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Conference Call

Foreign Exchange & Interest Rates
September 29, 2022, Conference Call
(This transcript has been lightly edited)

Good morning everybody. This is Jim Bianco. Welcome to the conference call. Usual housekeeping items. Most of you are on the webcast. I just updated some of the charts for yesterday's movement, so I did upload a new PDF if you want to go get that already. I'll drive along if you're listening to it, I'll do my best to yell out slide numbers. Sometimes I slip on that. Foreign exchange and Interest Rates were the title I gave it on Monday before everything got exciting. I'm going to give you where I want to go with this. Last week Jay Powell gave us an interest rate forecast. He wants every interest rate in as a positive real rate. He's not talking about tips. He's talking about core PCE, which is a 4.6% and if you believe the Cleveland Fed, it's going to go to 4.8.

He wants every interest rate above that number. He said the entire curve. Market started selling off both bonds and both stocks started selling off. Now let me pivot over to the UK because I'm going to talk about that too. Liz Truss about 10 days ago, announced her new budget. It is right out of the Reaganomics Maggie Thatcher playbook, cut taxes, cut regulations, borrow a lot of money and I think the market's problem with this budget is that it'll work, not that it won't work. And what do I mean by work? It's going to stimulate the UK economy. And the problem is you've got 10% inflation in the UK economy on its way to probably 13 to 15%. And now you want to turn up the electricity to stimulate the economy? So, the bond markets freaked out, the currency freaked out, it collapsed because they saw big inflation coming.

It got so bad yesterday. Let's talk about what happened yesterday in the UK and then I'll finish up my... Somebody was going to fail. It was that simple, that somebody was on the precipice of failing. This is not a credit event; this is an interest rate event. We haven't had one of those because as the total return charts show and stuff, we've never seen interest rates rise this much this fast. The last two days of what you saw say in the 30-year gilt and I've got some charts of it. There's 200 years of data in the UK and we haven't seen anything like this in 200 years. And it's all because, and I'll say this like I was talking to a retail investor.

Retail investors always has been, "Who buys bonds? They yield nothing," and this is before this year, "They yield nothing then price never moves. That's boring and there's no return opportunity." You're right, in some respect. So how do we incentivize people to buy bonds? We let you buy them on infinite leverage, otherwise known as the repo market. 5 billion bonds, you don't need a billion dollars. Go repo it out. Well, what is the assumption there? Bond prices will be relatively stable. What's happened in the UK in the last couple of weeks? Bond prices plunged in part to try and defend the currency as the Pound was on its way to parody with the Dollar what stops it? Sky high interest rates. But the problem there is so much leverage is in their market and our market and the Euro market and all markets that the losses... When you buy on infinite leverage, you take infinite losses. And I think that somebody told the financial stability committee at the Bank of England, if we don't do this today, this is my supposition, I wasn't told this. This is my supposition.

If we don't do this today, step up and start buying bonds and get a rally going in the market tonight, somebody is going to mark to market, they're going to be undercapitalized. They're going to have to report it because most financial institutions have daily funding. You cannot be under your regulatory capital and not tell anybody. And oh, by the way, please, buy my overnight paper, and as soon as one firm does that, the assumption is every firm in the same position. So, they had to step up and engineer a giant rally in order to stave off this crisis. Now what's it analogous to? I'll say the BNP money fund problem in August of '07, maybe Bear

Stearns in '08. It's not Lehman. And the reason that I'd say that is because the problem has not been fundamentally fixed. And what is the problem that has not been fundamentally fixed? And in the second half of the presentation, I want to talk about the bigger picture. And I've said this before, we are in a post pandemic economy.

This economy is different than 2019. As I've said, we're not going back to normal. This is normal. We're not going back to 2019. This is normal. The era of cheap labor, cheap goods and cheap energy is over. We are now in an era where all of those are going to be hard to find in a cheap form and therefore we are in a period of persistent inflation. Most people still do not believe this is persistent inflation. They still believe this economy is not much different than 2019. And I'll go through some charts and talk about that. And this is why we see the adjustment process in financial markets. They're being dragged, screaming, and kicking into the new era where people keep saying, buy the dip, it's overdone. Yell at Jay Powell. It's all his fault. He doesn't need to raise rates. Well, maybe he does if we have a persistent inflation problem.

And you see this when I call the misdirection, everybody keeps pointing out. If you saw Dr. Jeremy Siegel, I love Dr. Jeremy Siegel, so don't interpret my comments as a criticism to him in any way. He was screaming and yelling that the Fed blew it last year by being too easy, too long, a 100% with you, that might be the most egregious policy mistake in the history of the Federal Reserve was last year just continuing to pump money into the financial markets all the way to March of this year, before they really started to reverse. And they only started full QE or QT, excuse me, 29 days ago, September 1st, full QT 29 days ago. They are so ridiculously late; they might be bumping up against the next cycle. He then goes on to say it's obvious from the data that inflation is peaked.

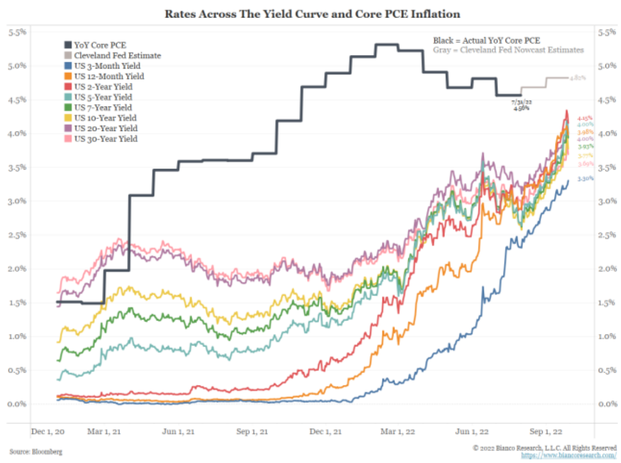
Okay, I'm with you there too and that's going to come down. I'm with you there too. But he doesn't say it, but he suggests or implies we're going back to 2%. I don't think we're going back to 2%, I think we're going back to 4 or 3 or 5 and that to be determined later, but some level materially higher. Now we might get to 2% if we really break the economy and have a bad recession, but that will be a cyclical low. That will not be the secular return to 2019 and then we're at 2% forever. And the Fed could drop rates to zero and continue on money printing like they did the last 15 years. In fact, all the central banks can do that. And this is the crux of the problem is that this is a new era. I'll say this now, so I don't forget to say it.

I don't think what I'm trying to say is a dystopian thing. It's different. It's an apple, it's not an orange. An apple is no better or worse than an orange, but it's not the same thing. And I think we need to understand that there is going to be tremendous opportunities to understand the economy and financial markets moving forward. To give you one example, the idea here is everybody knows how to invest, right? You buy an ETF, you buy a double levered spy, and then you just go on Twitter and say, "Fed cut rates to zero and start printing money. So, the S&P goes up," and that has been the big beta trade, everything goes to the upper right on all the charts and just get in there. And 90% of managers cannot beat the index. So don't bother with managers, that works in a period of low or cheap wage, cheap labor, cheap goods, and cheap energy. We're not in that period anymore. I think what we're going to transition back to, its period, more like the 70s and the 80s and maybe the early 90s in financial markets.

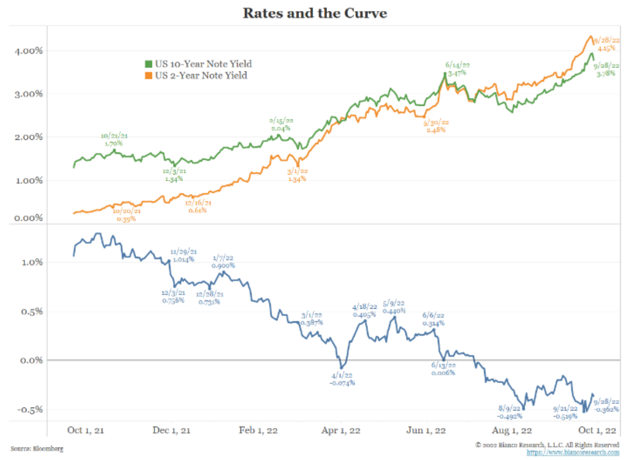
No, you just don't buy XLE the energy ETF. You got to figure out which energy company to buy because one of them will be a winner. They can handle, they can adapt to the no more cheap labor, cheap goods, cheap energy regime. Another one can't. So, it's no longer just buy XLE or just buy all the tech or just buy the S&P 500. It's back to old fashioned stock picking. Now let me say something that's going to upset some people. Most managers cannot do that. They have risen to their point where they have been beta managers just play the surf the entire market. And I think that this adjustment period is going to take some time and some understanding.

And therefore, I think what we're going to see as we move forward is more volatility and more recognition. This is not a onetime post pandemic thing that's happening. This is a secular change in the economy. All right, that's my preamble of what I want to try and attack. And so let me go to the charts. I'm going to start near term, talk about the last couple of weeks and then I want to end with the bigger picture stuff. So, Chairman

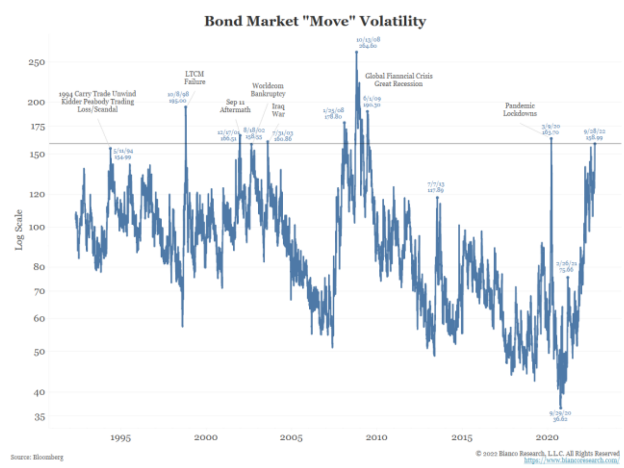
Powell said last week in his press conference, "You want to be at a place where real yields are positive across the yield curve." Okay. Across the entire yield curve, okay? So, he just told me he wants every single real rate positive. I think you would see at that time; you'd see positive real rates across the yield curve.



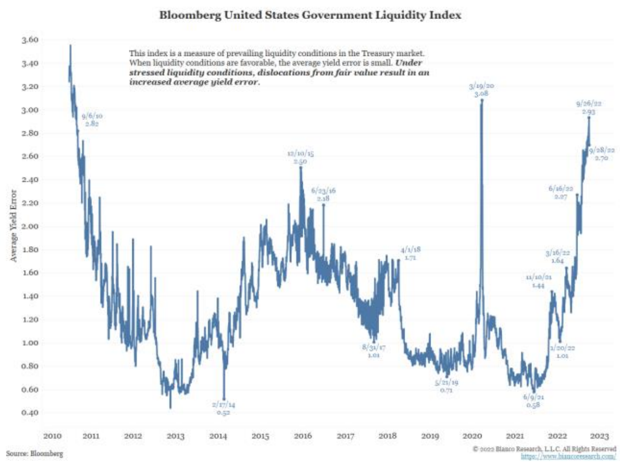
That is also an important consideration. Okay. What rate is he talking about? Couple paragraphs later. If you look at core PCE inflation, which is a good measure of where inflation is running now. Okay, so he told me, so here in the black line is core PCE. That is the over year change. As of July, it was at 456. I think tomorrow the August number comes out or maybe it was earlier today. Well, when the next day or two it's going to come out. The gray line here is the Cleveland Fed now cast for August and September. Okay, there's an estimate of what it's going to be. They've got core PCE at 482. Jay Powell wants every single one of these rates above this line, which is now currently in 42. Now what they're hoping for is this line goes down, these rates stay where they are, and you get your positive rates. But if you don't get those positive rates, the market has to keep going higher. So, what is the interest rate forecast? I'm not going fight the Chairman of the Fed, I'm not going to fight the Fed.



He wants every interest rate including the 333-month bill above core PCE. We got ways to go, even if core PCE comes down, we've got to waste to go, remember its core, this whole crude oil prices collapse the 50 bucks, it's not going to be a big deal for court. Consequently, here is my yield curve chart. The green line is the 10-year note, the orange line is the two-year note. And you could see the two-year note is above the 10-year note. And you can see that the curve is inverted. I think that taking what Powell said, the curve is stuck in a range between 30 and 50 basis points. It's going to parallel shift. So, if we have to go to four and a quarter, four and a half ish, 475, and I hope that we get above and core PCE comes down a little bit or maybe five, everything's going to parallel shift.



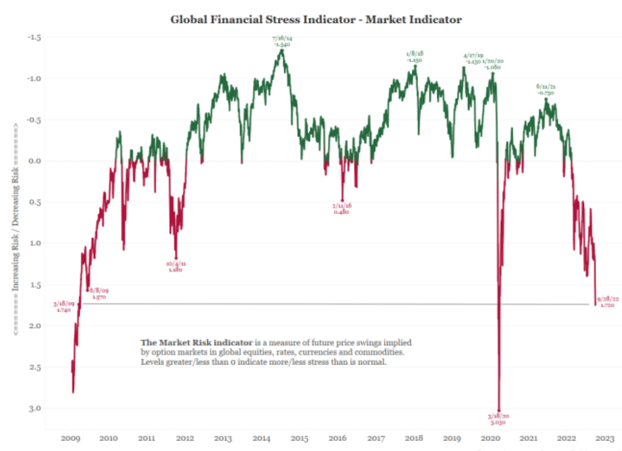
I don't think we're ready to go to minus a hundred on the curve just yet. And I'll talk about why. Well basically because I think a lot of people are looking at the labor numbers and they're saying that there's a problem with labor, there's not a problem with labor. I'll just tease that, and I'll get to that in a second. So, what's this doing to the bond market? I want to stick short term. Here's the move. The move is the Merrill Option Volatility Estimate. It is the VIX of the bond market. Last night, it closed at 158.99. It is barely below the 163, it was on March 9th, 2020, which might have been the worst market day during the pandemic. When the market was at its absolute losing its mind moment, bad English, but you get my point. I put a line in 158.99, and you can see that this is a period in by market volatility that we've rarely seen in the last 30 years and what has been consistent with all of these seams.



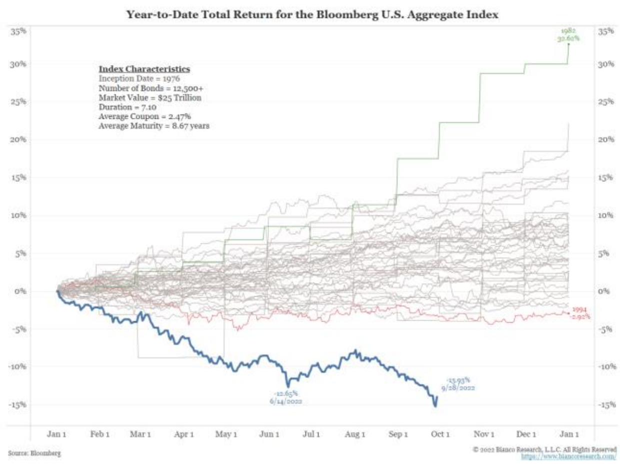
When you get above 155 on the VIX, the Fed is cutting the zero. The Fed is doing quantitative easing, bailouts are being constructed and most bond managers are running around with their hair on fire. Well, they are in the UK, they are a little bit in the US as well. Liquidity. Liquidity is bad. So here is the Bloomberg Liquidity Index and there is the explanation of what it is. Measures prevailing liquidity conditions in the treasury market, one, liquidities are favorable, the yield error is small. Under stress liquidity conditions, dislocations from fair value result in an increased average error. So, in other words, what they do is they have a fair value model. So, you know how this Merrill works. They have a fair value model for interest rates or where should they be based on their fair value model. I've looked at the model, it seems reasonable, I'm not going to quibble about the model too much.

And then they look at what rates actually are, and they plot the deviation from their fair value model. Well, this is where we are. There's March 19th, March 9th was that little notch right below it right there. And then you got to go back to 2010. So, liquidity is very bad in the bond market. There's no other way to say this. Quick word about liquidity. Bond markets are global in nature saying I know that the... Or let me say this, I know that Janet Yellen came out 12 hours before the Bank of England moved and said she sees no liquidity or de-leveraging problems. And then 12 hours later the Bank of England had to move. Which like I said, my opinion is they had to stop a failure. Somebody was undercapitalized, they had too much leverage, they were sitting on losses at those prices, and they needed to levitate gilt prices to prevent those losses.

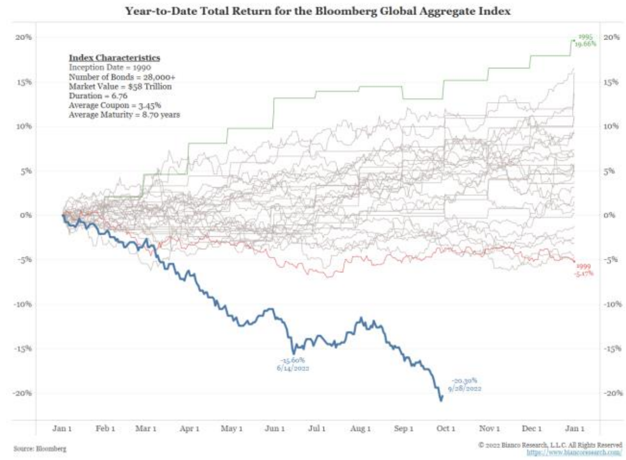
And remember in the UK, if you're a pension fund, you can buy bonds on leverage. Why? Because you had to meet your actuarial assumptions and rates were zero or close to zero and the Bank of England was printing money forever and ever and you were never going to get the yield that you needed to meet your actuarial assumption. So, we'll let you juice it with a little bit of leverage and that is exploding in our face right now. But I think that, I suspect that people come out and say, "Well, Janet meant the US market is not illiquid or dislocated. That doesn't preclude other markets." Look, that's like saying Chicago is not having a global warming problem, but New York is it. These markets are global in nature. If one G7 country is having a problem to the magnitude of the UK, every G7 country has got a major problem.



I'm talking about their bond markets, not their economies or their policies. I'm talking about if the UK market is this bad, so is everybody else. Bank of America has a global financial stress indicator. It says that right on the chart. I'm on slide six, I got to remember to yell out the numbers. The risk indicator is a measure of future price slings implied by options, markets and global equity rates, currencies, and commodities. So, they're looking at and they're aggregating all of the implied volatilities. And what is the market expecting for implied volatility? By the way, it's a deviation, it's a Z score, it says from the standard deviation. So, here's zero and I plotted it inversely. So, there's plus three standard deviations. Why'd I plot it inversely? Because I think most people are comfortable with the idea that worsening conditions is a falling line, not a rising line.



So, we're 1.7 standard deviations below where we've been in the past. Again, there's the pandemic freak out and you've got to go back to March of '09, March 18th, 2009, is where we are. This is coincidental, but that happened to be the day that Bernanke announced QE. You could see we were coming off that. So that's the level that we're at today, in terms of financial stress indicators, the same level we're at when Bernanke announced QE in March of 2009. I'm talking about full on treasury QE as well. The bond market is taking all of this news and it's having an epic year. So, here's the US Aggregate Index, Bloomberg US Aggregate Index. For those of you that have been around a while, this used to be Barclays, this used to be Lehman Brothers. It goes back to 1976. We are down 13.93% through yesterday and that includes yesterday's rally.

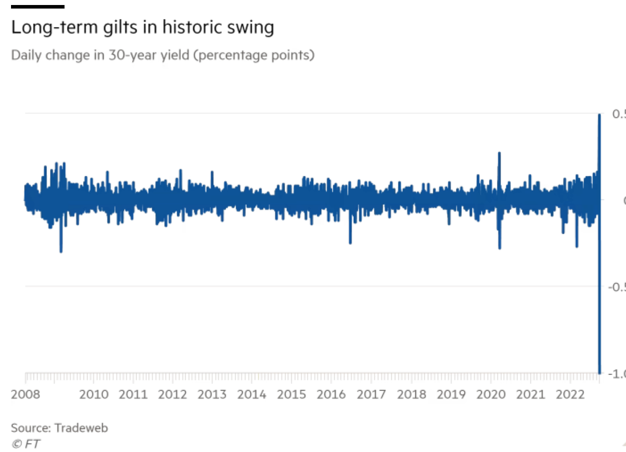


It's what that number includes. This is far and away the worst market that we've seen at least in 46 years in the US market. And if you look at the Global Aggregate Index, it is down 20%. I'll be honest with you, I was bearish coming into this year, but if you would've told me, yeah, by September the Global Aggregate Index is going to fall 20%, I would've been in that camp that says, no, you don't understand the bond market. It doesn't do that well, it just did. By the way, why is the global down 20% and the US Agg is down 13 or 14%? I think the difference is, 46% of the global is foreign securities. So, if you own foreign securities in a surging Dollar, you're getting currency translation killing you in that regard too. So, at some point when the Dollar peaks and it starts back down, you would expect the Global Agg, because again, it's the index, it's 46% not US securities and it's $58 trillion of market cap.

At least it was last week when I last updated. I assume it still is. That's why it is. So, all this stress, high volatility, terrible liquidity of financial stress, the worst level since when Bernanke started QE is, where's it showing up? It's showing in a pummeling of fixed income prices, a pummeling that we haven't seen ever. And as a matter of fact, I've talked about this before and I've highlighted before, look, total return losses are the price change plus the coupon. You can have a default; a credit event and you lose a 100% of your money or something less residual value or something like that. This is not a credit event; this is an interest rate move. And this interest rate move is, I've argued going back and looking at the data and some people have taken it back to the twenties. There is in Sidney Homer's book, a History of Interest Rates, it's a big thick book, I got it over there in the shelf.

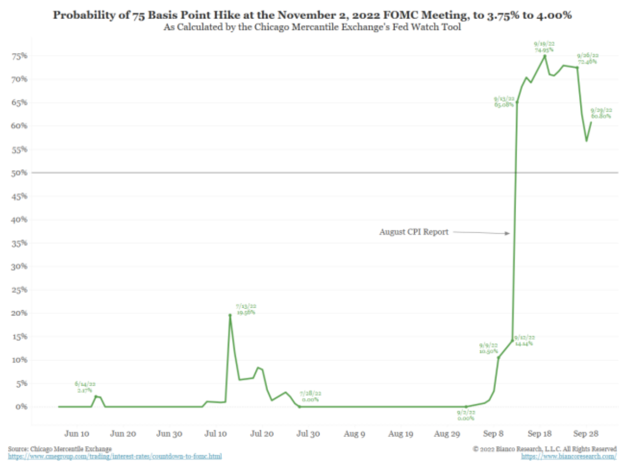
It's got 700 pages of interest rate data tables on it. It goes back to 3000 BC. That's why I say 5,000 years of data. I think this is the worst total return loss in 5,000 years. Now let me put the qualifier on it. That was not a credit event. This is just an interest rate move. Yes, other people defaulted and then they went the zero and they had a 100% loss. But this one is not a credit event. This is an interest rate duration move. We've never seen anything like this. And as I argued, if you told me in January we were going to see this because of interest rates, I would've been stunned. So let me go to the Bank of England.

So, the here is, on slide nine, their announcement yesterday, "Bank of England announces gilt market operations in line with its financial stability objective. The Bank of England stands ready to restore market functioning and reduce any risks from contingent to credit conditions for UK households and businesses. On September 28th, the Bank of England's financial policy committee noted that the risks to the UK financial stability from dysfunction in the gilt market." Let me put this in simple terms. This is the 30-year gilt. I use that because everybody's focusing on it. There's its price movement before Truss announced her budget of cutting taxes, cutting regulations, in borrowing a ton, there is what prices did. Prices fell 20 points. And starting at a 60 handle, you lost a third of the value of the third year. People buying on leverage were getting crushed. Banks, brokerage, insurance companies and then if I go to the next page, let me start with the chart. Here's the 30-year swing in long term gilt.

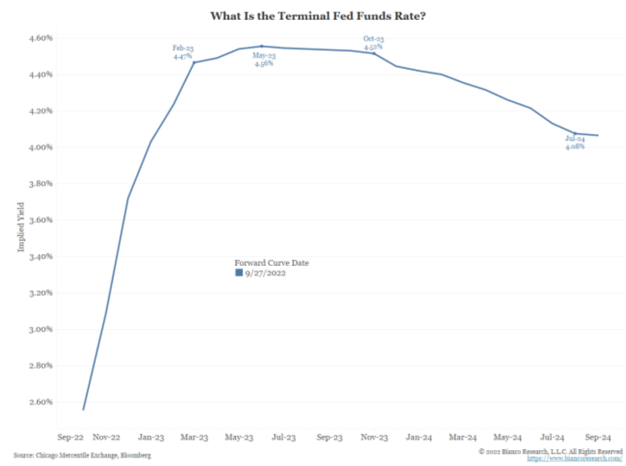


First on the announcement of the budget, the 30-year gilt went up 50 basis points. I mean, on the Bank of England's announcement, it fell a hundred basis points yesterday. This goes back to 2008, there's nothing close to that. I've seen some people say, "Look, the gilt market is the longest continuous market in history, traces back to the early 17th century. I don't think you've ever seen an interest rate move in the UK gilt market like this." No one expected this. So, the Financial Times is a story today, "It appears that players in the market ran out of collateral and dump gilt." What's that mean? If you bought a billion dollars' worth of bonds and you financed a 100% of it, okay, you're under collateralized. You've got to give me some bonds that you own not on leverage outright and post those as collateral.

And if there are longer term securities, there's going to be a haircut. You're going to have to post 105 or 108 or 110% of what your margin call is. If there was no intervention today, the gilt market could have gone to 7 or 8% from 4.5% this morning and that situation around 90% of the UK pension funds would've run out of collateral. If they did nothing yesterday, what would've happened after the market closed is again, if you're under regulatory capital, you cannot go out and issue overnight paper and say, "Oh, I forgot to tell you that we're under regulatory capital." That's fraud. You would see at least one, if not more, levered firms, banks, brokers say that they're undercapitalized. No one would fund them overnight. And then we would have something akin to Lehman. So, the Bank of England stepped in and rammed prices higher. That's a 100-basis point move that you saw in the yield, or if you look here, they took the price from about 40 to about 55, a 15-point rally. 40 to about 55 is a 25% rally. That was enough to get us through yesterday, is what that did. That's all it wound up doing. The problem still exists. Truss still wants to cut taxes and regulations. She is insistent on stimulating the UK economy. Again, I don't have a problem with that, except when you try to do it in a 10% inflation world on its way to 13 or 15, and your central bank is, at least in the last week, announced it's going to do quantitative tightening, and it's going to raise, and it's going to sell securities. Who's going to buy these bonds? Everybody freaked out. The currency collapsed because they're going to have a massive inflation problem.

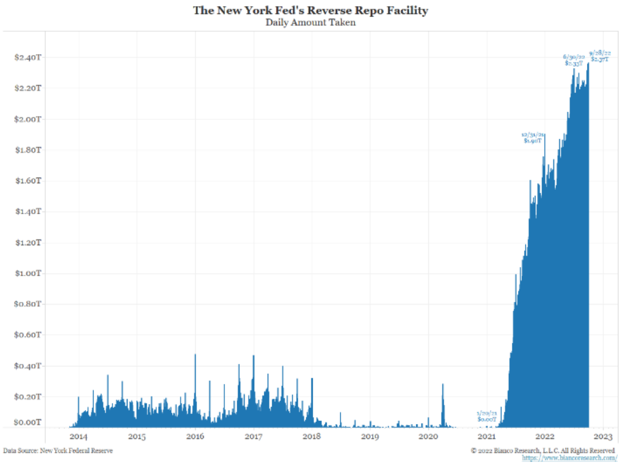


Again, my take is the problem with the policy is it's going to work, not that it's not going to work, and it's the wrong time for that kind of policy when we're in an inflation environment. Let me talk about the Fed. The story for the Fed is whether or not they're going to pivot. That has been the story all year. Is the Fed going to pivot? And everybody desperately wants the Fed to pivot. We keep trying to convince ourselves that the Fed is going to pivot. Here is the probability of a 75-basis point hike to 375 to 4% on November 2nd. Last night it closed, excuse me, at 60%. As this conference call was starting, it is currently at 73%, because of the claims report. Now, I'll get to that in a couple of slides. Here's the August CPI, which the core number blew away expectations at sixth tenths.

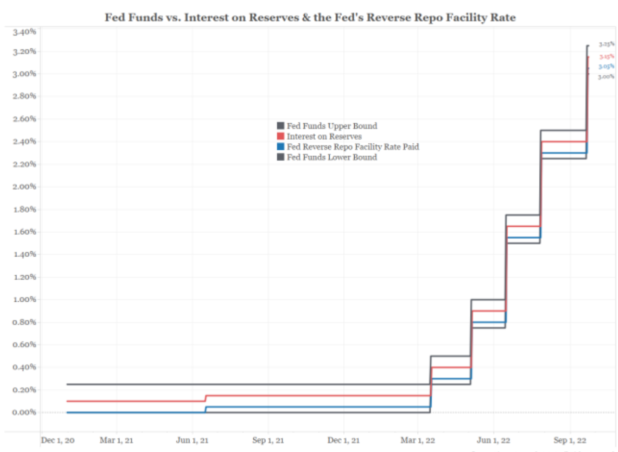


Probability of 75 basis points went from 14% to 65% in one day, and it's been above the 50% line ever since. There are no indications in this market that they think the Fed is going to pivot. Now the terminal rate is pretty much hostage to the Fed. The terminal rate is expected to get to about four and a half. This is the Fed Fund Futures forward curve. And look at this. You got February 447. You've got October at 452. Then you've got it declining. What does that mean? The pivot has been pushed off by the market a whole year. There will be no pivot next year is what the market is telling us.

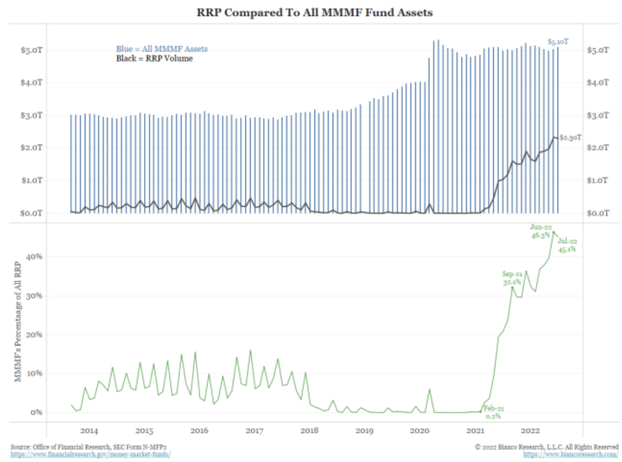
Now remember, just because the market prices it, doesn't mean it's correct. It does tell you what people are thinking, and the change was all these curves used to look like this, that there was going to be cutting of rates next year. Now they're saying we're going to go to 4.5%, and we're going to stay there for most of '23, and we're then going to start down on interest rates as we go forward from here. Before I get to reverse repo, let me make a couple of other quick comments. Well, I'll hold those for another chart that's a little bit more appropriate for that in a few minutes. I want to take a quick word and talk about reverse repo. So, this is a bit of a tangent for a second, because everybody looks at this, and I don't think everybody really understands it.



So, yesterday it was $2.37 trillion was in the Fed's reverse repo facility, a new record high. Taking out the record from, I think, Friday. And it dipped a little bit on Monday, and it made a new record high yesterday. Here are the rates. So, the upper bound of the Fed Fund Futures is 325. If you can't read that, that's 325. That's the upper bound in the Fed Fund Futures. Interest on reserves, when banks have excess reserves, and thanks to 15 years of QE, they all have excess reserves, they get paid 315 on their excess reserves. The reverse repo facility rate paid is 305. So, that's a lower rate, and then the lower end of the Fed Funds curve is 3%.

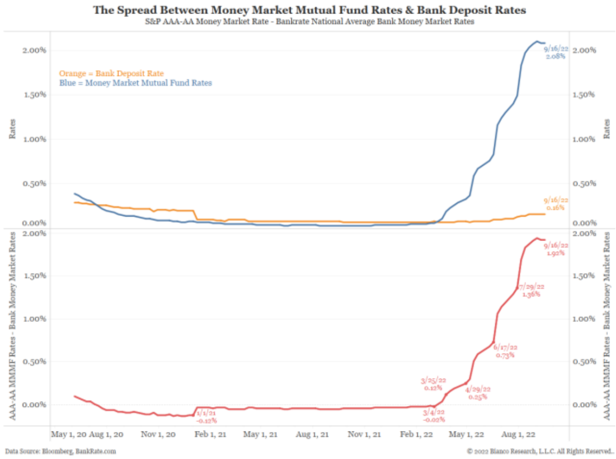


So, interest on reserves is 10 basis points below the upper end of the Fed Funds target range, which is three to three and a quarter, and reverse repos 20 basis points below it. So, why do I point this out? Banks have a better deal. They can keep their money in their reserve account and get 315 on it or they could take it out of the reserve account and put it into a reverse repo and get 305. Now why would they do that? And the answer is they don't do that. So, there's $2.3 trillion of reverse repo in the market. This chart here shows you all assets and money forms are $5 trillion. There's $5 trillion in money market funds. $2.30 of the $2.37 trillion is essentially in money market funds.



The other $70 billion or so, or $100 billion is the home loan banks. Commercial banks own zero of this. That is 45% of all assets in money market funds are just rolling repo, reverse repo at the Federal Reserve. Now why is this important? Because the Fed has been making noise that yes, we're going to do QE. And understand, if this isn't a money fund, this is a non-bank reserve. This is a drain of assets out of the banking system. And we've drained $2.3 trillion out of the banking system. This is far bigger than QT. Everybody hyperventilates about QT, but this is another drain on the banking system. The Fed's hope, and the Fed can't control this. They've got their rate. They've set their rate. They've got a limit of $160 billion per firm that you could buy. They've got about 105 money funds that can buy this stuff.

Not every one of them can, but about 105 can. And they got $2 trillion out. If you've got a bank account, I have a bank account at Citi, and I've already been contacted by Citi. "Hey, you've got some money in a deposit account earning 15 basis points. Move it to the Citi money market fund where it's yielding 2.8%." And so, that's getting money under the banking system into a non-bank asset. Now the Fed hopes that as they do QT, this money will matriculate, that line will go down, and it will matriculate back into the banking system. So, they're going to be pulling reserves out, but then we'll be pushing the reserves back into the banking system by lowering the reverse repo. To which question I ask, why? Why would that happen?



The orange line here is the rate that the average bank in the United States is giving you on your deposit account, you're checking account. 16 basis points. It is still zero. The blue line is the average rate that you can get on a money fund. And that chart's two weeks old, I got to update it. It's probably going to spike up because of the 75-basis point hike. And here's the spread. And notice that in March this spread was zero, and now it's 192 basis points. Why would I move my money out of my 2.5% or 2.8% money fund back into my Citibank account that yields me 16 basis points? I'm not going to do that. Now if my Citibank account yielded me 2.5, I might consider doing that. Now why aren't the deposit rates on the banks at 2.5 like the money funds are? Because they're over reserved as of 15 years of QE.

They got more reserves than they know what to do with, and they're getting paid 3.15% on those excess reserves at the Fed. And it runs into the trillions, thank you very much. There's no need for them to raise that rate. So, the RRP is a drain on bank reserves. QT is a drain on bank reserves. RRP is a bigger drain on bank reserves than QT has been to date. Now at some point, if those rates, if that spread close, then the natural reaction would be, ah, I'll just move my money back into the bank, as opposed to moving my money back into a money my fund. Or conversely, if we see on the other side, so like I said, the current rate is 315, 305 on reverse repo. If we were to see short term repo, one-month bills, short bills all get significantly above 315, then we would also see that money.

Then money fund managers would say, "Okay, everybody wants to keep their money in a money market fund," but I don't need reverse repo because I've got other competitive alternatives. Now why don't we see that? Because there's a lot of people that cannot buy or put their money in reverse repo. Like I said, only 100 money funds can do it. The rest of them have to buy Treasury Bills. Well, you've taken $2 trillion of Treasury Bill money out of the market and Treasury Bill issuance has been low. Net market is somewhat distorted. Their rates are well below RRP. Again, there's no incentive yet to go there. All right. So, what I've talked about so far is the Fed wants to raise rates with everything above the positive real yields, and they're defining that as core PCE. And the Cleveland Fed has September at 4.8%.

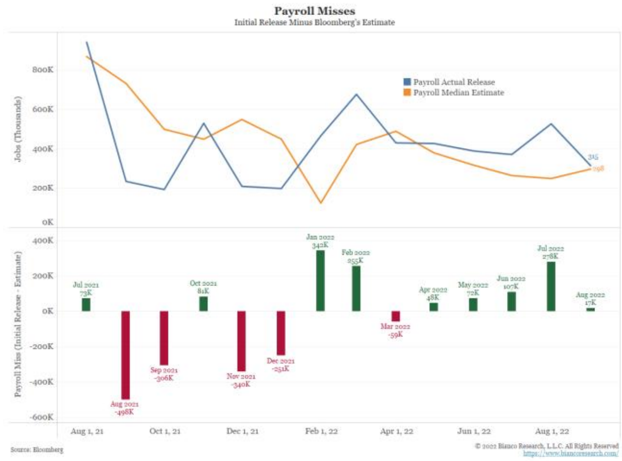
They want every single yield, including the three months at 330, above that number. The one year is much lower than that. I think it's 275, or something like that, which is where money funds are mostly trafficking these days. Somebody asked, why don't they shut down the RRP? I think they're afraid to. I think that they're afraid to reduce the amount of, the $160 billion that they've got, or reduce or shut down the RRP, because let's put it, all the kings' horses and all the kings' men at the Fed are war gaming this. And the answer I believe they're coming up to is we, don't know what'll happen if we shut this down. It could create havoc in the markets, and that is what they're really afraid of. So, they've created a monster, and the only way to get out of this monster is to get one-month bills above RRP, is to get deposit rates competitive with RRP.

Remember, when you have your money in a bank account, you've got sweet privileges and it's a lot more flexible what you could do with your money. We're talking about purchased money funds here that are yielding 280 to 3%. You have to do a transaction in your brokerage account to move that money into a purchased money fund. That's a little bit more cumbersome. So, that's why I said if deposit rates just got close to money funds, all right, this is 260, that's 285. I don't care about 25 basis points. I'll leave my money in the bank, but not 16 to 285. That's two big a spread. Money will continue to flow into money funds.

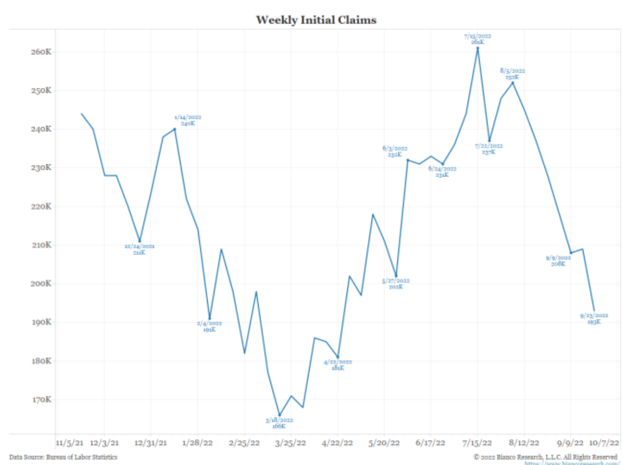
And remember, this is new. Five, six months ago, there was no spread. This is all because of the Fed's aggressive raising as well. Mark asked a question here. "I believe the Fed wants to not pivot, but I don't trust the Fed. Do you believe something materially breaks in the US and they won't pivot just like in the UK?" So, this gets me to my next point, and that's a very good question. It really comes down to, and I'll give you, again, my opinion here on this. I think Jay Powell, he's the chairman, is in the camp that inflation is persistent. He's in my camp. Yes, it's nine, it's 8.3, it's on its way down, but it is not going back to two. And we're going to have to adjust rates for a new higher regime world of four or five neutral rates.

Neutral rates need to get to four and a half. Then when you get the four and a half, we're only at neutral. We have not tightened, and we have to get all these rates above the core inflation rate. I don't think J Powell is in that camp. I don't think that the Fed staff is in that camp. I don't think Christine Lagarde is in that camp. I don't think Kuroda, the Bank of Japan, is in that camp. I think Andrew Bailey might be in that camp, although I go back and forth on him. He's the Bank of England Head.

But I do think that the guy, if you were to ask me this, let me rephrase it this way. Who's the single most bearish person on the FOMC? I think it's Jay Powell. No question about it. And the rest of them are just parroting his talking points because that's what you do as a president and a governor. The chairman tells you what you're going to do, and you go out and you sell it. And that's what they're doing. And I think that that's where Jay is. I happen to think he's right that we're in a period of change. Now I want to point out, the latest thing people are looking for on the pivot is you keep reading, "Oh, the labor market's going to fall." The labor market is falling apart, and the Fed has to stop. Okay, what is the data?

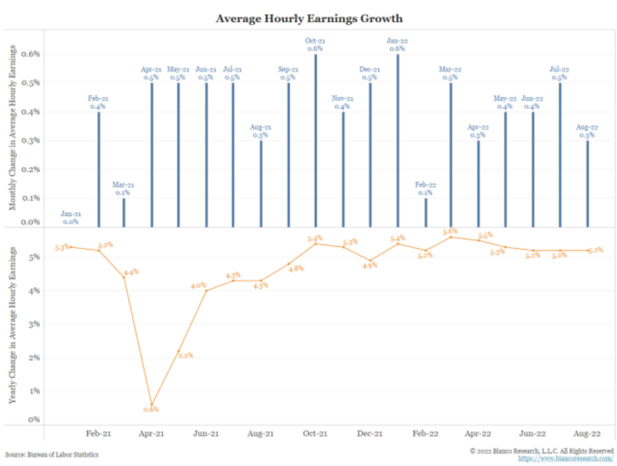


Here is the payroll report and the misses. Seven of the last eight months, all the way back to the beginning of this year, we constantly beat the payroll report. The only month we didn't do that was March. And every month this year payrolls have been above 300,000. Economists think we need to create 50,000 jobs to meet population growth than net immigration. We just need 50,000 jobs. We have created 300,000 jobs every single month this year. There is no evidence in the payroll report that the labor market is struggling. Initial claims came out today. It dove, again, under 200. In July, it was 261 initial claims. Now it's 193. Initial claims are falling. There is no evidence in initial claims that the labor market is struggling right now.



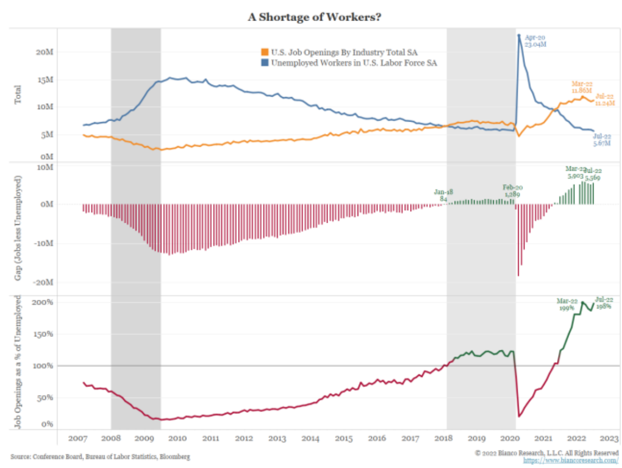
The problem with this is if we don't get the labor market to struggle, Jay Powell has mentioned these many times. If you go back to October of '21, here is year-over-year, yearly change in average hourly earnings, wage inflation. Wage inflation has been very consistent around 5%. It is not weakening at all. It's right in the middle of its range. If we continue to give 5% wage increases, you can pay 5% inflation, maybe 4.5%. But we're not going to have 2% inflation when everybody has a 5% wage increase. Three reals, that will create bidding for stuff and the inflation rate will go up.

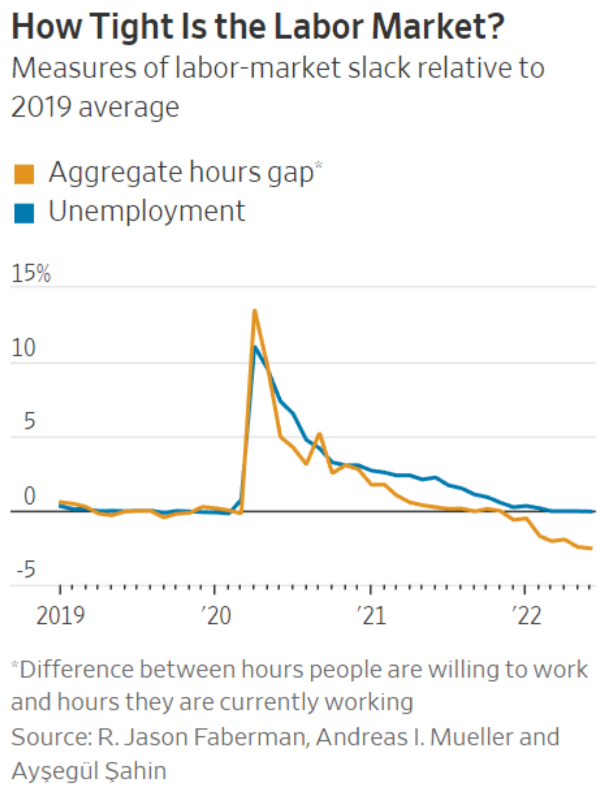
This has to go down. At a minimum, if you want 2% inflation, you got to get this to 2%. The problem is claims are plummeting and we keep creating 300,000 jobs every month. And the final chart here shows you that this is the Jolts report. There were 11.24 million jobs open in the United States. This is the old newspaper want ads, but it's a little bit more sophisticated, and it's 5.6 million unemployed people. The ratio is 1.98. For every unemployed person, there's 1.98 open jobs. Now not everybody is qualified for every job, maybe educationally, or experience, or geographically. You don't want to move to another city or so, but we have an abundance of jobs. I understand everybody wants, and I'll say this, yeah, everybody wants the labor market to fall apart, because then Jay will stop. And so, we stand on our head, and we twirl, and we go under the surface, behind the corner, under that bed over there.



Holy crap, the labor numbers are bad. Okay. Maybe they are. It's not going to change the Fed. You want to change the Fed, you want them to pivot, print 50,000 jobs. See claims spike 80,000 or 100,000 jobs. That will get the fed to pivot. The opposite is happening right now. Now a week from tomorrow, we're going to get the September payroll report and we'll see what happens with that one. So, yeah, you could scream and yell that the labor market is going to suffer, but you're assuming about the future, which if you're honest, and I'm not talking about anybody in particular, we've been making that assumption for 18 months and it has not come to pass. Now I'm not suggesting that the labor market is going to stay this way forever. What I am suggesting is there's no reason for a pivot.

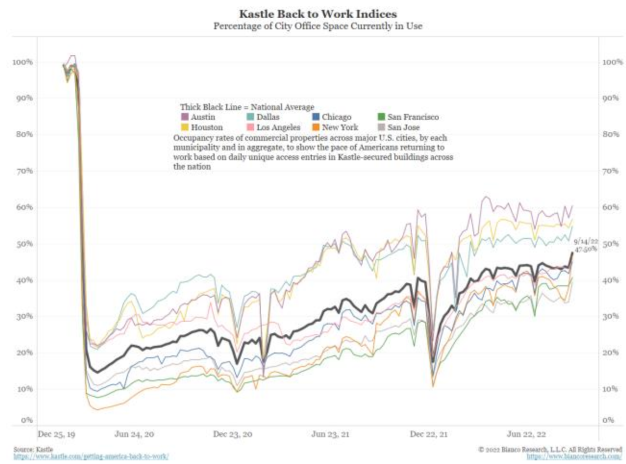
And I thought, if you wanted my opinion, and I'll wander off in the short-term stuff, what's killing the market today, the S&P is down 2.4% over 100 points and interest rates are up. I think that payer think that claims number was devastatingly bad. This tells the Fed to keep their foot on the gas. This tells the Fed the day after the UK financial system almost blew up, that we need a 73% chance that the Fed's going to hike 75 basis points at the next meeting. There is going to be no pivot. And that is what is very difficult. Everybody desperately wants a pivot. They want to return to 2019. And the problem is cheap labor is over. We have 5% inflation. We have 1.8 open jobs for every person. We have companies bidding for employees, paying up for them. So, there is no era anymore of cheap labor.





Greg Ip of the Wall Street Journal wrote an interesting story about this yesterday. Workers changing attitudes tighten the labor market. And I'll highlight one passage from it. "The COVID-19 panic might similarly have catalyzed a reappraisal of what workers are willing to do for how many hours and what wage. Why this mostly consists of anecdotal evidence." You can't measure it. So, I know how the Fed works. Here's seven PhDs. That can't measure it, so therefore it doesn't exist. But in 2029, they'll have it all measured out and tell you that it does exist and it's too late at that point. So, it's all anecdotal at this point. "Evidence of the great resignation, or quiet quitting, or some empirical evidence to points in the same direction." I've argued about this, that the labor market attitudes have changed. People don't value their job as much as they did before.

Now this is not new. The same thing happened 150 years ago when we moved off the farm, off of agricultural jobs into the cities and manufacturing jobs. We still have a legacy of that to this day, non-farm payroll. Then in the '40s, and the '50s, and the '60s, we moved from manufacturing jobs to office jobs. The Mad Men era was the beginning of it, and we kept going all the way through. So, we've done this twice before. We've devalued agriculture jobs. I'm sorry, we did. We devalued manufacturing jobs. Devalued means I don't want to do that. It's hard work. It doesn't pay enough. This job in a factory looks easier than farm work. This job in an office looks easier than manufacturing. I think post-COVID, we're now looking for digital work. We're now looking for a different type of job, that the traditional office job is over.

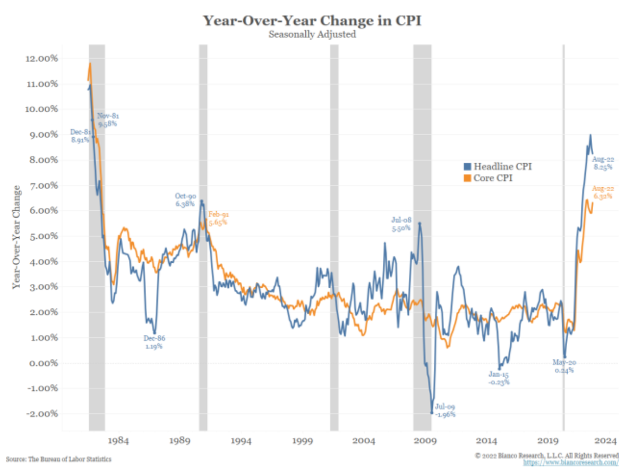


And so, here is the castle, I'll start with the chart. Kastle Back to Work, the swipe card company, maybe your company uses it, only half of the offices in the United States are back. And this is after everybody made this giant push on Labor Day. Got to get back to the office five days a week. Goldman Sachs, JP Morgan, and the like. We can't get that number nationally above 50%. The partnership for New York City surveys Manhattan businesses. And the latest survey came out for September of 2022, and I highlighted 9% of Manhattan office workers are full time, five days in their office. 9%.

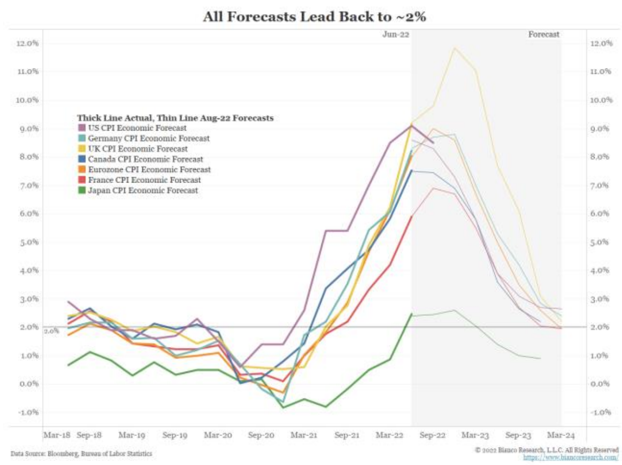
Let me say this emphatically. The era of going to the office five days a week is over. It is never coming back. We are not going to the office five days a week. Maybe 16% are fully remote. That's more people than is actually going into the office five days a week, and everybody's some version of hybrid. This is huge. It changes your attitude. It changes your consumption basket. It changes the way you live your life because you've got not two days at home, Saturday, and Sunday, but four or maybe five days at home. And lots of things change.

And I've talked about this before. This is why the supply chain, our entire supply chain is way too brittle. Companies are still too slow to recognize that there's been a tectonic change. Yes, I'm arguing this time is different. Yes, I understand this time is different. It is dangerous words on Wall Street, because it never is, and you wind up losing a money lot of money. Until it is, and that's devastating as well too. So, I think that this is the end of the cheap labor movement, and that's what you're seeing right now. Sarah Green Carmichael pointed out an interesting op-ed in Bloomberg yesterday or two days ago. "Even if we're not quite quitting, lying flat, or joining the Great Resignation, these movements set a signal about work."

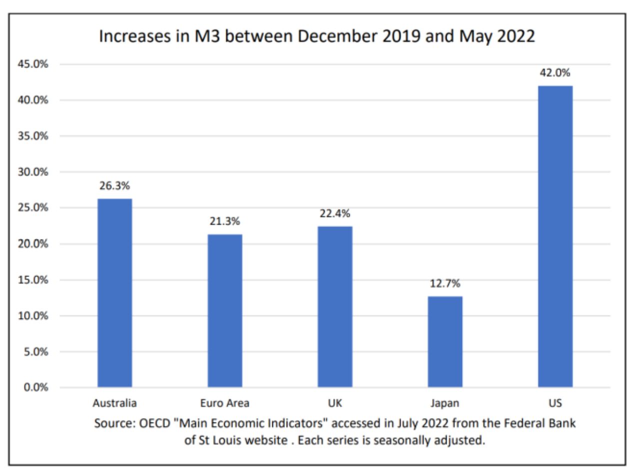
And her point was, she doesn't believe there's a great resignation. She doesn't believe lying flat. That was during COVID, I mean, during Omicron. We were all lying in bed, doing our work from lying in bed. And now we've got quiet quitting. She believes we're overstating all of those. But she says that the reason they keep coming up is that's everybody's fantasy. They want to resign. They want too quiet quit. They want to lay flat in bed. They do not want to go back. Yesterday, I forgot to put it in here. Yesterday GM abandoned their plans. General Motors abandoned their plans to get their office workers back in the office three days a week.



They put up such a stink that Mary Barra had to back down. We are not going back five days a week. And everybody at home, this is the end of the cheap labor error. Everybody needs workers, and you can have them all you want, pay up. Pay up, up, up. 5% wage growth means we cannot get below 5% inflation. That's why the bond market's freaking out. Here's the inflation rate. What does Wall Street think? Okay, there's the inflation rate, 8.3, rounds to 8.25 on the seasonally adjusted number. 6.3 on the seasonally adjusted number for core inflation. What does Wall Street think? Wall Street doesn't buy anything of what I just said. This is their forecast for inflation. You've seen this chart before. There is the black line, which is actual inflation. Every month Bloomberg does a survey of Wall Street. Wherever the inflation rate is, it's going back down, and it's going to 2%. It's going to stay at 2%. For the rest of humanity, that has been the forecast since the inflation rate got to 2.1%. It's going to go back to two and stay there forever, and everybody still thinks that's the case.



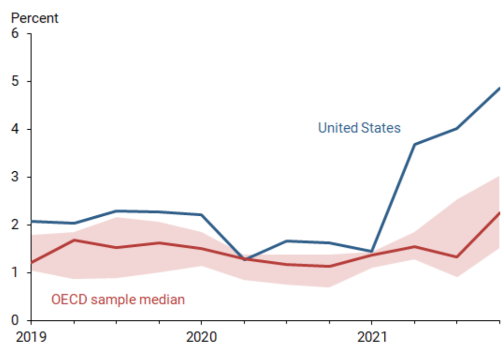
That is the US inflation forecast that is done by economists on Wall Street. Here's the global one. Here's all the inflation rates globally, and here's all the forecasts. Everybody's going back to 2% except for Japan. They're going to go to 1%, and this is going to be the end of it. Everybody believes that inflation is a onetime event that was because the economy reopened, and we're going back to 2% in 18 months or two years.



J Powell is over doing it. It's not necessary. Just be patient. And this is what's driving a lot of those ideas, and what is also driving this idea? Here comes from the St. Louis... I'm sorry. The San Francisco Fed did a study. M3 increases between December 19 and May of 2020. What we saw was money in the US surged way more than Australia, the Euro area, the UK, and Japan. We pumped more money into our economy than anybody else. I've used these charts before. The red part of this chart is the OECD, the Organization of Economic Cooperation and Development. That's 28 developed countries, not the US. This is annual core inflation in all those countries. This is through May. Our rate is significantly higher than everybody else's rate. If you look at real disposable income, here's 100. Everybody's disposable income was flat to down because of COVID, except the United States. We printed and we sent out a ton of money.

Figure 1

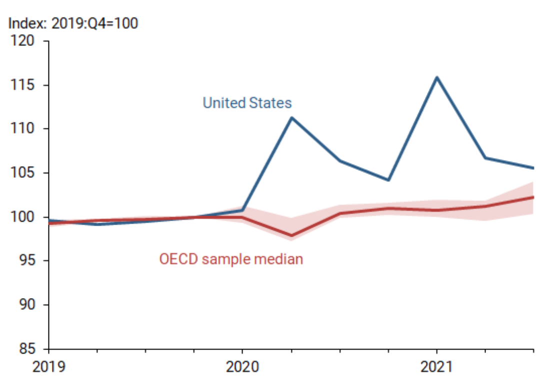
Annual core CPI inflation: U.S. versus OECD



Note: Shaded area reflects interquartile range for OECD sample.
Source: OECD Household Dashboard: cross country comparisons.

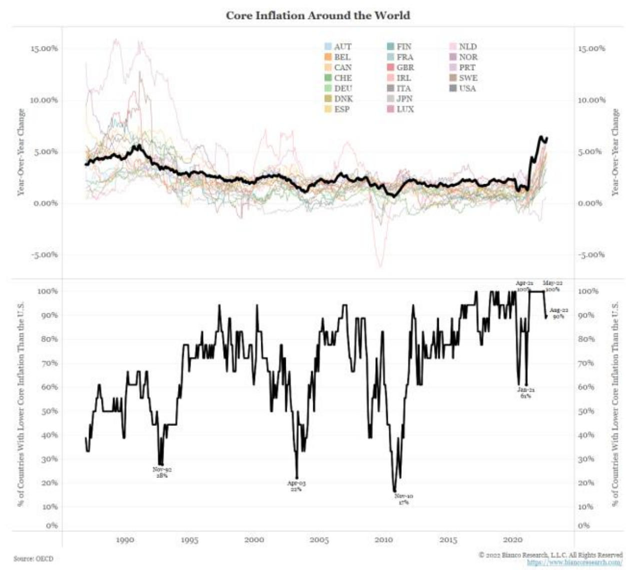
Figure 2

Real personal disposable income: U.S. versus OECD

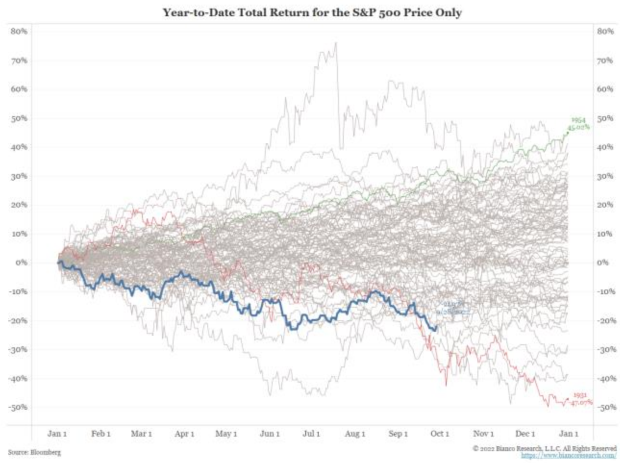


Note: Shaded area reflects interquartile range for OECD sample.
Source: OECD Household Dashboard: cross country comparisons.

So, people have argued, "Well yeah, see that's why we've got the inflation." They're right to that extent. And if you look at this next chart, here is all the OECD countries. This is their core inflation rate, and the black line is our core inflation rate. We are in the 90th percentile. I think it's Portugal and Sweden are the only ones that have core inflation rates higher than us. And in the case of Sweden, it's like by one basis point. Why are our rates higher? Because we stimulated way more than everybody else. So, when you hear the most... Last year, the egregious statement that economists made was inflation is transitory. This year, the egregious statement that they're making is the Fed can't ship. The Fed can't print oil. The Fed can't print people. There is a big component of excess demand in inflation and that is in the wheelhouse of the Fed. They could do something about it.

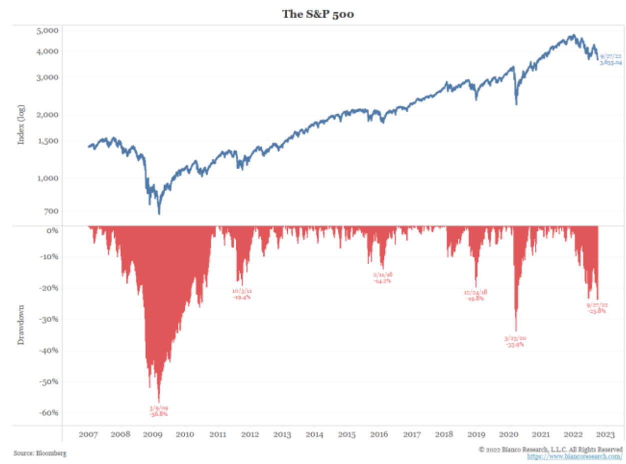


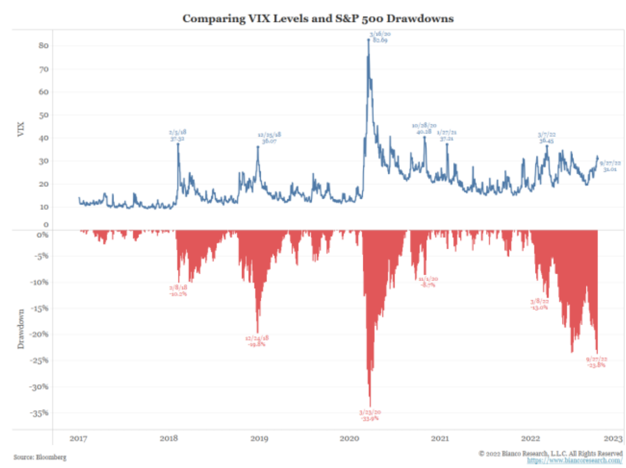
According to the San Francisco Fed, the 8% inflation number roughly breaks down to 2%, is kind of the long-term target. 3% is because of supply constraints. 3% is because of supply constraints. 3% is because of excess demand. It is equal to the supply constraints. In fact, they actually got it at 60%, slightly more than the supply constraints. To say that the Fed can't spread ships is egregiously off base as last year saying that inflation was transitory. So yes, we had this bulge of inflation and yes, money supply is coming down. We're not sending out checks anymore, and it is going to continue to come down. Now another market that's not getting this is the stock market. So here is the S&P. And as I look at the S&P, it is completely reversed today, down about 90 points or about 2.4%. So, we're down about 22.5% or maybe 23%, S&P year to date through September 29th.



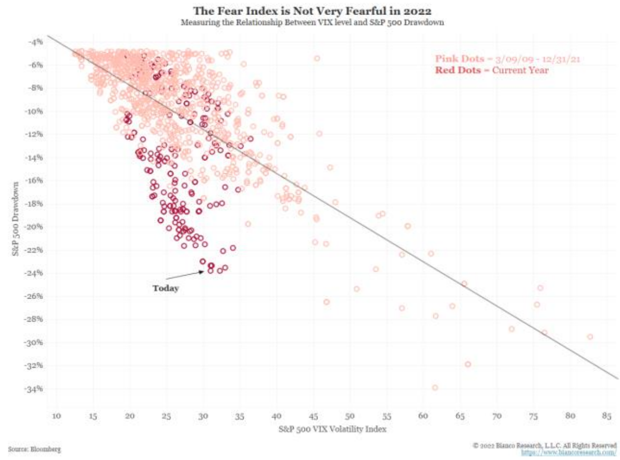
Here's 96 years of year to date, January 1st to December 31st data for the S&P 500. The blue line is this year. If you take two and a half percent out of that, at minus 23%, all you've got, the worst years than this, have been in chronological order is 1931, 1974 and 2002. In 2002 was the Iraq war, when we were freaking out about the Iraq war, and we had a giant credit problem in 2002. We had WorldCom, we had Enron. We had a lot of credit issues. Nevertheless, this is tracking the fourth worst year in the last 96. This stock market has been a complete disaster. If you look at the total return for the Russell 2000, this includes dividends. By the way, this is price only because I don't have dividend series dating back to 1926. But I do have price only. This is total return with dividends for the Russell 2000.

This chart goes back to 1978, 1978. We are at the worst year through September 29th, or maybe now mildly the second worst year. We're tracking 2008. That's how bad this year has been in small-cap stocks, is that if you've been holding the IWM, which is the rest of 2000 ETF or if you've been tracking in small-cap stocks, your index is giving you the worst first nine months of a year ever, maybe '08. But now you're comparing yourself to September of 2008, the month that Lehman failed. So, you've got really bad markets here.





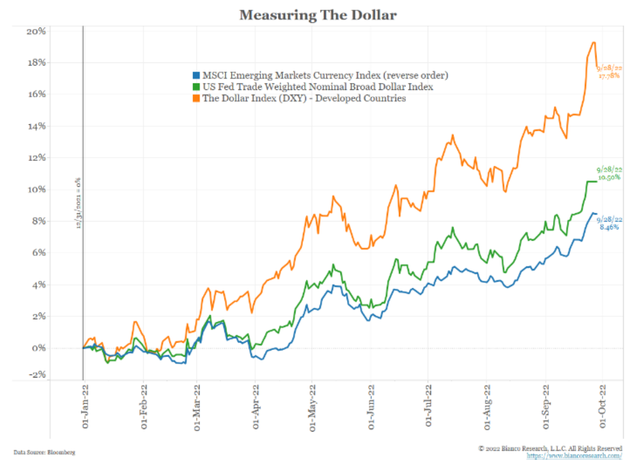
Now let me show this chart here. This goes back, this is not updated through yesterday. So, we're down 23.8%. I'm assuming when it all comes out in the wash, we'll probably be down there today unless the market stage is a 100-handle rally, we'll see. So, we're down 23%. If you look at, here's the VIX, and if you look at the 23% decline and compare it to the VIX, here is the scatter. This is the decline. This is the level of VIX. There is Tuesday, and at 23% decline, according to this regression, the VIX should be 65, not 32. It is way too low compared to where it should be if you believe this regression.



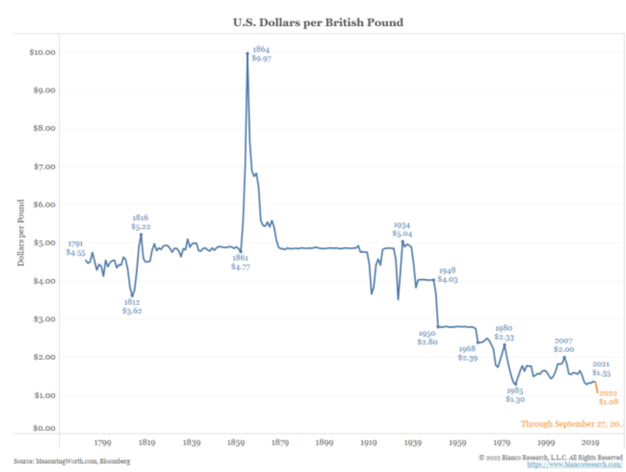
Now this goes back to the end of the great recession, March of '09 and the red dots of this year. The market is very sanguine. The market is worried. You want to know what stock traders; you want to know what Degen's... That's short for degenerate gambler. It's a crypto term. Want to know what Degen's are worried about when they stare at the ceiling at night? Not that the market's going to rip them for any more losses, that it is going to stage a face ripping rally as Josh Brown predicted two weeks ago, the guy on Fast Money who's president of Ritholtz Wealth. I love Josh. I'm not criticizing Josh. I've made bad calls too, but I'm just going to point that one out.

So, Josh, if you're listening to me, no, I love you man, but we all do it. I do it too. But he did say that because it's emblematic of what a lot of people are worried about. They're worried that this market's going to moon, another crypto turn for you, as opposed to collapse. And that's what the 32 VIX is suggesting right now is that it is very complacent. It should be much, much higher on the third or fourth worst year of the last 96 years. There's a big complacency. It is showing up in the dollar. The US is raising rates. Everybody else has been slow to raise rates, especially the ECB, Christine Lagarde, who I've jokingly called Christine Lagarde because they've been so slow in recognizing.

Kind of again, she ultimately believes that this is a one-off inflation problem, and it will go away, and there's no reason to be aggressive in raising rates like a lot of other people. Like I said, like Brainard believes, the Fed staff believes, she believes, Carota believes. I think that Jay Powell does not believe that. And I think he's the most hawkish member of the Fed. And I think Andrew Bailey is my guess, and I can be wrong on this. These are all my guesses. These are not measured things. I think Andrew Bailey leans more towards Powell than he does towards say, Lagarde.

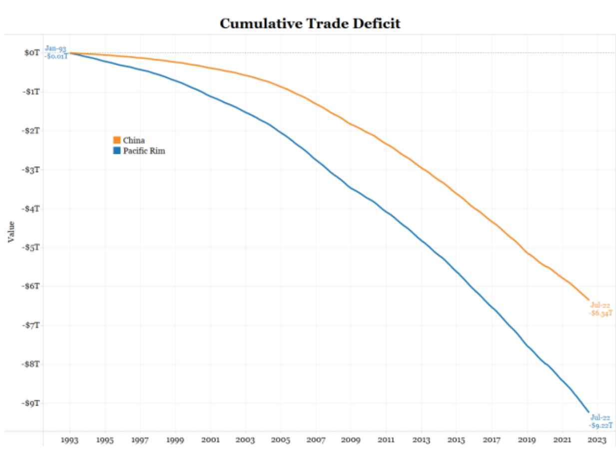


So, the dollar has been surging because we've got high interest rates, and we've got unstable markets. Flight to quality into the dollar and we've got surging interest rates, until a week ago in the UK. So, if you look at this chart, the dollar index, which is... Oh, let me start, emerging market currencies. So emerging market currencies. The dollar is appreciated 8.5% against emerging market currencies. But under developed countries, that's the dollar index, the DXY or the DXY. It's up 18%, 17.78 to be specific. Why are developed countries doing so much worse? Two reasons. Reason one is emerging markets tend to get most of their income from commodities, oil, copper, agricultural stuff, sugar, rubber, Take your pick.



It's been a good year for commodities. I know they're kind of all over the lot. People point their lumbers down, but that's usually just a US market. We're not importing that much lumber from foreign countries. We're cutting down trees in the US or in Canada. And so, they have benefited from that. And I think this is a measure of financial stress. There's a lot of financial stress. So, a lot of developed world people don't know what's going on. Hide in the reserve currency, hide in the safest place you can. That's why I believe that the developed currencies are doing so much worse as we move forward from here. British Pound, fund chart on the British Pound, it goes back to 1791. Great thing about the UK, continuous data on interest rates. Continuous data on currencies. 1861 to 1864 was the US getting their money out of the Civil War, and it surged the Pound and then it came back down after the Civil War. They're at an all-time low. They're at the lowest level in history.

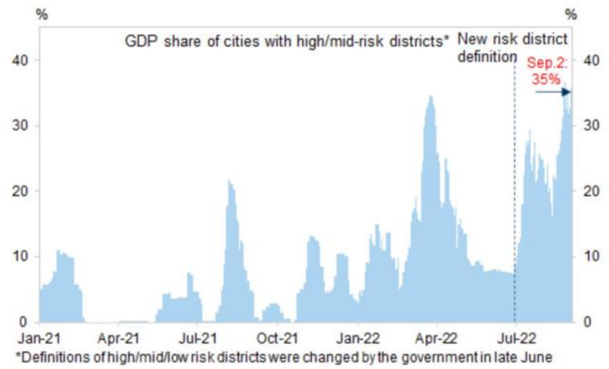
And this is 200 years of data. Just like I said, the volatility of the gilt market where you saw that giant rise and that giant collapse of rates. You get 230 years of data of that too, and I think you're never going to find another period like we've seen this week in the market as well. Quick other things. So, I've talked about the era of cheap labor is over. Quiet quitting and everything else. If it's not happening, it's our fantasy. Work from home is a thing. We're not going back to the office five days a week. That changes a lot of attitudes. People are not that exercised that I need to grind, put my nose to the grindstone to get ahead in my job. They're just not. There's been an attitude change about that. Not everybody does. Some people still believe that but not enough. And so therefore the era of cheap labor, people begging for the job, "I'll take it at the lowest possible price" is over. And if we keep having 5% inflation, we're going to keep having 5% unemployment.



And despite all of the machinations that the labor market's falling apart and look at this, it really isn't yet, or at least it isn't to the extent that the Fed would agree and consider a pivot. And today's claims number was a big blow against the idea that the labor market's falling apart. Now, maybe starting next week those numbers go up, but they're not now. And we shouldn't be looking for a pivot now. And that's why I said the day after the city of London almost exploded, the Fed is still going to raise rates 75 basis points because it's all about inflation. Human of trade deficit. This goes back 29 years. Cumulatively we have a $9 trillion deficit with the Pacific-rim. 6 trillion of that came from China. Two-thirds of our cheap goods have come from China. This has been an enormous benefit for us because they've come from China. We had cheap labor. How did we get people to not... We've had the Tea Party movement, we've had Occupy Wall Street.

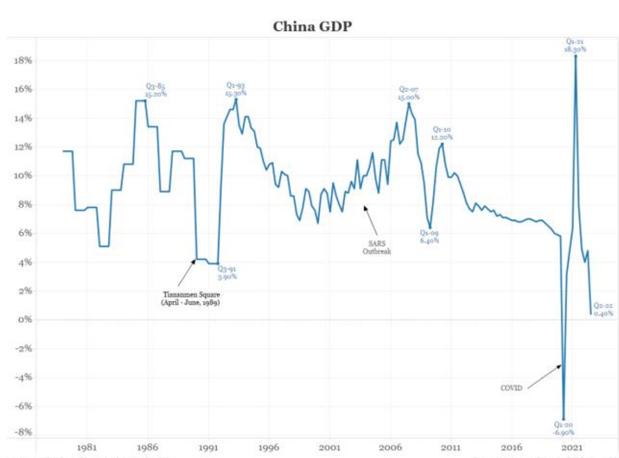
If you remember the movie Falling Down with Michael Douglas in the early nineties after the Soviet Union collapsed, and they were closing down a lot of the peace dividend. So, a lot of weapons manufacturing was closing, and there was the angry white male back then as well too, who was losing his job. We've had a lot of this because we haven't been paying people. We've been paying them rock bottom rates because there's been this ethos that I'll take the job at the lowest possible price because I need that job, and that ethos is over now. I don't even want to go back to the office five days a week. So how did we offset all of those populous rumblings? We had Brexit, we had Trump. We kept flooding Amazon and all the big... I'm sorry, flooding Amazon, yes, and Walmart and all the big rocks retailers with cheap shit to use the raid properly from China and from Asia.

Exhibit 4: Cities with high/mid-risk districts increased to around 35% of national GDP

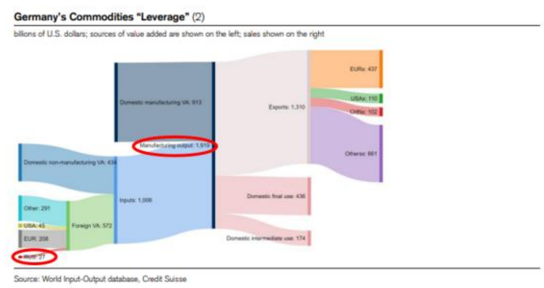


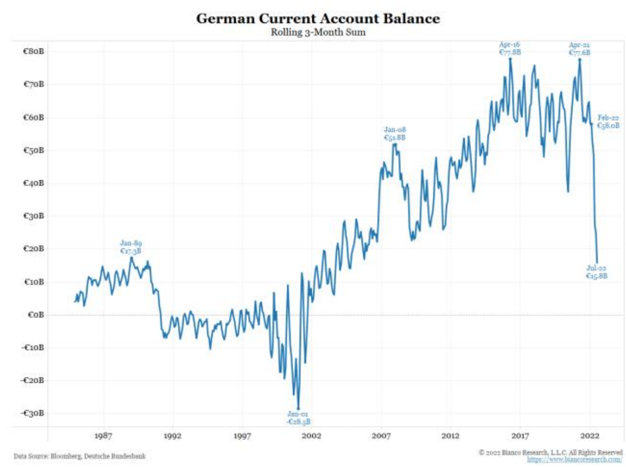
Source: NHC, CEIC, Goldman Sachs Global Investment Research

That era might also be over. We have tremendous tensions with China. There might be a reorientation of the axes between Russia and China and the West. We'll have to see if that comes up. But right now, if your long-term view is don't worry, and I'll use the word again, cheap shit will just keep flowing from China. That will keep prices depressed. I think that era is over right now as well. Shorter term, this is the percentage of GDP in China that is currently at zero COVID risk, 35% as of the beginning of the month. I haven't seen an update of this yet, but I don't think it's really changed much. This is the highest level since 2020. A third of all economic activity in China is impaired because they're in zero COVID. They're locked down, and they cannot go to work and do stuff. Now everybody's convincing themselves. The National Party Congress, where she is going to get elected for life in about two weeks is going to come, and then they're going to drop zero COVID right after that.



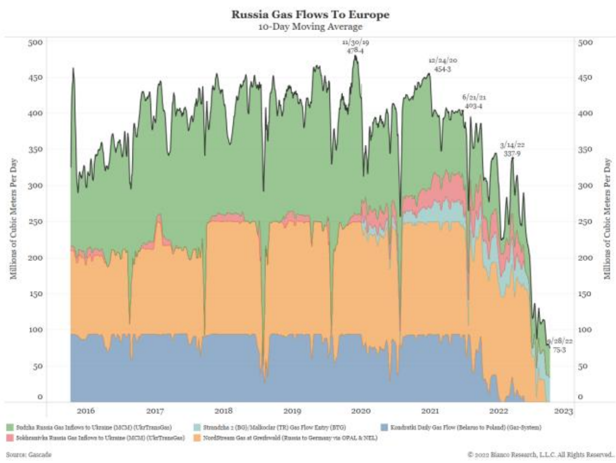
So don't worry, this is going to go away. Yeah. And we said that after the Olympics. This was only to show the world that China was superior to the US. Million people died in the US. They don't care about life. We do. We lock down. We protect life. We're going to show the world during the Olympics that, and then the Olympics ended and zero COVID continued as is. Now we could argue zero COVID's going to go away in China, and that would be an increase of economic activity in China. But I think the Olympics was a better argument to get rid of it than was what we see here. And you're seeing that in their GDP. Here's China's GDP back to 1978. It has never been negativing except for the shutdown in COVID, and we're very close to doing that again. This is devastating China's GDP, but we think like the West. "Oh my God, look at this. They've got to change things. They've got to end zero COVID. This is terrible for their economy."



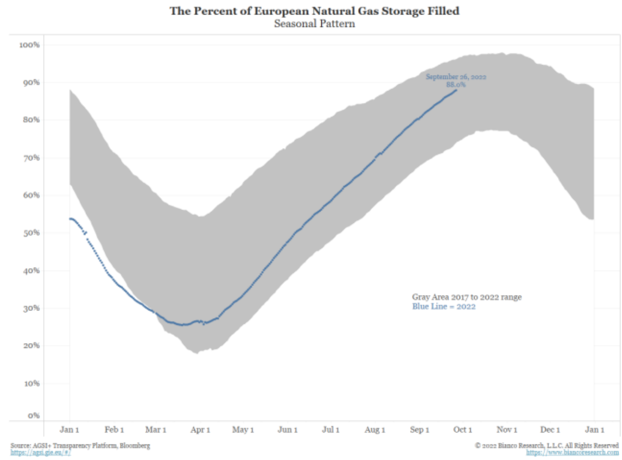


They don't look at it that way. They do not look at it that way. It's a command-and-control communist country. And I don't think they're that exercised about it. And if they're not, the era of cheap goods is over. And finally, cheap energy. This chart comes from Zoltan Pozsar, Credit Suisse. He points out here, excuse me. Here, that $27 billion of cheap Russian energy that flows into Europe is levered into $1.9 trillion worth of manufactured goods. What keeps

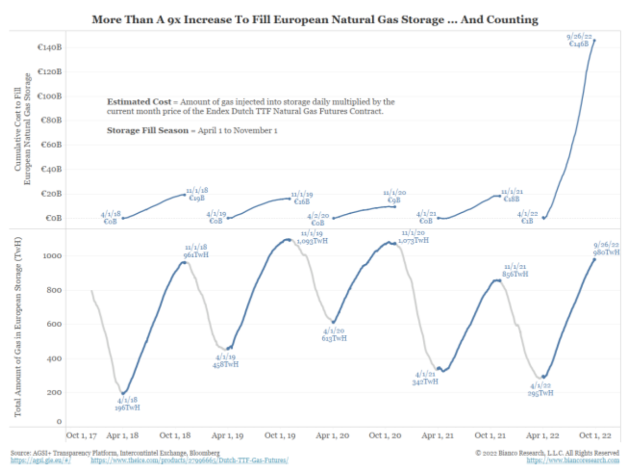
Europe's manufacturing base competitive? Cheap energy. Energy is a bigger input than labor. And the era of cheap energy coming from Russia seems to be over. And you're starting to see it because energy prices are going up so much. The German current account balance is plummeting. They cannot make a Mercedes in Stuttgart and make a profit on them. The energy input to make those cars is through the roof right now, and they cannot jack the price 30 or 40%, although they'd like to.



And so therefore they're doing less. Manufacturing facilities are closing because of high energy prices in Germany. And you're seeing that. Here is the 10-day gas flow from Russia to Europe. And here's the five big pipelines. Nord Stream 1 is the orange pipeline. Prior to the war they would send about 400 million cubic feet a day, cubic meters, excuse me, a day of gas to Europe. We're down to 75 million cubic meters. And it's really only two of the five pipelines. And now that Nord Stream 1 has been damaged by sabotage, there's been stories that thing may never reopen, that the cost of fixing it and the time and the effort to fix it is going to be prohibitive. The era of cheap energy is over. So, what does this mean for Europe? Here is the level of natural gas storage in Europe.



It is as of September 26th, their storage facilities are 88% full. They're right in the middle of the five-year average. The cycle is you use gas in winter to basically heat. Gas is also used for electricity generation, but that's used year-round. But these inventories are for to run down for space heating, and then you fill it in the summer from April 1st to November 1st. So, you saw stories like a couple of days ago, Italy announced they've got enough gas for the winter. Everybody has enough gas for the winter. They fail to recognize that in a capitalist society, there is no such thing as a shortage. What there is a shortage of money to pay for it. So here are the gas inventories of Europe right now.



The blue line is April 1st to November 1st, the fill season. You're filling your inventory, your storage for the winter. The top panel shows you how much it cost to fill that up. In 2018, it was $19 billion. In 2019 it was $16 billion. In '20 it was just $9 billion because the price of gas was cheap. Last year it was $18 billion. This year it is $146 billion, nine times more than we've seen in the past. So, let's put this in perspective. Europe, the good news is you could stay at 68 degrees or 20 Celsius all winter long and not worry about it. But your $125 a month gas bill is now a thousand dollars a month. Other than that, you can have all the gas that you want. Now what are the European governments trying to do about this? Subsidize.

They're trying to figure out ways they could borrow money or stuff to get people to pay for all this gas. And the Germans came out today and said, "Look, we won't. We're going to run out of gas because we're going to subsidize this, and everybody's going to use it and we're going to run out of gas. We need to get people to stop or use less." But they don't want to tell their populations, turn that thermostat down, idle a bunch of manufacturing facilities for this next six months, so we can get through the winter. They want to tell everybody that you're $125 bill is going to go to $135, and you can keep your temp, you keep it at 68 degrees. All is going to be fine. And I think the markets are starting to recognize that that's not the case, which is why you've got lots of calls for recession in Europe.

So let me summarize this and then let me jump on some of the questions here. We are in a period of a post pandemic economy. I think this is a period of epic change. I'm going to start big picture and work narrow now. The era of cheap labor, cheap goods, and cheap energy is over. We still have labor, we still have goods, we still have energy. We have to pay for it. We could still restructure the economy to find a way to get back to cheap labor, cheap goods, and cheap energy. That is trillions of dollars in many, many years. But we don't want to restructure the economy. We want to argue whether or not there is such a thing as a post pandemic economy. Don't worry, the inflation rate will go away in two years. There's nothing to see here. Just be patient. If that is egregiously wrong, as was transitory last year, you're going to see tremendous volatility in financial markets.

And guess what? You've got the worst total return ever in the bond market. The third or fourth worst year in the stock market. You've got all kind of soaring rates and currency, FX rates. And you nearly had a total meltdown in the UK yesterday. And I think it's all because we're not ready to say this is a 4% inflation world. The neutral rate is four and a half to five. The restrictive rate is much higher than that. We don't want to believe that. And yet that is where we are because that will crush multiples in risk assets that will crush levered players in safe assets like treasuries because they buy them all on leverage and it's going to be a very, very painful period. And we saw that because of the trust budget, she was proposing a budget to massively stimulate an economy that has a 10% inflation rate on its way higher. And that's why the market freaked out the most that it did in 22 years. And if the Bank of England didn't step in and artificially levitate prices, there would've been failures. There would've been under capitalized firms that would've had to make it public.

They don't have enough capital and you should know that before you give me your overnight funding. And of course, no one will. And we know this from '08. The minute you lose your overnight funding, you are out of business in three minutes. And so therefore they had to force those prices higher so everybody could stay capitalized and not make that devastating announcement. But they have not fundamentally fixed the problem. They kicked the can down the road. And like I said, I used the BNP money funds in August of '07. We didn't fix that problem. And then it popped up again with Lehman, I mean with Baron '08. And then we didn't fix that problem. And then everything hit the fan in September, October of '08 as well. I don't think it's going to be that bad as September, October of '08.

But what I take away is that '07, '08 period was another period where, like COVID was too... Remember everybody said it was going to be temporary and transitory for COVID, that was the original egregious transitory statement was COVID was going to be transitory. No one wants to believe that there's been a major change. That's what you see in the inflation numbers all going back to 2%. But I think there has been, and I think that we completely discount things like work from home. And one of the reasons we discounted is what industry is pushing the hardest to get everybody back to the office. Big money center banks in New York City. So, everybody that we expect that should figure out that work from home is a big deal and it's changed stuff, are being forced in the office five days a week and everybody does what they do. If I have to be in the office five days a week, so does everybody else. There's nothing to see here. Which companies are the least lax on work from home? West Coast tech firms. Twitter is permanently work from home 100%. And so therefore I think we're having a very difficult time adjusting to this. So, we're going to continue to see stressed markets. Yeah, we'll get an oversold. We'll get a bounce. Yes, we'll probably see some kind of bounce in interest rates, and then we'll do the same thing we've done three or four times. We'll hope this means the Fed's going to pivot. But I think we need unmistakable evidence that the labor market is turning down and that labor inflation is backing off that 5% number.

It has not in the last year, and we printed 300,000 jobs every month this year. We'll see what September brings up a week from tomorrow. But claims are giving you no indication that labor is falling apart right now. All right, let me stop there. Hopefully, that gives you both the big picture and what's been happening in the markets in the last couple of days.

Q&A

Let me answer some questions. First name only basis. I know you are.

Michael S. "Is credit the next shoe to drop, IG. OAS nearing the year-to-date peaks? How much wider can it go and what impact would it have on equities?" Yes, I would argue, this is my opinion again, the reason that investment grade credit or credit in general has been relatively better, I mean, it's not great, but it's been relatively better this year is, it's still the legacy in 2020.

In 2020, when credit was getting ugly, the Fed stepped up and they bought IG, investment grade bonds, they bought investment grade ETFs, they bought high yield ETFs, and the narrative on Wall Street was, "Everything is ugly but buy credit because you're co-investing with the Fed." There is a gigantic moral hazard in credit because we do not allow it to fall apart because the Fed will step up. And the joke I like to say is, "Buy some credit, buy some corporate bonds. Either the company will pay you back or Jay Powell will pay you back. But you're going to get paid back so don't worry about credit." And the part, again, why? Because the economists just told me that inflation will be at 2% in two years, and we'll go back to zero and everything will be fine. That narrative I think is going start to give way and when it does, I think credit is going to widen.

Chris says, "You totally lost me 5,000 years." Oh, hold on a second. This book right here, A History of Interest Rates by Sidney Homer and Richard Sylla, New York University Professor, is 700 pages of charts and tables and it tracks interest rates back to 3000 B.C. So, we have 5,000 years of interest rate data and what I'm arguing is that, from an interest rate movement, the total returns we've seen have been largely duration driven, interest rate driven, not credit driven, that this is possibly the worst interest rate driven market in 5,000 years, which is why you've got these horrific losses in markets across the world. It's giving us a lot of stress. So that's what I meant by 5,000 years**. "Inflation has always been the only answer to the central bank's printing process. Governments will never be able to pay these debts back. Do we go from a regime of lower for longer to higher for longer?"**

Yeah, I think so. I think we are regime shifting and regime shifting is not easy and if I'm right and the era of cheap goods, cheap labor, and cheap energy is over, this period of volatility will continue until we recognize, and we restructure. Does it mean at jubilee that would be a debt extinguishment or something like that? Yeah, I'm not ready to go there just yet, but it does mean I think higher inflation and higher interest rates except if we crush the economy we might see 2% inflation on a bad recession, and then when the recession is over, inflation rate goes back up. That was what we saw in the '70s. That's what we saw in the '40s as well. We crushed the economy. Hey, the inflation rate went away and then the economy expands and then the inflation rate comes back. So, yes, I think we are going to a higher for longer. And I will argue, again, I think that the beta argument, buy double levered S&P because you're just waiting for Jay to print money and make it go up, I think that era's over.

I think the era is not just buy XLE because energy looks like it's going to break out. I mean, of course, you can do that, but if you want it to be a little bit more nuanced, which energy company do you want to own? Because in the era of no more cheap energy, no more cheap labor, no more cheap goods, not every energy company is going to have the same input. Some are better at this point period than others. We're going to go back to the Peter Lynch era, picking stocks. I think that the beta period of just picking ETFs might be ending. Now, with the tremendous volatility, we're all going to gamble with ETFs, but I think once the volatility settles down, I wouldn't be surprised if we start seeing, I'm talking about in the next couple of years, active managers start beating the indexes because the indexes will be choking on certain things, and you can avoid them and see the index go better.

That's why I think it's an optimistic thing for some of us. We have to learn to pivot for this era and not necessarily just pine for, when can I buy my inverse levered or double levered and watch it go back up again?

Brett asks, "Where's the weak link when this interest rate event becomes a credit event?" It was almost yesterday if somebody had reported that they were undercapitalized yesterday, like I said earlier. If one company in the U.K., one pension fund, one broker, one investment manager says that they're undercapitalized because they've been buying bonds on leverage and the price fell too much and they don't have enough collateral, collateral being bonds unencumbered by borrowed money, to meet their margin requirements, one company says that, every company will be perceived to either be in the same position or very, very close to the same position and the markets will freak out.

So, I think that we were very close to it yesterday. I think we got a stay of execution, but I'm not so sure that we've solved the problem because if the pound continues to fall, now the pound is all messed up because of positioning right now, it's rallying, it's plunging and stuff, give it a couple weeks, if the pound starts back down towards parity with the dollar again, and why wouldn't it if you've dropped rates 100 basis points, you've made it that much more unattractive, then I think the only remedy is watch the pound collapse through the floor, which is terrible for their economy, or watch interest rates go to the moon to try and staved off the outflows, which is terrible for the city of London. So, you've got a very bad place. Now, what fixes all of this? What fixes all of this, I should say this up front, I'm wrong and that this is not a regime shift, that the consensus is correct that what we're seeing in the economy is a onetime pandemic reopening.

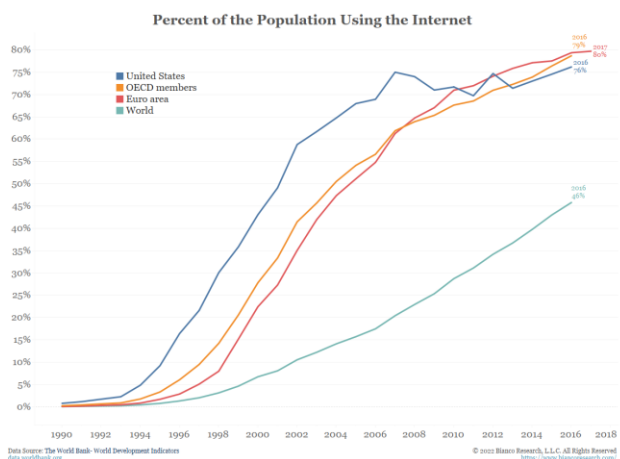
And where's that chart? Here, let me show you that chart. This chart here, a onetime pandemic reopening that goes back to 2% and stays at 2% forever. If that's the case and, look, anything's possible, I don't think it is, but anything's possible, then, yes, everything will calm down, we'll go back to 2019, we'll all go back to the office, and it'll all be 2019 all over again. But if we're in a period of epic change and, like I said, I think that the era of five days a week in the office is over, and that changes a lot if you're home more. And like I said, we did this when we moved from the farm to the factory. We moved from the factory to the office. Now we're moving from the office to a digital job. This is nothing new in the last 200 years of work migration. This is the next one.

What the pandemic did, and I've talked about this before, it speeds up a lot of trends. This would've happened over the next 20 or 30 years, but it sped it up and we did it in two or three years, and this is why we're having a hard time adjusting to this. But this was destined to happen. We're speeding up the movement towards digital jobs at a pace that the economy cannot handle.

Craig asks, "Jim, it seems that we're getting close to a policy error that may force a pivot. Assuming we either get a pivot or a pause, is it your belief we go back to risk on growth over value, junk over quality? Or is it a belief that persistent inflation in these risk on periods will be squashed far quicker than in the past?" First of all, I'll take issue with, I don't think we're close to a pivot. I do not think we're close to a pivot. I think everybody wants us to be close to a pivot, but we are not.

We have probabilities above 50% that the Fed's still going to raise 75 base points. And look at what the market's doing right now. Look at what happened in the U.K. yesterday. Can't get those odds out of there. But you're right. I fear, oh, everything got ugly, the Fed is going to pivot. Oh, good. Buy my double levered S&Ps. The problem with that is that, if we do believe that this is a regime shift, then all that's going to do is create inflation and it could backfire and it could make markets worse. Because if you're not going to fight inflation and you're going to pivot when, let's an argument that we're at 7.5% and the market and the S&P's ugly and the Fed's got to pivot, we're at 7.5% inflation and we're going to drop rates and we're going to create a wealth effect by having soaring stock prices and the like, how are we getting to two? And everybody that makes a ton of money because their house price appreciates, their portfolio appreciates says, "The hell with that job. I'll just stay home." So how do we get to 2% inflation? We don't.

And I think there's a real chance that if we pivot because of either the economy's falling apart or the financial markets are falling apart, it might not be a good thing. Now, Mohamed El-Erian puts a finer point on it. He did yesterday. If we are going to pivot because the stock market's falling apart too much or the economy's going to go into a deep recession, first, there's going to be even more bloodletting in financial markets because we've got to get to those points where it's impossible for the Fed to ignore it, which means ugliness. And that's not a good reason to pivot. The good reason to pivot is solid evidence the inflation rate is what the chart on the screen shows, temporary, rolling back to 2%, stay at 2% forever. Let me jump to the next question.



Oh okay, "Why don't they shut down the RRP?" I answered that question already. Hal asks, "How long would you think the new regime of higher inflation lasts? Longer term it seems like deflationary dynamics and aging populations would keep inflation in check." Yes. I forgot to talk about my last chart, so I'll point it out here one more time. Oops, there it is, Percentage of the Population Using the Internet. In the 1990s, it was zero, and now it's essentially 100%. Yeah, this chart's a couple years old because I can't find an update, but you get the point. Technology is a depressant on inflation. Demographics is a depressant on inflation. So, we've got that working for us. But if we don't have cheap labor, cheap goods, and cheap energy anymore, this is why I think we go to 4% inflation. If we lost the technological advantage and if the demographics weren't there, we'd go to eight or nine and stay there.

So yes, again, I'm in the camp, as everybody else. Inflation rate's probably peaking now if it's not already peaked, but that is a statement that's really not that important. What is important is, are we going back to two? And I don't think we're going back to two and that means that interest rates have to stay high. And yes, we have structured the economy for a low stable interest rate, inflation rate world as far as the eye can see. We have to restructure it if that's where we're going to go and that's exactly what financial markets have been signaling to us this year with the volatility that we've seen in the market. Let me see, a couple of other questions and then I'll answer this.

Larry asks, "Are we in recession now? If not, what potential catalyst would you see the U.S. pushing in the recession? What are your thoughts on what the recession would look like?"

Now, I've been very vocal on this. I think we are in recession now and I think we have been. I've pointed out that two negative GDP quarters has only occurred in a recession. First quarter was negative. Second quarter was negative. The third quarter, if you believe the Atlanta Fed GDP, they're still a month off dates coming, it's only a positive 0.3. There's a possibility we have a third negative quarter here. It's not out of the realm of possibility. And even if we don't, it's a very, very low number. Recessions are measured from the peak. We are past the peak. We are in recession. But I think that through September 29th the recession has been fairly mild. I think it's intensifying. It's like Ian last week as it was moving up towards Florida. It was intensifying and I think it will continue to intensify as we move forward.

But if the claims and the payroll numbers are to be believed, that intensification process might be a lot slower than we think and we'll be in a mild recession. Now, the problem with the word recession is it's a politically charged, emotionally charged word. Recession is supposed to mean the shit has hit the fan. It is not supposed to mean that we have a peak in economic activity off the peak. That's actually the definition of it, a peak off the peak. That's why I think we're in recession, but I think it's a mild recession. But I think that the answer to your question is, it will intensify as we move forward. I'm not sure how bad it will get. I'm a little more worried now when I saw what happened in the U.K. yesterday than what I was thinking last week as well. So, we'll go from there. But I do think it will continue to intensify at an irregular speed.

"Could the British government set a new global trend that lets governments around the world play good cop via fiscal loosening while the central banks play bad cop via more aggressive tightening?" They could try that, but the problem is, they've got the markets addicted to zero money. They've got the markets addicted to central bank bailouts. They've got the markets addicted to central banks allowing no displeasure in portfolios. You could do that from an economic standpoint, but I don't know if you can absolutely do that from a financial standpoint. A couple more questions and then I'll end it.

Ralph asks, "Why is gold tanking?" Very good question. I have been surprised by gold. Peter Schiff, this is everything he's ever wanted with gold, inflation, financial crisis, soaring interest rates, volatile markets, plunging crypto prices. It's everything you've ever wanted, and the price of gold cannot get out of its own way.

I think the answer is, gold has become too financialized. It's another currency. "Oh, buy gold because everything's going to hit the fan." Okay. How? Buy GLD. If it hits the fan, GLD's going to be worth nothing. You have to buy a sack of gold coins and put it under your bed. "Oh, that's too hard. I don't know how to do it." We've financialized it. We've turned it into a currency and it's plunging like every other currency. That is the problem. Gold is the way you get your money out of the financial system, but with all the derivatives and with all the futures and all the options and all the ETFs, it has become another financial asset just like a currency is and it trades more like a currency than some independent way to get your money out of the market.

"Thoughts on the impact of the midterms and Janet Yellen's rumored departure." I will do a midterm update tomorrow. The House is still going to go Republican if you look at Nate Silver's models, and if you look at the betting markets.

The Senate looks like the Democrats will hold it, but Nate Silver has the Republicans at a 30% chance of taking the Senate. The betting markets are back to 44, 45. That's close enough to even money five weeks away from the election. So, it is a slight lean Democrat. And the Republicans have been strengthening or the Democrats have been weakening. So that's the part on the midterms. I'll put an update of it out tomorrow. I was going to try and do that all week, but every day we always had some epic financial thing that I wanted to comment on, and I didn't want to overload our daily thing with too much stuff. So, I'll try and do it tomorrow. Rumored Janet Yellen departure, yeah, Janet Yelled turned out to be transitory. I think, in retrospect, she's in the wrong job. The Treasury Secretary is the President's negotiator with Congress on economic matters.

Maybe you don't like Mnuchin, or you did like Mnuchin. He was a wheeler dealer. He was well suited for what we want a Treasure Secretary to be. Janet Yellen is not that. She is in the wrong position. Peter principle, this is why she has been struggling at that job as much as she has been. I think that she is an extraordinary economist. She is an extraordinary person who's had an unbelievable life. She was the first woman Fed Reserve Chairman and the first woman Treasury Secretary, and those are hell of an accomplishment, but I'm sorry to say she's just not what we currently want in 2022 in a Treasury Secretary. We want somebody who's going to get Nancy on the phone and get Chuck on the phone, get Mitch on the phone, and get McCarthy on the phone and wheel and deal and get legislation passed. That is not her strong suit, but that's what we want the Treasury Secretary to be. And so, therefore, I think she's in the wrong job and that's why I think that she's going to wind up leaving at the end of the year.

Last question. I think this is the last. This will be the last question I'll take. Yeah, it is the last question.

Scott asks, "How much risk remains in buying the two-year Treasury yield at 4.2%?" Well, it depends on what you mean by risk. If you're going to go out and you're going to repo the whole thing, yeah, there's some risk. If you're going to say, "Look, with the way that these markets are behaving, give me a 4.2% yield and I'll rest well at night," then it's a good deal. And it might go lower in price, higher in yield, and you can buy more and average into a higher yield. But if now's the time to buy a billion and get the repo desk online so that you can repo the whole thing out, and it's a positive carry because repo rates are below that, I think that there is going to be big risk on that. The U.K. found that out yesterday. Remember all my charts in the beginning that the volatility has been extraordinary. The liquidity has been terrible, the financial risk has been high.

What has that all manifested in? Gigantic losses in the bond market. It is not manifesting itself into say what's happening in crude oil. I've argued that the crude oil market is dysfunctional too, but because of the SPR and because of the lack of demand out of China, because of zero COVID, a third of the country's locked down, they're not driving their cars, they're not consuming energy, or consuming very little energy, that dysfunctional market is declining in price, and we are all happy with this. This dysfunctional market is also declining in price, this dysfunctional market being the bond market, and yields are going up and we're unhappy with this. What has been the reaction to terrible high volatility, terrible liquidity, and big amounts of financial stress? Bonds tank. I don't see why if we take the VIX even higher and liquidity even worse, that they'll start to rally. Oh, they could rally for a couple of weeks. They can rally on an oversold bounce, but I don't think it's going to end it until we've rectified that situation.

All right, that's what I've got. Thank you very much. We'll put out the transcript on this, this weekend and I'll talk to you again in this format in a couple of weeks. Bye-bye.

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