Bianco Research L.L.C.
An Arbor Research & Trading Affiliated Company
January 2024 www.biancoresearch.com

# Conference Call

**Will Inflation and Liquidity Prove Sticky?**
January 18, 2024, Conference Call
(This transcript has been lightly edited)

Good morning, everybody. This is Jim Bianco. Welcome to the conference call. A couple of housekeeping items. I'm feeling a little under the weather, so I will apologize ahead of time for any coughing fit that I will have during this call. There is a handout. We had a little bit of technical difficulty, and we got it out late, but it's out. It's on the website. I have it. Hopefully, you can see it on the page as well, and I'll drive along.

If you have any questions during the call, you can send Alex Miletus an email at alex.malitas@ biancoresearch.com, or just hit reply to any of the Bianco Research emails that we send you.

Will inflation and liquidity prove sticky? I have long been under the opinion that the answer is yes. It will prove to be sticky as well. What I want to run through in today's call, I'll just give you kind of an upfront here. The crowd is expecting a recession. They're expecting five-ish rate cuts. They think that the reason that we need these cuts is because the level of interest rates is at a punishingly high level.

Two things. I don't think it's at a punishingly high level, and I'll detail that. I'm not seeing any signs of a soft landing or a hard landing. I'm in the no landing camp that we're going to at trend or maybe a little bit above trend. Remember my cynical take that Wall Street loves to forecast a soft landing because it has no definition. So, I will tell you we're going to have a soft landing, and then in a year I will give you the definition, so I'm right. A hard landing is recession. No landing is a trend. Those have a little bit more of a rigid definition, but the soft landing, you know, predict the soft landing every year and then redefine it to whatever you need it to be.

But I don't think we have one. I think we're going to stay very strong. Retailing is very good. People are not understanding that there's a shift of attitude among retailing. I heard Jim Caron and Morgan Stanley on Bloomberg TV this morning talking about where's the money was coming from. Wall Street’s mistake is that they're looking at excess pandemic savings and they're trying to torture that data into showing that everybody's got all this money burning a hole in their pocket. No, they have a different mindset. They want to spend it. They have a different mindset about their job. They're not afraid about their job and that they'll spend as long as they have a paycheck.

And today's claims number at 187,000, the second lowest number in 50 years, suggests that they shouldn't be worried about their jobs. Inflation, two things about inflation I want to talk about that services inflation continues to be the story. Within that, it continues to be shelter. I'll make the case to you that the shelters numbers are going to stay stickier than people think. Yes, they'll come down, but they're not going to come down nearly as fast as everybody thinks.

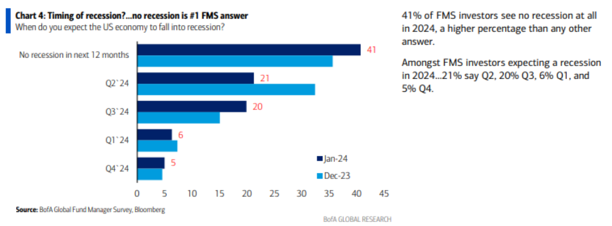
That's because OER and RPR, rents of primary residence, that's a rental inflation number. OER is the housing inflation number. They both use the same survey. I think that those numbers have undercounted the rent gains and the home price gains. They're going to have to stay sticky to close that gap. There is no goods inflation, but I do want to talk about the possibility that goods inflation is going to come back.

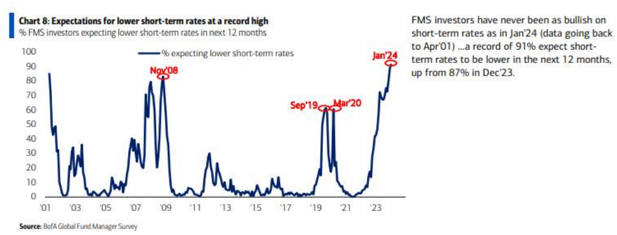
And I'm going to pivot to a bunch of charts to talk about what's happening in the Red Sea. I'm kind of into shipping a little bit. And I think that everybody's missing the boat on this, no pun intended, that it is a bigger deal than we think. The only way it's not a big deal is if you tell me this is going to end in a week or two. But right now, by the way that the shippers are behaving, they don't think it's going to end for months. So, we'll go through that a little bit too and talk a little bit more about inflation.

And then I want to talk about liquidity. I don't think there's a liquidity problem. I think everybody's worried about liquidity. I think it's overstated. The

Fed is worried about liquidity. They are going to taper QT. There's what I think. I don't think it's a big problem. It's what the Fed thinks. They do think it's a bit of a problem and they're going to taper QT. But I will say, if I'm right, no landing, sticky inflation, and they start cutting rates and they taper QT, there will be a bad reaction in the bond market.

So, I think that that's what we have to be careful of. So, this idea that, oh, the Fed's going to cut rates because they don't want Trump to be president. Yes, you can cut rates, but you cut rates in the teeth of inflation, you're going to make Trump president because the bond market's going to have a very bad reaction to that.



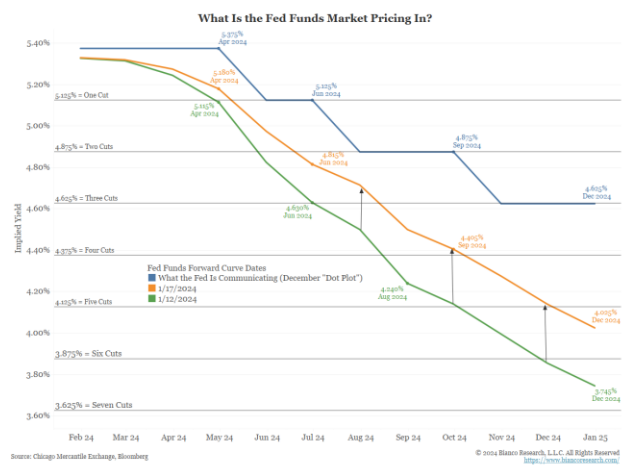




All Right. So, these are some of the things I want to talk about. Let's dig into some of these slides here. This comes from the Bank of America Global Fund Manager Survey. This is for January. It came out two days ago. They asked the timing of a recession. Forty-one percent said that there's going to be no recession in the next year. And of those that answered the question right here, 52% say that there will be a recession in the calendar year 2024.

So, this is an extension of what we've seen in 2023, and that is the recession is six months away. And in six months, we say the recession is six months away. And then in six months, we have a recession, we say, see, that's why I'm a highly paid professional because I'm very good at this stuff. But no, we're still predicting a recession.

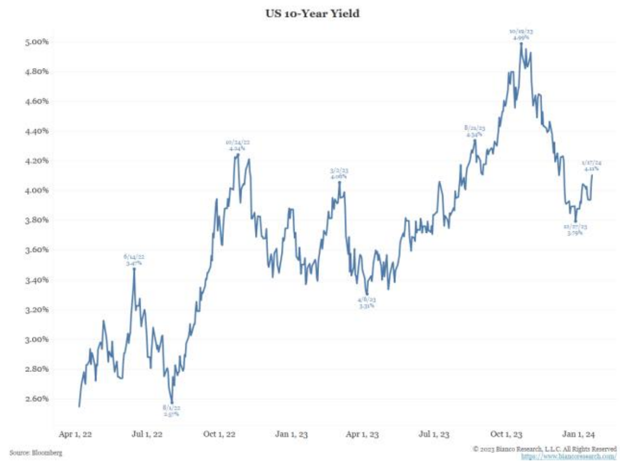
And as such, that's what we see on the top panel from the B of A survey. The bottom panel shows the percentage expectation for lower short-term rates. So, there were something like three hundred managers that were surveyed. Ninety-one percent of them said that in a year, short-term interest rates would be lower. In other words, central banks would be cutting rates, 91%. That number is higher than when we were collapsing during COVID. That number is higher than when we were collapsing during the Great Financial Crisis.

The expectations for rate cuts now are stronger than when the world was imploding in 2020 or in 2008. This is so ingrained in everybody's thinking right now that there have to be rate cuts. Now, clinical take number two, I think the problem with Wall Street forecasts is they tend to forecast what they want, not what's going to happen. What they want is lower rates. But that doesn't mean, because I want it, that we're going to necessarily get it.




So, here's a chart of the Forward Fed Fund Futures Curves. The blue line here is what the Fed communicated with their dot chart, one, two, three rate cuts in 2024. The green line on the chart is where we were on Friday. You could see that we were basically pricing in seven rate cuts. We had just gotten to the seventh rate cut on Friday, and the arrows show you that we've had a big shift upward in this curve in the last couple of days, and that's on the back of some strong retail sales numbers, the lower than expected initial claims, the beat in inflation last week, the beat in payrolls a couple of weeks ago.

The data just keeps coming in stronger than expected. But why are we pessimistic about inflation? We think about a recession, or that we think a recession's coming, and we think that there's going to be so many rate cuts that we have a stronger conviction the Fed's going to cut rates now than when the world was coming apart in 2020 or 2008.




And the answer is we're locked into this mentality. Here's the 10-year yield. We're locked into this mentality that the Fed raises rates until something breaks, and the hike in interest rates has broken things. And so therefore, we have to have rates come down, because we've broken a lot of stuff. So, here's the 10-year yield, just since the Fed started raising rates. "It was under 260, and now it's at 411 right now. You can see we peaked at 499 on October 19th. Excuse me, I'm doing my best here on this call. And you can see that generally, we've had an uptrend in interest rates. We still had a series of highs, lower highs, higher lows, higher highs, higher lows. So that means that the primary trend in interest rates is still higher. I've been of the opinion that August 2020 was the end of the 40-year bull market in bonds. We're in a multi-year bear market in bonds, and we're going to go to higher rates.

I would also say to you, just to interject here too, that at this point is not necessarily a bad thing, because there is an interest rate right now. The Bloomberg Aggregate Index has an average yield of between 465 and 470. There's a yield again. Or as my friend Jim Grant likes to say, who writes Grant's Interest Rate Observer, it's nice to have an interest rate to observe again. And because of that, even if I told you that we're going to go to 5.5, that's been my target, and I guess I'm going to put that on my headstone. But even if we did that, I still think that you can eke out the year with a positive total return, even in the face of that, because you've got a yield, and that yield needs to be protected.

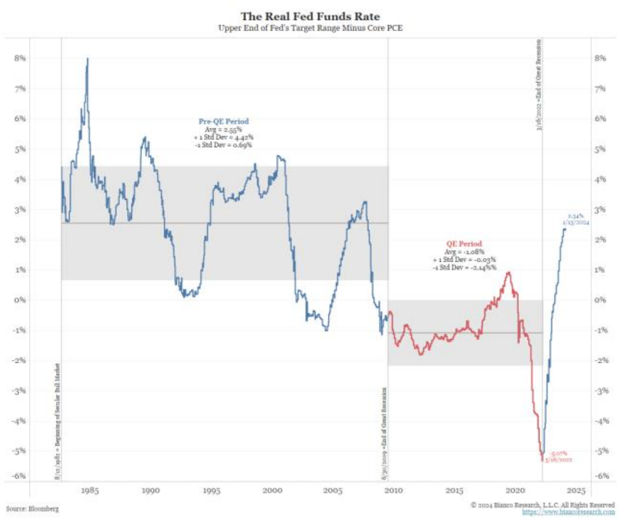
And so, this is not August 2020, when we're going to go up five hundred basis points, and we're starting with no yield. We're going to go up 150 or 50 above the October peak, and we're starting with a 465 to 470 yield. So, it isn't something to be feared that rates are going to go up, because I think we're still in a period of positive total return.


Now slide five is the TIPS yield, the ten-year TIPS yield. No less than Bill Ackman and Mary Daly have basically argued that real rates are punishingly high, and that as inflation comes down, real rates go up. So, the Fed needs to cut rates to march down with inflation. This is another version of the Fed raised rates. Rates are too high. It's crushing the economy. You've got to give us relief. That's why 91% of us are saying we've got to get relief.

When the world was imploding in 2020, and the stock market was falling 11% a day, we still weren't sure the Fed was going to cut rates. But now we think the Fed has to cut rates at this point. Now I think the problem here is an anchoring problem. So, here's the ten-year TIPS yield all the way back to its inception in 1997. That's when it started to trade. That's why this chart goes back that far. From 1997 to 2009, the ten-year TIPS break-even averaged 2.74%. I'm sorry, not the break-even, the yield. The TIPS yield averaged 2.74%. That's this line right here. That was the average real yield that you were getting pre-QE.

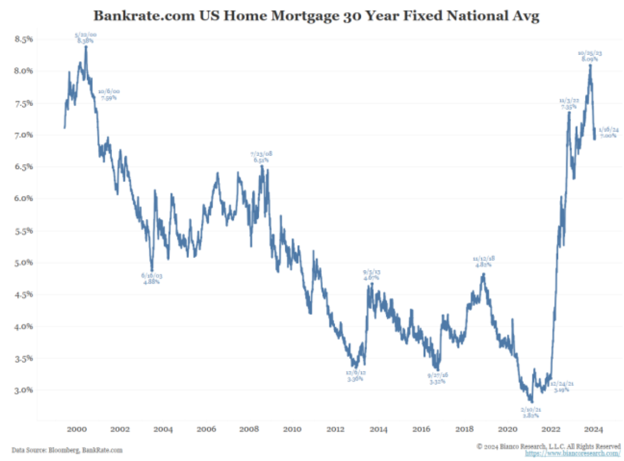
In the QE period, the average real yield you got was thirty-two basis points. What I think happened is we got used to this. And I think that for most managers, this is their career right here, 2009 to 2024. I've been in the business for 15 years, rates are supposed to be at zero forever and ever, amen. And when they go up to 2.5% or 180, that is punishingly too high. That is going to break things. So, the Fed has to cut rates. We're no longer in a QE period. We're in a QT period. And these rates that you're seeing on real rates are exactly what we used to see. In fact, they're a little below average that we used to see prior to QE. So, these are normal interest rates.

As I like to say, this 180 on real yields is normal. The last 14 years of thirty-two basis points were abnormal. That was the incorrect rate. This is more correct than that rate was. This way the Fed likes to look at it. So, this is the targeted Fed funds rate, less core PCE, same thing. Now there's more data. So, I took this back to 1982 when the bull market in stocks began, the mega bull market in stocks. And during that 1982 to 2009 period, when we had a mega bull market in stocks, we had the great moderation that we had ten-year expansions in the economy and falling to moderate inflation for the whole period, we averaged 255 on real funds rates.

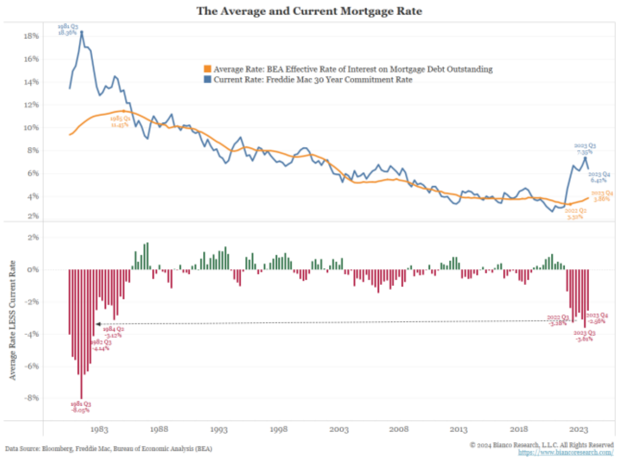



So that means that the funds rate was 2.5% above core PCE. And we boomed. We boomed and we had a great economy. During the QE period from 2009 to 2022, we averaged minus 1%, minus 1%. And we are currently now at 2.34%. Again, we are a little bit below the average for the pre-QE period, but we're all used to this. We're all used to a negative real funds rate that the Fed should keep the funds rate below the inflation rate. And we see this giant move up and we say, this is hurting things, this is crushing things. The Fed has to raise rates.

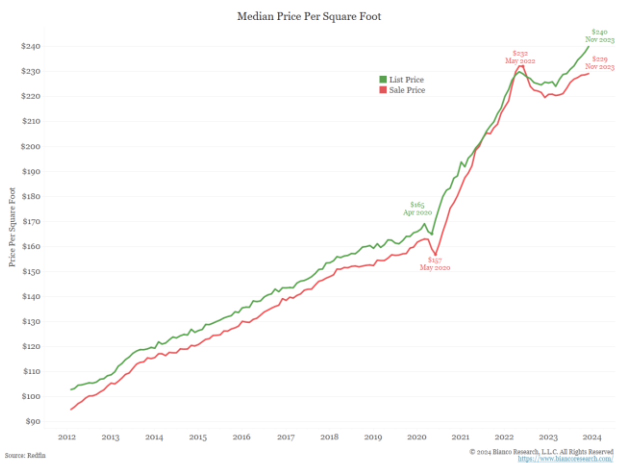
And the problem is the evidence that this is the argument. I understand the argument. I just don't think that the evidence supports it. Here's the 30-year fixed rate mortgage in the United States, according to Bankrate. Peaked at 809. It's currently at exactly 7% right now. Here's Jonathan Gray from Blackstone back in October, basically warning that 8% mortgages are going to crush the consumer and crush the economy. We have to get rates down. Again, more of this sentiment that we've seen.




But if we look at it a little differently, and this chart comes from the Bureau of Economic Analysis and Freddie Mac, what the orange line is, is the average mortgage rate in the United States. So, at the end of the fourth quarter, it was 3.86%. According to Freddie Mac, at the end of the fourth quarter, the average mortgage rate was 642. Now, that's their commitment rate. There's going to be some basis points added on top of that for the mortgage broker or the bank, but that's pretty close. So, the average mortgage in the United States is still under 4%. This shows you that the average mortgage rate is so far under current rates. You got to go back to 1981 to find the last time that happened. And in 1981, it was because we had soaring mortgage rates at 18%.

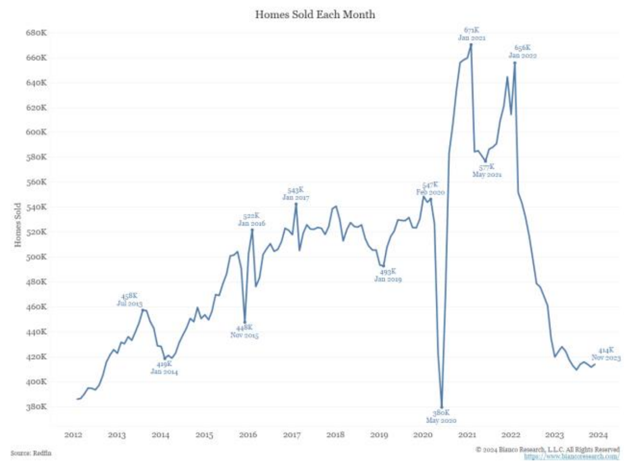



So, what I'm trying to show here in this chart is that mortgage rates, the average mortgage is not a problem. It's the marginal mortgage at the end that may be a problem, that 6% or 7% might be a problem. And the reason I use maybe or might be, if I go to slide nine, this comes from Redfin. Redfin has a lot of alternate data that they provide on the housing market, and it's very good. And one of my favorite metrics that Redfin gives us is the listing price and the sales price of homes per square foot.



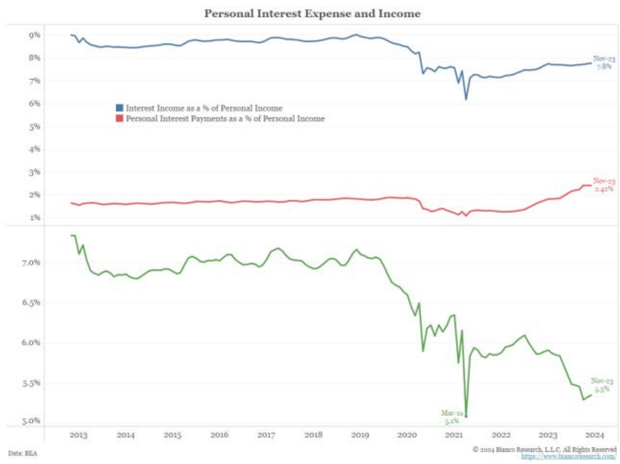

So instead of looking at median home prices, because maybe five bedrooms come on the market and then median home price goes up because they're more expensive homes, then when two or three bedrooms are on the market. So, let's look at the median price per square foot. It peaked in May of twenty-two when the feds started raising rates, it backed off. And what's been happening since the list price went to a new high, $240 a square foot. That's the average list price in the United States. People are looking at higher mortgages and saying, do you know what, I'm going to list my home at a record price. And the sale price of these homes is just off the May 22 record, just a couple of dollars off the May 22 record. Home prices are holding in.

Now brokers are saying, hey Jim, your home is, you want X for your home and mortgage rates are going up. So, the monthly payment's going up. You should maybe touch your price to get people in. And the answer I'm giving is, nope, I want my price. And if you don't give me my $240 a square foot or whatever my price is, even though it's a record, I'll just sit on it. I am not stressed. I am not forced to sell.




So consequently, we look at the number of homes sold, again, this is from Redfin, and they look at the number of homes sold each month according to their website. And you know, what it shows is home prices are falling. I mean, sales, transactions, excuse me, sales or transactions are falling. Yes, because the price is not coming down. "Coming down. And the reason the price, I believe, is not coming down is because homeowners are fine. I am not going to panic out of this home. I am not going to sell it at a fire sale price. I am going to fully price this home. And if no one shows up to look at it, no one shows up to look at it. And maybe that's part of the equation is because when I go buy another home, I'm trading out of my sub 4% mortgage to a 7% mortgage. So, I need that extra dollars in my pocket to compensate me for that. Maybe that's it. But we're not stressed. We are not stressed. So, home prices are holding up. And that's why you're seeing sales fall.

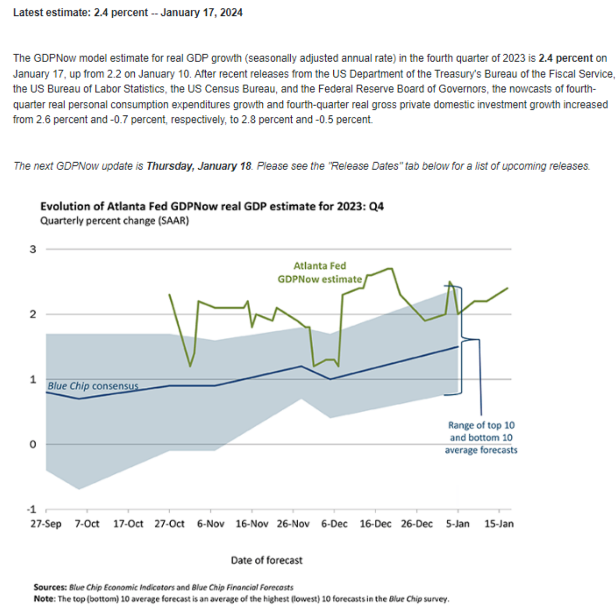
But again, if you were to ask me or anybody a year and a half ago, what would be the state of the home market when we got 7% or 8% mortgages in a year and a half? The answer is a hell of a lot worse than it actually turned out to be. It's actually not been too bad. So, if I go to the next chart here, again, punishing the interest rates. I don't think real rates are that high. I don't think that mortgage rates are that punishing. People are not cutting their home prices.




And if we were to look at personal interest expense and income. So, this comes from the savings report. We all look at rising rates and go, that must be hurting people. And I'll show some charts about that in a second. But if you look at personal income and personal expenses, you net the two together. So here is the percentage, this is the percentage of your paycheck that you're paying out on interest costs. And the percentage of your paycheck that you're paying out in, or that you're receiving in interest income. Interest income is going up, interest expenses are going up, but interest income is going up faster, which is why this chart is falling.

The average person, and I've talked about this with companies as well too. The average company, the average person is actually seeing an improvement in their financial position because interest income is rising faster than interest expense. Now, maybe the motivation of that is the inverted yield curve, because cash is definitely moving, you know, is giving you a big yield as well. But we're not being stressed by these rates. The assumption everybody has, well, Fed's got to cut rates because these real rates are too high, these mortgage rates are punishing. I'm not seeing it.

The old Rudy Dornbusch argument, he was an economist, famous economist who said, you know, that expansions don't die of old age, they're murdered. I currently don't see a murder weapon, although everybody thinks it's interest rates, or a murderer. Now maybe that will show up next week, but it isn't showing up right now.

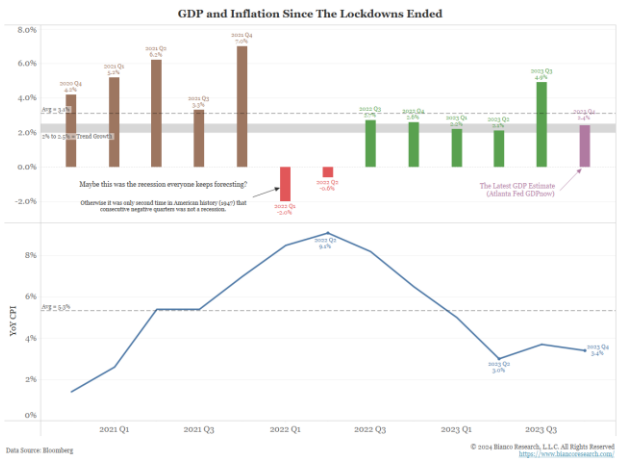



So, let's pivot to the economy. So yesterday, the Atlanta Fed GDP put out their estimate for fourth quarter GDP. And again, GDP is at the top line, all-encompassing numbers. What is the state of the economy? Well, let's measure it by GDP, because all the other numbers feed into it. That's all GDP is. And so, by looking at GDP, we could get a pretty good feel for what's going on.

Now, the GDP model that the Atlanta Fed has, I've likened it, and for those of you who've heard me say it before, I'll just say it quickly. It's kind of like your mile split at 10 miles or fifteen miles in the marathon. If you're running at a six-minute mile pace, what they do is they assume, they say, okay, you're at 15 miles and you've run at a six-minute mile pace. If we assume you will continue at a six-minute mile pace, you may not, you may speed up or slow down, but that's a different question. Your finishing time will be X.

Well, all the data that's come in to date tells us that we're running at a 2.4% GDP level. That's what we're doing. Now, the blue line on this chart is the blue-chip consensus. The consensus on Wall Street is at 1.5%, and there's the range, and it's lagged a little bit because blue chip wants you to buy the real-time data. They'll give it to the Fed for this chart on a lagged basis. So, the street is at 1.5%, and that's confirmed with what Bloomberg says, and Atlanta Fed is 2.4%. So, the data is running faster than what we've seen.

Now, keep in mind, we don't have all the data, and some of the data gets revised. So, sticking with my marathon example, you know, future miles might be speeding up or slowing down, and in this case, we might be revising your mile pace on some of the previous miles as well too. But what we know you've done so far, what we know the economy's done is 2.4%.

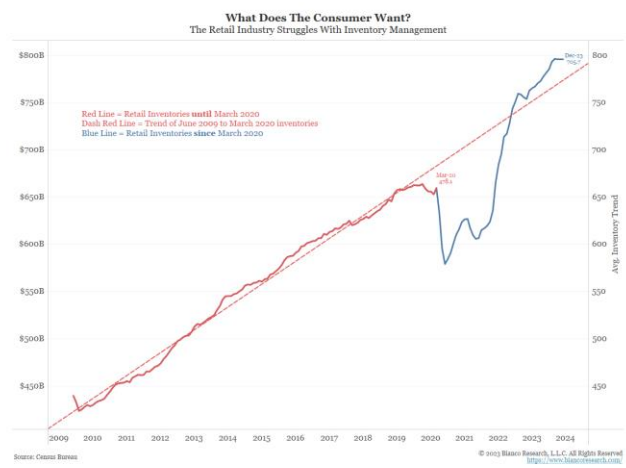



So, if I go to the next chart, here is GDP for the last eleven quarters. I put in the 2.4% from the Atlanta Fed GDP. It's as good an estimate as anything. Is it wrong? Sure. Every estimate is wrong. You know, one of my favorite, George Box, he's a Brit statistician, all models are wrong, but some are useful. Yes, it's wrong, but it's still useful, is what it is. It's still telling me what the run rate is of the data we've gotten so far. There's future data to come, and there's revisions, and that can change it. But that's kind of useful as well.

But there's 2.4%. The green bars are the previous five quarters. Then here are the consecutive negative quarters in the first and second quarter of 2022. I still contend that the recession everybody's looking for happened two years ago. You had consecutive negative quarters; you had a 25% decline in the stock market. You had a blistering sell-off in the bond market that had all the hallmarks of a recession. But we decided, we are being the National Bureau of Economic Research, the PUBAs that get together and proclaim a recession, that that wasn't a recession. There's been twenty-one times in the United States we've had consecutive GDP declines. Two of them, 1947 and 2022, were not recessions. The other nineteen were.

I would argue to you that that probably is the recession, or at a very minimum, the soft landing that everybody's predicting happened two years ago. And then here was the growth rate before that. So, if you look at this chart, trend growth is, trend growth means what should the economy expand at if no one's trying to stimulate it or slow it down? That's its natural rate of expansion. Remember, the natural rate for an economy is to no land. It's to continue to expand. And right now, that's a guess, but most economists say it's between 2% and 2.5%. So that's the shaded area right here, 2% to 2.5%. The dashed line on this chart shows you what we have seen over the last several quarters, 3.1%. We've had no landing. We've been running much above that, even with the two negative quarters in there.

Third quarter was 4.9%. That's way above trend. Everybody thought that we would have a pullback, a payback in the fourth quarter. Payback means well below trend, not pullback to trend like we saw in the previous four quarters. This economy is not a soft landing. It is continuing to move ahead as it has been.



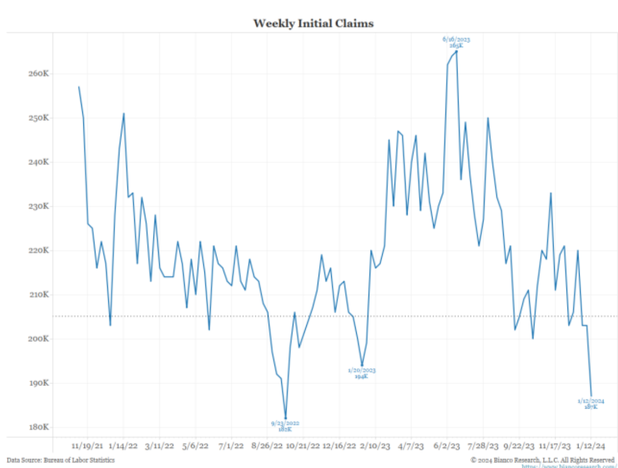

Now what's been going on with it is if we look at this chart here, what does the consumer want? What I show here in red, this is total consumer spending as well. So, what I show here in red is consumer spending. There's a dip during COVID, and it rebounds back to above trend. Consumers are spending. They're spending aggressively. Why are they spending aggressively? And this gets back to my Jim Caron argument, where's the money coming from? It's not that there's extra money. What we're assuming on where's the money coming from is there's a way that consumers spend money. And you can write it in a textbook. It never changes. They react the same in all weather, all the time. Their attitudes have changed. Their attitudes have changed. There's much more willingness to spend. How do I know that? I don't, but I would point to you in 2020.

In 2020, when the stock market went up and savings rates went up, your broker statement went up, your Zillow estimate of your house went up. After the financial crisis, what you did was you looked at the gains that you had and you said, "Oh, I feel good to have this extra cushion, this extra rainy-day fund." And you didn't do anything other than that.

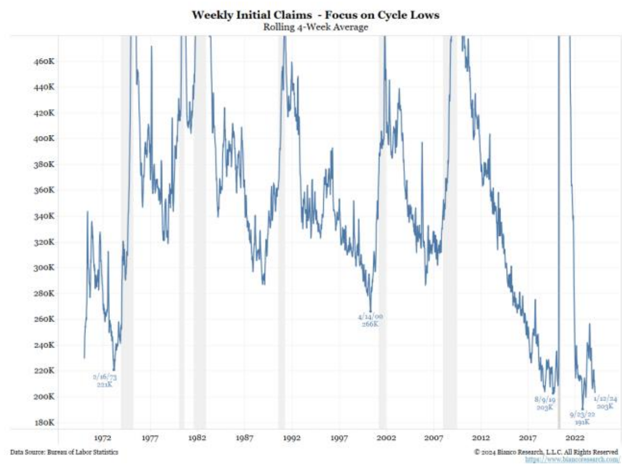
Today, when the stock market goes up or you get money mailed to you, money mailed to you in 2021, when we are fully open, when we're still wearing masks, what did we do with that money? We spent it. We didn't pile it up. We spent it. We speculated in meme stocks. Dave Portnoy was picking letters out of a Scrabble bag. And that's what we did. So, the attitude has changed.

So, you get your brokerage statement, and you see, "Wow, the stock market was up 26% last year, the S&P. My home price went up. I still have a job. What am I going to do about it? I'm going to the Bahamas. I'm buying a new car. I'm spending that money." And that's what we see. What answer is, where's the money coming from? There's no more money than there's ever been. It's an attitude change. And we saw that in 2021.

The attitude after the financial crisis was, make your savings as large as possible. The attitude right now is YOLO. You are only live once. Be sure you're driving a nice car. You have good experiences. You know, you're enjoying life. Spend your money. So, when we get stimulus in the economy, it gets spent. And yes, we feel pretty good about our job.

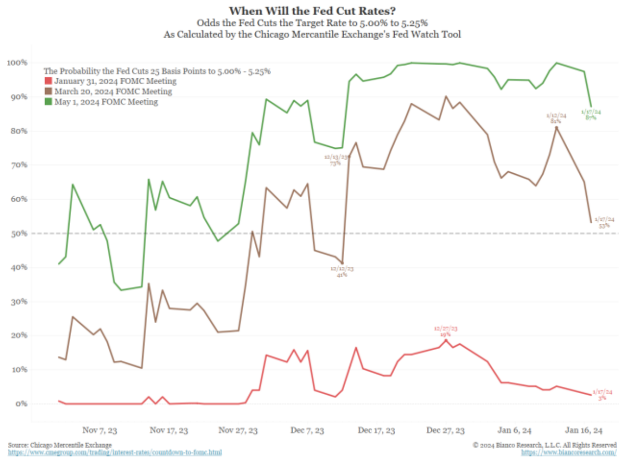



Here is the four-week moving average of initial claims. That's 203,000 four-week average. Again, 187,000 is what we had this morning. Let me go back to that. 187,000. That is the second lowest reading in the last 50 years. Only the reading in September of 2022 at $182,000 was lower.




Now, a lot of people are saying, there's a seasonal in there. It's going to pop back up. Sure. OK, fine. There's a seasonal in there. And it's going to pop back up. So, we're looking at that period from a year ago. It jumped down, and it jumped back up as well. But as this chart shows, this is some of the lowest numbers ever. And again, we anchor.

I would tell you, if you're looking at claims, when do claims kick in and tell us there's a problem with the economy, 350,000 to 400,000? But that's not the way Wall Street's going to do it. Wall Street wants the Fed to cut rates a zillion times. They'll tell you 225,000 that if we got back to that number, that that means that the labor market's weakening. It's not. The labor market is fine. People feel good about the labor market. They're looking at it, and they're saying, I have a paycheck. It's continuing to come in. I've got a little bit of gains. I'm going to spend it. We've seen that with the retail sales numbers. And that's why the economy stays strong.



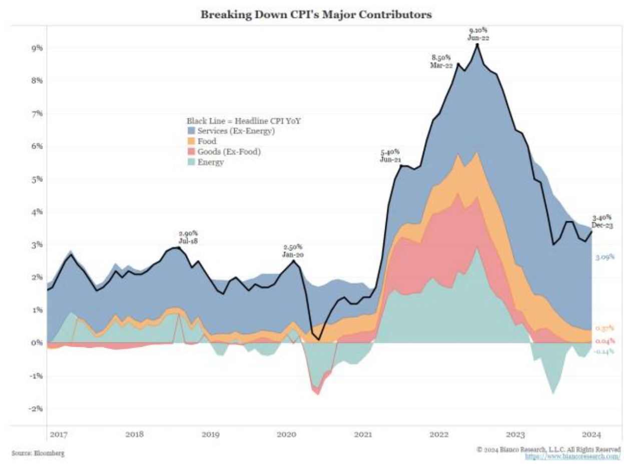

And that's why what we're seeing is the air coming out of the balloon for a March rate cut. So, here's the probability of a rate cut. January 31st is the next meeting. It's 3%. It's never, this is 50% right here. It hasn't been close, even remotely close to 50%. January is not and has never been on the table for a potential rate cut.

How about March 20th? That's in brown. Well, on December 13th, which was the Fed meeting when they said three rate cuts and Jay kind of pivoted and we had a pivot party and that Jay said we're going to, you know, everything is pivoted. We shot well above 50% on that day. And we stayed there all the way through now. And right now, we're weakening back down to the lowest number in a month at around 50-50 is where we are. And today's claims number didn't help much with that. But the air is coming out of the March rate cut.

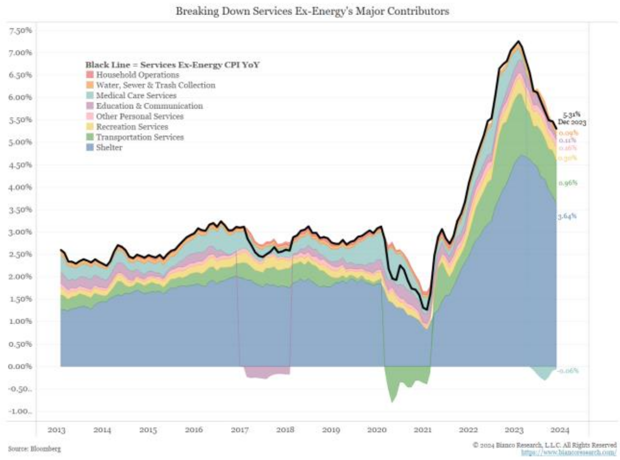
Well, what about May? May was 100% last week. It's at 87% now. But keep in mind, we still have three more payroll and three more CPI reports before we get to May. But this is the way it always is. You know, and Deutsche Bank did a study and they said that the rate cut, that the pivot that everybody's talking about, they argued this is the seventh pivot in the last two years. The first six, we never pivoted. Maybe this one is. But this is the way it is. Yes, we're going to pivot. When's the Fed going to raise cut rates, excuse me, cut rates? In three months. And then in three months, what do you tell me? In three months. And in three months, you tell me? In three months. It never actually arrives.

So, we already wrote off January. We're very close to writing off March. We'll see if May holds up. Back in April. And we'll see if the May numbers hold up. I think if the economy stays strong, they won't hold up.

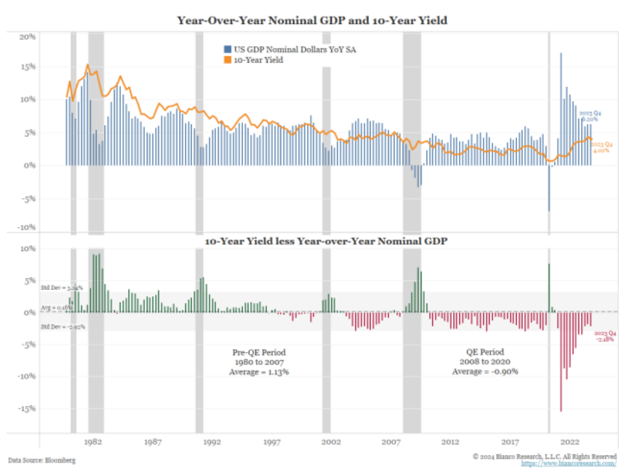
Inflation. I've argued that inflation is sticky. Two things can be true at once with inflation. First of all, there was a transitory element of inflation as it went up to 9% and it came back down. But once that transitory element is dissipated, and it already is, it is gone, we are at a much higher level than we saw pre-pandemic. So, what we're seeing with the inflation rate right now is higher numbers.



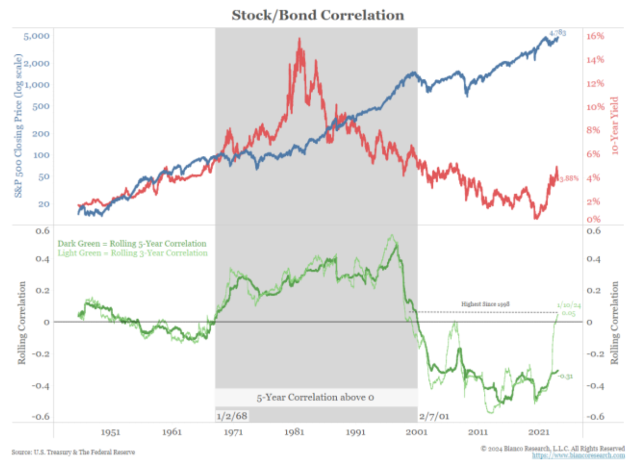

Now, where's the inflation coming from? Well, here's a breakdown of inflation. Services, X energy is the blue part. That's all of the that's virtually all of the inflation right now. Food is a little bit of inflation. But the big one is goods. Goods inflation, keep that in mind, I'm going to revisit that in a second, was a big problem during the transitory element of inflation and it's kind of dissipated. And I want to make the case to you that goods inflation could continue to come back up. But right now, it's services X energy. That's what's driving the inflation rate right now to 3.4%.




Services X energy has broken down a little bit more. The shelter component is the vast majority of  that is the vast majority of services X energy. It's shelter that is really driving inflation. And everybody looks at  before I talk about shelter, I do want to talk about that if we are sticking with a 3% inflation world and we are sticking with a 2, 2.5% real growth world, nominal GDP should come in at between 5 and 6%. The midpoint of that is 5.5%. That's where I got my target for the 10-year, is that I think that we're in a 5 to 6% nominal GDP world. Again, 3-ish is inflation, two to  let me be a little bit more specific here. So, you see the number 3 to 3.5 is where the inflation rate is. 2 to 2.5 is where the growth of the economy is. No landing, no soft landing. 5 to 6 is what that target is. 5.5 is the midpoint. That's where I produce the 10-year yield number.




Now, keep in mind here that here is in orange the 10-year yield. And this is in blue year-over-year nominal GDP, nominal again real plus inflation. They track each other very well. Pre-QE, that you saw that the average pre-QE was that nominal GDP, our interest rates would be about one hundred basis points above nominal GDP. During the QE period, they were about one hundred basis points below nominal GDP. 5, 6%, people have said to me, well, why can't rates go to four? Well, because we're not in QE anymore. Now, I'm not going to say that they need to go to 6.5, 100 basis points above 5 and 6. I'll just say that they have to be equal to it for right now. So, that's where I get the 5.5% number. That's why if inflation stays at 3 to 3.5, 2.5 on growth, that's where I ultimately think we're going when it comes to interest rates over the course of the year.




The market sees this as well, too. So, this chart shows the stock-bond correlation. I've used this chart many times. The blue line is S&P, goes back to World War II. World War II is when it goes back, so there's 80 years of data here. So, the blue line is S&P. The orange and red line is the 10-year yield. And then the bottom is the correlation of prices. And so, during the 1968 to 2001 period, stock and bond prices were correlated. They went up and down together. Why? That was the inflation mindset. Alex wrote a good piece about this last week. I think Thursday, a week ago today, it's on our website. During that period, when we were worried about inflation, the seventies, both stocks and bonds went down together. When we were relieved there was no inflation, they both went up together.

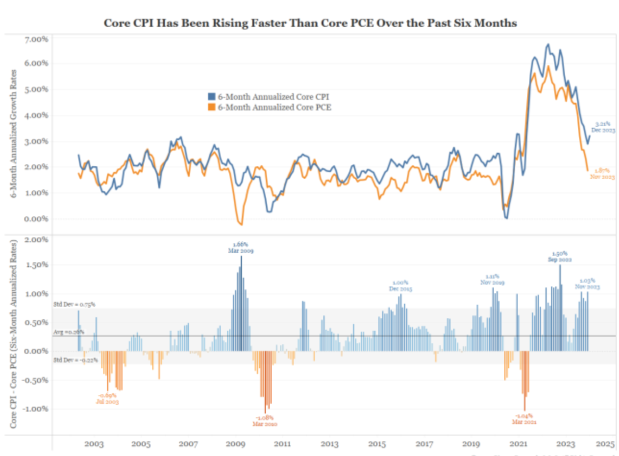
Well, that changed around 2001. The tech bust, 9-11, the Asian financial crisis, the Russian debt moratorium, and deflation became the mindset. So, we were always worried about deflation. And there's still a lot of people that are worried about deflation. Ship sailed many, many years ago. We had a period of deflation worries, and it's gone. And we're now in a period of inflation worries.

So, in the deflation world, the correlation between stocks and bonds is negative. So, when you're worried about deflation, stocks go down, bonds, safe assets rally. When you're relieved there is no deflation, risk assets like stocks go up, safe assets like bonds go down. And that negative correlation bred the risk parity trade, the 60-40 portfolio, even the concept of risk on, risk off, was all driven by the idea in the first place that there's a negative correlation.

Well, the dark line, the dark green line is the five-year correlation. The light green line is the three-year correlation. I use three because there is seasonality, and that's why I didn't use two and a half to go with half of the five-year. It is the highest it's been since 1998. The correlations are starting to go positive again. That means the stock and bond prices move up and down together. The 60-40 portfolio, does it still apply? Yes. All the rules you've been using for the last 25 years need to be changed.

What bonds are is a high-yield, low-beta version of the stock market. They will protect you because they will decline in the next inflationary period, but the big yield should offset it and maybe provide you either a small loss or no loss. If you go back to the late seventies and people hated bonds, they were given positive returns because they had gigantic yields on them. That's what I think is going to happen now, is that you're going to get those positive yields.

That's what the three-year does. One, we're relieved there is no inflation. Both will rally at the same time. But if you're pining for that negative correlation, the ship sailed. Era is over.

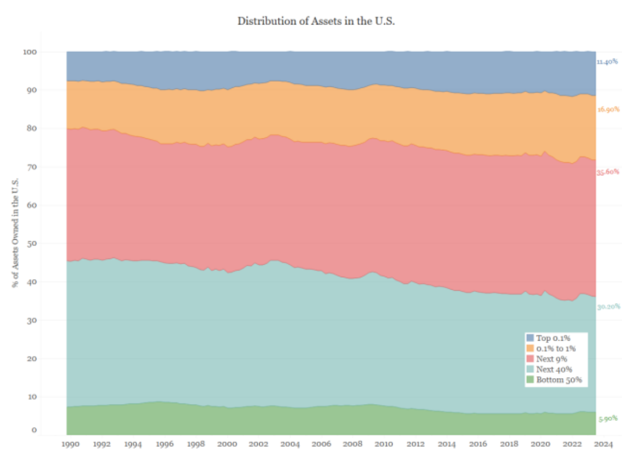



Well, wait a minute, isn't inflation done? Because we're all looking at the six-month annualized rate. This is the six-month annualized rate of core PCE, the Fed's target. It's 1.9%. It has hit the Fed's target. I 100% agree with Chris Waller two days ago. You just don't make one print on a six-month basis at 1.9% and say, we won, which is, by the way, exactly what Paul Krugman has been doing on his Twitter feed. Inflation has been defeated. It's over. We won. You lost. Team Transitory won. Of course, I've been dead wrong about it for the last five years, and he's just promoting the same incorrect argument that he's been doing as well.

But let's look at the six-month annualized of core CPI. It's 3.2. The difference between the two right now is a little over 1%. There's the average. The average is about twenty basis points, and it's well above one standard deviation.

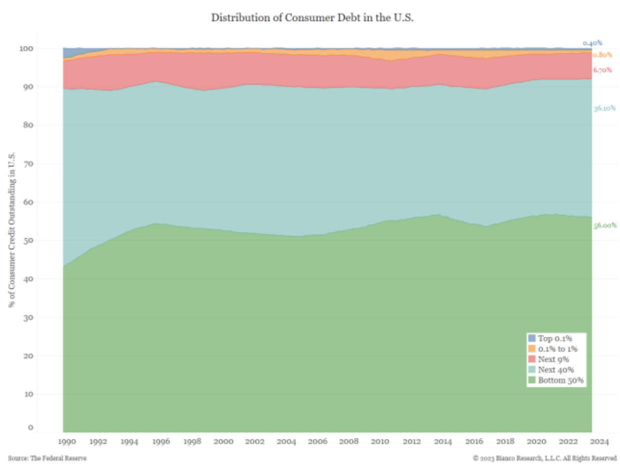
Bottom line with this measure is that what you're seeing here is, first of all, PCE and CPI use the same raw inputs. They use the same survey. They just weigh them differently, is what they do. I don't think that PCE could go down much more unless CPI goes down. Yes, in theory, we could blow this spread out to record levels, but I don't think we're going to. This blue line has to come down, but I think there's every indication, as you see right there, that it might be bottoming.

What we did was, on one measure, on one six-month, not even year-over-year, we hit 2%, and we bounced off of it. What about the argument that the Fed will just change the target to 3%, say mission accomplished, and start cutting rates? I think that would be disastrous for the Fed if they did that.



This is from the Federal Reserve. It comes from their survey of consumer finances. Distribution of assets in the United States. The top one-tenth of 1% owns 11% of the assets. The top 1%, which is the one-tenth of 1% and them, they own 28% of all assets in the United States. Over a quarter of the assets in the United States are held by 1%, the top 1% in income. If you go from the next 9%, from 1% to 9%, what you see here is something along the lines of about two-thirds of all the assets in the United States are held by 10% of the population.

Ten percent of the population benefits when stock and bond prices go up. Now, that's assets. The bottom 50% only own 5% of the assets. The top half of the country owns 95% of the assets. The bottom half of the country, again, half up top is income, own 5% of the assets.




Now here's the disturbing part. What about a distribution of debt? Who has the debt? Well, if you look at this chart, let's just go right to it. The bottom 50% own 5% of the assets, they own 5% of the assets. They have 56% of the debt. So, the rich have assets, the poor have debt, is the way they do it. And as Allied Bank found, 62% of the American public life's paycheck to paycheck. That's all these people in the bottom 50% that own all the debt. The top 1% of 1% have 0.4% of the debt. The top 1% have 1.2% of the debt and 28% of the assets.

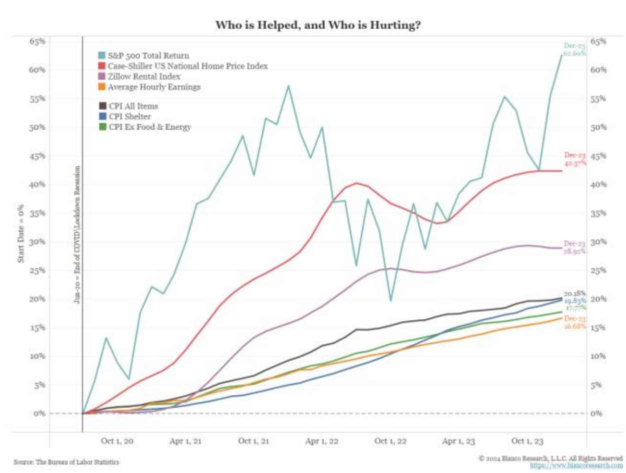
Now that's the way it always has been. So, this is not new. But as inflation becomes a problem and has interest rates stay up, it's a problem for the bottom half because they own the debt. When I showed you interest income rising faster than interest expense, what is really going on is when interest rates go up, rich people benefit, and stock prices go up and they benefit. When interest rates go up, poor people, the bottom 50% that live paycheck to paycheck, lose. And that is a problem.

So, if the Fed wants to say, let's change the rate to 3%, let me turn to the bottom half of the country and say, I'm done. I did all I can. Good luck. Godspeed. No, I think that would be a disaster for the Fed.

If you remember in 2022, I used to say, and that was kind of a meme that went around the market, do your duty, lose money with dignity, stop spending, bring down inflation. That's what was going on with stock and bond prices getting crushed. But we seem to be over with it.

Now, that feeds me into a question that's here right now. Jim asks, as you say, the consumers are spending and they are confident, but some polls show they don't like the economy. They don't like Bidenomics. What do you think explains this difference? This explains it. Most of the pollsters are asking the bottom 50%. They don't discriminate among income. The bottom 50% are very unhappy with what's going on because they're losing. The top 10% are very happy.

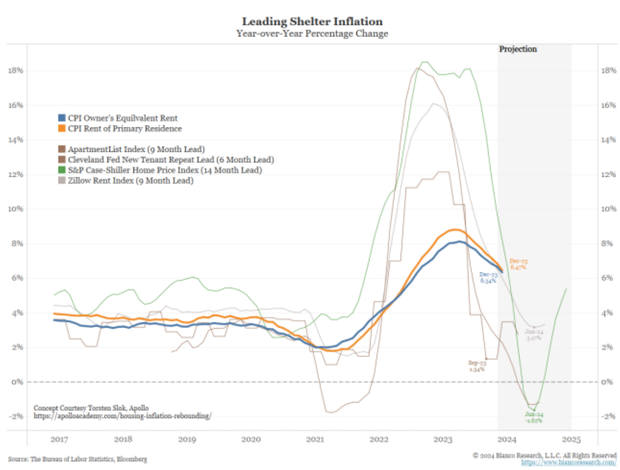
The other thing to keep in mind, too, is the top 10% do the vast majority of retail sales. Somebody said one%ers cost eleven times more than the bottom fifty. So, if two women are in a mall that are in the 1%, they're spending more than twenty-two bottom 50% people in that mall. So that's why the retail sales numbers are moving along. And you can see it from this chart here.




So, it's a message chart. And what it shows you is the cumulative gains. So I went back to June of 2020, two months after the recession ended. I tried not to be political and go to November, but it's kind of the same thing if you want to think about it that way. And the distortions of the shutdown, you know, lockdown, restart were a little bit behind us.

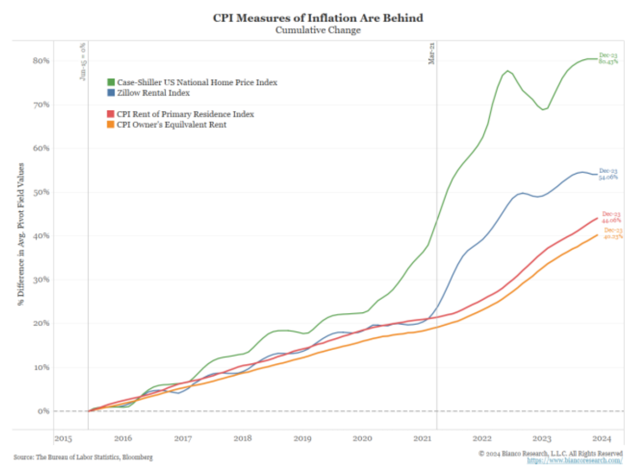
What's happened since June of 2020? The S&P is up 62%. The Case-Shiller Home Price Index is up 42%, the top 10%. Thank you very much. My home's up 40% in value on average. My portfolio's up 62% on average. Folio's up 62% since the lockdowns ended. Rents are up 28%, 29% during that period as well. Now, let's look at these charts, let's look at these lines on the bottom. Inflation is up 20%, shelter is up 19% and 17%, and average hourly earnings are up 16%. So, the bottom 50% have gotten a 16% pay raise. They see that everything costs 20% more. They have a real loss. They can't buy as many things as they could have bought in June of 2020. They don't own stocks. They don't own a home free of a crushing mortgage. They don't benefit from this. They just get crushed. That's why Biden's numbers are in the tank. It's the bottom 50% that are very unhappy.

And if Jay wants to go out and say, change the target to three, sorry, bottom 50%, but, you know, these people that own stocks, they've suffered enough. We need to give them some more gains. We need to get these big fat home prices up even more. It's their turn now. I don't think that that would be disastrous.

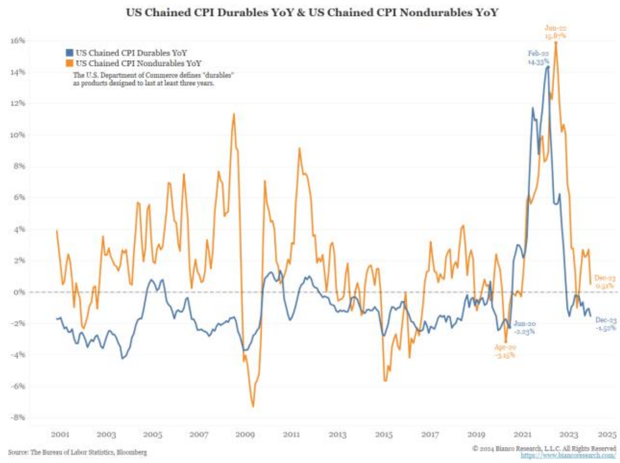



So let me turn to a big part of inflation. And let me go back here and just remind you on my inflation chart that services x energy is the big part of inflation. And shelter is the big part of services x energy. As well too. So, moving on to this chart here. This is a popular chart on Wall Street. And what it basically shows you is in blue and in orange is that OER and RPR on a year over year basis peaked and they're heading down. And then it shows you a bunch of real time measures of rents. The apartment.com measure, the Cleveland Fed has a new tenant repeat index, Case-Shiller I put in there and the Zillow rent index. And they're all led by various numbers. Nine months, 14, six, nine. And to be fair, I got those numbers from Torsten Slott at Apollo.

And it shows you that all these numbers are heading down. Although a couple of these have already bottomed out. And so, everybody thinks that OER and RPR are going to keep heading lower. And they're going to keep squashing inflation to the last mile to get it from 3% to 2%. I've actually joked that I think we've already hit the last mile. We're done or very, very close to being done with the last mile. But I'm arguing this is the wrong way to look at it. The right way to look at it is this way.

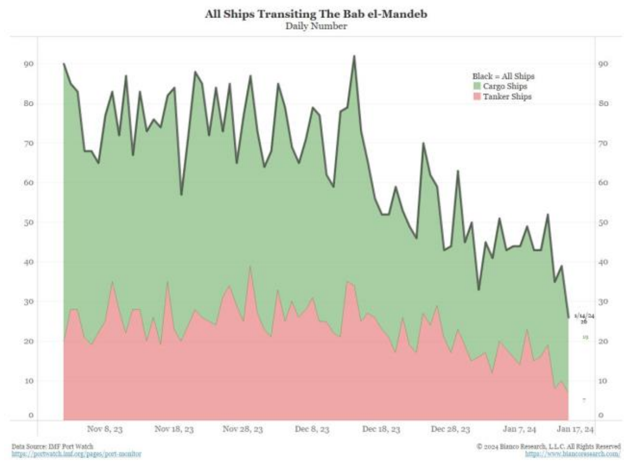



So, I went back to 2015 when Case-Shiller and Zillow started kicking in. And they tracked from 2015 to March of 2021. Their cumulative gains tracked well with the cumulative gains of OER and RPR. The inflation measures of housing inflation and rental inflation. Both of these numbers took off way above OER and RPR. The OER and RPR are undercounting the cumulative gains. That's why I think what's going to happen is this is going to come down much slower than people think. Because what they need to do is they need these numbers to go up faster than these numbers. And you can see Zillow's already starting to flatten. Maybe Case-Shiller's flattening out to close the gap. Because they're still undercounting the cumulative amount of inflation. That's going to keep the numbers sticky and inflation. And that is going to frustrate the Fed.

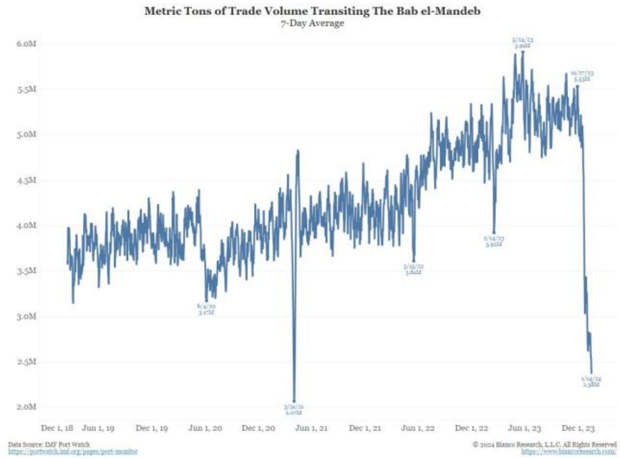



Good inflation. So, there's two types of goods. There are durable goods, which is anything that lasts longer than three years. That's the definition by the Commerce Department of durable. Non-durable is anything that lasts less than three years. In 2022, they hit 16% and 14% on a year-over-year basis. And they've come down to somewhere around zero. That was the supply chain problems with the reopening of the economy, getting rid of the supply chain problems. That was the transitory problems that we saw in the economy. I agree that is what those were. But people are making a big mistake. There is another set of transitory problems coming in goods inflation. And it's what's happening in the Red Sea.

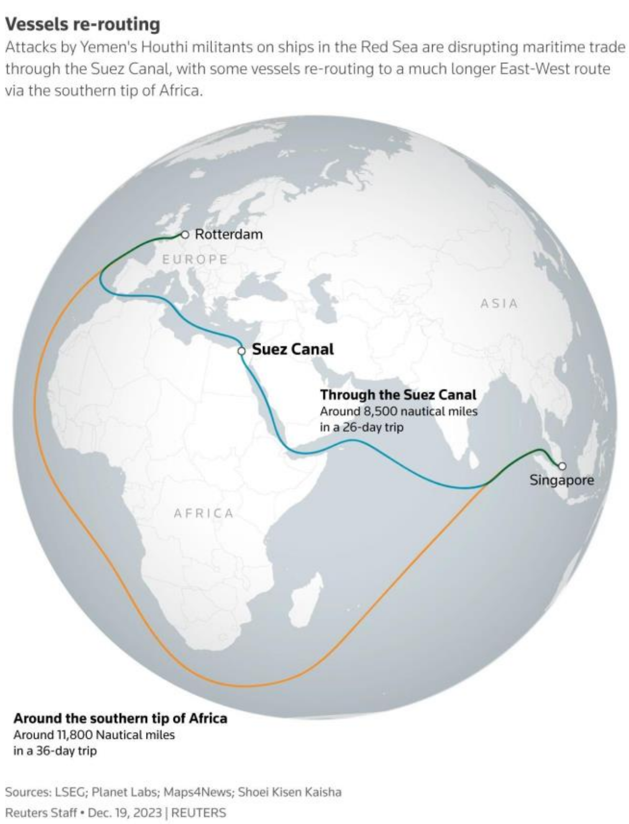

So, here's the Gulf of Aden. Here's the Red Sea. This is the southern part of the Red Sea. This little area right here is sixteen miles wide. And it's called the Bab al-Mandab, is what it's called, between Yemen and Djibouti, right here. This is where the Houthis are launching all the drones and the missiles right now at all of the shipping that's going through this area. The top of the Red Sea, so the Bab al-Mandab is down there, is the Suez Canal. This accounts for 12% of all shipping in the world. And 30%, 30% of all container shipping in the world goes through the Bab al-Mandab and up through the Suez. That's Asia to Europe, finished goods coming from Asia to Europe.



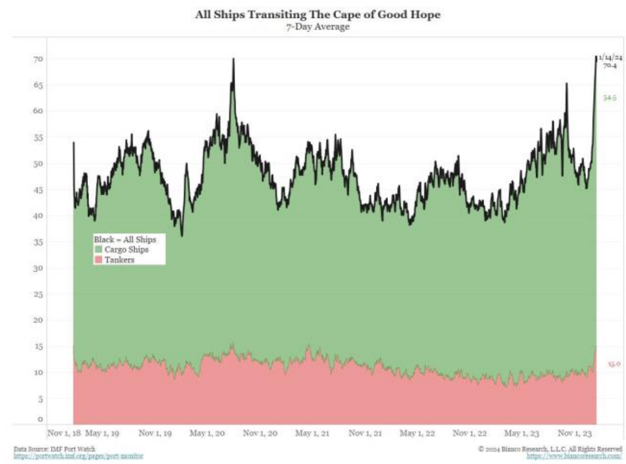

The number of ships tracking through the Bab al-Mandab. IMF actually in September mentioned a very good daily update called Port Watch. Most ships have a GPS, which is called AIS. But sometimes they turn them off, and they're really turning them off. But they also use satellite images. And they track on a daily basis how many ships are going through the Bab al-Mandab. Now, before all of this happened, about 80 a day were going through there. And this breaks down into cargo ships, which would include container ships, and tankers right here. Well, we've gone from 80 a day down to 26 a day. Now, people are arguing, well, it's not zero. So, everything's fine. It's down by two thirds.




And they also give you an estimate of the amount of tonnage that is going through the Bab al-Mandab. And it's down from five million tons a day flowing through it in all these container ships and tankers, halved it down to something like two and a half million. Now, where is everything going? It's going around Africa. So again, 30% of all shipping goes through Bab al-Mandab and Suez to Europe. If that is, on average, an 8,500-mile trip, and it takes 26 days is what this shows you here. Well, if they're going to go around Africa, it's now 11,800 miles, and it takes an extra 10 days, 20 days if you consider the round trip.




Now, what's been happening is we've been seeing signs that everybody's going around Africa. This is the number of ships that are going around the Cape of Good Hope. Again, the Cape of Good Hope is right here at the bottom of Africa. I know this is high school geography again. It is spiked to a record number of ships, 70 a day, which are going around the Cape of Good Hope.




But here's the problem. Boy, everything is really screwed up. Who's going through? Let me go back to this chart here. Who's going through Bab al-Mandab? Three types of ships are going through. Russian tankers that are violating the sanctions from the Ukraine war that are sending oil to India and China, Russia fills the tankers, they turn off their AIS, and they go through the Suez Canal, and they go through the Bab al-Mandab, and they go to India and China and deliver their oil, and Putin gets paid for it. And they turn off their AIS, but they're getting picked up by satellites. Chinese ships, Chinese container ships, Costco, because the Houthis are not shooting at either one of those types of ships. Chinese ships can go through. Costco is the big Chinese shipper. Russian oil tankers can go through.

And a third one, CGM, is a French container ship line, and the French have warships there, and their ships are on the hip of all of the French container ships escorting them through. This is what's so screwed up. The UK and the US are the ones fighting the Houthis. And now, keep in mind, who will go through the Bab al-Mandab? Anybody that can get war insurance. You have insurance on your ship, and its cargo, but it is not covered for war. So, if the Houthis hit your ship and damage the cargo or sink it, it's not covered by your insurance. You need a separate war insurance policy. Those policies are up from 0.02% to 1%, fifty times is what they're up right now. One percent of the cost of the ship and the cargo from 0.02 is where they've gone right now. And so, it has become prohibitively expensive for those ships.

That's why they're going around. If I were to go back to this chart, that's why they're going around Africa. What's screwed up about this is on your AIS, you can put a message, and these ships are putting messages, "Chinese owned, not affiliated with Israel," and now they're starting to say, "not affiliated with the US or the UK." The shipping insurers in London, no less, are not insuring US and UK ships, forcing them around Africa.

So, here's how unbelievably screwed up this is. The US military is fighting with the Houthis to keep the shipping lanes open for the Russians, violating sanctions, and the Chinese. And the American and UK shippers are going an extra 3,500 miles around Africa. We are protecting the Chinese and the Russians, and we've already lost two sailors. Two Navy SEALs are missing in the Bab El-Mandab, they're still searching for them, it's been several days. I hope they find them, but it doesn't look good.

And we're doing that for the Chinese, and we're doing that for the Russians. But the US and the shippers, the big Japanese shippers, Nippon, and the rest, announced yesterday they're going around Africa too. So, we are taking China, and we are taking Russia, who's violating sanctions, and protecting them with the US military and US military lives, at least two of them right now. We are not opening it up to the US and the UK. That is completely a disastrous policy, is what we got.

Now, that can be fixed, but right now, that's how bad it's gone. And today's the 18th. November 18th, two months ago to today, was the first Houthi attack on a ship. So, this has been going on for two months, and I would argue the worst is ever today. It's not getting better, it's getting worse, and now they can't even get insurance. And now we're putting American Navy sailors at risk to protect Chinese and Russian shipping, but not American shipping. Not UK shipping. They're going around Africa.

Why does this matter? Now, everybody will tell you it's no big deal, because everybody's got a vested interest in saying that it's no big deal. And what's their vested interest? The shippers have access capacity. So, if they go around Africa, what happens is it's an extra 10 days, but then 10 more days to go back. Seventy percent of all container ships are basically on a long-term contract. They basically go back and forth between Europe and Asia. And on average, they go back and forth six times a year, because it takes 26 days to go to Europe, unload, get a bunch of empty containers, sail back to China, load back up, sail back to Europe. Just go back and forth.

Well, if they're going to go around Africa, now they can't do six trips a year. They can only do four or five. So those extra one or two trips have to be made up in what's called the spot market, and that's unused on excess capacity ships. Those excess capacity ships are what you see, what everybody talks about, shipping rates are spiky. So, the shippers are like this. They've got too many ships. They've got excess capacity. This solves their excess capacity problem.

So, the shippers come out and say, no big deal. 100% of no ship has been sunk. No containers fell into the sea. You're going to get your stuff. You're going to get your stuff maybe 10 days late, maybe two weeks late, but you're going to get it. So don't worry about it.

The Navy, hey, the Navy's not going to tell you that they can't open the shipping lanes to the US and UK. They can't. And the Japanese. Yesterday, the Japanese announced they're going around Africa. The UK insurers will not insure the US and UK. They're going around Africa. But we're in there fighting and at risk. So, the Chinese, I mean, I cannot, you know, it blows my mind how upside down this policy is right now.

We have, the Navy has to understand that the definition of success is American and UK shippers can go through the bottom end and get reasonably priced war insurance. The reason they're going around Africa is the war insurance is so expensive. It's cheaper to go around Africa for the shipper. And the shipper will say, you'll get your stuff. The Navy will say, we got it under control. And Wall Street will say, see, there's no big deal here.

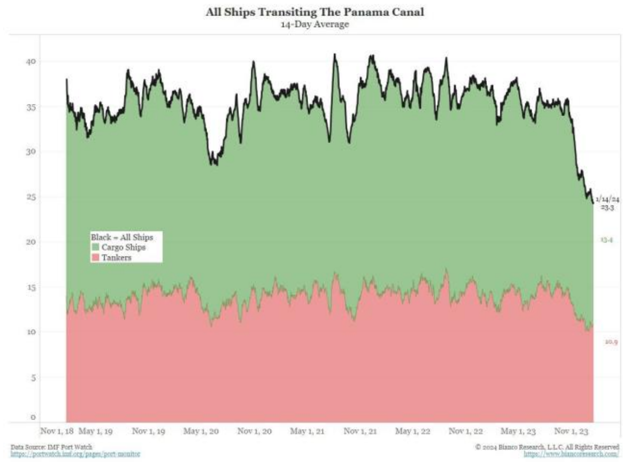
But the problem is most of the stuff that goes around Africa arrives late, we live in a just-in-time world. Tesla, Volvo, and Michelin have already announced, Tesla, Volvo, and Michelin have already announced they're going to idle capacity somewhere in February because the stuff that they need in just-in-time will not arrive. Stellantis, the old Chrysler, is air freighting in stuff from Asia, and it's like ten times more expensive to air freight, which is why we use container ships, because they don't want to shut down production. Crocs and Next, the UK company Next, have announced they may have to shut down production.

But everybody wants to say, it's fine, no big deal. No manufacturer wants to come out and say, we have to shut down production and watch their stock get hit. It reminds me of that old joke, you know, the window washer falls from a high floor. What does he say when he crosses the third story? So far, so good. And that's what everybody's saying. Yes, so far, so good. OK, but is the pavement coming up? And are you going to hit the pavement? That's what I want to know.

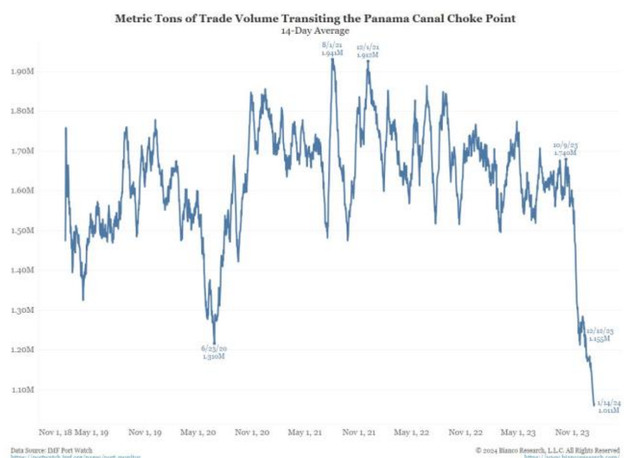
And ultimately, if this goes on for weeks or months, it is going to lead to problems. And it's going to lead to problems in just-in-time inventory and shortages. And people have money, and they demand things, and they're going to start bidding for them. And goods inflation is going to return. It is not going to return to the extent that it did in 2020. But it's enough that it's going to give me my 3% to 3.5% number, because goods inflation is coming back. And it's going to frustrate the bunch of Fed rate hikes that everybody's looking for. And it's going to frustrate the soft-landing crowd. It's going to frustrate the last mile crowd that we're at 3%, and we're going to 2% on inflation.

Now, this is a Europe problem, because all these ships, 30% of all the containers, this is Asia to Europe through the Suez. It's not a US problem. Wrong, because 35% of all of the containers that go to Europe then get put on another ship and go to New York, Charleston, or Savannah, the three big East Coast ports. Why do they go to the three big East Coast ports? Because there's a problem with the Panama Canal.

Here's an image of the Panama Canal. And you can see how it goes. There's a series of locks. There's Lake Gatun, and then another series of locks. Every time these locks are used, and then you sail across the lake and go on the lock, the equivalent of four hundred swimming pools of water is emptied into the ocean. The problem is Lake Gatun is at 81 feet, not eighty-seven feet. Here's the last 20 years. It's at the lowest it's ever been. Here's the concerning part. This is the rainy season. This is when it should be at the highest it should be for the year, and it's lower than it's ever been.




So consequently, the number of ships going through the Panama Canal is down to 23 a day. And a lot of the bigger ships have to unload on one side, so they don't draft, they don't go down as deep, and then reload on the other side, or come with two-thirds cargo. So, if you look at the amount of volume going through the Panama Canal, the Panama Canal's volume is lower than it was when we were shut down in 2020.




So, get back to the argument, this doesn't affect the U.S. Yeah, this is why they've been sending stuff to Europe and putting it on boats in Europe and sending it to the U.S., because they cannot get the throughput on the Panama Canal because of the low water levels. So now it's going to impact the U.S. What they're talking about is there's going to be another...There's a surge of shipping to the West Coast, and we're going to try and put it on rail, either coming into Oakland, Long Beach, Los Angeles, Seattle-Tacoma, or maybe Vancouver. We tried that two years ago, and we had backlogs, we had ships waiting, and everything else. It's easier said than done. So, there is a goods problem.


But what we learned, and this gets back to my mentality, when we had 2020, and here's an interesting statistic for you. I should have put the chart together for it in 2020. And here's all the choking points. So far, I've covered Panama, the Cape of Good Hope, Balboa Mendez, Suez Canal is what we've covered. We've covered half the choke points in the world right now, and you can see that things are changing.

But let me get back to what happened in 2020. In September of 2020, auto production in the United States, all auto production and light trucks was 200,000 units a month. By the end of 2021, it was 84,000 units a month. It was not, I'm just going to go back to my chart here really quick. It was not due to the idea of this chart here. It wasn't because the economy was weak, the economy was booming. We were printing 4%, 5%, and 6%, and even a 7% number on GDP.

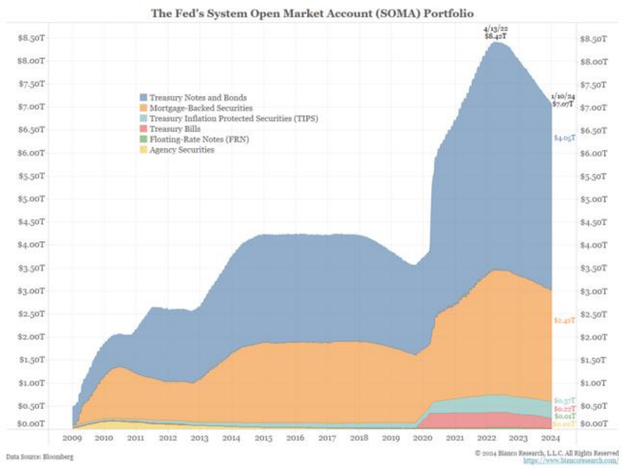
So, the reason that we went from 200,000 auto production to eighty-four between late twenty and late twenty-one was that we had a just-in-time shipping problem. We couldn't get semis, couldn't get parts. They had to slow down production. What did we find during that period? That in mid-twenty-one, something like 90% of cars sold above sticker. Some of them are as much as $10,000 above sticker. When things get crunched, what do the American public do? They pay. They pay up, and they pay because they want it.

So, if goods are going to be crunched, they're going to pay for them. They're not going to substitute out of them. That is the top 10% are going to pay for them. And why are the top 10% going to pay for them? Because they want them. They've made big gains in the stock market. They've got big gains in their homes, and they're going to pay up. We're going to have another round of good's inflation that is what's going to happen here. As we move forward.

So, I think that the story here is, yes, you tell me that this problem with Bob Elmendam and the Red Sea ends in a week or two, and it's not a big deal. But the definition of ends is UK, US, Japanese shippers can go through the Red Sea. In order to do that, they need warrants. They cannot risk a $100 million ship with $200 million of cargo, and the Houthis get lucky, and then some shippers got to write a check for $300 million. They cannot risk that. So, they go around Africa.

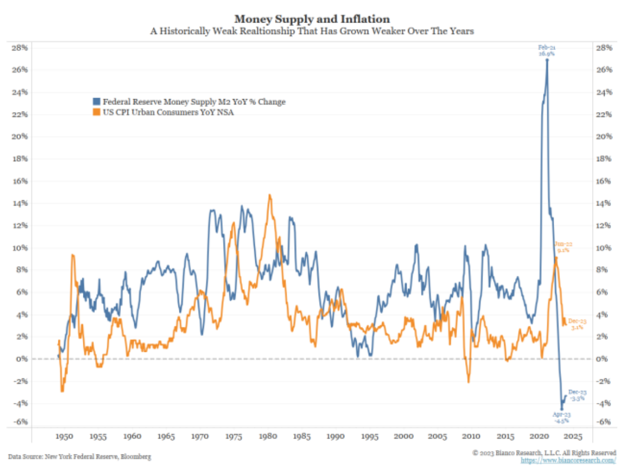
Are we anywhere near that? Yesterday, another ship was hit by a missile. Yesterday, the Japanese said they're going around Africa. And now the ships that are sailing through are telling us on our AIS, Chinese owned, not US. All of a sudden, it is a blight. It is an embarrassment to say that you're US owned. If you really want to know when this is truly over, it's the shipper Zim. The shipper Zim is partially Israeli owned. When is that going to be able to go through the Red Sea again?

Do you know what's going to happen? And I've talked to people as shipping experts. A lot of these shippers are going to just re-flag into China. They're going to become Chinese. And they're going to come under the thumb of the Chinese is what's going to happen. Because that's the only way they can get through the Red Sea if we're not careful. So, the Navy keeps telling you that they had successful attacks, and they took out launch pods from the Houthis. Great. And I have the utmost respect for the Navy. But the definition of success is when can the US, UK, Japanese, and Zim start using the Red Sea? It was going the opposite direction yesterday. It's not getting better.

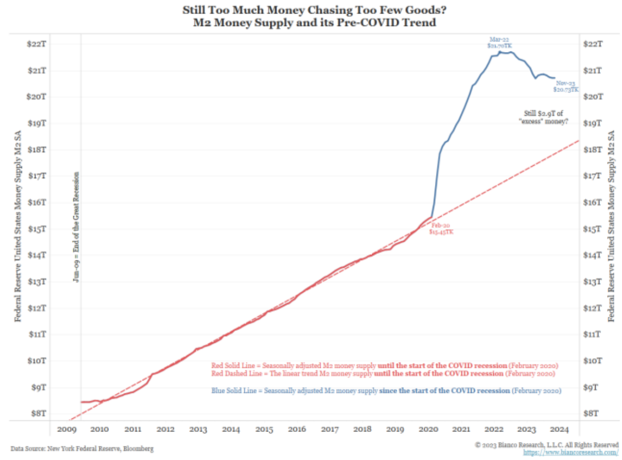



And that's going to lead to more shutdowns, more just-in-time problems, more shortages, and bidding of stuff. Last topic, liquidity. So, the Fed's balance sheet, this is the Fed's balance sheet. Peaked on April 22 at $8.4 trillion. It's down to $7 trillion. Four of them are in treasuries. Two and a half of it is in mortgages. So that's six and a half of the seven. And then bills, floating rate notes, and agencies make up the rest of it.

A lot of people have been looking at this decline in the Fed's balance sheet coupled with the money supply decline on a year-over-year basis. It's declining the most that we've seen basically in two generations. You've got to actually go back to the 1930s to find the last time it declined this much. And we're concluding that there's a liquidity problem in the market. I don't think there is.

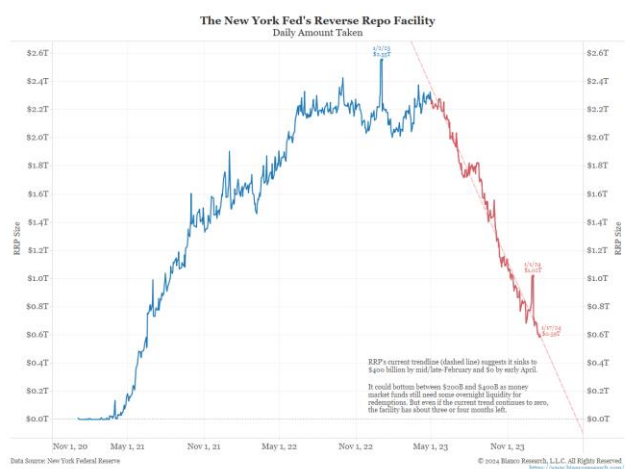



Ultimately, I think these year-over-year metrics that people use, like they did with home prices and like they're doing with money supply, I think the better way to look at it is look at the trend. That's the spurt in money supply. And that's where we are now. And we're so far above where we should be in trend, there's still a lot of excess money in the world right now. So, there isn't a liquidity crisis.

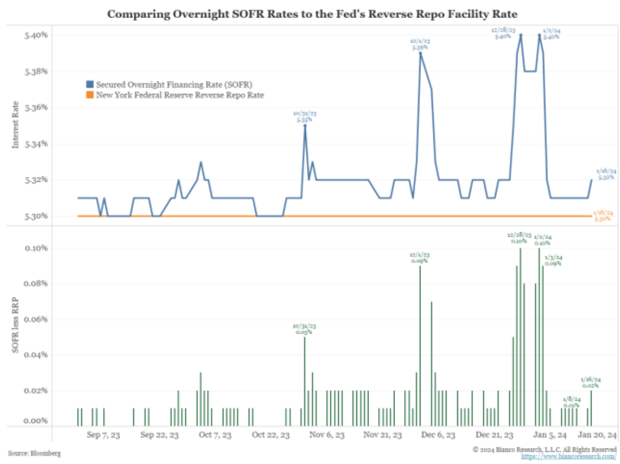



Now, there is a concern because of the Fed's reverse repo facility. The reverse repo facility is a way to take excess cash out of the financial system. How does this work? Ninety-five percent of all of the activity in the reverse repo facility comes from money market funds. A money market fund will take money, park it at the New York Fed, and the New York Fed will pay them an interest rate, twenty basis points below the top end of the funds rate. So, 5.3% is what they're getting paid. And $2 trillion went in.

When money goes into this, it is a drain of liquidity because it's money that still exists, but parked at the New York Fed, it's outside the financial system. So, what it does is it sops up extra funds. But when it's going down like this, it's money being reintroduced back into the financial system. So, there's a big rush of liquidity in.

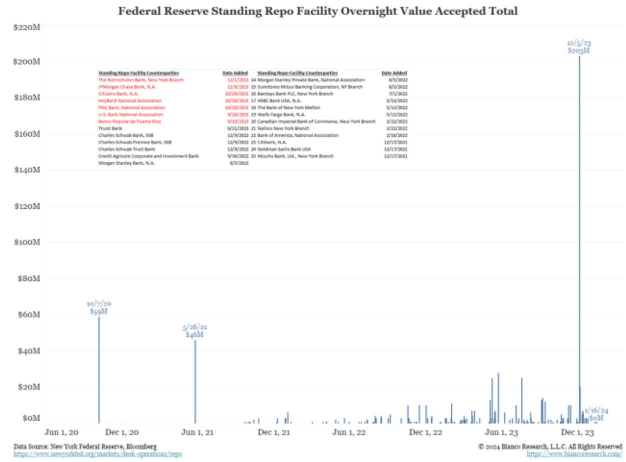


The concern is we've gone from $2.2 trillion to $600 billion. And if this trend line follows, and it's been following very closely, in about two months, we're going to be at zero. And actually, I argue here, I don't even think we're going to go all the way to zero. I think we're going to go to maybe $200 billion, maybe $400 billion before we stop. I don't think we have to go all the way to zero before we do it. So, there is a rush of liquidity in because the RRP is going down.

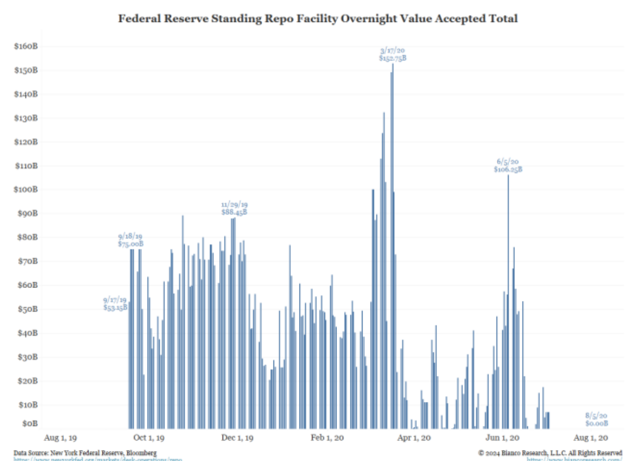



What are the money market funds doing? Instead of parking their money at the New York Fed, they're purchasing treasury bills. That's what they're doing with their money. So, people have been getting concerned because SOFR, the replacement for LIBOR, secured overnight financing rate in blue. And here's the New York Fed's reverse repo rate. It's at 5.30, 20 below the funds rate. This only goes back to September.

And you can see this bottom half shows you the spread between SOFR. So SOFR has popped up in the last couple of months, but it's always been a month end, month end, and year end. And it's getting out to like eight basis points, five basis points. It's been at one or two basis points. And people have been looking at these pop-ups and they've been saying, this is a sign that there might be some liquidity problems.



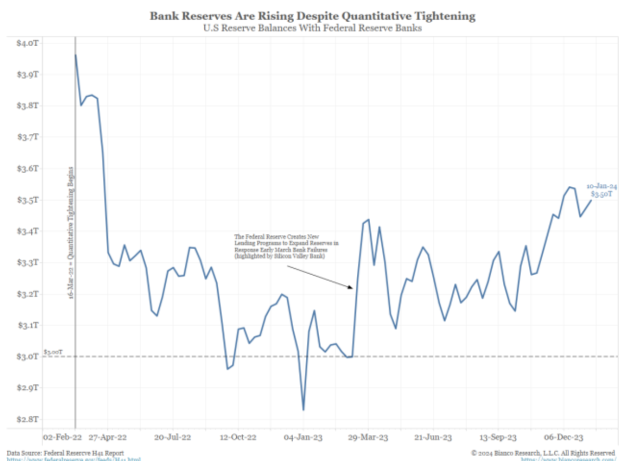

And then while I was talking here about the reverse repo facility coming out, the Fed has the opposite. They have a repo facility, a standing repo facility. Now they used to have this as a temporary facility in 2019 and 20. And at 21, they made it permanent. And everybody had to start signing up for it on twenty-one. That's not being used because this gives you a rate of 5.50.




Now what the Fed will do with the reverse repo facility is the dealers and the banks could come to the Fed with collateral, and they could get a loan for 5.50. And then they could turn around to the hedge funds and anybody else who's got collateral.

"Lend them loans at 5.50. No one's doing it because SOFR is currently at 5.32, just slightly above. So, it's much lower. So that's the ceiling on SOFR. SOFR will never go twenty basis points above wherever the reverse repo is, because at that point, you've got the Fed with its unlimited printing press that will offer an infinite amount of money at 5.50.

What we've seen with the SOFR, what we've seen with it back in December, was we saw a big one-day spike. This was probably a bank or a couple of banks testing the facility. We see that in the last couple of months in the red, fully a bunch of banks have been signing up for this facility. And people are starting to think, hmm, what they are surmising is this is going to hit zero. This is going to lead to big premiums in SOFR over RRP. And the banks and the dealers are getting ready for it by signing up for this facility so they can get unlimited money twenty basis points above RRP from the Fed. Ergo, we have a liquidity problem, is what the argument is made.




By the way, when this facility was temporary in 2019, it was lending out $100 billion, $150 billion, $100 billion from the repo crisis of September of 2019, all the way to when it shut down in August of 2020. Then it was reintroduced as a permanent facility, and everybody had to re-sign up for it because it was technically a new facility.

So the bottom line is even though the Fed has been doing QE or QT, excuse me, and reducing their balance sheet by $95 billion a month, let me go back to the balance sheet, and it's been coming down, this injection of money coming out of the New York Fed back into the financial system has led to that there's effectively been no QT in this market. Bank reserves have held steady for nearly two years now, because whenever the Fed is taking out of the system, the bank's RRP is putting back into the system, and that's why it's at the highest levels now. It's been since April 22.

There is no liquidity problem. But yesterday, Nick Timiraos pointed out that New York Fed President John Williams co-authored a paper and said that ultimately the target that the Fed wants on bank reserves is $3 trillion. We're at three and a half. Well, once RRP is done, this will start coming down. So, what they're saying is they're only going to reduce the Fed's balance sheet by another $500 billion less, however much more RRP comes down. Well, if they're reducing it $95 billion a month, we're going to get a tapering to QT or an end to QT probably in the second half of the year. That's where it is.

Now, I didn't think they needed to do it, but Williams just told us they are going to do it, because I don't think there has been a liquidity problem in this market. There's a lot of people, generals fighting the last war, worried about it. But here's my concern. If they QT and they cut rates and the inflation rate stays sticky, the bond market is not going to be like this. And it is going to sell off hard.

Why did the bond market sell off hard in the early twentieth century? Because the Fed was slow to deal with the inflation problem. You know, in March of twenty-two, what was the year-over-year rate of inflation? The year-over-year rate of inflation in March of 22, when the Fed started cutting or hiking is 8.6%. That's how long they waited. And it wasn't until the summer of twenty-two, when the Fed really ramped it up and started going 75 a meeting, that the bond market started to come down. But by that point, they were already over 4%. And then when the Fed started to back off in twenty-three, bonds went up.

What brings bonds to go down? A vigilant Fed, aggressively hiking rates, risking breaking something. Bonds rally. What gets bonds to sell off? A Fed that is not aggressive and is willing to accommodate stocks and home prices going up. Well, then I don't want to own your bond market if that's what you do. That's why we sold off in October. That's why we sold off, you know, into the mid part of twenty-two before we stabilized as well.

So the fear I have is if you're going to do a QT and you're going to cut rates, and if I'm right about the inflation rate, not going to that last mile, the 2%, you're going to make it worse is what you're going to do, because you're going to have a bad reaction in the stock market. Look at what stocks have done in the last couple of days. What's been bothering the stock market in the last couple of days? Interest rates, the ten-year yield going above 4%. That's what's driving everything right now is interest rates.

Yes, you could look at earnings, look at economic reports, talk to management, and get a good sense of where the economy is, where corporate America is, where the fundamentals are companies, or I can give you a bond rally. And the bond market and the stock market are saying, you should keep your earnings reports, give me a bond rally. And what the stock market is saying is maybe we are having no landing, but rates are going up. And so, it struggles. And that's what it did to October. Maybe that's what we've seen in the last week or so, as we snuck back above 4%, is that it kind of had an issue, again, with the sell-off that we saw yesterday and the day before.

But what I'm trying to say is that it is interest rates that drive everything. So yes, you could cut rates. And the stock market could, in theory, in abstract say, that's great, they're going to cut rates, load up on QQQs and load up on levered S&Ps. But if you don't get that follow through on inflation, and you don't get that, and you do QT, it will blow up. It will cause rates to go back to 5 to 550. It will cause the stock market to have indigestion. Whatever you're trying to accomplish, you will have made worse.

So really, it comes down to the inflation call more than anything else. And the Fed is telling you they want bank reserves to go down $500 billion. So, at this point, that's four or five months and $95 billion without the runoff in RRP to get to the $3 trillion number. And they'll probably start to taper it. But again, if the inflation rate doesn't cooperate, we've got a problem.

So bottom line, the economy's fine, inflation's sticky, 5% to 6% nominal GDP, 5.5% in the ten-year, that's where I think we're going, shameless plug. That's where the Bianco Index is lined up, B-T-R-I-N-D-X on your Bloomberg, and the Wisdom Tree Fund, WTBN, that tracks our index is out there too. Short duration, prepared for that, short on structure as well too, because I think that's going to keep volatility high in the market. You can go to biancoresearch.com if you want to see more about our index, or just ask me about it. I'll stop there on the crash commercial.

But yes, short duration, rates are going to go up. Inflation's going to stay sticky. I think we're having no landing. I don't think we're having a liquidity problem, but we're about to interject more liquidity. We're about to cut rates. If I'm right about inflation and the growth in the economy, there will be a bad reaction to that. If I'm wrong and it goes down, there'll be a good reaction.

Finally, the biggest new thing is the Red Sea. No one wants to admit it's a problem. The Navy doesn't want to tell you they have a problem, they can't stop the Houthis. Shippers don't want to tell you they have a problem; they love it because it's getting rid of their excess capacity. And their argument is, you're going to get your stuff, it's going to be a couple of weeks late, chill out, is basically what they're saying. Manufacturers don't want to say that they have a problem, they don't want their stocks to go down. So, everybody's falling off the scaffolding, and they've passed the third floor, and they're telling you everything's fine. Yes, if this ends in the next couple of weeks, and as I said, it gets worse every day, then it goes away. But if everything has..."To go around Africa, if everything is delayed, there's going to be a shortage of stuff. And 35% of all the stuff going to Europe, it's rerouted to the US, because the Panama Canal is low, and you can't get through the Panama Canal efficiently right now. And it means that we're going to have less stuff. And what do we know from twenty-one? What do we know about the consumer? I'll pay up because I want it. And we'll have goods inflation. It won't be 2020 goods inflation. We're not going to 14 to 16%, but we're going to lift off of zero on goods inflation. And that's going to provide more support for inflation and frustrate, I think, the numbers on going down to three to 2%.

What is the bull story? Tell me this ends next week. The definition of ends is the US, UK, and Japanese about face and start sending their ships through the Red Sea. Cheaper and faster. They're doing the opposite right now. So, I'd like to say it's going to end. I just don't see it. And the Biden administration came out and said, we never said we were going to stop the Houthis. So now we're in this unbelievable position where we're putting American soldiers at risk to protect Chinese and Russian shipping while American, UK, and Japanese shipping are going the long route and being at a competitive disadvantage. You can't make this up.

**Q&A**

All right, let me jump into some questions here as well. **Scott asks, if market expectations for aggressive rate cuts are correct, shouldn't earnings growth be taken down much lower? Can you have earnings growth expected at the same time cutting rates are projected?** The bull case is that the rate cuts are coming because the inflation rate is coming down. And the bull case is we could cut rates because we've got lower inflation, and we don't need as big a real yield. But as I talked about, you know, if I was to go back to my real yield charts here again one more time, as I talked about with real yields here, the perception is everybody sees the 180 on real yields and goes, oh my God, it's a 15-year high. We can't handle it. And I'm like, no, that was the QE era. That was the mistake. This is more normal. That's my argument. But their argument is that it's all because inflation is coming down. The Fed is one. We've licked the problem. And now we don't need to punish the high rates. But what you're implying is every time the Fed aggressively cuts rates, it's because the economy is going bad. And that's how your un-invert the curve, usually through a bull steepener that the Fed cuts short rates aggressively, 2020, 2008, 2001, 9-11. How did your un-invert the curve? Because those were the last three inversions. Because the Fed aggressively cut rates. Why? Technical language. This shit was hitting the fan, and they were panicking. And that's why they cut rates. And that's why you got the bull steepener to an un-inversion. So that's what you're implying is yes, if you're gonna get the bull steepener to an un-inversion because the Fed is panicking, that's not good for earnings. And that's not good for stocks. But the argument now is, no, this is, we won, inflation's going back to 2%. We don't need rates as high. So, it's a victory lap cut. So yes, that's why stocks could go up. That's what November and December were all about. But then we kind of hit a wall on that.

**How is the consumer benefiting from interest expenses? Is interest income greater than expenses? If 62% are smiling expensive credit card debt, that's the bottom 50%. That is the bottom 50% that is implying credit cards. But who is doing the majority of spending in the country?** The majority of retail sales are the top 10%. The vast majority of retail sales are the top 10%. The bottom 50% is pulling up on credit cards. The top 50% is going, stock market was up 28%. We're going to the Bahamas. We're buying a new car. We're buying stuff. That's why the credit card numbers will get worse. The retail sales will stay strong. The inflation rate won't come down. And the bottom 50% are going to take it out on Biden's approval rating. That's where we need to understand it. The bottom 50% at 56% of the debt, which is credit card debt in that number as well too. So, where's my, there's my chart. This is credit card debt. This is the bottom 50%. The top 50% or the top 10% have the assets and they don't have credit card debt. But this, these people, like I said, a 1% or spends eleven times more than a bottom 50%. So that's why we're going to get worse numbers in credit card debt. And we're going to keep having strong consumers numbers because home prices are up. Stocks are up. They're feeling a different attitude. It's more of a YOLO spend attitude. And that's why it's not coming down.

**It's pretty sure Biden will get crushed by Trump. This is Xavier. It's pretty sure that Trump will crush Biden. So, what does it mean for assets? And is that priced?** This is something the market will have to focus on. So, I thought, give us some thoughts early. I would disagree with the, it's pretty sure Biden will get crushed by Trump. And the reason I would disagree with that is to let me look at the betting markets. I'll do something on this in the next week or so. If you remember the betting markets, the prediction markets, as I've always argued, are nothing but summarize all the thinking into one probability. It doesn't mean they have specific insight into what's going on. Trump is 85% sure that Trump will crush Biden. Trump is under four indictments, ninety-three counts. He spent all yesterday in court and the judge threatened to bar him from the courtroom. That's what Trump is doing. And he's 78 years old. He's overweight. And he's 85% to get the nomination. Biden is not overweight. Biden has access instantaneously to the best healthcare system in the world because the president travels with a medical staff and an ambulance with him. Biden is the incumbent. Biden is running unopposed. And he's 75% to get the nomination. He should be ninety-five. Basically, what that market is telling you is there's still a chance he's not the nominee. Now it's too late for anybody to put their name on the ballot in New Hampshire and South Carolina and Nevada and California, which comes right after that. But he can be replaced at the convention. There is some lingering doubt whether or not he is going to be the nominee. And so, but Trump has been leading in the polls. By the way, like I said, I'll try to run this out. I do have the charts on all this. In 2020, if you look at the clear politics average, Trump did not lead for a single day ever against Biden in the polls. Now he's led every day in the clear politics average of polls. Every day since Labor Day, he has led in those polls. So, he's only leading by 1%. I wouldn't say it's a slam dunk. Pretty sure he will get crushed by Biden will get crushed by Trump. It'll be closer than we think. And what I also wanted to point out is, I don't, let me rephrase what you said. I'm not so sure Trump will beat the Democrat nominee. Because maybe that's not Biden. It's incredible that an unopposed incumbent should be trading 95%. The reason he would trade ninety-five, this is a 5% chance an 81-year-old might die between now, I'm sorry to be blunt about it, might die between now and the convention, the Republican, or the Democrat convention is in Chicago in July. That's when that contract would pay off. He shouldn't be trading in the mid-seventies, which is where he was trading. Because there is a, because he's not running against anybody. There isn't an alternative. You know, Gavin Newsom is the alternative. He's not on a single ballot. No one can vote for Gavin Newsom. So why is he not trading at 95%? Because there's some doubt that he is actually going to be the nominee.

Nominee, I'll try and do more on this later. And I was going to do more on this as we go forward. **JS, I didn't understand your argument that the US military is protecting Russian and Chinese ships. As you noted, the Houthis are allowing Chinese and Russian ships to translate the Bab-El-Mandeb with impunity. The US Navy is engaged solely because it's trying to permit UK and US ships to translate the Bab-El-Mandeb.**

The problem with that is, is that they're not, US and UK ships are not going through the Bab-El-Mandeb and the Red Sea. They're going around because they can't get insurance. So, they've given up on going through the Red Sea. The US military is fighting the Houthis and all they're accomplishing is making it safer for Russian and Chinese ships to go through because they're the only ones that are going through.

And the French are going through because every French ship that goes through has a warship on its hip, is why it's going through as well. And so that is what's been happening. We are not accomplishing that. Your question is correct. The definition of success is US and UK insurance rates, war insurance rates coming down so it's economical to sail the Red Sea and get there 10 days earlier? And the answer is no, but the military and the Navy are patting themselves on the back. We just took out every one of those launch sites perfectly. It's not accomplishing the goal of getting US, UK, and Japanese insurance rates down.

And what's happening is ships are transmitting on their AIS. We are not a US company. We are not a UK company. We are Chinese. They're telling the Houthis, please, we have nothing to do with the US. It has become something that makes you worse off to be affiliated with the US. It used to be them because they were Israeli owned or partially Israeli owned. Now it's the US. So yes, the US Navy is wonderful. They're great at their job. But the objective here is to open the shipping link to the US, UK, and Japan. And they're not. They're only keeping it open to the Chinese and the Russians. That's all that are using it right now.

So that's the way I would answer that question. Now, like I said, that's what's happening now. That can change. Maybe the Navy's got a way to make everybody calm down, make insurance rates come down and get the US to about US, UK, and Japanese shippers to start using the Red Sea and start alleviating the just-in-time inventory shortage that will come if this drags on forever and ever.

**Darcy asks, so what you're arguing is that the RRP and the QT mechanisms are just shuffling the deck chairs in a shell game.** Yes, they're QTing down the balance sheet, but they're getting away with it because it's being offset by the RRP. And the concern is the RRP is almost... Simon White at Bloomberg calls the RRP a liquidity pump. As it goes down, you're pumping more liquidity from the New York Fed back into the financial system. But the liquidity pump is almost dry.

And so, when it gets dry, the Fed is going to start to say, we'll back off on the QT. We don't want to be that tight because we're worried that there might be a liquidity problem. And I'm arguing there isn't one. There's just a bunch of worries about one, but it's good enough that there's worry about it, that it's good enough that it's got people worried about it. The Fed is openly talking about backing off of QT. And again, it's fine unless you get inflation. And then you're stimulated in an inflationary environment. And we saw what bonds did in twenty-two. And we saw what bonds did to October. And that's what you risk at that point.

Darcy asked again, can you highlight how the Treasury Reserve account factors into the whole liquidity picture? So, the Treasury Reserve account, the general account for this Treasury, when the US Treasury sells bills and notes and bonds and they raise money, it goes into their checking account. I'll keep the example simple. Their checking account is held at the New York Fed. That's money outside the financial system.

So, when they spend that money, they pay their bills, they pay their employees, they pay their life bills, the federal government's life bills, the federal government's employees. Then that money goes back into the financial system. But if the TGA, the general account, is always stuck at five hundred billion and never moves, it has no impact on liquidity. When it goes down, like it did through May, because we were running down the TGA, that's pumping liquidity into the system.

So, the first half of the year, when the reverse repo wasn't going up, we had the debt ceiling. And we ran the TGA down from seven hundred billion to $2 billion, literally $2 billion. And that was $698 billion of liquidity we pumped in. Okay, then we passed the debt ceiling increase and then we replenished that. But then we started running down the TGA starting in July. So, there's always been a liquidity pump in there somewhere.

Remember that the TGA and the RRP is money at the Fed that is not in the financial system. When the money at the Fed, the TGA or the RRP goes up, it's sucking money out. It's pulling liquidity out. When it goes down, it's reintroducing the liquidity back into the financial system. That money never gets destroyed. It never goes away. It's just not in the financial system. It's at the Fed. And that's why the RRP was developed, to get rid of excess money.

How long will the shipping delays be? Brett asks, hopefully that answers your question about the liquidity picture, Darcy. **Brett asks, how long will the shipping delays take to show up on the US shelves?** Probably a month or two. We are in the post-Christmas, post-holiday period. Everything got shipped for Christmas and the holidays. And usually this is a low. Most of the shipping that goes on right now is parts for other manufacturers.

But I think that as this continues to go, we'll probably start to see some kind of shortages show up somewhere. The biggest one, of course, will be in autos. Remember that an automobile uses more semiconductors than even a computer uses. They've got all kinds of semiconductors in them. They all come from Taiwan. And if all those semis are late, the example somebody gave me was, if I'm in the business of making navigation systems and I don't get my semiconductors, I can't finish my navigation system.

I can't send that to the dashboard assembler who can send that to the automobile assembler who could finish the car to send it to the dealer to send it to the customer. And if it's not a car, it's a truck. And they don't get the truck to make their deliveries. That whole daisy chain is messed up. I've messed up. The dashboard assembler is messed up. Manufacturers messed up. The dealer's messed up. The customer's messed up. If the customer is a truck for delivery, their customers are not getting delivery. All because those ships from Taiwan are going around Africa and they're late.

And that is going to be the problem. But again, the shippers don't want to tell you that. The shippers are in no position to tell you what the status of the adjustment time is. What the shippers will correctly tell you is 100% of what you ordered; you will get. It didn't fall into the ocean. No ships have been sunk. You're just not getting it the day you said we thought you were going to get it. You're going to get it two weeks late.

And you're sitting there if you're Stellantis or you're Michelin or you're Tesla or you're Volvo and going, I need these on the week of February 5th because I need to make these navigation systems that week. And you're telling me I can't make navigation systems. I might have to shut down or I might have to pay up and fly them in from Singapore or from Taiwan in order to keep my production going. But that tremendously raises my cost. So, it's coming. You tell me Next week, the US, UK, and Japan are again sailing the Red Sea with affordable insurance, and Zim is about to return. Then, I would tell you it'll be a minor problem. But it's all about just-in-time inventory. It's all about bottlenecks and the daisy chain, and Costco and Mersk and the rest of them have no idea about just-in-time. They're just saying to you, "You'll get your stuff, relax." But this is a just-in-time inventory world.

Getting it late if it's parts for your thing that you make is a problem. Maybe a finished consumer good that goes straight to the shelf, we'll eventually get it there. That might not be a problem. Anyway, with that said, that's all the questions I have. I'll end there.

And I think I should be on the three-week schedule that we were on. I was a week late because I was traveling last week. I didn't cough nearly as much as I thought I was going to. So that was good. Thank you for joining me on this call. And I'll talk to you again in this format in about three weeks. Thanks. Goodbye.

Inquiries: (800) 606-1872

*This message is intended only for the personal and confidential use of the designated recipient(s) named above. If you are not the intended recipient of this message you are hereby notified that any review, dissemination, distribution or copying of this message is strictly prohibited. This communication is for information purposes only and should not be regarded as an offer to sell or as a limitation of an offer to buy any financial product, an official confirmation of any transaction, or as an official statement of Bianco Research LLC. Email transmission cannot be guaranteed to be secure or error-free. Therefore, we do not stand for that this information is complete or accurate and it should not be relied upon as such. All information is subject to change without notice. Copyright © 2022 Bianco Research, L.L.C.*