Understanding the Market Cycles with Mike Singleton of Invictus Research

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Dave Alright, folks, welcome to Investing for Beginners Podcast. Today we have a very special guest with us; we have Mike Singleton, who is the senior research analyst and founder of Invictus Research. He also has worked at Broad Run Investment Management Mainstreet Capital Corporation, T Rowe Price. He has quite the resume graduated with DEP honors at the University of Notre Dame, where he studied finance and theology.

He's also a CFA charter holder and CFA Society of Washington, DC. So Mike is here to talk to us about some actually interesting stuff. So business cycles and macro. And, yes, he's going to demystify it a little bit for us, beginners, and everybody else. So Mike, thank you very much for taking the time to come join us today. We really appreciate it. We're looking forward very much to talking to you today.

Mike Thanks for having me, Dave. I love the show. Thank you.

Andrew We appreciate it. Mike, welcome. So can you start with the business cycles and macro? Maybe define what macro even means? And then how do business cycles tie into that?

Mike 1:00

Yes, of course, happy to do that. So when I use the word macro, typically, what I mean is the business cycle; a lot of industries will acknowledge the existence of the business cycle without integrating it into their investment process. And in my opinion, that's a huge mistake. Because the business cycle macro accounts for about 50% of price action. So if you're not integrating the business cycle of your process, you're gonna spend a lot of time sort of confused at why stocks are moving one way or the other. In terms of how we define the business cycle, I would define it as having two constituents cycles, the growth cycle, and the inflation cycle. And I think that should make sense to a lot of bottom-up fundamental investors, because ultimately, what drives business value, well, cashflow, right, and likewise, or you could take growth, maybe cash growth. And likewise, from the top down, that's also what drives the business cycle. And you can break down growth into the real part and the part that's coming from inflation, right? So growth and inflation, both cycle there, would drive real business activity. And that's what you need to get right if you're focused on the business cycle. And that's what we spend a lot of our time studying at Invictus. That

Andrew 2:05

makes sense? Does one drive the other? I kind of get the sense. That's kind of the idea. And then is there a way we can visualize it for people who are on

Mike 2:12

Yeah, well, that they are both related. And they have, you know, similar drivers to some extent. And the way I think about visualizing them is as a sine curve. So if you remember from trigonometry, the sine curve just looks like, you know, a wave going up and down, you know, sort of peaking and then trotting, and then peaking and then trotting. And that's exactly what the growth cycle looks like. That's what the inflation cycle looks like. We have a macro handbook on our website that sort of goes over the principles of our process. And one of the first slides is the growth cycle and the inflation cycle over time. And you can see the trends, the up and the down over and over again, for the last 50 years. And it's really, really obvious.

Andrew 2:46

Would you say we're in an inflation cycle now? And like, what characterizes an inflation cycle? What does it do? The businesses?

Mike 2:53

That's a great question. And I think that how you interpret growth and inflation is just as important as understanding that they are the two most important macro variables. When you're looking at growth and inflation, you really want to make sure that you're looking at the rate of change of growth and inflation, right. So it's not whether growth or inflation or high or low; what really matters in terms of forecasting asset market returns is whether they're getting better or worse, you know, it doesn't matter. So, for example, it doesn't really matter to the stock market that growth is high if it's about to crash, right? What matters is that it's, like I said, getting better or worse. Same with inflation. So right now, we actually have a view that we're about to enter sort of a deflationary macroeconomic regime. So that means that the rate of change of growth is going down, and the rate of change of inflation is going down. Right. The growth part, I think, maybe has become a little bit more obvious for people over the last call; a month or so, January was a very bad month for stocks. And it's, you know, come back a little bit since February. But obviously, when stocks start to go down fast, people start to realize, like, oh, maybe, maybe growth is going down. It's fairly obvious when you think about it because, in 2020, the entire world sort of stood still right with the lockdowns. And so you saw GDP go negative 9% and 2021, you have the reopening, right. So you were comping against, you know, the easiest comps in the history of the world, you're never going to comp against a completely, you know, standstill economy again. So obviously, the reopening print was very, very high. You saw 12.2% growth. Now in 2022, we're competing against that 12.2% growth. And obviously, we're not going to see growth like that, again, because that's just far beyond what our economy can produce

Andrew 4:29

real quick, just copied means we were at a really low point. So to improve on that was really easy because it was so low the year before

Mike 4:37

right. So, another way of describing it is called a base effect. A base effect is an impact that a reference point has on any measurement. So, you calculate the year over year rate of change as you know 2022 growth over 2021 growth, the impact that 2021 growth has in the denominator is the impact of the base effect, right. So you saw very fast growth part of the artificial because of the lack of rounds in 2021. But that's just going to be an impossible calm. So you're seeing declining growth against that you're seeing fiscal drag because we're not going to see the same level of stimulus that we saw last year. There's no impetus for it; there's no emergency, there's certainly not the political will, right. The consumer likewise isn't going to be getting the same handouts from the government debt and eviction. Moratoriums are set to expire. So the more money people are paying, servicing their debt, or paying their rent, the less they're spending on other stuff. And so that'll be a drag on consumer spending. Likewise, you know, if any measure of business spending that you would track any of the regional Fed surveys, any of the PMI is they're all declining. So that's the three parts of growth, right, the consumer business and the government, all three are going down at the same time, it's really hard to imagine, you know, growth going up when all three of its constituent parts are going down. That makes a lot of sense. And the second part about inflation is probably a little less obvious. Because we're, you know, obviously, we're seeing CPI prints above 7%. CPI is coming out tomorrow, again, for the month of January, you know, the consensus for that is 7.3%, I don't really have a, you know, a differentiated view on that, I think it's very likely that you'll start to see 7% start to become, you know, six and a half, percent, five and a half percent over the coming months. And the reasons that we think that are, you know, I think very reasonably. So they're a bunch of leading indicators that we look at for inflation. For example, you could look at the Baltic Dry Index, which is a measure of shipping costs, that's done 75%. From its peak in October, you can look at the prices paid and received from different regional Fed surveys; a lot of businesses are saying, Look, things are still getting more expensive, but they're not getting expensive as fast as they used to. And that means a slower rate of change, right? It means supply constraints are using unfilled orders, the diffusion indexes for unfilled orders and higher delivery times are both going down, which means that supply chains are normalizing, a lot of the stimulus-induced demand that was driving higher inflation is also going to run off, because for the same reasons that growth is slowing down, that'll also drive slower inflation because people just aren't buying as much stuff. If you look at the rate of change in commodity prices, those are also going down. So you put all those things together. And you can get a pretty good idea that the rate of change of inflation is also going to slow down over the coming months.

Dave 7:04

Yeah, that totally makes a lot of sense. I was recently listening to the PayPal earnings call. And they kind of highlighted that in their call, one of the things that the CEO said was that they were noticing in their lower-income cohort that those people were spending less money than they were six months a year ago. And I think that really kind of illustrates what you're saying about the stimulus, for example, is kind of is working its way out of the economy. And it's going to start affecting businesses. And they're going to see lower, they're going to see lower rates of growth for PayPal, in particular, but it's going to filter into other aspects of the economy as well.

Mike 7:42

Yeah, I think that's definitely true. And I could go into the longer-term impact of wealth, equality on growth, and inflation, but it's definitely true. It's just that people with less money spend less money as a percentage of their net worth. Right. And so, it doesn't circulate as quickly through the economy.

Dave 7:55

Right. Yeah, that totally makes sense. So you said something in the video that I watched earlier that I thought was interesting. And I thought maybe we could talk a little bit about how COVID had an impact on inflation. And I don't think that people really put together why that is, could you kind of lay that out for us?

Mike 8:11

Yes, it's a big question. And I guess I'll try to answer in three parts, there's a supply-side to inflation, and there's a demand-side to inflation, right. And so on the supply side, think about supply chains, right? They were disrupted because they were shut down really quickly and then reopened really quickly. And that's disruptive, right? It creates problems. On the demand side, it's just what it sounds like how much demand inflation is; you're the intersection of this supply and demand for goods and services, right? When the supply of goods and services goes down, that increases price; if demand goes up, that also increases the price. So on the one hand, you had, you know, huge supply shock, on the demand side, you had tons of fiscal stimulus, right, which increased demand, particularly from lower-income cohorts, right, and that got, you know, that got inflation really buzzing, I think the federal deficit as a percentage of GDP was maybe 15%, in 2020. And then it was in 2021, which was significant as well. And that was really the difference between the stimulus following the great financial crisis and the stimulus following COVID. Is that, you know, QE and all the monetary stimulus from 2009 to 2011 was largely financial in nature, right? So not very much of it got into the hands of people; it was in the banking system. And to get inflation, you have to have some sort of transmission mechanism from getting out of the banking system and into the hands of the people who can spend the money. Right. And this time, it didn't just stay in the banking system; it was, you know, went out through PPP. And it was also, you know, lent out through massive fiscal stimulus, right. So, the two ways that banking money can become real economy money is either through the Treasury spending it or through banks lending it out. And this time, you saw both, which is not, you know, the last time you didn't see that, and that was the difference in the inflation response. That's why you're seeing 7% inflation prints now. And you, You know, I think it topped out at two and a half or 3%—last cycle.

Dave 9:57

Do you think those kinds of forces will be causing the inflation to, I guess, spike up and spike down, if you will, quicker than maybe it has in the past? A, I'm the oldest one in the room. So I do remember the 80s. And I do remember inflation being really, really high in the 80s. So that seemed like that was a much longer period of time that inflation impacted everything where this feels like it's going to be a sharper up and down. Right?

Mike 10:25

Well, that's certainly our view at Invictus is that this is a transitory is a word that's sort of been abused. It's important to define your terms; I think when you're talking about transitory, so what I mean when I say transitory isn't that inflation is going to go to 2% anytime soon, because I don't think that it will, I think it'll trend toward 2%. In other words, we're not going to see, you know, 70 styles, runaway inflation, where it's, you know, going double digits for sort of multiple business cycles in a row. The reason for that is like you said, the last big inflation was sort of in the in, you know, in the 70s and ended with Volcker in the 80s. And the economy is very different now than it was back then. The reason we've seen the secular disinflation is sort of a hand handful of factors. You know, one is aging demographics, right, the country is much older now. Fertility rates are lower. The average age of the citizen is older federal debt; having a high national debt is deflationary. It's disinflationary, we've obviously spent a lot of money since 1980, our international, national debt is much higher, you know, the world has become much more globalized in terms of global supply chains, the dollar system has strengthened. And what I mean by that is, basically, we're able to get cheaper goods and cheaper labor from abroad, and we are within America. So that's also deflationary technologies deflationary, and none of those things reversed with COVID. Right. In fact, a lot of them were worse; we spent even more money, right, which is a long-term drag on growth and inflation, our demographics are even older, fertility rates dropped in 2020 in 2021. And obviously, your cost of the population also got older, none of those things have changed. What did change was this big spike in fiscal spending. And that's unlikely to be repeated. So I think that the logical conclusion has to be if none of the drivers of disinflation have been resolved, and we're unlikely to see that thing that drives short-term inflation persist, then disinflation has to be sort of the ultimate outcome from there.

Andrew 12:05

Can we talk about maybe the impact of the stock market and not like, where's the stock market gonna be in 12 months? Obviously, nobody knows that. But more on like a high-level general concept. We have two concepts. We have inflation and growth. And, you know, you mentioned they're tied to the business cycle. I guess I'm still there's still a disconnect in my head. Have you mentioned the sine curve going up and down? Are you talking about like the top is growth, the bottom's inflation? Or are you talking about there being two different sine curves going? And they could be going up or down at the same time? And how does that tie to the stock market?

Mike 12:42

Yeah, that's a good way of thinking about there are two different sine curves, you know, inflation going up and real growth going down. At the same time, you could think about it in terms of, you know, for different economic regimes or for different market regimes, right. So when growth is going up and inflation is going up, you call that reflation, right? If growth is going down, but inflation is going up at the stagflation. If they're both going down at the same time, that's deflation. That's really how we think about it.

Andrew 13:06

Is there a length of time that those tend to be? Are we talking about two sine curves that are just kind of completely random, and the economy gets what it gets?

Mike 13:16

It's a great question. There are different types of cycles. There are long-term debt cycles, which, you know, Ray Dalio writes about all the time that last 100 years, there's sort of intermediate-term debt cycles, which are also long, maybe ten years, right. And then there's the shorter-term business cycle, which tends to be about a year. And that's what we spend more time focused on. And Victus, although it really helps to understand the longer-term cycles as well, because that puts the shorter-term cycles into perspective, right? Our view on inflation is very much informed by what's been driving the long-term trend and disinflation since 1980. Right, not the 40-year trend. So I think to make an accurate call over the next 12 months, you have to understand the last 40 years. So hopefully, that helps.

Dave 13:55

It does. Yeah, yeah, it does. So how do investors guess, benefit, or, I guess, become more defensive, depending on the business cycle?

Mike 14:06

Yeah, that's a great question. So we spent a lot of time doing backtests. We just talked about the four different market regimes. We've backtested all the major tradable assets, sectors, and style factors against those market regimes. So we pretty much know what the historical precedent is for asset performance through all those different regimes. And that sets our expectations. And again, like so much of it is common sense, right? When growth and inflation are declining, typically, defensive equity sectors outperform defensive style factors tend to outperform. And that makes sense because they're less sensitive to the business cycle, right? You're not gonna turn off your utilities or stop buying toilet paper or toothpaste because, you know, the rate of change of GDP declined. But that very well could impact major discretionary purchases that you make, like a new kitchen in your home or buying a new car. In our, again, in our free macro handbook. We have sort of a, you know, bigger backtest, we have the backtest listed on one of the pages, but that's how we think about it. And that doesn't mean, You know, just because it's the deflation, you indiscriminately buy everything that's a backtested ball in that regime. Because every mark, every business cycle is incrementally different. So you have to make accommodation for that. But again, it's just sort of a way of setting your expectations.

Andrew 15:13

So maybe if we looked at what you talked about, and we're talking about the 70s and 80s, it was super high inflation. I wasn't alive back then. I'm not like a historian or anything. But I do know enough about the fact that our economy was really tied to oil back then. And oil prices kind of went out of control. And you fast forward to today and the biggest companies in the s&p 500; they're all technology companies. And you mentioned how technology is really deflationary. So would that be an example of the idea that you don't want to rely too heavily on upon, you know, something worked in the 70s or 80s? That doesn't mean it's going to work today? Because the economy could be completely different.

Mike 15:52

Right? Yeah, that's definitely true. I mean, I think the 70s were sort of defined by low real growth and high inflation. So that was sort of a stagflation airy Mark regime, although, you know, the assets that performed well through the 70s stagflation are the same assets that perform well through the smaller, less severe stagflation that we've seen since then. It's just the scale is different. Okay,

Dave 16:12

that makes sense. How do these shorter-term business cycles fit into the narrative of a long-term business cycle? Like,

Mike 16:19

yes, I can give it a shot. Okay. So the way I think about it is that you have trend growth in GDP, and then you have oscillations around trend growth, and that's the business cycle. Does that make sense? Right, so trend growth is driven by two things, essentially, one is growing in the labor force, and the other is labor productivity. And that kind of makes sense, right? Your trend GDP if labor force growth is 2%. And labor productivity is growing at 1%; then trend GDP should be 3%. Right? It's very logical. But you know, human beings are sort of imperfect allocators of capital; they over-invest in an under-invest, they over-consume, and they under-consume. And so you get oscillations around that trend growth. And then, on top of that, you have the credit cycle. You know, the government borrows businesses borrow, people borrow, and the credit cycle sort of amplifies that existing business cycle that's driven by basically psychology and imperfect decision making. Does that make sense? Does that answer your question?

Dave 17:17

Yeah, it makes sense to me, Andrew; your thoughts? Yep. Okay, so we talked a little bit about the asset. So we're talking about the stock market primarily. But how does the bond market fit into this whole story of business cycles? And how does that ebbs and flows as well?

Mike 17:36

That's a very good question. It's a very big question. Can I go back to what I said about trend growth earlier? Because I think that will help the bond market context. Yeah, absolutely. So right now, most developed markets are seeing declining trend growth as a result of lower labor force growth; right, people are getting older, they have fewer kids. So that's going to be a big headwind for growth in every developed market country, including the United States. And on top of that, labor productivity growth has also declined from the 1980s. And I don't really have a good explanation for that. I've spent a lot of time looking it up, no one really knows why labor productivity has declined, but you have both constituents of long-term trend growth going down. So the bond market would say rates, the yields on government bonds, particularly long-term bonds, are driven by two things, growth and term premium, but growth is the more important one. So the higher the long-term trend growth, the higher rates will be. So you know, when demographics were much better earlier in America's history, rates were higher. And now those demographics are getting worse. And you know, the growth outlook is getting worse, rates are lower, you know, someone who's probably more interested inequities, and I tend to be more interested in equities myself, I spent a lot of time thinking about the bond market and what it's signaling in terms of growth, because the bond market tends to be very sensitive to economic conditions, oftentimes, more so than the equity market. And so, if the bond market is signaling to us that growth is going to accelerate, that would be a good sign to get more risk on your equity market positioning. And if the bond market is sort of flashing yellow lights and saying, Hey, risk, that'd be a good sign to, you know, shift your portfolio to large-cap to defensive sectors and style factors. And we're now raising cash; there's nothing wrong with raising cash.

Andrew 19:17

You're talking about several ideas, basically, kind of asset allocating type ideas. So maybe title together, you know, for the average investor, somebody who's interested in learning about the macro, what kind of things do you advocate? Do people incorporate that knowledge into their portfolio management?

Mike 19:38

I think my number one advice would be to try and understand the business cycle. Right. You know, Wall Street, in general, is very compartmentalized. And you know, I had a lot of opportunities working for broad Ron to go speak with some of the best investors on the street. And one of the things that I noticed is, first of all, there are tons of geniuses in Wall Street, and I don't mean that euphemistically, I mean, really geniuses Super smart people. The other thing that I noticed is that Wall Street generally is very compartmentalized. You know, a research department has a technology guy and a commodities guy and an industrials guy. And I noticed that when these guys would get something wrong, it was generally not because they misunderstood the company, or they're missing some small key detail, a lot of times they're getting things wrong, because they would miss the forest for the trees, right, because they would miss the business cycle. I think I was telling you guys earlier the business cycle accounts for virtually 50% of price action. So no matter what kind of investor you are, no matter what your time horizon, understanding the business cycle helps; I mean, even if you're a buy and hold person, it'll give you some idea of when to start buying the dip and or when to not buy the dip, every decision that you make is sort of rife with the business cycle and macro implications. So And besides that, the business cycle cares about you, even if you're less interested in the business cycle. So you may as well learn about it. And I know, it's certainly been, you know, a wonderful benefit to my personal investing, and you know, my clients,

Andrew 21:03

I like this idea of thinking about what kind of stocks you want to buy, like, if you're buying the dip, and understanding, you know, this is a good time to buy this kind of a company or this kind of a company, you know, it doesn't have to be an all or nothing where I'm gonna try the time the market, because I think I know the business cycle, or I'm gonna ignore the business cycle. You're kind of talking about an approach where you still kind of dollar-cost average, still buy stocks and hold them for the long term, but maybe shift which stocks in which valuations you kind of prefer based on where you think the cycles going or where you think the cycle is?

Mike 21:42

Right, exactly. Although I, you know, sort of caveat it by saying most people sort of believing that you can't time the market. And I think that you can't time it in terms of perfectly predicting things, but you can make high probability bets and low probability bets. So for example, we know from our backtests that when growth is declining, and rate of change terms, and the Fed is tightening at the same time, that's typically a very bad setup for, you know, risk assets for stocks, sort of all the symptoms of that reflected in the markets. Right now. You see credit spreads widen; you're seeing the VIX making higher highs and higher lows; you're seeing most of the major indexes make highs and lows of signals that, hey, this is a good time to be patient. You know, even if you're a long-term investor, and you have, you know, salary, and you save part of that each month. You know, my suggestion might be to wait until growth trots out because you can measure that. So basically, what I was saying is that even if you're someone who has a salary and sets aside a little bit of that salary to invest each month, there are better times to invest than there are worst times, and you can make judgments based on history and probability. And typically, growth is the North Star. Right. So we think growth is probably going to trough around April. Right. So which incidentally coincides with the COVID lockdowns reopening. And then this is where growth would trough according to the basic facts. That's where we expect growth to start going up again. And you know, if we're back testimony correction, that'll be a higher probability period of time to get some good returns.

Dave 23:09

Yeah, yeah, it's very good. So I guess my kind of the last question, I guess it is, how can investors you know, the common everyday investors, how can they take advantage of this? What kinds of things can they do? What kinds of things can you do to help them?

Mike 23:26

You know, our process is very simple. All you have to do is understand growth and inflation. To really understand them, though, you have to do a bit of legwork, right? You have to read all the regional Fed surveys and all the releases from the different government organizations, the VA, the BLS, etc. And so, rather than making you do all of that, we do all of that we keep track of it for you, and then we communicate it for you, in short, digestible videos that are communicated in plain English, no macro jargon. And yet, the idea is that you will then be informed of the business cycle, you'll have access to all of our resources in terms of what performs well, and when our goal is to make all this available at a price point that's very affordable, right? Or, if you go to our website, our slogan is simple hedge fund quality research for everyone. So we started about 60 bucks a month, and our most expensive combo deal is 150 bucks a month. So we think the

Invictus macro bond is one of the best deals on Wall Street and the best way to sort of get acquainted with the business cycle and make sure you're everything.

Andrew 24:27

Yeah, that's awesome. Cool, well, where can people go to find out more about that service and more about you? So the best

Mike 24:35

So the best place to find those things is Invictus/slash Research. The second best place is probably my Twitter account, and the handle is @Invictusmacro.

Dave 24:43

Cool. Cool. All right. Well, Mike, we really, really appreciate you taking the time out of your day to come to talk to us and kind of educate us more about the business cycles and the ins and outs of that, and you really know your stuff. And I learned a lot today, so I appreciate you taking the time to come and talk to us.

Mike

My pleasure, guys; thank you for having me

Dave

You're welcome

So without any further ado, I'm going to go ahead and sign us off; you guys go out there and invest with a margin of safety. Emphasis on safety. Have a great week, and we'll talk to y'all next week.

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