Louis-Vincent Gave: Staying Humble in Troubling Times

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Erik: Joining me now is GaveKal co-founder Louis Vincent Gave. Louis, I've interviewed you quite a few times over the last several years. And if there's anything I've learned, the best way to approach an interview with you is take whatever the one really big macro theme of the day is and ask you to sort of frame that in terms of what the markets are telling us. Just one problem. I don't know how to decide! There's so many big macro themes, from geopolitics to energy to everything else. What's the biggest theme in your mind and what should we talk about this week?

Louis: Well, first thanks again for having me Erik. I really enjoy our conversations so thank you so much. To your question, to be honest, I'm as confused as you are. And I want to say this and really no modesty today. It is very hard to parcel things out. As you point out, you want to strip out the signal from the noise and all that stuff. But I think there's so many moving parts right now that I think any investor, the first thing we have to acknowledge is to be very humble, to accept that we're going through things that, probably no investor below 75 has gone through and you know, I've got a whole list, I'm happy to rattle off. But, the first thing and I know, you've done a number of episodes on this, but, we're going through the end of the peace dividend, right? I know, you've called it world war three. Some people call it the start of a new Cold War. Either way, we have the end of the peace dividend in here. I love what our mutual friend Luke Gromen pointed out the other day is if truth is the first casualty of war, then bonds is a close second. War is always and has always been inflationary, whether a Hot War or a Cold War. So that's for me as a first important, obviously, big marker. Wherever you care to look in the world every meaningful economy is increasing its defense spending. Whether in Europe, in China, obviously, in Russia, obviously in the US. And military spending is fundamentally unproductive spending. You’re spending money on a bunch of things, high priced items that you hope you never use. So that's a first dramatic shift. Unless you were investing 30 or 40 years ago, you're not used to rising military budgets, you've always had sort of shrinking military budgets.

Now against this, the second massive shift is, most countries are going through a very important demographic transition. Most countries are aging and aging fast. The big pools of excess labor in the world that used to be China, India, Mexico, places where women would have 2, 3, 4, 5 children per women now have less than two children per women. And so we are going through, you know, an aging in our societies, and just looking globally across the world. We no longer have somebody like China adding an additional 20 million workers to the workforce every year.

And for me, that's a paradigm shift. I know a big theme of yours has been the energy transition. And it's been one of mine as well, we've talked about this before, my go to line is that economic activity is energy transformed. And really the story of the past 250 years, the story really of rising wealth levels, rising disposable incomes, is fundamentally a story of humanity, always moving to more efficient methods of producing energy. You know, you start with coal, you move to whale oil, you move to oil, you move to natural gas, you move to nuclear. And for the past 10-15 years, we've decided, let's move away from all this and move towards more inefficient energies. Wind, solar, and we need to do this because otherwise we're going to destroy the planet. But in so doing, there's a tremendous economic economy cost and economic cost is, you know, means lower living standards. Higher energy prices means lower living standards. So we're going through this energy transition. And that's another big uncertainty out there.

But for me, perhaps the biggest, most important structural question is whether the monetary system such as we've known it for the past, really 70 years since World War Two is in the process of changing and you and I have talked about this before, but cutting off the biggest commodity exporter, namely Russia from the US dollar system, I think basically amounted to cutting our nose to spite our face. I know we don't like Russia, I know they're bad people. I know all these things. But the fact that we're now seeing deals for oil, deals for iron ore, deals for coal being done in Renminbi, Rupees, Thai Bahts. I think we've started a structural shift and the global monetary system and these things, of course, don't happen overnight. But that to me adds a lot a lot of uncertainty in the world that we live in. And then against that you have all the cyclical uncertainty. So you got these, for me these big four structural forces that add just enormous uncertainty for lack of a better word.

And then you got the cyclical stuff, you've got a Fed that's tightening, while on the fiscal side in the US, you're still running massive budget deficits, municipalities, state federal level of spending money willy-nilly. You have the second biggest economy in the world that had been locked down for three years that is reopening. And a Chinese government, I know we talked about the Xi pivot. Last time around, most people looked at the Xi pivot thinking, okay that was just the opening. It's not just that. It's getting rid of the red lines on real estate lending. It's recapitalizing the local authorities to get local infrastructure spending again. So you got all these things going on. And what fascinates me is that most people you talk to only want to talk about the Fed all day, every day. Because I think as you know, through the years of QE, through the years of zero interest rates, we raised an entire generation of investors to just worry about what the central bank was doing, and to basically build all their investment decisions on that one factor, on what is the Fed doing. I think, given all these forces that I've just described, what the Fed does actually matters less and less. We’re seeing it now right? The Fed is tightening but, meanwhile, inflation stayed strong. And growth in the US is actually not as bad as people thought it would be and growth around the world, as you know, and inflation around the world are turning out to be still decently high. So I think against all this uncertainty, you have to be very, very modest. You have to look at the markets and say what messages am I getting from the markets today?

And personally, the message I'm getting is, bonds are done for. We're now entering a second year where US Treasuries are losing money. OECD government bonds serve no purpose in portfolio. We're now entering the second year where emerging market bonds are up, outperforming OECD government bonds. For me, these are important, important messages. Energy stocks are volatile, but they continue to do pretty well in spite of an energy price that has remained stubbornly low. And that, to me is a big mystery. Why isn't energy rallying more but again, we have to be modest. There's dramatic shifts going on in the economy and to think, you know, I love to work with decision trees. It's like, okay, you ask a question, you go, yes-no, etc. But when you have 5, 6, 7, 8 questions and each time you have a yes-no answer, your decision tree gets to be too many branches. It's like being a chess player. I was a very modest chess player in my youth, I could think maybe three, maybe four moves ahead. The great chess players think eight, nine moves ahead, and they've got everything mapped out. Unfortunately, I was never that guy. And so um, in all honesty, I find today very, very tough.

Erik: I really want to hone in Louis, on this theme of letting the market tell us what's really going on. Because like you, I really believe that we should allow the market to give us important signals about how to interpret the world around us. But hang on a second, if I look at what's going on. And I look at my own objective analysis of the world, which is we've got the greatest threat of nuclear escalation, nuclear war escalation, not just since the Cuban Missile Crisis, but ever I mean, this is as big if not bigger than the risk of the Cuban missile crisis right here right now. And I also know for a fact that the world is dependent on Russian oil exports. Russia still exports almost 8 million barrels of oil, although they are being forced to take lower prices on it. The world can't live without that oil. If you took just half of Russia's oil off the market, there isn't enough spare production capacity in the rest of the world combined to make up the difference. It just doesn't exist. So I look at those risks. And I look at the US now agreeing to train Ukrainian fighter pilots in someplace in the Southwest US I forget where for F-16 training so that if they decide to give F-16 jets to Ukraine, their pilots will be ready to fly them. I'm looking at all of these signals of escalation.

Meanwhile, gold if you look at, you know, what's supposed to be the biggest geopolitical hedge. Yeah, it had a rally from November but that was driven as far as I can tell entirely on inflation and interest rate and what was going on with the Fed's hiking cycle. As you said, everybody's paying attention to the Fed. Looks like we're going to see real interest rates starting to come off again. That's good for gold as soon as we got a different inflation to print all the sudden it's reversed in the other direction. So we're not seeing the market... If I look at what the market, what the gold market is telling me, it's saying that I've got the geopolitical risk all wrong, there's no problem. And there's not really any big deal in Russia. Same thing with the oil market, we did see the first close above the 100 day continuation chart moving average on Monday, first one since July, I think, actually, there was one other one, but it only lasted one day, and then the market reversed abruptly after that. If this holds, it'll be the first time we've been above the 100 day for more than six months now. But it's taken now to get there and so do I interpret what the markets telling me which is, there's no problem?

Louis: So I think the first point to make is, gold has been disappointing. I agree with you, relative to everything that's been unfolding. Having said that, it's massively over the past couple years, it's massively outperformed US Treasuries, and so have many other bond markets. The Chinese bond markets has massively outperform US Treasuries, the Indian bond market, the Brazilian bond market. For me, that's the message. That's the message that's in this period, this current period of uncertainty, this current period of heightened fear, people are not rushing into the safe arms of Uncle Sam, like they used to. They're not rushing into the safe harbor of US Treasuries. And so, yes, you're right, gold hasn't done that great. But look, let's put things in perspective. If we'd met two or three years ago, and we said, look, the DXY is going to go up 15%. And short rates are going to move from zero to five, we probably would have bet that gold would be 1500 or even below. We would have thought that gold would be absolutely smoked. The fact that gold is holding itself up with short rates, basically moving up every day, with long bond yields starting to creep up once again. I think that's an important message. And yes, gold prices aren't going up. But you have a shrinking money supply in the US now. So it is doing its broad job, sort of holding its value in the face of a challenging environment.

So, I take your point, when you look at Gold is disappointing, etc. But over the past year, if you were in gold and not in US Treasuries, you're thinking you're lucky stars. And that to me, that is the important message given again. Remember, a couple years ago, everybody, everybody and their dog was arguing, oh, you know, deteriorating demographics. Well, that's deflationary. So, you got to buy bonds and rising, uncertainty around energy. Well that risks, you know, hurting growth. So you got to buy bonds, and, you know, geopolitical tensions around the world. Well, US Treasuries is a place you want to be. For me, that's the main message is against this backdrop, US Treasuries have failed and they failed in a very big way.

Erik: Louis, I still want to come back to the point earlier, which is, if I look at what is the market telling me. One or two things has to be true here, either the market is telling me through both gold and oil, that my fears about you know, nuclear war escalation and so forth are unfounded. I'm just the crazy Kook because we're too worried about this stuff. Or we're looking at the biggest market complacency bubble since the COVID crisis when I thought I was going crazy saying that, we're looking at it, I think it was in in the beginning, or the middle of February, end of February of 2020. And I had been losing money as the oil market kept going up. Because in the end of January, I started buying puts and shorting Crude Oil Futures aggressively saying, there's obviously a pandemic coming, you know, what the hell is going on? And the market just completely ignored it until one day it turned around. So is there about to be one day where this stuff all turns around or am I just, you know, need to take the message to heart that this is not as bad as I think.

Louis: Let me first say that I hope it's not as bad as you think.

Erik: I hope so too, because I think it's pretty bad.

Louis: Yeah, I know, I've listened to you over the past few months. And yeah, so I hope it's not as bad as you think. Let me also say that, I think when it comes to these big geopolitical events, and let's just wrap COVID into that... It wasn't a geopolitical event, but it's sort of exogenous shock. The markets are not always great at anticipating those, right? If you look at pre-World War One, the markets were rallying into World War One. The markets didn't sell off, like pre-Pearl Harbor and like even the bond markets was rallying pre-Pearl Harbor. And then obviously everything changed after that. I guess what I'm trying to highlight is, you really have two kinds of crises in markets. You have exogenous shocks and endogenous shocks. Your exogenous shocks, is exactly the kind of stuff you've talked about, you know, your COVID crisis was an exogenous shock, it's like this thing that comes out of nowhere. Here you're running a business, you're doing your thing. And then from one day to the next, the government says, shut down your business, send everybody home, etc. Huge exogenous shock for the global economy. And obviously, nukes flying around would be another huge exogenous shocks.

And then you have the endogenous problems. And I think a lot of the problems we've highlighted, have been more of the endogenous nature, like your demographics is obviously an endogenous problem. It's something that evolves over time. Your energy transition is an endogenous problem, something that evolves over time. And the shift in the monetary system is also an endogenous shock that moves over time. Now, market participants, I think, are pretty well, some of them are good at sussing out these endogenous problems. We saw with the mortgage crisis in 2007-2008 in the US, or the Euro crisis in 2011-2012. And I would say, today, it seems to me that we do have this demographic problem, we do have this energy problem, we do have this monetary transition, and people are positioning themselves for that. And that's why US Treasuries are underperforming.

I don't think anybody's positioning themselves to your point for World War Three, for nukes flying around. Partly because what's the point? Right, what's the point of positioning yourself for World War Three because if it happens, well, I'm probably dead anyway. And if it doesn't happen, and I've wasted capital, trying to protect myself from it, so there's a little bit of a tails I lose and heads, I don't win kind of thing in there. And so I think that's why, when it comes to these big geopolitical, exogenous shocks, etc. If and when they do happen, as we saw with COVID, you get this brutal realignment. And then typically, what I think is also happened, as we saw with COVID, is people don't expect governments to step in. And they, you know, there's this now expectation the Fed put, etc. It's like, markets fall 30%, get the change in policy, change in monetary policy, change in fiscal policy, even if each time you get a lower bang for your buck. And so, to your point, I think that's why people aren't loading up into gold. And that's why people aren't loading up on the oil. I think people are slowly positioning themselves for the endogenous shock. But yeah, nobody's positioning themselves for the World War Three that you described. And that I hope doesn't happen.

Erik: Well, I just want to clarify, I am not expecting all out nuclear warfare. And I agree, there's no reason to position against that. But it seems to me that it's pretty darn clear. You know, they're training the Ukrainian pilots to know how to fly F-16s. It's probably because they're getting ready to give some F-16s to Ukraine. There's no doubt in my mind that that will anger

Russia, and it will cause Russia to escalate in some way. And does that mean, somebody fires the first Tactical Nuke? You know, what's the next domino to drop? I'm not sure. But when this thing started, Biden was saying, we're not going to ever send any troops, we don't want to even send any weapons, because we don't want to exacerbate the situation. Well, they've exacerbated it, and they're going to continue to exacerbate it. And it seems pretty clear to me that the escalation of this conflict between the United States and Russia is not done. And meanwhile, China is kind of being pulled into it, or they're entering it. You know, we learned the hard way, that fighting two wars with Iraq and Afghanistan, which seemed like such tiny little countries that they couldn't possibly hurt us. That was a bigger deal than we thought it was going to be. That's behind us, thankfully.

So now we're going to fight wars with China and Russia. That's a very, very different game. It's a completely different thing. And if it was hard to win with Iraq and Afghanistan, how could it possibly be good? What's coming next? So I don't think it's nuclear Armageddon. But I think somebody firing a tactical nuke and some big escalation is a very real possibility.

Louis: Look, I think we now know, I think that Iraq and Afghanistan were the biggest policy own goals, probably in the past century. It hurt U.S. credibility, it cost a fortune. It cost a lot of blood and treasure. And yes, to your point, it is amazing to think that US policymakers are sitting around thinking okay, we basically had defeats in Iraq and Afghanistan, but let's take on Russia and China at the same time. It does boggle the mind. So I take your point, but let's remove ourselves dispassionately from the situation because of course wars generate passion and they generate anger, and fear, and all these things that really hurt you when you're trying to invest, right? It's so much of investing. I think when you invest you, you basically invest against yourself. It's so much of it is training, like getting your emotions in check. And not letting you know, again, first casualty in war is truth. That during war, propaganda efforts go through the roof, etc. And having all that not clouded your own judgment is extremely challenging. When the Zeitgeist all around you feeds you that daily dose of fear, that daily dose of emotions. And so if you go back through history, you look at World War One, you look at World War Two. You know, when these big conflicts broke out, who are the big winners? The only winners in a war are the people who stay out of the war. And wars again destroy capital, destroy people, either because they kill them, or they leave them mentally damaged or physically damaged.

So the best thing you can do in a war is, let's say, who's not participating, and that's where I want to invest. And today, in this conflict between Russia and the Western world, it's pretty obvious than most of the emerging markets are saying, I want no piece of this, you know, this is this is not my fight. This is, you know, I'm going to I want to keep trading with the US and I want to keep trading with Russia and India saying this, and to some extent, China saying this as well, even though, the US won't want to basically let them see that. So I don't think it's a mystery why emerging market bonds are outperforming. I don't think it's a mystery why emerging markets Ex-China equities are outperforming. You know, in my career, I'm obviously very Asia-centric, Asia focused. But every time the US dollar went up, every time the Fed raised interest rates, every time all prices went up, or energy prices went up, markets like India, or Indonesia would hit the wall. It was like, it was a given. In my career, Indonesia has always be the redheaded stepchild of markets, whenever something bad happens, they are the first one to get hit.

Well, look at what happened this time around. Last year, global equities down 20%. Indonesian equities up, Indonesian Bonds flat. That's mind boggling to me. Same story in India. Again, for me, you listen to the market, and the markets are telling you, maybe it's a Cold War, maybe it gets to something worse. Either way. Let's just invest in places that aren't involved in this war. And you get an added benefit is a lot of these places are not priced for perfection. I mean, maybe India's potentially priced and it's valued at a fairly high valuations. But a lot of these places. You're looking at your Chile, at your Brazil's, at your Indonesias, at your South Koreas. Like, a lot of these places are trading tractive valuations and they're staying the hell away from this.

And to me, that's the best way to keep your sanity is to say, okay, maybe there is this Cold War going on, maybe there's this big geopolitical tension. Let's find the new Switzerland, let's find the New Sweden. This is the only way you could preserve capital in World War Two was investing in Switzerland and Sweden because they stayed out of it, or investing in Latin America back then. You know, in 1950, it's mind boggling to think but in 1950, Argentina was the fourth richest country in the world in GDP per capita. After that they did a bunch of mistakes. And so you needed to leave. But, while people go at each other's throats, the best thing you can do is say, all right, you guys want to go nuts. Have at it. I'm doing something else.

Erik: Louis, I want to come back to energy because as I said, there has been a daily close now over the 100-day moving average. But look, this market has been going nowhere when everybody not just me, not crazy talk to me. But Goldman Sachs saying as soon as China reopens, baby, put your seatbelt on because the energy markets gone to the moon didn't happen. What's going on?

Louis: I've said the same thing. I'll put my hand up to this one. I've been super bullish energy on the very premise that China was going to reopen. And, once China reopened and it was going to go to the moon and beyond. And yes, to your point, it hasn't happened. And it is surprising because wars are usually energy intensive. You know, moving fleets around, moving fighter planes around. All these things are that creates extra demand for energy. So, why is why isn't it working? Why isn't the energy trade working? I can come up with two possible explanations. The first one basically amounts to we're not wrong, we're just early. Which is of course the refuge of every scoundrel in our business. But the reality is, today in China, you're still have about 300 flights a day. Pre-COVID you had 1300 flights. The reason for that is, they lost a lot of pilots, lots of pilots lost their licenses because they didn't fly enough hours during COVID. So, they've run out of pilots, you got to retrain pilots. Another issue, in terms of traveling, at least abroad is most Chinese People's passports have expired during COVID and couldn't get new passports during COVID. And so I think there's all this backlog. And if I look at Hong Kong, I expected by now to be overrun by Chinese tourists. And the reality is this, this hasn't happened yet. So maybe it's a delayed effect. That's what I think to be honest, I think it's a delayed effect. But if it doesn't happen in the next three to four months, I think we'll have to consider the possibility that we're wrong. So, that's one possible option.

A second possible option to explain what's happening in energy is the energy market of today is very different from the energy market that you and I have known throughout our careers is all of a sudden, you have Russia, you mentioned the 8 million barrels per day, you know, it's selling off markets, no longer in US dollars, to China, to India, for very long term contracts, at big discounts. And that brings an interesting question is if the rest of the world pays, let's say, $75-$80 for their oil, but China and India, get to pay $50 or $55 for their oil, and they do it in their local currency. So you got a $75 price, and you got your Renminbi price and your Rupee price. And it's supposed to be all the same price, then what does it mean? I think it basically means that the Renminbi at this point and the Indian Rupee and the Korean Wan, and the Thai Baht, and all these guys doing deals in other currencies, it means that these currencies, if they get to buy oil at 30% discount, then maybe it means that just that these currencies are 30% too cheap. So what could happen in the coming years, year two, or three. Is that either oil prices adjust higher, or Asian currencies adjust higher. Because I don't think you can have different markets in different prices for too long. So yeah, look, I think it's the energy story is a big quandary. Now, I'm loaded up on energy stocks. And you and I have talked about this before. Now, the reality is, you look at a lot of these energy names out there. You know, at $75-$80, these guys are still generating tons of cash flow, and they're buying back stock like Chevron has been doing, or they're raising dividends. And so, you're sort of paid to wait, like I said, the big problem is, maybe we're not wrong, we're just early. And I think if you've been trying to play energy through the futures, it's been painful. If you've been playing it through stocks, well, you know, last year, that was the only way to be up was to own energy stocks. And this year, they're still doing okay. So for me, I think the energy stocks, as you know, you're paid to wait. And at some point, you will get the pop. And when you get the pump, it might be in six months, it might be in 12 months, the energy stocks will rally with it.

Erik: Louis, let's come back to the Treasury market because, you know, a few years ago, I took a lot of flack from some of our institutional listeners just for inviting our mutual friend Luke Gromen on the show. They said you're losing credibility to put a nutcase crackpot lunatic on the show who's actually saying things like people are going to start transacting or settling oil transactions in anything other than the US dollar or even crazier than that, that central banks might start divesting their US Treasury holdings as the gold standard of central bank reserve asset.

Well Gee when Luke said those things ahead of the market, he was a nutcase crackpot lunatic. But now that they've all happened, everybody's just sort of acting like it's normal. But the bond market really, you know, there hasn't been any panic, there hasn't been any fear. It seems to me like the world is changing. And now we've got people like Zoltan Pozsar who is, you know, a mainstream guy saying a lot of the same things Luke was saying a few years ago. When does this all hit the tape and change the direction of markets?

Louis: So let me just first state that I think Luke does terrific work. I subscribe to his newsletter. I invite all your listeners to do the same. I think he's a genuine out of the box thinker. And I always enjoy reading what he says. Like, what you were describing made me think of what's the old saying it's like first they ignore you, then they laugh at you, then they attack you, and then they accept that you are right along or something along those lines. And, I think that's what somewhat unfolding on the US Treasury markets. I don't think it was the last one but a few times ago, like when you and I talked, and you posted on Twitter. Somebody posted a picture. Did you ever see that movie Office Space? You know, you got the consultants who come in and ask people tell me what you do here because they're really there to fire half the workforce in the business. And somebody sent me a picture with those two guys from the movie Office Space. The title was Louis Gave's conversation with bonds. And it was telling me what you do here?

The reality is, US Treasuries have not been doing the job in the portfolio's that they were hired to do for two years now, for two years. The first job of treasuries is to diversify your equity risk. That's their first job. And I would say their most important job. It's like an offensive lineman in football. Their first job is make sure nobody goes through to hit the quarterback. And they're failing dismally at this and again, again in February, you see February stocks down, bonds down. It's like a one for one correlation. And I think more and more people are waking up to the question, what do these US Treasuries do for me? And I think this question is even more important, for the geopolitical reasons you and I discussed, depending on who you are, because and you and I have discussed this before in the past, but when we seized the Russian assets, and when we seized all the oligarchs houses, and football clubs, and central Bay Beach houses and whatever else. We sent a message to the world, that the law doesn't apply equally to everyone. And individual people will be judged, not on what they've individually done, but on who they are, not what they've done. So now all of a sudden, if you're Chinese, if you're Saudi, if you're from Brunei, or Qatar, you might not feel as secure owning US Treasuries, as you did before.

Now, if you're French, or British, US Treasuries are fine. The problem is, if your French or British, your countries are running twin deficits over 8, 9, 10% of GDP. So actually, you're not really in a position to buy a ton of US Treasuries. Where all the excess savings in the world are accumulating right now is basically China, and oil producers. Those are the guys that are running huge current account surpluses, and more often than not fiscal surpluses as well. So those are the guys that technically would have the ability to buy more US Treasuries. And aside from Norway, we've told all these guys, your money's no good here. We've told all these guys, well, your money might be good here this week, but next week, we might change our mind, or next month or next year, we might decide you're Chinese, your leaders a jerk. So we're just going to take your stuff. And that's not a very attractive proposition, especially when real yields are still so low. It's like, why would I want to take this risk?

Which brings me to like one of my key themes for the past, you know, three years since I wrote my book, Clash of Empires, is we are living in a world that's deglobalizing, but not in the way people think. You know, when people think of deglobalization. They think of the Nike supply chain or the Apple supply chain. But if you look at China's exports to the US. In 2020, it was 30 billion a month. Today, it's 50 billion a month. So there's still tons of trade flowing. The real deglobalization is occurring in terms of financial flows. That's the important deglobalization. It's the fact that US pension funds are now being told by the US government, really guys, you should not invest in China. But that knife cuts both ways. You also have Chinese institutions that now feel you know what, maybe US Treasuries are not as safe as I thought they were. And again, the big difference is the US runs twin deficits of 10% of GDP and China doesn't. So the marginal savings in the world are actually again, happening in places like Saudi Arabia, like Kuwait, like the UAE, and, and China. And what message are we sending to these guys?

Well, the message you're sending to China right now is your money's no good here. And the message you're at the same time that, you know, we're sending to a place like Saudi Arabia, is we can confiscate your assets at will, without any kind of due process, without any court order. Without any discussion to Congress. We don't like you, we don't like your leader. We will take your stuff away and so on. Surprisingly, what was the biggest contrast last year? Well, Biden came to see NBS in Saudi Arabia. And the meeting was extremely cold. And Xi Jinping goes to Saudi Arabia. He gets a 21 gun salute, he gets a flying parade of airplanes. He I mean, he gets like the full on treatment, embraces and hugs, and the whole nine yards. Now you could say, well, that's just show and etc. But the reality today is for everybody saying is China's uninvestable. Well, it's uninvestable for American pension funds. Sure. It's not investable for the Abu Dhabi Investment Authority. It's not an investable for the Kuwait Investment Fund. It's not not uninvestable for the Saudis and they're pouring money in there. Because actually, for them, as crazy as it sounds to a Westerner, China might increasingly be more safe than the US. And so once you remove that safety aspect from the US Treasuries, what are you left with? Well, you're left with an asset class, that is that is falling all the time and that is deeply unattractive.

Erik: Louis, let's talk about whether there's going to be a recession in 2023 and if so, when's it going to happen? Because a lot of people thought first half of the year that was going to be your deep recession. Some people say it started, but if it has started, it's not as deep as a lot of people predicted. Is it still coming.

Louis: Hey, what if you throw a recession and nobody loses their job right? That's what it feels like right now. So the first question is where? Where in the world are we talking about this recession, because in the part of the world, I live in Asia, there's no recession, Chinese growth is re-accelerating, they're pumping it up. The Chinese policymakers know that they need to have a party. And we discussed this last time, they pissed off so many people with their silly COVID policies, that they now need a win. And a win is to, get things ramped up again. Hence, the removal of the three red lines, hence the removal of the recapitalizing of local authorities, etc. So in China, there's definitely no recession, which, by the way, is a huge massive shift that I don't think people have adjusted their portfolios to, you know, four or five months ago, everybody thought that growth in China could be negative at best could be one or 2%. And now all of a sudden, it's probably going to be five and a half or six. And as you look at the second biggest economy in the world, move from really a zero growth environment to probably six, you know, you should ask yourself, okay, how have I adjusted my portfolio to this new reality? And the reality is few people have because a few months before this happened, almost everybody decided that China was uninvestable. So it's hard to now turn around and buy back the things that you said, were on investable, 40% higher.

So there's no recession in China. And when China does well, emerging markets do well. And when China does well, Japan tends to do well. So does South Korea and Europe comes along for the ride, because at this point, Europe is just a leveraged play on emerging markets. And Europe basically sources most of its growth from emerging markets. So you're really left with the big question of the US. The US which is the one major economy that will not benefit from China's rebound. So can we see a recession in the US? Well, look, yeah you do have higher interest rates, but who does that impact? That impacts all your private equity guys, and that impact, you know, your commercial real estate lenders, but most of the consumers. I read recently that 99% of Americans today have a mortgage rates that is lower than the current mortgage rates. And a lot of people are paying three, three and a half.

Now on the problematic side, they're stuck in their homes, they can't move. So that's lower productivity, right? Because you can't say alright I'm leaving Michigan to go to Texas to get another job there. Because you're just moving houses, you're going to be taking, you're going to be taking a big mortgage hit. So yeah, look, I think there's there are reasons to think growth in the US will be disappointing. Will it be a recession when basically everywhere else in the world is rebounding? I'm not very big on the recession camp, no. I think growth in the US isn't going to be great, but it's not going to be that bad. It's just going to be much better everywhere else.

Erik: Louis, let's talk about interest rates and Fed policy. Now we're recording this interview on Monday evening. So you and I have not yet heard what Jay Powell is going to say Tuesday, which our listeners will have heard by now. So listeners bear with us if we're not aware of the latest news. Let's talk bigger picture though, Louis. A lot of people thought we were already at the terminal rate with the last hike. A lot of people said the last hike was going to be the last one. Now we've got Nomura coming out saying now forget 25 basis points. It's going to be 50 basis points this month. Is this not really over like people thought?

Louis: I definitely don't think inflation is over. I think we we've had a structural shift for the reasons we've discussed the new Cold War the demographics, the energy problems, all this to me points to higher structural inflation for a long time to come. But I do think the Fed's ability to do much about this is actually I think the Fed's on a tighter leash than most people believe and here, I very much agree with what a lot of Luke Gromen has been saying over the past year, which is and I think we had a preview of what could happen with the fed with the Bank of England. For me one of the bigger events of 2022 was in September, when the Bank of England was flexing its muscles saying, oh you know, I'm going to raise interest rates, and I'm going to do quantitative tightening. And I'm not going to let the UK government, you know, expand fiscal policy, etc. And bond yields shot up. And then the Bank of England was tapped on the shoulder and said, well look by 3pm today, most of the public pension funds are bust if yields stay where they are. And so the Bank of England said, okay well, then let's do another round of quantitative easing. Let's not call it quantitative easing. But let's go out to the long end of the yield curve and buy a bunch of bonds, which basically is quantitative easing. And in the space of 30 minutes, the Bank of England did a 180. And so, I look at the US government and interest expense, a year ago, $800 billion. Now, it's going to be $1.3 trillion this year, that's a $500 billion increase in interest payment. That's money that's got to come from something, that money has got to come from somewhere. Either the Fed is going to provide that money otherwise, who else? Like the numbers are starting to get really, really big.

So my belief is at some point, you'll have a bond market meltdown, and then the Fed will change its stripes. And when the Fed change its stripes, the US dollar will go down. And this goes down to one of my core beliefs, which is that most people think that central banks have two mandates, and those mandates are employment and inflation. The reality is that they have three mandates. The third mandate is make sure the government gets funded. And that third mandate is the most important as far as the central bank is concerned. Because if that doesn't happen, the central banker doesn't get paid at the end of the month. So, when push comes to shove, once bond yields, the long end of the yield curve in the US really starts selling off, which I think happens this year. I think the Fed stops talking hawkish, but for now, we're still in an environment, we're going to get the 25 basis points a meeting. I think we're getting 25 basis points this coming meeting and we'll probably get another 25 basis points, but at some point, they'll break the back of the bond market.

Erik: Louis, I always enjoy our conversations. It's really great to have you back. So I can't thank you enough for a terrific interview. But before I let you go, please tell our listeners a little bit more about what you do at Gavekal.

Louis: So we're a research firm. We started as a research firm based in Hong Kong. We evolved into institutional money management. We also have a private wealth arm in the US called Evergreen Gavekal. And if you want to find out about us, the best thing to do is really go into our website called Gavekal.com. And sign up for Charles for institutional research. We got free newsletters for retail clients. So sign up to either one of those things. I don't spend much time on social media. So yeah, apologies for that. So the best thing is really our website.

Erik: Patrick Ceresna, Nick Galarnyk, and I will be back as MacroVoices continues right here at macrovoices.com