***S**tate **O**f the **M**arkets:* Higher For Longer Is The New Normal

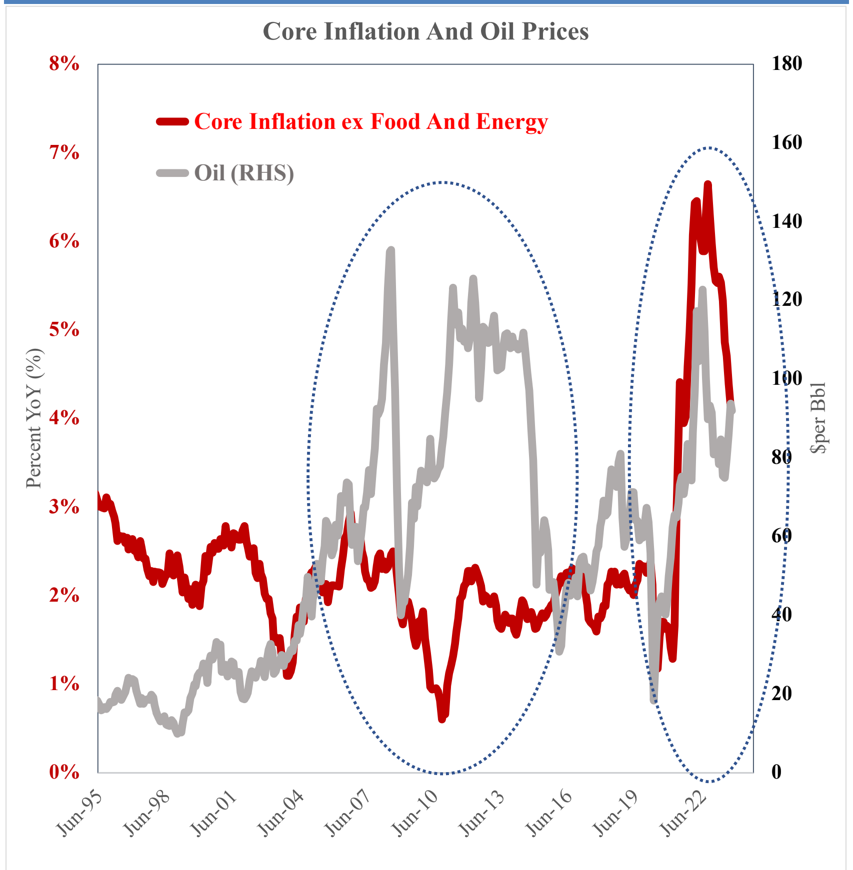
October 20, 2023

State Of the Markets: Higher For Longer Is The "New" Normal

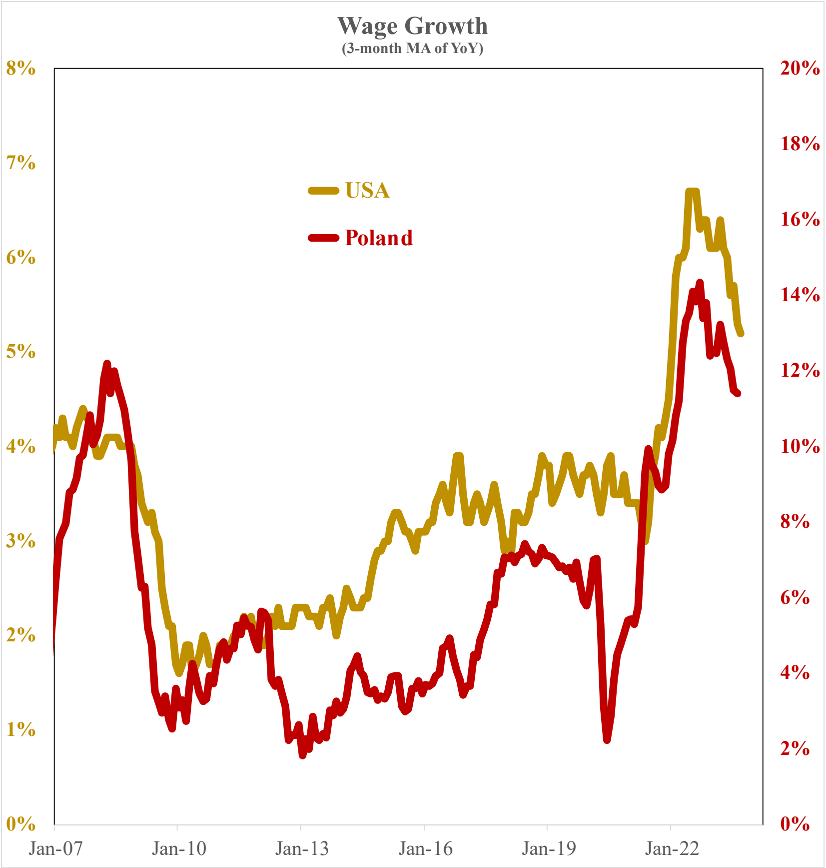
Step 1: Identify A Macro Theme

The New Normal: The End of Cheap Labor

Core Inflation Is Higher As Oil Price Surge…Why Now?



Because Wages Are Going Up All Around The World?



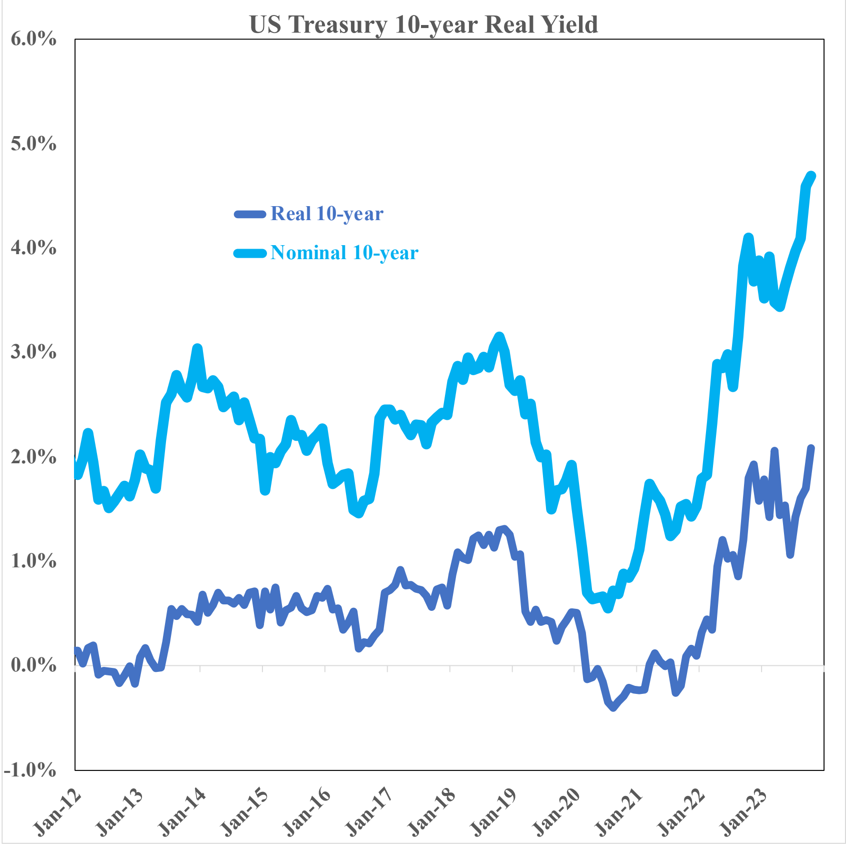
1. Bloomberg
2. Federal Reserve Bank of Atlanta, Wage Tracker

State Of the Markets: Higher For Longer Is The "New" Normal

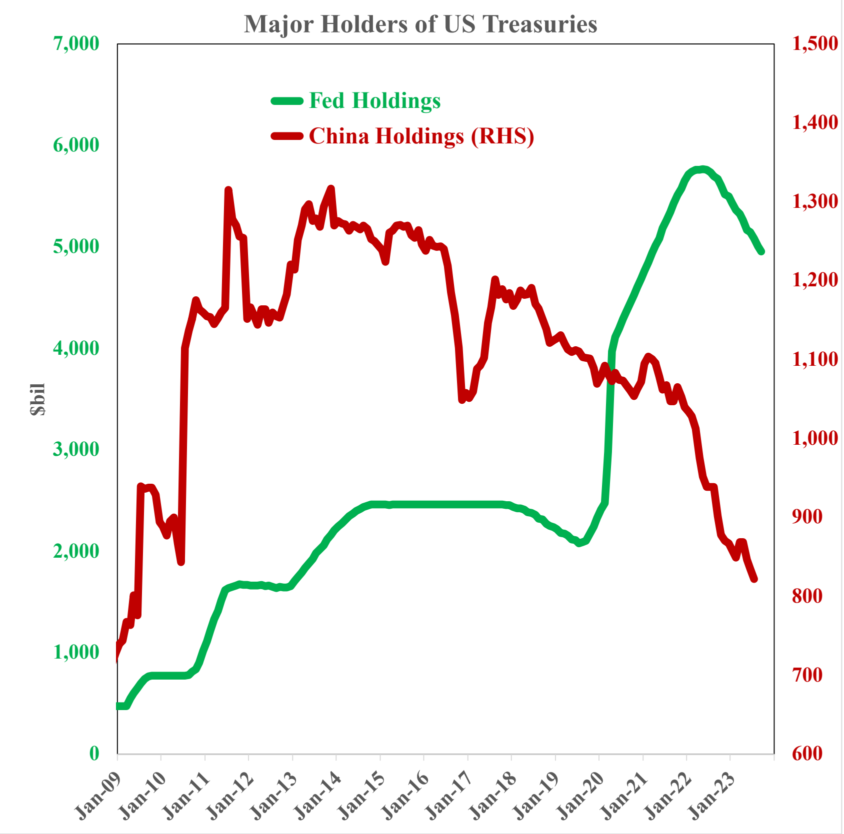
Step 1: Identify A Macro Theme

The New Normal: No Caps On Long Maturity Treasury Yields

Long Maturity Yields Are Rising…Why Now?



Because Large Investors Are Selling?



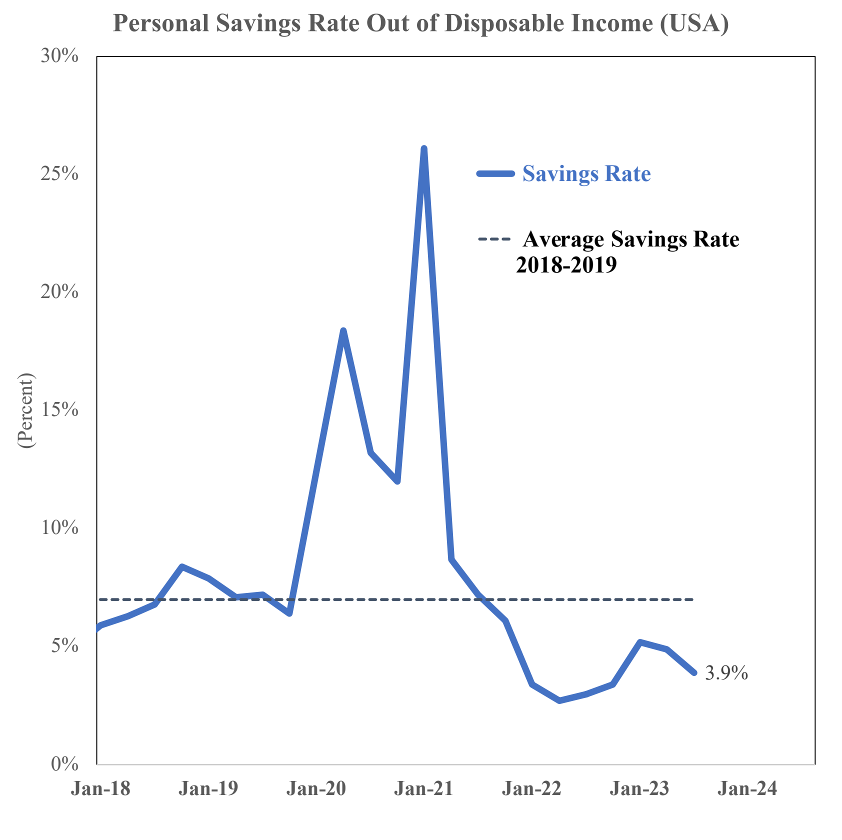
1. Bloomberg
2. Federal Reserve Bank of St. Louis, Fred database

State Of the Markets: Higher For Longer Is The "New" Normal

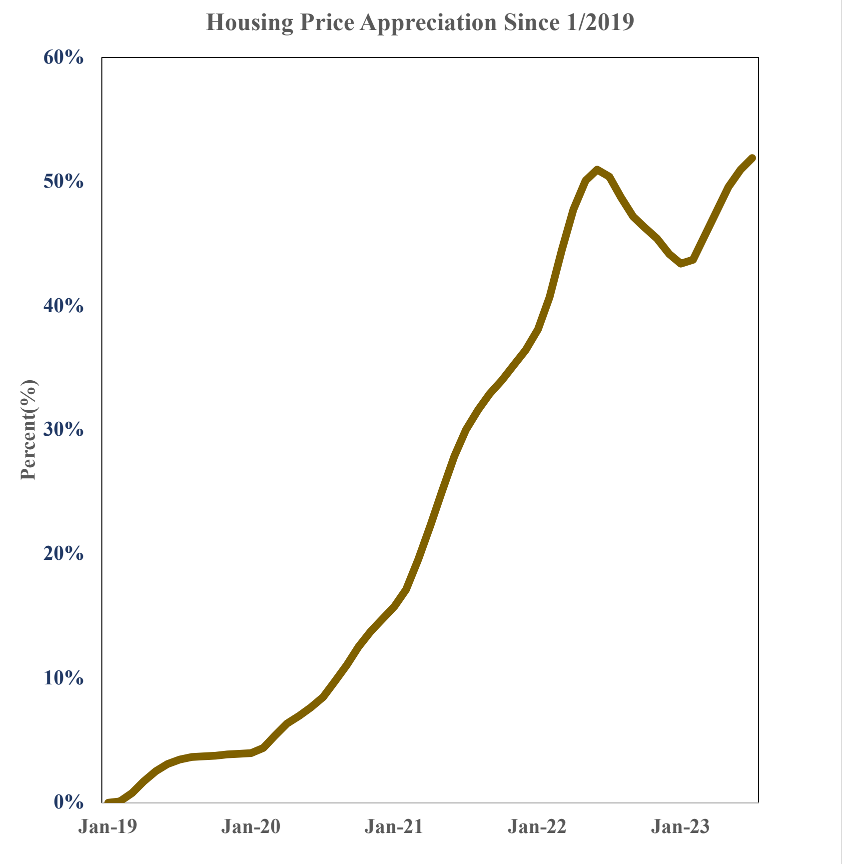
Step 1: Identify A Macro Theme

The New Normal: Consumers Spend And Don't Save

Savings Rates Have Fallen From Norms….Why Now?



Is It Because Household Wealth Is Rising?

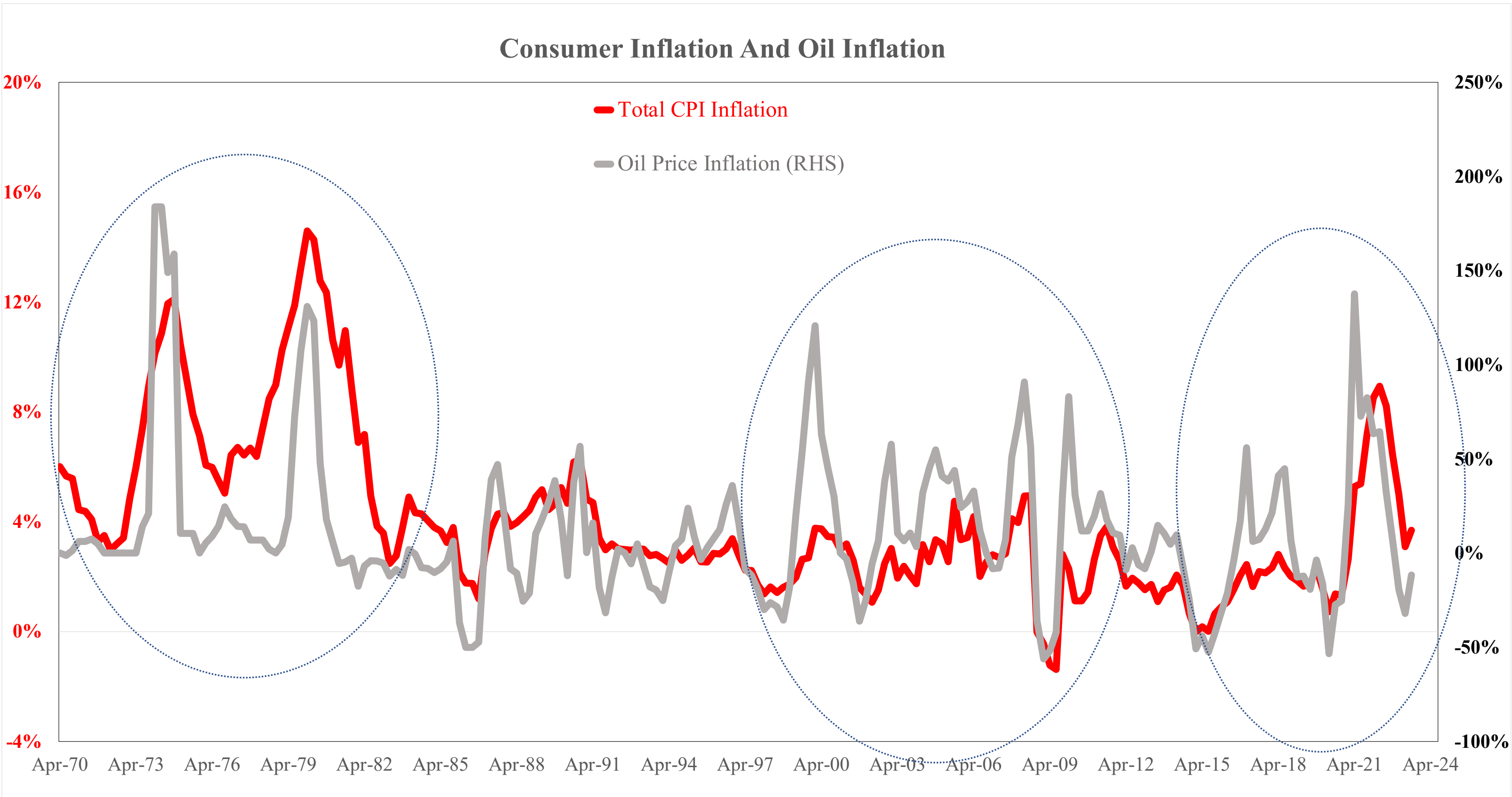


1. BEA
2. Board of Governors of The Federal Reserve, Z1 database

State Of the Markets: Higher For Longer Is The ”New” Normal

Step 2: Fundamental Economic Framework

The New Normal: The End of Cheap Labor And Why Inflation Is Surging Now After 30-yrs

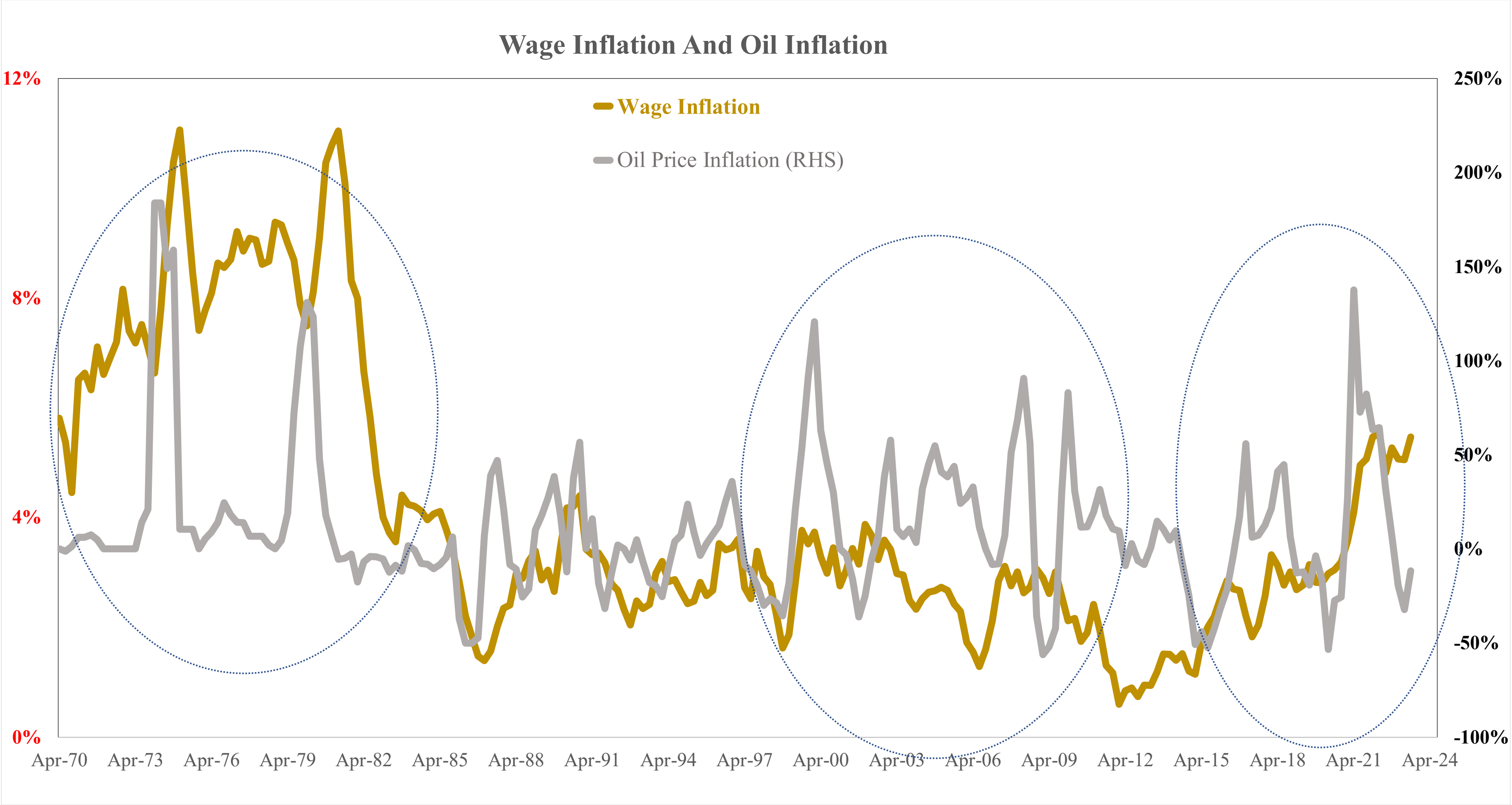


1. Bloomberg
2. Federal Reserve Bank of St. Louis, Fred database

State Of the Markets: Higher For Longer Is The "New" Normal

Step 2: Fundamental Economic Framework

The New Normal: The End of Cheap Labor Means Workers Asker For More Wages As Their Cost Rise

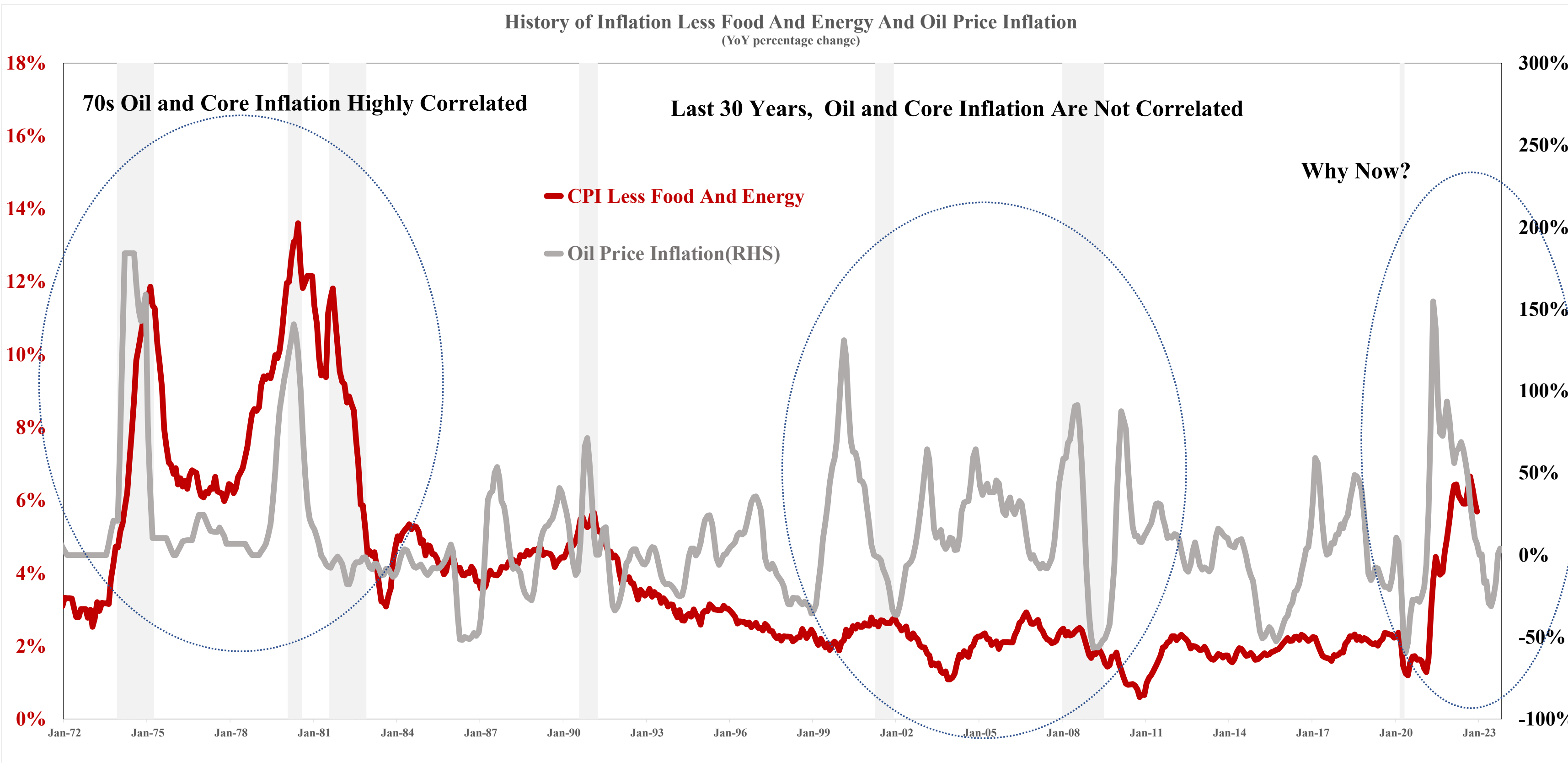


1. Bloomberg
2. Federal Reserve Bank of St. Louis, Fred database

State Of the Markets: Higher For Longer Is The "New" Normal

Step 2: Fundamental Economic Framework

The New Normal: The End of Cheap Labor Means Higher Wages Drives Core Inflation Higher

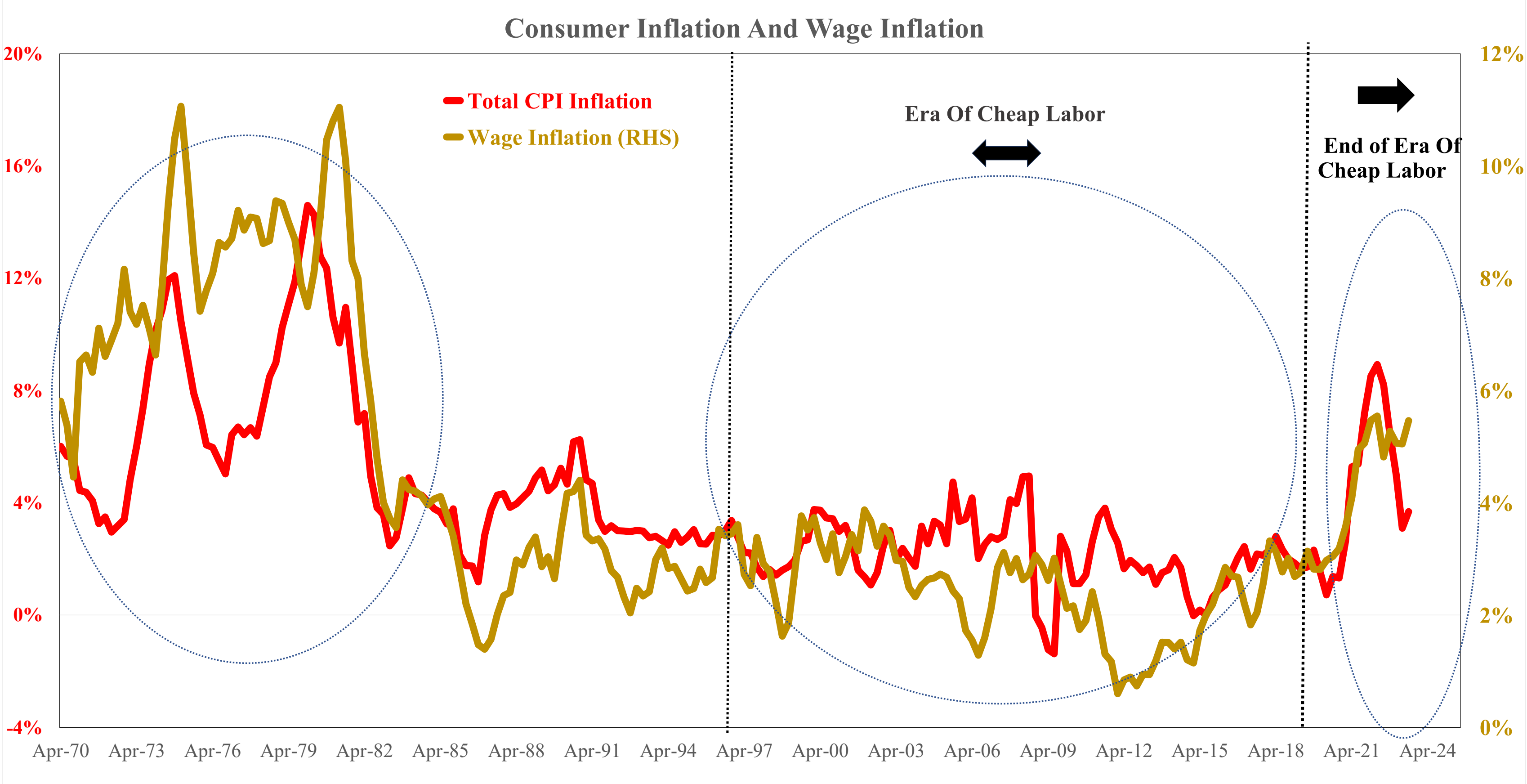


1. Bloomberg
2. Federal Reserve Bank of St. Louis, Fred database

State Of the Markets: Higher For Longer Is The ”New” Normal

Step 2: Fundamental Economic Framework

The New Normal: The End of Cheap Labor Means Higher Wages Drives Total Inflation Higher



1. Bloomberg
2. Federal Reserve Bank of St. Louis, Fred database

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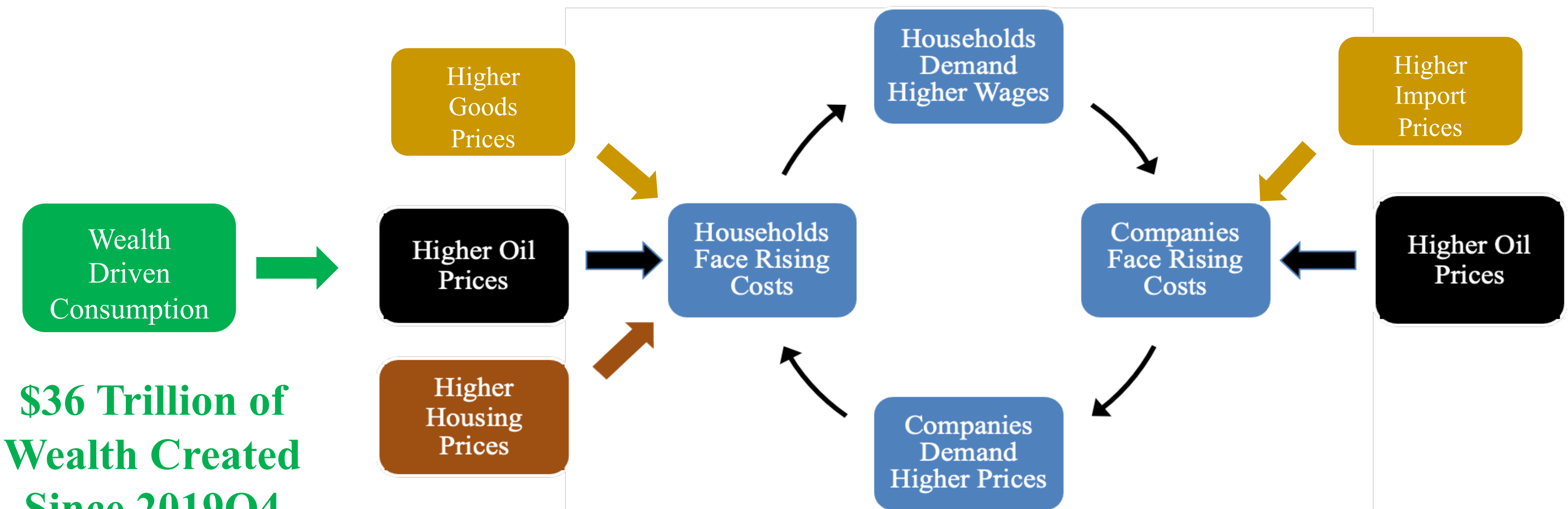
Step 2: Fundamental Economic Framework

The New Normal: The End of Cheap Labor And The Resurgence of Inflation Cycle of 30-yrs Ago



$36 Trillion of Wealth Created Since 2019Q4

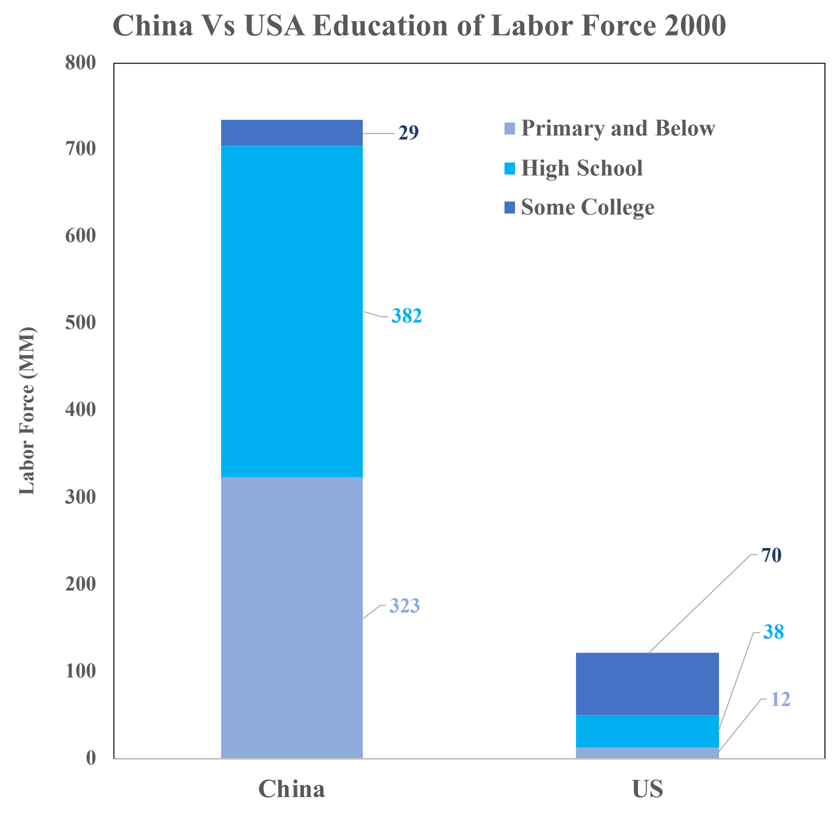
A 1970s Type Inflationary Cycle

State Of the Markets: Higher For Longer Is The "New" Normal

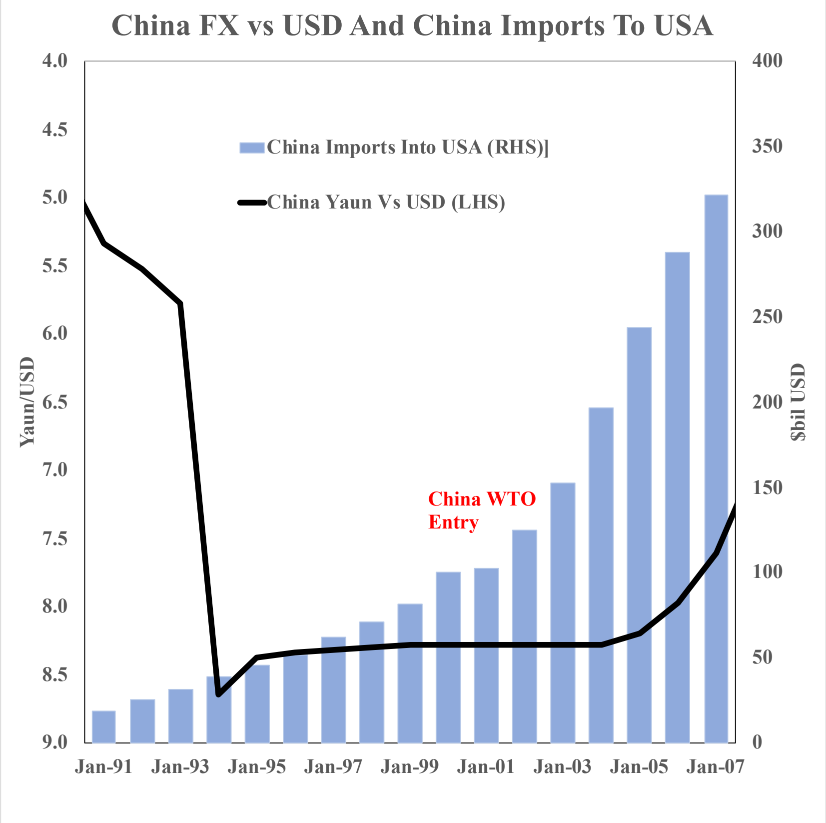
Step 2: Fundamental Economic Framework

The New Normal: Cheap Labor Started With China's Entry Into The WTO And Their Cheap Labor

China's Supply of Cheap Labor Dwarfed That Of The US[1,2]



China's Cheap Labor/FX Drove A Surge of Imports Into The US[3,4]



1. BES
2. China NBS
3. IMF, Direction of Trade Data Base
4. Federal Reserve Bank of St. Louis, Fred Data Base

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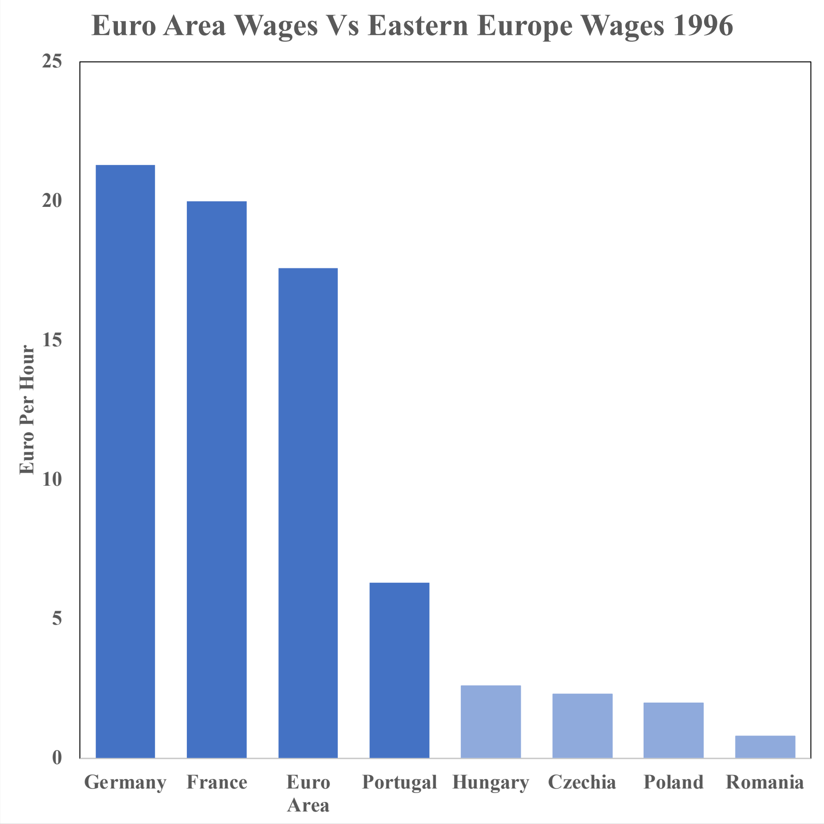
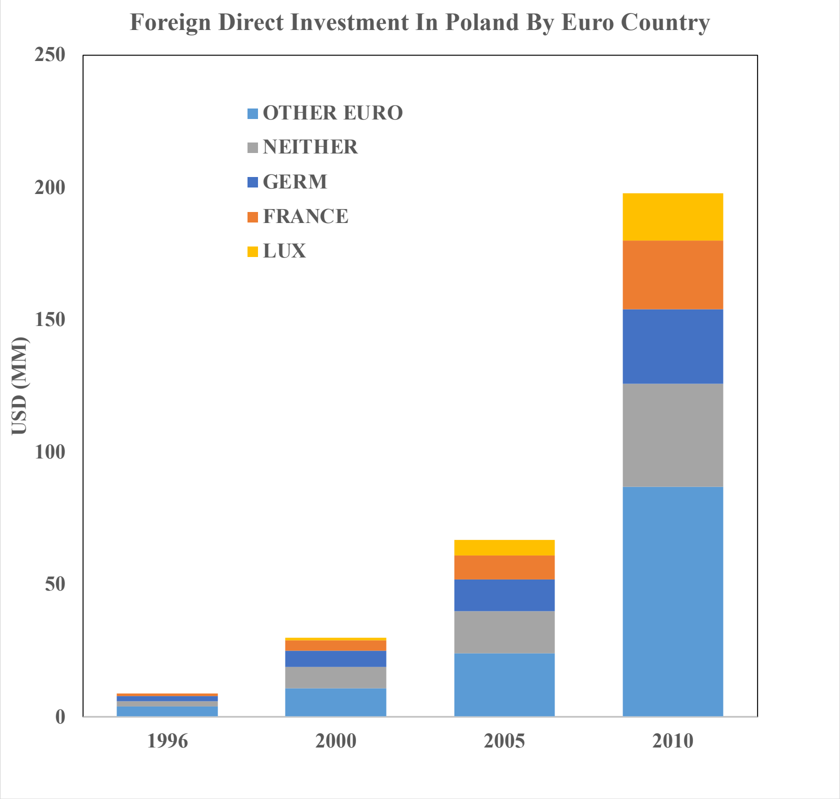
Step 2: Fundamental Economic Framework

The New Normal: Cheap Labor Was Abounded With Eastern Europe's Entry Into The EU

Cost of Eastern Europe's Labor Was A Fraction of Euro Area’s



The Euro Area Invested In Eastern Europe To Monetize that Cheapness



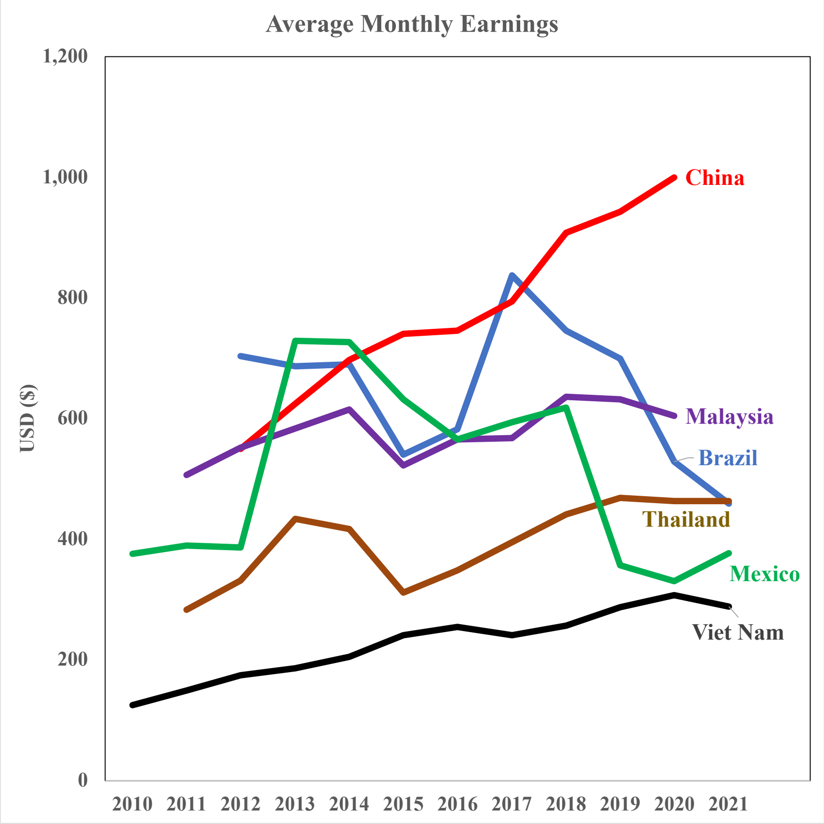
1. Eurostat
2. OECD FDI Data Base

State Of the Markets: Higher For Longer Is The "New" Normal

Step 2: Fundamental Economic Framework

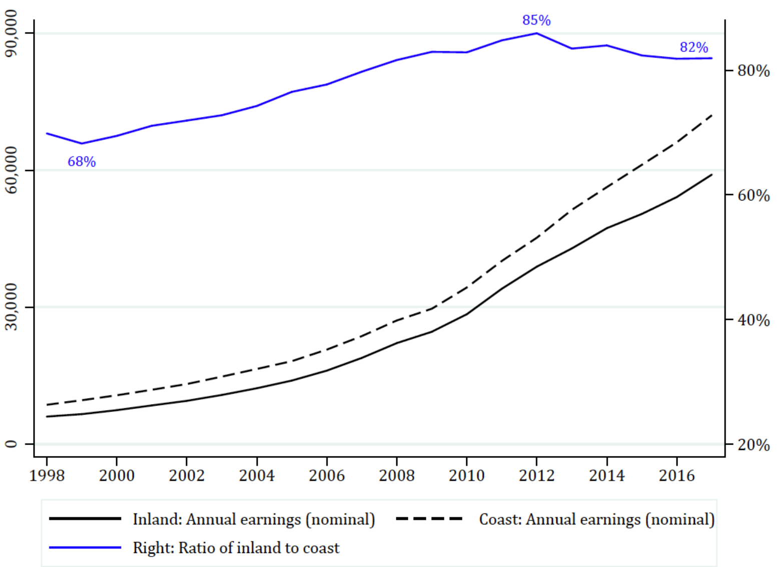
The New Normal: Cheap Labor Era Is Over Because Chinese Workers Have Become Expensive

Chinese Labor Intensive Sectors Are Now Uncompetitive



One Reason Is The Wage Discount For Inland Workers Has Vanished

Figure 18: Wage differentials between inland and coastal regions



Source: China Labor Statistical Yearbook

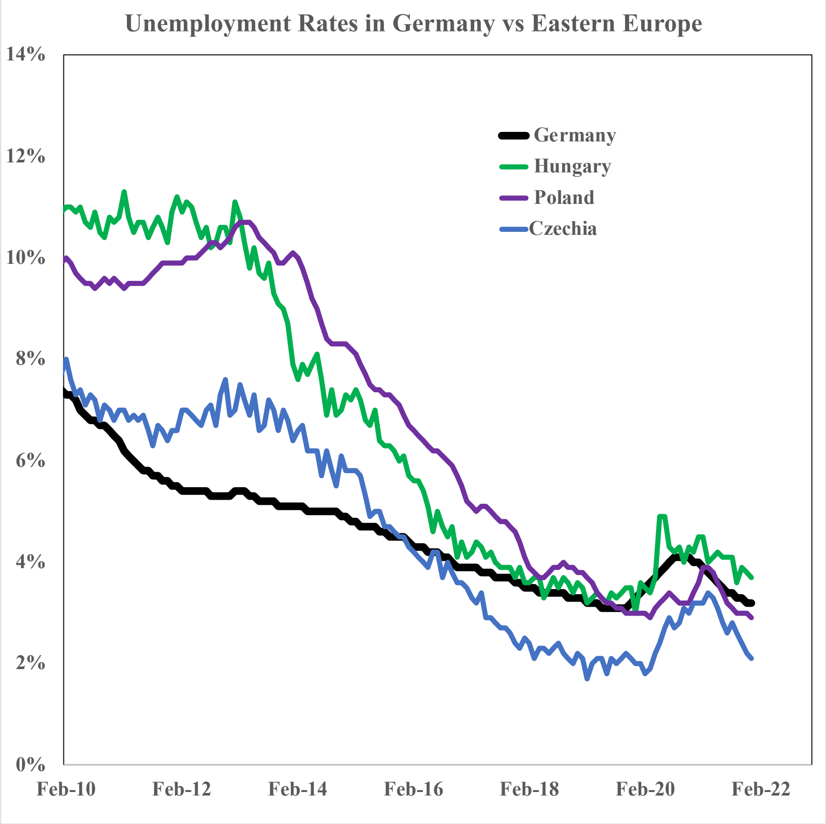
1. ILO.org data base
2. Chen, Li, " Estimating the Scale of Relocation of Labor-Intensive Manufacturing from China: Facts and Potentials," Institute of New Structural Economics, Peking University, December 2019

State Of the Markets: Higher For Longer Is The ”New” Normal

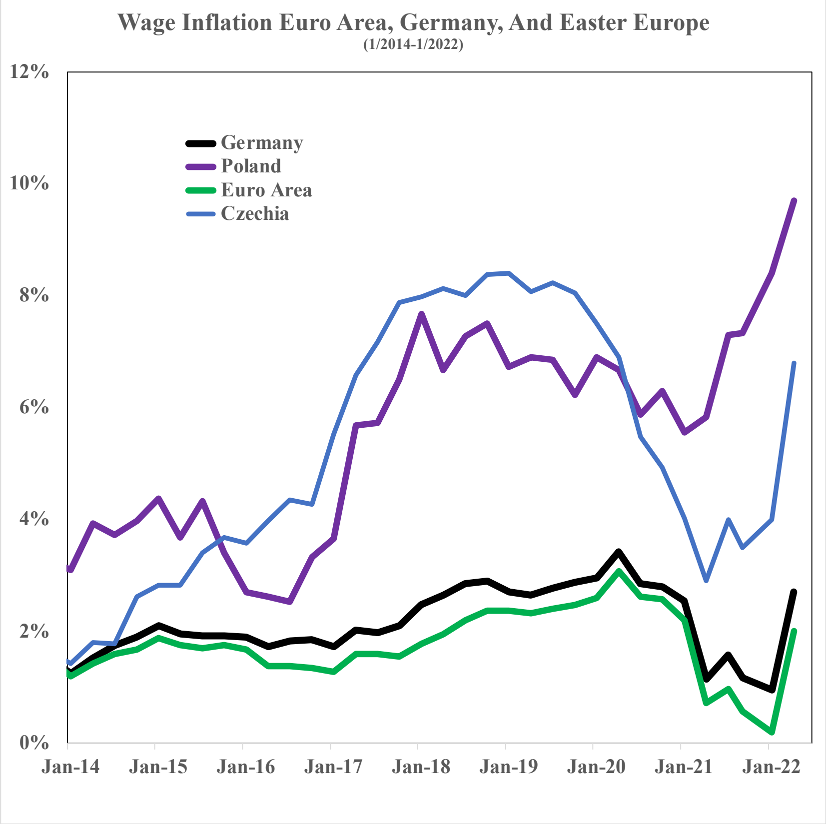
Step 2: Fundamental Economic Framework

The New Normal: Cheap Labor Era Is Over, So European Labor Demands And Gets Higher Wages[1]

Eastern Europe’s Labor Markets Are Tight….



Leading To Rising Wages And Higher Costs To Producers



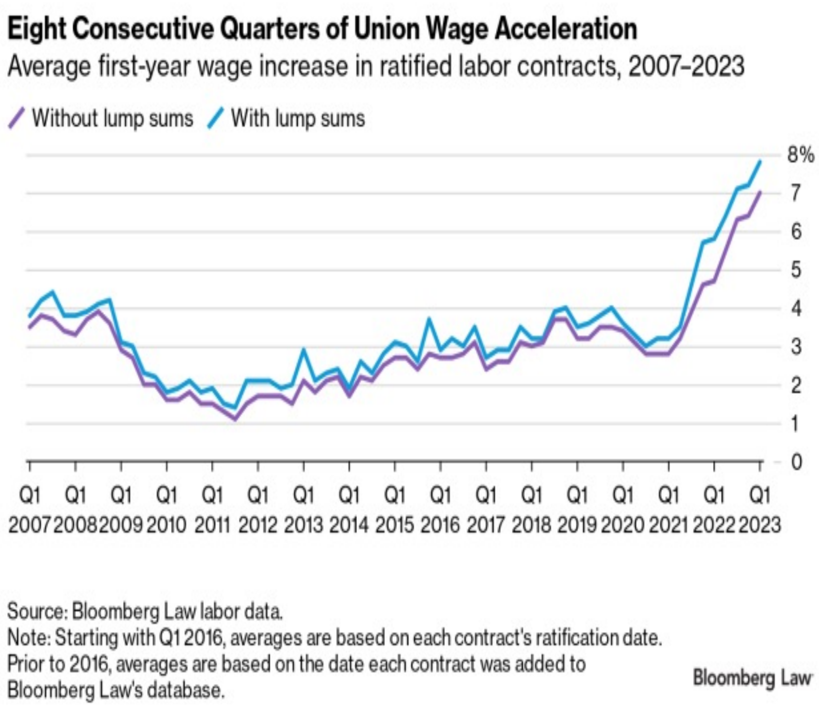
1. Eurostat

State Of the Markets: Higher For Longer Is The "New" Normal

Step 2: Fundamental Economic Framework

The New Normal: End Of Cheap Labor Means Labor Wage Hikes Start Another Inflationary Cycle

Union Wage Increase Reflect Their Growing Strength



Labor Income Is Growing Now That The Cheap Labor Era Is Over

1. Bloomberg Law Law Data Base
2. Federal Reserve Bank of St. Louis FRED data base

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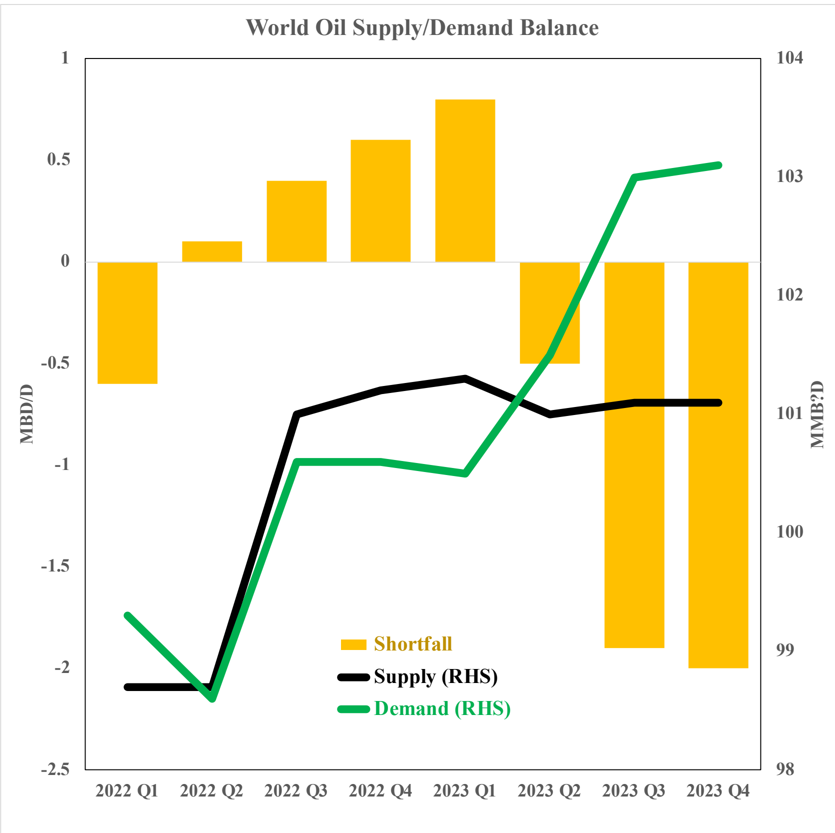
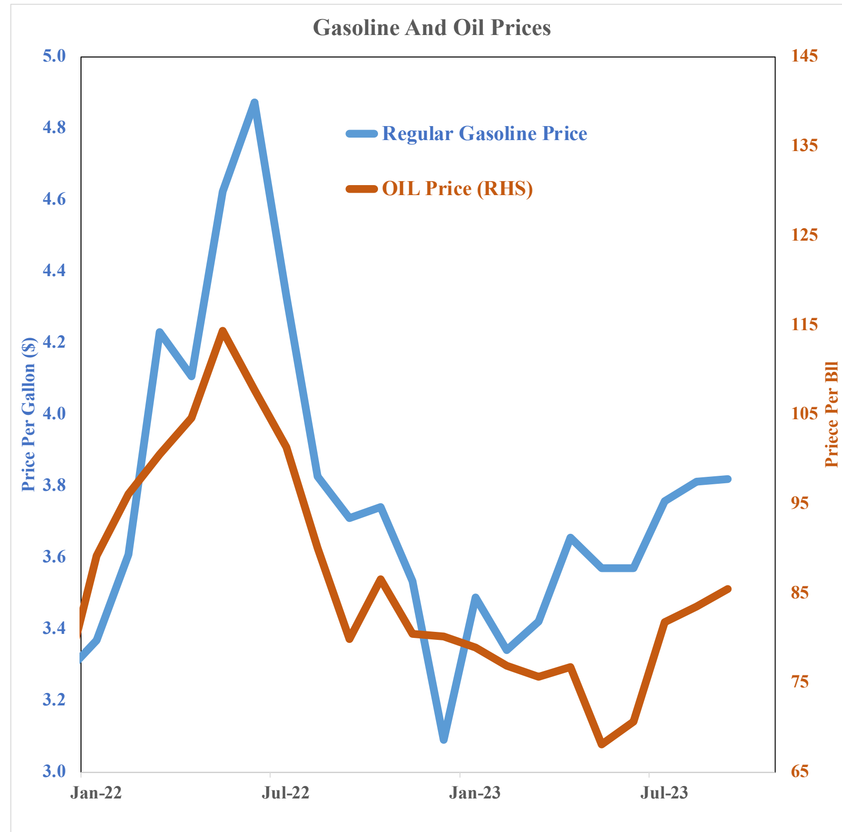
Step 3: Identify Potential Catalysts

Another Oil Shock Could Start the Cycle Again From An Increase In Oil Demand With Flat Supply Growth

Oil Demand Is Projected To Excess Supply By 2 MMB/D…



Creating Upward Pressure On Energy Prices For The Consumer



1. Federal Reserve Bank of St. Louis FRED data base
2. IEA

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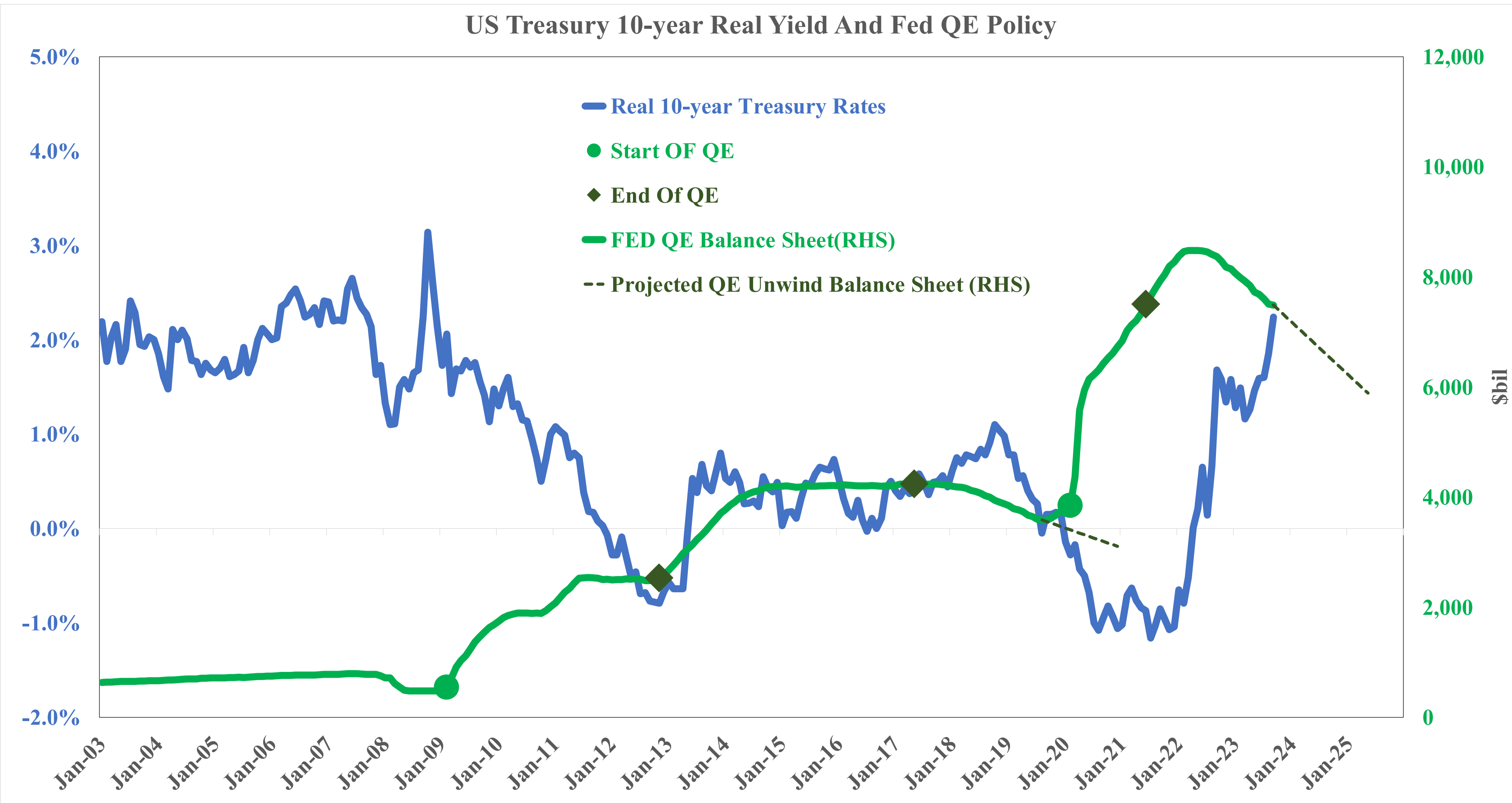
Step 2: Fundamental Economic Framework

The New Normal: No Caps On Long Maturity Yields As FED QT Starts



Federal Reserve Bank of St. Louis FRED data base

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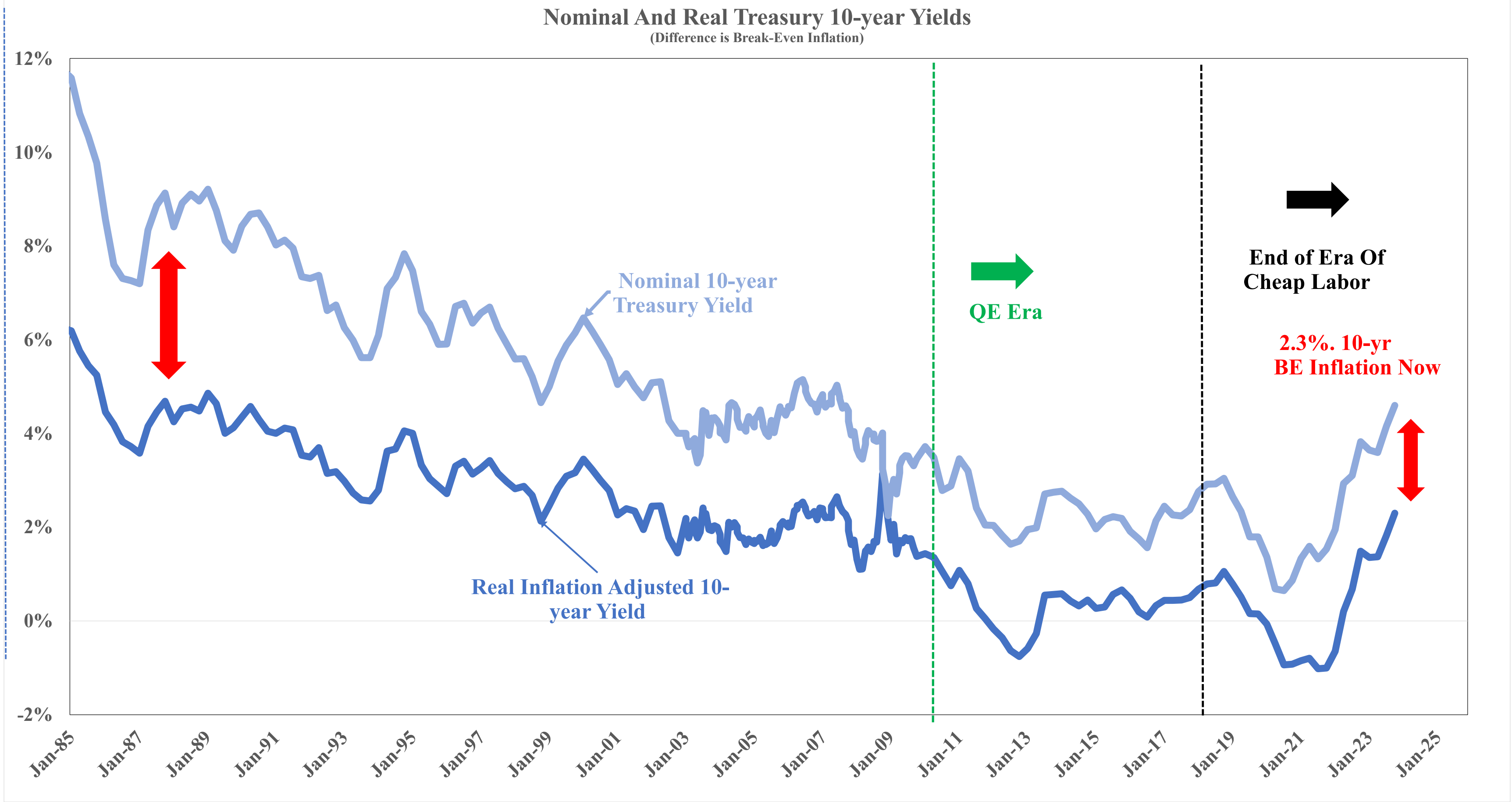
Step 3: Identify Potential Catalysts

The New Normal: No Cap On Long Maturity Yields If Inflation Expectation's Return To Normal



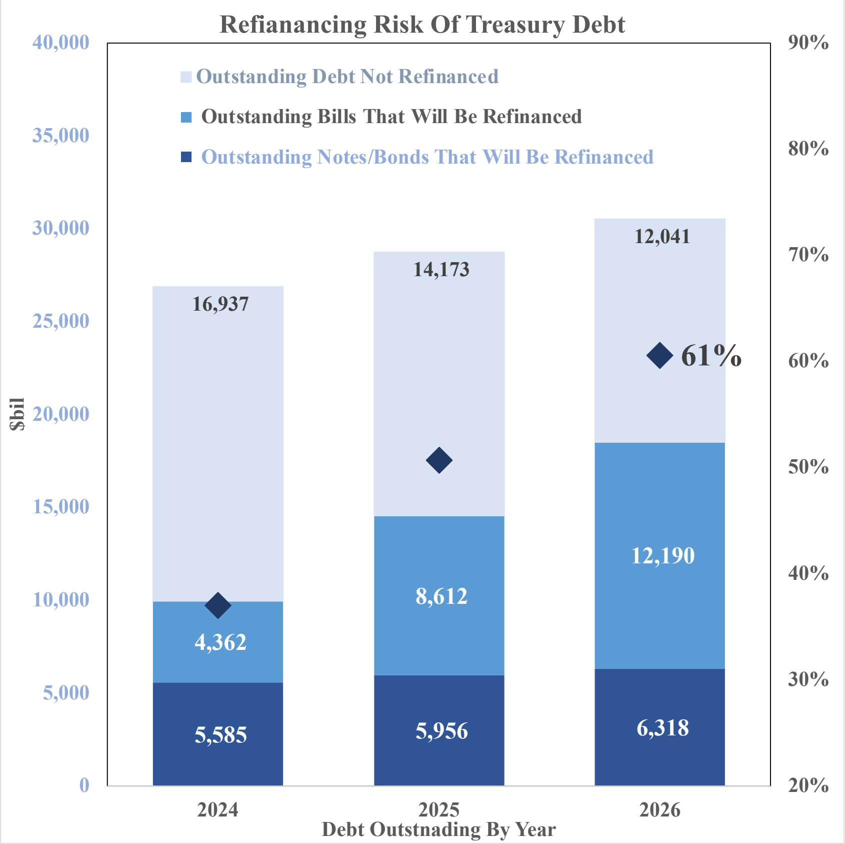
Federal Reserve Bank of St. Louis FRED data base

State Of the Markets: Higher For Longer Is The "New" Normal

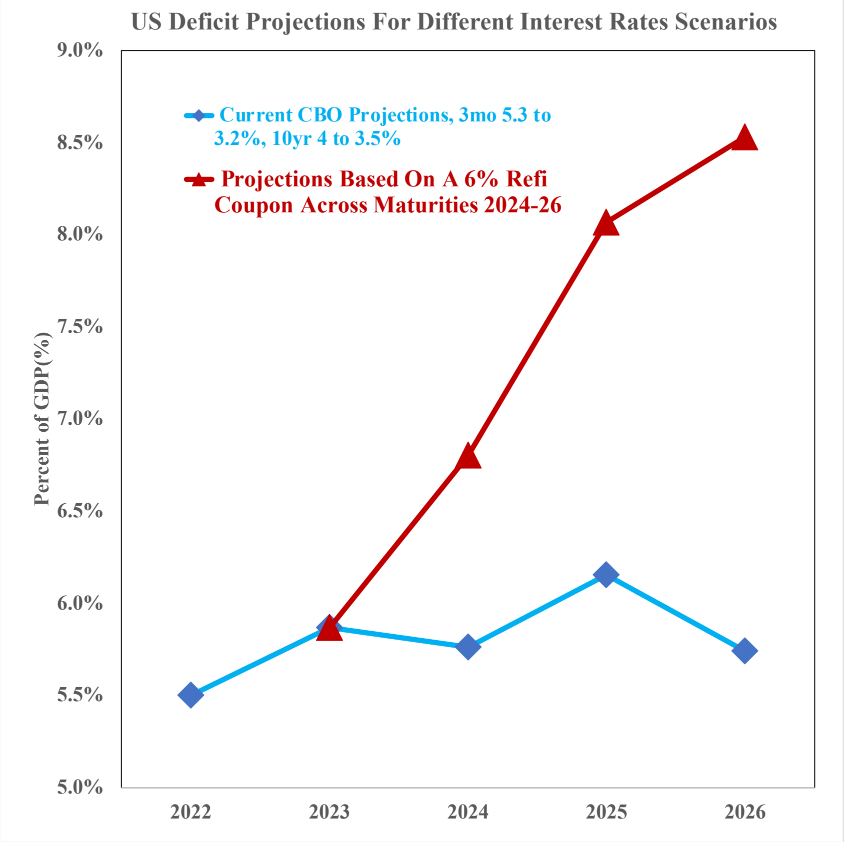
Step 3: Identify Potential Catalysts

The New Normal: No Cap On Long Maturity Yields As If Treasury Supply Surge Drive Yields Higher

2/3 of Treasury Is Exposed To Higher Rates By 2026



As A Result Treasury Interest Cost Could Surge With Higher Rates



1. US Treasury, Debt Outstanding database
2. CBO, CBO's Projections of Federal Receipts and Expenditures in the National Income and Product Accounts: 2023 to 2033, Sept 9 2023
3. Calculation of interest payments based on 6% on all debt that is refinanced. CBO assumes 3-mo bill, and 10-yr yields both go to 3.8%, and inflation goes to 2.1 by 2026. Issuance by maturity uses current proporti0n.

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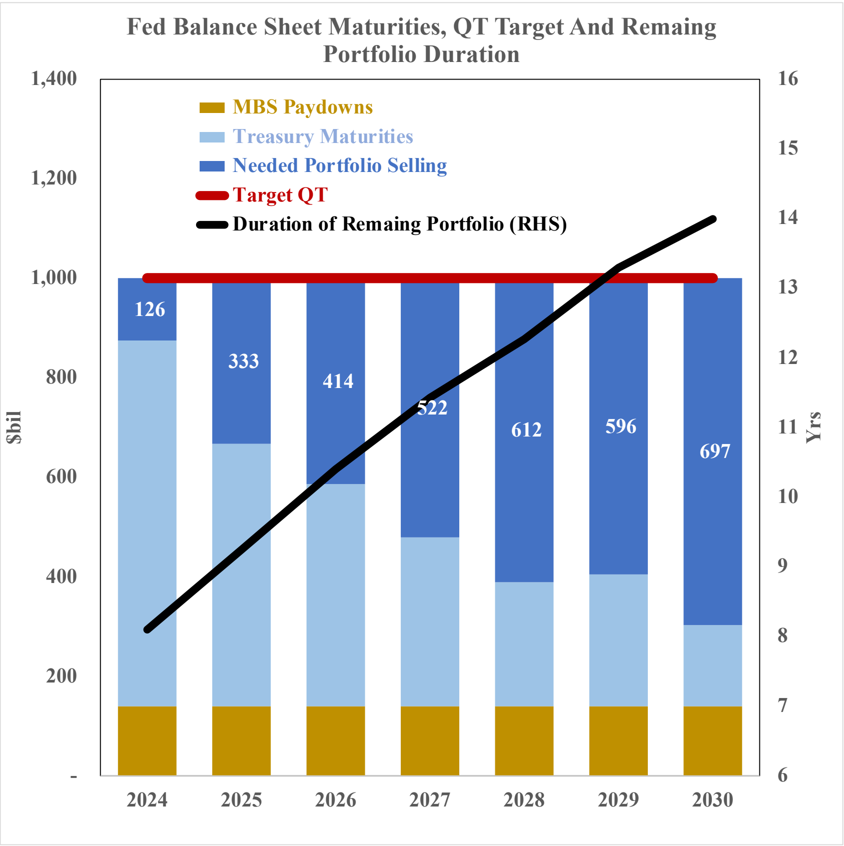
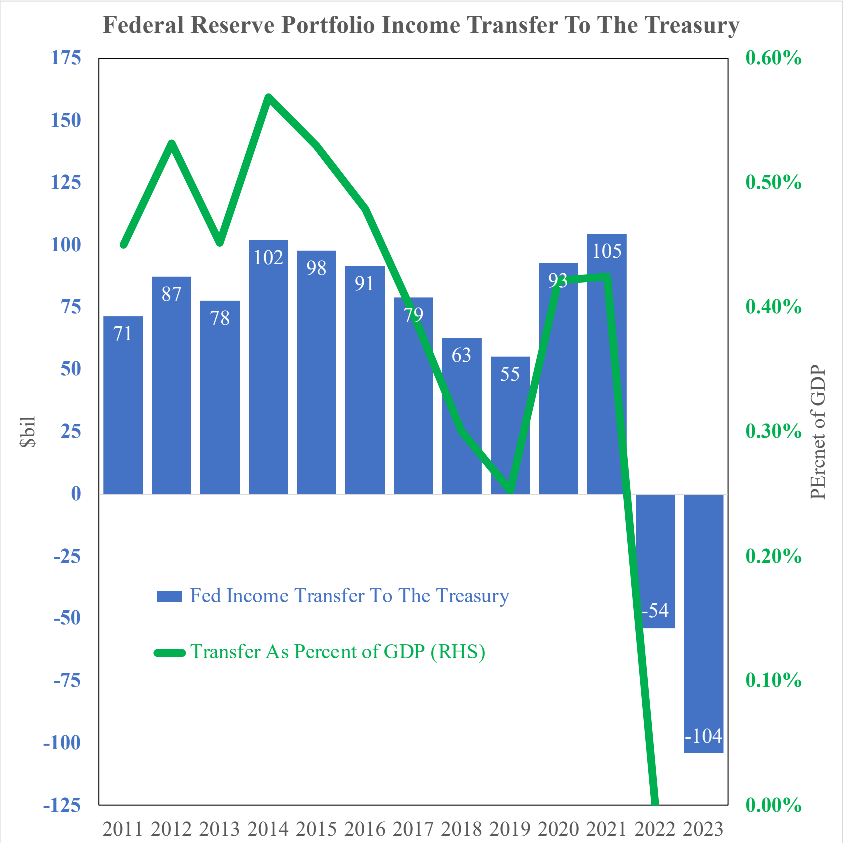
Step 3: Identify Potential Catalysts

Fed Balance Sheet Unwind Will Put Pressure On Both Demand And Supply Of Debt

QT Will Force The Fed To Sell Long Duration Assets…



And Increase Treasury Supply To Fund The Lack of Fed Income



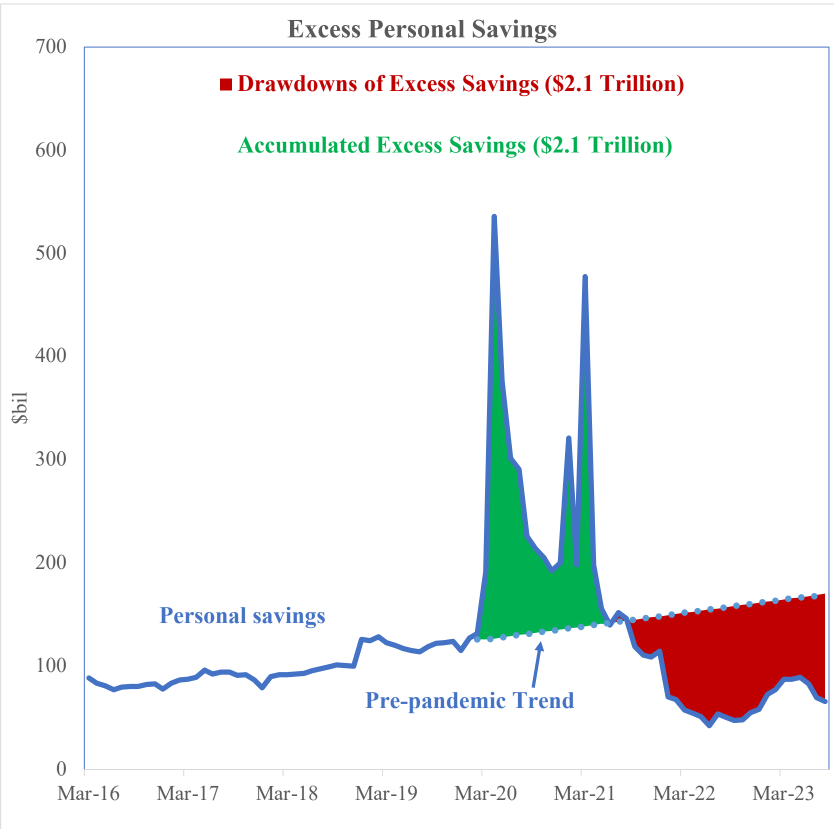
1. Federal Reserve Bank Of New York, SOMA database
2. Board of Governors of the Federal Reserve, H4 report
3. I assume that MBS paydowns at 6% per annum, with amortization. Duration of debt is based on all debt outstanding at that year.

State Of the Markets: Higher For Longer Is The ”New” Normal

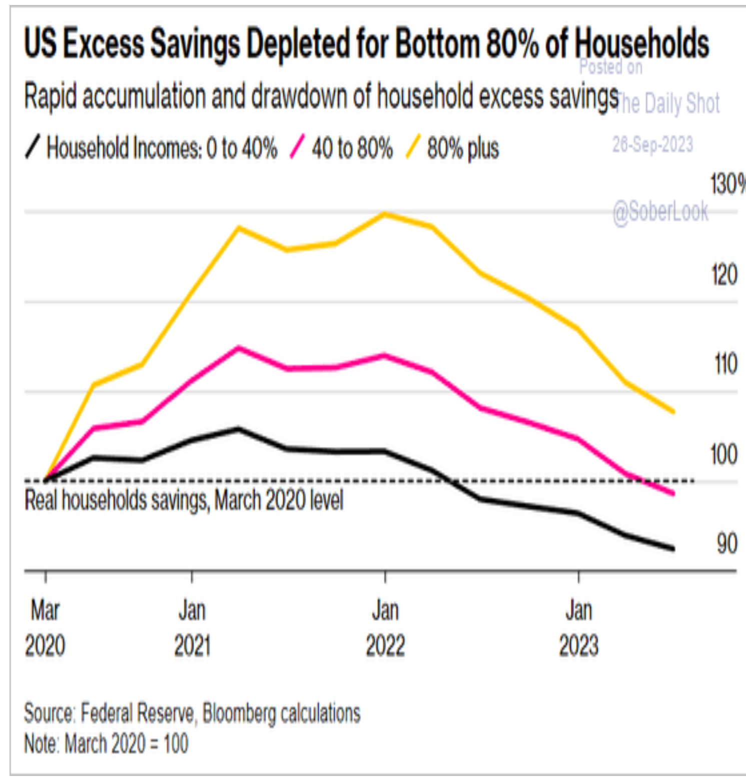
Step 2: Fundamental Economic Framework

Market Perception Was That ”Excess COVID” Saving Was Zero And Consumers Would Stop Spending..

Based On Pre-COVID Savings Rates, Excess Savings Has is Zero



Bottom 80% Could Slow Spending Because of Negative Real Excess



1. Abdelrahman, Hamza, and Luiz E. Oliveira. 2023. “The Rise and Fall of Pandemic Excess Savings.” *FRBSF Economic Letter* 2023-11, (May 8).
2. Tanzi, “Only Richest 20% of Americans Still have Excess Pandemic Savings”, Bloomberg Sept 25, 2023

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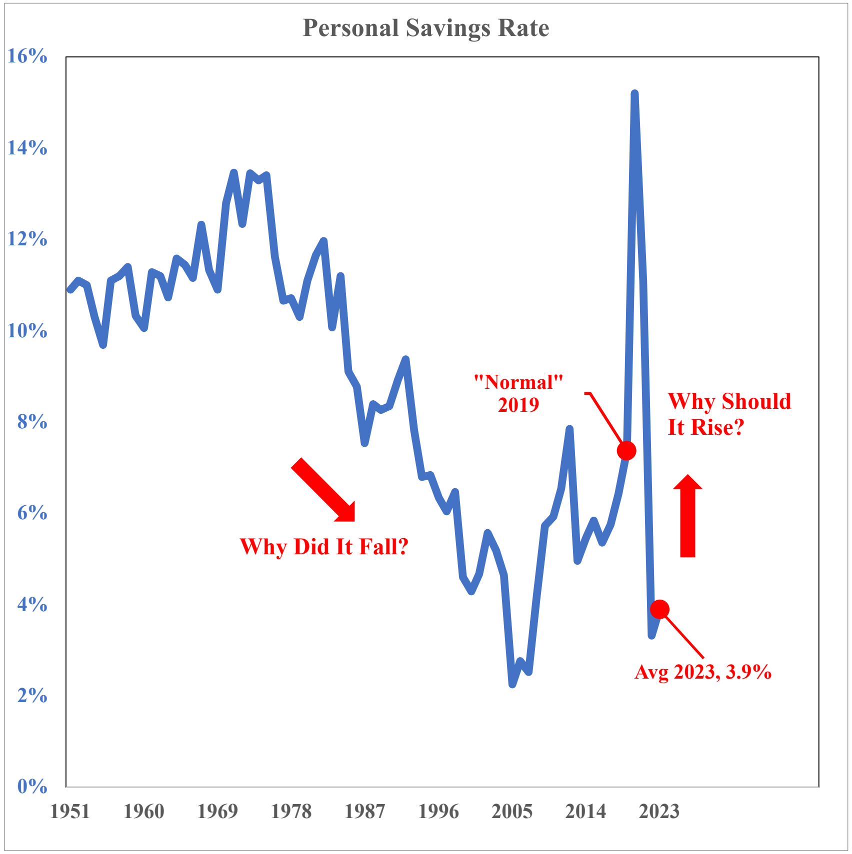
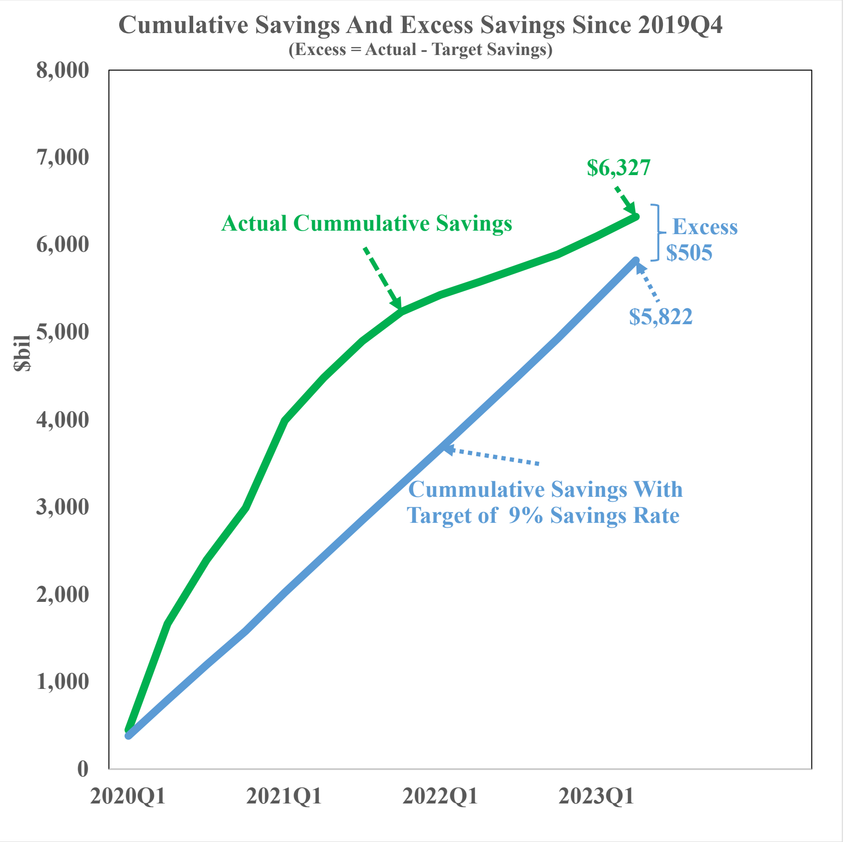
Step 2: Fundamental Economic Framework

View Was Spending Would Fall As Saving Moved Higher to "Normal" .. But Then …

If You Don't Know Why It Fell, Then Why Do You Know It Will Rise?



Level of "Normal" Savings Rate Drive Available Excess Savings



1. Federal Reserve Bank of St. Louis FRED data base
2. Board of Governors Of The Federal Reserve, Z1 Data Base
3. This analysis uses the updated savings rate/data which pushes "Normal" savings to 7% from 9%

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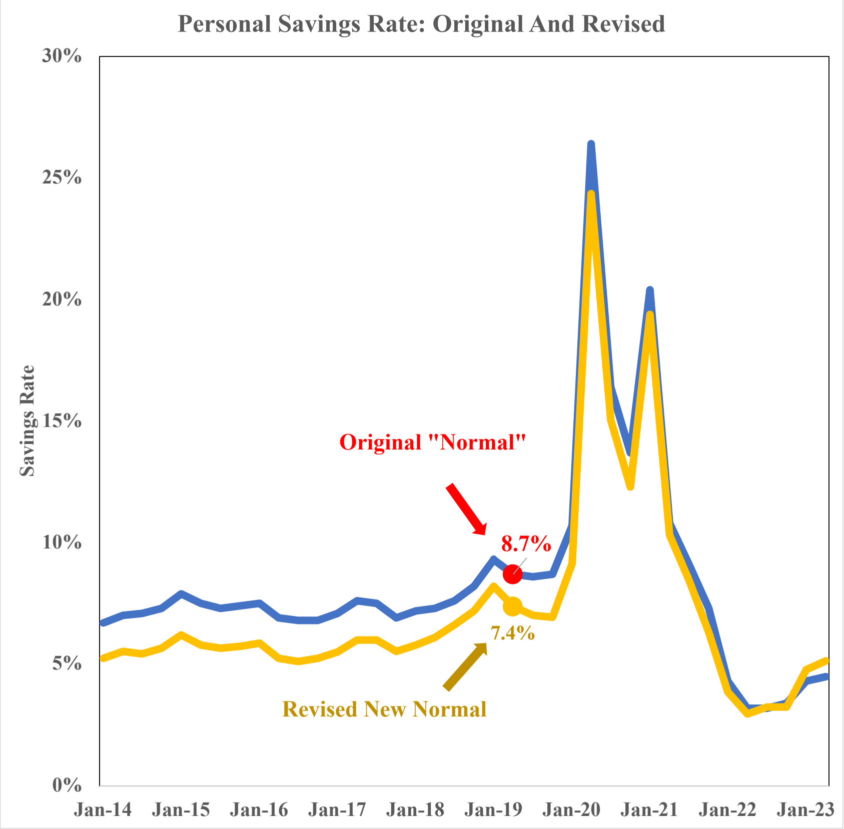
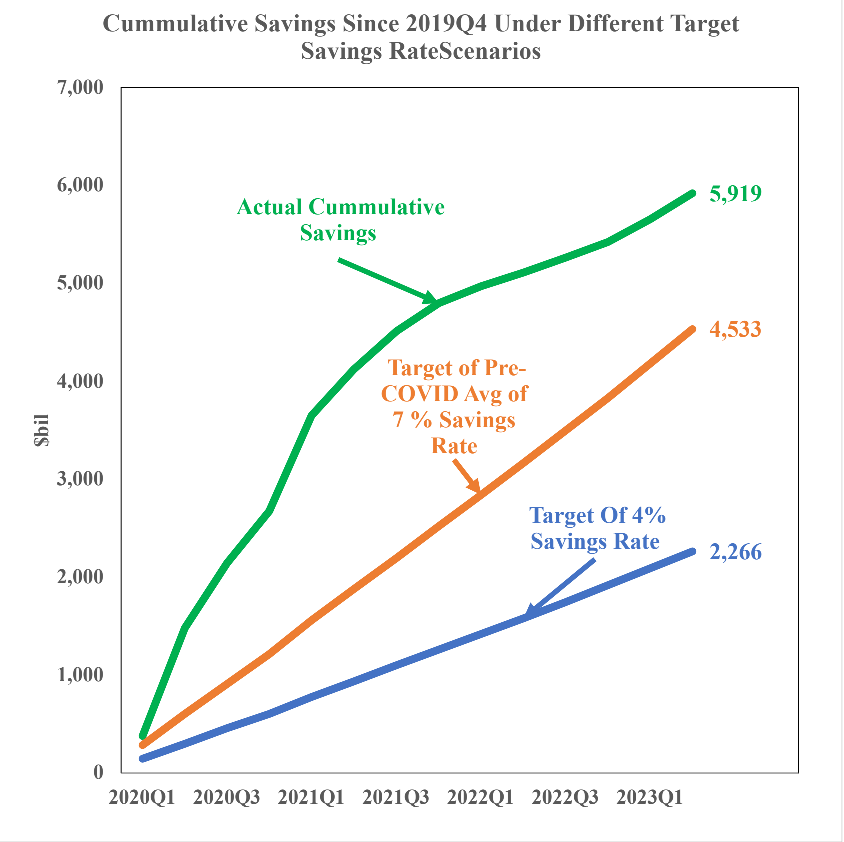
Step 2: Fundamental Economic Framework

Then "Normal" Based On 2019 Changed But Then What Happens If Savings Rate "Normal" Is Now

If You Don't Know Why It Fell, Then Why Do You Know It Will Rise?



Level of "Normal" Savings Rate Drive Available Excess Savings



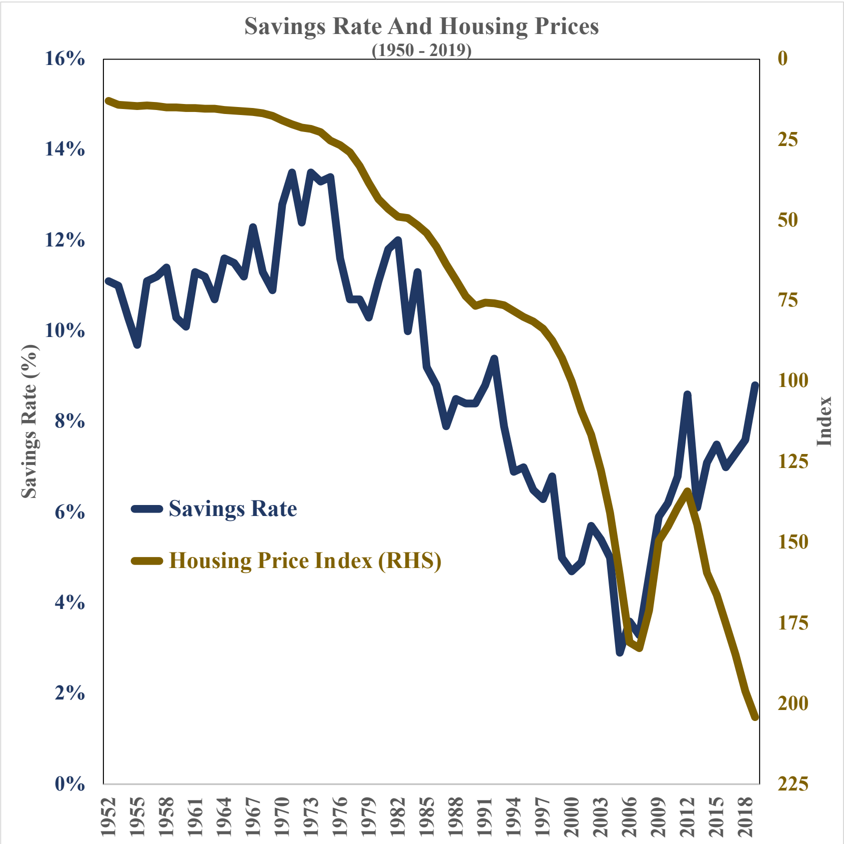
1. Federal Reserve Bank of St. Louis FRED data base
2. Board of Governors Of The Federal Reserve, Z1 Data Base
3. This analysis uses the updated savings rate/data which pushes "Normal" savings to 7% from 9%

State Of the Markets: Higher For Longer Is The "New" Normal

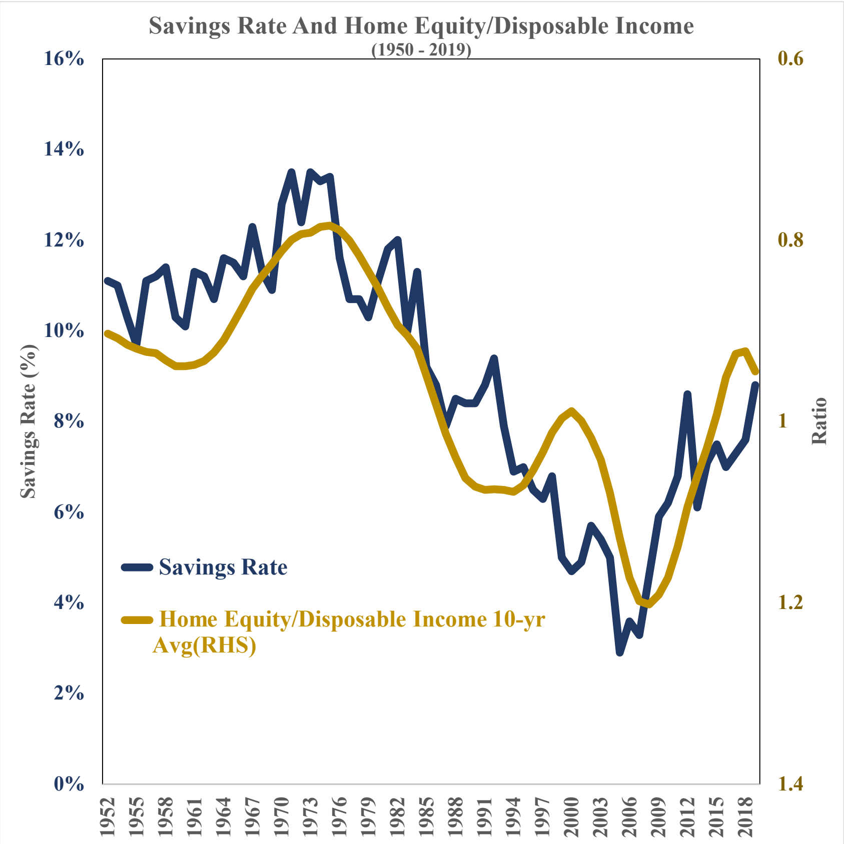
Step 2: Fundamental Economic Framework

The New Normal: Consumers Spend And Don't Save Because Their Wealth Growth Is Savings

Savings Rates Tend To Be Inversely Related Housing Price…



Not Surprisingly, A Measure of Home Equity Explains Savings Rates



1. Federal Reserve Bank of St. Louis FRED data base
2. Shiller data base on housing prices
3. . Board of Governors z1 Database

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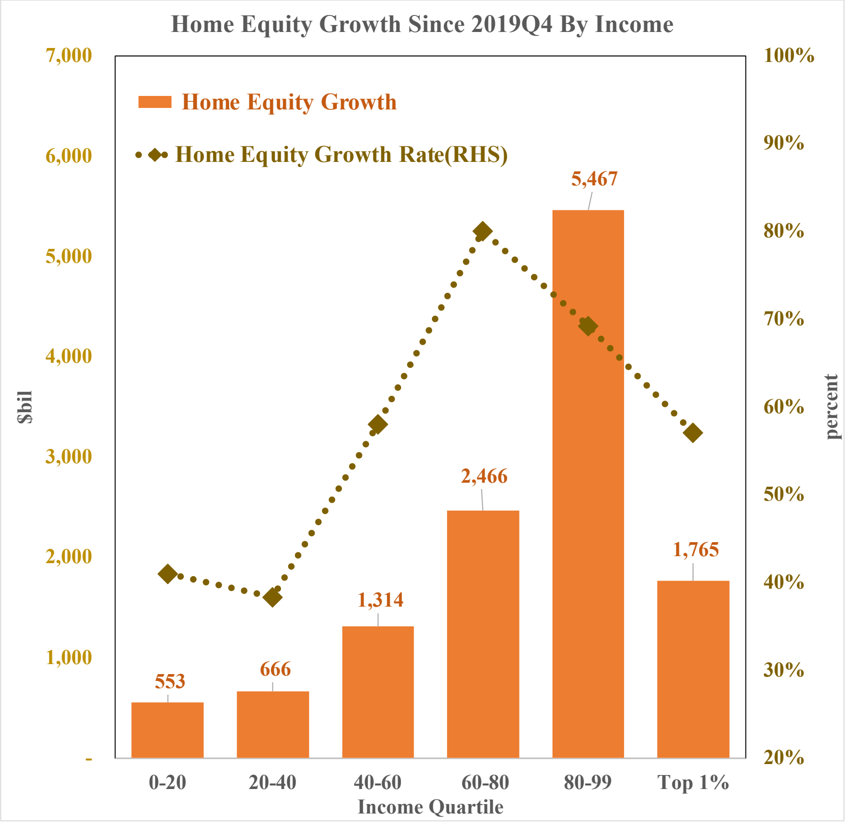
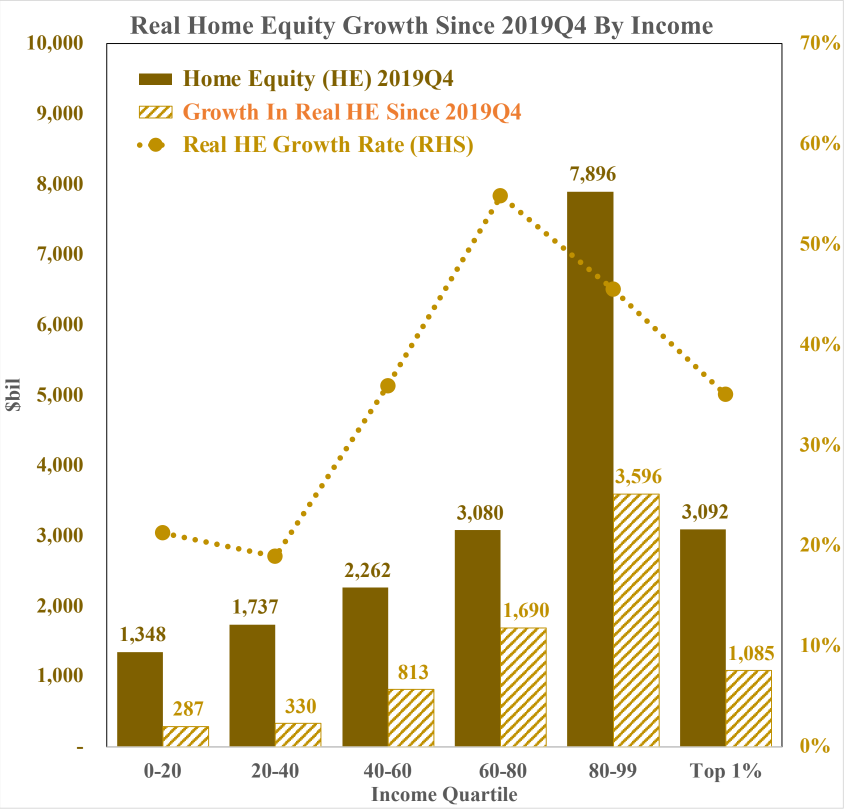
Step 2: Fundamental Economic Framework

More importantly, Home Equity Growth Has Surged By More Than 40% After Inflation

Home Equity Growth Has Grown By 60% For The Bottom 99%



Real Home Equity Has Grown By 41% For The Bottom 99%



1. Survey of Consumer Finance

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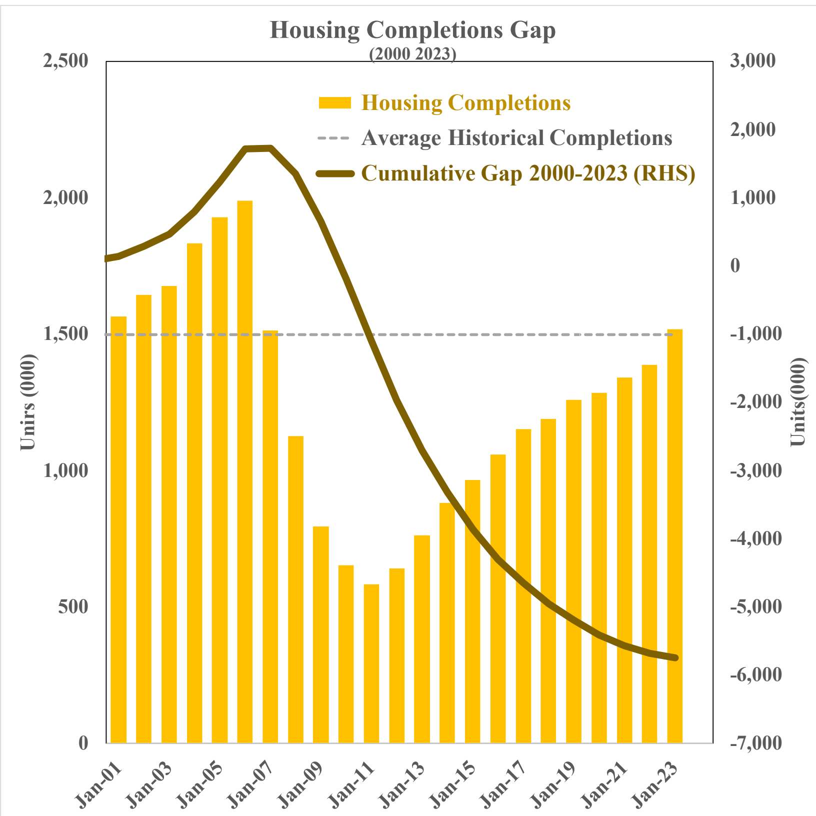
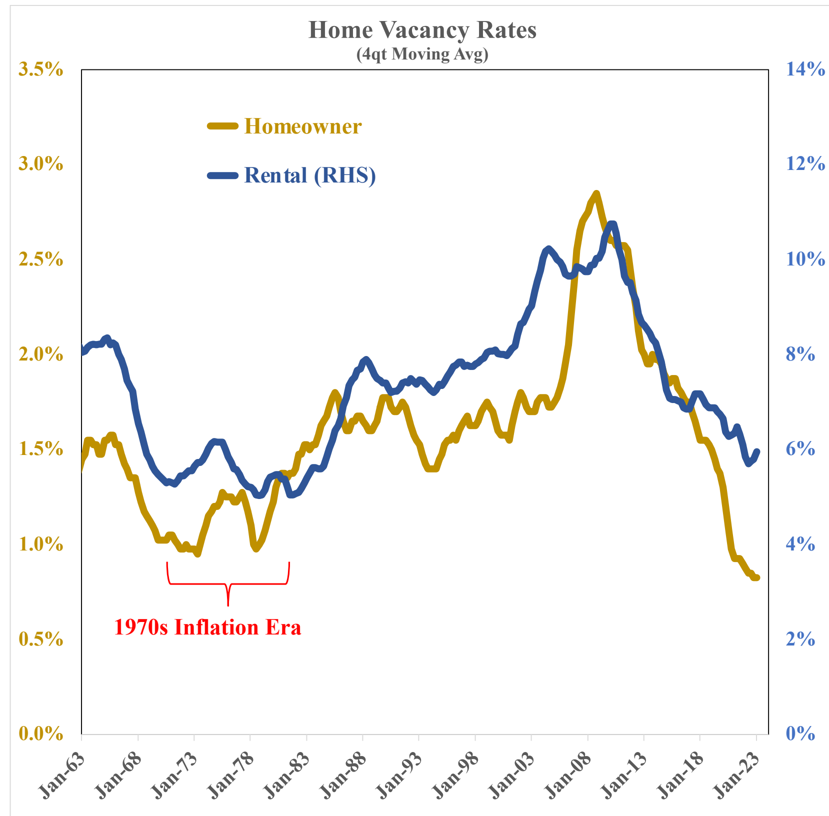
Step 2: Fundamental Economic Framework

Home Equity Is Not Going Away As Housing Market Reflects Too Much Demand And Too Little Supply

Starts Have Fallen Below Demand Creating A Shortage of 5.5 Million Homes



As A Result , Vacancies Are At Or Below Historical Lows



1. BLS
2. Federal Reserve Bank Of St. Louis, Fred Data Base

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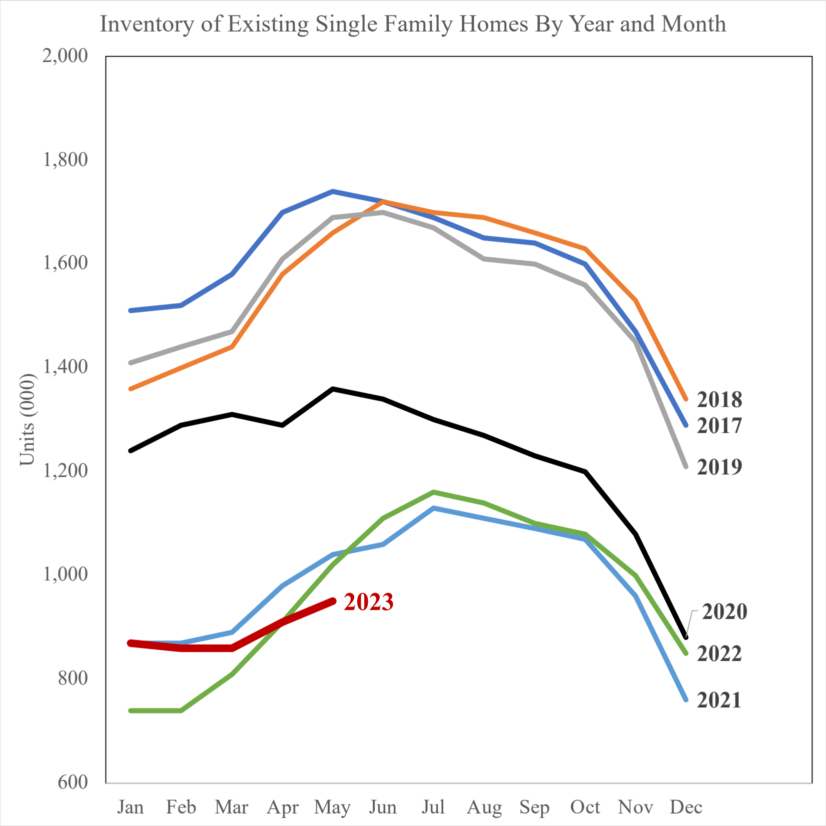
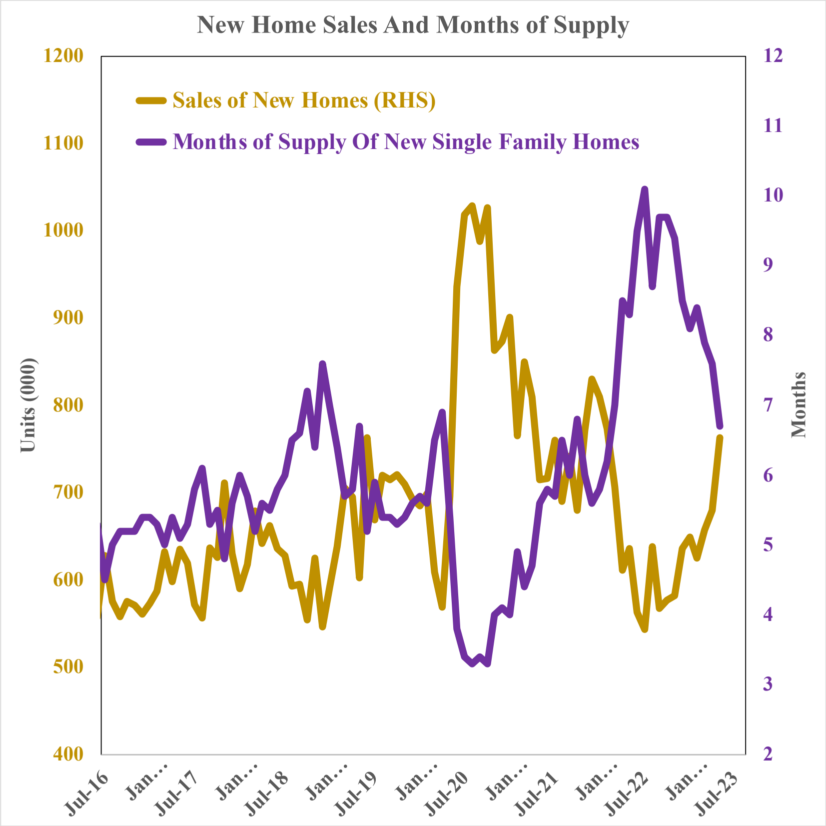
Step 2: Fundamental Economic Framework

And Not Enough Supply of Existing And New Homes

Existing Home For Sale Inventory Below Historical Norms…



Supply of New Homes Has Not Kept Pace With Demand



1. Bloomberg

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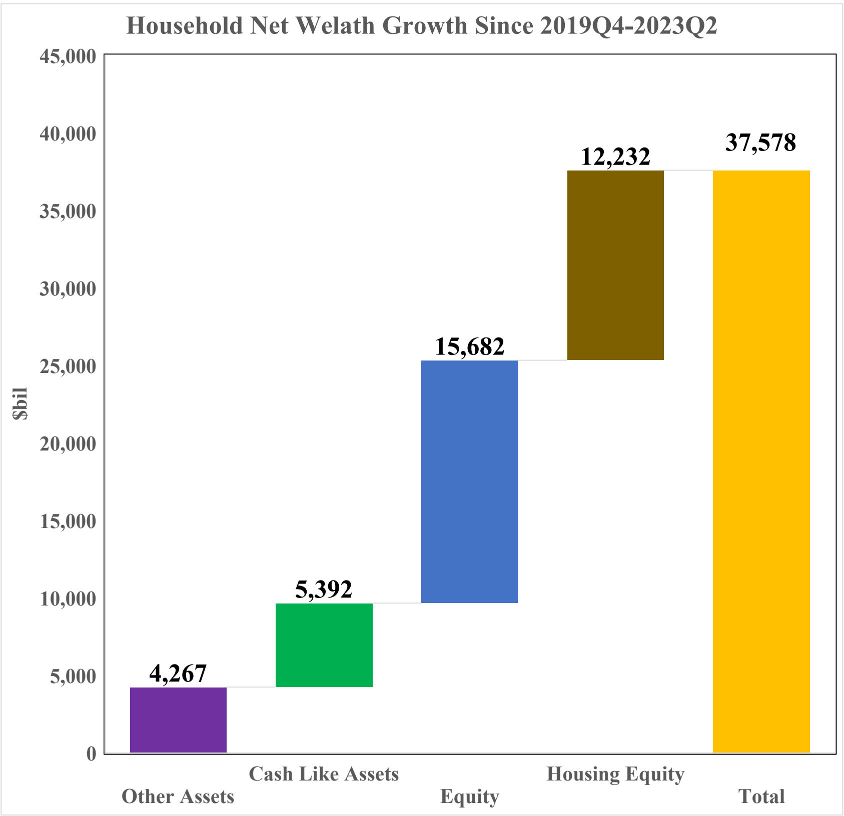
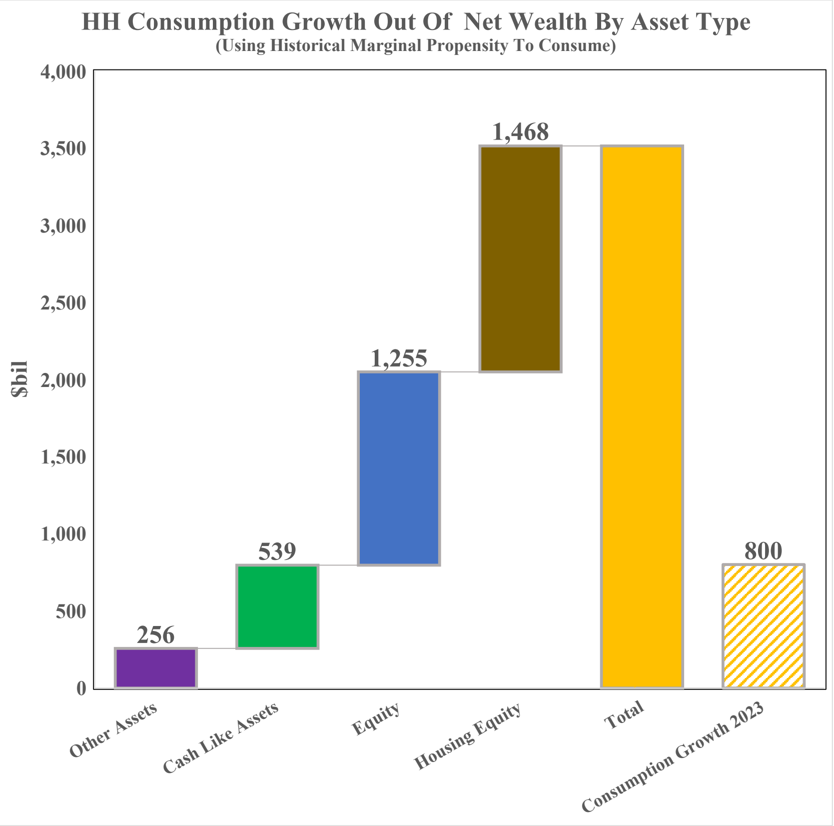
Step 3: Identify Potential Catalysts

The New Normal: The Consumer Will Spend Their Wealth And Not Return To Higher Savings Rates

Household Wealth Growth Has Surged Since 2019..



And this Could Lead to Substantially Higher Consumption vs History



1. Board of Governors z1 Database
2. I use marginal propensity to consume of 0.12 for housing wealth, 0.08 for equity/other asset wealth, and assume that cash holdings vs wealth returns to normal

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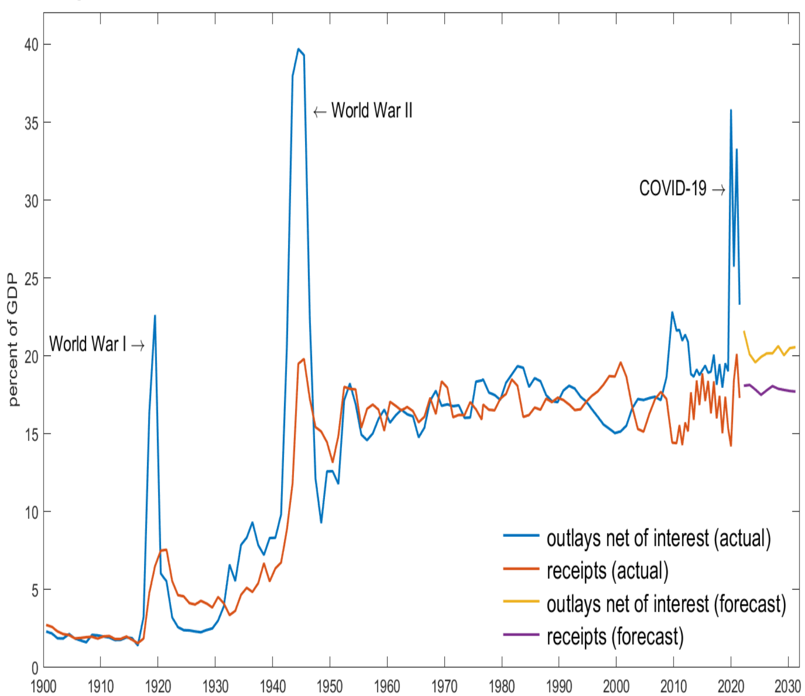
Step 3: Identify Potential Catalysts

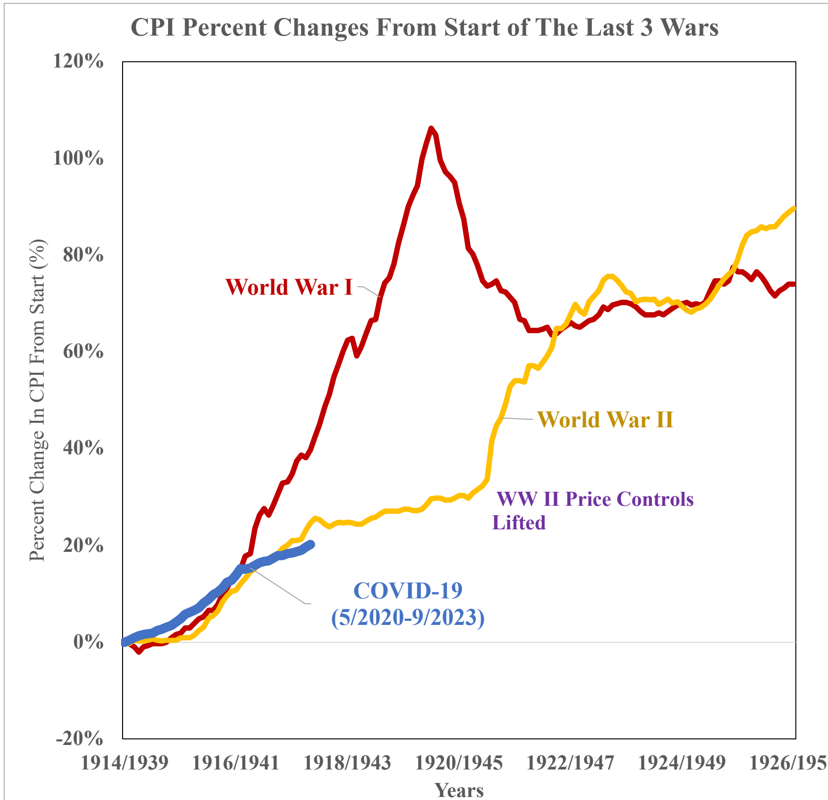
COVID Stimulus Was Equivalent To WW1/WW2, And That Could Mean that Inflations Goes Higher

COVID Stimulus Was Similar To A World War Stimulus And That

Figure 2: Outlays and Receipts: 1900-2031



Could Mena Inflation Could Go Higher If History Is Any Guide



1.Hall GJ, Sargent TJ. Three world wars: Fiscal-monetary consequences. Proc Natl Acad Sci U S A. 2022 May 3;119(18):e2200349119. doi: 10.1073/pnas.2200349119. Epub 2022 Apr 25. PMID: 35446688; PMCID: PMC9170155.

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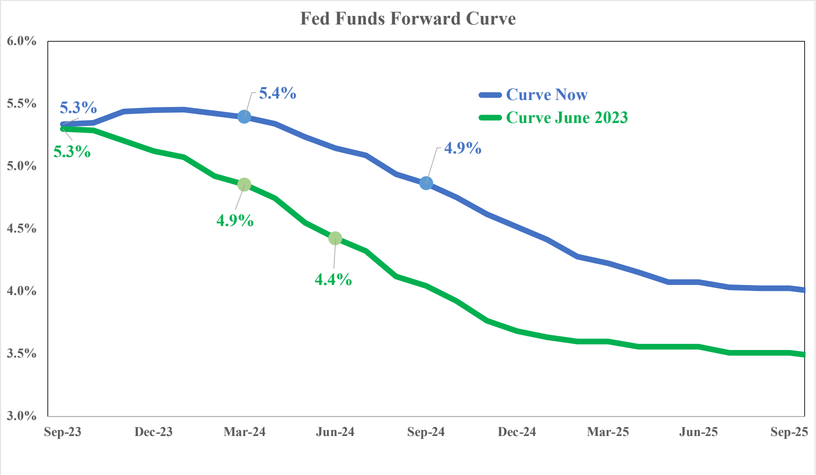
Step 4: Identify Asymmetric Trades

Buy 6-month Forward, 1-year ATM Payer Swaps

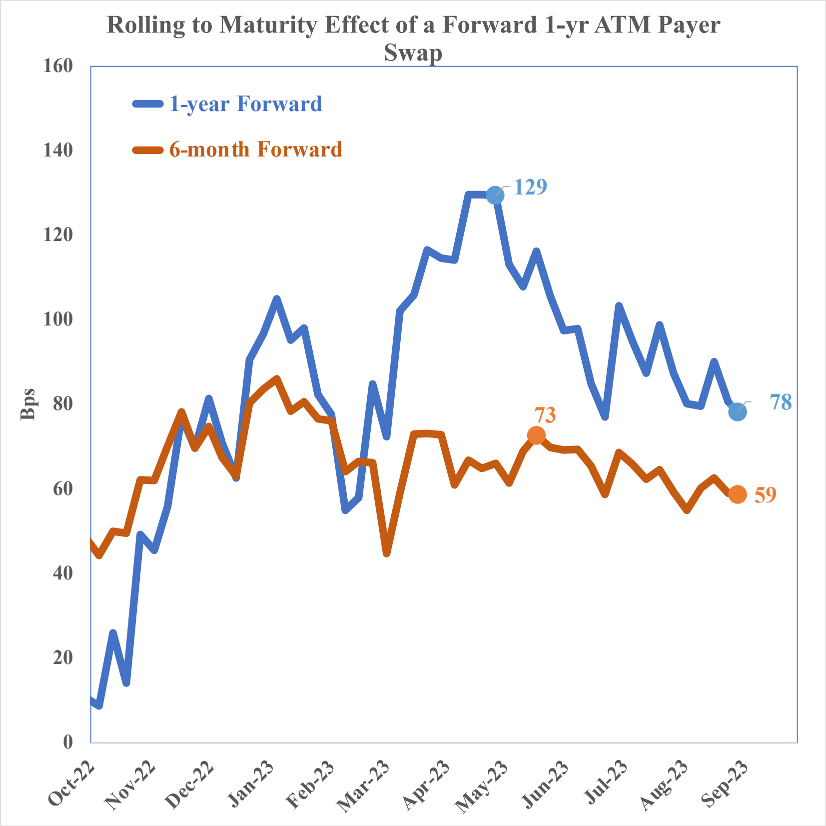
Trade Thesis

- Trade returns increase as it rolls to maturity up given expectations of Fed rate cuts
- Rolling to maturity after 6-months still remains attractive even with the change in Fed futures repricing
  - Returns can still be attractive even if the cuts rates given the steepness of the curve
- Cut may not happen an economic soft landing
- The Fed could even raise rates further and faster if inflation rebounds

Market Pricing In Substantial Fed Rate Cuts Even After Repricing



Rolling To Maturity Effect On A Forward 1-yr Payer Swap



1. Bloomberg

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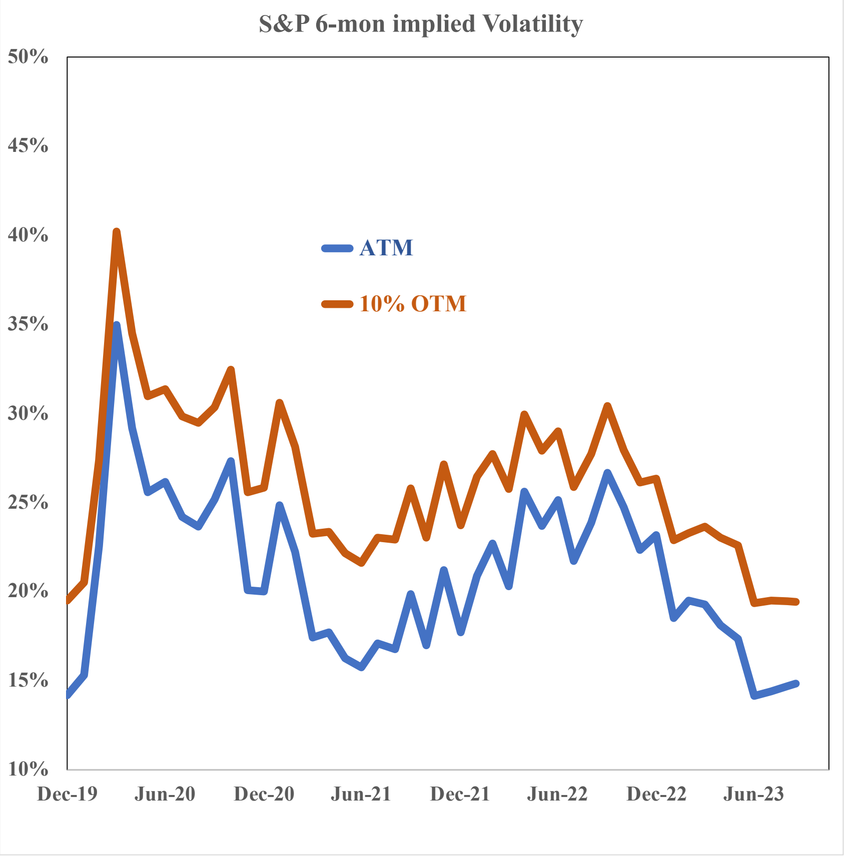
Step 4: Identify Asymmetric Trades

Buy 6-month 5% OTM Puts On S&P

Trade Thesis

- **Buy 6-month 5% OTM S&P puts**
- **Catalysts**
  - Equities could fall if central banks keep rates higher for longer to fight inflation
  - Equities could fall with stagflation economy or in a recession
  - Equities could fall if the market starts pricing in falling profit margins, particularly for S&P
- **Why S&P puts?**
  - Shorting US, not European equities to avoid the potential of an uptick in China stimulus
  - S&P could be repriced down substantially without the Nasdaq PM tailwind
  - Puts not an outright short with a stop because implied vol is near a 10-year low

Implied Vols Near Lows



1. Bloomberg

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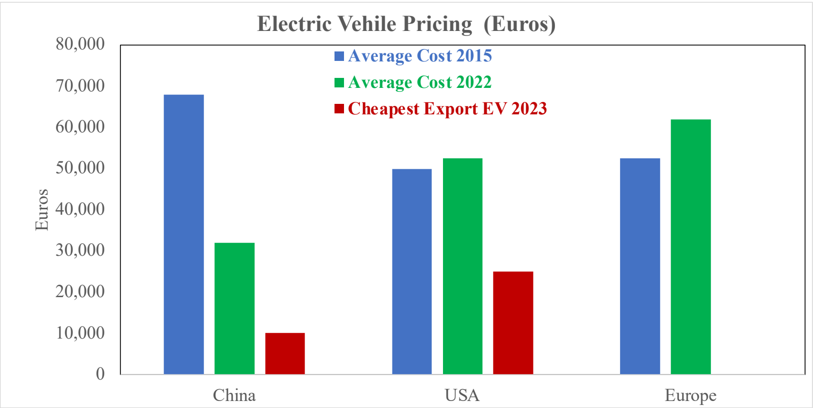
Step 4: Identify Asymmetric Trades

Buy 1-yr 5% OTM CNY Puts/USD Calls

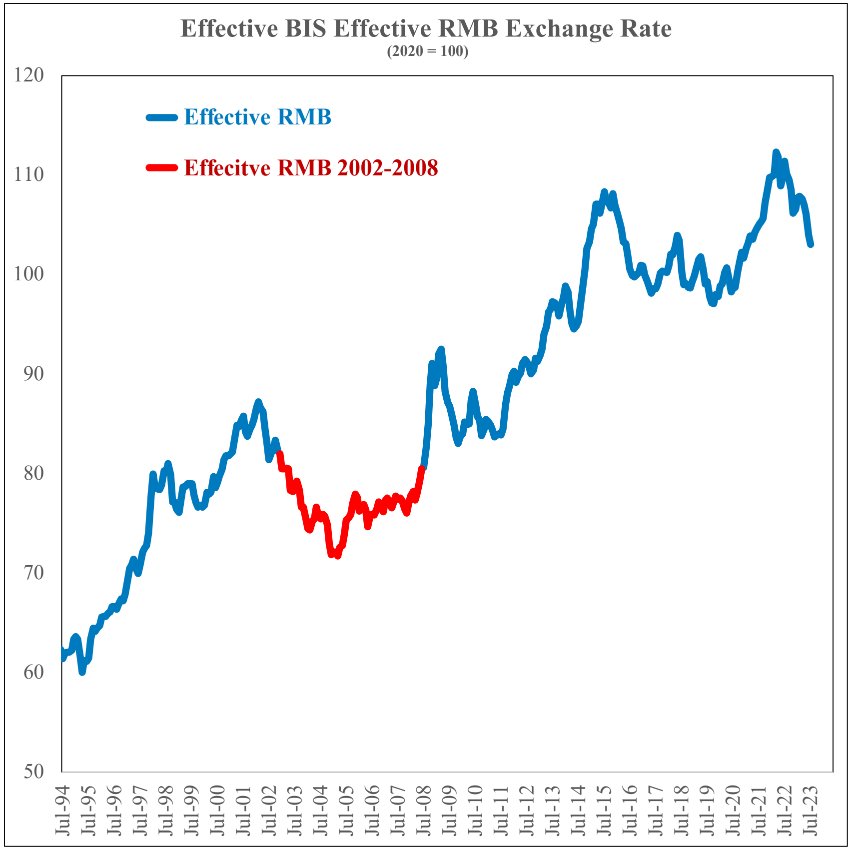
Trade Thesis

- China's current growth model is not sustainable
  - Baby bust, property bust, and now inflation are significant headwinds to China's existing growth model
  - Capital growth and consumption growth cannot support a 5% growth target without credit growth
  - A credit growth impulse to pull China out of deflation is too large to be realistic an causes too many imbalances
- China needs to return to its trade model for sustainable growth
- China needs to depreciate its currency for trade to become an alternative to investment growth alone
  - RMB would need to depreciate close to 20% or more to get back to levels during the trade boom in 2002-2008

China Already Produces the Cheapest EV, What Happens With It Devalue?



The RMB Needs To Devalue 20% To Get Back to GFC Levels



1. Bloomberg
2. Ptolemus

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