Mike:	**00:01:40**	Well, let's welcome everyone today we're riffing with Alfonso Peccatiello. Did I get that right?
Alfonso:	**00:01:44**	Not too bad, Mike. Not too bad.

Backgrounder

Mike:	**00:01:49**	The Macro Compass, of course, and also known as *Macro Alf* on Twitter, in the financial Twitter space. Alf, it's great to have you on and let's just jump in. Why don't you get started with letting everybody know sort of a quick history, your background, you know, why we should be listening to this particular fellow on FinTwit. You've got quite an immense amount of experience both in banking and managing assets within large financial institutions. So, love to give everybody a little bit of background on you and what you're doing, and then all of the great research you're doing.
Alfonso:	**00:02:26**	Mike, Adam, thanks for hosting me. A pleasure to be here with ReSolve. Who am I, a southern Italian guy, accent very thick. I think I can't even hide it if I want to. I run money for ING Bank, it's a large European bank, should say global probably, it's everywhere. It was a $20 billion institutional portfolio, mostly fixed income, but also credits, equities, FX at the end of the mandate, cash and derivative instruments, strategies running from relative performance against the benchmark to absolute return strategies. And that was what I did until the end of 2021. So, for roughly eight years. At the end of 2021, I decided that it was about time to try something different, which wasn't compliance constrained, let me put it like that. Because working in a highly regulated industry, you cannot really share the knowledge with people. It's impossible, and correctly so. It's a highly regulated industry. So, I decided to leave the industry and basically start my own firm, which is called *The Macro Compass.* And it focuses on sharing all these insights and macro knowledge I was lucky enough to accumulate over the years. Having a large institutional role allows you to chat with central bankers, policymakers, hedge funds, strategists, and accumulate a wealth of knowledge, together with trading this stuff, which also gives you some market knowledge on top of that, and now I'm sharing this with people.

Constant Comments

Adam:	**00:03:57**	Fantastic. All right. So, you publish prolifically as well. I mean, I've noticed that you've always got -- you're always commenting on something, you've got a narrative that adapts through time as new information comes in. And emails and reports that are sent out on a regular basis. What are you watching right now? What's catching your attention?

Alfonso: **00:04:21**

So, Adam, I'm focusing on when and if and how hard the recession will hit? What I learned in financial markets is that everybody can catch headlines by screaming that something is going to happen without giving a context of when, how, how hard. So, we're hearing now that the recession is coming. But when is that? How bad is that? Are we actually getting a recession? It's a very important call for a bunch of reasons. First, every recession over the last 100 years was inevitably able to slow down inflation pretty remarkably. So, if we get the recession one of the -- Well, it's bad first because people lose their job in a proper recession and earnings actually drop.

But at the end of the day in 12 to 16 months, you actually have a drop in inflation too, which might change the Federal Reserve reaction function. So, it's important for that. And also, it's important, obviously, for what's pricing across markets. From the bond market to the equity market to credit spreads to FX, it's really important to understand when, if and how hard the next recession is going to be. So, that's the focus at the moment.

Adam: **00:05:28**

Gotcha. There have been some articles out recently. I'm specifically referring to an article in Bloomberg the last couple of days, I forget whether it was Tuesday-Wednesday, suggesting that maybe Powell and some other sitting Fed chairs or Fed board members are coming to the conclusion that their quantitative easing policy over the last decade may have done more harm than good. Have you been noting any particular speeches or any other data or things that are suggesting that they may adopt a different reaction function going forward, even once inflation ebbs?

Alfonso: **00:06:18**

So, first, the answer to your first question on wealth inequality, let's say negative effects of quantitative easing. There are two main negative effects, I would say that have been quantified by research over time. The first is a rise in unproductive businesses and use of capital. Because when the *hurdle rate* is 0%, basically old zombie companies and old zombie business models seem feasible. When interest rates are at zero, even sending a rocket to Mars in 30 years seems to be a good idea, because as long as the cash flows are far out in the future, and there is a promise that these cash flow will grow over time, if your hurdle rate and your discounting rate is 0% it looks like a good idea. So, it basically increases the misallocation of capital, let's say. That's the first quantifiable negative effect.

And the second one is that it actually was counterintuitive for many reasons. So, in Germany or in Europe, there was research that showed that when real interest rates became negative, people started saving more, just completely counterintuitive. And you would expect people to invest more and to spend money in the real economy when real interest rates are zero, or below zero. But the reality was different. People understood that economic opportunities out there to actually invest were not many. So, what they ended up doing was investing more money in order to try and achieve their financial objectives. So, it was counterintuitive from that perspective.

And last of all, bank lending. People live under this assumption that the more financial liquidity in the system, the more banks will lend. But that worked for a bank for a lot of time. And I can tell you that banks lend based on three main pillars. A, how is the real economy doing? Do I have creditworthy borrowers out there that are looking for financing? Are they looking for financing in the first place? So, what's the loan demand out there? And third, what's the yield that I make on that loan against the capital that I need to attach to that loan for regulatory purposes?

So, if QE has brought interest rates into negative territory in Europe, for instance, and credit spreads were very tight. Loan yields were incredibly non-appealing for banks and the creditworthiness as companies were becoming more leveraged and the economy wasn't really running very hot was not great either. So, banks ended up lending less during QE. We had already seen that in Japan in the 90s, but we don't want to learn from history and we kept doing the same mistakes. So, there have been quite a lot of negative consequences from prolonged QE, Adam. So, that's a very valid question from your side.

And second, when it comes to the reaction function ahead, well, I think Powell was trying to scream effectively since March-April this year. I mean, he started using Volker, Volker-esque jargon already March-April this year, especially mentioning plenty of times the following sentence, "We will keep at it." And keeping at it is the name of the last Volker's book. I mean, Volcker was the last person that had to fight inflation seriously. And he made one single mistake in his process, which was at the first round of fighting inflation he gave up too easily. He thought he had actually tamed inflation. But he ended up discovering that it didn't. And so two years later, he needed to raise interest rates even more, sending 10 year treasuries to 15% to slow down inflation. It ended up causing recessions, a lot of damage in the real economy.

And Powell knows this. He wants to learn from history and he understands that after being so wrong for so much time on inflation. Remember in 2021, the Federal Reserve was still doing quantitative easing, was still super accommodative. So, they didn't see this coming, they have been wrong. Now they don't want to be wrong again, which means they will keep at it. So, the reaction function will be like somebody's driving a car, but rather than looking in front, looking in the rearview mirror, because there'll be only slowing down when enough damage is done, when inflation is dropping, but inflation is the most lagging indicators of all in the cycle. It drops even after a recession has already hit, which means the Fed will likely keep policy tight, even as it becomes increasingly clear that the recession is with us.

Mike:	**00:10:24**	That often leads to that second leg down too. I think, in all of the recessions, you get this first leg down, you get the declaration of a recession, and then you actually get a second leg down, in markets I mean. So, the economy is very different than markets. And I think I mean, you've got, I think, seven, the sample size of seven in that. But there is usually a second leg down in this type of environment. And I'm confused a little bit why everyone's cheering for the pivot, as the pivot seems to be a kind of a funny thing, right? If you pivot you something's probably gone wrong or broken? So, how are you sort of contemplating that? And as you look into the sort of forward looking indicators and things that you're looking at today, what do you see in that realm?
Alfonso:	**00:11:10**	So, I'm going to try and share my screen here with you. What I want to share here is 2001, which is a period that resembles a lot, in my opinion, what we're going to see in 2023.
Mike:	**00:11:22**	Let me kind of give some context before … Can you zoom in on that little bit? Yeah, can you kinda--
Alfonso:	**00:11:25**	…
Mike:	**00:11:27**	If you go to the top right side, and the three dots you can make your -- you can make it bigger. Yeah, there you go.
Alfonso:	**00:11:33**	What about this? Is it more readable?
Mike:	**00:11:35**	Yeah, that -- perfect. Now we're talking.
Alfonso:	**00:11:38**	There you go. Bit of technical non-savviness, from my end, sorry for that. So, let me try to give some context before we go into the table, and also for people just listening to that. So, I think 2023 is going to resemble 2001 very closely. And why do I think that? Let's take a step back. 1999 and 2000 are extremely similar to 2020 and 2021. And why do I say that, is because basically, in 1999 and 2000, you got these excess animal spirits in the market. You got anything that had a .com after their name trading at 200 times earnings. I mean, just ridiculous stuff, right? Excess animal spirits. That was exactly the same we saw in 2020 and 2021. 2022 is the equivalent of the second half of 2000, when the Federal Reserve decided to raise interest rates. They raised interest rates to six and a half percent at the end of 2000. And what they ended up doing during 2000 is it burst the .com bubble, exactly like we took away the excess animal spirits in 2022. Well, you know, high beta stuff actually got hammered very hard and Altcoins and all that stuff actually drove down 70-80%. Many of the SPAC companies are worth nothing. So, we are taking away the excess animal spirits exactly like we did in 2000. That is the reflection of tight fiscal and monetary policy exactly like in the 2000s.

Now 2001 was a reflection in markets and in the economy of the 2000 tight, fiscal and monetary policy. 2023 is going to be the reflection of the tight monetary and fiscal policy in 2022. So, you need to ask yourself, what happened in 2001, if that is the reference period for 2023. Now let's go back into this table. Let's specifically look at the returns between August 2000 and March 2001, or actually, I think there is a better way to visualize that. So, if you give me a second, I will give you the 2001 table of returns. Now, this is total 2001 returns. So, what happened in 2001 was the following. Earnings dropped like a stone. Labor market weakened materially, job losses in the second half of 2001, and the Federal Reserve, going back to Mike's point, did a massive pivot, a true pivot. They cut interest rates by 500 basis points in 15 months. So, that's the equivalent of bringing rates to zero by the beginning of 2024.

So, you would expect that during this process, stocks went through the roof right? Then think twice. Have a look at the asset class returns here. In 2001, the best asset class returns were in bonds. Well, not a surprise and Federal Reserve is cutting rates by 500 basis point, I'm going to guess bonds are going to perform very well. Cash also did well because you started from six and a half percent, so the average return on cash was roughly 4% as the Federal Reserve cut rates. Anything else, let's have a look at the S&P 500 Large Cap Equity over there, negative 12%. So, let's think about this for a second. The Fed cut rates by 500 freaking basis point in a year and the S&P dropped another 12%. What? The dollar is not here, but the dollar appreciated 7% that year with the Federal Reserve cutting rates basically to 1%.

So, what's happening? What happened there? It's the second leg down that Mike is discussing. It's the second leg down that happens when the first leg is already sort of exhausted. It's a valuation adjustment. It's a multiple compression from excesses back to something more normal, let's say, from long-term. The second leg of the bear market, it's an economic reality kicking in. It's people losing their jobs, it's consumer spending dropping, it's industrial production dropping, it's earnings dropping, etc, etc. That second leg of the bear market, it's rather a slog. It's a slow grind down. It's much less volatile than the first leg. But the Fed pivot doesn't solve that problem, because the Fed pivot is an accommodation of monetary policy that will only be reflected nine to 12 months later. So, that's the story for 2024. In 2023, you still need to go through that second leg of the bear market. That is very well reflected, I think, in this 2001 table.

Mike: 00:15:56 I think, Alf, the other thing is really interesting here that not too many market participants have been around for, which is a true, as you said, slog of a bear market. Where you were down 9%, in large cap equities in 2000, you're down 11% in 2001, and then 2002, down another 22%. So, three years of negative performance. And I don't think that most portfolios, we've kind of -- we reached maximum, let's call it peak 60/40 at some point in 2021. And I don't think most participants in the market are actually aware of this reality that you actually get two, three, four years of just negative performance.

And if you're withdrawing or have obligations for the portfolio, you have divestitures, whether they're, you know, you're paying out endowment, you're paying out a retirement, that's extremely destructive to wealth, right? You're having an income source come out, it goes down 9%, some income comes out, it goes down 11, some income comes out and it's down 22. Like this leads to pretty catastrophic destruction of the wealth that's supposed to provide some sort of income stream and I think it's …

Alfonso: **00:17:14** You are probably right, Mike, and it also leads to second round effects, which are vital for asset performance. So, I think this year that inflows of retail people into ETFs has been massively positive still, net flows going through ETFs. If you're losing your job next year, then you are not going to allocate further into equity markets, you are actually going to try and raise some cash. So, the way you raise some cash is basically you sell your equity portfolio. And on top of it, if you have a residential investment, which has become a thing, which was quite common, I should say between developed markets as the rental yields between 2014 and 2020, 2021 were exceptionally good and mortgage rates were dropping like a stone, quite a lot of people have actually invested in real estate one way or another.

Now, as long as things are going good and people are employed, they pay rent and risk free rates are very low and you are not losing your job, basically, the real estate market doesn't drop like a stone, but it freezes because affordability for new buyers is just terrible. It's the worst in over 50 years. It's a combination of high house prices and very high mortgage rates by recent standards. Wages have not increased materially, so that makes the equation impossible for new marginal buyers. But prices are not materially dropping yet. They've started to drop. I mean, let's be honest, in Canada, in Australia we're already 10% down from the top in a few months. And if I look at the annualized pace of drop in Case Shiller prices in the US, we're also looking at the same pace annualized of the great financial crisis already. So, it will get 15-20% drawdown to say the least in my estimate by the end of next year. That only brings us back though to roughly summer 2021 levels, Q1 2021 level so not even prior to pandemic levels.

Before we get there, what we need to see is people forced to sell, because marginal buyers are just cut out, but sellers are saying I don't need to sell. I'm doing good. I'm okay. You know, people are still paying rent, unemployment rate is 3.7%. I don't see the problem. I don't need to sell-- I don't need to sell. When you start to have some for sellers they will need to hit the lower bid. And the moment they hit a lower bid somebody else will get a tap on the shoulder especially on institutional investors, that now we're looking at the risk free rate at 4%, 5%. Why are you owning rental yields basically or investment in property-like bonds, or investments like that, that are returning as a cap rate something like the same, and you're getting exposure to draw down ahead of you when it comes to the asset price and potentially, the drawdown as well in economic activity ahead. So, you get tapped on the shoulders. And this will actually, as you suggested, Mike, compound this slog on the way down in equity prices and real estate prices that we're likely to see, in my opinion, in 2023. You're on mute, Adam.

Adam: **00:20:20** Yeah, sorry. Yeah, no, I was just -- While you were chatting I was listening and then also sort of looking at the -- because it is remarkable how closely 2000 returns look like the 2022 returns. You had this sort of -- you had a 9% loss on the year, but the peak to trough loss is about 17%. And although the sort of, the calendar year loss in 2001 was on the order of 10 to 12% total return for S&P, There was another peak to trough loss of 29% in that year, right? So, it was a lot more painful than that subsequent 12% loss seemed. And then, of course, there was another major drawdown into the final bottom in 2003, right? I mean, the full drawdown in the S&P there was on the order of 50%, between March 2000, and early 2003. And then, of course, the market really kicked into gear. But it's important, as you say, to recognize that the market didn't bottom until well over a year after the Fed started to pivot and there was another major leg down, which was larger than the first leg down after the Fed pivoted before we finally reached the final bottom after that long two and a half year grind.

Alfonso: **00:21:43** Adam, this is a perfect diagnosis. And the story goes that effectively, if you look at stock market bottoms in a cyclical economic downturn, they tend to happen when two conditions are met. A, PMI or earnings are very close to bottoming or actually have already bottomed, which means the negativity is well understood by market consensus and by analysts. Earnings have been revised down materially. PMIs have hit 45. I mean, we're talking about serious pain being priced and recognized by market participants. So, you're very advanced in the downgrade economic cycle. And the second condition is that the monetary policy conditions have been already accommodated for a while. A while generally is at least six or nine months of accommodation of monetary policy.

Nowadays, none of the two conditions are met. We have had some downgrades in analyst expectations for earnings from 10% year on year S&P 500 earnings per share next year was 10%. The analyst consensus says it's now 5% growth in earnings for 2023. Still a positive number, so there's been some negative revision, not nearly enough to be consistent with the recession. But the average drawdown in earnings is rather 15 to 20% negative. So, there is quite some way to go there. PMIs are dropping, but forward leading indicators are not suggesting at all that we are done with PMIs dropping. So, we are not yet ticking that first box.

Second, we should have monetary policy accommodation already behind us for some quarters. We are looking at the Federal Reserve which is going to keep hiking, and then the market seems to want to cherish on a Fed pause. So, Fed pause with Fed funds rate at four and a half to 5%, that's quite tight levels of risk free rates. That's not accommodation. That's keeping a tight monetary policy for longer, which is going to reverberate into weaker economic activity. So, the conditions for a bottom in risk assets seem to me to be validated at the earliest in Q3-Q4, 2023, because the economic cycle needs to play out. It's going to take some quarters. It's going to take even longer to convince the Federal Reserve to actually start easing. And then you need some time for this easing to be reflected in economic conditions as well.

So, I think 2023 is a year where people need to be very selective with their allocation in credits, in equities. They need to look at fundamentals because the damage being created by tight fiscal and monetary policy in 2022 is going to be reflected in the economic reality of 2023. So, you're looking at, if you have to be allocated as a long-term investor, you're looking at strong balance sheet companies, companies that are not subject to cyclical earnings activity, cyclical economic activity. You're looking at defensive stock market sectors. You're looking at the strongest balance sheet companies within the credit space -- the credit spread area, you have to be defensive. It's not -- This is not the time to go and buy over-levered companies that would benefit from tailwinds in economic activity and looser monetary policy. We are not nowhere near that point yet.

Mike: **00:24:54** How do you feel the bond market plays a -- … Go ahead. Sorry.

Adam: **00:24:58** Yeah, yeah. I was -- Because the market seems pricing in a perfect soft landing, right? The market is pricing in forward looking discount rates, right? So, they're sort of expecting discount rates at equilibrium in a couple of years at around three, three and a half percent. So, risk markets are kind of, are pricing that level long-term discount rates and they aren't pricing in any kind of real earnings recession at all. Right? So, you know, but I think it was Bridgewater that published a really interesting study that showed that if you adjust for the change in discount rates this year, that markets are actually, the S&P is actually more expensive now than it was coming into the year. Right? So, they're actually pricing earnings at a higher level than they were coming into the year. All of the drop in prices had just been a result of market participants discounting higher discount rates for longer, and not even the level of discount rates that the Fed has continued to promulgate. Right? They're still discounting much lower rates than the Fed has tried to communicate that they're targeting.

Alfonso: **00:26:15** That's correct. So, Adam, I looked at the bond market. It's my home turf, basically. And I want to share the screen again, to look at the many dimensions that the bond market has with it. It's not just looking at 10 year Treasuries up or down, but there are many dimensions. So, this is what I call *the volatility adjusted market dashboard.* And it's the rate section, interest rate section of it. It's a tool that I use to monitor market moves across jurisdictions, across asset classes, and to standardize them, color code them by the standard deviation of the move. So, the bigger is the magnitude of the move, the stronger the color. So, dark red, dark green, would actually catch your eye, and that will mean that the move has been very large according to historical standards in that sub asset class.

So, when I look at US rates move over the last month, I see three very interesting points. Let's start from volatility. So, if I look at swaption volatility, so it sounds complicated, but it's really the implied volatility, that fixed income participants are assigning to interest rates in the future. So, how volatile is a two-year Treasury future going to be your five year Treasury future going to be over the next year, and over the next three months, that's what we're pricing. It's a bit like trying to look at the VIX, but rather for the bond market to give you an idea.

Now look at that dark green, in implied volatility in a year from now, for two, five and 10 year rates. So, what's this telling you is that bond market investors are basically being pretty sure that the Federal Reserve is not going to make volatile monetary policy decisions next year? They're going to stick to a long Fed pause. It's going to be very predictable. Fed funds are going to be at 5%, and the hurdle to change this, so to raise to 7%, or to drop to 3% in 2023 is not very high. So, the hurdle is very high. So, the appetite to take volatile monetary policy decisions is not going to be there. In other words, implied volatility in the bond market is going to come down. That's what the bond market is betting on.

Now, this is the first interesting thing. The second is also reflected in the yield curve. So, if you look at that box, there, OIS curves, those are yield curves not in the treasury market, but in the OIS market, which I prefer. And it's a cleaner expression of what traders think about the Fed Fund's path over the next two, five, 10, 30 years. You'll see two interesting points. The first is the curve is flattening very aggressively between the two and the five year and the two and the 10 year, see the green colors in twos/fives and twos/tens there. Interestingly, it's also steepening, or it had been steepening between, say, the five and the third year part, the 10 and the third year part.

So, what's this telling you, again, is that bond market participants are thinking along these lines, there is going to be an economic slowdown, not the very strong recession, but an economic slowdown? It's reflected in this volatility section, so we expect the Fed to just do nothing with it. So, to just keep rates where they are even if we are going through a slowdown. So, what that means is that two year interest rates are going to be pinned at some point because they're highly influenced by the Fed policy. So, they're going to basically stick them to four and a half percent or wherever they are, which means the economic weakness must be reflected further on in the curve; five year, 10 year, which means the curve keeps inverting, as basically this tight policy will reverberate into economic weakness later on.

So, the tighter the Fed is during a recession, the more likely it is there is long-lasting damage to the economy, and that is reflected in a flatter yield curve between two-year and 10-year and two-year and five-year. But when you look at five-year and 30 years, what the market is thinking is like, as you suggested Adam, this is going to be an economic slowdown, maybe a very shallow recession. And you know, if the Fed really follows this curve and cut rates to 3%, in five years, that's probably enough to accommodate conditions. Naturally, over the very long-term economic growth can rebound a bit higher over the next 20 or 30 years, we can go back to normal growth level. So, I can basically price it in a steeper curve in the very long end. So, the market seems comfortable with the idea that the Fed pause is going to do some damage, the damage is not going to be incredibly big. So, the Federal Reserve will have to cut rates in '24, '25, but to 3%, three and a half percent levels, which are roughly neutral, a bit above neutral, and that will be enough to restore economic growth in the long-term. So, it can then be priced up further in the curve.

Again, if you look at the forward OIS rates, that section there tells you the future Fed Funds path being priced by the market. So, if you see three months/one month, six month/one month, one year/one month, it's telling you what the one month Fed funds rate will be in three months, in six months, in one year, in two year. And look at that, it's basically pricing that rates will be between four and 5% for 18 months. So, that's a long pause rather than a pivot. And then year two, year three, we go towards 3% and we stay there. But guys, a recession is not consistent with the Federal Reserve cutting rates so slowly and stopping at 3%.

We talked about 2001, and I want to give the example here what is a Fed pivot. This is a Fed pivot. Look at this chart. Fed Funds were six and a half percent. They were cut by 475 basis points during the recession. Same story in 2008. This is a cutting cycle, which is consistent with a recession, not 200 basis points spread across three years. That, Adam, basically validates your thesis that the market is sitting on a situation where they think it's going to be all controllable, all linear, predictable and as low easing by the Federal Reserve postponed to '24, '25, it's going to be enough to actually keep conditions loose enough for the economy to restore their economic growth in '26,'27, and going forward. So, that's where we sit today and I do not particularly agree with this assessment. Or I think that the risk/reward in taking this stance as your base case is not great if you focus on forward leading indicators, which are actually telling a different story.

Forward Looking Indicators

Adam:	**00:32:47**	That we're not going to see a soft landing, it's going to be a deeper recession that will last for longer and have a much larger impact on earnings.
Alfonso:	**00:32:56**	That's true. So, let's look at some forward looking indicators that I look at. Because my approach at the Macro Compass, Adam and Mike is very data driven. I mean, macro, everybody can come up with a narrative, right? I mean, we can be good storytellers and say the economy's going to bounce next year. We can all make up a case for something, but data actually speaks louder than narratives, if you ask me. So, I looked at a bunch of my forward looking indicators and I tried to grasp where are we going looking at those. So, one of it is my *global credit impulse*. And this metric is a prop metric that I built and it aggregates credit creation data for the five largest economies in the world. And what this really does is it looks at how much money are we getting, the private sector, how much money are we getting in our bank account? Are we increasing the amount of money we have at disposal? Is it increasing fast? Is it keeping pretty steady? And of course, the more money we have at disposal, the more money corporates, private sector agents have at disposal, the more likely it is nominal spending is going to pick up, growth is going to pick up, earnings are going to pick up, inflation is going to pick up later on. So, this is a very good forward looking indicator. It's the orange line, it's on the left hand side, and it's in real terms. So, it's *inflation adjusted credit creation*. It tells us how much real spending power the private sector has at any point in time. And you can see how in 2020, 2021, we saw this massive increase in the orange line, very fast. And look at the blue line. The blue line is earnings per share growth in the S&P, nine months later. So, it's giving you a lead time of nine months. Like a Swiss clock, it basically also moved up aggressively and earnings grew 50% plus, year on year, in 2021. As the reflection of a lot of real economy money that was thrown at the private sector to spend, re-openings actually helped this process and so earnings also went through the roof. But look at what has happened recently to the leading indicator, the global credit impulse. It has collapsed very aggressively. And why? Because fiscal stimulus has stopped completely all over the world since the first half of 2021. Bank lending in real terms in some jurisdictions is decent and some is pretty sluggish. And the Chinese are deleveraging at a very rapid pace, which is basically destroying money by drawing down real estate prices in China. So, the combination is actually generating a very negative credit impulse. And when -- …
Adam:	**00:35:31**	Do levels matter here, Alf? I'm just wondering whether -- So, my understanding of what happened to run this orange line up so high in 2020, was that effectively, the central bank via the Treasury, created a massive amount of reserves in the banking system when they fire hosed money into everybody's accounts in order to offset

the loss of income during the lockdowns. Right? So, you've still got, I recently looked at the levels of reserve deposits. And while certainly the bottom two quintiles of the earnings distribution in the US, we've seen their reserves dwindle and normalize, and they're now starting to feel a pinch from a saving standpoint.

But the top three quintiles by earnings, in other words, the wealthier households, the middle and upper middle class, are still very flush in terms of the amount of demand deposits, right, the amount of capital at their disposal for spending power, right. And we're starting to see inflation, well, not starting to see… about three months ago or so we saw inflation move from more of a goods-oriented phenomenon to a services-oriented phenomenon. So, where I'm going with this is, the higher income segment of the population is still relatively flush with cash. They also tend to be the segment of the population that has a higher marginal propensity to spend on services. Is it possible that the levels confound some of the signals that we get from rates of change in the credit impulse analysis that you're doing here?

Alfonso: **00:37:27** Very solid question and the answer is twofold. The first is actually fiscal stimulus is -- the unfunded fiscal stimulus, I should say. So, fiscal deficits are one of the strongest explanatory variables behind this credit impulse here in 2021. Think about it. I mean, basically, the US government blew a hole in their balance sheet and sent checks at home to people. And when the private sector gets a check from the government or taxes are cut, it's actually net worth increasing for us. We have more money at disposal without liability attached to it. When you get a mortgage, you also get all of a sudden more money than you had before and you go and buy a house. But hey, you have a mortgage on the other side of your balance sheet, correct? When the government actually sends a check at home to you, and it's on a fiscal deficit perspective, unless you are buying the Treasury, but you are not buying the Treasury, as you were saying before, the Fed was buying the Treasury, the banks were buying the Treasury. So, you do not have a liability attached to it, you just have more net worth. And that in real terms, as you can see on that chart, increased so rapidly, that the rate of change was incredibly important for earnings.

Now, in the credit impulse, historically speaking, the rate of change is a much better explanatory power than the absolute level of money in the system, Adam. And why that is the case is because our system is based on continuous money creation over time. Since the 70s, once we decided that we could create money without being pegged to a hard asset like gold, we basically have been creating money regularly. Every year, the amount of disposable money for the real economy grows. So, we take more debt on, we have fiscal deficits, basically, as a normal feature in developed markets wherever you look. Europe, Japan, the US, we have been doing fiscal deficits for years now, for decades. So, we keep growing, which means you're looking at the steady growth in the amount of money available for people. It's the rate of change of this growth that explains more as a better explanatory power on earnings on asset class's performance with a lag. That's why I tend to focus on that.

And the second point is this is in real terms, which means if you want to explain earnings, GDP growth or real retail sales, you need to look at this in an inflation adjusted way. Because obviously the more money you have in the system, the more spendable money you have in the system, unless the supply adjusts as well, so, there are more goods and more services, will over time result in slightly higher prices. which is also what we have seen happening in our economy over the last four years. So, looking at the real credit creation cuts away this pollution effect. Interestingly, the distribution of money available to the private sector is very interesting. And you have been spot on in your analysis, because if you look at the bottom 20%, these guys have seen the excess deposits created basically, by fiscal stimulus, in most cases, dwindle completely. So, they are reaching out to credit cards to bridge the problem. What they are doing is that they're basically taking credit, short-term credit on a credit card basis. They need to pay that back at the end of the month, or after three months. But they're doing this to try and kick the can down the road. So, they are looking pretty bad. They're feeling the impact of this negative drop much more.

The lowest part, the bottom 30% of US consumers, looking at the volume, actually account for the largest percentage of volume of consumption in the US. So, if it's true that the higher cohort will spend more on services, it's also true that on an aggregate basis, the lower cohort, so the last 30% of the bottom distribution, will be the one influencing more on an aggregate basis where retail sales are going to go for instance, or where GDP is going to go, right? So, if you combine all of this together, it still tells me that the prediction that the credit impulse is saying about earnings that they will shrink by 15 to 20%, by the end of 2023, is something that historically has proven to be a relatively robust forward looking indicators. There are more because you can judge the probability of a recession and the timing of a recession based on one indicator.

So, for instance, if we look at the Conference Board, top 10 leading indicator index. So the Conference Board aggregates the most statistically significant forward looking indicators. And as you can see, they put them all in an index, which is here in orange. And here I looked at the year-on-year change in this index. So, every single time you see the trigger here, there has been a negative print for two or more months in a row of this index. You always had a recession with an average lead time of seven months. Now, we're sitting here, the trigger has been hit in August 2022. It was the second month in a row where the year on year change in this index was negative, which means with an average lead time, you should see the start of a recession in March 2023. And if we want to define the recession, a recession, again is when people start losing their job, when earnings start to become negative year on year. It's not enough for GDP to drop, but also you need real spending powers to drop, job losses and earnings, an earnings recession.

Now the track record is immaculate. Over the last 50 years, this trigger, year on year negative, points for two or more months in a row with a seven month average lead time, as always anticipated the recession; '74, '80, '99 to 2001, 2008, 2020. Will this time be different? I don't know. But this looks like a second relatively robust indicator together with the global credit impulse that by March-April next year, we are going to be in a recession.

The other question and then I'm going to take a pause is how bad is this recession going to be? But it's hard to say there's going to be a recession. But how hard is it going to be? So, let's say that it starts, looking at a bunch of indicators, and people can read the full article. It's free on the Macro Compass. Let's say the median time expected by my models is roughly March-May next year. But how bad is it going to be? That's the second question. And the answer, looking at a bunch of indicators, is relatively bad. So, if you look at the housing market, for instance, in combination with what it's called the Sahm Rule from Claudia Sahm, an economist that worked at the Fed, the housing market is vital for the economy.

Actually, there was an economist that said, "*I think the housing market is the business cycle*". And I tend to agree with him because it explains alone roughly 15 to 16% of US GDP and employment. But most importantly, it's a very cyclical market. It's mortgage backed. So, when interest rates go up or down, it tends to move fast, it tends to move quick. And there are so many ancillary activities to the housing market; construction workers, brokers, furniture shops, durable goods expenditures, etc, etc.

So, if you look at the housing index built by the National Association of Homebuilders, it's in orange here, it's plotted on the left side and it's inverted. It leads by 12-months US unemployment. You can see a pretty tight relationship over time, unemployment rate is the blue line. What we're stating here is that one of the most rapid deteriorations in the housing index we have seen over the last 30 years. We have discussed about it, before housing affordability, the housing market is freezing, sales year on year are down 40%. Basically there is no activity any more effectively in the housing market. This tends to precede unemployment rates increasing with a lag of 12 months. That would also put us roughly in May-June 2023, as the recession starting time. But the magnitude of this recession, this index is calling unemployment rate at 7% by beginning of 2024. It's roughly double where we are today. It's a lot of job losses.

So, it could be relatively bad and the Sahm Rule, Claudia Sahm defined the recession starting when the three-month moving average of unemployment rate goes 50 basis point or higher than the last 12 months' low. The last 12 months' low in unemployment rate of 3.5%. Which means that if unemployment rate in the US on a three-month moving average will be above 4%, you have already started the recession, defined as job losses. We should probably be there by saying May next year, but we're going to go further, much further than that in unemployment rate at 7%, according to this indicator, which is quite a nasty recession.

Adam: **00:46:01** Amazing. Yeah.

Opportunities For Active Investing

Mike: **00:46:02** Yeah. So, that's like, a great, very positive talk. No. It's really interesting. But to me, it's an interesting set of circumstances where previously over the last decade, it has behooved investors to BTFD, like, buy the dip constantly, don't do anything private equity, private debt. There has been no need to liquidate a position or move on from a position because we haven't had defaults. And now we're in a very different regime. We're in a regime that most of the market hasn't seen before. You know, you talk to the younger generation, and they're saying, oh my God, interest rates are four and a half percent, they've never been this high. And I mean, I recall buying a Canada savings bond at 19 and a half percent in 1981. So, they can go a lot higher. Things can go a lot more awry than you might think.

But I think -- I want to leave hope here, right? This is an opportunity for active investing, correct? What I want to make sure people take away from this conversation, the regime shifted. You're not in Kansas anymore, Dorothy, you're in a very different place. And it requires different thinking and different actions in order to achieve some semblance of success. And I think that when you're looking at environments like this, whether it's what we do or Alf, what you're providing to people, both retail and institutional managers, is that inflation volatility, leads to economic volatility, which leads to asset class volatility, and this dispersion is larger now than it's been over the last decade. That large dispersion provides opportunities for profit in the active management space. And so you …

Alfonso: **00:48:09** I can't agree more. I can't agree more, Mike. And I again, I'm a chart guy, probably understood it by now. I really like charts as a visualization way. And I know we are on a podcast, but I'll try to walk people through this. The 2020s are going to be toxic for people that are basically still stuck in the 2010s. In the 2010s, a portfolio of bonds and stocks and real estate, possibly held, had a Sharpe ratio of one and a half plus. This is a hedge fund kind of Sharpe ratio, guys. I mean, we are talking about an incredible amount of performance against so little drawdowns and volatility, which invited Mike as you said, people to just do nothing. Just own assets, do nothing, don't risk manage, because the Fed is going to take care of risk management for you. Don't worry, it's perfect.

The 2020s are going to be materially different, and that's what I tried to explain with this chart. It's called don't confuse macro trends with macro cycles. And yes, there will be some change in trends. So, I expect growth to actually keep dropping. There are structural reasons, demographics, stagnant productivity, why growth in the developed markets is going to keep trending down. The trend in inflation, interestingly, might stop going down because we are doing some stuff that is actually inflationary here. We are doing deglobalization, we are onshoring supply chain, we are rethinking our dependence from energy, especially in Europe. So, we might do some things that are on the margin, inflationary.

The most important thing though, rather than these trends, are that macro cycles will be much more severe, much more vicious than before, both on the way up and on the way down. Which means if you're an investor, macro risk management should be at the key of what you do. Passively holding assets is going to be a bit more complicated when it comes to risk/return profiles. And in this chart here, you can see the orange lines that are the cycles. I expect these cycles around the trends to be much, much bigger than they were in the 2010s, which require people to have a deep understanding of macro, a deep understanding of portfolio management, and risk management techniques. Eyes on the ball. It requires people to study macro and get that kind of information and knowledge we are, for example, trying to, to share here, Mike and Adam with the work you're doing as well. People should get more attentive to risk management and macro cycles, much more than they were in 2010s.

End miniriff here

Adam: **00:50:42** And speaking of that, you just launched a service in furtherance of that. So, maybe let's close with you telling people what you've started to offer and what that business model is going to look like and how people can get engaged.

Alfonso: **00:50:58** Thanks, Adam, for the chance. So, the Macro Compass has been a very successful newsletter for 2022. It's actually probably the biggest in the world on the macro space. It's 120,000 people reading me, very happy about that, humbled actually.

Mike: **00:51:13** Congratulations.

Alfonso: **00:51:14** Thank you. I realize though, that the newsletter is a very good thing. But it's not enough to achieve this level of macro risk management that is needed, I think, in 2020s. So, I decided to complement that and to make it much more frequent, tailored for both retail and institutional with different products on offer, but also complemented with long-term ETF portfolio, tactical trade ideas, and interactive macro tools. That's really the important thing. People should get a chance to really understand and track market moves like the institutional investors have the chance to do, because they have access to a certain set of data, very expensive subscription models, etc., etc.

I want to make -- I want to democratize this process of people being able to play around with macro, understand the different dots they need to connect in the space and enhance their ability to macro risk manage. And also I'm going to do a lot of courses next year. Because I think we need to really go deep into how our monetary system works, how the monetary plumbing works. I've been in the trenches doing exactly that. Portfolio management, risk management that basically we'll do everything on one platform, which is on themacrocompass.com, if people want to go and check it out. There are different products for different types of investors from retail to more sophisticated retail, to institutional investors.

Mike: **00:52:34** Fantastic. And it's @macroalf on Twitter, as well, right?

Alfonso: **00:52:38** Yes, my Twitter handle is @macroalf, and there you'll find more snippets I think than anything else, and especially some pizza and bread recipes. I'm Italian after all.

Mike: **00:52:49** I do envy that when I see the fresh pizzas from Italy with the, you know, that prosciutto on it and the egg and like the real stuff. Actually, it angered me a couple of times when I saw it because I know how good it is. And I was sitting there not getting to have any -- …

Alfonso: **00:53:03** We can fix that. We can fix that. I can just have you as a guest. I mean, Southern Italians are very, very warm people. They generally try to share food with others. It's part of the culture.

Mike: **00:53:17** I love it. Put it on the calendar.

Adam: **00:53:18** We'll take you up on that for sure. Yeah, definitely.

Mike: **00:53:21** Absolutely. Well, thanks Alfonso Peccatiello.

Alfonso: **00:53:28** The first try was better than the last one, Mike. But it's really complicated.

Mike: **00:53:31** You say it again.

Alfonso: **00:53:32]** So, I'm going to try okay with all my Italian accent and that's Alfonso Peccatiello.

Alfonso: **00:53:36** Oh, Peccatiello.

Adam: **00:53:38** Alfonso Peccatiello.

Alfonso: **00:53:40** Very well done.

Mike:	**00:53:41**	The Macro Compass, Macro Alf. Thanks for taking the time today.
Adam:	**00:53:44**	Yes, thank you so much.
Alfonso:	**00:53:46**	Mike, Adam, a pleasure. And every time you want to have me back, just ping me up and I'll be here.
Adam:	**00:53:52**	Fantastic. Have a great weekend. Thanks, Alf.
Alfonso:	**00:53:54**	You too. Ciao.