Daniel Lacalle: Inflation, Recovery Outlook, Energy, Digital Currency & More

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Erik: Joining me now is Daniel Lacalle, a fund manager for Tressis Asset Management. Daniel, it's great to have you back on the show. It's been too long. I've been asking everybody about inflation. A lot of people, myself included, think maybe this is the beginning of a secular inflation. Of course, Janet assures it's just transitory. What do you think?

Daniel: Thank you very much, Erik, thanks for having me. Always a pleasure. I don't think that inflation is transitory. More importantly, I think that perceived inflation, what you and I, what our listeners do see in terms of inflationary pressures are not going away anytime soon. Because it was a trend that already existed before COVID-19. The Fed always, the Fed and central banks always look at inflation thinking that it's transitory. That it's going to be that is because of supply chain disruptions, etc. But when you look at the components, what you see is that. For example, we are seeing many commodities and many metals in which there is ample capacity. In fact, overcapacity like for example, aluminum going through the roof anyhow. And we're seeing that the food prices and the food price index that the FAO publishes reaching new highs that were already reached before COVID-19.

So you know the first question that we need to ask central banks is what do they measure as transitory? One year, two years, three years? And the second thing that we need to ask central banks is, are you really taking into account all the inflationary pressures because they're not taking into account house prices. They're not taken into account in some developed economies, Texas for example, utility bills, etc. So I think that the inflationary pressures that we have seen throughout the recovery are more sticky than what many would fear.

Erik: Let's talk about the recovery itself then because, you know, on the one hand, it seems like maybe we've got a significant risk of this delta strain and the continuing mutation of this virus, maybe it's going to be worse than we thought. But I'll make a prediction of my own Daniel, which is, I think that maybe even if it is worse than we thought. I think public sentiment has shifted to open the economy, period, whether it's safe or not. it's too much, time to open the economy. If I'm right, I think that's going to lead to a lot more tension between different people. Some people, of course feel that we shouldn't have closed the economy ever. Some people, you know, think it should stay close. I think that tension is going to get greater and I can't decide what it's going to mean for demand, because I think the economy does continue. But I think that the pandemics can continue too. how do we make sense of this?

Daniel: I think you're absolutely right. First, if we look at the history of pandemics, we know that there is always a second wave. And one of the mistakes that many people have made in the first part of last year was to believe that we had two waves of the pandemic, even three in 2020, that was a mistake, it was all the same. And now what we are seeing is what as you very well mentioned, a number of variants that so far are impacting the not so developed economies or the emerging economies, and but they're gradually reaching some of the most important economies in the world. And what we know from the first wave is that markets and governments don't truly react until it reaches the developed economies, even when it reached Italy or Spain, a reaction was still very subdued.

So what I do agree with you and i think it's that the mentality of the population have shifted. Having severe lockdowns for 12-16 months, in many cases has led to many people, the vast majority of the population I would say in developed economies to say absolutely, that they will not tolerate drastic lockdowns as a measure that has, by the way, proven to be extremely ineffective. France implemented very severe lockdowns with 150 cases per 100,000 inhabitants and maintained those lockdowns and with 500 cases. So what we need to do is basically to understand that it's going to be very difficult politically for governments to justify the severity of the lockdowns that we have seen in the past.

What I think is that the same way that we saw a dramatic, let's say, easing of the exuberance, post the third quarter of last year. We will likely witness a similar situation in the fourth quarter of 2021, probably in the third quarter itself. Once the sugar high of the reopening of the desire of the population to spend and to enjoy life, outdoors, etc. fades away. It is true that people tend to be significantly more conservative about their purchasing and investment decisions afterwards. And the virus coming back to the point that you were saying, that you were mentioning the viruses is very seasonal. So we all remember that last summer, the situation in general seem to be completely under control and fantastically improved. And then we saw that the cases started to ramp up throughout autumn, beginning of winter. So, you know, I would be extremely cautious about this tendency that we're seeing in consensus to replicate the reopening effect and the base effect that we're living right now in the economy throughout the third, fourth quarter, let alone 2022.

Erik: I wanted to start with that framework Daniel, before moving on to talk about the central bank policy trend, which at least in terms of the lip service that they give it is all turning to tapering. Now, help me understand this, we're probably going to have the pandemic get worse and there's going to be a lot of discontentment and disagreement among people in society about that. And there's going to be more health issues and more government spending. And that's going to be the reason that central banks don't need to keep printing money and it's okay to taper it. I'm missing the logic... What's going on here?

Daniel: You're not missing the logic, the tapering debate is completely nonsensical. There is not going to be any tapering. Either you believe in robust recovery with healthy inflation, and strong jobs recovery, which will inevitably not lead to tapering but to the end of stimulus and therefore, a very significant impact on financial assets. Or you believe in what is most likely to happen, which is that the recovery will be weak as it has been in every recovery since 1975. By the way, weaker levels of growth, weaker levels of productivity growth, and with it real wages, weaker levels of recovery of employment. we have to remember that with massive reopening and GDP estimates being revised upwards by 30-40%. The employment picture remains pretty similar to the pre review estimates.

So I think that it's very very unlikely that central banks end up tapering. And that's why the Fed is mentioning 2023. 2023 first is probably not even the members that are currently in the Fed will be there or at least half of them. But the other element about it is that if the picture of the economy that the Fed paints is correct. Then tapering will be faster, and that is unlikely to happen. And if the economy remains relatively weak, very indebted, deficit spending continues to be very significant. It is virtually impossible to believe in tapering. Sovereign issuers would not be able to to sustain or do or to accept that level of increase in borrowing costs.

Erik: Are we at a point yet where we have to worry about all of this money printing really starting to get to not just the secular inflation I see coming but a true runaway inflation where it's beyond the ability of central bankers to control it.

Daniel: I don't think we're going to see runaway inflation. I think that the disinflationary pressures that existed before COVID-19 remain. Aging of the population in developed economies, very high levels of debt, very high levels of government spending, which are deflationary in principle, and the advance of technology. All of those elements are disinflationary and put a little bit of a brake on runaway inflation. Think about what type of inflation the world would have, and developed economies would have if those pressures did not exist.

Now, that doesn't mean that the things that matter in our day to day spending, for our families, utilities, food, healthcare, education, the things that truly generate our concerns about affordability of the cost of living. Those things are not only rising in a period of recovery, they were already rising as well in a period of so called crisis. So, that's why I'm concerned about inflation, and inflationary pressures in general, but not runaway inflation, or hyperinflation.

Erik: Daniel as we look forward through this recovery, and you know, into what comes next after the pandemic, it seems that ESG; environmental, social and corporate governance aware investing is really becoming a big trend. And I gotta tell you, I don't think there is anything more noble or a better cause that I've ever heard of in my life than the owners of capital, taking responsibility for seeing that it's used responsibly to make the world a better place. So I want to make sure that I am crystal clear. That I am very much in favor of the concept. But frankly, I think this ESG trend on Wall Street is all about separating people from their money, and has almost nothing to do with environment, society, or governance. What do you make of this ESG stuff Daniel?

Daniel: I think that you have said it perfectly. We all are 100%, and me the first as well not in favor of capital allocators taking responsibility and being conscious about the environment, about social issues, about corporate governance and this is a trend. And this is important to understand as well. This is a trend that has been going for decades. I remember when I started in the buy side at Citadel that we had, you know, environmentally conscious, and activist policies towards investments, etc. all of those things. So environmental, social, and corporate governance action is something that we all agree with. And that is a trend that is absolutely unstoppable.

Now, we have to discern between the trend and the improvement in the view about stakeholder capitalism that Wall Street might be taking relative to and compared with this fashion about putting an ESG label on almost anything. To the point that for example, you can see some of the ETFs that are so called ESG, or socially responsible investments, and see that they're mostly comprised of energy companies now. Oil and gas companies, there are some of them that you can see out there. And the other thing that we need to understand is that the idea of ESG and socially conscious capitalism, and the idea of socially responsible investment and sustainability is that there is nothing that is more sustainable than a profit based economy.

So when the first thing that we need to understand as investors is that there's no sustainability without profit, and that trying to make investors think that unprofitable and weak business idea is going to be sort of a great investment and reach high valuations simply because it has the ESG label is a huge mistake. So you have to be extremely careful about the use of a label, in which in many cases, what investment banks or brokerage houses are using that label is to try to disguise unprofitable and very weak businesses. That one thing has to be made very clear is that what everyone that truly understands socially responsible investment is looking at is for businesses that generate good profits, good cash flows, and good margins to retain and increase those profits, cash flows, and margins with socially and environmentally sound policy, but not to make something that is unprofitable, and probably obsolete, simply acceptable as an investment, because it uses the label green, or SRI, or ESG.

We all remember the wave of bankruptcies in solar companies no? There was this big fashion about everything that had the renewable label as something that was going to be rising in value in the stock market all the time. But the reality showed that when you had a bad business that was extremely levered, and had weak margins, and that dependent too much on increased debt, it ended up going bankrupt anyhow. So the same way that being environmentally conscious, that focusing on renewables, that liking the technology is one thing, and looking at any renewable stock is a completely different thing. We have to do exactly that same exercise with the label of ESG. We have to remember that bubbles do not persist. If there is, if it's based on basically just, you know, marketing. What we need to understand is that companies that are conducting their businesses in an environmentally, social, and good corporate governance framework will perform better and they do perform better, but only when they're profitable and when they have a good long term strategy.

Erik: Let's talk about some of those environmentally related investment opportunities and where the markets are, because I think a lot of people now are looking at energy markets saying okay, here we are at $73 and change as were speaking on Wednesday. And it seems like we've come awfully far awfully fast. If you believe the secular inflation narrative as I do, you can make an argument for much higher oil prices over $100. It's also a pretty good argument for they're already way too far and need to retrace back down to a fair value. What do you make of energy markets and where are we headed?

Daniel: I think that we have seen the effect of three things in energy markets. The first is that, despite the reopening and the improvement of demand, supply cuts have remained exactly the same way as they were when the market was flooded with oil. So the market has tightened very quickly but supply cuts remain. And when we analyze the oil market, we need to always have in mind that there is a significant level of capacity, productive capacity out there that is idle because of a conscious decision of OPEC and its partners. So oil prices may go higher, because of the reopening increased demand, the monetary factor. Obviously, when you have increased money supply growth, there's more liquidity going to scarce assets.

And the fact that these were parts of the financial asset basket that were heavily underweight by investors, therefore, simply moving to equal weight has generated a significant inflation in prices, those things might persist. What I think is that we also have to look at the risk to the economy. Oil price impact on the economy is not necessarily because it goes up but how quickly it goes up relative to the economy. And for example, if we look at oil prices, they're up about 40 odd percent year to date. That is creating already tensions in terms of disposable income, in terms of consumption, etc.

So I think that the energy market is very tight right now. That two things are changing OPEC supply cuts and an agreement with Iran might alleviate that tightness, but not necessarily entirely because the monetary and the financial assets perspective that I mentioned, remain. But we need to understand that remember in 2008 when oil prices went through the roof they reached $120-$130, I think that they touched is that if they go up too fast, what they also do is to hinder the prospects of the economic recovery. And they can actually generate a significant impact in terms of expectations of growth consumption and investment.

I also think that from the perspective of energy prices, we need to be at least aware of the fact that with all this push from the IEA, from investors in some of the energy companies to do something which I find absolutely outrageous now, which is to say that there needs to be no more capital expenditure increases in the sector might generate a very big problem in the economy, and lead to stagflation the way that we lived in the 70s. Is that we can have a situation by which abruptly impacting capital expenditure in the energy sector leads to a very negative effect on the economy, that one thing is to believe, as I do firmly in energy transition driven by competition, by technology, diversification, and the technology advances. And another completely different thing is to be too ideological, and to force companies to stop investing in things that we need every day, as we do, way before the transition and at least, the ability of the market to substitute technologies is fully implemented.

So that I'm concerned about. I see that the level of CAPEX in energy companies is not just going down too fast, is that at the same time, it is going down into things in the areas in which there are the higher levels of bottlenecks. Whilst these energy companies in order to give and I go back to the ESG situation, to give an image of green energy, etc. The part in which they're increasing investment is not enough to offset the negative impact that can be created by a CAPEX slump in the energy sector. I'm very, very concerned about being too ideological and too quick to say I thought that the IEA message of no need for more capital expenditure in oil and gas was not just empirically not wrong, but extremely dangerous.

Erik: I want to move on now to another trend that I think is going to be important, which is the market needs to come to terms with digital currency. And you know, back a few years ago, when crypto was first getting popular, I used to tell people I said look, if you really love this digital currency stuff, just wait till central banks get their hands on this technology. Because when they do, they're not going to have the same goals that Satoshi had. And the prediction I made almost 10 years ago now. And not quite that long, maybe eight years ago, was I said. What began as a libertarian pipe dream is going to end as an Orwellian nightmare when central banks completely re-engineer money itself using digital currency technology. I guess I'm the only one who's really convinced that that's the risk. What do you think of that? And more importantly, you know, that's just my take. Broader spectrum, where's this whole thing headed? It started with crypto. Now CBDCs are coming in. Where are we headed with digital currency?

Daniel: I think your prediction eight years ago was spot on. We cannot...

Erik: Nobody seems to be worried about the Orwellian nightmare though. I don't get it.

Daniel: Well, you know, it's very interesting how naive investors can be.

Erik: ESG!

Daniel: It's very, very surprising how naive investors can be when you know. You know! You have the facts that central bank independence has all but gone out the window. Central Bank independence doesn't exist. Central banks have maintained very aggressive expansionary policies in growth periods. With record levels of employment because of political interference. Central banks have been maintaining financial repression at any cost in all types of economic environments. And you truly believe that central banks are going to implement a digital currency without any of the secondary negative effects. That's being extremely naive.

The biggest risk of central bank digital currency, to start with, we already know is that it's surveillance disguised as currency. Is that you are giving all the power to central banks that have been at least questionable in their independence to know exactly what you pay, what you invest, what you save, which you're giving all the power to those central banks, to wipe out your savings, when they believe that savings are too high. You are giving them all the power to elevate money supply without the limiting and factor and the break that the credit mechanism implies in monetary policy, because today, the reason why we may still have a debate about why quantitative easing was not massively inflationary and prices, the entire difference, the entire reason why quantitative easing is not as inflationary as direct money printing, Argentina style is because the mechanism of transmission of monetary policy is driven by demand of credit. And if credit demand doesn't go up, then that whole process is eliminating the risk of massive inflationary pressures in goods and services prices.

Now, think for a second, if you eliminate the transmission mechanism and intermediation in which demand works as a break for the increase of supply of money. It's you know, the limit is endless. Central banks can decide, central banks and governments can decide how and where to increase money supply. They can decide who gets in a way, penalized for being a bad citizen, who gets some kind of a reward for being a good citizen. it's very dangerous to give entities that have not the had proven not to be fully independent of further and higher control of the money supply. So, you know, those are important risks that we need to talk about. We can talk about the benefits. The benefits are obviously, you know, transparency, quicker access, but you don't need to have a central bank digital currency to achieve those benefits.

So we need to discuss those important negatives. And you mentioned one thing that I think is critical. The libertarian idea of a cryptocurrency might never be fully implemented, because what we at the same time are allowing is a level of control of the monetary system of central banks and governments that every time that cryptocurrencies become not even a threat to the monetary system, but a mild headline, they can immediately implement measures to ban them to put limits to their utilization, etc. But at the same time, the central bank of the major, especially the central banks of the major economies and governments do look at cryptocurrencies and think Hmm what a great way to quote unquote, improve the transmission mechanism of monetary policy. When central banks say that a central bank digital currency will improve the mechanism of, the transmission mechanism of monetary policy, what they're basically saying is that they will be able to generate more and more persistent inflation quicker and without any control.

Erik: Oh, and it's worse than that. I mean, as I described in my book three years ago. The central bankers haven't even begun to figure out how much opportunity this technology affords to create new super-duper powerful central banking tools that I for one do not advocate central bankers or anyone else having. But the technology has been invented. And once it's been invented, somebody usually ends up using it. So I want to actually react to something you said in the beginning of your response there Daniel, because to paraphrase, I think you said something like, you know, your biggest fear or the worst thing that could go wrong would be with all this digital currency technology would be government's getting a hold of it and using it in a way that has too much of a burden, or impairs the individual rights to privacy of individuals and so forth.

That's exactly what I used to think myself. When I wrote my book that's exactly what I said about this. I've changed my mind, I think that that's actually the second worst risk. I think the worst risk, you know, governments it for all of their failures, they're big and bureaucratic and slow moving. So they don't do damage all that quickly, they just do a lot of damage. On the other hand, Silicon Valley, the industry that I came from, software, is already out of control with how much power it has over the world. Facebook literally affects the outcome of elections all over the world. You know, there is a problem with power and society and Silicon Valley having too much of it. And frankly, there are people that are smart enough to design systems of whole new way for money to work, that would be cool, that would be engaging, that would make people want to use it because it's simple and easy and it's just drag and drop simplicity on your phone or tablet or whatever.

And what you don't really realize because it's kind of hidden underneath the veneer is guess what? Actually, Silicon Valley is engineering a way to really create a power structure for the designers of those currency systems, which gives them the power of a government themselves. I think and the thing is unlike the government central bank digital currency thing, they're going to screw it up for the first 10 years\ because they screw everything up for 10 years because their governments. the Silicon Valley boys know what they're doing. They know how to do damage. And I think it's a much bigger risk. Libra got shut down but it's trying to make a come back. There will be more, I think a Silicon Valley digital currency that tries to somehow kind of win public support and take over the world is a very real risk. And I don't think it could be stopped once it got to a certain point.

Daniel: That is a great point that I actually had not thought about. Because a central bank digital currency controlled by governments, be it because people understand that there's no real independence of the central bank or because or because it's even widely known will always have a certain level of suspicion from citizens. Completely agree with that. That is a truly great point. However, a very easy to use tool in a mobile phone, that is cool and at the same time attracts younger audience, etc. That is a much more at the same time, attractive, but also dangerous proposition if badly used. So I actually kind of agree that could be an important risk. I think that if I may, as we think about the subject, look at sort of in a sort of devil's advocate way. I would think that right now, technology giants depend too much on central bank action and on central bank loose monetary policy to destroy the power of central banks and their monetary policy.

Erik: Daniel, I can't thank you enough for a terrific interview. But before I let you go, I want to talk about your YouTube channel, which is Daniel Lacalle or if you're an English speaker, Daniel Lacalle. It automatically sense which way you pronounce it and speak to you in English or Spanish. Do you have that feature?

Daniel: Well, if you say it, it immediately finds me. I don't think it's even if you misspell it, you will find it quite easily. And there's two channels, one in Spanish and one in English. Daniel Lacalle in English is the name of the English channels to make it simple and easy. And that's where you're going to find all of my videos with my comments about the economy, conversations with different people and the latest conferences that I give.

Erik: Well, we'll look forward to getting you back on the show in a few months for another update. Patrick Ceresna and I will be back as MacroVoices continues right after this message from our sponsor.