MACRO Voices
with hedge fund manager Erik Townsend

Mark Grant: Central Bank Liquidity Drives Everything

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Erik: Joining me next on the program is Mark Grant, Chief Strategist and Managing Director at Hilltop Securities. Mark, thanks so much for joining me on the program. I want to start by reminding our listeners that we taped this interview on Wednesday morning, so we don't yet know the outcome of the FOMC meeting.

But just this morning (Wednesday morning) you published an article on Bloomberg describing why you don't think that this announcement that everybody has been looking forward to – will she or won't she reduce the size of her balance sheet – you don't think it's nearly as important as most people seem to. So please give us a summary of what's in that article – which our listeners will find a link to in their Research Roundup email.

Mark: Certainly. My comment is that the Fed actions today mean much less than most market participants are taking it. And the reasons – there are a number of reasons. The first one is that the Fed, in terms of their assets under management, is now the fourth largest of the central banks in the world with the Bank of China, the ECB, and then the Bank of Japan all being bigger, in that order.

And, consequently, while the people in the United States and the institutions in the United States tend to focus on what the Fed is doing, almost with laser-like quality, what the other central banks in the world are doing is every bit as important if not more important. The world is now global, and all three of them are continuing to print money at about $300 billion a month. And if the Fed cuts back today it'll be miniscule by comparison, so it'll only mean a little less money is globally available in the world to be invested.

Erik: We do have a link to the rest of that article in the Research Roundup email. Let's move on to the US dollar. You know, we've had so many guests on this program who were all dollar bulls until recently. And of course now there's been a fairly abrupt change. Do you think we're nearing a bottom here and this dollar rally is set to resume? Or do you think we're actually seeing a secular change of direction for the US dollar?

Mark: I think we're seeing a secular change of direction. I think a lot of it is caused by what Europe and the Bank of China have done in terms of their own portfolios; it's had a material effect on the dollar. I think the line in the sand, if you will, is 120 (which I've

said for about the last six months) versus the Euro. And if we break that support resistance line – we're currently at 1.1987 this morning, as we're talking – I think that's going to have a material impact on US corporations, both positive and negative – and especially the global corporations – in terms of exporting our goods and then of course in terms of our cost of importing goods from Europe and from Asia.

Erik: And let's talk about the US equity market outlook with that view on the dollar. So many people are calling "tops" here, saying it's just so over-valued and has to go down, but the market keeps on marching higher. What's your outlook for the US equity market?

Mark: I think the driver is not PE multiples or earnings or the normal things that ten years ago or more we would have looked at to be the causation of the S&P 500 or the Dow Jones. I think the driver of the equity market – and the debt market by the way – is one thing and one thing only at this point. And that's the over $19 trillion created by the central banks. And that money keeps equity prices high, keeps bond yields low, and causes a compression of risk assets, both equity and debt, versus our sovereign debt or Treasuries. I think that single factor is the driver for all the markets at present.

Erik: Now, when you say that is the single driver, does the fact that the Fed is talking now about beginning quantitative tightening cause you to think that that factor is going to stop having the effect it's been having? Or would you say that the quantitative tightening they're talking about is small enough that it's not really going make very much difference?

Mark: I would totally be in the camp of your second point, that the amount that they're talking about is so small compared to the amount of money that's manufactured every month by the other central banks that, realistically, it's going to make very little difference. I'm in the camp that, until the global central banks stop printing, that equities are going to head higher, bond yields are generally going to head lower, and corporate bonds, mortgages, and all of the risk assets are going to continue to tighten versus Treasuries.

Erik: And with respect to the Treasury outlook, you know, we've had this debate as to Jeff Gundlach famously called the one spot thirty-five, or whatever the number was, on the ten-year as that's it, it's all uphill in yields from here. Other people have been as bold as Raoul Pal, say, calling for 50 basis points on the ten-year before this is over. Do you think the 35-year bond bull market really is over like Jeff Gundlach thinks? Or do we still have lower to go in yields?

Mark: I think we have lower to go in yields. I know that Jeff called for 3% by this time on the ten-year and – not such a great call – I projected 2% in the short term, the lines in the sand, if you will, or resistance level on the ten-year to 232 on the upside and 2.16% on the downside. We're right in the middle of that range right now. And I think after the Fed comes out today, unless it's a huge surprise, bond prices are going to go higher, yields lower, once again.

Erik: I had Hugh Hendry on the program last week, Mark, and he surprised me by saying he sees inflation coming in a big way. And, of course, we haven't seen inflation in the economy for a long time. With the beginning of quantitative tightening, it seems like that's even harder to believe. Do you see inflation as a risk any time soon in the economy?

Mark: No, I do not. I think inflation is very subdued. And I think, of the upcoming weeks and quarters, because of the tremendous costs – Moody's analytics estimates the cost of the two hurricanes, Harvey and Irma, at about $150 billion. And then we have, of course, Maria swinging our way. And I think that's going to be a big factor in continuing to control inflation. And, of course, we saw that to some extent today, in terms of home sales that weren't nearly what people had thought. And I think a lot of that reason had to do with the two hurricanes.

Erik: And do you have – I know that you are down there in Florida in the thick of this – do you have a view as to how the hurricanes are going to affect markets in the sense of is this going to be this so-called broken window theory – that there's going to be economic stimulus because of all the rebuilding that's going to have to occur down there in Florida? Or do you think that this ultimately has a potential downside risk factor for financial markets?

Mark: Well, the downside risk factor is the first factor before we get to the rebuilding. And that, of course, is the tremendous amount of property damage. Also, it's going to have a big effect, I think, on the mortgage markets as a lot of people will not be able to afford their mortgage. Or, just, frankly, they won't pay their mortgage if their house was demolished such as about half of the houses in the Florida Keys. So I'm looking for the first impact, financially, to be a negative one.

And then, in terms of the rebuilding, you have to look at the tremendous costs to the federal government, but also to the states – to the state of Texas and the state of Florida – and to the local municipalities that are going to probably have to borrow more money in the marketplace to begin the rebuilding process. Which is one of the reasons that I think that the Fed's timing would be very ill-chosen to raise interest rates at this point.

Erik: If we see people walking away from their mortgages en masse because the destruction that occurred basically left them under water (pardon the pun) in terms of the equity in their properties, who takes the hit on that? I mean, obviously, most of this debt is securitized, so it's not bank stocks directly. Who holds all of that paper? And is there a concentration in Florida as to how that's distributed, in particular bond holdings? Or is it really just mortgage-backed securities in general that would take the hit from this?

Mark: It would be the banks in the first issue, though a very large amount of the mortgages, as

you point out, have been securitized. They're held by Fannie Mae and Freddie Mac. And we could see a material hit to their balance sheets if that takes place. Of course, also, in the case of the two housing agencies – those two agencies – there's been a lot of talk about privatization recently, and I think there's some risk there in owning those two federal agencies, far greater than owning some of the other federal agencies.

Erik: Mark, let's move on to precious metals, a topic that is near and dear to many of our listeners' hearts. Obviously, with the dollar, as you see it, taking a secular change of direction, that should be good for gold, I would think. Is your outlook favorable for gold and silver? And how do you see the market evolving from here?

Mark: My outlook, generally, is favorable but not overly favorable. The reason for that is that gold is driven, usually, by two factors. One: some sort of calamity. And two: inflation. So, since my outlook is for a very low inflation rate, I don't think that's going to be driving gold.

Two of the things that could drive gold are political events, the two most dangerous of which, if you will, are what's happening with North Korea and then what's happening in Venezuela. And those two events, if something actually hits the wall or unravels, could certainly drive gold to a higher price. So I'm slightly positive on gold, but I'm certainly not in any rush to go out and suggest that people or institutions buy it.

Erik: Let's move on to Europe. We've seen so much happening there, and a lot of people say the election of Macron is maybe a turning point for Europe. And of course we're seeing the Euro strengthening against the dollar suddenly. Do you think we are at a turning point? And, in terms of things like European exit contagion risk, do you think that's contained now? Or do you think that there's still more turbulence coming for Europe?

Mark: I think the Macron election in France was net positive. He's a businessman. He understands not only governmental affairs, but he understands how the capital markets work. I think that's always a positive, to have a prime minister or president in that position. And he also seemed to strengthen somewhat his ties with Germany, which I think is probably a positive.

The negative in Europe right now is in their corporate bonds sector. What they did was, the Italian banks – which was – instead of using the European stability mechanism to deal with the bad loans and the bankruptcies in Italy and also in Banco Popular in Spain – my opinion was a travesty. They said, basically, that any bonds that were sold to local investors were mis-sold. Which means that they're going to pay them back 100% on the dollar, while the actual institutional bondholders that are under subordinated debt, both in America and in Europe and in Asia, are going to have to take quite a haircut – a huge haircut.

And so there's no question that the institutions that I speak with are very upset about

what took place in the European corporate bond market. And they've cut back their positions – substantially in a number of cases – and I expect that to continue. I would also make the comment that, if Europe can do this for their bank debt, they can certainly do it for other debt. And if they do it for subordinated debt they can do it for senior debt.

So now we know that the indentures for European bonds have very little value because they can change them at the whim of their political process. And I've had any number of discussions with some major institutions in the United States, Europe, and Asia about that subject. And I think American debt is a much safer proposition for bondholders, whether they're institutions or people.

Erik: Let's move on to Asia. Kyle Bass has been very outspoken for several years now, and just last week kind of renewed his assertion that he thinks the massive credit expansion in China has to come to a very bad end. He – I think just last week – went on record saying he thinks it has to happen sometime within the next year. And so he's calling for, potentially, a major devaluation of the yuan, which he thinks will be necessary for China to be able to recap their banking system after a credit calamity.

Do you think there's any credibility in that argument? Certainly Kyle has been saying this for a few years, and it hasn't happened yet. Do you agree with him that it's coming? And how would you see it occurring?

Mark: I've read Kyle's comments before. They're certainly well-reasoned, with the exception that I think he's left a few issues out of his thinking process. One is: Of all the central banks in the world currently, the PBOC, or the People's Bank of China, is the largest in terms of assets. They can keep increasing their assets because they can print money and raise it even further. That would be one comment I would make that Kyle hasn't thought about. And I think that's what buoyed them to this point.

Two: They certainly can adjust their currencies. Many of your listeners probably know the Chinese have a two-tiered system – an internal valuation of their currency and an external valuation of their currency. So it's possible to devalue locally, or to devalue internationally, or to do both. And the offset, as I said, is the printing of more money to finance their debt expansion.

In normal circumstances, and given a country that wasn't so controlled politically, I would agree with Kyle's assertions. However, given that it's China and the way they operate, they can still go on several more years operating just the way they are now. Either by the currency adjustment as Kyle says – but they could also just keep adding to their printing presses, printing more money, and even expanding the balance sheet of the central bank further.

Erik: Mark, I want to go back to your earlier point, which was about what's driving these

markets in general. Could you elaborate for us a little bit more? It sounds like you really think that this central bank–supplied liquidity is the key to everything. Is that right?

Mark: That's correct. I'm reminded of the movie *All the President's Men* where they said, "Follow the money." And I think that statement is accurate, not only in the context of that movie, but the context of our current markets. You know, until the Lehman disaster and the financial debacle that followed, the markets were largely driven by PE multiples, earnings to some extent, and, to a great extent now, stock buybacks. And I just don't think that's true anymore, and I don't think many large investors have adjusted to the fact that it's the money that's driving these markets.

This tremendous creation of money at the central banks – as I said, now over $19 trillion, according to Yardeni Research – you've basically created an economy, or a country if you will, with no name, that has as much GDP, or has an economy as large as either the United States or China. And by this time next year they're printing about, still, globally, about $300 billion a month. We're going to have an economy that's bigger than any country in the world that's been created by 50 or so people at the central banks of the world. And we've never had, in the history of the financial markets, a situation like this.

So, in my opinion, it's not a question of a new normal or old normal, to quote my friend Bill Gross, but it's a question of absolutely no normal. Because we're in an economic situation, a financial situation, created by the central banks, that has never occurred before. And I think the flow of money is what's driving the markets.

Erik: A lot of people have asserted the viewpoint that corporate buybacks – that, of course, are enabled by these very low interest rates that central bankers have given us – are the real driving factor here. Would you agree with that view? And it seems like they're slowing down, at least a little bit. Although I think if we continue to see lower interest rates – you know, you would probably expect that to continue as long as there's a junk bond market to fund these buybacks. Do you think that plays a really big role? And do you see it continuing?

Mark: I think it plays a role but not a really big role. And, as a matter of fact, if you look at my general overall thesis, it's the fact that interest rates are where they are that is allowing these buybacks, because it makes sense economically. I would also point out that the United States, of all the major countries in the world now, has the highest interest rates, which makes no economic sense given our size, the depth of our markets, and the earnings of our economy. And yet the ECB has driven interest rates for various countries in Europe substantially below ours.

So, even in some countries, if you look a few years out at the two-year, you'll see that Germany and France and the Netherlands and a number of countries actually have negative yields. And here we are with our own two-year to 1.39 while, for instance,

Germany is minus 0.70. So the world's bond markets are totally driven by what the central banks have done, and the fundamentals that used to apply in terms of a country's economic position have very little to do with where interest rates globally are at this point.

Erik: Is there a limit to how negative the negative rates can go? You know, a lot of people have suggested if they go too far it creates a cash-hording incentive – and potentially a run on the fractional reserve banking system – as people start hording cash in order to get zero interest rates instead of having to pay a negative interest rate. Does this have a limit? And how far do you think central banks are willing to push this?

Mark: You know, since this is such a grand experiment, it's very difficult to know what any kind of limit is. If you look for instance at Switzerland, their two-year is minus .94%. Could it be minus 1.94%? Absolutely. You know, the issue sometimes becomes, in a situation like this – and I've given it a lot of thought – is you can't invest off-world.

So you're stuck, now, in this global environment of, you know, United States buying mortgages, and agencies and treasuries at our central bank. But, in the case of Switzerland and the case of Japan – Central Bank of Japan now owns about 70% of the equity market in Japan and they buy ETFs as well – and Switzerland is also buying equities along with debt. And there's been talk of some slowdown, which we're going to see in a few hours at the Fed, and the ECB has made a noise or two about it, but, so far, nothing.

And it also means, of course, that you're paying a bank – say, if you're at negative interest rates, you're paying the bank to hold your money. So we have something that five years ago I would have said out loud, and everybody would have said that I've lost my mind, and yet here we are in this very new situation where we have negative interest rates, which nobody ever thought could happen. And they've happened.

Erik: Now, the consequence of this that I see – and I'm surprised that it's not front page news in the mainstream press – is this situation of extremely low yields has, I think, basically paved our way to what I think has to be a pension crisis at some point. You see the whole pension system, whether it be state-backed entities that are underfunded, or corporate pensions that are underfunded, everybody is underfunded. Nobody is able to achieve the yields that they need, that their systems were designed for.

And a lot of people have suggested that this could mean that – and it's coming at the worst possible time, just as the baby boomers are entering retirement. Are we bound for a pension crisis? And, if so, what's it going to look like?

Mark: I think we're not bound for it. I think we are already in the pension crisis. It's a very severe crisis. But this isn't something where you fall off the bandwagon tomorrow, because the municipalities and the states, of course, can increase taxes to deal with it.

The pension assumptions that they've used, somewhat over 7%, aren't even close to reality, and we are now beginning to see tremendous pressure on a number of states.

So the worst states – so I can provide some information to your users that might own municipal bonds – are New Jersey, and Kentucky, Illinois, Connecticut, Colorado, Pennsylvania, Minnesota, South Carolina, Rhode Island, Massachusetts. And the situation year over year is worse. All of those states are at negative numbers in comparison with last year, which means their pension liabilities are increasing. And we're going to start having some real problems because of this.

I don't think it's a question of insolvency. I just think it's a question of the rating agencies – which did a terrible job during the sub-prime mortgage mess – I think have done a lousy job with many of the municipal credits. And I think anyone that owns municipal bonds, or is planning on buying municipal bonds, has to take a very close look at what the pension obligations of any state or municipal entity is to try to gauge the future economic health of the underlying entity, which, obviously, will affect the bonds that they own.

Erik: Let's carry this forward into how it might resolve, because I've been interested to see – a lot of analysts have said, okay, so we're going to go a few more years and then these systems are going to blow up and the retirees are not going to get their benefits. It's just mathematically impossible that they're going to get the benefits. And I kind of think, well, okay, I believe that argument.

But it's also socially impossible for them not to get their benefits. Because, you know, it's a democracy. And, if the largest demographic component that we have is the baby boomers, and you just tell them – hey, sorry, we're going to break our promises to you, you're not going to get your social security benefits – that would cause a massive political upheaval. So it would put tremendous pressure on politicians to quote unquote … do something.

What do they do? Do they just print more money at that point in order to satisfy all these obligations? And how would you see it unfolding?

Mark: Well, as you know, the states can't print money. It's only the federal government, it's only the Fed that can print money. But what they have to do then is turn around and raise taxes to begin to deal with it. There was a very thoughtful article out recently by John Mauldin, who was talking about that very issue. The politicians – he used very strong language, saying that they lied – but they certainly overpromised what they can deliver in terms of the pensions.

And then they used all these very high pension assumptions, in terms of the return on their investments. And that allowed them a number of years where they didn't have to put in nearly as much as they would have, had they used more realistic pension

assumptions. And now they're in trouble.

But I don't think it's a question of insolvency, meaning that they're going to fall over the cliff. What's going to happen is – and what we've seen happen, as a matter, of fact recently in California, is CalPERS, the large state pension fund for the state of California has gone to any number of cities, and it's been in the press, and they've cut back what they're going to pay the pensioners. Of course this is going to cause all kinds of social and political issues, but CalPERS said we only have X amount of money, we're only receiving X amount, and they've cut back the pensions of a number of people in a number of cities in California. And I think that this could spread out to these other states that are in trouble, and it's going to be a big mess.

Erik: Let's move on to geopolitical risks next. Obviously, you know, we've got sort of unprecedented events. North Korea is literally threatening to annihilate the United States with nuclear weapons and may have the capability to do so, or at least take a serious crack at it. China, meanwhile, is threatening that if the US were to initiate or take a preemptive strike against North Korea, that China would defend North Korea. So we've got a really big standoff.

How do you see this, both in terms of the geopolitical risk, but also, it's striking to me that it hasn't had hardly any effect on markets. I mean, you'd expect to see gold going to the moon and maybe the stock market at least taking a significant dip on this. And it's not happening. What's going on here?

Mark: What I think is going on is that rational people have a very hard time believing that something like that could actually happen, and so they dismiss it and don't pay attention to it and don't invest because of it. I think it's just the nature of being a human being that you can't believe that something like that could happen.

I think the situation – and I've written about it – is far more dire than most people think. I think the head of North Korea is not a very rational person. You've seen how he's executed his relatives with howitzers and fed other people to dogs. I mean, you have to ask yourself what kind of guy this is. And could he make a mistake? Or could he push it too far? I think the answer is yes.

One of the commentaries that I wrote – "Out of the Box" which I write daily, which goes to about 5,000 institutions in 48 countries – I wrote that if some 9th level technician did not program the last missile correctly, and it had landed on Japan instead of flying over it, you'd see the ten-year Treasury at 1.5% before you were able to blink your eyes. And I'm very concerned, because I think this is a very dangerous and very irrational person, and he reminds me to some extent of a fellow that caused World War II in Germany. So I think you can't dismiss it as that it can never happen. You have to consider in your mind that there is a possibility of it happening, even though all of us, any of us, hate to think of it.

In the case of Venezuela, you have a, virtually a socialist government that's become a dictatorship. They have big holdings in the United States because of their oil company. Mr. Trump and company have said that they're not going to allow any more new financing in the United States. At some point here, if it gets bad enough and they cut them off entirely, then you're going to see the court system probably seize their assets for various creditors, and you have not just a South American problem but you have an American problem. And, of course, then the price of oil could spike as a result of all this.

However, having said that, one big change in all of our lifetimes, all of your listeners' lifetimes, is that the United States, because of our shale oil production, now has bigger reserves of oil than anybody in the world. And we can – if we so choose – could literally choke some of these countries that are sponsoring terrorism just by keeping the price of oil low while their social programs in Saudi Arabia and Libya and a number of countries including Russia are 80 to 120 dollars a barrel. So, again, it's not insolvency tomorrow, but it's a grinding problem that's going to cause, in my opinion, material effects over a period of time.

Erik: One of the things that happened in Venezuela was there was a threat that one of the things we could do for sanctions would be to take away their ability to transact in dollars. And Venezuela almost preemptively responded by repricing their oil in yuan. Meanwhile, supposedly, the Shanghai Futures Exchange is working on a yuan-backed oil contract. What do you think of this trend of de-dollarization, of other nations trying to move away from the US dollar to reduce their dependence on the United States and its currency? And also, I guess, what impacts would you see it having on financial markets?

Mark: I think that they're trying to do that. You can certainly price whatever commodity in whatever currency you want to. But you have several major problems with that. One is that most of the world's transactions are done using the Swiss system which is the American system which uses the dollar in terms of scoring up transactions.

Two, while China would like to do that, they have a corresponding problem in trying to do that, which is that then they lose control of their currency both on an internal and external basis, which would cause them tremendous political problems. So I think people are trying to do this – various governments are trying to do it – I think the chances of any kind of real success are minimal.

Erik: Let's move on to President Trump. I think a lot of people have put a lot of expectation around the market responding to the very many things that President Trump campaigned on and promised to do. Now, I don't know about you, but it seems to me that President Trump is not exactly friends with a lot of people in Congress. It's hard for me to see how he's going to accomplish these things. Do you agree with my view that maybe not all this stuff is going to happen? And, if so, what does that mean in terms of any pricing that may already be built into markets assuming it was going to happen?

Mark: Certainly. So on November 8th and 9th I said publicly that Mr. Trump was going to win the election, and to buy equities, and I thought that was the right call at the time. I think in hindsight it was obviously the right call. The issue here is complex because he certainly ran on the Republican ticket. We really only have two parties in the United States, and he won on that ticket. But, whether he's really quote unquote … a Republican … is questionable.

So we have a man in the White House that, one, wasn't really a Republican, and, two, is more of a businessman and used to doing deals. And he has his own view of things and I don't think he understood fully that the judicial system and that the Congress or the other co-chairmen – he thought he was going to be the CEO and Chairman, and it doesn't work that way. And I think he's learned that, or may be still learning that.

Having said that, Congress – both Democrats and Republicans – have had a huge pushback against what he's wanted to do. And I think that probably has as much to do with his viewpoints as with the way he's trying to do things. We have Congress – of course, chockfull of insiders. They've been there for years, any number of them. They know how to play the game. They know how to do the negotiations. And I don't think Mr. Trump came to the office with that kind of information.

One of the issues, I think, going forward for the markets, is that a lot of President Trump's visions here, in terms of getting rid of Obamacare, in terms of building a wall, in terms of cutting back radically on taxes, are being accepted very well in Congress. And, while lately there seems to be a little bit of positive movement, I think that that's going to cause an agenda that doesn't take place nearly as fast as many people thought in the early days of his presidency.

Erik: And, finally, as we close, give us a quick overview of what you do at Hilltop Securities, and let our listeners know where they can follow your work.

Mark: I'm the chief strategist of the firm. We're 5,500–6,000 people. The firm is headquartered in Dallas. We're a regional investment banking firm, plus we also have prime mortgage and prime lending, and we own a number of banks. It's six different parts of the firm.

"Out of the Box" does not go to the general public, though they can read my comments in Seeking Alpha. I'm published there almost every day. And Bloomberg, because I'm a Bloomberg Prophet. They publish my articles every Wednesday, so they can find what I'm saying on Bloomberg on Wednesdays. But Seeking Alpha is the best place to get it.

And then, I deal directly with some of the largest institutions in the world, trying to give them some outside advice and helping them in executing their plans having to do with asset allocation and even as specific as certain equities or certain bonds. So my day is

rather full of that. Hilltop is listed on the New York Stock Exchange. HTH is the symbol, and we're a rapidly growing company that's competing in the United States with all the other lead banks and regional banks.

Erik: And our listeners can find a link to your latest article from this Wednesday on Bloomberg in the Research Roundup email that accompanies this episode of the podcast. We're going to have to leave it there in the interest of time, Mark. Thanks so much another fantastic interview. Patrick Ceresna and I will back as MacroVoices continues right here at macrovoices.com.