MACRO Voices
*with hedge fund manager Erik Townsend*

# David Hay: Why US Energy Prices Can Rise Even In Recession

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***Erik:*** Joining me now is David Hay, Chief Co-Investment Officer for Evergreen Gavekal and the founder of the Haymaker Social Media site. David has prepared a slide deck to accompany this week's interview. Listeners, you'll find the download link in your research roundup email Now if you don't have a research roundup email, just go to our homepage MacroVoices.com look for the red button that says looking for the downloads. David, it's great to have you back! I want to credit you for being the guy who told our listeners first about what you called Greenflation, the idea that, hey, as much as the climate agenda, and so forth, these are all noble goals, things we got to do to make the planet a better place. It doesn't come for free and you have to consider that these policy initiatives mean that it will introduce inflation into the economy. Well boy, you sure got that one right. So congratulations on that call. I'd like to ask you for an update. You know, you definitely called this one. How has this gone? I wasn't expecting President Biden to essentially say the same thing when he told everybody it's not a recession, it's a transition. And it's a cost of getting to green energy. How has this played out compared to what you expected and what do you see next for this green inflation story?

***David:*** Well, first of all Erik, it's great to be back on. We had a really lively discussion last time. I went back and I listened to it. And you and I made some pretty good calls at that point. In fact, both of us were very skeptical that energy prices would stay suppressed, particularly as we get deeper and deeper into what I would call the Great Green Energy Transition to use that transition word again. And it's pretty remarkable, really what's happened. I mean, it was, if you've remember that one of the big focus points in that discussion, which I think was October 28 of last year was what was already a serious energy crisis in Europe. Oil and gas prices, electricity prices were exploding already at that point. But since we talked, actually, electricity prices in France are up another 500% and in Germany, they're up 300%. I just don't think Americans realize, have any clue as to how bad it is over there. And a lot of this started way before Putin put on his Blitzl. Way before those tanks ever crossed the Ukrainian border. So this is a problem that's been festering for a long time.

***Erik:*** Well David, when you talk about lively discussions, I know you're a regular listener to the show. So I'm sure you heard my interview with Adam Rozencwajg last week. I'd love to get your reactions to that. Is there anything you disagree with Adam on and how do you see things compared to the way he described the energy situation?

***David:*** It was terrific and I'm a big fan of Adam's. I read their research routinely and have for years. In fact, that's one of the reasons I was so convinced that energy was a screaming buy last October even as far back as 2020. And one of the points that he made in a recent podcast that I thought was quite fascinating. Something I picked up on is this Freeport LNG outage which is a very big deal because Europe, and we've already talked about how severe their energy shortage is over there. So they desperately need U.S. LNG. A few months ago, there was an explosion at the Freeport LNG export facility in Texas. And that took off about 20% of US exports to Europe. So we exported that 10 billion cubic feet a day. We produce about 90, so it's significant. It's about 11% of total US production that's now being directed to Europe and again, those guys needed very much. It's almost life and death for them. And so when that was taken off, you would have thought there would have been a glut of natural gas in the United States at least until that plant came back online, because you weren't getting it out to Europe at the same rate that you were before the explosion. As he pointed out, what's shocking is that we're actually seeing inventories, natural gas inventories continue to contract in the United States. Very different than what the expectations were when that plant first came offline. So it is just remarkable to think about where gas is trading in Europe right now. It's $58 per MMBtu, which is British thermal units. But as I often say, and this is a pretty loose analogy, it's kind of like a gallon of gas. I mean usually natural gas in the United States kind of trades somewhere around a gallon of gas, maybe a little bit more, a little bit less. So imagine it would be like $58 gasoline that they've got over there.

And what's interesting, and this is actually a lead into a very important point because I also noticed in your back and forth with Adam, that you were expressing concerns that perhaps the US crude oil market could be glutted or even the global crude oil market might be in a glut situation because of demand destruction caused by a recession. And that's a whole another topic than ever we're gonna get to the economy and are we in recession or will be in a recession. But I want to make the point to you that even if we do go into a global recession, I believe there will be virtually no demand destruction of crude and the reason is fuel switching. So what you're starting to see in Europe is something I've been actually talking about for a couple of months running about, which is that the European companies and utilities. The big companies like the chemical companies, the petrochemical companies that are being threatened with shutting down because they can't get natural gas for their feedstock. But what the utilities are beginning to do and even some of the large companies that generate their own power is they're now saying they're going to switch over from burning coal or natural gas, because that's where the traditional fuel switching has been right between coal and natural gas, depending on which is cheaper. Now, oil is so much less expensive than either natural gas or coal. In Europe, they're going to burn oil. So this is what's the big, big deal. And right now, I think most recent projection I saw was that it would be an increase of about 800,000 barrels per day, almost a million barrels per day by the European industrial base starting to burn oil. And again, particularly utilities, because you can generate power with coal, natural gas or oil, or in some cases nuclear. And then there's of course, the burning of wood pellets. We may to talk about that. That's one of the most scandalous things that's going on and I don't want to go down that rabbit hole quite yet.

But if you look at oil on an MMBtu-equivalent basis, so $100 oil is equivalent to about 5.8 MMBtus per barrel. So if you do the math, what it really boils down to is we're talking about $18 equivalent gas. Now remember, it's 58 so they can buy oil, and they can get natural gas at a price equivalent of about $18. And they're going to be buying that every single spare barrel of oil that's out there. Europe will suck in, in my opinion. And it's also a heck of a lot easier to ship. As you know, LNG is tricky. You got to freeze it down to 270 degrees minus Fahrenheit. And then once you get it over to Europe, you've got to have a regasification facility, you've got to be able to deliver it to the various places where they need it, which typically isn't Germany. They're trying to put in floating regasification units on an overnight rush basis but oil is a much easier commodity to ship and much cheaper. So I think that's something that I really haven't heard hardly anybody talks about. I've heard a little bit from Cornerstone analytics, Mike Ross. I've heard a little bit from Marshall Adkins at Ray J. But for the most part, that's just off people's radar. And I think it's a big deal. We've never gone into a recession, with a major energy consumer unbelievably short of energy. So that's my little twist on that.

***Erik:*** I want to push back on that one. And I'm just doing this off the cuff here, because I hadn't thought about this but...

***David:*** There's something you haven not thought about? That's amazing!

***Erik:*** ... well what strikes me about this, I get the math on the energy equivalent, but the question that really hits me is okay, if I think about the politics, particularly of Europe, what you're saying is, somebody's got to go and say we got to make a very significant capital expenditure to put new equipment in because we're going to switch from burning natural gas as a fossil fuel to burning crude oil. It's not crude oil, but they're going to burn something that is produced directly from crude oil as opposed to directly from natural gas, they're going to burn heating oil or something that comes from crude oil. Well, wait a minute, how do you justify the capital expenditure of the changeover of equipment because the burners that are burning natural gas don't just burn fuel oil? You got to you got to buy a new furnace or a new, you know, machine, whatever it is that's consuming that energy.

How do you justify new capex on something that burns crude oil or a crude oil derivative in the political environment that exists in Europe? It sounds to me like a hard sell. Because look at what's going on in Germany. Despite this crazy crisis, they had announced that they were going to take their remaining three nuclear plants offline at the end of this year because of a misplaced belief that nuclear is anti-green, which according to the Green Movement, they think it's not a sustainable energy source or it's not green. If you can't keep your nuclear plant running, which doesn't require switching any equipment over. How do you justify buying and installing new equipment to burn a fuel which you're supposedly committed to phasing out?

***David:*** Okay, well, I appreciate that. And I would say that forget my opinion, and whatever I'm gonna say, beyond this first point, which is they're already doing it. So if you track, you can go online and look at these large companies in Europe. But again, including utilities that are

already making this switchover, they're doing it so obviously, they feel it's justifiable, I would go one step further and say they really have no choice. I mean, it's almost like whatever the cost, because the equipment costs relative to the price differential between oil and natural gas is so immense. And also too, realize that fuel switching has gone on for decades. It's just typically between natural gas and coal. So it's not that different. I would actually argue it's easier to switch from natural gas to oil, because you're going to liquid gas, almost quasi liquid versus coal. But it's just not really been done, and why hasn't it been done until recently? And again, it's happening already, so it's not conjecture. But in the past, nobody really thought about it. Because as you know, for years and years and years, decades, natural gas was a lot cheaper than oil.

Coal was a lot cheaper than oil. Coal was usually the cheapest of all, although there were times when natural gas crashed in price, and it became more attractive than coal, and certainly more attractive from an environmental standpoint and burns much cleaner, as you know. So it's happening. And I just don't think most people that focused on it yet. And they're still, I mean, your concerns are shared by a lot of you, every time you see, like yesterday, there was bad economic data out of China. And what happens to the oil market, it goes downhill, we're $54.50 a barrel. That's a big one day drop. So every time there's weakness, like when you might remember, right after we just had our chat, that three weeks later, the whole Omicron thing hit the scene and oil and oil stocks, energy stocks just got crushed right after Thanksgiving. And every one of these has been a great buying opportunity, because there is this underlying tightness that we have in the commodity market. And you're very skookum, very aware of what's going on in the oil market. So you're tracking what's happening here with this announcement, or the Biden administration is going to try to narrow the spread, and we're going to buy forward futures, to try to bring up the kind of solve that extreme backwardation situation that we've had, or at least partially eliminate that. And they have, you're well aware, it's come down pretty significantly.

But you know, this just as another manipulation of the oil market. The first one, of course, is the release of the SPR, which is a million barrels a day. So that's a big deal. That's a lot of oil, it's about 1% of the market. And they're going to run out of that at some point this fall. So you're gonna have that flipping, so there's a million barrels a day of reduced supply. Then, you're going to have China reopening, which is always a, it's kind of a G reek farce in a way or tragedy that they go through this, it looks like they're out of the woods, and then they're back in the woods, there's zero COVID policy has been real problematic in that regard. But then you're gonna have this fuel switching, which I think will be at least a million barrels a day. So you're looking at about a 4 million barrel a day swing, that is going to use up any demand destruction that occurs. And that would be to go down more than 4 million barrels a day would have to be just a horrific global economy, which I guess we could get. But I think that's unlikely.

***Erik:*** Well, that's where maybe we disagree a little bit, and I'm with you. What I've been saying for months now is, I thought that what we were going to see was the market needed to price in a recession, which meant that the flow of crude oil futures, all the speculative open interest, would come out of the market. Now that's already happened. And I thought once the

speculative open interest was out of the crude oil market, and we stabilized in terms of where the specs were on the open interest charts, the commitment of traders reports. I thought that we would then see a resumption of the bull market in crude oil prices. And what I've realized is, you know, there's plenty of scope considering that central banks all around the world overstimulated through the pandemic crisis, there's plenty of room for a really really deep global recession, which causes a whole lot of demand destruction, and it's the whole planet. So you know, I'm absolutely convinced of the basic thesis that what happens here is oil prices go down as we price in the recession, then eventually, they start going up again. But frankly, I've opened my mind to the possibility of another $20 of downside on oil prices before that resumption of the uptrend occurs. And the reason I say that is, I think that this coming global recession, not just US, could be a lot deeper and longer than most people think,

***David:*** I certainly agree with you, when it comes to Europe. Europe, just I just don't see how they avoid a nasty recession. And just so many things going against it, primarily energy. I mean, if you got a major drop in energy prices, that might throw them a lifeline, I just don't think you're gonna get that at least when it comes to crude oil. And I do think their natural gas prices at $58 per MMBtu is just, you know, that's just off the charts. So I wouldn't be surprised to see that come down fairly drastically, but probably not to that $18 equivalent on oil. So I do think you've got a bid there, that's going to be surprisingly persistent. And the other thing you got to look at China is, China has already gone through a slowdown. So I'd say that at some point, they've just got to live with COVID and make the decision that they're going to get back to life as normal. I mean, you look at the experience of Sweden and Norway and how they have behaved in a much less panicky way with regards to COVID. And they've had really a pretty comparable experience to most other parts of the world and in many cases, way better than, say, the Northeast United States in terms of death rate per million. I think this panic that we've been in for the last you know, more than two years over COVID is probably behind us and I think eventually China will adopt that kind of a mindset too and, and their demands down about 2 million barrels a day. So them coming back to normal is a very big deal. Then you got India, which has got 1.4 billion people and that's... they're definitely a major user of oil, a growing us. recoil.

So I think there's some real lasting demand drivers, but then look at supply. And if you look at the supply right now, in the United States, and it's way below where we... the normal, normal level, the seven year average, it's something like over 200 million barrels below normal right now. So we've got very tight inventories. And so, you know, that's you could be right. Anything's possible when it comes to the financial markets. And, to your point, when you look at the level of financialization of trading of the crude oil market, you probably know the stat better than I do, I believe it's about 28, to 1 other words, about 28 times as much paper trading in the oil market versus the physical market. And that's in most commodities, it's more like four or five times. So what the financial markets decided to do, and a lot of these are, of course, programmed by algorithms, and they see recession in the Beige Book and the recession readings in the Feds Beige Book are just off the charts. So that naturally puts a lot of financial selling pressure on. But as you point out, a lot of it's played out. And the lowest they were able to get oil prices was to about $90 a barrel, and then it had a nice rebound. So I think this, the assumption is that in a

recession, oil prices go down. The other assumption is in a recession, interest rates go down, I'm not sure either one of those is going to happen this time. But that's, of course, a whole different subject when you talk about interest rates.

***Erik:*** And I think it's important to, as we go back to the fuel switching idea, as you point out, there could be profound differences between the company that is consuming fuel oil versus the company that's consuming natural gas, for the reasons that you described. But at the end of the day, if you aggregate, the global supply that's available of both natural gas and of crude oil, and you include all of the spare capacity, that's the ability for producers to make more than they're making now by turning up the dials and producing as much as they can. It's still not enough to return the global economy to pre pandemic normal, we can't get there from here. And we've made policy mistakes that are going to prevent us from getting there for years to come. So although that pain is going to be concentrated, depending on what kind of fuel you're burning, at the end of the day, the big picture is we don't have enough energy to get the world back to where we were. And this whole idea that it's a green transition, and it's all a good thing. You know, I think this is a case of trying to phase out the old before the replacement was phased in. It's all a great idea. But we don't have the new green energy or enough of it to run the global economy, we still need fossil fuels. And we're disfavoring any new investment in fossil fuels or in petroleum refining capacity. And we've gotten ourselves into a really, really difficult position here. David, now that we've seen the rally in energy prices that you and I both predicted back in October, when we last spoke, that definitely came true. Now we've also seen the steep correction that I've described on the podcast since before it started, which was at some point we had to price in the coming recession. Seems like it's mostly priced in or almost completely priced in or maybe it's got more pricing into go. But at some point, though, it gets fully priced in. At that point, do you see a sharp resumption in energy prices? Or do we just muddle along and the already high energy prices, stifle the economy to the point where we don't get the growth that brings the demand back online? How does this play out from here?

***David:*** Well, I wish I knew. Absolutely, I have some inclinations. And one of my inclinations is that oil prices are gonna have another spike up. And one of the things we were going back and forth we didn't really talk about was Russia, and how much Russian oil is gonna come off the market. And so far, they've been pretty clever about getting around the sanctions. But I do think there's going to be a loss of Russian production, demand and supply. So if you're a buyer of Russian crude oil, obviously, a lot of countries won't do that other countries such as India, say, 'Sure, sign me up, I'll take that shoot cheap, crude.' But there's difficulties in getting it to market, you know, the Russian energy complex was really set up to send energy west to Europe through the pipelines, not really as well set up to get it on ships. And they certainly can, but it's obviously much more difficult and expensive, and time consuming to put it on a ship and sail all the way around, say to India versus piping it to Eastern Western Europe. So that's another issue.

I mean, originally, the IEA was saying that Russia was going to be down 4 million barrels, and in production, or at least in terms of demand for that production. And that's really not turned out that way. But there is going to be a loss and guessing how much that is, I would say probably a

million to 2 million barrels, but that's just another supportive factor for pricing. But I think we should also give ourselves a little pat on the back because I did go back and I made a note of what the s&p had done from that time where we had our last chat which is it's down 10% The NASDAQ is down 17%. The energy ETF, XLE is up 36%. Even the midstream is up 15. So those are huge deltas. And as you know, when we were both positive on energy back at that time, it was a very non consensus view. There were so many people in our business that felt an energy was an investable. And it turned out that was just a horrible decision. And even with the big rally, and it's what 4% of the s&p, so it's still a very, very small percentage of the s&p. And the other thing to your point about, watch out for a correction, there's been a brutal correction, much more so than the price of oil with a lot of the energy names down 2030, even 50%, from early June. So it was like a vicious bear market that came out of nowhere.

So I think you've got a great setup. There's some of these companies that are trading with 25%. free cash flow yields trading at three and four times earnings. And those earnings are based as you know, on that forward curve. So when analysts set their earnings estimates for 2024, they're looking at where's the futures market in 2024? Well, even though the backwardation which is to be clear that difference between the spot price and the let's say the two year out price, typically the spot price is at a discount, which would be contango the normal structure. Backwardation is where the spot price is above in this case, it's $20 a barrel above. And you and I both said one of the best plays back in late October was to buy the longer dated futures contracts. And boy, those work really well. And I still think they're a great buy. But the point is that because earnings estimates are based on those, those futures contracts, there's that undervaluation kind of built in as well. So I continue to think energy equities are going to be very strong performers over the next year or two.

***Erik:*** David, that buying opportunity you're describing is presented visually on slide one, what's going on in this chart?

***David:*** So basically, the red or pink dotted line is showing you where the energy index is trading. So you can see the huge move that happened after we had our first...

***Erik:*** Energy index means the stocks, energy stocks that posted the actual crude oil itself.

***David:*** Correct, like XLE, the energy stock ETF. And so you can see the big rise, but you can also see this big decline that I mentioned here earlier. But what is really striking between the pink line and the green line is that based upon where even the two year out futures contract is trading, which is right now about 80. That is well below, basically energy equities would need to trade up to about two a little over 800 on the index to be equivalent to where the two year featured oil contract is. And obviously it's bouncing around a little bit. So on this chart, it was 75. I think that's still about where it is right now. So the point is that just to be where even the undervalued futures oil contract is these energy equities would need to appreciate significantly. Basically, from roughly 500 to roughly 800. So that's about a 60% undervaluation. That's a big move.

***Erik:*** So you think the real buying opportunity is in the stocks, which are more discounted than the price of the energy itself is. Now, David, let's put this in context. Because we're looking at this chart and I'm sure a lot of our listeners would look at this and say, Boy, you know, yeah, it's sold off, there's a dip there. But before I buy that dip, you know, it's up a heck of a lot since the first of May. I think it's really important to put in context where we are in this story, which is, all summer long, we have been drawing down a million barrels a day from the SPR. Now I think in theory, the promise is that we would be rebuilding a million barrels a day, or maybe they're not going to put it back as fast as they took it out. So maybe it's a half a million barrels a day. But let's say we were getting a benefit of a million barrels a day. And we're supposedly going to pay back half a million barrels a day. That means there's a million and a half barrels a day, that's not going to be there as we go in the other direction from draining down the SPR to supposedly refilling the SPR.

Now personally, my prediction is the Biden administration is not really going to follow through and actually refill the SPR and replace all the oil that they sucked out of it over the last however many months it's been. But assuming that that were to happen, or even if it didn't, we still are losing the benefit of that million barrels a day. And I'm not sure where it's going to come from. It's not like anybody is dramatically increasing production. We're recording this interview on Tuesday morning, so we don't have the announcement from OPEC+, which will be out by the time the interview airs, but I'm pretty confident they're not going to be increasing by a million and a half barrels a day to allow room to stop drawing down the SPR and start replenishing it. So that would suggest that if they just stopped drawing down the SPR, which has been promised, supposedly now just pure coincidence to coincide with election season in November. After election season is over come first of November. There should be the impetus for or maybe another move up and energy prices? And of course, markets tend to see these things coming and move before that. So is it early to buy this dip? Or is it really a ripe time to buy this dip?

***David:*** Well, it was a very rough time a few weeks ago. But as you know that the kind of the whole real asset class area has been in rebound mode. But still, the amount of damage that was done from basically early June, early July was pretty epic. And there's only been a partial recovery. I mean, I think they have, it's been a pretty healthy bounce back. So it might make sense to just nibble a little bit for people that are underweight or not exposed energy at all. But which is, by definition, almost everybody, because you're well aware of the world has gotten so much toward indexing. And indexing, by definition has like a 4%, exposure to energy. So in my view, that's way too low and a world that is chronically short of energy and fossil fuels in particular.

So yes, I think you would buy a little bit here, but buy more aggressively in any pullback, limited. If we look at chart two, it shows what you were describing, which is this incredibly low level of, of oil in the United States. So this is actually a global phenomenon. It's not just the United States, it has got extremely low crude oil inventories. And as you point out, it's despite all this oil that's been released from the SPR, a million barrels a day, that's really a significant number. And it's going to stop sooner or later. And you did make a good point too that I really didn't, which is at some point, it's gonna go the other way. It needs to be replenished, and how soon they

replenish it? Who knows. That is, I agree with you, much more of a political decision than a real decision. But it's, it's getting dangerously low. So we think, just a matter of time, I guess by 2024, probably more likely that you'd start to see it being replenished in a fairly aggressive way. But regardless, inventories are super low. And these inventories at this level indicate price is much higher than where we are currently. Now, if we look at slide three, you kind of touched on this before, but just this impracticality of what's being attempted in the Great Green Energy Transition, and yet hydrocarbons still dominate the global energy mix, which is what slide three shows. And interestingly, it's not really the developed world that has been behind that, it's the developing world. Countries like China, India, Indonesia, so much so many of the developing countries have been relatively low hydrocarbon users. And now they're really ramping up. And one of the areas where it really US energy industry is doing a great thing is by exporting propane. In a lot of developing world, they don't have any, you can't flip a switch and turn on the gas or the lights. It's basically a wood burning or it's even dung burning. And usually with very poor ventilation, I might have touched on this last time, but the World Health Organization estimates two to three million people die every year from breathing poor air from their own homes, within their own homes. So getting cleaner, burning fossil fuels to them as a as a humanitarian favor that we're starting to do for the rest of the world.

***Erik:*** Now, let's just play devil's advocate here. You know that I passionately agree with you. I think that we are in the very early stages of a global energy crisis, which is going to be crippling to the global economy that's going to last the rest of the decade. But, there would be people on the other side of this argument, who would say, look, you guys are totally missing the point. The reason President Biden is talking about this great transition, the reason the World Economic Forum is talking about this is that wind and solar, that's a tiny little percentage at the top of your chart is about to take over baby, we're not going to need all that oil and gas, because really soon now we're going to be developing a huge amount of wind and solar. That's the whole transition. You guys are missing the story. What would you say to that?

***David:*** Well, I'd say that, there's very little doubt that wind and solar will continue to grow rapidly. Though, I do think a growth rate is likely to slow. And part of the reason why I think this growth rate is likely to slow is that a lot of these essential ingredients, if you will, are very expensive. And in short supply. Lithium was, of course, one of the most important of all the green energy sources or resources and it's gone up 1,000% over the last few years. And you're starting to see extreme jumps and pricing for other critical metallic, copper is one, even though copper prices are down right now because of economic fears. But right now, there's 24 million tons of copper that's consumed per year. Only about a million and a half tons of that go into green areas. And that is going to go up significantly, s&p is get it at 50 million tons of total demand for copper by 2035. I think Goldman Sachs has got it at 30 million tons. And most of that increase driven by green energy needs. So what's that going to do the price of copper. I know the folks that Goldman Sachs, Jeff Currie's team, they think copper is going to go absolutely parabolic at some point, but some of these already have. So that's one of the big problems is that there's this assumption that you'll always have cheap materials for renewables. I don't think that's going to be true. And actually, the way things are trending, it's not true even right now.

***Erik:*** Well, I think it's important to consider that one of the most important materials, if you want to call it a material that goes into energy, or any of these energy sources, is capital. And, you know, look, let's, let's look at this, from the investors perspective. You and I can agree that the world is about to face a really serious problem, which all has to do with fossil fuels and not having enough of them, we're not going to be able to get through this transition, because we've under invested in new exploration and production capacity. But wait a minute, for an investor looking at this, you could try to invest in solving that very important old problem, which is not a long term strategic play. Or you can get in on the ground floor, look at how tiny the wind and solar is at the top of your chart here on page three, that has to take over eventually, so that it's most of the chart. And world leaders are very clearly committed and dedicated to that they're providing governmental subsidies to help the investments that are made in those sectors to grow. If I'm an investor, why would I want to invest in the old stuff when I can invest in the future? Where the green energy is clearly where we're headed? Longer term? I would be? I don't know about you. But I'm certainly happy to acknowledge that my concerns about fossil fuels. I'm not saying it's the right strategic long term solution. I agree that renewables are the future. But what are we going to do if all the smart people put their investments in the long term future? And nobody's investing in solving this problem that we have right now with oil and gas? I think that's the real conundrum.

***David:*** Well, I think you're precisely right. But I think that's for a contrarian, that's actually really good news. I mean, you want to be where most people are not. Where there's under investment you want to avoid over investment you want to invest is, I've often quote Tony Deden, Grant Williams' Yoda, if you will. That you want to invest in scarcity. So where's scarcity? Scarcity is ironically, in not only fossil fuels, but in in things like copper, where it's not just capital starvation, you made that excellent point, which I didn't about energy. That there's been this absolute cliff dive when it comes to investing in new oil and gas production. And it's partially because of ESG. It's partially because there's been two oil busts, it's partially because there's tremendous pressure on Wall Street, not to reinvest, but to buy back shares and pay out dividends. So you've got that really across the commodity complex, and many of these commodities are essential for the Great Green Energy Transition like copper. So that's another way to approach it, Erik, because they say, Well, look, I believe it's gonna happen. And I do, I think we're gonna have millions of new EVs on the road coming up over the next four or five years. And how the grid is going to be able to handle that? That's another big question. What's going to happen the price of those batteries, because so many things, even solar panels are starting to go up in price instead of down in price. So that's an issue. You've also got the fact that the wind and solar are intermittent. And often times, they have to be backed up by things like natural gas plants. And also a lot of the developing world look at renewables much more skeptically than we do. There's been some pretty bad outcomes with countries that have really tried to aggressively go only renewable.

So it's, there's gonna be this ongoing demand from the developing world. And there's a lot more folks there than there are in the developed world. So the other thing I would point out too, is that when you think about who controls most of these critical materials for the Great Green Energy

Transition, almost all roads lead to China. And it's just look at the problem that Europe has for being heavily energy dependent on Russia. So does the rest of the West really want, and Europe for that matter, make that same mistake instead of jumping from the like, you should be jumping from the Russian frying pan into the Chinese fire in that regard. It doesn't get much press, but I think it's extremely dangerous for us to be trying to power the Western world on renewables, which have their intermittency issues, but they also have this scarcity problem and, and so much of it controlled by, by China. You probably know off the top of your head, I think it's something like 95% of rare earth minerals are controlled by China one way or the other, either in terms of the actual source of the processing.

***Erik:*** Yeah, it's ironic that, if I understand this correctly, one of the main reasons for that is that China has more lax environmental controls. And although the energy that we're talking about, you know, wind turbines are obviously a very green, renewable, you know, good feeling, environmental kind of thing. The rare earth elements that are needed to make the magnets inside the motors, or the turbine generators for those things. As I understand it, it's a very ugly mining process that's not environmentally friendly at all. China's willing to do it and take the environmental risks that I don't think you can compete with China elsewhere, because most other jurisdictions, as I understand it would not tolerate the environmental impact of that kind of mining. I don't know very much about it. But, boy, it's very interesting that this, on the day that we're recording this interview, just a couple of hours before we began recording, Nancy Pelosi landed in Taipei, first time in 25 years that a senior US government official has visited Taiwan. And already the Chinese military has pledged to conduct military responses and they haven't said what that's going to be yet. So we have escalating geopolitical tension with China at a time when our green energy transition is very much dependent on those rare earth elements that come mostly from China.

***David:*** You're right. Now, that's another bizarre geopolitical move as far as her visit at this point in time, but I guess they say is it is what it is.

***Erik:*** You know, something else that really struck me gold, which you have on page four of the chart deck is supposed to be at least some people think it's a geopolitical hedge. So when things get dicey in the geopolitical world, the price of gold goes up. Gold is absolutely flat on the day that Nancy Pelosi landed in Taipei and China vowed military response. And meanwhile, we have another conflict with another nuclear superpower. What's going on with gold here? And how come it's not, I guess, in your showing on the chart here that in US dollar terms, it's maybe not doing that great, but in other currencies, it is. Where do you see gold going from here?

***David:*** Well, I'm not as bullish on gold as I am on energy, and other commodities that are get consumed and are really vital to the operation of the world. The world could get by without gold, although it never will. It's, I think one of the reasons why gold got a persistent bid is because foreign central banks are gradually accumulating gold and in kind of erratically divesting themselves of treasuries. And, of course, the whole weaponization of the US dollar that happened with the sanctions due to the invasion of Ukraine makes foreign central banks even more hesitant to hold us dollars for treasuries. But speaking of the US dollar, that's what's really

been behind this correction in the price of gold, because gold and other as we see in in chart four and other currencies, it's actually made new highs. So if you're a Japanese investor, you're probably pretty, pretty happy with your gold holdings. But for the US where we kind of denominate everything in dollars is not so hot. And of course, the gold mining stocks have been even worse. They've been in during a really serious correction. Though they had a great move earlier in the year, they were up like 23 25%, in the first quarter, or during the first quarter when the market was down. Not anymore. Now you had it, you had to take some profits, or which we did. And that's, I guess that's maybe what we do differently than some typical gold oriented folks, because we do like the gold story long term. Because I do think we're going through this kind of gradual death of the fiat currencies.

And having gold and silver in your portfolio is I think the, you know, it's one of the best hedges against that kind of massive debasement. But that's not probably right around the corner, of course, but you get these powerful up moves, particularly in the miners. And we, you know, we don't get out, but we take significant profits when this went from April of 2020, to about September 2020, I've never made so much money for clients, as we did with the gold and silver miners at that point. But you had to take profits, and we took huge profits at that point. And we took profits earlier this year. But still, it's disappointing that they they trade as inexpensively as they do. But frankly, when you compare the valuations of the gold miners to something, let's say APA, the old Apache APA is the symbol, it's they just use an acronym for their name now. But that's one that's got about a 25%. If not over 30%, free cash flow yield. You don't find that with gold miners. And that's by the way, using estimated futures contracts for, that it's basically about $75 oil and under $5 natural gas to create those estimates. So gold is, you know, again, I think in this day and age, with all the crazy stuff that's going on whether it's geopolitically or monetarily, I think it's wise to have a position in gold and silver. But again, I think there's other areas that are more appealing.

***Erik:*** Moving on to page five, oh, boy, the Fed is still expanding its balance sheet, even in the face of inflation. How long can that continue?

***David:*** Well, they're trying to do QT right now. Well, the inverse of QE. So QE is when the balance sheet expands QT is when it contracts. As you can see, there's a little bit of a blue line below. But boy, it's they're certainly not moving at warp speed when it comes to shrinking the balance sheet. And what's absolutely incredible, one reason I included this chart was as recently as March, the Fed was still printing money. And when I say printing money, it's used loosely because they did not like the old Weinmar Republic. They don't create you know, trillions and trillions of dollars of dollar bills. They create reserves, which digital reserves which are used to buy treasuries to put them onto or mortgage backed securities, mostly treasuries, they put on their balance sheet. And what was really a kind of a head fake, for a lot of folks was, when the Fed first had QE1, QE2, QE3. And I would argue QE4 was the September 2019 intervention in the repo market where they started printing again 80 billion a month, and that's before COVID.

But what really changed the game was that when COVID happened, instead of the Fed just printing, the government stepped up and was spending every bit as much money as the Fed was creating. So we ran about a $7 trillion deficit there for that post COVID period, and the Fed bought most of that with their magical money machine. So it's, you know, all the end, that's this as a relates to the economy. It's a very intense debate right now as you know, are we going to have a recession? Are we in a recession? Because the Atlanta Feds number doesn't change because most listeners are aware, we've now had two negative quarters in a row from the Atlanta Fed on the economy. But it could be revised. And then you get people that are smart, and it's a good point, they'll say, Hey, you can't have a recession when you've got negative real yields like we have. Well yeah, the Fed Funds rates, 2.375, but inflation is almost seven full points above that.

And by the way, you know Erik, that never happened even in the 1970s. As maligned as Arthur Burns was as the Fed chairman, back in those days. He would get the Fed funds rate, up to an even beyond the inflation rate fairly quickly, there were two big spikes. Both caused by energy and he lagged a little bit, but at least got interest rates a little bit... so inflation was nine, he got to ten. And it wasn't huge. It wasn't Volcker-esque, but he got the Fed funds rate real. And a couple of times the 10 year treasury was two and a half percent above inflation. Imagine if that happened today, we'd have an 11 and a half percent 10 year treasury. And what are we today? 260, something like that. So the popular belief is that Jay Powell wants to become Paul Volcker. Well, before he becomes Paul Volcker, he better become Arthur burns.

***Erik:*** Well, the thing that's striking to me, David about page five is I mean, look at that, just insane overstimulation that occurred because of the COVID pandemic. And then you see that they continue to expand their balance sheet, we get one itsy bitsy, teeny, weeny little bar that's showing actual quantitative tightening, like we're actually sucking in the balance sheet. And what is the hottest topic in finance discussed more than anything else right now? The coming Fed pivot and how long it's going to take before they reverse direction. Right? So we got one itsy bitsy little tick of contraction in the Fed's balance sheet, and everybody, well, a lot of people are complaining that they think the Fed has taken too long to pivot back to a more dovish stance. It doesn't seem to me that there's any realistic plan to ever actually, you know, normalize the balance sheet to what it was before the 2008 crisis. I don't think that ever happens.

***David:*** I think you're right, I really doubt that. It's probably more likely that it's going to look more like the ECB balance sheet and like maybe eventually the Bank of Japan, which are much, much higher than where we are right now in terms of the Fed's balance sheet relative to the size of the economy. And if you wanted a visual of the negative real interest rates, just check out slide six, I mean, it was really shocking. And you can see there's the 1970s on there. And not even close. And again, kind of brief, and that's when Burns reacted and gotten interest rates up materially.

***Erik:*** David, let's move on to the rest of the slide deck. Looking at slide seven, I haven't seen this chart before, what's going on here?

***David:*** Well, it's pretty amazing that you would think more people would be agonizing about this. So basically shows that what happened in the first half of the year was the biggest wealth wiped out in financial market history, at least in the post world war two period, probably the 1930s were worse. So you had this triple whammy, you had a major stock market decline. You had the worst government bond market, according to Deutsche Bank since 1788. Now I've seen other ones going back to like 1917, something like that. It was an epic sell off in bonds. And actually, I listened to your very, very well done podcast with Harley Bassman who's another one of my heroes, he's probably knows the bond market better than anybody else. He invented the MOVE index, which is the volatility index with the bond market. And he was saying, I think we're in an era where the typical correlation between stocks and bonds doesn't work anymore. We're moving into that. And I would say we moved into it, not to pun on his volatility index.

But the point is that in the first half of the year, stocks went down. bonds typically go up. Instead, they got crushed. So he's right. I think it's a new era, but I think it's already begun. He was more saying this is what's going to happen. I think it's already happened. I think it's pretty hard to argue with that. So you would think the third part of the triple whammy was of course cryptos. And I think we should give ourselves a pat on the back about that because you and I were both very negative on the cryptos last October when they were white hot, then we're almost thermonuclear hot. And you look at what's happened with Dogecoin, down 90%. And, of course, the blow ups and Terra and Voyage and Celsius. The one that hasn't happened yet, though, is Tether. You and I both thought something with the tether would snap. But I continue to believe it's just a matter of time. And I think when it does that we're going to have another down leg in the crypto world. And you might have seen they disclosed an $840 million loan to Celsius, which is bankrupt now. And they still haven't performed an audit. I don't know how hard it is to audit of money market securities, but they can't seem to come up with one. So anyway, just I think we can feel good about that.

Where I think I was especially wrong was the dollar, because I did not think the dollar would continue to appreciate. And it's very odd, with inflation surging, which is another thing that we both anticipated and inflation was not transitory and we were dead right. It did accelerate, but man to have the dollar go up the way it has, with inflation, you know, on the warpath is very, very unusual. So as far as getting back to the market, if we went to slide nine, one of the things that I've noticed here lately is you've had a lot of bearish sentiment readings. If you look at the Michael Hartnett bull bear thing, his bull reading is at zero, it's hard to get much lower than that. And yet, if you look at allocations, like household allocations, their high net worth universe that they track, very high allocations to equities. So what you basically have I think, are a lot of fully invested bears.

So I continue to think that the stock market's going through a bear market rally, and that we're likely to see another down leg here before long. But maybe it's important to talk about things that are attractive. And you know, obviously, I've made the case for energy. And for gold miner has been another area that that has really gotten hit hard, though it's rallied a bit or double B rated bonds. And you may have seen that Jeff Gundlach, from DoubleLine, was on CNBC last

week saying that's an attractive area, we've been big buyers, they're getting yield in the six to 8% range. And so that's, you know, that continues to be appealing. There's actually an ETF, ANGL, the fallen angel ETF. And within that is where a lot of the double B rated names reside. And a lot of those look to us like upgrades and candidates. So there's been a quite a bit of spread widening. So the difference between treasuries and corporates is expanded. So that's a good opportunity to buy corporate debt. So that's, that's an area that looks pretty attractive. And other things that I would say that, you know, I wouldn't, I wouldn't go short the dollar versus things like the euro or the yen. But I do think the next big play or in fact, I'm gonna write a piece on it, but the next big short is anti dollar. I think the dollar is very extended, way too popular, way overvalued and we are a twin deficit country, our huge federal deficits or huge trade deficits at some point that's going to catch up with us. Entitlements that are unfunded, at some point, that's going to be a major drag on the dollar. But I would buy things that benefit from a weaker dollar. Some of the things we've talked about, like copper, for example, and even the gold miners. Lastly, well, actually more Harley Bassman to give him another shout out, he was pointing out that the mortgage backed securities market looks quite attractive, but very widespread. And he also has talked foolishly about the mortgage REITs. Now there's one AGNC that's got an 11% yield down about 30% very conservatively run. And we also like emerging market debt, which has been crushed lately. And the yields are in the 10 to 11% range, and a lot of these funds are selling at double digit discounts. So the point is, there's definitely places to put your capita,l even if you share my negative view on the overall environment for now.

***Erik:*** David, I can't thank you enough for a terrific interview. But before I let you go, please tell us briefly what do you do at [Evergreen Gavekal]? How can our listeners find out more about your work?

***David:*** Well, believe it or not, we actually do research. As you can tell, we're definitely not indexers. We like to do individual security analysis, including of bonds, which is even more rare. But in addition to [Evergreen Gavekal's] money management activities and research activities, I also have a [Haymaker website], which is obviously a play on my name. And we have, it's actually easy to access through substack. And we do both a Friday version, which tends to be a little bit more macro and then making Hay Monday as it tends to be market specific, with specific trade recommendations and a couple of both on income and an equity portfolio that are tracked on a regular basis.

Also, Erik, just real quickly, I did write his new book called ***[Bubble 3.0]***. Talking about how this is the third bubble, the biggest bubble of them all. The first being the tech bubble, the second being the housing and they're all related. There's definitely a connection from one, two and three. And we got that out early this year, because I was really of the belief that bubble 3.0 was in the process of popping. Still believe that I think that the evidence is pretty strong. In that regard. We were particularly negative on the what I used to call the crazy overpriced stocks, which are not so crazy overpriced anymore. Many are down 7080 90%. So anyway, that book is available now and online at substack. And also there's an audio book after people like to listen to the things while they're working out that basically it's an indictment of the Fed and that the

Fed is, is really just let us down hugely over the last one yours in this country that's really kind of the basic theme.

***Erik:*** Patrick Ceresna and I will be back as MacroVoices continues right after this