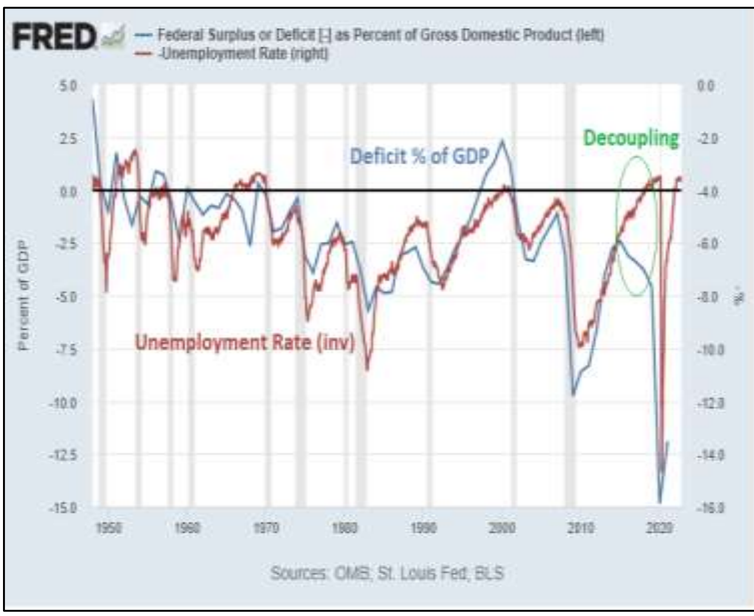
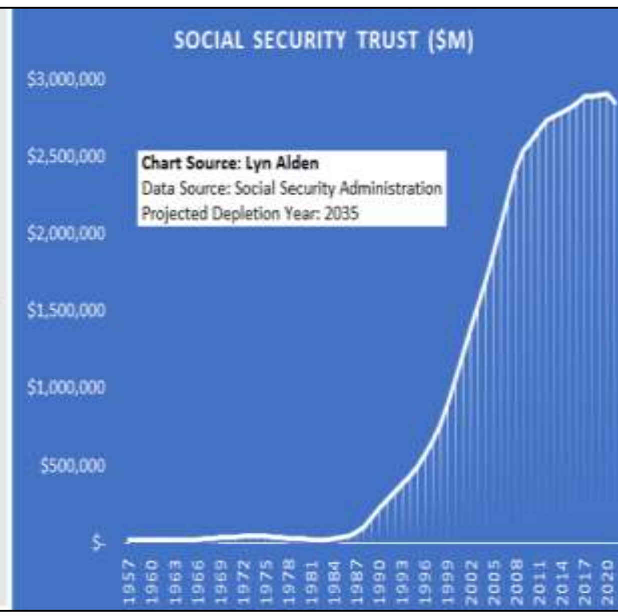
Energy – Long term bullish on Energy because the demand supply situation is very tight, especially on the supply side. In the near term at these low-price levels, it's been de-risked to some extent. While this cannot be called bottom due to lack of geopolitical clarity for the next few months in terms of de-accelerating economic activity, but if we look at couple of years down the line from here the situation is bullish.

Decoupling of Unemployment situation and Federal deficit in US – 2016 onwards, we started to see that even though the unemployment was starting to get better; the deficits actually begin widening. Historically throughout economic cycles normally tax receipts are never wrong and Federal deficits are correlated with the employment cycle.

But what we saw in the mid half of last decade, large part of demographics constituted of retiring people of the baby boomer generation and increased payouts to them, led to decoupling of deficits and employment numbers; which further blew out during covid.





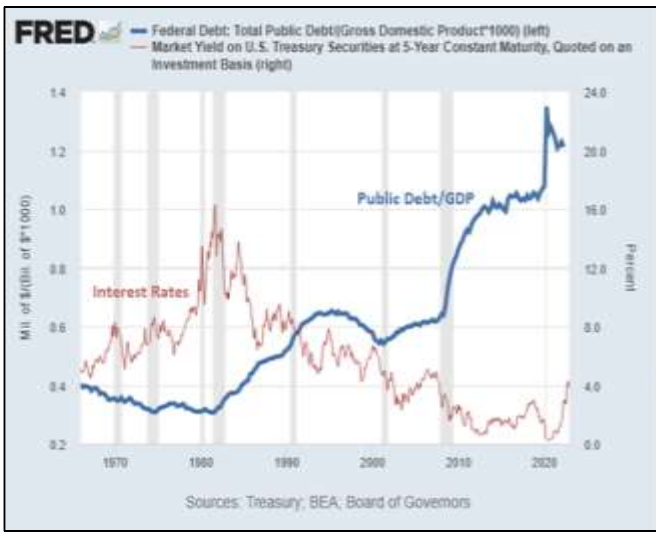
And then you have the social security trust, which for several decades saw lot of money flowing in from baby boomers and these trusts held investments in non-marketable treasuries. But, now over the past couple of years these trusts have started to roll over investments which means they are getting less money than they are paying out; which is largely use to demographics – people retiring etc. Based on the current projections by the security administration, this is expected to draw down completely by mid 2030s and beyond this period this expense item could be a permanent addition to the Federal budget expenses.

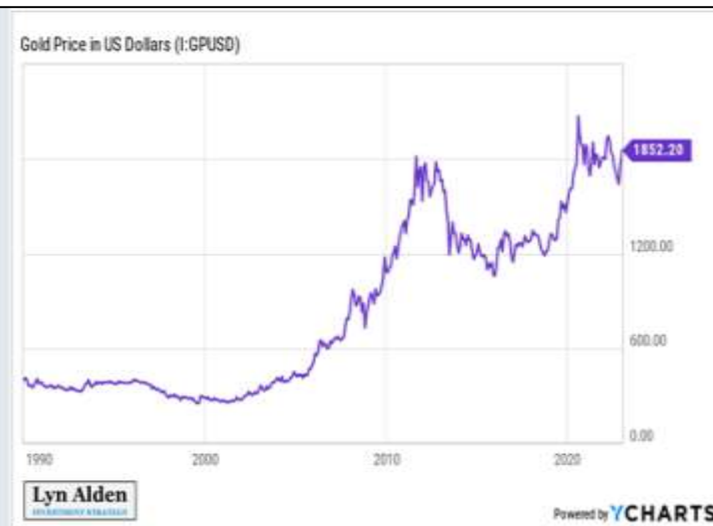
This really wasn't the case in the prior cycles and Fiscal spending (incl social security costs) going ahead will be important part of the riddle answering whether there will be structural inflation or deflation – which more looks like inflation than deflation.

(Article & Chart Source: Lyn Alden, Macro Voices Interview)

Gold – Real interest is the key variable; but, not the only variable for gold prices. From 1980 till now, we have seen higher and higher debt as a % of GDP and we also had lower and lower structural interest rates. During late 1980s there was lot of concern around debt as we saw high average interest rate and rising debt which led to huge interest payments. But the concern materialized only decades after as till 2022 the deficit were managed by keeping interest rates very low thereby leading to lower interest costs.

As this is starting to break out and as interest rates starts to move sideways now and with Debt/GDP % expected to remain elevated; we could see meaningful increase in interest costs which could led to fiscal spiral; because you need more treasury issuance just to pay off bigger interest burden. And to this if you add geopolitical conditions like freezing of reserves then for many nations Gold could be preferred over treasuries, in terms of marginal buying pressure.



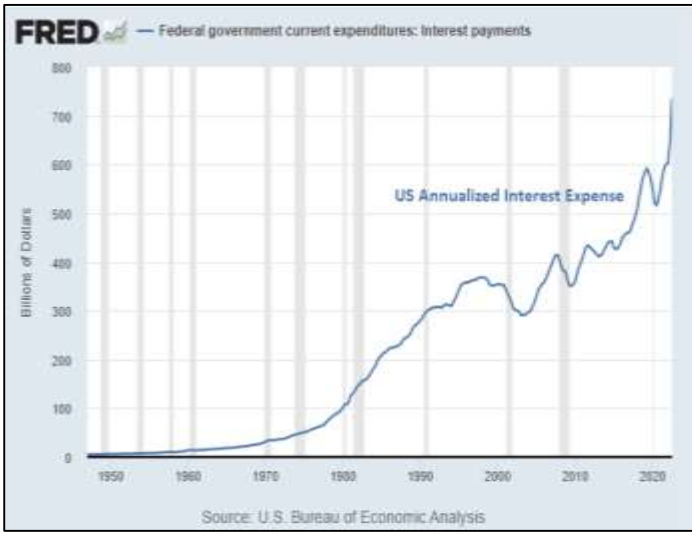


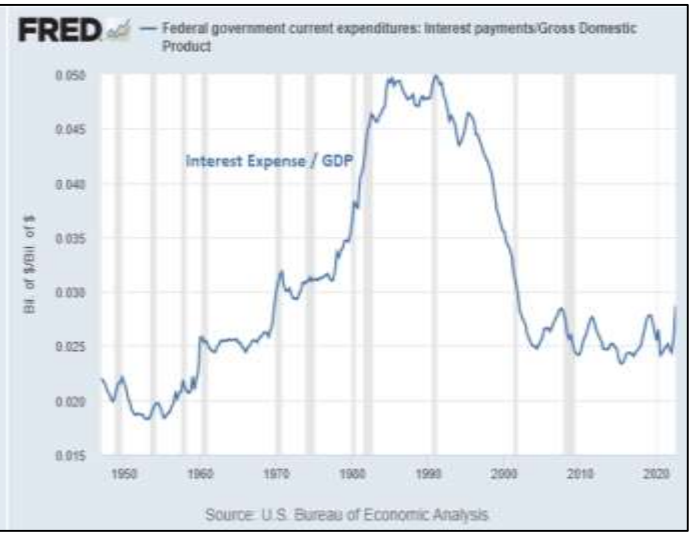
Interest Expense: US - Debt levels in the 1970s and 80s created concerns on the persistently rising interest expense; but these concerns did not turn into a scare as something changed in the past four decades. US interest expense actually started to flatten out in nominal terms and fell as a % of GDP. And this was due to variety of reasons like – peak demographics with baby boomers being peak in workforce leading to structurally multi decade high labour force participation rate; dotcom money leading to booming economy and smaller deficits and thereby falling interest rates.

What's different now is developed economies are entering structurally inflationary period due to commodity Capex cycle, supply side constraints, higher interest rates, more money creation. Combination of higher debts and rising interest rates is starting to blow out the interest expense again, after a four decadal pause. Interest expense as a % of GDP after moderating over past two decades due to forces mentioned above, has started to reverse upwards again.

(Article & Chart Source: Lyn Alden, Macro Voices Interview)

The Playbook this decade could be different





A lot of Government debt is fixed rate with average duration of 5-6 years, corporate debts are long term, consumer sector mortgages are ~30 years loans. So, just because Fed or treasury markets increase rates it doesn't create immediate pressure. The pressure starts quarter after quarter as these fixed rate debts start to mature in elevated interest rate environment and new ones get financed at elevated rates. This blows out the US interest expense which again gets financed by more and more Debt.

Fed Remittances - The Federal reserve's balance sheet has both Assets and Liabilities and just like any other bank its assets pay higher interest than its liabilities and after accounting for other operational expenses it remits the excess money to the US Treasury; which averaged around ~$100 bn per annum. However, because they raised rates so much and from such a low base, for the first time in kind of modern history; they reached a point where they are losing money.

(Article & Chart Source: Lyn Alden, Macro Voices Interview)

Their liabilities i.e., excess surplus from commercial bank parked in reverse repos are paying a higher interest than their Assets which is bonds with no yields on costs. The Central bank booking these losses as 'Deferred Assets' where even if they become profitable again, they get to pay themselves before they would begin sending money to the Treasury. The key takeaway here is this is another revenue source that the federal government has lost now, for the foreseeable future.

But if Fed is losing money who on the other side is making money? The Commercial banks. Banks are getting paid well over 4%, just to have their cash balance at the Fed and are paying less than 1%, on average, for their liability side to their depositors.

Is the big recession coming?

The area that's been resilient is the labor market. But the labor market has always been a lagging or coincident indicator. But, there have been early warning signs of weakness there - overtime hours are decelerating, temporary hires which are generally more volatile and leading compared to the broader nonfarm payroll measures have also decreased. Baseline - high probability of at least a mild recession; but with more inflationary characteristics. How severe or how long it is will partly depend on policymakers, because this is a very levered, centrally managed economic environment. But this recession could be different. Historically, whenever economy slows down and you see PMIs (Purchase Managers Index) going down you want to buy bonds. And you want to sell bonds, and you want to buy more risky assets when PMI is going back up. But of course, now you see a decoupling. You had the worst year for bonds in modern history, despite the fact that it was a period of economic deceleration, a bad stock market, downward PMIs.

Are we half way through the markets or is the final low in?

The markets very much been trading on liquidity and the Fed is withdrawing liquidity. That's been partially offset recently by the fact that the Treasury's borrowings have not been to the level that they said it would, so that the Treasury general accounts (TGA) have been drawing down. And that's actually that's positive for liquidity. And the looming debt ceiling, historically has caused the TGA to draw down almost to zero.

And presently the Feds QT drain is being offset by the TGA withdrawal. But by second half of this year, if the debt ceiling gets resolved and Fed is still doing QT, if the Treasury tries to refill the Treasury general account from that low base, that would suck a lot of liquidity out of the market. The environment could coincide with recession that may ultimately lead to the Fed to pause or to resume some sort of accommodative action. So, markets may not be out of woods yet but there could be surprising pockets of value in some sectors.

(Article & Chart Source: Lyn Alden, Macro Voices Interview)

PineTree Macro

Mr. Ritesh Jain

Co-Founder

Master of Business Economics (MBE)
Executive MBA - Haskayne School (Calgary)

He has held many senior leadership roles including CIO – BNP Paribas Mutual Fund, where he was responsible for managing US$1.2 billion of AUM and also has served as the CIO of Tata Mutual Fund, where he was responsible for managing AUM of 6 billion.

In 2019, LinkedIn rated him among the top three influencers in the world of Economy and Finance. He is also a recipient of numerous national and international awards in the field of fixed income and equity investments.

Ms. Chanchal Agarwal

Head - Products

Chartered Accountant
CFA Charterholder

She brings with her about 12 years of Industry experience spanning across verticals like Family Office Investment Advisory, Equity management, Investment banking, etc.

In 2020, AIWMI recognized her amongst the 'Top 100 women in Finance". She has featured in the Audio talk series 'Show me the Money' by Meghna Pant (available on Audible Suno). Her article reflecting on 'What stops women from investing' was published in The Hindu Newspaper.

Mr. Rohit Pandey

Global Macro Strategist

Post – Grad in Economics & Finance
Bachelor of Economics - Symbiosis

During his career span, he has gained experience working as a macro consultant and in creating products for algorithmic financial planning and healthcare analytics. He is currently pursuing a Masters in Data Science from Northwestern SPS.

PineTree Macro

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