MACRO Voices
with hedge fund manager Erik Townsend

Russell Napier: Buy the Dollar Dip   May 18, 2017

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Erik: Joining me next on the program is financial historian and consultant to institutional investors, Russell Napier, and Russell, I'm so glad to get you on the program. I have long been a big admirer of your work, and I've really been looking forward to this interview. I want to start with a subject that's near and dear to my heart, and I'm sure yours as well, which is the US dollar rally. I've been very bullish on the US dollar, I think structurally that this rally is set to continue, but boy, I woke up this morning and looked at the chart – it's looking awfully ugly. So, did I get it wrong?

Russell: Well, indeed, today is not a good day to be a bull of the dollar, and obviously, there are political issues besetting the dollar exchange rate today. But the challenges for the other major exchanges of the currencies of the world are significantly bigger. A very quick run through the three major ones to show the scale of this: Number one, Japan is running out of savings, and by that, I mean it is insufficient private sector savings to fun its government at least in the domestic marketplace, at least in yen. The Central Bank has stepped in, it's not doing counter devising, it's effect will be doing outright financing of the government deficits that has always led to a decline in the exchange rate. It is fairly volatile at the minute, but I would expect a major, further decline copping the yield curve and using Central Bank money. Copping the yield curve effectively puts an unlimited scale of purchase on counter devising or an extension of counter devising, and therefore I think the yen has much further—not structural issues, not a cyclical issue, it's not a political issue as we have with the dollar today that might pass as, at this point, as structural in nature with us for some considerable time; second, structural prolongs effects the Chinese currency, and that's a very simple one. It has pursued a policy of mercantilism, managing its currency relative to the dollar and thus to other currencies that has been aimed at taking market shares in exports, but it has a defined and direct impact on monetary policies, and structurally it's a policy which is unfit for purpose. You can't be probably the second biggest economy in the world and hope to rely on a mercantilist monetary policy, so that exchange rate target will have to go. I think most people who would pine to the supply and demand in the next international exchanges for the Renminbi and say the lower band have abandoned, that means a lower renminbi; and finally, the Euro, people are getting a bit more optimistic at the moment. It seems the European project is back on course, but ultimately the monetary federal system in Europe, I believe, is still set for failure. We will not be able to create over here a federal system that is necessary to backup the euro, and therefore we have a short-term rally in the euro. But what ever problems America may have with the president or other political problems, these are passing problems, whereas there's other problems that are far from passing, they're structural in nature; and finally, there's the amount of US dollar debt in the world borrowed cross-border. When we get an economical recession, take that economic recession associated with deflation and falling corporate cashflows, there's usually a rush to pay it back debt. When people pay back debt and aggregate that net buyers of the dollar, so that overlays everything that happens in foreign exchange markets. It's usually irrelevant for the United States dollar, but very occasionally as we saw in 2007 to 2008, you get one of these events, a deflationary event, where people rush to payback the debt, and it's bullish for the dollar. So, I can talk for one hour on the dollar alone, but that is the brief summary of the forces that remain very positive for the United States dollar.

Erik: I'm very much in agreement with you, Russell, but I'd like to kinda from the other side of this, which is, at some point, if you and I are right and all of these forces take the dollar higher it could potentially blow up emerging markets, for there's so much debt payable in dollars. Does that lead us to a Version 2 of the Plaza Accord, or some other kind of policy intervention where effectively it's worse to arrest the cent of the dollar? And, I guess, along that same vein, you know, Donald Trump clearly wants the dollar to be lower. Does he have any ability to really change it, or, ah, with the other policies that he's chosen? Or is he just, ah, all blowing smoke when he discusses it?

Russell: Yeah, I think it's a great question. Ah, number one: yes, he would create an extreme pain for the emerging markets, particularly, as I believe, it would be associated with a much smaller current-kind deficit for the United States of America, which is something we might come back to. It wouldn't just be a strong US dollar, it would be a strong US dollar reflecting the fact that America is simply not running the scale of deficits it used to. So, it'd be like two forms of pain coming to the emerging markets. The next question is a political question: could we get the political capital to forge a new Plaza Accord? That looks incredibly difficult at the moment because corporations probably not high, probably the best euphemism we could use in the international community. But remember, in the Plaza, the secret to that agreement was that somebody had to walk into the room and volunteer to have a strong currency, and that someone was Japan. And they volunteered to have a strong currency because they were genuinely fearful of protectionist rhetoric potentially measures coming out of the congress. Now, it's not clear to me today who would walk out into the international marketplace and volunteer for that stronger currency. People might say China, but I think that's unlikely given the pressure on their exchange rate actually has gotten worse. I think it's unlikely that China would, you know, go through a major rise in interest rates or some measure of, of, of that magnitude to try and put its exchange rate up. So, I think we need to get these things in the right order. A crisis first, which could deliver political agreement, but the disarray in the international sphere of corporations doesn't suggest that' we'd move smoothly to a world of the Plaza Accord. So, I'm afraid I think there'd have to be some sort of crisis first before we go up to that Accord.

Erik: Russell, before we leave the topic of the US dollar, because you are a financial historian I'd like to talk about the dollar's role in the world's reserve currency. Now, clearly, for the immediate future, the dollar has to stay the world's reserve currency because there is no viable alternative, there's no other bond market besides the US treasury market, that's deep and liquid enough to absorb central banks' capital flaws. But boy, there's an increasing number of people around the world who are very upset about the fact that the dollar has a monopoly on the reserve currencies status. We've got people like Sergey Kolyaskin in Russia advising Vladimir Putin to try to do everything he can to de-dollarize and move away from foreign trade in dollars. As a financial historian, are these the kind of things that lead to an eventual regime change, or the world's reserve currency, or is this just people blowing smoke in terms of whether it's gonna to actually change anything?

Russell: Well, we've seen a review change before and that was from stirring to the dollar. That being said that that regime change happened as the United Kingdom's economy became much more. The United Kingdom economy ended World War I incredibly indebted, ended World War I with incredibly low reserves, and during that period, you know, the States' economy had made massive, massive increases. Not just economic, I'd put- put over the proceeding periods in terms of the number of people. So that was a very clear- even then it wasn't a one-off event, but it was pretty clear to most people that that regime change had happened. So, short of a one-off event, and I guess it was a World War, which we don't foresee, then what we'd talk about is a slow, gradual process until we reach a tipping point. So, what investors have to look at, rather than trying to forecast when it will happen or if it will happen, it is looking at a tipping point. And, to me, the tipping point will be fairly straightforward, and that is, ah, evidence of a liquidation of treasuries by foreign central banks that pushed interest rates higher, that pushed the yield curve higher, that would be the key bit. As you know, global foreign exchanges are actually declining, and they're not as bad as they say, a lot of it is exchange rate impacts, but they're not going up. They're going down a little bit, and they haven't had any negative impact on the US yield curve. But if that began to happen then I think we are looking at a world where we can begin to talk about the time scale of this happening much more quickly than we thought. So, I would say there's very little evidence of it yet, but that's what investors should look out for. As you say, it should take a long time because we need to find another large liquid asset class in a jurisdiction with a rule of law. I would trust the last of those in Europe is clearly a jurisdiction like that, but I'm not sure about China, I'm not sure how comfortable people would be about holding huge amounts of assets in the Chinese currency given the rather dubious rule of law that exist, and enforcing property rights. So just watch the global foreign exchanges, there's one can watch that, it's published, and see if any of these liquidations affect interest rates, and if they don't I think we're still talking about something that's some considerable time in the future. For those of you who want a more colourful view of what that means, there is a novel on the subject, believe it or not, by Lionel Shriver called 'The Mandibles', and in that book, ah, that novel, that fictional account, Lionel Shriver looks at what happens when the Russians and the Chinese get together with a disintegrating eurozone to create a new currency, and the Russians do have a little bit of previous on this, uh, during the financial crisis, they then approach the Chinese and suggest that dumping in their dollars/treasuries may be an interesting tactic to pursue. So, it's not something that had slipped their minds, as you've mentioned. But I think it's an inoperable, ah, at this moment.

Erik: One more question I have on the US dollar before we move on is, with respect to the supply of the US dollars worldwide to support its role as world reserve currency, the petrodollar system really has been the primary driver of that, and now what we have with the shale oil revolution, is the united states producing as much oil as Saudi Arabia, practically. And that means a much—first of all, the current account deficit changes, and I wanted to come back to that because you mentioned it earlier, but also that just means we have a lot less dollars available to the global financial system, so how do you see this change in the sourcing of energy, moving it onshore, and how that affects the US dollar?

Russell: Yeah, I think that's a crucial point. It's a kind of a Triffin dilemma, but in reverse. The Triffin dilemma, as many in this world will remember, was pointed out in the early 1960s, and it said that with everybody linking United States dollar, the United States, to keep the world running, would have to run bigger and bigger deficits. But as those deficits go up, the current deficits got bigger, people would lose the ability, in America, to ultimately exchange dollars for gold. And that proved to be true because the current deficit got bigger and bigger, and that lose of faith actually occurred. Today, in my opinion, we have exactly the reverse problem, but the good news is not everybody is linking to the United States dollar, clearly, we have a lot of major currencies in the world that move freely onto the, ah, the euro in particular. But across the emerging world, we certainly have these. Across the petrol world, as you pointed out, we certainly have these currencies managed against the dollar. And in Switzerland we have a currency that is managed and not freely flowing – in other words, we don't in Bretton Woods system, but we don't live in a system of full flexural exchange rates either. So, it is important to keep liquidity in this system, that America runs bigger deficits. You pointed the one crucial reason for this that it's not running bigger deficits, and that is shale oil and gas. At the bottom of the US recession in 2009, the US current ran a deficit at the percentage GDP that was pretty close to where it is today. So that's been a remarkable thing. We've had this great growth in the economy, well some part-growth, but great growth by global standards and no growth in the current deficit, and that is a fundamental problem for the global monetary system. I can add other things in there, I would stress the rule of the baby boom generation and the aging of the baby boom generation. I believe the baby boom generation shifts towards services away from goods. As it ages, it may even eventually see it's savings rates going up. A rising savings and a shift from goods consumption to services consumption is gonna mean a smaller current deficit. So even with growth on the current deficit, relative to the GDP it's not growing, a recession slowdown of any sort, and American could find itself pretty rapidly in a current account surplus, and this system we have, this, ah, hawk, jerry-rigged system where many countries are chosen to follow the dollar simply does not work in that scenario. And, if you borrowed a lot of dollars, and there's no other dollar liquidity out there, then it's a fundamental reason why the dollar could spike sharply higher as people seek to repay their dollar debt because of a lack of dollar liquidity. That could be a real scramble to get dollars in that scenario.

Erik: As we move on, I'd like to touch on inflation expectations, because some people are starting to say 'OK, that deflationary force is over, it's all inflation from here,' others are saying, you know, we haven't even seen the worst of it yet. Where do you see this headed, not just in the short-term but in the immediate to intermediate long-term as well?

Russell: I'll remain in the deflation recount, I would begin by pointing out that inflation is every at all times of monetary phenomenon. Broad money supply growth is moderate, it's not high, it's not the level you'd associate with rapidly rising inflation. Actually, it's below levels that we'd associate with the great deflation of the past 30 years. So, it's not conclusive that it's gonna be inflation, it's not conclusive that it's gonna be deflation, just looking at money. You hear some people and think that the world is awash with money. Awash, perhaps, with central bank money, which is from reserves, but not awash with broad money, money that funs economic activity, money that funds our prices, money that ultimately would be responsible for inflation. So, on a monetary perspective, I think the jury is at least out. So why the jury is out do I find myself ending up in the deflation recount, well there are many destructional reasons for deflation, which I'm sure your listeners are familiar with, whether that's technological, r whether it's just China and it's ability to keep adding more and more capacity. But when you have a grossly over-average system and total global debt GDP rates show it's very probably at an all-time high. We don't have that data going back 100 years, 200 years, 300 years, we don't have good private sector debt going back over that time horizon, but almost certainly we are at an all-time high for total debt GDP. There is not a lot of room for mistakes, particularly slowing of growth and a falling of cashflows when debt and GDP levels are that high. And any mistake of that nature with the GDP that high, with inflation that low, raises pretty quickly the sector of deflation, and I think we had it as recently as last February when inflation expectations were incredibly low – they'd bounced a lot since last February – but in the last month and a half they've been coming off very rapidly. And I think one of the more amusing certificates is just looking at this famous, five-year forward, five-year, five-year – what people expect inflation expectations to be five-years out, for the next five-years, a famous indicator that Bernanke used to quote to us. While it's not 1.93 per cent, Bernanke—I think he started launching his counter devising every time it got 2.2 per cent. So, we're not below the level which Ben Bernanke thought it necessary to launch counter devising in the first place. So, I might be wrong in this deflation shock, it may not come, but I think it is far, far too early to be endorsing the view that we're moving towards higher levels of inflation, and I certainly wouldn't like to be investing investors money betting on inflation. So, the jury is out on having opinion, but the movement in the five-year—five-year forward should be raising some questions as to whether this great reflation that people have been betting on since really last February, is actually in course.

Erik: On a related note, the 35-year bull market in US treasuries, we've had some notable people, particularly Jeff Gundlach say 'OK, party's over, last summer that was it, the high is in, it's all over, it's all downhill in price and uphill in yield from here.' We had Dr. Lacy Hunt on the program last week saying, 'no way, it ain't over till it's over, and this thing ain't over.' How do you see this, Russell, is this something that is going to continue, as some of our guests have said, to 'turning Japanese' where we just get stuck in years and years of low-interest rates and economic stagnation?

Russell: Yeah, it's… I agree with Lacy Hunt. It's not over. There are two ways you can look at the loan treasury: it's more a measure a measure of inflation expectations, and, as a deflationist, clearly I believe that those yields are too high and will come down, but the second one is ultimately probably more important; if you believe in the prospect of a financial crisis because the world is over geared, there's too much debt in the world relative to income streams, and I think that fixed rates are actually getting worse, not getting better, which is not the consensus. But if you believe that can happen, then as soon as that were to happen, particularly with interest rates being extremely low-- Let's put it another way: with the medicine, available to central bankers being significantly more than – well, let's not say they've run out, but let's use the phrase significantly more limited – people will run to the large, liquid, high-quality asset class, and that remains the United States treasury. But if we don't have a financial crisis, I think with general slow trans inflation, which were positive for the treasury market. But if we have another market event of over-indebtedness somewhere in the financial system or a major devaluation in China or a major devaluation in Japan, both pouring goods at cheaper dollar prices into the marketplace, they break up part of the euro, the eurozone or the problem in emerging markets, very, very quickly people will be rushing for the liquid assets so then that remains the treasury, so I don't believe we've seen the low for treasury lows as yet.

Erik: I was actually very interested, we have Professor Steve Keene and then Lacy Hunt, two economists with very, very different perspectives but they both came to the same conclusion that we are one way or another going to be stuck for potentially a decade or more in economic stagnation and extremely low interest rates, in a trap that we can't get out of because of the over-indebtedness of the entire world. Do you agree with that view? And is Japan a template for what we're headed towards?

Russell: I do agree with the view, what your listeners have to try and get their heads around is how money is actually created. Money is created by an extension of commercial, by balance sheets. It's not ultimately created by the federal reserve, the federal reserve has long sort of controlled those commercial banks, and by controlling commercial banks the way one would control a team of horses, manages the supply of money. But when that is too high, there is at least a portion of the population, probably not people in private equities but homeowners who consider it prudent to begin to reduce their leverage and that begins to get more true the older we get, and we have this baby boom bulge going through the system, and we have a conundrum in the global economy, if I could quote from the maestro, and the conundrum is ‘how do we create money without creating debt? Or if we’re not going to create debt, because so many portions of the system or over-averaged and want to de-gear and if banks find it very difficult to grow the banks sheets because so many of their customers want to reduce their debts, how to we grow money?’ And it’s a question that’s not really been answered, so what I see every day on my screen, I see lots of evidence of more debt, primarily outside the banking system through the bond market, but not a lot of credit being created by the banks and therefore not a lot of money. And if you constantly add in more debt without the money that inevitably stimulates or is necessary for economic growth, in a modicum or a reasonable rate of inflation, you’re gonna get yourself into a real problem, and I think that’s the real problem that’s shaping up. In terms of the time of that, it’s incredibly difficult, but this inability of the banking system to grow, which I think is the man-driven not supply-driven, is something that the authorities, I think, have not paid enough attention to.

Erik: I’m very curious to pick up on that point, because, from what you’ve said you expect very low interest rates to continue for years to come. And it seems to me that that just paints an almost certain picture that we have to have a massive pension crisis, and of course the biggest social contract that we have in modern society is we tell the people that actually have to work for a living ‘look, you can trust smart finance-guys like us to run this system that’s gonna make sure that you’re gonna be comfortable in your retirement, everything’s gonna be fine,’ as far as I can tell, Russell, it is mathematically impossible for that promise to be kept based on where we are and based off of your expectations, which I agree with very much are, for interest rates. So, do you agree that a pension crisis is inevitable, and what do you see in terms of the consequences of it?

Russell: So, the answer is yes, and you don’t have to take my word for it. I think, you know, let’s just go to the Bundesbank. So, it’s a paper that’s not much read, but I think one of refined, refined implications for all of us. The paper written by the Bundesbank - from my memory, written in October 2014, may have been October 2015 – in which they look at the term structures of interest rates, and they look at the implications for the insurance industry, and they look at the implications for savers, and they conclude that at this level of interest rates, in 10 years it will be impossible for insurance companies to live up to the promises they have made tot eh orders of their policies. But since that was written, the whole economy has shifted even lower, and from the memory, the date in that report was that by 2020 we could expect German insurance companies to be able to make their commitments to their many generations coming, to the fixed yield commitments of their customers. I mentioned Germany rather than the United States because obviously the yield curve is much more depressed there, but also it’s because that is where the problems will be seen first. So, kicking the can down the road, I’m sure it’s something your, you know, I’m sure it’s politicians like to do, and cannot seem to be done for a very long time. But based on the analysis of the Bundesbank, we cannot kick the can down the road for much longer because the price to be paid in terms of inability to service and make good on promises to pensioners who are selling products is running out very rapidly. So given what the US yield curve is, it's a ticking time bomb, but in places like Germany, it may be about to explode.

Erik: As a financial historian, I'm very curious to know how you would see this playing out and what prior examples in history relate to it, because my opinion here is the general public, the masses, are never going to seek to understand the intricacies of yield curves and returns and so forth. They're going to wait and eventually, when they realize they're getting screwed, start throwing Molotov cocktails. So, it seems to me at some point there's a public uprising that the actions of central banks in the last eight or nine years have basically led to an inevitable, global pension crisis, where nobody, no government s and corporations are able to honour their pension commitments to retirees, and of course we have the demographic issue of the baby boom retirement at the same time. This seems like a colossal public uprising reset the system kind of set up, here. Am I wrong to think it's that significant?

Russell: Yeah, I think it's inevitable. The crucial thing for us is to work out which way we shift when that comes. So, the reason the central bankers have been so incredibly active, and I think is more apparent by the record by the day, is because politicians are so remarkably inactive. There is a stalemate on the hill, there has been for many, many, many, many years, politicians have been unable to deliver. I would argue that's true in other places of the world. For 30-odd years, politicians have passed political par beyond their domestic jurisdictions: in the Europe, clearly by passing it to Brussels, and we've done so by passing it to central bankers, we've done so by passing it to NAFTA, we've even passed out of the sovereign state, and this has put a huge pressure on the central banks to deliver. The central bans try to manipulate markets to deliver growth, that's effectively what they do by manipulating the price of money. If it doesn't work, then what? Well, it's pretty straightforward. Well, people the demand the politicians do something, people demand political action. But political action for those people who invest in financial markets means in some way reducing the par of financial markets, reducing the par of price. And yeah, I've speak to a lot of people about this. People fear inflation, they fear deflation. I fear something much bigger than that, that the political reaction to this is effectively to go through one of those periods again, what we'll called 'dark ages', where we basically- the politicians can make it and then they run the financial system, or they begin to get directly involved with the allocation of resources and capital and credit and we go back into that, let's call it the 1950s, 1960s, certainly a in a European context, that type of world is a world that the population demands because they look at central banks and say 'well you haven't been able tot do this using so-called market forces, so let us use non-market forces.' So, we're really dealing with something very existential, here, that this will be a shock to the face and the ability of the market to deliver, not only in the ability of central bankers, but in the ability in the ability of the market to deliver in a decided move towards intervention in markets.

Erik: You already have negative interest rates in parts of Europe, and Janet Yellen has alluded to being at least open to the possibility in exploring negative interest rates as a policy solution if more accommodation is needed in the future. What is your perspective on this whole issue?

Are negative interest rates a major risk? What are the potential potholes and risks that people might not seek coming from negative interest rate policies?

Russell: Well, negative interest rates are destructive of the financial system, and we've already discussed that in terms of what they're doing to the German insurance industry and therefore they can be a temporary phenomenon to get you back to growth, but they certainly can't be a permeant phenomenon, otherwise they'll destroy the financial system. So, it isn't conceivable to me that that is a policy which is in place for a long period of time, which takes us back to, and you know, I think it's very easy when you're in a battle to say 'here is who's fighting with that all, it's the central banks.' We must remember that that is not the only force that can fight this battle. There is also the government, and if you ever get that policy in the United States it'll become pretty clear pretty quickly just how much damage is being done to the fabric, the equity and solvency of the financial system, and then we will move onto more direct government actions. So, I think the fallacy at the minute is to say that our only hope is Janet Yellen, the only battle to be fought is by Janet Yellen, and there's this whole other wing of government that is not really on the battle field as yet, seems to be tied up at the minute with all the issues, but we'll come out onto the battlefield when necessary. If you want to know what central bankers have in store for us beyond negative normal interest rates, then Ben Bernanke is still active on the Brooking Institution, he has a blog, and this year he put out a few more suggestions as to where central bankers could go to provide us with more policy. That's what he does, he's a central banker, but I think what investors have to focus on is the new thing that takes the field and the new thing is government and not central banking. So, these policies are so destructive that actually we go without it in a different route. We don't have a government that can do that at the moment, certainly not in the United States of America, and there's no consensus on that, but a crisis can produce an incredible consensus. So, let's just see what happens when we get the next crisis.

Erik: I'd like to follow up on negative interest rates, specifically with respect to banning cash, which has been contemplated. Of course, Ken Rogoff is on a crusade to try and persuade the world to try and ban cash. But you know, cash has not been banned yet, and we do have negative interest rates in some places around the world. I predict that we'll have more negative interest rates around the world before this is over. I worry a lot about a run on the fractional-reserve system, where people recognize there's a financial incentive to hoard cash to basically take all of the cash out of their accounts and put it in a safe someplace rather than pay negative interest rates in order to pay the government to hold it for you. If that happens, it seems to me that you could have a collapse of the fractional reserve system. And although people have said to be 'well, we only have very small negative interest rates.' You're the financial historian here, but it seems to me that bank runs are emotional things, they start when somebody panics, and once they start they're hard to stop. Am I crazy for thinking there is a risk of negative interest rate policy leading to a global run on the financial system?

Russell: Well, it's a bank run of a very different sort. The normal bank run is that you believe you can't get your money, that's the normal form of bank run. So, this is a form of bank run we just haven't seen before. I think it has defined, negative implications for the financial system. I would not use the word collapse, however. One of the things that's happened to our banking system is flushed full of reserves. That's what happens when the central banks extend their banking sheets, they create lots of reserves in the banking system. A reserve is just a book entry de facto cash, which can be turned into notes at any given point in time, so those reserves would be turned into notes and coined to the public and presumably go under their bed, but that is bad for us. It is clearly bad for the economy. If you begin to strip financial resources or the funding of the banking system, it's not going to encourage the banks to get into the business of lending. So, I wouldn't use the word collapse, you can use that word when a run occurs because people really fear for the stability of the financial institution itself, and I'll just go back to those German insurance companies. There are reasons for concern in other tiers of the financial system, but this one is very bad for the economy. It's a parable of the towns from the Bible, and if people wish to store their wealth effectively under the bed in bind notes, that is not a productive use of the world's savings, and it is gonna be bad for economic activity, and that's why I would fear negative rates. But there are a lot of small people in America, and even in policy circles they know this, and to stress again, when you begin to look at how negative some of the policies begin to turn out, then the president will look around the table, or the next president will look around the table and say 'any other bright ideas?' And the other bright ideas won't be coming from central bankers. They'll be coming from Larry Summers, or people like that, people of a different ilk, who believe that fiscal policy, or manipulation of markets, have a role to play in this as well. So, they very fact that we're talking about that as a potential and the negatives associated with it, I think, just make it clearer that the next battle will be fought not just by central bankers.

Erik: I could go on for hours, I'm just so fascinated by your perspective on this history, but I want to shift gears now because my listeners will kill me if I don't get your view on the equity markets. So, with all of this backdrop that we've discussed, where do you see equities globally, in particular of the US, headed from here?

Russell: Equities are expansive, and I probably don't have to say that to your listeners, I'm sure they're well aware of that. The measure I like to use, which is currently in a little bit of disrepute, is the cyclically adjusted PE. I would like to point out that it is always in disrepute when it gets to a high level it becomes less when you have a mean-reverting series, and it has been over the very long-term of the mean-reverting series, mean reversion are always seen at its lowest just as it reaches its highest level. But historically there's nothing in the records that suggest you'll get good returns from equities at this level. The long-term return of 15-20-year return from here should at best be 2, 2.5 per cent, I think that's top-end of the annual, real return you can get from equities with dividends reinvested. That's a long way below the very long-run average of about 6.5. The problem with that average, many people may say 'yeah, I can kinda live with 2.5 real, it's not it's not that bad, and with compounding you'll get a decent number.' The problem is it doesn't help you with the distribution of those returns. So, with this level of valuation, you'd expect some pretty bad years. So maybe I'm being very clever and I'm waiting for some very bad years to be an investor in equities and get them cheap. Very bad years, the very worst years, which an issue in my book, are associated with the inflation, and because I believe we're actually still on the cusp of either inflation or deflation. We certainly haven't moved to sustainable reflation and inflation, then it is plausible that one of those very bad years is not very far away. So, I still urge caution on the equity markets of the world. US market is one of the most expensive in the world, but it is difficult to see how we could have a significant setback for US equities and see the rest of the world's equity markets simply ignore that. There's much more to be said on equities, but fundamentally, they're not really going to come down until their cashflows come down. Interest rates are very low, they're not likely to rise any time soon, if corporate cashflow stays up, then I suspect equity valuations will stay up. So, it's going to have to be something that undermines corporate cashflow something that has normally usually been a recession and the most damaging recession has been those associated with falling prices and harsh deflation. So, until we get an event like that, because I really can't see interest rates going up, then the equity markets are moving along where they are, but providing very long term returns with a significant risk of one very bad dime year, or two very bad dime years in that very low, long-term, future mid-term prospect.

Erik: I wanna pick up on another topic that is near and dear to many of our listeners' hearts, which is precious metals, particularly gold. You and I are both bullish long-term on the us dollar, normally you'd say almost by definition we have to be bearish on gold. Our mutual friend, Raoul Pal, has articulated our gold and US dollar going up at the same time thesis. I'm very curious to get your view on that and how you feel in general on precious metals.

Russell: Well I agree on that unique combination. And I agree on it for this reason: it's not a call on deflation or reinflation, it's not a call on higher rates of interests or zero rates of interest, which is all discussions you have about the relationship between the dollar and gold in normal times. You know, large negative real rates buy gold, high positive real rates sell gold, the dollar and the movements, the dollar obviously plays into those interest rate expectations. That is not particularly why you want to be buying gold. Why I am interested in buying gold is once again back to the same issues. If central banking fails something, another team takes the field, and that other team would have to be a government. Not just in fiscal interest and fiscal expenditure, but being more deeply involved in the allocation of credit and capital, making the financial system and savings less private and public. That's all happened before, I don't think any of that has happened particularly in the post World War era. And when that happens, then you go to gold. It's a form of capital, less susceptible to manipulation by the state, and I think that's why you have more of a bull market in gold, even as the United States dollar goes. Because as this dollar rises, as the emerging market problems begin to unfold, as the, I think, inserting inflation begins to unfold, people realize that the government is taking the field. And they will feel maybe it's just 2 per cent more in gold, 3 per cent more in gold, 4 per cent more in gold, but they will feel more comfortable having more of their wealth in an asset which is more susceptible to government manipulation.

Erik: The market herd tends to run in one direction, or the other, and it's very hard to tell the big picture sometimes. Just a few weeks ago, at Saint Black, the European Union was doomed to collapse, but in the last couple of weeks it's all better now. As a financial historian, Russell, what's your longer-term prognosis? Do you think that the European Union is structurally in big trouble, as some of our guests have suggested, or do you think this is going to blow over?

Russell: Well, it's structurally in big trouble because it has to end in some form of political union. If they can deliver some form of political union then the single currency will work, and if they can't then it won't work. So, the problem I think for many people who have made prognostications about the euro is that they've looked at it from an economic background and you really have to look at it form a political background. It's a currency union which works if it finally ends up a political union, and there are many people in it who've recognized that for many, many, many years. In the last few weeks, we've had some good news for people who think Europe can make it to a federal state. But I think it's really highly unlikely, across the continent, there is increasing dissent against federalization. And people, they find themselves in a terrible situation. They see themselves as Europeans, they clearly want to cooperate with each other. They see the European Union as part of that. They even, many of them, see the European currency as part of that, but they simultaneously do not want to give more of their sovereignty away to a federal state. And these things are all incompatible, which is why you get many incompatible answers to survey questions, you know. 'Do you like the euro? Yes. Do you like the euro? Yes. Do you want more par to your sovereign par? Yes!' And these are incompatible. While the timescale in which these incompatibilities turn into something bigger, stronger, are very difficult to asses. We don't know when they'll happen. But as long as one believes that people have seen as much passing away of sovereignty then one has to conclude that this currency union is failing. We've got another French election coming up very soon. We'll see how the new president gets on at that, but remember if we go back to the first round of the presidential election, 40 per cent of the French elected for the communist and the Front Nationale. And if that is replicated in the parliamentary election, we are going to have some severe problems for the president trying to rule France. What do those two parties have in common? What can the extreme right and the extreme left have in common? What they have in common is that they both believe France should not be passing any more sovereignty to the European Union. So, I think the core of that problem is that it cannot be solved unless something happens in Europe to persuade everybody that a much more federal system is acceptable. I cannot foresee that, and therefore I think that the slow demise of the euro continues.

Erik: Kyle Bass has suggested that China is coming apart at the seems, and we'll be forced to dramatically devalue the yuan and that that could send another wave of deflationary pressure around the world. How do you see that view, what's your outlook for the yuan, and what happens next in China?

Russell: So, what China's involved in is what sometimes called the Impossible Trinity. It is attempting to manage its exchange rate, and also manage its dramatic monetary policy, with some degree of capital in and out and clearly not complete free movement of capital in and out. And they have clamped down on that somewhat in recent times but clearly capital is moving out of China, everybody knows it, everybody can see it. It's called the Impossible Trinity for a good reason, it is ultimately in the long-term impossible. So, what I would agree with Kyle Bass is that the obvious and easy bit to give is the exchange rate, and the exchange rate has to fall. Today, we can look at Chinese interest rates. Chinese interest rates are turning upwards, they have gone upwards, pretty significantly. This morning, the three-month repo rate was just below 5 per cent, that's up from 3 per cent last October. That's a pretty significant move. I don't believe that move is engineered by the central bank. That is the Impossible Trinity proving that it is impossible to manage your exchange rate and your interest rates at the same time as long as there is some arbitrage available to the capital account. So that is not—that is not all saying that China is collapsing, but what it is saying is that interest rates are dictating lower growth. Money growth in China sounds very robust to most people listening to this, is 10.5 per cent year-on-year, 10.5% year-on-year's down around the bottom of the range last 30 years. So, you've got rising interest rates, slowing growth of money growth, and then an attempt to defend an exchange rate. And this scenario as growth slows, it's the exchange rate part that has to come to an end. It is very silly to maintain this policy, and when you know you are the world's second-biggest economy, when you want to know you want to become a consumer-oriented society, you'd better get a monetary policy that makes sense. Now they're stuck in this legacy policy, and they have that exchange rate come down significantly, but it's just simply not enough or interest rates wouldn't be rising. So, as we move forward into a new world, where China has a much more independent monetary policy I think we have to associate that with—not a China collapse, it might be a China collapse, it doesn't have to be, but we have to associate it with a significantly lower Renminbi and what I believe are the deflationary implications that flow once the Renminbi is allowed to decline.

Erik: Russell, last question. As a financial historian, you have a perspective that is broader that most people's. So, what I'd like to know is what question did I not think to ask, or what issue keeps you up at night? Or how do you think of the world in a way that might not occur to our listeners who are not financial historians?

Russell: Yeah, I think just look at the recent past to answer that question, and I'll turn to 1987, and I've written about this a few months ago. The biggest thing in the financial market today is the robots. There are lots of names for robots in the financial markets, but they are robots. And the robots have taken over much of the management of financial wealth, and are responsible for much of the turnover in the financial markets. We did something like this before but not the same in 1987 called Portfolio Insurance, and when things went wrong, the robots kept selling, and the people didn't rush from the foxholes to buy as the robots sold. But the rule of the robot is much, much higher than it was in 1987. There is a prospect that the robots make the same decision at the same time, and in an efficient market, the humans, the value players, jump out of the foxhole and rush to buy the value. And I wonder if that can happen this time because of the sheer size of the robots managing the money compared to the human beings, so it's a more recent historical analogy. But the Portfolio Insurance thing, why is that so worrying? Because it can happen very, very quickly. It was effectively an air pocket for financial markets, and I'm concerned that's an air pocket that we could hit again.

Erik: Russell, I can't thank you enough for a fantastic interview. We do have to leave it there, but before we go I just want to let our listeners know that your book, 'Anatomy of the Bear: Lessons from Wall Street's Four Great Bottoms' is absolutely outstanding, I highly recommend it. It's only for investing professionals, though. And at your request, we'll not provide the URL here, but certainly our institutional listeners can contact you directly to find out about your, essentially, eBay for investment research product. I do want to mention also that you developed a platform called ERIC, spelled with a 'c' rather than the 'k' in my name, and that is a platform for unbundled investment research for professional investors. You can easily, ah, Google that information in order to find it. Patrick Ceresna and I will be back as MacroVoices continues, right here at Macrovoices.com.