MACRO Voices
with hosts Erik Townsend and Patrick Ceresna

Jeroen Blokland: Inflation, Hard/Soft Landing, Geopolitics and More

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Erik: Joining me now is Jeroen Blokland. Jeroen, last time we had you on the show more than a year ago, you correctly anticipated that there was more inflation to come. Of course, you were right about that. Now, it seems like everybody's convinced inflation has peaked. And, boy, that we've gotten to the point where there's now just widespread expectations that the Fed completely reversing its policy to a campaign of cutting interest rates is just around the corner with rate cut odds in March, just blowing through the roof all the way up to 80% expectations now. So let's start with, first of all, good call, is the inflation really over at this point, or are we just looking at a lull in the storm? And where are we headed with respect to inflation?

Jeroen: I think that the deflationary, disinflationary or however you want to call it, pressures are pretty significant. I also expect that in the end, the US economy will slow down. So it has been much, much stronger than we all have expected. But I think that this year, growth levels will be significantly below what we have seen last year. And so, I think that this inflation story is set to continue. And only, let's say, supply chain bottlenecks, we now have the Middle East, or oil prices or things like that may be able to push that up again, I also expected the US labor market to slow, to be less strong. And that also means less wage growth. So yes, I think that inflation dropping to near or at the Federal Reserve target is pretty okay to expect, maybe not in the first part of this year, but towards the end of the year or early next year. So my idea is that inflation will remain relatively benign from here.

Erik: The other big argument in the macro community is soft landing, hard landing or no landing. What's your take?

Jeroen: Yeah, my idea is soft landing to hard landing. I cannot imagine that the US economy will continue to grow like this, it's really interesting to see that spiking interest rates have hardly caused any damage, for example, among consumer spending, so that's one thing. But I think if you look at base effects, if you look at how indebted credit card debts and things like that, so my idea is that we could get away with a soft landing. The reason why I'm not ruling out a hard landing is that even though, of course, the sample size of the yield curve, inverting is relatively small. But I have no reason to think that it does not point to a significant or severe slowdown of the US economy. And most of the time that has resulted in a recession, the same thing is true for massive tightening cycles of the Federal Reserve, that also most of the time, there's one exception, has resulted into a recession. So even though things look pretty okay now, I do not agree with markets pricing out a hard landing completely. I think that they're going too far, there is still a chance that we get a hard landing. No landing, I think is a very small chance that will happen.

Erik: I want to come back to the possibility of hard landing, because although I think the fundamentals are there for that, there's a view that's gaining a lot of popularity, which is, in an election year, the Fed, which is a lot more political than it admits to being is just not going to let that happen. They're going to ease as much as they need to prevent the hard landing, even if they risk inflation starting to run away again. First of all, is that a realistic view to have? And is there a risk of inflation running away as a result of that kind of policy?

Jeroen: Yes and yes. So I agree with the political views of the Federal Reserve, even though they won't say it is the case, of course. And also, if you look at, they now price three rate cuts, and the market is at roughly six. But I think it could well be eight, if necessary. And we are now at 5.5%. So even if you cut rates by 25 basis points eight times, you're still at 3.5%. If you look at the average since the great financial crisis, that's actually pretty high. So I think the Federal Reserve will have no problem to cut rates much more than markets expecting it and also what they expect themselves if necessary. Also, I think if you read through the press conferences of Powell, he is extremely keen on realizing that soft landing because it will put him in another category than other central bank Chairman before that were to face a recession in the end. So I think that they are very open to cutting rates. And of course, if it's gets hard lending, I think there will be many more rate cuts and even more QE perhaps, even though they will try to postpone that as long as possible, given that they were so wrong with the inflation peak. And then on inflation, yes, I think if we get a same kind of dynamic with growing budget deficits, fiscal stimulus, and quickly lower interest rates, and still pretty remarkable and big, fat balance sheets, then they also have inflation running high again, or at least a year later. So spiking again, yeah, they will increase significantly. So yes, I think both are possible in this election year.

Erik: Now, the official story for public consumption is that the reason that the Fed is about to begin some kind of easing cycle is because they've succeeded in their goal of taming inflation. And it's okay to reduce interest rates. But there's a popularly growing consensus, which is no, that's not the real reason. What's really going on is that they're concerned about the federal government's ability to fund itself, that there is so much debt rollover that's coming up, that they won't be able to afford to roll that debt over at current interest rates, and they're basically forced to cut rates, whether they think it's a smart idea or not. Is there any credibility to that view?

Jeroen: I think that's extremely credible. So even though no major central bank has an official targets of debt sustainability, to call it like that, I think it's a very clear, let's say, second hand go that they have. And if you look at the ECB for a minute, that it's even more obvious how, without the ECB, Italy would have been nowhere, it needs continuous support from the ECB to keep its debt sustainable. Now, in the US, you see the same thing. And of course, the trigger behind that is this spiking interest rates. If you look at how much of the total budget, the US government has to pay for its internet expenses, if you also add to that, things like health care, and also defense habits, is also becoming an increasingly important topic. If you also look at the expectations of the Congressional Budget Office, there will be massive budget deficits for years, unless there are structural austerity, I know to expect that in a very polarized political landscape. So yes, I think the Federal Reserve is very aware where that if they keep interest rates higher for longer, they will cause massive issues with debt sustainability and interest payments of the US government. So for me, it's very clear to put it like this, that this is something that the Fed literally takes into account and making monetary decisions.

Erik: Let's talk a little bit more about the federal debt in the United States and where it could be headed. Because something I find fascinating is, so many people predicted back when we had zero interest rates, they said, someday we're going to get back to 5% interest rates. And when we do, watch out, because what's going to happen is we're going to have such a rapid accumulation of the federal deficit, that we're going to be adding to the national debt at the rate of a trillion dollars per calendar quarter. And that's going to cause the whole sky to come crashing down. Jeroen, the crazy thing is, most of that story already happened, we really did get the trillion dollars in three months of additional national debt. The sky not only didn't come crashing down, but it didn't even make the news. What's going on here and how long or how much more debt accumulation can we tolerate before something actually breaks?

Jeroen: In my view, it did break the news, at least I'm very much focused on it. But if you, as an economy, realized…

Erik: Wouldn’t you agree that it was under-reported in the financial press? I mean, it wasn't that big of a deal in most people's minds that were…

Jeroen: Oh, maybe I'm spending too much time on the X or Twitter, because there, you see everyday there was some kind of graph showing the debt accumulation in the United States and the 1 trillion changes over time. But in general, why it has not caused a major collapse in whatever market, I think this also has to do with the US managing to realize a GDP growth, annualized GDP growth for the third quarter of over 5%. So, whenever your real GDP growth is higher than your real interest rates, then the discussion about debt sustainability is pushed back because whenever you grow faster, then you will have to pay on your debt, then most of the time, people will say okay, this debt is somehow sustainable. Still, the level, of course, also matters. But that is generally the idea that is the basic, some of the mathematical example that you can use. Now, if we go back to the beginning of this conversation that I expect US GDP growth to fall back to 2%, or even below that, if we get a soft/ hard landing. You also see that potential GDP growth in the United States is now well below 2%, by some, it's 1.8% by some others, it's 1.6%. If you go to these levels, let's say 1.6%, and the current real interest rate is 2% or 1.9%, then I expect people to be even more drawn to this issue of debt sustainability. So if you add potential GDP growth of, let's say, 1.6%, and then say, okay, now real interest rates are 2%, there’s this gap. And that makes it not sustainable. And I think this is going to be the dynamic that more people than now are going to be triggered by this development. And if you then, as the United States, add another budget deficit of 6,7,8 percent, partly caused by these rising interest rates expensive, then I think you will see a massive shift in markets. And this is also what I'm anticipating when we talk about gold, for example, people are starting to question if even the biggest economy on the planet is not overdoing it. As long as you vote 5%, that question will be pushed back, but I expect it to come back whenever GDP growth declines.

Erik: I definitely want to come back to gold in just a couple of minutes. But before we get there, let's talk about what it means for debt to be unsustainable, because the first time I heard this argument was in the 1992 presidential campaign, when Ross Perot famously said, a national debt of $5 trillion is unsustainable. Well, guess what? We're at $34 trillion and I don't think it's sustainable either. But clearly, it hasn't brought the system down yet. What would the signs be that, you know, the dam is finally starting to break? How would we know that an unsustainable level of debt, which I think we agree we already have, is actually starting to take the system down? What would that look like? And what would the warning signs be that it's happening?

Jeroen: My answer would be twofold. First is, let's take the example of Italy. Of course, we cannot compare Italy to the United States but they're the ideas. We are now at a point, even though it's a smaller country, even within the Eurozone, and you look at Germany and France, mostly. But you see that, without all of these measures, let's not go to all of them. and they already have raised a new one, of these measures by the ECB, they are targeted to keep debt sustainability for the weakest link. Now, in the United States, that is, of course, a little bit different, because they look a little bit better when it comes to potential GDP growth, realized GDP growth, but also as a safe haven assets. US Treasuries are still, by most investors, seen as one of the safest, most liquid assets in the world. But if you look from the great financial crisis, and you look at the size of the federal reserve balance sheet, and you look at the number of bonds that have been bought by the Federal Reserve, you already see clear signals that here to debt monetization is needed. If you want to continue to accumulate as much debt as the US is.

Now, the second part is, and that is very much to do with financial markets, we have learned that the combination of structurally low interest rates and especially with low real interest rates, as I mentioned, with a little bit more inflation, of course, that inflation should not spike and it should be manageable, it should be possible for the Fed to steer inflation, even though that is very difficult. But if you look at the combination of structurally low yields, and perhaps somewhat high inflation, then you can postpone, kick the can down the road, whatever you want to call it, this debt sustainability issue. So I think that a lot of policymakers, both at central banks and governments, they do not want to solve it. They want to postpone it, they want to extend it, and then leave it for somebody else to do with whenever interest rates go down. Everybody likes lower interest rates, there is also the public support for that, I think is much bigger than, for example, austerity. So I think that will be the case for the next 5,10 years, try to have these two things, low interest rates and high inflation, and then see what happens with growth. if debt levels come down. So I think that is the way to go. And that, of course, has major implications for your bond investments in a traditional portfolio, because how much return it will make, and how much, how volatile will they be caught.

Erik: Now, of course, the conventional wisdom is that if you're concerned about these things, precious metals, and gold in particular is the place to invest. We've been in this big, what I think is an ascending triangle pattern for a couple of years now, where it seems like about 2085 on the continuous futures chart, is the ceiling on this market. We've had a couple of false breakouts above that, including one big one around December 1, but seems like the market just doesn't move above that level and stay above it. Are we about to break out? I was certainly close, we're only within about 40 points as we're speaking now.

Jeroen: Yeah, I don't know when this is going to happen. But I look at Gold demand trends. So first of all, we have, in the world, a couple of a growing number, I should say, of central banks that are buying gold, like there is no tomorrow. And this includes China. This, of course, has to do with some geopolitical risks that are going on and their desire to be less dependent on the US dollar. But I also think, and when I talk to investors, and I look at how I approach a multi asset portfolio, you see, in general, that this whole concept of all of this debt and all of these currencies floating around, should we not have at least a bit of my portfolio or a bit of that related to something that has a value add to something that has proven value. And then of course, the first stop, because of its 1000s of years of history, would be gold. And so my idea is that gold is gaining popularity, because debt issues are rising. And as long as you do not break that trend, my idea would be that the demand for gold from investors, from savers, from central banks, will continue. And that means at some point, it will break to those ranges that you mentioned. So for the medium term, the longer term, my idea is that gold will rise significantly in price. And once that happens, together with lower real interest rates, the correlation between these two is very negative, then I think when the Fed starts cutting rates, and investors start to accept that there may be more than three or even six, and that's also long term yields are dragged down. That will be my starting point, if I have to point one out for another Bull Run lower or higher prices in gold, but if that is in two weeks or three months, I don't really care, but I think it will happen. So that will be my scenario for gold going higher.

Erik: Jeroen, let's go a little bit deeper into that. How much higher are we talking about? And tell us a little bit more about your thesis for what drives, that you just said, real interest rates. But you also mentioned some of the geopolitical factors, I want to come back to the geopolitics after we cover precious metals. But what kind of price level? Are you ultimately targeting for gold? And what is your thesis for why we would get there and what needs to happen economically to get us there?

Jeroen: So yeah, price level, let me try to derive one right here. In principle, so I look at failure of gold, mostly for its value as an insurance premium against experts market circumstances. And these are not the same, some people expect the end of the financial system, some people expect inflation, some people are scared of bonds. And if you look at the Gold/Silver ratio, for example, so gold is more scars than silver, but its price is much, much higher than you would expect, if you look at these two numbers, and nothing else. So from there, you can derive some kind of insurance premium, let it be 10, or 11 billion US dollars. My idea is that, that insurance premium over the years, will double. So I don't know how fast it will go. I don't know what timeline I should have. But my idea is that this whole concept, I want to have something that represents value, and also have some history. And I'm worried about geopolitics, political debt, and inflation, all the things I mentioned before. So my idea is that this insurance premium over the longer term is going to double, and of course, it matters what happens. So if what we discussed earlier, if we do get an inflation spike, because of massive federal reserve rate cuts, that of course, would accelerate this trend of gold. But yeah, my idea is that the insurance premium should at least double over the longer term. And so, a longer term is 5 to 10 years or something, but I have no clear price target for gold. Apart from, I'm pretty certain that it will go up.

Erik: Jeroen, let's move on to geopolitics, because there's a widespread view among analysts and pundits that there's not likely to be a major escalation to a regional conflict in the Middle East. I can't help but notice, it seems like things are kind of heating up with the missile attacks on shipping in the Red Sea. The US and the UK, are now very actively engaging with the Houthis. And I noticed also that it seems like there's a breakdown in agreement between the rest of the EU and that alliance between the US and the UK. So it seems like, you know, even the Western forces don't really agree with each other and what the right thing to do is here. Where do you see this all heading? And what does it mean for markets?

Jeroen: Yeah, it's a very difficult situation always in the Middle East. I think also over the years, because US is now the number one oil producer in the world by far. So the idea is behind what countries want from intervention. So you mentioned Europe, and within Europe and Europe versus the United States, that's also always a bit opaque, it is a little bit different to what you can expect. What I find more interesting is this, that I talked to quite a few people that say it's relatively contained. But if you see what it does to populations outside the Middle East, and how these populations are sometimes divided extremely about, which is the bad guy and which is the good guy. And add to that ,social media, I think that all of these issues, and the Middle East is a very important example, are very much global, because in their own populations, this is an issue that is not being resolved. To the contrary, people are even more polarized by what they see on social media. So my idea is that the odds that this escalates, also, within populations outside of the Middle East, these should be taken into account. So I'm not the biggest fan of geopolitics, when it comes to investing, because it's very, very difficult to incorporate it into your market view. So how do you do that? How do you value that? I'm very aware of the potential, let's say, explosive reaction it can have around the world, even though it's localized in a very contained area. So that is my general idea. And yeah, how this continues? I don't know, because it looks like a mess. And it has been a mess for decades. And I think it will flare down again, at some point, only in a couple of years or months or whatever to add. So the question is, must companies be less worth and should their value decline over this? And I think that a lot of investors that will forget pretty quickly so that it has no longer lasting impact, unless we get this global explosion of worries about these fees.

Erik: Let's expand the geopolitical conversation beyond the Middle East now and talk about the Russia/Ukraine conflict. It seems like there's one consensus that it's winding down, it's pretty much over the landscape, we'll be forced to negotiate with Russia, and this is all going to wind up. But then there's another view that says no, it's anything but over and it's likely to continue for at least another year. How do you fall in that divide? And what do you see, both for markets and for the outcome of the conflict?

Jeroen: Yeah, so for markets, I think the effects are getting smaller and smaller. Also, because I think a lot of policymakers outside will see it as a local problem that goes on for longer. I also read a story about an historian that showed, or argued at least, that the longer it takes, the more it will feel for the aggressor, that it is losing. So I don't know if that is the case here. But I think for markets, unfortunately, that is still the case, unfortunately, it will have less impact. Also, because if you look at things like sanctions, which totally not paid off, they were poorly implemented, of course. So yeah, I don't think for financial markets, it will matter that much, unless there is some escalation of the situations. But I agree with you, there is a reasonable chance that, and I don't know if that is in three months or 12 months, but that's at some point, thry will sit together. And then yeah, some kind of truce. I don't think they will fully resolve it. There will always be discussions about certain parts of the country, perhaps. And then these people there are stuck with that legacy. And that is something that they take decades before that is, but for the overall global economy and markets, unfortunately, it will have less impact or fortunately, if you're an investor. But I think at some point, we will see less and less of it and that is already the case. Of course it was front page news every day, and now, only when there are some major developments, you get to read more about that. So my idea is it cools down from an investor perspective.

Erik: You wrote another view that is growing in popularity is, that the real geopolitical story is not the conflicts that are already occurring, but rather, the growing alliances between China and Russia, where it could be headed in the future, and the potential of the West facing a new Cold War that maybe accelerates into some hot conflicts with an alliance or an axis of China and Russia becoming partners potentially in warfare. Is that a real concern? And how concerned should we be about it? Where does Taiwan fit into the story and where do you think it's all headed?

Jeroen: So on China, Russia, Taiwan relationships, I think, especially for markets, the trend is clear that all of these countries, China, Russia and also others, they want to reduce their dependency on the US dollar. And of course, this has to do with geopolitical tensions, also about resource security, about intellectual property. If you look at chipmakers, for example, even in the Netherlands, they are banned from exporting to China. I think in general, there's a massive race for energy, knowledge, defense, perhaps. And that means that if you want to build your own, let's say, economic bloc, and I think that is what China wants, and of course, Russia wants to join but I think China, of course, is in the elite, they want to have their own global economic bloc that provides for all of these things. Now, of course, some of this intellectual property is resided in US technology firms. So that immediately raises tensions on exporting or using these technologies. So that is also why I believe that in the longer term, inflation is also likely to be a little bit higher. Because, if you believe in globalization, and I think that a lot of people do, and you can also make it pretty clear that if you link all supply chains in the world together effectively, that it should lower prices, then if you do the reverse, if you went in the other direction, then prices would have to go up. So and also, they will become more volatile, because the odds of supply chain disruptions because of these new, let's say, global forces, is also high. And of course, Europe is an excellent example of that. When it comes to energy security, they have really shot themselves in the foot by ending all kinds of resources that are reliable, we don't want them perhaps, but we're reliable without having solid alternatives. So I think, for investors that did this, this is the key angle to take. So yes, higher inflation, more volatility. And of course, it could also end up in conflicts, even though I'm not an expert, also I don't, I never expect to conflict, which is also not very useful, as we have seen, but that is my general idea, different global powers. And it also means different global supply chains.

Erik: Jeroen, you talked about energy prices in that answer, let's dive into that in a little bit more depth. I agree with you that there's some really foolish decisions that have been made in Europe. Where do you think this is headed? It seems to me that on one hand, the Biden administration is very strongly incented to do everything it can to avoid higher energy prices through the US election. On the other hand, boy, there's just a lot of things brewing around the world. Where do you think it's all headed? And what's your outlook for energy prices?

Jeroen: Well, mostly, volatility. So it will partly depend on how these geopolitical tensions evolve. If they grow less, then oil prices could come down. If they increase, then it goes up, of course, but I think in the case of the United States, it's actually in a pretty solid starting position. And because they are the largest oil producer in the world, unlike Europe. So in the end, we all need energy, and we can discuss where this energy should come from. But if you don't have it, that is the worst thing you can do as a politician, and that is what is happening in Europe. So from that angle, the US is doing much better. And of course, because it's an election year, Biden and his colleagues will try to make that energy part as less important as possible. Also, because rising energy prices and gasoline prices, they negatively impact consumer confidence.

The other thing is, we should not forget is that, first of all, as we mentioned at the start, I expect global GDP growth and also that of the US to come down. That means less demand for all oil, which has been very, very strong as the highest ever, so that is a risk on the downside that we have to take into account. And the other thing is, that could also push oil prices lower, is that I will not argue that OPEC is falling apart here but we have seen another member that has decided to leave. And this of course, is related to the tensions that OPEC is trying to keep oil prices high. And that means they have to cut production every time. While the others that are not in OPEC, they see a very clear opportunity to take market share and produce more. So I also think that the strength of OPEC could be at debate at some point. And if that translate into overall higher supply, then I think downward pressure on oil prices can become even more significant. So even though a lot of investors expect oil prices to rise in the longer term, for everything, what is going on geopolitical, I can agree, but these two factors could actually mean the opposite, that we see lower oil prices. Just in this year, for example, and that would of course benefit Biden if this is one of his elections teams.

Erik: Jeroen, I can't thank you enough for a terrific interview. Before I let you go though, please tell our listeners how they can follow your work, what your social media handles are and so forth. You

Jeroen: You can find me on X or previously known Twitter, @jsblokland. You can also find my, just launched fund at blocklandfund.com. And from there you will be able to be redirected to everything I write and do on social media.

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