Jonathan Tepper: Is Retail a Consensus Short or a Contrarian Long?

November 30, 2017

Erik: Joining me next on the program is Variant Perception founder, Jonathan Tepper. Jonathan, we have a lot of super-popular and super-famous guests on this program. You have been definitely one of the most super-popular with our listeners. But probably not as super-famous as some.

For the benefit of our listeners who may be new to the show and have not heard your past interviews, or the interview we did with your associate Tian Yang, give us a little bit of background first on Variant Perception. I love the name, by the way. You guys are a very process-oriented shop and I think that it will help our listeners to understand the process that you approach investing and analysis with – before we get into my favorite macro topics.

So give us some background.

Jonathan: Thank you very much for having me on the podcast. We really enjoyed doing previous podcasts, myself and my colleague, so thank you very much.

In a way, it's funny that you say that I'm popular. The truth is we try to be anything but popular in terms of personalities. The reason for that is, if you look at the financial landscape, there are quite a lot of people who are – you could call them gurus – where people assume that they have a crystal ball and they have deep insights about how the world should be or what's going to happen.

And the truth is, some people forecast the 1987 crash, or they forecast bear markets, or they forecast – whatever the event might be. And the problem that we see with that approach is that if you do that once there's no guarantee that you're going to be able to do that again. So it's not necessarily a repeatable process.

What we've tried to do is figure out what things work regularly. What is repeatable? What's robust – meaning it works across different kinds of regimes. And what's scalable – meaning can this insight be applied not just, let's say, to the US, but more broadly. Or if you're looking at emerging markets, for example, and looking at, let's say, a currency crisis prediction tool – does this apply actually across time and across many emerging markets?

So our background is really basically all ex buy-side, all ex prop traders – we started building tools for ourselves when we were in our previous lives in different jobs. And then when we left, we just realized we enjoyed writing – to identify trading ideas. And really, over time, our client base has grown organically. It’s primarily hedge funds, family offices, and some long-only managers. And, really, we’ve just been sharing our tools and approach with them.

Variant really grew out of trying to find very asymmetric trading ideas. In 2005 to 2007 I was on a prop desk with some of my current colleagues, and we were trying to figure out when the next recession might happen.

If you look at what most Wall Street research focuses on – employment or inflation – the truth is, if you’re running a business, you don’t start firing your workers just because you have a bad month, or even two, or three. So employment, it really lags the business cycle significantly. And, likewise, inflation. You don’t start hiking your prices just because you have a good month of sales.

Most of the Wall Street research focuses on employment and inflation. It doesn’t really tell you anything about today. It tells you about yesterday. And when you think about stocks and bonds, what you’re worrying about is what’s going to happen, not what’s currently happening or even happened previously.

So we have built a lot of leading economic indicators and, even more importantly, leading liquidity indicators. Because, obviously, the only reason we care about the economy is to find trades. So we care more about asset prices than we do about industrial production. And, if you’re trying to forecast changes to asset prices, you really want to be focusing very heavily on global liquidity and credit conditions. And that is what we do.

The good thing is that these tools that we’ve built really don’t depend on me being a guru or having a crystal ball, being highly sensitive to my mood or state of mind – these tools work across time and they’re repeatable. The clients that Variant Perception has really like that.

That’s one reason why we don’t put our names on any reports: It’s not a guru model, it’s really very much, as you said, a process-driven model.

So when we come up with views – we will talk about many of our specific views on this podcast – what we’re really trying to do is take these economic and liquidity indicators and find turning points where our tools differ from the consensus. And that’s where the name Variant Perception comes from.

Essentially, if our tools agree with the consensus, then, generally, it’s momentum trade – meaning the view is correct and you want to stay with it. But, often, your most asymmetric trades come when there’s a deviation or a difference between what the market’s pricing versus what our tools are saying.

And so we look at sentiment positioning and valuation to try to measure what is the market thinking, and do our tools disagree with that. To the extent that our tools are turning up and positive, and people are extremely negative and valuations are low, and positioning, dumb money, is not long in the asset, that creates great opportunities.

One of our top investment themes last year – and I'm pretty sure we talked about it – was long Brazil. And that was because valuations on a cyclically adjusted basis were back to 1998 and 2002 levels. At the same time, retail had been pulling money for three years, and our liquidity and economic indicators were turning up. And the stock market in dollar terms has doubled since then.

So that's how we apply our tools. And we'll be talking about a few ideas on this podcast where some of these tools sort of align, you know, where our tools differ significantly from the sentiment positioning and valuation.

Erik: I feel an obligation, just to set expectations with our listeners, because we have both an institutional and a retail component to our audience – unfortunately, there is no $300 newsletter to sign up for if they're impressed with you. You are an institutional advisor with institutional pricing. And your Variant Perception reports, while they are – I've had the privilege of getting a chance to review some of them, they're absolutely fantastic content – but they're institutionally priced and not really within reach of the average retail investor. So it's a real treat to get you on the show.

Let's go ahead and dive in to a topic that I think is just fantastically important right now: the dollar. It seemed like we had a secular bull market on the dollar. I really felt, when this pullback occurred, that it was set to resume. But I'm becoming more and more persuaded of the dollar bear case. Where do you guys stand in terms of the dollar outlook?

Jonathan: The dollar has been one of the biggest drivers of many different asset classes for the last couple of years. Interestingly, earlier I was talking about sentiment, positioning, and valuation. The dollar itself, over the last 18 months, has really gone from one extreme to the other. So if you're looking at –

Bear in mind, for example, the Trump election last fall. Afterwards there was the sort of massive reflationary rally. People were expecting tax cuts, infrastructure spending – and the dollar rallied significantly. Back then – if you looked at *The Economist*, for example, they had a front cover, it had a strong dollar, it looked like a muscle man, it was a very contrarian indicator. If you looked at the *Commitment of Traders* reports, or the *Daily Sentiment Index*, they were extremes in terms of dollar longs.

And, generally, the speculators are wrong in extremes.

Sure enough, one of our top themes for the year with our clients was our short dollar theme. And that really flowed from valuation. If you remember, back in December or January, and looked at a variety of valuation indicators, and valuation with currency is – doesn't really matter in short runs – the fact that a currency is expensive on a PPP basis, or purchasing power parity, the average person wouldn't – it's a very lofty-sounding name for the idea that tradable goods should have similar prices. The Big Mac Index of *The Economist* is probably the most famous exposition of the purchasing power parity.

And you can then figure out whether the dollar is expensive or not.

Also you can look at the real effect of exchange rate, which is how does a currency trade relative to the basket of its cross rates. And then you can look at real interest rate differentials. The dollar was very overvalued on almost all of those. And it was really only cheap relative to the Swiss franc and the Norwegian krone. And, if you've ever been to either country, you know that they're absurdly expensive if you're trying to buy a Coke or a beer. So the dollar was very expensive on a valuation basis. It was obviously very stretched in terms of positioning.

And then we had various technical sell signals going off.

The dollar sold off, really, most of the year, in line with what we thought. Up until August or September. And then, what's very interesting, is we started seeing the opposite.

So it's not that it had become very cheap – currencies don't move from expensive to cheap that quickly – but it was no longer as expensive as it was. The euro had rallied very significantly against it. And then, if you looked at the positioning, everyone had switched essentially from being long dollar to being short dollar.

I visit a lot of family offices and hedge funds and very smart people, and, in general, these people do pretty well. But when they all agree on one thing, whenever I go to 20 meetings and hear 20 people agreeing on something, chances are that's sort of played itself out.

And so everyone was very, very negative on the dollar at that time. We then had been recommending long dollars since – that the trade has worked well, you could argue that it's a countertrend move, meaning that there's greater weakness ahead for the dollar going forward.

But one thing that's very interesting if you look at the dollar in terms of interest rate differentials versus a lot of its peers, it pays to hold dollars. In a sense. You're getting almost no carry in yen or euros. You are getting it in dollars. Interest rates and yields have been rising. The euro/US exchange rate, which is one of the biggest in terms of the dollar, is – the two-year yield differential is highly correlated – we've had that chart in previous monthlies and shown it – and that's pointing to a much, much lower euro and a much stronger dollar.

So the current supports for the dollar, I would say, are strong in terms of the interest rate differentials. And I think it's very unlikely that the ECB will be hiking, despite the – I would argue you need to do that – and so we're still positive on the dollar. And that's something we've been writing about and gotten it fairly well over the last 18 months. That's a very good example of applying the idea of our liquidity indicators – and then sentiment and positioning and valuation.

Erik: So it sounds like this is driven mostly by contrarian views on positioning. Do you think that the secular factors that were contributing to the dollar rally are still in place? The original dollar rally, before it rolled over?

I think that maybe a lot of what drove the dollar higher was the Fed had stopped easing while the ECB was continuing to ease. Is that still in play? Or are we potentially looking at a secular reversal of direction here?

Jonathan: I would hate to call anything secular, in the sense that I don't think we have very big secular forces at play with the dollar here. You know, most of our views are short term and are driven by the expected path of interest rates and monetary policy. And then sentiment positioning.

What is true, from a structural basis, is the world is generally short dollars. In a world where you have massive risk-on, people tend – the dollar tends to do poorly. In risk-off scenarios, as we've seen, you generally have a huge short dollar squeeze where everyone basically needs to scramble to get them. That's one thing I think that is not currently the case.

If we were to enter a global risk-off scenario, that would certainly matter quite a lot.

Erik: Let's move on – speaking of risk-on, risk-off – to equity markets generally. A theme that we've heard from a lot of our guests is: Nobody's really saying the stock market is cheap. I haven't heard that, but there's a huge divide.

Some people would say, look, these valuations are crazy, look at the CAPE ratio, it's time, it's all over. Other people are saying, hey, these valuations are ridiculously high, but there's nothing to stop them from going much higher from here. That's what happens – overpriced assets get more overpriced until there's a catalyst to change the direction of the market. And some of our guests have said they don't see the change.

Now, when we had Tian Yang, your associate, on – I think it was three or four months ago – he told us that it was not time to be short yet. But you guys thought maybe that was coming in the coming months.

Are we there yet? Is it time to be short? Is it time to be on the sidelines? What do you think about the equity market from here?

Jonathan: If you look at the equity market currently, we're very definitely in what you could refer to as a momentum-chasing mode. That often happens relatively late in the economic cycle, where valuations are high – which means that on a five- or ten-year basis your expected returns are very poor. But it doesn't necessarily tell you anything about the next three or six months in fact.

In the current market, given that we still have extremely tight credit spreads, for example, which does a great job in leading the real economy, and even equity markets – those are still very benign – obviously, if we started to see any deterioration in credit that would be bad for equities. Market health has actually been fairly positive up until now.

There have been brief periods of a week or two weeks where we've seen market health deteriorate. The market's been surprisingly resilient and bounced back. And that's one of the amazing things – if you look at the market this year, there are some reliable sell signals – there are very few sell signals, in fact, that work. Generally buy signals are much better. Buy signals are – bottoms tend to be V-shaped to marked by panic. Tops tend to be much more of a rounded process where you end up with a distribution.

And so, so far this year, no real sell signals have worked. We're still in a momentum-chasing mode. And it doesn't mean that on a short-term basis we might not have some selloffs here and there.

But, so far, we have yet to see the kind of weakness that we were seeing, for example, in the summer of 2015 – when we were very negative and noted to our clients that you had a lot more 52-week new lows and new highs, you had a deterioration in the advance decline, and you had a complete meltdown, essentially, in parts of the high-yield market – specifically energy. And credit spreads did lead equities back then.

We're not currently seeing that. So what Tian was referring to was the shorter term three to six month outlook. And you have to distinguish that from the valuation perspective. You remember, in 2000 the market peaked in Q1. And then the market sort of traded sideways and then went down 50%. And in 2002 the market basically retraced all its gains from 1996. So when declines happen from major market peaks, drawdowns can be horrific.

But if you had been shorting the market purely based on valuation, in late '98-'99 and even early 2000, you would have been on the wrong side of a momentum trade. And that is very similar to where we are now, where the long-term expected return on a wide variety of metrics is poor. But that doesn't necessarily give you a lot of information for the next one, two, three months.

Erik: You know, Jonathan, I love the Variant Perception letters that I've had the privilege of getting a review copy of. You have absolutely fantastic content. And I would love to share it with our listeners. Unfortunately, your institutional paying subscribers would throw a conniption fit if we did that, because they're paying through the nose to have exclusive access to your very extensive writings here.

Patrick was successful, though, in negotiating very aggressively with your staff. We do have a link in our Research Roundup email to a landing page at variantperception.com. We have a report that you did with an unlikely and, so far I think, very successful call that you made on the retail sector. And that normally is an institutional subscriber content thing that's not available for free. We could not give you the direct download link, folks, in the Research Roundup email, because the staff at Variant Perception were concerned that this not just get posted where anybody can see it.

So you're going to have to follow the link in the Research Roundup email. It will take you to a landing page at variantperception.com where you're going to have to give them your email address, because they want to track who this one goes to.

It's an excellent report, and your view has been proven to be quite prescient so far. So, Jonathan, please tell us: What is this report about? When was it published? What's the call? How's it working out so far?

Jonathan: Thank you. I mentioned earlier the way we think about trades, where we have our leading economic indicators, leading liquidity indicators, and then looking at sentiment, positioning, valuation. Now, if you think about the stars aligning, that doesn't necessarily happen too often. Often our tools are merely confirming what most people think. And there's not – there is a momentum trade there, but it's not a great contrarian trade.

In this case, this is probably – actually, not probably – this is the most contrarian and least-liked idea I've ever presented to anyone. And that's saying something, given that I've gone around and talked to clients about our views for many, many years.

This idea, and this trade, is the US retail sector. I recently did a two-week trip in the US (east and west coast) and saw about 40 clients and potential clients. So this report that MacroVoices readers will read is about US retail. Our clients and others were looking at this in October, and not a single person liked the idea. I couldn't meet a hedge fund or family office or long-only manager who thought this was a good idea.

And, if you remember, in the summertime, *The Economist*, once again – you know the contrary indicator – had a front cover with Amazon taking over the world. So the consensus view is that Amazon is growing quickly, it's going completely decimate existing retailers, and therefore you want to be long Amazon, short the retailers. And most if not all of them will end up going bust.

The problem with this view is that when stocks are priced this way, essentially, there's an awful lot of bad news priced in. Retailers, in many cases, have to simply not go bust for you to have a good long trade.

When we look at our leading indicators for retail, overall, they're still fairly positive. They had been negative late last year, early this year – part of that was due to an increase in rent, an increase in oil prices, and an increase in medical costs. Some of that was lagged effect from Obamacare.

If you think of whatever's left over in the consumer budget, it is left over after they've paid those expenses. So that had been negative, that had turned back up. The overall US economy-wide retail leading indicator was still positive. And so we don't see any immediate implosion in the retail sector from a macroeconomic standpoint.

Now, from a microeconomic standpoint you could argue that the terrible news of Amazon has already been priced in. And so we have many specific buy signals that we look at from a country level. We also look at them from a sector level.

And, believe it or not, some of our buy signals even work on a stock-specific basis, with very high back-tested returns. And so some of these signals were appearing for many retail names.

What's quite interesting with these buy signals is that you have to be out of your mind to take them. Meaning that, for example, many of our buy signals emerged in Europe in the summer of 2012. That was when everyone thought the euro was going to break up, and, therefore, if you were buying European equities you'd have to be crazy.

Likewise, they were emerging in Brazil at the end of 2015, early 2016, and you'd have to be out of your mind to be buying – *The Economist* had a front cover with Dilma Rousseff on the front page and there were corruption scandals.

The truth is some of the very best buying opportunities happen when everyone thinks something is terrible. You know, you don't tend to get – I think it was Howard Marks who said you don't tend to get great investments without horrible news.

And so, the retail idea -- you know, I went around with my colleague, our head of business development sales, Denise Hearn, and no one liked the idea. Sure enough, what happened was we had the last month and a half where retailers posted some positive numbers and then posted not bad numbers, and many of these retailers were up 20 30 40 percent.

Now, I think that there's still some left in the trade, in terms of a lot of these valuations, for some of them were extremely low. And if you look across the retail sector, surely, some of the sales are going to go to Amazon. But not all of these retailers are going to go bust. Many of them don't have a lot of debt. And even when you adjust for leases they're still fairly cheap.

So you'll be able to read that in the report. I think that this is like Brazil, this is one where all the stars do align, or have aligned. And it is a very good view of how we come up with ideas. It's not a guru-focused model. It's one where we've used our leading indicators, it's one where we've tied that down to sentiment, positioning, and valuation.

And, believe it or not, for a lot of these retailers, the short end drift is higher than it was after Lehman Brothers. That's telling you something about just how negative the outlook of the average investor towards the sector was.

So that's the report that everyone will be getting. And those are the kinds of reports that we try to produce for clients on a consistent basis. Not every single month has such wonderful ideas, but that's one that worked out very well for anyone who wanted to take it.

Erik: Jonathan, I'd like to ask a couple of follow-up questions on this one. I totally get the premise of, okay, everybody and their brother is talking about Amazon is going to conquer retail. And so, to say that that is overplayed, oversold, and there's a dead cat bounce if nothing else, I totally get that.

Is that the premise of your trade? Or are you going further than that to say, no, wait, the whole premise that Amazon is essentially defeating conventional brick and mortar retail is not really as bad as people think it is? Is it just that the market has overplayed it? Or is it that the fundamental idea is wrong?

Jonathan: I don't think that every retailer necessarily will survive. I think there's some of them that might be a longer process. You know, perhaps this is the dead cat bounce. But I don't think every retailer is going to go bust. A lot of them have shut lots of stores and done cutbacks.

There's one book that I highly recommend your listeners read, and that's *Capital Returns*. *Capital Returns* is a phenomenal book. It's based on the letters from Marathon Asset Management, edited by Edward Chancellor. It's a truly fantastic read.

And he makes the point that, generally, the best times to buy an industry – you know, when you've seen an enormous cutback in capex, when you've seen prices collapse, and people exiting the industry. That then means that everyone is miserable and depressed, the securities and the stocks are generally cheap. And then you end up with a rebound in terms of prices. And you end up with an improvement in the overall climate due to a reduction in supply.

And this is true currently in the retail case, where if you look at many of the leading brands which have actually seen an enormous cutback in spending and stores – this is also true, actually –

We have written a very big report for our clients in oil and gas. If you look back at oil, for example, in 2014, we were very negative oil and gas. And we wrote a very big report to clients pointing out that there was too much capex, there was too much debt, and most of these companies were going to go bust. We've since seen 120 bankruptcies in the shale area, with $85 billion of debt defaulted on.

Fast forward three years, it's a very different picture. What you actually see is that global oil capex has gone down by $300 billion.

Retailers are similar, where these industries go from periods of too many store openings, too much capex, too few stores being opened, too little capex. And, if you pay attention to the capital return cycle, it's very useful and instructive in understanding where industries are going. So, while I do think there's a dead cat bounce to some of these stocks, I don't think that's true for all these stocks. And a lot of these stocks simply have to not die – adjust themselves to a new reality where they're going to have to do some of their selling online as well. And the stocks will do well.

It's certainly not an across-the-board all-is-clear. But rather, for many of the stocks, certainly the ones that we've identified, they've done well. And I think that they will probably continue to do well.

Erik: My second follow-up question is, this was obviously a good call that you made, but it was a couple of months ago. And as you said, you're up 30% on some of the stocks that you recommended.

So, is it over, is it done? Is there still room? Does it make sense to consider this trade now? Or is this something that's just an example of a past trade that worked out for you?

Jonathan: We like MacroVoices. So we haven't given you something from February; we've given you a report from October. This was our October monthly – the trade has worked out much faster than we thought it would. I think that there is still something left in the trade, in the sense that a lot of these stocks are still very cheap, relative to where they might trade going forward.

And we don't recommend individual stocks to people. We're top-down in orientation. But what we have done is shown a few stocks where we have specific signals against them. And then shown the sector overall.

Erik: Let's move on to another topic that you have been very outspoken about for the last couple of years, which is Australian real estate. And I think, for a while there, you were the guy that wouldn't stop talking about Australian real estate. But nothing was really happening. Well, it looks like maybe it's starting to break. Like maybe you're being proven right, finally, on this Australian real estate situation.

Give us the update on what's going on there, and particularly what you see coming for the real estate (I think) bubble in Australia.

Jonathan: I don't like press attention. I try to not appear in the news if I can. I genuinely don't think there's anything to be had from appearing on CNBC or Bloomberg or anywhere else. I would prefer "a thousand times over" appearing on a thoughtful place like MacroVoices, where you can actually do some sort of long-form economic analysis, versus a two-minute sound bite.

But in the case of Australia, what happened was – I was in Australia visiting a very good friend John Hempton. He writes a blog which I highly recommend everyone read. It's called Bronte Capital. He lives near Bronte Beach, and John Hempton is a genius, and I always learn an enormous amount when I'm with him.

So I went out to Australia just to hang out with him. And spend time on the beach. And thought nothing more of it. It was really when I was there that he introduced me to a friend of his who was a reporter for 60 Minutes, and he asked if I would talk about the housing market. John and

I at that stage had, for fun, gone to see a house auction. This sounds weird to anyone who's not Australian, but, believe it or not, they auction houses as if they were auctioning Picassos.

If you live in a middle class neighborhood and there was a house for sale at the end of your street, you could get a hundred people showing up, and there would be trucks that would cater to adults, serving them coffee, and ice cream for the kids, and everyone would watch a middle class house be sold in an open auction.

John and I went and saw that, and saw a couple of those auctions, and thought it was totally nuts. The prices people were paying for what was effectively a middle class area, and very far from the beach, in Sydney. We though, you know what, this is too much fun. We're both nerds and love investing and economics and so on.

We then decided to drive around Greater Sydney and further afield, outside of Sydney, and visit a lot of the construction sites. So we went to see new tracts of land out west, we went to high-rise apartments that were being built. And then we started speaking to mortgage brokers, to buyers, and so on.

And it became very clear that – in the United States there was an awful lot of very bad lending that was driven by mortgage fraud – you know, the liar loans. That is present in Australia.

Now, the mortgage lenders in Australia insist that's not the case. The central banks, very much like in Ireland and Spain, are essentially shills for the bank, for the banking sector. This is not to say that everyone that works at the RBA (the Reserve Bank of Australia) is a shill. But, overall, you end up with what's known as regulatory capture.

What John and I saw is denied by the mortgage industry and by the Reserve Bank, but actually there's quite a lot of lying on loans. It was very clear that a lot of the bubble dynamics, in terms of people taking on an enormous amount of debt, where Sydney is now 12 or 13 times household income in terms of price – in America, at the peak, New York and San Francisco were about 7 times – put that in perspective – and then, nationally, it was about 5 times, in the US – and in Australia it's much closer to between 6 and 7.

You do have, obviously, some cities that are lower, and then Sydney and Melbourne that are quite high.

So we refer in the negative and put out a report on this to our clients. And pointed out that building permits are the best longest leading indicator of economic activity. And they're also one of the best leading indicators for house prices. So if you're a builder, and you have trouble selling, generally what happens is you build less.

And, you know, it's harder to move houses. And so what we've seen is a sharp downturn in building permits in Australia. And, if you're looking at house sales, while the price level overall appears positive, you're actually seeing fairly steep drops in some cities, like Perth and

Brisbane, and then you're actually seeing a very steep drop in some suburbs in Sydney – you know, which are less attractive or overbuilt – and then, what's very interesting, is stocks.

If you and I wanted to sell Apple tomorrow, you could do that in 30 seconds. Or even less, in fact. Depending on how good we were with our trading program. Whether it's Schwab or ETrade. You can't do that with a house. And, generally, the problem with houses is that people have an idea in their own mind of what their house is truly worth. If you think your house is worth $1.5 million, then you're going to be unlikely to sell it at 1.2 or 1.3. So you're just going to sit on it. Eventually, though, you're going to come around to the realization that it's not worth 1.5. You're going to sell it for, 1 or 800 or whatever the ultimate price is.

Australia right now has a very interesting feature that house sales overall in Australia are at four-year lows. And this is not what you'd really expect in a very healthy housing market with a lot of new construction and fairly high prices. And so we are seeing a downturn in Perth, Brisbane, suburbs in Sydney and Melbourne, and four-year lows in volume of sales.

I think all of this is telling you that there's a problem.

And then when you look at, in terms of debt, debt's continued to grow. Some of the main banks have tightened lending conditions. Some of the non-bank lenders have picked up lending. But, overall, you've seen wages in Australia – particularly real wages, which is wages after inflation – have been negative for a few years now and are negative now.

At the same time, we've seen credit growing at 5% or 6%. So, very clearly, people are not able to service the mortgage with higher rates. And their debt levels are rising relative to disposable income and household income. So Australia scores very poorly not only in Rs, but also on IMF and the bank of international settlements, in almost any risk metric.

So people can say whatever they like about me or my friend John Hempton and our work that we did investigating the housing bubble there. But if you actually take an outside view – and, by outside, I mean if you read the great work of Daniel Kahneman – he pointed out that, generally, people who are insiders think that they have unique insights, that this time is different, that whatever the details of this particular story is are true.

But if you have an outside perspective, meaning that you look at most countries before they've blown up, you've seen a few things in common. You've seen the bank assets to GDP have been very high. Mortgage lending relative to household income have been very high. You've generally seen rapid appreciation of house prices. You've seen a lot of lying or exaggeration of income and costs, in terms of mortgage lending.

All of these are present in Australia. And so that is the picture that we see in Australia today. And it would be extremely unlikely statistically that Australia would not have a problem, given that it checks so many boxes.

Erik: Now, when the US housing bubble was falling apart, the investment opportunity was so clear and so ripe that there was a movie about it: *The Big Short*. But that's because the US housing lending market was securitized, and you could buy credit default swaps on subprime CDOs.

You don't have a securitized lending market in Australia, as I understand it. So what is it that's at risk here? Is it the banking shares themselves? Is it something else? What's going to give when this falls apart?

Jonathan: I think one of the big problems when we discuss housing in general, from now going forward, is that Michael Lewis' book was a great success. Everyone's now seen the movie. And so everyone thinks whatever short there is is the big short.

In fact, when John and I went around Sydney and then our report was leaked to the public – we still don't know who did it – they were saying, oh, this is the next big short. We've never said that. The situation that presented itself in the United States was truly unique in the sense that you had these asymmetric derivatives that you could trade on – some people did – and that's just not true in every housing downturn.

There were no asymmetric derivatives in the Spanish downturn. There were none in the Irish downturn. And there are none in the Australian downturn.

And so the fact that you don't have an asymmetric trade via CDSs doesn't mean that the situation is not completely screwed up. And that this is not a disaster waiting to happen. So, in the case of Australia – I know that you wanted to talk about China. We'd spoken before this podcast going on. You know, they're basically highly levered to the Chinese demand for iron ore and Australian commodities. And they're highly levered to Australian housing. And neither of those do I think will turn out well.

Erik: So, do you think Kyle Bass will eventually be proven right on his theory that the credit expansion in China is going to blow up and it's going to force the PBOC to markedly devalue the yuan, potentially creating a deflationary shock risk to the rest of the world? Are you in line with that view? And is Australian housing potentially a proxy indicator that something's coming there?

Jonathan: I've not actually specifically seen what Kyle Bass has talked about, in terms of a video or a podcast, so I would hate to comment or characterize his views. But, broadly speaking, if we look at China, China scores very poorly on almost all debt metrics.

So we've seen an enormous buildup in private debt. Not government debt, but private debt. In many countries it tends to be in the household sector. In China it's primarily in the corporate sector. And, if you look at previous crises, normally when they reach the level of debt that China's reached it leads to problems.

So either China's different, and this time it is different, or China has problems that normally have led to crises. And so, in the case of China, what's happened is the Communist Party runs the country. And they want growth.

You can get growth by having healthy or reasonable growth, or you and I could build a factory of building something totally useless. And you could get growth, meaning that we build a factory and we hire workers, we build useless products, but it doesn't mean that's good for the long term. That doesn't mean that we're going to get a return on our investment as shareholders.

In the case of China what's happened is you have a lot of state-owned enterprises taking on an enormous amount of debt. You also have an enormous amount of building in terms of housing units. And that also creates a bubble in terms of house prices. And it doesn't mean that all these houses are needed. It doesn't mean that this is a good use of debt.

But what you've seen is – for example in late 2015 to early 2016 you had 15% of Chinese GDP was – debt was increased, sorry, by 15% of Chinese GDP in terms of the equivalent. All right, so this was a massive increase in leverage.

Now, China did manage to grow, it did manage to reflate a lot of commodity prices. But you could argue that this is not a very good thing in the long run. What you need is shutting down bad businesses, building fewer homes, basically trying to make sure that growth is productive rather than having growth for growth's sake.

And so the supreme irony here is that – whenever I speak to people who follow China, not closely, they always talk to me about China undergoing a capacity reduction and deleveraging. And in China they talk about deleveraging with Chinese characteristics. And that's where you talk about deleveraging but actually keep on releveraging. And that's currently what's going on.

Erik: While we're on this subject, let's cover Canada as well, because a lot of people have said that Australian real estate is a precursor for what's about to be the next shoe to drop. Which they think is Canada.

What's your feeling there? Is the Canadian real estate situation also in a bubble that is precariously perched, as Australia has been?

Jonathan: The answer is yes. Definitely. Canada has an enormous amount of problems in terms of the debt to household income, debt to GDP, and – if you look at lending, it's not, I would argue, necessarily as bad as Australia, but it's certainly not good. And, like Australia, been a big beneficiary of Chinese money. Those are slowing down in both places.

And so, Canada does score very poorly on most – again, as I was talking about Kahneman and outside perspective – Canada scores very poorly on most of the traditional debt metrics.

Erik: Okay. We are going to need to leave it there in the interest of time. But, before we close, for the benefit of our institutional listeners, first of all, who are able to consider the excellent services you offer, give us a quick rundown of what Variant Perception does. But then if you could also, just for the benefit of our retail audience, is there anything at all that they can follow in terms of blog posts or anything that's within reach of the retail investor that you guys do? Twitter handles, anything like that?

Jonathan: We don't currently have a retail product. We might in the future offer a much more limited set of tools and views. But currently our clients are hedge funds, family offices, endowments, and some long only managers.

And our views -- we do occasionally post on our blog, so if you visit variantperception.com you can find our blog. You can follow that, obviously, with an RSS reader or a Feedly if you want. And then, we do tweet charts that we think are interesting, so you can follow us on Twitter – I think there was a shortage of letters, so I think we're @VrntPerception – or search for Variant Perception on Twitter. We do tweet regularly.

And then, you know, we don't really give our views frequently or even publicly in the sense that. Our clients pay us for our views, so why would we undercut our clients' trust? But we love MacroVoices, and also many family offices and hedge funds do listen to MacroVoices. That's one reason why we enjoy being on this show.

Obviously, if you do subscribe to the kind of institutional research that we offer, we'd love to speak to you. And you can visit variantperception.com, we have a Contact form. And it's a genuine pleasure being able to do a podcast like this. We don't like Bloomberg or CNBC, and it's just always enjoyable to be able to be in a forum like this.

Erik: Well, it's a real pleasure for us to have you on the show. And someday we're going to twist enough arms to get one of your excellent Variant Perception letters – even if it's an old one – out to our listeners. Because I think you've got some really fantastic content there.

I can't thank you enough for another great interview, Jonathan. We look forward to having you back on the show soon. Patrick Ceresna and I will be back as MacroVoices continues. Right here at macrovoices.com.