Charles Gave: Our Industry in NOT prepared for secular inflation!

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Erik: Joining me next on the program is Gavekal partner and founder Charles Gave. Charles, thanks so much for joining us on the program. You penned an article recently – so many people look at the yield curve as a sign of oncoming recessions. But most people only bother to look at the yield curve on government debt, on Treasury debt.

You've recently observed that the corporate yield curve is sending a very different message than the government yield curve.

Please elaborate. Tell us what that was about. And give us a sense of what that signals in terms of your expectations for market conditions as a result of what you're seeing.

Charles: Okay, let's start with something that probably all your listeners agree. And it's a very simple one. It's that the government is not responsible for the growth in the economy. I think most people would agree with that.

So if your government is not responsible for the growth in the economy then why is the yield curve, which is basically the cost of money from the government which is subtracted from the cost of long-term money for the government. And there is no reason why it should work, because the government can always borrow on top of that, as there is no variable that the government cannot go.

So the answer is the - we have done a lot of work on a Swedish economist called Knut Wicksell. Wicksell lived at the end of the 19th century, beginning of the 20th. He had a massive influence on the Austrians and on Fisher and so on in the US.

And he/we had a brilliant idea. He said the economic cycle is created by the presence in the economy of two interest rates. And, let's put it simply – the rate at which you can borrow and the rate at which you can invest. Wicksell said, in order not to have too big an economic cycle, financial cycle, the two should be meet each other most of the time.

Because if the cost of capital is way above the retail invested capital, then it pays to repay the debt. And we move into what specialists call a debt deflation. Which means that's what you had in the 30's, that's what Japan had for a decade. And it doesn't work.

On the other hand, if the rates are too low, then it pays to buy against the assets by borrowing money. You borrow at 2 to buy an asset yielding 4. The price of these assets eventually goes up.

But nobody is investing new assets because it entails a risk.

And what it leads to at the end is that the rich get richer, the debt gets bigger, the price of assets goes higher. And what happens is the poor are getting poorer since nobody is investing into capital spending. So productivity goes down, and the poor guys, the only way for them to have the highest standard of living is capital spending for them to have a higher productivity.

So Wicksell was saying something quite brilliant. He says, look, trying to create growth by maintaining interest rates too low always ends badly. You never know when.

It always ends badly because it leads to accumulation of debt, inflated asset prices. And eventually the cost of money starts going up because everybody has been borrowing. So return on invested capital starts going down.

And we always end in a period where the cost of money moves above the cost of capital and you have a debt deflation. So he says, Wicksell, be careful guys, don't manipulate short-term rates lower because it always ends badly.

Keynes used a lot of Wicksell's work too. And it's almost a perfect condemnation of Keynes' theories.

So that's the first idea.

And what I'm trying to say is that – the classical yield curve works in the US for a very simple reason. It's because short rates on governments are proxy for the cost of capital. Long rates are a proxy for the long-term return on invested capital.

And so if the curve inverts, it means that the cost of capital is above the return on capital and then all hell breaks loose. It cannot – it leads to recession. But all I'm saying is it's a better idea to do it with the cost of capital for the private sector and the retail non-invested capital for the private sector also, rather than do it with the government sector.

That's all I'm trying to say.

Erik: Charles, what conclusions do you draw from what you're seeing in the corporate yield curve? And what does it tell you about what might be ahead for the equity market?

Charles: Okay, we are right now at a point where private sector yield curve is like– it's literally at zero. Totally flat. Which usually – if it stays there it's going to be uncomfortable, but we probably can survive.

But if suddenly it starts inverting with short rates going up, which it can do perhaps starting in June at the next meeting of the Fed, then – every time when the private sector yield curve inverted in the past we had a big financial, economic problem either in the US or outside of the

US.

Outside of the US it occurred if somebody had a fixed exchange rate system with the US – like Mexico in 1994 when the private sector yield curve inverted. Not much happened in the US economy, but Mexico went bust.

And then it inverted again in 1997 and there was a fixed exchange rate between the Asian currencies and the dollar at the time – not much happened in the US economy but Asia went bust.

And in 1999 it inverted again. And this time we had a recession in the US because this one mattered for the US economy.

So what I'm trying to say is that, the US being the reserve currency of the world, it's a difficult question. Because if you have countries that have a fixed exchange rate system with the US dollar – we don't have that many left but we still have a few – they could be hurting badly.

If right now, for example, the currency is overvalued, and the yield curve in the US inverts, which means that the rate of return on invested capital in this country is going to plummet –

What I'm trying to say is that, up to very recently, you could say – to put it bluntly – you have two kinds of bear markets in financial markets. You have 10–12% percent bear market (10–15%), which is a pause that refreshes to a certain extent. There is not much to be afraid of.

And there is what I call the big bad bear market, like a grizzly, it's a huge bear. And that occurs every 20-30 years.

So what I am saying is I can probably tell you that the probability of a downside movement of the market is pretty high. Especially if short rates keep going up in the US today. I have no way of telling you whether it's going to be a minus 10 or a minus 50. But the probability of a minus 10, you're getting nearer by the day.

Erik: You mentioned that countries that have currencies tied to the US dollar as Mexico had back in the '90s are potentially at risk. I know you have offices in Hong Kong. The Hong Kong Monetary Authority has been having difficulty maintaining the peg of the Hong Kong dollar. It seems that the carry trade has been so attractive that a lot of money is flowing out of Hong Kong, carry trading into US Treasuries.

Have you looked at that situation? And is that an indication of this same phenomenon? Or is it related?

Charles: It is related, totally. And the big question for Hong Kong – I mean, it's not a question there because it's not the first time that it occurs – they have had a currency board since the middle of the '80s, so it goes back a long way.

So the currency board, which is a fixed exchange rate, implying that if suddenly it's more interesting for the guys in Hong Kong to invest in the US than in Hong Kong, what happens then is that money flows out of Hong Kong, normally. And then the money supply in Hong Kong starts shrinking.

And usually what it leads to is some kind of a big fall in asset prices in Hong Kong. The mechanism of adjustment for Hong Kong has never been a difference in interest rates with the US, which is kind of what we have. It has been the volatility of the asset prices. And most of the asset prices in Hong Kong are either the stock market, which is big but not that big, but real estate.

In the last 20 years, you had two or three crashes in Hong Kong in real estate, which always took place when the private sector in the US – the private sector yield curve inverted. So, while I'm very bullish on Hong Kong long-term, I would not be buying real estate in Hong Kong right now, if you see what I mean. I would be waiting patiently.

Erik: Do you think that there is any risk that the Hong Kong Monetary Authority will lose that peg and be unable to maintain the peg? Or is that something where they have plenty of money?

Charles: No, that's impossible for a very simple reason. The central bank reserves of the Hong Kong Monetary Authority are bigger than the money supply in Hong Kong. So what it means is that they can buy back all the Hong Kong dollars that they want. And then that's it.

So, no, they cannot lose it.

Erik: Okay, so there's no real risk to the Hong Kong dollar although it has been riding its lower limit of its peg.

Charles: It's almost impossible. There is a risk on asset prices in Hong Kong. But there is no risk on the peg being broken.

Erik: So are you more bearish, then, on the Hang Seng than you are on the S&P because of this condition?

Charles: You have a lot of things happening in Asia. Yeah, I would be very careful. I've written quite a lot about it recently. China, for the last 10 years, at least since the big financial crisis, has been trying to de-dollarize Asia. They are going everywhere offering swaps to every central bank telling them, look, accept our country's currency for government reserves. We will accept yours.

They basically have created a kind of new IMF in China, a new World Bank in Beijing. So China wants to de-dollarize Asia. And what they are doing is they are simply almost underwriting the

current account deficits of Indonesia, or what have you, of all these countries.

So you have to understand something very important. When the US did that with the Marshall Plan in the '50s, what happened is that long interest rates in Germany at that time were at 7%, long interest rates in the US were at 2%. With the risk of Germany being underwritten by the US Federal Reserve Bank and the US government at the time, the two interest rates converged.

And the same thing is going to happen in Asia. So what is going to happen is that – let's see, Russian interest rates are at 8, Indonesian interest rates are around 7 or 8, Indian interest rates are at 7 or 8 – they will all converge in the next 10 years towards the 4% that China is paying.

So we are going to have the mother of all bull markets in Asia. With interest rates halving. And when interest rates halve, usually, long bonds in/and local currencies go through the roof. It goes without saying. And the second thing that happens is that real estate goes through the roof. And the third thing that happens is that growth stocks through the roof.

So what I'm trying to tell authorities – given the fact that China is now stabilizing Asia with an immense balance sheet, the least dangerous part of the world is today in Asia. Europe is extremely dangerous because the monetary system in Europe is not viable. And the US has a basic contradiction occurring right now between the monetary policy and the budget policy, not beginning to work.

So what I'm trying to say is, sellers, the only place where you should have bonds is in Asia. Because these bonds are going to go up and their currencies are going to go up. All central banks in Europe and the US won't until they clearly push their exchange rates to go down. These countries with China, they want accounts with their currencies to go up. And they serve you an interest rate of 8% or 9% or 7%.

So where in the world do you find interest rates on government bonds at 7% in a currency that is going to go up? This is an anomaly.

Erik: Now, I suppose that the counterargument would be a lot of people have said, look at the size of China's credit expansion. They are at risk of potentially having a credit crisis as big as the United States had in 2008 and 2009. Where does that fit into this equation?

Charles: Basically, it's a very simple answer. You see, credit crises occur if one of two things happen. The first one is that banks borrow short-term money from the financial system, or what have you. And use these borrowings to buy assets with a different duration that the money that they borrowed. So, basically, they borrow short-term and they invest long-term.

When we had the big crisis in 2008 the money that – central banks in the US had borrowed something like three times their capital to do transformation in the housing market and what have you. So the first reason why banks go bust is if they make the big mistake in the duration between what they borrow and what they invest in. Then they are very sensitive to a liquidity

crisis.

The second thing that can happen is if a central bank buys in a foreign currency, like Thailand in 1997. If you are borrowing a foreign currency, then you are screwed if suddenly you start accruing foreign currency that starts going up and you can't repay, or your currency goes down.

When you look at the Chinese debt, it's all the loans in China, all are financed by deposit – which is the simplest form of long-term financing. And, moreover, there is absolutely no borrowing from China in any other currency.

So what I am trying to impress on our listeners is, fellows, stop thinking about debt the way you do. The only thing that matters in debt is if you have a debt to a foreigner. China owes 100% of its money to domestic citizens in China. So on a consolidated basis, there is no debt in China.

France has a debt, because 70% of its government debt is owned by foreigners. Zero percent of the Chinese debt is owned by foreigners. So it's basically one part of the government lending money to a second part of the government with a guarantee of a third part of the government. China is not going to go bankrupt.

Let me give you the example of Japan. The Japanese central bank has been buying 50% of the Japanese government debt. And they have been buying that debt at zero interest rates while the debt was issued at 1 or 2. So, basically, they are buying at 110, repayable at 100. So everybody is happy. Because they have reached 110 instead of having 100, so they are very happy.

The second thing that happens is that Japan now buys the remaining 50%. Now all the debt is owned by the Japanese central bank. What does it mean?

Well, it means that then they can merge the treasury and the central bank. And cancel the debt. They have replaced the government bonds 10-year zero by a perpetual zero-coupon bond at zero interest rate which is called a bank note.

So what I'm trying to say is that people have been losing money in the Japanese bond market shorting it for the last 15 years without understanding that, since the debt was owned by the Japanese, there was no debt. It's absolutely extraordinary.

If I owe money to my sons, the family has no debt, consolidated. This is ridiculous.

So when you talk about debt, you have two kinds of debt. There is debt that can kill you – if you borrow money from foreigners and if you have the wrong durations. But when you look at yourself you can't have a banking crisis in a country that has massive excess savings. It makes no sense.

So this is one of the most ridiculous things – and I think it's probably tied to the German way of

thinking, which because debt and guilt are the same word in German. So debt is bad.

Debt is neither good nor bad; debt is a tool. It's like a hammer. A hammer is neither good nor bad. It's just a hammer. And a debt is just a debt. What matters is who borrows, when, at what duration and did what with it? And if he borrows from his neighbor, there is no debt.

Erik: We've been discussing the yield curve. Let's come back to the underlying interest rate itself. A lot of people are starting to say, look, the 35-year bond bull market is over, and we're coming up on a key level at about 3.05 on the US 10-year. A number of experts have said that's the technical level – if we break that it's all over, it's a big selloff.

And some people have even said that both stocks and bonds selling off at the same time could force a big unwind of the massive risk parity trade that so many institutions have on in the markets.

Do you agree with that view that we are potentially on the cusp of bond markets selling off dramatically and higher yields? And if so do you agree with the risk to risk parity?

Charles: Yes, I do agree on both. Because risk parity is just taking advantage of something that has worked for the last 30 years or so, when we had a negative correlation between the long-dated bond and the stock market. When the stock market was going down the bond market was going up. And when the bond market was going down the stock market was going up. It's what happens when you have a deflationary period. It's always the same thing.

Let's assume that this is over, that we're moving into a new phase of inflation, which is a possibility. Then, if you want to build a portfolio for an inflation period, having bonds for God's sake is the stupidest idea that you can have, because you are going to be destroyed with inflation right now.

So the idea of hedging an equity position with your bond position works only if we are in a zero or deflationary period.

So every computer now in the world is programmed to buy these portfolios. 50% in equities, 50% in bonds has worked very well over the last 30 years. So my fear is when you have massive positions that are managed by idiots. By that, I mean computers. And there is nothing more dangerous. As we saw in 1987, the computers got crazy and we had massive percentage decline in one day.

You see, computers compute very fast, but they are idiots.

Erik: I definitely want to come back to this subject of inflation as a secular trend. But before we go there, you wrote a piece recently called "The Upcoming Monetary War, With Gold as An Arbiter."

Please give us an overview. What do you see in terms of what's coming? And how does gold play into the story?

Charles: Okay, you are China. You want to de-dollarize the world. So you have to offer a credible alternative to the dollar. You want to de-dollarize not only trade between nations in Asia – if Korea was selling goods to Taiwan, they were settling their accounts, up to two or three years ago, in dollars. And the Chinese are saying, why on earth do we have to use the dollar to settle the account between us? So they are trying to do that.

They are also trying to de-dollarize the oil markets. That has started with Russia. Iran is now selling its oil in Euro. So you have a lot of movement saying that there is something happening also in the oil markets.

So the Chinese want to de-dollarize. But now the problem is that they want also to keep their capital account closed. In simple words, that means that they want to control the money that comes in and out of China. So it's difficult to tell people you should keep your reserves in renminbi if at the same time you prevent the guys from either investing in China or taking their money abroad. You see what I mean there.

There is a very astute solution that the Chinese have found: It has been to say, guys, look, if you have too many renminbi because you have been selling a lot of oil to China, or whatever, we will settle either in renminbi, you can keep your renminbi in your reserves, fine with us. Or we can give you gold instead of renminbi.

So you have to understand that the gold price is now a big play between the US and China. For the Chinese currency to be credible, a big rise in the price of gold would help them tremendously. Because they have been buying gold like crazy for the last six or seven years. So they have huge inventories of gold. And that is what will ultimately lend a lot of credibility to their currency.

On the other hand, the Americans don't want that de-dollarization because that's part of their power. And so what they are trying to do is prevent gold from going up. So, to a certain extent, the price of gold is going to tell you who is going to win in that effort to de-dollarize Asia. If gold goes up, it's China. If gold goes down, it's the US.

Erik: And do you have a favorite for who you think is likely to win? Because, obviously, you could argue that this is either a gold bullish or a gold bearish case, depending on who you think is going to win the war.

Charles: I never make a forecast. Because if anybody could make a forecast socialism would work. And we all know it doesn't.

So I'm just trying to analyze things the way they should be, and then look at the inflection point. What I've found, for example, if you compare the total return of the gold price an ounce of gold

to the total return of long-dated US/Euro government bond over five years.

Well, if gold outperforms the dollar bull market, it means that people are starting to be worried about the US dollar. They would rather own gold than a bond giving them a yield and so on.

So every time when gold outperforms, basically, a long-dated government bond in the US over five years on the moving average, then it means that inflation is coming back and it means, also, that the Chinese are winning. If gold underperforms the long-dated bond, then it's the other way around.

So let's try to think that one through. What I'm telling my clients, you look at whatever long-term government bond index you're following, you divide gold by that index. If it is above, it's moving outwards. Fine, you buy gold. If it is below, you stay with your bonds.

The big problem is you can't tell if it is or not by the last six months. The damned ratio has been exactly on its moving average. It cannot make up its mind. It's extraordinary. It stays there. There is a kind of stalemate. So I look at the stalemate and I wait to see which way it's going to break. If it moves, I will follow. If it doesn't move, I will stay put.

Erik: You made some comments about inflation a moment ago. I'd like to come back to that because it's way beyond my paygrade to guess whether or not right now is the time that we're going to see a return to secular inflation. But I know it's coming someday.

And it seems to me that, in a case like this, if something is coming, who you need to talk to is the guy that was there last time.

But, for something like a return of secular inflation, we're talking people that are working in the industry now that were also working in the industry in 1971 when this began last time. There's only about a dozen of you guys left, Charles. That scares me.

I don't think many people know what to do when inflation starts. Am I correct to worry about that? And what would you tell people since you were there?

Charles: Absolutely. You are absolutely right. I will give you the results – I've published some research on that for the youngsters who don't have the benefit of being as old as I am. These are the results.

First, when you have a period of zero or negative inflation, long bonds diversify an equity position extremely well. When inflation starts going up, bonds lose all their diversification power. They become positively correlated with the equities. And there is a lower return and a higher volatility. So, basically, owning bonds if you are entering into an inflationary period, you have to be totally stupid.

So the first thing is that 50% of your portfolio is probably now in bonds. This is the part that you

should be looking at very clearly, very carefully. This is a very important step.

The second thing, which I have checked in the '60s and '70s in the US, is that the bond market in the US was a disaster. But you had some countries out there that were fighting inflation reasonably and that was for example Germany.

So if you, instead of having to hedge your equity position in the US with the US bond market, which proves to be a disaster, if you had bought German bunds you did very well. So you can put against the coming inflationary period by using the bond market of a non-inflationary country. In the '70s you'd go to Germany or Switzerland. And my guess is that this time it could be, once again, China.

So maybe the name of the game if we enter an inflationary period is to replace, to hedge your equity position in the US which you should hedge the US bond market by the Chinese bond market.

So that is a very important point. Because a non-inflationary bond market keeps its diversifying power, and an inflationary bond market doesn't – for equities.

So the answer to your question is it is a lot more difficult to manage money in an inflationary period than in a deflationary period. Managing money in a deflationary period, basically, is a piece of cake because you always have a tailwind. Interest rates falling, that bails you out every time.

If you go into inflation, you have to be very careful.

And the second thing that happens in every inflationary period that I've studied is that value starts to outperform growth. Every time. Because value is a short-duration asset. Growth is a long-duration asset in equities. And long-duration assets are killed when you're moving into an inflationary period.

In every inflationary period, the Shiller PE ratio loses roughly 5% a year as long as prices are accelerating. Or one or two points of the Shiller PE ratio.

So what I'm trying to say is that, first, you are not going to be helped by rising P/E. Second, you are going to have a tough time because value will be better than growth and nobody owns any value stuff anymore. And, third, you will have to get the hell out of the US bond market if you want to get some kind of a hedge.

So managing money in an inflationary period is hell.

Erik: And the people who are working in the industry, other than yourself and a small handful of people who are old enough to remember the early '70s, it seems to me like it's a setup here for a whole industry full of professionals who really have no idea, have no

experience whatsoever. Inflation is something they read about in a textbook in college and forgot about ever since.

How did this go in the early '70s? Were people caught off guard? Did it take them a couple of years to figure it out and learn how to manage money in that environment? And what can people expect in coming years?

Charles: A couple of years? It took them ten years. I remember vividly there was a French bank called the Banque de Suez at the time.

So that's why I created my first research firm at the time, in 1973, called Cecogest. I sold a lot of that research in the US too because absolutely nobody had any clue. So you had very volatile markets – up, down, sideways. So it was difficult to be amused, if you see what I mean. It was a tough period.

So the same thing could happen. However, that Asia around China could play the role that Germany played in the '70s at the time to help to find a solution.

When I was managing money in France a few years ago, I was managing around $10 billion. Every time I didn't know what to do with my portfolios, I bought some bunds. Because, to a large extent, I believed that the Bundesbank was going to be on my side. So, by buying bunds, we were going to make money either on the exchange rate, or on the capital gain on the goods, or what have you.

So, to a certain extent, I think the same thing is happening in Asia around China. So what I'm trying to tell all the young people is, look, guys, I've seen the movie already once with Germany in the role of the American cavalry you see riding to the rescue at the end. Maybe I'm going to see it a second time, but this time with China. It's a difficult one, but don't underestimate the difficulty of managing money.

And two things happen. Two assets can play a clear role in portfolio construction. The first one is, of course, gold. It's very volatile, but it does play a role. It reduces a little bit the risk in your portfolio. And the second one, believe it or not, is cash. So, suddenly, if you are moving into an inflationary period, cash becomes a very attractive asset – because interest rates go up and you have no volatility.

So, in a deflationary period, you play with two assets: bonds and equities. In an inflationary period, you have to play with foreign bonds, local equities, local cash or foreign cash, and gold. So instead of being a world with two assets you have a world with four assets.

I can tell you it's not a piece of cake to manage money when you have inflation. It's difficult.

Erik: We have a lot of listeners who are in the millennial generation, people in their late 20s and 30s, who are working in professional finance. For those who don't want to be caught

with their pants down, who want to be ready for this, is there any particular book they should read or other action they should take to get ready so they'll know what to do when secular inflation eventually makes a return?

Charles: I've written a few pieces on how to manage money. Books, no. The problem is that – how can I put it?

The main issue that we have in the financial world is that now people don't think anymore. They use computers. They build models and they trust the models, which is a sure way to poverty.

So if I had to give them an advice, it is maybe you should read Von Mises, Milton Friedman, Irving Fisher, "The Debt-Deflation Theory of Great Depressions," and, then for God's sake, start thinking. Don't compute. Think. That's what a computer can never do.

Erik: Yeah, the computer is still programed to set you up with that risk parity model that I think a lot of people are correctly concerned is going to break sometime soon.

Charles: Absolutely. And it has to, because it has worked for 30 years in a row.

Erik: Charles, I can't thank you enough for a fantastic interview. It is just so helpful for our younger listeners to get the wisdom of your many decades in the industry.

Before we go, though, Gavekal is, of course, an institutional advisory firm. Please tell our institutional listeners where they can learn more about Gavekal and the services that you offer there.

Charles: Well, they can go on the Gavekal website, and they ask for a password, and then they have access to the research for a few weeks or a few months, and then somebody is going to call them and say are you interested or not, and then that's about it.

We are not a very aggressive marketing firm. We have 900 clients in the world in 55 different countries. But we are not very good at selling. We are very good at keeping our clients and having a discussion with them. But we are not hard marketers, if you see what I mean. The clients come to us because they like us, and because we do good work.

Erik: And you certainly have an impeccable reputation. So it's Gavekal.com for anyone who's interested. It is an institutional advisory firm.

Charles, I can't thank you enough for a fantastic interview. Patrick Ceresna and I will be back as MacroVoices continues, right here at macrovoices.com.