Louis-Vincent Gave:
A Major Geopolitical Transformation Is Underway

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Erik: Joining me now is Gavekal co-founder, Louis-Vincent Gave. Louis, it's great to have you back on the show. I've really been looking forward to getting you on because you know, you're a guy who is a French guy based in Hong Kong also have a home in Canada. Very international guy. And something that actually surprised me when I asked David Rosenberg last week about the Fed survey, citing 41% of respondents saying that divestiture of US assets was a major concern. Rosie thought it was not really a big deal. And I wanted to get the perspective of a European on this. How do you see this situation? Is it no big deal that in my feeling about this, we kind of abandoned the rule of law and said look, we know Russians are bad guys. So let's just take their FX reserves and these oligarchs, let's seize their yachts not through rigid and aggressive application of the rule of law with a court of order, but rather by abandoning rule of law and saying we don't need a court order. Their Russians after all, we can do whatever we want. Is this going to actually hurt the financial system or am I silly to think that that's a real concern?

Louis: Well first of all, great to hear from you Erik. I have to say I need to do a better job of tracking our conversations. Because each time we talk, it seems something fairly big is happening. I think, one time we had the oil price go negative while we were talking. This time, we've got the NASDAQ down almost 5%. So maybe I need to start buying puts each time you and I are scheduled to have a conversation just buy puts on everything, I guess. But no, look, it's great to catch up. And no, I think it's the way you frame the question is exactly right. I would add one more thing is, you know, we've basically chosen to in essence change the rule of the games on people we don't like. We've changed the rules of the games on the Russian. And we've decided to do so at a time when real returns on Western assets have never been so low right? So you got you know, your real rates, your real returns on US Treasuries is about as deeply negative as it's been in two generations. And it's at this moment that we choose to tell the world, not only are you going to lose 3, 4, or 5% real per year in these US Treasuries or in these German bonds. But if you don't behave in the way that we want you to behave, then you're going to lose 100% overnight. And without due process, without debate in Parliament, without, you know, your day in court. We're just going to grab your football club, grab your yacht, grab your everything.

Now, I do fundamentally believe that this is a massive game changer. Because, you know, the way I conceptualize the world, probably the greatest comparative advantage of the western world is the rule of law and the property rights that derive from that, right? You know, the reason every rich Chinese guy buys a house in Vancouver, the reason every Saudi prince buys a house in London, is not because they think oh returns on Vancouver real estate is going to be better than returns on Shanghai real estate. But it's an essence, it' your safety asset, right? You buy these assets, if something bad happens, I can move to my house in Vancouver and I'll be fine. But now what we've told the world is well if tomorrow, you know Xi Jinping invades Taiwan, then we're going to take your house in Vancouver. Now, if you're the rich Chinese guy who's bought this house, you think well I bought this house for precisely this potential scenario where all of a sudden there's a war in China, and I want to get out, and you're telling me that at this very moment, you're going to confiscate it? Well then this house isn't what I thought it was. And, you know, so that I think is the first massive shift. We've in essence put a big question mark on the safety of a lot of assets in the Western world.

But I would say there's a second, and I think most people that I talked to seem to understand this and are deeply uncomfortable with it. Because, you know, you take the Russians stuff today, tomorrow who's to say that, you know, you know, they're not going to take your stuff for making money on oil stocks and contributing to the climate crisis or the day after tomorrow, why can't we take the assets of, you know, the Social Media Barons because they've created a mental health pandemic amongst our kids. You know like once you can just grab stuff, you know, why stop at just the Russians. There's plenty of other bad guys out there. So you can just keep going down the list of bad guys and indeed if you're a Saudi prince, if you're a Chinese tycoon, you feel most likely that you're not that far down the list of bad guys. So right there, you know, I think by seizing the central bank reserves, we've really completely upends our entire global financial architecture. You know, before 71 we were on a gold-based system. After 71, we were really on a US-Treasury based system. And now we've just told the world the US Treasuries are not what you think they were. And neither is Western real estate. So that's a profound shift.

But there's a second shift, and I'm sorry to drawing on because this is really important. And that is, you know, if you're looking at this from an emerging market point of view, it's the speed at which decisions were made and the process through which decisions were made. You know, I think if you're an emerging market guy, let's say you're a Chinese tycoon, you're used to your government making unilateral decisions without debate in Parliament, without, you know, campaigning on a platform without any of these things. You know that's part of the world you live in. And that's one of the reasons you want to own Western assets. Because in the Western world, the policy risk is just far lower. It's you know, getting anything done is a long process. But again, this has just shifted. All of a sudden, what we've seen is that over the course of a weekend, across the western world, rules can be changed without voters having a say, without Parliament's having a say. And you could say, well we already knew this, because we saw this through COVID. But this is now a confirmation that the sort of processes that we saw through COVID where governments unilaterally decide to do stuff, again, without debate in Parliament, without any kind of, you know, democratic feedback loop can now be applied not only on people's, you know, freedom. I you know, locking down people, etc. But also on their property rights. So again, if you look at this from China, or from Saudi Arabia, or from any one of many emerging markets, you're like well this is just like home. Like, I used to think the Western world was so different. I used to think it was so special, but when push comes to shove and their back is against the wall, it turns out that actually, it's the same thing as emerging markets.

Erik: Now Zoltan Pozsar, the Credit Suisse Analyst who's a very smart guy on all subjects other than accepting our interview invitations has made the rather profound statement that the entire global financial system is essentially in the process of kind of a meltdown toward a total reset. And that's very consistent with my view, which has been that by the end of this fourth turning, I expect it's very possible that the US Dollars hegemony over the financial system will be challenged not by a conventional currency but by a digital currency that's created by people whose motive is to come up with a suitable or superior replacement for the US dollar. And what everybody told me when I predicted that in my book four years ago now is they said you're crazy because there will never be a viable alternative to the US dollar that can match the depth and liquidity characteristics of the US Treasury market. My contention is, first of all, you can actually use technology to match those depth and liquidity characteristics of US treasuries in a new digital sovereign bond market. But what seems to be happening now is the bar is getting lower. The depth and liquidity according to the Federal Reserve of the US Treasury market is suddenly getting really fragile. What could be the knock-on effects and implications if that really is true?

Louis: So look, I think, first things first it is a shame that Zoltan does not come on your show because he has been, I think, you know, he's been so right through this crisis. I think time will show that his analysis is has been very much on the ball. So having said this, here's for me your question is a very important one. Because we've always lived in a world where indeed, there was one head honcho, right? One like one big dog to dominate all others. It used to be gold, then it became the US dollar. And so I think, inherently we're formatted to believe that you need one currency to rule them. All right? And so to your point, if the US dollar isn't going to do that, because the US dollar all of a sudden no longer offers safety of assets for half of the world's population then who steps in? Well perhaps you know, you know here's an idea is perhaps we move to a world where there isn't one massive head honcho anymore dominating everybody. But just lots and lots of different currencies. In essence something where, if you look at China's trade with Indonesia gets settled in renminbi. India's trade with Russia gets settled in Rupee. Brazil's trade with Argentina gets settled in Brazilian real and so on. You no longer need to go through the intermediary of the US dollar because partly technologically, this is now you know much easier to do. I think there's already a massive signs of that, right?

You know, the obvious consequence of this crisis and one again because we decided everything in a weekend and perhaps, we didn't really think things through. You know, the first obvious consequences that Russia is now turning to countries that it deems friendly. IE Brazil, India, China and saying well look, you know, there's no point in me earning Euros or US dollars anymore. I can't do anything with them. So, if you want to buy my commodities, if you want to buy my weapons, pay me in your local currency, and so we're already seeing, you know, oil for rupee trades. We're already seeing coal for renminbi trades, and natural gas for renminbi trades. But this right there, this is a massive game changer. Now, you know, put yourself in Xi Jinping's shoes for just a second. You know, Russia exports $8 to $9 billion every month to China, which is, you know, roughly pretty much all of it as commodities, right. So that's $100 billion a year that China used to have to earn, it used to have to go to the US sell 100 billion dollars worth of tennis shoes and electronics and textiles and whatever else, and then turn around, take that money and buy the commodities needed from Russia. And now it can just print the money. It doesn't need to trade with the US anymore. So now if your Xi Jinping at the stroke of a pen, through the course of a weekend, you've had $100 billion improvement in your terms of trade right off the bat. And you've also gained massive leverage because now that Russia sells you your coal in Renminbi. Now that Russia sells you the oil and the gas in Renminbi and the iron ore. You can turn to Indonesia and say you know what Indonesia, I like your coal so much better than this Russian crap. It's such high quality, I really love your coal. But you know in Russia, I get to pay in Renminbi. So unless you're going to do a deal in Renminbi, I'm going to just buy more from Russia. And you can do the same with Saudi Arabia for oil, and so on and so forth.

So we move to a world where all of a sudden instead of having one currency, we move to many different currencies. And that brings me, and I’m sorry to be long winded, but that brings me to what I think is the single most important thing going on today that most people aren't taking enough time to think about it. And that's deglobalization. Now, when we talk about deglobalization, most people think about, you know, Apple's supply chain, or Nike supply chain and how the factories need to move from China back to Mexico wherever else. And that's true. That's an important deglobalization and that's contributing to today's inflation, etc. no doubt. But the much more important deglobalization for most of us who work in financial markets is the deglobalization of financial flows. That's much more important and has some far deeper consequences than Nike bringing factories back from China to Mexico.

You know looking at it this way, since the Asian crisis, all of emerging markets savings have basically flown into the Western world. And what you've had is an odd world where emerging market consumers were in essence subsidizing consumption in developed markets. Can subsidize consumption through undervalued exchange rates, subsidizing consumption through a constant recycling of savings. What if we move to a world where Chinese savings now stay in China and where Indian savings stay in India and where Russian savings stay in Russia. Where all this money no longer turns around to buy London real estate or buy US Treasuries or whatever else. Well then, how do Britain, France, the US all these countries that were benefiting running massive twin deficits year in, year out and funding them through the sale of assets. You know, how do they keep doing that? The answer is they don't.

So either you need these countries to adopt severe fiscal tightening and basically move into recession or their currencies are bound to go down structurally against those of emerging markets. And I know I'm being long winded, but I just want to finish on one point, because I think it's important if we'd spoken a year ago Erik, and if I'd said look Erik oil is going to be above 100 bucks, US Treasury yields will be 3%. The Fed is going to be very hawkish or sound at least sound very hawkish, the euro will be at 105. You know, the Yen is going to get crushed. And if I told you and by the way, you're going to massively outperform US Treasuries by owning Brazilian bonds. They'll be up for the year and Indian bonds they'll be flat and Indonesian bonds they'll be up for the year and Chinese bonds, I'll be only marginally down for the year. You'd have said Louis, you're the biggest idiot I know. And I'm never doing an interview with you again. Don't you know that after, you know, 30 years of working in markets, don't you know that when the Fed tightens emerging markets get smoked. And yet, here we are. You know we have the Fed tightening. And all your fragile fives, your Brazil, your India, your Indonesia are actually holding up very, very well. So it tells you right there, you know, it's like the dogs that didn't bark in the Sherlock Holmes thing. You know today the fact that Indonesia is holding up so well, India is holding up so well. It's the dog that didn't bark. These are the guys that are actually benefiting from the deglobalization of financial flows.

Erik: Well Louis isn't it true that under those circumstances, what does happen every single time is there is a flight to safety trade. But what's happening now is the flight to safety at least the perceived safety is in the opposite direction.

Louis: Yeah, but you know what's used to be... You're absolutely right. But the flight to safety used to be typically in US Treasuries. But now...

Erik: Right! They're fleeing to safety away from US Treasuries because if you've got US Treasuries, we can just change, you know, we have to pay that money back unless we kind of change our mind and decide we don't want to in which case nevermind.

Louis: Exactly so I mean, how is an asset that can be worth zero overnight, at the decision of a politician simply at the decision of a politician, not even out of a bunch of politicians? You know...

Erik: With no judge and no judicial system involved.

Louis: No judge, no judicial system, no debates in Parliament, no nothing. Just a White House that decides we're going to do this. How's that asset considered safe? Again, and it depends who you are, if you're French, if you're German, if you're Japanese, sure US Treasuries are safe. But the reality is these guys, you know, the French, the Germans, the Japanese haven't been a marginal buyer of US Treasuries for 25 years. The marginal buyer since the Asian crisis, the marginal buyer of US Treasuries, the foreign marginal buyer has been coming out of emerging markets. And that emerging market investor is very now I think, is now afraid of being on the wrong side of canceled culture. You know, we live in this canceled culture in the Western world. And you know, if a Russian oligarch can be punished for something Putin did, which by the way is another big departure in our legal systems. Our legal systems used to be all about, you only get punished for things that you do, you know, it's I can't get punished for the crimes of my father or the sins of my son, I can only get punished for what I do.

And here you know when you look at the punishment of the Russian oligarchs, it's like, oh, well, they're friends of Putin. So we're gonna take all their stuff. It's a very slippery slope, right? The whole point of our legal systems is, again, you can't be punished for being you know, I'm Catholic, I can't be punished for the sins of the Catholic Church. But here, you know, we've thrown all that to the wind for the Russians, I think out of the emotion of the horrible things happening in Ukraine. Our politicians want it to be seen to be doing something that was something so we did this, but the precedent it sets, again, if you're Chinese, if you're Saudi, etc. And you're looking at this, the precedent it sets is a very scary one for all those people.

Erik: Now with respect to the so called Russia, Ukraine war, something that I've said several times on this program is I don't think it's a Russia Ukraine war. I think it's the Battle of Russia, Ukraine, in the context of a much larger conflict between the world's largest superpowers. What I have feared is that the next battle might be the Battle of China and Taiwan. You know a whole lot more about China. And you actually mentioned that possibility earlier in this conversation. Am I right to be concerned about that? How close is China to potentially trying to forcefully take Taiwan which it claims as its part of its country back. And of course, Taiwan doesn't see it that way. Is this likely to come to a head in the next couple of years?

Louis: I don't think it is. I really don't think it is, you know, first, we could of course, say that look, that's perhaps the silver lining of the Russian invasion. The fact that Russia is really struggling with it is a reality check for China, so that, you know, on the first because, you know, militarily speaking an invasion of Taiwan would be much more complicated than invasion of Ukraine, right? You're having to cross an ocean, there's a Pacific Fleet between you and Taiwan. So there's, you know, just logistically speaking, it's a hell of an undertaking. Secondly, of course, there's there'd be the economic costs, which is another warning for China. So, again, if you want to look for a silver lining to this, you know, terrible Ukraine war, it'd be this one. But even before that, I didn't really believe in the whole Taiwan invasion for a pretty simple reason. And that is that, look at that generation that Xi Jinping is from and the entire Politburo is from. You know, I think we're all the fruits of our own experiences. And if you look at that Xi Jinping generation, these are the guys that were in their 20s during the Cultural Revolution, right? So they would have been sent to the countryside to dig out roots and boil leaves for food, they would have almost starved. All this in their formative years. And during those five or six years where they would have been in the countryside, the only book they had to read was Mao's Little Red Book that was the only you know approved reading which they would have all learned by hearts.

Now, I don't know if you've ever read Mao's Little Red Book. But it's basically a combination of Marxism for Dummies and guerrilla warfare for Dummies, because fundamentally, that's what Mao was right? He was a sort of poor Marxist thinker but a terrific guerrilla war leader. And so these guys in their formative years will have done nothing, but learn guerrilla warfare tactics. And the whole point of guerrilla warfare is you attack by stealth. You attack when your enemy is weak, you press your advantage, and then you retreat. And you never ever tried to confront a strong enemy head on, which you know, is how Mao won One China over which is of course how the Chinese supported Vietnamese ended up, you know, beating first the French then the

Americans. So in their whole mindset of the world, you don't fight wars head on. You attack your enemy by stealth. So maybe, you know, if your enemy has eight and a half percent inflation rates, you shut down your biggest port and you make sure that that inflation rate keeps on climbing because also, if you're a Marxist in your worldview, inflation ends up triggering revolutions and triggering social, all sorts of social problems. So if your enemy has inflation and you don't, then you press that advantage. And so you know, you reopen and you make sure that for the summer, the Walmart shelves are empty. And then you reopen just in time for the old price to go from 100 bucks 150 so that Americans can pay $7.50 a gallon to go to Walmart's where there's nothing on the shelves. To me that's what seems to be unfolding rather than a takeover of Taiwan.

Erik: Let's come back then to the situation in Russia particularly with regard to the European Union because what's going on right now is we've got a lot of political grandstanding in the EU where they're saying look Russia, if you're going to behave this way in Ukraine, we are going to teach you guys a lesson. And that lesson is going to be we're done with buying energy from Russia. Never again! Well you know what, that's an easy thing to say when you're a politician and it's May. In October, it's a little bit harder, considering that from an infrastructure standpoint, Europe is totally dependent on Russian gas. And I don't mean gasoline, I mean, natural gas and propane, you know, it's about the heating of Europe is mostly dependent on natural gas.

What if and it feels to me, like everybody thinks Russia is in a corner and has no options, and we're going to show those Russians, we're going to put them in their place. What if Russia were to say to China, look, we got a problem here, which is, we're really sick of dealing with the West. But we do need to sell our gas. What if we cut a deal with you China where you buy all of our oil and all of our gas, which means we got to build a new pipeline, but it's not that far to build that pipeline. And we're going to stop dealing with Europe completely. We're gonna turn this around and say Europe, you can't buy our gas. It's not for sale to you, find another source, we're going to sell it all to China. I have no idea what it would take from an infrastructure standpoint. How long it would take to build out a pipeline to make that happen. But it seems to me that politically, Russia and China are getting to be closer and closer friends. And if they could figure out a way to not need the West, particularly with respect to energy. I think they try to do it. Am I crazy to think that?

Louis: No, no, not at all. Look, I go one step further. I actually think that while it's fairly obvious that Europe is the massive loser out of this very unfortunate war, the big winner, I think, is potentially China because what's ended up happening here is that China, sorry, Russia, apologies Russia is in essence becoming an economic colony of or in time will become an economic colony of China. Look at it this way. All of Russia's commodities are now indeed going to be increasingly going towards the Chinese market. And they're going to be paid for in Renminbi which again, for China is a massive game changer. You know, China has been trying to get to this point of buying commodities in its own currency for the past 15 years. That's why they open up their bond markets. That's why they opened up the Renminbi to international investors. They've been trying to get to this point and in one weekend, they got there So for them, that's a massive massive boom. And then on the other side, the only goods that Russian people will be able to buy will be Chinese made goods, right. So they won't be able to buy Mercedes or Volkswagen cars anymore. They'll buy Cherry automotives or BYD cars. So it's, you know, this is a game changer. In essence, Russia is going to have the relationship with China that India had with Britain pre-World War Two. You may remember that, you know, Gandhi would complain that all of the Indian cotton would be sent to Britain, to be treated in the mills of Birmingham and Manchester and then sent back to India in the form of expensive textiles. And in this way, in essence, all the money from India would end up going back to Britain. Well that's exactly going to be the relationship between Russia and China going forward.

Louis: So, you know, this is not such a good deal for Russia by any stretch. The big winner will be will be China but yes, the massive loser will be Europe along with Russia, but the other big loser will be Europe. Now again put yourself here for a second in Xi Jinping's shoes. You've just had $100 billion improvement in your terms of trade, because now you can just print money and buy whatever commodity you want from Russia, and probably also from Indonesia, from Malaysia, etc., who will have to fall in line, or risk losing the China Business. So that's a big win, you've just had another big win. And that one of the problems or perhaps checks on your power was the threat that rich Chinese people would, you know, put their money away. Put it in Vancouver and Sydney and London and wherever else. Well that threat has just disappeared. Now you can turn to them and say hey look, all the Russian oligarchs who put their money abroad, they've lost everything, the oligarchs who stayed at home, they still have everything.

So you know if you're Xi Jinping, your ability to keep capital inside your country is just dramatically improved. Again, going back to this idea of the deglobalization of financial flows, and then when you look at your relationship with Europe. Your ability to push Europe around has just also improved because having lost the Russian market, Europe can now not afford to lose the Chinese market. You know, it'd be just too devastating economically for Europe. So now China can, you know, push Europe around a little more than it could before. So, you know, you put all this together it's pretty obvious who the winners and losers are I think.

Erik: Let's take this geopolitical conversation and tie it back to what's happening today in financial markets. Because when I said to David Rosenberg, boy, it seems to me like sell off in the stock market, sell off in treasuries really kind of accelerated right around the time that the US started these extra judicial seizures of assets and seizures of foreign exchange reserves and so forth. It seems to me like they might be related. Rosie said no look at the fact that the stock market sell off is really global. It's happening in other markets, it's not just the US, there's no reason to think that. What's your take? Is the current activity in markets being driven by these changes in US policy or is it just coincidence?

Louis: No, I think it is being totally being driven by it. You know, you look at since late February, US Treasuries and German boons have in essence been in meltdown mode. But meanwhile, if you look at Indian government bonds and Chinese government bonds, you know, I don't think it's been as bad. Now granted, you know, when you change the property rights on things, you end up with much higher risk premiums on everything. And that's what we're seeing. You know we're I think we're in a panic phase in the markets where people are realizing. You know, what, I've had risk premiums on too many things for too long. I was always expecting we never had inflation and that's turned out to be wrong. And I was always expecting that my property rights were sacrosanct and that turned out to be wrong. And now I have to live with a world where there's much greater bond market volatility, and there's much greater currency volatility. So, you know, all this makes for very different outcomes.

Erik: And what's your outlook for both US Treasury yields as well as for the S&P?

Louis: Well look, I'm a bear on bonds. I think you buy bonds for safety. And, you know, you can't change the rules and not expect long term consequences. So, I'm a big bear on US Treasuries. And, you know, that's a hell of a headwind for equity markets that are especially US equity markets that are priced, you know, they're not they're no longer crazy expensive, but they're not super cheap either. And, you know, I think when you look at US equities, it's pretty obvious to me that we're in a bear market, right? You know, where we've got increased volatility. I don't know, if we're down exactly the 20% on the S&P you need to call the bear market. You definitely down on the NASDAQ, and on all the aggressive growth stocks that was leading the stuff higher. But you know, that to end a bear market, you need either for the Fed to start, you know, adding liquidity and cutting interest rates. And that's definitely not a story for 2022, maybe 2023. But definitely not a story for 2022 or you need energy prices to collapse. And for all the reasons we discussed, they're nowhere near collapsing, they're gonna keep going up. So that's not going to provide any, you know, falling energy prices are going to provide additional liquidity to markets have very much needed or you need asset prices to get so cheap that things bounce back, just on their own, because it's so cheap but we're not really there. So we're in a bear markets on the S&P 500. And, you know, the usual things you would expect to stop the bear market are not there. The one that if, you know, if you if you want to look for a silver lining, you know, and you think, okay, how does this turn around. You know, one potential silver lining is there's some resolution in Russia, which allows energy prices to rollover at least in the short term. So that's one possibility. I don't really buy it. But if you know, as you and I always discuss, you know, money managers we're not paid to forecast we're paid to adapt. So if there's a change in Russia, then you adapt. And that's option one. Option two, maybe we don't get easing from the Fed, but we could get a bunch of easing from the PBOC and we could get a bunch of easing from China. If we get that however, my guess is the immediate impact will be higher commodity prices and rebounding emerging markets more than rebounding S&P 500. So, you know, I think the trade today is to be to be overweight emerging markets and underweight the S&P 500. Because if there's good news going to come, it's going to come from the emerging markets, I don't think it's going to come from the US.

Erik: Louis, one of the things that really shocks me is the number of people that are talking about the so called stock market crash. I don't see any crash. What I see is a bear market that has been remarkably orderly so far. It is you said we gotta look for what are the signs that tell you when a bear market is ending? It's usually when you see it become disorderly selling. That retail capitulation where people are panicking and just you know, selling into already technically oversold conditions. We're not seeing that yet. I think it's still to come. What are your thoughts and what could be ahead? How far do you think we could go on the S&P before this is over?

Louis: Well, I don't know. I don't think we're there. You know, I think all the way down, you've seen retail increases and you know, the high energy, high growth funds like Ark and others. So you know, you definitely haven't seen the retail capitulation. For me, you know, so, you know, the first quarter was pretty ugly. But interestingly, hedge funds didn't really have redemptions. And when you think of it, you know, most hedge funds have sort of, it's a quarterly redemption notice, and you got to put in, sort of 45 days ahead. So, you know for this late June, you should have put it in mid-May or late-May at the latest for the end June redemption where, you know, from what I'm hearing, you're still not really seeing that, still not really seeing that. So my guess is, you know, if the NASDAQ stays ugly, and right now it looks and feels ugly, for sure. And if all those, you know, long-short equity hedge funds that have proven to be much more long than short, and that have often even underperformed on the way down. So really showing that there wasn't much of a hedge at all. I think you're gonna see all these guys get redeemed in mid-August. And so that means that you come into late-September, and you get the selling. And what will be interesting then, is you get the selling, you know, it's the old story in a bear market you don't sell what you should, but what you can, and I think you get to September and in September, a lot of these funds will be facing redemptions by then. We'll be selling you know not all the illiquid stuff because that's not sellable. They'll sell the big names, they'll sell the Microsofts, the Apples, the Googles, all those things that have so far held up so well and that have given the impression that this hasn't been a bloodbath, right? Because to your point, you know, while it's been a bloodbath on the names like the Pelotons and the Coms, and the Shopify of this world. The underlying you know, the market has been held up by the Apples and the Googles. I think there's a chance this cracks in September because of the redemption cycle.

Erik: Let's go back to energy because that's a market where a lot of people I'm really surprised are saying, look, you know, we're over 100 bucks, that's kind of unprecedented, it never lasts. Surely energy prices are about to roll over. It seems to me like if anything, the opposite is true in the sense that we've done so much with the misplaced efforts of the ESG movement to vilify the oil and gas industry, that there's no investment in finding new resources to replace those whose production is in steep decline. And what's going on as I see it, is we're telling ourselves, you know, it's gonna get better any day now. But in reality, everything we're doing from a policy standpoint is making the situation worse. Where is this headed and where do you think energy prices could go from here?

Louis: Well look to your point, if you go back three years ago before COVID. The US was producing 13 million barrels per day and the oil price was 55 bucks. Fast forward to today, the oil price is you know, 105-110, pick your number. And the US is producing 11.8 million barrels per day. So I think there's a growing realization that US oil production that was only going one way for the period 2011 till basically 2020 it kept going higher. People are realizing this isn't a magic tap that you turn on and off. That indeed to your point, you know, there aren't enough workers in the oil patch. Getting that oil out is extremely capital intensive. All the capital that was spent to get that oil out in the first place in the previous decade actually turned out to have terrible returns on invested capital. And so no, so look, you and I have discussed this before, but we were entering into an energy crisis before Russia. You know, we were we were heading into massive energy shortages partly because of the ESG, partly because of the capital destruction that went on in the shale patch for 10 years, partly because of massive malinvestment in alternative forms of energy, partly because of knuckleheaded decisions in Europe to turn away from nuclear. You know, my own country of France which used to be a nuclear superpower. You know, we've gone down from in 10 years from 90% of our electricity produced by nuclear to 60%. And because we tried to meet the European Union directives that we needed more wind, and we needed more solar, which turns out to be like worse carbon. This is the stupidest thing of them all. Because when you do more wind and more solar, you need to have redundancies built in, which can only basically and you end up building coal plants. So you shut down the nuclear plants build more windmills and coal plants... real smart. Anyway, so we've done a bunch of that.

So anyway, it brings us to where we are today. And to answer your question, we're entering into an energy crisis. And you're going to have, I think, different kinds of countries. The first are countries like the US that are more or less energy self-sufficient. And so you know, those, you know, those will withstand it. You could say, well, you know, $150 oil is horrible for the US consumer. But it's not horrible in the way it used to be in the past, right. In the past, when oil was $150 bucks, it meant money was leaving the US to go to Nigeria, or to go to Saudi Arabia, or wherever else. Now, it means money will leave from New York to go to Texas and it'll leave Chicago to go to Oklahoma. So as far as the US goes, it's not an absolute disaster. It's probably a disaster for a lot of municipalities that are going to see their tax receipts absolutely plummets and people leave but that's a whole other debate. Then you have the countries that will be able to meet their energy needs from Russia and pay for it in their own currency. And, you know, the China's, the India's, maybe the Singapore's, the Thailand's of this world, and those guys will be I think, you know, winners out of everything that unfolds. And then you'll have the countries that that will face a choice, and the choice will be a pretty simple one. It will be either, we go back to coal and we get rid of all the climate change rhetoric and COP26 constraints and we keep our houses heated in the winter and our industry going. So we go back to coal, because we can turn that on decently quickly. There's lots of coal in the world. And you know, building coal plants is not that complicated.

So either we turn to coal or we ration energy. Now, if you look around the world, China's already decided to going back to coal. You know coal consumption, China is going through the roof. India's done the same. Brazil's done the same. It's pretty easy for emerging markets, you know, in a choice between paying a high price or increasing pollution. They choose pollution every day of the week and twice on Sunday. In the Western world. It's much more challenging at least for this current generation of political leaders who tied their political fates to the climate change rhetoric. But on this, you know, I'm decently hopeful there as well, you know, as Milton Friedman said, you know, politicians never learns but voters do. What's going to happen in countries like Germany and France is politicians will stand up and say you know what, you're paying too much for your electricity, you're paying too much to move your car. If you vote for me, we'll turn on the coal. And prices will collapse because producing electricity through coal is a fraction of producing electricity through any other measure. I think that's where we're heading towards and it's just going to take a little time,

Erik: Louis, some of our listeners have ridiculed me for making the statement that I think OPEC has run out of spare capacity. Now, another little known fellow decided to agree with me this week. His name is Prince Abdulaziz bin Salman, the Saudi Arabian oil minister who said this week that, hey, we don't have the ability to just increase production. Now, I'm sure some people would say, oh come on he's just saying that now because of this NOPEC bill. And you know, it's a political statement. I don't think so. Louis, I think that maybe the NOPEC Bill has made it timely for him to bring up this inconvenient truth but just look at what's going on with most OPEC producers being unable to meet their quotas. These guys have a decades long history of cheating and over producing beyond their quotas. Now all the sudden they can't make their quotas and nobody seems to get the message that it means they're out of spare capacity and we're in real trouble. Am I missing something?

Louis: No, I was about to say that. I was about to say look at the OPEC production for the past year. And pretty much every single country to your point isn't meeting their quota. Now, you know, with oil at 100 bucks. Why wouldn't you be meeting your quota? Right? You'd be to your point, historically, when you look at these guys patterns, with oil out 100 bucks, they would be cheating. So no, it's you know, if you think okay, already OPEC can't produce the capacity. How do we get back to normal? Well, how do we increase production if OPEC can't do it and if Russia can't do it? Well, there's the US. But that's massive capital intensive. And it's, you know, it's not going to turn on a dime. There's Brazil, where there's a lot of oil but here again, it's not going to turn on a dime. And it's very capital intensive and it's offshore and it takes a while. There's Iran. We can let Iran out from the cold. But you know, how much spare capacity is there truly in Iran and there's probably a lot of it already on the market anyway. So no, you look at it. And you could say well there's Venezuela, but you know the infrastructure in Venezuela is by now so derelict that to turn that around is going to take years.

So you know, wherever you look, you end up with a simple realization that anywhere you could get spare capacity is probably going to take a year or two except Iran, except Iran. But I'd add one more thing on this is, you know, we got oil out 100 bucks or over 100 bucks. And we have OPEC producing as much as they can etcetera, against the backdrop where Chinese imports are basically down 1-1.5 million barrels from where they should be. You know, if you believe in a world where at some point China abandons the zero COVID, then you know, oil prices I think have another 20 or 30 bucks in them just from China rejoining the global economy. And you know, you could say well, you know, that there'll be supplied by Russia and some of it will be in coal. And I agree with that. But, you know, there again, you mentioned, you know, we could Russia can build its pipelines and start serving Europe and start serving China. But here again, all these things take time, right? The distances between Russia's oil fields and Russia's gas fields to China are not, you know, it's big distances in extreme weather conditions. There's a reason nobody lives there in Siberia. It's a hard place to live.

Erik: Well Louis I can't thank you enough for a terrific interview. But before I let you go, please tell our institutional listeners a little bit more about what you do at Gavekal and how they can follow your work.

Louis: Well again thanks. It's always a great pleasure to catch up. The best easiest is to go to our website Gavekal.com. We also have a US Private Wealth arm and we publish a free newsletter from there called Evergreen Gavekal. So if you want our free newsletter comes out every Friday, you can sign up there. What we do, we're a bit of an odd firm. We have a money management arm where we manage money into Chinese fixed income. In fact, we recently launched and into Asian fixed income in general. We recently launched an Asian government bond ETF called tickers agov.us. So we've got a big money management arm and then we publish research for institutional investors. We have, you know, obviously, we're based in Hong Kong and Beijing. So we have a lot of what we publish on China but we do try to keep it global. Keep our clients engaged beyond just the China stuff.

Erik: We look forward to getting you back on the show for an update in a few months Patrick Ceresna and I will be back right after this message.