[00:00:00] Adam: Happy Friday! Welcome to our guest today, Julian Brigden. Thanks for joining us.

[00:00:07] Julian: Thanks or having me, gents.

[00:00:08] Adam: Before we get started, we gotta say our disclaimer, just for everyone. Remember, this is for educational, informational, and potentially entertainment purposes only. Whatever we talk about on this podcast is not advice and should not be viewed as such.

So we hope you enjoy our conversation, but don't go out and act in markets based on what you hear today. With that said Julian, welcome. Maybe just for those who would be hiding under a rock, tell us a little bit about you and your firm and what you've been working on lately.

Backgrounder

[00:00:45] Julian: Thanks very much gents. So look at MI2. We set MI2, oh God, this is where you realize you're just getting really old, right? Because this is like the third career. I've been doing this now 12 years at MI2. We got set up by a few hedge funds who liked my work when I was on the sell side of the market.

And we designed the firm to make the kind of decision making process that you would see within a macro fund, a private office, a big mutual fund manager. And so we start with kind of the top down view, and we're gonna talk about some of those things now. But then I've hired this team of guys and I think this is where it gets really frightening.

I think our collective market years is pushing 200 years now, right? And that's between six of us. Which is, which, when you get a little a little scary across all sorts of disciplines. And the reason for that is cuz I want to take those views on the world and try and make money. And that's really the only thing that we're interested in.

And then, you can subscribe to my stuff if you're an institutional client. You can, you could do that if you wanted to reach out to support@mi2partners.com. You've got, you can follow me on Twitter, probably some people do follow me on Twitter. It's @JulianMI2.

And then as I said to you guys, we have to put this shameless plug in, cuz it's a beautiful place to go. It looks exactly like Richard's background, in where he is now. We are having our first macro conference for MI2 on September 26th to 29th in Vail. It's the best time of the year to be out there.

Your spouses will love you for taking them there. Okay? So you can go off and be a complete wonk, doing all this macro stuff, and they can enjoy themselves hiking, biking, sparring, shopping. You'll hate the shopping, things are expensive. But everyone will have a good time. So yeah, there you go.

[00;02:35] Julian: And it's far away, gents. I'm open. I think it's a fantastic time in macro. I really do.

[00:02:42] Rodrigo: Yeah, you say that. I used to say that too. And now I'm exhausted by the whole macro thing

[00:02:47] Julian: Yeah I know what you mean.

[00:02:48] Rodrigo: In 2020, 2021, it was so exciting, amazing. But it has been just all over the map, it feels anyway. And I'm glad to hear it, that you think it continues to be fantastic.

[00:03:01] Julian: Look, it's never easy, right? Don't get me wrong. I, many days I wake up in the morning and go, I could have picked an easier job than trying to front run the global financial markets and get it right, okay? Because the markets are pretty good at feeling things out. But I said we've been doing it 12 years and, touch wood we've been pretty good so far.

But I do, the reason why I think things are interesting is we're in this sort of betwixt and between where you, if you look at the US and even across most of the world, we can see the cracks coming, right? We can see, I mean our, we think we're heading to recession driven by three factors. Even before the latest banking turmoil, we were tightening the credit cycle, and that's inevitable.

That's how central bank tightening works. That has ramifications from CapEx spending to retail sales, to commercial real estate. We are, we're gonna get an inventory cycle, a good old fashioned kind of inventory cycle. We've overstocked, demand is falling, unit sales are falling, we have to adjust production.

And then we think we're gonna get a collapse in housing related construction and all three of those, it gets us to a good old fashioned recession. We're not talking about 08-09, but a good old fashioned recession. But on the other side of the equation, you've got central banks who are not stupid.

They can see that too. But it's still like holding out for dear life. No, we've gotta do more. We've gotta do more. And I think that those two are opposite forces, like two magnets, right? When you try and push the two magnets together, one side is just gonna blow at some point. And when they

start to move away from each other, the forces are gonna be enormous. And that, to me, creates market opportunities.

[00:04:54] Richard: But does it give you pause? We were talking about this earlier, the fact that because of the SVB event and the banking crisis that ensued, essentially, the Fed not only thought about, didn't go through with, but thought about pausing the rate cycle hike, that particular meeting in March.

But they reversed essentially what was five or six months of QT in one fell swoop. I haven't looked at the data more recently, but they were spooked.

[00:05:22] Julian: ...a bit but you're right, Richard, it's still…

[00:05:24] Richard: Equity markets didn't really, the moves in rates were enormous, but equity markets didn't quite reflect that. How do you feel about that event and what does that do to your thesis, given their potential propensity to expand the balance sheet again?

[00:05:38] Julian: Right. Look, we've been living in this bizarre world right for a while, since 08-09, where we track the macro to figure out the policy, because the policy drives markets, right? You can wrap. And I frequently, look, I'm a macro guy, so I hate equity people, they're too bloody chipper. They're, the glass is always half full and I…

[00:06:03] Adam: Preach, Julian preach. Agreed? Yes.

[00:06:06] Julian: And…

[00:06:06] Rodrigo: ...wall of worry, everybody else has.

[00:06:08] Julian: Yeah , but, and I, equity analysts, I think, just the ambulance chasers, right? And I mean that in the sense that literally they just write a rhetoric that fits a price action. And I, look, I deal with a lot of very experienced journalists and have long conversations with these guys that I really admire and, been in the markets.

But frequently you get a phone call from some young kid at some magazine or TV station or website, and they ask you, so why did the market go up today? And I'm like, why do you even want to write

about that? Or don't you want to write about what happens tomorrow, today? Isn't that the whole idea? And so I look at all these markets and to your point, they're being driven by liquidity.

And we are fitting a narrative around it to suit the price action. And so it, it's not got anything really to do with fundamentals. Asset prices, certainly equities, level of the indexes, let's put it like that, is driven by liquidity provision. What happens underneath I think, in fairness, Richard, even though you say like, the market's quite high up, if you actually look underneath, it's quite a recessionary kind of price action that we're seeing, right?

We've gone back to this price action that we saw during the Covid where the FANGs have essentially, we called them during Covid, we call them ersatz bonds. So a replacement for a bond where essentially, an asset that goes up, when there is no real economic growth. And that's what's happened.

So it's those same stocks that, because of their weighting in the index, are underpinning the index, but look below the surface and it's pretty shitty, right?

[00:07:52] Richard: Yeah. Market breadth is pretty low. You're alluding to this reflexive nature of the passive drive and how the mega caps have become systemically more...

[00:08:01] Julian: Yes and no. There is a logic to it, right? These companies do seem to have an ability to a point, to continue to grow reasonable levels of revenue. But yes, look, Apple, if you, if it wasn't so big and it didn't have so much momentum and it wasn't buying back so much stock, it's a pretty ugh company when you look at its revenue growth and its product innovation, right? This really, they haven't done anything. They were supposed to take over, research Apple TV. They haven't really moved into the automation space, in the home space. Where is all this? Where's the car, all of this shit. They just sell us bloody phones and services to go in it.

And it's only old gits like me, but still buy an Apple phone cause I can't be bothered to move to an Android, which is arguably a better phone, that younger kids use. All of these sorts of things. It's not a very innovative company. It's a big stodgy semi-utility.

[00:08:59] Richard: And...

[00:08:59] Julian: A lot of money in it.

And that's what, and there's a lot of money in the world at the moment still.

[00:09:07] Richard: No, I totally agree. And big tech is now most likely in the crosshairs of regulators on both sides of the Atlantic. We know that. We also know that they're starting to block some of these acquisitions, right? Activision acquisition by Microsoft was blocked. So there's an argument to be made that top line growth will moderate and be, and they'll transition from being growth stocks to being cash cows, right?

They are generating...

[00:09:27] Julian: And I, look, I think the biggest issue facing the US equity market is the very fact that it's just outperformed to the degree that it has, right? I, if I think there is a variable this year, it has an awful lot to do with the dollar, and it has an awful lot to do with this reflexive inflow of funds that we've had over the last decade, which has driven, I mean from reflexive in the what, so says about reflexivity.

So the, in other words, the purchase of the asset underpins the fundamentals that underpin the price of that asset. So the more you buy, the more the fundamentals improve, the more you buy, et cetera, et cetera. So I think that we've been in a decade plus of that in the US, and the biggest thing that... I think where the opportunity lies is if that starts to change this year, because it doesn't mean the US market goes down necessarily. It just may be there are better things to buy rather than this. Let me buy some Apple, let me buy some Microsoft, let me buy some Google, let me hold dollars,

[00:10:33] Richard: That's the point though. It's less of it. It's less of an equity, US equity market story, more about a currency story, which I think is really the big story of the moment right now. I think that we, the…

[00:10:45] Julian: Potentially. We haven't done it yet, Richard, but the, if you look at the way things are falling into place, I think that's where the big surprise could come.

[00:10:55] Adam: So I just want to press pause because I, we could go a long way down this rabbit hole without addressing what I think is the elephant in the room, which is that Microsoft and Apple are within 5% of all time highs. And I have to tell you, and we all internally have been lamenting this concentrated growth oriented, hyper-cap tech, sustained tech rally for years.

Because it sucks all the oxygen out of every other dimension of the market. And it makes any attempt at diversification look idiotic, right? So I've been hoping for a shift in regime. I thought we were gonna, we were coming to that in 2022. I thought that was gonna break the back of big tech because it was gonna, it was gonna cause a shift away from duration oriented assets and towards short duration assets.

We've seen short duration assets get a big bid. Look at cash, look at the inverse of the yield curve, et cetera in rates. But it seems to me like, I was, I thought that the big tech concentrated growth oriented equity rally was a duration proxy bet, for years.

[00:12:23] Julian: It was.

[00:12:24] Adam: And that is...

[00:12:25] Julian: ...but look at

[00:12:26] Adam: ...being called into question is all I'm saying.

[00:12:28] Julian: No. Look, you're right. It's a bit soul destroying, especially for a macro guy, right? So you've got this natural proclivity to want to sell it. , even though my models are telling me to be long Euro stocks at the moment. The question is, and I do think you did get an adjustment in some element of the duration market, right?

The infinite duration market, right? The Kathy Wood shit, let's call it what it is, right? That Kathy Wood shit, this one track pony that she is, right? She's just, who I think has done more singularly to destroy shareholder value, and yet you have this groupie following of people who believe that she is gonna be right. She's wrong.

And she's been proved to be wrong, and that's why you've lost 70% of your money. The, that side of the marketplace did go down. So the infinite duration stuff has gone down. I don't know whether these half a dozen stops, you can really call 'em duration anymore. I don’t know whether you can really call Apple a growth stock anymore.

I call it, as I said, it's a cash generating utility, so...

[00:13:32] Richard: It's in the midst of a transition. Without a doubt. Big tech is transitioning. Yeah.

[00:13:36] Julian: And I think in fairness, what I would say about 2022 was it, you were right, it looked like this stuff was going. And I would put that down to a certain extent, 'cause it looked like the dollar was topping and then we get Ukraine and that vast, that last ounce of global liquidity that wasn't concentrated here, came in. And now I think the fundamental problem facing US markets and US stocks is all the world's money is here in dollars to, in other words, un-FX hedged, hanging out in US stocks, certain corners of the bond market. And could that continue? Yeah, maybe. But it, I think the cracks are beginning to show, right?

We've got a, US equities have been underperforming Europe in this last little run up in tech, fine, okay? But they've actually been, if you are a European investor since the end of last year, you'd have been better off having your money in Euro stocks, in Euros rather than S&P or Nasdaq, in dollars.

And that's important, right? Because, that's a big element. And the second element that's related to that is the reason why the money is here. The money is here as simply a balancing item to fund an enormous current account deficit, because as the reserve currency, we have a natural proclivity to have to run a current account deficit.

See, that's how we get dollars into the rest of the world. Okay? We either lend them or we spend them, right? And foreigners give us money on, in return. So they either lend us the money or they buy US assets. Because they haven't lent us the money really, cuz they've lent certain pockets of the market money, but they haven't, US banks aren't borrowing a lot of euros overseas and then turning those into dollars to lend to US consumers to go and buy BMWs, right?

What Germans have done, and Japanese have done and Brits have done, is they bought US assets and so the money is here. Now the problem with that is that relationship, as I said, is reflexive because, and it starts, if you look at the outperformance of US equity markets really starts powering in 2011 and then again in 2014 as the dollar starts to, when the dollar really takes a kicker in 2014, right? And the way that it works is, and we saw this in Japan going into the Nikkei bubble, we saw this in Australia in 2009 to 2011. So your currency starts to rise. So foreigners look around and think, oh look, dollar's rising up. Let me have some of that. So this starts to put money into dollars.

And what do they put the money in? They put it into stocks. So US stocks outperform. They put it into US corporate debt. US corporates take that money and they buy back stocks. So US stocks perform even more, or buy even more US stocks. The resultant effect of that is a booming wealth effect, which does two things.

Firstly, it causes the Fed to raise rates. Okay. Or the dollar outperforms even more. Let me own even more. And secondly, it funds a booming economy which fund, which requires or drives, sorry, a large current account deficit, which foreigners then have to fund. So it literally becomes self-reinforcing. But the problem is it's almost definitionally an unstable/stable equilibrium because it depends on the three metrics which should, we discussed earlier.

The first one is US asset outperformance because if US assets stop outperforming, the money goes home. Secondly, a strong dollar, right? Because I've lent you that money as a foreigner. I've lent the US the money unhedged, cuz I can't fund a current account deficit with hedged inflows. Okay? So the dollar has to keep outperforming cuz if that drops too much…

Like I said, you'd be better off as a European having your money back home, so the money goes home. And the third thing it depends on is the maintenance of that very large current account deficit. Because if we go into a recession and the current account deficit shrinks, the US doesn't need foreign money anymore, and the money, and US asset returns adjust so that the money goes home.

And I think we're starting to see changes in that self-reinforcing, amorphous kind of ball of interaction that those three variables create. And we're starting to see leakage. Does it stop? Maybe, but I think there's a vulnerability there. And that to me, is what will determine really, going forward, where I put my assets because I don't, if you put a gun to my head, I really don't think that the next decade looks like the last decade and in the last decade, literally as a European, if you'd have put your money into the IBEX, the Spanish equity market, you were up 18% since the lows of 09. Wait, you are a fucking idiot. But you should just put it all...

[00:18:56] Adam: Anywhere, except for the US equity markets, you're flat. Over the last, what is it, 13 years.

[00:19:03] Richard: In real terms, for sure. Yeah.

[00:19:04] Adam: in real terms.

[00:19:06] Richard: But I'd love to unpack those variables that you're alluding to Julian and maybe start with the last one, right? This idea of deficit spending in the US maybe being curved. Do you see anything?

[00:19:16] **Julian:** Typically, look, I said I think we're going into recession. In a recession, typically, consumer spending contracts. Given that a large part of the deficit is consumer durables and consumer related items, yeah, I think, I think that's falling. And I think that we started to see signs of the current account deficit peak. And I think it's coming down and I think that will adjust the relative yield of either the, in the bond market. And remember, Europe and Japan are having to spend an inordinate amount of money, which they haven't done up until now. There was a Bloomberg staff article a couple of months ago that said, Germans have earmarked, or think that they need spend 250 billion euros to hit their climate change objectives, I think by 2030.

No, the number is a trillion. They've got to boost defense spending, hundreds of billions of euros. The Japanese are doing the same, they're re-onshoring, right? All of these things. Where does the money come from? It has to come from relatively higher yields in Europe or Japan to attract the money home from where it is at the moment.

And where is it? Here. And as I said, the second thing is what happens to growth? If we go into the recession, current account deficit will drop and the money's just gonna go home. And if the dollar starts to fall, and that outperformance of the US equity market, and we call this, I thought it was quite clever, to pat myself on the back, but I called it a biblical, a rotation of biblical proportions, when I looked at the sectors in the US equity market. Why did I call it a rotation of biblical proportions? Because it's big, but also because of that expression in the Bible. The last become first and the first become last.

And if you look at the sectors that tend to perform in a dollar up environment in the US versus those sectors which tend to reform in a dollar down environment, they're exactly the opposite. When the dollar fell from 2002 to 2008 and it, please guys, I am not in the tin foil hat wearing Machiavellian… the dollar's over, it's not gonna be a reserve currency.

[00:21:39] Richard: The Yuan is not taking over. We know that.

[00:21:41] Julian: It’s physically impossible for them to take over at this point. They don't run a current account deficit. What logical Westerner is gonna want to put their money, or is gonna be allowed to put their money in a totalitarian state,? None, right?

[00:21:54] Richard: More important, how do you get out? Maybe they let it in, but how do you get it out?

[00:21:59] Rodrigo: No, we're just talking about a trade and maybe a cyclical reality for the US.

[00:22:04] Adam: It's the Hotel California currency trade, dude.

[00:22:06] Julian: Yeah, exactly. So what we're talking about is 2002, 2008, potentially repeat. So if you look at the relative performance of the sectors, the worst performance, tech, consumer discretionary, healthcare. The best performers, mining, metals, energy, transports. Everything that everyone is short or underweight versus everything that everyone is balls to the wall. Max overweight.

[00:22:39] Rodrigo: So Julian, I'm literally praying for that environment. Like I cannot wait to see that happen. So, like you're hitting all my buttons here. But the, when I think about that regime happening, back then, it was an inflationary growth environment that was led by China growth, pulling all these asset classes up, all these commodity prices up...

[00:23:03] Julian: Well, 2000, not 2002, right? Because this was 2002 to 2008. So not post the GFC. Way before the GFC, and actually what caused it back then was the end of the .com bubble.

[00:23:17] Rodrigo: Yeah.

[00:23:19] Julian: In a similar, I think, dynamic to here, because to me, there's no question on a relative basis, relative the US equity market, is a bubble versus the rest of the world.

Okay. The, it was just that the money leaving, and actually there's the dollar, and then the Fed's starting to cut, and the dollar rose into the recession. So the .com bubble bursts okay, in March of 2000, and the dollar keeps moving up. Now the .com bubble back then as a market was an ameba compared to the behemoth.

Just because it had Microsoft in, doesn't mean that the NASDAQ back then really mattered. The NASDAQ was down 40% and the Fed raised rates 50 basis points cuz the NASDAQ was like, oh, what was that on my shoe? Oh, sorry. No one cared. It was like Kathy Wood's ARK was this...

[00:24:08] Rodrigo: It was a growth index.

[00:24:10] Julian: Yeah, it was.

It was trying, but what happened was the US equity market, we rolled from the NASDAQ to the S&P. The S&P peaks in September of 2000, six months after the NASDAQ. And then that peaks, and then the money rolls into the Dow, which is the big market. And the Dow doesn't peak until May of 2001. And the dollar is rising this whole time because the Fed's being tough.

They're keeping to raising rates, the money's coming into the US, relative outperformance, et cetera, et cetera. And then the Fed starts to cut as we move into the recession. And as that happens, that's when the dollar starts to go. It acts as a natural, as we go, as the dollar falls, it tends to be reflationary for the rest of the world.

And that's what started that cycle. And 2002, 2008 was not a bad time to be in the US. It was quite a good time to be in the US, right? Wasn't the worst. It was just a shitty time to be invested in US assets. And it was bloody expensive as a US citizen to go on holiday in Europe. That's why I keep telling all my mates, go and buy your FX for your next five year’s worth of holidays now.

[00:25:19] Rodrigo: Yeah. The BRICS were massive during that. Like ,Brazil, Russia...

[00:25:23] Julian: At the end of it, they were kind of the place to be. It's when a beer was costing you, like back in 2008, like five bucks in Manhattan and 15 in Rio.

[00:25:32] Richard: Yeah, there was an improvement in the terms of trade of everybody else against the US because the...

[00:25:37] Adam: So, are we seeing a, are we seeing a counter trend move here then Julian, with tech moving back to all time highs?

[00:25:45] Julian: I think so because...

[00:25:46] Adam: ... moving lower?

[00:25:47] Julian: I think because we've, to Richard's point, I think because we had that reversal of the QT, because we have the liquidity coming into the system, it really hasn't done an awful lot to bolster the European versus US trade. That hasn't really moved at all.

I'm long IBEX, the Spanish market against the NASDAQ and as well against S&P, and it hasn't really moved at all, so it's not like the US is outperforming, .

[00:26:15] Rodrigo: So just to go back to that 2002 to 2008 period. You're saying it's simply that the dollar move is what causes then, the reflexive nature of international stocks outperforming, and commodities were also probably the best performing...

[00:26:31] Julian: Started to materially outperform, yes, absolutely.

[00:26:34] Rodrigo: So what caused the commodity outperformance, then?

[00:26:37] Julian: The dollar primarily. And as the dollar starts to fall, it is reflationary for the rest of the world. It is the grease that oils the cogs of the global machinery, right? So if you start to drop the value of the dollar, then the value of a hard asset should, and it's the denominator of that asset that the value of that asset should rise.

In Euro terms, copper should be maybe flat, you could argue, right? But in dollar terms, if the dollar is falling and the euro is rising, then in dollar terms, the copper should be going up, right? It's a little bit of money illusion, but at some point, to Richard's point, it does actually become a real thing, because you do get investment in the commodity space and that drives stronger economies in Australia, Canada,

[00:27:24] Rodrigo: I'm Peruvian, and I saw that period was amazing for Peru. It really brought poverty down quite aggressively. There was just so much work to be had on the commodity side, so it does have any real economic impact.

[00:27:36] Julian: It does have a real impact. And I think, look, I attended this dinner the other week with Jeff Curry, the Goldman commodity analyst. And I like Jeff. And it is interesting, we joked at the end of the dinner. We were two brothers from a, from different mothers, right?

And, his view is, what causes, and I totally agree with him, is what causes periods of commodity outperformance is a period of hyper financialization where you extend to, to your point, Adam, into these like super duration financial assets. So what you do is you neglect the real economy investment and you go and invest in ARK and you pump ARK to stupid levels because just, there's nothing else that you can buy, right?

So you just take the biggest ballsy risks in the biggest shit out there, right? But in the process of doing that, you're finally, you're taking money away from the rest of the real economy. And what comes back to bite you is that you need those real economic products. So as growth starts to pick up as the Fed cuts rates and the cycle starts to turn around, you go, oh shit.

I haven't got enough of those products. It's just a timing thing. And I think Rodrigo, to your point, a lot depends on the dollar. The dollar hasn't broken yet at all, in broad terms. It still looks pretty strong. It's still sitting, I'm looking at chart here where I like to look at the broad trade rating indexes, because then it cuts out some of the noise of, is it a Euro move, is it a Yen move, and all that sort of thing.

No, I'm just looking at the pure version I can, of the dollar and we're sitting just above the 2001, 2000 ... highs. Okay. And we are holding there. This is where we bounced, back in at the beginning of the year. This is where we accelerated through, into, through Covid. It's just, could it change and how does it change?

And this is gonna be a much quicker move into a recession than they realize because for all their huff and their puff, we know they are going to be, if something's wrong, and this is a systemic banking crisis, they are going to be cutting rates much quicker than they think.

[00:29:32] Julian: And when they do, the US banks, so I was having this conversation with a buddy of mine who's an extremely good banking analyst. The US banks are in a much shittier situation than the European banks. Much, much shittier situation. They're much...

[00:30:12] Richard: They've had negative rates for a while. Europe was actually caught in a, the European banking industry was caught in negative rates and that period really hurt them in a way that it didn't hurt the US.

[00:30:22] Julian: Well, there are other...

[00:30:23] Richard: The economy in the US was a lot more robust than the anemic growth that you saw in Europe.

[00:30:28] Julian: Yes, that's true. But there's also some other things. Following the sovereign crisis in Europe, the Europeans took some steps, for example, around hold to maturity and mark to market

of assets, which the US didn't. So pretty much all assets are marked to market in Europe and not held to maturity, even sovereign debt.

The second thing is a very large proportion of the assets in European banks are actually made up by mortgages. And mortgages don't default typically, right? That's not the case in the US banking system because US banks take those mortgages and then they sell 'em to Fannie and Freddy. So what you left within US banks, particularly the smaller regional banks, not the big boys, is much more economically sensitive.

Shit like commercial real estate, commercial and industrial loans, auto loans, personal loans, right? All of that sort of stuff. So the US banking system, outside the big boys, is much more cyclically sensitive than the European ones, which is once again, highly concentrated in the big banks, because we don't have, the US has got this, I keep joking whenever I go to other parts of the developed world that, and I come back to the US and I land at an airport and I'm like, fucking hell.

This is a third world masquerading is the first world when it comes to public transport. That's our banking system, we have a third world banking system.

[00:31:55] Rodrigo: Interesting.

[00:31:55] Julian: ...banking ...

[00:31:56] Rodrigo: So it is...

[00:31:57] Richard: I want to pull on the thread that you dropped about commercial property. Sorry, Rod, because that, whether we pull on that thread now or we put a pin on it, and because that is now starting to emerge as one of the major issues that these

[00:32:10] Julian: But everything's gonna emerge. Look I was looking at something. If you look at C&I loans, right? So commercial industrial aid, so funding to industry. It's a huge part of US banks' books. Looks to me like the loss ratio is running incredibly low. But when I look at where it's going, to double and triple, right? Now, the problem is, these guys don't have the assets to, what we've seen so far in the banking system is equivalent to the duration bond losses we've seen in credit, right?

So credit, if you look at credit, credit debt, you have two types of hits that you can take on it. It's a bond. So it can take a hit when interest rates rise, right? That's your duration hit. The longer the debt that you own, the bigger the hit, right? But it also, unlike a sovereign bond, really, theoretically it won't go there, but theoretically it also has a credit exposure, because you're lending to a company or a basket of underlying assets that you are, that you're lending on, right?

And so as the economy goes into recession, those start taking hits too. And when you look at credit pricing, I think all it's done is adjust for the duration hit. I don't think it's taken any, when I look at high yield debt, my models tell me high yield debt, which is like nine and nine and change at the moment, should be 17 or 18, right?

Yields right. And it's gonna come because you're gonna take losses in those portfolios. The banks, you've taken that kind of duration hit, Fed's raised rates, they've lost deposits. They've taken a hit on their holdings because they've extended too far, but they haven't taken the actual physical losses on the assets that is going to occur when people lose their jobs, when companies are going to go bankrupt.

And...

[00:34:09] Adam: But Julian...

[00:34:09] Julian: And that's going to recession.

[00:34:11] Adam: You've got leverage loan indices at or near record tights. You've got corporate bonds spreads at or near record tights, right down the credit curve. You've got employment prints coming in, moving the unemployment rate down, what was it from 3.6 to 3.4 or 3.7 to 3.4, something like that.

You've got average hourly earnings up considerably more than expected. You've got hours worked up considerably more than expected. It just doesn't, I hear you like, you make big money on contrarian calls, but where are we seeing confirmation?

[00:34:56] Julian: Okay, so you're seeing it in, you're seeing it in the credit metrics, you're, and even before SVB, you were seeing it in the credit metrics, right? The way, remember how banks make money? right? They borrow a bunch of money short term, and they leverage the shit out of it.

Ten, ten to one, basically. And they also do, they transform it in time transformation. You borrow short, you lend long, all that sort of stuff, right? So when the curve, when the central banks start to raise rates and the curve flattens, right? So normally a curve looks like this is short term rates, this is long term rates.

So when the curve starts to do this and those short term rates rise, the funding opportunities, or the profit opportunities of the banks deteriorate, right? So their natural proclivity then is to tighten. And so you were seeing that even before we got to SVB. SVB, we don't have all the data, but the anecdotal data and some of the data that we've seen, looks like it's quite materially accelerated things.

And I think going forward it will, because I don't see a solution for these regional banks, right? These regional banks will have to either, best case, their balance sheets don't grow. That means no growth in lending. That's bad. Worst case, their bank balance sheets in aggregate will continue to contract.

And that's really fucking bad because the big boys aren't gonna step up to fill the gap, okay? They have no interest. Okay. They're just saving their balance sheet so they can pick up super cheap assets as those regional banks discourage them. So JP Morgan has got no greater proclivity to give you a mortgage than your local bank has at the moment. And that's not great.

[00:36:36] Richard: No doubt that the Fed was spooked by SVB, which is the, their action on the balance sheet just tells you that, right?

[00:36:41] Julian: And they should be spooked, right, in the longer term as to their ability to drive inflation out of the system. But, that aside, so you're seeing it in the credit side, you're seeing it in manufacturing. We have shitty ISM and PMI numbers, right?

If you look at the Philly Fed survey that goes back to the 1960s, I think, we have never, never printed this number without a recession. Never.

[00:37:09] Adam: But we've also never had manufacturing as such a small sliver of the economy.

[00:37:17] Julian: Correct. But who is the client base of manufacturing? The client base of manufacturing is services. And so what manufacturing is adjusting to is the fact that services and their clients have massively over- ordered now. So this is, so what will happen, and this is the point, if you look at, it gets a little bit complicated, but look, companies work off nominal levels of activity.

So actual level, multiplied by the price, right? So their profits are a function of how many things they sell, times how much they charge for it.

But when you look at the real economy and you look at the firms' actual production, it's got nothing to do with what they sell it for. It's simply how many they produce.

So that's a real, so financial assets are nominal. The real economy is literally a real unit-based beast, right? How many widgets did I make? How many people do I need to employ to make those widgets? So if you look at the equity market, it's doing well, and you saw it again with Proctor and Gamble and Coca-Cola.

Their revenues were up. The reason why their revenue's up was their prices were up more than their revenues, which means their units of production are down. And if you look to, at the adjustment actually in consumer real incomes, the US corporate sector has done an amazingly good job at sticking their hands in people's pockets and taking every red cent of the stimulus and the wage increase, so it's not surprising that those, that they can't buy the same units that they did. And while it works in singularity that Proctor and Gamble increase prices and take an adjustment down on production, you push that across the whole economy, and all of a sudden your industrial production is down 3%. The number of people you employ is down 3%, and where you actually see, Adam, the deterioration in some of these metrics is in the rate of change. So the second derivative employment is deteriorating, right?

So you look at initial claims, the rate of change, initial claims is beginning to rise quite materially. In fact, it's above a level where, if you go back 60 years, we're either in the recession now, or we're one quarter away for the official announcement of the recession, right? So to me, there is absolutely no doubt we are going into recession.

I think it's a common old garden recession, but you do gotta understand what that means. The average rise in a post-war recession of unemployment is 3.3%. So that means we're heading to six and a half to 7%. If you go to six and a half to 7%, then your credit card losses are gonna triple from where they are now.

Your auto loan losses are gonna rise. Your C&I loan losses are gonna rise and this is already a banking sector that's fucking stressed, so none of this gets better. It's just a stay of execution and fine, they could ban short selling on Monday. Does absolutely nothing, but fuck a few shorts.

[00:40:32] Rodrigo: So can I just dig? Okay. So let's just talk about the markets and what the effect of what you just described has on them. So you, at some time in the future, there's gonna be a recession. That recession's gonna cause equity markets to possibly go down, right? One assumes.

[00:40:48] Julian: It depends on the liquidity provision Rodrigo, right? It really does depend on the liquidity because if the Fed, if there's a banking run and the Fed actually boosts liquidity, ... look in Covid, and this is the thing I wrote in March of 2020. I said, ignore the fundamentals, go with the liquidity, cuz we've been doing that for over a decade prior to that point.

You did it in the Weimar Republic. In the collapse in pre Nazi Germany, the equity market was going up as the economy was imploding, because they were printing so much money, and at the end of the day, an equity view, equity is a tangible asset, right? It's a claim on a stake in a company, right? The equity market becomes harder, or you want to run a relative game, so you'll long this one stock and short something else, right?

[00:41:38] Rodrigo: Okay, so let's move on from equity. A recession is, causes a US dollar probably to soften, which causes commodity prices to go up.

[00:41:47] Julian: Yes.

[00:41:48] Rodrigo: Which causes possibly global equity markets to be relatively outperformance.

[00:41:51] Julian: A rotation in global equity.

[00:41:53] Rodrigo: Versus US markets.

[00:41:54] Julian: Yes. Yes. And...

[00:41:56] Rodrigo: So one of the things, okay, so that's where I was getting stuck on, sorry, Julian.

I just want, because this is something I've been thinking about for a half hour. When we talk about the US dollar, generally when there is a panic market, you have a blowoff rally in the dollar.

[00:42:10] Julian: Correct?

[00:42:11] Rodrigo: And then you have this kind of 2002 to 2007. And so that blowoff rally might not happen if, depending on the liquidity provisions that the US government puts on US...

[00:42:23] Julian: I think it happened during, in Covid, right?

[00:42:25] Richard: It happened, during, yeah.

[00:42:26] Julian: Already, I think it's already happened. As I said, I think the money is here. I think, the risk is now, as I said, I've got a buy signal on US equities, which to say I've struggled with, and it's purely a momentum thing , it's the understatement of the decade, and I've chosen to be long other things, right, as opposed to US equities. But you could have a situation where we slip into a recession. Now in theory, the dollar, the US equity market should come down, right? I only said what I said because I just don't know how the nature of this recession's gonna come about. They're gonna have to step up, provide yet more liquidity, right, to save problems in the US banking system. And in that situation, you don't want to be short the indexes, right? Certainly not probably the NASDAQ, right? And the FANGs, right? But you want to be probably short cyclicals and you want to be short the banks still, and et cetera, et cetera.

And broadly you might want to be short US stocks, because probably, the dollar's going down at that point. So it really does depend on the nature in which you get there. But broadly speaking, the US equity market should underperform in a recession, right? You should. But I just don't how...

Crude and Treasury Yields

[00:43:32] Richard: The cap weighted indices…

[00:43:33] Julian: ... variable, that's the one, that's the tough one to call,

[00:43:36] Richard: Especially the cap weighted indices, because they are dominated by the mega caps, which in the bizzarro reversal world that we're talking about, would likely tend to suffer. But I love the way you're framing this Julian, because this is an idea that I've been playing around in the last few weeks as the month is over and writing commentary.

And so, you could argue that next to crude, the price of money, right, the yield on treasuries, particularly the 10 year, are the two most important variables in the economy. And the only thing

that's more important than their price levels is perhaps their rate of change. And the only thing that would trump that would be the direction.

So right now we have these structural forces, call it Fourth Turning-esque like the, this kind of inflection in this longer cycle that we might be in. There are some cyclical forces. And to your point, like the Fed has this direction that it's going with, it's trying to talk tough.

And Loretta Meiser comes out and says, we need to keep real Fed fund rates positive for the foreseeable future in order to quench inflation. And then Powell, thinking he's speaking to Vladimir Zelensky on the phone, tells the *hoaxster* that he sees equal chances of either missing a recession by a whisker, or a mild recession.

But that we have to talk about a political blunder, we have to quench the real wages and we have to rise, raise unemployment because this is the way to ...

[00:44:53] **Julian:** Look, I hate to say it because she, I find it really nauseating not because of her politics per se, but her delivery, and then just because she's a politician, but Elizabeth Warren was the whole, we've been, say writing to our clients that, I'm a deep central bank cynic.

But the whole, so the SEPs, the central forecast of the Fed, were just an example of kabuki, politically driven theater. . So the Fed said, we're going to have a, inflation's gonna melt away, fine. We're gonna rise, unemployment's gonna rise 1%, basically 1.1, and then it's gonna track sideways for three years.

And it's all gonna happen as the economy slows, but only just to the point close to recession, but not a recession. Never, ever happened in the post-war period because you've never had more than a, this is Sahm's rule, but we've refined it a little bit. It's quicker, it's a quicker indicator.

But once unemployment rises, 0.6, you're in a recession. So a 1% rise that they forecast, you'd not have a soft landing, you would have a recession of some magnitude. Secondly, unemployment looks like the mountain range in the background of your picture. So in other words, sharp peaks goes up, comes down quickly, and then rounded valleys, right? Rounded valleys, where it starts to lose momentum, and then that momentum flips the other way, and then it hits the tipping point, and all of a sudden it starts to rise materially. And so this idea that we were gonna have this sort of stunted little hill that went flattened out, never happened, right?

Never happened. So this was all just designed to give them political cover because they know the only way that you break the back of inflation, which at the end of the day is a function of excessive nominal growth, is to break the back of the thing that drives nominal growth. And what drives nominal growth is the labor market.

It's how many people are working, how many hours they are working, and how much they're earning per hour. Tough shit. You have to drive up the unemployment number.

[00:47:19] Richard: You're not gonna find any detractors here when it comes to cynicism on central banks. I've even said on this podcast before that there it's at least two-thirds theatrics or someone has put those numbers around it. There's definitely a lot of boisterous rhetoric.

And it's all about really unleashing animal spirits, without a doubt. But the problem is, all of a sudden this tightening and this hawkishness can change on a whim, if you see real, fiscal liquidity concerns from a banking run. So my question, coming back to the whole structural, right, that the cyclical forces and the structural forces, how do you make sense of those?

Because they do seem to be pulling in opposite directions and it seems like the marginal dollar of allocation is confused. It doesn't know where to go because it's hard to establish the level of money in the economy right now.

[00:48:03] Julian: So I think, look, I'm, there's something, look, if you look at, the bond market is certainly assuming a pretty rapid recession. Is it assuming a rapid enough downturn? Not necessarily, right? It could, the bond market could get you, you have had situations when you get a credit crunch.

We wrote a piece about *An Anatomy of a Credit Crunch*. We sent it to clients a couple of weeks ago and we'd written a piece on the credit freeze, the week before SVB. Hey, better to be lucky than smart, right? Better to be lucky than smart.

That’s the lesson, that things can fall apart much, much, much quicker than you think. And I think that's the big thing. So it's this, because if this credit crunch doesn't happen, I can tell you, the bond market is mispriced. The Fed is not going to cut rates, because I think what people don't understand, and none of this, none of the dollar stuff is gonna happen.

Nothing's gonna happen. The dollar will remain bid. And they will be hiking rates in next year, again. And it's not my bet. It's not what my models are showing me, it's not what my work is showing me. And because I'm a natural cynic when it comes to central banks, I have a friend who worked at the Fed, was Chief Senate Economist, is still in the market's, in his late seventies now.

And he said, I've followed the man, the Fed man and boy for 45 years. It's gonna be longer than 45 years now, I suspect. And I believe him. I believe him. So it's not my bet. But I think what people don't understand is the policy that the Fed is pursuing. So I talked a lot about my clients starting really in the end of Q3 of last year, about the whole concept of higher for longer. And people hadn't really got it. They didn't really understand it. The Fed hadn't really started to use that language. And it came about because I still have lots of friends in the policy space from my days when I worked at Medley Advisors.

And I was having a long discussion with that sort of diaspora that I know, and there were two ways that you tackle inflation, right? When you, of this magnitude. Option number one, is called deliberate disinflation. This is the Volker type role where you deliberately drive the economy into deflation, right?

You kill the economy, you don't care about the consequences, stab it through the heart, it's dead. Okay? Now option number two is called opportunistic disinflation, where you move rates to a restrictive level. You don't stab the guy through the heart, you stab him away from a vital organ. You hope, okay, now that's still unpleasant, and there's a chance that you could bleed out. But the hope is that, just that pain leaves you on the ground long enough, struggling, that something, that some nice Samaritan will come along and take the knife out and you'll be fine and clean you up and you'll eventually get, but what people didn't understand was, that's what Greenspan did in the nineties, and I was saying this to clients, he left rates unchanged for, remember in Q3 of last year, we were still pricing like rate cuts really quickly.

We were gonna do the up and then straight down. Greenspan left rates unchanged basically for four years. And that was to grind CPI out by 200 basis points. So this concept that we were just gonna, because we haven't killed the economy necessarily, we might have discovered that we've killed it, but that's a whole different issue, right? But the Fed, when you look at that framework and you look at what the Fed said, everything that Powell said this week makes total sense because what he said was, we've hit restrictive. In our policy framework, that means we just go on hold. We don't cut rates because we didn't kill the economy. And so because we didn't kill the economy, we're waiting to see that weakness.

In fact, we're going to embrace that weakness. It's what we intend to see. Now if the weakness doesn't happen, we are raising rates again. And so essentially at this point, as far as we are concerned, our policy framework is utterly asymmetric. Strength, rates go up. Weakness, what? What was that? I didn't hear anything.

And, the market has never believed this because they still believe that the central banks are their friend now, and this is what I've been saying to people for a year and a half, two years. They're your, as soon as inflation comes into the system, they're your arch nemesis. Now, do they end up having to be your friend because something else is broke? Breaks maybe. But I suspect if something else breaks, that revival of friendship comes from real intense pain first.

[00:53:14] Richard: Is there any scenario where they keep rates unchanged, but are forced back into some kind of, whether it's through the repo markets or through reengaging with the Kiwi instrument, keep rates unchanged, but are forced to provide more liquidity and what does that do for the effective interest rate...

[00:53:31] Julian: I think, you're talking about a situation where I could envision two things. The first, the obvious one, and the prescient one would be a situation where you continue to get problems in the regional banks, and somehow they have...

[00:53:42] Richard: Which you probably will.

[00:53:43] Julian: And you have to extend this facility to other things and more liquidity provision.

And they, it is like the sort of classic way that, separation of church and state, right? Which was always the way that modern democracies are supposed to be set up. And they have this sort of separation principle. Oh, rates are different from liquidity. Ah, no, they're not really ,right, no, they're not really. Bank markets are so proficient that they've learned how to use liquidity insanely well, right?

So you give us liquidity, we're gonna run this damn thing up, right? And you, the real economy may be deteriorating, but we just don't care, right? We, I say the Fed has created a crack addict for whom they've become beholden. And the only thing the crack addict cares about is how much crack he's getting.

He doesn't care about the price of the crack, right? They go up when bond yields go up because bond yields go up when you tend to have liquidity provision, and that's all they care about. They've totally broken the correlations, right?

They have, good luck ever getting out of this thing, right? So the second scenario where you could have liquidity provision, and this is a scarier one, and I don't think is an issue right here, right now, but fast forward to 2024 or 2025, 24, going into election, 25 with a new president. And let's say we're right, and we actually have a pretty nasty recession, and this thing is dragging on, and we have high debt levels and government decides they're gonna spend again, right?

Because we all know that fiscal proficiency is now the MO of politicians, right? And, or, where, you remember we're fighting three wars, gents, and they're really expensive. Climate change, kinetic war with Russia, cold war with China, right? And we have to massively ramp up defense spending or massively ramp up climate change related spending, right?

And the long end of the bond market goes, it's inflation's come back down, but the economy's recovering and inflation picks up really quickly. This is the lesson of the sixties and seventies, right? We had big cycles. It just never went back inside the box. It always was higher lows, those inflationary cycles.

And the bond market goes I'm outta here, the long end, right? And starts to sell off because it can smell there's more spending coming. We haven't truly rung inflation out of the system for whatever reason, right? And you start to challenge the solvency of the sovereign again, and ultimately the job of a central bank.

My good mate, Mike Taylor always says, this is the solvency of the sovereign and do you get a situation where the Fed has to do QE again, to buy treasuries.

[00:56:36] Richard: Let's go there. Debt ceiling, essentially this is what we're, I, is this debt ceiling altercation that this moment in Congress, is this any different than the previous ones? Because...

[00:56:46] Julian: I would say in terms of the intransigence that you've got within DC and the log jam that you've got within DC definitively, and there is a scenario that I've heard discussed that was contemplated by Obama and they refused to do it. And that is a situation where you could get up to the debt ceiling, and then you could declare the debt ceiling essentially null and void.

And what you argue is that they use the 14th amendment, and you argue with that in the passage of the proceeding legislation, so for example, the Inflation Reduction Act, there is an implicit spending bill attached to that. And so essentially you voted for that piece of legislation, so you can't then impose some retroactively, some old piece of legislation, either debt ceiling, so the debt ceiling's null and void.

Now it would go to Supreme Court, we'd see how that one would pan out, but it's possible that the bonds that were being issued to continue that new spending could themselves be declared invalid. So what yield would come with?

[00:58:00] Richard: On the hierarchy of fanciful ideas, is this more fanciful than the trillion dollar platinum coin? Like...

[00:58:06] Julian: Yeah.

[00:58:06] Richard: I don't know how to...

[00:58:07] Julian: Yes. Because this one was contemplated.

[00:58:11] Richard: Oh, so the platinum coins are more fanciful.

[00:58:14] Julian: No, I think it's more factual. The platinum coin. Yes.

[00:58:16] Richard: Yeah. Okay. Okay. So this is actually being considered by corners of government.

[00:58:20] Julian: It has been considered. It is the way that, look, it's a really look, understand guys, there's only one game in DC right? It isn't about running the economy and doing the best for the American people. It's getting yourself re-elected.

[00:58:35] Richard: Election cycles. Yeah.

[00:58:36] Julian: Yeah. It's just getting, and unfortunately we have this two years election cycle in the US basically, because we have midterms.

It's catastrophic, right? It's just catastrophic, right? And so the way that it's contemplated is, so we're in the summer, things are getting bad, like unemployment's dropped, employment's dropped. You

know the economy's starting to weaken. You're starting to, the equity markets maybe starting to come down.

People are beginning to get a little concerned. Then they get concerned that they're not gonna get their Medicaid checks and their social security checks. And then things weaken a little bit worse. And what the Democrats want is that everyone goes, *the Republicans*. And as soon as they say it's their fault, then the Democrats say, oh, but we have a solution. Okay? And then the hope is that they come up with this solution, irrespective of how much disruption it is, because all you want to do is just pin the shit on the Republicans. Because, then you go in and you do well, and you set yourself up for 2024. That's the thesis.

[00:59:39] **Rodrigo:** Yeah, the debt ceiling has always been an opportunity to pin one side against the other and have an acute moment of focus where everybody gets to yell and scream about what they believe to be right and go after their constituents, and then maybe get some other bills in within that approval process right there, the bargaining chips, right?

[00:59:59] Richard: The omnibus.

[01:00:00] Rodrigo: Whenever you have to get something done, a lot of deals get done. And so...

[01:00:05] Richard: Yeah. The problem is miscalculation, Rod.

[01:00:08] Rodrigo: Is the debt ceiling gonna be, probably not, but is there gonna be an issue or are we gonna have a last minute event, or some people gonna be disrupted in terms of payments for...

[01:00:16] Julian: I think they'll probably, I think they'll pull one of these other tricks. The question is just how the market takes to it. And I think that's the issue, because I said there is a question mark over, is the new debt, if the step you've taken to avoid the debt ceiling, is then subsequently ruled by the Supreme Court as illegal. Is the debt that you've issued to break that rule, valid?

[01:00:41] Rodrigo: Right.

[01:00:44] Richard: Again, just more uncertainty.

[01:00:45] Adam: They're not gonna go, they're not gonna go that direction. There's just no way.

[01:00:51] Julian: I would hope not, mate. Adam, this is, remember, you are dealing with a shower of individuals, right? They are just the world's worst.

[01:01:00] Richard: To draw an analogy with geopolitics, the big concern that people talk about now with US and China, is less about the risk of both of them wanting to escalate, but rather a risk of miscalculation, of posturing, which kind of is the same, it is what caused World War I, right?

Everybody said, Germany and England are too integrated in an economy. They'll never go to war. They went to war because it was a miscalculation, guns, ..., all that stuff. You have the same situation now over Taiwan. In the same way you could have this Congress, now you have a very weak leader in the Republicans that like, he barely, was how many votes, 12, 14 votes, to get this guy as a leader of the Republicans.

And you have the Democrats, fumbling into an attempt at reelection. They could miscalculate, right? I think this is what the conversation, right? The noise has been raising in this issue because of this risk of miscalculation, because there's more political polarization.

[01:01:46] Julian: I think it's a very dangerous time, right? I struggle to see catalysts for improvement. That's when I look at this economy and say, can we avoid a recession? As I said, I have a long conversation with a buddy of mine and it's how do these regional banks get out of their hole? How do they continue to, how do they raise capital to continue to expand lending? And the answer is, it's pretty much impossible for them to do that.

[01:02:17] Adam: Okay, but what about all the, there's a huge amount of cash on the corporate balance sheets. You've still got 700 billion in excess savings and deposit institutions from all the Covid handouts. I think this has been under appreciated by a lot of conventional economists over the last year, is just how resilient the consumer is, because their bank accounts are many thousands of dollars larger than they have ever been in, for 80% of the population.

And except for the bottom, one or two deciles by income, the rest of Americans are still profoundly well cashed up. And at the same time, you made a really good point about, just via Kalecki equation, we know that whatever the excess dis-savings were from, the Covid handouts that no longer reside on consumer balance sheets, now resides on corporate balance sheets.

So the other side of this is that the corporate sector could unleash a major investment boom. Like they were sitting on a huge amount of cash. They extended the duration of their debt. They took the Fed seriously in early 20, in late 2021, early 2022. They issued a huge amount of debt.

They got a huge amount of cash on the balance sheet, and they had all the excess. So that doesn't make a difference on the fact that we eventually have a recession, but I think we have to acknowledge the potential that it pushes out the recession and causes a miscalibration by decision makers

[01:03:58] Julian: Right. So...

[01:03:59] **Adam:** And so, it causes them to have higher rates for, or push, continue to push rates higher or hold them higher for too long, et cetera. And that tilts the banking system or some other sector into a major crisis, like commercial real estate.

[01:04:11] Julian: I, the reason why I was reaching it is, so I was at a conference and Stephanie Pomboy was there, and I was reaching around because she had a very interesting table and I'll just read it to you. So there's, the total amount of cash on the S&P balance sheet, okay, is basically 2.2 trillion. The top 10 is 850 billion. The top 25 is 1.1. So, half of all of that cash, to your point, is on the balance sheet, but it's in 25 companies. And I'm sorry, in aggregate, that isn't enough. That isn't enough. This was, this is something also that Jeff Curry brought up, but it was a hard one to get you a head round, right?

It's not the wealthy who create inflation. It's the poor,

[01:05:07] Adam: Right.

[01:05:07] Julian: The poor decide how many units of production are purchased. So Jeff Bezos can have 500 pairs of shoes. Makes no difference, right? If you gave Africa two pairs of shoes each, it's a hell of a lot more, and that's probably, that's really what counts.

And so this is the point, right? You can have lots of money on the balance sheets of these very big companies, and they can get bigger, and they can have a bigger market share, and they can have a bigger share of GDP, but they can't offset what all these other companies do. And when I look at my forward models for what CapEx is doing, it's going down, it is going profoundly negative, just like the inventory cycle.

And I, and the reason for that is in part, this tightening of credit, and we shouldn't forget that in 2000, right, we didn't technically have, we did have a technical recession because it was two quarters, but year over year GDP never went negative. And that was just on the back of an inventory cycle and a CapEx cycle.

And this time I think we've got an inventory cycle, a CapEx cycle, rising unemployment, a slowdown in housing production, and back then housing was accelerated. Okay? So I just don't see, and, and a bank and a credit crunch. I don't see how we avoid, irrespective what frigging Google does with their cash.

[01:06:34] Rodrigo: But that's not, the end game might be that the question is how long the WIC is, versus what the Fed is looking backwards and saying historically, it takes us 18 months to kill the labor market. It takes us ... the growth, market. It's really about the timing of things and luck...

[01:06:49] Julian: I totally concur with that. And I think it's, look, I put on, we put on *steepeners*, so we were looking at bets where front rates drop and the back end stays where it is. So it's a bet on a recession essentially in the bond market a few months back. And we put on five years against 30 years.

And the reason we looked at five years is I was concerned about the Fed, *higher for longer*. So I didn't want to be too closely, be betting on the front end of the bond market, rates coming down. That's moved quite a long way. It's very difficult for a risk, if you're in the trade, great. You just run it. I think it's got quite a long way to go.

It's a hard trade to put on now. You are absolutely right, Rodrigo. At this point, you are making a bet on when it happens. And to my mind, that's really either a bear on a banking crisis. Accelerating, or negative employment data, I would say would be the other variable. Now, if I go back to 1966 and the banking crisis back then, 66, 67, and I wrote that on *An Anatomy of a Banking Crisis.*

So look at that period there. Why? Because it was just a single event. It was a banking crisis. It gives you an indicator of, without other things going on, how that can affect. And the Fed wrote a letter, the banks similar thing. Banks were getting squeezed on both sides. They had long duration assets and they had a runoff in deposits.

So they were getting squeezed from both sides, and they started to sell their assets. They were Muni bonds at the time, municipal bonds, and the Fed didn't like that because it was starting to put

ReSolve ASSET MANAGEMENT

pressure on the long end of the curve, and they wanted to so they wrote them a letter on the 1st of September, 1966 saying, hold on, we want you, because inflation's rising, to start cutting back lending to the real economy. What we don't want you to do is sell the assets on your balance sheet, and here is the deposit, the deposit window you can go and borrow from that. A bit like the bank term deposit facility that we have it ,presently, right? That was on the 1st of September. One month, 22 days later, the Fed pivots and a month after that they start cutting and they cut by 300 basis points in five months.

[01:09:22] Rodrigo: Jesus.

[01:09:22] Adam: And McChesney Martin wrote a letter three years later saying that was the worst move that he could have made. And we've...

[01:09:31] Julian: But shit...

[01:09:32] Adam: We've learned lessons from that.

[01:09:34] Julian: Right? The problem is that the credit crunch was real, right? In, remember this was an economy that was growing very rapidly because we were doing guns and butter, right? And had underlying fiscal stimulus in the economy. A bit like we still have underlying fiscal stimulus in this economy still, right?

And but industrial production dropped 10%. G D P dropped six. Non-farm payroll went from plus 400,000 to minus 60, and housing activity dropped 50%, all within a year. Now I agree, he retrospectively, he wrote it was a big mistake. But the point is these things happen that forced the Fed's hands.

Okay, so that's option one. Okay. So it's possible, is the possible, is the point. So you could get a rapid pivot. Okay. Second it would have to be employment. And when I look at, my credit models tell me that in the next - I've stuck my neck on the line a little bit and I've said, the June report that you get in July, we will have a negative non-farm payroll print. And I think from there the numbers will continue to deteriorate, probably because as I said, once employment turns, it turns pretty rapidly. Now, initially the Fed's going to go like this, but still.

[01:11:09] Adam: The peek-a-boo Fed?

[01:11:11] Julian: It's like they hear no evil, see no evil. And you know they're gonna just try and ignore it, because this is what they've been waiting for. This is what markets don't understand. They're not your friend. They want you to stumble, they want you to lose your job. I'm sorry.

[01:11:28] Richard: But what does yesterday's do...

[01:11:29] Rodrigo: The rest of the world were aligned in the last 10 years. It wasn't that they were always your friend, that you just happened to be useful or, be, your interests happen to be aligned with theirs, and now they're, and now they're doing their job and you don't like it,

[01:11:41] Julian: They're doing their job.

[01:11:42] Rodrigo: You have not learned your lesson yet.

[01:11:44] Richard: So Julian, what does this do? I just want to get his take on yesterday's, on payroll numbers, because that surprised to the upside quite a bit. So it showed signs of accelerating to some degree. I think unemployment went...

[01:11:56] Julian: Yeah, I saw a chart of the variation versus expectations going back to 2003, and it's like...

[01:12:04] Richard: Yeah.

[01:12:05] Julian: This one's up here, right?

[01:12:07] Richard: Revisions. Revisions coming down the pike, potentially.

[01:12:10] Julian: Look, give it with one hand, take it to the other, right? We took 149,000 away...

[01:12:15] Richard: That's right. The previous number had...

[01:12:16] Julian: From the thing. And that actually is important because actually what it did to a lot of my work is, it reinforced the loss of momentum. So you, the, you are rolling. Okay. Gradually that kind of, that creation of jobs is non-farm payrolls and creation of jobs. And so you are losing that kind of momentum on the valley floor, right? So the next thing you start is unemployment starts to

rise. Now the strange one was the rising unemployment, oh, sorry, the drop in unemployment to 3.4.

But you're getting, even with their, you're getting to this point where you're 3.4, 3.6, 3.4, 3.6, 3.4, 3.6. And so you're no longer dropping materially. You seem to be losing some momentum. And I think some of these, look, it's the time of the year when it's spring again, you should be hiring.

But look, I'll say, if I'm wrong and this labor market isn't losing momentum, then the biggest risk to everything now is the bond market just reprices, because it's just bloody wrong.

[01:13:15] Adam: Absolutely. Yes, agreed. But hourly earnings were, for me, the biggest light bulb, right? Hourly earnings were up 0.5%, month over month?

[01:13:26] Julian: Yeah. And they're sticky. Wages are sticky, right? They're, most of our models on wages are showing that we hit the absolute higher, like 6%, but they're sticky. And this is, this goes to this point that the Fed has to see, this is why he can't give way, right? He's going to, if you are betting on the Fed resolve dropping, something material has to happen.

I'm not saying it's a bad bit, because there are actually some interesting market bets that you can put on. But you are, you want something really nasty to happen. You want unemployment to, non farm payroll to drop materially. You want this banking crisis to get worse materially. Otherwise, and that's a heart attack type of event.

Otherwise you are, and that's, you've stabbed it and the patient's died, right? Otherwise, you are just grinding this thing out in agony and they cannot let you out of pain. They're going to keep you in pain. They're gonna keep gently twisting that knife. And then, and I look, as I said, I look at this regional banking situation in that situation, and I just, okay, we maybe delay it three months, a quarter.

[01:14:51] Adam: I don't want to put too much weight on a single day. But were you not...

[01:14:58] Julian: ...payroll for God's sake.

[01:15:00] Adam: Yeah, but it's persisted the whole, it's, it, this has been the strangest day to me. Because it's signaled that we have, certainly a much more resilient earnings picture, right, that earnings are running considerably hotter than expectations.

Hourly earnings, like unemployment, or employment earnings rather, are running significantly hotter than expectations. That has been the single most important metric for the Fed. Bonds got the message, sold off aggressively. Equities and commodities had massive rallies. Oil up 4%, grains up 4%. Copper reversing higher.

[01:15:48] Julian: Growth is good for those real commodities, as opposed to precious metals. That's the tough one.

[01:15:53] Adam: But the reflexivity is what I don't get because this means the Fed is gonna have to be even more aggressive. So expect, growth expectations should be even lower.

[01:16:04] Julian: Yeah, but that's not how the...

[01:16:05] Adam: But, I think what's happening is, I think what's happening…

[01:16:08] Julian: ... like that anymore, right? They just, good employment numbers, strong growth by cyclical assets, right? Sell bonds, buy copper,

[01:16:18] Richard: It's all knee jerk, there's no strategy.

[01:16:21] Julian: No…

[01:16:21] Adam: I think the market is hearing Powell say we're not going any higher. They're seeing a hotter economic print and there's, and they're pricing that the Fed is gonna let inflation run hotter than every, than they've been talking about before, which is gonna be bad for bonds, great for stocks and commodities.

[01:16:43] Julian: So here's two outcomes, then there's two outcomes to that. Okay? First one, right? I'm gonna say there is reliable, no, I'm not gonna say that cause that's really rude. I say it some of my clients, but, teenage boys, girlfriends, that kind of thing, analogy, right? They're about as reliable as that. Okay? They tell you, this is the problem, right? This is always the problem at the lows on rates.

We're not raising rates. We're not raising rates, we're not raising, oh, Jesus Christ. Did you see that? And the bond market's pushed out duration, then goes "puke". So that's option number one. Okay.

That they'll lie and they'll just hike again. Okay. And in a, in the policy framework, I suggested that's what you, that's the bet you should take. Okay?

[01:17:33] Adam: Yep.

[01:17:33] Julian: Option number two is they lose control of the long end of the bond market. ...

[01:17:40] Adam: agreed. Yeah.

[01:17:42] Julian: And, that would be...

[01:17:45] Adam: Stocks are not getting that at all. Or if they are, they're saying yeah, and the Fed doesn't care. They're gonna let it run hot. They're gonna let the economy run...

[01:17:53] Julian: Well, then ultimately also the dollar goes, and then I think we're in a world of pain.

[01:17:58] Rodrigo: Okay, so guys, we're running into an hour and a half now. I do want to take the last five minutes, Julian, to ask you, we talked to a lot of macro commentators and what we find is that they have different models in terms of what are you trying to time for, right? What is your, what are you trying to predict?

Is it a two week thing, a three month thing, a year out thing? Is it a five year model that you offer? So why don't you walk us through kind of your services and who's, what type of traders are looking for your services?

[01:18:25] Julian: And I think, look...

[01:18:26] Rodrigo: ...in and out?

[01:18:27] Julian: Totally valid. So I'm not a day trader, right? I am definitively not a day trader. I am a, we are a kind of three to six month, sometimes it's longer. One month to three month to maybe six months. Sometimes it's longer. Like we started selling, betting on higher interest rates in November of 2021.

And started, that's, we did that all year. We bet on lower HYG in December of 2022. We bet on that, sorry, in 2021, we bet on that all year, right? It is all those sorts of things. Sometimes you get lucky, but generally we are more the sort of three to six months.

I say one month, because frequently you think it's gonna take six months, it happens in one month. These days you think it's gonna take six months. I was listening to Druckenmiller, he was saying, *I think about something, and I put a little bit on, and the odds are, before I get the chance to really think about it, it's already happened.* So you get those sorts of situations. So our client base is essentially hedge funds, very large proportion of large number of hedge funds, big mutual funds, family offices and some individual traders.

And so it's, as I said, I, everything that we do gents, is designed to make money for our clients. I don't care what inflation is going to be ultimately, unless there's a trade, right? Sure, I can get bragging rights. Someone said to me, I was talking to a journalist, and he goes, you're not an economist, right?

And I went no.

[01:20:06] Rodrigo: A, no.

[01:20:07] Richard: You took it with pride, actually, that...

[01:20:09] Julian: I did, I wore that one with pride, and because, I'm not saying they don't have a role, they do. Not quite sure what it is, but they have a role, but I'm interested in P&L and that is singularly all I care about. It's how to make my clients money.

[01:20:26] Rodrigo: So how many bets,

[01:20:27] Julian: I start losing it in a, if I'm talking to retail investors,

[01:20:32] Rodrigo: So how many bets would you say you have on average, that are orthogonal? Or is it just you have a big kind of thesis and you're placing that thesis bet with four or five different instruments?

[01:20:45] Julian: Yeah, occasionally you do find out you've got too much concentration risk, so you put on four different trades and they turn out to be the same trade, because the correlations all go

to one. That's never great. I would say generally we have between two and six. Two and four trades on at any one time.

We run an alpha capture platform for a big hedge fund. And that's, if I look at that's what we've got on.

[01:21:12] Rodrigo: Got it. Amazing. Julian. Always entertaining, very insightful. Loved having you back.

[01:21:19] Richard: We appreciate you coming. We could probably do this for another hour and a half at least. I have so many questions and there's so many threads to pull on from this conversation, but it's just another good excuse to have you on again.

[01:21:28] Rodrigo: Yeah. And don't forget Vail? When? When is it again? September...

[01:21:31] Julian: So, 26th to the 29th, it's, it literally does look like Richard's, out of Richard's background. So it's peak fall. It is the most beautiful time of the year to go there.

[01:21:41] Rodrigo: What's the format gonna be?

[01:21:43] Julian: So the format's gonna be, look, we're going into 2024. It's a big year, right? It's a big election year. There's gonna be a lot on the line.

The geopolitics, I think you're getting increasingly turbulent. So we're gonna talk, on day one, we're gonna talk about politics, macro, where we think the economy is, a little bit of *geopol*, but just give you people a framework of where our heads are, and we're inviting, there's lots of conferences you go where there's a lot of like, high profile people.

But I've found in 30 plus years of doing this that I don't really rely on high profile people. I have a ... of people that I truly have relied on for smart decisions and smart information, and those are the people that I'm inviting. I'm inviting the people I think, who are the best at giving me a read on what the Fed is gonna do. The best, who's going to gimme a read on what's going on in DC. The best people I can trust on what's going on in China.

And the people, I think who've got the best track record at calling the economy. And then on the second day, we are going to set it up with a bunch of people who know how to make money out of

those views. Now there'll be institutional guys, so PMs that I really have a lot of respect for who manage large amounts of money, but also I'm gonna invite a couple of wealth managers because the vast majority of retail guys aren't punting Eurodollars or bonds, right?

They want to know how to position their wealth so that they don't lose money in what I think all of us in this call, think, is it going to be a different decade from the last decade? And I've got a couple of guys that I really respect who don't just stand the, follow the stand and model of accumulating assets, telling you, can't time the market, telling you that you just need to be in this bucket, and in this bucket, and trust to God, right? But really, I think, understand what's coming and make decisions around portfolio allocation. And I think, I hope that's gonna be unique.

[01:24:02] Rodrigo: Amazing. Yeah, it looks to be very good. So everybody, I'm sure you're gonna be putting information out on your...

[01:24:09] Julian: You can look at our Twitter feed. We're just gonna launch a website soon. If you keep checking it, the MI2 Partners website, it'll be up there.

[01:24:16] Rodrigo: Fantastic, Julian, thank you so much. A pleasure. Enjoy your …

[01:24:20] Richard: Weekend. Have a great weekend.