MACRO Voices
with hedge fund manager Erik Townsend

Jonathan Tepper: The sea of excess liquidity which fueled the rally will soon dry up! March 16, 2017

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Erik: Joining me next on the program is Jonathan Tepper founder of Variant Perception. Jonathan for years now my thinking has been that this massive rally we've seen since 2009 is attributable primarily to excess liquidity that's generated by central bank policy.

You've done a huge amount of work on this subject and your conclusion has been that that excess liquidity may soon dry up and of course that would present a serious headwind for markets. So, please give us the whole back story here, where has all this liquidity been coming from for the last few years, why is it there and why do you think that that picture is about to change?

Jonathan: Sure, thank you, so basically, we've done quite a lot of work at Variant Perception. We build traditional leading economic indicators but we spend an enormous amount of time focusing on global liquidity indicators and economic indicators tend to lead things like industrial production for example and retail sales, whereas liquidity interestingly tends to lead acid prices a lot more than it leads the overall economy.

You were just mentioning excess liquidity which we would distinguish from a straightforward liquidity so for example if you think about liquidity a lot of that can drive the real economy so if money is growing you could end up with more industrial activity, retail sales and then you can end up with inflation and an increase in the C.P.I. level.

If you're pumping in more money than the economy actually needs or that in fact inflation is generated then all that excess liquidity sort of above and beyond needs of the economy tends to go into financial assets and that could be commodities, stocks and real estate.

So, one of the things that we do at Variant Perception to help our clients who are primarily hedge funds, family offices and endowments is to track these ups and downs of not only excess liquidity we look at the global shape of the yield curve.

We can talk more about some of these other things later but we track excess liquidity and its sort of a simple idea we define it as M1- inflation so it's real M1 and then minus economic activity and so this excess liquidity generally when it's very high these are the best times to invest historically.

So, excess liquidity tends to be high when money growth is high, when inflation is falling or low and economic activity is fairly subdued or low and these periods of time tend to be essentially coming out of recessions so you have like for example 1991, 92 that was a great period sort of in a 12 and 24-month forward basis coming out of the recession.

Likewise, when you have periods like 2002, 2003 or 2009, 2010 conversely the worst times to invest or when excess liquidity is turning down very sharply and that tends to be when money growth is starting to come down, inflation is rising, so therefore your real M1 is growing at a much lower rate or in fact contracting and when economic activity is rising which means there's very little or less excess liquidity to go into commodities or financial assets.

So, if you think of the last 24 months it's very interesting that we had essentially, oil had been very high and then it started to collapse in late 2014 so then you ended up with this massive boost from collapsing C.P.I. and P.P.I. as oil had fallen and at the same time because of emerging market troubles and lower growth in China – basically China and some emerging markets went into overdrive in terms of generating money growth – and so last year with a lagged effect you had essentially a 25% increase in M1 in China, basically it was comparable to 2009 and then you had a collapse in inflation, a huge surge in money and economic growth was relatively tepid and moderate around the world at best if not outright contractions in some countries like Russia and Brazil and some of the oil countries.

So, that meant that you had this huge surge in excess liquidity and surprisingly we've seen a surge in a lot of risk assets like commodities, emerging markets have been some of the primary beneficiaries but certainly it's helped develop indices as well and we're seeing some sort of blow off top right now in for example the Nasdaq and other indices.

So, your question was is this rolling over and is it changing now and what are our views, so if we take all these things and then fast forward to today we can see that oil has doubled from last year essentially it's gone up about $30. The yields are risen substantially in the United States and in many other places from the lows that we had seen in the in the early summer of 2016 and then at the same time you have economic growth has improved in many places around the world.

So, declining M1 rising inflation and strong economic growth means that excess liquidity is turned down very sharply. So, obviously, that presents a serious headwind to risk assets whereas previously had been a tailwind.

Erik: Now does that mean everything stops right now, short the market tomorrow or is this more of a forecast of what's coming in 6, 12 months down the road?

Jonathan: Exactly, so Milton Friedman talked about monetary policy having long and variable leads and so obviously when you look at these things, essentially they give you windows in time whether it's 3, 6, 9 0r 12 months, a lot of our indicators have varying leads, so for example like a six month might be the most appropriate for some liquidity indicators but it doesn't mean that in six months on the dot if it's turned down you're going to get a turn down in asses prices.

What it is telling you is that you have this wind at your back if it's turning up strongly within that sort of time frame, an average time frame, and likewise you can have sort of the wind in your face if within that timeframe, it's turning down sharply. So, this is a medium-term outlook obviously given a lot of the work to be done.

Erik: It sounds like that coincides, we've heard other guests talk about the cycle pattern that tends to exist with changing of the guard of the president of the United States from one party to another. Usually the new president gets a four to six-month honeymoon before they get slapped in the face with economic problems and it sounds like the timing is just about coincident with where you see liquidity drying up. Is it the same for emerging and developed markets or is it a different picture?

Jonathan: No so it's exactly the same in the sense that our tools we construct are global in nature. But one of the things that we've certainly noticed and written about has been that, emerging markets in particular tend to be marginal importers of capital and that means that when money's tight on the margin emerging markets tend to suffer most and when money is loosed they tend to benefit most.

So, obviously if you look at some of the best performers last year in the equity world or emerging markets that was obviously with high excess liquidity and likewise if you flip that on its head then marginal imports of capital, emerging markets should be among the worst performers and obviously emerging markets are very varied and heterogeneous so it doesn't mean that every single emerging market is going to be poor but you know rather that I would say that there's a disproportionate effect on emerging versus developed.

Erik: What about commodity prices does shrinking liquidity also mean that there's more downside for commodities and if so which ones will be hardest hit?

Jonathan: Sure so we don't do bottom up commodity work in terms of for example cost curves for mine supply, there are organizations that do a very good job of that so I don't pretend to be an expert on each individual commodity but broadly if you're looking the CRB index or you're looking at oil there's a very high correlation between a lot of these liquidity tools that we've built and commodities and obviously there what you want to look at is where is the supply highest still and where are stockpiles highest.

So, if China is going from pumping in money to now tightening then clearly if you're looking at whatever has the highest inventories in China and stockpiles should be ones that would suffer most and so clearly, we've seen massive stockpiling of iron ore for example and others and these have been some of the best performers.

Erik: Let's move on and talk about inflation next. When quantitative easing was first announced in 2009 a lot of people predicted that it was going to create runaway inflation but of course for the last eight years whatever inflationary effects may have occurred were overridden by that backdrop of deflation that existed in the economy. I would even go so far as to opine that we're probably living in a world where the current generation of professional traders have never personally experienced serious inflation which frankly I think is a pretty dangerous complacency situation.

So, now it seems like we're starting to see signs of inflation returning is it a serious risk and what are the implications for markets, what should we be watching for, what's next in terms of inflation?

Jonathan: A couple years ago, I wrote a book – co-authored it – called, Endgame and wrote about money growth and fiscal spending and inflation and I also wrote another book Code Red later which dealt with a lot of these themes. I've been surprised by how low inflation has been given that we've seen enormous amount of money created over the last couple years.

But part of the reason I think why inflation at least in goods and services has been fairly subdued is that you know normally what you need is central banks monetizing government liabilities and increases in government spending and so what we've seen is essentially an enormous amount of buying government bonds and then also mortgage backed securities and others by central banks but we actually haven't seen an enormous amount more on government spending

So, when you think historically of countries that have experienced very high levels of inflation whether it's Zimbabwe or Venezuela and the like, generally it's been very high government spending which essentially is paid for by the central bank and if you remember going back to 2011 when you had a centrally a government shutdown and potential default in United States, discretionary spending in the United States was essentially frozen at that stage and so we haven't really seen a huge surge in government spending.

I do think that going forward-- what we've seen is asset prices going up, essentially there's been sort of a lot of excess liquidity going on but not an enormous amount of government spending and what I do think it would be more troubling is if you remember last year people were talking about the limits of monetary policy in the need for a much more activist fiscal policy and even the Republicans who historically been much more fiscally conservative, now want to get in on the act and spend a trillion dollars in infrastructure and have a lot more government spending.

I think when you end up seeing more government spending and of fiscal monetary policy coordinating together then you'll certainly end up with much higher inflation and I would say that the very best book the listeners can buy and read on this it's called Monetary Regimes and Inflation and it's written by Peter Bernholz, I dedicated a chapter to the book summarizing some of the key ideas.

He points out that the high inflation tends to come when 20% of G.D.P. comes from government spending is monetized and 40% you end up with hyperinflation. So, we're definitely nowhere near those in terms of most developed countries the only country that currently fits Bernholz's criteria is Japan obviously, that's a problem.

Then on the demographic front we haven't had terrible demographics. One of the biggest drivers of inflation tends to be we have a lot of dependents, whether there are kids or old people and so obviously for example the kids, the baby boomers was one of the reasons why we had high inflation late 70's where you have a lot more people and consumption of goods without actually much more in terms of productive activity when the working for forces, labor force is high a lot of people who can produce not only demand services.

But anyway, these are some the broader considerations of inflation. I don't currently see a surge in inflation. We have leading economic indicators for headline and for core inflation and given that the economy in United States is relatively weak, I mean it's not dire recessionary but rather it's relatively weak and most of the inputs that we look at don't point to certain core inflation. We do see an upturn in headline inflation and a lot of that is driven by commodities.

Erik: Since you mentioned your book, Endgame why don't we go ahead and explain what that is for listeners who are probably wondering. Give us a quick summary of what the book is about.

Jonathan: Sure, thank you, so I wrote Endgame, and then wrote it and finished it essentially in 2011 I believe it was and wrote that with John Mauldin who has a newsletter that goes up to a million people once a week and really basically try to take some of the key ideas that others had written about. So, for example Reinhart and Rogoff, or Bernholz on inflation and essentially try to make sense of them for the average person and popularize them.

And particularly after financial crisis people were worried about what was going to happen with fiscal spending and increases debt–to–GDP and so what we did was basically go around the world and look at all the different countries and offer some hypotheses for what might happen and look at the euro we had a chapter on optimal currency area theory essentially trying to help readers understand what happens in currency areas with the euro breakup or not.

It did very well and ended become a best seller and I had a lot of interactions with its readers and so it's a pleasure to be able to speak to people about some of these things but really the book was mainly intended to sort of help educate people and inform.

Erik: It's ironic that the title is Endgame because I'd like to ask you for your feedback on a theory of mine about exactly that, the endgame. Whenever people ask me, this big monetary experiment, what's the endgame, how does this all end? What I tell them and I've been saying this for years is I don't know when it's coming but someday when we see runaway inflation that's when the endgame starts because let's face it with a deflationary backdrop, central bankers can just conjure money out of thin air to deal with whatever problem comes along.

When we get to a runaway inflation that's what ties their hands, they can't print more money because that would exacerbate the inflation and I think whenever that happens thus we will get to the point where I don't think there's a solution. Am I right to think that that's a serious risk and do you think that there's any chance of runaway inflation not just normal inflation in the next several years or are we still a long ways from that?

Jonathan: In the next four years, I think it is possible. It's impossible to forecast anything on the economic side further out than like 6 to 12 months. Inflation is very lagging so that means that you can get an even longer lead about 18 months but everything changes in the world and so I always laugh when I read stuff that forecast two, three, four years out there are very few things that are structural that allow you to forecast things so far out.

So, certainly things could change that would lead me to forecast much much higher in inflation than I currently do based on the indicated from inflation and I highlighted earlier that I think that that will probably come from a future downturn where you end up with a much more activist fiscal policy that essentially has monetary policy funding it.

So, I definitely do think that because we're now at zero down almost everywhere and then we're going to get a lot more fiscal activity and monetization and I think that that is highly likely to be an endgame in a way in the future once you get fiscal policy kicking in with monetary policy.

Erik: Let's move on now to the 35-year secular bull market in sovereign bonds. We're starting to see some very notable people like Bill Gross and Jeff Gundlach declaring that the secular bull market is over and that it's going to be all uphill from here in terms of treasury yields.

Meanwhile we've heard other experts suggest, no look we're are way overdue for a recession when it comes to the depth of that next perception that's going to be the low point for the ten-year yield and it's probably going to be lower than the 135 that we saw as a record low last year. What's your view, is the party over for treasuries here?

Jonathan: I don't intend to make very long term structural calls just because I don't think there are a lot of tools out there that allow people to make these calls. I mean everyone's got a view and one of the things that we've tried to do in Variant Perception has been essentially to move away from a guru model. There are a lot of people that I have great admiration for like Marc Faber or Nouriel Roubini and Gary Shilling and others but for all intents and purposes these people are just very bright and they read a lot and have viewpoints and that's essentially a guru model sometimes they're right sometimes they're wrong.

What we try to do is to create a framework of tools that are repeatable and robust and ideally can be scaled to deliver solutions to clients and so we try to stay away from anything that doesn't fit into tools that work and I don't know any tools that would allow me to give you a 15, 20, 30 year view in yields.

We may be at the end of it I don't know there are certainly are some demographic tools as I mentioned earlier ratios of working age to non-working age population which seem to do a good job and leading longer things like equity bull markets, housing cycles and bond yield cycles but this is just one tool and certainly the demographic picture there would agree with them where it would indicate that we're in at a low in yields and about to turn up and this is driven much more by demographic factors.

Erik: Going back to the more immediate tools that you use to forecast things that your clients can actually trade on, I know some of the work that you've done recently leads you to anticipate a flattening of the yield curve and I believe you were recommending a two stands flattener to some of your clients. What's the rationale there, why do you see this flattening coming?

Jonathan: So, obviously, we have tools to give us different time frames and then we try to highlight trades to clients that we think are important and to give diagnostics because obviously as our tools and indicators change then we'll change our minds so we're not wedded to for example inflation or deflation if our indicators for inflation turning up will call for inflation.

So, in the case of bond yields and the yield curve we've found one of the better tools for forecasting ups and downs there has been our own Variant Perception excess liquidity measures. And so interestingly it had been turning out much of last year and this is obviously pre-Trump pre-hopes of reflation and sure enough last year we had steepening of the yield curve obviously, you and I were having this discussion earlier about the decline in excess liquidity and if rising excess liquidity leads to a steeper yield curves and a falling would lead to flatter.

This also fits with what tends to happen very late in the economic cycle which is treasury yield curves tend to flatten and so that is something that we're seeing right now and obviously discussing with clients.

Erik: You've written quite a bit recently about Australia so let's talk about that next. When I visited Melbourne in early 2012 it felt to me like 2006 United States, housing bubble in full bloom but of course the housing bubble just kept on inflating more and more since then, I guess that's the nature of bubbles it's hard to tell when they're over. What comes next is the housing situation in Australia finally coming to a head and how do you see the story evolving?

Jonathan: So, we did a report last year, we try not to make our reports public our clients pay us for reports, our clients don't pay us to put out that report to the general public, occasionally we do put out some thought pieces and we do enjoy having-- obviously we need new clients to raise our profile, we're essentially very small and not necessarily well known and so sometimes we do put out reports.

Last year as it happened, I don't know who sent it out, but our report on Australia went viral and was picked up by most of the Australian press and I was insulted and I went around Sydney with my friend John Hampton. So, I think we became the least popular people in Australia I think for a couple weeks given that real estate is a national pastime in Australia.

But Australia is a very interesting one you mentioned obviously that you had gone there are a couple years ago, and the real estate bubble just continues so if you look at Spain and Ireland and the United States in 2005, 2007 so 05 was the U.S. peak and then 07 was that the peak for Spain and Ireland. In the U.S., nationally house prices were five times price to income ratio and then in Ireland they peaked at seven times.

So, Australia overall nationally is about seven times and then in Sydney and Melbourne, in Sydney it's about 13 times and then it's about 9 times in Melbourne. So, certainly we're at real extremes in terms of price to income in Australia and one of the things that became very apparent to us was that lending is still very loose in Australia, lending criteria is very poor even though much like Spain and Ireland they pretend that it's very good and the United States as well and we've seen a huge surge in building permits a lot for multifamily, sort of apartment units in the capital city centers.

But there's also quite a lot of single family residential construction and that we've seen that reach all-time highs in early last year they've both started to turn down much more the apartments we probably should have sat on our report for a few more months and put it out later than we did these things take time but we very definitely have passed the peak in building permits and that leads to a decline in prices it did in the United States, Spain and Ireland almost all housing bubbles and we expect nothing less in Australia and in fact if you're looking at the decline in house prices if you look at northern territories, Western Australia.

So, what seems to have happened is that you have a mining downturn which has affected a lot of these areas and then people have left the mining regions and gone to Sydney and Melbourne which has led to a slight increase in demand and then because of the downturn, you know the R.B.A. was cutting rates last year, and that sort of provided a final leg up in the housing market due to at least lending conditions and even lower rates.

They now seem to be aware of the extent of the problem whereas before they essentially denied it and so we're now seeing stronger moves by A.S.I.C. which is like their F.C.C. equivalent and then A.P.R.A which is essentially their prudential regulator and then the R.B.A. essentially it purely acts as a lender of last resort but it does set capital levels and so we're now seeing tightening conditions across all of these and A.S.I.C. recently brought a case against Westpac on improper mortgage lending and so I think we'll see more of that tightened. Then you also have China tightening outflows from China and so they've been some the main buyers of apartments in Australia.

So, very definitely our report last year was a little early but all the dynamics that we described are still essentially happening in terms of building permits and title lending criteria and yesterday the Fed raised rates and I can tell you that when you have an economy like Australia that has 190% to household disposable income you know higher rates and high leverage tends to produce spectacular results you know when it turns down.

Erik: Since we're talking about the southern hemisphere let's cover Brazil next. The situation there is obviously pretty dire. So, what comes next have we hit that blood in the streets moment when it's time to start buying equities or is there more downside in Brazil?

Jonathan: That was one of our top ideas from last year one that we wrote to clients about and one that we spoke a lot in meetings and almost no one liked the idea. I even got a phone call from a client getting after me for our views. So, I can tell you that Brazil was probably one of the most hated ideas I've ever seen and we've been recommending that for over a year as I mentioned we try to find areas where our leading economic indicators and liquidity indicators are turning up areas that are cheap on a valuation basis.

Certainly, on a cyclical basis, often in a downturn things will appear bad because companies are not making money but if you looking at it in a cyclically adjusted basis they might be cheap, Brazil early last year had seen outflows from retail investors for about three years so it was completely hated everyone pulled money from Brazil possibly could.

There was blood in the streets last January you know there's the Economist front cover indicator, they had Dilma Rousseff on the front cover I remember now and basically every single person in the world at that stage knew that Brazil was a disaster and the economy was contracting and so that was a highly-constrained trade.

Brazil essentially in dollar terms was double last year so that’s something that we flagged to clients and obviously, that's that the value of the work that we do. Currently obviously when something's doubled it's a lot less attractive than it was 12 months ago. So, we're not certainly very negatively in Brazil we just are not as positive as we used to be.

Erik: Let's move on to Asia and we've heard just dramatically different views from guests on this program when it comes to China this question of are they going to be forced to dramatically devalued the Juan as Kyle Bass who's probably been most outspoken in saying we've had other guests on the program like Hugh Hendry saying no way it'll never happen, just completely impossible, how do you see this debt overhang situation in China, how does it eventually get resolved?

Jonathan: So, we've written quite a lot about China, my colleagues in particular and over the years I think we've probably written maybe one to two reports on China a year and these are sort of standalone reports that are separate from monthly views we use our liquidity indicators and economic indicators to provide ups and downs in the business cycle and they've done a fantastic job of providing an advanced read on China and that's obviously helped clients with commodities, the Australian dollar and anything that's China related.

Chinese equities seem to have their own particular dynamics at play it's a very imperfect markets so a lot of the indicators are actually correlate very well with Chinese local equities but they do correlate with China related to external equities.

So, the best way to think about China is that you have sort of the structural story and then you can have the short term cyclical stories so even within a massive structural downturn you can still have cyclical ups and downs and if you think of Japan, the Nikkei peaked in December of 1989 and then declined 80% over the next 13 years and within that you had three separate 50% rallies. So, you can have big ups and downs within a structural downturn.

In the case of China, they have an enormous amount of debt and leverage. Their debt has growing much faster than income or the G.D.P. and which is why the debt–to–G.D.P. ratio has rocketed and so that's going to be a huge problem and is going to painful to deleverage even with the reforms and rebalancing of the economy, it’s still going to be many very painful.

So, within that you can still end up with a Japan type situation where you have big ups and downs along the way and that's where our tools our economic and liquidity indicators are very helpful in navigating this.

So, I think it's not a black or white picture it's rather you think about structural and cyclical and then understand where you are at what point.

Erik: Speaking of Japan why don't we cover that next what do you see there particularly with the J.G.B. situation?

Jonathan: Sure so Japan is a very strange one where obviously they've been experimenting in all sorts of ways recently and the biggest thing that we have seen over the last sort of year and half to two years has been they embarked upon a disastrous sort of negative interest rate policy, obviously Europe's done something similar and in general we know when we look at leading economic indicators some of the things that we look at much closely is the shape of the yield curve and certainly if you put together a global yield curve it does a great job of flagging ups and downs and economic growth.

So, in the case of Japan the negative interest rate policy had taken yields negative across the board but it also had been a massive flattening and so that's just terrible for growth so we thought that was disastrous and we were in fact quite negative on that, negative in Japan in part for that reason once they announced their new policy last year which was sort of yield curve control they had been steeping the curve and then almost all the other inputs that go into our leading indicators have been improving.

So, with Japan I can tell you we do a lot of meetings and speak to clients and potential clients and people have really lost interest valuations are pretty low level and then at same time we had a change in tact from the B. A. J. abandoning what we viewed as a disastrous yield curve flattening negative industry policy and so that has made us much more positive.

Erik: Quite a few guests on this program have predicted that the US dollar rally will soon resume in earnest but others have said the party's over and President Trump will soon find a way to arrest the dollar’s appreciation. What's your view, are the fundamentals in place to support a continued rally of the dollar and if so, will policymakers eventually intervene with some kind of Plaza Accord 2.0 in order to prevent the undesired effects of that?

Jonathan: Well, currencies are extremely difficult to predict and it's probably one the asset classes where there are fewest tools I would argue. You obviously have interest rates differentials as one of the drivers and we track that very closely and you know when you get big moves that deviate from those you can get interesting trading opportunities.

Valuations of currencies are pretty broad and there's not necessarily timing tools. A couple years ago the dollar was quite weak relative to a lot of other currencies but if you look at it now and you can use whether it's the Big Mac Index and the economist or you can look at the real effect of exchange rate and you can see that the dollar is expensive versus almost all currencies except for the Swiss Franc and the Norwegian kroner and so clearly this is telling you that the dollar shouldn't be appreciating in a fundamental basis here much more given that it's fairly expensive.

But in the short run much like all asset classes, momentum is a big driver and so certainly what we've seen recently has been, momentum has been one of the bigger drivers for the dollar even though on a valuation basis, on a longer term view you wouldn't want to be a big buyer of the dollar here looking at valuations.

Erik: I wanted to start with your market views here because that's the format of the program but frankly Jonathan what fascinates me the most about your work is the process that you apply. Just about everybody in this business is sitting on the edge of their seat waiting for the big government data releases to come out primarily G.D.P. non-farm payrolls and the other big economic releases but you intentionally ignore a lot of that stuff. Now you must be on to something because your results have been fantastic.

So, please give us an overview of why you approach this business differently than most people do, how do you go about it, what's the picture of the process that you use at Variant Perception?

Jonathan: Thank you for your kind comments so it's probably helpful here for me to give a little background about how Variant started given that that feeds directly into the answer to your question. I used to work at Bank of America in London in 05 to 07 essentially right before the recession and I was trading rates and currencies and looking at other asset classes and trying to get permission to trade and one of the things that I was doing in my spare time – because you don't necessarily spend your whole day you do a lot of reading and researching and building models – I was trying to figure out when the next recession might happen.

I have a degree in economics and I'm a graduate with honors in it and so I went away and was doing lots of academic reading and noticed that nine out of ten economists missed the last four recessions or at least 05 to 07 and even the recessions that are restarted and I thought this is strange given that these are people with Ph. D.'s from good universities so they're not dumb and they're certainly well-educated so there has to be something systematically wrong with the way that the problem's approached.

And I realize that the two fundamental flaws with the way a lot of the economic research is done and one of them is that they focus on lagging economic indicators for example non-farm payrolls and employment, employment which lags the economic cycle. So it tells you a bit about where the economy was 6 to 12 months ago.

likewise inflation for example everyone fixates on that that's part of the Fed's dual mandate that tells you about we're economy was 6 to 12 months ago if not 18 months because if you think intuitively about this if you run a store just because you have a good month of sales doesn't mean these are hiking your prices you only do that when you're certain that you can get away with higher prices Likewise if you have seen a few bad months of sales you don't start firing all your workers or cutting your prices you want to make sure that this is in fact a downturn that's sustained and so those two things in a way tell you very little about future.

Things that tend to tell you a lot more about the future, and investing is about anticipating the future rather than you know reacting to the past. We look at things like for example building permits and intuitively if you get a permit to build then the digging into the ground and buying the lumber that's going to be essentially something that gives you a few months' lead and then once the house is built then you've got to go buy your washing machines and carpets and so on.

So, there's a natural lead to building permits likewise the yield curve tends to be one of the best in leading indicators so what we've done is create economic leading indicators and we've also created liquidity indicators because we care about asset prices so when it when I left Bank of America essentially Variant grew out of all the tools that I'd been building for myself at that stage.

The other thing that I realized pre- sort of the financial crisis and post financial crisis, I mentioned earlier the guru model you know I'm doing this podcast with you but you know I have no special insights or a crystal ball and I'm not a genius and what we've tried to do is to make sure that all my colleagues at Variant Perception who work in the company essentially have sort of equal if not superior insights to me because what we've done is we've created a set of tools that are not based on the inspiration of a guru and are really based on a systematic framework.

So, we talk about repeatable robust and scalable framework meaning that if you have an insight as a guru that's a one off right but if you have tools that work across business cycles that's actually repeatable and that's useful and so we try to find things that are robust also each business cycle is different right.

The problem with some models is that they train themselves too much on the previous recession but in fact each recession is different and so we try to find things that are robust and repeatable and then they're not guru driven.

Erik: I have to tell you Jonathan I interview in this podcast both a lot of newsletter guys and a lot of fund managers and frankly when I listen to your background as a prop trader and the way you think about markets it feels much more to me like I'm talking to a money manager than a newsletter guy. So, help me understand why are you writing in his letter rather than running a fund?

Jonathan: That's a very good question essentially I left Bank of America at a stage I was trying to get permission to short a lot of the subprime tranches and personally had put on personal trading when I left a lot of positions, very difficult time to raise money I kept on writing my reports and I thought you know what, if people want to pay for me to build the ideal research service that I would want as a portfolio manager then that's fantastic and essentially that's what we've done at Variant which is putting ourselves in the shoes of the portfolio manager and saying if our clients are simply paying us to build one of the tools and then these are useful to them and then we've got more and more useful tools.

So, we don't currently manage money, we don't plan on competing with our clients at all but some of our clients are for example family offices and endowments and so they have a very long term view of the world and what they want to be able to do is to invest rather than internally or in house allocate money externally to some of our insights and so we're currently speaking to some endowments ad family offices we have some commitments and we'll start systematic funds that are not based on us waking up one day and having an insight and then putting a trade on but rather for example earlier we've been discussing excess liquidity you know when we discussed emerging markets being marginal importers of capital you know we know the ups and downs in our excess liquidity indicator do a very good job of telling you whether you should under or over invested in emerging markets for asset allocation standpoint .

So, we will be launching funds that are based on our tools and they do a very good job. I certainly enjoy writing my colleagues do but ultimately what we're trying to do is build tools that help make money and then we have no interest in competing with our clients but for some clients that do want a longer term systematic asset allocation or sectoral views we can then provide them with a way of actually implementing what they're reading about.

Erik: OK, so for our institutional audience there's actually two products here one is your extremely impressive letter which I was lucky enough to get a sample copy of in preparation for this interview. I really enjoyed reading it. I'll let our retail audience download it is institutionally priced so don't waste your time unless you're able to afford institutionally priced products on that one and you're also soft circling money it sounds like to launch at least one maybe more than one fund on this same theme. So, I think that covers our institutional audience I know you really are institutionally driven but I believe you have a blog at variantperception.com it's available to everyone is that true?

Jonathan: Yeah, absolutely and we were also on Twitter which is a great place to find it. So, if people go to variantperception.com one of our tabs is the blog link to the blog. I recommend listeners go there there's a lot of great charts and insights and we have quite a lot of people who follow that and then our Twitter handle if you search for variant perception on Twitter we couldn't get all the letters so it's the VRNT perception on Twitter that has a lot of great charts.

For obvious reasons, we're not giving out our latest news on the blog or our or Twitter stream but we do provide some broad themes that we're looking at and obviously, a smart reader can figure out themselves how they could implement it.

For example, recently we've been tweeting about corporate profit margins and tight labor market and things like that and so you know we might provide more specific trades in our publications for clients but a lot of those charts we do put on Twitter and we do put on our blog and comment on and we have a lot of followers. If you go to our blog for example you can sign up and then when we do a blog post it will get sent out to you and then on our Twitter if you follow us obviously, you'll see the tweets streaming and you know they're just fantastic charts.

Erik: I can't recommend it highly enough and that covers of course the public domain what everybody can get our producer Patrick Ceresna was good enough to really negotiate with your team and although we obviously out of respect for your paying institutional subscribers, we can't give out a copy of your latest newsletter Patrick was able to persuade your guys to give us a couple of older pieces that we're going to distribute to all of our registered users you've got the link in your research roundup email. Can you give us a sense of what's in those pieces that are not available to the public that we've got for our Macro Voices listeners?

Jonathan: Absolutely, I can't remember what business book I read it in and it was fantastic it basically talked about celebrity chefs you know they publish their recipes and you'd think well why would a celebrity chef do that, someone could steal his recipe but the truth is that people still like going to the restaurant and most of the don't enjoy cooking themselves so taking that in mind I thought why don't we just tell people how we build our tools and how we look at the world.

So, we've basically written a series of pieces called understanding, so we are like understanding recession, understand volatility and we basically explain how we think about these issues and what kind of tools we built and these are really thought pieces they are anywhere from 15 to 30 pages, very easy to read through, with a lot of charts.

The ones that we sent to you are probably recession and volatility which I think are most relevant, we have quite a few more than that, we probably have about a dozen of these pieces and they're just fabulous in terms of the feedback we've gotten from readers because they just help people think and put these things in context and then know what things to look at what's important what's not.

Erik: Well our registered users already have the link to download those in your research roundup email, if you're not registered yet just look in the description of this interview on our home page and there's instructions there for how to get registered get the download. I cannot thank you enough for a fantastic interview Jonathan.

Jonathan: My pleasure, thank you for having us.

Erik: We really appreciate it we look forward to having you back again soon Patrick Ceresna and I will be back as Macro Voices continues right here at macrovoices.com.

End of Interview