Luke Gromen: The FED Faces No Easy Choices

January 14th, 2020

Erik: Joining me now is Forest for the Trees founder, Luke Gromen.

Luke, it's great to get you back on the show. You've been on my mind lately, because I have been saying for I don't know how many years it's been now, I'm absolutely certain Luke Gromen will be proven right in the end. But I kind of thought in the beginning you were a little bit early. Maybe I guess you were, as history has proven out.

Are we at the point where we have the so-called Luke Gromen moment where the US dollar really does start a decline that's a one-way direction beginning to lose reserve currency status, it's the beginning of the end kind of moment?

And, if so, I think a lot of people, including myself initially, had maybe misunderstood you on that: Some people thought you were predicting a dollar crash. And I really don't think you are. I think you're predicting more of a slow process.

So how do you see this playing out? And where are we in the story at this point?

Luke: Thanks for having me back on, Erik. It's great to be here and happy new year to everybody.

I think we are really getting into the process. I think COVID accelerated things meaningfully.

We've been saying that we think it's a process of a change in the structure of the dollar's reserve status, which effectively is the key hallmark, which is foreigners ceasing to grow their holdings of Treasuries as the primary reserve asset in favor of gold in particular, but other sovereign bonds, as well basically balancing things out.

And there was actually an article on Bloomberg this morning highlighting that, for the first time ever, Russia has gold holdings in their FX reserves are higher than their dollar holdings. And the #1 reserve they have in FX reserves is euros, followed by gold, followed by dollars, followed by yuan.

And I think that's sort of where the world is moving, where it's if you can buy commodities, and energy in particular, in euros or yuan – which you absolutely can buy the marginal barrel of oil

globally in either of those currencies – and that means the world needs structurally significantly less dollar reserves over time.

So I think where the world is going and where we continue to be in is this multi-currency, energy-pricing, multi-pricing FX reserve system where gold takes shares from the Treasury bond as the world's primary reserve asset.

And the flip side of that is, since the world doesn't need to hold as many dollars and as many Treasuries structurally if they can buy energy in their own currency increasingly over time, then the flip side to that is, because most countries – and particularly Europe, China, Japan, the big creditors of this entire system – their biggest deficits are in energy and in commodity imports, then the flip side is they don't need to hold as many Treasuries and somebody else needs to finance US government deficits, which are big and rising cyclically because of COVID and rising structurally because of demographics and the promises we've made to the baby boomers.

And our case has long been that the marginal financier of US deficits as this happens will have to be the Fed. And that's what's been happening. And I think it's going to continue happening.

Now, what does that mean for the dollar in the near term I think is a different discussion. I wouldn't be surprised if we get a bit of a bounce here. I think the Fed is pretty concerned about what the dollar has done in the last 12 months or the last nine months. And I think they're a bit cornered. But I think some of what they could do might see a dollar bounce in the short run.

Erik: Luke, with respect to your outlook, obviously there's two aspects to this.

One is the dollar losing real purchasing power against a basket of whatever somebody is buying. The other is the relative measure against other fiat currencies, which tends to be more about the race to the bottom (so to speak) in a competitive devaluation scenario.

Is it both of those things? Is it one of those things predominately?

What is it that you really see going on here in terms of the outcome that you're predicting? Is it a loss of purchasing power? Or is it a relative decline relative to other fiat currencies because of the dollar's changing role in the global financial system?

Luke: I think it's both. I think relative to other currencies, if you look at what China, Russia – or, excuse me, the creditors of the system as they stand now, which are really the big three, it's China, it's Japan, and it's Europe.

And if all three of them – and in particular China and Europe, the two biggest – can buy energy, in particular commodities, more broadly in their own currency increasingly on the margin, then that system is one where basically every major player has to finance their own deficits, as opposed to a system where all commodities are bought in dollars and everybody finances the US's deficits for them, for the US.

So if everybody has to finance their own deficits, it comes back to a relative game of who has the biggest current-account deficits to finance.

And the Europeans have the biggest current-account surplus in aggregate. That's primarily Germany, but EU has the biggest current-account surplus. China has the second biggest current-account surplus. The Japanese are third.

There's a bunch of countries that are slight surpluses, slight deficits. And then there's the UK, which has a really big deficit. And then the United States, which has an enormous current account deficit.

So, effectively, what has to happen if these creditor countries basically can buy their biggest deficit items – which are energy and commodities, generally speaking – in their own currency is everybody has got to finance their own deficit.

And Europe and China and Japan don't have deficits. The UK and the US do. So they're going to have to print the money. Basically they have to find somebody to finance those deficits.

And our view has long been that the way those will be financed is by the central bank with printed money. And that's what's been happening.

So, basically, you would reorder the global currency system along the lines of in order of current-account balance, which is the way the currency system worked for pretty much all of history up until 1971.

So I think you'll see the dollar weaken structurally against the euro, against the yuan, against the yen over time. I think the pound sterling will weaken against the euro, the yuan, and the yen over time as well.

The question, then, just tactically is always the US has to print the most, but will they print the fastest? And in 2020 they printed the fastest as well as the most. The question is: Going forward will that be the case?

And there are signs that, as of right now, the US, the Fed won't print enough or fast enough relative to what they need to, which would be good for the dollar.

Because we saw in 2018 the US didn't print enough, it was good for the dollar. They didn't print enough in 2019, at least until the very end of the year. It was good for the dollar.

And it's really both against CPI and against foreign currencies as well.

Erik: Let's talk about the political situation in the United States and the Democrats having just taken control of the Senate. A lot of people are connecting this with the increase in bond yields.

The argument is basically if you've got an expectation of a whole lot more deficit spending, that means the government is going to have to sell a whole lot more bonds. If you're selling more bonds, that means there's more supply, less demand. The price goes down.

It seems to me that kind of misses the question of, okay, but what is the Fed going to do to intervene and not allow yields to go too far in the other direction?

How do you see this playing out in terms of the Democrats taking control of the government, the expectation of more spending? How does that play into this whole picture?

Luke: I think it's interesting to see that US tax receipts have begun declining again on a year-over-year basis when you look at – on a trailing 12-month tax receipts. And it coincides with the roll-off of stimulus.

So if the US economy can bounce back strongly, then that's one set of outcomes.

But as it looks now, it looks like the US economy can't survive, really, without increasing government stimulus. And I think, at least in the near term until we fully recover from COVID, that's probably the case.

So then you get to the point that you just made, which I think is the right one, by all accounts it sounds like the Democratic control of the Congress is going to result in increased stimulus spending. And, all else equal, if I was a bond holder that would make me want to sell bonds, make me want to sell Treasuries, and yields up.

And, to your point, the $64,000 question is: What is the level of yields that (a) freaks out the Fed and/or breaks something systemic in markets?

And I think realistically that's probably one and the same thing. The level that freaks out the Fed is the level that causes something systemic to break.

So I think, basically, we're likely to continue to see yields rise in the US until something systemic breaks.

And what's interesting is it's been linear to this point. I think we're now getting to yield levels where, at some point in the not too distant future, those linear increases in yields will start to become non-linear. It will be more of a gamma trade, where it just feeds on itself for hedging etc. as people hedge further risk of yield increases etc.

And I think we could go from sort of a linear, orderly rise in yields to a disorderly rise in yields. And at that point I would expect the stock market or portions of the stock market or something somewhere else to break.

And at that point I would expect the Fed to do exactly what you noted, which is come in with yield-curve control of some description or increase the monthly levels of QE to get that under control.

What's been interesting to me in this whole process is that the dollar hasn't responded to these yield increases at all. And I think Louis Gave said it best a couple of weeks ago in an interview, he said when I see a nation who has rising yields and a falling currency, alarm bells go off. That's a symptom of a balance of payments problem.

And I think that's a way – from the yield increases, which I think the Occam's razor explanation for why yields are rising, particularly post-election, is on expectation of the stimulus.

I think the reason behind the reason is that the reason we need the stimulus is because the US has a balance of payments problem in the aftermath of COVID. When you look at the hole that was blown in the US fiscal budget after COVID, it really looks, to our eyes, irrecoverable without some massive stimulus or a big devaluation in the dollar or something of that sort.

Erik: Now, a phrase that I've heard you use a lot before, Luke, is deficits don't matter until they do. The implication being that, at some point, if you no longer have the position of prominence that the US has enjoyed, with the rest of the world buying up its debt, all of a sudden the game is different.

But, on the other hand, you can spend pretty much an unlimited amount of money if the Fed just buys all the Treasuries and you don't have to depend on outside investors for that.

How do you see this increased spending, lots and lots of stimulus planned, a growing political sentiment around MMT to say let's just spend whatever we need to, we can always print the money to buy the bonds if necessary?

How long does that game go on until deficits do matter?

Luke: I think they've started to matter already. I think they started to matter in 3Q14 when global central banks stopped buying Treasuries on net.

If you look at what they have bought from 3Q14 to present on net, they have not added any Treasury bonds on net to their FX reserves, which I think that is really the kickoff of when they started to matter.

There have been on this front a couple of interesting op-eds in the *Wall Street Journal* in the last month, one by former Goldman CEO and Treasury Secretary Hank Paulson, one by former Fed governor Kevin Warsh last week.

And both of them I think are really important op-eds because they both suggest that the Fed and the US government have a problem, which is that the US needs to refinance (call it) $7 to

$8 trillion net this year.

In 2020, the Fed bought more than 100% of net issuance of US Treasury. And so the Fed financed – more than 100% financed the US government, effectively, last year. And we saw that in the response of the dollar.

But for 2021, at this point, the plan – and this is as far as I know, before any additional Biden stimulus – the plan is that the Fed is going to buy, or the net issuance is going to be $1.8 trillion more than what the Fed is going to buy.

And so the issue is that now you're back into this dollar short-squeeze mechanic. So the US government will be in a position to crowd out other global private dollar markets, send the dollar higher, send yields higher. So that's sort of one side of the coin.

The other side of the coin that both Paulson and Warsh talked about – Paulson's op-ed I think was titled *I Think Beijing Wants to be The World's Banker.* And Warsh's talked about the same thing, which is that China is putting pressure on the US. They are keeping us honest.

And for the last 40 years, 30 years, since the Berlin Wall came down, we haven't had anybody else to keep us honest, which is to say both Paulson and Warsh noted that you can get 3% to 3.75% in a Chinese 10-year versus whatever we're getting.

So you're seeing capital flows to China away from the US at the same time China has recently signed this massive trade deal, the reset across Southeast Asia and the European investment deal. And you have two stalwart US allies in the EU and Japan signing on with these big trade deals with China in the last month.

So there is this capital flow issue that Warsh and Paulson identified. You've got the Fed needing to help the US government finance these deficits.

But the dollar is sitting right at a crucial level where, if the Fed does do more, you run the risk of what I would say is truly the Fed's worst-case scenario, which is the dollar starts falling and the equity markets start falling in response to a falling dollar – as opposed to rising like they did again last year – in which case, the Fed is really hamstrung.

So I think the Fed is sort of caught between a rock and a hard place where you're seeing capital flows away from the US. You see it in the performance of the Chinese stock market. You see it in the performance of the EU stock market. You can see the relative interest rates higher in China.

Domestically, you're seeing capital flight into bitcoin and gold. And gold volumes, physical gold volumes, I think I saw one the other day up 700% year-over-year.

You've got this financing problem where you need to finance it. If rates rise too much, you

cause stocks to fall. But if you help too much financing it, then the dollar falls and you could have stocks fall because the dollar is falling too fast.

So I think the Fed is really pretty cornered. And I think it all points to this: When do deficits matter?

I think they started to matter six and a half years ago. And I think we're getting to the point of the game where – we wrote a report the other day – sooner or later everybody sits down to a banquet of consequences. It's a quote by Robert Lewis Stevenson.

I think 2021 we're all going to sit down to this banquet of consequences. The Fed's going to have to make a choice of what they want to do.

Erik: And what's the tradeoff in that choice that will confront us in 2021?

Luke: Crush the economy or crush the dollar.

Erik: Luke, expound on that. How do we crush the economy? How do we crush the dollar? What are the mechanics of each of those options?

Luke: Crush the economy is, effectively, the Fed stands aside and does whatever they're going to do in terms of QE, or even taper QE, and force the global private sector dollar markets to finance US deficits and let interest rates just rise and rise and rise. And go to wherever they're going to go find their level until something really breaks.

And crush the dollar is, effectively, have – either at that point or prior to that point – have the Fed say whatever the Biden Administration wants we'll supply – which is just another way of saying yield curve control, really.

It's just saying we're not going to let yields go over X. And whatever the Biden Administration wants to do they can do; yields are not going to go over X.

And what yield curve control will do will effectively create the Lacy Hunt scenario of the Fed will be lending to the government, who will be spending.

And, yes, they will be separate entities. But they will be married. If the husband is lending and the wife is spending, the household is spending. And it will be the same type of thing.

So those are really, I think, the two paths that the Fed is going to have to choose here in 2021: the banquet of consequences.

Erik: Do you have a view on what their choice is likely to be?

Luke: I think they would love to keep riding two horses with one ass for as long as they can. I

think they've done a very nice job of it – I think these Paulson and Warsh op-eds are a sign – to try to defend the dollar and the dollar system for a little bit longer.

You've seen a couple of different Fed officials over the last couple of days talk about, well, maybe we can start to think about tapering here or there. So there is some jawboning going on to that effect.

Ultimately, I don't think they have a choice. The only politically palatable choice is to supply whatever the Biden Administration wants.

And part of that is because of what we saw in 2019 and 2020 with the REPO rates spike and then how the Treasury market traded. Because the thing that very few people are talking about is, because of how dependent on the stock market the US economy has become, once the stock market falls enough, it starts to reflexively reverberate back into the Treasury market.

And so we saw for nine days in March of 2020 – from March 9 to March 18 2020, we saw the Treasury market begin to crash alongside the US equity market nearly tick for tick.

And that was not an accident. That was something that I thought would eventually happen. I was surprised how fast it happened. Some of that has to do with how severe the selloff was related to COVID.

But the issue is, with the US government's debt as high as it is, with foreign central banks not buying Treasuries the way they used to, with the US's net international investment position at negative 60% of GDP – which means foreigners own $40 trillion gross, $12 trillion net of dollar assets.

With the foreigners being as short dollars as they are relative to their dollar borrowings – and, of course, relative to Jeff Snider's ongoing point about the eurodollar market – the point is, basically, as soon as the dollar gets too high they begin dumping dollar assets. And they dump what they can, not necessarily what they want to.

And what they can dump are Treasuries.

So, paradoxically, something that we've begun to see, and which I think we will see in spades in each cycle going forward for the foreseeable future, is that, once the stock market falls too far, Treasury yields will start rising. Which is the complete opposite of everything we've seen throughout our entire careers.

I've been doing this 25 years. And up until March of 2020, when stocks fell yields went down. And in March 2020, stocks fell and yields went up. And that's a classic emerging market thing, the balance of payments problem.

And we saw it again in October. That was down 800 points one day in October, I forget which

day. And the TOT was down, yields were up.

So the longwinded way of saying it is the Fed has a choice, but it's really a Hobson's choice, which is to say they don't have a choice.

Because they can pretend to try to defend the dollar. They can try to defend the dollar. I think they might even be about to here, for a little bit.

But the second the dollar gets too strong, you're going to start to see stocks sell off. You'll see the economy start to weaken as a result of declining stock market consumption, through the consumption link.

And you can't have GDP decline when you're running debt to GDP at 130% because you'll default on your debt.

So it really is just a question of path.

My bet is that they probably try to defend the dollar here for a little bit but that, ultimately, they're going to have to acquiesce and basically use yield-curve control some time later this year to provide the Biden Administration with what they want.

Erik: Well, I have to confess, Luke, it was a trick question because I knew the answer would be it's really hard to tell and we're not sure exactly when each decision is going to be made.

With all of that in mind ,how do you translate this back to an investment strategy when clearly there is a lot of moving parts here and it's not clear exactly which direction is going to happen and when?

Luke: It's hard. It's very political. It comes down to not just the domestic politics, which I think people are very focused on, but these international geopolitics that I think people are at this point still relatively less focused on than they are, at least here in the US, of the domestic politics.

Look, for me, because I'm of a view that any move down is likely to be a whoosh move down, I continue to be positioned as I've been positioned all through last year, which is I own gold, I own bitcoin, I own gold miners. My three largest positions. And then I also own a lot of equities. And I own no bonds.

And that's how I've been positioned over the last – well, really, in December actually, when bitcoin broke above $20,000, I added quite a bit to that position actually. So I am completely cognizant that the risk is that they try to strengthen the dollar or support the dollar. And if they do that, that's not going to be good for any of my positions.

I'm unlevered, and so I'm willing to take that pain.

If I was running a book where I was managing money on a monthly basis, I would probably be de-risking a bit right here relative to those positions to give myself a little bit of cash and some dry powder and some cushion.

Basically, I think they may, like I said, to defend the dollar system as advocated by Warsh and by Paulson in the last month.

But the holes in the system are just so big and the holes in the fiscal position are just so big after COVID. And when I say that I should probably define what I mean.

What I mean by that is if you look at the third quarter TBAC (Treasury Borrowing Advisory Committee) report, it shows that the US's big three expenditures – entitlements, defense, and interest expense/Treasury spending – are 140% of tax receipts. If you look at that same report, it shows you that the US's true interest expense, which is interest expense plus the entitlements and the pay-as-you-go portion of entitlements, it's 120% of tax receipts.

So what that tells you is that if the US tries the austerity route, they try to strengthen the dollar, they try to squeeze out adversaries, it's not going to be very long before the US doesn't have the money to pay entitlements, defense, or interest.

And the US is not going to default on any three of those for lack of money, for lack of printed money. They will get that money.

So that's my point there in terms of that – what it all points to with the debt being where it is, is the US needs significantly negative real rates for an extended period of time. And increasingly negative real rates.

And so consensus, to me, still appears to be that US real rates bottomed in August at negative 1.1%. I think they're probably, I think, at a minimum, on their way to negative 5% and maybe on their way to negative 10% or more.

Erik: Now, that is just fantastically bullish for gold in the long run.

But what we're hearing this week, and I certainly agree with it, is some analysis saying, look, the reason that gold is off this week and likely still has room to go to the downside is specifically because rates are backing up right now. And at least short term, the trend is higher real yields.

How long do higher real yields last? And I think that's explained, as we talked about at the beginning of this interview, by the expectation of a lot of stimulus spending resulting in the Treasury having to sell a whole bunch of bonds to finance that government spending.

For the moment, the trend is higher real yields, gold down.

Do you wait this out for that to get to some better buying opportunity? Or are we already there? How do you play this with respect to gold? And where do you think real yields are going to go?

Luke: It's a great question. I think it just depends on your time horizon. But I think, ultimately, the US is so levered to the stock market, the US is so levered period – we're talking about –

Basically, if real rates keep rising, do you want to buy gold here with (I don't know) 5% to 7% downside, 5% to 8 % downside, and a whole bunch of upside? Or would you prefer to wait and maybe pick it up 5% to 8%, maybe 10% cheaper – I'd be shocked if it got 10% cheaper but certainly, I suppose, possible – and buy it there?

To me, it feels cute because the flip side to that is when you're talking about a trade that has 5% to 8%m let's say 10% downside max, and 50% to 100% upside – because the flip side of it is if Biden comes out and says we're going to do $2,000 dollars to everybody and, by the way, I'm also going to do an executive order where we're going to forgive $50,000 dollars of student debt for everybody – you're never going to get gold better than here again, probably for the foreseeable future.

So, to me, I don't trade month to month. I would rather just – I'm a buyer of it here. I'm a buyer of bitcoin here. I'm a buyer of gold miners here. If you're a trader, with real rates doing what they're doing, I get it. But to me it just feels like trying to be cute.

Erik: I want to touch on the bitcoin versus gold subject. Because I know that you have for a long time been investing in both bitcoin and gold. It seems to me that you could argue this two ways.

You could say, look, gold is really in a soft patch here. And, well, at least until last week, bitcoin was having an incredible bull run – it was time last week, maybe not as much this week, to take profits and rebalance.

If you see you've got two assets that have the same goal and one tremendously outperforms the other, the rebalancing theory is you lighten up on whatever has done better because you figure that it's a good time to shift that allocation so that you're selling the high asset and buying the low asset.

The other argument that I guess you could make is, now look, this is happening because gold is old-fashioned, it's your father's Oldsmobile. Bitcoin is the new thing. You don't want to be taking away from your bitcoin position to be buying gold. If anything, you should go in the other direction because gold is on the way out.

Which way do you see this? Or is it something completely different?

Luke: I think there are a number of things that bitcoin does better than gold. And there's a

number of bitcoin proponents that would tell you what those things are.

I think there are two things where bitcoin underperforms gold or does worse than gold. And those two things are (#1) gold is final payment. It does not have any additional energy debt owed to it.

In other words, if you hold a gold coin in your hand you don't need electricity to make that gold coin work, to make it stay. It is final. It's a reserve asset with no additional energy debt owed to it.

Whereas bitcoin has an ongoing energy debt owed to it in the form of the grid and the amount of energy it will take to keep all the miners and all of the networking nodes all going.

So that's one way.

The other way that I think gold is better or at least needs to be in a portfolio alongside bitcoin is that gold sits on central bank balance sheets, gold sits on the US government and other sovereigns' balance sheets, and bitcoin doesn't.

And I think this is relevant, particularly now when you get to a point where the center of the system, the United States, is as cornered as it is fiscally and from a debt perspective.

And what I mean by that is – we wrote to our clients recently – if you look at Warsh interview or the Warsh op-ed in the *Wall Street Journal*, it's fascinating because it lays out that, okay, we need to refinance all this debt. We need the Fed to do more.

But if the Fed doesn't do more, then rates will rise and risk assets will eventually fall.

If the Fed does do more, then the dollar will fall and it's getting to a level where it could get disorderly fast, and then we could see asset prices fall because the dollar is falling so fast.

And we need to raise rates to defend or to compete with China because they're offering 3.25% and we're offering 1.15%. And they've got this trade deal that now they've signed up to compete with people, so there's actually going to be more demand for their bonds as it is.

And we've got this bitcoin thing going on in the US where there is very clearly starting to be a bit of a jailbreak with US investors, US retail investors, US corporations saving in bitcoin instead of in Treasuries.

So, basically, we need to do the Paul Volcker playbook and raise rates to defend the dollar. But if we do that, we'll break the system and rates will rise anyway, which is we're sort of in trouble because, unlike – when Volcker ran his playbook, US debt to GDP was 30%. It's 130% today.

So the thing that is very, very different now versus 1980 is if the US runs the Volcker playbook,

the entity that will go broke relatively quickly will be the US government, without that printed money. Which defeats the whole purpose.

So what I think is the other big advantage or the other reason that I think you need to have gold alongside bitcoin is – the way out, if you read the Warsh op-ed, is the US needs to de-lever its own balance sheet in order to normalize rates without bankrupting the US government to be able to defend the dollar.

So what do you do? There is a playbook where the US Treasury could instruct the Fed: I want you to remonetize gold at some really big number. And, basically, every $4,000 on gold is about a trillion dollars that will be deposited into the US Treasury general account. Because that's how it works.

So, basically, if Treasury tells the Fed to remonetize gold, the funds show up in the TGA (the Treasury General Account). And the Treasury could then spend that into the economy however they want to spend it.

And so let's say the US government, the Treasury says I want to put $5 trillion into the TGA.

$5 trillion divided by 1 per $4,000. So that's 5 x 4,000. So it's $20,000 more on gold. That gives me $5 trillion into the TGA.

So now the TGA is sitting at $5 trillion plus. And the Fed's data in terms of the stimulus, around the COVID stimulus was that it was about a multiplier of 1.5.

So we take the $5 trillion, we spend that on a variety of stimulus, infrastructure in the US with a multiplier of 1.5. So that's $7.5 trillion – $5 trillion x 1.5 – $7.5 trillion.

$7.5 trillion on a $22 trillion GDP is going to significantly de-lever the US's economy.

By the time that's said and done, you're going to be talking about debt to GDP that's gone from 130% to probably something well below 100%. At which point the Fed then could raise rates, normalize rates. And away you go.

So the punchline is that basically, because the Fed is so cornered, because the Treasury is so cornered by the factors I described, it's increasingly looking like the only way out is to use the gold to de-lever the Fed's balance sheet and then raise rates.

And so I think that's why you need to have both gold and bitcoin on your balance sheet.

In terms of balancing, I think it's a personal preference. Obviously, you can see the relative volatilities are very, very different. But for me I like having them both in pretty good size alongside each other.

Erik: Let's tie this back in to the stock market.

I can make the argument that, hey, look, it's 10 years of straight up for the stock market. It's way overdone. We're at the final blow-off stage of a very, very late-stage bull market which surely must be about to end.

Or I could make the opposite argument that, based on the amount of stimulus and the political will to create more and more and more money, balance sheet expansion and so forth, could be just the beginning of a crackup boom that takes the stock market, at least in nominal terms, straight up from here.

Which side of that argument would you pick? Or is it even possible to know?

Luke: I shake towards that crackup boom. And the reason that is is, for a number of years now, I think investing has become increasingly a relative game. I guess it's always a relative game.

But what I mean by that is, yes, stocks are expensive. Yes, real estate is expensive. Yes, there is a bubble in everything. But the biggest bubble of all by far is in sovereign debt and specifically in US Treasury bonds.

And US treasury bonds are the risk-free asset underpinning everything.

And what I mean by that is, yes, the Nasdaq is expensive at (whatever it is) how many times earnings, how many times sales, how many times prices, however many times income.

But if you take a look at US Treasury bonds, you have the US government is an entity that has – you know, we're not going to look at – we always quote debt to GDP at whatever, 130% 70-year high.

Well, I think it's relevant if you want to look at the comparative bubbles, look at the US's debt to revenues.

US's revenues are about $3.3 trillion. We've got $27 trillion in debt. So right now, the US government, US Treasury bond sells at 9 times revenues.

So then you say, okay, the US government, the US Treasury has – the valuation of their OPEB liabilities, or pension and entitlement liabilities – US owes somewhere between $100 and $200 trillion there off balance sheet.

So the Treasury is, again, $100 to $200 trillion divided by $3.3 trillion in revenues. Treasuries are trading at somewhere between 33 and 60 times revenues.

Furthermore, since the US has not run a surplus since 2000, we have not turned a profit in

(quote unquote) profit in over 20 years. So when you look – and what's more is our biggest creditor, our biggest bankers cut us off in 2014 in 3Q14 when foreign central banks stopped growing their holdings of Treasuries.

So when I look at the valuation of everything, I have to start with the asset that underpins all of it. The risk-free asset and the capital asset pricing model is arguably the biggest bubble in the history of mankind.

And if I start there and say, okay, well, if the (quote unquote) safe asset is in a sort of ludicrous range of valuation, then it comes down to I want to own stuff that's more finite.

And so would I rather own a US Treasury bond or would I rather own a share of Microsoft? Would I rather own a share of Amazon? Would I rather own a share of Intel. Would I rather own a share of Parker Hannifin? Eaton Corporation? Boeing?

And to me the answer has long been and continues to be I'd rather own the latter because there is just – unless there is a significant political change shading towards austerity, I just don't see how this doesn't continue and make – I think it forces this crackup boom dynamic within all other asset markets.

Erik: Well, I agree with you on the crackup boom being the more likely outcome. And it seems like, really, the environment we're in is if the only way out of this for the government is to depreciate the value of the currency, that means the price of everything has to keep going up.

But that begs the question, Luke, which is so far – curiously, despite many predictions of runaway inflation dating back 10 years now – what's really happened is there has been this explosive appreciation of financial assets. But really, in terms of consumer price inflation, it's been a lot more muted than what some people expected.

Are we finally at the point where we're getting close to a transmission of this into the real economy and runaway wage and price inflation?

Luke: I think we're getting closer. Yes, I think we're almost in between two trapezes.

If you look historically – and Professor Richard Werner has done a lot of really good work on this – there's two components of inflation basically. There is the asset price inflation and then there's real economy inflation.

And we have structured our economy to basically sterilize what the central banks have – government spending through asset markets a number of different ways.

So that's where the inflation has shown up.

Now, I think the reason that is changing is twofold.

#1 Lyn Alden has a great chart showing QE and the fiscal deficits in 2008, 2009, 2010, and last year. And it's night and day.

In '08, '09, '10, the deficits did not blow out. So, basically, the government did not spend to stimulate. And this time they did. So we did start to see some CPI inflation metrics rise off of low levels in the back half of last year in particular. But I would argue that was still just filling in a hole.

What is starting to be harder, or why I think it may have more legs than most people think, is because of the damage of COVID, because the US government, the debt is as high as it is, because aggregate debt is as high as it is, it means no one can afford a recession without touching off a death spiral across the system.

And because the US government is now such a big part of GDP at 20% or 22% of GDP, they can't pull back.

So people say, well, you need the banks to lend to drive inflation. And I think that's true.

Then you take a look and see what happened in 2020, which was that US bank loans to the US government were up about 35% year over year, which is to say their holdings of Treasury bonds rose 35%.

So you're seeing banks lend very aggressively to the government. Ostensibly, some people – I know Jeff Snider says that's just because they want to be safe, and maybe that's true. But at the end of the day, functionally, there is no difference between a bond and a loan.

So the banks are lending to the government and the government is absolutely spending. And so it really is a political question, then, of are we about to get that inflation.

And, to me, the politics all point in one direction, which is yes. Whether you look at what happened last week, whether you look at the unrest over the summer, etc., etc., to me it seems pretty clear that the political winds are suggesting that the government increasing their spending, and federal bank lending, US commercial bank lending will continue and accelerate.

And if that happens then I think we will see that inflation show up.

Erik: And do you have a time frame? Generally speaking, when inflation starts it's good news in the beginning until you start to get to the wage and price part that tends to be more of a draw on the economy.

And usually in the beginning of an inflation, it's good for the stock market and it becomes bad for the stock market only when the real economy starts to suffer.

How far away are we from the point where it becomes a significant stock market headwind as opposed to the tailwind that it always starts as?

Luke: I think we're a long way from it. And the reason I say that – there was a great tweet by Mike Krieger last week (or maybe the week before) and it was let me make me one thing clear: There is no Paul Volcker coming this time. And it was a great, great tweet.

And the reason I think it's such a great tweet is you can see how this is going to go. The US's debt to GDP is 130%. When Volcker showed up to control inflation, it was 30%. And our demographics are much older. And our economy is significantly more financialized, which is to say every 100 basis points higher is a much more pronounced negative impact on the US economy than it was back in 1980.

So the way I think this goes down is I think my base case is the Biden Administration comes in, they spend more, the US commercial banks and Fed increase their holdings of Treasuries, the government then spends more. And that goes on.

And eventually we start to see it show up in CPI. The bond market backs up to a point. And the bond market is going to back up to a point when CPI does something.

And, unlike when Volcker showed up, he stomped out inflation, what the Fed is going to say is, okay, that's it, the 10-year is not moving any higher than 2% no matter what we do. And then the Biden Administration comes out and says hey it's $3,000 checks this quarter, guys. And the Fed buys more 10-years. The 10-year doesn't move over 2%. Wages start rising, CPI higher, 2%.

And so, basically, at some point not too far along that whole process, the Fed's balance sheet goes $7 trillion, $8 trillion, $10 trillion, $15 trillion, $30 trillion as the entire bond market starts to realize, oh my God, they're not going to stop this. They're going to de-lever on the back of my purchasing power.

So it's a very slippery slope. It's one I think that has the Fed scared to death. I think it's one that's inevitable that the Fed is going to have to do.

And what it speaks to is that I think the reason they are so coy about yield-curve control is that I think they know that after Treasury yield-curve control, like two months later comes corporate curve control. And then after that, mortgage curve control. And then after that, junk bond curve control.

And it's a very slippery slope where, by Christmas 2022 or July 4 2023, the Fed could own some gigantic percentage of the entire dollar bond market globally. And that's I think why they don't want to start yield-curve control if they can avoid it. But I think that's where this movie is going.

Now, once inflation runs high enough for long enough and if you've run wage inflation at 10%

or 15% for five years and everyone's mortgage is pinned at 3%, it's a debt jubilee. And everyone in five years wakes up and their mortgage, instead of being 40% of their monthly income, it's 5% of their monthly income.

And at that point, you can raise rates and you can normalize the curve and sort of in theory – you'd probably have to take some draconian steps at some point to bring inflation back under control. But I think that's where this is all going.

And, to me, really the biggest question is just are we going to start that process right away under the Biden Administration? Or are we going to run through this charade of we're going to try to defend the dollar system one last time and blow up risk markets and then give the Fed the cover to come in and start this process after a whoosh down?

That is really the biggest question in my mind.

Erik: You mentioned a debt jubilee and that got me curious. Because, back when Paul Volcker was still alive, he was very outspoken publically in saying his own prescriptions that fixed inflation in the early 1980s would never work today because of exactly the reason that you stated, that we have a dramatically higher government debt level.

So does that mean that when we someday – and I do not think it's coming tomorrow or anything like that; I think it's still quite a ways off – someday we're going to get to runaway inflation where inflation is running out of control and something has to be done to contain it.

Volcker's prescriptions clearly will not work per Volcker's own admission before he died. Does that mean a debt jubilee is the only choice that's left? Or are there other options?

Luke: No, there is another option. That's Option 1.

Option 2 is what we talked about before, which is Treasury says, Fed, we want you to bid for gold at $50,000 an ounce per – let's use $40,000 for round math. At $40,000 per ounce, the math we laid out before, it's $1 trillion into the TGA for every $4,000 dollars in gold.

So there's $10 trillion into the TGA.

$10 trillion into the TGA at a multiplier of 1.5 (that we talked about before with the Fed's own math) would give you an impact of $15 trillion spent into the economy.

And if you did that, the US economy would basically – that money in the TGA would represent an increase in US government spending without a commensurate rise in US government debt.

And it's a way to de-lever. It's a debt jubilee. You do it all at once. It would result in a massive one-time surge in inflation.

But you'd wake up and US GDP would be (I don't know) $35 to $40 trillion in two years. And debt would still be sitting at $27 trillion.

And so we would be at 60% debt to GDP (call it) for easy math.

And at 60% debt to GDP, in a couple of years – and, really, you could probably start all along – but at that rate, you could take Fed funds from zero to probably 3.

And you could take the 10-year from probably wherever it is today (1.15, 1.2) to 5.

And the banks are healthy because they're making a positive spread. The inflation in the economy nominally is preventing anyone from defaulting, which otherwise would occur if you tried to raise rates in that fashion without first doing something this draconian.

But that's the other way you can do it.

So it's really – their choice is – in my view the only politically palatable choices are just do it in a process over five years or do it all at once in this remonetizing – using the gold to basically do a one-time massive increase in the TGA, using the gold to basically fund a massive infrastructure and stimulus spend, instead of funding an infrastructure and stimulus spend with further increases in debt, which is just chasing your own tail.

And this is something mainstream economists are absolutely aware of.

If you go back to 2013, Paul Krugman wrote about the trillion dollar platinum coin, if you remember that. He wasn't the only one. He said, look, we could mint a platinum coin and say it's worth a trillion dollars and then we could spend that money into the economy, we could get our way out of this. It's gimmicky, it's wonkish. It would absolutely work.

The question just really is one of how they want to go about it and what sort of political processes would they need before they did it.

Erik: Let's talk about something that a lot of people think could be very, very near-term on the horizon in the Biden Administration, which is a forgiveness of student loan debt. That would be, in a sense, debt jubilee light.

Is that coming? And if so, what are the consequences and knock-on effects in terms of financial markets?

Luke: I don't know if it's coming. I have been following it with great interest. I saw something that Biden allegedly said that he thought that the legal basis for him to do that was arguable. In other words, he wasn't sure he had that authority. I've seen others say he could do it via Executive Order on Day One.

So I just don't know.

In terms of if he did it, I think it would be enormously bullish for stock markets broadly. I think it would be quite bearish for the dollar. I think it would probably be bearish for bonds. I think it would be bullish for gold. And it could be bullish for bitcoin.

It would on one level be opening a Pandora's box. But on another level, it's probably the right thing to do relative to where we are politically, divisively, basically having a bunch of young, highly-indebted, angry people is sub-optimal, as we're seeing.

And I don't know how much longer we need to see this before we start doing something like this, because this is going to be the endgame no matter what. We can choose the happy way of doing it or we can do it the hard way.

But that's how I think from a financial market perspective. It would be stocks up, bonds down, dollar down, gold up, bitcoin up.

Erik: Luke, I can't thank you enough for a terrific interview. Before I let you go, tell us a little bit about what you do at Forset for the Trees.

Luke: Absolutely. We do unique investment research. We aggregate a large amount of information from publically available sources and put it together in a unique manner trying to identify developing economic bottlenecks for our clients.

And we publish reports weekly for our clients. We've got an institutional product. We have a retail and smaller investor product, both of which are quite popular. And if you want to learn more about either one of them you can check us out at our website fftt-llc.com or you can look us up on Twitter @lukegromen.

Erik: And, again, that's fftt-llc.com. Patrick Ceresna and I will be back as MacroVoices continues, right after this message from our sponsor.