Kyle Bass: Commodity Bull Market, Inflation & Singapore

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Erik: Joining me now is Hayman Capital founder and fund manager Kyle Bass.

Kyle, it's great to finally get you on MacroVoices. I think you are our most requested guest ever.

Here we are: global pandemic, big explosion in cases, hospitalizations, deaths. Monday this week, Mayor de Blasio said get ready for a possible total shutdown of New York City.

Lots of bad stuff going on. Stock market rallying to effectively all-time highs.

What's going on here? Is it basically we're in a new market paradigm where it's all about expectations of Fed stimulus? Or how is it possible that we're at all-time highs with, really, a hundred-year disaster on our hands?

Kyle: I tell you, the markets are very good at looking across even the Grand Canyon when you're talking about different shapes of recovery.

But I think in this case we've seen – this word is so often used today that it becomes lest impactful. But we've seen an unprecedented coordinated global central-bank response to the Chinese pandemic that I think the amount of both M1 and M2 in global systems, coupled with the fact that we are getting to a place where we have a vaccine that shows a very effective response – call it 90%-plus efficacy – and its ability to vaccinate against this horrible virus.

So I think by the middle of 2021, we're going to have a vaccine-led boom in global markets coupled with the fact that we have so much cash sloshing around. That's why you see both stocks and bitcoin and assets and basically everything you and I can buy is headed to new highs.

Because we're going to have – I agree with Jeff Currie, listening to your prior Smarter Markets podcasts – I agree with the view that we're going to see a new secular cycle in commodities because of these two (call it) enormous tailwinds.

Erik: Well, great minds think alike. That was going to be my next question.

So let's come to Jeff Currie's view where he says it's not just a new secular bull market in commodities with COVID-19 being the catalyst to bring that about. But he also said that that leads to an inflation cycle that eventually becomes self-reinforcing.

Do you agree with the inflation aspect of that as well? And what do you conclude in terms of investment outlook? Do we think about the commodities first and worry about inflation later? Or do we start hedging the inflation now?

How do you break this down?

Kyle: I don't know, Erik. If you look around your life, is there anything that you purchased in the last 10 years that is much cheaper than it used to be?

I mean, in my life, whether you're buying farm and ranch vehicles or whether you're buying even technology-based investments, whether you're buying a new PC or whether you're buying a new iPhone, their capacity has greatly increased. But the actual net price tag has also increased.

And the way that the inflation experts, using chain weighting, calculate inflation, I basically am offended by the fact that people out there don't believe we have inflation already.

We've seen enormous inflation, whether you're buying automobiles, houses, technology. Technology per storage unit or cycle unit has definitely gone down in value, but we have many more units in each device. Therefore the net price is higher.

So I expect pretty significant inflation. And it will widen the gap between the haves and the have-nots. And we can expect to see even more social discourse going forward, which will be the negative associated with the positive of (call it) rallying markets and enormous inflation.

Erik: And of course those rallying markets only exacerbate that social divide because the haves have more and the have-nots have less.

In terms of investment outlook, can we think about things like copper and copper miners, mining stocks generally? How do we think as investors about this coming inflation that both you and Jeff C – and also this coming commodity secular bull market?

Is this something that you play by holding the commodities? Or do you think it's better to be in the mining stocks and other producers? How do you play it?

Kyle: My view is slightly different than just about everyone's. Everyone has their own view on this.

And my view is in the last few cycles that were secular bull trending in commodities, as you and I probably know, the break-evens in iron or break-evens in copper mining companies all continued to move substantially higher because of the inputs. The labor, the machinery, the maintenance, the permitting, all of those costs, all of the input costs that go into mining, the tires and this and that, end up going up.

And so, while in various periods there is convexity in the equities of these companies, I'd much rather own the pure play, I'd much rather own the commodity itself.

Because in owning a commodity, you're actually the net beneficiary of the shortages and also the bottlenecks in supply constraints and also costs that are factors of each of these businesses. So I tend to lean much more towards the commodity than the companies.

Erik: Another point that Jeff Currie made in the interview that you mention was he drew a distinction between fiat debasement – and he said we've got plenty of that coming between MMT and what the Fed has already done with balance sheet expansion – and inflation, which really he said are two different things.

Gold is the hedge, according to Jeff Currie, against fiat debasement. But oil is a much better hedge against price inflation in the broader economy.

Do you agree with that distinction? And is gold still the big play here as the hedge? Or are things like copper, that we actually need to build out the infrastructure that a lot of people see on the horizon, going to end up being a better investment than gold?

Kyle: I would say all of the above, because I don't know where investors capital is going to focus.

As we all know, the digital gold of this century has been bitcoin and that has probably subtracted net new purchasers from commodity gold in a large way in the last (call it) 10 years.

You ask is oil a hedge. Well, again, there's idiosyncrasies to all commodities.

I think if you look towards energy and you look towards the lack of CapEx that's gone into these companies over the last four years due to the market – both bringing in a new vertical ESG mentality to investing and/or not investing in many of these hydrocarbon-based companies.

And you also have the markets and the banks in the market really lowering their borrowing bases and being much more reluctant to lend to even good energy companies that have significantly more assets than liabilities.

So you have a constraint of capital. You have a lack of material CapEx in this space for a long time. And you're about to see two things happen, in my view.

So I'm going to say that energy is a much more convex play to hedge yourself from the enormity of the inflation going into (call it) mid to late 2021.

We’re going to have a vaccine-led recovery.

We’re going to have pent-up travel demand, both business and recreational travel demand. Therefore, while I’m not saying we’re going to see oil demand go right back to where it was pre Chinese pandemic, I do think in a very short term, once the vaccine-led recovery happens, we’re actually going to see more people travel than have ever traveled before.

And so I think we’re going to exceed hydrocarbon demand pre-COVID for a short period of time in 2021. And the supply side will not be able to react. So I actually think you’re going to see a very large energy, energy move higher.

Erik: Kyle, let’s move on to fixed income. Jeff Gundlach told us – what was it, four years ago? – that 1.34 (I think that was it), the bond bull market was over. And we got almost 100 basis points lower, at least on an intraday basis.

Are we finally done? Is the 38-year bond bull market finally done? Or are we headed to negative yields on the US 10-year?

Kyle: That’s the best question you’ve ever asked me.

And I believe that we’re going to see significant inflation. I think we’re going to be able to run it, as the Fed calls it, run it hot for a while, i.e. exceeding the Fed’s inflation parameters.

But that doesn’t necessarily mean we’re going to see a major bond selloff or even have the bond vigilantes – if those that might be still alive show their faces yet again.

Given the amount of debt that the global pandemic has left all of the developed world – and even the lesser developed world – basically they’ve been saddled with, I think you’re going to see nominal changes in bond yields.

Maybe the 30-year US Treasury base – what, about at 1.65? – could that see 2.50? It could. But could the short end, do you think the US short end is going to go from zero to 2 or 2-1/2%? Absolutely not. Even if we run big inflation numbers we can’t afford to let those rates move.

So my view is you might see some kind of shocking moves that might move 50 to 100 bits. And those would be shocking.

But if you just look back to the history of this massive bond market rally, really, since what? 1989 or so? I think you’re not going to see any kind of meaningful yield moves higher. I think you’re just going to see asset prices move higher.

Erik: So, essentially, we need to inflate away some of the debt that we’ve built up because the debt, at least in real terms, right now just doesn’t permit higher bond yields. Is that the gist of it?

Kyle: That's correct. I just think once you head down this road that the central banks have clearly headed down there is no turning back. There is no letting the bond market and the market rates dictate where, again, where an effective zero real rate would be.

So I think we're going to have negative real rates and I think that's going to further exacerbate the Jeff Currie phenomenon of feedback loop of more and more inflation.

Erik: And how does the US look compared to the rest of the world, in terms of we're already seeing negative yields in Europe? Do those recover out of negative territory as this inflation begins? Or are they stuck there?

Kyle: I think they're stuck.

My own view is that Europe – Europe is a perfect example, I think. Last week Portugal got to a zero yields. I mean, some of the most profligate spenders in Europe, being the PIGS – Portugal, Italy, Greece, Spain – those yields are now some of those at or below zero. You have Germany negative.

I think in a world in which you still see material inflation, I think that the central banks keep those yields pegged. Again, they might allow some flexibility in the beginning – 50 to 100 bits – but I don't think you'll see much more than that.

Erik: Let's move on to the presidential election.

I think it's pretty darned clear that President Trump, if he's going to pull a rabbit out of a hat, he'd better do it pretty darned quick here. Because it seems pretty certain that Joe Biden is going to be the president in 2021.

What does it mean for markets? How does the Biden Administration change the macro outlook?

Kyle: I'll stay away from wherever the Georgia election is going to end up and let's assume that there is a check and a balance in the system, i.e. that there is still a Republican-led majority in the Senate so that there is not a full blue wave.

If that's the case, one of the bright spots of a Biden administration will be the Biden energy and climate plan. And I think you're going to see tens of billions of dollars, if not trillions of dollars, globally being spent on alternative energy, trying to wean the world off of its insatiable demand for hydrocarbon consumption.

And I think when you look at the Biden plan, I think that is going to be one of the core tenets of the best part of the Biden Administration. And investing around that is going to be, I think, very rewarding to those who understand where it's going.

Erik: And if that is the outlook, I would assume, then, going back to what you said earlier, that the play is going to be in oil. Not in oil-producing companies, because they're going to be potentially the victims of some of Biden's policies. The result will be higher oil prices.

Would you agree with that analysis?

Kyle: I would agree with that. And I think that there are a couple of reasons –

I wouldn't even say it's the best play. It's a play.

I think that the best plays are going to be on the electrification of transport and all the concentric circles that surround that electrification, some of which, as you know, have already been exploited, maybe fully exploited like in companies like Tesla.

But there are going to be many, many, many concentric circles around the thought about what did the Obama Administration miss in their desire to bring alternative energy to the United States.

And what the Obama Administration learned was that there aren't any real transmission lines from the best areas of our country to develop alternative energy. Let's say the northern panhandle of Oklahoma, or Nevada – you need enormous transmission lines to get to places like the Tennessee Valley Authority and get to the West Coast to get to the grids to propagate that electricity.

I think you're going to see a Biden Administration come with plans that kind of eliminate and address those specific bottleneck issues that get us to a better and more electrified economy. The net beneficiary of all of this – so that's the explicit goal.

The implicit benefits are going to be they're going to make it much harder and much more expensive. This gets to your point on whether you choose oil or an oil company or hydrocarbon-based company or the hydro carbon itself.

They're going to make it much more expensive to explore for, develop, and permit hydrocarbon-based investments, whether it be natural gas or crude.

And I think that in itself will have a serious effect on the price, making all of the inputs more expensive. They're going to make the actual commodity more expensive.

And that will be coupled with the fact that I think we're going to have a V-shaped acceleration in our economy as soon as the population gets substantially vaccinated, (call it) middle 2021.

So there are two large tailwinds going into a business that hasn't had any real CapEx spent in the last handful of years. And demand will exceed the prior demand peak.

So, again, we're going to see another energy super-cycle that will both benefit alternative energy as well as old energy, which I don't think the youths in today's markets, the millennials that are running these funds and investing in Robin Hood, kind of fully grasp yet. But I think they will next year.

Erik: It seems to me if you think electrification is the big thing, what I feel like everybody is missing is you can't have this electric vehicle revolution everybody is talking about without rebuilding the electric grid first. The electric grid just doesn't have the capacity to recharge all of those electric vehicles.

I think that means there has to be just enormous demand for copper. What else does it mean? What are the other implications of electrification of the economy?

Kyle: Yes, I think this is – we get to talking about China, and in China people say, oh, they're building so many electric cars and Secretary Xi has said he is going to run carbon neutral by a certain day.

Well, first of all, we all know that is not the truth, as is normal coming out of the Chinese Communist Party's mouth.

But it's important to note that Chinese electric cars are basically coal-burning cars. And what I mean by that is China still generates the majority of its electricity by burning coal. And so, while they feel good about driving electric cars, what generates that electricity is still the worst possible commodity on the planet.

In the US, what this means is if we are to try to electrify not only the grid in a better way but to electrify transport, the net beneficiary of that electrification is going to be natural gas.

And I think you're going to see both natural gas and natural gas transport companies continue to do better and better and better in the coming decades if we get to this transformation of America's energy business.

And if you just look at the numbers, and even if you look at (let's say) a turbocharged adaptation or acceleration into those electric vehicles, and the electrification of the grid, I don't even think you see a material impact on hydrocarbon demand until the mid-2030s.

Again, that lack of focus on CapEx is going to catch up to the governments that have not focused on that specific – governments and markets that haven't focused on that desperate need globally for CapEx in that sector.

Erik: You mentioned China a minute ago. I want to talk a little bit about Hong Kong.

I know that you've had great passion for the loss of Hong Kong's independence. And I certainly as a legal resident of Hong Kong appreciate your concern.

But I want to talk about the market implications of that. Hong Kong has historically been the gateway city to Asia for finance. And the whole benefit is Hong Kong under treaty was independent under its own democratic legal system until 2047. Except it looks like they're not going to honor that now.

What does that mean in terms of Hong Kong being the financial center for Asia? It feels to me like it has to be displaced. Who is the winner?

Kyle: If you were to pin me down and say which city will end up reigning over Asia as the financial center, I would have to say it's Singapore.

If you were to allow me to see which handful of cities – if you look at the flow of some of the highest amounts of intellectual capital in Hong Kong, it's mostly going to go to the UK. It's mostly going to go to Singapore. It's going to go to Sydney. It's going to go, some of it, to New York. Some of it to – I think you're going to see it disperse.

But I think if you're looking for a new financial center in Asia, it will be Singapore. And Singapore will end up being the hub for a lot of the equity and commodity trading in Southeast Asia, and I think that they will be the net beneficiary.

And you probably saw over the weekend, Erik, that the UK, who is offering citizenship to those Hong Kongers that have those special passports, they were processing five Hong Kong passports per minute all weekend for that transition date being January 1.

So Hong Kong is going to lose 10-20% of its top minds immediately in the next 12 months. And if they lose 5% of their deposits, Hong Kong's financial markets and banking system end up detonating. So get ready for an interesting 2021.

Erik: And so what does that mean for Singapore if Singapore is going to be the new financial center on the scale that Hong Kong was? I know they're already seeing an explosion of high-end real estate. Huge amount of money has moved out of Hong Kong and into Singapore.

Is the play on the Singapore economy? Is the play on what happens in the Singapore financial system? If you want to invest in Singapore as the up and coming place, how do you do that?

Kyle: The answer is yes to all of the above.

I think you're going to see, again, asset prices will be agnostic to region unless it's one of the regions that has China's heavy hand over it, like Hong Kong. I think you'll see pretty significant declines in some of the markets there.

But I think in Singapore, whether you're looking at real estate or you're looking at equities, or as – Erik, I know I've heard in your prior podcasts – you and I are both investors in a company the former Goldman Sachs executive by the name of Josh Crumb, who is setting up a new exchange.

And he's standardizing commodities trading based in Singapore. And especially in a global LNG contract, which is hard to believe there really isn't a standardized contract.

But I think we end up thinking that that is going to be the nexus of Southeast Asia. I don't mean to put words in your mouth. But people like Josh Crumb have been so prescient in their views over time that they've chosen the right markets, the right regions, the right macros altogether. And they've been able to look three, four, five years ahead and get to that place.

And someone like Josh Crumb would be someone that you should bring on to your show and let him explain his own thinking. But he's someone that I invest in. I invest in him as a person because I love his brain. You should get Josh on and deconstruct his brain about the tokenization of commodity markets and the various dimensions of how Singapore will be the new hub of Asia.

Erik: I've been trying to get Josh to do that. He doesn't want the Smarter Markets podcast, which he is sponsoring, to appear to be an infomercial. So he's asking me to interview the subject matter experts.

But I do want to ask you about Abaxx, since you brought it up. And, again, listeners, in the interest of full disclosure, Kyle and I are both angel investors in this company, so we do have a vested interest.

But something I found interesting, Kyle, is every investor I've talked to has a different concept of what this company is. Robert Friedland had very different reasons for investing than I did. I think of it really as a FinTech startup that's mostly about using distributed ledger technology to modernize the way commodity futures markets work.

Now, I didn't even get it until I interviewed Tom McMahon for the Smarter Markets podcast. And that interview has not aired yet; it will air this coming Saturday.

Until I did that interview, I didn't really even understand the importance of the LNG aspect of it, which I guess for some investors is the whole story.

So how do you think about Abaxx as a company? Aside from Josh Crumb as an individual, what do you think this investment is about? Because I thought it was a FinTech thing. Robert Friedland thought it was something else.

How do you interpret the company Abaxx?

Kyle: It's a great point.

For me, when I think about what is necessary for the world to be able to trade a commodity that I think will exceed the notional value of crude here in the next year or two – and that will be LNG – and the fact that there is no standardized LNG contract, that it's all bespoke and traded between some of its end users on a conversation-by-conversation basis, I think getting a hub like Singapore, finding a place where there can be a nexus of the convergence of these players that can withstand (let's say) the test of time and location, I think that will be Abaxx and Singapore.

The same people between the Goldman Sachs, the Nymex, and the various players that created or standardized the Henry Hub natural gas contract are the same exact people putting together the standardized contract for LNG in Singapore through Abaxx.

So I thought that was enough to make the investment. And the most beautiful part of understanding the many facets of how Josh and his team think are, secondarily, you now have this ability to tokenize commodity markets by bringing in blockchain.

Again, you can't talk about creating new markets and new technology at the same time.

But if you want to start bringing into this aspect of commodities trading the ESG, let's say global citizen desire to trade hydrocarbon-based commodities that maybe even have a carbon offset attached to them, the opportunities are endless.

And it's very similar to the way that – Jeff Currie said how we eliminated acid rain by creating the catalytic converter and making sulphur something that we all must deal with. It's been dealt with. There is no more acid rain.

I think the fact that we have the ability to now tokenize all commodities trading and basically, like they did with blood diamonds in Africa, we can start thinking about cleaner commodities. We can think about the social welfare of the need to trade these kinds of commodities in these areas of the world.

And there is no team better than the Abaxx team that's been put together, again, with former Goldman partners and Nymex heads, I think you have a great team. And, again, they've already achieved something pretty substantial.

The Singaporean authorities have granted them the ability to create this exchange and they're very close to finishing creating the first exchange for a standardized LNG contract.

So I think this is the beginning of a pretty interesting wild ride in the tokenization of commodity markets.

Erik: That's very fascinating. So you see it first as the LNG contract in the energy market, which makes perfect sense for Singapore because it is an established energy trading hub.

I tend to focus on the longer-term picture of who is going to redesign markets to embrace secure digital bearer instruments.

Let me run this scenario by you. If that works and it's a threat to US markets, what does that mean in terms of relationships?

We've seen a lot get lost to Asia. And in this case we've got not only American-invented technology that's being used, but there's a lot of American guys that are involved in this particular venture – and Canadian guys – that are building something which, for a lot of regulatory reasons, is going to be domiciled in Singapore.

When this gets to the point where it's a threat to ICE and CME group, what does that mean in terms of the international relations aspects of it?

Kyle: We had a big weekend in the last (call it) three days here. (Today is December 14, the date of this podcast.)

And I think that what we've seen is we've seen the Chinese Communist Party documents released over the weekend that show where 1.9 million members of the Chinese Communist Party are embedded in various government super-national institutions as well as corporations.

So when you think about the domicile, we think about where the risks are to the world and how this technology might be misappropriated, I think Josh has got his hands full.

But I think as we move forward there has got to be somewhere in Asia that runs a rules-based English-law version of a high-growth area like Singapore. And I think the world's money is starting to move towards that view.

I just think that, whether you're looking at Josh or Andrew or Catherine or Jeff or Margot that are all there, I think you realize that they foresaw what was coming.

And maybe they weren't counting on China abrogating its contract with Hong Kong a few decades early. But they will be the net beneficiary of that abrogation.

And it will just accelerate this move towards, again, standardizing not only LNG but other commodity contracts over in Singapore. And I think it will be a new high-velocity exchange.

And you said, what does that mean to CME or ICE? Well, CME or ICE wind up either having to create something on their own or acquire something. So I think the sky is the limit to what these guys are doing.

Erik: Moving off of Abaxx and just going back to Singapore as a new financial center.

When I moved to Hong Kong in 2009, I evaluated both Singapore and Hong Kong. And it was because of the treaty that I felt like, okay, I'll be pretty old in 2047. I knew that Hong Kong would eventually be annexed into China. But I figured, you know, there is a written treaty. I'm good until 2047.

Do we need to be worried that Singapore is eventually going to be annexed into China. They're physically a little bit further apart, but what are the potential risks there?

Kyle: Yes. I think the world needs to be aware of the fact that China is the largest risk to democracy globally. And I think that, whether you're in Singapore or whether you're in Hong Kong or whether you're in Cambodia or whether you're in Vietnam or the Philippines or anywhere over there, China is a menace.

It's a menace in the South China Sea. It's a menace both economically and technologically to all developed democracies around the world. You see it daily now in the press.

So the answer is yes. It's a real risk. It's a real risk that instead of conducting a cyberwar or an information war or an economic war, which are the three wars that China has been fighting with the West since the early 2000s, we just have to hope things don't go kinetically.

And what China does with Taiwan in both the near and the medium term I think is going to answer your question better than I can. But if you see China move on Taiwan then I think Southeast Asia is all at risk.

So when you moved to Hong Kong in 2009, Hong Kong was a very different place than it is today.

Over the weekend, we literally saw the billionaire founder of *Apple Daily*, Jimmy Lai, we saw him in shackles. I mean, are you kidding me? You need to put a 70-year-old in shackles for some sort of sedition because he reported on the heavy-handed nature of the Chinese Communist Party? If that isn't indication enough to you to get out of Hong Kong, I don't know what could be.

Erik: Well, and it's not so much a question – I've already – I'm still a legal resident and I don't spend much time in Hong Kong. But I think about Singapore and I think, boy, I was really confident Hong Kong was going to be there until 2047. And I know that China has its eyes on Taiwan, and Singapore is in the same neighborhood. So I don't know what to make of that.

But moving on from Singapore, Kyle, what else are you and the team at Hayman thinking about in terms of the macro landscape?

Kyle: One of the topics we danced around here but not really addressed is crypto currency, and specifically bitcoin, and how that either does or doesn't play into macro-based investing or hedging. Or how you think about life going forward in the next 10 years.

So I'm curious to get your view on how you think about it and then I'd love to share mine.

Erik: Well, my view is changing. I wrote a book about this in 2018.

At that time I said, look, the things you need to understand about bitcoin are #1 it is strongly in governments' best interest to outlaw it. And so far they've been very slow to do that. But it is in their best interest to outlaw it, and don't believe the nonsense you hear about how it's impossible to outlaw it. That's just not true.

I also said though that the longer they go without outlawing it and the more institutional adoption that it sees as an investment asset, the harder it will become politically for them to eventually outlaw it.

I very much still think that.

And we've seen so much – I didn't think we'd get this far, but we've seen a lot more adoption.

Our listeners have heard me say this 1,000 times over – and you know this better than I do, Kyle – but you never want to make your bets based on what you think is right and what you think the market and the world should be doing according to you. You've got to look at what the world is doing around you.

And as much as I think that bitcoin is seriously flawed, for a long list of reasons that are in my book, you know what? The rest of the world doesn't seem to be reading my book, and they're buying it [bitcoin].

What I see that I think is a very important trend is bitcoin is taking market share from gold. And you could look at that as an opportunity to buy the dip in gold.

Or you could look at it as the beginning of a new trend where, even though I don't agree with it, we're going to see a new generation decide that the scarcity asset that you use to hedge fiat debasement risk is not gold anymore it's bitcoin.

And I think that's silly for a number of reasons. But it seems like it's maybe what's starting to happen.

And I'm starting to think that you almost have to have some kind of hedge, a long bitcoin position, not because I believe in bitcoin but because I do believe that a whole lot of people don't see the shortcomings that I see in bitcoin.

Kyle: Well, you and I have somewhat similar views here. I think that bitcoin is definitely the millennials' gold. And we've seen adoption begin to move institutionally over the last year or so.

And I think that adoption is going to take it to new highs. And that means that I think it's a tradable asset.

But I would agree with you that if you put myself into the role of finance minister or head of the Treasury of any of the major Western nations, it's kind of the antithesis of the economic system and the manner in which these governments operate, i.e. one of our sharpest swords here in the United States is our ability to impose economic sanctions, including in the most egregious examples removing companies from the SWIFT system.

If we get to an ungovernable global currency where just scarcity equals value and it becomes untraceable and/or more difficult to trace transactions, I think that's, again, antithetical to the manner in which Western democracies operate.

I think that there are plenty of levers that can be thrown to challenge new entrants.

So I've always thought that bitcoin's success will actually be its failure or its own stumbling blocks, i.e. the more it becomes ubiquitous and the more it becomes standardized, the more governments are going to have to pay attention to it. And also look to regulate it from an AML KYC perspective, which is what these bitcoin trading houses are starting to do to weed out the criminals, which I think is necessary.

But then also from the perspective of maybe if we count it as a commodity or if it's deemed to be a currency, then wherever bitcoin is trading at year end, you could be forced to pay capital gains tax on it.

And it will always be short-term, just like owning bullion or owning a futures contract. Even if you haven't sold the contract, at year end, your mark to market happens and you pay gains.

That could slow down the adoption of these types of inflation hedges. And I think that those taxes are coming.

Erik: Kyle I want to ask you how close do you think we are to the point where it becomes politically inexpedient for outlawing it to be an option anymore? It seems to me like they could still outlaw bitcoin. But, boy, if we get a whole lot further down this path, it's going to be hard to do that politically.

Kyle: I actually don't believe that you'll ever see a prohibition or an outlawing. I think what you're going to see are many tethers attached to it that make it infinitely more difficult for it to achieve all of its objectives, as the people in bitcoin are hoping it can.

Meaning, again, you may have short-term taxable gains or losses applied annually. You might have to do full disclosure on your tax return. If you don't check that box that says *I own bitcoin* or *I own cryptocurrency and here are all of my transactions*, and you get caught, that could be a felony punishable by multiple years in prison and disgorgement plus reparations or whatever on gains, plus interest.

So there are plenty of things that can happen that will make it much more difficult for it to achieve its objectives. And I think that's what you're going to start seeing. I don't think you're going to ever see just an outright prohibition.

Erik: But the headwinds keep getting stronger and stronger along the way.

What else do you guys – are you starting to consider a position in it because of its popularity? Or are you still skeptics? Where are you at with respect to bitcoin and other cryptocurrencies?

Kyle: For me, when you say a hedge, would anyone put 1% of their portfolio there? Yes. Would anyone put 5% of their portfolio there? Probably. But is it something that could move – if you woke up tomorrow and bitcoin was down 20% tomorrow, you'd say, well, it's down 20%.

It's not really a store of value. It's a speculative trading asset. And that's why it doesn't have any real tangible percentages in people's net worth.

I realize there are people in there that are making billions and making fortunes by being early and long. But they've also suffered enormous bouts of volatility. And I think when you have global – when you think about the G7, G7 currencies don't move 20% in a day. They don't move 20% in a year, normally.

So I think it will stay, it will remain a tradable speculative asset. But for us, we're not participating.

And, in the interest of full disclosure, we did try to participate a few years ago. And we hired armies of lawyers. And we got to this point where we couldn't comply with SEC law because it's not a bindable asset and we couldn't find a true institutional custodian a few years ago. And a few years ago means we tried when it was $2,000 a coin, not $10,000 a coin.

So we're not spending a lot of time trying to figure out how to make it an investment in our portfolio. I think you're going to see population demographic trends in the US are going to intensify over the next decade and I think there are, let's say, better risk-averse ways to make exceptional returns over the next 10 years.

Erik: I agree with you. And obviously, as you say, people have made an absolute fortune on this thing. People are going to continue to make an absolute fortune on this thing.

People made absolute fortunes on tulip bulbs too. It was just a question of being lucky to be in the right place. You couldn't make logic- and intelligence-based decisions on when the tide was going to turn.

And the things that I think most people are missing, first of all there is very little understanding – what is the intrinsic value of bitcoin? Intrinsic value is a pretty well-defined term. You can get even people in finance that specialize in this stuff to agree.

A lot of them think that the electricity consumed in the hashing algorithms in order to mine the bitcoin becomes intrinsic value, which is just nonsense. But people really believe this stuff.

And, at the same time, I think a lot of people don't understand that distributed ledger technology is advancing. We're not going to need mining anymore in order to have distributed ledgers work, and work at a much, much more functional level – several orders of magnitude better performance – without mining than with it. As soon as we get rid of proof-of-work-validated blockchains and use better distributed ledgers.

This goes back to Upton Sinclair's famous quote: *You can't get a man to understand something if his salary depends on him not understanding*.

And what it will take for bitcoin to do the right thing, which is ditch blockchain and replace it with a non-proof-of-work-dependent ledger system is going to be for the miners to say, hey, we're irrelevant now. It doesn't make any sense for us to continue to exist. Let's just accept this and move on. It's going to be very hard culturally for the bitcoin community to accept that mining needs to go away.

And that leaves room for a new digital currency system, whether it be a Silicon Valley digital currency or even a sovereign digital currency, to come in with a better distributed ledger and steal the show. And I don't think a lot of people understand that.

So I think we're very much of the same mindset on that.

Anything else on your mind in terms of what you guys have on the macro radar?

Kyle: I'll leave you with one last thought on bitcoin though. I think the speculative frenzy has definitely not peaked.

And if you were to draw an anecdote back towards the Tulip Mania, if you remember, the one tulip, the coveted tulip during Tulip Mania was this tulip called the *Semper Augustus*. And the *Semper Augustus* actually got to a point, it reached a level that actually priced about the approximate nature of a house in Holland, i.e. the full investment of a dwelling is what that reached.

So if that is any kind of indication of to where bitcoin is going to go in its speculative frenzy, I think it still has a much higher price we're going to see, again. But I think fundamentally, organizationally governments can't let it be what it is today. So I agree with you there. But I also am going to tell you that I think you haven't seen the hockey stick yet.

Erik: I agree with that. Now, I think that that could mean a pretty big downdraft for gold. So many people are going to watch bitcoin break to new all-time highs and say, okay, look, these gold bug boomer types don't know anything. It's all bitcoin, baby. Forget about gold.

And I could see a lot of younger people selling all their gold to go buy more bitcoin and chase it higher.

Do you think that's right? And if so how low can gold go as a result of the bitcoin drain effect?

Kyle: That's a great question. When I see global central banks continually acquiring gold – and you look at China, China will never publicly mention what it's doing with gold. It just continues to mine it and keep it, mine it and keep it. Because I think it takes a page out of Keynes' playbook: You can't have a complete fiat-based currency without some sort of underlying value.

And I think when you look at what these countries are doing, the developed world is doing with its gold at central banks, I can't imagine there are many millennials left that own gold.

So I would say that you're not going to see an enormous gold selloff if that bitcoin hockey sticks. I think you would see gold flat to higher in that environment. That's just my view and I know that conflicts with yours. I just think that we've already seen the millennials' picture of selling gold.

Erik: Well, Kyle, I can't thank you enough for a terrific interview. I'm going to take your advice to heart and try to get Josh Crumb to come on the Smarter Markets podcast and talk about all of the different things that they're doing there. I may need your help though, because he's been resistant so far.

Kyle: We can make that happen.

Erik: Well maybe we'll just get listeners to beat him up on Twitter or something. We'll figure it out. In any event, Kyle, I'd love to welcome you back either to MacroVoices or the Smarter Markets podcast. We'd love to get you back and continue the conversation.

We're going to leave it there for today's interview. Patrick Ceresna and I will be back right after this message from our sponsor.