MACRO Voices
with hedge fund manager Erik Townsend

Daniel Lacalle: U.S. Election, European Outlook & More

November 19th, 2020

Erik: Joining me now is author, fund manager, and chief economist for Tressis, Daniel Lecalle.

Daniel, it's great to have you back on the show. I always look forward to getting your perspective as a European. Here in the United States, we have an interesting situation, which is the presidential election is still contested – although it looks almost certain that Biden will win.

At the same time, we have, on one hand, a great big increase both in the United States and globally in coronavirus infections hospitalizations and deaths. On the other hand, we have two bits of very promising vaccine news, one from Pfizer and just a new one Monday of this week from Moderna.

Stocks rallying to fresh all-time highs, or at least on a closing basis it would be a fresh all-time highs at the numbers we're seeing right now on the S&P.

What do you make of this? Is it the vaccine that's doing it? Or was this market just ready to move higher after the election anyway?

Daniel: Thank you so much, Erik. And I think it's a very, very interesting situation because I think that we're living in an environment in which markets start to sometimes double and triple discount some news. No?

Remember that markets had already rallied on the hopes of a prompt solution with a vaccine coming from AstraZenec, then the Pfizer news. Now we see markets rally again with the new tests from Moderna saying that their vaccine is 94% efficient.

I think that what we are looking is at an environment in which investors are almost looking at any excuse to buy particularly equities.

Because what they also discount is that there is going to be a concerted effort of financial repression from central banks that the bond yield environment is going to continue to be extremely tight, that we are going to continue to see central banks depressing bond yields all over the world.

And, therefore, almost any piece of newsflow – even if it's something that should already be considered discounted – is an excuse to buy equities with the prospect that bonds will continue to be extremely expensive.

I think that also what happens is that you have an environment in which people know that this is not going to make huge differences to economic growth estimates for 2021. Remember that all of consensus estimates and big international bodies' estimates for 2021 already assumed the positive effect of a vaccine and the end of the pandemic.

Erik: Daniel, I'd like to run my own hypothesis past you, because although I do think that these Moderna vaccines offer a lot of promise long term. Maybe they will solve this crisis.

Look, at least in the case of the Pfizer vaccine, the refrigeration requirements alone would make it nearly impossible to distribute on a wide scale until they make some significant improvements there. Moderna looks more promising.

But even so, if you add up what it's going to take to get beyond the clinical trials, resolve the problems, get these vaccines to the point where they truly are ready to be scaled up for mass distribution, and then you do the production and the distribution and you figure this all out world-wide, I don't see how it could be any less than the second half of 2021 – probably the fourth quarter of 2021 – where you would even begin to approach the point where you've actually vaccinated enough people that now it's safe to travel, enough of the population has been vaccinated that essentially the crisis has been averted.

It seems to me like, best case, that's still a year away. But what we have right here, right now, which nobody's really paying a lot of attention to, is a massive, almost a parabolic spike up. Not just in new cases, which could be a reflection of testing, but also in hospitalizations and deaths.

So it seems to me like what's really going on is this crisis is about to get a lot worse before it gets much better about a year from now. I don't think that's what the market is discounting.

Am I missing something? Or is there maybe a downside surprise before it eventually gets better?

Daniel: I completely agree. I think that markets are only accepting the positive newsflow without analyzing the real path to the widespread distribution of a vaccine. And even if you look at (for example) the messages that Pfizer, AstraZenec, and Moderna are saying, you're absolutely right, we're talking about the latter part of the second half – best case – third quarter of 2021.

And in the meantime, you have a much worse situation in Europe, much worse situation in the United States. The hospitalization rates are much higher. The level of tightness in the intensive care units is extremely, extremely complex right now. And very, very, very, very challenging.

So I think that you are absolutely right: Things will get worse before they will get better.

However, I think that for the average investor it is almost the following: When you get very bad news, as you've seen for example in Europe, what you bet on is that central banks, European Central Bank will massively increase the stimulus package, increase the purchasing program, launch a bazooka as they call it, etc.

And when the news are good, you just buy it because the news are good. You see what I mean? That the level of risk taking that an average investor is adding on to a portfolio is completely disconnected with the reality of the path of the vaccine – obviously a very, very, very positive piece of newsflow, however very challenging in terms of distribution.

You just mentioned the storage complications. But even in the most benign scenario (which I recently put in my Twitter feed), the most benign scenario assumes that by the end of 2021, less than 38% of the population at risk will have access to a vaccine, which means that the situation is getting very, very difficult in developed economies.

In the United States it is quite probably that if there is a new administration, lockdowns will be implemented. We are seeing lockdowns implemented in countries that rejected the idea – like for example Austria recently, in Europe.

So you're absolutely right. The erosion of the potential of growth and the weakness of the economy is something that is much more important and certainly much more challenging than what markets are willing to take into account.

And everybody seems to be betting aggressively on the combination of massive monetary stimulus plus the idea that vaccines will solve everything at some point.

Erik: Let's talk about how this transmits into the bond market. Because we also see the US 10-year – as we're speaking on Monday morning, we're looking at a 90-basis-point yield, which is the highest I've seen in the last several months.

It seems like you could explain that as the reverse safety trade where money is coming out of bonds and moving back into stocks as people have a greater risk appetite.

But, wait a minute, if the expectation is really around a lot of government stimulus, wouldn't that suggest lower yields?

Daniel: I think that you're absolutely right. There is something that does not add up in the way in which markets are reacting right now. No?

On one side, you see that sovereign bond yields are going up. Yet, at the same time, you see for example that often calls for weakness in the US dollar is not happening as expected. It's remaining pretty much where it was.

You see that the general perception about risk appetite is divided between the most cyclical part of the stock market, the most cyclical part of risky assets.

Let's consider the so-called value stocks. We've seen, for example, banks and energy stocks rally.

So it's been more, in my opinion, sort of trying to buy the laggards into an environment in which bond yields are gradually shifting higher on the idea that massive fiscal stimulus will not necessarily be compensated with the amount of monetary stimulus that would bring yields lower.

So I think that something doesn't add up. And I think that it's likely the decision from some market participants to buy into the more cyclical part of the risky asset availability.

I think that what you have right now is probably an unwinding of an overly crowded trade into the elections and into the second wave of coronavirus.

And that will gradually move to something close to what you've just mentioned, which is that the 10-year yield in the US bond will go lower and that we'll see a lower appetite for banks, for example, and energy stocks, and the so-called value cyclical stocks in the forthcoming two months. Something like that.

Erik: Daniel, a subject that we've debated quite a bit with other guests on MacroVoices is whether or not we're headed toward a return to secular inflation. Not just a little blip of inflation but secular inflation – 1970s style stagflation, potentially.

And the argument that some people have made is that, look, if you have a new administration that's going to favor a lot of deficit spending, the MMT narrative is gaining popularity with politicians. It just seems that we're headed toward a lot of money printing, a lot of deficit spending, and it has to eventually lead toward a lot of inflation.

Would you agree with that view? Or is there another side to this story?

Daniel: Well, I think that there is certainly a risk of stagflation.

But more in the mid-term. We will first probably see a very aggressive level of deflation. Because inflation only happens when the newly-created money is going to the real economy. And therefore it becomes a massive devaluation of the purchasing power of the currency, which leads to a widespread rise in prices despite no economic growth.

In this case, what is happening is that newly-created money is going to bonds – and fundamentally to sovereign bonds, obviously. And therefore inflation is being generated – and massively in sovereign bonds.

We have in the Eurozone countries that are all but bankrupt or completely insolvent financing themselves at the lowest yields in history. That is massive inflation. Okay?

And when all of that newly-created money is utilized by governments to do two things – one is to perpetuation overcapacity and current spending that does not generate real economic return.

The reality is that it does not create inflation the way that we would expect, because you're basically

adding overcapacity to overcapacity that makes it impossible to generate inflation.

Second, the newly-created money goes actually to current spending with no real economic return.

So it's very difficult to see the levels of inflation that we saw in the '70s. And, also, economies are much more open. Everybody is exporting, so that makes it more difficult.

However, on the other side, what you have is a situation that I find fascinating, is that while official CPI, official index of consumer prices, is very low, the goods and services that people actually want to buy are actually rising much faster than real wages, than nominal wages, and than the official CPI.

So, for example, we're seeing how health care, education, food, clothing, utility bills, those elements are actually growing faster. And what's coming down is everything that is subject to technology.

So non-replicable goods go up faster than official CPI and replicable goods go down significantly. Technology, tourism, hospitality. You name it.

So I think that what we are seeing right now is that, on one side, central banks do not see inflation. And, on the other side, you have a growing discontent among the lower classes, the less well-off, and the middle class because the access to goods and services is more challenging.

Cost of living is rising faster than nominal and real wages.

So, in my opinion, the risk of what is going on right now with the policy of central banks is, first, ignoring that the cost of living for the people in the middle to lower classes is rising much faster.

Second is to ignore the fact that there is actually a level of inflation in financial assets that is significantly more worrying than what anybody would imagine.

Think about this.

Just an increase of 100 basis points in the yields of sovereign countries would really bring them to absolute collapse in an environment in which 100 basis points would still be at a completely abnormal level of yield.

The problem from the central bank perceptive is that they are doing the following: Central banks are looking at the rearview mirror. It's like somebody driving down the road at 250 miles an hour, looking at the rearview mirror, and saying "We haven't crashed yet. Let's accelerate."

And the point here is that the risk of stagflation is rising very, very rapidly because of those factors that I mentioned. Because the non-replicable goods and services are rising faster than expected and because, at the same time, the economy is stagnating because of the debt saturation effect.

Erik: Daniel, a few minutes ago you said that we have a situation where countries which are frankly

not all the solvent are borrowing at historically yields.

And then, just a moment ago, you said they really can't tolerate even a 100-basis-point backup in yields.

Now, when we've talked about this problem relative to the United States, most experts we've talked to have said, look, in theory, you know, you get to a situation where they can't pay their bills.

But, look, the US can just print money and pay its bills and it's going to be a long time before the world gives up on the US as the world's reserve currency just because they used a little bit of MMT.

On the other hand, if I look at peripheral European countries that are borrowing in perhaps reckless ways, is there at some point an intervention by the ECB which is maybe not so much a bailout but to stop them from going further?

Because if I was the ECB looking at some of these countries, I'd be saying, look, our whole currency system is being put at risk by the least solvent countries in the Union, still borrowing when, frankly, they've already done more borrowing than they should have done.

On the other hand, if you cut them off you could be crashing their economies. That's not good either.

What is the tradeoff? Or what is the challenge that the ECB is facing with respect to the borrowing habits of the peripheral countries that are not in the greatest shape?

Daniel:Yeah, I think that the problem here is understanding when this activity, when this whole craziness stops working. Okay?

And it stops working in a moment that is very difficult to predict from the perspective of a central banker, which is when the global demand for a currency stops rising, starts to go down.

You see for example in countries like Argentina, like Turkey, like Iran, the level of inflation that they have and the level of weakness in access to investors and being able to borrow.

The reality is that what has driven to all of that is that the global demand for the currency has not only fallen but also domestic demand for the currency.

In the case of the United States, the United States can print only as much as the demand that exists globally for US dollars is out there. So you can only print as much as the global demand dictates.

It's not what the Fed decides. It's not what the government decides. Deficits are financed only because there is a perception globally that holding US Treasuries is a good investment and that the purchasing power of the US dollar is going to remain relatively stable compared to my local currency.

So if I am a citizen in Brazil, I prefer to invest in dollar assets, in US Treasuries, because I know that the

US dollar plus the yield that I get out of that bond – first, that I'm going to receive my money back. Second, the purchasing power of that dollar is going to be higher than the purchasing power of the real that moved globally.

So the limits of MMT are the limits that the world demand of a currency dictates.

And that is not decided by the government. The government just cannot go out and print as much as it wants. It can only print as much as it is demanded.

And that demand is weakening the moment that the level of growth and therefore the security that the United States will repay its debt is hindered.

So the point that I get to in there comes back to the European Union is that you expect that southern economies in the European Union take more debt because you believe that when they recover they grow faster and they generate a higher level of activity for the European Union.

So it's a leverage buyout, if I may put that example. It's basically just using leverage to give some money to countries that when they grow they grow more.

Now, the problem is that, once you've started to let those countries reach 120/130/180 percent debt to GDP, is that when they fall they fall as abruptly as we are seeing right now – 7/10/20 percent in the case of Spain – and they don't recover as fast.

Therefore, that's when you really start to scare the global investor about the prospect of getting your money back in terms of the debt that you have acquired and the purchasing power of that asset.

And that is very important.

And that's something that needs to be repeated over and over again to all of those that say that the United States can print all the money that it wants without a problem. That is not true.

It can only print the money that the rest of the world accepts as collateral to their own investment, to their savings.

In fact, the US dollar as a world reserve currency and the US deficit financed by the rest of the world – even if a vast majority of it is also financed by the Federal Reserve – at the end of the day, the connecting point to all of that is whether a citizen out there globally believes that a US dollar is going to have stronger purchasing power in the future than the domestic currency, be it the euro, be it the real, the peso.

You name it, it doesn't matter.

So this is something that, at least historically – I have had the opportunity and the honor of working with a few people from the Federal Reserve. The Federal Reserve always paid attention to global

demand of dollars.

Now, what is the problem with the European Central Bank? The European Central Bank did the opposite. It said, look, if we finance the excessive deficits of the peripheral countries, then the growth in internal demand of those peripheral countries, once they recover, is going to absolve all of the excess of euros that we have placed in the market.

That is a very dangerous trade.

Because if Spain, Italy, fall in 2020 12/10 percent of their GDP – and you see in 2021 that they recover 4/5 percent – then that quid pro quo, that trade, that leveraged trade against the higher growth of the future breaks.

Which is what generated the destruction of the carry trade in emerging market currencies we have seen in 2020 – and we saw it last year as well – how, despite a dollar that was not rising at all actually in its dollar DXY index, you had most of the emerging market currencies collapsing.

So the United States – be it with Joe Biden, be it with anybody else – needs to understand that the moment that it starts to implement policies that will put a burden on growth, that put a burden on jobs, that create more slack in the economy and therefore the productivity growth is weaker, then it puts at risk the US dollar as the world reserve currency and, with it, the ability of the United States government to finance its deficit.

And it's definitely in no way what MMT defenders think. There is absolutely no possibility for the United States to continue to be a country that delivers on the promise of growth and repayment of its debt with excessive money printing that is constantly used for mal-investment and non-productive, non-economic return spending.

It's the formula of the European Union.

The moment that you start to see that the United States starts to get into the stagnation mode of the European Union, then the risk of the US dollar being the world reserve currency, and with it the ability of the government and the Fed to finance the deficit with a level of (let's say) easiness that they expect, that is broken very, very quickly.

Erik: I understand the currency demand argument, particularly as it relates to the United States dollar.

It seems to me in Europe, though, that the levers are a little bit different in the sense that, while there could be demand, let's say lots of demand for euros, there might be no demand for Greek or Spanish government bonds, which are denominated in euros.

The problem, though, is that, as the yield starts to back up and it threatens those economies, now the ECB is presented with the conundrum of, okay, do they print in order to buy those bonds in order to

rescue the peripheral countries?

It seems to me at some point you get to – just as the United States has had a lot of divisiveness over politics, it seems to me at some point you get a core versus periphery tension in Europe where the core is saying the ECB should not be in the business of bailing out peripheral nations that are borrowing too much.

How does that get resolved? And what could it mean in terms of potentially a peripheral Europe sovereign bond crisis? And how would the ECB be expected to react to that in this new MMT world where it seems like money printing is a lot more palatable to more people than it used to be?

Daniel: It's a very, very good question.

Monetary policy in the Eurozone should be what it was designed to be, which is a tool to provide countries time to implement the structural reforms that are going to allow them to be stronger, more productive, and more solvent in the future.

However, monetary policy in the Eurozone had gone from being a tool that looks to provide some time for governments to implement structural reforms to being an excuse not to implement them.

And that tension between the north and the south is already happening.

You've seen it, for example, with the European Recovery Fund. How immediately there was this idea that the frugal countries were attacking the southern European countries because they did not want to monetize and mutualize all of the spending without question.

Because solidarity mechanisms exist in the Eurozone, but they don't have to be something that goes from being a solidarity mechanism to a donation mechanism. And especially a donation to perpetuate and accelerate the structural imbalances and the weaknesses of the economy.

So what I think that the European Central Bank should do is to be a lot less strict about the rule. I think that the only thing that they need to do is to follow very, very simple rules by which both sides feel that there is a support. But at the same time it's not a perverse incentive to undo reforms.

Which is what we're seeing, for example, in Spain or, at some point, we saw in Italy.

And everything, just like in the United States it would be solved as well, would be solved by a set of measures in which discretionality of the individuals at the European Central Bank is limited.

So, for example, you have an asset purchase program. The asset purchase program goes to X amount of bonds but it doesn't go beyond that.

And you say it very clearly, you explain it well in advance – communication consistent and constant about those rules – so that it's very clear that those are the rules and those have to be implemented.

And then you have at least some level of security that governments will not use the period of expansionary monetary policies to simply get worse and to become almost too big to fail, as you were mentioning.

Because what's happening right now is the following, and we saw it between 2014 and 2017 with Mario Draghi. Mario Draghi used to go to the market and say monetary policy is not enough. Countries have to implement structural reforms. If structural reforms are not implemented, monetary policy is not going to work.

And, literally, governments heard that the same way as they could hear a commercial on TV. They just didn't even pay any attention.

What ends up happening is that governments would be at least aware that they could not use monetary policy to continue to increase the imbalances of the economy and the European Central Bank. The only thing it needs to do is to follow very strictly those rules. That would certainly prevent the perverse incentive that is being created right now.

Erik: Daniel, technically there is still an open question in the US election, but it seems pretty darned clear that Joe Biden is going to defeat Donald Trump as the next president of the United States.

And that probably means what I consider to be kind of a reversal of US policy where it used to be China bad guy, Russia okay (or at least a little bit okay).

I think that's maybe about to switch to where, unlike Trump's policy, I think Biden is much more likely to be friendlier with China but much less friendly with Russia, from just a geopolitical standpoint.

First of all, do you agree with that interpretation? And, if so, what would it mean for markets?

Daniel:I kind of agree. I think that if there is anything that seems pretty clear about the policies that Joe Biden wants to implement, it is that he will have a policy with China very, very similar to the one that was implemented throughout the Obama tenure, the eight years of the Obama Administration in which he was Vice President.

So what would that mean for markets?

What we know about that period is the following: It basically allows the Chinese government to devalue the currency and to increase the trade surplus with the United States without any consequence.

So if you start to lift tariffs and you start to allow an economy, China – that has been closing down actually in the last years and become less transparent, not more transparent – there is certainly going to be a process like we saw in the eight years of the Obama Administration, in which the Chinese government basically aims to maximize the trade surplus – and maximize at the same time its

competitive advantage by devaluing the yuan.

I think that also from the perspective of markets there is – I don't think that the relationship with Russia is very important, to be fairly honest.

I think that, before, the relationship with Russia was important for one reason: Throughout the Obama administration the United States went from being the biggest importer of oil to being one of the biggest producers of oil. It's interesting, because everybody sees it as a sort of very green administration, but it is true that the fracking revolution happened throughout those years.

I think that what we will likely see is a much weaker position from the United States in terms of defending its market. Because, ultimately, if you look at the world geopolitically, you have one market where all of the exporters want to sell – the United States – and one market where all of the exporters want to produce, which is China.

Cost and consumer. Consumer and cost.

So I think that if Joe Biden implements that policy, now is not the same as it was in 2009.

In 2009, the Chinese had a strict and open view about liberalizing and strengthening and being more transparent and being more open. It was very few years ago – actually at the end of the Obama Administration – in which the Chinese government went from opening the economy to shutting down the economy.

So obviously it would be bad for US exporters. It would be bad also for the inflationary expectations of the Biden Administration because China exports deflation.

It would be bad, certainly, for manufacturing jobs. And it would be certainly, at least from the perspective of markets, it would reduce the cost of capital risk attached to the investments in China and in countries close to China.

So obviously, all of that can be debatable. But I think that it would be like coming back to 2009 with a Chinese economy that is not the same as in 2009.

Erik: Daniel, let's go back to fracking and Joe Biden. On one hand, he's kind of tough about fracking. On the other hand, if he goes to Pennsylvania, the story seems to change a little bit.

What do you think his true intentions are? Does the US shale industry face a major threat from Joe Biden?

Daniel: It's interesting that markets have reacted with a massive buying of energy stocks and fracking stocks after the (at least) announcement from the media that Joe Biden could be the winner.

And the reason why I think that is happening is because if Joe Biden really understands anything about

energy, he knows that you cannot have low unemployment in the states that are fully devoted, mainly devoted to manufacturing. You cannot have low unemployment and at the same time a green economy today.

And that there is only one way in which the United States gets into a competitive energy transition to a more green model, which is with the combination of renewables and natural gas. And when we talk natural gas, natural gas is fracking.

So banning fracking would be disastrous for both the employment situation of the United States and the investment situation of the United States. And it would be very, very negative for the energy transition that they want to implement.

A competitive energy transition system can only happen with the combination of natural gas and renewables, as they did (by the way) in the years in which Obama was in the administration, where you saw that the United States was the only country in the world in which the development of renewables didn't make utility bills – electricity and gas – soar. Thanks to the competition with natural gas and oil from the fracking revolution.

Therefore, if Joe Biden decides to shoot the US economy in the foot and ban fracking, you would have the outcome that Germany saw.

Germany decided to shut down the nuclear plants and to invest everything in renewables with massive subsidies. Utility bills soared for household consumers. And today, as we speak, they depend more on lignite, which is coal, and on Russian gas than [anyone ever] expected.

So the point that I'm trying to make is that if he truly cares about growth, jobs, and the economy, he must understand that you cannot offset the jobs lost in manufacturing and in energy with jobs in the renweable business. I have been investing all my life in renewables. You don't need the number of employees that you need in a solar plant or in a group or windmills compared to the ones that you need in a group of oil rigs.

So the point that I'm trying to make is: One, he needs to develop a plan of competitive energy transition.

If he puts as leaders of that plan the most ideologically driven people in the Democratic party, that would be atrocious for utility bills, for households, for jobs, and for growth.

So I think that if they've learned anything about the last years it's that the United States has been one of the very few countries that has been able to reduce emissions without increasing utility bills for households. Employment has gone to record levels. And, at the same time, it is a leader in renewable investments.

All of that comes from one beautiful word: Competition.

That does not exist in so many other developed economies in the Eurozone in terms of energy.

And that's what they need to do: Competition and technology will drive the energy transition better for everybody than intervention from the side of the most ideologically driven people in the Democratic party.

Erik: Daniel, I can't thank you enough for a terrific interview.

For the benefit of our accredited investors and institutional investors, please tell them where they can learn more information about the fund that you manage. And, for the non-accredited audience, is there a blog or a Twitter handle? Or how can they follow your work?

Daniel: Thank you very much. Yes, you can follow the funds that I am working at Tressis. And you can also follow me on Twitter at dlacalle_ia or my website dlacalle.com.

So I'm not difficult to find. You put Daniel Lacalle on Google you'll find me pretty easily. And I hope to continue the dialog with everyone.

Erik: Thanks so much. We look forward to getting you back for another interview in a few months. Patrick Ceresna and I will be back right after this message from our spon