

[00:00:00] Rodrigo Gordillo: All right, we're live, ladies and gentlemen. Welcome. Welcome, everybody. All right, so what happens if stocks fall, bonds don't rally, and commodity prices rise? The answer is it's real ugly for most investors. 60/40 is an all in bet on disinflationary strong growth. How prepared is your portfolio if we have inflationary weakness?

This is going to be one of the many topics that we're going to address today. This is a recent tweet by our guest, Bob Elliot, CEO of Unlimited Funds. We're going to get through his thoughts on the tweet, many other things, but before we get into it, just a little bit of housekeeping. We're going to talk about all of these topics and we're going to give some high level understanding of what's going on, but ultimately everybody here is trying to help everybody out there.

And for example, Bob runs an exchange rate of fund. HFND is the ticker. Unlimited Multi Strategy Return Tracker ETF. And this is the things that you're going to need to be looking for, right? Non-correlated return streams that are very different from your traditional equities and bonds. And so if you like that, do go check Bob's Funds out at unlimitedfunds.com. From the perspective of ReSolve, go to investresolve.com. We have a wide variety of solutions there from private pools to public funds, to separately managed accounts, including the Return Stacked series. So please do check us out. And now we can get right into it, get Bob's thoughts. Let's go.

[00:01:22] Richard Laterman: And before we do, let's just remind everyone that nothing we discuss here today should be considered investment advice. This conversation is for entertainment, hopefully, but definitely informational purposes. So with that, we kick it over to Bob. How you doing, Bob?

[00:01:36] Bob Elliot: Hey, how's it going, folks? Good to see y'all.

[00:01:41] Adam Butler: Yeah, welcome. It's, this is actually a really timely occasion, right? We just had the Fed announce and comment and they seem to have caught markets off guard again. Anything, any surprises in Jay Powell's talk or in their policy actions or in the so called dot plots.

[00:02:03] Bob Elliot: Yeah. It's not just the Fed. I like to think that we had a central bank bonanza that we're all recovering from right, over the last 10 days, where we got ECB, BOJ, BOE, Bank of Canada, Fed, plus the Nordics and a few odds and ends in addition, and I think, when I scan across basically all of those central banks, I think nearly all those banks are basically at a point where they're saying that they've done enough, that they're not particularly urgently moving to additional tightening.

They're much more focused on a wait and see approach. And I think that's particularly interesting in the context that none of them are even close to achieving their inflation mandates. Basically all of them need, in one way or another, are supposed to deliver 2 percent inflation and take the ECB, they're stopping their hikes at 4 percent and inflation is between five and six. It's not, and it's been stable that way basically, for a while. Take the BOE, core inflation has been stable at 6 percent for 12 or 15 months. And they're stopping their hiking cycle, right? And so the same, the Fed is probably a little bit ahead of most others, but still pausing their hiking cycle when it's certainly not clear that inflation is definitely durably going back to their 2 percent band. And so you yeah.

[00:03:28] Adam Butler: Go ahead. It's been turning up lately.

[00:03:30] Bob Elliot: And if anything, and this has all occurred as oil prices are turning up and energy prices are turning up. And so you're getting, and a lot of that disinflationary impulse that really helped bring, basically took inflation from being at the high single digits to the mid single digits that's unwinding, right? There was a big inflation-disinflationary impulse that's behind us, not ahead of us. And so you add that all up and I look at this market and I say to myself is it, is there a possibility that the bigger mistake these central banks will be making is that they stopped too early?

Is that the biggest mistake and the thing we should be worried about much more so than did they tighten a little too much and are we going to get an economic, some economic weakness? Yeah. And I think you don't want to be this, that inspired a lot of comments. Oh my God. I can't wait.

[00:04:16] Rodrigo Gordillo: Everybody out of my way.

[00:04:19] Bob Elliot: Go ahead, Adam.

[00:04:20] Adam Butler: Yeah, I was just wondering, if we were to compare this to the 60s, 70s, and maybe that's not the right analog, it does remind me in some ways of McChesney Martin in the late 60s, and he paused and he had a sort of mini panic because they did observe not just inflation gauges rolling over, but some credit gauges rolling over and other economic metrics.

And so put the brakes on vastly too soon. And then of course we saw the real surge in inflation and it's, we've seen UPS with just a massive increase in compensation for their drivers. We've got this UAW negotiation going on that's going to affect hundreds of thousands of auto workers. And these are just the ones that we see. Are we starting to now see dynamics become entrenched, just as the Fed is becoming more sanguine that things are going to turn out ok?.

[00:05:20] Bob Elliot: Yeah. I like the sixties analogy. Because if you, when you turn to the seventies, you got some of the issues with the, like oil prices went up five X, like that's not happening right now. And that had a lot of second, it was after a period of 15 years where inflation was let to run a little too hot for a little too long. And so I think the second half of the sixties and that sixties period is actually a good one, income driven expansion. Not much credit orientation.

Inflation remains a little too high for a little too long. And then, of course, an important recognition that I think connects well today is, you have a foreign war that we're in part paying for. Expansionary fiscal policy. At that time, it was both war related policy as well as domestic spending.

We have a lot of the similarities there. And I think the key lesson at that point was you know, the Fed just didn't get ahead of the inflationary dynamic. They were building off of the dis, the, obviously the very disinflationary thirties, and then even the post war period in the fifties was quite, quite boring in that sense, after we resolved the post war issues.

And the expectation was this won't really be a big deal. We can run huge government budget deficits We can run monetary policy that's not particularly tight in the face of moderately rising inflation or elevated inflation, and it'll be okay. And then, it wasn't okay.

And so I think that's actually a great analogy in terms of where we are. Now less, a less of a Burns moment and more like a sixties moment. Yeah. Of the McChesney, a McChesney moment, we've got. You and I should probably start pitching that on Twitter. See if we can get people to pick that up. But it's a McChesney moment.

[00:07:10] Rodrigo Gordillo: But really it's interesting, because the paper that the IMF came out with, *the A Hundred Stylized or the A Hundred Inflation Shocks, Seven Stylized Facts*, does a good job of summarizing kind of the big moving parts here and the big issues that the Fed has, which is, or any central bank, which is what has happened historically when you stopped too early? I know you tweeted about this. Bob what are your thoughts on using historical analogs, broadly speaking, where the central bank in Europe is or in, in the UK is versus the US and what mistakes are they making?

[00:07:42] Bob Elliot: Look at what that paper shows, which I think, anytime you're looking at those circumstances, the value is not in like the precise numbers, right? The value is in understanding the linkages in terms of how things work. And the thing that I found the most interesting in that paper, the gist was that if you ran monetary, if you had inflation shock of some sort and you ran monetary policy, like largely consistent with the Taylor rule in one form or another, you basically resolved your

inflation problem, in relatively short order. And if you run monetary policy that is more dovish than the Taylor rule, then your inflation problem doesn't get resolved in the near term. And take a look at what the U S and other central banks have done, like the fact that they relate to the game.

All of that points to the fact that they did not run policy sufficiently tight in response to that shock. And, we're paying the price for that right now, which is that the inflation dynamic is a lot more entrenched than it would have been otherwise. I think the thing that is super interesting about that paper is that often people will say that there's a trade off. You don't want to tighten too hard because you might slow growth and that might cause an economic weakness, an undesirable economic weakness, but the thing that paper actually shows is that if you run monetary policy consistent with the Taylor rule and you tighten relatively aggressively, your medium term growth outcomes are actually better than if you're late, if you tighten less than the Taylor rule and you let your inflation problem be unresolved. And so that's what taught me...

[00:09:13] Rodrigo Gordillo: That was what's really interesting about that. And right. It's just counterintuitive.

[00:09:17] Bob Elliot: Yeah, it is. It is. It's the thing that drives, you have, the thing that drives medium to longer term growth outcomes is stability, right? Productivity benefits from stability. Stability, the biggest thing that undermines stability is inflation. And in that sense, the sort of linkages that you see are relatively straightforward. And I think, there's just a lot of nervousness that, you might have a growth problem, the tightening might lead to a growth problem in an immediate sense and not appreciating what that means over five or 10 years.

[00:09:50] Adam Butler: What do we, what do you make of the very substantial backup in rates after Powell announced? The bond market clearly was not taking a great deal of confidence in in palace statement, right? And then they backed up again overnight. And now we're at, at or near new highs for the cycle. I think we're at, new 15 or 18 year highs or something in the 10 year rate. Is the bond market saying that the Fed should not be done here, that in fact, inflation, long term inflation risks are higher than the Fed is giving credit to?

[00:10:30] Bob Elliot: Yeah. Yeah. I feel like speaking like an old man. I remember when bond yields were above five. Holy crap. We've forgotten like bond yields can be above five. Like it's, it's not like a rule of the ...

[00:10:41] Adam Butler: ...universe.

[00:10:42] Bob Elliot: Yeah. And everything is, can be okay. It was bond yields above five, right? Like that, we had that. Not just like in our lifetimes and our professional lifetimes. And not that long ago, I think the thing that you're basically seeing in terms of dynamics in the bond market is, the worst counter intuitively, the worst thing for bonds long duration today is the Fed stopping their hiking cycle, right?

The best thing for bonds is the Fed hiking aggressively. And so that's basically what we're seeing is the Fed is. I've had, and other central banks have basically said, look, we're done on the hiking side, like short rates aren't going any higher and we'll just wait the sucker out.

And I think basically what people are starting to recognize is, okay what that means in conjunction with the fact that we haven't gotten inflation back down durably, clearly durably to target, is that risk of long term elevated inflation, the probabilities of that go up in that instance, which means that that bond yields are selling off.

And of course there's some flows issues related to US bond yields, but in the short term, I think that's basically the market action that we're seeing is that very classic bear steepening in response to a central bank, just not being tight enough in response to the underlying economic conditions.

[00:12:01] Adam Butler: And we saw follow through on that too, on the Japanese inflation numbers and the BOJ.

[00:12:09] Bob Elliot: Yeah, the BOJ, Japan's in a different, bit of a different circumstance. If anything, they could probably benefit from a little bit of inflation and their inflation problem is more like in the three to four range versus, if you look at Europe, you're in the five to six.

If you're in the UK, you're in the sixes and above. The Japanese situation, like for the whole year, basically I keep telling people like, look, yeah, sure. Running, capping rates at an extremely low level doesn't make much sense, which they mostly have dealt with, but like the, like Bank of Japan is not going to get on the move in terms of tightening anytime soon, like the economy is still depressed, inflationary.

You still have a big hangover from decades of deflation. You still have that mindset in place. Inflation isn't nearly as high as in other economies. Japan's going to take this easy. And I think some people thought Ueda was going to come in and just totally wreck the place. And, that was a bad trade. And

instead, he's just cautiously... very modestly tightening a little bit in that economy, which is mostly what it, what's appropriate for it. If it gets, if it's the upper bound for the first time in decades.

[00:13:13] Adam Butler: They're clearly acting, there's, they're signaling that they're ready to act should inflation get uncomfortably high, but there's no reason to think that it is.

[00:13:24] Bob Elliot: But it's fin,. three percent inflation in Japan, right? Even what they needed.

[00:13:31] Richard Laterman: That's right. Historically they've been begging for, but to maybe double click on the US for a second. So some of the estimates I saw, as per the Taylor rule of where Fed fund rates should be right now, given all the other variables would be somewhere in the seven, seven and a half. This seems to be, or at least he would want us to believe that this is Powell 2.0, that this is not the *Pivot Powell* of October 2018, that this is a new Powell that is very serious about inflation. All of his latest, like the Jackson Hole appearance and his short and focused speech said that his eye was still on the ball.

Obviously they know all the historical precedents. They know of the McKesson, McChesney, or whatever the reference that you guys just use, or the Arthur...

[00:14:17] Bob Elliot: Burns. McChesney.

[00:14:18] Richard Laterman: McChesney, that's the gentleman.

[00:14:19] Bob Elliot: ...

[00:14:19] Richard Laterman: And given that they know all these historical precedents, and they know, and they can calculate the Taylor rule, what do you think is keeping them from actually moving? Is it just political expediency? They're de facto beholden even though they have political legal independence from government. At the end of the day, they continue to be an arm of the US government.

[00:14:37] Bob Elliot: No. I don't, I really strongly believe that there's not a political, in any partisan or any sense related to that in terms of the Fed. I think, they're more controlled by longer term *great principles of life*. Volcker often said, "The threats to raising interest rates too high are always obvious", right? You're always concerned. It's always clearer.

The concern, the concerns about tightening are always much clearer than the concerns about not tightening enough. And I think that's basically what they're experiencing. And I actually think it's a, this McChesney moment thing, I think, I'm really like digging on that because I think that actually is a really good corollary that you have to think about how central banks fight inflationary periods as like a psychological dynamic, and they almost always behave in it, basically the same way, which is there's an inflation shock, they're behind the curve. They think it's transitory, they're behind the curve. They tighten a reasonable amount, but not quite enough because they're concerned about growth, right? And then they do this interplay where they're, they tighten a little bit more and then that's not quite enough. Growth slows and then they get a little worried and they go back and forth and that creates this sort of inflation meandering up the curve over a period of time.

And then at some point you get to a point where the distance, the state destabilizing effects of the inflation becomes so acute that it's obvious, becomes obvious to everyone that it makes sense to fight the inflation and not worry too much about growth, even though you know that it's going to be a growth problem, but to get to that point, like it can take a very long time.

And even the Volcker situation, I always like to remind people of this, like Volcker fought inflation and then gave up two times before he finally succeeded in the span of three years. So like it, even Volcker, who's like the best, who had the biggest mandate to fight inflation, who goes down in central bank history as the greatest central banker in the history of time, yeah, he also screwed it up a few times, right? So that gives you a sense...

[00:16:41] Rodrigo Gordillo: Yeah. He struck out twice and, or he had two balls and finally hit it out of the ballpark in the third pitch.

So to that, you may or may not be able to answer this question from our listeners. This is from *Panoramic London*. Where does Bob think the Fed funds should go to bring core PCE to the Fed's target of 2%?

Now, before you do answer that though, I everybody that's listening here, Panoramic, you, everybody, Please do, smash that Like button, that Subscribe button. It does help us bring amazing guests like Bob to our channel. And also don't forget that we do these types of things for educational purposes, but we also have a business. Bob has an amazing ETF at Unlimited ETFs.com. If you want to visit us you can go to investresolve.com. And I'll just address one thing that's been coming up quite a bit.

I think, our public products and Bob's public products sometimes are seen as very difficult to put into portfolio to make some room in your portfolio in order to make it work. It feels like you're taking away from returns and equities and bonds. But as Bob alluded to in one of the previous tweets, if they have a similar Sharpe ratio long term, then you should not care. But if you do care about short term underperformance, you I think, would benefit from going into returnstacked.com. This is a kind of a dedicated website that talks about ways that you can create capital efficiency using public ETFs and mutual funds. So that way you can make room in your portfolio, keep your traditional core bond holdings and then stack funds like Bob's funds on top and of course the things that we do. Please do check out any one of those websites, all of them, and now we can get back to our regularly scheduled programming, Panoramic London asking, "where does Bob think Fed funds should go to bring core PCE to Fed target at 2%?" What are your thoughts, Bob?

[00:18:26] Bob Elliot: Yeah I think the question I won't try and dodge the question I, cause I think part of it is like. I probably wouldn't even think about Fed funds. Like it's not that interesting at this point because the Fed's not going to bring Fed funds anywhere beyond where roughly it is today, or maybe 25 basis points more, anytime in the near future.

So it's *the Fed's dead*. So then let's talk about what actually has to happen to bring Core PCE down, which is you have to have, the main issue is that there's too much wage growth. Wages in the US are growing at five to six percent. Productivity growth in the US is about zero.

The same is basically true in Europe and the U. K. where you have zero productivity growth and wages that are growing at five, six, seven in the UK, even eight percent, depending on how you measure it. So that's really, the gap is too high a nominal wage growth relative to productivity growth that creates structural inflation.

And so how do you break that? You've got to create easing in the labor markets. How do you create easing in the labor markets? To do that, you've got to slow down demand relative to the capacity. How do you slow down demand? You got to get people to start saving more of their income and spending less of their income. And how do you do that? You've got to get asset prices down to start changing that choice between spending and savings. And so the thing that's really going to create the durable decline to the 2 percent PCE rate, is getting a meaningful turn in the cycle, which is going to require a shift in asset prices.

Not really short rates. Short rates aren't going to move much from here. It's really about the asset prices. And I was saying on Twitter yesterday, just like trying to work through, where does, where's

the peak of bond yields look like? And what's necessary to bring the cycle down? I think we're probably going to need bond yields into the fives to get enough of an equity market softening to change, to start to create a tipping of the cycle down in that sort of self reinforcing negative type dynamic.

And how are we going to get that move in the bond yields? It's going to be a market tightening. It's not going to be a Fed tightening. It's going to be a market tightening. And that's how this is going to play out is, bear steepening, market based tightening affecting, affecting asset prices, and that creates the dynamic to get us to bring inflation down.

[00:20:42] Adam Butler: I love that. That, that's the first time I've heard someone clearly say that. There's, the implicit target of the Fed is to lower asset prices in order to put pressure on household balance sheets and I guess corporate balance sheets to a different kind of extent, to get people a little bit less enthusiastic about spending and more enthusiastic about saving.

We know that we still have a lot of leftover residual in demand deposits from where government deposited funds directly into people's bank accounts to make up for lost income during the COVID lockdowns. And we continue to see deficits running in the six, seven percent range. And according to the Congressional Budget Office, we're going to see 6 to 9 percent annual budget deficits about as far as the eye can see.

In the face of such a major fiscal tailwind, in your mind, does that mean that the Fed's job is even harder and they're going to have to get more aggressive either with their QT operations with higher rates or current rates for much longer than people expect, or maybe changing the composition of their QT?

Maybe shifting into selling mortgages outright or some other type of action in order to get markets to react to the extent that they need to, in order to get the consumer less confident and less likely to spend.

[00:22:16] Bob Elliot: Yeah. I think a lot of ways the Fed being dead also, it goes to short term interest rates. It also goes to the, to quantitative tightening. Like I, I don't really under, I don't understand why the Fed seems to be like having a brain blockage about flexibly using quantitative tightening. Those of us who traded through the 2010s, like quantitative easing went up, it went down I mean like hundreds of billions of dollars on an annualized pace.

We did twists, we did all sorts of innovative, interesting things that created flexibility when interest rates were around zero and the Fed needed that flexibility to implement monetary policy. And we get to today and it's like QT 95. That's it. We're never going to talk about it again.

It's just it's like the problem we have today, I like to say we don't have a price of credit problem. Like price of credit's gone up. People have stopped borrowing. But yet the economy continues to persist. We have an asset price problem. If you have an asset price problem, sell the assets, right? Do something more in terms of selling the assets, but they won't do it. And I don't know why. And I think they're just like scared of some liquidity thing. And it's pretty bad. It's, this is a real error on their part, not using that flexibly.

But what it does do, is it means that in many ways, Janet Yellen is back in her old role, and the reason why I say that is because she controls duration supply these days. She can figure out whether there's going to be more or less duration supply. And she's essentially doing QT over the course of the next couple quarters in a way that the Fed, for whatever reason, isn't doing it. And so I think that's probably how this plays out.

A combination of just generalized market based tightening and then Janet Yellen increasing duration supply from the Treasury is going to create that pressure on bond prices and on asset prices and create that turn in the cycle. And that's, we've seen a little bit of it and it's hard, these flows from the Treasury are going to be so big that it's going to be, you're going to actually have to see the flows to impact the price. No one can front run the magnitude of this in the same way. No one could really front run QE when it started. No one can really front run this. And I was reading a tweet earlier today where someone mentioned, talking to a big bond CIO and he said, there's just too many bonds coming.

They're just, there's all these bonds. They just keep coming. I can't buy all these bonds. They just keep coming. And I think that's basically, that's where we're at right now.

[00:24:43] Rodrigo Gordillo: Is the Treasury providing that for the Fed in any way?

[00:24:44] Richard Laterman: Bob, do you think that there's coordinated action taking place here. And could you see the Treasury trying to provide cover to some degree? The Fed has played bad cop for a while. Now there's a change in the preference for duration. Is there a chance because she sat in that seat, and because we have heard central banks clamoring for more help from fiscal for so many years, is fiscal finally heeding the calls?

[00:25:12] Bob Elliot: Duration supply is picking up mostly because the Treasury is constrained in terms of their ability to like, not supply duration. And I think is it providing, I don't know. I don't think there's much ...

[00:25:25] Adam Butler: About that though, Bob, what do you mean the Treasury is constrained in their ability to not supply duration? Why couldn't they substantially alter the mix of bills versus coupon issuance?

[00:25:37] Bob Elliot: Yeah. The first thing is they didn't supply duration because we were at the at the debt ceiling, right? We were like, yes, legally could, required not to supply duration. And then... what happened was, they drew down the TGA and then refilled it with the bill issuance.

But now at this point, bills are basically at the, it's not a statutory decision. It's a strategic decision in terms of bills shouldn't be more than 22 percent or whatever the number is. Like a long-term sort of historical precedent. Yeah. The long-term guidance that exists from the technocrats in terms of the composition of the debt market and so that's really what's happening here is that the government's running meaningful deficits. They basically hit their cap on bills. And so now they basically have to issue the duration and so in some ways I don't know what to call it.

It's lucky that this is how it's worked out. But it is fortuitous that at a time when we still need some asset price weakness in order to achieve the overall economic mandate of the Fed, the Treasury happens to be supplying it. The frank reality is I bet the Fed would have preferred that the Treasury supplied this duration a year ago and tightened up things, a year earlier.

[00:26:48] Adam Butler: So, they also have preferred this given they would have been issuing duration at rates that were two or three percent below, if you're able to issue 10 or 20 year maturities at two or three percentage points lower. That adds up dramatically too, in terms of fiscal accruals, right?

It seems like they had an opportunity a year and a half ago to issue a lot more duration at much lower rates and at a time when that duration would have been really helpful because it would have further lowered asset prices and probably bolstered the Fed's actions as they're trying to fight inflation, it seems like a dollar, what is it, *a day late in a dollar short?*

[00:27:32] Bob Elliot: Yeah, I mean they're out of sync. Well, I mean what's the real thing, like they're you know, so there was a time when interest rates were at zero for 10 years and a lot better

borrowing. This is like the Larry Summers argument, which I always thought was compelling, which is if interest rates are at zero, borrow until the cows come home and just build all sorts of productive capacity and infrastructure and all that in the economy.

And instead, this is, like the road outside my house. They're like, basically doing some sort of meaningless cosmetic set of work related to the infrastructure bill. And at a time when the unemployment rate is like three and a half percent, like, why are we building roads when the unemployment rate is three and a half percent?

Like what an incredible waste. That's how the, at some level, that's how the government works and, I think what I'd say is maybe not, that's how the government works. I think we have transitioned, which is why I think the sixties is a good, is a good corollary to a world where we have more proactive fiscal policy than reactive fiscal policy.

Those of us who grew up in the nineties and the two thousands in terms of thinking about these things, fiscal policy was essentially responsive to what was going on rather than, and cushioning it, rather than proactive, but we have now a proactive-like second half of the sixties style fiscal policy environment where you have to think about fiscal policy as a proactive force in the overall economy and markets in a way that really until this year you hadn't had to. It's a rant about zero interest rates and investment, but there you go.

[00:29:04] Adam Butler: Signals are not indicating that investors are starting to wake up to the potential for a much more sustained inflationary impulse, right? You've got the bond market, seems at least, nominal rates seem to be accelerating maybe in the recognition, but we're, we still see long-term inflation, actually market based long-term inflation expectations stuck around that sort of high two, very low three range. What's it going to take to see those expectations budge?

[00:29:43] Bob Elliot: Oh, it, the market, the market, and particularly, let's say, long-only bond managers, it feels a lot like, it feels a lot like 2011. Now, I don't know, 2010, 2011, I don't know how acutely that is in your mind. But the reason why I say that is at that time obviously we were having a deleveraging environment, which was different from a traditional, a more traditional cyclical environment.

But nonetheless, you had basically V shaped recovery getting priced into the short rate market, right? So like actually the greatest trade of all time was like long bonds against that V shaped recovery because we essentially had an L recovery, for a really long time, right? For 10 years.

And so it, it feels a lot like that, which is at that time, investors in their whole careers had only known basically cyclical down, cyclical up, cyclical down, cyclical up, in the same way bond investors today only know two percent inflation, right? They only know a negative relationship, a negative correlation between stocks and bonds and a two percent inflation number.

Sometimes, people ask me why is breaking inflation just stuck at two percent? And I say I think the answer is that the modelers just typed in 2 percent and hard coded the number in Excel, like they forgot that it could possibly be different.

[00:31:06] Richard Laterman: No, let's pull on that thread on the TIPS because I, you hear these commentators talking about how TIPS have quite a low predictive power historically for actual inflation. And it really is just a non-arbitrage relationship. And do you subscribe to that? Do you find TIPS a compelling way to forecast inflation or are you on the camp that TIPS are just another instrument and variable to gauge currently would be the breakeven, but not necessarily a strong predictive variable for forecasting inflation?

[00:31:36] Bob Elliot: Yeah. I wouldn't use TIPS to break even inflation applied by TIPS to forecast inflation, like at all. It's an asset market. It's a tradable asset market and you can start to think about what drives those assets and what's priced in. It's very useful to understand what's priced in. That's very useful to do that.

And you can trade against it in the same way. You wouldn't necessarily rely too much on the short rate curve. Just tell you exactly what was going to happen to monetary policy, because I was certainly, you wouldn't in the last 18 months. Because how many times is the short rate curve going to think that there's going to be 400 to 600 basis, 400 basis points of cuts and then get disappointed.

You'd think a toddler would learn after two or three times of this that their expectations haven't come true, but not, I guess those short rate traders still think that, still keep hoping for the cuts to come.

[00:32:29] Richard Laterman: It's a misinterpretation of these variables, right? If you think about it, there's a liquidity component to TIPS and that signaling mechanism was broken to some degree to the extent that TIPS became a target of QE at one point and became part of the Fed's balance sheet. But so when you look across the asset class landscape, what do you think are the most egregiously mispriced asset classes versus your expectations for inflation?

So Maybe bonds are starting to catch up. Do you think equities are catching up? They've been selling off for a couple of days, but they seem to be still, pretty high versus other historical periods with inflation. And then if you can bleed into the commentary around commodities, if that makes sense?

[00:33:08] Bob Elliot: I was going to say, I think if you look across assets, where are the biggest mispricings, I think we've got, we still have a meaningful very low term premium. It's something I was writing about yesterday. And we're probably still a hundred-ish basis points below what sort of a, even like a normal-ish term premium, is that we should expect along bonds.

And that term premium, it's very important because it affects everything. Like it's the reason why five year TIPS look better than 30 year TIPS. That's the reason why bills look better than 10 year bonds. And frankly, it's part of the reason why equities don't look that great relative to cash, is because that term premium exists in all financial assets.

And so term premium doesn't seem right. We still, we've moved. We've moved to some extent off the bottoms, but there's still, I think, probably a ways to go on that, and particularly like that intersects with the flows dynamic related to the supply of bonds, because it's one thing if this bond supply is constrained with a low term premium that you can keep clearing the market at that price. But the problem is, if you're trying to issue a whole bunch of bonds, when the value essentially is very poor, like, how do you get the next, the guy who stuffed, *IRImpossible*, it was the Ackman tweet from earlier today, like the bond, the long only bond manager is stuffed to the gills with bonds.

So how do you get people like you, like the four of us, when are you going to buy bonds? I'm not interested in buying bonds now, but I'm going to need to buy bonds. They're five and a half. I'm certainly, interested in the market. Anyway, that's a long banded off your original question, which I can get back to...

[00:34:48] Rodrigo Gordillo: I do want to take this step by step because I think a lot of the times when people who follow you and Bridgewater, and everybody that looks at markets and then what's priced in, they don't understand how you price things, right? What do you mean it's not priced in?

There's a price that's out in the market that's supposed to be correct. And there's the price that I believe to be true. So you mentioned a couple of interesting things. You said term doesn't seem right. So I, let me try to translate and then you can tell me where I'm wrong. When you say that you mean like relative to history? The price of like term premium should be X. And right now it's X minus that. And we need to get back up to that long term average. Is that, am I right in the first assertion?

[00:35:32] Bob Elliot: Yeah, yeah. I, the basic observation, like that, the basic point, just think about it very simply. There is, cash has no risk. Lending your money out has risk even against a person, an entity that will for sure pay you back. There's interest rate risk. And so in order to do that and you're parting with your money for some period of time. And so you'd expect to get more in the future than you get today.

If you part with your money and you lend it to someone that, and some of us, a very simple observation but what that means is, okay, so how does that work? You're, the yield that you're getting on cash necessarily is lower than the yield that you should get on longer dated instruments because you'd expect to get a higher yield to be to incentivize you to lend out your cash for that term. Now, of course you have to think about that in the context of what is the expected path of cash relative to those long interest rates, and so it's not just like, literally the yield curve defines what that looks like. But if you start to think about, okay, we expect maybe a very modest easing of monetary policy.

So the expected forward yield of cash is still pretty elevated, frankly. And then what you look at is those bond yields that are trading at a hundred basis points below cash. You start to say to yourself it's, what am I getting for giving my money for 10 years? And the answer is not much. In fact, maybe even. Negative. Negative.

[00:36:56] Rodrigo Gordillo: We're trying to solve this point, okay. And so let me know. No. I just want to make sure I understand. So you have, that's what you have. That's one thing, right? That's differential. Now we also have the added element of there's a bunch of supply coming in from the Treasury and other places.

So is this, there's one thing to say that's it's undervalued, equity markets have been overvalued for a decade. The other thing is when is it going, when there's going to be a catalyst in order for that to turn around?

[00:37:26] Bob Elliot: And that really, what it comes down to is there's value, which really, if you think about term premium, that's a value concept. And then there's, supply and demand at any one moment. And so you have to think about who are the buyers and who are the sellers at that any one moment. And also start to think about not just their incremental buying and selling, but their balance sheets.

And so if you're a long only, if you're a pension fund or an endowment or stuff like that, and you went hog wild for those 350 yields that were being offered earlier in this year, like you've, not only have you probably fill, gotten your fill on how many bonds you're holding, but also you're a little burned by that by having lost, 10 to 15 percent on that trade.

And you're starting to like, okay, so then who are the folks who are going to come in and buy the bonds? I know that sounds like such a simple point, but it's like, where are the people that buy the bonds? If you look back in the last 10 years, who bought the bonds? The Fed?

They're selling, now foreign central banks, they're selling now. Big, large money, long dated, pension funds, real money type accounts. They're stuffed to the gills with bonds. Like who is going to buy the bonds? That's the question. And the answer is, it's tough to find the person who's going to buy the bonds. And the way that gets resolved is just through a mere, through a mis-repricing, maybe just re-priced, repression, right?

[00:38:49] Richard Laterman: Which is the Russell Napier hypothesis that we are going to live through a period of financial repression. We had in the early to mid 20th century and financial institutions are going to be required to own more bonds, whether it's insurance and reinsurance companies, regulation shifts in order to provide cover for government.

[00:39:11] Bob Elliot: So I wouldn't be surprised, but I did want to follow up with the way, that it's important to recognize on that also *IRImpossible*, thank you for your running commentary. Also banks were buying bonds. got burned by it and have been forced to reduce their duration, not increase their duration, in order to reduce their regulatory, the regulatory risk that they have on their balance sheet.

So they're not buying bonds anytime soon. I think the most the most important thing when you think about that story, which is financial oppression, sure, but not that useful to trade markets. Not that useful to trade markets. I'll tell you why that is. It's because there's an ordering of financial repression, right?

It's like folks who say, eventually the Fed's going to have to print. Yeah, sure. Eventually the Fed's going to have to print. But how are we going to get to a point where the Fed has to print? First, the yields rise. Then the economy suffers. Then asset prices suffer. Then the economy suffers. Then those interest rates are unacceptable and there's steps taken to bring those interest rates down, but the ordering matters a ton, right? Don't get caught thinking that a recession, sure, I bet a

recession will happen in the next two years, almost for certain there will be a marked recession in the next two years, but that doesn't mean this is the time to buy bonds, because first the yields have to rise.

Then the asset prices fall. Then it becomes interesting to buy bonds. That's the ordering. And so repression, sure. Maybe it'll come someday. I don't, in the life of a trader is trading in a sort of two, three, four, five, six month timeframe. I don't really care. Does, we'll get to that point when we, yeah.

[00:40:44] Richard Laterman: But to get a little bit of clarity, I just want to clarify when you talk about a mispricing across the US Treasury term structure of a hundred base points, that's on average, so I guess, is that a growing mispricing, the longer you go out on that duration curve. So it's mispriced, maybe 30 to 50 basis points on the shorter end. And then that mispricing grows obviously because of reinvestment risk and duration risk and that sort of thing, as you go out on the term structure, is that an accurate...

[00:41:10] Bob Elliot: Let me just say it's relatively homogenous across the curve. The real, like the real uncertainty now we're going to get into some of the the nooks and crannies of bond market mechanics or whatever. But like the real uncertainty in the bond market that anyone really trades on is within the first 10 years. What's going to be the interest, what's going to be the interest rate, the 10 year interest rate, 20 years forward, like no one knows, that, yeah.

And no one's really changing their view on it, because you, there's no reason to change the view on it. And really all the bond market dynamics, price dynamics even out on the long end are really mostly driven by what's happening in those first 10 years. And so that's why you could get overcomplicated, look at the 10 year term premium. It's close enough. It's basically the thing that matters to the bond market. And that's the thing that's basically, right now it's zero when it should be like at least a hundred basis points.

[00:42:04] Adam Butler: Gotcha. Fair enough. No, I lost what, I had something...

[00:42:06] Rodrigo Gordillo: Okay I have a question that kind of ties into what we were discussing last week with PJ Pierre, which is the contention from I think he's a, he comes from the school of Modern Monetary Theory.

Warren Mosler and one of the things that he said was that the reason, one of the major reasons that might be driving inflation is the fact that we're increasing interest rates, because we're getting to a point where the state, the money coming into the economy from savings of those interest rates are much larger than the expenses of the economy and so you know this is, and this was the first time I've heard something like this, it was an interesting point. What are your thoughts on that thesis, on that and that approach, that in fact the Fed raising rates is a bad idea That rates don't matter. And raising rates will mean, more savings, more spending, more inflation?

[00:42:55] Bob Elliot: Yeah I think there's, you can think about that problem conceptually. And of course, to the extent that there's higher interest rates, debtors are paying creditors higher yields, higher income, essentially. And that like core connection or linkage is true, but I think you've got to think about and really add up and quantify all those pieces to really understand what the incremental effect is. Like, the way that interest rates affect the economy in first is through the repricing of credit.

And if you look at how that's transpired, it hasn't been an extreme credit, for sure, it hasn't been a big credit cycle, nothing like the dynamic in 2008 or whatever like that. You have seen credit slow from running at a trillion, trillion and a half a year to close to zero now.

Okay that's a drag. And then you think about those borrowers who are incrementally paying. So that's incremental borrowing has slowed. So do interest rates affect incremental borrowing? Yes, they affect incremental borrowing. It matters a fair amount. If you look at what's going on with the debtors, like on the margin, debtors are paying higher interest rates.

It's taking a little bit of time. Because a lot of stuff was termed out and fixed rate and all that stuff. And what do you get there? Essentially, the way that works is that debtors are, typically have a higher marginal propensity to spend than do savers. And so while it's true, you might have a tran, you do have a transfer of higher payments from debtors to creditors, given the fact that the creditor's marginal propensity to spend is typically lower on the margin, even if it's a dollar for dollar transfer, that's a growth negative rather than a growth positive.

That's, the one outlier on that, of course, is the government that essentially in the US case is unconstrained, right? Their spending is unrelated to their borrowing which is an important fact to consider. And so there, I think you don't, you just want to quantify, what's the government paying out in terms of incremental income?

Who is it going to, the vast majority? Look, the vast majority of entities that hold US Treasuries are the Fed, foreign central banks and real asset managers, right? Like pension funds, endowments, and stuff like that. What are they doing with the higher income? Nothing. Just to be very clear, nothing.

They're buying more financial assets and that's supporting the overall financial asset environment. But like, how many people are actually earning so much more income that it's meaningfully affecting their spending and economic behavior? And I think the answer is not really, not, I, and you have to weigh that against, oh, I should also say the last thing is, of course, higher interest rates affect asset prices because they increase the discount rate that flows into all these asset prices, as we've seen in the last couple of days or whatever.

And that hit, the asset prices then affects spending behavior, savings rates, et cetera. And so you add that all up. I have a hard time solving the simultaneous equations in a way that says that when I net that all out, it means that higher interest rates lead to more spending, not less spending.

I guess it's possible. I'd have to think about how to construct all those pieces, but I don't, the quantities, the quantification of those different levers. That's out still to pretty negative in my mind. And I think, as asset prices come down, we'll be even more negative than we've seen so far.

[00:46:19] Adam Butler: The timing and the leverage in the economy matters a lot too, right? Like it takes a while for the government's debt to roll up into higher interest rates, right? There's, most of the debt has some kind of term. You have to wait for those bonds to mature, and then they need to be reissued at higher rates, right?

So it's not like those higher rates happen overnight. And also the amount of debt in the economy matters, right? Back in the 1970s, the aggregate debt to GDP and the aggregate deficit to GDP was very small. We're now nudging up against 100 percent debt to GDP, like just in terms of deficit, size of the deficit to GDP.

And much higher rates on that amount of debt is going to have a larger impact on the economy than it would if the size of the deficit was lower. But I want to zero in on that specific point, which I haven't heard the MMT crowd talk about, which is, okay, great. The marginal propensity to spend on goods and services by the beneficiaries of these higher interest payments, which are typically insurance firms, pension funds.

[00:47:37] Bob Elliot: Foreign central banks, and the Fed. Central banks.

[00:47:40] Adam Butler: Exactly is very small. So where does that money go? It has to go into back into markets. So tying back to your point about the fact that a core factor in the slowing of the economy needs to be the lowering of asset prices in order for consumers to become less confident about their savings situation and therefore shift some cash flows from spending into the savings pool. This is a dynamic that may increasingly affect the demand for assets, to supply.

[00:48:21] Bob Elliot: That's why it really comes down to this, to the long end, right? I think part of the issue is that we haven't gotten, like, the Fed being behind the curve has meant that, that inflation, and if you think about stocks, right? Like what are stocks? They're basically nominal, it's nominal variable, nominal cash flows discounted by fixed nominal interest rates. And the problem is because the Fed has been behind the curve, that nominal cash flow growth on the top of the equation has been growing too fast relative to the shifts upward in the discount rate.

And so the result is That even though, rates have been rising, they just haven't been rising enough. To offset that top line growth and so that, it's not precisely that way because stocks are down a little bit, but like the big picture sense is we haven't, we, in a traditional recessionary environment, what happens is the interest rates rise a lot relative to the incremental rise in the top line cash flows, and that's what creates the asset price hit.

And that in the inner market action, like why did like bond yields go up 10 basis points long and go up 10 basis points yesterday? And what do you see, stocks go down 200 basis points and long duration stocks are even worse off. That's how you get this resolved quickly, is not by persistently being behind the curve, but those rates get, start to move ahead of the curve faster than that income growth happens. And that then creates a circumstance where you start to see the asset price declines and that's been the problem we've seen.

[00:49:52] Adam Butler: Like we see that happen in the short term. We saw that back in 2022 and it was a little bit more sustained, but in 2023, we've continued to see a major, like rates are substantially higher today than they were at the end of 2022, but so are equity prices.

So we aren't seeing that effect be sustained in the equity market, right? The equity market continues to say fiscal policy is way more stimulative. Nominal growth is way higher and more sustainable than people expect. And so I'm going to price higher earnings a lot further. And that's going to cause me to raise my multiples. And obviously there's just enough supply of liquidity to create that demand for equities.

[00:50:40] Bob Elliot: Yeah. I, but I think a big part of that in that equation is typically in a credit driven cycle, the rise in interest rates would cause credit to compress so significantly that it would create a drag on spending.

And this cycle, we have something very different, which was initially, a government transfer driven, and then an income driven cycle, which means like if you think about it, income growth for lower quartiles is growing at 6, 7, 8 percent. Interest rates have not risen that much relative to 6, 7, 8 percent.

And so that's the basic problem is the income growth, the nominal income growth is too high. And that's what's now financing the situation. I understand that the government is running a reasonable deficit. Its impactfulness mostly occurred when it created a bunch of fiscal transfers to help bridge the gap between, to basically cushion the gap between the inflationary impulse and the point in which incomes could catch up, income growth could catch up. But today, there's no government transfers. Like where are the government transfers? They don't exist.

[00:51:48] Adam Butler: There's a massive investment, through the Inflation Reduction Act. And we're investing in a bunch of infrastructure projects demanding lower and medium skilled workers. You're talking about the guys on the side of the road who are fixing the storm drains or whatever. These are typically blue collar. They're not necessarily bottom decile, but they're, these workers have very high propensity to spend, right? So then, and these are the recipients of the kinds of stimulus that the government is currently engaged in.

Yes, it's not as direct as the fiscal transfers we saw during COVID. But it's still hitting the, I'm going to take that extra income and use it to either pay down debt or which we know they're not doing, because we've seen savings rates collapse or turn around and consume, right? To your point about the fact that this it's an income led consumption boom, and part of that income led consumption boom is being funded by fiscal outlays for investment, arguably really good, smart policy, right? Investing in at least some sub sectors of sustainable higher productivity capital, right? But it's having this effect.

[00:53:07] Bob Elliot: Yeah. It's just it's, I agree with you that the government doing that marginally is supporting this expansion, but the government is not the driver of the expansion.

It's not the primary driver of the expansion. The primary driver of the expansion is continued elevated nominal demand from households, nominal consumption demand. And that nominal

consumption demand is coming from private sector wage growth that continues to be very elevated. And that's the core.

And I think one of the challenges is, I think the, one of the biggest challenges that people have, like sort of people who, traditional sort of macro folks is, they're tearing their, pulling their hair out. Like, how can that work? Like the government, the deficit is, actually can compress, is elevated, but it has compressed basically, once you look through the seasonal factors and the California thing or whatever, it's lower than it was.

Three years ago, right? The deficit is smaller today than it was three years ago. Okay? Money supply has gone down, right? Interest rates have gone up. Credit has compressed. Now, hold on a minute. Like fiscal policy is tighter than it was before. It's still level wise loose, but fiscal policy is tighter than it was before.

Money supply is contracting, interest rates are rising, and credit is contracting. And nonetheless, we get nominal growth of 4, 5, 6%. Now, how is that possible? It goes against every linkage that we've learned over the course of the last 20 years, in terms of what drives how these things work. And the simple answer, which is a hard answer for people to understand, is that it's income growth. And how is income growth happening? It's happening from velocity. Velocity? What the heck is velocity? Like velocity we thought was dead, buried into the ground. But it's a real thing. It's a real thing that you can have all of these measures of money contract and nonetheless have nominal demand expand simply by everyone agreeing with each other that they're just going to pay each other more. And if you had lived through many emerging market debt crises and inflationary experiences, what you, this would be a very familiar story. It's, how does it work? I don't know, interest rates go to the moon, but nonetheless, inflation persists because we just hand the money to each other faster and faster, because we don't want it in our pocket.

We're not obviously having a Turkish-like inflation here, but or Argentinian-like inflation but the essence of that linkage is how this works. And that dynamic is very similar to how expansions worked back in the fifties and sixties. And that's why those periods are so interesting to think about when you're thinking about the dynamics and the linkages that are going on right now.

They're really the things to study because that's, those were income driven. Velocity paid for economic expansions. It's just, anyone who's seen that before is dead.

[00:56:03] Adam Butler: That's the way that the economy is traditionally supposed to work. This is the actual economy that we set out to build, where you've got workers who earn a decent wage, feel confident and therefore willing to spend, build a life, buy a home, start a family, right?

This is the sort of positive feedback mechanism that creates. It's a middle class and global prosperity that we haven't really seen in the last two cycles at all. So I think that's why.

[00:56:36] Rodrigo Gordillo: But that's assuming that the wages that they are getting are above the rate of inflation.

[00:56:43] Bob Elliot: Because at the end of the day, no, that doesn't matter. That doesn't matter because growth is a nominal concept. Inflation is a nominal concept.

[00:56:51] Rodrigo Gordillo: But standard of living doesn't get better. As my point, that's not the conversation I'm presenting it as. This is the dream. This is that, but it doesn't actually lead to a better outcome.

[00:57:01] Adam Butler: Sustainable prosperity.

Yes. You do need incomes to, that's, that's effectively productivity, right?

[00:57:09] Bob Elliot: That is productivity. That's exactly right.

[00:57:12] Adam Butler: And inflation. You're talking about wage price spiral.

[00:57:14] Bob Elliot: In essence. But, what's interesting about this case... not a spiral, and I think that's an important thing. Not a spiral. In dynamic, they could, at the limit, become a spiral. Right now, it doesn't have such a pernicious element to it. It just reinforces itself, right? And part of it, and part of the thing, like if you go study and the reason why this is so familiar to me is if you go study sort of classic toy economies.

I highly recommend everyone read the economic principles or *The Economic Organization of a P.O.W. Camp*. Twelve pages, literally, that document, the only thing you need to know, the only things you need to know about macro, everything you need to know about macro and how economies work. Twelve pages, promise you it's worth the, it's worth reading.

I'll say that one more time. *The Economic Organization of a P.O.W. Camp*. Okay. And I think it's such a good, it's such a good toy economy. And what do you see in those circumstances is you see these sorts of dynamics where income growth can create, can be funded through velocity. So they had cigarettes as their money because that's what came in the IMF packages, and then what would happen is the cigarettes would come in, obviously there was a deflationary force because people smoke the cigarettes, but nonetheless, you could have increasing economic activity, because one guy creates the tea and one guy is the coffee guy, the barista before there was a Starbucks, and one guy cuts the hair and one guy does these various things.

That economic activity can expand in an environment where you have a contracting money supply, a contracting volume of money. You can have an increasing output because the money just travels faster, right? Even though it has a deflationary force in the money supply as the stuff gets smoked, you can have increasing, because everybody's ...

[00:58:57] Adam Butler: Happy to have less cigarettes in their pocket.

[00:59:00] Bob Elliot: And they just hand them faster. And it's really, it's like actually not that big a deal.

[00:59:06] Rodrigo Gordillo: And, that's what we're seeing. Clearly, I'm not smart enough to understand why, how this doesn't make everybody worse off. You got less cigarettes, you work harder you're making more transactions. You have more output, you're getting less cigarettes. In this case, you are creating nominal wage growth, but it is real growth happening anyway.

[00:59:24] Bob Elliot: You're missing the temporal aspect of it is because with increasing velocity, like just think about it. Instead of getting, let's just say like one, a shave once a week, I can then get a shave at, once a day, right? And that's how you're better off in that environment.

[00:59:40] Adam Butler: You're better off in terms of your consumption. You're not better off in terms of your wealth. You're spending down your savings.

[00:59:48] Bob Elliot: You're not spending no. Because your income gross,...

[00:59:51] Rodrigo Gordillo: Your income's getting higher. You're not saving it. Income's getting higher on...

[00:59:53] Bob Elliot: Going higher. Yeah.

[00:59:55] Adam Butler: Your income's getting higher, but your total aggregate savings is going down and you're willing to live with lower savings because you've got greater confidence in the economy and you're spending. In your wage growth.

[01:00:05] Bob Elliot: In your wage growth, right? And you spend your wage.

[01:00:09] Rodrigo Gordillo: When you say your lower savings, you mean your purchasing power is going down, but because your income is going higher you can spend? Are you actually saying that? You're, the economy currently is getting higher wage growth and they're spending even more out of pocket from their savings to live that life.

[01:00:24] Bob Elliot: You don't need to have any savings. And I think this is the, your savings can stay, if you think about the savings as the constrained amount of cigarettes in the economy and a truly toy economy where there's money, where your money supply is your only savings element. It's like functionally true that the deflationary forces are in the cigarettes getting smoked, means that there's less literal physical savings, but you don't really care about what your literal physical savings is. What you care about is how much you can consume, right? And so if your income's going up you can. What you care about is the fact that your consumption can rise in that circumstance, not the fact that there's only so many cigarettes that you can hold in your pocket because you're just moving faster and faster.

[01:01:07] Adam Butler: Savings is higher because your expected income in the future is also higher.

[01:01:12] Bob Elliot: Exactly. Exactly. So it's why like the same in that particular toy economy, like, savings isn't, is there's other elements of it that connect to savings, but in that particular example that I'm giving it's not, savings isn't really the key element because consumption happens through the fact that sort of temporarily over time, you get more activity rather than have more in your pocket that you could plausibly demand into the future.

[01:01:40] Rodrigo Gordillo: So, moving forward in the conversation because okay, so you have this. Not what you were expecting to talk about here.

[01:01:42] Bob Elliot: No, this is really good.

[01:01:45] Rodrigo Gordillo: I'm going to read that. It's going to be great. You, one of your tweets was that sentiment today, feels very similar to mid 08. Many folks creating justifying narratives as to why the US and global economy could navigate the period without a recession. So maybe we can link that, what you were discussing with this comment, and what we can see in the future with regards to a recession, and maybe the equity market. But before we do, everybody who's still hanging around, please do smash that Like button.

Make sure that you're subscribing to the channel and follow Bob here, Unlimited Bob, right? Bob Unlimited?

[01:02:18] Bob Elliot: Bobby Unlimited, right there. BobbyUnlimited on Twitter.

[01:02:20] Rodrigo Gordillo: But yeah, Bob let's get into that part. Why does it feel that way and what is the, what can we do to understand the impact of the economy in real reality, the impact of the economy and maybe the stock market?

[01:02:35] Bob Elliot: Yeah. So I think when you're trading financial markets what you want to think about is you want to think about what's priced in. And then what do you think is likely to transpire relative to what's priced, in order to have a view on which assets look good and which assets look bad.

And I think all too often, people forget the priced in part of it, because they think just, and the last 15 years haven't been that helpful because most people think on a momentum basis, right? They're like I think growth is going to be strong, so things are going to look good, et cetera, et cetera.

And I think we've lost our touch of saying, okay, let's start, let's have the discipline, start with what's priced in. So let's talk about what's priced in right now. What's priced in today is 12 percent earnings growth in 2024 and 13 percent earnings growth in 2025. Twenty-five percent earnings growth over the next two years.

That's for the S&P 500. Okay so that's, what's priced in now what's likely to transpire, like 25 percent earnings growth coming off of what is a very late cycle environment. It and a significant amount of monetary tightening that's occurred is certainly, would be an unusual outcome. Not an impossible outcome, but an unusual outcome and remember in order to be indifferent to stocks you have to see that earnings growth not just come in right at that 25 percent over the next two years, but yeah, it has to beat, right, in order to hold stocks in that environment. And so when I look at what's going

on, I think we've gone to a point, I guess it's peaked about, about eight. So when I think it was right when that Atlanta Fed GDP now kept printing at 6 percent and everyone's like, the US economy will never slow down again.

You know what I mean? It's never going to slow down again. There will, we had surveys of investors that said, 80 percent of investors said that there will be a no landing, soft landing type dynamic. And the possibility that we get no landing soft landing is certainly not zero. But it's not 80%. And it's certainly, the probability distribution in terms of that we get 25 percent earnings growth maybe could happen, could be missing something, could be a shock that somehow is supportive, but probably not and so that's when you start to add things up.

It's not, as an example, that the US economy is like a disaster right now or the global economy is a disaster. It's just everyone expects things to be so good that even like blah, it will disappoint, meaningfully disappoint expectations.

[01:05:07] Rodrigo Gordillo: Yeah. So can I, can we shift the strategy and what people can do about this just broadly speaking?

You come from Bridgewater and we're big proponents of everything risk parity, but also the alpha portion, right, which is an interesting addition to this concept of, okay, we have all these different cross currents. Is it going to be continuous growth? Is it going to be, if we're going to break the back of inflation and create a disinflationary environment, or are we going to have continuous inflation at which point bonds and equities will go down together?

What is the role? So I can see a role for commodities, obviously from a passive portfolio, from a *do no harm* portfolio, always be prepared, right? The All Weather, the Risk Parity. Where does a Multi-strat like the hedge fund space come in to play in this environment today? And, is it something that should be a dominant part of people's portfolios? Should, are we thinking about equal weight here? Should we equalize the risk across a well diversified Multi-strat, commodities aggregation, bonds? Like how do you think about your portfolio in that aside from the trade?

[01:06:15] Bob Elliot: I think...

[01:06:15] Adam Butler: 100 percent cigarettes. That's what I got.

[01:06:18] Bob Elliot: Yeah, the answer is find, one deflationary currency and go all in, right? No, that's ask Japan how that went. Not so great. No, so that's not, so this is what I'd say is if you look at most investors.

[01:06:33] Rodrigo Gordillo: Just when we should ask people to smash the Like button until he comes back. Smash,

[01:06:39] Adam Butler: Smash. If they smash it twice, is it Unlike? Yeah.

[01:06:42] Rodrigo Gordillo: That's right. Don't smash it twice,

[01:06:43] Bob Elliot: Just smash it once. I don't know if you've seen that, Smash it an odd number of times, if possible. I was about to give the great insight into how to engage in portfolio construction and the internet. I did that on purpose, just to keep people 60/40.

One way or the other, and if you think about what a lot of people do all day, is they like, nitpick the 60 and nitpick the 40. I don't know, do you like these bonds or these bonds. Do you like these cows or, I don't know, dividend things, or I don't know, there's all these different stocks you could possibly buy, foreign, domestic. All this stuff, none of that shit matters just to be clear over immediately, over any reasonable time frame, none of that shit matters.

Reach. So let's start with that point, which is 95 percent of the attention goes to things that make no impact on your portfolio over any timeframe that you care about, as a saver. Okay. So then let's talk about, let's talk about the things that do actually make an impact. There's three things that can make an impact on your portfolio, a meaningful impact on your portfolio if you hold 60/40.

The first is gold the second is diversified commodities, and the third is diversified alpha strategies. And, I'll say gold and commodities, relatively straightforward. Even 10 percent allocations to gold and 10 percent allocations to diversified commodities can radically change your portfolio's positioning when it comes to inflationary environments.

And the reason why that is because those have nice convexity in the event that inflation remains elevated relative to expectations. And man, most of you would have preferred to have been holding some gold and commodities over the course of the last couple of years, rather than holding purely 60/40.

And I'll emphasize, When people talk to me about gold, I'm not like some crazy gold bug. Like I'm a, I'm an empiricist about this, right? Like in, if you go back over the last 75 years in the US or the last 50 years in the US of all the 12 month periods where stocks are down over the last 50 years in the US, gold outperformed bonds in 60 percent of the instances, okay? That, let's, you don't have to get too complicated about that. Like yet, no one holds gold, right? Everyone holds bonds as their diversifier to stock. No one holds gold. It doesn't make any sense, right? At a minimum, you should hold them an equal proportion on a risk weighted basis. Ten percent, close enough, just get it done and improve your portfolio diversification and just take a quick look at that chart between gold and bonds over the last three years. And man, you wish you would've been holding bonds, gold instead of bonds over the last three years, if you're trying to diversify your equity exposure. So those are the main, gold commodities, straightforward, go out. There's lots of cheap, easy, efficient ways to go buy.

[01:09:23] Rodrigo Gordillo: Wait. You're missing private equity, private credit. Aren't those amazing diversifiers? That's what mostly ...

[01:09:30] Bob Elliot: Those assets suck, and I'll tell you why they suck. They suck because they charge 700 basis points of fees. What is going on? If you actually match the same time frame that you can get your cash flows out of venture and out of private equity, if you match timeframes, right?

Because if you invest in a venture fund, it's not like you can mark the market however you want, at any quarter or days, who cares? Like you can't get your money. So let's talk about 10 year timeframes, right, because that's the timeframe that you get your money back. If you look at it on a 10 year timeframe venture, as an example, if you look at a 10 year timeframe, it hurts your Sharpe ratio.

It hurts the Sharpe ratio of a 60/40 portfolio, if accounted for on a 10 year time frame. What a terrible asset. You're making these venture capitalists rich, paying them 700 basis points in fees, and you're hurting your portfolio. That is crazy that you would spend your time investing in it. Not to mention you can't get your money out, like the liquidity option.

[01:10:29] Rodrigo Gordillo: You can't get your money. It's complicated, convoluted. There's obscurity. You don't know what the fees are. I get it. I get it.

[01:10:34] Adam Butler: That's why you put everything in private credit.

[01:10:39] Bob Elliot: Oh, man, you're forgetting the volatility laundering benefit that you get.

[01:10:44] Rodrigo Gordillo: From a behavioral aspect.

[01:10:47] Bob Elliot: That people love to hold these assets and why advisors and allocators love it is because the lack of mark to market and the illiquidity. It's actually not a discount, but rather premium behaviorally. Sure. Yeah. The question is how much does it cost? I'll tell you at 700 basis points, I'll give you a different option. Just open your brokerage statement once a year, once every five years, right? And then you can save the 700 basis points that you're paying to make the private equity guys you know, wealthy, like that's a very efficient way to do it.

[01:11:15] Rodrigo Gordillo: Have a capital call every five years that's large enough to fund your retirement. Dealing with all those. I'm not going to convince anybody of any of this. So that's okay. We were, you were at some gold, commodities. Now, let's talk about diversified alpha.

[01:11:26] Bob Elliot: Now I think alpha is very interesting because there's a lot of alpha opportunities that are out there. And like, when you look at hedge fund managers as an example, there's lots of good hedge fund managers that produce alpha. And on average, the hedge fund industry has, before you start talking about fees, has returns that are better than stocks, half the volatility, a third of the drawdowns.

Okay. That's a pretty, pretty good set of returns. And one of the things that's really interesting. So the question is not like, is alpha a good or bad thing? Alpha is clearly a good thing. The question is how much do you pay for the alpha relative to how good the alpha is? And the problem with most alpha strategies is the managers basically take all the alpha for themselves and you're not that much better off.

And so if that's the case, if you can, if the alpha costs too much, then it could be there, but then it gets eaten away and the manager takes it all and it's not worth putting in your portfolio. And so the truth of the matter is most investors would benefit from not even talking about alpha at all because it's not going to make sense for them.

But if you can access cheap, diversified alpha, that's when this starts to get interesting. And in particular, I think the thing that's very interesting that I've been thinking a lot about lately is how do you think about creating balanced alpha. Because alphas emerge at different points in a cycle, different points in an economic cycle, there are different opportunities to generate alphas.

And one of the challenges that many investors have is they might find a return stream, managed futures, which has nice convexity to their overall asset portfolio, but in three quarters of periods it sucks as an investment strategy. And that's because in three quarters of the periods, the circumstances are not consistent with generating meaningful alphas there.

So how do you actually create an alpha portfolio that you can live with? How do you create the diversified alpha portfolio you can live with? And I think that's a really interesting question, which is you can't do it if you're holding funds because they cost too much and because you can't agilely move between the alpha strategies as you move through the cycle.

But as we increasingly get these alpha tools, these alpha indexing tools that exist, we can start to think about how do you package those alpha indexing tools together. First, the outcomes are much more knowable because they're indexes rather than individual managers, which have huge dispersion. So the attributes of those alphas are much more understood.

And then what you can do is you can start to put them together, agile, you can shift between them in a way that takes into consideration that there are certain times where certain alphas are more effective, and there are other times when other alphas are more effective, and that is a very, like that is, that's the cutting edge, like that. And if you can put that in a portfolio, you could do a hell of a job for people.

[01:14:24] Rodrigo Gordillo: I have some interest in this idea. When you say funds you mean private pools and hedge funds where you're getting monthly liquidity or quarterly liquidity. And that's why it's difficult to shift between one and the other. And what you mean by these indices is you mean indices that one can replicate and put into ETF wrappers like you've done.

We've done a similar thing. Certainly anything, replication go to Bob's site. We've also done a paper called *Peering Around Corners*, how to replicate Trend following managed futures, which is if you're interested in knowing how that game works there's plenty of stuff out there, but I think what you're saying, Bob is not only is it good to diversify across those alphas, it's, are you also saying timing those alphas?

[01:15:02] Bob Elliot: Timing those alphas, yeah. And I think there's two steps. The first step is how do you create balanced alphas, which I think that is, because I think the challenge, I don't have to convince you guys that like managed futures is a good asset to have. It's a good alpha to have in your portfolio.

The question is not, is it a good alpha or not? If you just, if you could only look at your brokerage statement once every 10 years, it would be a great asset. I'll just buy the assets, stick it in there. Don't stress about it. The challenge with it is it underperforms for periods of time, right?

And has underperformed for meaningful periods of time. So people, like insurance, give up on it right before it really pays out. And so you have to understand the behavioral aspects of these things. And so part of what you can do to help improve the behavioral aspect is by creating packages of alphas that are more reliable than, and what I call the sort of balanced alpha approach, which recognizes that. As an example, you took, say, I don't know, 25 percent macro, 25 percent managed futures, and then on the other side of that, like a portfolio of equity, long, short and fixed income and emerging markets and stuff like that. And you put that balance, take that as a balanced alpha concept, right? That is much more reliable. It's about twice as reliable as managed futures. And it's the sort of package that could be much more, much easier for an advisor to deal with than just trying to slot in the managed futures. And you get a lot of the other portfolio diversification benefits and Sharpe ratio improvements that could come from that sort of thing.

[01:16:40] Rodrigo Gordillo: And just again, point of clarity. When you say emerging market and all those other things, you mean long, short, market neutral type of alphas, not...

[01:16:49] Bob Elliot: Yeah, it could be market neutral. Could have some beta in them. There's reasons why you might want beta in your alpha. Because it's, oh, now I caught his eye on that one. There's a reason why managers have some beta in their alpha and the reason why that is, is because beta is positive expected value. And if you're creating...timing data is a form of alpha, right? If you think about it

[01:17:10] Rodrigo Gordillo: They're not timing data most of the time, though, from what I, think constructs...

[01:17:14] Bob Elliot: Even structural beta makes sense as a manager to increase performance reliability. The issue is if you look at like a mutual fund manager, it's 90%, 95 percent beta and 5 percent alpha, but hedge funds have in general about 0.2-ish or 0.25-ish beta in their portfolios. And that's about what a good complementary return stream is, given the goodness of alphas, goodness of betas and trying to create a more consistent return.

[01:17:42] Rodrigo Gordillo: I think what it addresses is your point of behavioral issues by adding a little bit of beta into your alpha. It's like adding a little bit of sugar into your medicine. You shouldn't show up for medicine, but it is palatable, right?

[01:17:57] Adam Butler: No, you're done now. What are the things that can, that is, has troubled me though, over the last decade or so is the fact that hedge fund correlation to equities has increased substantially, even while the beta has gone down. And the reason for that is that the vol has also gone down, right?

So beta is a combination of volatility and correlation. So you have low beta, even if you've got a, even if you're a hundred percent correlated with equities, you can still have a 0.2 beta. Your vol is 20 percent of equity vol, right? I just think it's a point of observation, certainly, and something to think about that when you're allocating to diversifiers, **beta is not sufficient to determine whether you've got a good diversifier.**

Really what you're looking for is something that's going to add volatility to the portfolio in an orthogonal direction. To all of the other sources of volatility in your portfolio. Correlation and volatility and beta, all of these things matter. And you should be looking at all of them, right?

[01:19:05] Bob Elliot: I totally, I would just add rolling correlation that varies over time, right? A rolling correlation, that's not static, but rather that it's, if you draw the correlation against Trend following that it varies because you're drawing some of your returns from Trend, the same way that you're drawing some of your returns from equities, bonds or commodities or even currencies, right?

[01:19:26] Adam Butler: So, for a while, same for equity long/short, right? The good thing about market neutral is that, in theory, the vast majority of the time, except when you've got these major, these sort of weird liquidity shocks, by definition, **they're going to have zero correlation to equities.**

There are some other strategies like that as well. You can do that with managed futures and other strategies too, but okay. Anyway, this is this opens up a whole can of worms.

[01:19:47] Rodrigo Gordillo: But ...

[01:19:47] Bob Elliot: I think I feel like we're going to get to our third hour here on structuring alpha portfolios for those of, you know, who aren't too hammered already to ...

[01:19:57] Rodrigo Gordillo: Yeah, raise your glass. Just give me some beer emojis if you're still sticking around. So one of the things that I tweeted recently that there's too many individual investors, advisors, small pension plans, and small corporate plans that are dying to run their portfolios. Like that, like the like their, the foundation, the Yale endowment.

Like the Yale endowment, right? Which is really overweighting privates and really overweighting these obscure type of funds rather than taking an equity risk in general. Which is all like, and so they're trying to replicate the endowment portfolio when in fact, what the endowment portfolio lacks is a mandate flexibility and portfolio agility, something that the average investor does have a lot of.

And so the question is given that the average, the smaller investors have those two things and the flexibility and portfolio agility, if the behavioral aspect wasn't that big a deal, how should they be thinking about weighting their equities, their bonds, their commodities and their alpha in an ideal way? Like, actually forget about the 60/40 and having to keep and giving 10 percent to alpha is like, what is the ideal weighting across those things? Can we just think about those as four buckets?

[01:21:13] Bob Elliot: Yeah I think it goes to basically, how do you think about the influence or the baseline need of an investor? And that is, real spending power out into the future in a way, growing that real spending power in the future in a way that doesn't have undue volatility. And so if you think about how do you put that together from a beta portfolio perspective, it's probably no surprise to anyone that I'd probably start with a risk parity type framework because I think, that has good reason why you'd believe that it should be more diverse in terms of a different set of economic environments. I think its primary limitation is it's pretty inefficient particularly in environments where there's elevated inflation, which leads to tighter monetary policy than would otherwise be expected to occur. And so taking that risk parity and then tilting diversifiers for elevated inflationary scenarios like commodities and gold, I think is really important, because the thing that ruins an investor is not, the thing that ruins an investor is your assets go down, inflation goes up, right? That's the thing that really screws you. And if that's the thing that really screws you, then prepare. Then you got to tilt towards inflation protection. And that is a big deal.

Not only does everyone hold 60/40, like it would be better if you got over to risk parity, but no, don't go far. You have to go farther than that, than risk parity. And then what you want to do on top of that's your beta portfolio, your structural portfolio through time, et cetera.

And then I think from there, my, my two thoughts would be, you want to put in some Trend structurally, structural exposure to Trend. It doesn't have to be a 236 asset, highly sophisticated, crazy type Trend following strategy that the most sophisticated managers are running. Like, you can take the, like the four assets that we talked about and just run a one by 12 and it's probably good enough and agile and try and move or buy some of these ETFs that are great.

Just buy the ETF, 10 percent into it, 15 percent of your portfolio into it. And then take the rest of that, assume it to be clear, assuming that you can handle the fact that the behavioral aspect of it, that you'll stick with it through time and to be clear, all of this, like holding gold requires behavioral aspects. Like, how many... gold kind of sucked from 2012 to, 2002 or 200 to 2022, 2021, right? Sucked, but you had to stick it out because then you got the benefit relative to bonds more recently. So a little bit of Trend helps you navigate, helps you get that sort of tactical allocation into the portfolio.

And then I think a diversified or a balanced alpha, which you know, deserves, I don't know, 20, 15-20 percent of your portfolio, because you don't want to get, you want to get overweight on alpha because it might work, it might not work. And beta is cheap and reliable and pretty certain more certain.

Alpha is typically a little more expensive and a little less certain. You don't want to get over your skis in terms of betting the farm on alpha. And so that's like you put that together and you have the possibility like relative to 60/40 to meaningfully reduce your real drawdowns with a portfolio like that and meaningfully improve your sort of Sharpe ratio.

Over time, you can, there's no reason why you can't have twice as good a Sharpe ratio and, half the draw, real return drawdowns that you're expected to experience with 60/40.

[01:24:48] Adam Butler: That's awesome Bob. That's it, show's over.

[01:24:49] Bob Elliot: We're done.

[01:24:51] Rodrigo Gordillo: Perfect. So the only thing I'll add to high point, the only thing I'll add to that because you know what, what happens when we have, that's exactly where I thought you would go, and where I think most investors just think if they have the emotional fortitude to be different.

So there's a few divergent personalities here I'm sure, that might be able to attack that, but the real issue always becomes, once you put those three things together, volatility collapses so much that it becomes such a boring portfolio that it's tough to stick to when you're seeing the S&P 500 and your neighbors do, having a 30 percent year, right?

So I think when you create a much more diversified portfolio, you straighten out that equity line, you'll also oftentimes reduce the absolute volatility and possibly the absolute return momentarily relative to the things that you care about.

[01:25:37] Bob Elliot: And so that's why I, so like I, I wrote this blog, a simple investment game plan, which people can go see at unlimitedfunds.com., which, is like my ideal portfolio for one with meaningful intestinal fortitude. But what if I'm talking to an advisor, I was talking to a bunch of advisors at Future Proof last week. What I like, talking to them about is look, let's not get over our skis on how to do this.

Let's do a couple simple things. 10 percent in gold. 10 percent in commodities, 10 percent in diversified alpha strategies. What do you get out of that? You can get a 50 percent improvement in your Sharpe ratio, a meaningful reduction in your drawdowns, a meaningful improvement in your real, where your real return/risk that exists and you're still over 90 percent correlated to 60/40 on a monthly basis. Like, just do that because at least you're moving in the right direction and you don't have all the peer risk. There's better ways to do it. There's crazier ways to do it. But I totally get if you're just, you're advising, 100, 000 clients in in suburban Atlanta or something that maybe you don't want to go all out away from the 60/40 and you want to get something with a little less peer risk. And you can go a long way without, with doing relatively simple things to improve the allocation.

[01:26:54] Rodrigo Gordillo: Yeah. And also, just to finish this up, I think you're right. I think we need to ease people in. I also wanted people to know what the full gem looks like. And then ultimately the fact that now that with the concept of *return stacking*, you can actually continue to get that alpha and beta return of your portfolio, but really stack a lot of these alphas on top of your portfolio.

If you don't know what I mean, I'm not going to get into it now. Just go check out, just type in *return stacking*. You'll be able to see it. But this is a new, this is a kind of an exciting time where the issue of making a this or that decision is moved away now. We can make a bit more of yes and decisions, right?

You can buy an ETF out there that is 50 percent equity, 100 percent equity, 100 percent bonds. You sell 10 percent of your equities, 10 percent of your bonds, replace it with a CTF. Now you've made 10 percent of room in your portfolio to buy funds the Bob's funds. And in essence, once you x ray that, you'll be able to get your equity and bond back.

And then add a little 10 percent on top of the alpha. And then you get a hundred percent of what you wanted and a little bit of that medicine. Very exciting times for diversification I think in the public sphere, a lot of exciting stuff with the alpha stuff. I want to, I can't wait to see what's coming down the pike for you on the timing of these alphas, Bob. I'm sure that something's percolating there.

[01:28:09] Bob Elliot: Oh yeah. Yeah, that's where we're going is this idea of balanced alpha. Tactical alpha, thinking about these things in the context of the drivers of the alphas, because that's the thing. This is where we have, I think the managed futures folks have been the on the cutting edge of this stuff in terms of this idea of indexation and the noble properties of indexation, creating an, essentially an asset, a known asset in the way that you know stocks, in the way that you know bonds, in the way you know commodities. But I think the challenge is we don't, we haven't done that with things like equity long/short and global macro and fixed income strategies and stuff like that, but it's totally possible.

It's totally indexation. And once you index and you can understand the properties, then that opens a whole world, opens the whole, low cost indexing of beta, totally changed the way that we thought about portfolio construction. Think about a world where we can low cost index alphas. Right? That is an incredibly, incredible opportunity. And obviously you can probably tell by my tone what gets me fired up about where things are going.

[01:29:23] Rodrigo Gordillo: We're just as fired up as you, Bob. Awesome. Awesome. What a great episode. Thanks, Bob, for your time on all the macro stuff. Again, just if anybody needs to follow Bob, Twitter, you do an amazing job there educating the world about how to think about macro, even macro guys.

[01:29:39] Adam Butler: Totally agree. One of the top two or three accounts on Twitter.

[01:29:43] Bob Elliot: I appreciate that.

[01:29:45] Rodrigo Gordillo: @BobEUnlimited take his, I think you still have it, your tweet pin there of how you taught people at Bridgewater how to think about macros. So I'd recommend people think about and look into that and also go visit Bob's website UnlimitedETFs.com. All right. With that, I'm going to give you, thank you for taking so much of your time for us today, Bob.

[01:30:05] Bob Elliot: No problem. No problem. I love talking about this stuff, right? This is the fun, this is the fun part of I don't know if we're going to hang out and talk about more fun stuff for the next two hours.

[01:30:12] Rodrigo Gordillo: I bought this and we're going to drink up the beer.

[01:30:17] Adam Butler: Next time, I promise you'll hear more of Richard who was uncharacteristically quiet today, but he was crowded out by Rodrigo's enthusiasm.

[01:30:25] Rodrigo Gordillo: All right, guys. Thank you.

[01:30:26] Bob Elliot: See y'all later. Thanks for having me.