MACRO Voices
with hedge fund manager Erik Townsend

Jeffrey Snider: Understanding the Global U.S. Dollar Shortage
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Erik: Jeffrey Snider from Alhambra Partners joins me now as this week's featured interview guest. Jeff put together a fantastic book of charts and graphs to support this interview and I strongly encourage you to download it so that you can refer to it while you're listening.

Registered users at macrovoices.com will find the download link in your research roundup email. If you're not yet registered Patrick told you earlier in the show how to get registered and get the download.

Jeff your last interview back in August was one of our most popular shows ever. But we also lost a few people because we dove straight into the intricacies of the Eurodollar futures market without stopping to first define what a Eurodollar is and why that's important.

So, to set the stage for this interview the term Eurodollar refers to time deposits at banks outside the United States which are denominated in U.S. dollars so in other words U.S. dollars on deposit outside of the United States. The term Eurodollar originally referred to bank deposits in Europe but in today's usage it really refers to any place in the world that U.S. dollars are on deposit in banks other than U.S. banks.

Now at first glance it might seem that the Eurodollar market would only be of interest to international corporations who need to hold dollar denominated deposits around the world. So, it's tempting to question why an investor located in the United States would even care about Eurodollars.

So, Jeff let's start by answering that question what signals can the Eurodollar market give us about the global economy. Why is it so important for an investor who seeks to understand the global economy to understand the Eurodollar market and the messages that it's sending us?

Jeffrey: Well first of all Erik I want to thank you for having me back here I really appreciate the opportunity. I think you guys do a fantastic job with your podcast and I'm a big fan of it too. To answer your question, the Eurodollar is as you describe it. It's an offshore currency market of various forms and as it evolved in the last half century or so it's taken on far more proportions than just deposit accounts or vanilla currency transactions. In fact, it's become sort of ubiquitous. What I mean by that is that there's Eurodollars pretty much behind every facet of global finance and economy.

If you look back at 2008 for example, the panic in 2008 was actually a Eurodollar panic not specifically one of Wall Street but one of Lombard Street and you were correct to point out

that the main Eurodollar is sort of a misnomer because it denotes any offshore currency transactions that happen all over the world. It just so happened that the earliest markets of these offshore dollar areas happen to be in Europe, London, Zurich, Frankfurt but there was Eurodollar markets all over the world. Montreal was one, Tokyo was another big one.

So, there's a global system that is a currency system, a reserve currency system, that really isn't currency though and it functions in a lot of ways that are to our first brush, kind of strange and unusual and maybe a little bit too unfamiliar to allow comfortable interpretation.

Erik: OK, and of course the Eurodollar spread to treasuries is very commonly cited known as the TED spread as a gauge of risk in the banking system. So, there's a lot of reasons to pay attention to this.

Let's go ahead and move on to your chart book on page two we see that the ten-year swap spread which had been positive for the last several years went negative in late 2015 and it stayed negative ever since.

So first of all, what swap are we talking about here, ten year what swapped for what and then please explain what message is being sent by the spread turning negative?

Jeffrey: Well the swap spread is essentially the quoted price of the interest rate swap at the ten-year maturity minus the equivalent ten-year maturity U.S. treasury rate and the swaps spread is supposed to be a measure of risk in the financial system from the perspective of the swap market.

If you analyze the swap spread especially negative swap spread on a fundamental basis it doesn't make any sense because what a negative swap spread says – and that's again the quoted price of the interest rate swap below the U.S. treasury yield – what it says is that the swap market views the counterparty in the interest rate swap as less of a risk than the U.S. government. Of course, that's just not the case a negative swap spread on fundamental terms is nonsense.

And so, what is important about a negative swap spread especially if it persists is not particularly risk in the environment of the swap markets but rather that there's something nonsensical about it and so what’s important is the nonsense rather than trying to interpret what it actually means.

Erik: On page three, we're moving on to a comparison of treasury repo rates with the Fed funds rate. What is this chart telling us?

Jeffrey: It's actually quite similar to a swap spread chart in the same manner in which I describe it in other words what we're really getting at here is that money market rates are supposed to be described in function with a determined hierarchy. Things are supposed to work in order in other words the swap rate is supposed to be above the treasury rate because that's the way it makes sense in all the economic and finance textbooks that have ever been written. The treasury market gives us the risk-free rate and therefore any other rates that are related to it should be at a positive premium.

In the repo market in the federal funds market for example there's a similar hierarchy. The repo is a secured overnight or term interbank lending transaction where federal funds are

liable or unsecured and therefore the repo rate should always, always be below the federal funds or actually the other way around the federal funds should always be above the repo rate because that should represent additional risk.

So, what we see quite commonly since August 2007 that that hierarchy is broken down here again just like the swap spread what is supposed to happen isn't happening and it doesn't happen over a persisting and stubborn length of time. So, that tells us again that there's something wrong here. The hierarchy of these money markets has broken down.

Erik: And it looks like we've got more of this story with some more evidence of that, on pages four and five. What's going on there?

Jeffrey: These are cross currency basis swaps and cross currency basis swaps without getting into too much about what they are, it's a similar thing, there should be no large negative or positive premium within them and if there is it should be closed relatively quickly again because there's supposed to be a hierarchy at play here.

One of the things in cross currency basis swaps that just jumped out actually was if you read it properly what it tells you, is there's a huge amount of money to be made taking that trade at a negative premium with the Japanese yen for example you can buy any kind of Japanese government bond at a negative yield and still make a killing on the trade because a negative basis is so large.

So, the question is, the question for all of these charts so far is has been, is where are the people arbitraging away these spreads because that's what's supposed to happen, that's what hierarchy really means.

Hierarchy is or at least was where there was somebody in the middle of all these markets, money dealers, who would take the other sides of these trades and never let the spreads get out of hand. So, that they started into the nonsensical trading patterns let alone persisting in those nonsensical trades patterns.

So, what we're seeing here, whether it be swaps spread, the repo rate relationship, the unsecured or the cross-currency basis swaps is the absence of hierarchy and from that we can infer the absence of money dealers in these markets.

Erik: I want to pick up on that theme of the available arbitrages not being taken because on page six you're talking about covered interest parity and for any of our listeners who may not be familiar with that term. It has very long been recognized that the interest rate that's implied by foreign exchange swap markets has to match the prevailing interest rate in the cash market and the reason for that is very simple if it didn't match it would create a risk-free arbitrage opportunity.

So, this rule depends on the strongest known force in the universe which of course is the greed of bankers. So, if these rates don't match that means that bankers are leaving profits on the table. They have a risk-free opportunity to profit from a trade and they're not doing it.

Now Jeff how is that possible because what you're saying here is that bankers are not taking profits that it's not the question of risking money on speculation but they have completely risk free profit opportunities and they're not taking the bait, so what's going

on? What would cause that and what conclusion should we draw from the fact that they're not taking the bait?

Jeffrey: Well there's a couple of things that we conclude and number one is the fact that the mainstream of economic thought, if you will, the orthodoxy of economic theory is starting to notice those kind of things, tells you that it's a very serious problem. And apologies to any economists who might be listening to this podcast, I take a very dim view of economists for this reason it shouldn't have taken them ten years to figure this out because these kinds of things have become fairly common.

But you're right I mean it was an immutable law of finance that this kind of think doesn't happen. It shouldn't happen in fact it was believed that it couldn't happen. When the swaps spread – the 30-year swap spread – turned negative in 2008 for example for the first time there were rumors that trading machines wouldn't even allow a negative input because it was theorized to be impossible.

So, the fact that it not only occurred but has continued to occur and not only has continued to occur but has proliferated tells us that where are these greedy bankers? So, we know pretty well that they're not there.

So, there must be some kind of issue with the banking system where they're not taking all of these invitations for essentially free arbitrages, it's free arbitrage, if they're unable to do that then the reason that they're unable to do that is very powerful in terms of explaining where we are and how we got here.

Erik: On pages eight and nine you're showing Treasury International Capital or TIC report data because I think a lot of our listeners are familiar with the different TIC report I want to just stress that on this particular chart we're not talking about foreign holdings of U.S. treasuries which is the most commonly quoted statistic from the TIC reports you're talking about something different here.

So, let's start with what you're talking about U.S. banking data what does that mean in the TIC reports and then from there let's move on to what is this chart telling us.

Jeffrey: Sure, and the reason I want to bring up the TIC report in the banking data was to further establish the point I made before which is if we're seeing an absence of banks in these arbitrage situations, where are the money dealers, we should be able to see that somewhere that shouldn't just be conjecture. We should be able to find that somewhere in hard data.

The TIC data is actually quite deep and there's a lot of detail to it that isn't usually perhaps widely disseminated that should be. So, there's a lot of variables data including within it and part of that is U.S. banking cross border transactions.

Remember we're talking about the Eurodollar system which is essentially an offshore dollar system which by its very nature would lead to a great deal cross border transactions all in dollars and so U.S. banks provide dollars to this offshore market as well as source dollars from it.

So, what the TIC banking data tells us is essentially the fluidity cross border transactions within it from that we can infer whether or not it's functioning properly or malfunctioning

and this chart specifically shows exactly that. Exactly what you would expect.

You see the lack of arbitrage in all these markets and the breakdown of hierarchy. Not only does it show that specific case but it actually shows the timing of it which matches our perceptions of market behavior and all of these prices that confirm that there is an absence of banks and money dealers in these markets.

So, the first chart is U.S. banks claims and foreigners so that there the outbound supply from U.S. banks. What's notable about it is the central part the light blue series as opposed to the middle part which is the medium blue series. In other words, there are various channels for cross border dollars and the one that is broken down is specifically that to foreign banks which again is a confirmation of our theory that banks are absent and increasingly absent from these money dealing spaces.

Erik: Now I notice a trend forming here because if I look at that first graph on page eight, that peak which occurs just barely under three and a half trillion dollars there that was in the spring of 2011. Now if I look at page ten I notice that the Eurodollar futures prices seem to change direction about the same time.

So, what's going on with the spring of 2011 and what is this chart telling us overall in terms of what happened in the first half of 2011 that seems to be showing up throughout quite a few of your charts?

Jeffrey: Well I think what happened from a narrative perspective was that we had the event in 2008 that was shocking and it was devastating in a lot of ways but it wasn't necessarily a permanent rupture. I mean it turned out to be a permanent rupture but I don't think at the time everybody thought that was the case including the money dealing banks who are the issue here.

What I think happened was that we had a panic and then the fed came in with QE and everybody kind of sighed a sigh of relief that OK this was going to fix everything we'll go back to normal and so between 2009 and 2011 there was sort of a partial restoration in the Eurodollar functions in terms of volume and prices and everything else that was captured by the Eurodollar futures market as a greater possibility of returning back to normal.

Now what happened in 2011 was that we had another dollar liquidity crisis even though there had been two rounds of QEs by that point which to a lot of people and to a lot of banks in particular kind of blew up in the idea that QE was money printing money, it was even stimulus in fact the transcription from 2011 that were just released last month show a great deal of consternation and confusion on the part of Fed officials who kept saying that this was all happening – the breakdown in repo markets in particular – this was all happening despite one point six trillion dollars in bank reserves.

In other words, the Fed had supposedly created one point six trillion additional money printing yet it wasn't acting like that in any of these money markets. So, what happened in 2011 from the respective of the banks was, there was a tremendous difference in outlook and perception about volatility and risk and that essentially, I think convinced them that they no longer wanted to be money dealers in any sense, they were reticent about restoration up to 2011 but after 2011 it was it was pretty much a permanent rupture.

So, the processes that began during the panic in 2008 were further cemented and so it has

then since that time sustained and complete withdrawal of banks from the Eurodollar.

Erik: Page ten was showing us Eurodollar futures prices from which one could of course infer effective interest rates but now on page 11 and 12, we're looking at the Eurodollar money supply which I presume means the total number of US dollars that are on deposit with banks around the world other than banks in the United States.

Now put another way we're looking at how many U.S. dollars are available to the banking system but considering that the U.S. dollar is the world's reserve currency and is used to settle most international trade. How is it possible that this dollar supply has remained in a steady decline ever since 2008 because the stock market is telling us that we're in full-on economic recovery mode and happy days are here again and everything's great but from this chart it kind of looks like the Eurodollar market didn't get the memo, so Jeff what's going on here?

Jeffrey: Well you know the problem with socks is one that people bring about time because it seems like there's a huge disconnect here and I think there is. And the thing that we have to keep in mind is the Eurodollar system is not comprehensive. there's always been other sources of dollars and funding in currency beyond just strictly in the Eurodollar system and so there are different channels for financial flows to get into stocks whereas they might not be in terms of the Eurodollar to present here.

The reason for that is the Eurodollar we're talking about is primarily a bank driven system. The only central banker I've ever seen correctly identify it was the PBOC Governor Zhou who said in March 2009, he correctly identified this as a credit driven reserve currency regime.

What credit driven means is exactly that is it's a bank drawn currency that isn't necessarily a currency because it's not comprehensive, it's not like everything has to be a Eurodollar, primarily the expansion before2008 was done through the Eurodollar system through banking expansion but these are not the only ways for money to transfer and transform. So, stocks for example have several different other sources of funds such as corporate repurchases, or other foreign central banks, foreign sovereign wealth funds or any number of ways where stock prices can be disconnected from the Eurodollar system.

However, the Eurodollar system being a bank driven system especially in a global fashion is more economic related and I think that's why you seem the economy being so bad after 2008 which is keeping very much in concert with what you see in the Eurodollar dimension,

I think I should add that what I've presented here in terms of money supply isn’t actual money supply it’s these various different dimensions of these Eurodollar capacities. Derivatives are one of the reasons that the Eurodollar system grew rapidly. It grew rapidly regardless of what monetary policy was prior to 2007, 2008.

So, without that kind of bank balance sheet expansions, what we're really looking at here is the degree of banks who are willing to extend balance sheet capacity and consequently unwilling to extend that balance sheet capacity so it further add to this idea that the banks since 2007 have been missing from what is a bank driven currency and so that's an enormous problem.

Erik: On page 13 you're talking about the U.S. dollar index and bringing that into this story and of course the dollar rally has been the biggest story in macro for the last couple of years.

So, Jeff the most common narrative that you hear in the industry is that the dollar rally is primarily due to reflationary policies that President Trumps focus on demanding that repatriation of assets by major U.S. based international corporations is the big driver of all this strength that we're seeing in the dollar, Jeff do you agree with that narrative or is there another story here that most people are missing?

Jeffrey: Yeah, I could not disagree with that more. The dollar index rose more so in 2014 and early 2015 than it has recently and the last thing that we could describe that period was reflation.

In fact, the dollar started to rise as a consequence what we're really talking about here where I say a rising dollars is a euphemism for a dollar shortage and if you think about the dollar shortage as sort of a synthetic short position that global banks hold a rising dollar makes sense because whenever you get into a short squeeze the price of whatever is being squeezed usually skyrockets.

So, that's kind of the way I think about the exchange value of the dollar. The rise in it tells us that the dollar conditions or the dollar shortage has become that much more acute which is exactly what happened in 2014 and 2015 we had various central banks all over the world step into the dollar markets with ad hoc emergency programs which are usually captured in the in the upper level tic statistics on selling U.S. treasury because these central banks are selling treasuries in order to fill the dollar funding gap it only goes that much larger and that much more problematic.

So, the rising dollar to me is not about economic strength at all. It's about the fragility in the malfunction of the global Eurodollar system as banks further retreat from it. So as the private banking system gets out of money dealings, central banks are forced to try to offset that withdrawal as best they possibly can and obviously with central banks they usually can't do that very well at all and certainly not on a sustained basis.

Erik: On page 14 it looks like the summer of 2014 about the time that crude oil peaked was where a massive sell off in Treasury holdings owned by foreigners began. So, what's going on here and what's special about the summer of 2014?

Jeffrey: There is any number of events to explain why there was such an inflection but you're right to bring in oil prices here because oil prices obviously relate to dollar conditions as well. The commodity collapse that started at that point is very much related to the dollar shortage going that much worse.

What you see on page 14, it's the official sector, foreign central banks primarily are selling off treasuries as much as they can without disrupting their own reserve positions in order to fill dollar gaps that are left behind as the dollar system and the dollar shortage get that much worse.

So, there has been a lot made about why are foreigners selling treasuries and a lot of it is completely wrong because a lot of really much relates mostly to the fact that there's a dollar shortage that has gotten that much worse and that it had destabilized foreign economies to such a high degree that they had no choice but to intervene in ways that they

are usually are very reluctant to do so and they've intervened very heavily.

Erik: On page 15 you're showing yet again that there is a massive shortage of U.S. dollars but I feel like there's something missing from this story Jeff because you just showed us at page 14 that there's been this massive sale of U.S. treasuries and it would seem natural to me to think if you sell a whole bunch of treasuries for dollars that would increase the surplus of Eurodollars but we're seeing the exact opposite. So where are the proceeds of all of those treasury sales going if they're not creating more Eurodollars?

Jeffrey: What you see in 15 is where they're going – again were going back to the TIC data – and its foreign official institutions injecting dollars into banks. So on the one hand they're selling their pile of treasuries to raise dollars and then those dollars not remaining on account in the hands of the foreign central banks, they're being lent, they're being forwarded, they're being all sorts of different transactions to banks in the U.S. and banks elsewhere because the private money beyond system hasn't retreated from these places and so it's kind of a last resort effort and sort of the other side of the chart before which shows the selling of the treasuries. So, we have the selling of the treasuries and then where did those dollars end up.

So, it's not cumulatively an addition to the Eurodollar system but rather an attended offset to the overall private withdrawal and of course it's nowhere near the same size and scale which is why we have the problem and of course that's the nature of central banking. Central banks always respond and they leave the dollar short.

Erik: On page 17 you've described in detail how international trade creates demand for Eurodollars. So, I'll leave it to our listeners to read that one on their own.

Moving on to page 18 you're asserting that the Bretton Woods system was effectively replaced by the Eurodollar system way back in the 1960's. So, that begs some explanation. I mean prior to 1971 we still had gold convertibility of the U.S. dollar. So how and why did your Eurodollars become so important way back in the 1960's?

Jeffrey: There's a couple reasons and I should state at the beginning that we don't really know how the Eurodollar market started. There's any number of stories for it. One of the primary stories you hear is that the Soviet Union fearful of depositing dollars that they obtained in the natural course of economic business didn't want to deposit them in American banks so they started depositing them in European banks fearful of the political consequences of, perhaps the Kennedy administration was going to confiscate Soviet balances and such.

There's other stories for how the Eurodollar got started. But the way in which it started it doesn't matter so much as what happened after it was started throughout the 1960's it experienced rapid growth and all happened pretty much underneath the radar until that by 1971 there was a tremendously deep Eurodollar market already in existence that when Nixon actually closed the gold window there was something there already there that had already taken much of its place.

So instead of converting dollar balances into gold, Central Bank throughout the 1960 had been converting dollar balances into Eurodollar balances and they had done so primarily to circumvent the Bretton Woods system.

I'll give you an example, the Swiss National Bank in the early 60's had a statutory

requirement where if they obtained a certain amount of dollars – I forget what the exact level was – but past a certain balance of dollars that they acquired in keeping the franc steady as a fixed currency regime, past that certain point they were required to convert those dollars into U.S. gold but rather than do that, the Swiss National Bank had interests that coincided with the U.S. federal reserve, the Bank of England and others who had formed the London gold pool in 1960 so as to limit the decline in U.S. gold stock.

The Swiss National Bank in particular would swap these balances above their threshold into the Eurodollar market. So, the Eurodollar markets throughout the 1960 grew in a lot of ways due to official interventions in it they were already intending to get around the Bretton Woods System as it was.

So, by the time in the early 70's the Eurodollar system was already functioning in a capacity for global dollar liquidity.

Erik: On page 19 we're looking at Chinese Yuan exchange rates and banking reserve ratios. So how does that play into this dollar shortage story?

Jeffrey: What you see is that Chinese currency exchange is a very good proxy for the dollar supply, Eurodollar supply in all these various formats. Since they removed the peg in 2005, it appreciated and it appreciated rather steadily and often very quickly which matched the inflow of dollars from the Eurodollar market which most people know is hot money because of that tremendous inflow the Chinese were forced to restrict its effect on internal R. and D. liquidity amongst its banks. So, that's why you see a very good relationship between the currency exchange rate and the R. and R. which is the required reserves from largest banks.

So as dollars were flowing into China the currency exchange rate appreciated and the PBOC had to tighten internal liquidity because of that. After 2013 everything reversed and so you have the falling C.N.Y rate as well as the falling Rand R rate which tells us again the severity and degree of the dollar problem that is facing China.

Erik: The next few slides are about the Brazilian Real now are you trying to make a point here about Brazil in specific or are you just using Brazil to further support your argument for the dollar shortage and what are these lines telling us?

Jeffrey: Brazil has a similar situation as the Chinese do that their short of dollars and after 2013 that short became a very big problem as we know the Real depreciation similar to CNY appreciation without getting into too much detail about how the Brazilian dollar market actually works which is kind of complex and counterintuitive. What you see there is the Banco do Brazil, the Brazilian Central Bank efforts to combat – once again – the dollar shortage by taking short dollar swap position potentially and so it's further confirmation of the global nature of the Eurodollar banking problem.

The absence of the Eurodollar banks in all of these places creates this dollar shortage that we call the rising dollar essentially. So, the currency regime or the currency exchange rates that we see all over the world aren't necessarily prices about what is each economy doing so much as a barometer for the dollar system as a whole.

Erik: On page 23 it looks like inflation breakevens really started to take off again just around the time that you were last on Macro Voices last summer. So, what's going on there? Why are

inflation breakevens taking off and what does this chart tell us in general?

Jeffrey: Nothing ever happens in a straight line even the Eurodollar problem has not been a singular event. It's not been a decade long straight line of decay and dysfunction. It has been some specific episodes 2008 was a specific dollar episode, 2011was a specific dollar episode, 2013, 2014 again same thing.

What happens is in between the specific dollar episodes' things that really dark in the economy as well as markets start to look really bad, in between these dollar events people started to be relieved, things start to look a little bit better as markets often do. There's a retracement passed whatever, a pessimistic bottom has been reached within those dollar episodes and so every instance of a reflation that we've experienced so far has been after a specific dollar event has ended and a renewed sense of hope has taken its place.

That happened again in July 2016 as the dollar event ended on February 11th last year and. so by July enough time had passed and enough distance had been put behind that people started to be more hopeful about the economic future.

But we shouldn't confuse that with actual recovery. What we're dealing with is probability distribution and so we're reflating in the sense, especially this last one, last year, isn't even really as enthusiastic or strong as any other prior reflation events for that very reason. The fact that after enough time these markets have adjusted to the fact that the economy's going to be bad for a very long time until something actually changes and so true reflation is predicated on something actually changing rather than the hope that something might change.

Erik: When the Fed announced quantitative easing a lot of us worried that if they printed too many dollars that could lead to runaway inflation. But you have a completely different view. So please explain what the graphs on page 24 are telling us?

Jeffrey: That was actually the first instance in my view of reflation it was the idea back in 2007 that there was this problem that nobody really understood but everybody thought OK it's probably a serious problem but it's – subprime mortgages, there are some financial irregularities and banks are starting to make some noises but at that time the degree of faith in the federal reserve was still relatively high, relatively high than it was in the late 90's of course but people still had a lot of faith that the Fed was going to fix everything.

As everything progressed in 2007 as you see later that year it started to become more of not only will the feds fix it but because of the severity they might overdo it. So, there was a fear that the Fed was going to over-stimulate so as to counteract the subprime mortgage problem that was spreading.

So, all the way up until July 2008 that was a prevailing view that the Fed was not only going to be successful it was going to be too successful and they started hedging against inflationary possibilities because of that fact and not only would we avoid recession the Fed was going to go too far and spur inflation on the other side of the minor subprime mortgage cycle.

What happened in July 2008 obviously was the fact that everyone decided almost all at once that wasn't the right interpretation of what the Fed was doing nor was it the right interpretation of the dollar system overall.

So, that reflation ended in reality which was the dollar system was eroding and it was eroding in a very dangerous way and that's why oil prices essentially crashed from July till I think January 2009.

The Chinese Yuan forced the PBOC back into the currency market to peg it all over again at almost exactly the same moment. It's almost like somebody flipped the switch where the myth of the Fed fell from everybody's eyes and then it brought the reality of the dollar system which was nothing like what everybody thought it was.

Erik: On page 25 you seem to be saying that we're basically stuck in a trap where we're going to have super low interest rates and the Fed can't really do anything to change it but hang on a second because the Fed always can raise policy rates and unless you think we're going to have a sustained inverted yield curve, it would seem reasonable to assume that longer term rates have to eventually follow suit. So why do you think that we're trapped here with low interest rates?

Jeffrey: I think with the Eurodollar markets; Eurodollar futures market in particular is saying is that if the Fed is going to raise rates it's not to raise rates for a long or it's not going to be able to raise rates for long.

If the yield curve happens to invert again if they ever get that far then it will immediately like 2005 or 2006 all over again it won't stay that way for very long either the market will force the Feds' hand or the Fed will realize the error and correct it.

But I think what's important about this is that in each of these reflation episodes you can clearly see the market's faith in that reflation diminishes each time for these very reasons that we're talking about because these markets have become attuned to the fact the Fed isn't exactly what everybody thought it was, monetary policy isn't what everybody thought it was.

Sure, they can control the federal funds rate but as we noted at the outset without hierarchy in money markets what does that actually mean? It doesn't actually mean a whole lot. So, what you see in the Eurodollar futures curved especially recently how much flatter it's been, how shriveled it's been compared to last bouts of reflation reflects the fact that there is a sense of powerlessness about doing what we can do to get out of this mess.

In fact, it's no matter what the Fed does we're kind of stuck and until something actually changes in a meaningful fashion we're going to remain stuck for the long term. By the way I think I should add the Federal Reserve actually agrees with that assessment.

Erik: On pages 26, 27 and 28 you are comparing the 2013 and 2016 reflations using treasury spreads which of course is the difference between interest rates at various different treasury maturities. So, what are these slides telling us?

Jeffrey: It's the same kind of thing I was just talking earlier about the futures It's another part of the markets that reflect upon the idea that the probability scenarios for economic and financial future are much darker now than they were three years ago.

The last reflation 2013 when people were positive of recovery due to tapering of QE, it was much more robust, it was much more enthusiastic it was much wider and a broader

adoption. Whereas now I think it's almost more of a media creation than an actual market creation.

Yeah nominal rates have risen but the yield curve, the Eurodollar futures have not budged that much and the reason is again for the same thing that we've been talking about all along the fact that these markets realize that there's a problem in Eurodollar system, there's no banking to be had, no additional marginal banking capacity being added and without it none of these stuff really matters, none of these other stuff really matters. That's the only thing that truly matters.

So, if the nominal Treasury rates rise somewhat, that just tells us a little bit about the immediate future rather than what the yield curve tells us about the long run prospect.

Erik: On page 30 we see that the 30-year swap spreads are starting to go positive just briefly in the summer of 2013 but they stay very firmly in negative territory in the 2016 reflation. So, what's the significance of this?

Jeffrey: The 30 year swaps trade has been negative consistently since 2008. So, for several years there it was an indication, sort of a thorn in the side of the Federal Reserve that something still wasn't right no matter how many QEs they had done no matter what it didn't correct and it was a very prominent signal that something remained wrong.

For a brief moment in the middle of 2013, the spread went positive again and it was a signal to many people and not without reason that reflation was actually real this time, that there was a recovery coming. So, things were actually going to normalize with the swaps spread going positive again and again getting back to hierarchy it suggested that maybe banks were coming back into the system and therefore the probability of an actual full recovery might be right in a very real and meaningful sense.

Of course, it didn't prove to be the case and in fact that particular spread proved to be fleeting. Where it really turned was again in 2014 early 2015 with the reintroduction of the dollar shortage as a rising dollar. So, the difference between 2013 and 2016 seems to be that the swap market is in the fold again.

Erik: So, if I summarize everything that we've discussed so far Jeff you've basically presented a mountain of evidence from a number of different angles all coming to the same conclusion which is that we have a global shortage of U.S. dollars available outside of the United States.

There's not enough U.S. dollars available to support the international monetary system and for some reason there's a breakdown where the bankers are not doing their job and they're actually leaving risk free profit opportunities on the table and you contend that all of this puts us in an interest rate trap that you believe the Fed cannot fix no matter what they do that we're going to be stuck here.

So, what conclusions do we draw from this what is this going to mean for the global economy in the next few years and what do the last couple of slides in your chart book tell us about that story?

Jeffrey: I think what it means overall is until we fix the global dollar problem we're not going to fix the global economy and so we're kind of stuck gyrating between various levels of really bad. We go from the lack of recovery to what looks like a global recession to the lack of

recovery and back again.

So, I don't think that changes and that's why I think reflation is going to fail. That's also why I think reflation isn't that the enthusiastically embraced as it is now because I think a lot of these markets come to the same conclusion that without banking capacity the Eurodollar market doesn't work and it doesn't appear that banks are coming back into this anytime soon and without them there's really no chance of getting out of this rut.

We've already lost one decade to it and it looks like, I hate to think of what the next decade might look like because history is not very kind in these kinds of situations where you have prolonged periods of stagnation.

I know the Japanese have put a quarter century into that condition already but the rest of the world doesn't have that kind of social stability to allow prolonged stagnation or worse. So, we have to at least consider how we get out of it.

Whereas the Fed on the other hand because of how they've defined the last ten years no longer believes that it's in its interest to do anything in other words monetary policy operates in what's called the output cap which is simply the difference between current output and their estimated level of potential. Monetary policy is specifically tailored to demand side and the supply side therefore I find that’s the problem which is potential or trend and there's nothing that the Fed can do about it.

So, what the Fed has done in the last couple of years by raising interest rates twice maybe doing so again your future, is they've essentially not validated the idea that there's going to be a recovery rather the opposite condition that there won't ever be a recovery because what they've essentially said is that trend has been so deteriorated that there is nothing left for them to do. There's no more positive output gap for them to stimulate into.

And so, without a positive output gap there's no sense in doing anything at all which is one of the reasons why the Fed has been kind of cool as to the suggestions of what the Trump administration might do in terms of infrastructure spending and fiscal stimulus. In a situation where there is no output gap from their perspective there's nothing for stimulus to actually accomplish.

So, I think that's a tremendous problem to not for the obvious reasons that we want them to do more QE or go back to zero interest rates again but we want them to actually believe that there is something for them to do that’s different than those things which is to actually view the dollar system as it is rather than how they continue to think it is which isn't what it is.

In other words, we want them to start considering the global currency system and how it actually is operating and failing rather than their stylized academic approach which doesn't apply. And until they're actually convinced that there is a role for the central bank in that condition output gap or not, we're kind of stuck.

Erik: Jeff as I listen to you talking about all this, I can't help but think like a politician you’re saying there's this huge shortage of dollars and rather than think about what the right solution is to that, it sounds to me if you think like a politician, like an invitation. Why not do a whole bunch more money printing it sounds like you're saying we've got lots of capacity to do that. So, can there in should there be another round of quantitative easing

from the Fed and if not why not?

Jeffrey: Well I don't think there can be or should there be there's a couple reasons for that. I don't know how the Fed would actually interject anything that they do into the Eurodollar market. Statutorily they're prevented from any kind of foreign interventions. When they did the dollar swaps in late 2008 those were limited to other foreign central banks and there was a great deal of consternation about the legality of it.

So, I don't know how the Fed would if it ever intended to do say something like a QEE which would be a QE Eurodollar so I don't know how they'd get into the Eurodollar market and furthermore the Eurodollar is much more than just bank reserves how would affect for example cross currency basis swaps? Would they start taking the other side of those trades? So, there's a whole bunch of functional issues that would argue against any kind of intervention or any successful intervention.

But beyond that what we're describing with the dollar shortage doesn't necessarily propose a money supply solution. I think what we're seeing with the dollar shortage isn't so much the shortage per se it's the fact that it's a symptom of what is an inherently unstable system and I think that's the answers that we need to start defining.

The fact that the issue isn't supply quantity more or less but rather the instability of it and so there's a shortage I think because the fact that the post crisis period has been entirely unstable and getting more so. So, the reason banks are withdrawing from the system is that it's just is no longer tenable.

So, the answer is not how do we increase the amount of more unstable currency but to eliminate the instability in the currency altogether so that's not going to be accomplished by QE and I think the only way it is accomplished is if we affect actual banking in currency reform that is not just piecemeal, ad hoc and segmented.

So there has to be some kind of – whether you want to look at it like another Bretton Woods – conference, a global monetary system, a global monetary get together where people start to analyze solutions to the problem as they are rather than keep trying to apply band aids that are not going to work.

Erik: So is there something that can and should be done here is it time-- let's imagine that you were put in charge of the world and could do anything, you say call another Bretton Woods like conference. What should central bankers do at this conference? What action should be taken to solve this dollar shortage and get the economy back on track?

Jeffrey: I think the first thing that needs to be done is to define the parameters that are required for a global recovery and what do we mean by a stable currency, what do we mean by a stable system, how do we go about achieving those kinds of things and there are no easy answers here.

In fact, I would argue that doing a QE is much easier than trying to tackle these issues because you're talking about all of them across many different types of transactions and financial arrangements but you also have all sorts of differences and currency systems and banking systems and so analyzing a globally stable system is incredibly difficult. We know that from experience the Bretton Woods itself only functionally lasted about 15 years, the London gold pool in 1960 was essentially the fault of the Bretton Woods System.

So, it's a Herculean task that lays ahead but step one of that task is to actually recognize the problem as it is and so doing more stimulus or doing more QE isn't going to solve anything it isn’t do anything just like prior QEs and prior stimulus haven't done anything either because the problem is an unstable system.

Erik: Jeff I would love to pick your brain for another hour on this but unfortunately, we're coming up against our time limit before we close I just want to touch on what you do there at Alhambra Partners, I know that you're a registered investment advisor. What services do you offer and where can people find out more information about your work?

Jeffrey: As you said we’re a retail investment advisor, located and headquartered in Florida. They could find us at alhambrapartners.com and we do portfolio management services.

Erik: Fantastic, well I cannot thank you enough for another fantastic interview Jeff. I can't wait to get you back on the program next time to get an update. Patrick Ceresna and I will be back as Macro Voices continues right here macrovoices.com.

[End of interview]