Louis-Vincent Gave: The Xi Pivot vs. The Powell Pivot

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Erik: Joining me now is Gavekal co-founder Louis-Vincent Gave. Louis, I am so excited to get you back on the show, as I'm sure you know, as you're a regular listener. Lately, I've been having trouble finding people to disagree with me and bring a little bit of bullishness to the table. I admit to being the guy who's usually the biggest skeptic in the room. But lately, everybody's telling me it's worse than I think. And I remember at our MacroVoices LIVE event, you were not at all hesitant to call me out when you disagreed on it. I don't remember what I said but I remember the answer was, and people think Luke Gromen is crazy. Remember what I said, but I know you're not afraid to set me straight.

So listen, I am a little bit concerned because it looks to me like we've got a heck of a liquidity crisis on our hand. I see the US Dollar Index running away and people say well, yeah, but that's just because the Euro and the Yen are crashing, that's all! Well yeah, its kidding. That's the problem and I think the reason that the stock market is not outright crashing Louis is because everybody knows the Fed pivot is just around the corner. I don't see why they think that given the data so I'm still in gloomy mode. Set me straight.!

Louis: Well, first, thanks. Thanks a bunch for having me, Erik. I'd say it's always great to catch up like there's a lot to be gloomy about right now. Right? The world is changing very rapidly in front of our eyes. And yes, to your point on the hope springs eternal, I think today, the one sort of clutch of hope that people can hold on to is the belief that it's okay, the Fed will ride in on its, with its magic cape and turn it around for us, just in time for year end and maybe I can get a bonus at the end of the year. I have my own vision of this sort of hope springs eternal. Except that it's not Jay Powell that arrives with the cavalry. But it's Xi Jinping and let me explain my own sort of Hope springs eternal thinking.

I think there's something pretty odd going on in the world right now. And as you point out, we are in an obvious liquidity crisis, right? All the signs are there. Shrinking central bank reserves, which clearly tells you there's not enough money to go around. US dollar shooting up tells you there's not enough dollars in the system and of course asset prices falling. But the odd thing is, the US current account deficit could not be any bigger than it is right now. I mean, right now the US is sending $300 billion every quarter to the rest of the world. That's $100 billion a month that the US consumer is pushing to the rest of the world. And it's almost like the rest of the world is taking this money and saying, that's not enough, even though that's more than the rest of the world has ever made. So how can we be in a world where on the one hand, the US current account deficit is bigger than it's ever been. And on the other, there's not enough dollars to go around? I've been really struggling with it. It's almost as if the US is sending the US consumer sending money and that money is just going down some kind of black hole and disappearing. And perhaps that is somewhat happening and that black hole happens to be China.

When you look at the US current account deficits. So, the 100 billion a month, 50 to 60 of that goes to China. Now I think historically, the Chinese toy manufacturer or the guy who makes tennis shoes or whatever else on the other side of that trade, would have taken that money. And that money would have been recycled one way or the other decently quickly. Maybe the toy manufacturer takes his girlfriend to Paris and buys her 10 LVMH handbag or maybe the tennis shoe manufacturer buys himself an apartment in Vancouver, or maybe just an apartment in Shanghai. And as he does, he changes his US dollars for Renminbi, the central banks ends up with the Renminbi and puts them back in US Treasuries. That money gets recycled. But and this is perhaps the one of the bigger anomalies in our system that people aren't thinking through enough. What you have today is the world's second largest economy and by far our largest exporter on lockdown still, and I know it's not lockdown. I know it's dynamic lockdown, but for all intents and purposes, each time you go to the supermarket in China, you worried that, hey, they may shut down the supermarkets because somebody just tested positive for COVID and I'm going to be stuck there for three weeks. So that doesn't really generate much economic activity, right? I mean, most people in China right now are going to work, going home, going to the corner store getting food, and that's it.

And so all this money this 50-60 billion a month that China's making is perhaps just sort of stuck there in the system. And I highlight this because today everybody's waiting for the Fed pivot. Personally, I'm waiting for the Xi Jinping pivot because I think there's basically this Chinese zero COVID. Imagine a huge dam that's sort of holding up this mass of liquidity. And this huge dam is China's COVID policies and when that goes, it's going to unleash a wave of domestic growth to begin with. We've seen everywhere that stopped lockdown have big parties, right? The first thing people do when the lockdowns leave is they go to the restaurant, they go visit their parents, they go visit friends, tourism booms. So that's the first thing we can expect.

But the second thing we can expect is probably all of a sudden capital outflows out of China and into assets around the world to be reignited in a way that it's just never been before. Now you know, I was saying, people waiting for the Fed pivot, it's hope spring eternal. I personally, I've been waiting and I've been wrong. I've been waiting for this Xi Jinping pivot on zero COVID for over for well, over a year. You know, I thought it would come with the Olympic Games. I think we talked about it at the time. I thought the post Olympic Games will be a good time for China to reopen. Instead of reopening, we had the super harsh lockdowns of Shanghai. So you know, that crush that hope.

Today, obviously, is the hope that post the party congress, and perhaps pre Chinese New Year, does China want to go through a third Chinese New Year where travel is discouraged and people can't visit their families? That you see a loosening of a lot of the restrictions? I guess we'll know in the coming days. If we do…you know, you're asking me for a bullish argument. Imagine that China moves away from zero COVID. I'm not saying they will, I'm saying imagine, then all of a sudden, the demand for all sorts of basic materials, the demand for luxury goods. I'll give you just an example. I just went around Europe visiting clients and the hotel rooms that used to cost me 200 euros now costs 400 euros, and you can't get room service at night because they don't have enough staff anymore. What happens when the Chinese tourists come back? That probably goes from 400 euros to 600 euros. So we live in a world that's already been inflationary without Chinese demand. If Chinese demand is now unleashed, where do we end up? I guess that's the big question for me for the coming year.

Erik: Louis, I want to touch on how we got stuck in zero COVID policy and China in the first place because the experts that I think have been most right throughout the crisis. People like Dr. John Campbell in the UK have said once you get to the R naught levels of Omicron, it just doesn't make sense to consider lockdowns as an intervention anymore. They work at lower transmission rates, but at the Omicron transmission rate, it just has to be allowed to burn through. And it simply does not serve any purpose to have these continuing lockdowns. Now that said, there's conspiracy theories that say, oh, China knows that they could unlock but they're doing it in order to keep their people enslaved or something. That doesn't make sense to me, they want their economy to come back. And I don't think by any means that they're stupid. If there's anything I learned from living in Hong Kong, it is that China is an extremely sophisticated intelligent society, maybe different culture and different values than we're used to, but they're no dummies. What's going on here? Why do they have these policies that as far as I can tell, don't serve their own interests?

Louis: I think there's only two ways to look at this. One of the ways is the one you just highlighted. It's a tool of political control that is exerted by the party over its own population. That's option one. And it could be a tool, you know, some people have expressed a view, it's a tool of political control. It's a tool of economic control, make sure that you don't get capital flight at a time when you're correcting through real estate, etc. So that's option one. I don't really buy it. I think the only possible explanation is that Xi Jinping made a massive mistake. when COVID outbreak started. He said, I'm in charge of this, this is a big deal. I'm in charge of this file. I'll handle this. Now, you've worked in enough organizations to know that the first rule of management is that if something really bad happens, you delegate somebody to it like this when the thing doesn't get fixed. You can say okay, I had put Sam in charge of fixing this, but Sam has done a terrible job. So now I'm firing Sam, and I'm putting Mike in charge instead.

And Xi Jinping having basically put himself in charge, put himself in a situation where A) of course nobody wanted to contradict him and B) there was really no turning back. And I think one of the big problems for China and I'm sure you've met people like this in the past couple years, is that it by all accounts, it looks like Xi Jinping is one of these people that is deeply COVID paranoid. And I've met a lot of people like this, of course. You know, colleagues, friends, and to some extent, the more people read about COVID, the more they became paranoid about it, right? Which makes sense, the more you read about a disease, the scarier it looks typically. So I think Xi Jinping decided I'm going to be in charge of this, I'm going to read everything there is about it. And the more you read, the more you freaked himself out. And so you get stuck in the situation we're in. Now, the one sort of, perhaps, sort of silver lining to this pretty dark cloud, is that when you look at the Chinese Communist Party, the Chinese Communist Party is first and foremost in the game of providing social stability. And you and I have discussed this in the past, much more than delivering economic growth. The Chinese Communist Party is about delivering social stability, because that comes at a huge premium in China after 150 years of anarchy, you know, Civil War, Famines, etc. Now, what you've seen lately, in Shenzhen and Chengdu, out of the more recent lockdowns is you're starting to see people push back. They've actually had to unleash riot police in Chengdu and Shenzhen because people were starting to push back against the idea of lock downs.

So, for two and a half years, that really, there was an economic cost to China, of the lockdowns but you know, they could bear it. They didn't really mind. But there was no real social and political cost. This is now starting to change. People are now starting to push back. And so, that is perhaps my one hope, and why I still believe in the Xi Jinping pivot is that they're going to need to pivot not because economically they need to, although they do, they do. But because politically, it might be dangerous for them if they don't. And so that fundamentally will be the reason why they would change. And so, you know, the more they lockdown, the more they run the risk of riots, the more riots you start to get, the less likely they are to keep the current policy. So I think that long winded answer to your question, but obviously the zero COVID has been a policy mistake of epic proportions. And it's a policy mistake that needs to be put in at Xi Jinping's feet. Whether he did it out of some sort of nefarious view or because he panicked. At the end of the day, it doesn't really matter, it leaves you in the same place. What matters is where do you go from here? Do you continue on this zero COVID mistake pr do you start changing? In other words, what are we first likely to see? Are we first likely to see a Fed pivot or are we first likely to see a Xi Jinping pivot?

Arguably, we've seen massive policy mistakes all around the world. The Fed policies, and the fiscal spending and the crazy monetary policies during the COVID years. That was ridiculous, and we're today paying the price. And we've had also very wrong policies in China with the zero COVID. Now today, we're stuck in a situation where for the markets to rebound, you either need the Fed to pivot or XI Jinping to pivot, which will happen first? Because importantly, it doesn't lead to the same outcome, it doesn't lead to the same things rebounding, right. If you say tomorrow up, Fed is going to pivot, then you think okay, I'm going to go out and buy the US growth stocks, I'm going to go out and buy maybe US Treasuries again. However, if its Xi Jinping who pivots first, I'm gonna go out and buy commodities, I'm gonna go buy emerging markets, I'm gonna bet that the US dollar rolls over hard. So it's not exactly the same place depending on which pivot you have first.

Erik: Okay, I agree completely, that the Xi Jinping pivot is probably bigger, if not as big as the Fed. And we clearly want to figure out, what do we do? What do we look for as early signals to tell us it's coming. Now, if I invoke what you said about organizational dynamics, and think back to my own corporate days,. Okay, what I would expect Xi Jinping to do if he's the CEO of a major Fortune 500 company is first declare success that his personal leadership over the lockdown was a great success and everything went beautifully. And now because the transition out of lockdown, it doesn't require his personal skill, he's going to delegate that to Joe. And that way, Joe is expendable if Joe screws it up, and it won't be his fault.

So it seems to me the thing to watch for would be Xi Jinping appointing somebody or creating a czar of the of the ‘unlockdown,’ if you will. Would we know that if it was happening, I don't know nearly as much as you do about Chinese politics and how this all works. They've got Congress going on right now, they actually just delayed the release of their economic data during their National Congress. I would think that that would be a logical time if Xi Jinping wants to declare that he succeeded on the lockdown and somebody else is in charge of unlocking down the economy. Would that be the time for it to happen?

Louis: You would think right? That's my thinking exactly. That you would think that this this current party congress is a great time to do this. All the more so since the US just threw a massive artillery barrage at China with the announcement that basically the semiconductor restrictions that were on Huawei, are now going to be implemented all across Chinese corporates in the broader Chinese economy. So if you are Xi Jinping, this gives you the great out, right? You can easily say, okay, you can make a speech, say, you know what, more than a million people died of COVID in the US. More than a million people died of COVID in Europe. But we in China, we had very few deaths. So well done us and yes, I now pass this on to X, Y, or Z, who's going to handle this, because the new big problem for us is that the US is trying to prevent us from rising to our legitimate role in the global economy, by restricting us access to semiconductors. So, our new number one mantra now is going to have to be to become technologically independent. And for that to happen efficiently, my clear and forthright leadership is going to be needed. So um, you know, I can't be on everything at once. I'm going to be focusing on that from here on out. So, that'd be the obvious speech to make, right?

And what's interesting if you look at his kickoff speech, and if you look at the number of times each the various phrases appear in the reports. Xi Jinping, in his speech yesterday, he mentioned 91 times the word security. And as opposed if you go back to 10 years ago, in his first maiden speech, he mentioned it 33 times, so that's three times as much. Meanwhile, in his maiden speech, Xi Jinping had mentioned 105 times the word economy and yesterday, he mentioned it only 60 times. If you look at science and technology, he mentioned science and technology 41 times yesterday. He mentioned 12 times in 2012 so his whole speech yesterday, his inauguration of the party Congress was about security and was about science and technology. It wasn't about economy, and it wasn't about reform. Those were the buzzwords 10 years ago, the buzzwords today, security, science, and technology.

So, perhaps we're setting ourselves up for that. Perhaps not, here's the thing we'll know in 10 days, I don't think it makes any sense to go out and say, Oh, we're seeing the Xi Jinping pivot? We don't know yet. But I think we'll know in the coming days or a week or two. And what you have to be ready is to think, Okay, if there is a Xi Jinping pivot, because I don't think we're going to see a Fed pivot in the next two weeks. So if there's going to be a Xi Jinping pivot, what would I buy? How would I position my portfolio and be ready to act if and when it came. If it doesn't come well, you've done preparatory work for nothing, but you haven't lost any money. And if it comes, you're ready to act, because then the market, the market moves could be quite big and quite violent.

Erik: Well, this is absolutely fascinating Louis because as you know, my whole thesis around the global energy crisis is that we've already proven through market action, that even without China coming out of COVID, we can't really get back to pre-pandemic normal, because there simply isn't enough energy supply. There's not enough oil supply in order to do that. And my whole thesis has been that when China comes out of their lockdowns, that's going to be the moment where we see a huge move up in oil prices. Now, just this week, Bloomberg Javier blasts, probably the smartest analyst or reporter in the oil market, penned an article which I think was a message to President Biden, and I sure hope he's listening. And what it said basically was, look, we kind of think really carefully about the threats that are being levied with this no Peck Bill, what President Biden is trying to I think is to resurrect the NOPEC bill that's been floating around for years and years. And it would essentially, authorize the United States to apply its own anti trust legislation or its anti trust laws to what Saudi Arabia does on its own sovereign territory, which doesn't make any sense to me. It just spits in the face of the rule of law, but that's what they're doing or that's what they want to do.

What Javier Blas said is look, think about what's going on Mr. President. He didn't address it to Biden. I'm writing that into the story. But what he's saying is think about what the next volley is going to be. The next move of the Saudis is going to be to dump their US Treasury holdings and start pricing their oil in a currency other than the US Dollar as their next move to counter what Biden does with the NOPEC bill. Now, you could argue that, okay, this whole theory that, Saudi Arabia could dump its treasuries and that would crash the bond market has been overhyped by conspiracy theorists for years. Well okay, we've got an incredibly vulnerable moment in the bond market, Louis already. This is not a good time for anybody to be intentionally dumping US Treasury holdings as a tool of economic warfare, which is what Javier Blast seems to think could happen if this NOPEC bill is resurrected. So if you had that, which could really have an impact on the US bond market and China reopening at the same time, I mean, just imagine the next 10 days that they managed to pass the no OPEC bill and China announces it's coming out of COVID, lockdown. Okay, I'm going back into gloom and doom mode. I can't help it. But Louis, this scares the crap out of me.

Louis: Well look, I think Franklin Delano Roosevelt was smart enough to know that he couldn't really fight a war on two fronts at the same time. He decided, first we clean up Europe, and then once we've cleaned up Europe, we will turn to Japan. We'll do what we what we must do to contain Japan, but the wrath of the US Navy was really only turned against Japan starting in 1945, right? Once it was pretty clear that Germany was done. I highlight this, because fighting a war on many fronts is, it's a big ask. And of course, back in the 1940s, the US had, you know, it was full scale war and war effort and all this. But right now, it seems to me that the US obviously has a fight with Russia on which is fine. But it's choosing this time to also have a fight with China. And to in essence, amp up its fight with China with the blocking of the semiconductors. And at the same time, is now picking a fight with OPEC.

Now, I would say that's probably one fight maybe even two fights too many. It seems to be pretty hubristic from the United States, to pick three fights at the same time. Now I get that the US is super powerful. I get that they control the world ceilings, I get that they control the world, semiconductor industry. But what you know, the old rule is divide and conquer, right? You pick off people one by one, you don't pick them up all at once, so that they can unite with each other and create something. And yet to me, it seems to me that this is precisely what the US is doing right now. Instead of doing divide and conquer. They're making all these American foes for lack of a better word. Russia, China, the Middle East all unite. It's mind blowing to me. I just don't get it. I don't get what American diplomacy is trying to achieve here. So no look it's very, very troubling. Now, to your point on, the world can't afford for China to reopen, because then the oil price goes through the roof. A point I agree with you fully worth because China probably right now is under consuming by about a million and a half barrels per day. So if they come back in and consume an additional million and a half barrels, you have to wonder where that million and a half barrels is going to come from?

Maybe this is the reason that China isn't reopening. When we're scratching our heads saying, Well, you know, China's staying lockdown makes no sense. That the Chinese leadership is first and foremost worried about inflation. So perhaps the Chinese leadership first wants to make sure that they've built the necessary inventories and Energy, built up their stock. And I think what people forget, is that there was an energy crisis in China last summer. Last summer, China ran out of coal ran out of electricity. That's when China decided to make Bitcoin illegal because it was just consuming too much electricity. They shut down some steel mill, some naval shipyards, and they basically told all the coal miners alright guys, go back to the mines and dig up some more coal.

So, perhaps, well, not perhaps... The only solution out of our current energy predicament triggered by under investments in energy production for the past decade. The only immediate solution is to call. You and I have discussed this before. I continue to believe that people get really angry when you talk, when I say this, because you know, coal is dirty. But, we've left ourselves in this situation where we're now dependent on coil. So perhaps the answer is until China has restocked off on coal imported a lot from Indonesia and poured a lot from Australia and put it a lot from Russia, we not reopened. But once that's done, then then we can reopen and yes, it means higher pollution. And yes, it means terrible news for the planet long term. But maybe that helps prevent oil from going to 200 bucks because if you get there, you start having real inflationary problems not just in the US, but in China as well. And that's the Chinese regime, just one half. There are, you know, the Chinese regime is down to being the last inflation Hawk in the world.

Erik: Well, Louis, what resonated most for me, and what you just said is maybe the reason that China is staying in lockdown is because they know that coming out of lockdown is going to trigger a global inflation, which is going to be really, really crazy. And perhaps because they're very good at thinking ahead and planning ahead. Maybe what they're doing is just trying to stockpile everything they need, so that they can get through that inflation. But I hope that we're in agreement that they wouldn't just stay in lockdown forever, it would be stay in lockdown until they can prepare. Once they've prepared, they're going to come out of lockdown.

If it unleashes an inflation when and how could it not when you consider that it's got to drive oil prices dramatically higher? Oil isn't or energy in general is an input cost to the price of almost everything. So you know there's going to be globally a increase in inflation when China reopens. Doesn't that pretty much eliminate the possibility of the Fed pivoting? I mean, it would mean that the Fed would be pivoting if they did pivot into increasing inflation, and really risking almost a hyperinflationary runaway situation. It seems to me like there's a real quandary here that between China and oil and inflation, the absolute last thing you can afford to do is, is pissed Saudi Arabia off even more to the point where maybe you get to the point where you say, okay, the inflation is going crazy, the Fed can't pivot, we're really in trouble. And we've just passed the NOPEC bill. And Saudi Arabia just calmly says, oh, yeah, now that you've passed this bill, unfortunately, we can't do business with you anymore. So you'll have to buy your oil elsewhere. And just by the way, China just reopened. We actually kind of coordinated that behind the scenes. We weren't telling you about that. And we've got another buyer for our oil. So since Mr. President, you've told the American people several times that your country is energy independent. You don't need us anyway. Good luck.

Louis: Yep. No, I think that's, well like I said...

Erik: I've been the gloomy guy. You gotta be the one to tell me. You're supposed to say, No Erik, that's crazy. That's conspiracy theory talk. The reason that's not realistic is fill in the blank, Louis...

Louis: Well, okay we weren't supposed to talk about US diplomacy because there indeed, I find it very hard to not be gloomy. You know, the level of hubris, like I said, that that's going on in US diplomacy right now. picking fights with everyone, to me is mind blowing. And yes, you do leave yourself, you know, you are in an energy crisis. So probably now is not the time to pick a fight with Saudi Arabia. That seems to me pretty, pretty elementary. Now would be a good time to restart the Canadian pipelines. That and I know, this means that, you have to swallow your pride and undo the things the, you know, Biden's very first act in office was to block the Keystone pipeline right? Which was a symbol all in and of itself. But say, okay, times have changed, we now need to make arrangements. Now, there's a ton of energy in Canada, that just requires not so much marginal investment to keep to start flowing into the US. So the long winded answer to your question is,.. right now, not only is the US picking a fight on Russia, picking a fight on China, picking a fight on OPEC, but it's also picking a fight on climate change. So the bullish argument is that some of these are going to have to go. Now you're going to have an election coming up in the US in a few weeks. And it seems pretty likely to me that the fight on climate change is gonna go the way of the dodo, at least for a little while. And that as the fight on the climate change goes the way of the dodo, then you can get reinvestments into pipelines into Canada, and you're gonna get investments into coal, because look at the end of the day, economic activity has energy transformed, right? And we thought that we could massively increase our cost of energy massively, you know, through alternatives and whatever else, and that this would have no impact on economic activity. Turns out that obviously the maths were wrong. And not only do we produce not enough energy, but the cost is much higher. And so we're stuck in the situation we're in now.

As you project yourself forward over the next five years, you left with a simple quandary. And that is, who will have the cheap cost of energy looking forward? Looking ahead. And the answer is twofold. It's number one, whoever accepts to trade with Russia, which in essence, is China and India. Number two, who will have cheap energy, it will be whoever accepts to turn back to coal, which is basically whoever accepts the tariff COP26. And put the climate change directives on, you know, far into the rearview mirror and, and decide to just burn coal. Most emerging markets are already there. China's obviously there, India's there, South Africa is there, Brazil is there. All the emerging markets are already there. The question is, does the US join them? And perhaps, following this November election, the US will join them. But all this brings me to another point. I think it was Bruce Kovner of Caxton that use to say that wherever he's made the most money in markets was when consensus held was like firmly of one belief. Meanwhile, the market was already moving in another direction, but consensus hadn't moved. Consensus still believed, still believe the one thing. Now, today, the one consensus opinion out there that's held, like stronger than anything, is that the US has the cleanest dirty shirt, right? That the US is, is just the only place in the world you can deploy capital, everywhere else stinks. So you should deploy all your money in the US. And I say okay, well, how clean is this dirty shirt because the bond markets down 20% and the equity markets down 25 I mean, that's, that's a pretty stinky dirty shirt. It's not that clean at all.

Meanwhile, if you look at most emerging markets, the bond markets are flat to marginally down for the year and a lot of emerging market equity markets whether you're Indonesia, your Indias, your Brazils, your Mexicos, your South Africas... A lot of these guys are flat to up for the year. So everybody's going around telling you oh, you know, the guys that are getting crushed the down 20 25%., that's a clean dirty shirt. Meanwhile, Brazil whose bond markets up 10% and equity markets up 10%, Indonesia, basically bond market flat and equity market up 5 or 6%. Now, you don't want those shirts. India now you don't want that shirt. So the transition is already happening. And it's happening towards the countries that are either willing to trade with Russia, or willing to burn coal. And I know why nobody's talking about it. Because this is the most on politically correct thing you can talk about, you know, to say, hey, I'm going to invest in the guys that are friendly with Russia, and that are burning coal is a sure way to not be invited to next week's dinner party. You're gonna get kicked out of polite society. And but unfortunately, that's the world that that we live in, you have to invest in the countries that are, in essence going to embrace tomorrow's cheap form of energy. And we might hate it. But it's coal and it's Russia.

Erik: You know, this is fascinating Louis because when you were saying the most important thing to think about is that variant perception. When you've got one view, but the market has an opposite view, and you're pretty confident that the markets wrong, what I thought you were leading up to was not the cleanest dirty shirt argument, but rather that one of the strongest beliefs that exists in the market now is inflation is transitory. It's already peaked, it's about to go away. And I think you and I both agree that as soon as China opens, price of crude oil goes to the moon. And it's really hard to imagine how inflation comes down when the price of crude oil goes to the moon, considering it's an input cost to almost everything. So on the topic of that variant perception, what do we make of this? What could happen if you and I are right, and you know, most of the market is positioned around inflation is transitory and about to go away? If it turns out that inflation is only just begun, and it's about to get a whole lot worse when China opens, and China is smart enough to see it coming. So they're prepared for it or they're preparing for it now. And by the time that they reopened, they will be prepared for it and we're not. What could that mean for markets in the economy?

Louis: I think the first thing to acknowledge about inflation is that it's a massively volatile number. You know, when inflation when it's low, it's quite stable. So you're 1.5-2% and you hover down there, but once you move above 5%. At least was the experience of the 1970s. You know, you can be at 8% and then you're down to 3% the next year, but then you're right back at 10. And that's how inflationary environments work where you have this volatility. And then because initially to your point, most people don't buy into it at first. They don't buy into it because, capitalism is a fundamentally deflationary force, right? Every businessman wakes up every morning, thinking, how do I produce more with less. This is what everybody's trying to do all day, every day. The reason inflation comes around is a number of factors. Of course, it's the crazy monetary policies, it's the too much money printing, but invariably, it's just too much government intervention. And today, that's exactly what we have.

Today, ask yourself this, do you have more or less government intervention in your economy than you did a year ago than you did three years ago than you did five years ago? Every day that goes by you're getting more government intervention. This week, it was the US government coming in and saying and telling you Look, you're not allowed to sell semiconductors to China anymore. So now all of a sudden, you've just wreaked havoc on a number of supply chains. A number of people who were producing stuff in China, with US semiconductors to sell it all over the world, they have to rethink everything. And the reason that we're doing and did that way in the first place is because that was the most efficient, they'll find a way to cope, because that's what capitalism do. That's what business people do. But when you keep changing the rules, you increase the costs, and, and you lower the productivity. And so I think we're still in the phase of the cycle where we're getting more government intervention rather than less. And that comes across through higher inflation. I mean, find me one place right now. I think we're still in the hubristic phase of governments almost everywhere, in Europe, and in the US where wherever there's a problem, the government's feel, oh, there's a problem. Therefore, it is up to me to provide the solution. You know, we're nowhere in the world do we do we have a government that says, oh, there's a problem, I'm going to get out of the way and let the market deal with this.

So while we're still in this hubristic phase, I completely agree with you that, we're not only in a hubristic phase, but we're in such a hubristic phase that our government not only makes things harder for our businesses, but creates massive uncertainty by picking fights everywhere. I mean, does the US government really need to pick a fight with OPEC? I mean, does it really. I understand that Biden's pride was hurt\ that, he went to Saudi Arabia and begged for more oil, didn't get it, and then MBS turns around and slaps him, slaps him a car to understand that humiliating. Does that still warrant a fight? Is the timing right today to cut China off semiconductors? I mean amidst a massive inflationary crisis in the US? Isn't that like, having your priorities a little wrong? In terms of what's important right here right now? I mean, I guess, people will have different opinions on this. But however you cut it, wars, whether hot wars or Cold Wars, and we are starting a bunch of Cold Wars everywhere, are inflationary? You know, the great big deflationary wave really happened with the collapse of the Berlin Wall, and the end of the Cold War.

So, we are now at war, people have forgotten that wars are inflationary. And yes, inflation is a volatile number. So, it might be lower in six months time, because rents are going down and money supply is going down. And you know, you've had some energy prices stabilizing. So the year on year comparisons will get easier and all that stuff. But to your point, if and when China reopens a lot of these trends shift into completely different gears. And by the way, on this one more point, you have whatever it is eight and a half percent inflation in the US, with the US dollar that's gone up 20%. I mean, imagine what inflation would have been, if the US dollar hadn't been as strong, right? If the US dollar had been weak, or even just flat and import prices had risen the way they should have, then you'd be a double digit easy. Now I say this, because what are the odds having already risen 20% that the US dollar rises another 20% over the coming six months? I think the answers are the odds are very small. And so imagine an environment where China reopens m goes up and US dollar weakens. What does that do to your inflation data?

Erik: Louis, final topic I want to discuss today is one that really concerns me and frankly, is here at *Gloom and Doom Central* is I look to the other 'gloom and doomers,' I think they're missing the point because there's so much concern about, oh boy, this is not looking good. What if we got a stock market crash as bad as 2008, could be really bad. And I just think to myself, who cares? A stock market crash basically means rich guys aren't as rich anymore. And that trickles down, and it screws up the whole economy. And of course, 2008 was a big deal. But something that from my perception at least, it seems like even professional finance people don't seem to appreciate is the difference between a stock market crash and a bond market crash. If you have a stock market crash, it means rich guys aren't rich anymore. If you have a bond market crash, it means the entire global economy stops, because the funding mechanisms for everything are broken, it means grocery stores don't have groceries, because the commercial paper system that's needed in order to finance paying for the groceries until they can sell them isn't in place anymore. It means the entire global economy is broken. And you know, I'm not saying that's going to happen. But if I was going to because hey, I am mister gloom and doom it seems. If I'm going to be Mr. gloom and doom, I want to worry about a bond market crash and I'm not saying it's less likely, I suppose, than a stock market crash. But it seems to me that's the really big risk. And I don't think most people understand how much of a bigger deal, a bond market crash would be than a stock market crash.

And people say, well that's crazy. A bond market crash the bond market is not what you what you'd expect to crash because the risk capital goes into the stock market, the bond market is the stable one. Well hang on a second, Louis, if we're at 4% on the US 10 year right now, and you've got around 8 or 9% inflation. And the variant perception you and I have is that when China does reopen, it means inflation is going to go up substantially not down. Well, wait a minute doesn't doubling the interest rate. If you have to match that inflation in order to fight it. You got to go from 4% to 8%. Doesn't that mean a 50% down from here on the bond market?

Louis: Yeah so...

Erik: Is there any pension fund on the planet that could possibly tolerate a 50% down from here on the bond market? And what would be the snowball effect of when they have to start liquidating and bailing out? It just makes the bond market crash worse., I'm not saying it's gonna happen. But please tell me why this is crazy conspiracy talk, what's wrong?

Louis: I don't think it's crazy conspiracy talk. So to your point,

Erik: I want it to be, I want it to be! I want to be wrong on this.

Louis: So I think your starting point is absolutely right. The bond markets matter 10 times more than the equity markets. First, they're bigger, and they hold a lot more indeed of the world's long term savings. But to your point, you know, 2008, the reason 2008 was a disaster was not because equities went down. But because the mortgage, the mortgage bond market imploded, that was the real problem, right? It was the mortgage bonds implosion that triggered the collapse of banks that triggered the collapse of AIG. That was the real issue, as opposed to...

Erik: But that was just mortgages...

Louis: Yep. It was just....

Erik: And there was contagion to other markets. But it started just this is a very, very different cause and effect we are looking at now.

Louis: This is much bigger. So if you look, for example, at 2000-2001, you had a hell of an equity bear market, but by and large, it was like whatever. it was the economy took it in its stride. And there was a small recession made worse, of course, by 911, and all these things, but all in all the bond markets in 2000-2001 did their job. I think what's quite worrisome today is if you look at the total amount of capital destruction, and I've published a few charts on this, but if you look at the total amount of capital destruction, we've already destroyed more capital than we did in 2008. Because in 2008, when you lost money on equities, you made it on government bonds. And when you lost money on mortgage bonds, you made it on government bonds. So there was some balancing effect. Here you know, I'm sure you've seen the charts highlighting that your typical 60/40 portfolio has had its worst returns in 100 years. And we think of that 60/40 portfolio as grandpa's portfolio, but it's a lot of pension funds, portfolios. And on that note, um, you might have also seen these charts floating around. If you compare a 30-year gilt to Bitcoin, the 30-year gilt has done worse this year, worst than Bitcoin. So to some extent, we are in the middle of this, you know, you're saying I'm worried about the bond market crash. Well, we're in the middle of it and that brings me to...

Erik: Are you saying it's only half done...

Louis: Well, so here's, I don't know. To be honest, I don't know. Because here's the interesting thing, right? In the UK, where the crash has been amongst the worst, the UK pension funds were obviously the first to cry uncle. Now the UK pension funds system is not any small pension fund system. You know, it's actually one of the world's biggest, of course, the US pension fund system is by far the world's biggest. Australia's is very big... Canada's is very big, and the UK is right up there. So for the UK pension funds system, to say, look, we can't take any more losses on bonds, or we are going bankrupt. And we need government, we need central bank intervention here and now and not discuss it, but we're calling at 10:30AM. And by 4PM, we're declaring bankruptcy, which is what happened a couple of weeks ago, is, to me, that was a very big deal. Because, fundamentally, most of us think of Central Bank as having two mandates. We think of them as having a mandate on inflation. And we think of them as having a mandate on economic growth/job creation.

But in reality, they have three mandates. And the third mandate is making sure that the government's get funded. And that, therefore, the bond markets are operating fairly smoothly. When you go back to the dark days of the COVID lock downs in March 2020. You know, equity markets were puking, and the Fed did nothing until you started to see the government bond market puke. Until basically, the US Treasuries went no bid. And that's when the US Treasuries when no bid. That's when the Fed stepped in. Now, I highlight this, because that's what's just happened in the UK. In essence, the bond market was going no bid and the pension funds were going bust. And the Bank of England said, Okay, well, out of our three mandates, right, now, we have to forget the inflation mandate. We'll deal with that later. Right. Now we have to focus on our bond market stability mandates.

And so now you have a bank of England, that is adopting yield curve controls, just like the Bank of Japan adopted yield curve controls. And on this, through my career, I've seen the Bank of Japan do different things. And they were always at the forefront. And they were always made fun of when they first did it. So, the Bank of Japan was the first to go into zero interest rates, right? And you remember, and at the time, it was like these Japanese, they're just nuts, zero interest rates that makes that makes zero sense. Like, what's wrong with these guys. And then, within a couple years, everybody was at zero interest rates, then Japan did QE, same story, then Japan did negative interest rates, and same story then everybody followed on negative interest rates. And now Japan does yield curve controls. You know, my take is, we'll all end up with yield curve controls except of course, the countries that didn't follow crazy monetary policies and crazy fiscal policies, who didn't blow out their government debt to kingdom come, who didn't basically undermine the very structure of their bond markets through crazy policies, and who continued to undermine it through crazy fiscal policies. Because amidst all this, you know, what government is legitimately tightening its belt. Most of the governments everywhere are, are going around saying, oh we have an energy crisis. Well, let's print more money to deal with the energy crisis.

Germany just announced a 200 billion euro plan, that's 5% of GDP plan to basically subsidize energy for its consumers. France just did 100 billion. That's 2, well, that's what 3% of France's GDP. These big numbers, just to deal with the energy crisis. So, all this to say that in this environment, I think, basically all the major countries are going to deal with yield curve control. And as they do, the trend that has already started of massive emerging market, bone out performance, and massive emerging market equity outperformance will continue, because that will be the one place where capital, lo and behold actually ends up being somewhat protected. And so today, everybody's running around saying I have to be in the US because the US is the cleanest dirty shirt, even though I'm taking a 20% hit to my bonds and a 25% hit to my equities. This is where I have to be, forget it, it's not where you have to be, is in the places that aren't following crazy fiscal and crazy monetary policies, you have to be in the places that aren't declaring war to the climate on the one hand and to four other countries on the other and that are trying to keep their show on the road and keep their heads down places like Brazil, places like Indonesia, places like India, places like Singapore.

Fundamentally, I think there's three ways to make money in markets. You run a momentum trade, you run a return to the mean trade, or you run a carry trade. And right now, there's only two asset classes that take all three of these boxes. It's energy on the one hand, it's emerging markets on the other. And I would say well, if you've got all three momentum, positive carry and return to the main attributes, then you back up the truck. You back up the truck because That doesn't come around that often. The reason it's coming around right now is because, we're in a global liquidity crisis, we're in a bear market. So you get you're being given a great opportunity to pick up a lot of these assets for very cheap, but make no mistake about it. The next big bull market is over there. So we can indeed sit around and think, Oh, my God, things are terrible. We're in amidst this big crisis. And for all the reasons that your previous guests have discussed and that you've discussed as well, etc. Well, we can think, okay, there's a crisis for sure. Where's the opportunity? The opportunity sets is energy. It's emerging markets. Let's not overthink it. Let's just do that.

Erik: Louis, I can't thank you enough for a terrific interview. But before I let you go, I want to ask you first what you do at Gavekal, which is an institutional advisory firm, but you also now have Evergreen Gavekal after you acquired or partnered with our friend David Hayes company. Evergreen. For our listeners, both on the institutional and high end retail side who want to follow your work. Please tell us where they can do so.

Louis: Well first thanks again for having me. We do lots of different things we publish research for institutional investors at gavekal.com. That's the best place to follow us. I don't really spend unfortunately much time on social media. We also have a free newsletter that goes through the private wealth arm of Gavekal, Evergreen Gavekal and we're hoping to ramp that up that this private wealth part in the coming years or in the coming quarters. We'll be making announcements on that front very soon. So yeah, best way to contact us either through the website gavekal.com or evergreengavekal.com.

Erik: Patrick Ceresna, Nick Galarnyk and I will be back as MacroVoices continues right after this.