MACRO Voices
with hedge fund manager Erik Townsend

Tian Yang: It’s not time to be short the stock market. Yet.

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Erik: Joining me next on the program is Tian Yang who heads up the research department at VariantPerception. For anyone who’s not connecting the dots VariantPerception of course is Jonathan Tepper's company. We’ve interviewed Jonathan Tepper several months ago in the program.

What I'm really glad to see in the beginning of your chart book and for our listeners if you didn't already get it you definitely want to download the chart book. The link is in your research roundup email if you're not yet registered we told you earlier in the program how to register and get the download.

I see here that you're starting because I think to some people the very name of your company VariantPerception is not even clear talk to us a little bit about the process that you use and how you identify these trading opportunities that are perhaps a step outside of where the herd is going?

Tian: Yeah absolutely so I think when you look at macro oftentimes specific events will seem very unique when people look back in history, so you've got housing bust, you've got Russian default and so often it's not clear if you can repeat the investment process you had the time.

What we've tried to do at VariantPerception is essentially trying to create a framework that's robust and repeatable. So, we've looked back at the various historical boom and bust cycles and try to figure out what is persistent through time and different kind of political regimes in economic environment such that we can create this framework. So, here we’re heavily influenced by the works of the likes of Kindleberger and Minsky and so forth.

So, what we got out of that is basically what we see here on slides through the presentation. Essentially to us there’s two key cycles that we want to focus on. One is the growth cycle of the economic cycle and the second is the liquidity cycle.

Now obviously lots of people talk about growth cycles and there's lots of different definitions. For us there's really two key things that we want to focus on here, one is where leading economic indicators are taking us so that's a very short term three to six month kind of cycle and then two is we’re looking at very much investment or inventory to sales, so this is giving a sense of longer term where we are in a typical growth cycle.

In terms of liquidity typically what we're looking for is again two things. One is this idea of excess liquidity which I think Jonathan discussed last time which is this idea that when money is created in the economic system if it's not being used by the real economy then it is excess and therefore it will tend to flow into asset market and tend to support asset market.

The second component of liquidity is really when we talk about the credit cycle. So, really it's about are people demanding to borrow more and are banks willing to lend more.

So, when we think about macro in that context this can give us a very clear sense of where we are both in terms of wider cycle and where we are for the next three to six month and so I think this is a framework that you can consistently apply when we look at the U.S. when we look at China and obviously as we go through the presentation we'll kind of get to the details of how we actually do that.

Erik: Well that's great because I couldn't agree more that it's interesting to talk about theoretical fundamentals of supply and demand but who's got money to spend counts a lot more and I think the credit cycle is going to be very important. I know you've got a slide coming up on that so I don't want to jump ahead.

Let's talk though about your next point here which is three pillars of global macro being U.S. China and global liquidity. I know those are very important to me but I'm guessing your reasons for that may be a little different so please elaborate a little bit on what you mean by those three key pillars?

Tian: Yes sure, I think obviously over time as the world economy changes there's certain key things you have to get right to get the broad direction right and obviously right now the world we live in, the U.S. obviously is still a very big economy but China's influence is – even though everyone is aware that China's very big people still underestimate just how much impact China has in terms of the global growth cycle, in terms of global deflation and global liquidity.

So, these days before you get into any of the nitty gritty in terms of how to structure a trade, or if you want to look at some of the proxy markets really you have to decide do we get the U.S. economy, do we understand China and do we understand global liquidity. So, that's why I've kind of called it the three pillars here and that's why I think that's the main thrust of the presentation here.

Erik: In the next slide you make the point that the U.S. growth cycle is very long in the tooth, I couldn't possibly agree more with you on that but I've been saying this, we had Raoul Pal on the program probably more than a year ago now making that same argument that hey it's crazy that this growth cycle has gone on so long, what is causing it to extend so far beyond historical means, what's going to be the catalyst to turn this around?

Tian: That's a great point obviously typically historically the average U.S. growth cycle is about five years obviously now we're going to the eighth year this one but the one thing I will say about that is obviously there's no magic number here in terms of when the cycle ends, it's just more to give us a sense of are we closer to the end or the beginning and if we need to start looking out for catalyst.

So, on slide four here what I've shown is some charts that can be more structural in nature so they give you a good sense of where in the grand scheme of things we are in this five to six year kind of eight year cycle. So, obviously when we look at things like U.S. inventory sales, when we look at private domestic investment, the chart hasn't changed much from a year ago but the message is broadly similar that we're clearly nearer to the next recession than the beginning therefore it's important to pay attention to what cyclical lead indicators are doing and I think that's the key difference where even a year ago, six months ago, even

today we know we're late in the cycle but we need to focus on where leading economic indicators are going to get a sense of the timing.

We move on to slide five here we can see something about cyclical lead indicators so these will tend to be a bit more reactive tend to project out three to six months and it's here that we can see why despite a lot of the structural typical late cycle signs we're seeing some of the longer term data like inventory to sales in terms of three to six months cycle we're still very much in this temporary upswing and really you want to wait for U.S. allies to turn down and be aligned with the longer term cycles and that's when you really want to start worrying.

Erik: So it's not quite time to worry yet and it looks like your outlook for U.S. recession is it's still not quite time it is that correct?

Tian: Yes, I think the one thing that-- something that we think about a lot and a mental model we use this idea of inside versus outsiders because we are here day to day looking at data, looking at models, there's a tendency to obviously get very tied up into the specifics and sometimes it's helpful to just take a step back and say if an alien dropped in from mars and looked at all the data what would he think?

So, I think very much this idea of long in the tooth, the fact that the structural indicators show we're late cycle is an outsider perspective, it's just important to be aware of that and on the balance of probability which we want to be looking but then you want to get into the nitty gritty of looking at leading indicators and so in particular obviously and after the U.S. election you had a lot of the survey data, you had the yield curve steepen, we had a lot of positive data and that's basically responsible for this uptake we see our indicator here. [Inaudible 00:06:50] it's not quite there and you kind of need to keep dancing while the short term cycle is turning up.

However because the outsider model also warns us that we're closer to the next recession than the last it's very important to focus in now on the recession risk and so this is why I've kind of devoted a separate chart, separate slide here on the slide six to U.S. recession because I think right now even though markets are making all-time highs and people seem somewhat comfortable this is definitely the number one macro risk to watch out for as we're going to the second half of the year.

I think there's a general misconception about how people think about recessions, typically you see a lot of these charts where people will plot in industrial production, retail sales and they'll plot it over the last fifty years and say hey every time this has turned negative there's previous been a recession and look it's turned negative now therefore there's a recession.

To us recession doesn't really work like that. It's not a continuous process where we very smoothly go from slowing down to recession and go back. To us it's kind of like a face shift, so it's like a jump process in a way, so when we build our models to look at U.S. recession we're really trying to detect this idea of a pace shift, so when we build our models we use for example mockup switching models but really the key idea is that with a pace shift things can change very quickly and so it's important to watch the data closely.

Erik: I would make the arguments we discussed at the very beginning that post the great financial crisis liquidity is more important than ever and you are saying here in the next slide that the U.S. credit cycle has definitely rolled over, I noticed you're not saying that may be coming

that's already happened, so what does that tell us about this whole story?

Tian: Almost all indicators we look at that track the U.S. credit cycle show us we're very very late in the cycle. If you look at Fed loans surveys, if you look at the real growth for U.S. dollar to bank assets these are all slowing down dramatically and this is obviously a huge concern because the Fed has started to raise rates.

In a typical credit cycle behavior tends to change as the cycle matures so obviously later on the cycle you've had a lot of inverted balance sheets, a lot of bad balance sheet structures in the economy, so that I was rates going up and as banks don't want to lend anymore, suddenly people's mindset shifts.

And your loan office is no longer thinking about your money from the loans people start to worry about the return of the principle and so when we see evidence of asset groups growing when we see evidence that that lending is tightening that's what really worries us because that's typically when you get that shift in mindset it's very hard for that to turn around.

So, to us it's very clear that in terms of the credit cycle people moving towards a return of capital and capital preservation mindset which makes us a lot more vulnerable today than we've been any point in the last five or six years.

Erik: In terms of global liquidity which I think we agree is very important, tell us a little bit about what metrics you use, how do you measure the available liquidity and what are your indicators telling you?

Tian: I think we've covered this on slide eight, to us there's obviously lots of definitions of liquidity but what we found that consistently actually leads risk assets prices is what we call global excess liquidity.

Now this is typically – we define it as narrow real money growth minus economic growth – As I mentioned earlier this is the idea that when central banks, when commercial banks, an entire financial system is creating extra money it goes to contribute towards growth and inflation and then whatever is left will tend to flow into assets. So this is what we call excess liquidity, obviously when this is rising there will tend to be a sea of liquidity that will tend to flow into the market by the dip and act as a support but when excess liquidity is falling obviously you don't have that safety net there.

So to us the key analogy is that when excess liquidity is good that's the safety net for the market but today excess liquidity is actually falling so we no longer have a safety net. This doesn't mean obviously the market will sell off tomorrow but it certainly means as whole risk assets are a lot more vulnerable to draw down which is why I think an environment where excess liquidity is falling it makes it almost sense to raise some cash levels and to actually spend some premium on tail hedges because when we're entering this lowing liquidity environment a lot of those 5:1, 10:1 payoff type trades-- obviously the 5:1 and 10:1 for a reason right because they are very low probability but in this kind of environment it suddenly starts making a lot more sense.

Today I think that's really something we're watching very closely the fact that global excess liquidity is falling I think analogy that we almost tend to over use but I think is super appropriate is this idea of if you're trying to balance a ruler on your fingertips and the ruler

falls off, why does it fall off? It could be because the wind blew or somebody bumped into you, but those tend to be proximal causes the fundamental cause was that it was unstable to start with because you're trying to balance a ruler on your fingertips.

So, to us when global excess liquidity is falling we are very much into a fundamentally unstable state of the market so now suddenly it makes more sense to pay attention to tail hedges, to have a lot more of these bearish risk asset trades.

Erik: We've seen some interesting sudden moves in markets in the last several weeks a few weeks ago tech stocks sold off very suddenly and with no apparent proximal catalyst or trigger. There'd been a few very sudden moves in the S&P do you think that those are early warnings of something being wrong with the available market liquidity or is that just a coincidence and those a percentage basis that tech stock selloff was nothing but if you look at how quickly it happened and how it happened with no apparent news event as a catalyst it made me kind of wonder is liquidity drying up in the markets is there a connection there?

Tian: We certainly think so and obviously it's not just us for example you have the Brazil selloff as well a few weeks back so I think a lot of these are signs that when people run for the dollar the liquidity that they expect is not necessarily there and so I think a lot of these signs are early warning signs that we need to pay attention.

Now clearly given what I said earlier about the fact that short term in the U.S. allies are still at a high level but that doesn't mean obviously go out and short everything by it certainly means in terms of context you want to start reducing your exposure raising, cash levels, adding some of these tail hedges.

Erik: And tell us how China fits into this story as you guys see it?

Tian: So China is an interesting one we actually were secretly very bullish on China throughout 2016 back when the market consensus was clearly that China was going to blow up. We had a very memorable trip at the beginning of 2016 where we saw twenty of our clients and I just remember everybody was short rmb at that point even guys who weren't necessarily macro guys who used to be value guys. So what was interesting is at that moment our China lead indicator had actually turned out very very strongly so both our China growth and China liquidity lead indicators turned out very strongly at that point. So, around 2016 we were actually very bullish.

Now today we're almost sort of having the opposite effect where the market consensus has gone towards China values is bad and obviously you've got the [inaudible 00:13:38] obviously you got rmb strengthening at the moment so the sentiments is that there are some inflows into China but today our China growth lead indicators are actually topping whilst our China liquidity indicators are actually falling and dramatically. So, we kind of almost have the mirror image of what we had back then.

If you look on slide nine here the bottom left hand chart here shows our China physical activity indicator so this is basically a proxy using things like cement, steel production, auto sales, building completion and so forth so you can see after that surge things have actually started slowing down a bit, but what's really the kicker here is you look at the top right hand chart liquidity is really falling in China in particular liquidity that used to be provided by the shadow banking system.

So to us these are some major warning signs are we're actually very proactively pushing short China trades and to take advantage of the current kind of benign market view towards China because if you look at the likes of implied volatility on C.N.H. It's never been as cheap as this in the past year or two.

So, this is actually very very attractive levels to start adding short China exposure and indeed you can see that even inside China the authorities are probably starting to get a bit more worried the right hand chart is quite interesting, its shows the different house price indices that's used to track house prices in China. What's really interesting is the black line here, the SouFun index it actually stopped being published at the beginning of this year. Apparently they voluntarily discontinued publishing it for the benefit of the Chinese economy.

When you see things like this it shows you that people get nervous about the data coming out of China and so when people are nervous sometimes they just stop publishing it. But even though they stopped publishing it, there are still good signs that the housing go down might be a bit more dramatic than people think. Typically house prices in China will tend to track closely with volumes so as we see the volume of real estate transactions that you follow so that suggests prices are coming up.

So, there's a number of the signs that suggest to us that things are actually getting a bit more nervy inside China and a lot of this optimism towards China right now is quite misplaced.

Erik: And it does look though that your views about China rolling over, you're not in the camp that says China is about to blow up as some people are still saying would you comment on just Kyle Bass for example has said that China's just enormous credit expansion since 2009 will eventually force a massive credit crisis in China, it's going to force the P.B.O.C. to devalue the Yuan, it's going to send a crippling wave of deflation around the world to lead to the next globe financial crisis. It sounds like that's not your view at all, so do you think that there's any possibility of those things, do you think the people that see it that way are not seeing the story correctly give, us a little bit more perspective.

Tian: Obviously Kyle Bass is a very smart guy, he's been very successful but obviously clearly on China you've had lots of very famous investors on both sides of the equation, so for example Hugh Henry obviously he's been quite bullish at the same time. To us we view China as basically an analogy to Japan after the burst in the late 1980s early 1990s. So, we see China not playing out in this acute one off big devalue type but more like Japan where the problems of over indebtedness are there and it gets just get dragged out for many many years.

Ultimately we think that if they're going to devalue it, it's because the government wants, it not because they will be forced into it. China has, as we've seen this year so far where they've managed to climb down capital outflows quite heavily they have more tools and people expect with a typical Western economy.

So it's very unrealistic to expect the market to force they hand because they've been doing this for the past 20, 30 years and because they don't have a lot of foreign debt and because a lot of the debts is denominating in Yuan they aren't likely to be forced so that's why we think the Japan analogy is very similar.

So, if you look back in the Japan boom and bust cycle they have a very similar way of

allocating credit. In Japan it was also a lot about relationships, it was not so much driven by credit risk and this is what we see in China. People are making loans based on government connection and based on understanding this political faction will bail out these industries, people in generally they're not using credit risk to make the allocate so from that point of view it's possible then to carry on rolling over the loans trying to kick the can down the road and just drag this thing out and I think we tend to view China in the context of this big secular kind of slowdown like Japan.

Now having said that even within this big secular slowdown you can still get huge waves of market moves because there are still lots of opportunities both on the long and short side. So I think for Japan from 1990 to 2003 I think they had on three episodes where the Nikkei was up more than 50% and we think there will be similar opportunities in China where you can get huge rallies like we saw last year in China related assets like commodities but then subsequently once the temporary liquid boost is over then those rallies kind of peak out and things fall back and then they'll try and step on the peddle again so, I think that's kind of how we're seeing china at the moment.

Erik: That's an excellent macro backdrop for the whole global economy let's bring it back around to U.S. equities and the subject that's obviously near and dear to investors, what does all this mean for the equity market?

Tian: I think when you add on the fact that we're late cycle but we don't have a recession on the horizon but liquidity is falling and we could get China risk that suggests to us as I said earlier to reduce risk but not to be outright short. I think you still have some exposure and some skin in the game but clearly you need to be somewhat more flexible.

So, some of our favorite hedges recently has been looking up plays on for example euro-dollar curve playing for the Fed not hiking because a lot of the payoffs here are very very good so that if you get the kind of shock event out of China for example then the Fed is not likely to hike but then because of the 7 or 8:1 payoffs that are currently available on the spread then suddenly you have that kind of liquidity in your portfolio to withstand some of these drawdowns that could be coming.

I will say this probably isn't the big one yet because typically really big falls in equities are cascade falls so that basically means financial markets and the real economy stop feeding each other so the real economy weakens which drives asset prices down which beats back into the real economy and so far we haven't really seen that where typically you had maybe one part of the economy being weak but not both at the same time and before we see that it's very unlikely we'll get this kind of 30% kind of big end the cycle type selloff.

In fact I think if we go back to slide six the bottom right hand chart that you can kind of see how we tend to break things down between the hard economic data input into our recession models and the soft market data or survey data that go into it and you can see that typically you need both to be signaling recession for us to really want to pave the kind of defensive actions that recession would necessitate.

So, it's really interesting for example to begin in 2016 when markets were selling off and generally speaking people freaking out about U.S. recession back then, well our recession model basically showed almost 0% chance of recession at that time mainly because yes we saw that soft market data was signaling recession but the hard economic data wasn't.

Today we kind of have a slight reverse situation where a lot of the soft market data has improved markedly but all the fundamental data things like truck sales, building permits is slowing down but again that just suggest to us that we're late in the cycle but you really need both to give us that huge huge kind of cascade fall.

Overall now we think it's prudent to be allocating less risk because in the grand scheme of things we're late in the cycle but it doesn't make sense to be trying to fight the market and go out right short right now.

Erik: Let's move on to fixed income and bond yields on slide 11, we've had quite a few different views on this program about the big picture so why don't we start with that before we get into the immediate term. Jeff Gundlach famously declared the 35 year bond bull market to be over do you guys have a view is to whether or not there's any truth to that or what do you think is likely to happen the next?

Tian: This is obviously very interesting one the one hand you do have Gundlach and on the other hand you have guys like Lacy Hunt talking about the trend continuing I think within our framework we're not smart enough to make a call on something that's 30 years out but what we can do is try to focus on something that we do think we have an edge on which is some of the lead indicators that we have for U.S. growth, for us inflation, for U.S. wages which are ultimately obviously very important to driving fair value assumptions or where yields should be.

So, from that point of view what we see today is that we do still expect U.S. wage growth to pick up, we still expect to see moderate inflation and we still expect to see moderate growth and so when you add it all together it does seem like there's a lot of macro forces that do you suggest the fair value rates will probably be slightly higher.

Clearly that's one way of looking at it, the other side of it the risk obviously is that as euphoria about risk assets, about Trump led reflation these things peak out, then clearly people go back to the kind of secular stagnation view. So, I think that's what people kind of oscillating between.

So, for us I think those two it's not super clear which of those forces are actually going to win out in the end but we do think that in the meantime because you have this kind of two things on either sides of the market it does create a lot of tactical opportunities.

So on slide 11 on the bottom left hand chart it's one of our favorite charts and it's something that has worked very well historically indeed over the past few years, it just basically shows the total return of holding ten year U.S. treasuries on a year on year on basis and what you find is that typically performance gets very good and people pile in then becomes over positioned, you get a flip and then equally if people get too bearish and the lower kind of standard deviation here on the chart then typically you expect a bounce.

So, what's interesting is that ten year yields, U.S. treasuries total return-wise is sold off or rather the total return has gone down sufficiently that where the bottom kind of minus one standard deviation so from here it actually does suggest we should see some of the rally in fixed income so the rate is going to be a bit lower and indeed this still trends to lineup with the narrative so actually I do think the bullish U.S. fixed income trade makes sense but I think in the medium term inflation wages might not be the kind of huge kind of wage inflation spiral that would justify the ending of a bond bull market but certainly I think we'll

see moderate inflation and wages which actually means you can stick with a secular stagnation view for the rest of this year you are waiting to see those lead indicators for inflation wages come down before you go back on that view.

Erik: Tian a lot of people have observed that high yield junk bonds have not really reversed as you would expect them to because there is so much risk in the high yield market associated with shale oil drillers and a lot of people assume that if we saw a rollover in all prices which we have definitely seen that that would cause high yield to take a nosedive and there's been some correction there but it's not a nosedive. How do you see that market and is there an opportunity there?

Tian: Yeah again the overall context has obviously been in an environment where liquidity has been abundant and in the chase for yield obviously the extra kind of basis points you pick up investing in high yield is what kind of drive people into the trade. However as we kind of uncovered earlier on today when the Fed may decide to hike, when there's a lot signs of the credit cycle is a late cycle and where there are signs that excess liquidity is starting to fall then this is the kind of environment that we could get a selloff here.

To us high yield spread are probably some of the most mispriced instruments out there today and the short there certainly looks very very compelling even in terms of absolute levels the credit spreads are basically back to cycle lows. So, yeah I think that's definitely an area investors are buying into high yields because the trailing short ratio has been very good it's basically like equities with a lower volatility but now that the kind of macro regime has change in particular the credit and the liquidity regime we do think that's actually a very very compelling way to add a hedge to a portfolio or to actually do a right short trade.

Erik: OK so long treasuries and short high yield sounds like it's the trend.

Tian: Yeah absolutely.

Erik: Let's move on to the U.S. dollar we've seen I think a lot of surprises for the dollar bulls in the dollar index chart, we've heard a lot of arguments on this program for why the secular dollar rally should continue but should and will seem to be two different things how do you see this?

Tian: Yes, so the dollar has been interesting, one of key themes this year was that we thought the dollar would go down in a trading range kind of fashion which is actually what's actually played out to now, the main reason had been that we thought dollar valuations were very high at the same time there's real rates in the U.S. not justifying such a strong dollar rally, so the fact that we didn't see high real rates in the U.S. meant that we didn't expect a lot of capital inflows into the U.S. which meant that a lot of the speculative long positioning had to be unwound.

Now today I think we've seen some of the unwind but clearly if you look at the bottom left hand chart here which breaks down speculative positioning on the dollar versus DM and EM currencies it's mostly been EM that people have been going long and short dollar again. In terms of the DM currencies, the positioning has still yet unwind a bit which is why I think overall there's still a scope for the U.S. dollar to trend a bit low. For us really the key driver FX is on real rate differentials and so here the top right hand chart gives a very good illustration where real rates are for dollar versus other developed countries and clearly we're just very much reverting to where the dollar index probably should be given the fact

that real rate differentials are not very high.

The thing about a secular dollar bull market, I think I'm more probably a fan of the dollar smile theory that I think Stephen originally put forward which is the idea that the dollar basically does really well when the U.S. economy is either doing really poorly or really well so basically the dollar is rallying in one of those risk off scenarios or in scenario where real rates in the U.S. are going up because the U.S. economy is doing well.

To me it feels like we're not at either of those extremes at the moment we're somewhere stuck in the middle which is why given the smile we would expect dollar to actually perform rather poorly.

Erik: Do you have a downside target for the dollar index?

Tian: We are not really technical experts so I don't necessarily have a level but I do think obviously clearly on a lot of technical indicators things are getting to a point where the dollar is a bit oversold so I think the way we're trying to position tactically is saying sell rallies. So, we're looking at drawing the trend and selling dollar as we move towards the top end of the channel.

Erik: Let's move over to Europe because that obviously has a big part to play in this dollar story a lot of people seem to be acting like Europe's problems are over I personally don't see it that way I think they are just beginning but what do you see in terms of the outlook for further European exit contagion where the various situations – there's almost too many to mention – are going between France and the U.K. and so forth?

Tian: I absolutely agree with you here, I think the longer term structural picture hasn't really change despite all the euphoria around Micron and further integration now I think we might need to break this down again into the kind of three to six months view versus the structural picture because obviously right now given the fact that economic data s improving in Europe, you have lead indicators across both the core and the periphery surge recently and given the noise come out the ECB it probably doesn't quite make sense to stand in the way of freight train quite but clearly in some of the breakup zones it's very very unlikely that the Europeans are going to be able to figure out this euro problem.

We've gone back and looked at the history of various currency unions and historically all currency unions are made for political reasons and break up because eventually the core gets sick of subsidizing the periphery and then the core breaks it off.

I think that's a very useful analogue to see where Europe is at today, historical examples would be say when the Ruble zone broke up after the Soviet Union disintegration where essentially in the end it was Russia that decided they were sick of all the countries free riding of the cheap money that they were creating and so it was Russia that broke it up.

Today what we're focused on is actually what the core is doing and not necessarily what the periphery is doing. To us a lot of the noise around for example Italy leaving, Greece, they're probably somewhat more of a red herring that will cause a market reaction but those are the opportunities to buy the-- what's really the key to watch for as the core and whether the core is trying to move away or towards integration.

So, for now what we see is that the likes of Germany and France are trying to pull towards

further integration and trying to keep it together but basically really means they're still happy to subsidize the periphery and to run monetary policy like it should for the periphery.

If you look at the Taylor rule it would recommend interest rates should be-- it's like 6% European rates are probably 6% too low for Germany but they just about right for the likes of Spain and Italy. So right now a lot of the European project is being run for the periphery but as we carry on say when the economy slow down or we get U.S. recession or we get China related growth slowdown when suddenly in the core people start feeling the economic pain again certainly at that point I think a lot of the kind of the populism, the kind of anti-euro sentiments will start to come back and I think that's the number one thing to watch for, for the kind of eventual breakup risk.

So for now I do think that has receded and given improvement data you don't really want to fight it but structurally I don't think it's possible to make the sole of the fact that when you have a fixed exchange rate you get wildly divergent real effective exchange rates within Europe and given that the European countries trade among themselves you're never going to be able to kind of offset that. So, Germany is always going to benefit because they will always have a lower real effective exchange rate relative to everybody else and so it's only creates enough problems for Germany politically that we'll likely see this kind of euro disintegration going to backup.

Erik: So it sounds like the trading strategy is essentially get out of the way of this freight train of euphoria but then get ready for reality to sink back in at some point in the future with a particular focus--

Well I guess what I'm pretty particularly interested in is it sounds like Germany is going to play a pivotal role in this because they're very much at the center, at the same time Germany is in my opinion up against some pretty difficult political challenges right now. If this refugee crime situation gets much worse I think there's going to be a real division in Germany about whether or not the current leadership is on the right track or whether to change it. Does that potentially create the catalyst that brings about this change of direction from the center that you talked about earlier?

Tian: Yes possibly, obviously we don't claim to be political experts but that could be any number of things. So I think that might be a potential flashpoint but probably an even bigger flashpoint ultimately is the fact that the reason German is running such a big current account surplus and has such a strong economy was that they've basically done it at the expense of German workers who've had lower wage growth, there are able to kind of consume less and demand less while a lot of the Southern Europeans obviously have been borrowing money and living better at least in the boom years.

So you've had the German population that's going through all the house reforms agreed to limit their wage growth that kind of attitude where they don't see the kind of periphery countries willing to do the same and given that the divergence in real effective exchange rates you will need to see huge real wage cuts, 20, 30% in some of the peripheral countries which just isn't going to happen, I think that's what probably creates discontent, with the German populous the story becomes we're supporting all of these guys but they don't want to be prudent, they don't want to take less money basically. I think that's probably going to be ultimately what the trigger point is and that's probably what's going to be very kind of fertile material for another kind of wave of populism.

Erik: We've talked about China earlier and now Europe let's go back to Asia and talk about Japan and the situation there, how do you see the Japanese economy developing and do you think that the people that are concerned about your JGBs have got it right or wrong what do you see going on there?

Tian: Yes. To us the most significant macro event last year was actually the BOJ decision to target the yield curve, to us this is a very close historical analogy to the Fed Treasury Accord after the Second World War in the U.S. where essentially the BOJ agreed to give up control of their balance sheet in return for capping yields. Now obviously in Japan technically speaking it's not capping yields but we think in practice it's basically a step towards monetizing the debt.

When we look at Japan I think there’s a big historic context about when hyperinflation hits so the best book to read on this is actually by Peter Bernholz where he basically identifies every single historical incidence of hyperinflation and said what are the sign posts for eventual hyperinflation and in particular he said there were two things, the first is your budget deficit as a percentage of your total government revenues is more than 40% and the second is that you are basically monetizing the budget deficit, the entire budget deficit is being covered by central bank balance sheet expansion.

So, Japan is the only country in the world right now that actually fit both of these descriptions so they’re basically according to Bernholz past the point of no return. So here it’s just a case of how they try and get there and I think a lot of the moves we’ve seen for example getting their pension funds to move out of the JGBs allocating towards equities foreign assets these are all signs that they understand this bigger picture here that they’re e going to be moving towards the hyperinflation kind of scenario.

So, for us seeing that the B.O.J. yield curve targeting we think it really just means capping, it really means trying to create this mechanism whereby if yield curve start to steepen, if monetary velocity starts picking up, there’s a mechanism there to kind of generate a lot inflation quickly to kind of lower the real value of the debt. So I think that’s the big kind of historical context in which this is going to happen.

Now in terms of right now in the market clearly there’s going to be some doubts around the kind of Japan reflation theme this year obviously if you look at foreigner investments in Japan, there’s been actually a decent amount of outflows recently but ultimately I think this is just a more position related and that it’s actually a great opportunity to get back into the Japan trade so long Nikkei short Yen.

Erik: We have quite a few listeners in Australia and since you mentioned the China situation rolling over as you know a huge amount of Australian GDP is attributable to exports to China so what does the China story and other factors in general tell you about where the Australian economy may be headed?

Tian: Australia I think its Jonathan’s favorite topic, I think he’s made a lot of fans down in Australia pointing out the housing bubble there. I think broadly speaking we obviously still think Australia is experiencing a very big housing bubble that's increasingly vulnerable to down turn and today we think actually there’s a lot of signs that are leading indicators that the housing market has actually rolled over.

So, if you look at building approvals in Australia they are declining somewhere in the reach of 20% year on year now. So this is a very very significant development and indeed if you look across Australia, outside of the major kind of Sydney, Melbourne and in some of the capital cities prices have actually started rolling over, while indeed in places like Perth they've actually started declining.

We actually think today a lot of things are lined up in Australia to go back on the bearish Australia trade. Australia lead indicators are rolling over, building permits are falling, yield curves are flattening at the same time if you look at the commentary and the general anecdotes coming out of Australia and indeed the kind of general sell side research a lot of that tone has changed as well. Most people have shifted tone towards being concerned about the doggy banks, being concerned about the momentum of the housing market concerned about the fact that two thirds of loans are interest only.

So I think there's been a clear shift in narrative from when we kind of first discussed this a year ago so today I think the short Australia trades actually makes a lot of sense and indeed that's one of the major trades we have on as well.

Erik: OK I just want to touch on that because a lot of people don't understand that Australian housing debt is not securitized the way US is so you don't really have The Big Short equivalent in Australia is it just shorting the banks that you are using as the way to short the housing bubble that you see there or is there some other technique for shorting Australian housing?

Tian: I think it's the banks so in terms of mortgage intermediaries, I think the banks are a very clean expression of the trade because two thirds of the bank loan books in Australia are actually housing related but the banks have very very low loan loss provision at the moment so it's somewhere in the region of twenty basis points. So there's not a lot of room for error for Australian banks at the moment and at the same time in terms of valuations they're trading at over two times tangible book value, whereas comparable banks tend to trade one, one and a half Australia is two, two and half so there's a lot of things lined up that suggest that Australian banks should be a very very clean expression of the trade.

But other than that, and I think obviously short the dollar is also quite a clean way of playing it but that's likely to be more delayed where essentially the housing bust happens then the banks need to be bailed out and then the RBA bails them out it's that bailing out consequence where they lower rates and then drags the Aussie dollar lower so I think that the slightly less direct way of doing it equally longer fixed income will be a very similar indirect way of doing it. I think short Australian banks is a very clean and I think a very high beta way of doing it.

Erik: We do have some information about your company at the end of the chart book but for anyone who was not able to get the download give us just a quick 30 second bird's eye view of what you do at VariantPerception.

Tian: Sure, so at Variant we provide independent investment strategy and global macro research. The key thing I would emphasize here is that we emphasize very much our investment framework so it's about focusing on what's robust and repeatable during different economic cycles.

We are trying to kind of position ourselves as the opposite of the guru model, it's not

anyone, it's not just say Jonathan Tepper who's the genius, who's going to make the call, have an epiphany and tell you when the next blow up is going to be, we have a process that we follow and so we have this repeatable way of generating ideas to make sure that our research process is not so dependent on which side of bed Jonathan gets out of in the morning.

Erik: Well Tian, thank you for a fantastic interview. Patrick Ceresna and I will be back as MacroVoices continues right here macrovoices.com.