# Axel Merk: Market outlook for the coming Coronavirus

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***Erik***: Joining me now is Axel Merk, founder of Merk Investments. Axel, it's great to get you back on the show. It's been way too long. I'm really looking forward to this interview.

Let's start with the high-level big picture of what's going on – both the stock market coming off of its all-time highs, new all-time lows in bond yields.

Is this all about the coronavirus crisis? Or is the coronavirus just a catalyst that brought something else about?

***Axel***: Great to be with you. In this industry we always love to give a story to the action and, by all means, let's fit that story, right?

Clearly, we've had a many-year bull market, stocks were at an all-time high – that may have been due for a correction according to many. And sure enough, we got a shock. And it helped us. And so, ultimately, does it really matter?

One of the things, if you've been around the block a few times now, is that there is a storyline that starts these things. And then these stories evolve. Remember in 2000 for example (or whenever you've had a crisis or a bear market coming), it starts somewhere. But then suddenly there are ripple effects that you don't foresee.

And the challenge with focusing on one item is that then, precisely, you forget the big picture, that maybe stocks are expensive. Maybe this happens or that happens.

Now does that mean I have a crystal ball what's going to happen tomorrow? Absolutely not. I don't think anybody has. What we can do is risk management and pursue the plan that we have.

***Erik***: And what do you think about the current valuations on the stock market. What we're seeing as we're recording on Tuesday afternoon, haven't quite retested the lows from the last couple of days, we're about 27.50 on the S&P right now.

Are the lows in? Or is this just the beginning? How do you see this playing out from here?

***Axel***: Well, forecasts are difficult when they deal with the future. What we do know is that volatility in recent days has been extreme. Historically, that's been an indicator that we're

trying to find the bottom.

We know that the earnings yield in the S&P 500, or the cash flow yield, is high. Now, earnings may be coming down because of the shock we have. And aside from corona, obviously, the oil surprise we've had there.

But even if cash flow is cut in half relative to the yields in Treasuries, stocks are attractive.

Now, as we also know, stocks tend to overreact, on the upside and on the downside. So I am not going to be there trying to catch a falling knife, if that's what it is.

That said, as I indicated just before, it's about sticking to a strategy. And most people don't.

So if your strategy is – let's say you have a 60/40 portfolio. Well, what you ought to have done on the way up is gradually take some chips off the table and move it to the (quote, unquote) safer bucket. (And we can talk about that safety bucket, how it's not safe anymore.)

But still, there is a strategy.

And so similarly then, as the market tumbles, you might want to rebalance back in whether there is a low or not, just so that you have this consistent layout.

What has happened in practice is investors have wanted to have their cake and eat it. So they don't want to take gains. Maybe that's because they don't want to pay the taxes on the gains.

But, instead, the way they have their cake and eat it, they're adding this tiny component to a portfolio that is super-volatile but diversified – I'm thinking about gold, gold mining type of thing – and that's certainly not safe. But they think that's how they can get diversification.

If people were already spooked, they would be moving to cash.

And so we've seen, obviously, some of that in recent days. But a lot of the action we've had in this extreme volatility has been a deleveraging of leveraged plates which obviously happens after a period of extended low volatility. People gear up and then it blows up in their faces.

***Erik***: Axel, you're known as a currency expert, among other things. Quite a few people, myself included, held a view about the US dollar and this coronavirus crisis. We felt that, hey, this thing is going to affect the whole world, and it seems like it's going to affect the United States last. It's got to be super-bullish for the US dollar as safety trades go out of other assets and into US dollar denominated assets.

Market says we got it dead wrong. And I'll be the first to admit I don't understand why.

What the heck is going on that all of this is so dollar-negative?

***Axel***: Well, market teaches us to be humble. Whatever prevailing view we may have on just about anything, we are proven wrong. And it could be technicals. It could be fundamentals.

But let's keep in mind that the dollar is a high-yielding currency these days. It's the highest-yielding G-10 currency. As of a few weeks ago, the real yields, based on the breaking rates, the 10-year rates, are negative. That's unusual for the dollar.

But still the dollar is a high-yielding currency. And so when you have a risk-off environment, the high-yielding currency gets sold and the funding currency gets bought. Historically, that was only the yen. Maybe the Swiss franc. These days, it's the euro as well.

And if you talk about the dollar, it's usually the dollar index. And the dollar index has a heavy overweight of the euro. And the euro was hated by everybody going into this virus. So, sure enough, people took down leverage, which means they had to buy the euro, sell the dollar.

And usually when you have these crunches, it kind of goes that everybody needs to get their funding in US dollars and so forth. But this time around, that's how it played out. And if you want to have a story, that's the story that explains why it is.

But, obviously, as we talk on this specific day, it's the other way around. So all these things, they work for a while and then there is again a storyline that will take over.

***Erik***: Let's move on to Treasury yields. Because this is another area where – I guess it's one that I got right. But I've been amazed at how right. It doesn't really jibe with my expectations.

I think it was three weeks ago I told our audience I think we're going below that record low from 2016 of 1.34 on the 10-year yield. And everybody thought I was crazy. We got lots of emails from listeners saying, that's nuts.

A week later, we were there. I said I think we're going sub-1%. A week later, we were at 92 basis points. That was last week.

I said I think we're going to 50 basis points before this coronavirus situation is over. I didn't think it was going to happen in less than a week. And, boy, what did we get down to? 27 bips or something? I mean, just crazy.

So first question is, why is the yield on Treasuries crashing so hard when the stock market – I mean, yes, it's down. And it was a very significant day on Monday this week.

But nothing, in my mind, compared to what's going on with Treasury yields. Why so much action there? And can it continue?

***Axel***: Well, many questions in there, several that you didn't ask. One is the speed. I think the

hallmark of this correction, if you want to call it such, is the speed.

Markets have been functioning properly. There have been no big gaps other than there were some very quiet Asian hours. These markets have been working well – and we can talk about the functioning of the market as well.

And, yes, the bond market has been screaming. But the equity market has held up reasonably well, except for Monday, the 9th of March, where we've had this amazing plunge. We talk about these crocodile jaws where you have these correlation charts and suddenly they diverge and then they snap back together.

And so you can have these dislocations or these anomalies in the markets for an extended period. But then they have to meet somehow. And, obviously – I mean, the reason why Treasuries rally is because there is a flight to safety.

And when you have a flight to safety, you go to the one that's most liquid. And so that tends to be Treasuries. That also happens to be the yen.

When you need to have (quote, unquote) safety immediately – and I'm not making an endorsement of anything safe here – the yen is something that's liquid, so people pile into it. And the yen was up over 3% on Monday the 9th.

And so those sort of things can happen. And, yes, in my view that is extreme.

Now, at the same time, you can also say, hey, maybe that's the new normal. Maybe that is how I am going to be. Maybe we're going to be living in a world where we all are working remotely and are never going to consume anything anymore – we can talk about that. I happen to disagree on that.

But the market seems to be taking the most recent views as the most important one.

And as I mentioned, is it all the coronavirus? Maybe we price in a different type of government in the US that's not as business friendly.

There are all kinds of things that the market might be pricing in going forward that, when the glass is half empty, well, darn it, it is half empty. And obviously, you can be at the other side of that trade and see an opportunity.

More broadly speaking, though – and if I can make that broader point – with yields as low – and Monday the 9th is probably going to prove me wrong on that – can bonds really provide that sort of diversification that you want them to do?

People buy bonds rarely because they love them but because in that 60/40 portfolio, that 40 bucket is providing them that sort of diversification.

A journal several weeks ago kind of had an analysis that in the Eurozone, bonds don't rally as much anymore in risk-off environments. Now, Monday, they rallied again. But, still, can you still get the sort of diversification you used to get in bonds?

I think that is the sort of thing investors should chew on. How the hell do you diversify going forward?

Because, ultimately, you – of course, you can have a crystal ball and know what's going to happen. But, if not, you want to have some safeguards in your portfolio. And are the traditional safeguards still working?

***Erik***: Let's talk about the zero-bound on Treasury yields and whether it really is a magic line in the sand.

There's a lot of people who have made the argument that, because the US dollar is still the world's global reserve currency, it's impossible for the US 10-year to actually trade at negative yields. I have to note that the exact same people said the same thing about the German bund a couple of years ago – and were wrong.

But let's discuss. Is there a magic number at zero? Or is it just a step along the way as we see potentially a move into negative yields for the US Treasury Bonds?

***Axel***: Well, the financial crisis and the years since have taught us to be humble. That policy can make us come up with the craziest of ideas. And so on the 10-year, I would say absolutely not, there is no magic line.

The question to me is more is there a magic line on the short end? Can the Fed funds rate be negative?

In the Eurozone, we have negative rates, as an example. And I don't think they're terribly happy with it. I have a hard time imagining that we'll go negative in the US, simply because of the structure of the market.

Just think about money market funds. They would yield negative returns for retail investors. In Europe, the negative rates are felt by institutions, but not by retail. That's a big, big leap to take.

And, as you know, the Swedes (for example), they got rid of the negative rates. They said STUPID. They didn't use those words, but that's effectively – it doesn't work.

And so the sort of chatter I hear right now, it first started in Europe. I heard it as we speak this morning in the US on the major news channels is that, well, why not ease the capital standards of the banks? And so get rid of some of these very tight standards in this environment to make

sure that money flows to the small- and medium-sized enterprises.

So in the sort of environment we're in, I would think those sorts of policies would be more effective as fiscal policy. But if you want to do something on the monetary side, easing the standards for the banks in a way that they can provide more money to where it's needed is going to be more effective than cutting rates.

But the question, can the 10-year be negative? I would think absolutely it can.

***Erik***: So, with that in mind, would you say at this point in the crisis – I think that the coronavirus situation, unfortunately, we're really only looking at the beginning of the crisis.

Europe is just starting to really hit the inflection point in that exponential growth curve. Italy's hospital systems are completely overwhelmed already. But, really, it's only Italy. I think the same is coming for the rest of Europe and then ultimately for the United States.

And some people have estimated that by the second week of May every hospital bed in the United States will be overbooked and there will be a necessity of triage to turn away some people that need hospital care. And I think that could occur globally.

So, with those kinds of things – I guess the first question let's start with is do you agree that those kinds of risks are on the table?

***Axel***: Before I answer that, let me do one more comment on the 10-year. Negative yields on the 10-year means that people would rather give money to a government than invest in any other project.

And, to me, that is not necessarily a monetary phenomenon. It's a regulatory phenomenon. It's a phenomenon where people just don't see possibilities to invest in something. And that's very, very odd to me. And I don't think a virus can even stop that.

If you have a well-functioning economy – and I would be the first to say Europe has lots of problems. In the US, that shouldn't be the case.

You shouldn't be able to have a yield curve where the 10-years are negative. So it shouldn't be possible. But, obviously, in times of panic and so forth, it can.

Now, yes, the health-care system being overwhelmed. Absolutely, that's possible. There are stories coming out of Italy that hospitals have revamped. Every single patient has the same diagnosis. Everything else is put on the sideline and there are lots of challenges.

Now, that said, the Chinese say they have gotten things under control. We, obviously, always have to take these things with a grain of salt.

I like to look at the South Korean data. The South Koreans appears to have been the most meticulous and they have more trustworthy data. The South Koreans have drive-thru tests these days. And so there you can get a hunch of mortality rates and whatnot.

But, put differently, if people are still around – some people might go bankrupt in this environment. Let's say in fracking. Oil prices plunge and suddenly you can't sell anything anymore. You might go out of business.

But that means the debtholders will take over the equipment and they can operate it. And if the marginal cost is higher than the cost of running this thing, or if it's too expensive to shut it down, we'll continue to keep this running.

Similarly, if you sit at home and save the money on fuel – you save money on fuel because you spend less – you will have higher savings. And you can spend that elsewhere. And eventually people will do it.

The question to me is what will happen in the interim period as we transition to this sort of environment? Will systems be overwhelmed in the interim? Absolutely, that's very likely.

And so certain sectors of the economy will be affected. I actually travelled the last two weeks a little bit. I was in Europe as well. And, depending on the folks I was with, they have a very different attitude towards the coronavirus. And, obviously, people are complacent about it until it hits them.

But can this induce a severe slowdown? Absolutely.

There is a saying that the markets will recover when the policy makers panic. Or the markets will stop panicking when the policy makers start panicking.

And that's part of the reason, as we talk about this rumor, we'll have a fiscal response in the US. And, not too surprisingly, it's going to take a little while to get that in shape.

So if we have the sort of leadership that gets people confident that we can get the grip of that, then we can go back to life as normal – or the new normal.

So we've had a dramatic correction in the market. Is it enough? Or will we go down another 20-30-40%? I don't know. I don't think anybody knows.

But it's the role of policy makers to help instill confidence. And I think that, while they'll all be critical of the response, over time they'll get a better handle of it. Just as they did in China. In the beginning, very critical. And now, Xi just went to work to show that everything is in order.

Obviously, we don't know whether it is, but it's those sorts of things that will help to regain the confidence of people.

***Erik***: I want to pick up on something you said a minute ago. And this relates to what some of our other guests like Jeff Snider have said on MacroVoices, which is we've gotten to the point in this zero-yield environment where US Treasury Bonds are no longer a sensible investment. They are a very important balance sheet management tool for institutions. But for an individual, if it's paying zero, it doesn't really make sense to have it in your portfolio.

What most of the retail universe has done is they've shifted. Where they used to have a 60/40 portfolio with Treasury Bonds, now they have it with high-yield bonds. And this is just my personal opinion, I think most of them don't understand that there is a reason this stuff is called junk bonds.

A lot of people, myself included, have made the mistake of being early to short high-yield. And, of course, that's a negative-carry trade. And it was painful to be early to that.

Is it finally time to short high yield? And what could go wrong here?

***Axel***: Well, you said it. The negative carry can go wrong.

That's the challenge with shorting in general. Most shorts are negative carry. And so you've got to get the timing right. I mean, that's the gist of that. You just have a battle against time. And so you better be darned good or darned lucky to be able to short.

That's why, for most people, cash is the more prudent diversifier. Unless you do some long-short strategy where you can mitigate the impact of the short by having a systematic or some other sort of strategy that allows you to kind of balance that.

We do, of course, have the Bailout-in-Chief, the Fed, that makes these high-yielding things appear safer.

And, until a few weeks ago, I was one of the few ones that was cautioning about an overheating economy. Now, you can throw all the egg in my face that you want to, but the challenge we have is – or had, until recently – we had near full employment, tight labor market. And we have had accommodative monetary policy – even now, you could argue – for providing a stimulus on top of that.

What happens if the bad-case scenarios don't unfold?

And at some point, if we are at the tail end of this – I don't know whether that's in three months. More likely it's six to nine months. Or is it in a year or 18 months? Or maybe the world is falling apart.

But let's assume that people in the high-skill industry may not be laying off people because they might be afraid of [not] getting them back. And so the economy might be chunking along.

So then, let's say you have an overheating economy – and obviously, that's not the concern of the day – but how do you deal with that? Because then the Fed does have to hike rates.

And when you do that – and the reason I mention it is the context – what do you then with the high-yielding stuff? What do you do with the companies that are at that brink? You cannot hike rates without toppling them over. So the Fed put, so to speak, has locked them in.

And so I actually think a hot economy is a much bigger risk these days. If you have a plunging economy, we know what the Fed does. They can pretty much guarantee everything that's out there. And all the zombie enterprises can continue living happily ever after.

And, of course, the flip side of that is the investors are piling in on that stuff.

Now what they may have realized is, yeah, high-yield stuff is highly correlated with risk assets. Now we've had spreads widen in the high-yield space.

But, because the yields on the safe stuff have come down so much, the overall borrowing cost actually hasn't gone up that much. Now, I'm not suggesting that people were able to issue a lot of debt at the peak now of some of these tumultuous days. But the overall yields, while they have gone higher, we are nothing yet as far as kind of a system that might be seizing up.

And already are we trying – oh, we need to bail out the airlines. We need to provide help here and there.

So, as a reminder, we have an election year. So it's in the administration's interest to keep the economy rolling. And maybe by the time this broadcasts, we know more. But odds are we will have this trickle effect of having one help announcement after the other to try to buffer the down-turning economy.

Now, I'm not suggesting that's necessarily going to be able to keep the markets up if the forces are bigger. But policy makers are very willing to dole out bailouts I think. And the only kind of pushback against that is it's an election year and so compressional things may come late.

But things like easing capital requirements of the banks, I think that's something that's well within the cards of how the executive might be reacting to the environment we are in.

***Erik***: Just as you were speaking – and this is Tuesday that we're recording this – I saw a headline go by that President Trump has indicated a willingness to provide a Federal bailout to shale oil producers. That's an interesting one. And it certainly speaks to what you're saying. That governments are going to be very open to bailouts.

As you said, it's an election year –

***Axel***: But – let's talk about this. This is completely useless. The shale producer is a marginal producer. They tend to be smaller guys. They tend to have higher costs.

The last time we – a few years ago at Thanksgiving, OPEC decided to pump more oil, prices plunged. And we currently are producing, I think, about 13 million barrels per day. The US is the largest oil producer in the world.

Does it matter if it dips down a little bit? Saudi Arabia is jumping in. Does it really matter if some of them go out of business? Those rigs will be there. The folks who own the debt can take it over and continue operating that stuff.

But if we do these bailouts, we are further eroding the discipline of capitalism. I mean, who on earth should be surprised that people are storming to Bernie Sanders and saying capitalism is rigged? I can't blame those guys. Because does it really hurt so much to change that?

And it's – I have more sympathy for that if it's something that's in the national security of the country. You might not be able to save an airline. But even an airline can go into Chapter 11. They can continue operating. You can wipe out the shareholders and save the operation of the airline.

So I think it's a dangerous road we've been on in the last 10 years on these perma-bailouts. And I don't think it's healthy for society as a whole, because we are promoting it, aside from the fact that we were complaining about the low-growth environment we had for many years after the financial crisis.

That's because we kept the zombie enterprises alive. And guess what. They are not as protective as if we had reinvested our capital into new businesses.

***Erik***: Let's talk a little bit more about how this could progress. Because, although most political experts have opined – at least in the past they thought it would be very, very difficult for Bernie Sanders to win the presidency because to get Americans to abandon capitalism and vote for a guy who openly embraces socialism seems like too tough of a pill to swallow.

Now the way I look at this is, okay, hang on. That was then. I think what's going to happen between now and election time in the United States is it's very, very likely that the United States will go through what Italy is going through right now. Suddenly, the guy that wants to give away health care to everybody for free sounds pretty darned good to most people.

You and I might agree that government-controlled health care would probably do less to keep Americans safe. But most people are not going to see it that way.

I think that this coronavirus crisis really creates a very significant opportunity for Bernie Sanders to actually take the presidency, something I would have though impossible before this occurred.

Do you think that that is plausible? And, if so, what would it mean for capital markets?

***Axel***: I guess I'll give you the same response as to the 10-year yield going negative. Is it likely? No. Is it possible? Yes.

And a few years ago we would have thought it's impossible for Donald Trump to become president. And then he won the nomination. He became president.

And so would I say it's impossible for Bernie Sanders to become the Democratic nominee? Well, is it really impossible? No, of course not.

Now if you look at the current trend, at the prediction market, they now fully bet on Biden. And, to me, that's the more plausible scenario.

Is it impossible? No.

What we do know is that, yes, as the coronavirus has escalated, the prediction markets – and I'm talking about the betting markets – have given a decreasing chance of Trump being reelected. The odds were above 50%, in the high 50s, and now he's pretty much tying with Biden as the next president.

Now, mind you, these betting markets are most volatile and so they can change on a dime.

But still, as you point out, if or when this crisis worsens – the health crisis, I'm referring to – then it really depends on the leadership that we're seeing. And if it's conceived not to be good, that can slow down the economy. But, obviously, that can also reduce the election odds.

And, yes, US health care has some problems. It has deficiencies.

If you are an undocumented worker, are you going to get tested? One of the things that President Trump talked about in his Monday news conference is that if you are an hourly worker, we'll think of something. That you can go get tested. Because, otherwise, why would you get tested? Because you are dependent on the paycheck.

If you are a single parent and are juggling a bazillion priorities, are you going to get tested? Or are you going to take your kid to the next whatever, dance studio event or this or that?

I just talked to a bank this morning in Europe. And I don't think I've had a time when this fellow that I tried to reach hasn't been sick. I've been calling him for 10 years, every couple of months. Every time he is sick and he's back in two or three days.

You don't have that in the US because you don't have that safety net. And so, yes, that can spread a virus and that can have an impact.

And it's – historically, you elect the populist on the right after a financial crisis and then it's quite possible to do a sharp turn to the left.

Right now, it looks like we might (quote, unquote) only get a Biden if we kick out Trump. But absolutely, the public can get disenchanted with markets. And the coronavirus might well be a catalyst of that.

***Erik***: What would a Biden presidency mean for markets?

***Axel***: Well, I have a team of analysts that I've been sending out going through the policies. The good news about the way American politics works is usually you have gridlock. So you can deal with whoever you have.

The challenge always comes in when you have both the House and the Senate and the White House be of the same party. Because then they can really do change.

And Biden, by the way, is in favor of keeping the filibuster. And so that shows that the changes – the odds are the changes would be more marginal. Obviously, you have a lot of rhetoric during the campaign, but ultimately things don't change all that much.

I happen to think that monetary policy has a bigger impact on the fabric of the nation than fiscal policy does. And a big chunk that is because it is not so easy to change things.

And, obviously, what that means in practice is you do a lot of things on the executive side. And the things that you can do on the executive side, Trump has figured out, is immigration and trade. And it's in the news – the more scandalous something appears, the bigger the headline and the happier he is, so to speak.

But, at the same time, now we have an election year. So it is in his interest to calm things down. And, obviously, with the virus in there, it is in his interest to ease policy where he can. And he obviously has a big impact on the regulation.

I mentioned one example on the banking side. But there are a lot of regulations that can be eased to provide a stimulus in case Congress doesn't come along.

And, to answer your question, it really depends on whether the House and the Senate will all be of the same party. Right now, the odds of that happening have increased. But they are still in the 20% range in the betting markets.

***Erik***: I think one thing we could agree on is, regardless of who is president, there is very likely to be considerably more policy of accommodation – monetary and possibly also fiscal.

So let's talk about another area where you are regarded as an expert, which is precious metals.

What do you see on the horizon for gold, with everything that's going on?

***Axel***: First, I disagree with you on the first one. So let me talk about that first.

***Erik***: Okay.

***Axel***: Accommodation. We have in Europe a new ECB Chair as of last fall, Madame Lagarde. And since Day One she has been talking about climate change.

And when I think of monetary policy and climate change, the one connection I would make is, well, you've got to figure out that if you had a big natural catastrophe that financial institutions don't topple over because of whatever payout they have to do or because businesses go out of business.

That is not how Lagarde thinks about it. She thinks about coercing banks to favor green investment over other investments. There is obviously a huge ESG [environmental, social, and governance] wave around the world. And she seems to be very open to the stuff that you call, I think, modern monetary theory – where you hook up with fiscal policy makers to print money to support jobs. So there is more room for monetary accommodation.

If you look at Powell in the US, he obviously doesn't go as far or extreme as I would say as Lagarde does. But he is turning on a dime when there is a tweet on trade, when the market panics.

And so if we have a very bad-case scenario on this virus, I wouldn't rule out that he is very open to cooperating with fiscal authorities to make money available. So never say never. We've broken many taboos in the financial crisis. And when push comes to shove, monetary policy is going to be there to support what the fiscal authorities want.

So that's just on that point.

Now, on the precious metals side, obviously it's been an interesting roller coaster. The price of gold historically isn't really correlated to anything. That is what makes it so beautiful.

The one thing it's more correlated than many other things is real interest rates. When you hold cash and get compensated for holding cash, then, obviously, why should you hold this brick that doesn't pay any dividend?

But if you look at the correlation to real yields, look at the 10-year comparison, the price of gold has been reasonably highly correlated. And as real yields have come down, the price of gold has come up.

I mean, you tell me if real interest rates are going to be hearty, then you may not want to hold gold. If you think that real interest rates are going to go below, then I think gold is very sensible.

The other thing, of course, is that in every bear market since the early ‘70s , with the big exception of the early ‘80s, the price of gold has done very well during a bear market and risk assets. And part of that is the lack of cash flow when volatility goes up. A lack of cash flow provides less discounting to a cash flow that doesn’t exist in gold. So that does well.

But, obviously, because real interest rates tend to go down as interest rates go down. And in the early ‘80s, real interest rates by Volcker were pushed very high.

So that is why gold historically has been a good diversifier. And that’s why we also see a lot of people buy gold as a diversifier.

***Erik***: I want to pick up on that point where you described gold as being a good diversifier against a move down in risk assets. I certainly agree with you, couldn’t agree more, in fact, in the long run. I think that this pressure downward on risk assets has to be positive for gold. And I’m very bullish in the long term.

But what we saw right around the 24th of February really reminded me of 2008 when we – in 2008 with the stock market crashing – even though it had to be bullish in the long term for gold, there were people that just had to sell everything to meet their margin calls.

Are we going to see that again if this market really crashes? It seems like maybe what we saw in the last two or three weeks might be a precursor to a repeat of 2008 where correlations go to one, regardless of the fundamentals.

***Axel***: Well, in the long run, the correlation of the price of gold versus the S&P 500 is zero. It’s not minus one. And so that means that it doesn’t always work with things going down. Remember, the price of gold has also gone up when the S&P has gone up. And so I think the market’s goal is to frustrate investors. And it’s very good at that.

So I would be reluctant to say something is necessarily going to happen one way or the other.

One of the things leading into this was that speculators were very long gold. And when you are long gold as a speculator, when you use derivatives to buy something, you tend to be leveraged. You have a risk-off environment. You need to liquidate. And so you need to take down your positions. You need to flush those out.

So it is not surprising when people are piling in on the trade, that when things go rough, well, they get out of that trade. It might be a good idea. But when you go into something with leverage, you may need to de-lever when volatility goes up.

And that was exactly what we saw.

And so these sorts of things, when you know 100% that this is the thing you need to do to

diversify and everybody else does it, well, then it doesn't work the way you thought it would.

So that sort of thing can happen.

And then, of course, the question is what will policy makers make us do and so forth?

But I mentioned earlier the scenario of a hot economy. Well, if we were to have a hot economy, odds are that the Fed would hike rates. But the Fed has promised to hike rates. Would they do it? Would they not do it?

So what you get in the end is a volatile environment.

The one other thing to add about gold is partially because there aren't so many fundamentals on gold. It attracts a lot of technical traders. And those guys were gone during the bear years on gold, to a significant extent, because gold didn't do anything.

Now that gold is more volatile again, you have all these technical traders back in the game. And you have more coming in every day. And so we talk about it more in the news. But that will also exacerbate some of those moves.

And you can call it noise. All the more important it is that you have a strategy. If you have a strategy to outwit the day trader, good for you. If you are a long-term investor, good for you.

The sort of trends, if you have it as a long-term diversification, if you have it because you think that real interest rates have a difficult [time] rising higher, I think that investors may want to consider it as a diversifier in their portfolio.

But if you are a short-term trader, yes, you better have a good strategy.

***Erik***: Gold itself has, on the net, done pretty well through this coronavirus crisis. It did have that big dip down as we saw equity markets sell off sharply. But it came back.

On the other hand, gold mining shares, they went down but they didn't come back, or haven't so far. What's going on there? And what's your outlook?

***Axel***: Well, over a 12-month period, gold-mining shares have gone up quite substantially. And in some ways you have similar things here.

First of all, compared to the last bull market – I call it a bull market that we had in gold mining – several things have changed. One is that, at this stage, companies are still fairly prudent. They don't try to increase ounces at any cost. You have energy costs – that's about a good 20% of the cost of mining – has come down. So that should reach for margin expansion.

Beyond that, the big companies have underinvested for many years. So they may need to

acquire companies downstream.

Now what hasn't changed is that – especially downstream – the smaller companies, they are always in notorious need of capital because they always fund the next exploration and so forth. And so, obviously, when capital markets are at risk of drying up, people are saying, oh my God, there is not going to be money around for us.

So that provides a challenge to the industry.

And because there is this periodic financing requirement with many of these mining companies in periods of risk-off, it can well be that they get whacked just like everybody else.

So historically – and also in a liquidation, a broad liquidation, those things get sold as much as anybody. And the smaller companies are more volatile.

It is a notoriously volatile space, so people shouldn't expect that thing to explode to the upside every day. It's been a very good year, and we've come back somewhat from that.

I would think that, as we get used to this environment, there are amazing opportunities in there. I mean, these smaller plays in the mining sector, they are obviously highly speculative. They are like auctions, whether you strike gold, literally speaking. So the market will reward them over time.

But make no mistake about it, this is a volatile space. And people better be comfortable with the risks that come with it.

***Erik***: Axel, let's talk about what's coming next from the Federal Reserve. They've obviously already had an emergency 50-basis-points cut that occurred between regularly scheduled meetings.

Markets are already pricing in, at least according to some estimates I've seen, as much as 75 basis points of additional cuts coming at their next meeting. That would be kind of unprecedented to first have a 50-point emergency cut and then, normally, 75 is bigger than you would ever get in a single meeting.

Is that realistic? And what should we expect?

***Axel***: Well, Powell has been very willing to cut, obviously. I mean the argument for cutting is, hey, we don't have inflation, and why not? We don't want the yield curve to invert. As we speak, currently the 3-month 10-year is 30 basis points, so we are not at the risk of inverting right now. But why not cut?

The argument against it is that, hey, you can't cure a virus with a rate cut.

We have as our senior economic advisor Bill Poole. He, until 2008, was the president of the St Louis Fed. And he recently said – and he was considered a hawk, so he certainly was not in the cutting camp. But he said what the Fed should do – and that doesn't mean they will do it – but what he said the Fed should do is, yes, they should go down with the market and cut, cut deeply.

But indicate that they are cutting because they don't want to drain liquidity from the market. And that they will be just as willing to normalize again, should these markets come back. And so cutting, not so much saying, hey, we are going to now to go zero percent and stay there. But saying we do it so that we are not a kind of an obstacle to liquidity.

And that kind of makes sense.

As you point out, 75 basis points seems to be priced in. I don't know whether they'll do 50 or 75. If you look at historically, most of the time when you've had an inter-meeting rate cut, then you had a follow-up rate cut of – you had an inter-meeting rate cut of 50 basis points and then at the actual meeting you had another 50-basis-points rate cut.

Obviously, when we had the inter-meeting cut, the market tanked anyway. And that's obviously the risk.

Now, obviously, if you are in Powell's shoes, there is no way to win this. If he had done nothing, then he may be accused of inaction. Had he gone 25 basis points, it would not have been enough. At 50 basis points, it's wasted ammunition.

The Fed is not there to get praise from anybody. Mostly, the Fed's role should be to be out of the way. And if they do what Bill Poole says, then that's as good as anything.

If I look at what's priced in, the market is firmly betting on deep, deep cuts. The question is, of course, hey, what happens next and so forth? I would continue to argue that you can't cure a disease with this.

But with any of these things, and anything we discussed, it doesn't really matter what you or I think. It matters what the policy makers will do. And Powell has shown that he will oblige to what the market demands. That's been his history. He hasn't been around that long, but that's his history and that's what I'm working with at this stage.

***Erik***: Well, Axel, I can't thank you enough for a terrific interview.

Before I let you go, please tell our listeners at little bit more about what you do at Merk Investments. I think you guys run a couple of ETFs and have some other products. For our listeners who are not already familiar with Merk Investments, give us the rundown.

***Axel***: Sure. Come to merkinvestments.com and browse around. We do all kinds of little things.

One of the things, if you want to get my live opinions, I am active on social media @AxelMerk on Twitter, where you get a live interpretation on the news.

But, yes, we run some investment products both on the precious metals side, the physical one, and the mining side. We have a currency fund as well. We do a lot of macro work. Deep dives into central banks. We publish research reports. Actually, we have a research service as well, where we publish consistent chart books.

We are actually launching a new website pretty soon in that it's going to be a little spiffier than the little arcane format we've been publishing in.

And then we have a systematic ethics program as well where we – it's one of the things that, we used to have a mutual fund on it but it wasn't popular. I happen to think it was the best thing since sliced bread. We don't deploy it for the retail space these days.

But one of the things you can do in the long/short currency spaces, you can generate uncorrelated returns with a very well-defined risk profile, which is ultimately something I think investors will be longing for if this market is not going to be an eternal bull market.

And so we do all kinds of little things. We have a lot of technical capabilities. But, for most folks, it might be the most entertaining to follow me on social media, if you want to dive deeper. From merkinvestments.com you can get links to the various other things that we do.

***Erik***: Axel, we look forward to getting you back on the program in a few months for another update. Patrick Ceresna and I will be back as MacroVoices continues right here at macrovoices.com.