Darius Dale: Still Bullish

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Erik: Joining me now is 42 Macro founder Darius Dale. Darius, as always, has prepared an extensive slide deck to accompany today's interview. Registered users will find the link to the slide deck in your Research Roundup email. If you don't have a Research Roundup email, just go to our homepage macrovoices.com, click the red button above Darius's photo that says *Looking for the Downloads*. Darius, it's great to get you back on the show. We've kind of made a tradition of doing January interviews for the last few years, you've had some really good calls at the beginning of the year. I guess we slipped it into the beginning of February this year. But give us the big picture. What should we expect this year? Last we had you on, you were still expecting a recession and maybe a lower low in the bear market. Needless to say, we're looking at new all-time highs. So, how's the new market data line up with your expectations?

Darius: Yeah, Erik. Thanks, again, for having me back on the show. It's always a pleasure. So just to make one quick caveat to your intro there, the last time I was on the show, we were calling for a blow off top in the equity market as a function of a potential recession on the calendar that is sensitive.

Erik: That's right. And you predicted that we would get new all-time highs first before the bear market would resume. I forgot that. So that is playing out if that's what you still think is happening.

Darius: Yeah, so we've been generally bullish since January of last of 2023 continue to be pretty bullish. There's a lot of economic information and critical macro, micro and policy updates this week that could potentially change that. But, barring any material change to that, I think it's potentially off to the races. So I'll give you a quick background on where we are, from a quantitative standpoint, in terms of how we think about the world. We use a system of quantitative tools here at 42Macro, to keep our clients on the right side of market risk. If we throw up slide 7, in this deck, where we just show, we are still currently in a Goldilocks market regime, I mean, Goldilocks appears to have peaked, but certainly doesn't necessarily mean that it has to end anytime soon. With respect to the anytime soon portion of that, if you go to slide 10 in the deck, where we show today's update of our macro weather model, which we update and refresh, along with all of our quantitative risk management signals for our clients six times a week here at 42 Macro. The current constellation of signals there in the middle of the page per asset class, sort of gives us a, I would say middling probability of continuing in this risk on type condition over the next three months. And then, when you layer that on with our fundamental research, which is what the broad, most of the content in this presentation addresses. So on slide 15, we summarize all that content, when you layer it on with our fundamental research, we believe this could be another really good year for investors. The probability of recession has diminished substantially and the probability of a soft landing has risen substantially. I don't think I'm cracking any eggs when I say that. But I do think it's important for investors to understand why those probabilities have shifted, because ultimately, that will allow investors have some confidence and faith on the sustainability of a bull run, continuation of the bull run that we call for.

Erik: Now, it sounds like you're mostly looking at sustained bull run, that scenario we talked about last time of that bull run ending and rolling over to a new bear market, is that still on the table?

Darius: You know, I would say the probability of it rolling over into a new bear market has also diminished substantially. So, you can make the case that, we probably were right for the wrong reasons in calling for the blow off top the last time we were on the program last summer. But ultimately, we run a Bayesian research process and a Bayesian risk management process. And the evolution of those signals, in terms of both of those independent processes, has pushed us into the soft landing camp for now. I'll be very clear to investors, I think it's very important that investors avoid pigeon holing themselves into either the soft knoll or hard landing camps. It's our job as investors to make and save money in financial markets, period. So at the end of the day, we're riding with the hot hand and the hot hand is soft landing, and we can unpack why the hot hand to me continued to be soft, the soft landing with respect to the medium term, intermediate term.

Erik: Darius, it sounds like there has been a change then in the sense that, you said recession risk is coming down. You're expecting that this bull run could last. So it's a much more optimistic outlook than we had last time. What's changed in order to improve the outlook?

Darius: Yeah, absolutely. So the number one thing that's changed at the margins is this big bump we've seen in productivity growth. If you go to slide 38, where we show on the top panel, productivity growth, the Fed funds rate in the second panel and the growth rate of government consumption and investment in the third panel, we see that productivity growth is popped up to an above trend rate. And the reason that's important is because, it's one of those elements that you need to actually experience a soft landing in the economy. That's what the green dotted lines in that chart indicate, the red dotted lines indicate a hard landing. And so, as you can see, we've only had two of the last nine tightening cycles since the Fed began using the Fed funds rate as the main policy tool, have ended in soft landings. So what has to happen actually, to have a soft landing? Well, you need to have above trend productivity growth coupled by above trend of fiscal stimulus and fit in a pit and a quick Fed pivot to rate cuts. And that's sort of what we're currently getting, that policy mix that we are currently getting now, with respect to the Fed funds rate, or at least with price in the money markets. And the current uptrend. fiscal spending, coinciding with this sort of above trend level of productivity growth, is creating a higher probability of a soft landing here in the US economy. If you look at slide 39, where we show our corporate profitability model, relative to the growth rate of NIPA corporate profits, corporate profitability model for those who are unfamiliar, it's the growth rate of nominal gross domestic income minus the spread between unit labor cost and productivity growth. And as you can see, we are moving in the right direction with respect to that green shaded area curve moving up in terms of corporate profitability. So that's taking pressure off of corporate margins, in terms of reducing the need for them to fire workers or pass on price increases from, through the lens of trying to maintain margins.

If you look at slide 40, where we show our corporate profitability model, overlaid with liberal corporate profit growth S&P earnings and S&P earnings on a max drawdown basis, we see that, this recovery in our corporate profitability model, which has historically led a big draw downs in S&P earnings. This recovery that we're observing in our corporate profitability model suggests that we're not going to see a big drawdown in S&P earnings. Slide 41 suggests we're not going to see a big enough drawdown in NIPA corporate profits, to expect the kind of mass hiring that you would typically need to see, as an investor, typically deceive the NBR to get excited about a recession. And so the kind of the key takeaway on all this is really on slide 42, where we show the spread and the blue line, the spread between unit labor. So it's a spread between wage growth and productivity growth, the red line shows headline CPI, and the black line shows core PCE and as you can see, we're kind of back to a more middling level, in terms of the blue line, which is historically been a leading indicator of, these big sharp fluctuations and inflation. And it makes a lot of sense, right? If you're paying your workers, the growth rate of what you're paying them far exceeds their productivity, you typically need to push the price increases through the economy, to protect markets, while the need for them to do that is obviously much lower now than where it was the last time we spoke. And so, these critical economic developments have all occurred under the guise of a more immaculate disinflation with respect to the inflation data. If you just quickly go to slide 35, we show core PPI overlaid with core CPI and core PCE, core PPI is back to a more normal level, which suggests that the more lagging components, of core CPI, core PCE, are likely to trend lower. Slide 36 shows the immaculate disinflation that we continue to observe in the core PCE time series, in so much that the three month annualized rate is one below the target and then lower than the six month annualized, which itself is lower than the year over year. So we know all those numbers are headed lower over the medium term. That's the same dynamic we're observing on slide 37, with super core CPI, which is core services x housing. So just to kind of summarize all that, the probability of a soft landing has gone up, it's gone up in the context of continuing to observe immaculate disinflation in the time series. And so, this is why the bond market, the money markets have really been correct in pricing in about-face pivot by the Fed, which are obviously, going back to that chart 38, we talked about would support a soft landing expectation in the economy. So in our opinion, I think it's a lot of good news, and we're going to get out these data points this week. And so, check back with us for that update, in terms of our subscribers, but for now, things are things are pretty good.

Erik: Okay, so it's basically a good news picture for investors. I know that your system is designed to break the economy down according to growth and inflation and basically make asset allocation recommendations, depending on which season we're in cyclically. What are your models telling you? Where should investors be allocating assets in the cycle?

Darius: Yeah, so, there are two elements of our process, in terms of how we use our signals and research to support investors. One, we run a systematic portfolio construction process. That's called our KISS portfolio construction process, where we show that on slide 11, that's the background on it. Slide 12 just shows the back tests, the sample back tests that were running live, and by the way, I use this KISS system to manage my entire liquid net worth so it's obviously doing quite well for our clients since its introduction. So the key takeaways, on slide 12, there are, in KISS, you can expect an average annual return of about 12% in this process versus an average annual return of about 6%, 8% for 60/40. On a max drawdown basis KISS is about -11% versus -22% for 60/40 and -26% for a trend following process, similar to KISS, that does not feature the risk management overlays that we introduced with slide 11. And so, right now, if you go to slide 13, where we show our current KISS portfolio construction, we're at 10% cash from 2% equities, 30% fixed Income and 10% Bitcoin, 83% of our max exposure in equities, we're at 100% of our max exposure in fixed income, we're at 100% of our max exposure in Bitcoin and only 10% of our max exposure in terms of cash. We do have some put premium on, in terms of all three of those positions. And again, it's only ever three positions.

So we do have some put premium on, expecting that we could potentially see some adverse outcomes and some of the important critical economic updates we're going to get this week, not the least of which is the QRA, which we can talk about the job support we are going to get tomorrow, on Wednesday, we're going to get the employment cost index, and Thursday, unit labor cost productivity, and then obviously, jobs report on Friday. And oh, by the way, we have five of the seven Magnificent Seven reporting this week as well. So there's a lot of information for investors to digest. And this is why we thought, from a discretionary standpoint, adding some put premium for an investor portfolio for a long-only portfolio made sense. But broadly speaking, we are generally bullish, and until one of our signals change, either the quantitative elements of our risk management process, or the fundamental elements of our research process change in a material manner, I do believe that we're going to be rewarded for maintaining this bullish posture, which again, we've had since January of last year. In terms of how other investors use our research so that, you know, we built our KISS, we're full of construction process really to satisfy the investment needs, and objectives of retail investors, and RAA type investors, investment advisor type investors. But we also have, obviously, clients all over the globe of Wall Street, across various different capacities. And we use our discretion investment idea summary on slide 14, as a risk management overlay for those investors. So you can sort of see exactly what our systems and our models and fundamental research process is sort of recommending across the various sectors and asset classes. And the key takeaway is that, it's broadly bullish, there's some obviously negative signals in there. If you look at the Japanese Yen or commodities, no position, but broadly speaking, this has been a good time to take risks. We've been right about that for quite a while. And it continues to be a good time to take risks, again, albeit with the caveat that we may get some data that changes that this week.

Erik: Let's talk about where we are in the inflation cycle. A lot of the fear was that the Fed might be having to try to cut rates but still be fighting inflation up toward the election. Do we have a risk that inflation is going to rear its ugly head before the election? And is that going to put the Fed in a difficult position?

Darius: Yeah, that's definitely a risk. We continue to see that as the, so if you think about this from a distributional standpoint, if there are three outcomes of the economy, you can experience based on the starting point: there's a soft landing, there's a no landing. And by the way, we'll define it just to help investors so that we're all kind of speaking the same language here. Soft Landing, in our opinion, just means there's a period of trend or below trend growth that allows inflation to decelerate without causing a significant drawdown in total employment or income, consumption, investment, all that good stuff. The hard landing, would obviously be a recession, everyone knows what that looks like, what it smells like. Then, a no landing would just be, growth stays at or above trend in a way that prevents inflation in the labor market from continuing to cool. Just as an aside, the reason we're calling it a macro disinflation is because it's typically not observed prior to a recession. I think we showed the slide last time we were on.

So Erik, on slide 60, in that deck, where we show inflation being the most lagging indicator of the business cycle. When you look at the relationship to that cycle, and all the different indicators that comprise the inflation cycle, they typically break down in about six to eight months after a recession starts, which is the most lagging breakdown, relative to the other elements of the economy, when you think about housing orders, production, profit, employment, etc. If you look at slide 61, the particular column that shows the evolution of core PCE prior to recession is typically flat up on the median basis. So all of the disinflation that we've observed, year to date, or really not year to date, over the last kind of several quarters, on that disinflation has been very immaculate. And so, when you think about the risk to the market regime, obviously being Goldilocks pricing in that rising and elevated probability of a soft landing, that threat to Goldilocks will either come from what we call inflation, which is at risk off regime with an inflationary bias, or deflation, which is a risk off regime with a disinflationary bias. In our opinion, we think inflation is more likely to be the next regime up, in terms of Goldilocks, whenever Goldilocks does, and we have a view that it's probably not going to end, at least over the next quarter or two. If it doesn't, in the next quarter or two, it's probably going to be as a function of the data we received this particular week. But again, we'll reserve judgement on that. In terms of, if I can show one more slide, if you look at slide 64, where we show median CPI, trimmed mean CPI, the median PCE deflator to mean PCE deflator, the core PCE deflator, and the super core PCE deflator, you're getting you know, sort of what I would call very positive news from the perspective of the PCE deflator elements of these underlying inflation elements, you know, median PCE deflator is at 2.8%. That's slightly above trend, three-month annualized were 2.3%, trimmed mean PCE at slightly above trend. We're right at trend, in terms of core PCE at 1.5%, lowest number we've seen since mid to late 2020. We're right at trend, in terms of super core PCE, in terms of the three-month annualized, level three with annualized rate, their lowest number we've seen since kind of late 2020 as well. But what worries me is that we are now moving in the wrong direction. In terms of the trend, the underlying trend, things like median CPI, and trimmed mean CPI and those numbers, are well above their respective trends at 4.6% and 3.4%, three-month annualized respectively. So that's something that is quite concerning.

We did a deep dive study on investing during the fourth turning regime last fall, and continue to update the data in that study on a live basis. And one of the key takeaways in that particular study, on slide 70 and 71, we show that inflation tends to be relatively strong and spike during fourth turnings. That's exactly what we observed. In this particular fourth turning, as well, we expect that dynamic to persist. And then you look at our secular inflation model, which you and I talked about two years ago, Erik, we were making the call that the some of the elements of inflation were in fact not transitory, and we were likely to see significant change to policy that back then, our cycle inflation model is still saying that the underlying trend of core PCE inflation has migrated about 100 to 150-ish basis points higher, relative to the prior decade. So we still believe that the inflation genie has not been put back in the bottle, it probably won't be truly put back in the bottle until we get to the other side of a recession. But as we started the conversation with, and continue to have a decent amount of confidence and the other side of recession could be a long ways away. And between the other side of recession, between now and the other side of recession could just be more evidence of a rising probability of a soft landing. And we need investors to understand that even if you're if you're bearish, you have to understand that it will pay to wait till you start to receive some confirmation, either from asset markets or from the data we're tracking both daily, six times a week here at 42 Macro, you need to get some confirmation that it's okay to be a bear. Because right now, we continue to think that the probability bears getting squeezed into the spring remain quite high.

Erik: A lot of people think that the rate cycle is behind us. And that peak rates, peak interest rates have already happened. Is that true? Are peak rates behind us? And if not, where could they peak?

Darius: Yeah, so we think rates have peaked for this particular business cycle, it's unlikely that we move back into a realm where nominal GDP is in the sixes are even higher than that. So in our opinion, you know, at around 4%, 4.5% in the 10 year Treasury is appropriately priced. Especially, if you look at this from the perspective of term premia, on slide 65, term premia, basically is flat after being deeply negative for much of the past decade. Plus, we had a nice pop into positive territory a few months ago, when we were having the bond market, and really, global assets sell off in the summertime, the summertime swoon, that unwind itself. So you can make the case that, bonds are fairly appropriately priced or fair prices they've been in quite some time. And so, in our opinion, we probably have seen peak rates for the cycle. But that does not necessarily mean that they're about to head down into material fashion over the medium term. Because again, we don't see that as the highest probability outcome either. Because we're not calling for a hard landing, at least not yet.

Erik: A lot of people are calling for as many as twice as many interest rate cuts from the Fed, as the dot plot is officially representing, what's your take? How many interest rate cuts do we get in 2024? Where do we end in terms of policy rates at the end of the year?

Darius: Oh, yeah, great question. So, I mean, I don't play pin-the-tail-on-the-donkey on policy rates, I think there's a lot more higher hanging fruit to pick off the tree, from the spectrum of managing risk. But on slide 34, we just show what's priced into money markets from the perspective of the policy rates. So for the Fed in the top panel, ECB, second panel, UK bank of England, third panel, the Bank of Japan, fourth panel, you know, over the next 12 months, we're pricing in about seven rate cuts, in terms of OIS curves out one year. So that's obviously quite aggressive, relative to the Fed's guidance of three rate cuts. We think there's a reconciliation process headed for us in over the medium term. And that reconciliation process won't be good from the perspective of risk assets, and is a big threat to the current Goldilocks regime. But in our opinion, that reconciliation process is not going to come out of nowhere, it's going to have to come from evidence of a no landing, rising at the expense of the current soft landing being the modal outcome. In our opinion, we have not seen any real hard evidence that no landing scenario is the highest probability outcome.

So, in our opinion, yes, what the markets are pricing in, again, from a rate cut cycle perspective, is aggressive. We think that there is a day of reckoning ahead of us. But again, putting on that trade today, it requires some very aggressive assumptions with respect to where productivity is going to be where unit labor costs are going to be, where employment costs are going to be and ultimately where nominal GDP is going to be. And I don't think we, as investors, have received enough information, new information from the economy, to suggest that those positive trends and all those sort of core underlying features of the economy have changed. And so, once we get evidence that something is potentially changing, and again, we're going to get a lot of data this week, once we get evidence that something has potentially changed, and our quantitative risk management signals, namely that global macro risk matrix that we talked about on slide 6 and slide 7, if those things start to change, they will start to say, hey, it's time to really think about booking some gains on this bull run that we've really, our clients at 42 Macro, have benefited from over the past year.

Erik: Darius, let's talk fiscal policy, we got about 10 months until the election, that's going to be an interesting ride, I think. What should we expect in terms of fiscal policy? And how's it going to affect the market?

Darius: Yeah, more good news. I mean, it's less good than it had been, you know, the fiscal impulse is definitely getting smaller, but it's still positive at the margins. So, if we go to slide 33, that's our fiscal policy monitor, that helps us keep track of different changes in the composition and size of different elements of the federal revenues and expenditures. So what we show is that, if you look at the year over year nominal Delta, of the federal budget deficit in 2023, it was up $364 billion, a massive fiscal stimulus, and that is actually smaller than it was in June, would have peaked out at about plus $834 billion year over year. In June, that number since trended lower, but it's still obviously a massive number. And so, some of the elements that drove that number higher throughout 2023, are unlikely to be repeated, certainly not to the same degree, here in 2024. And you think about things like individual income taxes, which are about half the federal budget deficit, they were down 16% year over year. And last year, thanks to California and in parts of Hawaii being offline, from a tax collection perspective, you get a cost of living increase adjustment of plus 8.7%, that inflated things like Medicare and Social Security, which are 14% to 22% of the federal expenditures, respectively, those things are growing plus 17%, plus 12% last year. They're not going to grow as fast as they were this year, as they did last year, yet net interest, which obviously the government is paying interest to the private sector, folks who own those bonds. And by the way, the private sector now is the dominant shareholder of marketable Treasury securities at north of 50% now, up from about 36%, in late 2021, you know, that we were growing net interest at about 41%, year over year, back to back years. And obviously, net interest being about 12% of the budget deficit is obviously one of these big factors that has contributed to, some of the resiliency in household incomes. We got the first part of the QRA today, this afternoon, if we look at slide 52, we haven't gotten the updated issuance composition yet that's going to accommodate 30 on Wednesday, this week, but we did get some insights in terms of how the Treasury is thinking about its immediate term borrowing path, and it continues to be very positive. And it's something that's very much in line with what our research has been signaling, since late October, in terms of the Treasury really supporting asset markets with its policy mix. So if you look at the Q1 2024 net marketable borrowing estimate of $760 billion, that's down $19 billion, from the estimate in October 2023 QRA, if you look at that marketable borrowing estimate for the second quarter of this year, that's all the way down at $202 billion, that's $558 billion Delta on a quarter over quarter basis. So, if you're bearish on liquidity dynamics in the economy, it's definitely not going to come from the treasury, at least not over the very immediate term.

If you look at slide 51, we show the elements of our net liquidity model, that balance sheet minus TGA, minus RP, the model that Morgan Stanley made very popular across global Wall Street, but that's neither here nor there. The elements of that model, we're talking about the TGA getting down to $750 billion, and sticking there by the end of Q1, sticking there for Q2. So there's obviously some dry powder from the perspective of both the RRP, in terms of the Janet Yellen and her friends continuing to tap that as a source of excess demand for T bills, relative to coupons. And there's obviously about 70-ish billion dollars, or $80 billion there abouts of excess TGA that needs to be spent down into the end of Q1 or Q2. And oh, by the way, they're likely to announce something on the order of the Treasury buyback. We're going to get information about that this year, and when they're going to start that program, as well as they're talking, Lorie Logan, a Dallas Fed President, Lorie Logan floated the idea of tapering the Fed's so-called quantitative tightening program. Now, the Fed isn't doing quantitative tightening, you and I both know that they're doing balance sheet roll off because they're not selling bonds into the market. But that's neither here nor there. What really matters is to asset markets is, are these dynamics getting better or worse at the margins, and at the margins, they continue to get better from the perspective of US and global liquidity. And final slide, just the final thing I'll say on global liquidity, the impulse is appreciably positive for the second consecutive month, we show that on slide 48, our global liquidity proxy, which is the global central bank balance sheet, global broad money supply and global FX reserves minus gold, that number is appreciably positive over the next couple of months. And if you look at slide 49, complicated chart we don't have time to explain here now, but the key takeaway is that we should expect the elements of global liquidity that are being driven by private sector, private market participants of those elements are likely to continue trending higher over the medium term, absent some material change in this discussion around macro disinflation, absent a material change and discussion around the rising probability of a soft landing in the US, and absent any material change and some of the green shoots that we're observing globally, from the perspective of global economies, which we can touch on.

Erik: Darius, let's move on to China. But before we even get into the Chinese data, I want to start at a really high level, which is, tell me how I should be thinking about China. Back in earlier in my life, the best way for an American to think about China was as a vendor, that was the role of China in the global economy, was to build stuff and sell it to us through Walmart. What should we be thinking? Is China a competitor? Is China a rival? Is China still a vendor? Who is China to the West? And how should we be thinking about them and their role in the marketplace?

Darius: So, China is increasingly a rival to the West. It's broadly uninvestable from the perspective of long term capital allocators. We kind of reiterate that view, we authored that view, going back to February of last year, we were telling investors to sell China and liquidate their China and related holdings. And that was obviously a great call and then calling for, you know, US exceptionalism is exactly what we have seen and continue to see globally. But, with respect to China, from a cyclical standpoint, we do believe that China is viable for a trade. Now, I don't ever feel comfortable telling anyone, with their own money or their clients money to go buy a share of a Chinese company, I guess you're not really buying what you think you're buying. But I do believe that, China proxies, particularly in the commodity space, certainly have upside risk over the medium term. So, we'll kind of just walk you through our thesis on that. So on slide 131, where we show total loans of financial institutions in China, and the year over year growth rate of fiscal expenditures in China, we just use these as proxy for Chinese catch all proxies for Chinese policy, most Credit Allocation in China is administrative, in terms of the targets that the PBOC sets for various sectors of the economy. And then obviously, the fiscal expenditures coming directly from the government itself, what we see is that credit growth and the fiscal expenditures growth tends to peak in Q1 on a calendar basis in China. So that typically means that Beijing typically front loads policy support. And so that's exactly what we're seeing. If you look at slide 132, this is the third consecutive month, the China liquidity impulse has been appreciably positive, hasn't really done anything for the Chinese economy, but it's certainly supporting global asset markets vis-a-vis global liquidity. And again, just for those who are investors, who are familiar with our work on liquidity, China liquidity proxies, that's the PBOC's balance sheet plus broad money supply in China plus China's FX reserves minus gold. If you look at slide 131,133, the PBOC continues to flex its balance sheet to push both broad and targeted stimulus into the real economy. So, we're just showing all the various tools and levers that the PBOC uses to enact Chinese monetary policy vis-a-vis repo rates, medium term facility rates, the loan prime rates, the reserve requirement ratio, which they cut last week, effective next week, about $139 billion of incremental fresh liquidity being pumped into the Chinese economy, Chinese financial sector. And then on the bottom panel, we show our China liquidity proxy, PBOC balance sheet PBOC FX reserves on the PBOC balance sheet. So the key takeaway here is that, a lot of those black lines in these charts, whether it be the auto lending facilities of the Chinese, the PBOC, is implemented at about $2.6 trillion, numbers are going straight up. If you look at the supplement, supplemental lending, right around $500 billion, that number is going straight up. If you look at reserve requirement, so that number is going to come down in terms of the cut to the reserve requirement ratio, and in aggregate, the Chinese PBOC balance sheet continues to grow, it's at about $6.4 trillion. So, the PBOC continues to push liquidity into the Chinese economy.

If you look at slide 134, a lot of investors are concerned that it might have an inflationary impact. And I would suspect that, you know, just more headlines around this information and also the fact that a lot of this liquidity is likely to wind itself up across borders from a fundamental eligibility perspective, you're going to see, it's very likely we see medium term appreciation in commodity markets, but probably not the kind of, the big boom blockbuster appreciation that will get investors very nervous about inflation. And the reason I say that is because we're likely to see offsetting Renminbi depreciation as a function of that. This chart here on slide 134, shows the PBOC balance sheet foreign exchange reserves. The red line shows the PBOC balance sheet total assets. And you can see the foreign exchange reserves are at about 40% of the PBOC balance sheet, down from about a peak of 83% in March of 2014, you know, once the Renminbi really started to breakout on a real effective exchange rate basis, you really started to see capital outflows and persistent capital outflows in the Chinese economy because ultimately, what's happening here, you know, China Inc, is not generating enough of those current account flows to inflate the money supply in China like it used to. So a lot of the money supply inflation that we've seen in China since 2014, over the past decade or so, has really just come by the PBOC. flexing its muscles and flexing muscles is obviously disinflationary and so, if we continue to see depreciation, that's obviously a disinflationary force for the global economy and positive for risk.

So if you look at this from a cyclical standpoint, Erik, Chinese growth has stabilized, what we show on slide 135, just showing the composite PMIs for the US, eurozone, UK, Japan, China and the global economy, it's green shoots globally. There’s no economy, no major economy that's slowing at the current juncture, and most of them are starting to trend higher. Now, we're not calling for a material, big surge in global growth that investors need to get all horned up about, but certainly think stabilizing globally, relative to some extremely muted expectations over the medium term could create an upside trade for ,again, global commodity prices and, you know, progress, emerging market type exposures. We're never going to be, hey, you got to be overweight, emerging markets. You know, I think that calls dead in the context of some of the AI development we're seeing here develop domestically, but I do believe those things could have some positive absolute returns.

On slide 136, the evolution of consensus estimates for Chinese growth, those numbers are quite low relative to the official targets. So you can see some upside momentum develop in those numbers over the coming months. Again, we're not calling for a big raging boom bull market in China, we're not even calling for Chinese growth to really materially inflect higher, we're just saying that they're going to front load policy support, and investors need to be aware that they’re front loading policy support so they expect liquidity to trend higher globally, as a function of Chinese liquidity and expect more positive headlines, at least over the medium term. Now, broadening this out, Erik, I mentioned that China was extremely investable from a perspective of a long term capital allocator. And there's a few reasons why. On slide 137, we just showed China's poor demographics, just showing the five year for old age dependency ratio relative to the working age population ratio, that five year for CAGR, you know, China's just in no man's land for the setup of its demographics, relative to other emerging market economies. China is among the worst credit cycle dynamics of any major economy. On slide 138, where we show the five-year Z score, the non-financial sector credit to GDP ratio, and the non-financial sector debt service ratio, both those numbers are way too high to expect no significant rebound in the Chinese economy or a sustained rebound in the Chinese economy. If you look at slide 139, where we unpack the debt, the credit to GDP ratio on a time series basis, China's got the world beating private sector debt burden, that's going to be a problem for Chinese economic growth for a long time, in the context of slide 140, where we show China's debt service ratio. China's debt service ratio at about 21% means one out of every 5 Renminbi of gross domestic income growth is going to service debt. So this is what we mean by the liquidity trap that we called for in China, China is pushing on a string from a policy perspective. And we can see a hard evidence of that on slide 141. If you look at the China credit impulse, that's the black line in this chart here. You know, you go back and look at the previous cycles, China credit impulse typically rises very sharply in response to kind of cyclical monetary and fiscal policy in China. But we have not seen that in this particular cycle. In our opinion, the reason we have not seen that is because of this liquidity trap dynamic that we called for back in February 2023, is obviously, was the right call in terms of getting investors out of long China into to potentially short China into short related assets. So, I think it’s a complicated question, Erik. Certainly, I do believe that China creates a tailwind for asset markets over the medium term, but from the side of Chinese assets, I mean, it's going to take a lot more policy structural reforms, which we believe that are unlikely to be implemented in the near term, to get investors truly excited about that particular risk.,

Erik: Darius you just did a deep dive on China's balance sheet dynamics. Do you have the same data for the US? Can we do the same deep dive on US balance sheet dynamics?

Darius: Oh, yeah, absolutely. So, it's been featured in these presentations every month for 42 Macro clients, since going back to the summer of 2022. And we authored the resilient US economy theme that got bears ran over, or got steam rolled, rather, in 2023, in about a way where we were bullish, bearish, you know, we go both ways here at 42 Macro. So when I poke fun at bears, it’s just taking in good spirits. At some point I'll be poking fun of bulls. So it is what it is. But just getting back to this balance sheet question here, if we show slide 17 in that deck, where we show household balance sheets being flushed with cash, so we're showing here in this chart, top panel is the total amount of cash on household balance sheets and that’s comprised of checkable deposits and currencies and money market fund exposure and 5% of total household assets. households have not had this kind of share of cash or this kind of stock of savings of cash, since the 1950s. So that's obviously quite positive. When you look at US balance sheet further on slide 18, the third panel and fourth panel there, draw your eyes to those panels, household debt, the nominal GDP is at a 73.7%. And most recent print, obviously, well lower than what it was in prior business cycles. So definitely some room for the household sector here in the US to lever up if they want to spend more and extend the business cycle, household debt service ratios, an effective all-time low of 9.8%. So obviously, very, very favorable dynamics from the perspective of the US household sector. So quite the opposite of what we're seeing in China.

If you look at this on the threat of corporates, on slide 19, where we show corporate balance sheets, those are flush with cash as well, same similar ratio in terms of total cash divided by total corporate assets. That's about 5% highest ratio we've seen since going back to the mid 1950s. If you look at corporate floating rate debt, for instance, divided by their total debt, only 33% of the total, much higher, you've seen significantly higher ratios going back previous business cycles. And then lastly, on slide 20, where we show corporate debt, the nominal GDP, that ratio in the third panel and the corporate debt service ratio in the fourth panel, 76.5% and 41.5% respectively. You know, we're not at levels that will get you really concerned about the sustainability of the US business cycle and really the long term outlook for generating profits and generating economic output, generating productivity here in the US economy, which is why, in our opinion, the US exceptionalism story is not dead. Everyone wants to get you to go buy small caps and everyone wants to get you to go buy your favorite cousin's emerging market economy, because everyone's trying to play catch up from, you know, not listening to 42 Macro in 2023. But the reality is, a lot of the things that have created the US outperformance are very much stable and likely to persist from a balance sheet perspective. And so that's why we started all of our presentations, since the summer 2022, with these balance sheet dynamics to help investors understand the resiliency of the economy. So, I think if investors aren't doing this kind of deep dive analysis on the economy on, six days a week, I highly recommend they partner with somebody that is, because again, understanding this information is the difference between getting steamrolled for a year and actually making a ton of money. And obviously, our job is to help our clients at 42 Macro make a ton of money.

Erik: Well, Darius, I can't thank you enough for a terrific interview. Before I let you go, tell us a little bit more for people who do want to gain access to this incredible slide deck that you have. It's not just a one-time thing for 42 Macro subscribers, they can get updated versions of this every single month. And you also do regular newsletters and other publications along with us. Tell us about the suite of offerings that are available at 42 Macro

Darius: Well Erik, I appreciate that and as always, a pleasure, thank you for having me. You know, I hate wearing the sales guy hat but obviously got a family to feed and employees to pay. So you know, I'll just say, look, like I said, we do research like this on a regular basis at 42 Macro. This particular slide deck is our January 2024 monthly macro scouting report, we publish that the beginning of every month. We also at the end of every week, on Saturday, we publish a weekly webcast called *Around the Horn.* That's a much more condensed short version of this with respect to and really focused on what investors should be doing from a risk management standpoint in asset markets. And then daily, we write about each of these dynamics in our leadoff morning note that's chock full of slides as well. So if you think about our leadoff morning note, is like a daily version of connecting the dots between each monthly Macro Scouting Report and every weekend, we update investors with Around the Horn, so come check us out at 42 Macro. highly recommend it. One of the best investments you make from the perspective of managing risk and also from this point of learning more about how these critical economic dynamics work, because if you don't do macro, macro will do you. I think investors have learned that lesson the hard way in the last few years.

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