Louis-Vincent Gave: Translating 2016 Events to 2017 Strategies
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Erik: Joining me next on the program is Louis Vincent Gave of course from a very famous institutional advisor firm Gavekal headquartered in Hong Kong. Louis thanks so much for joining us.

I want to start by talking about you being headquartered in Hong Kong there. This whole China reflation trade, a year ago, the buzz was, "hey 2016 is going to be the year where China is forced to devalue markedly and that will send a massive deflationary shockwave around the world." Well it didn't happen in 2016, how do you see this, is that really a risk, is that the right story, what's going on with China?

Louis: To be honest, you're absolutely right, that's been one of the biggest surprises of 2016. I think if you look back at the past year most people – and you talk about the surprises – most people talk about Trump and they talk about Brexit because this is what makes newspaper headlines. But you're absolutely right that a year ago, everyone thought China was going to implode.

Instead of imploding the government obviously re-stimulated the economy. You saw big spending from state owned enterprises, you saw oil imports go up 24% year on year in the first quarter, iron ore imports, copper imports everything goes through the roof in the first half of 2016 and instead of imploding China turned out to be reflationary force for the rest of the world to the point where actually today everybody talks about the Trump-flation and how the U.S. election has triggered a big reflationary trade for the world, for me it's not as much Trump and what's happening in the U.S. really as what occurred in China we had another round of fiscal stimulus just like we had in 2009,2010 and this led to rebound in commodities, rebound in Baltic Dry Index, rebound in steel prices.

Now interestingly I think if you project yourself forward to this summer – China basically stopped stimulating around the summer of 2016 and in fact starting in November, they started to tighten monetary policy, started to raise interest rates, started to lean on the banks to lend less – so if you project yourself to this summer the big risk for me is that perhaps – now there's reasons to think that reflation trade will continue and we can maybe go into that – but one of the risk is that as Chinese growth rolls over as the year on year comparisons for China get tougher what you will see in China is weaker growth starting this summer and that might start to curtail the reflation trade you're seeing on the markets today.

Erik: So, do you buy the story that we are returning to a secular increase in inflation or do you think this is temporary and maybe going to roll over as you said in the summer when this reflation trade sort of runs out of steam.

Louis: I don't want to answer like a Jesuit and answer your question with another question but it really depends and to be honest it really depends on what you think happens to the U.S. dollar from here.

I tend to think that Donald Trump will do everything he can to make sure that the U.S. dollar does not go up because at this point if Donald Trump wants to be reelected and let's face it, most presidents want to be reelected Donald Trump wants to be reelected he'll need to carry the Midwest, Michigan, Indiana, Ohio etc. in the next election. The only way you do that is if you bring back manufacturing jobs and the only way you bring back manufacturing jobs is if you get a weaker U.S. dollar.

And today the U.S. dollar is too strong for us manufacturing and in the very first interview that Donald Trump made following his swearing in with the Wall Street Journal his first point was that he wanted the U.S. dollar to go down.

Now if you think that Donald Trump will be successful in bringing down the U.S. dollar and again that's a big if – I happen to believe he will be – but if you think he will be successful in doing that then yes most likely inflation will pick up specially here in the U.S. because everything you import from abroad will start costing more.

Erik: And it's interesting that you see it that way. I couldn't agree more that Donald Trump very much needs to try to accomplish a lower dollar but a lot of people would say that the very policies that he's pursuing in order to achieve what you just described, getting manufacturing back into the U.S., he's really pressuring a lot of multinationals to repatriate assets to the U.S. which of course creates a dollar demand at least in the short run and I think a lot of analysts are seeing that as dollar bullish do you see it differently or how would you explain that apparent paradox?

Louis: Yeah, I think that's the corner in the big uncertainty in markets there, you're absolutely right. So, if you're Donald Trump you know the outcome that you want. You know that you want the U.S. dollar to go down. The question is how do you get there and do you get there by imposing protectionist measures on the rest of the world? Well if you do that as we saw with all the bashing of Mexico you actually drive other people's currencies lower. So, it's obviously not a good outcome for you.

So, beating the protectionist drum again as you've seen with Mexico with the peso going like 18 to 23 very, very quickly becomes in essence self-defeating even if you say we're going to slap a 30% tariff on Mexico if at the same time, you have a 30% devaluation of the currency you're right back where you started.

So I think what Donald Trump will try to do and let's not forget he sees himself as dealmaker is sit down bilaterally with country to country, and he's already started with Germany, I think he started to some extent with Japan and he'll do the same with China, sit down with country to country and say look you guys have to revalue your currency at the very least your currencies can't go down anymore or there will be protectionism and repercussions on your businesses here in the U.S. and so it'll be a give and take.

Now you can say, well, he thinks himself a dealmaker but that doesn't mean he has one and he won't manage to bully other central banks and other governments into changing their policies. There is a historical precedent for this of course which is in the 80's. In the mid 80's Reagan administration got everybody together in Paris, you have the Louvre Accord, the

Plaza Accord where every central bank and every big Ministry of Finance agreed to basically prevent the U.S. dollar from rising any further after the huge rise of the early 80's and this triggered an enormous boom in emerging markets, it triggered an enormous boom in Japan because back then just as in today one of the big risk for investors, when you deploy capital in markets, in emerging markets or back then in Japan, was that the currency would go down. Take away that risk and all of sudden not only local investors but foreign investors as well find the valuation gap prevailing in all those markets extremely compelling.

You know if you look at Asia today we're trading roughly at 11, 12 times running against 80 times for the U.S. The reason for that partly is the fear of currency devaluations. You remove that fear and all of a sudden you get a mass boom all around the world and with that I think an outperformance of the rest of the world and the U.S. dollar that stays capped.

So, this is by the way the same thing that you saw in 2003 when Bernanke came out with his famous helicopter speech that was the starting gun for a massive emerging market boom because once again the biggest risk in emerging markets very often is that the U.S. dollar goes up, remove that risk and you get a tremendous boom.

Erik: And a lot of analysts have been very concerned about this massive debt overhang that has grown in China since 2008. Kyle Bass probably being the most outspoken saying that it all has to blow up and it's going to force China to markedly devalue in order to recap their banking system.

Do you see this overhang of debt in China as big of an issue as some people are saying or do you have a different view?

Louis: I have a different view; no doubt debt has grown in China and it is not a healthy development. Like most other countries in the world China has seen a much faster growth in its debt than in its G.D.P. I mean if you look at the U.S. as an example under President Obama total government debt grew by seven trillion U.S. dollars for a one trillion dollar increase and in U.S. G.D.P. so it is not just a Chinese phenomenon it's everywhere around the world, you're seeing faster and faster increasing in debts relative to growth. So, you could say everywhere this is really a negative development.

Now when it comes to China I think when you look at potential debt crisis, you have to remember that debt crisis come in one or two forms. The first if you have a country that basically lives above its means. That runs large current account deficits for years and it depends on the willingness of strangers to fund that debt.

Now this is not going to happen in China. You know foreigners have not been funding Chinese debts so the sort of Argentine or Greek or Spanish scenario where one day foreigners wake up and say you know what, I don’t want to buy any more Greek bonds. I don’t want to buy any more Argentinian bonds isn't going to happen in China for the simple reason that foreigners do not own any Chinese debt today. The entire increase in Chinese debt has been funded wholly by Chinese savings.

So, then the question becomes can you get the second kind of crisis? And the second kind of crisis is you get a real estate boom and banks love lending to real estate and banks one day basically outgrow their own deposits.

They need to get more money to continue to the lending and so they borrow short to lend long. They borrow money from money markets, they borrow money from bond markets and basically that way [indiscernible 00:09:37] because borrowing short to lend long is a very ledger balance sheet extremely, extremely threatened at the first time of a potential reversal.

So, the question is you know could we have this kind of crisis in China? Well no, well not yet at least because Chinese banks today are still funded almost exclusively on domestic deposits. So, the only scenario you can get to a bank crisis in China is massive bankruptcy. That's basically the moment folks decide I want to take my money out of the bank.

But frankly that's a scenario you can make anywhere. You know if tomorrow I tell you 30% of Americans will want to take their money out of American banks then the American banks will go bust and the same in France and the same in Sweden.

And so, the way you have to conceptualize Chinese banks today is that yes, they're poorly run institutions but they're actually extremely conservatively run institutions. They're not very leveraged, they have very high reserve requirements. If you look at total Chinese debt, total Chinese debt it's equal to one time bank deposits. If look at the U.S. Its two and a half time banks deposits.

So, the reality is China can still leverage up because the leverage is a fairly new and recent phenomenon in China now of course the pace is quite fast but because you start from such a low pace you can still go for quite a while.

Erik: Let's go around the world to the site of the next major event of 2016 which of course was Brexit some people feel that that last rally in the bond market might have marked a top in the secular bull market and bonds might be over, some people are saying that the E.U. is doomed that Brexit was the beginning of the end, other people are saying it's just a flash in the pan and nothing to worry about.

How do you see the significance of Brexit and let's expand the question to what's your outlook for the future of the European Union?

Louis: Well, we could spend hours on this one alone. I think Brexit was the first sign indeed that the European Union is a doomed project. Basically, I think England was right. It's you know basically pulling the plug on a project that doesn't work.

When you see the economic misery in Greece, the economic misery in Italy, the economic misery Portugal it is obvious that European construct has failed if not the majority at least a very significant proportion of the European population where if you look at Italy standards of living, G.D.P. per capita stands at basically below where it was 20 years ago, same for Greece same for Portugal etc.

So, the European Union has been a failure and so Britain decided you know what given this failure we'll be heading out now thank you, we'll be checking out.

Now does that mean that the unraveling of the European Union is upon us, to be honest I think it's going to take a long time partly because so much political capital has been invested in this. So many careers, so many bureaucrats are tied up and heavily invested into the European Union that it's hard to see it unravel in just a year but you could say well the unraveling really started five years ago with the European crisis and we're just going through the motions but you have, you know as an investor what we have to realize is there's a lot of embedded interests which we'll fight tooth and nail to keep this thing going the least of which of course the European Central Bank which given its printing press does have significant powers.

So, making money on the breakup of the European Union is not an easy task what it does mean is that structurally while this construct is still going on, the European Union is not a great place to deploy capital and frankly if look at the relative performance of European equities today we're at the same low levels as we were in 2012 and 13 in the midst of the European crisis. Europe has been a bad place to deploy capital.

Now I actually think that cyclically for the next six to nine months Europe will most likely do very decently well. European equities I think in the next six to nine months will do very well. So, it's a good cyclically trade on the back of stable oil price, weak euro, easy monetary policy and perhaps a political risk that today is overplayed, the fear of Marine Le Pen which I still don't believe will be the French president, so once it becomes clear that Marine Le Pen won't win you'll probably get a relief rally.

But structurally for me Brexit and the doomed European Union, means that structurally this is not a great place to deploy capital. Cyclically you may want to play some rebounds here and there and the next six months could be a good opportunity but structurally I still think that Asia is a much better story than the European Union.

Erik: I want to touch on another international development, so many eyes were on Brexit in the E.U. but around the world back in the Philippines they elected a new president Duterte who has basically kind of told the U.S. to get lost and is re-affiliating that country with China and it makes me wonder is this just one guy who's got a crazy attitude or is it maybe an indication of things to come in terms of U.S. foreign relations and what does this mean for the Trump presidency if long time alliances are kind of switching teams sort of speak and do you see more coming along the same lines?

Louis: I do see more coming and you're absolutely right for me Duterte's election was actually a very big deal because here was a guy running in the Philippines and put this in context the Philippines has historically been one of the staunchest U.S. allies across the Asian Pacific region. It's a very key geostrategic point because you control all the eastern sea side of the South China Sea. The U.S. historically had military bases there or military presence and you know it used to be a U.S. colony so the ties between the Philippines and U.S. go way, way back anyway.

Anyway, this guy runs, Duterte, during the election and during the campaign he basically says look China has been encroaching on our reefs for the past five years. We're obviously not going to go to war with China because we don't have a navy, we don't have an air force, we'd get our ass kicked so instead we've asked the U.S. for help but really the U.S. is an unreliable ally and we've done absolutely nothing for us.

So, what I'm going to do as soon as I'm elected. I'm going to go to Beijing. I'm going to sit down with Xi Jinping and I'm going to tell him look you can keep these islands but against that we want investments in ports, airports, power plants, roads, railways, basically the infrastructure that the Philippines lacks today to be a genuine first world nation because actually the Philippines has a decently educated population, they've got an English-speaking population what they clearly lack is decent infrastructure.

So, Duterte gets elected and sure enough goes to Beijing and turns around and then tells us to get lost. Now this is a massive coup for China. Xi Jinping since he's arrived has been very clear that China now had imperial ambitions.

If I could summarize Xi Jinping's program in one sentence I would say that Xi Jinping main goal is to make China great again. He sees China as the center of a broader Asian Empire and basically all China's neighbors tied economically to Beijing and to the Chinese economy.

Now empire building is fundamentally a road building exercise. There's a reason in Europe we say all roads lead to Rome. Empires build roads to bring commodities in cheaper and push finished goods out to the outer realms of the empire and when you listen to Xi Jinping all he talks about is one road, one belt, the silk road fund, the Asia infrastructure investment banking, so on and so forth.

So, the Philippines moving away from the U.S. empire into the Chinese empire for me is a big deal it's a sign of things to come. Another big domino that fell this past year has been Malaysia.

Now one interesting point on this is you know the U.S. administration if you remember President Obama's pivot to Asia, the core of the Obama administration was trying to contain China with big trade agreements with all of America's friends around Asia, the transpacific partnership and of course the first thing Donald Trump did when he came in was to put the transpacific partnership into the bin.

So, imagine if you're a country like Indonesia or a country like Thailand and a year or two ago you were told don't side with China stay with us, we'll give you some trade deals. It will all work and the next guy comes in and says no trade deal for you meanwhile China is knocking on your door and saying hey how would you like some money to develop roads, to develop power plants. It's pretty easy to see why more and more countries are deciding, well maybe I should play the China card after all.

So, for me this rise of the Chinese empire is one of the single most important macro development, the Duterte win really crystallizes the switch and yet in the western world very few people are talking about it.

Erik: Another big event of 2016 was over in India where 80% of the outstanding value of the currency system was taken out of circulation when they retired the largest denomination bank notes.

This is a story that's obviously very, very significant there but didn't get a whole lot of press coverage in the United States. So, what's going on there, what's the motive, why would they do this, what are the consequences, what does it mean?

Louis: Well actually it was 85%, so it's basically equivalent – if you think of the US – it would be equivalent of the government turning around one morning and saying, "hey, the hundred dollar notes and the 50 dollars notes are no longer legal tender you've got two or three weeks to bring them in to the bank to get smaller notes and by the way if you bring in more than ten thousand dollars in notes you better have a good explanation as to why you have so much money."

This is pretty much what happened in India in November and yes it took most investors by surprise. You had a 20% dip in the Indian stock market and I think frankly also a dip in gold as a lot of Indian entrepreneurs were scrambling for cash and thus had to either sell some of their equities or sell some of their gold to basically pay the parallel payments that they often have to make.

Now why did Modi do this? I think in every emerging market's development curve, all emerging markets and this is true also by the way of Singapore and Hong Kong, Taiwan, the successful emerging markets it starts off with a decently high level of corruption why because frankly corruption helps grease the wheels of the system, it helps economic activity move on.

You know if you think of the U.S. the U.S. doesn't have much corruption but it has an extremely costly deal system. Lots of lawyers, lots of judges, time spent in court etc. Now this is of course good to have such a strong judicial system for an economy that can afford it but if you're a poor economy you can't afford to have all these lawyers and judges etc. and so corruption comes in and allows business to move forward without all the legal apparatus that weighs down the economy.

However, you get to a certain level of growth and corruption instead of helping growth starts to hinder growth. It starts to basically mean that you can only do business with people you know not people you don't know and it becomes a real break to potential economic development and I think this is why China has gone through a massive anti-corruption drive in the past five years.

The other sentence you could use to describe Xi Jinping is he puts more than forty thousand senior party members in jail. So clearly, he's been draining the swamp and I think Modi is seeing his role as something similar. Corruption in India today is a real issue. It does prevent economic growth and how do you tackle it?

Well one way to tackle it, is to do like Xi Jinping a put 40 thousand people in jail. However, in India the government doesn't have the same autocratic advantages that you have in China and so that's not really an option.

So, he came up with the next option well let's target cash which after all is the number one way to get corruption done and now I think for India in the short term it obviously put a big hit on the economy it was a hit, a self-imposed hit that came out of nowhere. I think for the long term it's actually positive. It's a positive development and hopefully one that will allow India to basically become more efficient in its use of capital, whether human capital or physical capital. It will allow people to not work just with the people they know but broaden out the economy and give more opportunities across the board to all the young people that are now joining the Indian economy.

Erik: I wanted to start with all those international topics because I know that you guys cover them so well but let's come back to the United States because we saw again this morning yet another record all time high on the S&P 500 and the view of investors seems to be that Donald Trump's deregulation and tax cut objectives just have to spell up, up and away from here. It's seems like nobody is paying attention to all of the talk of protectionism.

So, I wonder how do you see this Trump rally or I guess I should start by saying do you agree with the view that that's what's driving it and does it keep going or is this a blow off we're setting up for, what's happening here and perhaps related to that do you think at some point the dollar rally has to be stopped a Plaza Accord 2.0 or something like that?

Louis: Yeah great questions and I wish I had the answers. The way I look at it is I think people are focusing too much on Trump for the overall global rally because it's not just in the U.S. you know since the beginning of this year emerging markets have massively outperformed the U.S. and Europe and Japan are also doing OK. So, it's a global phenomenon it's not just the U.S. phenomenon.

Look I like tax cuts and I like deregulation as much as the next guy and I do think the U.S. will see deregulation I think the tax picture is curvy and it may be a while until all the ducks are in a row to get proper tax cuts in the U.S. So here perhaps you could say the market is getting ahead of itself.

But for me the big rally which is really a reflation trade rally, you know outperformance of materials, outperformance of cyclical, the outperformance of emerging markets really rests on two things at this point. It rests one on the stimulus that you got in China and that led to a rebound in Chinese growth that frankly the market was not expecting at all in fact the market was priced for the opposite. It was priced for a big slowdown in China instead we've got a reacceleration of growth but it's a reacceleration of growth that risks fading from the summer onwards. So, you know that puts a brake on your global reflation trade starting this summer.

Your second real I think catalyst for this the next move up was Donald Trump's speech on the U.S. dollar. As we've discussed before if the U.S. dollar is now capped if you believe the U.S. dollar no longer rises, then yes the reflation trade everywhere around the world makes sense and the market could reap higher just like the markets reaped hirer following the Louvre and the Plaza Accord in the mid 80's and we could be in such a phase.

If the U.S. dollar starts moving back up however and at the same time we start getting dodgier numbers out of China, then all of a sudden, the global picture will look a lot more daunting and even deregulation in the U.S. even with tax cuts in the U.S. I don't think they'll be enough to carry the market but for now we've got a U.S. administration that basically says U.S. dollar is not going to go up and the Chinese government that has been stimulating the economy with its money so you've got the two largest economies in the world that are sending fairly positive signals.

Add to that some decent data coming out of Europe which you know has done very little for five or six years and the scope for a decent cyclical rebound in Europe even though structurally there remains a lot of headwind as we discussed earlier, a cyclical background for Europe and you know the background isn't that bad.

Decent growth in Europe, U.S. keeping the dollar in check and China re-stimulating that makes for a pretty powerful combo on a lot of cyclical asset classes like emerging markets materials and all the other reflation trades.

Erik: We've touched now on equities and the dollar. Let's also include the other big asset class that you talked about in a recent piece that we're going to send to our subscribers which is both U.S. treasuries and other O.E.C.D. bonds. What's your outlook for fixed income?

Louis: Well look I think if the reflation trade is on between you know it's already started if like me you believe it goes into the summer then there's no real reason to jump into bonds today. Why do you own bonds at the end of the day, I think you own bonds for one of three reasons either because the offer tremendous value and for us that basically means real rate of above 3%.

When you get real rates of above 3% you just back up the truck and you buy bonds because that's the best structural growth rate the economy can reach. So, if bonds are offering you higher rates than the structural economy can offer you then you should back up the truck. Today obviously, we're not there.

You can also buy bonds if you think inflation and growth are going to be rolling over. That's when bonds really outperform and the third reason you buy bonds is to diversify an equity portfolio.

Now if you look at today real rates aren't at 3% almost it's hard to find real rates of 3% anywhere in the world growth and inflation are most likely still in an acceleration mode from now till the summer and so again as the inflation data ticks higher as the growth data ticks higher why would you really want to buy bonds and then the third option of course is to diversify equity risk and you know that's true at any one point.

So, really for me I look at bonds today and I think well the risk reward is just not that great but come this summer they may start to look a lot better because if I'm right about Chinese growth going over the summer then all of this on some of the inflation data that we've seen, some of the growth data that we've seen will start rolling over and if bond yields have picked up a little bit more by then the valuation will be more interesting. So, on bonds I think I'd be patient and start to go back in at some point this is summer.

Erik: Something I really enjoy about the way you guys think at Gavekal is you break your investment thesis into three categories, carry trades, mean reversion trades and momentum trades. So, let's just go through each category starting with carry trades. What do you see, where are the opportunities here as we look forward into 2017?

Louis: So, reason we do this by the way we split our investments into basically baskets is because I think you have to be very clear in your head that's why you're buying something. If you're buying something because it has terrific momentum and it's a growth story and you think something is going to the moon when the momentum turns, then you should just get rid of it.

But if you buy something because you think it's very cheap and it's a good attractive asset that the market is underpricing then the market then goes down another 20% then instead of selling it you should buy more.

And really and you know carry trades is the one basket where timing is especially important because changes in yield curves, changes in interest rates can move carry trades from being an attractive diversified portfolio to all of a sudden being source of significant capital losses.

Now there's no doubt if you look at the past six months that – and that by the way predates Trump's election, yields really bottomed in the summer – that the markets had been moving away from any kind of carry trade. Anything with a yield has really been getting crushed and for the reason that you and I just discussed it may still be that you know picking up yields over the next few months there's been no pick up just continue rising inflation and growth chasing yields will not be a very profitable endeavor. Still I think coming into the summer you'll want to have more yield in your portfolio.

And today where can you find yield? Well, you can still find it in U.S. M.L.P.'s which should benefit the energy sector deregulation in the U.S. that's one interesting area potentially same really with Canadian REITs.

As you get more energy deregulation in the U.S. as you get Keystone Pipeline etc. as the Trump administration makes it easier for Canadian oil to flow down into the US that should be good for the Canadian dollar so Canadian dollar REITs, Canadian dollar yields I think are interesting.

And then beyond that we've been long steadfast owners and believers and investors in the Chinese RMB bond markets. My view is that it's very simple if China wants to be an empire it can't do it on somebody else's dime. It has to basically transform the renminbi into Asia's trading and reserve currency which is what of course they're gradually doing.

It is of course the reason they're opening up their bond markets and their currency markets. If you're a Chinese technocrat control freak sitting in Beijing, why would you give up control of your interest rate and exchange rates you obviously do it because you think that there's something better on the other side and something better is turning the renminbi in to a reserve currency.

Now as the renminbi slowly, gradually becomes the reserve currency and we saw China join the SDR a year ago as the renminbi slowly becomes a reserve currency, what you have is an opportunity for Chinese bond yields to continue moving down and down and down and one of the interesting thing if you look at the past five years, if you'd invested a hundred dollars in Chinese bonds and a hundred dollars in U.S. treasuries, you would have done a whole lot better in Chinese bonds even with the currency devaluation simply because of the higher yields that prevail in China.

So, as I always tell our clients look, if you like your bonds to come with a yield then China's not a bad place to look the problem of course of most of the world today is that too many of the bond markets come with too little yields and thus instead of reducing your volatility in the portfolio, reducing the risk in your overall portfolio bonds today actually increase the risk because when bond yields are at 1% or 0.5 the slightest change in yield has a massive impact on the capital value of the bonds.

So, today I think, if you're chasing yields you have to chase yields in emerging market debts, whether in India, in Indonesia and in China all of which interests are very interesting to me and if you're constrained to the US. Then I think things like M.L.P.'s Canadian REITs are interesting.

Erik: And what about mean reversion and momentum trades?

Louis: So, mean reversion here the idea is you're looking for assets that are unloved, possibly contrarian, mispriced and basically been abandoned by everyone. And on this front I really like Hong Kong equities that are trading close to record lows in terms of price to book, in terms of PE's and definitely relative to U.S. very much at record lows.

So, I think Hong Kong equities are very, very cheap and that reflects partly the poor political situation that we've had Hong Kong for the past few years so that's one.

Number two, I really like the Mexican peso at this level. The Mexican peso has got to be one of the cheapest currencies. It's obviously gotten beaten up big time by Donald Trump's election. The news flow in Mexico has been terrible. But with the Mexican peso a 22 or 23 it is a currency that is now severely undervalued putting Mexico at a competitive advantage for a number of its manufacturing industries and whatever else.

And the other one a little bit like that that I really like is sterling. I think basically anybody who was long sterling has now thrown in the towel. Everybody, all the financials have come out of the U.K. and out of the fear of Brexit and the Brexit uncertainty and meanwhile I think there's a good chance that in the next year that France and Germany get together and give Britain a decent deal because the weak sterling is killing French farmers and killing German automakers and French farmers and German automakers are each respective country's biggest lobbying groups and both those groups are now lobbying government aggressively saying hey we can't live with the sterling where it is so do something about it

And the only thing those guys can do is give Britain a halfway decent deal and as soon as the deal gets struck I think the sterling will bounce back 15% pretty quickly.

Erik: And momentum trades?

Louis: Well, you know the momentum trades, we've discussed some of them, U.S. equities of course are strong and I think a lot of the reflation trades that are going on are still probably going to go strong till the summer.

Now my big fear is that come this summer we have a big turn in the momentum but for now we have to stand in awe of the momentum both on very cyclical sectors like materials, cyclicals, consumer cyclicals, on technology and frankly on financials.

Of all these sectors the one I probably like the most at this point is financials. Normally of course they are the big beneficiaries of the steepening yield curve but more importantly financials have really spent the past ten years, almost ten years, cutting their costs, getting leaner, dealing with an extremely hostile regulatory environment.

Now the regulatory environment is changing for them you can expect that they won't be getting massive amounts of fines as they did sort of for the past eight years or so and the productivity of the individual worker-- you know most banks you look at them they slashed their workforce in half and a lot of them are doing more business today than they were back when they had double the workforce. So, the productivity of the individual worker has really gone through the roof in most financial institutions. So, after ten years of consolidation, after ten years of cutting costs, I think financials are quite interesting today.

Erik: And of course, in addition to those three legs of investing that are all designed to make money we also have to think about hedges in case something goes wrong. So, what could go wrong in 2017 and how would you hedge against it?

Louis: So, many things could go wrong. You talked about protectionism, we talked about China trying to roll out an empire and potentially overstepping its bounds and creating tensions around the region. We've got Saudi Arabia today that's basically fighting a war on three different fronts in Yemen, in Syria, in Iraq and losing the war pretty much on all these fronts and funding itself through a very low oil price that already is not high enough to sustain its own domestic budget.

So, if you’re looking for things to go wrong one of things that could easily go wrong is a budget or even a social crisis in Saudi Arabia and the potential toppling of a government that would either mean $10 oil or $200 oil.

I think right now what Saudi is doing it's trying it’s very best to keep the oil price above $50 so that they can get the Saudi Aramco I.P.O. through the door at the end of this year or beginning of next at a two trillion valuation which is what they're hoping to get and here by replenish the coffers of the Kingdom that are increasingly bare. But if things start to go really wrong for Saudi then holding that line at 50 bucks and curtailing production may no longer be an option.

Other things that could go wrong, of course Europe we've got a bunch of elections there though I think that risk is perhaps overpriced in the markets. We have an important political transition year in China. The overall consensus is that Xi Jinping will be able to consolidate and solidify his power base but for all we know that may not happen.

So, the main thing is, given all the uncertainties out there, I think you have to maintain a diversified portfolio which is where you want some movement trades, some return to the mean trades, some carry trades. You want have a diversified portfolio and you want to remain flexible as facts change, you change your mind.

Erik: Louis, throughout history something that I've learned as I've studied history is that people who live through really exciting times things like the great depression and World War two. They generally don't even realize as its happening it's only when they look back on it that they can reflect on the enormity of it.

You closed a recent research piece that you wrote saying that we live in revolutionary times give us a little bit of perspective on what you meant by that and how do you see the world today?

Louis: I was using a quote from Lenin who about the Russian revolution, to your point said, there are decades when nothing happens and there are weeks when decades happen. That basically all of a sudden things, a lot of the things can happen in very short periods of time.

Now the whole point of the revolutionary piece was to highlight that-- and this has been a long theme of mine really since 2005, since I wrote my first book, Our Brave New World, that the structure of production in our entire economies have changed.

If you go back to my parents' generation most people worked for big companies. So I.B.M. would have had three hundred thousand workers and Citibank would have had three hundred thousand workers and basically society was organized very much in a pyramid framework where you had tons and tons of workers and then a few managers and then a few managers of those managers and all the way to the top like a pyramid. And if you go back to the 1970’s economic books you've got pyramids all over them.

Now today of course organizations are completely different, they cross boundaries, they're much flatter and the days of managers of managers of managers are gone. Today if you're the C.E.O. I don't know of Unilever you've got systems in place to know exactly at any one point how your sales in India are doing, how your margins in Australia are doing etc. and information flows immediately straight back to the top.

Now our political system, we're organized to reflect these pyramid organizations and very often, if you look at Europe, when we changed from being an agricultural society to an industrial society, you had revolutions because the political organization that reflected the agricultural society no longer worked for a society that moved to full industrial.

As we move from industrial to service industry again you've seen some transformation in the political organization but our political organizations still reflect really what we put in place at the time when the world was all organized along big pyramids or around big industrial consortiums and frankly our economies have moved on and I'm not sure our political systems have and so I think we'll have over the coming years continued political upheavals. Maybe Donald Trump is the first symbol of that and Brexit is another to some extent.

And the good thing about democracy is it allows us to make these changes over time and gradually you know we can feel our way into the systems that we want to have. So, I tend to believe that our democracies will prevail but they'll be a lot hit and miss along the way.

Erik: Institutional investors are very familiar with your extremely popular research notes which of course are called Gavekal ideas. We have a sample of one of your excellent pieces written back in January which actually covers all the topics that we discussed today in even more detail. A link to that piece has already been emailed to you in your research roundup e-mail but Louis beyond that one I know you've written several books tell people a little bit more about how they can follow your work and learn more about what you do at Gavekal?

Louis: Thank you very much, thanks for the [indiscernible 00:44:13] I appreciate it. The best way to be honest is to go to our website gavekal.com and that's gavekal.com and yes, we write different books. We've got a fairly big research team, an analyst team and anyone on any given year and usually about every nine months one of us will write a book on a topic.

So, right now our latest book written by my colleague Tom Miller is called China's Asian Dream it's a terrific book talking about what we discussed earlier China's geopolitical reach and I think it's like I said one of the most important macro developments unfolding today.

That book came out just two weeks ago, so it's fresh off the printing press people can buy it on our website, they can buy it on Amazon, they can buy it at their bookstores. But otherwise yeah go to our website. We have some free stuff on there. We give out free trials.

Our research is mostly geared towards institutional investors and so institutional investors should definitely sign up for a trial and if what we do helps them to allocate capital then they can sign up and subscribe.

Erik: Fantastic, well I cannot thank you enough for an excellent interview Patrick Ceresna and I will be back as macro voices continues right here at macrovoices.com.