Mike Green: Inflation Is Dead? Can You Buy Commodities Anyway?

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Erik: Joining me now is Mike Green, chief investment strategist and portfolio manager for Simplify Asset Management. Mike, it's great to get you back on the show. It's been too long. I want to start with this whole question of inflation and monetary policy. Jim Bianco really got my attention with a tweet thread he had up last week where he said, hey, I think maybe inflation has already bottomed and is about to start increasing. And, of course, the consequence of that could be, or at least I think the consequence of that is, just about everybody in the market is, in my opinion, very complacent and feeling that it's a certainty. We just know now that there's going to be rate cuts, the Fed said there was going to be rate cuts, there have to be rate cuts, especially in an election year, the whole, you know, 2024 is going to be punctuated by rate cuts. What if the data told the Fed to go the other direction, and we had rate hikes between now and the election? Feels to me like nobody's positioned for that. Is that a risk? And should we be thinking about that?

Mike: Well, I think it's always a risk. But I think it's important for people to recognize that, that actually is a priced risk, right? So, if I look at the options surface, in the SOFR futures, which would be the way the mechanism that you would typically use for trading those types of expectations, there's about a 15% chance priced in currently, that the Fed will actually hike rates at some point this year. Now, that's heavily skewed. Let's be really clear about that. That's heavily skewed towards rate cuts. But the cone of possibility is there for rate hikes. And I'm not really sure that I agree with Jim that it is, as ignored a prospect as he is indicating, I think there's a general consensus that inflation has retreated. And it is likely to head towards the 2% goal that the Fed has articulated. I think there's an awful lot of conviction that there are multiple waves of inflation that will carry through, and that that's going to be a much more challenging path. But a lot of the discussion is around, is the right answer 3%, not so much as the right answer 9%. So I think 9% would clearly surprise people, I think that's, you know, return to the high levels that we saw, or in a repeat of the 1970s, even higher levels. I think that would be a catastrophe for markets in terms of expectations. I just don't share Jim's conviction that that's what's actually happening. I think he's misreading the data.

Erik: Let's imagine that we had a second "hot" inflation print in a row and to be clear, this last "hot" inflation print, you know, hot in air quotes there. It wasn't all that hot. It was, you know, oh, 0.1%, above what the consensus expectations were. Suppose we had another one like that just to, you know, a slightly hotter than expected print, and the market starts to come around and realize, oh, okay, maybe, maybe even if we are headed to 2%, it's not going to be a straight line, and we're about to see a bounce in inflation here. Does that cause a panic? Or is that just kind of a, shrug it off, not a big deal?

Mike: Well, I think it depends on two separate components. I think that there is a growing element of panic within areas of the market that I think had managed to convince themselves far more so than market participants, that rate cuts were imminent. I would suggest that those that are in the real estate space, particularly in commercial real estate, are looking at their portfolios, and basically begging the Fed to start cutting because they know that they really can't afford these current levels of interest rates. And unlike the corporate sector, those rates are currently in the process of being renegotiated; the lines of credit, the construction loans, the underwritten mortgages, etc. On the commercial real estate, those are all coming back up for refinancing. And the really key thing is, is going to be the appraisals against that many of the businesses, many of the owners of commercial real estate are going to be forced to come up with actual checks to pay down the loan to value ratios. And they're just not in a position to do that.

Erik: Now, there's an alternate interpretation of this whole thing, which is not super popular, but I find fascinating just the same, which is some people have said, look, what's really going on? It's not so much that the Fed is reacting to inflation signals the way they say they are. It's more the case that they know that Treasury is going to have to float an incredible amount of new T bill issuance this year, because of all of the excessive spending and so forth. And the government just can't afford these kind of rates, they've got to cut rates, whether it makes monetary policy sense to do so or not. They've got to cut rates in order to essentially, give the Treasury sweetheart pricing on all of the paper it has to issue. Is there any truth to them?

Mike: Oh, I think that there's unquestionably a dynamic around the increase in supply, putting pressure on rates and potentially creating conditions under which demand is not met. I think that was much bigger story in the third quarter of 2023, were what I would describe as sticky portfolio allocations, people unwilling to change their 60/40 allocation to a 50/50, based on the relative attractiveness of equities versus bonds. I think we saw signs that in the fourth quarter of last year, that that began to change in a fairly meaningful way. Many sponsors of corporate pension plans, for example, realized that they had an opportunity to defeat their obligations, and simply walk away from these components by matching liabilities against the earning assets. That seems to have broken the back a little bit of this, where are we possibly going to find the demand. And since then, we've had better statistics in terms of auction participation, etc., than I think many people had anticipated.

Erik: I want to move on to the subject of passive investing, something that you've written a tremendous amount about. And I don't just mean the strategy of passive investing, but its systemic effects and the risks that it creates on markets overall. When you started writing about this, I couldn't help but think to myself, Mike makes really great points. But you know what, the fund flows just show that, the passive flow is not stopping. It's still coming. It's still coming. It's still coming, whether it's good or bad. There's just this this ongoing, passive inflow into markets, whatever is driving it, I don't know. But it's driving. It seems like maybe that's changing. What's going on?

Mike: Well, I think that there's a couple of things that are happening. I mean, one, there's a very influential last interview that was done of David Einhorn, very recently by Barry Ritholtz on his Masters in Business podcast. I encourage, I know I'm on a competing platform so I don't want to over encourage that, but I do think it's actually a very powerful interview, that begins to talk through some of the dynamics around how he saw the market change. A lot of people have focused on this idea that he claimed markets are broken without actually understanding what he was highlighting, which is this dynamic, but markets are designed to seek out value or attempting to discount the information to place the right price on almost every security, so that the returns are largely similar across them. In other words, it's like horse handicapping, right? We're trying to put more weight on to more weight, meaning it's more difficult to outperform to the best companies and less weight on the other. And what he's articulating is this, he's just not seeing a lot of evidence that that's actually happening. I think that's true. And I think that there's a growing awareness that there are distortive impacts of passive and in particular, the academic literature is beginning to explode around the fact that market cap weighting does not equate to the same thing as liquidity weighting, or market impact weighting. And just to emphasize that, if you think about a company like an Apple or Microsoft, which are currently in the neighborhood of about 7% of the S&P 500, if we think about $1,000 going into an index fund, that implies $70 is going into Apple or Microsoft. On the flip side of that equation, if I think about a small stock within the S&P 500, let's just randomly pick out Delta Airlines, for example, it's going to be like, about a penny and a half, maybe 20 cents, it's going into Delta Airlines, the distortive impact of that $70 versus the few cents, is actually quite significant.

And this is highlighted in academic papers by Valentin Haddad or by Zvi Gabbay. And Ralph Koijen, Ralph Koijen has written other papers on it. The underlying dynamic is, is that a more distortive impact is happening at the largest companies. And paradoxically, that means as money flows into passive, it's pushing the largest stocks to outperform. David highlighted another metric, another component that I highlight all the time, which is the redemptions that are coming out of the market, the negative flows that are coming out of the market, are almost exclusively happening amongst active managers, those active managers tend to overweight small and value. And what that means is, is that they have painstakingly crafted portfolios of names that they like and love, and they think should be worth more, are actually being sold out from under them, pushing the pressure down. And that's what David's highlighting, when he talks about markets being broken. And I completely agree with his analysis. I know that he was influenced by my analysis, so it's not surprising, but this is very consistent with the data that we're seeing. And I think it's important for people to recognize that the narrative is starting to appreciate this change. If I think about when I started talking about this nearly eight years ago, people would largely dismiss it. They say that can't possibly be true, market cap weighting is the way to go. The awareness that there is distortion occurring is growing and increasingly accepted. Almost everybody I interact with now says, well, yes, I accept that they are influencing the market, but it now becomes a question to the trade-offs. Is it more important that we have a non-distorted market? Or is it more important that people are able to access low-cost asset management services? And unfortunately, I would emphasize that the market is ultimately more important for us. We try to be a capitalist society and market is about establishing a cost of capital and allocating resources. It's not about guaranteeing a return or offering you low-cost retirement savings. That's not what markets are supposed to do. We're asking him to do too much. This, by the way, is a quote, you know, Jim Bianco graciously gave me credit for that. But that is an area where Jim and I both agree, like we're just asking markets to do too much.

Erik: Well, let's talk about what the specific risks are. Because, we can say it's kind of crazy to have this whole business, where the idea is, we take your money, you pay us to basically invest your money for you. And then we take great pride in advertising as a feature that we don't think about it before we invest your money, we just, you know, passively invested in the market without thinking. And that's a feature, which is kind of an interesting thing. But what does it mean in terms of, you know, what's the mechanism of how this blows up someday? If we get this distorted market, does it eventually correct, where everybody realizes, oh my gosh, we've overweighted, all of these largest cap stocks, they're all overvalued, small cap is all undervalued, and there's like a crash down and a crash up on the same day? Or what happens?

Mike: So unfortunately, I don't think that all can be used in any of this analysis, right? Not everything is tied to passive, not all the data that we're seeing is influenced by this. There are fundamental reasons why some companies are outperforming, clearly Nvidia's results have been spectacular, they do deserve for their share price to rise, it just becomes a question of, are we properly pricing that outcome? And what are the implications associated with it? I'd also slightly characterize the Vanguard or passive approach slightly differently. It actually reminds me, remarkably, of the language I heard around Madoff in 2005, 2006, which is this dynamic of, wink wink, nod nod. We know he's not actually doing split strike options, we assume he's trading ahead of his clients. So effectively, front running the orders that he receives through his trading, through his brokerage firm. Like, I think there's something very similar in the passive dynamic, right? Wink wink, nod nod, why pay for the services of active management? Or why really try to beat when you can be a free rider on the system and outperform, because you're paying less than everybody else, right? It's a very much kind of insider, this is what all the smart people would do. Don't be one of those rubes who gets caught up in the dynamics of trying to outperform for active management. I've started trying to frame it for people in the context of a web 2.0 language we use, if you're not doing the work and you're not paying for the product, you ARE the product. What they want is your assets and they're marketing to you. And you know, there's an interview that I did of Bob Pisani where he waxes philosophically about, how wonderful John Bogle sounded and how he sounded like John Bogle and how he gave him information about things. And I just said, Bob, you do understand he was selling you. And he was horrified to say, how could you say that about John Bogle, right? How could you say he was marketing to me, but that's what he was doing. He was selling Bob, and he was a master marketer.

Erik: I want to come back to something you said earlier about commercial real estate and its vulnerability to rates and especially, if rates were to hike as opposed to cut from here. I hear that the risk in commercial real estate, which seems pretty darn significant to me, is contained and anytime I hear the word contained, I think back to Ben Bernanke telling us that subprime was contained. Is commercial real estate risk, a systemic risk that we should be more concerned about than people are? And are there other risks that are supposedly contained, where “contained” as in air quotes, and doesn't really mean what it sounds like?

Mike: Yeah, I mean, I think that's a really challenging one, right? So, the whole subprime is contained, remember that the housing market broke in 2006, it really started to crack in 2005. With the spiking gasoline prices that made it unsustainable for people to drive an hour and a half to work each way, they effectively discovered they were paying far more for an exurban home in total costs than they were for something closer to their work. That led to the abandonment of the wholesale buying of low value exurban type properties, and started the collapse in the housing market is March 2007, right? So almost 18 months after that point that Ben Bernanke announced the subprime was contained. And in fact, we had had interest rates, the Fed funds rate, the last hike was in May 2006. So, we were a solid, you know, give or take 10 months into the pause process, before Ben Bernanke actually said that. Within a few months after that statement, by August of 2007, we began to see the dynamics of what was initially referred to as the *quant quake*, where we discovered the positions were over levered and too crowded. And the markets began to vacillate, the Fed began cutting interest rates and found itself cutting all the way through 2009. I can't possibly know that this is going to be identical. But it does feel, from the language that's out there, that CRE is contained, commercial real estate is contained. The Bank of England has now come out and said, we think 70% of the impacts of the hikes are already through the system. I just think there's no way you could possibly say that, because we haven't actually seen the refinancings, we haven't seen the transactions. We effectively have been doing the opposite, or not quite the opposite, of extend and pretend, which was the language from early 2009, which was basically, let's not make things due.

This time around, you have, I can't be catchy and think of it but it's effectively something like avoid and pray, right? Let's not refinance, let's push ourselves to the absolute end to see if we can get some optionality here. And maybe if we're lucky, other people will start to fail first, and the Fed will be forced to cut rates, giving us some protection. That's kind of what I think is happening. What we're seeing, we see this in high yield, we see it in commercial real estate. I would argue that it's a critical component of Americans’ unwillingness to shed their 2.75% mortgages. They know they can't really afford their existing home at a 6%, 7%, 8% mortgage in some situations. So they're doing everything they can to avoid triggering that dynamic. The hard part with recessions is that they forced those choices forward. You lose your job, suddenly, really doesn't matter what the interest rate on your home is, you might be forced to sell it. You need to relocate for work, you might be forced to sell that house. The supply, in turn, begins to increase. I think we're early in that process. But we are at that point where, believe it or not, as much as everybody wants to argue in the opposite direction, unemployment is starting to tick up. We are beginning to see the more vulnerable elements of society, particularly those at the lower end, begin to experience the classic cyclical rising of unemployment, that I think people are just desperately trying to say doesn't exist out there. But it clearly does.

I think the other component is really interesting in this is, what you have to watch for is beginning to change in a very meaningful way. The level of unemployment compensation is so low and so intrusive. In many regions around the country, California would be a great example, Florida would be another one, where the level of compensation is so low that people aren't even bothering to file for unemployment. Instead, they're saying I've got a car, I've got to pay way too much for the payment on this car, I might as well use it to drive for Uber. And so, if you look at the last two earnings reports from Uber and Lyft, they both are using the same language: driver availability is increasing. You can interpret that as a very positive metric if you're an Uber investor. But if you're a macro investor and looking at the status of the US economy, you have to acknowledge that full-time employment has fallen, that people are increasingly forced to seek out that second job to allow them to make ends meet. And something like an Uber or Lyft is a fantastic resource for a limited number of people, right? The system can absorb x increase in people, before it, in turn, begins to impact the incomes associated with all the other Uber drivers. And then you go a step further and recognize that, if unemployment rises, enough demand for Uber starts to fall even as the supply begins to rise. And that system really can't function as the unemployment insurance. But it's doing a great job right now of concealing a lot of those dynamics.

Erik: And let's talk about commodities in general. A lot of people have said, Okay, new commodity supercycle, it's all bullish from here. But at the same time, you know, we are looking at least for now, a contracting inflation. Where do you see commodities headed, and particularly with respect to the changes, now that we're starting to see structural backwardation in a lot of commodities, you're getting a positive carry that makes it more attractive. How do you see the commodity markets in general evolving from here?

Mike: Well, I think you just hit on a really critical point. So where I disagree with a lot of people in the commodity space is, I'm not at all convinced that we have a big bull market of commodity investing ahead of us, where spot prices rise significantly. In general, that tends to be associated with a significant fall in the US dollar. I know that there are people out there that think that that's imminent. The challenge, of course, is if everything we talked about, that theoretically the Fed could delay cutting rates, if I look around the rest of the world, it seems that the odds are higher that the rest of the world would want to cut rates before the US, all else being equal. New Zealand is an interesting one, because they've gone in the opposite direction. And we can talk about that if you want. But I don't think that we ultimately want to rely on New Zealand as the guide for monetary policy for the entire world. But there is actually a really significant change that has happened that I think makes commodity investing interesting, regardless of your belief of the change in spot prices. And this is a substantive change, right? So I wrote about this, this past week in my substack. And if you go back and you look at 2004, 2005, there was an academic paper written by Gary Gordon, currently at Yale University, called *Facts and Fantasies of Commodity Futures*, that white paper kicked off a boom in ETFs. And investing in commodities in the institutional space, that in many ways is not dissimilar to what we're seeing in private credit or private equity today, or even Bitcoin to be quite candid. The flow of funds into the commodity space, change the forward curve. So we actually suddenly went from markets where you could buy commodities, with a lower price into the future and carry positively as you move towards spot, what has traditionally been called the convenience yield associated with commodities. That was, by and large, responsible for the vast majority of returns associated with commodity investing, alongside the levels of higher rates themselves. Because again, remember, with a commodity and a commodity future, you're not actually paying cash, you're typically collateralizing it against treasuries, so you have a combination of the Treasury yield, and the carry associated with it. That now looks really attractive.

We're actually at a point where that backwardation, in many markets, is significantly better, the carry yield over the next year is more attractive than it was prior to 2005. That means it's possible to invest in commodities and make money without having prices, spot prices move to an extraordinary degree. And I know that's nowhere near as sexy and exciting, as a spot price move that takes copper to $27 a pound. But the simple reality is, that's historically been the real source of returns associated with commodities. And I think that opportunity is wide open again. On the flip side of that, I think that, this general fear that we're in, you know, another commodity cycle is just increasingly being disproven, the supply response that came out, even at modestly higher levels of oil prices in the United States, and the requirements from Saudi Arabia to cut production and things like oil are actually evidence of demand side of the equation. It's not nearly as strong as people thought it was, unfortunately, PR on Iran saw that in spades and 2023. If I look a step further actually, and ask, what are the implications of this? Ironically, it actually feeds back into the inflation discussion that we had at the start, and not in a way that a lot of people appreciate the way the BLS calculates rent. And the rental component of the CPI is, they actually note that a portion of most rents is the utilities that are included. So often, if you rent an apartment, it will include things like heat. Well, that's paid for by natural gas. And so when natural gas prices fall, that's actually treated by the BLS as an energy services component, a utility component of housing, and stripped out. So when natural gas falls as aggressively as it has. perversely, that means that even if the rent didn't change, because you're paying less, or you're receiving less value for the embedded, included utilities, that shows up as a fairly significant increase in rents. It sounds crazy, I understand that. But that's actually how it's calculated. And if you then go a step further, and you look at something like core CPI, when you do core, you're stripping out all those energy services, and you're concentrating it in the remaining components. What I actually think has happened is that bounce in owner’s equivalent rent, that Jim and others are pointing to and saying, oh my gosh, it's the return of inflation monster. Ironically, I think that's actually prices falling in the energy sector that's really driving that dynamic.

Erik: Let's talk about gold specifically. When the Fed pivoted and said okay, well, you know, the dot plot came out and said there's going to be rate cuts in 2024. Something I noticed was quite a few people, you know, the blogs and so forth on the internet, we're kind of saying, okay, the new narrative is: for sure, the cuts are coming, this has to be the year that gold breaks out through its new all-time highs. And when it does, that means if you just extend the target on the cup and handle pattern, you're looking at $2700, $2750, just around the corner. It's, you can't lose, it's time to lever up gold, because you know, it's coming for sure. Anytime anybody talks about anything coming for sure, I get really nervous about things going in the opposite direction. What could go wrong here for gold?

Mike: Well, I think there's a couple of things that you highlighted. One is obviously a repeat of the dynamics from 2008, which is that, it actually turns out that credit spreads widened dramatically. Gold is a funded entity, as we were just talking about with futures. You know, it's always a question of, can I provide the capital to hold the position that can sell off? I do think that gold is interesting, I think there's a couple of things that are probably going on there. One is obviously Bitcoin, is now competing with gold under the rubric of digital gold, I think there's some evidence that that competition has lowered the value of the responsiveness of gold. And we'll see if that ends up playing out in the cycle that creates some risks. The bigger one that I'm more focused on is actually the deflationary pulse, the risk that we're looking at a credit event, and that, unfortunately, is consistent with what we're seeing in the dynamics we were talking about before of, kind of this, avoid and pray type dynamic we're seeing in the credit markets.

Erik: Mike, let's come back to inflation and go into a little bit more detail. You know, not many people really pay attention to the difference between headline and core inflation and things that are adjusted out and so forth. Give us a little perspective on the difference between inflation indicators, you mentioned Truflation earlier, how that compares or differs from the BLS data and what investors need to know about that.

Mike: Yeah, I think that's actually a really interesting one. And I would encourage people to check out the Truflation website, I have no affiliation with them, other than being friendly with the founders, and occasionally offering them my thoughts and perspective on things. If you look at their website, and you look at their CPI dashboard, you'll see this pause in progress towards disinflation, housing was a big component of that. And I think that there is, of course, a very broad recognition that the housing markets are stronger than people had anticipated. But that consolidation, which could have led to a discussion around, is inflation rebounding, has now definitively resolved itself lower. I think that that is actually, unfortunately, the direction that we're going to see ourselves going. And the Fed choosing to pause and wait, is creating conditions, I think that actually reinforce that.

The dynamic that I was highlighting with Truflation is twofold. One is, firstly, they're much closer to the PCE metric than the CPI metric. So that largely involves a lower weight to the housing component, then you have in the CPI, and the CPI, it's about 40%, of total CPI, it's 38%, I think it is, versus only about 25% in PCE. If I go to something like core CPI, remember what I'm doing in core CPI is, I'm stripping out many of the things like gasoline prices, et cetera, that makes somewhere up around 15% of the basket, and further concentrating it into that housing sector. So I've got this, you know, giant housing number that has been created, ironically, by falling prices in natural gas, or the utility component that perversely is leading to this data that says, oh my gosh, prices are exploding, again to the top side. I just don't think there's any evidence for that. And if we look at the private sector components, which again, Truflation is really relying on, they're using data that's coming from various published sources on the Internet or elsewhere. We are seeing data that is much lower than what the Fed is arguing.

Now some, again, people argue, single family versus multifamily, is their worst trend in multifamily than single family? Absolutely, that's absolutely true. But the single family itself is not running at the six type percent that we're talking about. Even the most ardent proponents of higher expected inflation would point to single family being more like 3% to 4%, which is roughly in line actually, with what the housing sector was producing prior to the 2020 cycle. The last thing that I would just say about the Truflation type dynamics is, they are not trying to hedonically adjust. They are trying to capture things like shrinkflation, they may not do it perfectly, but they seem to do a pretty good job from what I'm seeing and from what I understand of their methodology. And so, I think it's very frustrating for people to hear the language that inflation is retreating, even as they're looking at their grocery bill that is significantly higher than it was three years ago, or their car insurance that is significantly higher than it was three years ago. And unfortunately, that's just a misunderstanding of inflation. Inflation is not the price level, it's the change in the price level. And so most of those prices are not going up anymore or not going up at an accelerated rate.

There are isolated incidences, I just have to emphasize, like car insurance. Absolutely, it's going up. Why? Because when the cost of a new car has risen. When that price level has risen, when the insurance company is confronted with the need to replace your car, if you're in an accident, and remember, the frequency of accidents doesn't change because of the price level, right? People are just as stupid with $50,000 cars as they are with $35,000 cars, in terms of their driving habits. So you crash the car, you need to replace it, guess what, the insurance is going to have to pay out more money. And they are in turn, going to charge you for that. This is exacerbated by the dynamics of consolidation and pricing power that has occurred. Many states are now confronting the reality that they have very few participants in their insurance market, whether that's tied to autos, or to homes, we just don't have truly competitive markets in many areas, and that's contributing to it. But that's a historical data point, unless you think that new prices for cars, or prices for used cars are going to accelerate again, this year. And the evidence is actually it's going the opposite direction, then you should expect very little increase in insurance costs for 2024. And my guess is that's what we're ultimately going to see, that a lot of this short term stuff we're seeing turns into be a little bit of a tempest in a teapot.

Erik: I want to come back to something you said a few minutes ago, you talked about how we had this debate, if you will, in markets about, okay, it looks like inflation maybe is starting to run away. No, no, no, it's going to retrace, it's going to move back to the downside. And as you said, the consensus eventually came around to, okay, now inflation is going to start trending back down towards 2%. And that's what we've been seeing. But hang on a second, Mike, that whole debate happened before the last, I've lost count on how many wars have broken out now in the last six months, I've lost count. Wars are always inflationary, and frankly, the way I'm interpreting the trend, I think that we're headed toward a continuing escalation that may be I don't want to say goes to, I don't want to use the phrase hot war with Russia, in the sense that it implies, you know, ballistic missiles flying. But I think that direct or more direct conflict with Russia, I see the Ukraine conflict is entirely a US-Russia proxy war, but I think it gets less proxy and more war over time. That means potentially, if we see more of shipping being impacted if we see more losses occurring as a result of military interdictions, if we see increasing, as you just said, in the case of automobiles, if we see higher freight insurance rates, because there's a higher risk of your containership being blown up in the Red Sea or something, isn't that all inflationary? And if you're going to have a big war trend, doesn't it imply a longer term inflation trend?

Mike: Well, again, I think it's important that people define what they mean by inflation. And so, ironically, like it's very frustrating, because inflation feels like it should be the most straightforward thing in the world. I walk into a store, I have $100 in my wallet, I walk out with less than I did last year. That's what inflation feels like it should be. And so, an increase in shipping costs, does seem like that should be inflationary that can be passed through. It doesn't have to be passed through. And in part, when you talk about increasing prices into an environment of relative weakness, it becomes a question of how much can get captured. In competitive markets, those types of cost increases, at least a fraction of it is going to be captured as a surplus that is actually received by the consumer, relative to the producer. The producer wants to bring the product to market, they have to transport it from their factory or their production facility. And the consumer really doesn't care. The consumer is ambivalent between a car that is sourced or somewhat ambivalent between a car, or let's use a TV because that's easier. A TV that is sourced from Japan versus a TV that is sourced from, and I'm going to choose something completely absurd, Saudi Arabia. If the cost to ship TVs from Saudi Arabia rises, or through the Suez Canal, basically China to Europe, you'll see less of it. And you'll see more that transits to the United States and so perversely, a lot of the disruptions that we're talking about, adversely affect the ability for Europe to consume, and for Europe to sell to China. In many ways, that's actually a net positive for the United States, whose shipping lines largely remain open. We're not seeing the type of disruptions in our ports that we saw in 2021 and 2022. Yes, there are some costs increases. It's unclear how much of that will be absorbed by the public, showing up as higher prices, and how much of that will be absorbed by the corporate sector, showing up as lower margins.

Erik: Okay, but a lot of people, including some US military commanders, have warned that where this is all headed, is not just a conflict with Russia, but eventually a growing escalation of conflict between the United States and China. Do you get to the point where, at some point, there are major restrictions on trade? And how do we resolve the many dependencies that we have where, frankly, sole source for a lot of products, including pharmaceuticals from China, you know, we can't live without them, but we're maybe about to go to war with them. That doesn't seem like a good recipe.

Mike: Yeah, I mean, this is unfortunately the byproduct of an interconnected world, I am not sure that I would put the emphasis on the US side, might lean the emphasis more towards China. The simple reality is that China needs its customers around the world to absorb its production. If we choose to stop trading with China, absolutely, prices will increase for all sorts of goods that we currently take for granted. Husband your umbrellas and baseball caps very carefully, recognize that a lot of the things that we think of, and we only have to go back to 2020 and look at things like PPE, if you are dependent on China for it, the risk of that supply being disrupted is meaningful. But even more important is, China relies on us, so that we can absorb their productive capacity. And this is increasingly true for Europe, it's part of what's contributing to the rising tensions and awareness that China is not actually going to be allowed to grow in the manner that it has. And I would argue that China has made a number of missteps, in terms of its attempts to move up the value chain, as it effectively confronts fewer labor resources with a shrinking pool of workers. They're trying to increase their value add, so that they can ultimately raise incomes associated with that, that means they're running headlong into the dynamics of the European auto industry. They're out competing with better products at lower prices. But that's exactly what the Japanese did in the late 1980s That ultimately flipped the script on Japan, and caused the rest of the world to wake up and say, no, we're not taking all this, you have to invest in our countries, you have to provide us with resources. We're not just going to allow this to be a one way move. And China is resisting that. And I can understand that. Like, nobody wants to be told, well, the customer's right, you're wrong. But those are simply the realities of business.

Erik: Mike, let's talk about where the escalation could come from, from here. And you know, I'll just be honest, I think that important skill of investors is to recognize your own weaknesses. One of my weaknesses is I've become very cynical about this, I'm very frustrated with how easily our government seems to be willing to just start new wars or enter new wars. And frankly, my personal frustration with policy matters is probably skewing my judgement. So how do you see the risk of further escalation? I'm very concerned about it. What do you think the next five years bring to the world, in terms of geopolitical escalations? Where do the risks lie? And what are the both geopolitical and market implications of those escalations if they do occur?

Mike: So, I think it really is an important question. And it's one that, unfortunately, I have a personally vested interest in, my son is actually in the military. And the last thing I want is to see proxy wars turned into outright wars. I do think that, you know, you and I have talked about this, I was one of the early people to say, we've probably started World War III, it definitely feels a lot more like that today than it did two years ago, when I started putting that bug in your ear. And I think as people become more aware of it, ironically, it actually has the potential to both increase the probability of the event and at the same time, lower the probability of the event. I think we're moving into a very bimodal world, where one of two things is going to happen. Either that escalation occurs, and we basically decide, alright, let's have it out. And in that situation, you're absolutely correct. Shipping lanes are going to be disrupted, the ability to sell stuff around the world and to trade and take advantage of the benefits associated with that will experience at least the period of disruption. At the same time, it also seems highly likely that type of war is or a modern type of war is going to be very different than the B52s flying into Europe or into Japan, where you have tons and tons of metal and equipment and tanks and everything else, right? We seem to be seeing, and I think this is fairly straightforward, an incredible growth in the use of precision munitions and the use of drones, which require far less material to carry out their disruptive mission. That doesn't mean fewer people die. Hopefully, it means fewer civilians relative to combatants die, that is always kind of an objective, it's something you should be aiming for. But it does suggest that the material intensity of this type of war is actually going to be quite different than what we've seen so far. Eventually, you get down to the point where you have to say, okay, you know, fix bayonets, and let's actually go in and start stabbing each other, if you get close enough for that. But that's pretty far down the line, right? There's a lot of proxies, there's a lot of precision munitions that get used. And to your point, the US government does seem very happy to engage in military conflict. But part of the reason why, because it's actually fallen in price. So far, that in many ways, it's actually to our interest to conduct policy on other people's shores, versus in the United States. I don't like that. I don't think it's a good policy, per se. But I understand why it's happening. And I think, you know, Pippa Malmgren and others will talk about this as well. This feels like it's going to be a very different type of war, focused much more on domestic disturbance, focused much more on things like drones, precision munitions. And in all likelihood, there's a reasonable chance that most Americans, somewhat similar to where we are today, don't actually even realize that we're conducting operations that look an awful lot like full scale war.

Erik: Well, Mike, I can't thank you enough for another terrific interview. As our listeners know, I always give our guests a minute to plug their services at the end. In your case, I'm going to be a little more specific and ask you to go into some specific detail into which of the ETFs you guys manage, relate to or support some of the specific investing themes that we discussed in today's interview. Particularly, something that used to be the case in markets was, if you were smart enough to understand the way commodities work, as you said, the carry as opposed to a change in the spot price is where you tend to make most of the returns. Few people understood that and you really had to be an accredited investor who was qualified to invest with a commodity trading advisor to get somebody to run your money for you, who knew how to do that. Now, you could do it yourself, if you knew which commodities were in backwardation and you're switching from one ETF to the next. But getting somebody who knows how this works, to figure out which commodities are offering the most backwardation and therefore the most roll carry. There didn't used to be any way for retail investors to access those kinds of strategies. Do any of your ETFs do that kind of stuff? And if so, which ones?

Mike: Yeah, so we actually introduced two products in the trend following space. The first has the ticker, CTA as in Commodity Trading Advisor, that is a broad trend following strategy that incorporates elements of both spot price change for trend, as well as mean reversion in terms of extension, or overvaluation. And then really importantly, has a large element of carry, recognizing that that has been the historical components of return. We saw this change in terms of the dynamics of the move towards backwardation, we recognized that even if we disagreed on the potential for a large commodity cycle, that the opportunity was emerging for vehicles to invest in these products, because of the things like the reemergence of positive carry characteristics, as well as the positive carry characteristics associated with the collateral that you're holding, the bonds now actually offer a reasonable yield as well. So the two products that we have in that space are CTA, which is broadly across both financial instruments and commodities, and then Hard, which is for the hard assets strictly focused on the commodity components. And both those products are done in concert with my good friend, Charlie McGarrough, who I believe you've interacted with in the past, Charlie used to run the metals desk at Goldman Sachs. His firm Altis has a long history in terms of managing trend following strategies, and it's incorporated a lot of the insights that Charlie brings from his time trading commodities, into how those products are designed, again, emphasizing things like carry so that you're not fully trapped in terms of a spot price appreciation model. On the credit cycle side, if you are concerned about an increase in the credit spreads or the risks in the high yield space, there we have a product called CDX, which is ultimately focused around a high yield exposure, with a credit hedge overlay. That credit hedge overlay is unique within the world of either mutual funds or ETFs. We have both an equity long-short overlay that does a phenomenal job of mimicking credit spreads in its behavior. In other words, it outperforms when credit spreads are widening. It underperforms in a somewhat asymmetric manner when credit spreads are tightening. And all we're doing there is that we are creating a long-short overlay that is tied effectively to this refinancing feature that we were talking about before. We're long companies that never need to tap capital markets and in many situations are returning capital, again, similar to that discussion that David Einhorn had earlier last week. And we're short companies that need to refinance. And so, it gives us a behavior that's almost identical to credit spreads. That's one mechanism that we're using for protection. We also have in that product, the ability to do the full hedge fund suite of using things like credit default swaps, so we remove any risk of basis differential in terms of the performance of that hedge, or at least a portion of that that product is currently positioned for a widening of credit spreads. But if credit spreads don't widen, if I'm wrong on that analysis, you still have the core exposure to the high yield market that should allow you to deliver a better than risk-free return profile and ultimately, even though we've seen credit spreads tighten over the past couple of years, that product has been able to keep pace with its benchmark, actually slightly outperforming it.

Erik: Listeners, Mike mentioned an interview between David Einhorn and Barry Ritholtz, we'll have that linked in your Research Roundup email. Patrick Ceresna, Nick Galarnyk and I will be back as MacroVoices continues right here at macrovoices.com.