growth, migration, and things that drive the manufacturing sector, which are interest rates, exchange rates, you know, things of that nature so that's something to call out.

And then number six, the final reason we call out in terms of the things that are, you know were evident at the time, and still are some certainly evident in the data is labor hoarding on slide 54 where we just show the total labor force relative to its pre-COVID and post-GFC trend lines, and then we show the gross domestic income relative to its post GFC trend. And you can see we've recovered the trend line in gross domestic income, meaning that corporates have, you know, probably demand for labor, which obviously could see in the JOLTS report but they we just don't have the supply of labor as a function of, you know, the great retirement and other factors that are contributing to the reduction in labor supply relative to trends. So companies have found it very difficult to find and attract and retain talent in this business cycle. And as a function of that they've just been reluctant to fire as quickly as they probably would have in other business cycles. And so in our view, you know, this is something that's been, you know, contributed to resiliency to the labor market, and may continue to contribute to the resiliency of the labor market until you really start to see corporate fund operating fundamentals really deteriorate.

***Erik:*** Darius so far, we've been talking primarily about growth related issues. Let's move on to inflation particularly, you know, I had the Juliette DeClercq on the show last week, telling me she thinks we're in an immaculate disinflation. I hate to disagree with Juliette because she's a brilliant woman, but I'm just not buying it. And I think we're in a new secular inflation, but honestly, I don't have any good strong data to make my case with so I can't wait to hear your take. I want to hear your short term take but honestly, what I'm much more concerned with is not what's going to happen in the short term, but longer term are we in a new secular inflation or is this all gonna blow over because it was just a transient effect from the pandemic as so many people seem to think?

***Darius:*** Yeah no great question and I completely agree with your sentiments on Juliette and for the listeners who have not had a chance to review Juliette's discussion from last week, definitely make time to review that she's definitely one of the top macro minds out there and in this space, so a huge fan of hers. I have a lot of respect for her work. So she's definitely one of those people on my shortlist of if you disagree with them, you better come correct with the analysis. So shout out to Juliette so anyway getting back to this discussion on slide 85, we have observed a considerable amount of immaculate disinflation here in the US economy if you can sort of look at the top panel, where we show a significant breakdown on the three month annualized rate of change basis, in median CPI to 4.7%. You know we are as high as 7.6% in October of last year. We've seen a significant breakdown in true mean CPI to 3.1% on a three month annualized rate of change basis, you know, we peaked at 7.8% in this metric going back to December of last year, meaning the PCE these numbers are really breaking down, as well. We've also seen a pretty decent deceleration in core services PCE inflation ex-housing. So super Core inflation which is Powell's current favorite inflation metric, you know, that sort of justifies their view that at 3.8% three month annualized. That number is kind of well off where we were, you know, kind of north of 5-5.5% in recent quarters. So, we have seen a significant amount of the disinflation, immaculate disinflation that's really contributed to this transitory Goldilocks vibe. At least prior to last couple of months in asset markets. And part of the reason for that are kind of labeling this as immaculate disinflation is because it's immaculate. Going back to going back to slide 60 of our of our deck, what we going back, you know, we discuss our hopeless AI framework where we show inflation is the most lagging indicator of the business cycle. It tends to break down well into a recession on balance on an immediate basis that tends to break down six to eight months after the recession begins. And so it's our view and it's our data's view that we are not in recession, we can talk about why we don't believe we're currently in recession right now.

But if you go back to slide 89, which we briefly touched on earlier and draw your eyes over to the core PCE set of columns in the table, where you show the basis point change in t minus one, t minus one means the delta that we observe in core PCE time series ahead of a recession in the year leading up to each of these recessions in the sample. And what we find is that core PCE is typically flat, leading up to a recession, you know, right around plus five basis points. And there's only one negative outcome in this sample leading up to the 81-82 recession. All other observations in the sample show that core PCE is flat or either or accelerating into recession. And so in that in the context of our hopeless I framework on slide 60. That in our view gives us a pretty clear indication that the lot of the disinflation that we've observed thus far in financial markets has been very immaculate relative to historical business cycles. So it's our view that we're going to see your macro disinflation conclude pretty soon. And the reason for that is, if you go to slide 86, you know, we've been tracking the supplier delivery times throughout the pandemic, as a proxy for, you know, kind of pandemic related inflation impulses. And you can see both with effective manufacturing, which is the blue line in the chart, and red line is the services sector, which is arguably more important for the inflation outlook from here. Both of those numbers are well below levels that have historically been consistent with anything but 2% or less inflation. In the black line, we show container freight rates, you know, those numbers are back to their kind of trend, pre-COVID trend levels as well.

So a lot of the transitory inflation that we observed in the in the pandemic is now in our view has come out of the system, or, you know, very soon to come out of the system. I think we'll see one to two more months of immaculate disinflation, from a record inflation standpoint. But when you get towards the latter part of Q3 and really into Q4, and the recession has not started, you're going to have a window of time between the end of immaculate disinflation, and let's call it going back to that HOPE+I framework. I don't know one to two quarters into the recession, before you actually start to see some real positive outcomes as it relates to inflation. And one other thing that actually concerns me about this immaculate disinflation narrative in the second half of the year is that housing disinflation may take an unwelcome breather in the second half of this year, as well. So on slide 87, on this chart, we show the top panel the FHFA home price index on a three month annualized rate of change basis at the blue line, the red line, or the blue bars. The red line shows the year over year rate of change in that time series. We show Case-Shiller home prices in the second panel, those numbers are a rolling three month average. So they are a bit lagged from the shelter CPI of in the third panel, and we show a PC housing deflator in the fourth panel. And what we show is that we've lagged the shelter CPI and the PCE housing deflator in this chart by 19 months, and the reason we've knighted by 19 months because that is the current lag between the impulse in home price appreciation and the impulse and in the ultimate reserve and the reported inflation for the housing sector. And so if you go back to 19 months ago, over the next couple of quarters 19 months ago, we saw a real acceleration in the three month annualized rate of change of home prices, in terms of looking at the FHFA, housing price index, and the Case-Shiller Index. So that's something that is ahead of us in terms of potentially seeing what could be, you know, kind of a dissipation of the disinflation in the housing sector.

You know, we know the housing sectors is bottomed. You know, part of the couple of things that have really contributed to the positivity that we've seen in housing. So if you jump to slide 55 in this deck, you can see that the housing sector is experiencing a cyclical recovery now. I'll draw your eyes to the second panel on this chart, where we show housing starts are actually accelerating on a three month annualized basis are growing at 54% on a three month annualized basis. If you look at new home sales in the bottom panel in this chart, new home sales are growing at 88% on a three month annualized basis. Those numbers are up to 5.7% and plus 20%, respectively. So why are we seeing this kind of robust recovery in the kind of a new home sales segment of the housing market, which is obviously more relevant to employment in particular, and the reason for that is the is on slide 56. So there's a variety of reasons for why the housing market has been resilient. And we identified these, you know these reasons of going back to to the fall of last year. We did not I'll be very clear, we did not make the bull call on homebuilders. And so we definitely missed out on monetizing this research. But you know, kudos to any of our subscribers who did monetize this research, because we definitely put it out there, which is, you know, we have these very low mortgage debt service ratios in the US economy at only 2.9%. That's the red line in the top panel. It's a very low mortgage debt environment to begin with, but certainly the mortgage debt service ratio is really low. And the reason that mortgage debt service ratio was low is if you look at the blue line in the second panel, the effective mortgage rate or mortgage that outstanding is only 3.55%. The marginal mortgage rate for anyone in the market to buy a house is 7.31%. So that positive spread at 326 basis points is effectively causing a stasis in the existing home sales market and putting all the demand and incremental supply to the new home sales segment of the market. And this is why in the bottom panel, you're seeing the housing starts to existing home sales ratio, breach an all time high and the most recent data at 38%.

***Erik:*** Darius, let's move on to China. I think the biggest macro analyst mistake that a lot of people myself included, made in 2023 was we were assuming that the recovery of China was going to be an economic recovery. We didn't really factor in the changing nature of the geopolitical world that we live in. And it seems like maybe China is not going to have exactly the same role in the global economy after the pandemic that it had before the pandemic, give me the lay down. What do you see in terms of China, China growth? How come China didn't contribute to the recovery from the pandemic, the way so many people thought and what comes next?

***Darius:*** Great question Erik! I think that's a very important topic to unpack because again China is the world's second largest economy, it's kind of been dormant for a few years now. But it is it is the world's second largest economy. It's the world's largest consumer of manufactured goods. So we definitely have to make sure we understand it. And it obviously relative to anyone, benchmark to EM type assets, you know, it's clearly the lion's share of those assets. So it's a really important topic from the perspective of institutional capital allocators. And so we definitely make sure we monitor that alongside many other major economies in the context of our rate of change analysis. But if you go to slide 45, where we show our global liquidity cycle monitor, which sort of, you know, kind of tries to track the most important metrics across growth, inflation, and policy, and we try to marry those, those changes and those metrics to systematic trade ideas right now, there's very few actually jumping off the screen right now, Brazil's kind of the only economy with some trade ideas as a function of this process. But going to China, which is the second row in this chart, you know, one of the things we correctly thought I guess, proved prescient on is the likelihood that China would reopen its economy back into the structural liquidity trap that it was already mired in prior to COVID. You know, we've been doing this for long enough to, you know, to have enough muscle memory and, you know, refreshing so many of the same charts for so long that prior to COVID you know, the narrative around China was this economy that had a debt overhang, and it was contributing to, you know, below trend growth, demand growth, below trend inflation, and ultimately, in the absence of fiscal stimulus, which we, you know, we ultimately got that the river card on that information in early March, in the absence of fiscal stimulus, meaningful fiscal stimulus, which they continue to be reluctant to supplying the market with in Beijing, they were very likely to reopen the Chinese economy back into that structural liquidity trap, and we can certainly see it in terms of some of these indicators. PMIs are declining in China, Economic surprises China has the lowest or second lowest economic surprise index level in the entire table of all the major economies in the world. And, you know, it's just been one economic miss after another in China because again, the political authority that the political will and China has been to resist the temptation to pursue large scale stimulus programs, just as a Chinese economy that, you know, in our view has sort of, you know, kind of is very much aware of the private non financial sector vulnerabilities that they have in that economy. You're talking about 200 plus percent of GDP, private non-financial sector debt-to-GDP, you're talking about an economy that is very much potentially mired in a middle income trap. And so those two, those two statistics are very incongruent on why we believe Beijing has been very reluctant to pursue again, you know, kind of those large scale easing cycles of years past which obviously coincide with, you know, much more debt growth.

And you know, where you can see China's on disappointing recovery, then an inflation statistics. You know we got the most recent data points over this weekend, a headline CPI is tracking with deflation, 0.0%, that's a minus 1.9 sigma value relative to the trailing 10 year mean. Core inflation is at 0.4%. That's a minus 1.9. Sigma as wel. Chinese inflation surprises are the the deepest negative inflation surprises in the entire world. And so, you know, you kind of sum it all up. Part of the few things that are really weighing on the Chinese economy. One, you know, the degradation in the current account. Obviously, the rest of the world is just not demanding Chinese goods to the same degree as they were. And we're not seeing that sort of current account monetization, that we've seen in historic cycles in China, whereby Chinese, you know exporters export money, they convert that money because their currency is not convertible. They convert that money at the PBOC whose FX reserves, you know, kind of built as a function of that into Renminbi and that Renminbi has been really the lifeblood of the Chinese financial sectors growth in recent decades. That process has really slowed significantly, as the Chinese authorities have tried to downshift that kind of business model and kind of change the shape and nature of the Chinese economy into a consumption oriented economy. You know, they may be successful in that, I think it's way too early to tell. But certainly, they are doing what it takes to be successful with that, which is again, resisting the urge to go back to the wood on these previous cycles. So ultimately, we do believe if you go to slide 105 in this deck which I think is the final slide in the deck. We do believe that the trend is going to continue increasing liquidity. If you call China and Japan of the two economies that are the major economies that contribute to our global liquidity proxy, which is the sum of the global central bank balance sheet, the global FX or global money supply, and global FX reserves minus gold. We show that on slides 41 and 42 in terms of those metrics.

The two economies that contributed most to the rise, the surge in global liquidity, you know, from the fall of last year to the early part of this year were China and Japan. And China's you know, kind of reopening really kind of wanted to aid and abet that reopening process. But it's pretty clear from our perspective, that they no longer want to pursue such large scale measures. Now they are pursuing measures, China has recently cut its loan prime rates, its repo rate, we suspect that a triple cut is on the way as well. And so they're going to see, you know, more liquidity filter into the global economy and the global financial system, vis à vis China in the coming months, it's just probably not going to be as significant as it was, you know, kind of going back to the fall of last year into the first quarter and early part of the second quarter of this year. And so in this chart, I'm showing the correlation to the year over year rate of change to have the Select leading indicators to the China liquidity proxy. The China liquidity proxy is just the global liquidity proxy but just focused on China. So we had the Chinese central bank balance sheet plus Chinese brought money supply plus the PBOC FX reserves minus gold. And we look at a basket of indicators that have historically been proven to lead or be a coincident indicator of those cycles. And if you look at the indicator that the most amount of information on a three to six month leading basis. It's the Chinese equity market. The locals know in China in terms of you know, when the next wave of liquidity or provision or the next wave of liquidity reduction is coming. And right now, as you can see the Chinese equity market on the right where we show the z-scores are the latest values of those indicators on a cyclical basis, trailing three years and the structural basis trailing 10 years. You know, the Chinese equity market is telling you that look, it's probably not a big wave of liquidity coming out of China. Now again, there is more liquidity coming out of China. We do suspect our China liquidity proxy to end third quarter much higher than levels than it is currently today. That favors Chinese equities but again, this is not your grandfather's or your older brothers China's stimulus cycle. This is not a very, in our view, very unlikely to be to create significant demand for physical commodities, etc. And it's probably going to be very concentrated in terms of the market response to Chinese equities which have obviously lagged in conjunction with that call we made back in February. We told investors many of them that taking advantage of the Chinese reopening theme at the time back in February to liquidate all of their China and China related holdings and obviously that came to fruition so we think it's that trade is overdone and it's probably time to get back into China. Just be aware that this probably not going to spill over into the broader commodity markets.

***Erik:*** Well Darius I can't thank you enough for a terrific interview and a terrific slide deck. Obviously, we didn't get time to go to all 106 slides in the deck today. I encourage our listeners to peruse the deck. But for the benefit of our listeners who are not going to be satisfied with the abridged version of this and want the entire deck with nothing blurred, please tell us about what you do at 42 Macro. And what does it take for somebody to get this slide deck, not the blurred version, but the whole version and get it updated every single month?

***Darius:*** Great question, Erik. Thanks, again, for having me on. Again, as I said it's a real blessing to be a regular contributor to this podcast. So in terms of acquiring our research. We make it very easy, very simple. You know, just a little bit of background on what 42 Macro is. We are a top in, top shelf, very, very top shelf, institutional macro research firm. We serve as all the top asset managers that you the who's who, if you can name them, they are probably our client. You know, from my 15 years on global Wall Street, we service you know, corporations, central banks, etc. with our research, but we have a twist. And the twist is, you know, I have a firm believer that everyone needs this information, not just the hallowed halls of institutional finance. I'm very big in terms of democratizing this type of information to make sure that, you know, retail investors are a type of investors, which has historically not had the budgets to take advantage of research like this can afford it. So our price points are extremely affordable. You know, I'm constantly doing market research to understand, you know where the price points are gravitating towards in this business. And, you know, we are still very much on the low-end of pricing our product, because again I think, you know, I don't believe that we need to be embargoing this in terms of high fees, etc. So definitely come check us out at 42 macro. We have price point, we publish a slide deck every month, alongside a webcast going through each of these charts. Every week, we publish what we call our round the horn, which is sort of an abridged version of this deck, specifically as it pertains to what you should be doing in your portfolio from an actionable investment standpoint. And then lastly, we obviously publish out a lead off morning note every morning which is kind of connecting the dots and all the things that are moving in the growth, inflation, liquidity cycles, etc. So, definitely come check us out. If you can't afford our research, which is obviously very reasonably priced. We do obviously do a lot of podcast appearances as well. So come check us out at 42macro.com/appearances. You can definitely find a compendium of all of our podcast appearance, including this one when it's published.

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