Russell Napier: Signs of incipient inflation are a false alarm and won't last long

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Erik: Joining me next on the program is macroeconomic strategist Russell Napier, also author of *Anatomy of the Bear*, one of the most respected books on bear markets and bear market bottoms.

Russell, thanks so much for joining us on the program. You recently penned an excellent article emphasizing the case for deflation rather than inflation in the United States, based on central bank policy.

One of the things you emphasized in that article, back at the time it was written everybody and his brother were saying the US dollar is about to crash. You said no, the opposite, the US dollar is bottoming and about to strengthen. And a lot of people thought you were crazy.

Needless to say, the tape action has proven you right, at least so far. We're seeing very strong positive action in the US dollar.

So please give our listeners a quick overview of your argument favoring deflation, and why you have such a bullish view on the US dollar at this particular juncture in time.

Russell: Sure, happy to do so. And I would just – there's many issues I could raise for the US dollar, but let me just pick on two: The level of real rates of interest in the United States of America and the growing prospects of a credit event or a default outside the United States of America.

Both of these, I think, are ingredients for a strong dollar and also ingredients for lower global inflation. And it may be globally feeding back into the United States of America.

The interest rates – I know most people, or just about everybody, believes that US rates are rising to reflect more inflation. And, of course, that could be correct.

I would point out something that's happened with that US Treasury market that hasn't happened in my entire investment career, which is now 30 years old, and that is that, as we speak today, central bankers are net sellers of Treasuries.

We know what the Federal Reserve plans to sell this calendar year, $228 billion. We know what the rise in global foreign reserves is, and about 64% of that will flow into the United States' assets. Slightly less of that will flow into Treasuries.

$228 billion, at the current rate at which foreign reserves are accumulating, we are not going to see foreign central bankers offsetting the sales from the Fed. So that's a net sell. We don't know what that net sale will be, but it's a net sale from central bankers at a time when the Congressional Budget Office forecasts a roughly $1 trillion fiscal deficit.

This is the first time in my investment career that savers will have to fund the whole lot. And it's perfectly normal that real rates of interest have to go higher to attract those savings.

$1 trillion is still a large amount of money. It can come from anywhere in the world. It can come from outside the United States. It can come from inside the United States. But it's a liquidation of other assets or a rise in the savings rate, which is necessary to fund this. Either of these things is positive for the dollar.

What we can't know for sure is how much of the capital to fund the US Treasury will actually come from offshore. But history suggests that huge amounts of money can be attracted into the US dollar at reasonable rates of interest.

I think we'll come on to discuss whether this is a reasonable rate of interest or not, but the fact that the dollar started to rise in the last few weeks is perhaps confirming that foreigners believe that this is an attractive rate of interest. And it is, obviously, relative to what is available in the so-called risk-free assets that are government bonds – compared to Japan, compared to Northern Europe.

Therefore, that is attracting capital. And that will continue for quite some time. It will clearly have to bring up, to some extent, European yields with it. It can't bring up Japanese yields. So I think it will continue for some time.

And that's the first thing that underpins the United States dollar.

Very briefly, because I suspect we'll come back to it, are these credit events that are recognized in various places in the world. Remember, the United States dollar is heavily borrowed across the planet. And it is also heavily borrowed by people who don't actually generate US dollar revenue.

The rise in the dollar, the rise in interest rates, the rise in the spread of cost of borrowing dollars in Europe is causing some distress.

My particular bugbear in this is Turkey, where I think the whole country has basically been getting to the edge of defaulting on its debts. It's a $432 billion credit risk, Turkey, on the global financial system. I think it's important.

And history shows one thing and one thing clearly. If you get into a situation of a credit event, particularly as it pertains to people who borrow dollars and don't actually have them or generate them, then you get a strong dollar. We get an unwinding of that situation. And I think if we were very unlucky, it could spread beyond Turkey into other emerging markets.

So that would be the two building blocks for saying why the dollar is probably going up and not down.

Erik: Russell, in your article, which we have a link to in our Research Roundup email for our listeners' convenience, you make an excellent argument for why the environment in the United States really favors deflation not inflation.

Yet, a lot of people are observing a lot of signs that sure look like inflation. Whether it be oil and copper prices (and commodities generally) catching a bid, very strong social pressure for increasing minimum wages, a number of other things that we're seeing, a number of other data points, it look like inflation is making a comeback.

What do you think is going on, considering – as you've argued so well – it really doesn't make sense to expect monetary inflation in this environment?

Russell: I think I focus on the fact we have had this before. We have had a combination of these things before which were absolutely pointing to higher inflation. And that was the first half of 2008.

With the benefit of hindsight, we know that the US economy peaked in December 2007, was actually contracting through both the quarters at which commodity prices in particular were very strong.

The European Central Bank actually raised interest rates in that period, believing that these commodity prices would feed through to inflation. I'm not suggesting the surprise can be as bad this time, but the surprise that came along that we didn't really get is that these credit events in America coming out of the residential property market were big enough not just to slow US growth but actually, through a credit crisis, slow global growth.

So I would at first point out that it's not new to see inflation and commodity prices rising even as we are about to head in the other direction.

The specific issues I would raise in relation to why inflation in the United States can come down – and this may not be necessarily to do with lower economic growth – but why it should come down is, first, money supply growth.

Now, I know that not everybody believes that money supply growth is an important thing. I think it is important. Money supply growth with velocity fairly steady to actually falling. It's down at 4% M2 growth. I've looked at all the quarters since World War II. In only 16% of quarters has the growth in American M2 been as low or lower than that.

I recently came across a really interesting presentation by Milton Friedman on a Friday in October 1987 where he remarked upon the slowdown in M2 growth – not dissimilar to the slowdown we've seen since the 3rd quarter of 2016 – saying this slowdown in M2 growth means we're going to have a recession in 1988. Now, he was wrong. There was no recession in 1988. But the stock market did fall 22% the Monday after he made his comment.

So I just look at the level of M2 growth, and I say – can this be reconciled with the consensus? Because the consensus view is higher real growth, higher inflation, and higher asset prices. And I find it difficult to reconcile the growth in money with that.

I could be wrong that money is negative for inflation. Maybe inflation goes up and it's real growth that takes the pain. And maybe it's inflation goes up and it's the stock market that takes the pain. But, on the whole, it's hard to reconcile that number with rising growth and rising inflation.

And if any – if real growth takes the pain or the asset market takes the pain, I think quite quickly inflation expectations would change anyway. Because we would assume there will be some impact on inflation, certainly from lower economic growth and perhaps a negative wealth effect from sharply lower asset prices. So money supply growth.

And, finally, the stronger US dollar, which I talked about briefly earlier, clearly that tends to import deflation into America. It has done that remarkably well in the past. I think particularly of the late 1990s against the background of a crisis elsewhere in the world. The dollar was going higher and import prices were falling.

And then, finally, also as I mentioned earlier, a credit crunch, where the easiest way to believe in lower inflation at least, if not deflation, is the credit event that slows global growth.

And, as someone who believes in the credit event that slows global growth, particularly emerging market growth, then – whatever you think is being generated internally in terms of inflation in the United States throwing a spanner in the works of emerging market growth – I think would quite quickly have inflation expectations and ultimately inflation itself coming down, led by commodity prices, given the role of emerging market growth in falling commodity prices.

Erik: Well, your reference to 2008 obviously begs the question as to what may be in store both for equity markets. And is there a risk of another credit crisis? I don't know if we want to take those together or separately. We can start with equity markets, or maybe the two are interrelated.

What do you see in terms of equity market? Some people are saying this is the beginning of a really big bear market. It's not just a correction, it's a really big deal.

You're the man who wrote the book on bear markets. So, do you see that as a serious risk?

And, if it's related, we can cover credit as part of that or we can come back to credit crisis, if that fits better.

Russell: Well, let's start with the credit crisis, actually. Because we never looked at the four great bottoms. There's been lots of bottoms and lots of opportunities to buy equities. But the four great bottoms are by definition associated with the most distress.

And that distress, probably not in 1921, but otherwise is associated with some degree of credit distress. So, if it is going to be a big one, we have to see that credit distress.

Now, I would argue that we are in a world where that is likely. The simple metrics that say that it's likely is the total debt-to-GDP ratio of the world is significantly above its 2007 level. And we had an economic recession there, which threatened to turn into a depression because of levels of gearing.

It's actually higher. Even if we take out government and say government debt is not risky, private sector debt – not private non-financial sector debt – is actually also at a new all-time high.

So if there was fragility in the system associated with the way we ran the financial system in 2007, I think it's around today.

Looking at America, particularly for banks, it wouldn't seem to be particularly worrisome directly for the United States of America's banking system. They are much better capitalized, the risk models they use are much more reasonable, or leverage models. There's so many thing that have happened to make that US banking system look much, much more stable and much more capable of coping with credit problems than it was before.

But, as I stressed in the opening statement, I think the credit issues really fall outside the United States. So it's not clear to me that the banking systems outside of the United States of America have been significantly improved and recapitalized.

Particularly in Europe, lack of capital, I think, is noticeable. The fact that they're still using their old risk models also is somewhat worrying.

And, of course, in the emerging markets we've seen unparalleled growth in debt to GDP. Some recent work by the BIS suggests that the most worrying – the early warning indicator for a credit crisis is really the pace of growth in credit to GDP relative to trend. And if we pick all the problem children out of the world based on the BIS numbers, the vast majority of them are emerging markets.

So the credit issue I don't think will be particularly bad for the United States of America, but could be bad very much elsewhere. I would point to the fact that that should lead to a particularly strong dollar. If that is the correct call.

But efforts to buoy up the banking systems elsewhere, outside of America, are usually sort of easier monetary policy. Whereas America, they continue to go very much on their own path with a very strong United States dollar.

This could be a very major issue with interest rates so low. It would definitely have a feedback effect on the United States of America and its equity market, particularly given the need to fund the United States Treasury. But I think most of the pain of this would actually fall outside the US. So I haven't given you a very clear answer and I'd be surprised if this was necessarily the big one for the United States. We'll have to sit and watch that.

But for some other markets, particularly the European markets, this could really be very dangerous indeed. And I should just add again about Turkey. If Turkey goes down, and I think it will do that by devaluing and imposing exchange controls, the burden of that falls on the European banks.

But there's potentially a huge social burden as well. Turkey is looking after 3 million refugees for the European Union. It's being paid by the European Union to do so. And if, for whatever reason, the president of Turkey decided to release those refugees, then Europe would face an economic crisis and a social crisis simultaneously. I'd be, therefore, much more concerned about the outlook for European equities than American equities.

Erik: There is the old expression that when the United States sneezes the rest of the world catches a cold, because there is just so much dominance that the US dollar plays in the rest of the financial system. It seems to me that their credit risk, if you look at China's credit growth since 2009, I mean it's just off the charts in terms of crazy, crazy credit growth.

In terms of contagion risk, if China not only sneezes but gets outright credit pneumonia, is the contagion risk there to the rest of the world in terms of bringing on a global crisis? Or do you think it would be contained in China and, say, in surrounding Asian economies?

Russell: I think that's a great question. We've always said that about America, haven't we? And, to some extent, it's been true. But we don't live in this kind of unipolar world anymore. We now have this huge – the second-largest economy in the world – and it has been important. It's been crucially important for countries such as Australia and Canada in terms of resources. And also for the rest of Asia.

So the key contamination from China to the rest of the world is the exchange rate. It's not necessarily lower growth in China. It's not necessarily a credit event in China. It's if China had to solve those problems via lower exchange rate. And that's the transmission mechanism. If when America sneezes the rest of the world catches a cold, it's true, I would also say, when the dollar rises the world catches a cold. Because so many emerging markets have linked to the dollar.

And, therefore, just a rising dollar – even against the background of a reasonably buoyant US economy, can cause havoc in emerging markets. I would go back to the late 1990s again, 1997–1998, the US economy was doing fine. But the dollar was going up. And many, many emerging market economies went bankrupt. They had too much debt, the dollar went up, liquidity tightened, and it was all over.

Now, China didn't, because China was running a very large and robust current account surplus and it has only recently devalued itself. It was highly competitive.

That's not where China is today. It runs a much, much smaller current account surplus. As we know, the capital account is theoretically closed but, in practice, leaks pretty badly. And there is a significant will amongst the people to get their money out of China.

So the strong dollar, if it continues and if it comes to pass, really could force China into a corner. That, combined with the trade tariff policies of the president, may be leading us to a more flexible exchange rate. Or at least what will be billed as a more flexible exchange rate but, for all intents and purposes, is likely to be a weaker Chinese exchange rate.

So I was just going to read you the list of those emerging market economies where the debt-to-GDP ratio has been going so strongly that actually the BIS suggests there is a risk of a systemic banking crisis. China is top of the list; you're absolutely right to point to China.

But, anyway, here is the list of countries where the current rate of growth of debt to GDP suggests a credit crisis: China, Hong Kong, Singapore, Canada, Switzerland, Mexico, Norway, Turkey, Czech Republic, Malaysia, Chile, Indonesia, Thailand, Saudi Arabia, Colombia.

And they've just added France to the amber list for a country that should be warned about.

So the focus is, of course, on China. It is a quasi-command economy. They tend to keep cycles going for longer than any of us can believe. But the spread – and there are three developed world economies on that list as well – the spread of economies where debt to GDP has been growing very, very rapidly is really very wide indeed. And well beyond China.

Erik: It seems like your focus on where the risks lie is primarily in credit crises. And I can't help but think, boy, where we are at this moment in history, we're getting precipitously close to some key technical levels in interest rates and bond yields.

Specifically the 30-year US Treasury has not seen a monthly close above its 100-month moving average since the early 1980s. That level now is about 3.25%, or about 12 basis points above the current yield as we're speaking this week.

So maybe it's a little bit early to deliver a decisive call that a reversal into a secular bond bear market has begun. But it seems like we could certainly make the argument that we're getting close or that there is a risk of that if it's not actually confirmed.

So I guess it strikes me that the risk of credit crisis has to be worse if you're in a secular environment where interest rates – money is getting more expensive not less expensive, as was the case in the last credit crisis.

How does that play out? And, from a monetary history standpoint, what do you think the significance and consequences are of such a long-term trend reversal in yields coming at a time when it seems like the economy – in your description – is not able to tolerate much higher yields (if I've understood you correctly)?

Russell: I think there is definitely a role already being played by higher US rates. So if the dollar goes higher as well, it's definitely playing a role in creating vulnerabilities. We've seen a couple of large Chinese companies unable to pay their US dollar credit.

As I've mentioned, there's a lot of Turkish companies that really can't pay it. And that is already something to do with the rise in US yields. They've gone from incredibly low levels to low levels. But it's enough at the margin when global debt to GDP is to shine the light on particularly vulnerable economies and particularly vulnerable companies.

It's not my view that we have begun a new secular bear market, for the reasons I've mentioned. Basically, I'm looking at that going the other way. However, if it does, I did write a report back in 2009 trying to advise investors as to how long they should hold until they enter the bull market, having written a pretty bullish piece at the beginning of 2009. And I came to this conclusion.

Now, that wasn't rising bond yields per se, if we did get growth in inflation, that would call the end to the US equity bull market. What would call an end to it was actually inflation. Inflation was a better gauge.

I know there should be a link between inflation and bonds, and I looked at that. I did come up with a magic number – any magic number is clearly dangerous, but the magic number was 4% inflation.

In other words, if bond yields are rising in the United States of America it reflects higher growth and higher inflation. And that's not necessarily, in the early stages, bad for US equities.

However, history has shown that about 4% inflation the Fed had tended to get quite aggressive. Tended not to acquiesce so much to what was going on, get aggressive. And that seemed to be when equities reacted negatively. Why wouldn't they, if nominal rates or short-term rates are going up, the risk-free rate is going up to attack growth?

In terms of a discounting model, a higher discount rate and a lower growth rate are clearly bad for net present value. But the crucial thing was that was when inflation was closer to 4%. And we've got quite a ways to go on that.

So all I would add – let's say I'm wrong on US rates and these yields continue to rise, I think that's particularly bearish for those outside of America who borrowed dollars, people we've already focused on. I think United States growth may be good. United States inflation may be rising. I wouldn't specifically see any particularly bad credit issues in America. I don't see it being anything like we've seen in the past.

But outside of America, I think there would be an awful lot of pain going on as interest rates go higher and higher and higher. Remembering that, roughly, the European banks – I should say non-US global banks – have got a loan book in dollars of about 4.5 trillion.

That's a big loan book for people who don't really take US dollar deposits. And the implications of higher US rates and a higher dollar mean that the pain may not be so America specific, but it could be very emerging market specific.

Erik: More and more people have been suggesting that the US dollar is slowly losing its reserve currency status. You and I discussed the possibility off the air of doing an interview comparing what happened when the pound sterling lost its reserve currency status and what we might expect from that.

But you observed that the circumstances are just so different today from the situation that existed back then that a direct comparison is probably not relevant.

So why don't we talk about this whole idea of the US dollar losing reserve currency status in terms of the actual present conditions? And I guess the first question that comes to my mind is, historically, reserve currency has referred to the currency that's used for international trade settlement as well as for central bank reserves.

Back in the days when these concepts were first invented, it wasn't possible to do forex transactions at the click of a mouse in a few milliseconds. So, in an environment where you can easily transact globally in any currency that you want, do we still need a reserve currency per se? And what are the criteria that are important for a currency to have? And it seems to me like maybe the definition of what a reserve currency is is changing as a result of the times.

Russell: In preparation for that, I went away and did some studying. Because, like everybody else, I think I know what the decline of sterling was all about, but then when you begin to read it you realize that you don't really get at sterling being the last reserve currency. There's an excellent book on this by Catherine Schenk.

I could spend all day going through the differences, but let's pick a key one: capital controls. During most of the decline of sterling, which we'll take from the end of World War II let's say until the involvement of the IMF in the mid-1970s, with the United Kingdom economy.

The United Kingdom operated under capital controls. So the states' system, the central bankers, may have been able to take money out – and even that was pretty difficult and needed some permissions. But the private sector didn't.

We live in an entirely different world today. Where, at least today, in most countries, private sector capital moves freely. So that one reason alone, I think, it's difficult to draw conclusions.

But there are actually many, many others in terms of who were the owners of British government debt at the end of the Second World War. They were mostly ex-colonies, part of the Empire, becoming part of the Commonwealth. And you can see that the ties and the links there made it just very different from the much more commercial relationships that operate between the United States and the people who owns reserves.

So I think you've hit on a really important point there. It's possible to have a reserve currency that nobody accumulates. If we lived in a world of entirely flexible exchange rates, nobody would be accumulating reserve currency. Nobody would be liquidating the reserve currency. But nobody would be accumulating it.

The reason we've had such a huge boom in the total amount of reserves, the total amount of Treasuries, owned by foreign central bankers is that they chose to intervene in their exchange rates. Now, obviously, they still are. But nowhere near to the forced intervention – it's nowhere near as great as it used to be in recent times.

I calculate, based on the current rise in world foreign exchange reserves, that their gross buying of US Treasuries will be about $116 billion this year, which, against an issuance of nearly a trillion is pretty much chicken feed. So that has fallen away.

This is one of two things. One, they're giving up or they're much less keen on determining an exchange rate. Or number two, simply their external accounts are pretty close to balanced at the exchange rate they want. And if the private sector is effectively balancing the exchange rate where they want, through a combination of current account and capital account, then there is no intervention.

So we can debate long run about the reserve currency status of the dollar. But, at the minute, there's not a lot of dollar accumulation going on from central banks.

You have made the case for a strong dollar, but it hasn't been based at all on the actions of central bankers. It's been based entirely on the actions of private savers, particularly life insurance and pension plans of Japan and North Europe. So I think we'll see the dollar and dollar yields as attractive, but it's not based on foreign central banks.

So there's one thing we can't really forecast, and that is that policy choice. At any moment, any of the major central bankers of the world could announce a shift within their reserves. I don't think they could announce they're reducing their reserves, unless they wanted to push their exchange rates up, but they could announce a shift in the reserve. And they could announce a shift away from the dollar.

Now, that could happen. But it's very, very difficult to predict.

Your listeners should know that the IMF publishes every quarter a composition of world reserves. So we can watch it every quarter. And there can be obfuscation, even from official sources, on the currencies that they hold. But we can watch it from quarter to quarter to see whether the percentage holding in United States is dollars is falling. So we should get some warning if central bankers have decided to shift from one to the other.

But I think the crucial thing about our future, and particularly for the US Treasury market, is that the need to accumulate reserves is going down. And that means the need to buy Treasuries is going down. And that just puts a huge pressure on private savers to fund the US government.

And that, I think, is really what's been going on, really for the whole of this year. We're seeing a huge tectonic shift of higher yields dragging savings from other assets. Those assets have to be liquidated, and that pushes the price down. And this is a movement that will be underway for many years.

So the big question you asked: Will the dollar lose its reserve currency status? Unlikely to be in a timeframe of the next one or two years that matters for any of us. But we are living in a world where the accumulation of dollar reserves by foreign central bankers has really slowed dramatically.

With the Fed liquidating its position in Treasuries, then there's massive pressure on private sector savings to get into the Treasury market. It's another reason why I remain very cautious on all equity markets on global growth. And particularly on assets outside the United States of America.

So the world has changed. Because, for the first time in 30 years, foreign central bankers are net sellers of Treasuries. And that, I think, changes everything. But it does not, as yet, undermine the reserve currency status of the United States dollar.

Erik: Russell, one hypothesis that many people have posited is that as the dollar loses its reserve currency status – or even if it doesn't lose that status – if, just as you say, central banks are no longer feeling compelled to buy US Treasuries, that causes the US to lose its so-called exorbitant privilege (the ability to fund its deficit spending without paying the penalty of much higher interest rates).

And people have predicted that what's going to happen is the US will be unable to continue its practice of borrowing and spending beyond its means, which it's grown accustomed to for a period of decades. Because suddenly the bond market is going to insist that, yes, deficits do matter again.

Some people have even gone on to suggest that it could bring about a US Treasury bond market crisis, an actual bear market that's a dramatic selloff because people are panicking in the situation.

How much of this is real? And how much of this is conspiracy? Do we need to be concerned about the US government being unable to fund itself because suddenly the bond market doesn't want to play ball anymore?

Russell: That day might come. And, really, just referring back to the last question, if central bankers aren't buying Treasuries, even though it remains the reserve currency, part of the exorbitant privilege goes. I mean, they continue to own what they own, that clearly is part of an exorbitant privilege. But the real exorbitant bit of the privilege is when you force them to buy more. And that might be coming to an end.

However, I'm certainly not in the camp that believes we're about to see a spike in Treasury yields and our government struggling to fund itself. Because, of course, everybody in the planet is a saver relative to something else in the world.

And as long as the Europeans hold down their yield curve, as long as the Japanese hold down their yield curve, then it creates an incentive for private capital, private savings, to fund the United States government. There'd be much, much greater concern, I think, for the US if we were looking at rapidly rising yields in Japan and Germany. If you like, then there's kind of a governments fighting for a funding.

But at this yield – not everybody agrees on this, clearly, because they do worry about inflation – but at this yield I think real rates in America are very attractive. And the concern about spiking yields would be much more true if we were looking at rising yields in Germany and Japan and Northern Europe. But we're not yet doing that, and so I don't have that concern.

I've said it several times now in this call: I think that the American government can really suck in savings from all over the world to fund itself at rates at or not far above where it is today. But this is the absolutely crucial point – remember that the savings that have to be liquidated to fund the US government can come from anywhere on the planet. They don't have to come from the United States of America.

And, therefore, funding what is now a $1 trillion deficit, with a $228 billion Federal Reserve liquidation on top of that – it's a very, very big number. And it's highly likely to be somewhat negative for US equities.

But it can come from all over the planet, and the impacts it can have outside of the US are much bigger. So I wouldn't worry about that unless we see significant rises in European so-called risk-free rates and Japanese so-called risk-free rates.

Erik: Another trend that we're seeing is an apparent attack on the petrodollar system. Of course, the US is no longer the biggest consumer of imported oil from the Middle East. At the same time, we have just this week Nicolás Maduro offered to sell Venezuelan oil at a deep discount if the Indians would pay for it in his new cryptocurrency, bypassing US dollars. We've seen Sergey Glazyev in Russia trying to pressure other countries to abandon the US dollar for oil transaction.

Is this de-dollarization trend, if you will, away from the petrodollar system a serious risk to the US dollar's hegemony? And what consequences or implications does it have?

Russell: Yes, it's a long-term trend. And clearly, that's an issue. And clearly, it will develop. And China will be absolutely key in this going forward, given that it's already the world's second biggest economy.

You pointed out earlier that there are two reasons we use the reserve currency. One is for transactions. And then one is, if you like, store of value, particularly by central bankers.

We can see from your question that we are moving towards some new ways of doing these transactions. The question is are we moving to a new way of store of value? Or, once we conduct that transaction, what do we hold the balance in? And will people be happy to hold these other balances?

Will they be happy to hold Maduro cryptocurrency? My answer to that is no, given the history of Venezuela in managing currencies. But maybe I'm wrong.

But, crucially, in terms of this whole thing, the real question is will they be happy to hold the renminbi if we manage to create these renminbi petrodollar oil contracts? My answer to that, again, is, on balance, no. They will not be happy to hold the balances that they accumulate in renminbi.

Now that relates to the fairly weak rule of law in China and a rise in the rule of man relative to the rule of law. I used to be a lawyer, so maybe I'm putting excessive weight on those legal rights that one gets in America, the United Kingdom, and Europe, and one doesn't receive in China. But I think we have some way to go before people would be happy holding significant balances in either Maduro's currency or Xi Jinping's currency.

But when that happens, of course we're looking at a world where the dollar does not have to be held as a store of value, either by the central bankers or, actually, by the private sector. But, at the minute, even private sector transactions – I can't imagine them ending up in renminbi or bitcoin currencies as holdings, as stores of wealth.

The dollar, as we all know, loses some value every year. That is the goal of the central bank, apparently, to make sure it loses some value every year. But, ultimately, the rule of law and the right to protect your property are more important than that annual marginal depreciation they like to call inflation.

Erik: Now, of course, the gold bugs would tell you that the oil-selling countries are going to use this petro-yuan contract, which supposedly has a convertibility clause – although I'm not sure it really assures any conversion rate – where you could use your Chinese yuan proceeds from selling your oil to buy gold in the Shanghai Futures Exchange and take delivery of your gold.

Do you think that there is a realistic chance of a trend developing where they're taking the gold and that potentially creates additional demand for gold and a bull market in gold bullion?

Or is that more just the gold bug pipe dream that drives those kinds of speculations?

Russell: I think that's a more realistic way of looking at this. Gold is a recognized store of value. A volatile store of value, but over the long term we can show that it's a store of value. I think it's interesting – if that is the correct term in that contract – that the flow of capital in the renminbi has an option to go back into gold may be suggesting to the people who have issued it in China that the contract may not work that well if people were forced to end up owning renminbi balances.

And that side trip into gold is important. So, yeah, if we were looking for something in the world that could be a store of value in this new world, I would certainly put gold ahead of the renminbi, for very obvious reasons. In terms of the title, one has the gold compared to the title one has to the renminbi. So it may well be a bull case for gold.

I think gold will do exceedingly well over the long term – and I define the long term as more than a couple of years. It's initially challenged by a world with a very strong dollar and rising interest rates. Rising real rates of interest and a strong dollar are somewhat of a challenge for gold.

But we're moving into a world of much, much more government, much more of the word *control* and much less of the word *price*. You can find a nice chart on Google of the number of times the word *control* gets mentioned in the press and the number of times the word *price* gets mentioned in the press. And the more the word *control* goes up, the more the price of gold is going up. And that's a huge structural normal.

So any weakness in gold associated with a strong dollar is a buying opportunity. And those contracts you mentioned, they are a government action, which is going to make gold more attractive relative to paper currencies.

Erik: A final question on reserve currencies – I'll just open it to you. What other factors can you think of that are important for investors to consider or think about in this environment where, maybe we're not moving from the dollar to a different reserve currency, but certainly the definition of reserve currency and what it means and the necessity of having just one of them is clearly changing.

What else should investors be thinking about in this environment?

Russell: What they should be thinking about is this is kind of a fake question. It may be that we're going to a new reserve currency. It may be the dollar is going down. And those are all possibilities.

It is not a probability. It is not only likely but probable that the pace of accumulation of reserve currencies itself has slowed dramatically or stopped.

If we shift the focus away from trying to second guess which central bank will be the first to liquidate the US Treasuries, and focus more on the fact that that mechanism has stopped, then we focus on where in the near term – and I mean within the next couple of years – where the rubber hits the road.

And the rubber hits the road in the US Treasury market. These central bankers have bought, since 1991 until their peak ownership in 2014, they added $6 trillion in US Treasuries to their holdings. That's foreign central bankers and the Fed. They're now liquidating.

Had they not bought $6 trillion worth of US Treasuries, then the private sector would have had to buy $6 trillion worth of US Treasuries.

Now, it's easy just to speculate on that must mean a high yield in Treasuries. Perhaps it does. But it's much easier to say that it means mass liquidation of private sector assets to fund the United States government.

Now, that's a very different place you end up in if you ask a different question, which is not let's try and guess the geopolitics of reserve currency holdings, and simply observe the fact that we are not getting central bankers buying in aggregate Treasury securities.

So my own view, as we've talked about during this interview, is that real yields don't have to go much higher to push all those savings into the Treasury market. But people should be looking at what will be liquidated in that process. Or how high global savings rates will now have to go to generate the extra savings necessary to fund the government.

The numbers are stark. Going back three years ago, the US fiscal deficit was like $480 billion – now it's looking at a trillion. It could easily be bigger than that. But when you add in the Fed's liquidation, we're going for $480 billion deficit to a total supply of Treasuries to the marketplace of $1.3 trillion. And foreign central bankers are buying very little. That is what we need to focus on.

So let's stop talking about the theoretical of what will not be a reserve currency long term. And, interesting as it is and important as it is, let's talk about the near term. What happens in a world where central bankers stop buying Treasuries?

Erik: Well, let's talk about that then. You wrote the book on bear markets. It sounds to me like you think there has to be a wholesale liquidation of some other asset in order to provide this Treasury funding. I have to believe that that other asset is stocks.

So what do you see on the horizon in terms of what comes next for equity markets?

Russell: Yeah, it has to be portfolio assets. It has to be something that's liquid. Stocks are the one we think of. But corporate bonds are another one. And, just to stress, it could be government bonds of countries other than the United States of America, that currently have very low yields.

So I'm negative on stocks because I see the liquidation. But I find it very difficult to point to a specific asset class that's going to be liquidated, apart from emerging market equities – because it's the obvious one.

Because these things that are going on in America, it's not – I mean, there's this liquidation going on. But these things that are happening in America – higher rates of interest, a stronger dollar, perhaps lower growth, perhaps not lower growth – really, really, really have the biggest impact on those countries that have borrowed dollars.

So, as we begin to see fundamental impacts, real economy impacts, where will they be at the greatest? The real economy impacts will be greatest in emerging markets, for the reasons I mentioned.

I think of flow-through into Europe. It would be easier to liquidate these equities, corporate bonds, than it would be to liquidate American equities and corporate bonds, because they are in the very firing line of a deteriorating fundamental position. And estimating the United States economy is much more difficult because of the scale of the fiscal stimulus.

So, yes, liquidation across the board of equities, but perhaps a US equity market that outperforms even as it falls. Because the real economic impacts could easily fall outside of America.

When America sneezes the world catches a cold. When the dollar goes up the world catches pneumonia.

Erik: And what happens to junk bonds in this environment? It seems to me that would be the logical choice besides stocks. If suddenly Treasuries are paying a worthwhile yield, who wants to own junk bonds anymore?

Russell: Junk bonds would be a reflection of corporate cash flows. So I would put junk bonds and emerging market bonds together and say this: When we're worrying about future cash flows, you should be much more concerned about emerging markets than you should be about

United States-issued junk bonds. That's where the real damage will be done.

There will be a flow-through of course. As emerging market bonds start going, I think we'll be looking at the world of credit with a more skeptical eye generally. And, clearly, there are a lot of credits in America which are much lower quality than they have been in recent years.

So, absolutely, I wouldn't go and, junk bonds. I think it will be kind of a slow grind for US junk bonds in this scenario. But something pretty dramatic and quick can happen in emerging market bonds.

So can this become a credit event in America of the scale of the last one? I think it's highly unlikely. You can still lose money on these investments, but I don't think it can be of that magnitude. But there are other places in the world where this absolutely can be of the magnitude that we saw in the United States.

So the junk bond may look relatively good compared to emerging market debt, but it's absolutely not a place you're going to be making money.

It's time to be incredibly cautious. I'm usually someone who recommends cash, which has been a bad recommendation for some time. But, in this environment, cash becomes a rather good investment as we're watching and not really knowing what will be liquidated to sell those Treasuries.

So it's best to remain cautious in cash and wait to see where that liquidation process really begins to bite hardest. But my guess is where the economic impact is the greatest, that will be emerging markets and not America.

Erik: Finally, Russell, we haven't talked about Japan yet. The yen has been falling. What do you see in terms of implications for what that means for the rest of the markets?

Russell: As you said earlier, as we discussed, the dollar is going up, and maybe it doesn't look that unusual that the yen should be going down.

Something else is happening, a dramatic contrast between what's happening in the balance sheet of the Federal Reserve, shrinking from November 2017, to what is happening with the balance sheet of the Bank of Japan, which continues to grow apace and I think will actually accelerate in its growth.

We entered global quantitative easing at roughly the same time. Remember back in – I think it was the Mexican finance minister who told us about the currency war that was coming? There wasn't much of a dislocation in currency markets, because we were all doing quantitative easing at the same time.

However, we are definitely not exiting quantitative easing at the same time. And the standout country that I think just can't stop quantitative easing is Japan. It's doing it – well, we know why it's doing it – it's trying to generate money supply growth and economic growth and inflation.

But it's also doing it because the savings system in Japan has been filled up with government debt. It runs a fiscal deficit-to-GDP ratio of 4%. In short, if the central bank wasn't funding the government it is difficult to see who would, particularly at reasonable interest rates commensurate with the growth of the inflation they want to deliver.

So as time progresses, I think the Fed will continue with its $228 billion Treasury liquidation, $120 billion liquidation of other assets, as Japan goes the other way. Then the yen will take the strain and people will begin to realize that Japan can't stop.

That is very bullish for Japanese equities. It adds to the strength of the dollar, obviously. It creates issues for the renminbi as people look at a weak yen. A crucial part of the Asian economic crisis of 1997 was a very weak yen. And a very weak yen has negative implications for its neighbors and those who compete with it in trade, but it is positive for Japanese equities.

So perhaps just – and this has been true now since November – perhaps just in the last few weeks the market is beginning to focus on this thing that's changed.

One country is hitting the bricks. And one country has the foot on the accelerator as measured by the expansion of central bank balance sheets. And that ultimately has to feed through into the relative value of their exchange rates.

Erik: Russell, I can't thank you enough for a fantastic interview. We're going to have to leave it there in the interest of time.

You are one of my favorite authors. You just have a fantastic, prolific writing style. For the retail component of our audience, probably the best place to find that is going to be in your book *Anatomy of the Bear*, which is an excellent analysis of all of the major bear market bottoms, how to identify them, how to look for buying opportunities at the bottom of bear markets.

Unfortunately for the retail audience, your professional writings, which are actually free to registered and regulated professionals, are only available to that audience. Please tell us more about that for the professional component of our audience.

Russell: Apologies for that, but that is the world that we live in. I own a website called ERIC and if you put my name and ERIC into Google, you will find it very quickly. It's where regulated providers of investment research and regulated fund managers can meet. We're changing the way research is consumed in the professional business, and that is no longer tied or attached to commission quite the way it used to be.

So I've set up this website. We've got 130 research providers in there selling top-class world-class research. So, for professional investors, if you go in there you get my – I write every fortnight and I write for free for the professionals who come in there. And you can also have a look around and see if there is other research that fits your needs in this world of new research. But I'm afraid it is professional investors only for that particular site.

Erik: We've provided a link to that website in the Research Roundup email. Again, unfortunately that is only for the regulated professionals in our audience, which makes up a little more than half of our audience, actually.

Russell, I can't thank you enough for a fantastic interview. We are going to need to leave it there. Patrick Ceresna and I will be back as MacroVoices continues right here at macrovoices.com.