Vincent Deluard: The Nuclear Winter of the 60/40 Portfolio

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Erik: Joining me now is Vincent Deluard, global macro strategist for StoneX - that's formerly known as INTL FC Stone. StoneX, I guess is the new name of your firm. Vincent, it's great to have you on the program. Thanks for joining us.

Vincent: Thanks for having me. I've been listening for many years to these podcasts. And it truly is the best financial market podcast. I mean, you give a ton of content that used to be the privilege of a happy few when you give it away to everyone and you're doing a great public service mission here and I'm glad to be here.

Erik: Listeners, Vincent has prepared a slide deck to accompany today's interview, you'll find the download link in your research roundup email. If you don't have a research roundup email, it means you're not registered yet at macrovoices.com. Just go to our homepage macrovoices.com look for the red button that says looking for the downloads right above Vincent's picture.

Vincent, I want to give you credit as well because we've had a lot of really smart guests talk to about the shortcomings of the 60/40 portfolio design, which of course, has been the gold standard of portfolio design. For the last several decades, a lot of the smartest guys on the street have been talking about the reasons it's not likely to perform as well in the future, as it has in the past.

But you get the title for the best name, calling it the nuclear winter of the 60/40 portfolio. So, what do you mean by that? Why is it a nuclear winter? And what are the implications because it's really what almost the entire industry recommends to most individual investors.

Vincent: Well, thank you for the kind words. So if you start on the deck on page four, you will kind of understand the term nuclear winter because what the trod does is a long term view of the nominal and real return over a 10 year trading period of a 60/40 portfolio. And what I find amazing about this chart is how steady it has been, I mean, if you have the time to wait for pretty much my

entire life and probably several decades before that, you would be pretty certain that over 10 years, you would average real returns of about 8 to 9% with a 60/40 allocation.
I mean, the only dip - it was very brief - was after the oil crisis when briefly the 10 year trading return went negative before obviously becoming very positive, as we had this massive rally in both treasuries and equities. And if we look at where we are today, we are right, actually a little above average, for the past 10 years a 60/40 portfolio has delivered real return of close to 10%, which is a bit higher than the average of 8% in large part because inflation has been lower than what it has been.

So, the real return has been boosted by the lack of inflation. And I'm sure we'll get into this later in the conversation that that's something that I expect will change. But I also expect that even the nominal return of the 60/40 portfolio, that trading 10 year return of about 10% annually, is a complete misrepresentation of what's likely going to take place over the next 10 years.

So that's why the term nuclear winter, which will include in my view, a decade of negative real return for traditional asset allocation. Something that really no one who's career started, you know, in the basket years has experienced. Maybe that happened in the 70's, but outside of that, that's not something that any one of us has seen.

Erik: Now, what are the implications of that? If we say that, you know, for the next decade, the 60/40 portfolio, you just don't think it's going to work? Presumably, for the first couple of years of losing money everybody just says oh well, you know, it's just a blip, these things happen. Just wait it out, you know, buy and hold stocks for the long term. At what point does the world figure out that it's really not working and what are the implications when they do figure it out in terms of people moving out of the asset classes they've become accustomed to as is just the standard for so many decades?

Vincent: It will be a very messy process, because as you pointed out the entire industry is designed for a world where you know, bonds deliver about 4 or 5% return equities. Around 10 or 11 and you take the average of that, and they are negatively correlated, and you get some diversification. Risk parity strategies rely on that, pension funds rely on that, individual investors rely on that, robo advisors build that into their own assumptions. So the entire world is really based on that framework. So as you as you take it off, the adjustment will be painful. I think that the quicker it happens, the better it will be.

I mean, the way to restore the expected return of such a portfolio is to have lower starting price. I mean over time, one of the biggest drivers of your return is what was the valuation of an asset when you bought it. So we need these valuations to come down so that we can restore that portfolio, so the effect would be a massive repricing of financial assets and it will be messy.

I think you will probably see bubbles in other assets. I mean, I think gold is probably, obviously a beneficiary of this nuclear winter of the of the 60/40 portfolio. And I think we're just at the beginning of that process, maybe other things will benefit from it. Whether it's Bitcoin or other more non-traditional assets, I mean, money needs to be invested somewhere.

So as money leaves, the strategies, others will benefit, and really only time will give us the answer. One thing that we know for sure, though, is that the people who rely on these return expectations specifically, I'm thinking about pension funds in the US. I think on the latest survey of the American Association of public pension funds, the median return assumption was 7.25% a year. That's what these guys expect to get.

Well, you have 50 basis points in the 10-year yield, you have a P of close to 30. So that converts to an earnings yield of around 4% even with buybacks on top of that. Junk bond yields I would say around 5% and investment grade, you're close to nothing. So you take the average of these assets, and that's probably around 3 to 4%, and then pension forms tell you well, by mixing all of that, I'm going to get to 7.25. I mean, this is not going to happen.

Maybe some of them are going to be super smart, and they're going to earn a trading return, and they'll do the right thing at the right time. But collectively, the industry cannot earn the returns that he expects to earn.

Erik : Vincent, another theme that I've noticed with some of the smartest guests that we have on Macro Voices is a lot of people are saying, okay look, we're either beginning now or we're going to begin a transition towards secular inflation in the next few years. And it seems like a whole lot of smart people are telling that basic high-level story, but each one of them has their own version of it. So moving on to slide 11. What's your take on why inflation may be on the horizon? And what does it look like?

Vincent: Well, I think inflation has been a question that most strategies and investment managers have preferred to avoid or not think about because it's uncomfortable. And it's also the initial way to look like an idiot. People who worried about inflation offset QE1, QE2, QE3 have all been proven wrong. So I think they say a lot of resistance now to make the inflation call.

The burden of the proof is indeed a mutation scam. But I think we have enough evidence that now is different. And in the presentation mentioned, what I call the horsemen of inflation, we saw signs of inflation that you see across time and across countries that have always led to inflation. I would say that all six horsemen are here in the us today. I will briefly name them then we can just, you know jump into any of them.

The first one is asset price bubbles, which by any definition, if you look at the forward P/E ratio of the Russell 2000 index to something like 100, if you look at the price and sell ratio of Microsoft at 11 or 12, the fact that Apple has almost doubled in the past six months.

I mean, you see these bubbles nearly everywhere. Of course, these bubbles are not as impressive measured in terms of gold. I mean, you could only argue by the way that gold has outperformed equities for the past five years. We've seen a way that can be seen as a definition of an inflationary bull market; a period where financial asset returns like that of gold would be an asset that produces nothing. So asset price bubble is the first one.

The second one is the Great Central Bank bubble also discussed, that many times before the explosion in liquidity that's been accelerating the past six months. Eventually, if there's any truth to the MD or PT equation, the increase in M has been so large that eventually you should see some impact on prices.

The next one is protectionism and what I would describe as a as a cost shock. I think when we send on, COVID will be seen for increasing the cost of stuff. The same way after 1973 the price of oil increased so the price of everything that used oil went up. With COVID we have all these restrictions on how people can work, how they can travel, which will increase the cost of doing business in around the world.

The fourth one is debt. We came into this with a huge corporate debt problem and you've profitability problem in the United States. And on top of that was added now much more public debt. So we really have too much debt, and inflation has been historically a way to deal with debt in a politically not so painful way.

Which then brings me to the next horseman which is Manipulated Prices. I mean, typically inflation does not last in free market economies because the price mechanism ensures that you know, resources are okay when needed. Even the smart and creative, and that tends to bring price down.

However, when you have a system where prices aren't monitored by markets, but they are set by you know central banks or political comedies, it's much harder to squeeze inflation out the system. As experienced by the Soviet Union, Venezuela and other countries that have tried to kind of take oriented markets, which I think is where we're going in the US.

And then the last one, which is probably the most important when we think about secular inflation is generational divide. One of the biggest crisis in the US is the wealth and income gap between the

young and the old generation. And in a curious way, I think inflation is going to be the only feasible solution to bridge that gap.
Erik: And how do you see that gap being bridged by inflation? What are the policy changes that you expect that would bring about that change?

Vincent*:* A lot of it would have to do with MMT or what I think the Ray Dalio calls that monetary policy 3.0. Where you see a transition from really QE for the rich. I mean, that's kind of what we already have. We have 10 years of MMT behind us. It just been spent for the benefit of asset owners.

I mean, typically when the central bank uses the common resource, which is the currency issued by the government, and use it to buy assets. So we had already, in some way really 10 years of MMT. We just gave it to whoever owns treasuries, mortgage backed securities, now junk bonds, corporate bonds and so forth.

And I think what we are witnessing progressively (but I think COVID has kind of accelerated that shift) is a transition towards fiscal policy, direct decimalization and an MMT that actually is more about sending money to people. Whether that's through unemployment benefits, or eventually through UBI. Or through this, you know, better healthcare which the US badly needs, or could be the combination of student loan debt. So I think that is the transition that will prove inflationary and in a way solve some of the generational gap.

Erik: Vincent let's move on to the US dollar. We've seen the dollar index test a low 92 handle intraday recently and we're still just barely above 93. A lot of people thought for what seemed like 96 was really good support and all the sudden the bottom fell out. Is this the beginning of the big move that Luke Gromen and others have predicted, you know, the end of the dollar? Or is this more of just a cyclical move that's likely to eventually retrace to the upside?

Vincent: My answer would be somewhere in the middle. I think it's really too early to proclaim the death of the US dollar as a reserve currency, although that that will probably happen someday. I mean, that has happened to hundreds of currencies before. But it's probably too early to put it that way. I also would not underestimate this as a short term cyclical move.

I think we are entering a secular bear market for the dollar, not necessarily one where or the dollar loses its exorbitant privilege but something more like what we experienced between 2002 to 2007. Where the Euro went from parity to close to 1.6 at the beat and the dollar lost ground against major currencies, including the Brazilian real, which you know usually is not a currency that appreciates. So I think that's where we are, the dollar has gotten to be massively overvalued.

International assets have been repressed compared to our assets. And then there's a little bit of a self-fulfilling prophecy, because as the dollar weakens it makes it easier for emerging markets more to service their dept. It improves global growth, improves their profit, and improves commodity prices. So this loop really is just starting between the weak dollar and out performance on international assets. And typically these things last for five to seven years. Now time will tell if this will lead into a complete demise of the dollar or if it's just one of those normal, kind of healthy cycles of dollar weakness.

Erik: Vincent, I know that before moving to StoneX, you were with Ned Davis research where you created their European Research product. Talk to us a little bit about how Europe fits into this big macro picture. We've clearly got, you know, the US markets recovering even if the US economy isn't. What's your outlook for Europe, both markets and the economy?

Vincent: I would say to some extent, cautiously, cautiously optimistic. In the first phase of the pandemic, it looked like Europe was really going to be the biggest victim of it and for good reason. I mean, we had the most death, we had the harshest lockdowns. Then we have an economy in Europe that is heavily dependent on tourism, on mobility – you know, you look at a European index and there's basically no tech. It's car manufacturers and service-related stuff that was going to be badly impacted by COVID.

So for a bit it looked like Europe was going to really suffer the brunt of this. And that lasted up until the US really messed it up. And now in comparison you're like, 'well Europe looks pretty good!' You know, Germany and most of Northern and Eastern Europe did actually okay, containing the bad of it. They are opening up. I mean, yeah, we've seen a little spike of infections here and there. But you know, I think that compared to where we are in the US it's under control. So, you know, this is probably a good moment for Europe.

There's certainly being this massive fiscal impulse, which people have – Europe has been dying for 10 years from the North's refusal to engage in fiscal spending. And it's as if the COVID crisis has led to some sort of qualitative realization of pragmatism, 'Hey, this could take us all down.' I don't think the Germans or the Dutch are doing this out of their hearts, but they realize that their economy requires Spain, Italy and Greece not to fall off the cliff and that's where we're going to go.

So I think in a way the departure of the of England – Brexit – has helped that. Because, you know England has always been a foreign horse. So now that England's gone, well, Germany doesn't have much a choice and has to turn back to France, and it has to do some of these kind of fiscal stimulus measures and more integration. I still think there are severe issues with the euro over the long term, but over the short term it's cheap, the economy's somewhat recovering, and we are seeing political momentum.

I see an opportunity provided, and that's a big big *'if'*, provided the virus doesn't get worse. I mean, if there is a vaccine, I think Europe is a fantastic value opportunity. If we have a second wave, I don't think the European economy can survive operating in a COVID world; where people have to social distance, can't go on vacation, can't go to hotels, and all that stuff. So to me the vaccine covered that in Europe, not in the US.

I know all the Robin Hood day traders who tried to buy airline or cruise ships, you would do much better buying cyclical European stuff for much cheaper and much further along the way of the recovery.

Erik: Vincent, I want to come back to the subject of political unrest and this generational crisis that you alluded to a few minutes ago. You've got a series of slides talking about this starting on page 19 of your slide deck. This is a topic that is near and dear to my heart. I've spoken quite a bit about it on MacroVoices, but I want to get your take. How do you see this situation? Why do we have all of this political unrest? What's driving it? Is it the fourth turning that Neil Howe talks about or something else? What's driving it? Where's it headed, and how does it eventually get resolved?

Vincent: Well, I think the biggest driver is really that first shot we see on page 19, which looks at the ratio of the S&P 500 Index to the minimum wage. And basically what it tells you is how many hours you need to work at the minimum wage, in order to buy one share of the index.

And in 1970's, when the boomers were growing up, leaving their home, starting to get jobs, starting households, that was about two weeks. Today it is closer to two months, a fourfold increase in this ratio. And the way I interpret this ratio is that it really measures the terms of trade between generations.

I mean, you can think of the young generation, as a generation. For the most of us – at least who don't have trust funds – we need to offer work in order to buy assets. And typically, our work when we're young is not that qualified. It's closer to minimum wage then a career. So, we earn the minimum wage and we try to build assets with that.

Conversely, you can think of the old generation as a generation whose human capital is mostly depleted, right? I mean, if you're past 65 you retire. So really, your goal now is to convert the capital that you've accumulated over your career into work that will be provided to you by other people. So the term of the trade has increased by fourfold in favor of the old generation, they can buy a lot more labor with their assets. Conversely, the young generation can buy a lot fewer assets with the labor than they used to. Not only that, but we also have what I call the differentiated inflation problem.

The Bureau of Labor Statistics report only one basic number – I mean we only care about one which is the CPIU, which is the typical basket of an urban consumer. Knowing that basket, some of the very big waves are things like housing about 20 to 30% on this rent equivalent, then the next best thing aggregated is healthcare expense and then education. Well, if you think about where these expenses fall, they fall very differently across generations.

For the old generation, they don't pay for housing; most people own their home. If anything they may even be able to rent it out, have Airbnb people so that the house price inflation for the old generation is actually positive for them. Conversely you've got the young. Typically a young household pays – if you live in a major city – it's going to be 30 to 40% of your salary spent on rent.

Same thing with healthcare. I mean the US if you are past 65 – it may go down to 60 – you get Medicare, you don't have to pay for it. So you're insured against the risk of healthcare inflation. Conversely, if you're young, typically you don't consume a lot of health care. I mean, I never see a doctor because I'm never sick. Yet my insurance premium goes up by 10% every year. So you keep paying more for something that you don't consume.

And then last, education. Obviously, if you're retired you're not going to pay college dept, you're not going to pay to go to college. But if you're young you need to build your skills. That's what we've been told by society, and that's what we've done. And if you have college debt, you will go to high interest, and as far as I'm aware it's the only debt in the US that you cannot be forced upon. So you have these unextinguishable depts, usually at high interest that an entire generation carries.

So what I did in the charts in designing the second short is I fixed the CPIU and created a boomer consumer index, which is indeed deflationary. Because what it captures is the fact that the cost of shopping at Walmart has gone down because of China. The cost of travel has gone down because of globalization, the cost of the European cruise vacation has gone down, the things that old people buy are going for cheaper. And then I've built another index which is much more heavily skewed towards housing, education and healthcare, which is much more representative of what the young generation's spending is experiencing. And that has increased by 5 to 10% every year for the past decade.

So in a way, I would argue we already have inflation, it just only hit one group. One group has had inflation and another group has had deflation and on average we had like 1.5% inflation, but that average does not capture the reality of anybody. What we need to do if we want to have proper economic growth, if we want to restore some semblance of cohesion in society, is we need these trends to invert.

We need the prices of the stuff that the young people pay for to go down, and conversely, maybe increase the cost of living for old people. That is the solution, and I think to some extent, brought inflation because of MMT, because of rising wages and then falling asset prices, will bring that outcome.

Erik: Vincent, let's come back to inflation and specifically why it hasn't happened. You've got a series of slides in the deck coming up that talks about that starting on page 21.

Vincent: Yes. So back in 2009-2010, when we started these massive monetary expansion and QE programs, a lot of people were worried about inflation; basically MV equals PD, we increase M eventually P will increase. And that didn't happen. And I think the reason that didn't happen is because monetary policy was doing one thing, but fiscal policy was doing another. Especially in Europe, prudential policy was another thing.

So the central bank was easing, but at the same time we had massive fiscal tightening. I mean in the US, I think it was 8% or 9%, the budget deficit was supposed to 10% of GDP. By the end of the second Obama mandate, it was down to 2%. Europe had a more insane experiment with fiscal contraction because we eventually went to a surplus, because Germany, the Netherlands, Austria, the virtuous countries actually had a budget surplus; it went from minus 10 to a surplus. So massive fiscal retrenchment at the time we had this easing.

Then also in Europe – which I think is the better case for the deflationary economy – we also had prudential regulation that forces the bank to deleverage. I mean, going into ’08, European banks had you know, 2:1 capital ratio of like 2%. And now they're on 12%. So in order to do that, you have to do a tremendous amount of deleveraging of banks’ balance sheets, given how essential that the banking system is in Europe in the intermediation process that redefined the economy.

So the monetary liquidity injections did not reach intended effect for the past 10 years. Now, I think that we are we already have experienced a shift. I mean, the US people are being paid $1,000 a week to play the PlayStation. We are seeing the $750 billion release package in Europe, that's going to be spent on unemployment benefit, on direct aid, and so forth.

Now, it hasn't been inflationary yet, mostly because these things take time. I mean, this system is not set up for treasury issuance of $3 trillion in three months. This is where we've been in the past three months, usually that takes 3 to 5 years. So it takes time for things to be spent.

I mean, if you don’t get the general government account at the Fed, 25% of the Fed's balance sheet is sitting on the Fed's balance sheet, because the treasury hasn't spent the money. It’s issued the debt,

the Fed bought it, but then the cash has come back on the balance sheet because the treasury hasn't had time to spend money. So just give the time. Now we get this impression that, ‘oh we can spend money and there won't be any inflation.’ Well, that's because the money hasn't been spent.

A lot of it also is going through money market funds, which is typically what you see in a flight to safety. After ‘08, we saw an increase of 1.5 trillion money market funds, now it's more like 2 trillion. It's a crazy economy where the government issues dept to send money to people, and then the people take the money the government sends them, and they buy treasury debt. As long as it happens, and we have these very high savings rates, then yeah we can keep going; there won't be any inflation.

But when the economy starts to normalize, when the government actually starts to spend the money – and spend it well because that's what governments do – when the economy reopens, the savings rate is going to fall down. And you'll see that they often increase and that's when we’ll have inflation problems.

Just give it time, my estimate is that it’s going to start to happen by the end of the year. In 2021, you will already see inflation above the 2% target. At the beginning, I think the Fed would welcome that to say ‘look, it's working, we're saving the economy, this is great,’ and then it will just keep picking up up up up up until, it becomes a problem.

Erik: Let's talk about what to do about that problem. Golden precious metals are the obvious investment answer. Now until very recently, it had starting to feel almost like a blow off top that I was really getting concerned about. We're recording this interview on Tuesday, a couple days before our listeners will hear it. And we're finally seeing the first significant down day in the gold market, in months and months. Down by almost $100, as we're speaking on the day, where is this headed? Is this a buy the dip moment? Should we be jumping at this? Or is the gold market maybe a little bit ahead of itself? And it's better to wait for a bigger dip?

Vincent: I would say both. I'm totally on board with the view that it's not healthy. I mean, it was like 7 or 8 days of like up, up, up, up. Even as a gold bulls, you really don't want to see that, because that creates the risk of a dip. And it could be that we have a dip. I'm not smart enough to predict how big it's going to be, how long it’s going to last, but what I know is if your investment horizon is more than a year, I think you should buy it.

The case for gold remains, and in a weird way the case for gold today is almost the same argument that used to be made against gold five years ago. Let me explain that a little bit. I mean, one argument against gold is that it has no intrinsic value. You can't do a discounted cash flow nowadays, it's in the eye of the beholder. You can make that an argument for the upside as well. Is gold overvalued at

$2,000? I don't know. No one knows. It depends on how much people want to own gold. So you know, there's no limit to the upside or the downside (other than zero) on the on the price of gold.

The other argument that people make against gold is that it doesn't produce any cash flow, doesn't pay dividends, doesn't do a buyback. Well, we are going to be in a world where dividends are going to be dirt, buybacks are always being hammered everywhere. So gold is not suffering for that because there's no dividend or buyback to charge.

And then finally, the usual argument is that gold doesn't produce anything, doesn't generate cash flow. Well guess what, there's $15 trillion of bonds that have a negative yield. You know, gold is a high yield asset compared to government bonds at this point. Real yield is collapsing all around the world. I mean, you look at the 10-year inflation protected Treasury security in the US, you're going to get negative 60 yield. So if you if you want to hold it to maturity, you got to lose 6% in front of your purchasing power. As long as you have that, gold is a better alternative and just can keep going.

Erik: Vincent, I know a lot of the work that you do at StoneX focuses on Latin America, does that play into the gold story? Or why is Latin America such a big part of your work?

Vincent: Absolutely. And I think it's an answer to your earlier concern, which is totally valid about gold for having the run up too quickly, too fast, and the risk of a rule of stopping gold. Well, what can you do if you're concerned about that, but you see concern about inflation, you see a concern about the weak dollar.

I think Latin American assets in general and equity in particular are our way to capitalize on that and buy an asset that is still trading at generational lows. You don't have the froth in the market that you've seen in the gold market. And you have a very much same dynamic, I mean, Latin America is a weak dollar trade on crack.

I mean, these are economies that are borrowing dollars, so they have a massive national dollar. And they earn revenues in inflation sensitive assets, typically commodities. Usually that's a horrible thing to do. And that's why Latin American assets are usually a bad idea. But you should expect the dollar to go down and if you expect to see inflation, you get it at secularly lower evaluation.

I mean, here's one last stat I'm going to mention on this. Amazon as a company is worth three times more than the MSCI Brazil index. You know, you can make a joke about the Amazon River and Amazon the company if you want to make that fun. But the point is that one US company is worth three times more than a continent sized economy with amazing natural resources with earnings.

If you look at earnings over the past 10 years on an inflation adjusted basis, Brazilian stocks have earned 10 times more than Amazon, and yet they trade for a third of the price. Of course there is plenty of risk with Latin America, political risk especially in Brazil, COVID risk. But, if the concern is weak dollar inflation and you want to hedge to cheap assets, Latin American equities is where you want to go.

Erik: And finally, Vincent, we have links in our research roundup email to several sample institutional research reports, which you've recently written. Please tell our listeners what they can expect to find there, what are these reports about, and what should they expect when they open them up?

Vincent: Absolutely. So there are four reports that will be made public. One is on this generational divide, which is called *"Not Ok, Boomer!"* and he goes into this differentiated inflation measure between boomers, millennials, and gen Z and how to solve it – and how I expect it to be solved by MMT.

There is another one going through the six horsemen. There's another one on the nuclear winter 60/40 portfolio, breaking down where the decision comes from. Can the FAANMG really go into the evaluation? How can we achieve it? What would happen to bond prices if yields went negative?

And then the last one is something that I pulled out: "The Bull Market Cult is Killing the Economy." It basically goes into a view that what's good for the stock market is not bad for the economy. And conversely, if we had a good economy, we'd have a bad stock market.

So this is an example of the work I put use for at StoneX. If people are interested, they should reach out to me on Twitter. I will put a link to a page where they can sign up for my work. The best way to get it of course to trade with us. We trade a lot of stuff, we have offices around the world, but even if you are not industry level with an account, I'm with StoneX, you can reach out to me and we can figure out a way to get you the research.

Erik: Vincent, I want to thank you for a terrific interview Patrick Ceresna and I will be back as MacroVoices continues right here. At macrovoices.com