Darius Dale: Changing World Order

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Erik: Joining me now is 42 Macro founder, Darius Dale. For any new listeners who aren't familiar with Darius' work, he's known for his absolutely fantastic charts and graphs and extremely long and detailed chart books, just so you know what to expect in the download that you'll find linked in your Research Roundup email, it will be a great big slide deck of, oh boy. What is it? 160 or so slides. You'll see that many of them are grayed out. That's necessarily out of respect for Darius' paying subscribers. They don't want all of his information given away for free. So only the slides that we discuss in today's interview will be visible. Please forgive the fact that the rest have to be grayed out.

Darius, it's great to get you back on the show. Before we even dive into your famous slide deck, you mentioned off the air that you really enjoyed my interview last week with our mutual friend Jim Bianco from Bianco Research. Let's talk a little bit about what if Jim's right, and because President Trump is definitely an agent for change, and we're in a fourth turning, something you and I have discussed before, a time when the major rules of the game and the major institutions that define the game tend to get changed. What if President Trump actually were to bring about a whole new monetary regime where what changes is the way that the US finances its foreign debt is instead of paying interest, they start paying essentially protection services with the military to other governments. That would fundamentally change the balance of flows, all the things that we're used to, following tick reports and so forth. I think the analysis, does it get thrown out the window? Or how do you deal with the idea that something that big might happen, and how does it affect your process?

Darius: Great question. And I just want to say thanks again for having me, always a real pleasure to be here, really, I did really enjoy Jim's presentation last week. I thought you guys asked and answered some really important questions, as it relates to where we are in this great time. I mean, as you and I talked about over the last few years, about how we are currently in a fourth turning and what that's likely to entail, from the respective of economic risks, monetary policy risks, fiscal policy risks, geopolitical risks, etc. And as it relates to some of the ideas that Jim floated with respect to changing the geopolitical world order, I think that's something that we need to have a serious conversation about. Because, as to your point, Erik, it could potentially have a significant influence over how the US Treasury market gets capitalized, and ultimately, how that impacts broader asset markets.

Erik, I know you're familiar with our investing, doing a fourth turning study a couple of years ago, in the summer of 2023, we performed a deep dive empirical study spanning dozens, if not

hundreds, of time series to identify exactly what we should expect as investors throughout the duration of this fourth turning. We don't have time to explain the fourth turning, but for those who may be unfamiliar, so it's a time of great institutional and geopolitical change, and understanding that we're going to have a lot of great institutional geopolitical change, we need to have a thoughtful framework for how some of that change is likely to evolve. So, we broke down our investing to the fourth turning regime analysis into sort of four different categories. There's number one, fiscal policy risk, because to me, I think that's the most important dynamic that could change in this fourth turning is the size of the US government, how it ultimately gets capitalized, and who ultimately foots that bill. So if you look at slide 107 in this presentation, where we summarize our investing due to fourth turning regime analysis, specifically the fiscal policy section, what we know is that, historically, in fourth turnings, we typically see explosive growth in sovereign deficits, explosive growth in sovereign debt, the size of the government, and ultimately we see explosive growth in the cost to finance the government. And so, this is the baseline. This is what you should be expecting as an investor in a fourth turning. By the way, this has already happened since the fourth turning catalyzed itself back in 2008, and so I think we're just kind of on that path. When we jump to monetary policy risk on slide 120, where we summarize the key risk there, it's financial repression and monetary debasement, right? It's the central bank. It's the monetary authority using its balance sheet to step in as a lender of last resort to the explosive growth in sovereign debts and deficits with respect to economic risks we see on slide 30, where we summarize our analysis on the economic side. We know historically speaking, we've seen structural uptrends in nominal GDP inflation, wage growth and asset price inflation in fourth turnings. So, I know we're talking about a lot of change here, but historically, these fourth turning dynamics have seen faster rates of asset price inflation, primarily as a function of the monetary authority's response to fiscal dominance. And then finally, on slide 143, where we summarize the fourth turning geopolitical risks. The key risks in the fourth turning from a geopolitical standpoint, are a structural downtrend in income inequality from, albeit extremely high level. You typically see declining birth rates, increased trade protectionism and total war. And so, these are the kinds of risks that we see on the table here, as it relates to the balance of this fourth turning, which my former colleague and one of mentors, Neil Howe, believes is likely to persist into the late 2020s or early 2030s. And so going back to your discussion with Jim, Erik, there's a lot of stuff that's about to hit the tape over the next four to eight years, and I think it's very important for us as investors to have a framework to deal with this stuff.

Erik: Darius, you work from a systematic macro framework that's driven by growth and inflation, and what those two variables are doing is kind of the starting point for everything else. With respect to growth, I think we pretty much discussed your bullish views on the economy and so forth in your last interview pretty thoroughly. But with respect to inflation, I really want to focus on that in today's interview, because you've been talking about sticky inflation, as I have, for a long time, a lot of people kind of rolled their eyes. They were really convinced that we had that wrong. Inflation was headed back to 2%, it was all transitory story, and it was coming out of the system. I think maybe people are a little more receptive to the possibility that inflation really is sticky. So why don't we start with, why you think it's sticky, why we're not headed back to 2% and what you do see on the horizon for inflation?

Darius: Yeah, great question. Erik, little minor correction in terms of the preamble there, you said we work from a macro framework that's focused primarily on growth and inflation, and I would expand that. Growth and inflation are important cycles that we track in the context of our systematic research process, but just as important in our opinion, our monetary policy, fiscal policy and our tracking of liquidity. I think we're among the world's experts in tracking liquidity variables and forecasting them. But the number one thing we do for our clients, as we show on slide 5, when we introduce our macro risk management process, is we help them identify and position for the market regime, that the most important thing we do and the best thing we do for our clients here at 42 Macro is trend following and nowcasting the market regime and having clients position for that in asset allocation and portfolio construction terms. On the asset allocation side, you can see where we are in terms of our KISS portfolio construction process on slide 11, that's a three ETF process, three ETF solution that dials up and dials down client exposures to the equity, gold and Bitcoin markets. On slide 12, that's a retail investor oriented product. On slide 12, we have our discretionary risk management overlay, which takes our market regime nowcasting signal and create proper trade recommendations across 70 different factors, you know, looking at US equities, US equity factors, global equities, fixed income sectors, currencies, commodities and crypto. And so, in my opinion, that's what our process is focused on. And everything else we talk about today is particularly when I'm in these interviews, kind of outside of our pay wall, most of the stuff I talk about outside of our paywall has nothing to do with how our clients are positioned or should be positioned. It's really just to talk about the full distribution of probable economic outcomes so that clients and non-clients can have some sort of anticipation of how those trend following signals are likely to evolve. So, I just want to make sure that we hammer that point home before we kind of get too deep into the presentation on the inflation side. I think it's a really important topic. And this is probably where we're most divergent from consensus here. And in fact, if you look at slide 42, where we show our grid model for the US, you can see where our model for core PCE inflation has it bottoming in Q1 and starting to trend higher throughout 2025, with the trend really starting to accelerate, kind of in mid to late Q2. That's very counter to Bloomberg consensus, which is Wall Street economist consensus, which is calling for core PCE to meander lower throughout the year, kind of on this very tardy path back to 2% inflation.

So, let me answer the question that you asked, Erik, about why we think inflation is likely to remain sticky. Recall that we've been of the view that inflation is going to be sticky. we've always thought the equilibrium inflation rate in this particular business cycle was higher than, much higher than it had been in recent business cycles. And so, this concept, this kind of wonky, academic concept of trying to get back to 2% inflation, in our opinion, that's a policy mistake. It may turn out to be a grave policy mistake, if the Fed does not respond to some of these pressures, in our opinion, with a little bit more lax monetary policy. So, on slide 65, so I'm going to say, performed an empirical deep dive study several times today, probably because that's kind of what we do here at 42 Macro on the econometric side. And one of the empirical deep dive studies we performed over the past couple of years is our business cycle analysis, of which it taught us a lot of different things about the US business cycle from an empirical standpoint. One of the more important things we learned from that study, of which we analyzed hundreds of economic indicators to identify which indicators were leading, lagging and

coincident indicators of the broader business cycle, one of the most important things we determined from that study, which looked at all 12 of the post war US business cycles, is that we determined that inflation is the most lagging indicator within the business cycle. It's the most lagging cycle of the eight cycles that comprise the business cycle. As you can see there on slide 65, the chart on the left, inflation breaks down durably below trend, 12 to 15 months on average after a recession, on a median basis after recession, again, this a median path that the each of those 12 cycles has taken three years before and three years after recession has started with zero being the recession. You can see it a little bit clearer on the chart on the right, where we just show growth, headline inflation and core inflation, and you can see the stickiness of inflation persisting well into a recession. Well, okay, so if you understand that, okay, inflation is a sticky process. It typically doesn't break down to a bit below trend until well into a recession. Let's talk about, well, are we going to have a recession or not? Well, if you look at slide 35, where we show the same chart on the left, but the chart on the right, on slide 35 shows the current data for the relative for each of those cycles that are represented by the chart on the left, and what we find is that the chart on the right does not resemble the chart on the left, right? Historically, what we've seen is policy tends to get restrictive you know, call it 15, 18 months out of recession, then the corporate profits break down durably below trend, around a year ahead of a recession, then liquidity breaks down about three quarters out of a recession, then growth breaks down simultaneously with stocks around two quarters out of recession. Employment breaks down dribbly below trend right around when the recession starts, which makes sense. Credit breaks down, breaks down our delinquencies and charge us to break out. This is the charge Delta adjusted. They break down durably below trend, say, a quarter after recession, and then again, inflation being the most lag indicator, the business cycle breaks down durably below trend, 12 to 15 months after recession. And so, when you look at the chart on the right, you see, okay, we don't have the leading indicators of these cycles breaking down in that cascading fashion that we historically have seen. So, we should not anticipate a recession as a high probability outcome over medium term time horizon. And that takes me back to where we started with inflation. If we don't have an inflation over medium term time horizon, then we should not expect, if you go to slide 66, headline CPI to break down durably below trend without a recession. On slide 67, we should not expect core CPI to break down durably below trend without a recession. On slide 68, we should not expect PCE inflation to break down durably below trend without a recession. On slide 69, you should not expect underlying inflation to break down durably below trend without a recession. And that's exactly what you're seeing in each of these time series. It's looking like we're bottoming at the prior trends and starting to meander sideways and or tick up higher in a lot of these indicators. And in my opinion, that's supportive of our long return thesis on inflation.

Erik: So just to be clear, you're not saying that you're expecting a recession, because that's the predicate in order for those things to happen. You're saying because you don't expect a recession, you don't think those things are likely to happen, correct?

Darius: Yeah, we do not expect a recession. Recall that we authored the resilience economy theme back in the summer of 2022 when everyone was concerned about a recession. We maintain that theme, we now see growth slowing, but it's unlikely to slow to a level that would

even get anyone concerned about a recession. I mean, we could talk about growth, but I think our views on growth are pretty aligned with consensus. Certainly, if you look at our forecasts, I don't think we're too divergent there. A lot of what happened, a lot of what's happened since the summer of 2022 is consensus, and both Wall Street and investor consensus having to catch up to where we were on the economy side of things. Now that they have caught up to where we were, I don't think that's much of a market risk from here, where we see market risk is really on the inflation side. And I got five reasons why we think inflation is likely to prove sticky here when we look into the balance of 2025. So on slide 70, number one, the housing market is structurally tight, and so investors have to be careful not to straight line the improvement in housing PCE inflation, like if you look at the household formation to existing home inventory ratio, that's currently 1.3, it's essentially a double where it trended at prior to COVID in the 2015 and 2019 trend. So, we have this really structurally tight housing market on a structurally low level of turnover, as you can see there in the bottom panel on that chart, on slide 70.

So in our opinion, the housing supply shortage has not been fixed, and so as a function of that, a lot of the disinflation we've seen in the housing and shelter CPI type statistics, in my opinion, is really just a lag of some of the distant of some of the tightness coming out of the market. But we're likely to stabilize at a much tighter level that causes inflation to stabilize at a much higher level by the time it's all said and done, we kind of look backwards on 2025. On number two, on slide 71, the Fed has done a poor job of reining in liquidity since the regional banking crisis, but maybe that was the plan all along. So, if you just look at the Fed balance sheet contracting, the Fed's balance sheet has not, you know, to drain liquidity from a money supply perspective, in fact, money supply kind of bottomed during the regional banking crisis, when the Fed started implementing its alphabet soup of liquidity provision, instruments, facilities, and then the Treasury started to concentrate issuance on the short end of the curve to start to free up some of that trapped liquidity in the Fed's reverse repo facility. Almost two plus trillion dollars have come out of the reverse repo facility since then, and so we've seen liquidity broadly actually start to trend higher again, despite the Fed “shrinking its balance sheet” with “quantitative tightening.” But we know they're not actually selling bonds to the market. Number three on slide 72, domestic credit growth is now trending higher, and global credit growth is on the precipice of an uptrend. You know, we got the January senior loan officer survey data the other week, and that was consistent with a positive trend in credit growth here in the United States. We continue to see percentage respondents tightening policy, ease at the margins, we're seeing more demand for loans. So, things like that continue to give a signal that the kind of the credit machine here in the United States is alive and well. And then I would say that the fourth thing to me is one of the most important dynamics that I don't see here enough people talking about, because it's hard to quantify, but it's important for us to at least attempt to quantify, which is what happens when we turn off the positive labor supply shock. So, on slide 73, we had millions of illegal migrants enter the country. I want to say, if you look at the duration of Biden's presidency on a trial, only 48 month basis, we grew the labor supply by 11 million bodies, which is essentially an all-time high nominal rate over a 12-48 month time frame. So, there was a lot of, you know, sort of low-cost labor supply entering into our labor market, which had the impact of deflating wage growth pretty substantially. If you look at slide 74, where we show the private sector employment cost index, that peaked at about 6% in the middle of 2022 and it decelerated

300 basis points to 2.9% in 3Q 2023. Now that we've sort of been a quarter or two since Biden kind of tightened the screws in the border, obviously, Trump took it a step further with his executive orders last month. Now that we're sort of on the other side of all that, we're now starting to see private sector employment costs and unit labor costs re accelerate. We're now at 3.4% quarter over quarter star in terms of private sector employment costs, unit labor costs backed up from basically 1% to 3% currently. And so, unless you have a big boom in productivity growth, which it's hard to forecast, I'm not smart enough to forecast, I believe anybody's smart enough to forecast productivity growth, to be quite honest. But unless you have a big boom in productivity growth, the tightening of the labor market from a lack of incremental supply is going to cause wage growth to stabilize at a much higher level than the prior trend, which ultimately is likely to cause inflation to stabilize at a much higher level than the prior trend. And this is, you can kind of see this on slide 75, when you think about translate this to companies. So, in the chart on slide 75, we show the corporate profitability model, which is nominal GDP, the growth rate of nominal GDP minus the spread between unit labor cost inflation and productivity growth. And as you can see, that metric tracks the corporate profits like a glove, and has since the late 1940s and so what we find is that now that unit labor cost inflation is starting to accelerate, and we have top line growth slowing because nominal GDP growth is slowing, you now have more market pressure on corporate margins than you had, let's say last year, when inflation was persistently decelerating and companies didn't feel the need or the urge to pass on prices. So now that dynamic has reversed. So, you have companies that are going to just feel more confident or more out of necessity to protect margins, they're going to start to feel pressure to raise prices.

And then finally slide 76, where we show leading indicators are supporting our hawkish next 12 month outlook for inflation. If you look at core PPI, which a lot of the core PPI indicators find their way into the core PCE, but ultimately, core PCE is lagged as this core CPI, because of the shelter components, the blue line bottomed at a level that is wildly inconsistent with 2% inflation in this particular cycle. And by the way, the blue line was leading the deceleration in the red and black lines by a year and a half, and it's been accelerating an uptrend for about a year plus now. And so, it's our belief that the red line and the black line in this chart, which are again core CPI and core PCE inflator, are going to bottom at levels that are wildly inconsistent with 2% inflation and start to either meander sideways or trend higher over the medium term. So, in our opinion, there's five reasons, fundamental standpoint, from a first principal standpoint, why inflation is likely to firm up at a level that is inconsistent with the Fed's, in my opinion, at this point, ridiculous 2% inflation target. And if they don't do anything about that inflation target, or just allow themselves more time to get to 2% inflation, which is the choice they've made thus far, we're going to have problems in asset markets, because it ultimately means that they're not going to be able to use their balance sheet to perform the necessary monetary debasement and financial oppression that is required by the monetary authority, in a fiscally dominant regime which fourth turning calls for.

Erik: Okay, so your call has been for sticky inflation. The word sticky just means it's not going away, but it doesn't imply anything about whether it's getting a lot bigger from here. So, is your call that inflation is just going to stabilize around the current level? Or do you think that it's just

bottoming and about to trend significantly higher? And if so, how much higher is significantly higher?

Darius: Yeah, great question. So, in slide 78 where we show the key takeaway from this kind of aspect of our sticky inflation theme, we have our forecast for core PCE inflation down there in the bottom right of the chart. So, the black line is the realized data. The blue line is our forecast, and the red line is the Bloomberg consensus forecasts, which are Wall Street economist consensus. And as you can see, we have core PCE inflation bottoming in January, 2.6% trending sideways roughly it's at 2.7% for February through April, climbing to 2.8% in May, and then climbing to 2.9% in June, and then climbing to 3% in August, and kind of meandering higher from there. So, we're not calling for a substantial reacceleration in inflation. We're just calling for inflation to bottom in Q1 and start to move in the wrong direction throughout the balance of 2025 as those five factors really start to culminate and push inflation pressure higher in the system. And one thing I will say on this, on this type or topic of inflation, to me, what I think is kind of missing from the, you know, when we listen and one of the things I love about programs like MacroVoices and you were among the first in the world to kind of put us onto this, Erik, which is the quality of discussion that's being had away from mainstream financial media is significantly higher at this point, because you have guys like myself coming on and talking and unpacking slide decks for 30-45 minutes, as opposed to these one to two minute sound bites of this and that, and you can't get to unpacking slide 77 like we're about to, where we show our secular inflation model.

And so this is what I think is missing from the mainstream narrative around inflation, and it's obviously missing from the Fed's narrative, because they very clearly don't agree with this, which is our model suggests the equilibrium rate of core PCE inflation is in the high twos and low threes, and it has ever since we built the model in January of 2022. There's been some variants throughout the way we refresh this model every time we get an important data point for our clients. But, on the low end of the variance has been about, kind of 2.6%, 2.7%, on the high end of the variance is somewhere around 3.2% or 3.3%. And so, for three years, our model has consistently said, when you're looking at roughly 20 indicators that have all been proven by academic research to be co-integrated or correlated with inflation, they're all suggesting that there is a significantly higher level of inflation pressure in the US economy. And by the way, the equilibrium level, core PCE inflation in the prior cycle was around 1.6%, so we're talking high twos, low threes. It's almost a double when you look at some of the factors that our model is both weighted and unweighted, they kind of arrive at the same conclusion. When you look at the factors that are weighted, you know, de-globalization is contributing a modest amount of inflationary pressure. Demographics is contributing a modest amount of disinflationary pressure. Fiscal policy is contributing a modest amount of inflationary pressure. Housing supplies is contributing a meaningful amount of inflationary pressure. Productivity is contributing a modest amount of disinflationary pressure. Technology is contributing a meaningful amount of disinflationary pressure. But on the offsetting that are wages, which are contributing a meaningful amount of inflationary pressure, and then what we call our West Village Montauk effect, which is just a supply of spendable cash that's on household sector balance sheets, is at this record high, both in nominal and as a share of total assets. And that's contributing just a

gargantuan amount of inflationary pressure. I mean, if you think about simplistically boiling down inflation to too much money, chasing too few goods and services, there's a lot more money in the economy that can be spent on goods and services relative to the starting point prior to the pandemic. So, in our opinion, until the Fed acknowledges that, we are living in a 2.5% to 3% trend, core PCE type world, perhaps even maybe a touch higher. Jim was saying it's somewhere between 3% or 4%. Our model is saying it's high twos, low threes, until the Fed acknowledges that they're not going to be able to meaningfully expand their balance sheet in ways that I think will ultimately, kind of extend the business cycle and ultimately appease the Treasury market and keep the financial stability concerns from creeping back into the treasury market, like what we saw back in the regional banking crisis.

Erik: Darius, one more inflation question before we move on. It seems to me, given your outlook, one of three scenarios has to play out. Let's start with scenario two. That's the one where the Fed says, okay, we got to get to 2%, we're going to do whatever it takes. We're going to change policy in order to get there, because what we're doing isn't working. What would they do and what would the consequence of that be for markets?

Darius: Well, look, I mean, that's the scenario where we talk, put rate hikes back on the table right now. If you look at slide 45 where we show the Fed's dot plot relative to market based estimates of the Fed funds rate. And you know, over various time horizons, we see that the Fed, the median FOMC member thinks the neutral rate is 3% and there are 150 basis points currently above neutral with a bias to ease. That would be very wrong in a scenario where the Fed ultimately decides it has to do more. Because with that, that's a two-step process whereby they have to revise up their, as a longer run estimate of the neutral rate to something that's a lot closer to where we currently are, and then potentially think about making policy more restrictive. And so that two-step process, in our opinion, is to potentially cause some serious problems in the bond market and broader asset markets, because what you're going to do in that process is ultimately increase the risk of, an increase the probability of a hard landing, and also cause more pain in the fixed income markets and the fixed income volatility would be a negative for liquidity.

Erik: Okay, and scenario number three is the one where the Fed capitulates and says, okay, we didn't really mean 2%, it's actually 3.5%. That's our new target. What would that mean for markets?

Darius: Oh, boy, that's so bullish. And again, that is our long term expectation. We’ve been of the view that ever since we performed our investing during a fourth turning regime analysis in the summer of 2023, again, one of the key conclusions is that the monetary authority will be dragged along for the ride, whether they kick into screaming or not, to capitalize Uncle Sam and this throughout the duration of this fourth turning regime. In fact, if you go to slide 127, where we show various cohorts of the marketable Treasury market from an investor standpoint, we see that the Fed has been reducing its share, or, the Fed has been allowing treasuries to roll off its balance sheet, and so as a function of that, it's been reducing its share. Now, it's about 15% of the marketable Treasury market. Commercial banks, up until, essentially up until late Q ‘23

they've been losing share as well. They kind of stabilized at around 15%. Former central banks, which at the black line, they've been shrinking their share of the marketable Treasury market significantly. Since peaking out in middle 2008, they peaked at around 40%. Now they're about 14% currently. And so, offsetting that is us, the private sector, various investor cohorts, agents, we're all kind of lumped together in one bucket here. You know, we've grown our share of the marketable Treasury market from 36% to 56%. And so ultimately, what's happened in the last few years, particularly from 2020 through 2022 to the highs and yields that we saw in the summer of 2023, was the market repricing, because ultimately we were placing a lot of these economically insensitive buyers, people who are buying for either policy purposes or for regulatory purposes like Basel III, Dodd-Frank, et cetera, we're replacing those instant price and sensitive buyers with price sensitive buyers, investors that want ex ante units of return for taking risk in their portfolios. And as a function of that, we've seen a significant repricing of yields, et cetera, in the treasury market. And so, it's our view that if the Fed comes around to where we've been since January of 2022, which is, you got to get that inflation target higher. If they get that inflation target higher, it's going to allow them to alleviate that pressure that we see on the Treasury market from the pink line in this chart of 127 going higher. Which is us, the private sector, now owning by far the lion's share of marketable Treasury securities, at 56% of the total.

And one final thing I'll say is that, on slide 128, investors should expect incremental financial repression, because commercial banks have ample capacity to lend to the Treasury market. On one side, you're going to have incremental monetary debasement, because the Fed, in our opinion, where we think this is headed, it might not be headed there 2025, but ultimately the Fed will capitulate to our view that the equilibrium core PCE inflation rate is much higher in this business cycle. And they're going to have to just acknowledge that and move on, quite frankly, from this ridiculous 2% target that's quite frankly, made up. And so, if you think about the Fed being able to flex its muscle in terms of on the regulatory side, you know, you go back to the last fourth turning. If you look at this panel, the panel three on slide 128, the last fourth turning, commercial banks owned about 50% of commercial bank assets were in Treasury securities. Right now, it's only about 19%. So there's a lot more upside there from the Fed, in terms of the Fed's balance sheet and in terms of how the Fed and other government agencies can regulate commercial banks into the treasury market to take some pressure off of US investors. Because ultimately, they need to take pressure off of US investors. Erik, one final chart I'll show you on this topic, which is slide 102, where we show term premia and the top panel there at about 33 basis points wide, well shy of the long run mean of about 150 basis points. When you subtract the deviation from the long run mean of term premium from the current level of the Treasury yield to just see what a normalized Treasury yield would be if you had a “normal level of term premium.” You're talking about a treasury yield today that has a fair value of 5.68% on the 10Y, right? 5.68% on the 10Y, up from 4.54% right? Now, you know that if you have that and didn't have any change to real interest rates, then you're talking about inflation, breakeven price in of about 3.6%, as opposed to the current 2.46%. In our opinion, that's what the bond market should look like as a function of the structural shift in the investor, the investor participation in the bond market in terms of that changing, the changing ratios, in terms of who owns what, on the treasury bond market, we should have a much higher level of term premium. There's a variety of reasons why term premiums should be wider right now, but among them is the fact

that we have higher inflation, higher inflation volatility, positive excess inflation relative to the Fed's target, which means ultimately, they're unable to gobble up as many bonds as they were able to in the prior cycle. You know, there's a lot of reasons why we should have a "normal level of term premium," I can make the case from just a statistical standpoint that we could, we should probably have a slightly higher than normal level of term premium. So, in our opinion, the bond market is mispriced, and the only entity in the world with a balance sheet big enough to undo that mispricing, or to make that pricing process kind of go smoothly, to get it back to a normal level of price, is the Fed and how they influence commercial banks with regulation.

Erik: Let's go all the way back to page 7 in the deck, where you summarize your fundamental research outlook views. We've talked about the first three of them either in this interview or in previous interviews, but you've got a new one that you added in November of '24, I think that was after our last interview you called the Triple S's. What does Triple S stand for, and what's the outlook?

Darius: Yeah, great question, Erik. So Triple S's, is really an acknowledgement that, from the starting point of very asymmetric bullish positioning, when you look at some of the structural bullish positioning indicators in our positioning model, we have this sort of crowded, asymmetric bullish positioning, but we also have a lot of change coming down the pike, and those two things historically have been incongruent. Historically, whenever you've had a lot of, you know, that crowded bullish positioning was built for a reason, and so anytime you interject a lot of change from a fiscal, regulatory, trade policy perspective, the risk is that that positioning unwinds. And so, what our Triple S 's theme aims to sort of unpack is the ways in which that crowded bullish positioning can unwind. And so, on one side, if you think about President Trump's economic agenda, there's sort of five main cohorts attendance of that agenda, on the negative side that may result in a negative supply shock in the economy and asset markets. You have the tariff policy and then you have securing the border, which we've alluded, briefly alluded to on the positive side. You have tax cuts, deregulation, and the DOGE budget cuts, which should contribute it to a positive supply shock in the economy, particularly from an objective of capital. And so those things are positive at the margin.

And so, when you think about kind of, how does it all net out? One, I don't think we know. I don't think anybody in the administration understands how it's all going to net out, because Congress is going to play a significant factor in determining all that. But ultimately, how it all nets out could potentially cause some problems for asset markets, not to mention the sequence of it all as well. You could get the negative stuff first. In fact, we have already gotten a lot of the negative stuff first, right? We've gotten the tariff headlines. President Trump is floating another tariff headline this afternoon on autos and pharmaceutical imports and semiconductors. So we're getting a lot of the negativity first, front loaded. And ultimately the positive stuff, you think about tax cuts, deregulation and DOGE budget cuts, that stuff could come quite late in the process, which could potentially create, like an air pocket in asset markets until we ultimately get to, President Trump saves us, saves the market with the elixir of his policy. So that's sort of the key takeaway for the theme. There are few aspects of the theme that I think are worthy of discussing that we kind of gotten critical updates on recently. So, on one side, I will start by saying the reciprocal trade

policy, or reciprocal tariff policy, in our opinion, reduces the risk that we get a too strong US Dollar as a function of those tariffs. Historically speaking, what we've seen, and what we've observed just from academic studies, is that countries that get tariffs levied upon them tend to offset tariffs to a significant degree in the currency market, particularly China. If you go back and you look at the last couple of trade spats we had with China, we see the Chinese yuan devalue by, let's call it 12% to 15% in those two instances. And what we've seen historically is that we've seen a lot of sympathy devaluation and major currencies to match the yuan, the incremental competitiveness that's gained from yuan devaluation. And so ultimately, you wind up with this US dollar that gets way too strong, and the dollar that gets way too strong as a direct headwind for global liquidity, as we show on slide 80. On slide 80, we see the other year over year rate of change of our global liquidity proxy, which is the aggregated sum of the 10 major economy central banks, their broad money supply from their economies, and then their Fiat FX reserves. And then we show that on year over year rate of change basis in the black line, the green line, and the chart on the left is the US dollars, real effective exchange rate on a year over year change basis. As you can see, very inversely correlated to liquidity. The green line and the chart on the right is the currency volatility, which is also inversely correlated to liquidity. Historically speaking, the dollar has been highly correlated with currency volatility. So that's one dynamic that could be an issue. And the reason that's an issue is because, on slide 79, we know global liquidity is a key driver of asset markets. So, on the chart on the right, these charts show that the black lines and the charts on 79 are the same black lines on the chart on 70. On slide 80, it's our year over year rate of change of our global liquidity proxy. And the blue line in the chart on the left is the year over year rate of change of the global equity market capitalization. And then the Bitcoin, orange line on the chart on the right is the Bitcoin price on year over year rate of change basis. And as you can see, our global liquidity proxy is incredibly correlated with the rate of change of asset markets, incredibly correlated, very, very tight correlations over a decade plus. And so, in our opinion, if we got a dollar that just got too strong as a function of tariffs, that would be a big issue. But in our opinion, the reciprocal tariff strategy, to the extent he can stick to it, I'm not sure he can, but if he sticks to it, yeah, I think that would reduce a little bit of pressure from the system.

Another thing that could reduce a little bit of pressure from the system in terms of the sequence of it all, is the fact that Treasury Secretary Scott Bassent, who I've known for many years as longtime client, very bright man, is going to do some great things for our country. He's already made a very smart choice in terms of keeping issuance on the quarterly refunding side pretty stable. You know, recall that he was hyper critical of outgoing Treasury Secretary Janet Yellen, net financing policy in terms of concentrating issuance in the bill market, which I believe she did for two reasons. One, to kind of make sure the regional banking crisis then turned to a global financial crisis, and two, to free up a lot of that excess liquidity that was trapped on the Fed's balance sheet in the form of the reverse repo market, right? But that money was there because it was looking for short duration instruments, and there were not enough of them. And so ultimately, Yellen satisfied that demand, that market demand for short duration instruments. And it was kind of a win-win for both the economy and asset markets. And so, Treasury, Scott Bessent, now that he's in the seat, I think he recognizes what I just said, and is ultimately decided to, at least for now, or at least “for the next several quarters,” stick with that policy. A

couple things I would say on this, with respect to the Triple S's process, is that for now, things should be pretty good in terms of the Treasury's net impact on liquidity and asset markets. Right now, you have over $800 billion of money in the treasury general account balance that's likely to get spent into the economy. I would say for some upwards of $500 billion of that is likely to get spent into the economy and asset markets over the next, let's call it three to five months, just depending on how long it takes them to get the debt limit lifted and or punted in terms of the reconciliation process. If they go with a one bill solution, it's going to take longer than a two bill solution, but it seems like the house is full speed ahead on a one bill solution. So that's great for asset markets, because ultimately it means we're going to get more TGA spend down, not less. And right now, the Treasury is not really even a factor. If you think about the fact that we've already hit the debt limit, you know, they were going to issue $816 billion of net new borrowing here in Q1. That's $816 billion that's not going to capitalize the US government now, it can either stay where it was in asset markets or go capitalize, go further out on the risk spectrum and capitalize risk assets.

So those are all positive dynamics that are likely to get worse as we move forward in time, but at least for the next quarter or two, those things are supportive on the, I wouldn't say negative side yet, but I do believe it's going to become a negative factor for asset markets when it's all said and done. We've had this view kind of going back to where we started the conversation, Erik, that US fiscal policy is on a very unsustainable path. And in our opinion, that's very part and parcel with a fourth turning. If you look at slide 98, where we show the trailing five-year moving average of US nominal GDP, that's the blue line the top panel. It's at 606.4% currently, the trailing five-year average of the budget deficit GDP ratio is 8.6%. And so, if you see, basically once we went into the fourth turning and with the GFC, since then, we've largely been tracking at a positive spread in terms of our trailing five-year budget deficit GDP ratio, relative to our trailing five-year nominal GDP. So we are accumulating debt at a very, very unsustainably fast rate. And again, this is very consistent with how the economy and asset, where the economy has evolved, fiscal policy has evolved in historical fourth turning episodes, again, deciding that that study that we highlight at the beginning of this discussion with data going all the way back to 1800. So any of those, if someone wants to kind of get their hands on that that study, just sign up and buy the presentation. It's not very expensive. But, the thing I would say on this is that I think there's a big risk that the DOGE process disappoints asset markets. Right now, it's a positive for asset markets, because right now we have this kind of, we don't really know how big of a bite of the apple they're going to take, as it relates to potential deficit reduction in this process. In our opinion, though, just likely to be very disappointing with respect to deficit reduction, because ultimately, there's a couple of things that are causing that. One is political, they've ring fenced very large categories from the DOGE process. When you think about Medicare, National Defense, Social Security and obviously net interest, they're kind of powerless to do anything about. And then you're also layering on the extension and expansion of the Trump tax cuts. So even though we're on record saying that DOGE is likely to achieve somewhere between mean 500 billion and a trillion dollars in cuts, just as a function of that process, it's unlikely to have a significant impact on the deficit when you factor in the reduction relative to baseline of current law, the reduction in revenues, and ultimately, the fact that we're ring fencing. And on the ring fencing, and I'll shut up after this, but I got to make this point, when

you ring fence 2/3 of the federal budget from the DOGE process, you're going to wind up with a result that is disappointing, right? If you think about those four categories again, Medicare, National Defense, net interest and Social Security, Erik, those categories are roughly about $5 trillion on a calendar, annualized, year to date basis. Again, we have one month of data, but in terms of 2025, but it's about $5 trillion, it's 2/3 of the federal budget, 14% of nominal GDP, and those four categories, on an aggregate basis, have compounded at +15% on a trailing three-year CAGR basis. Again, these categories, this is 2/3 of the federal budget, compounding at +15% on a trailing three-year CAGR basis, and we know it's going to continue to go up. Medicare and Social Security are going to continue to rise. If you look at the chart of the right, slide 100, the US' old age dependency ratio is going to go from 95% to 115% over the next decade or so. So, we know Medicare and Social Security is going to continue to go up. We know net interest has to go up. You know, we're talking about refinancing around $9.5 trillion just over the next 12 months into a higher interest rate regime that will cost us about $125-$130 billion of additional net interest expense. And then national defense, they've already outlined that they want to raise that by $200 to $300 billion. So again, 2/3 of the federal deficit, due to the federal budget, are compounding it on a trailing three-year carrier basis of +15%, and that number may actually go up. So, DOGE is going to have to take a gigantic chainsaw to everything else. In my opinion, I don't think it's politically palatable for them to do that, because you're talking about pissing off a lot of lawmakers down in DC, even on the Republican side, especially in the Senate. So, in our opinion, I think when we get to this process, when it's all said and done, there is upside risk to bond yields as a function of a perceived significant widening of the deficit relative to current expectations that they're going to at least try to get our fiscal house in order.

Erik: Let's talk a little bit more about the left and right tail risks that I think are presented by uncertainty risk in the outcome of this DOGE process. Because the way I see it, it's very clear that President Trump and Elon Musk are reaching for really big headlines. They're in a PR war with their political opponents, where they're saying, look, millions of people in the Social Security system who are over 140 years old and supposedly eligible for benefits, this is massive corruption. It has to be fixed. And they've got a number of other things that they're pushing, massive fraud in the USAID system and other NGOs and so forth, I could see this going one direction, which is those exposes on major government corruption and misuse of taxpayer money leads to huge populist support, and the DOGE thing really takes on a life of its own and gets bigger. I could also see President Trump's political opponents being successful in the judicial system, and potentially the Supreme Court just says, okay, we're slamming the gavel down. Elon is not a legitimate elected official. He has no authority to do any of this. We're shutting DOGE down by order of the Supreme Court, no more. Take those two extreme outcomes of either DOGE gets much bigger from here, or DOGE gets shut down. What are the market implications? Because I think either of those outcomes is possible.

Darius: Yeah, and I think the probability that DOGE gets more popular from here is greater than the probability that it gets less popular. Again, I feel like I took a lot of heat back in December when we first made the call that, hey, they're not going to get anywhere near $2 trillion of expenditure reduction, here's all the reasons why you got a very horny contingent of

Elon Musk fan boys on Twitter. So took some heat on that, but it looks like we're going to be right on that. But ultimately, I do want to make the point that DOGE is a very necessary process to prevent the risk of a US fiscal crisis here in this fourth turning and the potential loss of our exorbitant privilege, which in my opinion, I think would very much lead to World War III, because we're not going to lay down and give that up. Nobody, no country, has ever laid down and gave up exorbitant privilege. So, in our opinion, I think it's a very necessary process. I applaud Elon for what he's trying to do, but ultimately, this is a more of a political process statement. Our analysis is that it’s political, we understand that you're not going to be able to cut the remaining third of the federal budget by 30 plus percent in order to just stabilize the growth rate of expenditures, which is what needs to happen. You know, that's not going to be it. Nobody in Congress is going to allow that to happen. So we're going to cut around the margins and then perhaps, pretty meaningfully. But again, it's not going to result in significant deficit reduction. Because again, not only are you not only cutting less than the growth rate of the main categories that are causing the budget deficit, you're also allowing for the extension and expansion of Trump tax cuts to reduce revenues relative to the baseline of current law, which adds additional deficits from the perspective of treasury bond market supply. They're going to try to use this process where they can benchmark the reconciliation program or process to current policy, as opposed to current law. The current law has the Trump tax cuts expiring at the end of this year. Current policy obviously does not, so the headline figure in terms of the deficit impact will be lower, but the incremental Treasury supply will be the same. And so that's the risk, is that the bond market is smart enough not to fall for that accounting gimmickry. On the other side, Erik, you were saying that the Democrats or Trump's political opponents would make enough stink in the courts to cause the DOGE process to disappear. I mean, I don't think that's where we're headed. I don't think that DOGE is going to get pushed back enough in court to kind of cause Elon to get out of DC and go back and do what he was doing prior. But I ultimately do think that, again, they're not going to be able to cut enough of the rest of the federal budget to really achieve significant deficit reduction in the context of extending and expanding the Trump tax cuts, and in the context of our friend Luke Gromen, sort of net true interest expense metric compounding and +15% per year. So, I think the probability of the court situation is lower than the probability that this gets very popular. But either outcome is, in my opinion, I think the highest probability outcome is that DOGE cuts $500 billion to a trillion dollars out of deficit, are out of the federal expenditures. We replace that with more revenue reduction. And ultimately, the categories that DOGE really isn't able to take a big chainsaw to, continue to compound at double digit rates.

Erik: Well, Darius, I can't thank you enough for another terrific interview. Before we let you go, tell us a little more about what you do at [42 Macro], what services are on offer, how people can find out more and follow your work.

Darius: I appreciate you, Erik. Always a pleasure to be here. Our ethos at [42 Macro] is narrowing the information asymmetry between our institutional investor clients, we have many across global Wall Street, and our retail investor clients, so we build solutions to help them both stay on the right side of market risk. As we talked about earlier, at the beginning of this presentation on slide 10 and 11, where we show our case portfolio construction process. You

know, that's the solution that we built for retail investors to stay on the right side of market risk. We have 1000s of very happy retail investor clients that have participated in these raging bull markets over the past couple of years, in part because of this system, and also they've had the confidence to participate in the system because of our bullish fundamental views. And then on slide 12, where we show our discretionary risk management overlay, aka Dr Mo, our institutional clients and our sophisticated retail trader clients use this as a market timing and position sizing guide for their factory long-short bets. And so, I would say again, as I said at the beginning of this talk, the most important thing that we do, that we are among the world's best at, is nowcasting the market regime and sending out very timely signals for when the market regime changes, from risk-on to risk-off, from risk-on with the inflationary bias to risk-on, with a disinflationary bias, to risk-off with an inflationary bias, or to risk-on with an inflationary bias. And then that's when this model here, this Dr. Mo table, will start to change its proper trade recommendations for the various factors that any institutional investor or retail trader could be long or short at any given time. And so what we're ultimately trying to do is make sure our clients are constantly compounding returns and staying on the right side of market risk, as opposed to what I think a lot of other investors are doing, what I used to do, which worked for a while, but I certainly don't think it's working for most people in this post COVID environment, which is predict something and put on a position and hope that the prediction comes true. There's a better way to invest. You can actually just nowcast what's happening in the markets and participate in what's happening in the markets with systems like our case portfolio construction process and our discretionary risk management overlay, Dr. Mo, so if folks want to stay on the right side of market risk, irrespective of what we think about growth, inflation, policy, liquidity, of which, check my track record on this program, I think we have some of the best views on that stuff as anyone. But that, in my opinion, I don't think that's relevant for investing. I think what's relevant for investing is making sure that you're responding to the market and ultimately participating with the market China pricing. So come check us out at 42 Macro, if that sounds good to you.

Erik: Patrick Ceresna and I will be back as MacroVoices continues right here at macrovoices.com.