MACRO Voices
with hedge fund manager Erik Townsend

Daniel Lacalle: Energy in the New War Economy

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Erik: Joining me now is Daniel Lacalle. A fund manager and chief economist for Tressis. Daniel, it's great to have you back on the show. What to talk about? Holy cow! Well, let's see, we have the beginning of a tightening cycle and oh, by the way, World War Three broke out, what do we make of this?

Daniel: Thanks very much for having me to start. It's a great pleasure to be here. Again, I think that where we are right now is in a very difficult situation. I wouldn't like to be in the place of Mr. Powell these days because on the one hand, central banks need to find a way to put a break on inflationary pressures. And they need to give a clear signal to markets about their willingness to do so while at the same time be extremely accommodative. Because the deficit spending of governments remains elevated. The US government is likely to enter into a third year of record deficit spending. And that means a risk of seeing bond yields going through the roof if normalization actually does happen. So I'm pretty skeptical about this path of seven hikes that has been repeated over and over. Fundamentally because the reality that we have seen in estimates all over the world from independent analysts is one of a worrying trend, which is on the one hand reduction in growth estimates with an increase in inflation estimates.

And what's more concerning to me about what I see from consensus is that those inflation estimates come down very very rapidly in the second half of 2022 to reach a level that seems acceptable for those analysts. And if one makes an analysis of what would be required for that abrupt reduction in inflation to happen, it would essentially need to come from massive destruction of demand, which obviously means that the estimates of GDP are either wrong or the estimates of inflation are wrong. And in that situation, the Fed, the European Central Bank, even more so caught between a rock and a hard place. They need to on the one hand give a clear signal of their willingness to curb inflation. And on the one hand, they need to continue to be extremely accommodative in our market and in a sovereign bond environment in which the issuers and market participants remain extremely complacent.

Erik: Let's talk about what this means for both growth and inflation rates in various different economies around the world because something I'm noticing is different analysts are coming to radically different views. Some are saying look the Fed has setting up what almost certainly has to be a recession that has to mean that major destruction of demand that you're talking about, we're headed into deep recession, demand is going down, you know, forget about the inflation, it's going to be forgotten before you know it. Other people are saying no you don't understand

this inflation is out of the bag. It can't be stopped now! It's gonna be difficult to stop it. Which is it or what should we be worried about as we look ahead for the next 6 to 12 months?

Daniel: Yes, I think that the difference with for example 2008 and other periods in recent history is that inflationary pressures have been contained by an abrupt destruction of demand hence a recession. That is not so clear this time. You can actually have a recession because of the rise in core inflation because of the increase in price of non-replicable goods and services despite the change of the economy. You can have an environment, there are many economies in which the increase in prices has absolutely nothing to do with demand growth. There are numerous economies and in Europe, for example, we have seen that prior to the Euro. I've read a couple of articles out there. So maybe we're thinking too much about the 70s and thinking too much about 2008 and not thinking enough about the 40s. In which protectionist measures in which there are all of these ideas that have suddenly reappeared in the minds of politicians about autarky and trying to limit the exports or the imports from one country or another come back and there is inflationary pressures because of supply challenges and because of lack of availability of products that we have grown accustomed to see widely available.

And there is a recession coming also from that factor, which is, at the same time you get real wages coming down, and you get an environment in which consumers feel the pinch of revising core inflation despite a recessionary environment. So, my point is, that is more likely that we see a stagflation environment in the next year or year and a half. And that with it, it's a very complicated environment for both governments and for central banks because obviously, governments and central banks seem to be reasonably equipped to take measures to curb inflationary or deflationary problems, but hardly with occasion tools, they're going to be able to manage an environment of stagflation. So that is to me the biggest problem. The risk of stagflation is rising and we actually could find ourselves in a situation in which either the Ukraine war ends. And all the conflict remains in a prolonged sort of way, as we have seen so many other conflicts and inflationary pressures and supply challenges remain in the economy without that sort of injection of higher demand.

Erik: Daniel, I'd like to clarify what you just said about stagflation. You're in Europe. Are we talking about the Eurozone is where you foresee the stagflation? Do you mean everywhere and I guess let's just broaden it. Let's go through the different geographies around the world and talk about growth and inflation starting with the Eurozone. What do you see in the Eurozone, then we'll move on to US, Russia, China, etc.

Daniel: In our estimates, the risk of stagflation in the Eurozone is the highest, it's about 85% right now. Followed by Latin American economies, which already had a problem of inflation despite the period of what we called in the US or the Eurozone, no inflation. So those two economies are the ones where the risk of Stagflation is the highest, almost, as I said 80-85%. In the case of the United States, I think it's different. And I think it's different for one reason. The core CPI is rising rapidly. But the US economy is better equipped to pass through the Ukraine crisis in a much more robust way. Let's start with why. The first, obviously, the United States economy doesn't have almost any exposure to Russia. The second one is that it's an economy

that exports very little in the case of the United States, exports relative to GDP are almost less than half what they are in the Eurozone. And the third is that obviously, the inflationary pressures coming from energy have two ways. On the one hand, obviously, they impact consumers, but at the same time, the energy industry in the United States is relatively stronger.

So that is the reason why I believe the risk of stagflation in the United States is slightly lower than in the Eurozone or in Latin America. In China, we have a problem with the data, because it's extremely hard to believe that the inflation that CPI as published by the Chinese government is as low as it is. And the other problem that we have with the data and that we have discussed in other occasions is the reliability of the GDP figure also coming from the deflector of CPI that they use to reach that real GDP figure. So I'm not entirely sure about what is the possibility of, let's say, official stagflation in China. However, the risk of a very abrupt slowdown of the Chinese economy is enormous because of the burst of the real estate bubble. And inflation, we believe is probably twice if not 2.5 times higher than the official one.

Erik: Daniel, I want to focus a little bit more on energy and what you've said about that, because I'm hearing one view that seems to be pretty common out there, which is people are saying, look, you've got this big inflation risk but don't worry about that relative to energy because what's going to happen is we're going to have a recession, thanks to the Fed's hiking policy and that's going to take care of any tension that might exist with respect to energy prices. I think that's very naive thinking. I think it's the exact opposite. I think it's much more like, wait a minute, what if the cause of the recession is runaway high energy prices? And that's the issue that we have to contend with? What do you think here? Do we need to be worried about energy being the center of an inflation problem or is the inflation really independent of energy?

Daniel: I completely agree with you! I think that people are extremely naive about this idea that it's repeated now for more than a year that it's going to come down next month. And it comes a time in which you start to you really start to really be a little bit more intellectually honest. And those people should start to see that what is happening in the energy space, it has structural and at the same time, current problems. The structural problems is massive under investment. And we know that for many years because of capital allocation preferences into other sectors, etc. The energy complex and the mining complex has been sort of neglected to a certain extent. And that has led to an environment in which even with significant reduction in demand estimates coming from for example, OPEC, the reality is that prices continue to increase and that inventories continue to drop.

So I think that we need to be more concerned about energy prices and less concerned about rate hikes. We hear many times in financial analysis, etc. and media that it's too many rate hikes, what is going to generate a recession... Well, no, because this time to start with, even if we believed which I don't that the path of rate hikes that has been laid at the dotplot by the Federal Reserve, it will continue to be real negative rate territory. So that to start with is something that doesn't bother me and financial conditions remain extremely loose. So those two, don't worry me as the drivers of recession. What worries me about a driver of recession is that energy prices remain extremely elevated and start to feed through all of the other goods

and services that we utilize. And it becomes one of the driving factors of a recession. And that which comes back to the point of the 1940s or the the crisis of 2008.

Erik: Daniel let's talk a little bit more about what this situation means for the Chinese economy. Where is China going to be through this crisis with Ukraine and what are the consequences for the US relationship with China going to be?

Daniel: It's very very difficult to predict because China right now is in is in a very tough position. Because on the one hand Russia is a key partner of China and numerous economies and in general perception about the strategy and their view of global politics. And on the other hand, China needs to continue to export massively to the rest of the world in order to at least try to offset the brutal impact on the economy of the burst of the real estate bubble. And having such an enormous real estate bubble as China has, which is directly and indirectly weighs about 25% of the GDP of their country. Its position in terms of where they stand relative to Russia and Ukraine leaves them in a very weak position as well in terms of their export capacity and their attraction of investment.

So for China, the first thing that I would say is that it's very difficult for an economy to grow at the pace that the Communist Party has laid out when one, they have such a massive real estate bubble that is bursting in front of our eyes. Second, at the same time, they're trying to impose massive restrictions and corporate governance intervention on key sectors that would in some capacity be the drivers of future growth. So what that tells us is that the Chinese economy is closing, not opening. And at the same time, it's becoming more risky for foreign investors to put money in China, in the real economy because of intervention in different sectors according to the political view of the moment.

The position with Russia is very difficult as well, because China is very exposed both to Russia and to Ukraine. This is the biggest foreign investor in Ukraine and also the biggest foreign investor in Russia. So the impact on its financial sector of the sanctions imposed on Russia are relevant. Difficult to assess right now because obviously, China has capital controls. And at the same time, it has less than transparent way of dealing with non performing loans, etc, compared to let's say Europe or the US. So my concern in China is that the situation is very delicate and very delicate in a moment in which internal demand is not the driver of GDP growth. I think, obviously, the Chinese economy is phenomenal. And it's a very, very strong economy but it has a significant weakness, which is its dependence on the US dollar. It has a currency, the Yuan that is used and less than 3% of global transactions, whilst the US dollar is used at 41%. And that Yuan on top of it has capital controls and a fixed rate that obviously, many participants might prefer to believe that is realistic or not. But we don't know, because it's not free floating.

So, China needs to continue to export massively. The exports to the Eurozone are coming down very very rapidly because of the weakness of the eurozone and the second derivative impact of the Ukraine war on the Eurozone. We saw for example recently the data of trade surplus in the Eurozone which has been a major driver of its growth, and it's gone from trade surplus to a trade deficit. This is negative for the euro, it is negative for these economies that need the

external market to grow because obviously, either demographically, or because of other factors, Eurozone countries are not high growth economies. And China is is there sort of in the middle between a Russia that is likely to lose between 11 to 15% of its GDP in 2022 with massive inflation. Inflation estimates for Russia move around 20-25%. And obviously, a market that was absolutely critical for China, Russia, Ukraine, Europe in order to reach its 5.5-6% level of GDP growth has been reduced dramatically. It's been cut massively because those levels of consumption that were expected to happen in 2022 are not going to happen.

So ultimately, the problem in China is how do they deal with the real estate bubble and what is going on with real estate sector, it is not very transparent. So it's not easy to monitor the same way that we would monitor the US or the European real estate bubble. Second, how they offset the real estate weight in the economy with other sectors, not very easy to do. Even less so third, because of massive intervention in the key sectors that could actually attract foreign investment and generate higher growth. And finally, its external position is seeing that their highest added value exports are going to be suffering because of the Eurozone slowdown and the Russia collapse while their position relative to the BELT and ROAD Initiative which has been a financial nightmare is worse as Latin American and some African countries find themselves in a twin deficit situation.

Erik: Daniel, let's go back to central bank policy. We talked about the hiking cycle that's just begun. Now, Goldman Sachs I think had a note out saying the next two hikes would be 50 basis points each back to back at the next two meetings. It sounds like your view is much more on the other end of the spectrum towards less hikes. Tell us why? What is it that you see differently from the way Goldman sees this?

Daniel: In my opinion, I found the Goldman Sachs note very interesting because I find it very difficult to bet on one thing, and the opposite at the same time. The massive slash of GDP estimates that Goldman Sachs is implemented makes it very difficult for the Fed to put in action such aggressive rate hikes and we saw it with the last one. It was going to be 50 even 75 basis points, it ended up being 25. The second thing about that note is that Goldman Sachs basically sees that the reason why inflation is running fast in the United States economy is a function of high growth, high demand growth, and strong wage growth. But, I I would disagree with that. The reality is that real wage growth is very subdued if not negative. The reality is that real consumption is very subdued as well and has been worse, and that the growth of the US economy has been fundamentally led by a massive increase in, for example, in the last GDP figure of inventories.

So, I think that the likelihood that we see a Federal Reserve that does not a U-turn like in 2018. But that starts to give the message as they did in previous years that the impact on the global economy of the Ukraine war is more severe than what we expected. Therefore, because of geopolitical concerns, we are going to be slower in the rate hike path in my opinion is very likely because they've done it in the past. Janet Yellem even Jerome Powell both decided to step down on the path of rate hikes or normalization that they announced because not just have slowed down or reductions in the estimates for the domestic economy but because of concerns

about the global economy. I find it very, very difficult to believe that the two things: a massive worsening of global GDP growth to virtually stagflation, even recession, numerous economies like the one that Goldman Sachs is estimating would happen and at the same time see the Federal Reserve take the levels of aggressive action that they estimate.

Also, for a very simple reason is that the Federal Reserve can cling on to the message that the vast majority of inflationary pressures are coming from energy. Even though I disagree because inflationary pressures existed before because the monetary factor is enormous. Countries in Asia that have a lot more exposure to imported energy have half of the inflation that the United States or the Eurozone have. So I think that the Federal Reserve will have to decide between being very aggressive or follow the path of rate hikes that they have indicated, or the more accommodative because the situation in the global economy is significantly weaker than they anticipated. My opinion, they're likely to fall on the side of the latter.

Erik: Now, that all makes sense to me, but I want to challenge one specific aspect of it because what you're saying as I understand it, is as the economy is weakening and not performing quite as well, as they expect, they're going to have to say, okay, look, we're gonna, you know, slow down the tapering process a little bit. What if we have a situation where just as you say, the economy is really doing poorly but inflation is also running away, perhaps driven by energy prices.

So you've got that situation where as you're anticipating, the Fed wants to slow down the hiking process, because it seems like things haven't been going so well in the economy. But at the same time, the biggest problem in the economy is runaway energy prices. And you do have to do something to combat that, could we get into a situation where they are in such a stagflation, that they have to continue hiking, even though they don't really want to?

Daniel: The problem in this cycle is, in my opinion the following. Rate hikes themselves are not going to make inventories go up. Rate hikes are not going to make the energy complex reduce prices. And why fundamentally because it is the inflationary pressures that we are seeing don't come from run amok demand growth. It is not you or I or anybody that's listening to us right now that is taking more credit, and being more aggressive, and buying three homes with very low rates, etc. It is government's spending massively on infrastructure or sending checks to families and to businesses, rescuing, bailing out sectors, etc, etc. Therefore, for a central bank that situation is very, very difficult to contain. So the reason why I believe that they will not go down 50 basis points in the next meeting. 50 basis points in the other like that is because they haven't done it already. If they haven't done it with an economy in which the wage growth that they look at is good. The GDP growth that they look at is good, because they look at wage growth in nominal terms, not in real terms. The GDP growth that they have seen is good. And the job market that they see is robust and they haven't done it and they haven't gone down the 50 basis points route.

Then I find it very difficult to believe that they will do it in September when the situation is not as strong in either of those three points. In my view, right now the Federal Reserve is confident

because although we have seen some volatility in markets, credit conditions remain strong, equity markets are correcting but not collapsing. There is nothing that sort of rocks the boat for them in the financial world. But obviously, we haven't yet started to see non-performing loans going through the roof because of the Russian situation. And because of the slowdown in the economy, we have not yet seen a significant slowdown in the job market, because there's still this concept of the great retirement and all these things. So what I basically look at is the way that the Federal Reserve takes decisions about the economy is by looking at a picture that is static, which is what has happened now. And their estimates historically have been very poor, about inflation, and also significantly poorer than other independent analysis in terms of growth. So they start to adjust those. If I was in the position, I would be as prudent as I have shown to be in the last rate hike that we saw.

Erik: Daniel, I've been looking at the energy situation, which I think is absolutely essential to all of this. And I've been looking at it primarily from a US centric viewpoint, just because that's my background in Area of Knowledge. You're in Europe and have a lot of perspective on the European situation. Give us a an overview of what's going on in terms of energy in Europe and the various measures that are being contemplated in terms of how we might react to the whole situation with Ukraine and so forth.

Daniel: It's very important to look at the past. Energy prices for consumers in the European Union and the eurozone have been rising all the time even in periods in which natural gas prices were weak in which the oil price was weak. So the big difference between the United States and the European Union in terms of energy for consumers is taxes. I sometimes envy my friends in America when they talk about $4 a gallon because we're paying the equivalent of three times that in many places now. So, to start, we need to understand that the pricing structure in energy in Europe is full of taxes about 50% of the price of gasoline comes from taxes higher than 50% actually. Same with electricity. And there's something completely different from the United States, which there is a carbon tax. The CO_2 price that elevates prices even in periods in which gas, coal, or oil prices are moderately weak.

So the problem of the of the European Union that generates less competitiveness and less growth that existed prior to COVID-19 and prior to the Ukraine crisis. What has happened now is that what was already in 2018 very significant problem was a lack of competitiveness and demand destruction has proven to be an even worst nightmare when commodities have started to rise. And what we're seeing from the European Union is extremely concerning is that the European Commission is starting to think about the worst economic ideas that can be implemented, which is intervention of prices, intervention of companies, talking about the possibility of even capping prices or subsidizing part of the structure in order to try to mitigate the impact of the energy crisis. But what we're seeing for example all over the European Union, is that the agricultural sector is drowning in the cost of energy, that everything that has to do with industry is starting to shut down because of this problem. And instead of the European Commission trying to find more diversification of supply, better access to, for example, ample resources of natural gas coming from the United States, etc, of using all technologies in order to

mitigate the energy crisis. What it is doing is shooting itself in the foot by implementing interventionist measures which are not going to help reduce the dependency on Russian gas.

Europe imports about 150 BCM of gas from Russia. It's very, very difficult to offset the gas coming from Russia with gas coming from natural gas coming from other sources because of lack of interconnection with pipelines and also because of price. So my worry is that yet again, like in 2008, the European Union instead of deciding to go through a period in which what they can do is to increase diversification of supply improvement of the different sources, and use all technologies to mitigate the impact on consumers. What it is aiming to do is to solve a problem of interventionism with even more interventionism. We must remember that electricity prices for households in the European Union are about twice as high than those for the average household in the United States. And also pretty similar with natural gas prices for households.

And that inflationary pressure plus interventionism means lower investment, lower job growth, and weaker companies in the future which has not helped the European Union. In the past, we have seen some of the large corporations of the European Union dissolve from being 60, 80, 90 billion companies to almost midcap size for US standards. And what we need to do is to pay a lot of attention because I am truly concerned about this, this almost optimistic and idealistic view that what the European Union needs to do or the United States need to do is to basically revamp the old and failed ideas of intervention of prices, intervention of sectors, virtual backdoor, Nationalization of companies, and the implementation of the measures that basically led European countries in their own prior to the Eurozone being created to be significantly behind their potential.

Erik: Daniel, an issue that's gotten a lot of attention has been the effective confiscation of Russia's foreign exchange reserves by the US government. And specifically, what a number of people have raised is the question of if the US government is going to essentially assert the authority to cancel the existence of a sovereign nations, regardless of what they may have done to deserve it. But if the US government is going to take punitive action on a country like Russia, and effectively take away its foreign exchange reserves, can the US government still be trusted as the issuer of the global reserve currency? A lot of people have said other nations around the world are going to look more skeptically at the dollar, because of the aggressive action that was taken against Russia. What do you make of this? Do you agree? Is this is this an area of concern?

Daniel: I don't agree. And the reason why is because there's no alternative. Let's start with the premise. It is not the United States that has implemented this. It is the United States, the European Union, the UK, Japan. So who's the alternative? Because it's easy to think that that sanctions against Russia have been implemented by the United States, and that the US dollar is the one that is exerting this sort of monopoly of the financial system globally. No, no, no, no, no, no. The Russian Central Bank has been sanctioned, and not limited, but it's unavailable for them to get access to their reserves in Wuro, which are the biggest ones, the biggest percentage of reserves of the Russian Central Bank is the Euro at 36%. Followed by the US dollar about 20%. Followed by Gold. But let's all remember, because a lot of people when they

talk about gold reserves in a central bank believe it's in a vault in a in a basement, those are mainly swaps. And it doesn't have access to its Pounds or its Yen.

So the issue here is not one of the US Dollar versus Russia and what others may think about the US dollar. It's what you think about the Yen, the Pound, the Euro, the Dollar. It is what you think about fiat currency, in general, is that what we have shown with this crisis is that fiat currency in itself doesn't have any type of support in a global environment in which reserves are created by financial promissory notes including the gold reserves. So for me the the issue is the following. First, there is no alternative. Which alternative do you have to the US dollar, there is no alternative. The UN is as I said before, is a currency with capital controls. And with a fixed exchange rate from the central bank. The Yuan is only used in 2.7% of transactions globally, which means that not even the multinationals in China use the UN for their own transactions. And the Euro is with the US dollar imposing these sanctions. So other countries may think, Oh I don't want to have reserves in US dollars. What can I have reserves in?

Well, think about this. Are you going to have reserves in our currency, the Yuan that has capital controls and a fixed exchange rate? Obviously not. And not just obviously, because of what is logical about those two problems. But because the likelihood that in the case of a political or geopolitical situation, the Chinese government would do exactly the same, but worse than the United States and the European Union, and Japan and the UK, and why? Because rule of law, security, investor security, and the legal system is not as transparent and is not as robust is even worse. So the problem I find is not about the US Dollar versus the yuan, which you know, you don't substitute a bad fiat currency, the US dollar but one that has high flexibility, high legal security, high investor security, and a tremendous level of liquidity with one that has all of the negatives of the US dollar. The Yuan is also massively printed. The gold reserves of China are less than 0.3% of M2, the money supply of the of the country. So you don't find an alternative of a fiat currency that is widely available free and open and transparent with one that has all the negatives but it's not transparent and it's not free.

So maybe what this ends up doing is that other central banks might start to think about physical gold, which might be that other central banks might start to think about cryptocurrencies. But it still so far fetched because let's be fairly honest, there is no central bank in the world that can go today and purchase the amount of physical gold reserves that they need in order to offset the reserves that they have in Dollars or in Euro or Yen or in Pound. And more importantly, even if they did, that does not mean that their fiat currency is going to be safe or stable in an environment of these severe financial sanctions as the one that we have seen. Because I come back to the point, we all remember the messages of the ruble being the most gold backed currency in the world, which is true. But look where the ruble was not just after the sanctions but prior to the sanctions.

Erik: Well, Daniel, I can't thank you enough for a terrific interview. Before I let you go, please tell our listeners a little bit about what you do at Tressis and for our institutional investors who are able to invest in hedge funds how they can contact you.

Daniel: I'm the Chief Economist at Tressis and at Tressis, we have a number of products that go from hedge funds to different long-lonely products and in fixed income, etc. It's mostly high net worth individual money. And the best way to find me is it's quite difficult not to find me. You can find me on Twitter, my Twitter account is @DLacalle_IA. My website is dlacalle.com/en in English. You can find me on obviously in different books and you have available my latest book which is *"Freedom or Equality?"*. The previous one talks about many of these things that we talked about in the interview, *"Escape from the Central Bank Trap"*, and prior to that *"Life in the Financial Markets"* all available in the in any any retailer.

Erik: Patrick Cerensa and I will be back as MacroVoices continues right after this message from our sponsor.