Part 2 - Mark Yusko: All Things Macro

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Ancr: This is a special edition of MacroVoices with hedge fund manager Erik Townsend, the premier financial podcast targeting professional finance, high net worth individuals, family offices, and other sophisticated investors. Now, for this special edition of MacroVoices, here are your hosts Erik Townsend and Patrick Ceresna.

Erik: MacroVoices Episode 82 Alpha was recorded on September 28th, 2017. I'm Erik Townsend.

My interview with Morgan Creek founder and CIO Mark Yusko in this week's regularly scheduled Episode Number 82 was going so well that I couldn't bring myself to cut him off after we used up most of our time budget on my very first question out of more than 10 that I had planned.

So we changed our plans on the fly in favor of a dramatically extended interview which ended up running well over an hour. We couldn't possibly fit all of that into a single mp3 file, so we're releasing this special episode to bring you the rest of what was a really fantastic interview with Morgan Creek's Mark Yusko.

Be sure to listen to the beginning of this interview in our regularly scheduled Episode 82, which is always free of charge at macrovoices.com. I told you in the intro for that episode that you should download Mark's 144-page slide deck to accompany that interview, but we never even referenced it in our discussion of the US dollar, which was actually in that episode.

I assure you, though, that in what follows we're definitely going to be referring to the chart book. So you're going to want that download for sure, before you listen to this. Registered users at macrovoices.com will find the download link in your Research Roundup email. If you're not yet registered just go to our home page at macrovoices.com and click on the red button labeled "*Looking for the Downloads?*"

Now, without further ado, let's pick up where we left off. Mark had just finished sharing his views on the US dollar, and we were about to move on to the stock market.

Ancr: And now, with this week's special guest, here's hedge fund manager Erik Townsend.

Erik: Let's move on and talk about the stock market now. I want to get into this fantastic slide deck that you sent us. Specifically, I'd like to refer to Page 7 in your slide deck and to the mania phase that is shown on this particular chart.

Mark, I think we're in agreement that we're in the mania phase. But as much as, emotionally, I want so badly to declare, okay, that's it, these equity valuations are insane, they're ridiculously high, the market's about to crash, it has to be imminent – if I take a pause and I look at what this chart really teaches me, you're showing me that most of the upside occurs during the mania phase in these markets.

And, to be sure, the general public right now is more bullish the stock market than ever before. But, you know, that's kind of a new thing. It's only recently that that's come about.

So, I have to ask myself, are we in the early mania stage? Or are we in the late mania stage? Retail participation is back, but it was kind of late in coming. So it seems to me like there's room to argue that we could be only in the first half of the mania, and that maybe it has a lot farther to go to the upside. Which is clearly irrational, but that's the way these mania markets go.

So my question is: Is this really another – okay it's 2000, it's time to be going short in the stock market here? Or is it more like 1998 or 1999, when we were very definitely in a bubble. Things were overvalued, but they kept getting more overvalued for, like, two years after that, and 100% higher before it finally ended.

So where are we in this story?

Mark: Okay, again, such an incredibly insightful question. And, for those who aren't familiar with this bubble chart, all bubbles are the same. They all have these: stealth phase, awareness phase, mania phase, and blowoff phase. You're absolutely right, if the mania phase is monster in terms of turn. It usually lasts about that two years-ish.

And, what's really interesting is, where this comes from is Jeremy Grantham in 2014 wrote a piece about is there a bubble? And a lot of people were talking about a bubble then. And he said, God, there is no bubble. We're not even close to a bubble yet. In fact there'll be a bubble probably in 2016.

At the time, you know, we're 1800, and he thought we'd get to 2,300-ish. He actually said 2,250, then he revised it to 2,300 by election day. And then he said we could go even a little bit further, but then we'd have the inevitable correction down 50% back to fair value.

And after the election he kind of came out and said – or right before the election he came out and said, no, I just don't see the euphoria. I don't see the delusion and the new paradigm talk that you need to be at the very tippy-top.

So what's interesting is, in January, again, I did these Ten Surprises. And one of my surprises was that I had earlier that year felt like we were in a repeat of the 2000–2001–2002 cycle. And that the election year '16 was going to be just like 2000. And then we'd have the recession in '17. Then over that three-year period we'd drop the typical 40% for the correction.

But after Trump got elected I was like, wow, that kind of changes things, because he is like Hoover. And now I have this hashtag #welcometohooverville, and it basically says that maybe this is 1929. And maybe the steepness of this slope, as you talk about in the mania phase, is going to go truly vertical and axiomatic.

And so what that said is, I said, all right, that means that the Dow would have to go to 2,400 to match the peak of 1929. And it would happen around here, in September. And that the S&P would go to 2,800. And so I put those numbers out there and it kind of just got absolutely ridiculed. And – you know what? I think I tweeted this the other day that what's interesting is the louder the laughter at an idea the more likely it is to be right.

When everybody's patting you on the back and saying, oh, that's a really smart thing – you should probably just stop and do the opposite. But when everyone's laughing at you, that's usually when you've got something that has likelihood of being right.

So we came into this year looking back a year, and things didn't really look very bubbly, other than FANG (Facebook, Amazon, Apple, Netflix, Google) – and you can throw Microsoft in there too and make a FANGM or however you'd pronounce it – but we really didn't have much of a bubble.

Fast forward a year from the election to today. Now – I mean, you've had FANG stocks double in 12 months. You've had Chinese internet stocks go up 200% in 12 months. And so there were starting to be some signs of that bubble.

And what I did is I looked back at kind of what happened in 1929, and it's really quite extraordinary that, basically, the market went up pretty sharply in January but then had given back all of its gains through the middle of the year. So the market was dead flat for the first half of 1929.

And then from June to September 3rd it had rallied almost 26%, and a huge part of that – 8% of it – in August. And so you got the blowoff top. And that's when Roger Babson famously said on September 15th, 1929: I repeat what I said a year ago and two years ago that there's going to be a correction and it could be terrific. Or it could – actually he said crash. He said there's going to be a crash and it could be terrific, and he meant big. And everybody laughed at him. In fact, Irving Fisher three weeks later said, no, the bears are going to be wrong again and the market has reached a new permanently higher plateau.

And so here we are in September – and I just did my gaul yesterday about September to Remember – and was it possible that we had reached that point, that Babson break, again. And I don't think we have. We really needed that last spectacular about a 12%-13% move from here 2,500 to 2,800.

And, if we get that final move – whether it's now, whether it's the first part of October, whether if people think there's a Santa Claus rally – then I think we're at the end of the mania phase, we're at that new paradigm. Well, we're already at the new paradigm with people like Janet Yellen saying, you know, we can't have a financial crisis in our lifetime.

Really? You want to say that? That's as bad as the Greenspan comment or the Bernanke comment.

So, that's another one – we may get to this at some point – everyone talks about this Fed "put," and everything's fine. And you can buy stocks without worrying because the Fed's got our back. Well, Greenspan had our back in 2000, and the market went down 5o% peak to trough. Bernanke had our back in 2008, and the market went down 58% peak to trough. So I'm not feeling really good about this central bank "put" that everybody talks about.

So, I think we are almost at the end of the mania phase. I think we need that one last speculative blowoff top. And then there's a lot of downside on the other side.

Erik: Well, that aligns incredibly well with a lot of thoughts that I've been having lately. Because for the market to crash in October of 2017 it would have to be the first time in history that a market has crashed when so many people predicted that that would be exactly when it would happen. You've got Jeff Gundlach, you've got quite a few people that have been saying: this is it, it's this fall, that's it.

It seems to me like what you're suggesting is very much in line with what I've been thinking lately, which is the market loves to prove as many people wrong as possible.

So what happens is, we see in October–November smooth sailing. There's a bearish capitulation. We get the Santa Claus rally to that blowoff where it seems like it's just going parabolic as all those bears were proven wrong. We get to the end of the year at let's say 2,800 to 3,000 on the S&P. And then it's into January where it all comes unraveled.

Would that be consistent with what you're thinking?

Mark: Absolutely, yeah. And what's really interesting is, I did a letter recently talking about Sir

Isaac Newton. And that came from – you know, Roger Babson was just obsessed with Sir Isaac Newton and gravity – and so I wrote a letter a couple of quarters ago called "Gravity Rules." And it talked about why Roger Babson was right, and why you need to go back to the teaching of Ben Graham and value.

And then I wrote this other letter (with the eclipse coming up) titled "Darkness Falls" and basically talking about why Newton is right. Right? For every action there is an equal and opposite reaction.

And, basically, you have to have this big upward surge where the market tier point sucks in as many unwitting participants as possible who buy right at the top (as humans always do) and then it makes a fool out of as many people as possible, which is the market's job.

And so, in writing that, I wrote about this guy WD Gann, who famously put together these financial forecast tables, based on some pretty sketchy stuff in many people's eyes (philosophy, numerology, astrology), but he actually mapped out for 100 years what he thought was going to happen in markets. And it's been eerily correct.

He said 1929 would be the absolute peak, and then there'd be a three-year bear market. He said there'd be a peak in '87. He said there'd be a bear market in '91. He said there'd be a bear market in 2007. I mean, all of these things he said in 1909.

And his picture, his one-year forecast for 1929 that he released in November of '28, literally had the trough in March, the trough in June, the peak in September, and then the trough in December.

So, the guy was really good. His forecast actually says 2019 is the ultimate peak of this cycle. Now, all of this could play out that way. And it could come earlier; it could come in 2018.

Here's what I think is a little bit different: We had, I believe, a recession in 2015-2016. It wasn't called a recession because it was really concentrated in a couple of industries, primarily energy, and machinery, industrials.

There was actually a depression in the energy business. I mean, half a trillion dollars of capex came out of that market. I mean, there were companies that were literally put out of business. And, if you look at everything – I mean, we had industrial production in the United States negative for almost 20 months. That's a recession.

Now, NBER didn't call it. We actually had deleveraging of margin accounts through February of 2016. We had all the classic signs. ISM got below 50, everything was pointing that we were in a recession.

And then, suddenly, you had another boost of global QE, topped off by a trillion dollars of liquidity put into the markets by the PBOC, which is the one no one ever talks about. Everyone talks about the ECB and the BOJ and the Fed, but they don't talk about the PBOC, which – if it weren't for the PBOC, the world might have ended financially in 2008-2009. I mean, without their four trillion dollars of stimulus I'm not sure we get out of 2009 at the bottom.

But, that said, they put another trillion dollars in – in February 2016. And I think that's partly why the Chinese equity market has recovered. I think it's partly why you've seen this, basically, straight line up and the highest Sharpe Ratio – I think the second highest Sharpe Ratio in the history of stock market in the US – over the last year.

So all this kind of goes to this issue of I do think the fact that everybody, including myself, believed that Q3-Q4 was going to be challenging? And that we were going to see this repeat of 1929?

I think that is probably, to your point, not going to happen. And it's going to befuddle everybody. And everybody who's short is going to have to cover. And we're going to get these spikey upward moves. We hit that 2,800-2,900 (whatever the number is) and, yeah, then I think it could get ugly in a hurry.

Because if you just look at the math, right? The sheer valuation of assets and where we are in terms of PE ratios relative to margins and earnings, this is the most expensive US equities have ever been in their history. There's no other time when they've been more expensive.

Because in 2000 the PE of the S&P looked higher, because it was so concentrated in this cap waiting. But now you've got so many markets. You've got NASDAQ, you've got the S&P, you've got the Wilshire – and, if you look at the median price to sales, it's the highest it's ever been, by a factor of 50%.

And the stat that really got me was, in the last two bubble tops – 2000 and 2007 – the ratio of equities to cash and money market funds hit 3.4. Okay? Those were double the long-term average. Today we're at almost 5.

So, when we're talking about the most hated bull market, that is such a crock of BS. This is the most loved bull market in history. It's got the most money exposed to it. And it's the "everything bubble," as Jesse Felder has talked about. When it blows it's not going to be small. Newton is right. For every action there's an equal and opposite reaction.

And so, if you – let's just deal with the Dow. If the Dow goes to its '29-equivalent peak of 24,000 – great, you've got 2,000 points of upside. You've got 19,000 points of downside on the other side. That's a horrible risk-reward any way you cut it.

Erik: Mark, in our last interview, which was back in October of last year, we discussed the short VIX trade, which started with pension funds desperate for yield, trying to monetize the contango yield that was inherent to the forward structure of the VIX futures contract.

Now, you and I agreed back at the time that that was a really, really bad idea. Since then, that trade has become popular with retail investors who are shorting the VXX ETF.

But I see on Slide 13 of your deck that now the true luminaries of finance are getting into the deal. So please give us an update, not just on the VIX trade but also – I lump that into a category with a number of other things: excessive use of leverage, margin debt, other signs that we typically see to tell us when we're getting to that late mania stage in a bull market.

Mark: It's a great point. On Page 13 I show this *New York Times* article, and it talks about this former Target manager, who has turned half a million dollars into 12 million dollars shorting the VIX, now wanting to start a hedge fund. And, look, I am not criticizing him and I'm not making fun of him in any way. The guy took the risk. And the fact that he had no experience as a trader, I don't hold that against him either. He's clearly done a great job turning a little bit of money into – not a little bit of money but a decent amount of money – into a lot of money.

He took the risk; he got paid. But from here, what's the risk-reward? I mean, VIX last month hit the lowest level ever. Bond volatility hit the lowest level ever. The CBOE VIX futures I got on Page 13 – open interest is the highest in almost two decades.

You look at the next page, on Page 14, in what world is it normal that equity volatility would be below bond volatility? You know, I think we have the second highest Sharpe Ratio in the S&P that we've ever had.

And the only other time we had this type of low volatility and this inversion of stock and bond volatility, we ended up with a global financial crisis. And I actually affectionately call the period since 2000 the new abnormal.

You know, some people want to call it normal. But I don't think there's anything normal about a world in which the S&P 500 has a four Sharpe, and the people are buying stocks like bonds and buying bonds like stocks. That never ends well on either side.

The next page, on 15, is interesting in that – here's the part that I don't really understand. So, if being long equities is good, then levered long must be better. Okay.

You know, that has historically been a good idea. If you wanted to own your house, don't own it for cash, own it with big leverage. Four times leverage: 20% down, four times leverage, awesome. In fact, if four times leverage is good, then ten times leverage is better: 10% down. Well, then, why not put 5% down? You've 20 times leverage. If prices only go up, then you should take as much leverage as possible, axiomatically.

But we're in a level of credit in equities which have a little more day-to-day minute-to-minute volatility than your house. I mean, the only reason people are comfortable with levering their house is they don't see the price fluctuate day to day. If the price fluctuated every day, you'd never have 4–5–8–10 times leverage on your house.

But people are levering this market to a level that they've never seen. And you can kind of see what I was talking about earlier, in terms of, in '15-'16 you see that there was this de-levering. And the market was rolling over. And we were going to have what I thought was going to be a normal cyclical correction. And we were going to get back to normal. And we'd cleanse all of this excess leverage.

But financial repression kicked in, and the Fed and the PBOC bailed us out, and now we're re-levering again.

And so, Page 16 says people have more money than sense today. You've seen the things in the art market that have sold for 100 million dollars here. And, you know, a skull encrusted with diamonds, and the diamonds are valued at, like, 10 grand, and the guy paid 120 million for it. Or the one where, supposedly, reportedly, the guy had to put in a whole new cooling system in his house, because the thing was made of human blood or something so he had to keep it cool. Crazy.

So, whenever Sotheby's reaches a peak like this, we've had a correction, a global devaluation. So money is becoming worthless.

When we think about equity valuations, on Page 17, second highest in history, do we really want to get into the neighborhood of the highest?

And Page 18 is interesting. On the right-hand side is: Look, the market should go up over time. Equities should rise. Why? Because they pay dividends. So that's a little bit. There's inflation, which gets embedded back in the price of nominal equities. And then you've got real growth in earnings, which is 1% less than GDP growth. And so you put those three things together and you should get about a 8%-9% increase in the value of equities over the long term. So that red line slopes up.

The problem is, human beings don't pay attention to math. We pay attention to emotion. So we get overbought and oversold. And one of the things that you'll notice is that, when you get to the top end of the channel – and what's the channel? Somewhere between 100% over fair value and 130%–140 % – somewhere in that range you end up correcting really quickly.

And you'll notice that you don't correct slowly. You correct quickly.

Page 19 is one of my favorites. You know, it's the Buffett indicator (although he didn't invent it, he just gets credit for it) and you think about – what this is is the ratio of equities in the economy relative to the GDP of that economy. And it should be 70%, because it costs money to make money. So you should pay – 70% of your GDP should translate into equity value.

Now, some will say: Well, no, at a low interest rate environment it should be 100%. So that's the second red line on the right-hand side. Let's say I bought that – I actually don't, but let's say I did – even with that measure, we're still 33% overvalued and should drop a huge amount. So, I think we're 50% over fair value, and we could easily drop 50%.

Page 20. We've only been more expensive than this three and a half percent recorded history.

And then my favorite, on Page 21. And what this shows is the ratio of inflation multiples. So, when we have zero to low inflation, it makes sense (some think logically) to have a higher PE ratio.

I can argue it's actually the opposite. When you have low inflation or negative inflation, that means you're going to have lower growth in the future, and therefore you should pay a lower multiple, not a higher. But that's not the way we do things.

And the yellow circles with red lines around them are the craziness of the tech bubble. And nobody wants to go back there, that I'm aware of. Nobody wants to go back to a place where we're going to drop 60+% from the peak and 90% if you're in NASDAQ.

But, other than August and September of 1929, current valuations – the current PE ratio of the market – has only been worse in those two months in '29 and the tech bubble. So I just think we're in a weird place.

And my last favorite is on Page 23, which comes from one of your other guests over time, Grant. And Grant has this great chart from his "Things That Make You Go Hmmm." Grant Williams.

And I love it that, you know, we all know Willy Wonka, and we all know that he was pretty crazy. But even Willy (as you can see with the side eye) can't believe that we've gone from the silly valuations of the dot com to the stupid valuations of the housing bubble to a world of pure imagination and craziness in the median price to revenue of the S&P.

So I think that's where we are. And I think it can go longer than we think. And that ride in Willy's crazy boat on the river with the bugs and all that stuff that freaked us all out as little kids – that ride can go on much longer than you think. But at the end it's going to stop, and we're going to come back, and gravity's going to take over.

Erik: I think we agree that what's gotten us to these really high valuations is central bank–supplied liquidity. So when I hear you talk about how long it can go on or how long it can't go on, I have to come back to something I've been thinking a lot about lately, which is this so-called stock versus flow argument.

Some people in finance say that it is the absolute size of the Fed's balance sheet that supports the financial markets and the economy and so forth. That's the Ben Bernanke view of how quantitative easing works: It's about the amount of assets that are on the Fed's balance sheet.

Now there's another view, which is the so-called flow argument (I'll call that the zero-hedge version), which is to say, no, look, it's really about the flow in and out. It's when they are buying assets that creates buying pressure. When they start to shrink the balance sheet, that's creating selling pressure. And, even if the balance sheet is really big, as long as it's shrinking that's going to be effectively the tide going out, and it has an adverse effect.

So, it seems to me, this question of how long this can go on really depends on what you think. Is it the stock or the flow argument? What's your perspective, Mark? How do you see this?

Mark: Look, I don't know how you can argue that it's the stock. I mean, clearly, all the evidence points that every time the Fed or the ECB or the Bank of Japan stops buying, equities go down.

So I don't know how you can say it other than you're trying to convince people that it's not about what they're doing, it's about something else. But the data doesn't support that.

If you go to my Page 52, it is hard to be short when the global central bank balance sheets are growing. And the stat that I just can't believe – I just saw it yesterday for the first time and it just blew me away – that global central banks in 2017 have put as much liquidity into the market as they did during the global financial crisis in 2009. Three trillion dollars. I just wasn't paying attention.

And so that's why emerging market stocks are up so much, and European stocks are up so much, and US stocks are up, and the art market's up, and collectible cars just set new records and – you know, we're devaluing global currencies at a rate that we've just never seen.

And so don't fight the Fed, the ECB, the BOJ, the S&B, the PBOC, all those letters.

And then you go to the next page and you look at Page 53, and you see that global central banks have really done a pretty amazing job of monetizing all of the expansion of the debt base in the world since the global financial crisis.

And, one of the things – and there is one place where I do start to get a little bit nervous with my own view, which is probably a good thing because I think people talk about wise people are full of doubt, so you try to be that – but the one thing is, as I was putting these slides together it kind of hit me that it is certainly possible that we've now entered a world where there is no way out.

So why is it that the Bank of Japan has 93% of GDP on their balance sheet? Why do they own 75% of all the ETFs in Japan? Why do they own 58% of all the Japanese government bonds? Well, maybe it's because they are moving to a world of debt jubilee. Which is: If you eventually own all the debt, you literally can turn to the treasury and say, we're good. And cancel it. If they say, no, you can't do that, it would destroy the currency ... Ah, au contraire! They've been destroying their currency.

So if, Erik, you owned a bunch of bonds and I'm the Bank of Japan, and I print money out of thin air, and I buy your bonds, you have yen. So now you have yen, you can go spend it, you can go invest it, you can go do whatever you want with it.

But I already created the yen. Now I own that debt. I'm supposed to get paid back by the treasury that issued it. But if I just say, no, we're good – we're good. And so I do think –

And if you go to Page 55, it gets a little spooky in that the reason I think the Fed is never going to shrink their balance sheet, and the reason the Bank of Japan is never going to shrink their balance sheet, and the reason the stock is going to continue to – and it really is about the flow – and why that flow is going to be tough to be short, is, if you look at this chart of labor force participation rate, it's pretty highly correlated to the expansion of the balance sheet.

And one thing we know is: Every single day in the United States 10,000 people turn 65. Every single day. Same thing happens in Europe. And I don't know the number in Japan, but my guess is it's an equivalent percentage.

And so we know that the labor force participation rate is going to do this. Right? There's no way to fix it. And, in fact, the only way you could fix it is with immigration. We're going the wrong way policy-wise on that.

If it were up to me, I would actually send 747s over to Shanghai and India and get all the smartest people and I'd put them on a plane, and I'd bring them back here, and I'd give them free land to build businesses. But no one's asking me.

So I do think that what this is telling us is we're going to have more flow and we're going to have more stock. But there is a limitation.

On Page 57 there is a limitation in that – and this goes to what I was saying – is that the Bank of Japan is the red line in the lower left was at high 20%s percentage of GDP on their balance sheet.

And they did, in 2006 – interestingly, ten and a half years ago – decrease their balance sheet a little bit. And then they tried to keep it stable. But then what happened is – you can see on the right hand side – they weren't able to prevent the stock market from falling. The NIKKEI collapsed.

And then they went all in – in 2012 – and started buying. And, what's interesting is – I don't have the line on here, but – you can see the red line. The left is gone up to the 90+% but the NIKKEI stopped going up. So there is a point at which the QE actually loses effectiveness.

And so that's a very long-winded way of saying I think the stocks are going to keep rising. I think the flow's going to be there. And it is the one thing that's causing me cognitive dissonance about my view, which is Newton was right: Every action has to have an equal and opposite reaction and that we are due for a crash.

And the thing that gives me, then, comfort to that dissonance is seeing what has happened in Japan. They tried to maintain the balance sheet; they ended up with a lower stock market. And it wasn't until they went REALLY big that they got the recovery.

So if we go ahead and actually try to reduce the balance sheet, we're definitely having a crash.

Erik: Let's move on now to fixed income. Jeff Gundlach famously proclaimed last year that, okay, that's it, the all-time low in 10-year yields is in at 1.36. And, to some extent, rates have backed up considerably since he said that. But now the twos-tens curve is not looking pretty. And some analysts are questioning how much the Fed can realistically tighten from here.

So please give us your overall outlook on fixed income. Is the 35-year bond bull market really over like Jeff Gundlach has suggested? And how do you see things playing out from here?

Mark: I am an interesting contrarian here in that I do believe that the lows secularly in yields – global bond yields – are in front of us, not behind us. I do love every summer. You know, the bond kings (or self-anointed bond kings) come out and start talking their book.

Although I have a problem with that in that they're actually talking their little book. So, the bulk of the money they manage is long bonds. Yet they also have these little hedge funds that can go short bonds. Well, they get paid a lot more on the hedge funds. And so, by saying that the bond bull market is over, and making bonds sell off, they get paid a lot in their hedge fund. But all their holders of their long-only funds suffer. I'm not quite sure how that makes sense.

But, that said, interest rates are a function of working-age population growth. And working-age population growth is declining. And it's going to decline for another decade.

And I really take most of this – and I really take most of my cue on interest rates from Lacy Hunt and Van Hoisington at Hoisington Capital – and Lacy's great because he just makes it very clear. He has a line at the end of every quarterly letter: Either be in cash or be in long bonds. And he's still staying in long bonds, and I still think that's the right place.

And then a friend of mine, Alex Gurevich, also has written a book on this that it's, you know, the last great trade, or the next great trade. And I really do think that the "Killer Ds" – demographics, which are horrible in the West (we've got a greying population); excess debt; and deflation caused by technology – are all going to continue to push rates down.

And, on the ten-year, all of the talk about growth and inflation and all that stuff, that it's spooking the market, it doesn't seem to spook it at the point where we break the long-term trend. So, until we break the previous lower high at 3% I think we're still in a hearty downtrend in interest rates.

And the twos-tens continues to flatten instead of steepen. That's saying it doesn't believe all the nonsense about better growth and – I don't know who came out yesterday, one of the administration, I think it was Wilbur Ross – saying that the tax reform could be worth one point of GDP growth.

No. It can't. It's just mathematically impossible. GDP growth is working-age population growth plus productivity. Both of which are sub-1%.

So we're going to have nominal GDP growth of probably two at the high end. And I don't care what you do with taxes, you're not going to change that. So I just don't understand why people don't pay attention to math. And the math on growth and interest rates, basically, points in a downward direction.

Erik: Now, a view that I've held for years about the bond market is that the junk bond market in particular at some point has got to take a serious dive. It just seems to me, with these easy money policies we've had from the Fed for the last several years – the lending standards have been ridiculously lax.

Now, frankly, that view (if it's right) was very early, because I've either been wrong or very early to date. I finally abandoned my short junk bond trade because it just wasn't paying out.

So which was it? Was I wrong or was I just early? Do you think that junk bonds are going to have their day in the sun as far as short trade?

Mark: I definitely think it's going to happen. The challenge of shorting is – and I heard this analogy, which I just think is so beautiful for shorting, particularly for anyone who's a chess player – is shorting is just like playing chess.

So, shorting during the opening is just foolish. Because you have no idea what's going to happen. You don't know who's a better player, you don't – you're just positioning pieces on the board. And so you're not likely to make money; you're not likely to lose a lot of money. But it just doesn't make any sense.

Shorting during the middle game is lethal, because that's where you actually find out who the better player is. And, if you're on the wrong side of a trade or a move, you could lose a lot of money. The endgame, after you kind of know who's going to win the game, you can short with abandon there.

And I think the challenge with junk bonds is we're in a world of financial repression. So the Fed, and the People's Bank of China – less so the PBOC – but the Fed, the ECB, and the Bank of Japan, are basically holding interest rates at abnormal levels to force investors into risk-bearing assets.

And so we have now what I call not-so-high-yield bonds – because the yields are not high – and, worse, to your point on the lending standards, we have the majority – in fact the highest percentage ever in history – of no-covenant bonds or covenant-light bonds.

Well, no-covenant bonds are almost equity, not really bonds. And covey-light (depending on how light) can be pretty close to equity too. So, what we've got it this massive demand, limited supply, which leads to higher prices and a nightmare for people shorting.

So, until we start to see some increase in defaults – because, look, we're at the lowest overall credit rating of corporate bond market in US history because everybody's got too much leverage – and, yes, they can cover the cost of leverage.

But here's the interesting thing: You know, there's three types of finance or borrowing or leverage. Right?

There's hedged finance where, Erik, I lend you money and I actually expect that you're going to pay me back principle and interest, and I take collateral as a hedge against that loan.

Then there's speculative finance: I say, Erik, I like you, I'm going to lend you this money and I know you can't pay me back the principle, but I know you can service the debt. And so, we're friends, you're good for it, and I know you'll sell the property, and eventually I'll get my money back. And I could also seize the property because I've some collateral.

Then there's Ponzi finance which is: Erik, I know there's no way you can pay me back the principle or the interest. But I'll give you a bullet loan, and I know you're going to flip the property and get me my money back, or hope that you're going to do that.

We're definitely in Ponzi finance today. I mean, the people that bought the latest Tesla bonds, I don't know what they're thinking. People who own Tesla equity, I don't know what they're thinking. I mean, they just can't do math. Again, it all comes back to math when you look at capital structures of businesses.

So I do think the high-yield, or not-so-high-yield market is very dangerous. I wouldn't be long here.

With one caveat: If you're using it as an equity substitute – great. Right? You're actually senior in the capital structure. You have a contractually claim instead of a contingent claim. Fine.

But if you're using it as a bond substitute, or as a cash substitute (God forbid!), look, you could lose 3–4–5 years of income in a month. That's just a bad risk-reward.

So financial repression is an evil, evil thing. And it basically transfers wealth from the masses to the few – which is kind of the purpose of the Fed and the banks to begin with, but that's what it does. And the more people get into this trap of buying bonds like stocks, and they think they're going to make some sort of return on them, the more dangerous I think it gets.

So I believe you and agree with you that there will be a time to be short on high-yield bonds. I'm not quite there, so I think you're wise to have covered. I definitely don't think you're wrong. And people say "early" is the euphemism for "wrong." I'm okay with that.

But there will come a time when that trade's going to be very, very profitable. The challenge right now is lack of covenance and this delusional view that all risk is the same risk. And that buying bonds with no protections, and limited upside.

And now people are paying more than par for a bond. That just makes no sense.

Because, think about it. Right? If you buy a bond that pays you 100 for 105 and you hold it to maturity, you only get 100. So you lose 5 cents. That just doesn't make any sense. So you're actually buying a loss, and then you're hoping to make it up on income. But the reality is it could default in the meantime.

Look what happened at ToysRUs. Those bonds were trading in the 90s, I think, the day before – I can't remember the exact number, but they were trading in really high numbers the day before the bankruptcy – and then they went to the 20s. So, as I like to say, hashtag #riskhappensfast.

Erik: I interviewed Hugh Hendry recently, and I was surprised that Hugh sees a major cycle of wage and price inflation. Not asset inflation, but wage and price inflation, just over the horizon.

So please share your outlook with our audience. Is the deflation out of the system now and inflation on the horizon as Hugh suggested? Or is quantitative tightening going to lead to even more deflationary pressure?

Mark: Ohh. Such an important question. Maybe ***the*** important question. We started the interview talking about the dollar, and I've said for the last couple of years that getting the dollar right might be the most important decision in investing. And I think it was in '15–'16–'17. I think getting inflation right for the next five to ten years I think is going to be the decision.

And the other guy I follow most on this is Kiril Sokoloff at 13D Research, maybe the best writer of all writers that I read on a routine basis. He's fantastic. But he writes about this secular trend toward inflation and reflation coming again. And I do think that's going to happen. So I am starting to see evidence of reflation around the world, and rising inflation.

But it's in places where most people aren't looking. I think it's not in the developed world. It's in the developing world. And I don't think it's going to be in some of the places that people are used to seeing it, like in CPI. But I do think you're seeing it – you're definitely seeing it in assets.

That's what financial repression does, it causes asset inflation. So art and collectible cars and wine and Toronto condo prices. So that inflation we're already seeing.

Wage inflation, I think, is tougher too, but I would agree with Hugh in the sense that, as the declining labor force participation continues, there's just going to be fewer skilled, trained workers. And they're going to have more pricing power.

And you actually are seeing a little bit of that. In places like China wages are rising. You're seeing some of the manufacturing move to other countries like Cambodia, Myanmar, and Vietnam. And so you are starting to see evidence of that around the world.

So I agree with him – I don't know that it's going to be as rapid as maybe Hugh sees. I am starting to position portfolios more in favor of real assets – you know, kind of, get real – so, thinking about things like commodities. And I think we are going to start a new commodities super-cycle.

So, I guess, again, that's a rambling way of saying I agree, mostly. And I do see emerging signs of inflation and reflation. But I am still a little bit worried about deflation in some places.

You know, Indian inflation has been cratering lately. It used to be at 7%. Now it's sub-2%, so that's a little worrisome. Inflation in China – actually they had deflation in China for most of the last ten years. They finally got PPI back up to positive numbers and started to roll over again this summer, although it ticked back up in August. So maybe they've got that under control.

But, in order to reflate, in order to create this type of wage and price inflation, we really have to have credit growth. And to get credit growth, I don't know how you do quantitative tightening. I think we're going to end up with more easing.

Erik: Mark, you mentioned commodities briefly there. Let's go back to commodities and precious metals in particular. Presumably, given your bearish view on the US dollar, you must be a commodity bull, and particularly a gold bull. Is that right?

Mark: Yes. Absolutely.

Erik: And where do you see the opportunities for investors?

Mark: Yeah, I think you have to break commodities into a couple of different buckets. You've got precious metals, gold and silver. You've got the industrial metals like copper and iron ore. You've got oil and gas and other petroleum-related commodities. And then you've got the ags.

And I think if you look at them a little bit differently – I've always viewed the precious metals as currencies as opposed to commodities. I think when they're viewed as commodities they're less valuable, even though the use case in silver is actually pretty good with electronics.

But I really do think that, as a currency, what's interesting is I think gold has outperformed every currency in the world over the last 20 years. I think I have that stat right, from Stray Ricket Sprot. And I think it's going to continue to outperform as a currency, because it's the one thing that you can't devalue.

And I guess you can throw bitcoin in there too as a new potential store of value, digital gold, or whatever people want to call it. You know, the "gold people" hate when you call bitcoin digital gold, and they hate that they use a gold coin as their image for this ethereal thing that exists in the ether.

So I like precious metals here, and I think that there is going to be a flight to safety as the global race to the bottom – in terms of devaluing currencies to kind of deflate their way out of their debt – continues.

Industrial metals, we're actually pretty bullish here – and this goes back to the 13D thesis of reflation and commodities super-cycle. Copper had a really strong run. It rolled over hard here in September. But we think it is going to continue to have supply-demand positive, particularly with the one belt one road project going on in China. And also China cyclically has been destocking copper and needs to replenish those stocks. So we think there's going to be some positive pressure there.

Iron ore is a little bit tougher. We like iron ore, we think it's interesting. It did have a pretty big run. The challenge in some of these industrial metals is the amount of speculative money out of China into the futures markets related to these commodities.

One of the challenges of commodities, physical commodities of all kinds, is the futures market. What a futures market does is it allows you to create, again, out of thin air, a commodity. It used to be, if I wanted to sell you, Erik, a barrel of oil, I better have a barrel of oil to sell you. Now I can sell you a contract, and if I don't have the barrel I can go find it someplace, hopefully. Or we can settle the contract before I actually have to deliver it. So what happens is when the paper barrels or the paper bushels or paper ingots tend to get out of whack with the physical, you get these wild volatile price swings and you usually end up with price collapses.

So I do worry a little bit about that in iron ore today, that there's a little bit too much speculative capital.

And then the last one in industrial that I think is interesting is metallurgical coal. Not thermal coal, which I think is going to be in secular decline, but metallurgical coal for steel making. Again, linked back to the one belt one road. And those prices we think are going to stabilize and there could be interesting opportunity there.

Then, lastly, oil and gas, one of our favorite commodities over the long term. Short term, we think oil is stuck in this 40–60 range. We thought it would decline to 40 by mid-year and bounce back towards 60 by the second half. We got the first half right; we'll see how the second half goes.

And then with natural gas, that one's tougher because it's so dependent on weather.

And the supply in the States is just so prolific. And the big wild card there is that, as the Permian basin is getting increasingly drilled for oil, they're having excess gas production, which is messing with the supply-demand balance and causing some stress there.

So, a lot of people were calling for 4 or 5-dollar gas we just don't see that happening right away.

So, commodities, generally, we like them. We think you should be overweighting commodities relative to financial assets, and that's why my hashtag #getreal is so important here.

Erik: Let's come back to OBOR, one belt one road, which you've mentioned a couple of times. We had Dr. Pippa Malmgren on the program. She was extremely outspoken in saying it's so important for investors to understand this.

So, give us your take. Why is it important to understand what China is up to with one belt one road?

Mark: China is very, very long-term focused. As I said maybe earlier, they are playing "go" when everyone is arguing about how to set up the checker board. And they really think in decades and centuries. And what they've decided is that the best way to secure that they are back in the center of the economic universe and financial universe is to bring it back toward Eurasia where it used to be.

And so what's the best way to do that? It's to recreate the old silk road routes all over Eurasia and bring Chindia (China and India) back to their dominant place in the global economy.

So they have partnered with governments all over Eurasia from India to Pakistan to Egypt to Holland to Russia, and this is going to be the greatest construction project in the history of mankind. And, look, I speak in hyperbole all the time, but that's not hyperbole. This is fact. This is going to be the greatest construction program that the world has ever seen.

And, yeah, I know, people have seen the things, but, you all have seen, or many have seen, that machine that picks up those concrete barriers on the highway and moves them from one lane to the other. It's kind of cool.

China has one of those that spits out high-speed rail elevated track, doing the same thing. It kind of moves along slowly, and, behind, it leaves a trail of high-speed rail track. So, they're just so far advanced technologically in so many areas, most of them related to construction and engineering, and I think that's going to continue to be a huge benefit to them.

And one of the reasons that we're more bullish about China than we are India in the near term – although we're still very bullish about India long term – is that they've got this commitment to having infrastructure ahead of the growth. And the infrastructure actually then creates the growth. Very similar to the US when we did the railways and then the interstate highway system.

Erik: As we close, a common practice among prominent fund managers like yourself is to write a quarterly letter to investors. But you're an exception to that, Mark. You don't write a quarterly letter; you write a quarterly novel for investors. And it's probably one of the very best in the industry.

So, as we close, please share with our listeners a little bit about what your quarterly letters (as you call them) typically contain, and where they can sign up to receive them.

Mark: Yeah, you're very kind. My wife hates them. She says I spend way too much time on them. And I probably do. Although the reason they are long, and they are long – I mean, they've been known to top 80+ pages – she says, well, I don't have time to read 80+ pages.

Then don't. It's three sections. Every letter contains three sections. It has a quarterly review, so what happened in the current quarter. It has a market outlook, so what we think is going to happen in the future. And then it has an intro section which talks about some topic that I think is interesting.

So I usually write about a famous investor or a famous figure, and then tie it to investing. And I've done letters on everyone from Sir John Templeton, George Soros, and Julian Robertson, and AW Jones, Roger Babson, to historical figures like Shakespeare and Prince, and I recently wrote about Sir Isaac Newton.

So what I try to do is bring – one of my favorites was Rocky & Bullwinkle, actually – but I try to bring a sense of quotes or ideas or concepts that you've thought about or heard about, whether it be reading Shakespeare or Newton's third law of thermodynamics, and then try to bring it and relate it to investing. And that's it. That's more interesting and historical, and you don't have to read that part if you're not interested.

But, you know, the review of the quarter, you can get that in a lot of places. I tend to do a little more text than chart, and try to put some interpretation.

But I loved your comment earlier in the conversation that you want to really steer clear of the person who's most eloquent about describing what has already happened, because that's really not that useful – you really want to focus more on the outlook.

So we do a long market outlook section that we actually put ourselves out there and we write down what we think is going to happen. And, one time, my wife saw me speak at a conference, she said, you know, Mark, you can't say things so forcefully. I said, well, why not? She said, well, people will believe you. I said, that's actually kind of the idea. So – and she reminds me – I'm occasionally wrong, but never in doubt.

But it's not about being right or wrong, right? It's like Soros said. It's about how much money you make when you're right and how much money you lose when you're wrong.

And so the reason I write big letters is it helps me think, it helps me crystallize my views. Because if I don't, if I can't read what I wrote, how do I know what I think? And there is the old adage that if I had more time I would have written a shorter memo. So if I did have more time, I could condense them down and edit them. But I don't. Because I spend the time writing the key thoughts and processes, and then I don't edit. I just leave it in a raw form and I let the reader decide what's useful and what's not.

So you can find them at our website morgancreekcap.com. And, as I said, there are ones that you may like because you have a preference for a certain type of individual. Some people like George Soros, some people don't. So don't read that one if you don't like him. Some people like Julian Robertson, some don't. So read that one if you like him. You know, if you don't like philosophy, don't read the one that I did on a philosopher. If you don't like Prince music, don't read the one about Prince.

But I do think they're incredibly useful for me, in terms of crystallizing how I think. And what's really useful, actually, is when people do read them and then question me, and have dialog and debate. Because that's where the best ideas come from, is conversations like these on MacroVoices, where you can actually have open dialog and debate, and go back and talk about things you said before, and did it work out or did it not work out? And analyze and –

My whole view of investing comes from my training. I trained in biology and chemistry, and I thought I was going to be a doctor. Everybody says, what does that have to do with investing? I think it has everything to do with investing. Investing is about hypothesis formation, testing, and reformation, and retesting. It's always about having a view and ultimately taking intelligent risks.

Our job as investors is to take intelligent risks. We're not going to be right all the time. In fact, the legends, Steinhardt, Soros, Robertson are right 58% of the time. So if your ego says you have to be right all the time, bad decision to be in investing. So I aspire to get more than 50%, but I also try to focus on making sure to press the things that are winning and sell the things that are losing. And not have to be right, because that's not important. It's about making money.

Erik: And, Mark, I have to say that, for a person as prominent as you are, you are more available than most anyone else in the industry, responding to almost anyone through your Twitter handle [@MarkYusko](https://twitter.com/MarkYusko). So, listeners, by all means, engage Mark

@MarkYusko on Twitter with any questions and debate that you may have.

I hope you've enjoyed this interview as much as I have. I cannot thank you enough, Mark, for giving us such an excellent extended interview. By the time our listeners hear it, I'm sure it will have been broken down into Part One and Part Two, if not Part Three.

Thanks again.