[00:00:00] Adam: Lucky you, because we've got Dominique Dwor-Frecaut from Macro Hive with us today, and we're going to have what I think is going to be a somewhat controversial review of the macro environment.

So Richard, I know you've been especially excited and have been preparing some questions. So why don't I just hand it off to you? Before I do, I'll just note for everybody listening that this is not to be taken as advice and that this is for educational information purposes only. Please talk to your financial advisor before acting on anything that you hear today.

With that, I'll hand it over to Richard, and take it away.

[00:00:38] Richard: Thanks, Adam. Great intro. Very smooth compliance prologue to all, and Dominique, thanks for joining us today. Welcome.

[00:00:46] Dominique: Thank you.

Backgrounder

[00:00:47] Richard: Would you give us a brief overview of your career and the arc that it's taken that has brought you here today.

[00:00:55] Dominique: Okay. I'm lucky. I think I have ended up in the perfect place. I work fora startup called Macro Hive, where we have a fantastic culture of meritocracy, of ideas. With a small group we have a lot of experience, market experience between ourselves, but we're all very curious, very open to other peoples' ideas, very open to learning from mistakes.

Those don't come too often, but when they come, they are very valuable. We are a startup where everybody's opinion and contribution is valued. So you have people who have only a few years experience of markets, challenging the more established members of the team. And it's absolutely wonderful.

I love it. This is my end point, but before that, I've had a number of iterations in large organizations, the IMF, the New York Fed. I put Bridgewater in there. I also had a couple of stints at a startup macro hedge fund where you had this startup vibe, but I have to say macro is truly exceptional in the quality of the relationship and the thinking that's going on there. So I'm a happy person.

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[00:02:19] Adam: How big is the team at Macro Hive?

[00:02:21] Dominique: This is one of the brilliant ideas of one of our founders. You can think of us as concentric circles, if you will. We have about 20 full-time employees, but we have networks. So we have people we know, we trust, with whom we have an ongoing dialogue. Then, of course we have our clients who are an invaluable source of info and intellectual challenge and stimulation, but, so we have a close network, if you will, and then a bigger network that we can draw on when we have specific needs.

Our clients ask us to do something where we don't have the expertise in-house. We have the usual, and we reach to this to this extended circle, if you will.

[00:03:12] Richard: And what are you particularly focused on in your research and what you write about?

[00:03:16] Dominique: So me, I'm the person who gets to write about the Fed and the US economy. And it's long been a passion of mine. So I was born in France. My husband and my family are American, so I'm in between cultures and I've always been fascinated by the US as the contrast with Europe. Also, large organizations, quite frankly are not my cup of tea, but it's fascinating to see how they make decisions because they are a collection of very …, certainly where I've worked the, IMF, the World Bank, the New York Fed, very bright, very motivated people, but somehow the sum of the parts is not always what shall I say, as efficient as it could be. So these people together tend to think in very specific ways, which I find fascinating to look at.

[00:04:09] Richard: So in straddling these two worlds, what are the main differences that stand out to you between the way policy is enacted in the US versus in Europe and I guess cultural undertones that might influence.

[00:04:23] Dominique: I'd say so the US in a way was the first financial market to develop. It was ahead of everybody else. We had a nice fullfledged crisis in the 1930s possibly because we had greater financialization of the, than the rest of the world. So you have the plus and minuses that come with that.

So a lot of historical inheritance that frankly is a bit like, think about the Fed. The Fed has 12 Reserve Banks, and you're not going to believe this, but they have two Reserve Banks in the same state of Missouri. And I bet you being Canadian only have approximate idea of where a Missouri is, and one

Federal Reserve for the whole of the west coast of the United States. It's crazy. If you look at the way the US releases its data, it's also very obsolete and inefficient. But at the same time, I just love it here because it's, there is something really uniquely American and enterprising, and there is a sense of innovation, and especially in California where I live. I would say the bureaucratic inertia, perhaps heavier here because the finance sector has been established for longer. But the sense of insurgency or the potential for insurgency, I think is stronger on this side of the Atlantic.

[00:05:56] Richard: Interesting. You mentioned that the 1930s were particularly harsh east of the Atlantic because of more financialization that Europe had versus the US. I'm interested to pull a little bit on that thread just because my own understanding or what I thought was the main cause of that, was the consequence of the Post First World War and the interwar period and the hyperinflation of the Weimar Republic, and all those dynamics that had caused particular economic pain in Europe. But I guess I wasn't aware that Europe was way more financialized than the US back then.

[00:06:29] Dominique: Actually, no, I meant the US was way more financialized. In fact the way more financialized venue, the economic historian Barry Eichengreen has written a very interesting paper describing the crisis of the 1930s as a credit boom gone bust, basically. And I thought this was terribly perceptive and interesting.

I think, in terms of Europe and the US in the 1930s, there was a breakdown of civil society in Europe that didn't exist in the US. In the US we escaped fascism, we didn't get hyperinflation. So there were different dimensions, even pains in Europe that didn't exist in the US and made for this lesser financialization of society in Europe.

[00:07:19] Richard: Yeah, that makes sense. What do you currently see right now? If you could summarize the scenario that you currently see for the way the Fed has been behaving over the past few months in particular, and how do you see that as the backdrop for financial assets?

[00:07:35] Dominique: Okay I think we are in a great environment for risk assets because we have strong growth, high, but stable inflation, and speaking of the Fed, a very dovish Fed. So what's not to like? And that reflects factors that, I don't think will last forever, unfortunately. But let me list them.

Certainly the biggest driver is that the US is going through a negative energy price shock. If you look at energy prices, they're lower. For instance energy CPI or PCE, it's about 15% lower than it was a year ago. And that's fantastic because it means household income is higher. Real income is higher.

In the US, we all like to drive. I live in Los Angeles, unfortunately no choice but to take my car. So we spend about 5% of average income on energy. So 15% decline in price is nothing to be sneezed at. Same for businesses, manufacturing obviously, but even services, small services businesses, energy costs are not zero.

And then so that supports profits. And then on the cost side, the pressure to increase wages is not as strong because people are being held, real wages are being held by lower energy prices. And I think that's a key reason why we have this combination of strong growth and stable inflation.

If you add to that fiscal, the US fiscal growth, which in my view is reaching new heights, unbelievable. That the 12 month budget deficit in the US is more than 8% of GDP, when unemployment is the lowest it's been in 50 years. This is crazy. And so wow, what a party.

And then I think, and that's perhaps one of my more controversial views, I think that the monetary policy is still quite loose. And it's not just me saying that, but I'm going to quote here. The president of the Cleveland Fed, Loretta Mester, she has a beautiful chart where she compares the real policy, right? So the real Fed funds right. This cycle and previous cycles.

And what she shows is that first of all, the Fed started much further behind the curve than in any other cycle since the oil shorts of the 1970s and second, that with barely made up for last ground, that in terms of comparing the Fed funds rates using PCE inflation, we are barely where we were a couple of tightening cycles ago.

So we are barely in positive territory. And so to me this means loose policy. You can use, if you like more sophisticated benchmark, you can use a Taylor Rule, as it's a rule that computes, it's a back of the envelope calculation really that computes the Fed funds rate needed to stabilize the economy as a weighted average of the deviation of inflation from its long-term target and the deviation of unemployment from its long-term level.

So there are 1001 ways of computing this Taylor rule, but what they all say is the same thing. We're still well below where we need to get. My own version of the Taylor rule is about seven to 8%. So way to go Fed. And that's why we are having such a party now. It's not going to last forever, but for now, the going is good. No question.

[00:11:29] Adam: So let's step into your decomposition. So the first thing that you listed as a motivation for why we should be bullish risk assets was the substantial drop in energy prices and

how that flows through to households and businesses. Can you maybe just offer a little bit more detail on that? Going through the information you sent over, I noticed that you spent some time explaining how energy price prices, even though they strip out food and energy from Core PCE, because energy prices flow into so many other items, it still has an impact.

Maybe just walk us through just how important energy is even for Core PCE and therefore why this negative price shock has had such a potential stimulatory effect.

[00:12:20] Dominique: Sure. So I am a nerd and all nerds, I love my charts. Do you mind if I share with you,

[00:12:27] Adam: Please.

[00:12:28] Dominique: Can you see this chart here showing a Core PCE and Energy PCE?

[00:12:35] Richard: Yeah.

[00:12:36] Dominique: Okay.

[00:12:37] Adam: See Core PCE and unemployment.

[00:12:40] Dominique: Ah, and now…

[00:12:42] Adam: Yes. Perfect.

[00:12:43] Dominique: Okay, so here I am, I'm going to be a little bit of a nerd and talk about my favorite inflation model and as context, one thing I want to stress is that since we haven't had inflation in what, 25 years, until the, or 30 years before the pandemic, macroeconomic research on inflation has been almost non-existent.

If you look at your favorite central bank or think tank program of seminars, you'll see that until about six months ago, there was almost no discussion of inflation. However, there is one institution which has come up with a model which in my view, certainly for me, it's been the most helpful, and that's the BIS, and their model consists basically in dividing inflation situations into low inflation and high inflation. And basically what they say is low inflation, when inflation is low, people practice what is

called rational inattention. If there is a shock, a price shock, an energy price shock, for instance people won't pay attention to it because inflation is so low anyway.

And so in that low inflation environment, charts tend to be self-correcting. But when inflation is high, suddenly people start incorporating their expectations of inflation in their behavior. So inflation starts impacting behavior. And basically people look around to see what prices are like, what wages are like, and as a result they end up converging to a sort of a common inflation measure.

And what is that? If you look at the components of the CPI, the common component becomes very large. So everything becomes correlated - every price becomes correlated with every other price. And in that situation, what happens is that energy prices become correlated with core, with non-energy prices, which is what this picture shows you in the seventies and eighties.

And you can see that the correlation lasts until the early 1990s because these were times when inflation was high. But then you have continued disinflation and you have decoupling of energy inflation and core and non-energy inflation, and look at the decoupling. It lasts until the pandemic.

And in fact, what's fascinating is that there is a very, a famous speech by Janet Yellen, I think it's called *Inflation Dynamics and Monetary Policy of 2015*, where she actually looks at this chart up to 2015, and she wonders about the correlation between core and non-core inflation and why it's gone. And the explanation for me comes from the BIS model that we moved to a low inflation regime and shocks became self-correcting, and look at this variation in energy prices that had no impact on non-energy inflation.

And then what happens with the pandemic? We have a jump in inflation. We've been above 2% since mid 2021. And guess what? Energy and core inflation. So energy and non-energy inflation become correlated again. That's why in my view, we've had this slowdown. So that's how I see the impact of the, of the negative energy price shock. It's been amplified because we are still in a high inflation regime.

[00:16:36] Richard: So it's less about other components. So the, it's less about the components of core PCE being impacted directly by energy, but more so that there's a self-fulfilling prophecy that then spreads across multiple measures of inflation. Is that, would that be an accurate depiction?

[00:16:55] Dominique: Exactly that. Basically, you and I we're worried about inflation. We go to fill our gas tank and we see the price of gas going up. We see the price of groceries going up. We realize

that our paychecks are not going as far as they used to be. And so we start, we start demanding higher wages.

If you own a business, you'll start raising your prices based on everybody else's prices that you can observe, and that's how you converge. everybody converges to this common expectation of inflation, which is embodied in price and wage behavior. So that's exactly as you described it, it becomes a self-fulfilling prophecy. And the reason it becomes a self-fulfilling prophecy is that it's high. So it makes a difference, and you want to adapt to this high expectation.

[00:17:51] Adam: I think a more common narrative for why the core sensitivity to energy prices seemed to have declined relatively steadily from the 1970s to today might be that there's been a profound shift from the energy intensity per unit of GDP, for the US economy in particular. And perhaps the primary driver of that was a switch effectively from more of a manufacturing oriented composition to more of a services oriented composition. I think you are suggesting that actually doesn't really play a very large role, or rather that role is subordinate to the attention channel. Is that right? It's just that when inflation is low, nobody is paying attention to energy prices because I guess none of the other prices in their consumption basket are alarming them. But when all of those prices go up at once, they begin to pay, it seems like there should be a bit of a two-way street here. Like I, do you buy the explanation that there was an inflation impulse as a, due to a combination of supply constraints during the pandemic and coming out of the pandemic that were exacerbated by fiscal largess that sustained that inflation impulse as well. It seems like those might be contributing factors that caused prices to rise and then caused people to pay attention to the rising prices, and I'm just trying to figure out what some of the feedback loops here might be.

[00:19:42] Dominique: So a hundred percent. There is no question that there was a supply shock. There was an enormous demand shock as well. But the problem is that it's produced inflation in, because now people's expectations of inflation have moved. And you see it, for instance, in the University of Michigan Consumer Confidence Long-term Inflation Expectation.

It's creeping up, up, ever so slowly. But, so direction is clear. We're now at 3.1% for medium term expectations of prices which was where we were in the mid 1990s. We, I think you described very accurately how we ended up where we are. But I think climbing down is going to be really difficult because of this inertia, because inflation expectations that have moved, you're going to have, you are going to need something to convince people that inflation is coming down.

And I fear this *something* is going to be a recession. I just don't believe that magically inflation expectations are going to move down and we are going to end where we were before the pandemic, which by the way, is a Fed macroeconomic scenario and the scenario of many people in the markets. And I just don't see how that could happen.

[00:21:10] Adam: So I know that Powell has said on multiple occasions that his big fear is that inflation becomes entrenched within the expectations channel. And so I'm trying to reconcile or how might you help me reconcile. In your opinion Powell and perhaps the majority of the other governors are erring on the, on a more dovish side of the policy debate, given we're seeing such a steady increase in the expectations channel and some of the other dimensions of the economy that they would typically expect to cause a slowing and therefore to bring Core PCE down, don't seem to be having the same effect this cycle. So what is motivating the Fed?

First of all, why do you think the Fed is more dovish than the market maybe perceives? And then why is the Fed this dovish in the face of creeping EV sustainably, creeping higher inflation expectations?

[00:22:20] Dominique: Ah, so you've given me an opportunity to show another one of my favorite charts. This one. Can you, this one shows inflation and unemployment.

[00:22:31] Richard: No, we still see the Core PCE and Energy PCE.

[00:22:35] Adam: Yep.

[00:22:36] Dominique: Okay, cool.

[00:22:36] Richard: Yeah, that's

[00:22:37] Dominique: Alright, so this chart is making my case that we should watch what the Fed is doing and not what the Fed is saying, and then I'll explain why I think they're dovish. What this chart shows is unemployment, that's a dotted yellow line, actual unemployment, and then the projection of the end 2023 unemployment rates in the SCP.

So the projection started with the September 20 20 FOMC meeting, and they were updated, every other meeting with the SCP. Now, this is actual Core PCE year on year, and this is the forecast for

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the end 2023 Core PCE, which like the forecast for unemployment, was started at the September 2020 FOMC and regularly updated.

What does the chart show? It shows that as far as predicting unemployment, and you have to understand that from the Fed perspective, the SCP is not just pure prediction. It basically shows you the macroeconomic scenarios they are prepared to consider, because we have to assume that those people believe they can change things.

So if they wanted to have lower unemployment or higher unemployment, for instance, they could tighten policy. So this scenario actually is showing you what the Fed finds acceptable and look at the contrast between inflation and unemployment. They have kept their forecast to what they consider to be acceptable unemployment at the cycle, low near 4%.

But on the other hand, every meeting they have upgraded their forecast of PCE. So you get 20 basis point here, 10 basis points here, 30 basis points here. What this chart shows you is that they're now prepared to consider PCE that is twice, almost twice as high as their target. Their target is 2%. The forecast for N 2023 Core PCE is 3.9%.

So to me, this is a fad that is almost entirely focused on the employment leg of the mandate and completely oblivious to the inflation leg of the mandate. And that's why I'm saying let's not listen to them. Let's look at what they are actually doing. And what they have actually done is allowed inflation to rise to twice as much as the target. And my contention is that it's going to get much higher.

[00:25:22] Richard: What do you attribute the fact that inflation break-evens have collapsed quite a bit, especially since March when we had the SVB debacle and this sort of brewing crisis in the US banking system. Last I looked, break-evens were quite close to 2%. Do you think there might be a somewhat broken signaling mechanism between TIPS, the dynamic between TIPS and nominal treasuries, because of the Fed's balance sheet dynamics? Why do you think the market is underpricing inflation versus the Fed's PCE projections?

[00:26:00] Adam: I, can in, yeah, go ahead.

[00:26:02] Dominique: So I was just going to say that historically TIPS have not been great predictors of inflation, especially around turning point. This could be because of the technical factors that you've just mentioned, illiquid market Fed on the fair bunch of total TIPS outstanding. It could also

be because markets would rather not consider the alternative to this very rosy inflation forecast because it is too awful to consider. Obviously these beautiful rallys that we've had and that I expect to continue, is not going to last if my predictions on inflation are not to be correct.

[00:26:43] Richard: Wishful thinking, in essence.

[00:26:46] Dominique: Yeah, I can always be wrong. Okay. But to the best of my ability and on the basis of the information available, I respectfully disagree with Mr. Market and respectfully disagree with the Fed as well.

[00:27:01] Adam: Are there any market mechanisms that are creeping up to signify that in some segments of the market, participants are concerned about sustained higher inflation than we've experienced over the last 10 or 20 years.

[00:27:16] Dominique: It's hard to say. You could argue that the inversion of the yield curve maybe is an indication of that. I'm not sure. I think it has much further, to go. And to be very honest with you, this market translation part, is not my strongest point I have. We have a really deep bench of market talent at Macro Hive, so it's more my colleagues Bilal and Mustafa who would be the ones to give you a better quality answer to your question.

[00:27:49] Adam: No problem. I actually, I want to dig into what I think was your second point of decomposition of why PCE, Core PCE is likely to stay high, and that relates to the large fiscal impulse that we've experienced over the last 12 months. And that according to the Budget Office is, I think they're planning on sustaining annual deficits that are about twice the size relative to current GDP or GDP expectations to what we have seen in the 2010 to 2020 period.

Again, I find this really mysterious why the market doesn't seem to be catching onto the fact that you can't have this amount of fiscal largess, while maintaining the same inflation climate that we had when the deficits were half the size. Do you have any insight on that?

[00:28:42] Dominique: No I'm completely with you on that, Adam. And to me, one of the biggest mysteries is why no one is screaming at the size of the deficit, and the CBO keeps churning out those dire forecasts, which quite frankly are probably on the conservative side. And no one is objecting. And one of the things that really surprised me this year actually was a debt ceiling standoff that the Republicans made a deal with the Democrats with very limited amount of fiscal consolidation.

I think this was, if I recall correctly, this was the equivalent of about 70 basis points of GDP in expenditure cuts. All I can think of is that having the world global currency is both a blessing and curse. It's curses because it means you basically get enough rope to hang yourself in the sense that you have a softer budget constraint than, I don't know, if you are Italy or Argentina.

And eventually this will come back to haunt us. But I am as perplexed as you are.

[00:29:52] Adam: Do you have any…

[00:29:53] Richard: …to have been.

[00:29:54] Adam: …reliable models? Just let me close the loop on this one, Richard, but do you have any reliable models that, that help to infer the expected Core PCE year over year, given certain levels of budget deficits? I looked into this some time ago and I didn't find anything that I found as reliable as I'd wished.

But, it seems to me that there should be, it should be model-able, right? Like certain level of budget deficits relative to GDP should translate to an expectation of a certain number of excess percentage points of inflation year over year. Do you have any insights on that at all, or is that not nearly as easily modeled as I am implying.

[00:30:38] Dominique: So there is a whole group of academics who have devoted their entire lives to do, to doing exactly what you're describing Adam. But to be honest, it's very model driven. And so there is the issue of the model assumption. And then typically those things work better for the medium terms and the short term. And Mr. Market tends to be very short term focused. So I haven't looked into that with great detail because I'm not sure it's going to give me very short term insights.

[00:31:15] Adam: Gotcha. Sorry, Richard, go ahead.

[00:31:17] Richard: Not at all. I was just going to say that it seems the GOP's inclination towards fiscal responsibility or some fiscal conservatism has become a thing of the past, at least for the past several years, and it's one of the few bipartisan things in Washington now, is that they're both become big spenders, and fiscal populism has become the name of the game. I just wonder if you, to your earlier point about not paying attention to what the Fed is saying, but actually what they're doing, that perhaps what they're actually doing is allowing for inflation to erode the real value of this huge amount of debt that exists in the system and providing some cover for the Treasury to

continue to spend a little bit more freely given your contention that they're not really fighting inflation nearly as much as they should be by Taylor Rule metrics and others.

[00:32:05] Dominique: Definitely what you are, this, their policy or side effects or of their policy is to support, fiscal …. I am not sure this is strictly what they intend to do. I think there are a couple of issues. The first issue is that they were surprised by inflation and they were ill-equipped to deal with inflation.

Their workhorse model of inflation was the *Inflation Expectations Augmented Phillips Curve,* and the prediction was that inflation would be transitory, basically that we would be in the low inflation regime of the BIS. And I think there was no awareness that when you are in the high inflation regime as the BIS argues, the dynamics of inflation are different.

So I think the first reason for their dovishness is they have a lot of inertia, a lot of institutional inertia. They're probably still living in their old world of reliable 2% inflation. Their models are not working. They have not really updated them. They have not come up with an alternative model.

So that's one reason for the dovishness. The other reason is they basically want to be nice guys. They have these, these meetings of Fed, or I forgot what it's called, *Meet and Greet Shindigs* with civil society. And they want to be popular. They want to be loved. And I'm sorry, I don't think it's their mandate because there are times when they have to exercise tough love and do things which are painful for society.

The problem is, if they don't do it, they will still have to do it. They will still have to stabilize inflation, but as we saw in the 1970s, it'll be much more painful than if they had been more proactive. So I think an institutional issue here is really this desire for popularity, which in my view doesn't belong to a Central Bank.

[00:34:05] Adam: It's, it strikes me that so long as the bond market is willing to lend the government money at rates that are substantially below inflation expectations, that I'm not sure why the government would stop issuing debt, right? I mean it, where are these bond vigilantes who are supposed to ensure that they're buying bonds that are going to preserve their value plus some premium over the long term?

It seems like they're, they've completely left their watch, right? So as long as the bond market is going to accommodate, six to 8% of GDP annual budget deficits and, Core PCE that is substantially

above intermediate to long-term bond yields, I guess the Fed can say the bond market is allowing the government to be propagated. I don't have much to do with it.

[00:35:02] Dominique: Definitely, and it's …. I would prefer a Fed that was more assertive and like the ECB, would take government to task on their fiscal prophecy. And I would also like a Fed that would talk about competition policy and what it can do to reduce the cost of lowering inflation. But unfortunately we have a Fed with a very narrow interpretation of its mandate and a chairperson who has very systematically refused to engage on the impacts of fiscal prophecy on inflation. I agree, but this is a situation we are facing. So in terms of you know what I'm telling investors, I'm telling them that the Fed is not going to step up policy tightening until you see very strong signs that inflation is not slowing.

And by that time, the Fed of course, will be behind the curve, but we are not there yet. I think we still have a nice summer ahead of us because of things that could tilt inflation, core inflation upwards. I don't see them happening until later in the year.

[00:36:12] Adam: So what we need to do, is cross pollinate some members of the Bundesbank into the Federal Reserve system.

[00:36:18] Dominique: It sounds like a great plan, actually. They talk to each other because they have these monthly BIS meetings which are supposedly in grand style in Basel. BIS is rumored to have an amazing wine cellar, so this would be perfect for the crosts pollination, but somehow it hasn't happened yet.

[00:36:37] Adam: Gotcha.

[00:36:38] Richard: the US continues to benefit from having the reserve currency as well as the reserve asset, and this cleanest dirty shirt dynamic continues to be their main tailwind in being able to I guess, spend as much the, allow the treasury to spend as much as they are and provide some level of cover.

Do you give any credence or what do you, what is your take on this these reports of reduced appetite on a global stage for Treasuries from global actors and global central banks. Does that give you any pause that we might be nearing some form of inflection in terms of appetite for the reserve asset?

[00:37:20] Dominique: So I've been hearing this story for as long as I have been in the market, many more years than I care to count, and still look at, look at the recent auctions. There is no sign that foreign buyers are moving away from the US Treasury markets. I think, the network effects and the incumbency is enormous. And also, what are the alternatives? China, no rule of law, no transparency. No financial, real financial market to speak of. The Eurozone, it's, I mean it has its own dysfunctional features. I won't go into that, but we all know what they are. It's a combination of sovereign states, so you don't really have a common bond market.

And then if you look at the alternative, Australia, Canada, it's small. It's small. And Japan, you get no spread. So it's not just the incumbency, but the lack of alternatives. And so I, as you said, I can see this game going on for quite, quite some time.

[00:38:26] Adam: Dominique let's talk a little bit about you, you hinted at this earlier. I want to make sure we pull on this, you said probably for the summer it's going to be a rosy picture or risk assets, because there's nothing really on the near term horizon that might derail the party. Maybe talk a little bit about why you think that's the case and then let's push the time horizon out a little bit. When do you see the potential for clouds to gather and what might be some of the elements that would contribute to those gathering clouds down the road?

[00:39:02] Dominique: So biggest cloud on the horizon is, of course, energy prices. You've seen all right, it's recent range. I was expecting a recovery in energy prices mainly based on China coming back online because for the past year or 18 months that is, the beginning is, the beginning of this year, China's oil consumption had been flat.

China is now recovering. So maybe there is more of a basis for a sustained recovery in energy prices. That would be my number one party spoiler. The second party spoiler. Not as clear could be industrial action. Another thing that shocks me is no one is talking about the UPS strike, UPS parcel delivery service.

If there is no agreement by the end of next week, we will have 400, no 340,000 workers going on strike. It'll be the biggest strike in US history. And UPS accounts for about 45% of parcel deliveries. Its competitors don't have the spare capacity to take on new customers. So this strike on its own has a potential to cut growth and raise inflation.

But it could be much worse if the strike turns out to be the canary in the coal mine and we have a wave of industrial actions that follows, as we've seen this year in the UK. And it would make sense

to me given how tight the labor market is and the fact that real wages, until recently were actually falling. So that's my second cloud, but it's further away. It's not as clear as the energy price cloud.

[00:40:49] Adam: So a pickup in wage inflation, that might be triggered by large strikes that set a precedent and get the, get that flywheel moving.

[00:41:00] Dominique: Exactly. And the thing is, in the US we are under- reporting industrial action because the BEA reports only strikes that involve more than 1000 workers. So we are completely under reporting. We have to use Cornell University, or there is even a union, a trade union website that gives you a sense of what there is, and there is a lot more than what the BEA has reported. And I think that's one reason this is not on the radar screen of investors.

[00:41:31] Adam: Are we actually seeing, I think you noticed that wage inflation, despite the fact that, you've got at maybe a more local level, you've got strike actions happening, but they don't seem to be resulting in substantial wage negotiation wins for labor because we're, as you said, we're really not seeing that translate into the headline wage inflation numbers. Any insight as to why that puzzle exists?

[00:41:59] Dominique: So I think a couple of things. First of all, the loss of unionization in the US. So there are not very many mechanisms for people to push their wage demands aggressively. And also the labor market tends to adjust to the lag. For instance, prices get adjusted, typically increased, much more often than wages.

So basically it takes time for all these things to bubble, to come to fruition. Also it could be that because of the enormous transfers from the government to household during the pandemic, which is crazy, and have not been spent fully yet, it could also be that people were not so worried about the decline in their real wages.

So we could, all this could mean that there is a lag in terms of the response of the labor market and of wages to the very, very low unemployment.

[00:43:00] Adam: That's a good point. Yeah. So it's less that labor is not perceiving that their wages are falling behind price levels and more that there's maybe not the level of urgency that you would expect to see at this point, because the level of excess savings in the economy is so much larger than it was in prior cycles.

[00:43:22] Dominique: Exactly.

[00:43:23] Adam: One of the things you raised in your notes, which I was really curious about, I was hoping you should shed, you could shed some light on, you mentioned something about in the 1970s the governments put in place, laws or regulations to prevent a wage spiral. Can you say more about what that, what those legislations were, and just maybe map them onto what might be coming down the pipe in the current cycle?

[00:43:47] Dominique: So there was a low I think, under the Carter administration. There were also some wage and price freezes under the Nixon administration. And those didn't work because, wages were frozen, but prices were not. So there was no consensus to keep wages and prices low. Because one of the tricks of lowering inflation is that wage behavior feeds on price behavior, right?

You ask for high wages because you think that prices are going to go up. So if you get, if you could get everybody at the bargaining table and agree that they're not going to raise wages, they're not going to raise prices, you could have a decline in inflation and in inflation expectations. Most importantly, that would be relatively painless.

I think this is what these laws and price controls we're trying to achieve, but they didn't work because there was no social consensus. And also monetary and fiscal policy were not consistent with this inflation. And I think that took a lot of credibility away from those exercises. And frankly, I can't see a wage or price policy happening now.

There is not enough consensus. Our society's too fractured. And also we don't have the institutions in place to do that. Unions are too few, not representative enough. Also even in terms of the government, look at how difficult it was to give to the private sectors, these various schemes.

The paycheck protection program and all this, it was super hard to implement. Look at the state of US employment agencies. There are problems in state, after state. We have issues with fraud, dysfunction and so on and so forth. So I don't think these policies would be feasible now. And so the alternative is a recession because that will bring down everybody's inflation expectations.

[00:45:46] Richard: Do you expect the labor market to continue to tighten? Given we have pretty low participation rate right now. It's been persistently low and declining for some time now. And there's some evidence now that some of the workers that left the workforce during the pandemic are not returning, but rather they're retiring.

So do you expect the bargaining power to continue to increase towards labor, the pendulum, so to speak, to swing a little bit farther of labor and for this to continue to feed inflation expectations.

[00:46:17] Dominique: Oh, definitely. And also if you look, if you take a long-term perspective, the share of labor in income, in national income has been declining for the past 30 years. And I think we've reached the point where it's politically not feasible to go any lower. And that's why I'm expecting long-term recovery.

And that's one of the reasons I believe we are going back to a macroenvironment with much more inflation than before the pandemic. In a way, the pandemic was a catalyst for a lot of things that were going on before, and now have become apparent. And one of those is the fact that we've reached a sort of floor for the share of labor income.

[00:47:06] Richard: So you're painting a picture that seems pretty consistent and pretty well grounded for persistent high inflation for the foreseeable future. But there are a couple things that I'm wondering that might burst that scenario, but that that, that might put a different, put us on a different trajectory.

One of them being China and their recovery kind of stalling at this point, and we've seen the latest activity figures being pretty low and the PBOC now coming out with some easing and additional liquidity facilities in order to try and prop up growth. Obviously this is at least to some degree related to the bursting of their property bubble.

Do you think that China could once again be exporting deflation to the world? That's one dynamic. Obviously there, there's this geopolitical tension now, and this idea of reshoring, that China might not be as relevant going forward to the availability of goods. And then the second one, if you might comment, is the, this slow moving crisis in the US banking sector.

We haven't heard anything really meaningful since SVB, although Yellen recently talked about how the property sector in the US and the loans, the property sector not performing in the coming quarters, could become a real challenge for the banking sector. So I'm wondering if you might take those two as possible deflationary impulses.

[00:48:25] Dominique: Sure. So on China I see the deflationary impulse more through commodities prices than through exporting goods because there is a process of de-globalization going on, and

the US is really actively trying to isolate China. So you have a shortening of supply, global supply curves. You have suppliers moving to Mexico and even Canada.

And that is actually quite inflationary, right? Because it means costs are not going to be as low as they used to be. And the elasticity of supply is not as great as it used to be. Deflation risk from China, mainly through commodities prices. And definitely, one way I could be wrong with my resilient inflation picture is if all prices instead of going up, go down.

Say $50 or $40 a barrel from where we are now. If I'm wrong, my view will be falsified. The US banking sector? Yeah. I think what's important to realize here is that this crisis has been growing since the GFC, basically because the resolution of the GFC involved the buildup of four banks that were too big to fail.

So you always had a funding advantage of those four banks, relative to the rest. And again the crisis we've had, which is basically the Fed hiking being so far behind the curve that it had to rush to hike rates. So the crisis, we've just, is once again an example of a, something that was going on for a long time. A crisis that was brewing in the background for a long time and has been exposed by one event, which was the surge in inflation and the policy response from the Fed. I think it'll get resolved with basically even greater concentration of the of the US banking system. I don't think it's going to make that much of a difference because if you look at the service of small businesses, their reliance on credit is actually quite low.

It fell a lot after the GFC and since then it's not, they've not become more reliant on credit also, at this stage in the business cycle, typically. The economy is less reliant on that. That's what the data shows. If you look at what I call the *credit impulse*, so the 12 month change in the ratio of our price sector credit to GDP, it's typically negative after a recession.

Why? Because this is when people repay their debt. When people borrow is when there is a recession, and they borrow to tide them over. But once their income goes back up, that's when they repay because they want to rebuild their balance sheet. I see more of the risk, to my view, coming from China through commodities prices than through the banking crisis.

[00:51:32] Adam: It seems to me that if there's no consensus in Washington and no prospect of any kind of consensus that might try to deal with wage inflation via, and price inflation via the regulation channel, then. We are likely to face, to your point, high levels of entrenched inflation. And there's nothing that anybody will be willing to do about that.

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And the only agent with the ability to regulate or take action, because they don't require a consensus, is the Fed and perhaps the Treasury, who will take it out on the bond market, who will say, we can't control, the Fed's going to say we can't control the budget the government has decided to spend. They've already made these commitments.

And we are going to force you banks to buy those Treasuries even though the yield on those Treasuries is below current inflation rates. And, you get this sort of sustained financial repression. Do you see that as perhaps the most likely outcome here?

[00:52:53] Dominique: I am not sure and I'm, because I would argue that's what happened after the GFC. If you look at the share of bonds and cash in bank assets, it's enormous. It's 30%. So we already are in that situation. So could the Fed tighten rules to get the banks to buy more banks? More bonds? Sorry, possible. I would argue that right now the measures they are considering, like an increase in capital requirements. This is more likely to put a … on the growth of their assets. So I'm not very sure if it could get them to buy more bonds. I'm not sure. The banking lobby, and as in America we have a super strong lobby, the banking lobby is formidable. Would they let the Fed, burden them even more? I'm not sure.

[00:53:44] Adam: I guess my question is, at the moment the bond market seems to be more than willing to absorb Treasury issuance. So, it's not an issue at the moment. I don't, the Treasury hasn't really tested the bond market because they've really, they haven't issued any coupons, like they just continue to roll bills.

It'll be interesting to see how the duration market responds when and if they decide to issue more coupons. But at the moment, I, the bond market is saying we are willing to absorb as much, we're, we are here, we're here to buy bonds. But if the bond market were to shift in its view and take on the view that inflation is entrenched, it's likely to be sustained at this level or higher for many years to come, then we may face a situation where there just aren't natural willing buyers of Treasuries at rates that the economy will support.

And so the Fed needs to, they need to force the financial intermediaries to absorb those instead of, because the markets themselves are not willing to do that. So that's, I'm not saying right now that it's a problem. That clearly isn't, but I'm just saying when and if the bond vigilantes wake up and say we actually are going to demand a premium on our yields above inflation, and now we believe that inflation is entrenched, try to figure out what happens then.

[00:55:11] Richard: And a potential change in regulation, maybe not for the banks, but for insurance companies, reinsurers, other financial intermediaries, the broader ecosystem that has some need to hold either Treasuries for their balance sheets or for pristine collateral, let's call it. Could you see a scenario where that financial repression, if not for the US banking lobby's formidable defense against regulation, that it spills over into the remaining sectors of the financial service industry?

[00:55:41] Dominique: Sure. I would argue that QE is a form of financial repression. Once a Fed is, a balance sheet is as bloated as possible with this, with the, these bonds, the next candidate to buy them would be the banks. It's possible, it's possible. We are, I think, moving to a market environment with much higher inflation and there are going to be some very painful adjustments. And so this could be very well how the adjustment is implemented.

[00:56:12] Richard: So for the scenario that you're painting it seems the market really is underpricing the risk of sustained inflation for the next few years. Are there other risks that you are perceiving that the market might not be attuned to right now or per or potential downstream effects of that sustained inflation?

[00:56:34] Dominique: Sure. It's leverage. We've been loading up on debt in an environment of very low interest rates and at some point it's going to come back and bite us. And my macro scenario is that when the Fed finally masters will to bring down inflation and jacks up the right close to the Taylor rule, I think we're going to have very, possibly very scary financial volatility. We are going to have issues with solvency, corporate solvency, even as all balance sheets that look strong at the moment. Maybe less and imagine if the government has to suddenly face explosive, that dynamic, and is forced to contract its deficit, so you would have monetary tightening and fiscal tightening. I think there is no easy exit from this high inflation, high underlying inflation that we are in. This is going to be a very bumpy, bumpy situation.

[00:57:35] Richard: You're painting scenario of potential for fiscal dominance here if this continues, especially because if the Congressional Budget Office is projecting higher deficits of the order that we don't really see outside of war or pandemic scenarios. And then entitlement spending continues to grow as a share of those deficits.

If the Fed were to hike rates into this seven, 8%, maybe even higher might be required, depending on what the dynamics are at play. What gives, the trade-offs here don't seem really appealing. There don't seem to be any good outs for government.

[00:58:17] Dominique: No. You could see Congress curtailing the independence of the Fed. We've been there before. In the fifties you had fiscal dominance, you had the Fed targeting bond yields. Fed independence is a fairly recent phenomenon. So if there is instability, there are stresses in the system, we could very well go back to those years where the Fed is basically a passive banker for the Treasury. I hope this won't be the case, but that's certainly how a crisis could get resolved.

[00:58:51] Adam: Do you pay any credence to the MMT assertions about the fact that interest payments on the debt are also a source of potential stimulus? And so as interest rates go higher and the Fed needs to continue to refinance its debt, then you've got, you continue to raise the amount of interest that's going out from the Treasury to the private sector as well, and that ends up being a major source of stimulus. It's obviously not a major source of stimulus if the size of the debt is small relative to the economy, but because the size of the debt is so large relative to the economy, I'm sympathetic to the view, and I'm interested in your perspective on this of the, that in fact, high interest rates may actually end up being counterproductive at some point, and that may catalyze this sort of spiral where the Treasury can never get back ahead of its debt obligation, because of the fact that the bond market continues to demand higher rates. Those higher rates then feed back into higher interest payments out into the private sector, et cetera. You see this sort of cycle I'm painting.

[01:00:02] Dominique: Adam, I was going to crack a joke that my one word reply to MMT is Argentina. Those guys have been practicing MMT forever, with the results that we know. The sort of feedback loop that you describe is typically associated with hyperinflation.

That's basically when people lose total confidence in the currency, they don't want to hold it and the value of that, of the currency falls exponentially. Yeah. Some people have argued that QE was going to lead to hyperinflation if it led to a wholesale loss of confidence in the currency. I, so I'm not a fan of MMT. This is a long-winded way of saying it.

I think, the idea that interest payments would end up stimulating the economy rather than restraining it, I'm sure you can find a model that will give this result, but you will have to make fairly extreme assumptions. No I'm not, again, I'm not sure how relevant MMT is to, bread and butter economics, the bread and butter economics set, that I tend to do.

[01:01:13] Adam: So one, one interesting case study of this dynamic at play is the fact that the US corporate sector, in 2020 and 2021 rebuilt their balance sheets issue with a huge amount of debt at low rates, obviously picking up on the signals that were being sent by the rise in inflation. And I think Powell at one point became pretty clear in his intentions. There was a massive amount of corporate

debt issuance, and I've been, I, in looking at the numbers it seems like that debt has largely just been sitting on corporate balance sheets as term deposits.

And so what you've, what's ended up happening is that the corporate sector sold their, sold bonds to raise cash and then they've invested this cash effectively. They haven't invested any of it. They've just raised it, and now it's sitting in demand deposits earning 4 or 5%.

So issue debt at zero to whatever, one to 2%, and then now earning four or 5% on it. That, there basically is, acting as a giant carry on interest rates. And that by the estimates that I've seen that is impacting corporate earnings to the tune of four or 5% year over year, bolstering them. So you can see mechanically how this higher rate dynamic could lead to a compounding stimulative effect from this kind of now, eventually the bonds that the company's issued roll over and they need to be refinanced at higher rates and the party ends, right? But, we could be several years away from that.

[01:02:53] Dominique: Sure. For sure, issuance at very low rates, long-term has locked in. That's one of the reasons why Fed policy is not having an impact, because corporate households even more have been locking in low rates for a very long time. Yeah. So it could take a while before we see a FED tightening impact to corporate.

Or alternatively, you would need much tougher FED tightening, perhaps even more than what the … rule implies because you've had this, because we're basically coming out of several decades of very low interest rates and people have been able to lock in those rates. So definitely that is a, that is a risk.

[01:03:38] Richard: So to, to linger on the MMT point here just for another moment, while we haven't seen the printing of the trillion dollar platinum coins or anything that extreme, it's hard to argue that Washington continues to move a little bit further in the direction of some of the policies that MMT would espouse, the deficit spending, the striving for full employment and that sort of thing.

So I'm wondering, we discussed a few minutes ago, how the US through their reserve currency of network effects and the reserve asset will continue to be the predominant financial power globally, and that there will still be some demand for Treasuries and then for the US dollar.

But then you were describing a moment ago that if this continues, and if we do arrive in this fiscal dominance and deficit spending continues to grow, that there might be a tipping point for this

demand. But it seems like without any alternative globally, the US might be able to get away with this and continue to spend well beyond its means and continue to increase their debt leverage. Can you maybe square that for us?

[01:04:46] Dominique: The, even if there is no budget constraint, I think the US will continue to fuel high inflation and at some point, high inflation will become politically unpalatable. We already know that the administration is held responsible for the high level of inflation. This is one of the factors that have impacted the popularity of President Biden. Inflation is stable. It's around 5%. It can get much higher. If it gets much higher, it's going to be become more of a political issue. So I think this is one way in which fiscal policy could be, could become more rational.

[01:05:26] Adam: Sneaking up on an hour and a half here. I wonder if I could put you a little bit on the spot, and I know it's, it's one thing to discuss the mechanisms by which investors feel safe and want to put risk on, and then discuss the mechanism for clouds to form. Do you have any sense of timing for whether there might be some structural reasons or other reasons why the clouds might form at a certain point next year or later this year?

[01:05:55] Dominique: Sure. Our oil analysts see the market, the oil market becoming under supplied towards the latter part of the year. So I am thinking that the big rally in energy prices that I need for my dire views to turn out correct is more likely towards the end of the year. So that's why I am thinking we have a good summer, possibly fall, ahead of us. In terms of unknown, so one I think that seems the most possible is this industrial action and pressure on wages. And that would build gradually. When it's 110 outside, people don't want to demonstrate. So maybe this is more of a full a full story. So that's the sort of timing I have in mind.

[01:06:44] Adam: Beautiful. Thank you. We could go on for a while, but I feel like this is maybe a natural stopping point and it's nice to leave something for next time. Dominique, thank you so much for sharing what I think have been some very unique insights and I think you've given us a lot to think about.

[01:07:00] Dominique: Thank you very much for having me.

[01:07:01] Richard: Thanks for coming.