MACRO Voices
with hedge fund manager Erik Townsend

Hugh Hendry: Inflation is just over the horizon!
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Erik: Joining me now is Hugh Hendry, manager of the Eclectica hedge fund. Hugh, last time you were on the program, several people on Wall Street were starting to say that the market was overdue for a correction or an outright bear market. But you very confidently assured us that things were better than feared, and, so far, you've been absolutely right in that call.

But now the chorus of doomsayers has grown much larger. Jeff Gundlach has been extremely outspoken, saying he's going to make at least 400% on his S&P puts. Quite a few pundits have suggested that the business cycle is long overdue for a recession. Analogies to 2000 and 2007 are everywhere you look. Even Goldman Sachs Chief, Lloyd Blankfein, recently commented publicly that asset prices have gone up too much for too long.

So, Hugh, is the growing chorus of bears about to be proven right? Or do you think that this global economy still has room to grow, and markets have room to march even higher?

Hugh: Well, I guess it won't surprise many that I probably find myself in what feels like a little bit – it's uncomfortable from the vantage point of managing a macro portfolio to say that I still believe the system is healing. And, yes, I certainly accept that valuations are high, but I can't really see anything to get in the way (if you will). Now, you mentioned corrections. One can never really dismiss that they are an ever-present with us in financial markets. But, in terms of calling an end to proceedings and looking for a correction greater than 20%, drawdowns in S&P are rare like hen's teeth. But something severe and something of the order of what we saw, of course, in 2008, and eight years previously, I want to say I just don't see the setup for that situation presently.

Erik: Now, before we move on to what you do see going on in today's economy, I want to talk about how we got as far as we have without seeing any inflation. Because, when the Fed announced QE in 2009, a whole bunch of people were convinced it was going to cause massive crushing inflation. So far, that inflation has never come. How is that possible? How did we get through so much money printing out of thin air injected into the economy, without wage and price inflation ensuing?

Hugh: Well, indeed. And who knows? I can merely sketch out – hopefully not too pithy comments – but, to my mind, the core of the response to your question is really that

that liquidity, this immense borrowing of money that was created in the first order by central banks, it was distributed to the very rich.

I mean, I've been at pains to present papers on the role of the global creditor. The last four decades have been a magnificently rewarding period for the global creditor, the people who supply the capital to our hard-working entrepreneurs in our economy who go on and create jobs and income for all of us. Those creditors, for many decades, had actually enjoyed this very high real rate of return on lending money to others. And then, of course, with the advent of quantitative easing, they found themselves receiving this immense distribution from central banks.

And the problem is that these rich folk (if you will), they have a very low monetary velocity. Which is to say, their impulse – or their marginal desire to consume that wealth – is really, really, very low. So, at the margin, we gave dollars to people who really didn't have the inclination to spend money, and, therefore, this injection, this great largesse, came to be stored rather than multiplied by the fractional reserve banking system.

You know, true money creation is when people say, hey, give me a loan, I feel good. And then we start – the banking system (if you will) almost creates money out of thin air. So it was never – it was distributed (if you will) to the wrong folk. And then, in the years that passed, if we turn our attention back, what, four years ago, to what's come to be known as the "taper tantrum" – we saw a Fed which pronounced a desire and an intention to start reining back quantitative easing, and so to tighten (if you will) – but, I think the Fed's intention had been to be tentative and slow and cautious.

But, nevertheless, to tighten when we had a national unemployment rate in America of 7.6%, and, really, no indication of excess in terms of wages and cost-push items, which can generate nasty inflation – so, really, quite hawkish intention by the Federal Reserve.

And then it was greeted (if you will) by the monkey mind of the capital markets. And the capital markets is, the tantrum notion is – we saw a huge selloff in ten-year US government bonds, and yields went up to 3% at the ten-year level. And so we saw this immediate tightening. And of course the aftermath of that has been the tightening was unwarranted, the economy wasn't firing on all cylinders.

We saw, I guess, a well-placed bear market in oil. And then, of course, we've had these, what I like to refer to as these ghosts in the machine, these great paranoias. I think the most notable of the 2015 vintage would have been this great fear of a significant devaluation in the Chinese renminbi. And of course these were fears which, so far, have not materialized. But I would like to say the combination of all of those events inevitably led to this grind, grind, grind lower in the price-inflation series that we see today.

Erik: Now, the reason that I wanted to start by understanding how we got this far without serious inflation is that, while the bears are all drawing parallels to 2000 and 2007, you told me off the air that you actually see a closer similarity between today and 1965. First of all, I haven't heard anyone make that connection. But, it seems to me, too, that 1965 was just before the start of an utterly massive wage and price inflation cycle.

So are you predicting a return to inflation in the next several years? And what is going to change, I guess, is the real question? How is it that we didn't have any inflation after this massive money printing, and now you see that it is coming, even as the QE programs are being wound down? Help me understand that.

Hugh: Of course, we have to go back almost to the Ice Age – I mean the 1960s. But, you're right in your assertion that, after the events of 1965 – and we'll try and explore them – but for 16 years inflation rose. We didn't see inflation below 2% for 16 years. It took another 17 years to bottom out. So 1965 is worth consideration.

And I'm speaking to you, and we are in the midst – or the aftermath, if you will – of this dramatic hurricane, Hurricane Irma, the largest Atlantic hurricane in a century. And, again, it just shows you – I'm very close to it because I'm very fortunate in that I have a property in the very beautiful island of St. Barts, and so the last five or six days have been rather traumatic, watching events. But, when I think of it, there's another cycle there. There's been a building boom. And when I think of the beautiful villas on that island, nothing pre-dates, really – and the last big one, which was 1993, and the one behind that was Hurricane Ivan in 1988 – these are just so long ago that they have been either forgotten, dismissed, or that we are inured to the devastation that can be brought on.

So let's go back. Why 1964-65? And I have to say the reason is because you had pretty much all the same signals from the labor market. Unemployment was below 4.5%. Now, I must preface that and say that we had, of course, two periods before that. We had 2005 and, back in 2000 in the height of the [TMT (technology, media, and telecom) bubble, wherein, again, we had a national unemployment level which was 4.5% or tighter.

Those two latter events were economic periods which were, if you will, they were ripe for a correction in economic momentum. You know, we had bubbles. We had a misallocation of resources within the American economy with regard to, of course, residential property in the latter years of 2004-05-06, and previously in telecoms and technology. And, therefore, interest rates and the Fed tightening actually had an immense impact in taking away any incipient inflation.

But 1964-65 is relevant. And I think it's relevant today, because, I think, one of the big analytical errors that people may be making is that we should recognize that recessions do not come out of thin air. It's not like you set your watch or your calendar and you say, it's four or five years, or six years, and it's long overdue. Recessions emanate from a vulnerability with regard to the errors of all of us in getting too excited about particular areas and over-investing, if you will.

And, therefore, we are potentially compromised when you see a Fed come in and begin a tightening cycle. And so, I would contend – it's contentious to say – but I would contend that, barring these unforeseen black swan events, there is just nothing of the magnitude of credit excess within our economies today which makes it vulnerable.

And, secondly, I'd say that capital markets, macro hedge funds – but, really, the managers of real money, these big huge pools of pension funds money – have largely given up and they've come alongside the Federal Reserve. They've stopped berating the looseness of monetary policy. And now everyone is resigned to the notion that inflation is structurally low and the only response can be looseness in policy. So there are, if you will, there are no agitators for tightness.

And, back in 1964, as I said, the figures – it just looks like today, you know? Again, if we look at today, the unemployment rate – the low 4.5% – is very low. Job openings, they're very high. The CRIP ratio is very high, which is to say, if those in jobs are now feeling confident enough to say, well, hey, look, if you don't give me a pay rise, I'm going to cross the street and join the competition. The hiring rate hasn't increased as much. And therefore, to my mind, you've got a pot and it's bubbling, and I can hear the lid begin to rattle somewhat.

But my point is, yes, I'm drawing comparison with regard to these levels. Again, for through transparency, there's one statistic: the level of unemployment for those actively seeking jobs. You know, those (if you will) between (I don't know) the ages of 20 and 64 if you will, we're not quite as low as we saw in '64-'65. But the thing, the true linkage, is that there aren't the credit excesses and therefore the vulnerability.

And there really is no group, no group strong enough, to agitate that we should be hiking now and taking that risk off the table. Because, when we look at wages or this cost-push inflation, I think the experience of that time suggests it's immensely difficult to contain – far harder than containing asset-price inflation – and therefore brings to mind the comparison of how Hemingway described going broke. It was slow. It was – you almost didn't have any sense of it. And then it was devastatingly quick.

And there's no one in our community that's willing to say, hey, listen, I don't want to underwrite this devastatingly quick phenomenon. So that's (if you will) – I'm simply trying to be a provocateur, and I'm trying to say there was a big hurricane and it feels like it's offshore just now. And, when these things come onshore, you know – really? Are you prepared for it?

Erik: I just want to be clear. You're making an analogy to the economic conditions that existed in '64 and '65. Are you necessarily forecasting that that massive wave of inflation that came in the late '60s and early '70s is coming? Or are you merely saying it's something we should be watching for because we have the ingredients – the barometric pressure says it's possible a storm could arise? Do you see the storm coming in on the radar, or are you just concerned it's hurricane season?

Hugh: I'm concerned it's hurricane season. The various measurements we have – if you will, the atmospheric pressure of the US labor market, and the lack, if you will – so let's bring the metaphor full forward. The sea temperature in the Caribbean etc. has been very high, and that's what powers the devastating force of a hurricane. And, for me, the sea temperature – my analogy is, with the lack of resistance, no one now believes that we should be pre-emptive and hawkish. Everyone is saying, let it pass, you know, I don't want to take the extra mile.

No. What I want to say to you is I've tried and tried and tried to withdraw myself from this role of being a prognosticator, like a soothsayer, to tell you what is going to happen in the future. I just, I've always struck out with that concept. Yes, we have these brilliant minds, but, until we invent a time machine, no one can see the future. And I find it is just, it's pathetic for me to sit here and say, there's going to be this high inflation in 2019.

Instead, I see my role as an architect. And I have clients. It is my duty of care to build structures that can withstand even the most intense things that nature can throw at us. At a reasonable cost. So, yes, you could insure a building to withstand damage. But, of course, what's your budget? And so, really, I'm kind of excited today, because with this huge consensus I can – if you will, as my architect role – I can defend my properties from even something as severe as 1964-65. But (if you will) I'm like Noah. I'm saying to you, where are the Noah's in our community?

Now, you mentioned Gundlach, who might even be in the same sentence. So Jeff's got S&P options and realized volatility and implied volatility and, indeed, the spread between those two, and they're low, which is to say the price of that hurricane insurance is cheap. But we get into these price regimes with equity volatility. It trends. And it continues just to feed on itself and trend. And so, buying equity volatility, or buying these puts just because they're cheap, has never really worked as a viable technique, I believe, to insuring portfolios.

And, then, finally – I speak too much – but, the big concern that I have is that our system, our financial system, your wealth today, is subject to the defense of your managers having really quite a large allocation to ten-year Treasuries. For the last four decades, whenever we've had a correction or a more severe rout in stocks, those Treasuries have gone the other way, which is to say they've gone up, they've made you money, and they've made the damage less.

Today, I just – if I was an architect, I would not be using the building blocks of US Treasuries to defend my wealth.

Erik: Now, the last time that I interviewed you, you were decidedly bullish on the US dollar on a secular level. But the inflation that began in the late '60s also marked a period of great dollar weakness that led to the collapse of the Bretton Woods system in August of '71 when President Nixon famously slammed the gold window. So does this new view of yours about inflation mean that you've reversed your outlook for the US dollar from bullish to bearish?

Or is there a different view? Help us understand how you now see the US dollar.

Hugh: Again, with full transparency, I have endured a very, very unpleasant – or my clients, if you will, but I count myself alongside them – a very, very unpleasant summer. And yet – in a sense I've lost money, if you will. And, yet, nothing has gone wrong. I've found myself in this terribly uncomfortable position where my risk book has become correlated to the maelstrom which is the presidency of Donald Trump. And, of course, these news-bombs that emanate, of course, from the Korean peninsula (and no pun intended).

Now you're right. The dollar has had in the order now of about at least 12 if not more percent in terms of a drawdown. Now, I've had exposure to that. My exposure, however, has been limited. Indeed, my narrative is limited exclusively to the dollar-yen rate. I have been running a long dollar position versus the Japanese yen. And the reason for that is – I hope is consistent with what I've been saying – in that I think what we're going to see, if any (if you will) if any of my feelings about that labor market in 1964-65 has relevance, in terms of where this labor market is going to take us, then I think we're going to see a great fight between market and managed prices.

As you know, the Japanese authorities are intent on maintaining the price – or the price fix – on ten-year Japanese government bonds. Whereas, of course, in other G7 and across the world, our government bond prices are really determined and dictated by the free market sector. And so (if you will) the catalyst being that at some point we cross this Rubicon and we start seeing more sustained and higher US wage gains (if you will) which feeds through into higher inflation. Then the Fed will raise rates.

Now, the shock – if you will, the shock – what would be a new thing, is higher interest rates failing to juice a recession. Don't forget, the great minds presently – the Fed has rates of 1, just over 1% – and markets are telling the Fed, in terms of the flattening, this dramatic flattening in the US U-curve– that's the U-differential between two-year and ten-year – the market is telling the Fed that rates at 1% are going to slam the economy into a recession. That's what the market is saying today. And I think the market is wrong in that. I don't think we see any evidence of that. And I'm willing to bet that we could get to 2% rates, or 3% rates, and it will fail to induce a recession.

Now, why is that? It's because if we see sustained wage increases then you end up squaring the circle. Because, what was the problem that we said about QE initially? The problem was you gave liquidity to folk who didn't have any desire to spend it. When you turn that on its head, when via wage price gains you give marginal dollars, you're giving marginal dollars to people who want to spend the money. And so you get a lot closer to the conjecture of the helicopter money that Chairman Bernanke promised back in 2002. But subsequent central bankers, not just in America but elsewhere, they dare not distribute it. We get into that point.

And so I think the economy could actually prove to be far more robust in the face of higher interest rates. Companies will continue to employ staff, wages will be increasing – which is to say that, in totality, corporate revenues will be holding up, probably rising. If they can achieve productivity gains. That's a big if. But if they can, profitability will remain reasonable.

And so I think it's safe to say that those corporations will commit to pay staff more. And they will raise their prices to cover these incremental wage costs and higher interest rates. So the short, to my mind, could be Fed at 3% rates and an economy which is not tanking, if you will. Now if that comes to pass, and the Bank of Japan is still maintaining JDB (Japan Development Bank) nominal ten-year yields at zero, then we're into a world where dollar-yen has to trade at one twenty, one thirty, and keep going, keep adding 10 increments as you move into that environment.

Erik: But it sounds like that outlook really is a dollar-yen outlook. It's not so much a secular dollar is going to be strong against everything; it's really a more specific trade as opposed to a dollar outlook. Is that right?

Hugh: It is. You're right. You saw through me immediately by – I'm shirking your question. In general dollar terms, I have to say, right here, right now, I can't see much in the way of impetus apart from its being oversold. But I can't see much in the way of impetus for anyone to be immensely bullish – the general basket of the US dollar against other currencies.

Erik: Okay, great. Now let's move on and translate this outlook to what it means for the bond market. We still have some prominent people – our mutual friend Raoul Pal is predicting 50 basis point on the ten-year at some point – expecting that we're going to continue to see a big move down in yields. With inflation on the horizon, I assume that you're envisioning higher bond yields secularly over time. So give us your overall forecast – including how the yield curve would evolve – in the outlook that you have.

Hugh: Well, I think I intimated to you that the yield curve is just way too flat, that the yield curve is saying that present Federal Reserve official rates will induce a recession. And I believe that that is Raoul's view, that a recession is coming. As I say, my retort to that is that they don't come out of thin air, that it is the presence of higher interest rates which festers (if you will) a point of misallocation of resources within the real economy. And the fact is, the real economy has been okay. But it hasn't been red-hot, and entrepreneurs haven't gone crazy. Yes, high-end real estate is expensive. You know, there are pockets of expense, but I believe that they owe more to circumstances such as the pool of savings out of emerging markets being able to invest in the US.

So, really, my point today is I find it very hard to dissuade anyone not to invest in (if you will) the permanent portfolio. A permanent portfolio construct would be: a quarter of your assets in Treasuries, a quarter of your assets in the S&P, a quarter in the dollar, and a quarter in precious metals (but, for that matter, let's just call that commodities).

My view is that the S&P will continue to glide higher. I think there's probably more money. I think I could envisage a world where, actually, European markets could actually stretch out and try and reclaim the highs that we saw back in 2000. Now if that's the case, you're talking 40-50% upside in those markets. And I say that because the click, the change, this year, is that we are in the midst of a synchronized global economic expansion. We haven't been able to say that for a long, long time – ten years or more.

So, I think equities are glide path, which is still higher. For all of my reservations about the Treasury market, I just don't see it cracking. Commodities – they've already told you the world is subject now to synchronized economic expansion. Industrial commodity prices have jumped higher. I think they're now on an upward path like equities. And then the dollar – stale money, if you will – but, as a construct, I think you'll find that the majority of active macro portfolios today pose a struggle to beat a permanent portfolio composition.

Now, personally, I wouldn't? recommend that, because I don't like those Treasuries. And I don't like them because ten-year Treasuries today look like a very, very expensive zero-growth equity. So let's think of it. I accept – even with my claims that we're okay – equities are expensive. So why would I want to put a 25% allocation into another equity-like product which is expensive and has no prospect of growth? If you will, you're simply doubling up on the risks of owning what are expensive assets.

So in the short term, for the next (if you will) 18 months, I just think this pot of tepid water is just – the temperature's going to keep rising, and that the existing trends are going to be reinforced, and that the only flaw in the thinking just now is the over-reliance on G7 sovereign bonds to diversify and protect portfolios. That's my concern.

Erik: I want to come back to equities in just a couple of minutes. But first I want to talk about a couple of trades here, because you mentioned to me off the air that your team at Eclectica is working on a trade that involves a curve-steepener on the MOVE index. Now, as I understand it, the MOVE index is basically the VIX for the bond market. It's a measure of volatility in the Treasury bond market. So please explain the concept behind this trade. Why do you see a better opportunity to trade vol in bond markets as opposed to the yields themselves?

Hugh: Well, I'm showboating… I find myself in an environment where I have to try and impress other people, if you will. This is me. I'm the magpie with the shiny coin, putting it in my nest, if you will. Why? I think I gave mention to Gundlach and his S&P puts and the notion that equity volatility is low. Fixed income volatility, of course, is also low. The data is sketchy, but I don't think it's been lower than this for three decades. I employ people in my business, and for all of their lifetime fixed income volatility has never been as low as it is today.

And when I look at correlations -- again, with Jeff and his S&P puts, he's long volatility. And, when you look at correlations, you need negative correlation, which is to say you need the underlying asset (that is, the S&P) to fall, to go down a lot, to make money. That is not the case with being long fixed income volatility presently, when you look at the models of how it reacts and how the price moves around.

So I like that because I have huge reservations about Treasuries. But, like most things, I really just cannot foresee this Fed changing its spots (if you will) and becoming an activist, and saying, hey, we're going to take off that risk that we ran in the 1964-65 scenario. This Fed – and, again, as we mentioned with the dollar – this Fed is going to just keep itself kind of uncontentious, and it's not going to try and bring on a slowdown in the US economy.

So I think bonds are just kind of going to sit there being ugly – ugly as anything – but not doing anything. So I don't want to have an asset or a bet, a speculation, today which is dependent on a crash in that instrument over the next 12 months. And so I think fixed income volatility is low, it doesn't have the same trending characteristics as equity, and we're now at levels which are reminiscent of the eve of the crisis of 2008, where the price is so low that to really get it wrong you have to see a further cascading in fixed income volatility to lose money.

Now, again, if I try and be smart, I think yield curves are going to steepen at some point. And so when I look – I could put on a yield curve steepening vol trade – there was an expectation that the Fed would be hiking rates farther into yearend. That has dissipated over the summer. As the prospect of the Fed being more proactive has receded, what you find is that the price volatility that the uncertainty and the convexity has been bid up, which is to say that two-year Treasury fixed income options are expensive. Whereas, reassuringly, ten-year is still cheap.

So I, kind of, want to pay ten-year volatility and I want to receive two-year Treasury volatility. Which is to say, I think, I want two-year price volatility to fall and I can conceive of ten-year price volatility going up a lot.

So I would pass over that in many respects. You know it's my job – my job, in some respects, is complexity. This is a complex trade, and it's designed to recognize the environment that we might find ourselves in for the next 12-18 months of becalmed Treasury prices. You know, they have no real yield. These are securities which are priced to make you nothing. They're a great redistributor of income. They are redistributing income from wealthy folk who own them for the fear factor, and they're setting up an environment where we might stock up a great bout of wage-price inflation from the labor market. So maybe we should encourage that.

I would say to you that, perhaps, at the end of the day, quantitative easing will end up doing what it was always supposed to do in the first place. Quantitative easing was a system which was designed to increase – not decrease – interest rates. It was designed to create a robust and growing economy. And that growth would come via higher wages. And those higher wages – and reasonable evidence of profitability would be able to deal with the burden of higher interest rates – so higher interest rates will be the success, the triumph, of quantitative easing.

Erik: So if I can just summarize that to make sure I got it straight: If you look at this market, even though you are very quick to say you think there is room for more growth you would stay long in the stock market. At the same time, you acknowledge nothing is cheap. Valuations all over the place are just very expensive.

And, if what you want to do is buy something that's ridiculously cheap, the one thing that you can find is this very complex differential trade – which is essentially being long ten-year volatility, short two-year volatility– because you see an imbalance there. And that's basically the only place you can find anything that is ridiculously cheap. Is that a fair assessment?

Hugh: You got it.

Erik: Perfect. Okay. Let's move on to a subject which is definitely of interest to a lot of our listeners – near and dear to their hearts – which is precious metals. Now, you're seeing both increasing inflation and increasing interest rates. And, of course, increasing inflation is very good for gold, but increasing interest rates not so much, unless the inflation is outpacing the interest rates.

So what do you see on the horizon for precious metals, in this scenario that you envision?

Hugh: I've had a personal journey with precious metals. When I set the macro fund up 15 years ago – 15 years ago at the end of this month I set that fund up with the explicit intention to have a mandate wide enough which would allow me to invest in precious metals, and gold in particular. And so I was fired up. I had an immense imagination about the events that were going to come – and take the gold price higher. And I was very fortunate that they came to pass. I'm kind of – if you will, I bought gold when I was a naive teenager, and now I feel like I'm a grumpy pensioner 15 years later. That's what capital markets do to you. And I just find my passions can't be stirred in the way that they used to with precious metals.

Now, that having been said, I would not dissuade anyone to own precious metals just now. Would I make a distinction between precious metals and other commodities? Not really... not really. I don't think precious metals will defend a portfolio under the scenarios that I describe.

But I think, for those scenarios to come true, will probably be creating an environment over the next 18 months to 24 months which will be positive for precious metals. And, of course, we all kind of look at the hothouse of price charts, and it's reassuring that precious metals have had a big and a protracted bear market. And the bottom around $1,300 has been tested many times now – and it would seem that it's held – and (if you will) this seems to be the notion of a triangle in terms of, if we tabulate this long drawn-out bear market in gold, which has been five-six years, the portents are that it's shifting gear and perhaps we might be entering into the Klondike of a rising trend.

So I am apathetic. The attraction of gold, if you will, is that at least it's had a severe, severe 50% correction. And it's been on its ass for five years. And contrast that with the S&P which has only had 10%–12% periodic correction, so –

But I see them as the same. When I go round my permanent portfolio, Treasuries just look like a really, really expensive zero-growth equity. Equities look expensive but are trending higher. And we just really can't see anything sensible about the valuation of gold. It is what other people are willing to pay. What we can see is that it looks as if it now wants to trend higher for a while. So, yeah. Why not?

Erik: Let's come back to equities, since you've mentioned those a couple of times. I know you don't hold equities in your fund, because your mandate is to offer your clients diversification from equities. But, obviously, you think about this a lot. So, setting your own holdings aside, what do you see ahead for global equity markets? Not just the US, but around the world – particularly, how would you favor any markets over others? Are there parts of the world that you see as stronger or weaker than others?

Hugh: Well, forgive me, because I feel that I've answered that. I think you should go back in the conversation, I suggested that European equities. Europe survived a great challenge – a challenge this year, with populism at its peak (or what seems to be a peak) with the successful election of Macron. And it survived a very tardy (if you will) response from the European Central Bank for many years. But the reality is the Central Bank got there belatedly – in January of 2015 – in terms of quantitative easing.

And so for the last two years now, Europe has been subject to the appropriate looseness of monetary policy, and European economies are now rising, and perhaps will begin to reflect that populism may be reversing. Let's hope so. I can't say, but – I can't really see anything to get in the way of Europe continuing to move forward. And, if that's the case then why not? Why can't Europe reclaim the lost ground from the highs of the year 2000? I mean, that's 17 years ago.

So, but, for all of these gains – remember, we're talking about nominal price changes in stock markets. And, in nominal terms, Europe has been better this year. But, when you adjust for currencies – well, I should say the other way around, Europe looks as though it's been poorer– but when you adjust for the weakness of the dollar it's been a splendid investment for American investors.

So I think, really, the great frustration for me is that the implications of sustained global economic growth – you know, they're good for others. It's good because it underwrites positive performance in stocks, and I'm saying I would stay low. But it's bad news for folk like me because we're required to demonstrate negative correlation with stocks. So when they go up, guess what? We don't. And, as you said on that risk underwriting, all of our clients have equities. So, even if I think equities are a great bet, I really can't invest in them. But I'll get off my soapbox. And I think we'll move on.

Erik: Another topic that we discussed last time you were on the program is this massive credit expansion in China. Quite a few notable people, including Kyle Bass, have been very outspoken and saying that the Chinese credit house of cards has to come crashing down sooner or later. It's only a matter of time before PBOC (People's Bank of China) will be forced to devalue the yuan dramatically, send a wave of deflation around the world, crippling markets – so on and so forth – you've heard the story.

When we spoke last time, you were very confident that was not going to happen. You thought those concerns were misplaced and, to your credit, you've been exactly right so far. But, also, since the last time we've spoken that credit expansion has continued. The amount of credit expansion that has occurred in China since 2009 is staggering.

So do you continue to hold the same view? Do you have any concerns? Do you think it eventually has to bust? Or can China grow through this with maybe the inflation that you see on the horizon?

Hugh: Yeah, pretty much I'm of the same views that I previously offered. Now, I was saying, this notion that people forget – especially in this ghost in the machine which is the recurring angst that the American economy is going to endure a recession – my point is recessions don't come out of thin air. They come out of the excess of credit supply (if you will) in the real economy. So, I don't see that in America.

But, to Kyle's point, and it's a very, very relevant point, the omens – when we look around and we draw conclusions for previous great setbacks at the economic level, it's always (at the core) has been following a massive and sustained bout of credit creation. So China is, rightly, very much at the top of relevant things that could go wrong. It's just that it hasn't gone wrong.

And, I'm afraid – I really begin to think it's necessary to pull rope away from the guys that every single year say "it's gonna happen, it's gonna happen" – it's like, I'm sorry but you're not employed to be the boy who called wolf. You're employed to be the intelligence system which told you within a relevant period of 18 months that there was a wolf in the pack. And so, as we know, our other magnificent, intelligent, brave, and fearless Texan investor, Mark Hart (a great friend of Kyle's, I know) has eventually accepted that reality and has changed his tune.

So what could Kyle be missing?

First of all, a lot of that debt and that credit creation has been a function of these ugly creatures, these state-owned enterprises. And they're very basic industries. This year, when we look at prices from copper to iron ore, if it was an "X Factor" contestant you would have to say that, given the price movements in commodity prices, they just don't look like a source of renewed angst or fear. Okay?

So the only other area of credit, and certainly a lot of debt, is the property market. Now, within the property market, only 10% of sales in a year are tier one. Tier one, I'd largely forget about. Tier one is just billionaire paradise. It's not property – it's a very, very expensive safety deposit box.

Another 30% of sales, tier two: cities, if you will. And they're not billionaires, but pretty insulated. There's a lot of savings underlying those investments.

So the big canary in the coal mine has been the tier three cities. That's where we had this immense – I mean the Chinese property market is just this twelve-headed insane dragon, if you will, that's immensely difficult to control. And all of that excess, really, is from these tier three cities. And a year ago, when we were having discussions, it was really, really scary. Excess properties, the inventory of excess properties was something like 40 months of supply. And this accounts for the majority of the Chinese property market, 60% of the property market.

But the reality is these are incredibly low-cost housing units. It was never about affordability versus incomes from the folk who could live there. It was about the excess capacity. And the thing that has changed has been the relaxation in the internal passport system there – I won't try and pronounce it – which has (if you will) just addressed the supply issue by creating a new source of demand. So, by liberalizing these internal passports, more people are permitted to live in these cities, and that inventory cycle has gone from absolute violet "get out of the room" signals to I think it's – I think we're down to about 17-18 months, which is certainly more typical for the nature of that market.

So I want to roll the dice again, and I want to say in 12 months' time that we will not have seen any devastating correction in the Chinese economy or indeed its currency. In fact, if we look at events recently, we've had steps taken by the PBOC where, actually, if anything, you know – because, as you know, the Chinese renminbi has been a very strong currency this year, and the Chinese are now saying, we're kinda cool with this, and we're so kind of chilled (if you will) – that, at the margin, they're now paring back the emergency capital walls. So I think – and I maintain that the Chinese currency at these levels just seems very, very solid.

Erik: Now, speaking of Kyle Bass and that trade in China in particular, Kyle was interviewed last week by our mutual friend Grant Williams, and Kyle posed a question for you. Which was, essentially, if you were in his shoes as a macro fund manager, in that situation of having a very strong conviction about a negative carry trade that's taking longer than you expected to turn profitable for you, how do you deal with that as a macro fund manager?

Now, as tempting as it may be for me to front-run our friends over at Real Vision and ask you that question myself, I'm not going to do that, because Grant's a good friend and I would never do that to him. What I do want to do is let our listeners know that we're going to have to cut this short here, because we're already at our time budget. But if you want to hear Hugh's answer to that question, as well as a whole bunch of other questions posed to him by Grant Williams, be sure to tune in to our friends over at Adventures in Finance. Their podcast this Thursday evening will also be featuring Hugh as their featured interview guest. Grant will be asking him that question and a whole bunch more.

So, Hugh, since I can't ask you that question on this show (as a courtesy to Grant) I'm going to turn it around to you. Is there anything else on your mind that you'd like to add before we close – about the current market or anything else that you're thinking about?

Hugh: I think I will end with another lament. I think we're in the death throes of the global macro hedge fund entity, if you will. I want to say that the global macro model just looks as if it's broken, and I question whether it can be sustained. The global macro model had been a function of sustained and high real rates of return from ten-year Treasuries. And you could leverage that return – given the sample liquidity – and you would make – the carry would be, in risk-adjusted terms, just pure oxygen, if you will.

It would afford you to carry the expenses of running a hedge fund group, it would afford you to run the expenses of running regulation, and it would afford you, periodically, to buy what can be expensive options, typically options like Jeff is referring to on the S&P. And so, if there was ever a correction or a crash like 2008, it just added to the bounty (if you will) of global macro funds.

Today, I think quantitative easing really has succeeded in killing the global macro community with a zero-point 3% real return – even leveraging US Treasuries really doesn't seem a sensible course. And it just doesn't leave enough to cover the costs of running small pools of capital in the global macro area. So I can foresee a storm in perhaps 18-24 months, which will be made all the more worse because Treasuries will not defend risk books. And I fear that we might look back and say, where were all the macro hedge funds?

Erik: You know, Hugh, I have to tell you, I have always just been struck by your shocking honesty. It gives me so much respect for you personally. And, to close an interview by reflecting so honestly that you see a major risk to the viability of your own business, is so out of character for Wall Street guys. Everybody's always talking their own book, and doing everything they can to try to look good regardless of the actual circumstances. And your consistent honesty just blows me away.

So it's a real honor for me to interview you. I hope that you're wrong about that, and that your business flourishes and things change in the global macro hedge fund world. But I tremendously salute your honesty and being so candid about it.

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