



MACRO Voices
with hedge fund manager Erik Townsend

Jim Bianco: Deep dive into fixed income

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Erik: Joining me now is [Jim Bianco](#), founder of [Bianco Research](#), which, of course, is a fixed-income institutional advisory firm headquartered in Chicago.

Jim prepared a terrific slide deck for us called “Understanding the Fixed Income Market,” a great deck of slides. I strongly encourage you to download it. Registered users will find the download link in your Research Roundup email. If you’re not yet registered, just go to our home page at [macrovoices.com](#), look for the red button that says [Looking for the Downloads?](#) next to Jim’s picture on the home page.

Jim, I guess the hot topic in fixed income this week is the prognostications of Zoltan Pozsar that (basically between now and the end of the year and probably this week), oh, boy, hang on, here it comes, the big repo dislocation (bigger than September) that could potentially, in Pozsar’s prognostication, force the Fed’s hands and force a full-on QE4.

It seems like a lot of people disagree with that view. What’s your take? And how do we make sense of this? And what should we be paying attention to?

Jim: I’m with him that there is going to need to be a great deal of intervention to keep the repo market calm and medicated. In my slide deck, I’ve got a chart that kind of highlights that as well too. It’s on Page 20.

And it shows that, to date, we have had \$400 billion of support from the Federal Reserve. And we’re probably going to get another \$100 to \$150 billion before the end of the year.

So Zoltan might be wrong that the repo market doesn’t lose its mind. But he was right that they needed to pour in half a trillion dollars to medicate this market into submission.

And the bigger issue is all we seem to be talking about is what’s going to happen through the end of the year. How are we going to get through all of this? How much money is it going to take?

But nowhere in this discussion is The Federal Reserve is the lender of last resort in the repo market. They were never that until the middle of September.

How are they going to get out? What’s the plan to get the repo market back to some sense of normalcy?

And they don't have a plan. Or, if they have one, they have not articulated it – and it's been over three months.

So I'm with him, there is a big problem in the market. I do think, though, that they might be able to just bury it with enough money to get through the end of the year. But that's all they're doing. And then we have to deal with the issues, starting in January, that we have not resolved. And how to fix this thing.

Erik: Now, how should investors be thinking about this? Because it seems to me like the mentality of the last 10 years was basically, okay, we have these quantitative easing things where the Fed conjures a whole bunch of money out of thin air, uses it to buy bonds.

As Ray Dalio has so eloquently described, the sellers of those bonds now have money burning a hole in their pocket. They buy other things, including stocks. It causes all financial assets, particularly the stock market, to go through the roof.

It seems to me like the old normal since 2009 was, okay, when the stock market starts to crash, that's when the Fed comes riding to the rescue and provides more QE.

It seems like people right now are thinking, oh, that's not an issue because the stock market is at all-time highs. There is no fear, there is no concern. There is no problem.

But it seems to me like the repo funding crisis is causing the Fed to freak out just as much as a major correction in the stock market would. So it seems to me like the Fed is kind of running scared but stock market investors aren't getting the memo and aren't getting scared with them.

Am I reading that right? Or how should we think about what this means to markets in general and what it means in terms of what's coming from the Fed in the next year, say?

Jim: You're right that the Fed is running scared because what they don't want to say out loud is they broke it. They're one of the primary reasons that this market is in trouble.

The reason I think that we have this problem is, in the post-crisis era, we looked back and we said repo is a problem. We're going to pile on all these new regulations on the banks to make sure we don't have a 2008 crisis again.

So the Fed instituted liquidity coverage ratio rules, they've instituted high-quality liquid asset rules, there's Basel III rules, there's what's called systemically important banker G-SIB rules. And all of these rules have rendered a tried and true measure that the monitors use to look at excess reserves meaningless.

There's supposedly a trillion dollars of excess reserves in the system, but you can't do anything with that money. And so we've constricted the market that it actually becomes too small. And, oh, don't forget, add in a trillion-dollar deficit that we're continuing to add more and more

Treasury securities. And the repo market is the way we finance that.

So the fix to this problem would be the Fed needs to back off on their rules.

The problem with that fix is Liz Warren came out in October – this was after Steve Mnuchin said, hey, we should back off on the rules to get the banks lending again – and she said, no. Liz Warren, writing a letter to Steve Mnuchin – don't you dare back off on the rules on the banks.

To one time I quipped, the Fed has already got one president mad at them, Donald Trump. Let's start working on the next one (before they even become elected) mad at them, so they're afraid to pull back on the rules.

Sheila Bair is out literally in the last 24 hours saying don't pull back on the rules. Former Fed officials like Alan Blinder are saying don't pull back on the rules.

Okay, if you're not going to pull back on the rules, how are you going to fix this problem then? You are going to be the permanent lender in the repo market over a long period of time. That is not going to be a good thing.

The repo market still has a credit function.

If you call up JP Morgan or Bank of New York Mellon – those are the two primary players in the market, or were the primary players before the Fed came in – and you said, hey, I've got a trillion dollars' or a billion dollars' or a million dollars' worth of Treasuries, here, take them for a guaranteed overnight loan – they're going to stop and ask you why you're going to do that.

Because they do not want to be stuck with the collateral any more than a bank would say, hey, if I'm going to give you a mortgage you're going to sign the house over to me so if you default I'll take the house, no big deal.

We tried that 10-12 years ago. It didn't work out so well. So they do a credit analysis to try and figure out why you want that loan, and they'll restrict you or maybe over-collateralize you or charge you a higher interest rate.

The Fed won't do that. The Fed will just say, here is the posted rate, everybody is a primary dealer no questions asked, just deposit your securities with us, you can get cash.

And in a period of stress, that can become problematic. No less than Jamie Dimon in 2007, famously said about LIBOR –

LIBOR is an unsecured loan, where repo is a secured loan. And during that period, we had some banks that needed to pay premiums to get unsecured loans. But when they reported to the British Bankers' Association the LIBOR numbers, they lied. They just didn't tell the right number.

Because if they did, as Jamie Dimon said, if they told the right number that they were having to pay premiums, there would have been a run on the bank. That would have been a red flag that there is a problem. So lie through your teeth, your bank survives, and three years later you pay a fine and you move on.

Well, that's kind of what I'm worried about if the Fed stays in the repo market. Not that there will be lying, but when people get desperate they'll say put all the Treasury securities at the Fed, get some cash, let's try and dig ourselves out of some kind of a hole.

Where a JP Morgan or a Bank of New York Mellon might sniff that out and say, hold on a minute, the Fed won't. So we don't want them in there for the long term. That's the long-term issue we need to solve.

Shorter term, we've called the repo market the plumbing of the financial system. I like that analogy and I'll use it with your house.

If you list your house and you then say to a prospective buyer, this house has the greatest plumbing (do your Donald Trump), this has the greatest plumbing ever created, you can't charge any extra for your house – because the plumbing is expected to work.

But if you list your house and the plumbing breaks and you've got leaky pipes, it's going to reduce the value of your home.

So the repo market will not cause markets to go up. But if it stays leaky and problematic, it can cause them to go down.

For now, the Fed – to keep with my analogy – the Fed has gotten out the duct tape and they've duct taped all of the leaks. There's no leaks behind the walls for now, but there's bad piping with duct tape on them.

That needs to be addressed. They are not quite sure what to do about it right now. Because if they were, they'd be telling us.

Erik: Now, Zoltan's conclusion, at least as I interpret it, is this basically makes full-on QE4 – buying coupons not bills – a done deal.

And perhaps that's the reason the stock market keeps pushing to new all-time highs is people are saying, hey, we've got a Lehman-sized liquidity problem that's going to cause the Fed to respond with a Lehman-sized reaction with QE. Hurray, the party is on.

Is that's what's going on here? And would you agree with Zoltan that QE4 is a near certainty based on what we have?

Jim: I think it's already started. I think if you look at the definition of QE as Ben Bernanke

gave it to us in 2009, it was the expansion of reserves to buy financial assets.

And central bankers do this all the time. They set up the definition of something and it only works until it's inconvenient. That was the definition of QE. This is a QE. It's a front end on the QE.

Yes, I can see what he's saying that, if we have to keep pushing this, that they might move into short-term coupons as well, too, and start buying short-term coupons. So that could definitely be coming down the pike next as well, too.

And I might add, if you want to look at a famous not-QE example from the past, let's go back to the special facility that the Fed did during Y2K in 1999. That would be, in modern parlance, a not-QE event were they were providing liquidity to the banks to get over the millennium turn.

The Nasdaq went up 50% during that period from October to March. And it was a week after they ended that securities facility, once they got past the year end, that we had the high that lasted for 14 years in the Nasdaq.

So when you start increasing reserves to purchase assets – and in this case it's Treasury bills – that is a QE. I'll agree, it's not as impactful as it would be if you were buying 10-year notes, but it is still a QE.

And I agree with Zoltan that eventually, if they don't show signs of being able to fix this problem and it grows and it grows, they will have to creep out into short-term securities.

So, while repo may not cause markets to go up, the Fed knows they broke this. They know it's their responsibility to fix it. And their solution of more money and just saying it's not QE is going to have – even if you look at the way markets have been trading since October – is having the same effect of a QE program.

Erik: Let's talk about where all of this is headed, Jim. Because Danielle DiMartino Booth and several other guests that we've had on the program have said ultimately we're headed toward negative interest rates in the United States, which seems unthinkable.

But the last round of QE got us down to a zero Fed funds rate and a 1.30 low on the 10-year.

You've got a terrific chart on Page 5 of your slide deck, which I really encourage listeners to look at, showing that this past August – actually the end of August, beginning of September – we peaked out at \$17 trillion of negative-yielding sovereign bonds outstanding globally.

Now, as of this week, hurray, we're down to only \$11 of \$12 trillion of negative-yielding sovereign debt. And of course it makes no logical sense that there could even be negative-yielding bonds.

So where is this all headed? Are we headed toward retracing this correction here and a new high in sovereign debt? And does the United States eventually get there? And what are the consequences for markets?

Jim: Yes, I think that as much as they'll protest at the Fed – and even this week again Kaplan at the Dallas Fed was out saying that he's not sure that negative interest rates work – the Fed will tell you that zero interest rates worked from 2009 to 2015. In their mind it worked.

I think in the next downturn – and that's an important qualifier – in the next downturn, the Fed is destined to at least take interest rates back to zero again, the funds rate back to zero, like they did from '09 to '15.

But this time they're going to do it with a flat curve. So you could wind up with an inverted yield curve. And so, yes, negative interest rates – again with my qualifier, on the next downturn – is a big possibility.

Also remember that central bankers are like doctors. They will never give up on the patient, as much as they'll say at highfalutin presentations to other central bankers there's limits to what we can do. Yes there is. And there's limits to the effectiveness of our tools. Yes there is.

They will never say to the general public, I've done all I can, good luck. They will continue to go deeper and deeper into negative territory, as Christine Lagarde has suggested, because it will show that they're trying to do something.

The Fed will never stop at 0.5% or 1% or zero and say, okay, the economy is doing poorly and we've cut rates but we can't do anything more. They'll keep doing it, even if they know it's ineffective. They have to keep trying at that point. So, yes, I do think that on the next downturn there is a high probability that we wind up with negative interest rates.

Erik: Now, when you say the next downturn, let's qualify that. Are we talking about an economic downturn that's defined by growth? Are we talking about a stock market downturn? Or are we talking about some other kind of downturn?

Jim: That's a good question. It depends on how the Fed wants to view it.

It was a stock market downturn literally a year ago through today when the stock market fell 20% in the fourth quarter that the Fed tried to say it doesn't matter and then panicked by early January and said it did matter.

But, more to the point, to your question, I do think we're talking about an economic downturn at that point.

And a quick word about economic downturns. I'll use Australia as my example.

They're at, what, in year 28 of an economic expansion. They sidestepped the whole global financial crisis. The natural state for an economy is to expand. And they keep expanding.

The reason we have downturns and the reason we have cycles is that we have human nature and something comes along and breaks the economy. Most of the time, it's high oil prices. And, yes, in 2008 we did hit \$147 on WTI crude oil.

So the next downturn will probably come because we break something, whether it's high oil prices or whether it's the stock market declining, or maybe –

One of the things I fear is the breakage might come just from the mal-investment building up over years of too much QE and too much central bank involvement – that when that breaks, that will lead to an immediate response that we have to repair this damage, whatever the damage might be. And that would be that the central bank will drop rates to zero (if not negative) if necessary.

So that's what I mean by the next downturn and how the next downturn will come.

So those that like to look at the data and say, oh, I just looked at all of the industrial production and non-farm payrolls and all of that and I don't see evidence of a downturn, you're never going to see it in that data. That data will be a symptom of it.

It will be an event. It will be just like 2008. We broke the housing market and high oil prices. 2001 – 911. 1990 was the Gulf War. There's always something that broke the economy.

Now, every couple of years we have something that breaks. We had 2016, we had \$26 oil. 2015 we had the Chinese devaluation. And we survive a lot of these breaks.

But somewhere down the line there will be something that will break that will tip the balance of the scale. We don't know what it is.

But when it happens, yes, then the Fed will respond in kind. They are like a doctor, they can never say you're just going to die. Here's some pills to make you comfortable. Now go away. They will try till the very end of time to fix it with whatever tools they have.

Erik: Now, I have my own prediction for the next downturn, by which I mean economic downturn where people are losing their jobs, unemployment is on the rise, the economy is broken.

What I predict will happen is politicians will politicize quantitative easing and they'll say, look, central banks have proven over the last 10 years that you really can conjure money out of thin air without taxing anybody and without causing runaway inflation, and what they did is they gave the money to all of these fat cat rich investors. That's no good.

What we need to do is more QE. But it's helicopter money. It's to fund universal basic income, forgiveness of college debt, and a long list of other socially active programs.

First question is, do you agree that that's a possibility?

But particularly what I'm interested in is, okay, if that were to happen, it seems to me that it could result in a sea change of sentiment in the bond market where all of a sudden bond investors sort of wake up one day and say, hey wait a minute, even if the Fed does do a whole bunch of more QE they're not going to buy bonds on the open market with it. I don't have a buyer of last resort to sell my bonds to. And these things are next-to-nothing-yielding or even negative-yielding in some cases. Oh my God. Panic sell.

So I wonder if there is a big event on the horizon for the bond market. Not today, not tomorrow, but a couple of years into the future, after QE is politicized. Am I just a crazy conspiracy theorist to be thinking these things?

Jim: No you're not. I think that that's exactly right.

Jeremy Corbyn in the UK has called it QE for the people. He coined the term, I believe. And that they're going to look at doing QE.

You know they've talked about – I've heard people talk about the Fed will print money and, instead of buying bonds or buying equities, as Black Rock has suggested that they do in Europe, no they're going to pay for health care or they're going to pay for college or they're going to do a universal basic income or something along those lines.

Now, the good news for you is Andrew Yang. Andrew Yang is running for president of the United States. And, as Saturday Night Live likes to parody him, "Hi, I'm Andrew Yang and I'd like to give everybody a thousand dollars and I can't get above 2% in the polls."

So the good news is the public is not quite there yet, ready for them to start printing money and handing it to them. I know Yang says his program is essentially not printing, but it has the same effect.

But we're not in a downturn yet. So it's still a ways away just yet. But, yes, I do fear that that's what's going to come.

And what you said is – you're exactly right – is that the next downturn comes. Quick, we have to front-run the Fed. Buy bonds because they're going to print the money and then we're going to sell it to them at a higher price. Until you realize, no, they're going to print the money so everybody can go to college for free and everybody can go to the doctor for free and everybody can get a thousand-dollar check.

And you, the bond holder, your phone is not going to ring with an offering from your local

regional bank and the Federal Reserve. And, yes, then we're going to have a reckoning in the bond market that there could be a sell.

That is definitely in the cards. But you're right to say not today, not tomorrow. It's some of the consequences that that event comes with that breaks the economy and a recession. Fortunately, that even hasn't happened for 11 years now and we'll have to see when or if it happens as we move into the new decade.

Erik: What would the consequences be – looking at your chart here on Page 5, let's say we get back up to \$17 to \$20 trillion of negative-yielding debt and all of a sudden people figure out that central banks are not the buyer of last resort anymore.

Does that stuff just go no bid? And, if it does, what are the systemic consequences of that?

Because at that point I guess they've got to keep buying at least some bonds so that governments can continue issuing bonds. Because otherwise they're going to have a major fiscal crisis.

Jim: Right.

Erik: So how would this play out? And what would the consequences be in fixed income markets?

Jim: So you have a downturn and there is a demand to do something about it. And I suspect that on the next downturn, like on the last downturn and like what we've seen in Europe and a lot of other places around the world, you'll probably have some kind of protests and you'll have some people that are upset. And the demand will be to do something.

And what you'll see the negative-yielding debt chart do is plummet to near zero. Because what we'll realize is, no, they're not printing bonds and getting a list of G-SIBs of what securities they want to buy and at what price they want to buy.

They're going to leave them out in the cold and they're going to do QE for the people. At that point, what I fear is going to happen is it's going to test the underpinnings of the post-crisis financial system.

And let me explain what I mean by that, quickly.

There are 13,000 wealth management firms in the United States that employ 440,000 wealth managers and they have 43 million accounts. The collective net worth of those 43 million accounts is 75% of the net worth of the United States.

Why does somebody go to a wealth manager? Because they have money. So let's rule out the millennials. They're not there yet with the money. They've witnessed 2008 and 2000, they

know that the market can go down. And they, correctly, in my mind, view a bear market as time.

If you're 65 years old, and you're of reasonably health and not overweight and don't smoke, check all of those boxes, according to the mortality tables you should live to 86. So that's 21 more years.

But if you're in your 60s, approaching 65 and we have a standard bear market, yes, the market goes down 30% or 40% and it takes 7 to 10 years to recover, it's half your expected life.

You don't want to wait half your expected life to have the market round trip on you. It's fine if you're 35.

So you engage a wealth manager. And the wealth manager says the solution for you is the 60/40 portfolio – 60% equities, 40% bonds. And that's what you've been seeing in the flow statistics and everything else. That, even though the stock market is having a great year, we're going to have record flows into bonds because everything is being driven by the 60/40 portfolio.

When you get to that downturn and you have QE for the people, you have bonds going down, you have stocks going down. You haven't had that in the post-crisis period to any great degree. You had it for maybe a couple of weeks at the end of last year, but only for a couple of weeks.

And what the wealth managers have been saying is, see, the stock market is going up, you're making money. And when the market corrects, see, the bond market is going up and it's offsetting your losses so you're not going to become a pauper in your advanced age. So this strategy is working, working, working.

When you get to QE for the people, everything you own loses you money at that point. And then the reality, the panic sets in. I'm 68 years old. I cannot have a half of my net worth go away because I can't wait 10 years for it to recover.

But right now the assumption everybody has is that the 60/40 portfolio is kind of a seesaw that one side works, then the other side works, and it keeps me moving forward and increasing my net worth. Maybe not 28% like the S&P this year, but going up in the high teens. And I have downside protection whenever things go bad because I've got a 40% leg.

That's out the window if we wind up with this QE-for-the-people scenario on the next downturn.

And then 43 million accounts, the majority of the United States, is going to have to rethink how they've invested their money in the post-crisis era. And they'll have to do it at the worst time to do it, right in the middle of another crisis.

And I know what they'll do. They'll call up and say, how do I make money? And the answer they don't want to hear is you can't, because you could buy stocks and lose money or you could buy bonds and you could lose a little bit less money, but you're going to lose money anyway. That's not happened to them in a long time and I don't think they'd be ready for it.

Erik: When I think about fixed-income markets in general, one of the things that's been perplexing me for years – and talk about being early on something – clearly, shorting junk bonds hasn't worked yet and a lot of people have lost a lot of money being too early to that trade.

But we're actually in this environment where the last 10 years of easy money policy has resulted in so much low-quality credit, low-quality corporate credit, both junk-rated as well as triple-B rated credits.

And a lot of people have written about that overloading of triple-B credits that at some point, if there is an economic downturn and that has to get downgraded, all of a sudden it becomes junk. And institutions that are by mandate forced to sell it cause an absolute dump of the market.

And it sounds so good. It sounded so good for years to, oh boy, I'm just going to back up the leverage truck and I'm going to short all of the junk and triple-B rated credit that I possibly can.

Well, Jim, I'm looking at my screen here of JNK and HYG, the two junk bond ETFs. I'm not sure if these are all-time highs, but it looks like highs on my chart at least. It seems like this just never ends.

Is it not until we get out of the QE that is about bond buying as opposed to QE-for-the-people regime that anything changes. Or, I know in Europe they actually have negative-yielding junk bonds. This is crazy. But anybody who's tried to short it has gotten burned.

What do you make of this? And how should we think about it? And when does that trade eventually have its day in the sun?

Jim: Part of my answer is what you just said. JNK and HYG. The stage-three high-yield ETF is JNK and HYG is the Black Rock high-yield ETF. Those two instruments alone are probably a third to half of the trading in the junk-bond market. 33% to 50%.

No other market – if you look at biotech stocks and the biotech ETFs, or if you look at SPDRs to the overall market or gold to GLD, no other market is remotely close to those type of percentages. The investment grade might be next and it's still less than 10%.

So what I'm saying here is that the buyer on the margin does not pick credit. They plow their money into these ETFs. They think that they've found some magic spinner that can turn straw into gold because the high yield market is somewhat illiquid.

But I could day trade it through JNK and HYG. The flows are driving these markets, especially at the investment grade level. And that is what is going into being the big buyer on the margin.

This is part of the broader mosaic that we've seen in markets, that people have been moving away from active management to passive management. And they're doing this now with this reach for yield. So there is your buyer that just keeps these markets relentlessly going.

And one other little nuance that people that don't trade in the high yield market might not be aware of, that you can do an exchange on these if you are a professional investor. What do I mean by that?

You are a professional investor and you are tasked with buying \$100 million of high-yield bonds. Go ahead and call up Goldman Sachs and go ahead and call up JP Morgan and smash the phone down on your desk and realize that these things trade by appointment and it's very hard to get these prices.

And then here comes Black Rock. And Black Rock says, with one jiggle of the mouse you can buy \$100 million worth of HYG. Then you could come to us and we'll take bonds out of our portfolio – and here's the important part – that is representative of the index. So we won't skew it, but we'll make it representative of the index. And then we'll exchange it. So we'll exchange it for what you want in terms of bonds for our ETF.

Now, you could give them some rules. I need energy in the appropriate weighting – 18% is the weighting but I don't want Petrobras. Okay, fine, we'll give you 18% energy but we won't give you Petrobras. But as long as you go with minor rules like that –

And a lot more of the trading is going on this way. And a lot more people are going on that way. And don't forget those 43 million people engaged with wealth managers. And the wealth manager says it's a 60/40 portfolio and we're going to reach for yield on that 40 and we're going to put you in a corporate bond ETF or a high-yield ETF.

That's your relentless buyer. They're not discriminating about credit as much as you'd think they should be.

The next downturn, when both stocks and bonds go and that strategy doesn't work, they'll run away from this. And you said it right. The next downturn is when that triple-B stack starts falling down into high-yield at exactly the moment you wind up losing your biggest buyer.

So what I think people need to come to understand is that the high-yield market is fundamentally changed because of JNK and HYG.

And, by the way, they're not stopping there. They're trying to do this with frontier markets. Oh, it's really hard to buy Gabon and it's really hard to buy Nigeria. So, here, buy the Black Rock

frontier market ETF and then we can talk about an exchange later on.

And there you go. You can buy these stocks and you don't have to get all frustrated trying to find a broker that's going to trade it to you. Now that's in its infancy, but it's coming.

So this is the way that they've started to trade this market and this is where this relentless bid comes for high yield and a lot of other things. And it won't probably end until the cycle ends.

I'm not sure it will lead the cycle, because I think it's going to have to end when the outflows start to ensue out of the 40% leg. And I don't see that happening any time soon.

Erik: Jim, it's absolutely fascinating to me to learn that (I think you said) as much as 50% of junk bonds are traded through those two ETFs, JNK and HYG. The question that that brings to mind is, okay, who are the holders of those ETF shares?

Because if we're talking about institutional holder who, at least in theory, don't panic as quickly as retail does in a crisis, that's one thing. If we're talking about this has become a retail phenomenon because a whole bunch of retail guys who don't understand what they're buying are reaching for yield, that says ticking time bomb to me.

So do we know what the composition is of holders of those shares?

Jim: We have some ideas. About \$8 to \$9 billion a day of paramount trades of high-yield securities. And probably \$3 to \$4 [billion] is tied up with the ETF trade. So that's where you get that 33% to 50%. Those are the absolute numbers.

Most of the ETF holders are retail. Because, as I said, with that exchange thing, if you are a large money manager, you might purchase a lot of HYG and then you exchange it for the underlying bonds because you want to hold those underlying bonds. Because, like I said, you call Black Rock and they'll take the ETF from you and they'll give you the underlying securities.

So, roughly speaking – it's hard to give estimates, but the estimates I've seen from etf.com is maybe upwards of two-thirds of all ETFs (I'm not talking about high-yield now, but all EFTs) – are held in retail accounts, most of those accounts directed by a wealth manager. So that's who's holding them.

You're right, what is it that they own? It's part of the mosaic of their 40% leg. And it's there because they want to show a little extra yield so when they get that capital distribution or that dividend at the end of the year they get a little bit more yield. That's where it is.

So you're right, it is in that leg right now.

And so what it's going to take for people to be shaken of that confidence is they've got to be shaken of the confidence of the entire 60/40 portfolio. Then they're going to have to rethink all

of that.

And, like I said, that happens when both stocks and bonds go down together, something they haven't done for at least 15 or 18 years. You'd have to go back pre-crisis to see the last meaningful time that they've done that as well.

And that could happen, as we talked about earlier, on the next downturn if the QE is not buying financial assets but it's basically going to the people. And then we'd wind up realizing what we're owning. And so, yes, the structure of a lot of these markets is changing a lot. Because of the move towards passive investing as well too.

Erik: Okay, Jim. Hold on. Let me see if I've got this straight. What you're telling me here is who holds these junk-rated securities, these securities whose price behavior is much closer to equities than other fixed income instruments, who holds it is retail investors who have it in the portion of their portfolio that's designed to be the safe part, the part that's designed to be their hedge against something going wrong in the stock market.

That sounds like a recipe for abject disaster.

At some point, you get the downturn, stock market and bond market both moving down at the same time exactly as you said, something that, among other things, triggers a necessary unwind of a lot of institutional trades in the risk-parity space. And that exacerbates it.

And now you've got the guy who the portion of his 60/40 retail investor portfolio that was supposed to be the safe part to hedge the risk part on the equity market is going down faster than the equity market.

What could be a better setup for people to panic-sell everything and cause an outright crash of both fixed income and equity markets at the same time?

Jim: Yes, that's right. It can be. But let's define this a little bit more.

In your 40% leg, maybe 10% (or one quarter of that 40% leg) is probably in something that is a reach for yield. The rest of it is in some kind of a broader-based investment-grade type of ETF to mimic the broader bond market, of which a big portion of that would be government securities, either sovereigns from other countries as well, too.

Now, some people might hear me say that and go, wait a minute, isn't there like a trillion dollars of these securities outstanding? And isn't there like \$20-ish billion of the ETF JNK and HYG.

Yes, and there's also about 40 other ETFs that trade in that space. But keep in mind that only \$9 billion a day of that trillion outstanding trade – so 98% of it – never trades. The majority of the stuff that trades every day can be found in the securities that back up these ETFs. The high-yield

ETFs as well, too.

And we've even heard stories that some of the high-yield ETF issuers will even go as far as saying, when it comes to how illiquid these markets are, that there is no such thing as a discount or a premium when it comes to high yield.

And what I mean by that is that you might – if you have like a Bloomberg financial markets, you can go and get an intraday NAV for HYG and it will tell you to the second all the bonds that are in that portfolio, what it's worth. And then you can see what the price of the ETF is worth and you can calculate the difference between the two.

And then you can see – and in normal times we would say the ETF is being mispriced – but when it comes to the high-yield market, we say, no, the high-yield market is being mispriced. If the ETF moves, everybody reprices all those illiquid securities to the ETF is the way that it works.

So, even though these are small, they have an enormous influence on this market. They set the marginal price in this market. And, as long as there is not a panic out, that we will see them continue.

Now, the Black Rocks of the world will say, look, these have been battle tested. We had energy prices go from \$107 to \$26 in 2015 and '16. We've had the fourth quarter of last year. We've had a lot of other things – the US losing its triple-A rating in 2011. These securities, this scheme made it through these intact.

And the answer I would give you is, yes, because the 60/40 portfolio made it through all of those intact. What we haven't tested is a scheme like the '80s or the '70s when you had higher inflation and you had both bond prices and stock prices go down together. That we have not had in the post-crisis period.

So you're right, this can be a problem if we get to that point. Now, like I said, we've been waiting for this point for 11 years. It might be next week, it might be like we're going to be Australia and it might be 18 more years.

But at some point, if we ever get to the stress point where the public demands action – and action means don't print money to buy bonds, print money to make me go to college for free – then we could possibly see this happen where both stocks and bonds go down. And that being the problem in the high-yield market surfacing will be one of the many problems that we will see come to life at that point.

Erik: It seems to me that it creates a perfect storm scenario, really, for the entire fixed-income complex, which is you've got both equities and fixed income going down at the same time.

First of all, there's a whole generation of professional investors who believe incorrectly that that's impossible. And it starts to happen. And that's causing –

Jim: Erik, we created the entire modern wealth modern business based on the idea that stocks and bonds can't both go down together at the same time. Now 43 million accounts and those 440,000 wealth managers are in existence because they believe that doesn't happen.

So, yes, you're right. I think that's the underlying pinning of the bull market since 2009, this idea of the 60/40 portfolio to keep people that were burned twice in 2000 and 2008 at least somewhat engaged in the stock market and then somewhat engaged in the stock market via corporates and high yields as well too. So you knock that underpinning out and it will be a big shock to a lot of people when and if that occurs.

Erik: So, on the private wealth side, the private wealth management side, you've got a whole industry of people who think that this is impossible. And clearly that has to mean that they don't know what to do when it starts to happen. And you and I both agree it's going to start to happen.

On the other hand, on the institutional side, you've got the whole risk-parity business, which Ray Dalio was probably the grandfather of. That is one of the biggest trends in institutional finance.

And, for them, they're very mechanical about the way they do things. Nobody has to panic. All they do is follow their rules. And as soon as that correlation to equities, the inverse correlation breaks down, they have to close their positions. The whole industry full of risk-parity trades has to close their positions.

It seems to me that it creates this perfect storm of self-reinforcing crisis situation. And I don't want anybody listening to think that I'm predicting this any time soon. None of this happens until you get an economic downturn that forces stocks and bonds to start selling off at the same time.

I think probably the catalyst for it is QE for the people. When the markets realize, hey, wait a minute, the money conjured out of thin air by governments is not going into financial markets anymore. It's going someplace else. That seems to me like it could be the catalyst for a major, major perfect storm event.

Am I missing anything there?

Jim: No, it can be. And I'll point listeners to Slide 7 in my chart book. Total population over the age of 65. This is the 20 developed countries of the world.

There is currently 308 million aged 65 or older. Every day for the next 16 years we're going to create 8,000 new people over the age of 65 so that, by the year 2030, we're going to have not

308 million but nearly 350 million people aged 65 or older.

As they age, what is the thing that they will be looking to do with their money? Protect it. The need for moving towards some kind of 60/40 or maybe 50/50 if you get into your 70s, the portfolio is only going to grow. This is going to get bigger and bigger.

And this is one of the reasons why I've argued – going back to my chart about negative interest rates – that there is this relentless bid for bonds that has driven interest rates so low that we have \$11 trillion dollars (we used to have \$17 trillion) of negative debt – is that we have this need on the 40% leg.

And we have 300 million people (on our way to 350 million in the next couple of years) that want to make sure that on the next downturn they don't lose half their money. And so there is this relentless bid.

Now, Wall Street – let me back up even before that. Ben Bernanke coined the term “global savings glut.” And he saw this (correctly) coming in 2005. Wall Street saw this coming and created a bunch of securities revolving around subprime, going to the credit-rating agencies and getting a triple-A and selling it to the Swedish pension funds. And that all ended in disaster.

So, today, you've still got 65-year-olds. They still want protection. They're not going to buy a structured product that has a big fat yield, except maybe if you want to call an ETF a structured product. But it gives the illusion of liquidity because it's on a screen and it flashes on the screen that the prices move all the time, so it gives that illusion of liquidity.

I say illusion because liquidity is always abundant when you don't need it. It always disappears at the exact moment you need it. That's the paradox of liquidity.

So what I'm leading up to is that, as we progress down this pike – you know, go to year 12 of the expansion and year 13 of the expansion – the amount of people that are going to get older and demand a 60/40 portfolio or demand some kind of a lower-risk alternative is going to grow.

That bid on the 40% leg that has been, I think, a primary driver of pushing yields down is going to continue and continue until it breaks. And then it reverses.

So, in the absence of nothing happening, we continue to move towards even more of this, even more people wanting to own bonds, even more of a bid for bonds. Even in a year when stocks are up 28%, we still get another big bid for bonds.

The EFPR saying, what, \$250 billion is going to be going into bond funds this year, which is going to be a yearly record in a year that the stock market is up 28%.

And one of the reasons why that's happening is I don't need to buy stocks because they keep appreciating and they keep the 60% leg going. Any new money I have, I have to put it into the

bond market so that that keeps the 40 going. Because if I don't, I wind up being 70/30 if I don't keep rebalancing.

So that's why these strong stock markets actually create these giant bids for the bond market and you wind up pushing these yields lower. So the year that the stock market went up 28%, the year that the European stock market, which this week made new all-time highs, is also the year that you wind up with \$17 trillion worth of negative-yielding debt, because you've put together a giant bid for them at the same time.

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

But, before I let you go, I know you're a regular listener to the show, so you know the routine here. Please tell our listeners where they can learn more about what you do at Bianco Research. What's your Twitter handle? And how can they follow your work?

Jim: We provide research to the institutional investor, but it is available to a lot of other people.

I am very active on Twitter: [@biancoresearch](https://twitter.com/biancoresearch).

Our B.R. website is appropriately named biancoresearch.com. There's some free trials. On both my profile and on our website, you can request a free trial to take a look at our research, see what we have to offer. Or follow me on Twitter. I usually talk tangentially about a lot of those same issues there as well.

Erik: Patrick Ceresna and I will be back as MacroVoices continues, right here at macrovoices.com.