Keith McCullough: Inflation Accelerating

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Erik: Joining me now is Keith McCullough, founder of Hedgeye Risk Management and one of the most popular guests that we've had on the show. Keith, it's great to have you back. Now, our regular listeners already know that the guys at Hedgeye can be counted on for some of the best slide decks in the business. So, listeners, I strongly encourage you to download the slide deck which accompanies today's interview. You can find the download link in your Research Roundup email. If you're not yet registered, just go to our home page at macrovoices.com, look for the red button that says Looking for the Downloads? next to Keith's picture on the home page.

Keith, the first dozen slides or so in the slide deck talk about the process that you use at Hedgeye. And I can't emphasize strongly enough the importance of process and having a process.

But, since we've covered this whole process before, I'm going to refer our listeners to several of the previous interviews that we've done with Keith. If you haven't heard those interviews, I do encourage you to learn all about the process that Hedgeye Risk Management uses. It's one of the best in the business. Just type in Keith's name on the search box at macrovoices.com, go back to his first interview where we went into this in detail.

Keith, I want to skip ahead and just do a quick review of your process, or at least the essential process concepts from Slides 4 and 5, before we move on to the rest of the deck, because I'm really looking forward to going deep on your recommendations for this quarter.

Slide 4, you talk about the second derivative and slope and why that's so important. Please give us a refresher course starting on Page 4.

Keith: Sure, and thanks Erik for the kind compliments. Process – if I didn't have one, I probably shouldn't be on MacroVoices. So I appreciate that.

We focus on the rate of change or the second derivative move on both growth – GDP growth – and headline inflation. The reason why we do that is, of course, because it backtests as being the most causal factors for your asset allocation at the macro level, which would fully include sectors, long and short, and your factor exposure.

So on Slide 4 we're just showing you what the prevailing consensus wisdom is, which is not that people focus or anchor on valuation as a starting point, this time is different, economic gobbledygook theory, etc.

But, again, I'm just trying to figure out where the next and most probably dot is, if you will, for growth and inflation within the confines of that sine curve. So that's on Slide 4.

And then on Slide 5 we wrap that into what is effectively a two-by-two model. So you have two things, you have growth and you have inflation. And both are being measured and mapped on a trending basis, which means three months or more, all of the economic data.

We run that 30 data points per month, which would give you 90 times per quarter to change your view based on a data-dependent view. So there's no politics to it, of course. And, again, there is no valuation bend to it.

Quad 1, 2, 3, and 4 is what you see there. Quad 1 and 2 are pro-growth. That's when everything is great, rainbows and puppy dogs from a growth perspective.

Quad 2 is, of course, when you have both growth and inflation accelerating at the same time. And even the Federal Reserve figures it out and they have a central tendency to raise rates. That's why in Quad 2, Treasury bonds, for example, across the curve are a terrible place to be. And so is gold.

Conversely, Quad 4 is the best place to be for long-term Treasury bonds and for gold, because you have both the rate of change of growth and inflation slowing at the same time.

When the Fed figures that out, they try to cut interest rates, devalue the dollar, and drive you – Essentially, they'd like to have you back in Quad 1 or 2, but they have a central tendency to take you to Quad 3, which is – you could just name that stagflation – where you have the rate of change of inflation accelerating as real growth declines, which is where I think the US economy is right now.

Erik: Okay, so you are characterizing the current condition of the economy into one of these four Quads at any moment in time. And, again, listeners, if these concepts are new to you, I highly encourage you to listen to Keith's first interview where we really go into details about this process.

Let's skip ahead now to Slide 13, which is where we get into the current condition. You're saying we're coming out of Quad 4 and maybe into Quad 2 or Quad 3.

Tell us what's going on here. Why is that the case? And what does that mean in terms of asset allocation?

Keith: Well, the biggest thing that it means is that what already happened for the last year, Erik, is in the rearview mirror now.

Quad 4, as I pointed out, loves Treasuries across the curve. It loves anything that looks like a

Treasury, which would include utilities, REITs, bond proxies, gold, silver. Housing loves Quad 4.

So, again, we started making the Quad 4 call last year, in September 27, 2018. You'd make that call when the US economic cycle is officially at the peak. Then you slow from the peak and then you just continue to slow.

So the end of Quad 4 was comparing against the 2018 US economic cycle peak. Because we had Quad 4 in Q3 of 2019, so that was the end of Quad 4. The market has been trying to price that in.

Then, essentially, the next move is into Quad 2 or Quad 3 is what we're saying. The data is stacking up much more so in line with Quad 3. So, again, Quad 3 is stagflation whereas Quad 2 is up, up, and away.

And I do think it's quite an interesting setup because historically there's no precedent to have the President of the United States trumping up and tweeting up the stock market and talking about deals, and people getting excited about what could be a Quad 2. But there is no data that supports a Quad 2, which would fully include buying a lot of soy beans.

So that's where we're at on that.

On Slide 14, you can see how our quads are. Which is, again, the United States, our most probably outcome, deal or no deal – and again if the post-deal data were to change that, we'll change our mind.

I'm not in the business of saying what the data should do. I'm telling you what the data actually is doing. So if you look at the world's economy, what you see here is the top 20 countries by GDP. The USA is at the bottom.

And it goes – our outlook is Quad 3, Quad 3, and then Quad 4, with Quad 4, again, coming back in the middle of 2020 ahead of the US election, which would be a pretty nasty setup for the stock market if you were to take it from the all-time high, which is, of course, at the time of us having this conversation.

So I think it's a pretty interesting setup, suffice it to say. I don't really care what Quad it is. I'm long the things that work in both Quad 2 and Quad 3. But, again, the data is tracking in Quad 3, both in China and in the US, which matter more than anything else.

So what I'm going to be long is inflation, which is similar in Quad 2 and Quad 3, is that, no matter what you have, inflation going up for the first time in a year instead of down.

So there's a lot of different things that we can do in terms of asset allocation on that. The biggest pivot in terms of fixed income is to get long TIPS.

If you look at it in terms of equities, the biggest pivot from being short in Quad 4 to long in Quad 3 is energy – energy stocks. Energy of course is hated and under-owned on a historical measure, I might add.

And then on the short side, what you do at the US equity sector style level is you get out of what was a great long during Quad 4, which is a bond proxy sector called consumer staples. And you short that.

Consumer staples in Quad 3 is a good example really, Erik, of stagflation, because you have input costs rising. Stagflation is when you have inflation rising, both labor in this case, and the input costs. (We're bullish on commodities in Quad 3, just to reiterate that.) But you don't have any pricing power.

So you've got these companies – these companies are older than dirt in some cases – that have not really had pricing power for a long time, and all of a sudden their costs start going up so their margins compress and the stocks go down.

So that's one simple way, I think, to read through how Quad 3 can play into a sector and a company.

Erik: Now, I want to address specifically, you said inflation accelerating is one of the key trends you've got on Slide 13. And you just said a moment ago, that's what you want to be long is things that do well when inflation is accelerating.

Some people would say, okay, #1 rule of macro is gold is your inflation hedge. So if you think inflation is coming, it has to mean that you're stepping up your allocation to gold. I'm not sure that you guys see it that way.

Please give us the perspective on how gold plays into this story.

Keith: That's a real important question. It still takes me – I mean, every year is a new year trying to learn something that I don't know. And what I didn't know when I was a younger man was that what you just said is not true, if indeed the economy is in Quad 2. Okay?

So Quad 2 is you have inflation rising but you have real growth rising. Gold hates that because real yields are rising.

So gold, what it really likes is when real yields, as you know, are falling. Now that can happen with inflation or without it. And that's why gold works in Quad 4 and Quad 3.

Again, when you look at it in Quad 3, that's when you have stagflation. And real yields are still falling. So I think when you think about gold as an inflation hedge, it's especially a good inflation hedge when you have a stagflating economy and a lack of alternatives to invest in.

Again, you can go back historically and see that there have been many times, notwithstanding one of the most epic Quad 3s that has ever happened in the US economy.

And, again, these quads aren't subject to debate. They are just economic facts. It just characterizes what the economy was doing.

And if you go back to 2011 when gold hit an all-time high, you didn't have Quad 4. You had Quad 3. And that's when you had plenty of things that people would believe. Oh, wow, look, Bernanke is devaluing the dollar to a 40-year low. I've got inflation ripping to new highs.

That's when the CRB index, which is a broad base of commodities, 19 different commodities, was hitting new all-time highs. So of course you had inflation. And of course he wasn't admitting it.

But you of course also had gold work in that environment too.

Erik: Moving on to Slide 15, we're getting into China. Now it seems like almost everybody, at least the mainstream media, our friends on the cable networks, are talking about how, hey, as soon as a trade deal comes through with China, that's just the game changer. Everything is unicorns and roses from there.

Is that the right way to think about this? And I know that you have the utmost respect and esteem for our friends on the cable networks. But do you see it maybe a little bit differently?

Keith: That's a joke. I mean, you wouldn't be on MacroVoices if you were a macro tourist like that. That's what macro tourism is. To define it, it's when people jump from headline to headline because they don't know what else to do, as opposed to jumping from time series to time series.

And that's what a good rate-of-change person does is that they don't care what anybody on CNBC says or otherwise. Some of these other ones, I'm surprised that people even watch. But the reality is that what we're trying to watch is what the data is doing within the lens of the process.

So on Slide 15, you can take two different views of China, i.e. it's bottomed, which is on the left side of that chart. Or, on the right side of that chart, if you use a three-year comp or a three-year basis factor – simplify that, a three-year look back on what actually happened in the world – you'd say oh, no, it's going to continue to slow at a faster rate.

As we're signing Phase 1 of the deal, and doing the curtains and everything, and celebrating the all-time highs in the stock market, it's going to slow and slow and slow for the next three quarters post the deal.

So, again, the reason why we're using a three-year lookback on that chart, Erik (which you know, but just to explain it), what it's showing is secondary industries in China. So that's heavy construction, partly empty cities, all the stuff that China stimulated back in 2016. And, for that matter, which they stimulated in 2009.

These are the 64 million empty apartments and the most concrete used in human history. This is what they do and this is what they did.

But they're not doing it right now. so that's the point. The biggest stimulus in the history of China. And I think everybody on this call, because they are macro-aware, knows that there is a long history in China.

You know, if you took that from zero percent growth in late 2015, 2016, when Xi was about to get elected for life, and he ripped it to 14% growth, which equated to 50% of Chinese GDP growth. And now, as the base effect of that stimulus continues to heighten, incoming data continues to slow at a faster pace.

And even the Chinese, who are making up their numbers, are admitting that. That's why they continue to cut their numbers and are actually willing to try to do some kind of a deal because they think that they need it.

But it's not going to change it. This is a secular picture. And I can't use that word more often. And I'm not talking about "secular growers," which everybody on the planet Earth that's long tech continues to talk about. I'm talking about secular slower.

China is a secular slower. And that's the point here, is that we're well past their peak. They've stimulated multiple times to have the world believe that that wasn't a secular peak.

And, from here, I actually think that China, as the data continues to look as bad as it does on their own made-up numbers, it looks like Japan in the 1990s. And it's going to be – you're going to have to have a hell of a lot more tweets and bean deals to eliminate the economic gravity associated with that.

Erik: Now, if we go five years back even, there were lots of people predicting, okay, China is just at this unrealistic artificial level, they're going to start going into decline. It's going to send a deflationary shock around the world.

Half of that came true. They really are in significant decline, as your charts are showing here on Slide 16. But we haven't seen a contagion to where China blows up the global economy.

Is there still a risk of that? Was that just a crazy idea in the first place? How do we think now about what could happen in China and what it's going to mean to the rest of the world?

Keith: Well, that's a real important question. And at every stage and at every point in the next cycle, we get neither cyclical factors that run into new realities.

So the new reality here is that the dollar is at a 20-year high. And that the Chinese – if you just look at that, actually, on the next couple of slides – Slide 16 in particular reminds you that this isn't like 2016, by the way. You weren't at a 20-year high on the trade-weighted dollar index. And the Chinese themselves weren't all that willing to devalue their currency.

Again, they're short of dollars is the other point. So, again, if you think about that in terms of Slide 17, which should remind you of why they are the world's largest borrower of US dollar denominated debt.

Well, unlike in prior cycles, when China was running a big surplus, current account surplus, now they have a developing current account deficit. And the only way they can fund their deficit is in dollars.

So if the Fed doesn't get off their schneid and cut interest rates more aggressively – I think the way you asked the question is important. Because, to me, the answer is, how do things blow up?

It's if the Fed doesn't get the dollar down, then you're not going to be able to get away from these realities that are (a) new and (b) making the transmission mechanism for Chinese liquidity (quote, unquote) to not be impaired.

On the right side of Slide 17 you can see that. It literally is impaired. You've basically cut the reserve requirement ratio – or interest rates – in China six times since they started slowing again in 2018.

And it hasn't done anything for Chinese demand. In fact, we're on the lows in terms of even shadow financing demand for loans fully loaded.

So that's the problem, is if the Fed – and that's really the final point – and I'm not the guy that tries to get famous writing a book on how the world blows up on what day of what month, Erik. I think that's a little ridiculous. If you get that right, then, cool. But that's not what I do.

What I would just submit is, on Slide 18, is the market is right on what the Fed should be doing, which is devaluing the dollar, which is what I'm showing you here.

In order for Beijing to bail us out, the Fed has to capitulate and cut rates more aggressively. If the Fed doesn't do than, then there is going to be a non-linear pattern to the downside that most people aren't prepared for.

So, again, this has actually never happened before. So those of you that follow the Fed's dot plot, which is accurate about 30% of the time at best – again, it's showing you the Fed's forecast versus what Fed fund futures are implying. And it's at its widest deviation or divergence (however you want to characterize it) going all the way back to when the dot plot was invented by the Federal Reserve, or at least published.

So, again, what this is saying is that, if you think that the China bean deal and that the Fed are going to be right post the deal, that everything is going to be back to rainbows and puppy dogs, well that's completely off-sides with what the market is expecting in terms of interest rate cuts. And, more importantly, like I said, what the market needs and the global economy needs, which is a weakening of the US dollar, which you can only have if the Fed indeed goes incrementally more dovish from here.

Erik: Now, I've been following your daily updates on the dollar. And, obviously, as you know and as our listeners know, the dollar hit an all-time high on some indices – on the dollar index it's not an all-time high but it's still certainly a cycle high – back on October 1.

But, ever since these announcements from the Fed, it's been selling off. We've reached the point where at least your short-term support levels, the Hedgeye bottom of the trading range, have kicked in.

Does that mean that we're going to see a reversal here? Or is this going to be maybe a dead cat bounce before we break through those levels and see a new trend emerge?

Keith: Our call on the dollar was crystal-clear. I mean, I couldn't make it more clear.

When we're in Quad 4, when both the global and US economy are in Quad 4, the dollar goes up. That's it, period.

And that was our call going back to when China, EM – and Europe for that matter – all started slowing at the beginning of 2018. And it was pretty easy to see that the dollar liked that in lieu of other people's currencies and problems.

And then the dollar really liked the fact that the Fed had to go from hawkish to dovish at the end of 2018 and early 2019. So that's it. If you can't show me –

Which, by the way, so I do think it's a six-month short call or get out of the dollar-long position and think of the other side if it (we can get into that too), which is, I think, just buy commodities. That's the easiest way to go right to the asset allocation vein.

But, again, until we get back into the market discounting that we're going to reenter in Quad 4 – i.e. when both growth and inflation are slowing at the same time – which we have happening again in the middle of next year, then I think that the dollar starts to break down.

That's basically what you're pointing out on the Hedgeye risk range, is that when the risk range starts to develop a series of lower highs and lower lows, the trend eventually breaks to the downside. And that's what – I'm not willing to believe that, just, market signal.

When I look at a market I look at where are my quads? Where is the most probably outcome economically (a)? And (b) what is the market signal? Is it agreeing or disagreeing with that?

The market signal is agreeing with what my quads see. And, again, in Quad 3, the dollar is not a long, it's a short.

Erik: Okay, so the October 1 top, you think that has a good chance of being *the* top, at least for a while.

Keith: Yeah, for at least six months. Because, again, it would fit right on the screws when Quad 4 in Q3 of 2019 ended.

So, again, I'm using these words specifically because, mathematically, that's just a fact. I mean, you had Quad 4 in Q3, obviously, at the end of September. And, lo and behold, the damned dollar just stopped going up right at that point in early October.

Erik: Got it.

Let's come back to Slide 19 in the deck where you're saying that equities are a 2019 "fear of missing out" story. What's going on here?

Keith: Thanks for spelling it out, too. I mean, I am a – inasmuch as some people are compensated to be addicted to the FOMO, I think people need to understand the link if they are gainfully employed to buy stocks.

FOMO, to me, is like – I have my own personal FOMO on not using the FOMO because it's just like such a great narrative that only Wall Street could be addicted to.

But just remember that the story this year is that you have to be willing to believe. "Believe me," in the words of your favorite president. You've got to believe. You've just got to believe that earnings have bottomed, even though nobody on Wall Street a year ago said that earnings have topped, other than us and maybe some others – maybe you said it too.

But you know that you have to believe – even though you couldn't believe that you were going to slow from the cycle peak of earnings to now negative year-over-year earnings – that you've just got to buy stocks. You know, you've just got to buy them. Even though historically when this has happened, and we're at the widest divergence –

And, again, I pay a lot of attention to divergences that have a central tendency to mean revert or come back to where they've always been.

The difference between the level of the S&P 500 and the earnings revisions to the downside hasn't been this wide going all the way back to – and I'm showing you what the forward P/E is implied right now on Slide 19 relative to where we started the year – going all the way back to

2000-2001. Which is not a good reference point to buy stocks. You know that's just not smart.

So I think that even though – again, if you go back to October of '07, obviously, the stock market, what could possibly go wrong? It went up almost every day, and then finally stopped going up in early November. So that's an interesting thing.

On Slide 20, though, you can see this. The global GDP trend is, obviously, down into the bottom right. That's why bond yields globally did what they did this year.

And at the same time, on the right side, which is this like Walley World chart, I think, I think it's crazy. I guess being a macro person, you're always going to see crazy. But you don't want to be crazy. You don't want to be the person buying this.

The next 12 months of earnings expected in the S&P versus the Russell, you could drive a truck through that. That's the widest it's ever been.

So the way I read that chart is that the Russell earnings don't hope for any bean deal or any big China resolution, because it's more local. And the S&P 500, you're just waiting for companies to tell you the truth. Which, by the way – and systematically – has started to happen.

So you're seeing an earnings season now, earnings are down about 2-3% year over year, which is the worst it's been.

And it's a broadening. So you're seeing it broaden to negative 6% year over year in tech and in consumer discretionary, which is the other big sector people are long, now have negative earnings and falling.

You have to believe that that's a bottom that you never called for to begin with, and then an acceleration. Which is – I think that's the stuff of madness, personally.

But that's how I look at it. I think that it could only be summarized with the acronym FOMO. I mean, how could you not just chase year-end benchmarks? Because that's what you get paid to do.

So it's interesting, because that's obviously always been Wall Street's problem is that they'll take living in the fear of God of that index return and they will be willing to believe pretty much anything.

Erik: Keith, I couldn't possibly agree with you more. And if I look ahead to Slide 21, you can see CapEx is already on the decline. These slides are all painting a really, really strong picture of hey, guys, the party is ending. It's not time to be piling into stocks expecting the next big move up.

But I want to play devil's advocate for a minute, because I've become pretty cynical about this market. What if I were to say, look, we're living in a kind of screwed-up reality of central bank control now that we didn't use to have.

So if I look at all this, what I see is bad economic data. That means, as you've said, the Fed is going to need to continue cutting. That's going to enable more easy money financing for corporate buybacks. That's going to allow the S&P to melt up even more, as crazy as it might seem to you and me. Therefore, maybe a fear of missing out is not the right rationale.

But there's certainly – I don't want to be jumping into the short side of this market right here. I'm afraid that we could see a melt-up just based on easy money driving more corporate buybacks.

Keith: Yeah, we are already – to characterize what's happening today – or it's late October early November – as a non-melt-up, I think would be a mischaracterization. We are seeing a melt-up.

I mean, there is a melt-up across the board of people chasing, like I said, you're willing to pay a higher and higher multiple for less and less earnings. And that is – I think you're in it.

I mean, I think that if you also kind of take a step back – I always look at what the market has done going backwards, because there have been multiple periods of FOMO where within five to six weeks people are on their knees crawling on the linoleum floor begging for more cowbell.

And, by the way, buying every one of those non-stressful dips was the thing to do. I think I agree with you on that, Erik, as well. Because, again, at the end of April, at the end of July, right now, I mean, if you get sucked in at the wrong spot, you can have a 6-8% drawdown in a very short period of time. And then who really is willing to buy at that level?

So, for me, I resolve this by basically buying what I like anyway at the low end of the range. I mean, the current part of the melt-up, by the way, has been driven by a sector that I'm long and most people won't touch with an 80,000 foot pole, which is energy.

So I think it's more about being long – that's essentially the genesis of the Hedgeye process. Relax. Stop being so stressed about CNBC marketing of the Dow, BRO, and SPYs. You can be smarter than that. For the last year, you could have owned something that outperformed SPYs by almost 2000 basis points in REITs and utilities.

Again, we're trying to find the thing that we can own within the thing. So, again, the sectors of the S&P 500 that we want to be long. And not living the daily stress of trying to beat the S&P 500's benchmark gain. Or loss for that matter.

Don't forget, the S&P lost 20% of its value over a three-month period at this time last year, not that anybody remembers. But you'd be reminded of that if it happened to your own capital.

Erik: Now, you guys are obviously data junkies. I think that we agree that what's going on right now is there are already clear, clear macroeconomic signs that stock prices should be lower. That's not happening because we are seeing a melt-up for the reasons that I've described, having to do with easy money enabling buybacks and so forth.

Is there some indicator? Is there some magic Hedgeye chart that says, okay, here is the signal to watch for that tells you that gravity is about to set in and reality is going to take over instead of this melt-up on easy money mentality that we've been in? Or is that unpredictable?

Keith: Unless – again, unless it's different this time, which, as we alluded to at the beginning of the conversation, that's not what I do. You get somebody who's got a much bigger brain than me to come up with all these different theories on how it's different this time.

I'm a student of cycles. And never in the history of cycles have earnings deteriorated from peak cycle to slowing to negative – then more and more, and negative on a year-over-year basis – have you not seen a commensurate decline and multiple compression in stocks and/or a widening of credit spreads.

So that's it. We're literally right at the end of the thing.

Most credit investors will say, okay, that's fine. Look at credit. Credit, the all-time tights were in in early '18 when the global economic cycle peaked. USA continued to chug along. So there are plenty of parts of credit that did fine over the course of the next year.

But the parts of credit that were linked to China and China demand falling, they wiped.

And, again, you had – credit has been deteriorating underneath the hood, inasmuch as the S&P 500 has been. Don't forget, the Russell 2000 is still down 8-9% from where it peaked in 2018. And plenty of sectors have been horrendous places to be, relative to the alternatives.

So, again, I just think that it's actually happening with the boogeyman being the thing that macro tourists stare at, which is the headline Dow in points, saying, oh, it's all clear.

Look at the amount of new highs in either the S&P or the Dow, for that matter relative to the Dow, and the S&P 500 making new all-time highs on their own. It's at a very wide divergence, which is also pretty consistent with, by the way, a market top and people capitulating, saying, oh my God, this is never going to go down again.

And then it could go down in a ball of flames. Again, that's not my call. But certainly if it does go down in a ball of flames I'm not going to lose money like the people that don't think that it will.

Erik: Let's come back to Slide 22, where you get into labor's share of income and corporate margins. Talk us through what's going on here.

Keith: So that's a way of just showing a picture of what I just said.

And another reason why, to be clear, that we're super-bullish on growth and all the stocks you should be long in Quads 1 and 2, is when you have GDP growth growing faster than the wage growth.

So that was Hedegeye's call from mid-2016 until we said, basically, the peak of the cycle of Q3 of 2018. For me that's a long ride. But it's also the ride that you're on. GDP growth was greater than wage growth.

Now we have GDP growth falling, and falling below wage growth. So the whole point of wage growth – that it's the latest of late cycle indicators. So 100% of the time – and, again, this is not different this time, Erik – 100% of the time, wages continue to accelerate into a recession and perpetuate a profit recession and a broader recession.

Basically we're at that point now.

And what I'm trying to say with the quads, is that, by Q2 of 2020, your highest recessionary risk on this basis will have, will be staring you in the face. Because, again, there is no catalyst to get people's wages lower.

There is a reason why GM has had a successful strike, the people did against the company. And the last time they had one like this was in 2007, again, at the cycle peak. That's when the people have more leverage, because corporate profits are coming off their peak.

So, again, we're going to see margin pressure. I think it's a foregone conclusion. I think Wall Street is off-sides on seeing a continuation of that.

So if you look at Slide 23, I'm just showing you the rate of change of year-over-year sales and earnings for the S&P 500.

And what the Street is basically saying is that, okay, I get it. This whole China thing, you can blame everything on China. You can blame it all on China.

Nothing on the cycle, God forbid. Or tax reform perpetuating the peak of the cycle in conjunction with the Chinese stimulus. Those two things back to back are, like, the most epic stimulus you could think of in historical terms.

And the Street is looking for a reacceleration of earnings in the first half of next year. Of course, as companies continue to dive down in the fourth quarter – so you're going to have, basically, two quarters going on three in a row of negative year-over-year earnings.

Again, it's pretty simple to understand. If the Fed doesn't get that dollar down, the demand continues to flow, labor continues to rise against peak comps, then you will see a further, and I think a faster, degradation in earnings.

We think that earnings could be easily down 5-8% year over year within the next either this quarter or the next quarter. And that's – if it's like 2001, that's the beginning of a very nasty period for US stocks.

And 100% of people that I've worked with, never mind the people that were spewing old Wall research to me as a young analyst in 2001, 100% of them had that wrong. Because they said, oh, we're growth investors. We're all long tech and coms and everything else.

And then, lo and behold, S&P earnings were actually down in the teens year over year for multiple quarters in a row. And that's when the real proverbial poop hits the fan.

Erik: Moving on to Slide 24, we're coming to my former occupation, which is the software industry. What's going on here?

Keith: Well, it peaked. That to me is the call within the call, is that you have a bubble.

Erik: It peaked when I got out of it in '98. Obviously, that was the secular catalyst.

Keith: You should have come back to it, Erik. It's like MacroVoices is a service. You could have got a multiple on that. It's just crazy. It's not crazy what happened. It's actually predictable.

So we have tax reform and we have the largest sales force in America right now, or at least the biggest and best-paid is that that sells software as a service. You know that. And that's where all the market cap has been created. And there is a bubble that was brewing.

All this great technology, all these apps and everything that people love, now we have massive sales forces – salesforce.com is almost metaphorically the big building it's built for that in San Francisco – to me is kind of like Encana at the peak of the energy market in Calgary, Alberta. But, again, I digress.

You basically had a catalyst at the end of what was a developing bubble, which was tax reform.

So tax reform, for anyone who doesn't know, you can depreciate 100% CapEx against your net income. So, if you're like me or Erik or anybody who has their own company, you're looking for things that you can deduct, right? What can I invest in my business that can make my business better?

And software becoming a capital expenditure as opposed to an operating expenditure became basically what you see there. The peak of software's growth rate was basically at this time last year. So growing, like double-digit growth year over year.

We're showing you software CapEx on a year-over-year basis. And, again, the whole point is that, as you compare against those peak growth rates, you're going to slow anyway. So that's the point.

At this point, Amazon web services, which is basically one of the largest cloud companies in the world, has slowed 260 basis points year over year, which is a lot. But that's in line with the basis factor of the comp going up about the same.

So, to me, it's just math. Your software might be the greatest thing since the last time I was told that the Internet was not called the cloud. And, to your point, back in 1998, that was a great ride to be on. But, again, we've renamed a lot of different things but we've given them similar multiples.

We talk a lot about the TAM, 15 to 20 times the revenue. And it's all good and fine until the companies tell you that their growth rates are slowing, with rising labor forces and cost structures.

So, to me, that's why we're short software. And it's been working, really. I mean, it peaked, obviously, back in July. So, even though the market is making – like, the SPYs are making all-time highs and people have to buy stocks.

If they bought the wrong software stock, they got their ass handed to them. And that's the problem.

I see more short-selling opportunities in these secular growers that are meeting a cyclical slowdown (i.e. a secular grower), which – Wall Street essentially came up with that – is just a company that has never seen a cycle. So I think there are loads of companies like that. Not the least of which are the ones that are the most famous and kind and dear to their hearts, like Uber.

Erik: Keith, moving on to Slide 25, I know you guys at Hedgeye very much embrace the long-short equity strategy.

And I happen to know that because I just released a video on how to run the long-short equity strategy, which is the original hedge fund strategy, in a private investment account. And I actually mention Hedgeye in that video because you guys are the only ones that I know of that are available to retail investors who provide both long and short equity recommendations.

Talk us through the concept of what a long-short pairs trade is and why is it that long energy, short software right now is a particular favorite that you're describing here on Page 25.

Keith: Yeah, that's perfect. And, by the way, most people aren't perfect at making short sales. So when you think about a long-short strategy, you have to have not just somebody who has short ideas but somebody who has accurate short ideas.

So the #1 place you should go is thinking about the rates of change. Again, you can think about that in terms of a company or you can think about that in terms of sectors.

Now, sectors, like which we're showing here on Slide 25, I think it's a great pair trade just using CapEx. So again, CapEx from a top-down perspective is slowing.

Now software CapEx is slowing at a faster rate against bubble comparisons. Whereas energy CapEx has negative comparisons, easy comparisons, because energy has been blowing up for some time now, as it should during Quad 4.

So now you've got energy CapEx can be down 5-10% year over year, whereas software CapEx can flow – and in the prior slide we show – from up 11-12% year over year to something in the low single digits. I mean, it already did back in 2015. You can see that.

So, again, now when you look at that pair – because, again, it's based on the same premise – you're starting with the cycle. And you're, like, okay, what's going to accelerate and what's going to decelerate? Then you look at the index weights.

Now, as a percentage of the S&P 500, energy is on its lows. Everybody knows that. That's why you can't get a diversified portfolio, mutual fund manager, to buy energy. Because they haven't had to.

So, again, they all own tech. They all own consumer discretionary. And most of them, really, own software. Okay?

So, software, as you can see, is coming off its highest level ever as a percentage of the index. And energy is coming off its lowest level. All I really need to have this work, Erik, is for energy to go up in terms of price.

So, if I'm right on my inflation-accelerating theme, and natural gas and oil continue to make a series of higher lows and break out to the upside, then energy just has to be 5-6-7% of the index. And it has to come out of somewhere. And I think it's going to come out of the place that has the most obvious slowing, which is software.

Erik: And, again, just to explain this concept for any newer listeners who are not familiar with hedge fund strategies, the whole idea here is you don't know what's going to happen to the S&P. Is it going to go up 30%? Or is it going to go down 30%?

What you want to have is a balanced portfolio of both long and short positions so that you make money if the market goes up and you still make money if the market goes down – because in that scenario, your shorts outperform your longs.

That is the subject, both what I think you teach, Keith, on an ongoing basis on your macro show on the Hedgeye network, and it's also the subject of a video that we just released on the MacroVoices YouTube channel. (It's a free video, so be sure to check that out.)

Let's go ahead and move on to your final slide, which is what you guys are doing. Keith, we actually waited until now to get you on the program – we've had several listener requests to get you back on. But we happen to know that your marketing guys wait until Cyber Monday (right after Thanksgiving) for your very best pricing of the year. And we wanted to wait to have you on when you could offer our MacroVoices listeners the very, very best deal.

This time of year is when Hedgeye offers their products at the lowest available prices. Patrick has negotiated with Matt and Dan on your side to get an additional discount for MacroVoices listeners only.

So give us the rundown between the Hedge:IQ, Elite Pass, and Platinum All Access Pass products. What are these things? Who are they for? Give us the story.

Keith: They are for everyone. What we're learning is that, as we open up more of what we do in terms of the entirety of the process – and again there is a singularity to our process – so there are a lot of components to a good risk-management process.

It's tiered in terms of access to those components of what we do in terms of price. What we wondered is if people prefer to get a bucket.

So the smallest bucket, of course, is the one where you get our quarterly macro themes, which is the **Hedge:IQ** product. So, again, you're going to know every three months what our themes are and where the big changes are coming.

And then we give you the ETF Pro Plus, which is basically long and shorts across the board, as Erik and I have been talking back and forth. Again, this is global macro long-shorts. Again, that includes a bunch of commodity ETFs on the long and the short side, depending on where we are in any different quarter.

The **Elite Pass** just broadens that out so you get the Early Look, the Macro Show, the Daily Ranges. That's for more of a power-user. Real-Time Alerts, obviously.

And then the big one, which is the one that's actually, I think, the most popular (even though it's the highest priced), is the **Platinum All Access Pass**, which basically gives you every single thing that we publish to the non-institutional community.

But also large components of what we provide to our institutional clients, who pay a lot more than that price, I can assure you.

So that's the deal. And we like to do it – like you said, you figured out when we do it because we only do it once a year.

Erik: Well, and the deal for MacroVoices listeners is actually even better than the deal that you only do once a year for everybody else.

I'm going to take personal credit for a part of that story. I know you guys didn't used to offer the Macro Select product as part of the packages, and I have been telling Dan Holland for a couple of years now, don't underestimate the high-end retail people.

We've had a lot of guests on MacroVoices who assume that their boutique institutional research, they think, we don't sell it to retail because they would never understand it. There's a few people that do understand what you guys do in your Macro Select, which I believe you used to only do that for your institutional clients. And so I'll take credit for having encouraged you to expand your offerings.

Now, I wanted to start by giving you your chance to plug your product. But, even for the benefit of our listeners who are not interested in buying anything, I want to give you a little tip, guys, because there is a lot of free stuff here that's not obvious.

In your Research Roundup email there is a download link for the slide deck that we've just talked through. There is a separate download link for what looks like it is just a one-page sales brochure for these different products.

What's not obvious is the whole list of products that are in blue, those are links to free issues of each one of these different products. Even the high-end Platinum All Access Pass, which includes Macro Select (which is institutional-level macro research), and Demography Unplugged (which is Neil Howe's podcast).

A lot of our long-time listeners know that Neil Howe is probably my favorite intellectual alive, in terms of his work on fourth turnings and so forth, absolutely brilliant guy.

There's free examples of all this stuff. And it's not obvious. It looks like it's just a one-page sales brochure. It's actually a list of links to free stuff. So I strongly encourage all of our listeners, whether you're interested in buying anything or not, to take advantage of the free samples that are included through the links on that sales brochure, which is a download in your Research Roundup email.

If you do want to buy anything from Hedgeye, be sure to use these links that are on Page 26 of the slide deck, because they do give you additional discounts that are even lower than the going prices that other people are paying during this Cyber Monday promotion.

So the $899.95 for the Elite Pass, I think it's $999.95 for the general public. And I think the Platinum All Access is $2,000 for the general public, it's $1,750 for MacroVoices listeners. So be sure to use the right links in order to get the appropriate discount.

We’re going to have to leave it there in the interest of time. Patrick Ceresna and I will be back as MacroVoices continues, right here at macrovoices.com.