Jeff Snider: From Waller Speak to Risk, After Risk, After Risk

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Erik: Joining me now is Eurodollar University founder Jeff Snider. Jeff prepared a slide deck to accompany this week's interview. For any new listeners who haven't heard Jeff's interviews before, Jeff is famous for really detailed and complete slide decks, this week is no exception with 77 slides in the deck. We're not going to get to all of them, unfortunately, due to time, but I encourage all of you to peruse the entire deck, Jeff is famous for the quality of his charts and graphs. Jeff, it's been way too long. I think the thing on everybody's mind is, I think there's a framework of macro, everybody understood where the most important thing to watch was rate cut expectations, because if we had rate cut expectations coming out of the system, that had to mean down for risk assets. But all of a sudden, Fed Commissioner Waller said some funny stuff about what sounded almost like a reverse Operation Twist and everybody's got a different mindset. And despite the fact that rate cut expectations are coming off the table, this week, we still got the melt up in everything, particularly gold and Bitcoin. So, what's going on? What did Waller really say? Is Zero Hedge, right? That this is reverse Operation Twist? And if it is, what does that mean?

Jeff: Oh, boy, I mean, while I really opened a can of worms here didn't I. As I was putting together the slide deck, I thought, boy, I'd have to redo all those slides just to go over those because you knew it would be a topic of conversation. As you said, Erik, it's definitely something that people are wondering about, because it doesn't sound like it's anything the Fed has done before. So it's quite natural people would say what is really happened? What the hell did the guy even say? And all he really said was they need to rejigger the portfolio maturity, the Fed's portfolio maturity, to make it more like it was pre-crisis. That's the first part. Essentially, you go back to before 2008, the Fed SOMA holdings were about a third treasuries and was Fed's, specifically treasuries, because they didn't have any other assets. And over time, through the various programs, they've had to extend the maturity in the portfolio, repeated QE, in essence, to try to fool the marketplace into believing that there's actual huge amounts of stimulus going on. And then you go to 2019, we had all that funky stuff in the repo market. And the Fed not wanting to engage in the QE, call it not QE, what it really was, but in order to make it not QE, they ended up buying Treasury bills, that proved to be a bit of a disaster, because demand for Treasury bills was so high. And so you get to March of 2020, and the Fed realized that was a mistake. So they stopped buying bills. And so, the build proportion in the summer portfolio has really dwindled, forcing the Fed to buy lots of longer duration assets. And what Waller was saying is like, I would like to get back to more of a traditional style, or at least a pre-crisis allocation to shorter term duration. Then he mentioned some other things like what that would do in a future QE episode, it would allow the Fed to roll off treasury bills as they expire, and then use the proceeds to buy longer dated debt, which would then allow the Fed to do QE as it sees it, but not actually expand their balance sheet. So there's a whole bunch of factors there where people were like, what the hell is this? Is this QT? Is this tightening? Is this an Operation Twist like 2011 And 2012? What is really happening here?

Erik: Okay, Jeff, you mentioned, so that the Fed would be able to do QE in the future. It feels to me, like Waller said, some comments that he probably regrets now, alluding to just a possibility that if the Fed ever wanted to do QE again, this would help them be in a position to do that. I think a lot of people are jumping to the conclusion: the Fed just announced QE is coming, it's a certain thing, it's around the corner. Is that what's going on? Is that how the market is perceiving this? And if so, is that how the market should be perceiving this?

Jeff: Well, the question preceding those to, Erik, is that what Waller said? Because I'm not sure it was, I think he was really concerned more about the mechanics. And of course, now we're into interpreting the guy's words, which is always a fool's errand to begin with. But I mean, I think in my personal perception, Waller wasn't saying anything, and what he was saying was basically, we would like to shift our portfolio back to a more traditional style of portfolio as we see it. And this is the kind of the way that maybe the path of least resistance to do so. But Erik, I think you're absolutely right, the market took it as very different. And for a couple of decent reasons. You go back to 2011, September of 2011, the Fed did the original Operation Twist that was a bunch of bull crap, too. They call it Operation Twist, because they didn't want to do QE three. So soon after doing QE two, remember QE two had finished up just a couple of months before then, and the market was in a complete disaster mode. You had rates falling, had stocks falling, you had the economy falling, you had banks nearly falling, and the Fed talking about bailing out the repo market yet again. And so, they did this Operation Twist, which was transparently another attempt to do a QE or some kind of stimulus as the Fed sees it. So you're thinking, okay, the Fed in 2011 does this Operation Twist. And here's Waller in 2024 sounding somewhat similar. It's understandable, to an extent, why the market would go nuts and thinking, yeah, he just… I mean, the Fed is doing something weird, maybe they're doing another Operation Twist. And they're changing up the parameters like either 2019 or 2011, just so that they don't have to admit that that's what they're actually doing. And personally, I think that's going way too far with what Waller is saying, I think that's overreacting. But as you're pointing out, Erik, there was absolutely a clear reaction in the marketplace, gold, treasuries to an extent, and Bitcoin, as you mentioned, I don't know if that was necessarily the market interpretation. Maybe there are some other factors. I saw some people talking about, it unleashed a torrent of short covering and gold perhaps. And it's always difficult to interpret short run market moves anyway. But there's definitely a correlation with Waller's speech, you could see that on the charts. But I don't think Waller said we're doing, we're about ready to do QE, I don't think that's what he was saying at all. But you're right, I believe this morning, he's probably regretting all of his statements to this point.

Erik: Let's go ahead and dive into your slide deck, which is titled *The Landing Risks*. Of course, everybody has been talking about. For a while it was, is it a soft landing or a hard landing or an outright crash? Now, it seems like no landing is becoming the consensus that the economy is firing on all cylinders. And you know, everything's fine, there's no recession on the horizon, and it's all clear sailing ahead. What is the data telling us about the economy starting on page three?

Jeff: Well, that's the other part. You know, going back to what Waller and the interpretation of Waller, you understand why some people are thinking, okay, maybe this is the Fed moving toward a QE-like program, because despite some of the outright euphoria over the economic situation, but you're right, we're back in no landing paradigm again. A lot of the data doesn't look anything like, in fact, we have a clear, very clear bifurcations, a lot of statistics look like a recession, or at least look like the recessions that are spreading around the rest of the world. And of course, that's a big risk, too, when you see the R word begin to be used more effectively, in more and more places, not just Europe. Now we've got Japan in recession, too. I mean, Finland just fell into recession. You see recession spreading around the world, you see the divergence in data inside the United States. And then you see Christopher Waller come out, and you hear Christopher Waller come out and say, we're going to do something weird with our portfolio. It's not that far of a leap to say, okay, what's really actually happening here? But I start from the position that we went through this no landing, soft landing, recession back at the end of 2022, nearly part of 2023. And we just, we never really left that. We kind of go back and forth between recession and no landing or soft landing as the short run trends run their course. And I think that's one reason why the data looks like it does, where some of it looks really, really good. And other parts of it look really, really concerning. Like, they look a lot like what we see coming out of Europe and Europe's been in recession for over a year. It's a difference in timing in cycle where the timing is unlike anything that we've seen before. And a lot of that has to do with the labor market and labor hoarding. So the timing is out of whack, there's less familiarity with the cycle. And the US economy in particular, there's a bunch of idiosyncrasies like automobile demand, and automobile production, believe it or not, that has everything just feeling like it's out of whack. And so, the default interpretation for most people, certainly risk asset classes, is that everything must be fine, because it doesn't seem to be clearly not fine. So the question is, does the data converge in one direction or the other?

And so, what I thought we would talk about, Erik, and you seem to be receptive to that was, what are the risks to the overall, not just US economic situation, but the global situation? We start out with just the US economy, we go into the second slide right away, you've got the mainstream media talking about how this economy feels like a recession to a lot of people but it doesn't seem to be a recession, at least that's what the official statistics say. Or at least the official statistics that everyone pays attention to, yet at the same time, as I mentioned, overseas economies are just struggling really badly. Go to slide four, GDP, I think everybody knows this. We're going to go through these really quickly because we don't need to spend a whole lot of time on them. GDP, last half of last year, defied all expectations looked really good. A lot of it because of slide five, consumption expenditures were good. But where the downside comes in, we start with slide six, nominal GDP is slowing. And history shows that slowing nominal economies don't do so in a continuous fashion. Although they have, so far, over the last couple years. At some point, there's a risk that nominal slowing actually accelerates and becomes not slowing, it becomes actual contraction. Whereas the Federal Reserve and most mainstream expectations is that slow down levels off at a very nice gentle pace, we get into the soft landing and no landing. Slide seven, same with personal expenditures. Hopefully they level off. But when we start getting into the questions, I know a lot of people have talked about this before, slide eight, the difference between GDP and GDI, which has been a difference for going back over a year. Now, really back to the technical recession, early part of 2022, GDP looks relatively good, but GDI says this looks more like a recession. And again, when you go to the slides in Europe, GDI looks a lot like the economic stats coming out of Europe where there is more actual recession-like behavior than not, more diverging data in the establishment survey itself. Slide nine, the payroll report, the last couple of them, especially for January and December, were absolutely terrific, well above expectations, way above expectations. In fact, suspiciously above expectations. Yet, in the very same survey, hours worked actually tumbled to nearly the lows of the 2020 crisis, which that tells you something's not right there. There's probably a statistical issue as well as underlying weakness.

And you just keep going, slide 10, again, payrolls versus ours, there's a divergence going back to the middle of 2022, which is consistent with GDI versus GDP. The household survey versus the establishment survey, that's slide 11. And one of the common things that I, maybe you run across this too, Erik, I certainly have people, when they describe the labor market, they're not necessarily talking about layoffs. If you go to slide 12, in addition to ours being cut, full time jobs not being as plentiful as they had been before, there is definitely a hiring freeze. Now, we saw a pickup in layoffs over the last couple of months, more than that, it seems like companies have just stopped hiring. And in fact, you talk to people in the real economy, especially white collar workers that have decent jobs, they're deathly afraid of the fact that if they do get laid off, at some point, they'll have nothing. There's nobody hiring anywhere. And there's lots of data. And in addition to those anecdotes, which suggests the US labor market, for whatever the case may be, as far as layoffs, as far as hiring is going, it isn't going, that isn't happening. So businesses are taking active steps to control their costs, which is not the kind of situation you would associate with a no landing type scenario, that sounds a lot more like an economy heading toward recession. So you look at the JOLTS data, that's on slide 12, hiring has come way down. And then slide 13, is the reaction to hiring, which is quits, which has fallen off pretty dramatically. Both of those have, really since last May. Just last couple of slides on the US economy, 14 and 15. You can see how GDI actually fits some of the other statistics better than GDP does. On this case, S&P Global's US composite, which doesn't argue for a sharp recession. It just argues for something that's closer to recession than this no landing scenario. Slide 16. You get into jobless claims, initial claims look like the mainstream data, but continued claims, those argue for the hiring problems. When you do get laid off and you do get involuntarily separated, you tend to stay on unemployment longer, which is not a good sign as far as hiring goes. And of course, the risks in the economy don't seem to be inflation, despite the fact that the January CPI was a little bit higher than people had expected, that’s slide 17 and 18. We get into 19, we get into the CPI, the idea that much of the CPI is being driven by shelter prices, and whether that's a real phenomena. Many people have noted that, that's what you see on slide 19, all items in the CPI less shelter has been pretty much disinflationary and solidly so for over a year. So the question is whether or not you believe the shelter index is anything real.

So just to sum up, the first part of the slide deck here, the US economy, the statistics that most of the public knows, you know, GDP, the unemployment rates, payroll report, that kind of thing. They all look terrific, they all look fantastic. But even the survey data that they're drawn from, doesn't agree with those interpretation. There is a solid amount of evidence and a growing amount of evidence suggesting the US economy is very, very slowly working its way still toward the downside of a cycle. And I think that's the overriding part of the more anomalous part of all of this, is how long it has taken to transition toward that downside of the cycle. But when you look at all the data, it still looks like it is an economic cycle, especially when you put it in the context of all these other global economies or national economies around the world, moving in the same direction.

Erik: Jeff, you caught my attention when you said that the labor data looked suspiciously better than expectations. What is it that you're suspecting?

Jeff: The payroll report, especially for December and January, as I mentioned, and as you know Erik, way, way above expectations. And, even the most optimistic analysts were thinking nowhere near like what those were. But those two came with the benchmark revisions to the entire payroll series. So, to my mind, and I think the hours number ,which is right next to it on slide 9, is telling us that there's a statistical problem with the payroll report and has to do with how the payroll report actually comes out every year. Well, how the BLS puts together its seasonally adjusted numbers, how they attempt to smooth out the variations, and in this case, for last year's benchmarks changes, they had to kind of revise down those payroll numbers from earlier in the year and then revise up the last couple numbers to try to straighten out the overall trend in the establishment survey. So what I think of the parts that I've got circled there, on slide 9 on the left side, is I think it's a telltale sign of overly smoothing and overly adjusting the payroll series. And that's really what the hours index is telling us, in addition to weakness, real weakness in hours, there's too much statistics going on in the payroll report.

Erik: Now, Jeff, I usually ask our guests on MacroVoices to tell me what the risks are in the macro environment, I budget a minute or two for that. You've got 50 slides in two groups of US risks, followed by a China economic backdrop, followed by China risks and I can't count how many slides here, followed by European risks. I have the impression, Jeff, that you think there may be more risks than the consensus perceives to exist in this macro environment?

Jeff: Yeah, I do. And I hope that you're giving me more than two minutes to go through it. I think this is the important part.

Erik: You got as long as you need, why don't we dive in on page 21 here, with the first batch? Well, what's the difference between group one and group two of risks in US risks?

Jeff: Well, group one is actually kind of two groups and group two, as you'll see, is very different. Group one, let's focus on that. It's basically banking in, I think one of the things that most people have their eye on, which is commercial real estate, which we all know is going to be an issue. We just don't know how much of an issue or how it's going to develop, when we start trying to look at what commercial real estate may be, how it's developing where it is. And maybe we can figure out where it's going. Let's look at what the banks themselves are doing.

So, the Federal Reserve's H8 statistics are the assets, liabilities of all the commercial banks in United States. And you see, first of all, going back to last year, they've been hoarding cash again, which is a defensive sign. It's certainly a signal that doesn't look like banks are all that optimistic about a whole bunch of potential issues. But that's just a place to start, the banking system seems to be wanting to hoard cash. And it's a substantial change in their behavior, dating back to last summer, which is when we saw a bunch of substantial changes and a lot of other things. We keep going forward to the bank statistics, page 22, you see all loans and leases. Basically, we're in a credit crunch situation, but not a horrible one. So the risk here is that, if banks do get triggered in some fashion or some way, if it is commercial real estate or something else, maybe it's reverse Operation Twist, who knows, then this mild credit crunch becomes something more severe. And then, what would the impact be on the general economy? And what would the impact be on the US economy, that may be weaker than people are appreciating, given some of these other statistics. Same thing with page 23, one of the places where we start to see some more bigger impacts of the credit crunch, that's commercial loans. I've already seen credit card balances, non-revolving consumer credit balances are really weak lately. So that's an additional risk for consumer spending, which everybody has focused on the resilient consumer, we'll see if that holds up.

Commercial industrial loans, that's slide 24, that ends up being more of a cyclical indicator too. And again, it's the same sort of gentle credit crunch, not an absolutely severe one. And the risk is, therefore, if it becomes a severe credit crunch, what does that do in the economy? But then slide 25, we start getting into the main event, which is commercial real estate loans. And thus far, banks haven't really done a whole lot about commercial real estate, which is I think, consistent with the way the space has developed over the last year, commercial real estate has sort of just been stuck. It's almost like everybody is just waiting for something to happen, waiting for the first shoe to drop. And there was some concern, of course, as you know, Erik, back at the end of January and early February with New York Community Bancorp, and that would be the start of maybe some more disclosures. If not, maybe some actions, because the real thing here is, when you look at the data, we look at the statistics and we'll go through a couple of things here just in a second, there definitely is a problem. Commercial real estate had a huge amount of leverage added to that sector in a very short condensed period of time, and it did so under some pretty bad assumptions that are not holding up, prices got crazy. And we all know what that means, that type of bubble behavior means there has to be a repricing at some point. And that repricing means somebody's going to have to take a loss. And really, there's going to be a lot of somebody's taking a lot of losses. We just don't know who, we don't know how and we don't know when that all comes out. But as I said, you look at the statistics in slide 26, we're transitioning to the Z1, which is the Financial Accounts of United States, again, that's a Federal

Reserve data, multifamily residential mortgages. You can't really see it there, but if you go to the next page, slide 27, there is definitely a bubble type bump in depository institution lending in multifamily residential mortgages, which I think is consistent with what everybody's sense of commercial real estate was the last couple of years. And you can see that slide 28, bank holdings or bank lending in multifamily residential mortgages shot up 31%. In a matter of just, it really about six quarters, which is an enormous increase in that space. So banks are absolutely exposed to that sector. Continuing with slide 29, this is commercial mortgages, not multifamily. These are the infamous office towers and retail parks that you keep hearing about. Again, there was a noticeable bubble. And the good news here, if you really want to focus on that, is that it's not as bad as certainly the residential mortgage real estate bubble had been in the prior generation. And in some respects, it's not even as bad as commercial mortgages had been in the late cycle period back then. But either way, it's still an enormous bubble, it is still a misalignment of fundamentals.

And if we just keep going to slide 30, you can see once more that US banks are the heaviest on the debt side, into commercial mortgages. Go to slide 31, you can see commercial banks and how they're doing, but really, the big one is page 32. When we combine multifamily apartment mortgages, with commercial mortgages, put those two together, you get about a trillion dollar increase in a very short period of time, which is about 20% in debt, which is a huge allocation in terms of GDP. And again, as I said, bad assumptions, huge price swing, that's a trillion dollars in additional debt that just underlies our basic sense that this was a out of control bubble period. And as the assumptions that went into it proved to be false, we have to go through the revaluation process, there's going to be a lot of losses. So the numbers here tell us and verify that statement that there is going to be a lot of losses, that we just don't know who gets them and how it turns out. The real risk is that as these losses begin to be taken, it leads to the sort of fire sale, forced liquidation process that leads into the worst of the worst case scenarios. Now, there's no reason to believe that that's the base case, that this commercial real estate problem becomes an uncontrolled disorderly unwind. But it is a substantial number, huge numbers everywhere. And we can't discount that risk. And even if we don't get that far, we have just the revaluation that we see in these numbers as they are, that could lead to negative consequences in the real economy. As banks begin to book losses, they're not going to be in the mood to lend in commercial industrial loans or consumer loans. So that could actually spill over into the section I just said, which was the risk of a credit crunch, which is right now sort of a gentle and mild one becoming a much more a much bigger problem in that sense. So even if you don't have the crisis level of unwinding commercial real estate, it could lead to effects in the real economy too. And we shouldn't discount the probability that that could something like that could happen.

Erik: Jeff, before we move on to the next batch of a dozen risk slides that's coming up, I just want to talk a little bit more about, what I feel is a complacency in credit markets. Where it feels to me, like most people are kind of saying, okay, maybe we're not going to get the cuts as quickly as we thought we were, but at least we know, we're past peak rates. There's no way we're going beyond that peak again. I think that's way too complacent. So hypothetically, and this is not a forecast on my part, but hypothetically, if we ended the year with a 6% 10 year

Treasury rate, is anybody ready for that? And what would it mean? What would the risk be if that happened?

Jeff: I don't think many people are ready for that. And as far as what would that do to a commercial real estate specifically, would be really bad. Because one of the biggest problems that we're facing and what everybody's really waiting for, is the refinancing. The wave of refinancings that we all know are coming. And a lot of these, you know, at 6% rates, almost none of it becomes a profitable. If you're a lender, if you're an equity owner, I mean, none of its equity owners are going to walk away, because they're not going to be able to afford to refinance at rates that are like that. So a 6% rate, if that were to actually happen, I think it would be a huge problem in commercial real estate, which would obviously increase the probability of that disorderly unwind, because then you'd be left with what we're really worried about, is that if banks have to repossess properties, what are they going to do with them? If they repossess a couple of properties, that's maybe not a big deal, because it can hang on to them, as long as they have the balance sheet capacity and the wherewithal to hire people to run them, which shouldn't be an issue. But if they start getting loaded with properties that they have to take over, they're going to have to start selling them, especially if they don't have the balance sheet capacity to do so. And at 6% rates, too, they're not going to be a lot of buyers, which means the price pressures become even more of a pressure and be more of a negative factor. So no, Erik, I agree, there's no way the commercial real estate problem would not go into a bigger issue at 6% rate. So the question is, is that a realistic risk?

Erik: And do you think it is a realistic risk?

Jeff: In my mind? No, I don't think that's where the interest rates are going. And I think we're in one of those periods where we're over interpreting moves in the marketplace. Because generally, what happens after a huge bond rally, like we saw at the end of last year, rates back up, that's just what they do. That doesn't mean that the market is taking rate cuts off the table. It just means the market is reassessing the situation. That's not a problem, too. The market does not forecast rate cuts, it forecasts probabilities. So at the end of last year, when interest rates were down sharply, and inversions were huge, and it looked like the curve was about the bowl steepen, which is the worst of the worst case, that wasn't the market saying expected six rate cuts in 2024. What the market was really saying is that there is a non-trivial probability that rates are zero at the end of the year. And there's also a non-trivial probability that rates don't go all that far. And the net, the median, so to speak, and between those two positions looks like six rate cuts. And so the probability distribution has shifted a little bit back toward rates and remaining where they are, and being less extreme about the downside. But even that is, I don't think, is a function of anything more than just fluctuations in the marketplace. And so the general perception is really still, to this day, that there's more downside risk, then there is a probability that rates stay about where they are, let alone go a lot higher. So unless something substantial changes that, you know, completely erases the way the market is thinking and the market has been thinking this way, for a long time, and nothing has changed its mind yet, it is still prepared for a substantial, more of a more of a probability of rates going down and in by quite a lot than rates going up by quite a lot.

Erik: We've got five more slides starting on page 36 on US risks.

Jeff: Now, the other US risks, I think most people are really concerned about as they should, is Uncle Sam, it's just been insane. It's just been absolutely incredible. The amount of debt that was issued last year with no war, no pandemic or anything else. It just boggles the mind. The problem I have is that people then associate that with, okay, well, that's going to be hugely inflationary. Now, that is one possible risk or it's going to blow up the Treasury market. When the evidence throughout history, not just recent history, shows it's actually not either of those. So that's what slide 36 shows you, look at the big increases in debt to GDP. As far as inflation goes, those tend to come during deflationary period or disinflationary periods for a couple of different reasons. But focusing on the later silent depression, to use Emil's term, since 2008, 2009, that one's pretty obvious. The government responded to an economy that was falling off. And they did so in the textbook Keynesian way, which was to increase aggregate demand through deficit financed spending. And it didn't do anything, it didn't create a recovery. It just left a lot of debt on the books, but because of the lack of recovery, the negative fundamentals in that type of situation, the marketplace demand safety and liquidity, which is US Treasuries. So the demand for treasuries perversely goes up and allows the government to continue its reckless spending ways, as Milton Friedman said in slide 37, deficits can contribute to inflation. But it really depends on the circumstances. The biggest problem with sustained deficits is that it rewards irresponsible government spending, because governments believe they're the solution to all the problems. And if they think the problem is the economy isn't working, what do they do? They end up spending more.

So if you think that bond vigilantism is going to stop the government here, that's just not happening because of the demand for safety and liquidity. The federal government has carte blanche to spend and the problem that we solved the last year, is that politicians know it. They were kind of on the fence about it over the last 15 years, they were still kind of, you know, Bush went too far in 2008. Because he said, what's going to be Great Depression 2, if we don't. Obama, then he was more careful thought, well, I don't want to push it too far. Trump administration, same thing. But over the last couple of years, really, since the pandemic, politicians have realized that there's no market penalty for their insane, reckless behavior. So as frequent was pointing out, that's really the downside here. And as I would argue, and I think history shows, if you go to 38, or 39, what really happens is government spending, which is incredibly wasteful, incredibly irresponsible, incredibly unproductive. In the circumstances that we find ourselves today, that doesn't contribute to inflation. It actually contributes to more disinflation, if not deflation, because it makes the economy less productive, less efficient, and less of everything that we want and need it to be in order to be in recovery. So it actually contributes to slowing down the economy over time, maybe more so than anything the Fed does, sure. So even though there's a short run sugar high to government spending, which may be why last year turned out to be as seemingly robust as it was, over the long run, it actually subtracts from economic potential because of how wasteful and inefficient it is. And then the last part of that slide 40, you just see that over the last year, little bit over a year, going back to late 2022, as the amount of debt that was issued was just absolutely crazy. As I put in slide 39, we were talking about 3.4 trillion in new money last year, if you just thought it intuitively, it would sound like prices on treasuries, the federal government's debt would have had to have just absolutely collapsed. But the opposite happened. Instead, the market more than absorbed that Treasury issuance. And in fact, rates are pretty much about where they were at the end of 2022. And that's despite not only the huge Treasury supply, that's despite the fact that all the excuses you normally hear about the Treasury market, none of them were happening last year. There was no QE, there's no change in regulation that forced the pension funds to own more liquid assets. There's actually Fed QT, not that that does a whole lot. But I mean, the Fed did about a trillion dollars, little over a trillion dollars, in just UST as loan.

And on top of all of that, the Fed hiked an additional 100 basis points at the short end of the curve. And yet, despite everything, the bond market is saying, we took it all in and then some, which is itself, I think, another reflection of everything we've talked about with economic, as well as financial risks in the economy in the United States that may be weaker than people are appreciating. As well as the huge risks to commercial real estate that are, I mean, we all know what's going to happen. We all know that there's going to be some problems associated with, and I think that's one of the things that are keeping the demand for safety and liquidity, as robust as it is in the face of all of these things. And you know, again, don't shoot the messenger here. I agree with the idea behind bond vigilantism. I would love for the market to slam the door shut on the federal government. But it's not happening, and there's no reason to believe it's going to happen. The solution to the fiscal problem is as obviously a political one, it's up to voters to demand something like that. But the sad part of it is that politicians have figured out they can buy votes. So what's going to change here?

Erik: Jeff, let's talk about the mechanisms of how it would eventually come to a head. Because, I think, ever since the 1992 presidential election, when Ross Perot made a big issue of the unsustainability of the national debt. any sane person can easily see, yeah, it's unsustainable, you know, it's a great word, unsustainable. Well, what's the mechanism of the breakdown? And what's the catalyst that causes it to break? Because, let's face it, as much as we want to get angry at politicians who just say, oh, deficits don't matter. You know, the empirical data is, they've gotten away with this for several decades now, of just insane borrowing and spending and the national debt is going up by trillions of dollars in a calendar quarter, or at least more than 1 trillion in a calendar quarter, which was a new record. It continues, and it doesn't seem like it breaks anything. Why is this, just all of a sudden, something goes crazy and 2008 happens overnight, or how does it break?

Jeff: Well, I mean, you're exactly right. It sounds like there should be a breaking point. There should be a limit. But we've seen numerous counter examples where it hasn't been, and you just mentioned we are living one. We've been dealing with this, we've been talking about it for a very long time. It really goes back further, back to the 1970s, the second half of the 70s under the Carter administration, and of course the Reagan administration actually outdid the Carter administration, in terms of increasing the level of debt. Then there was that low, in the mid 90s, but was that really about Ross Perot, or was that just the economy outgrew the government? I think that was really what happened. The last half of the 90s was, you know, the government didn't catch up to where they could have gone. Thank God, they could have gotten even worse. But the economy outgrew the deficits, and then of course, in the 21st century, went right back into it again, because the economy started to settle down and slow down. And then of course, 2009, the economy fell off, and government spending accelerated.

So is there a mechanism that causes the federal government to come to its understanding that it's, I don't want to use the word unsustainable, because history has shown that it actually can be sustained, which is the problem here. Because like you said, the problem with the government is that it's like putting its thumb on the scale of the overall economy, the more the central planners think that they have to central plan, the worse it becomes. And then the more the central planners have to central plan, it is the Japanese example. And the Japanese, of course, is the prime example for the sustainability of insanity for a very, very, very long time. You look at Japanese debt to GDP, which is just the primary fiscal deficit, it's far in advance of what we have here. And of course, they have a secondary budget. That's just as ridiculously insane. So I don't know if I would use the term unsustainable. I think that's actually, I would prefer not to use that term. Because I think we shouldn't fool ourselves into believing that there is a magic mechanism that forces everybody to come to the table and say, we need to stop this. I would think that, it has to be a grassroots effort where we force politicians to stop it, by not voting for those who continues to do this stuff. By forcing people to realize that the long run downside harm is far greater than any short run benefit, whatever that may be. It actually is, I think, it's a matter of realizing that, rather than thinking that somebody's going to do this job for us. We shouldn't be lazy about this and think that there is a magic moment where the light bulb just goes off in Washington, it's not going to happen. They've realized that they can get away with this, and so, they absolutely are going to. You don't blame a shark for biting you, because that's what sharks do. You don't blame a politician for doing this, if they think they can get away with it. And so, the market has shown that they can get away with it. It's up to the public and the voters to stop them. And that's what I'm really afraid of, that voters don't have the education and financial literacy to know that they should. Of course, anything in the mainstream is, everything is lined up against understanding that to begin with. Everybody thinks that government spending equates to economy anyway, that government reallocation is somehow a good and justifiable process. So I don't want to be that pessimistic, because it would actually be better if it was unsustainable, if it would be better, if there was a trigger that just stopped it all. But I don't think we're going to get off that easy.

Erik: Well, that's exactly what my thought has been, Jeff, is I don't think it's unsustainable, I think that we're already seeing and have seen a very slow motion result, which is, as you said, it started in the 70s. Look, we don't have the economic conditions of the boom times of the 80s and 90s, we've got more and more people literally living in tents on sidewalks. And it's this slow motion decline in standard of living, which I think is set to continue indefinitely, and nothing ever blows up. And unfortunately, what you're saying, Jeff, if I really just kind of rephrase what you just said a minute ago, it's like, look, the one thing that we can look forward to is when the voters recognize that handouts from politicians are a warning signal that they should cause to vote those politicians out of office. That's not very compatible with human behavior, just in terms of how people react, especially when, you know, a very small percentage of the population can understand these long term effects, expecting the voters to say, wait a minute, because I know that there's more people living on sidewalks in the 2020s than in the 1990s. That means that we should really question any politician who wants to give us more free handouts. I don't see that ever sinking in.

Jeff Snider 39:15
Yeah, I agree with you. That's the problem. That the downside risk is that voters never wake up. And it requires a little bit of, requires a lot of being able to act beyond self-interest, right? Because if you're the one getting the handout, you only want more of it. And that's quite natural, understandable. So yeah, I agree with you, Erik, that it's one of those catch, not really catch 22, but it's a rock and a hard place. We would like the markets to do something for us. But the markets have shown that they're not really willing to do it. In fact, there's all sorts of perverse incentives for that not to happen, at the same time, depending upon the voting public, which has shown absolutely no tendency to demand fiscal responsibility. I mean, outside of some massive effective educational program, I don't know what that would actually look like. So that's not really going to happen either. And I share your concern that nothing changes, that we just sit here. And that's where we are. I mean, it's been 15 years of lack of economic growth and massive government deficits, those two things actually do go together. And nothing has changed outside of the pandemic period, which politicians looked at as validation of everything that they had done. So I share your concerns 1,000%, that nothing will change. And that is the worst case.

Erik: Jeff, I so enjoy talking to you, I sometimes lose track of time, we've got a whole section on China and another one on Europe. And we're not out of time yet. But we're going to have to pick up the pace a little bit. So let's run through the China economy slides. China is so important. By some measures, it's actually the world's largest economy, bigger than the United States. And boy, a lot of people thought once we got out of COVID, that the Chinese economic machine was really going to go back into high gear, seems like changing geopolitics, or I'm not sure what. It's a different picture than most people thought. So how do you see it? What's coming?

Jeff: I wanted to include all of these slides and all these others, because I think these are important risks that we should be aware of, to not just the United States economy slowing down and commercial real estate, there's also foreign risks. And not just those economies that have already fallen into recession. As you mentioned, Erik, China is a big important one. Whether or not it's the largest economy, it is the largest contributor to marginal economic growth, at least it has been over the last several decades. So if China is really slowing down, it may be worse on a permanent basis. What does that do to the rest of the world? I can assure you, it's not anything good. And that's one of the reasons I believe the bond market has been so steadfast in this demand for safety and liquidity. By bond market, I don't just mean US Treasuries. Look at government bonds around the world. They're very highly synchronized for what are global risks and global perceptions. As far as Chinese economy goes, as you just hit the nail on the head, Erik, last year was supposed to be reopening, China was going to come zooming back to life. And that was going to cure, not just a lot of Chinese Prime, but a lot of global problems, too. And it just never happened. And I think the important point about that is people understand and ask themselves, why didn't it happen? What was the real problem? Because the explanation was zero COVID. And if once the Chinese end zero COVID, it was just like flipping a switch. But as we've seen, in a lot of different cases, it's never that simple. In fact, there are underlying weaknesses, that really go back a long ways that China's economic problems are far deeper than even that we had everybody believing. So you look at all the statistics, they all look pretty much the same, got a huge amount of economic volatility, so 42,43,44,45, and all that, really into 46, a lot of economic volatility in China during the pandemic period, which it makes sense, you see that around the rest of the world. But then outside of base effects in the statistics, nothing really picked up on the other side, which gets us to the real China risk. Which is, more and more, last year, as it became clear, reopening wasn't producing the way it was supposed to. It led Chinese authorities to begin to panic. They're like, okay, we were willing to give reopening a chance here. And by the time we get to the middle of last year, they were already in, we need to start stimulating mode, which was already a huge sign that things were going the wrong way. And I think the biggest problem with China really goes to their banking system. Obviously, just like commercial real estate in the US, China has a massive real estate problem, which, I mean, we're getting news about it all the time. There was something, just today, China banking, one of the last investment grade developers in China is running into a liquidity problem. So you can understand why China is more and more panicky.

At the same time, China's banking system is acting like a Western banking system, becoming more and more risk averse. The more the Chinese government does, this is a shorthand I always use, the more the Chinese government does, the worse you know it is. So that's really what the slides are telling us. The Chinese are starting to do a lot of stuff, the PBOC balance sheet expansion, and then the credit statistics beginning in slide 54, shows that the banking system is ignoring all of those inputs from the monetary policy from People's Bank of China. Banks are slamming the door shut, which goes, I mean economic risk as well as the property bubble in other type of risks, too.

Erik: Jeff, let's move on to Europe. Boy, the migrant crisis is causing so many, both social and economic distortions, what's going on in the European economy? And where are the risks there?

Jeff: The risks are that, the recession that Europe has been in for over a year now. Now, as we've been saying, nothing changes because whether or not we have two straight quarters of negative GDP, that's not really a recession, that doesn't really matter. They’ve had negative growth across the entire Euro area for five consecutive quarters, even though this hasn't been continuous, nor has any one of those quarters been really ugly and bad and horrific. Five quarters is an enormous period of time to go without economic growth in real terms. And so, you add those political pressures that you just mentioned, to an economy that's already suffering, and one that you can see in slide 65, that never really came close to coming back after the pandemic in real terms, which means actual activity and volume, Europe's in a really bad shape, far worse than anyplace else. China and the United States, of course, obviously, comparison there. And one of the worst cases in Europe is Germany, Germany is just a complete, utter mess, and it's getting worse. And again, it's not about a massive, you know, 4% or 5% drop in

GDP during a quarter. It's even worse. It's a slow, gradual grinding decline that does not want to end. And so that's the worst case that we keep going, because time is the biggest factor here and Germany is just a complete and utter mess. So the risk here is that it actually does get worse. Not only is there the danger of nothing changing, you go to slide 70, you start looking at the banking statistics and banks in Europe are behaving in the same way that we see in the United States. There is a growing and consistent credit crunch that has all the same hallmarks of a slow burn, a gentle decline, a gentle credit crunch, that could become a more serious one at some point. And so, what does the economic case look like, if banks start to cut back even more, or even, they don't even need to cut back a whole lot more for the European economy, which is already experiencing a substantial, prolonged recession, to become even more prolonged, and maybe even further to the downside. So there's an enormous economic and financial risk, just from Europe, the way it is already.

Erik: Well, Jeff, I appreciate the rapid fire on those slides. I do encourage our listeners to take your time and peruse the full deck, because there's some really great graphs and charts here. Jeff, for any of our new listeners who are not already familiar with Eurodollar University, a project you and I started, originally, just as a series of podcasts here on MacroVoices, you've grown it into something rather amazing. Tell us all about it.

Jeff: Yeah, that starts with you, right. I mean, back to what, 2017, We started talking about Eurodollar University and putting it together in some more of a formal format. Well, it's taken me a few years, but I finally got it done. And Eurodollar University, we go over the Eurodollar system, what money is, what banking is. Why do we spend so much time with bond markets and financial curves and signals and what they're telling us. So we're looking at the macro economy, the financial system from the perspective of all of this Eurodollar stuff. And so, Eurodollar University as far as the content that we provide, I have a YouTube show almost every day, six days a week, we go through some macro or monetary event, again through the Eurodollar perspective. And then we also have subscriptions and memberships available. Eurodollar University membership is really about the background detail, understanding where all this stuff came from and why it matters. And then we do more subscription of a daily briefing, where you talk about the day's macroeconomic news and market movements. And then finally, a deep dive analysis subscription, where we go very deep into all of these topics to really understand, first of all, where they came from, and then hopefully give us a better sense of, not forecasting, certainly not predicting, but having a better sense of the probabilities of maybe where all of these things are going in the future. So that's Eurodollar University in all its various parts.

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