Eric Peters: The Era of Monetary Dominance will give way to Fiscal Dominance

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Erik: Joining me now is One River Asset Management Chief Investment Officer, Eric Peters. Eric is known for his weekend reading notes (wkndnotes) and I've been particularly enjoying reading a couple of them this week that I want to talk about.

We have secured permission to share those with our listeners, so you'll find the download links in your Research Roundup email. If you're not registered yet just go to our home page at macrovoices.com. Look for the red button that says Looking for the Downloads? next to Eric's picture on the home page.

Eric, It's great to have you back on the show. I want to talk about some of your weekend reading notes because they resonate very much with a number of themes that I've been thinking about.

I wanted to start with monetary policy and how long the monetary paradigm, if you will, can last. It seems to me like, really for the last 10 years, we've been propping up asset markets with what I think is easy money policy, with quantitative easing and very accommodative monetary policy.

But a number of people have said, look, there is only so far monetary policy can take you. Feels to me like we're coming to the end of that path.

Are we at the end of the path? And if so what comes next?

Eric: Hey, Erik, thanks so much for having me back on the show. I appreciate it. It's always fun.

When I think about what you're describing, I think it's the most important thing going on in the markets, certainly in the here and now. And here and now for us means over the next year or two.

There is this transition that is I think clearly taking place. And it's a handoff from what I would call this paradigm of monetary dominance to fiscal dominance. Meaning, really since I began my career, which is 30 years ago, we've seen the same set of policies dominate markets. And those are really monetary policies.

And politics has kind of carried on, of course, but they've really been in the background from an economic perspective and certainly from a market perspective.

Rates have fallen progressively lower with each cycle. And they've finally ground their way down to zero here in the US and negative overseas. The US tried to break higher and we managed to raise rates a couple hundred basis points up the lows. But we're on the way back down.

And we now find ourselves in a spot where – you can just listen to the central bankers and they're telling you that they're largely finished.

So Powell is, I think, trying to play his last game, which is he's saying if we undershoot our inflation target but then promise that we'll overshoot in the future, that can have a really positive impact potentially.

But that's where we've hardly left. We're just, we're kind of promising to overcompensate with inflation in the future.

And I'd say it's far from clear that that's really stimulative anyway.

And then in Europe, Draghi has made it explicit that the time for fiscal policy to take charge is upon us. And that, had they had a real fiscal response in place to date, it would have made the monetary policies that they've implemented more effective. And it would have prevented them from having some of the damaging effects that they have.

But Draghi is, kind of, obviously done. When you look at where rates are in Europe there is just very, very little that they can do.

Erik: It's easy to say, okay, monetary policy is pretty much petered out here so fiscal policy has to come next.

But what are the various options for what shape that could take? What kind of fiscal policy options might be under consideration? And what's the range of possibilities we need to think about?

Eric: Well, the interesting thing about the handoff from monetary to fiscal is that, when you think about monetary policy, there really are quite a limited suite of policies that our central bankers can implement.

I think we can agree that the US is the most important central bank in the world because it presides over the US dollar, essentially, and the largest economy.

So the Fed over the years has adopted a suite of policies and playbooks that over time have grown to be standard everywhere. Even, really, quite frankly, including China – and China is a little bit of a unique situation because they are able to close their capital account and play various games that you're able to play when you can do that.

But, by and large, all the central banks have done pretty much the same thing.

Now, at times they move at different speeds. And that has created some volatility.

But in this handoff, what's so interesting is, when you think about what fiscal policy is, it's a policy that is no longer implemented by central banks. So you have a world where central bankers have become homogeneous in terms of their policy tools and playbooks because they follow the Fed. And they're now saying we need to hand it off to the fiscal authorities.

Well, the fiscal authorities are politicians. And politicians are not really homogeneous. So, even here in the US, the fiscal response that we may have to the next crisis could look and would look very different under a Trump presidency relative to a Warren presidency, for instance.

In Europe, the same thing applies. When you look at what happened to Italy, fiscal policy under one set of politicians could look very different from under another set. Same with Germany and same with France.

So, depending on what politicians we have in place, we could have very different fiscal policies. And that's what's going to make the world look awfully different in the coming years.

Because the central banks can't direct fiscal policy, it is only the politicians. And because the politicians are not homogeneous, that's where we're going to get some very different outcomes.

Now, in terms of what can we do on the fiscal side? There are all kinds of different flavors. I think – and this will go into some of the discussions I'm sure we'll have about the generational conflict that is looming – but, ultimately, I think what countries adopt is something that looks an awful lot like what we're calling MMT.

But, really, governments are going to spend an awful lot more money because they have limited ability to really stimulate growth at this point. And a lot of the tax policy and – just redistributing growth around an economy that's already running very slowly is quite difficult to do with taxes.

So, ultimately, there is going to be quite a robust fiscal stimulus that happens – through borrowed money of course.

Erik: One of the things that I've really become convinced of, Eric, is that what politicians have seen in the last 10 years – and you know they don't really understand all of the intricacies of monetary policy and so forth— but just looking at it from their vantage point, they've learned that there is a trick they didn't know about.

You can conjure trillions of dollars of liquidity essentially out of thin air with quantitative easing and spend it without having to tax anybody in order to do so. They didn't know that was possible. And I think they want in on the deal.

And I think that's both sides of the aisle – and with very different agendas. I think the left probably wants to fund universal basic income and a long list of other social handout programs, and I think that the right probably has a different spending agenda. But politicians everywhere just love the idea of spending money and not having to be accountable to any particular individual who got taxed for it who is not going to vote for them.

So would you agree that that's going to play a big role? And how do you think it will affect the coming election year?

Eric: I think it will play a big role, so I agree with your thinking on that, Erik.

And, look, we can see with what happened here in the US with the Republican Party. It wasn't long ago that we were talking about the Republican Party as being owned by the Tea Party and real fiscal conservatives. And then the Republican Party took power and implemented a $1-1/2 trillion tax cut and all kinds of other budget-increasing measures.

I've done some advisory work with some of the Dems as well, and there's just clearly no strong focus on fiscal conservatism. And I think that that's natural.

And, by the way, it's probably healthy in the sense that we've had kind of orthodox economic thinkers warning us of all kinds of tragedy post the 2008 crisis with this monetary policy response that we saw from the Fed. People warned about massive inflation. They warned about all kinds of catastrophe that would come along with QE.

But probably the biggest catastrophe that's happened I think from an overall economic and social perspective is just the widening of the inequality.

We haven't seen the big inflation. We haven't seen the collapse in the currency. We haven't seen some of the types of chaos that fiscal conservatives warned us about. So naturally politicians are going to say, well, if we haven't seen those problems already, then why don't we just keep doing more of this.

But I think the "more of this" will shift away from this pure monetary response, which is widening out inequality, and it will shift toward a fiscal response which actually will work to narrow that inequality.

So one of the things that I think as a 52-year-old I've come to see a little bit more clearly over the course of my career is that the establishment – and when I say the establishment, I'm talking about the political establishment but also the economic establishment – they really don't want to see significant change. And I think that collectively they've done a good job of warning that any real type of fiscal expansion will threaten our prosperity as a nation.

And part of the reason for that, I think, is that there is this mistrust of politicians. And if politicians are able to just spend a lot of money, people worry that it will get wasted.

But a big part of it as well is the establishment. By definition, they are the ones in power. And they don't want to see really significant change either politically or economically.

So any of these programs like the Green New Deal or making college cheap or free, or providing Medicare for all, and doing so with borrowed dollars, these are things that really disrupt the status quo. That's a big part of why people that I'm calling "the establishment" don't want that. And they've convinced us that any of these changes would be catastrophic.

But I think what we've seen over the past decade, which is really interesting, is that some of these policies have not been catastrophic. If anything, they've just widened inequality. And now we're seeing that political backlash. And that's what will drive the real change. That's what's going to be so interesting here.

Erik: You've written recently about a re-division of the proverbial pie and I agree with you that this is coming.

Let's go a little deeper into that. How do you see this coming about? What do you think the political and social changes are going to be? And what will the implications be on the economy when it happens?

Eric: The implications on the economy, I would say it will depend on how some of these things are implemented.

If you take it back and look at it from a very high level, you can look at a redistribution as being a very positive thing in the sense that, historically, when you've seen mass inequality that continues to widen, historically you've had revolutions.

And that's a really, really bad outcome.

So if we can have some type of sensible redistribution that falls well shy of a revolution, I think we should all agree that that's a super-positive thing. And I think you've seen a lot of extremely wealthy people in the US who would agree with that and would much prefer a thoughtful redistribution to something that's more revolutionary.

How it actually happens, again, I think it, like everything that we're going to have to start contemplating as we look out over the coming years, it's hard to predict because it's a function of politics. It's not a function of central banks.

Over the past few decades, you could look at almost any issue and just try to think about what would be the monetary response and how do I model that. I think that the redistribution that's coming will be political and it really will depend on who's in power.

The market impact, though, I think will be unambiguously negative, at least for a period of time as you readjust. Because, when you think about what has really driven a whole range of these trends, we've had stock buybacks, we have very high profit margins. And high profit margins are really the inverse of low wages.

So if you think that we're heading toward redistribution, that relationship is going to change, meaning wages go up which means profit margins go down.

We've had a very low tax regime. That seems like it's pretty obviously going to change. If it doesn't in this election cycle, I think it will change even more dramatically in the next one.

And then we've seen – a big driver certainly in the US market has been these technology names. And there has been loose to almost no regulation of these companies. And that seems very clearly something that is going to change as part of this redistribution.

I think we've hit a point where there are too many people out (principally) on the left coast that have made enormous amounts of money and have, in some respects ,advanced society but have also gutted a lot of labor through some of the different types of products and services that they have put in place.

So I think there will be a lot more regulation.

These are just some of the things that will start changing in a redistribution. And they seem pretty unambiguously bad for markets relative to what we've experienced. They should lead to higher inflation. And that will ultimately savage bond markets.

These things will take some time to play out. But that's why I see it having such a big impact.

Erik: Eric, something else I know you've written about I'd like you to touch on is what I see as a generational gap.

There are issues like climate change where – let's try not to take sides for the sake of this interview – but you've got a whole bunch of people who are absolutely convinced that there is absolutely no scientific basis for it. And you've got a whole bunch of people who think that the science is just so clear that there is no room for debate.

And, curiously, if you look at – how is it possible that people disagree so much? It's generational and political boundaries that the disagreement seems to occur on, even though the science in theory should be independent of those things.

What's going on here? Why is it that we have what seems to me like a growing generational and political division in the country? And what is it going to mean for the economy?

Eric: I'm fascinated by this conflict between generations. And I think it's a really important one to focus on, even from a market perspective.

So we've recently seen this climate strike that's rippled globally. It's touched just about every – certainly every developed nation in the world but a lot of developing nations in the world as well. Everyone except China which shut down any type of protest on the climate.

Irrespective of your views on the legitimacy of climate change or the speed at which it's changing, you just look at, in my lifetime, the fish population in the oceans is down 50%. A lot of commercial species are down 75%. Bird and reptile populations in North America are down 30% to 50%.

So there are some really profound changes that are happening around us. And what is fascinating is that young people have latched on to this. It's not just young people in the US or Sweden or Europe. It really is global. And they are able to communicate and coordinate for the first time in human history at a scale that we've just never seen.

While the older people – meaning, I guess, people like myself and you and others – a lot of people who have been investing for the last few decades, we've been so focused on GDP and debt and productivity and interest rates and profit margins and taxes. And you have a large body of younger people that are not prioritizing those things.

Maybe over the coming decades they'll recognize that these are really important. But in the here and now they're not a major priority.

And why that's interesting is because – one of the things I hear often is that the world is going to become like Japan. Japan's society began aging first and then Europe came after that. And then China and the US hit their peak working-age populations after Europe.

So you've seen this model whereby people say, well, all of this economic stagnation is a function of just aging populations and consequently inflation is coming lower etc. And that's just not going to change because it's age related.

Well, I would say that one of the interesting dynamics that you find in Japan is a very cohesive society. So after their bubble burst and their working-age population peaked, I'd say that as it grew they accepted economic stability for, really, stagnation. That was the tradeoff.

What stagnation means is you just have a less dynamic society for younger people. And what I do not observe are younger people in the US and increasingly in Europe just willing to accept this stagnation in exchange for stability. I think that is going to be the pressure that bubbles up from underneath for real change.

Not just in the next recession, but I think we're seeing it right now where there is just a greater push to rethink how we're doing all kinds of things, whether it's the economy – and increasingly it will be fiscal policy.

And that's really where MMT comes in. Because what happens is that older people right now, globally – and there are a lot of them – they're worried about things like their medical care, their pensions, etc. And a lot of these are not in great shape, so they're going to have to get bailed out and that's going to cost a lot of money.

The younger people are worried about the environment.

So you either have a situation where the young people and the old people start fighting over where is the money going to be spent? Is it going to be spent on things that are dynamic and help restructure our corporations and industry to be greener? Or is the money going to be spent on Medicare and Medicaid and plugging holes in pensions?

And the answer historically is, in a fiat currency system, both of those parties will be satisfied because the politicians will choose the path that is least painful. And that's going to be to create more money to go after the funding of a Green New Deal and provide that while also plugging the pension and providing Medicare and Medicaid etc.

So I think that's super-important. And that's why it's highly unlikely that the West follows the same path as Japan.

Erik: I really strongly agree with you on these points. I think that it's very clear that younger generations simply have different priorities, different values. And, hey, they are going to become the dominant force in the economy. So, clearly, at some point, their priorities, whether old folks agree with them or not, are going to become the dominant force.

Is that something that you think happens through a slow grind? Or are there going to be sudden spikes and events where all of a sudden there's kind of a little revolution and it, dammit, there has to be free college or forgiveness of student debt or whatever – and it happens all quickly?

Eric: Oh, I think it happens in bursts and it happens quickly.

Just look at this climate strike. It's stunning. Just go online and Google climate strike in any country you want to choose. What you'll find is you'll find very similar or identical placards – that are handwritten, by the way, they're not mass produced – with similar or identical messages all over the world.

In little island nations in the Pacific, in Indian and Australia, throughout Africa, the US of course, all over the world, you see the same thing.

And how did that happen? It happens through this coordination. I think we really underappreciate how these younger people are mobilizing in ways that we can't – we don't have a framework for it.

So I think some of these changes will happen quickly. And, again, because we're entering this world of the political – politics can change just overnight. Monetary policy historically just hasn't. It's just moved in this kind of steady fashion over decades.

So yeah I think this this change will happen – I think it is happening very quickly. It is happening very quickly.

Erik: Eric, let's tie these high-level views into an outlook for the markets. Obviously there's a lot of change I think that we both agree is coming socially.

How do you relate that to what you see on the horizon in the investable timeframe? Why don't we start with equity markets?

Eric: Equity markets, for starters they seem like they really don't want to go down right now, just in the here and now. I think they've been enormously resilient in the face of a really awful, awful news flow.

And one of the ironies of the negative news flow that we've seen for a long time is that it's provided this almost endless wall of worry that the market has, I think, been able to climb.

I think the markets' reaction function or investors' reaction function in a world where rates are this low and there are so many trillions of dollars of negative yielding bonds is just to look for anything that has yield and continue to be willing to accept less and less liquidity in their investments in exchange for just some type of incremental return.

One of the big sources of generating some type of incremental return has been through selling volatility. And so I think, until there is a real change in market direction here, a lot of those behaviors will continue as they have done. And that, ultimately, is just supportive of markets.

So it's this – I think that we remain in this environment where lower vol is begetting lower vol because it's reinforcing the investment behaviors and patterns that support market stability.

But the changes that we've talked about today, beneath the surface, when markets do finally transition away from this monetary policy dominance towards fiscal dominance, I think once they make that transition, then a lot of the changes that are happening underneath the surface will become quite manifest. And the behaviors that have been rewarded will be punished quite severely.

And I'd say one of the biggest behaviors is this vol selling. It's interesting that, where equity markets – at least in the US – were up generally around all-time highs, implied vol markets, certainly in FX, are down near all-time lows. And rates are at extraordinarily low levels.

So when the transition happens, there is room for a lot of very significant market moves here across asset classes. So I think we'll see some very big trends.

But for the time being, the money is just trying to hide in anything that can provide an incremental return.

Erik: Do you think bond yields have bottomed at (what was it?) 1.40-something on the 10-year? We're now back up to 1.70-something as we're speaking.

Are we seeing the beginnings of a change of trend? Or is this just a correction?

Eric: I don't know. I suspect that we're in a bottoming pattern.

I think that the next real economic crisis will be met with some quite powerful monetary policy in the sense that they're going to go right back at it and try to buy a lot of bonds and do a lot of QE. I don't think that it will lower rates to levels that most people expect, because markets are pretty good at looking out six to nine months.

I think in the next bout of real economic weakness, the markets are going to see that there is going to be a very powerful fiscal response.

So the first response naturally will be monetary, just because you have guys in power who can implement a new round of QE or something like that. But the markets are smarter than just following those guys all the way down. The markets will sniff out major fiscal, MMT, whatever you want to call it. A major fiscal response.

And that should prevent rates from going as low as people are probably expecting in this next round.

I think if politicians are just utterly impotent, then rates have a lot further to go. But I think what we're seeing is that's not really the case. We have politicians that have big plans for big spending and Lord knows, with climate change and Medicare and Medicaid to pay for, there are plenty of places to borrow a lot of money and spend it.

Erik: Coming back to equity markets, it's pretty darn clear that global equity markets are selling off here. But, as you said, the S&P has been extremely resilient. That could be interpreted either of a couple of ways.

You could say, okay, that means the S&P is late to the game, it's time to short the S&P now because it's high and about to follow the other guys down.

Or you could say, no, wait a minute, this is because of some secular driver in the global economy that's attracting capital to the United States and the US is going to continue to substantially outperform over the next several years.

Which way do you see that going?

Eric: The US has a lot of advantages over the rest of the world – in the world that I see unfolding – in the sense that, while our politics may look like they're a real mess, I think we at least have a political construct that can make some decisions around a real fiscal response to the next bout of weakness.

Europe is really handicapped in that respect. I think that their central bankers have really hurt their overall economic structure by lowering rates as deeply as they have into negative territory. When you look at how they're priced, they're priced at basically zero or lower rates out for eight-ish years.

So Europe is in a tough spot. Until the Germans really crack, they're not going to do anything significant on the fiscal side.

The Chinese have all kinds of problems, not that that's a market that people are extremely active in.

Japan wants to become more austere, incredibly. Even if that hasn't worked out for them over the last couple decades, I think they're ready to raise the consumption tax.

So the US, actually, even though we have horrible political headlines in terms of what's happening domestically, I think that we continue to be quite a flexible economy. I think that our equity markets will go down. But I don't think it's completely irrational to have our markets outperforming some of the other ones.

Erik: And where do you see precious metals with everything that we've discussed about the changing generational trends and so forth?

I supposed one argument is that if we're about to have a lot of government spending, probably gold is a really good place to be. And if you really want to take the generational argument a little further, you could say, well, no, gold is out, crypto is in.

How do you see that? What do you think precious metals have in store? And if you have a view on crypto, tell us that as well.

Eric: Precious metals I think will go a lot higher. The thing is, they've had a bit of a move here. And the natural response of people the next bout of economic weakness is that we're going to get a deflation. And so they may come off.

It's a little bit like bond yields. Gold may come off, bonds yields may go down. But gold is not going to go down a very long way, because the next response, really, will be materially inflationary.

So I think that's a very interesting space.

Crypto. That's a longer discussion. That's not a place where we are active. I watch it I think it's extremely interesting. But I just don't think that that's a place to put any significant money for the foreseeable future.

Erik: And finally, Eric, the word on the street is that One River may be gearing up to launch a couple of new funds. What can you tell us about these rumors and what's going on there?

Eric: Thanks, nice to have rumors floating around like that. We currently manage some volatility strategies and systematic trends strategies. We're coming out with a couple more, which I think is very exciting.

We have a relative value vol trading strategy that we have been managing now for over a year. It's done very well.

There are also lots of flows in the vol space that have presented us with some really attractive risk reward opportunities, and we see that continuing. It's a very high-Sharpe strategy which we like.

We are also doing some things in the systematic long-vol space for clients that are looking to hedge some of their negative convexity in their portfolio.

In a world where interest rates are this low there are very few good diversifiers left and we've developed a strategy and have run it now for clients in managed accounts for about four years. And it's performed extremely well.

And then in our trend, we have top-decile trend performer for the past five years and are launching a new trend focused on esoteric markets, alternative markets, things like European power markets and equity sectors.

And I think there are some very interesting opportunities in markets that are not so heavily trafficked.

So we are applying our algorithms to those markets and we've got great backing from some wonderful investors across the board for all these products.

So, yeah, it's a busy Qq4 for us.

Erik: And of course these investments are only available to accredited investors. For the very significant accredited audience that we have, how can our accredited investors reach you if they want to get more information about your funds?

Eric: They can go to our website: oneriveram.com.

Erik: 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.