MACRO Voices
with hedge fund manager Erik Townsend

Jesse Felder: Questioning the Soft Landing Narrative

September 7th, 2023

Erik: Joining me now is The Felder Report founder and publisher Jesse Felder. Jesse, it's great to get you back on the show. Listeners, Jesse prepared a slide deck for this week's interview; you'll find the download link in your research roundup email. If you don't have a research roundup email, it means you haven't registered yet at macrovoices.com. Just go to our homepage, click the red button above Jesse's picture that says, "Looking for the downloads." Jessie, as we dive into the slide deck on page one here, you've got equity valuations and interest rates. Before we even get into that, I want to just start with a real high-level picture that I think is on everybody's mind, which is all the smartest guys said, "Hey, it's a bear market rally, you know, don't trust it, it's gonna roll back over, the bear market's not over, the bottom is not in yet." Boy, if that's right, and this bear market rally sure is pretty long in the tooth. What's going on here? Is something changed? Or why are we having this experience where everybody's waiting for the recession and the resumption of the bear market? But it's not happening?

Jesse: Well, I mean, that's the question that is on everyone's minds, right? Is this a bear market rally? Are we going to have a soft landing? I've been thinking about this idea of a soft landing. And to me, it's pretty astounding. It reminds me of the old joke about the optimist who falls off the top of a skyscraper and on the way down, as he passes every level, he says to himself, "So far, so good," because he hasn't hit the bottom yet. That maybe things are going to work out, okay? And I think that's kind of where we are in the cycle, where people are looking to say, "Well, we don't see a recession materializing right now in front of our eyes. And so maybe things are going to work out." But I think they are underestimating the impact. It's astounding to me that it's obvious to everybody, everybody knows that these things work with long and variable lags, monetary policy and the rise in interest rates and all of these things. But we're not willing to wait until those lags actually kick in, which is, you know, right about now. I have a couple of charts in there that show a 24-month lead on a composite of the dollar, interest rates, and oil prices, and all these kinds of leading indicators suggest that if a recession is going to happen, it should start to materialize before the end of the year, over the next several months. So I still think we're kind of halfway down, you know, after we've fallen off the top of the skyscraper, and we haven't hit the ground yet, but we're headed in that direction. And so I think the idea that we're headed for a soft landing is overly optimistic.

Erik: I agree with you that it's overly optimistic, but I sure can't explain what's been going on with the equity market. I mean, it just seems like we've got this immunity to what a lot of people agree are some pretty significant macro risks. Any thoughts on why? There's really seemingly no reaction to these risks.

Jesse: Yeah, you know, I think Bridgewater did an interesting podcast about a month ago on the topic of the liquidity hole, which is, you know, a term Greg Jensen used, one of the CO-CIOs over there. And, you know, I think you can kind of see it visually in slide four of my chart deck there, which is a chart that we should all be familiar with. This is an indicator that everybody has been looking at for months now, but it's gone. You know, people have kind of stopped looking at it over the last couple of months thinking, you know, it doesn't work. But essentially what Jensen was saying in this podcast is the liquidity hole that Bridgewater expected to materialize at the beginning of the year was delayed due to a couple of things. One, the rescue of the regional banking system, where the Fed had to come in and expand the balance sheet again, kind of undo some of its quantitative tightening. As Stan Druckenmiller said, they undid, you know, about a year's worth of quantitative tightening in a week, which is a big deal. And then we had the issue with the Treasury general account being run down to next to nothing as a result of the debt ceiling. And those two things created a positive effect on liquidity over the first half of the year that it was kind of difficult to foresee until we actually got into those things.

And so the liquidity hole is now materializing. And just to kind of define that, I think it's the Treasury now needs to, and it's already gone a certain distance towards kind of ramping up the general account again, refilling the coffers of the Treasury, but has a ton more debt to sell through year-end. And that creates a crowding-out effect. It makes it difficult for other assets to attract capital, which is why interest rates have been going up for the last month. And so I think when you look at it visually on this slide, it's pretty clear the trend in liquidity didn't continue lower as a lot of people expected this year and actually reversed strongly higher through the spring and into the summer. Now it's reversing again lower, and that's an important dynamic as to why we had such a strong rally through the first half of this year.

Erik: I skipped ahead a little bit; let's come back to the first page of the slide deck where you're showing equity valuations versus interest rates. I was expecting the blue line to be the S&P 500 price, but you're actually showing something else called the Buffett yardstick. Tell us what that's about.

Jesse: Yeah, the Buffett yardstick is a metric that Warren Buffett first I think wrote about in Fortune magazine back in 2000, at the top of the dot-com bubble. You can see that peak there in that 1990-2000 timeframe, where he suggested valuations had reached a level that were totally unsustainable. And you could see that after that peak in 2000, valuations reverted for over a decade. Essentially, this metric measures the total value of the stock market, total market cap, relative to the size of the economy. In this case, we're using GDP. I think he's used GNP in the past, but market cap to GDP is basically like a price-to-sales ratio. What we've seen over the last few years is that we've actually taken out those dot-com mania highs and have hit new record highs in terms of valuations on this metric. That coincided with this period of falling interest rates. Jeremy Grantham recently said in an interview with Bloomberg, "In the end, life is simple: low rates push up asset prices, higher rates push down asset prices." He went on to say, "We're now in an era that will average higher rates than we had for the last 10 years." We've already seen the 10-year yield go over 4%, and as this chart suggests, there's a lag

effect with valuations when interest rates go up. It takes time for valuations to reflect that. So I think that's what we're looking at over the next 18 months – the stock market may now be starting to reconcile itself with the fact that interest rates might be higher for longer, and valuations may need to revert back to a more normal level relative to interest rates.

Erik: I'm really curious about this blue line on the chart because, as you're saying, this is Buffett's indicator that kind of tells you when the system is in bubble mode, you know, when we've got crazy valuations. As you say, we saw that in late 1999, going into 2000. There's that big peak there. But as I look at this chart, Jesse, we had obviously a huge peak after the COVID stimulus reaction to the pandemic. But hey, wait a minute, it's pretty much reverted back down to trendline growth. We're back down to the trendline. Now, it seems like the fluff is out of the system, at least according to this chart on the blue line. Am I reading that wrong?

Jesse: Yeah, I think, you know, actually valuations, the only reason I think they've been trending higher for this period of time from 1990 to today is the fact that interest rates were going down. That's the red dotted line there. It's inverted on the scale, right? So back in 1990, the ten-year yield was, you know, eight plus percent, and it's fallen to almost zero, as you know, at the peak of the pandemic bubble in 2021, which helped to support the record high valuations. But if you believe that, I mean, I don't think you have to believe that interest rates have made a secular low and are now going to trend higher. Just the fact that they've gone from 50 basis points on the ten-year to over 4% today suggests that equities are significantly out of line in terms of risk-free rates. Another way to look at this is if you look at just the stock-to-bond ratio, take a simple ratio of SPY to TLT on a monthly timeframe and on a quarterly timeframe. Stocks have never been more overbought in terms of relative strength, never been more overbought relative to bonds than they are today. So all that means is TLT has been hammered, right? Bonds have been hammered over the last year, year and a half, and stocks have not. Usually, they kind of trade in a range with each other; the risk-free rate goes up, valuations have to come down. I think that's where we're headed over the next 18 months or so, with the stock market starting to reflect a sustainably higher discount rate.

Erik: On page two, you're showing a macro earnings model, what's the model and what are these two indicators or these two lines on the chart telling us?

Jesse: The way equity investors could be right and valuations remain elevated as they are today is if we did get a soft landing in the economy, right? If we had we avoided a recession, inflation comes down sustainably in a way that allows the Fed to lower interest rates significantly. And for both of those things to happen, I think a lot of people, I think most people believe that, you know, that's kind of threading the needle in a way that we've probably never seen a central bank accomplish before. In order to bring inflation down sustainably, we need a recession. So what this next slide represents is a leading indicator for corporate earnings. It's basically just a two-year lead of the 10-year Treasury yield, the oil price, and the dollar index. You can see that this composite of leading indicators does a very good job of telling you where corporate earnings are going over the next two years. So what we've seen is, I mean, you could see back in the 2021-22 timeframe, we had a terrific surge in earnings. That was absolutely

perfectly forecasted by the dramatic drop in interest rates, oil prices, and the dollar in reaction to the onset of COVID. But now that those have reversed, and we've seen a strong rise in interest rates, oil prices, and the dollar, it suggests that over the next year or two, earnings are going to come under a great deal of pressure. This is a really good leading indicator not just for corporate earnings but for economic activity, ISM, and other things. It suggests that the idea of a soft landing is, as I said, overly optimistic just because what we've seen in terms of the economic headwinds as a result of these leading indicators are so significant that we're very likely to see a significant decline in economic activity and earnings over the next several quarters.

Erik: Now, Jesse, I agree with what you just said, and I think we are headed back towards secular inflation. But for the sake of doing my journalistic job here, let's channel our friend Alex Gurevich, who I'm sure if he were listening to this would say, "Wait a minute, Jesse, you're missing the story here. Look at that red line. It bottomed down there, and that was all COVID, you know, stuff that caused this exogenous event on interest rates, and you're seeing the beginnings now of a recovery and probably a little bit of a pullback on that recovery. This is your opportunity to buy bonds here because we're headed not just to zero interest rates, but we're going negative interest rates. It's all coming." How would you react to that view? Because Alex has a pretty good point and he's made some pretty good calls.

Jesse: Yeah, I absolutely agree. I think right now, traditionally, as a macro investor, if you thought we're headed for a hard landing, it would be time to buy bonds, right? Interest rates are going to come down because the Fed is going to have to respond to rising unemployment and these things. And it's going to have to focus on that side of the mandate because inflation is going to not be a problem because the economy's going to go in the toilet. I think the difficult thing that makes this cycle uniquely difficult is that there's that supply-demand dynamic in the treasury market. Bill Dudley has been warning about it, former head of the New York Fed. And Ray Dalio, these are two people who understand the workings of these markets better than 99% of people on the planet. And when they say, Bill Dudley has been warning for the entire year, he'd be surprised if we don't see turbulence in the treasury market at some point this year simply due to supply-demand dynamics. The Treasury has so much debt to sell, and the demand for it is waning. The Fed's not a buyer anymore, the Fed's doing quantitative tightening, foreign central banks have been reducing their appetite for treasuries. Who's gonna buy all this debt? And I think that's, when we look at the technicals, just look at the chart of the 10-year yield, to me, it looks like we've seen a bullish flag pattern since the October high. And we're now testing that high again, and if it breaks out higher, we could be heading to 5%. And to me, when I look at the technicals, and they validate what I see in terms of just the supply-demand issue, and what people like Bill Dudley and Ray Dalio have been warning about, I don't necessarily want to step in front of that issuance freight train that the Treasury's kind of embarking on right now.

Erik: Jesse, page three is titled financial shenanigans in the economy. I don't doubt that there's any financial shenanigans in the economy. But why don't you tell us exactly what the blue line really tells us on the chart here?

Jesse: Yeah, so this is…I said corporate earnings look like they're headed for recessionary territory. And in fact, that slide on chart two suggests that the potential for a decline in earnings is as great as anything we've seen in the last three decades. This next chart suggests that we already see this materializing in S&P 500 earnings. So basically, this chart shows the ratio between the S&P 500 reported earnings and NIPA profits as reported by the Bureau of Economic Analysis. And when you see this huge divergence between the two, between S&P 500 earnings and reported earnings by the BEA, it's always a sign of a recession. Right now there's a 40% gap. We saw that in 2020, we saw it in 2009, we saw it in 2001, we saw this in 1974 and in 1980. Every time we've seen such a big gap between S&P 500 earnings and NIPA profits like this, it's been either very close to a recession or already in a recession.

And so what does this mean? Essentially, it means that S&P 500 companies are doing everything in their power as earnings are starting to roll over and decline to make them look better than they really are. For example, Google in its first-quarter report extended the usable life of its server infrastructure to six years from four years. So that reduces the depreciation that they're running through the earning statement and increases earnings. And so when you look at a number of companies doing these types of things on a grand scale, it suggests that profits are inflated in a way that is totally unsustainable. And it's usually companies trying to stretch out as much profit as they can and make things look as good as they can before they finally have to give in and start reflecting the true trend in earnings, which is significantly lower.

Erik: We touched on slide four earlier, but I want to come back to it because the title "Don't Fight the Fed" is probably the most respected wisdom there is in markets. But look at this chart, Jesse, the S&P, the blue line is clearly fighting the Fed and seems to be winning. What's going on?

Jesse: Well, I think it is the soft landing narrative, right, everybody's thinking that the Fed has won the fight with inflation, and the economy is going to avoid recession. And so allowing the Fed to lower interest rates. As I said, I think those were probably wrong on both sides of that narrative that cyclically, inflation is coming down, yes, but longer term inflation dynamics, I don't think there's any sign the Fed has sustainably brought them back down below target. And there are tons of signs suggesting that recession, if it's not here already, is coming in the fourth quarter. So I think that yeah, the market is fighting the Fed, it did. So you know, August, a year ago, right, and immediately reversed, lower. Now, it hasn't done so, as quickly this time. But I do think, with this liquidity hole materializing, which is I think what this with this chart starts to show and it actually doesn't even show the real effect. You know, Bridgewater is kind of referring to this just shows Fed's quantitative tightening the forecast and the red line for that goes forward from today is just communicated, quantitative tightening the Fed has already said it's going to do it doesn't include any increase in the TGA, or increased Treasury issuance or anything like that. So if you get that massive increase in Treasury issuance, on top of the quantitative tightening, this picture is even more negative than the chart represents.

Erik: Moving on to page five, we've got the stocks and speculators chart. What's going on here?

Jesse: Well, I think it is the soft landing narrative, right? Everybody's thinking that the Fed has won the fight with inflation, and the economy is going to avoid a recession. And so, allowing the Fed to lower interest rates. As I said, I think those are probably wrong on both sides of that narrative that cyclically, inflation is coming down, yes, but longer-term inflation dynamics, I don't think there's any sign the Fed has sustainably brought them back down below target. And there are tons of signs suggesting that a recession, if it's not here already, is coming in the fourth quarter. So I think that, yeah, the market is fighting the Fed, it did. So, you know, August, a year ago, right, and immediately reversed, lower. Now, it hasn't done so, as quickly this time. But I do think, with this liquidity hole materializing, which is I think what this chart starts to show and it actually doesn't even show the real effect. You know, Bridgewater is kind of referring to this, just shows Fed's quantitative tightening, the forecast, and the red line for that goes forward from today is just communicated, quantitative tightening the Fed has already said it's going to do. It doesn't include any increase in the TGA or increased Treasury issuance or anything like that. So if you get that massive increase in Treasury issuance, on top of the quantitative tightening, this picture is even more negative than the chart represents.

Erik: Jesse, tell me about the chasing growth chart on page six.

Jesse: No, this is a price analog. And I can't remember where I found this, I wish I could give credit where it's due here. But this is essentially just the S&P 500 growth index from 1997 to 2003. That's the red dotted line. And from 2019 to today. And you can see that obviously, if you thought, ’99, 2000 was a bubble. That burst, you can see kind of as my friend, Tom McClellan would say, the dance moves are pretty well in line with each other here, it's maybe not a perfect price analogue. But you can see how bubbles unwind, right? It's not a straight line where they go straight up, and then you know, straight down. And so this bear market rally that we've seen this year rhymes pretty well, there's, there was a similar dance step, you know, in the early 2001 2002, timeframe, before that.com, bust had fully run its course. And so I think it's interesting to me that you see, the ‘98, sell-off, lines up very nicely with the 2020 COVID crash. And so there are patterns that kind of govern these things. Price analog is not the be all end all of investment analysis by any stretch of the imagination. But I think it's just evidence that you can have massive rallies and still be in a bear market. And that's exactly what we saw during the dotcom bust 20 years ago.

Erik: On page seven, your title is "The Magnificent Seven." And I don't know what you're going to tell us about these stocks. But I can't help but observe from the list here that it seems to be the same stocks that most people under 30 years old believe are impossible to go down other than in the shortest time frames. What could go wrong here?

Jesse: Basically, this chart just shows the valuation of these. I've basically just aggregated their market cap, let's just add all their market cap together and multiple trillions of dollars, and then aggregate all of their free cash flow, right? And see, what is the multiple of these seven

stocks as this is? I mean, I think they're 25% of the S&P 500, Dow, and 50% of the NASDAQ 100. So they have a huge, I mean, the strength in the stock prices has driven the broad market higher this year. And there's been a ton of people pointed this out, and not the first by any stretch. But the fact that these stocks now trade as a group 60 times their free cash flow suggests to me that they are very vulnerable to a hard landing in the economy. You look at over the last 10 years, the average valuation that they've traded at is about 30 times free cash flow. So they trade twice their tenure historical valuation. So part of this is, you know, we've talked about the dynamics here, that part of this is the fact that they've been spending so heavily, especially companies like Microsoft and Alphabet, massively spending on this AI infrastructure and building out these large language models and things. And that capital expenditure starts to eat into free cash flow, right? Free cash flow is just operating cash flow, less capital expenditures.

And so the fact that these companies are slowing top-line revenue growth, they've all seen their top-line revenue growth slow, and now they're spending tons of money to keep up in this AI arms race suggested profitability is declining. And it's probably not a great time to want to invest in these types of stocks when they trade at such obscene multiples. Now, if the top-line growth continues to decline, as I think it will, into a recession, profitability could suffer dramatically, in terms of free cash flow here, that suggests that there's a potential for a significant reversion in valuations in these stocks. And the fact that they're such a big part of the broad market suggests that everybody who owns, you know, S&P 500 or any other the major indexes is vulnerable to this type of reversion in valuations here.

Erik: Well Jesse I can't thank you enough for a terrific interview. But before I let you go, please tell us more about what you do at The Felder Report and where people who have not discovered your newsletter can find out more about it.

Jesse: Well, this chart deck I took just from a monthly chart book I put together for premium subscribers to The Felder Report. It's just one of the reports I put out regularly. I put out a weekly market comment. That's basically just kind of a recap of themes that I'm tracking, narratives in the markets that I think are driving asset prices. And it can be anything from what's driving Chinese equities to inflation to the soft landing narrative and yeah, put on the market comment I write for a weekly chart book for pro subscribers and trade ideas. So individual equities ideas, and then at the FelderReport.com, I put out a weekly free blog post that just kind of highlights some of the five most interesting things I found during the week, and so you can sign up for that right on the homepage.

Erik: And that's all at thefelderreport.com. Patrick Ceresna, and I will be back as MacroVoices continues right here at macrovoices.com