Axel Merk: Trump reflation trade is dead. Equity market hasn't noticed yet.

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Erik: Joining me next on the program is Axel Merk from Merk Funds and Axel, boy talk about a news day for us to be speaking on Thursday morning. There's so much to talk about, but let's start with the ECB. A lot of expectations were growing into this morning's ECB press conference that this might be that policy reversal moment akin to Ben Bernanke's famous announcement of the tapering of stimulus that might reverse the whole direction of ECB policy. Tell us what actually happened, and let's probably broaden it from there into what you see in terms of implications for the Eurozone generally.

Axel: Yes, well it's great to be with you, and I think you set it up right. There was a lot of expectation heading into this meeting, and as a result of that the Euro had had quite a run-up into that meeting and not too surprisingly, at least in the immediate aftermath, there is some profit taking, some selling of the Euro. Now, if you look at the media, they, the media are no smarter or dumber than we are, but they've got to their job, and so they look at the immediate reaction. The Euro dips down and so, alright, Draghi was dovish, and that doesn't even begin to scratch the surface. The most relevant thing, and it was anticipated, the most relevant thing is that Draghi pointed out that they're not going to lower rates any further, and they used to have that in the statement and that's dropped, and so you would think that, yes, that means tapering is next, and if you recall when Bernanke thought it was tapering, well the tapering doesn't stop for years, so it was always this anticipation, and of course in the meantime, the Dollar was rallying, rallying, rallying because the FED is going to be so hawkish, and we're going to talk about the FED later, I presume.

Now, Draghi succeeded in the impossible in convincing the market that this is actually dovish, and the reason this is dovish is because they're not yet tapering, they didn't even, quote on quote discuss normalization. He did point out two on his board talked about it, but then he kind of said, nope, that was not a discussion, just them talking about it, because I presume, he didn't engage, and he didn't want to have it, he called it discussion. He did say that the growth in Eurozone is robust. He said he feels deflation is over, the risk is only internationally globally, yet, he's going to continue to print the same amount of money as he has because he doesn't have proof yet that we'll reach 2% inflation, and that statement, that in some form or shape he has brought up in the past has kept folks at bay from further defying the Euro in the short-term anyway. Now that said, the program currently for those that don't watch ECB every five minutes, the purchase program lasts until December, and everybody expects it to be extended, but at some point, probably in September, they will have to give us indication of what's going to be next, how long is this going to continue, are they going to reduce the number of purchases…so he'll have to face reality sooner rather than later, and the current lower rates are just unsustainable for Europe, and so my own view is that the Euro is going to get substantially stronger, especially in the context of a couple of things I presume we'll be talking about in a few seconds or moment. Back to you.

Erik: As we're speaking on Thursday morning in the US, the polls are open in the UK, but the result of the UK election is not yet know to us. It probably will be known to many of our listeners by the time they hear this program. It seems to me that there is a heck of a lot at stake for the UK and this election, and I can't help but notice that it was a heck of a lot at stake for the United States. It seems like elections in general are getting higher stakes. So, what do you see as the significance of either outcome? What does it mean for the UK? What does it mean for the global economy in either result that might happen from today's election in the United Kingdom?

Axel: Yea, if I give you my forecast, I'm sure I'm going to have egg on my face no matter what I'm going to tell you. I think first of all, I think, one thing that is very relevant is that historically if you were on the political left or on political right, then you chose your party accordingly. With the nationalist and populist movements we've had of late, and I don't think they're over by any means. Those boundaries have been blurred. If you take in the US, for example, the typical Trump voter used to be a Democrat, and right now, he's voting for Trump. So, similarly, when it comes to Brexit, Brexit is more defined by age. The old people are going to be gone sooner rather than later, they want to be out of it, and the young people want to be in, and now historically, including the UK, the young people are leaning more to the left, and the older people more to the right. I happen to think that Theresa May is not your traditional Conservative, and I'm not sure whether your audience is aware of that. She has proposed price controls on energy prices, for example. That is not something, well I guess Nixon did it, but it's not something that Conservatives traditionally do. She has proposed all kinds of things, and so when it comes to the significance, clearly what is relevant as the UK is negotiating with the EU, a clear majority is helpful, because then you have a mandate, and it doesn't really matter whether the majority is on the left or on the right, you just need a majority, and the goal of Theresa May is obviously to expand the majority. Now, she has not previously been elected to office.

She is not, it appears to be, the typical person that would've bubbled to the top in a typical political discourse, and so she has had a couple of gasps, including taking some retirement benefits away only to do a U-turn and a few other things, and so I wouldn't be surprised if her support is going to be lack-luster.

Now, all that said, it doesn't really matter. The reason it doesn't really matter is if you think about the way that the EU works, it's almost impossible to get anything done, and they have to renegotiate hundreds, or even thousands of pages of contracts, and they are very late to the game, and then they have to have unanimity in how they are going to pass them. I see it all but impossible to come up with a decent agreement, and so what that means, basically, is that there's going to be uncertainty. It's going to be difficult, the UK government will have to give huge incentives for businesses to move to the UK. Under Osborne, in the previous government, they had austerity and with austerity, they had back deficits. I think they are going to have horrendous deficits going forward. I've said in the past that they're going to go down the Italian path that yep, that'll be ok, but it's going to be a cascadingly lower currency over time with high inflation, and that's how they'll get things worked.

Now, the counterargument to that is that say they have the rule of law, it's good to be separated, they can further new basis, and so well then, maybe they'll have found their footing, but I think they'll have to make a lot of promises to make their voters happy, and as we know from the world all over, including the US, backpedaling on those promises is very very difficult, and so I do think deficits are going to be sky high in the UK for the foreseeable future, is my takeaway.

Erik: Now, you said earlier that you expected the Euro to rally in the immediate short-term in reaction to everything that's going on. At the same time, we've heard a lot of people opine that in the longer term, boy this situation in Europe is just not good with exit contagion, more countries considering exiting and so forth. Do you see the beginning of a lasting bull market in the Euro that has legs, or do you just see this as a short-term move higher in the Euro?

Axel: Actually, in short-term I think there's profit taking, in short-term I'm not so sure we're going to get a rally. I think medium to long-term, there's going to be a rally, and yes, Europe is a mess, Europe has been a mess and will continue to be a mess. It is just darn difficult to weaken the Euro. One of the reasons Europe is a mess is because historically, they embrace austerity more. Austerity means consumers are saving more, they're spending less. That's a positive core currency. People have this notion that you have to have economic growth to have a strong currency. That only applies if you depended on foreigners financing your deficits. In the European Union, that's not the case. The EU, with its twin deficits, that is the case. Japan, the more dysfunctional the economy is, the stronger the Yen historically is. The UK is on the other side, the UK you introduce various to trade debt, and the trade deficit, the currency weakens. The Euro can strengthen that sort of back term. That doesn't mean things will be great in the Eurozone, and Draghi this Thursday morning said that the sea of deflation is over. And part of that is that the entire process, as dysfunctional as it has been in Europe has been to get the Eurozone strong enough to stomach the default of a country or of banks. Indeed, just this week, as we are talking, a Spanish bank failed, and the market didn't even blink. Now, it was a Spanish bank, you can argue that it was not of systemic importance, but still, the processes are starting to work. In the US, by the way, there are bank failures all the time, and the FDIC is stepping in and the Dollar doesn't have an effect, and to reason that the Dollar doesn't have an effect when these things happen is because you have a sound institutional process in place to handle these things. Now, do you have sound institutional processes in place in Europe? No, but they're getting better, and even in the absence of these institutional processes, you kind of know what policy makers are up to, you know the playbook, and once you know the playbook, you can price it in, you can work with those sort of things. Now, more importantly, maybe, Europe is taking over a lot of the funding from the rest of the world or from the US, in particular, Warren Buffet issued Euro-denominated bonds the other day, and there are a bunch of reasons for that. One is that the fear of the imminent crisis is over. The other one is that, and I don't want to get too much into detail, but last October you might recall were changes in institutional money market fund rules, and the short of it is that those institutional money market funds had an implicit incentive to buy riskier assets that maybe they should've. European banks used to get a lot of their funding from those markets. Well, that's not as attractive anymore, so more funding is taking place domestically, and what that means, in addition to the low interest rates in Europe, is that the Euro have become a funding currency, and that means that when times are good, the Euro might weaken, but if for whatever reason, equity prices might one day go down, in the last couple of years you've seen ever more frequently that the Euro is actually rallying on these things. So, if for whatever reason, you might have a slightly negative outlook on equity markets or risk markets in general, I would not write off the Euro. The Euro can rally in those sort of environments, and I can go into that in more detail, but for the time being, I'd just like to keep it at that eye level.

Erik: Let's move back to the United States. For the last several months, the theme that seems to be giving a tailwind to asset markets in the US is the so-called "Trump reflation trade," where a lot of people have believed that Mr. Trump would be able to achieve the many things that he set out to do, and it was going to be wonderful for asset prices and equities, in particular. It seems that Mr. Trump is kind of running into some turbulence. As we speak on Thursday morning, James Comey, the fired FBI director is testifying. It may cause some turbulence there. There's a lot of other things going on, and quite a few people have come out in recent weeks saying, ok, this Trump reflation trade is probably over now or ending. What's your view? Does Donald Trump save the day? Play it out as far as it's going to go, or is there more to this rally?

Axel: The Trump reflation trade is dead, except the equity markets haven't noticed it yet. And it's not so much saying that Trump is great or horrible- he's just unlikely to get things done. Trump has a "take no prisoner" approach, and his supporters love him for that, but you don't make many friends with that, and he recently showed it to the rest of the world the way he's been treating folks domestically, and that also means if you take the healthcare reform-Republicans can't agree on something and part of that is that he hasn't rallied people behind his agenda, he probably doesn't care about healthcare all that much, he wants the tax cuts. And this week, as we speak, is supposed to be a week where he's touting infrastructure reform, a topic where you would think you can get five partisan reports, well he gets so distracted by the news in a recent rally, and I already applauded him for finally going out there and actually rallying by this point, something that Obama did all the time, it doesn't even matter as far as getting things done, but once in a while you've got to, from the bully pulpit also, forward your agenda, you can't just do that on Twitter, but he didn't talk about infrastructure until very late into his speech. That is not how you rally people, including those in Congress, those guys, because I mean it's a zoo there, you've got to be playing babysitter. You've got to get these people in the right direction, and when you don't do that, it's more difficult to get things done. And so if you take healthcare reform, no sane person in the world wants to own that problem, I mean, the cost of healthcare is going to go up, it's only a question of the rate of increase, and so nobody is really invested in that and is really pushing it. Yet, you have Paul Ryan, who I think is a Technocrat, who has some very good ideas but is unable to sell those ideas. Basically, what that means is you don't make any friends in Congress, you work with a Technocrat, you don't provide the leadership, the short of it is, you're not going to get many things done. Now, if you don't get many things done, you're going to do exactly what Obama did, you're going to rule by Executive order, and those who love it will love it, and those who hate it will hate it. Implication, though, is that just like under Obama, investors in businesses will not make long-term decision because these Executive orders can be changed by the next guy or gal who is going to be in office, and so that is one of the key reasons why the bonds are again rallying, why we're not getting higher real rates, and for those of you who haven't noticed, I mean, we're talking about FED rate hike that's imminent. We're currently pricing in, if we're assuming that we're pricing in a total of 2.5 rate hikes 40 years, that includes the one earlier this year, that includes the presumed June rate hike. That means after that, we're going to get another quote on quote half-rate hike for this year and then a little less than one next year. That means after this coming rate hike, we're going to get one more rate hike, and that's in an economy that's supposed to be booming, banging on all cylinders, where we're getting rid of the slack in the economy. It means that the market thinks that this Trump rally is over, and the only folks that have noticed are the folks buying equities, and part of it might be that low interest rates warn high equity evaluations, that's well possible, but to me it shows that we're going to have an administration that's not going to get all that much done, and sometimes that's not a bad thing, but many of these things that supposedly were the Trump trade have fizzled out, and the most direct answer is in the bond market.

Erik: Speaking of the bond market, I want to go to the US Dollar next. We've had quite a few prominent guest on the program who have articulated a bullish secular view on the US Dollar. All those arguments made perfect sense to me, but boy, look at the chart, that's not what it's doing. Some people have dismissed that and said it's just short-term noise because of the strength of the Euro. Others have said, no, there's a bigger picture here. So, where do you see the US Dollar going? Is the rally that we've seen for the last couple of years set to resume, or are we looking at a reversal point here?

Axel: Well, we had four years of a Dollar rally. If you look along at the charts, we were two set of deviations above its average, and I'm not a technician, but to me that indicates maybe, just maybe, the Dollar got ahead of itself. And I mentioned earlier, we had Bernanke, who said, hey, I'm going to taper, and by the way, the reason he wanted to taper in my view, is because he was retiring. Similarly now, Yellen wants to normalize the balance sheet. It's not because of something that happened in the economy, it's because she's retiring early next year. And, by the way, we should talk about that, what's going to happen there. But, when you have that sort of environment, you're letting the market anticipate, oh I'm going to be so tough. A year ago, it was more than apparent that the FED is hostage of the markets. This year, the market delivered the rate hike on a silver platter. As long as the market allows the FED to do that, it will continue doing that, but we seem to be at the end of the tightening cycle, whereas in Europe they're at the beginning of the tightening circle, and you can tell me you all you want that things are better in the US than in Europe, and I would even agree with that, but it's all relevant to what is being priced in, and they are we're going to, now again, we shoved it out a few months. In September probably, we're going to hear that we're going to buy quite as many securities, we're not going to extend security programs as long as expected. That's the same sort of things that Bernanke did that provided tail end to the Dollar, and this one is providing a tail end to the Euro this time around, also in trade, if we're going to have more trade disputes, that is a Dollar negative. Now, the Mexican Peso can soften under that, and if indeed a more work could be built, but it's not going to happen, because the US, especially corn export for example, are so dependent on exports to Mexico, that's why what is going to happen, is that abroad and Mexico has an election next year, you're not going to elect leaders that are US government friendly, and so any trade renegotiation counts for the US are not necessarily going to be better, and the folks who are suffering in a trade war, just broadly speaking, are those with a current account deficit, that's is my view, and the US has had account deficit, and so these tension on trades, if anything is going to hurt it. And, by the way, I don't think we're going to get a trade war because of a renegotiated trade deal or failure of, I think we're going to get a trade war because the US is going to shoot itself in the South China Sea or similar place, and we're going to upset the Chinese, and they're going to retaliate with trade. I think that's the sort of dynamic that I see more unfolding, but the short of it is, is that the Dollar has had a huge rally, pricing in amazing recovery, and the yield curve is flattening, that means the FED is tightening into a weakening economy, where as in the rest of the world, and Europe in particular, we have the cyclical recover, and things are getting better there. So, to me, over the next 18 months to a year, that means, yep, the Euro is going to strengthen. Now, you tell me what's going to happen in 20 years, well then, we should stop talking about entitlement and other things, which provide wonderful pressures in various directions and various markets.

Erik: I want to come back to those longer term factors in just a minute, but first, let's go ahead and take that deep dive into US monetary policy, because as you said, we've got the FED hiking into a flattening yield curve, and that by itself really to me, is a topic of conversation. Why does it make sense to be hiking into a very weak economy? But as you say, we know that Janet Yellen is going to retire, we know that Donald Trump is not going to reappoint Janet Yellen. We don't know what's going to happen next. How do you see things folding out for US monetary policy in general? What other factors, maybe, that I have not brought up, should we be thinking about?

Axel: Well, first of all, the FED has an uncanny ability to tighten into a weakening market. They are always late, they are always tight, and that's why we get cycles, and some people say you can only ever be a market of stocks if you have a recession. I tend to point people to 1987, where we have a crash without a recession, so maybe we're going to get our recession and then we'll finally get our bare market, who knows? I attended a conference at the Hoover Institute of Stanford recently, where you had a bunch of FED officials, some current, some former, debate what's going to happen in the next downturn, how are we going to with things and so forth, and the question wasn't so much whether we're going to go back to QE, but what should we do in the interim, before we likely go there again. And, what I noticed was that the folks who were not in charge, the folks who were more academically minded, or were non-voting members, tended be more in saying, hey, let's normalize the balance sheet all the way back to where we were before the crisis and yes, we have to add a bunch of money because more currency notes are in circulation, but otherwise we go back there, whereas the folks who actually pull the trigger, so to speak, who are in charge, said oh, no, no, it's much more complicated than that, and there was even a voice that said it lubricates the markets better because when you have a high balance sheet, you don't have all these differences in rates and the different markets and it doesn't look bad if you have it. Charlie Plosser, the former Philly FED President, said, well maybe it's good that the market actually gives us some information, but where we're heading to, and I think the key question is who is going to succeed Yellen. I personally have my chips with Kevin Warsh, he was FED governor during the financial crisis. He's been positioning himself to be the next FED chair at that particular conference he gave what I dubbed a campaign speech. Now, somebody pointed out to me afterwards that if he had been asked by the administration, he would shut up and wouldn't give a campaign speech any more to be the next FED chair, but the short of it is, that his view is that folks at central banks shouldn't be rock stars, they should be quiet, unless there's a crisis. He also pointed out that the only folks who have benefited are those holding financial assets. That's not the way to run the FED, and so he wants to have a bunch of changes, and a couple that we've just had nominations for, empty governor seats. Now, folks that are unlikely to ascend, but they're more quoted toward the rules based camp. Some people have pointed out that means they will be more hawkish, but it also means, one of them at least, might be interested in going to negative rates rather than QE. The short of it is, though, when you have a new FED chair come in, no matter who it's going to be, they come in with the best of intentions, and so take Kevin Warsh, he says, I am going to now probably hike rates because this is just bad, creating all these unintended consequences. Anybody at the FED will tell you that they are not going to be moved by the markets if markets plunge. They're not going to change their outlook, their rate paths, because markets plunge, but in the same sentence they may well tell you that they will change where they think interest rates should be if conditions deteriorate. Now, you tell me what the difference is. Usually when the market crashes, bonds rally, junk bonds plunge, and guess what? Financial conditions deteriorate, and so, yes, they absolutely react to stock prices, and so what you're going to have is, you're going to have somebody brave come in, they're going to do something, probably dislodge the markets, pretend it doesn't matter, until a few weeks later they notice, oops, recession happened, or financing conditions are just horrible, and guess what? They'll lower rates and might move towards QE, and this is all of course in the backdrop of record low volatility. Low volatility creates higher asset prices because it reduces the risk in the market or perceived risk in the market, and so as volatility goes up, asset prices should come down, good luck, fasten your seatbelts, that's the sort of thing that I anticipate with FED policy over the next 18 months going forward.

Erik: You touched briefly on longer term effects. I want to come back to that now, because this is a subject that I feel a lot of passion for, Axel. You know, we're in an environment of what a lot of people think is the beginning of a secular stagnation, where we're going to be stuck with very low interest rates for a very long time, and I just look at this and I think that the most important social contract that we have in civilized society is this promise that we make to the firemen and the carpenters and the plumbers and all the people that actually work hard for a living, what we tell them is that smart finance guys like us are in charge of this pension retirement system, that's going to guarantee, just trust us, and you're going to be comfortable in your retirement, because we're planning it all out for you. Now, I look at this, Axel, and I don't see any possible way of averting a major pension crisis, because the yield that's needed to support the models that that industry based on doesn't exist anymore. Am I missing something, or is it really that bad?

Axel: I'd say that, I mean just abstractly speaking, the way you can deal with major obligations going forward is, the big categories are growth, inflation, or default, and throughout the world we have similar problems, and I think the way to survive this financially, or to even make money, is to think about culturally how different countries will react to these things. In the US, we don't need to default, because we can print the money. Indeed, we have this magic wand called the printing press that's been bailing us out left and right, and we seem to be very willing and eager to use it.

One scenario I can imagine is that Congress is going to ask the FED to finance the infrastructure rally. They've already asked the FED to finance the consumer protection agencies, which is probably unconstitutional and what not. This came up at that conference the other day, and Charlie Prosser said, this isn't an abstract topic because he was asked just that by somebody in Congress in testimony, whether that could happen. And so, if we keep paying interest on reserves, it's a political minefield in many directions, but that may well happen.

The other one, of course, is default, and default can happen in various ways. You can do an outright default, but if you use that term broadly, cutting benefits is also a form of default, where you're reducing benefits. That is the most prudent way to go about it, but it's pretty darn difficult. I sometimes bring up the example that I live in a Palo Alto community, and they want them to shut down the local dog show, mostly because pension cost of the employees are too high. Well guess what? It was impossible. It was impossible. If you can't shut down a dog show, than how can you take away retirement benefits? Whenever we give a new benefit, it's almost impossible to take it away, just take the last days of the Obama administration, all kinds of things were signed to put new benefits in place, and Trump is this horrible person for taking them away. And so, whenever these things happen, the backlash is just tremendous, even on minor issues, take healthcare, right. Now, healthcare is suddenly, is it a right or is it a privilege, and oh my god, we have these millions of unemployed people. The only way you can contain the cost of healthcare, is if you make people be part of that, if they feel that there's an expense, and unfortunately that means high deductibles, that means that there's personal responsibility. Is that something pleasant? No, and that is why it is so extremely difficult to push the reform that incorporates aspects of that, and we can talk about healthcare. I don't like any proposal of any of the Democrats or Republicans, but any program that is supposed to get our entitlements on a sustainable cap has to involve the personal payment someway, so that we have an incentive to actually keep the cost low, and yes, as long as we think that hey, there's this magic wand around, and it's not going to happen, and so in the US, I happen to think, and we have a pretty good printing press, we can do this for quite a while, but yeah, the math just doesn't work. This is unsustainable, and it is fixable, but the political majorities to fix it, I just don't see them anywhere on the horizon.

Erik: Now, when you say, it's fixable, do you mean it is fixable in a way that you would consider politically viable, or do you just mean in theory it could be fixed if people were willing to do very difficult things that in Democracy they usually don't want to do because it doesn't buy anybody any votes?

Axel: I've been asked many times over the years kind of what I would do, and I've kind of always given the same answer, and I think that same answer is also possible on a national/political level, that the best short-term solution is a good long-term solution. If somebody, and you can plug in many different things, indeed, I even think that there are solutions both on the left and the right that could make the system sustainable. There doesn't seem to be the leadership to have that frank talk with the public, saying yea, we're are in a mess that we've got to fix. Is it possible that we get that sort of leader that might do that? Yes, is it possible that that leader might succeed? The odds are low but not impossible, and so I happen to think that yes, problems are fixable. Do I see anything in the near term, or even in the next six, seven, eight years that's going to get us there? Most unlikely. Most unlikely.

Erik: Let's keep the conversation moving around the world. Kyle Bass and a number of other notables have suggested that the Chinese debt situation is just so out of control that eventually a collapse of the explosion of credit expansion in China will force the PBOC to markedly devalue the Yuan, and that could send a wave of deflation around the world, big enough to maybe spark the next major financial crisis. You're a currency expert, Axel. Is that view crazy? Has that got some weight to it? How do you see this, what do you think is next for the whole situation in China with how much debt has been expanded since 2009?

Axel: It's a baseline scenario for us these days, that said, the timing of that is very very difficult, and to just kind of link that to the previous question, one of the reasons I said 6-8 years is that the wonderful incentive to get things done is a crisis, and you saw that in the top of the Eurozone debt crisis suddenly, real reform took place. The key reason why we don't have reform in the US is because we get away with things, because we've got the printing press. And so, similarly, if you move over to China, as long as things kind of stick together, they'll continue what they are going to do. We used to have a mutual fund that used to belong to Renminbi, and we shut that down once we turned negative. Indeed, our timing was pretty decent, because the Renminbi continued to appreciate until then, and Kyle Bass was already negative in those days. Then we turned negative, and these days and some other work we do, we short-term Renminbi for full disclosure. It is thought something, you have a negative carry when you do that, so it's costs you a couple percent's a year to close that, and if you're dealing, obviously, with a government that might stick around for a while, right? I mean, we have these things, oh my god, this deadline is coming up, and everything is going to crash and burn on this specific date, and then more often than not, it doesn't happen, because yet they've pulled another trick out of their hat, and things are going to continue. Now, yes, the explosion of credit in China is breathtaking, and it's screaming that there's going to be an issue at some point. I had been positive on China, and the reason I used to be positive on China is because I thought you can fix China, and the way you fix China is to allocate credit more efficiently to small and medium size enterprises. In China, most of the money goes to the state of enterprises, and they are then pushed to build infrastructure things and so forth to get things going, whereas the small and medium size enterprises, they have to go through loan sharks, they have to go through the shadow banking system, and if you institute reform to allocate credit more efficiently, and then gave them some sort of entrepreneurial boost, I sometimes joke that hey, give them Ronald Reagan to give them a vision, meaning with propaganda you can do it. You could unleash an entrepreneurial goal. They didn't do that. They instituted a lot of reform until the IMF said, you can join this special drawing rights basket here, but ever since then, they've taken steps back. So, you get this wording coming out that they're all open, but then they use their traditional reforms. In the meantime, a key reason is that they probably have more billionaires in their Congress than the Trump administration has, and there's these vested interests to keep supporting the establishment at the detriment of the small and medium size enterprises, that the reforms are just not taking care of, and that means you've pushed things to ever greater extremes, and being active in the currency market, one of the things we see is well how do they use the leverage? They often use, you might recall, we had a couple of years ago, we had this scandal where people used copper and other commodities as collateral for their trades, and guess what? People were pledging that same collateral multiple times, and one of the reasons they used physical metals as collateral is because that was one way to circumvent the capital controls and so forth, and so, at this stage they've tightened many of the capital controls and everything looks good, and just because the waters have calmed superficially doesn't mean you don't have a crisis brewing underneath. The timing of that is very difficult. I happen to think to short the Renminbi at this stage at the carrying cost of minus 5267% I see on the screen for 12 months C&H, that's acceptable to me. Now, I'm not giving investment advice here, because it is very difficult, something could happen, but if you're looking at what crisis could happen in Europe or the US, yea, let's blame China, and by the way, it's always wonderful to blame somebody else for your own problems, and so, it's going to be the Chinese's fault if everything falls apart somewhere else in the world.

Erik: Let's talk about Japan, while we're in Asia. You know, a lot of people have been betting for, not just years, but decades saying, ok this debt load in Japan is unsustainable. JGB's have to crash at some point, because there's just, you know crazy debt to GDP ratio, but it goes on and it goes on. Some people think it's now coming unglued. How do you see the Japanese Yen, and particularly, the Japanese treasury debt with JGB's?

Axel: The biggest threat to Japan is that the policies are working, and the reason I say that is that if the policies were to work, real rates would move higher, that means the JGB would need to plunge. For the time being, they can monetize their debt, and the markets appear to accept it, and it's a waiting game, if you want to short the JGB, it's inexpensive because rates are zero there. On the ten year as well, depending on the day, even are very very low, and so when and what is going to blow up, who knows. The Yen has been migrating between being this risk off currency, where it rallies when things are bad in the world, but with abenomics, the Euro, as I indicated early, has increasingly taken on that role, and so with the Yen, we've changed our view numerous times in the last couple of years, and so, right now, I actually don't have a very strong view on the Yen, simply because you haven't had this built up of precious one way or another.

We talked about the British election. Unlike some of the other events, if you looked at the French elections, the most important thing for the French elections for currency traders, which is very unusual, appears to be that they keep their job. And the reason I say that, is people bought so much insurance about a Le Pen victory at the time that even if Le Pen had won, it's not the end of the world in France, because she wouldn't have had a majority in the French assembly. And so, that's when you get distortions and tensions in the markets, if you look at the British election today, you mentioned earlier that it's very important, I beg to differ a little bit. The UK is becoming less and less relevant, and indeed, yes, there's a little bit of insurance people took out, but a very very little. People are kind of moving on from that election, and clearly, if there's an unusual outcome, the markets will have some fireworks, but what you don't have, you don't have this huge tension right now. And, similarly if I look at the Yen, there's no huge tension. It's not clear what their next policy move is going to be, I happen to be quite negative on risk assets, and that means there might be a short-term upward move in the Yen, and that kind of balances my long-term negative view on the Yen, and that's why I currently would not want to give a recommendation on the Yen.

Erik: You know, I look at commodities in general, they're really showing some weakness. The CRB is taken out its 200 day moving average in the last few weeks. We saw oil death crossing in the last couple days on this move down, lot of just general commodity weakness, but boy, I look at gold, and it's really holding its own pretty well here, considering everything else that's going on here. What do you think is up with gold, and where is it headed from here?

Axel: Yea, as we talk, gold is actually down a little over a percent, but yes…

Erik: As we've been speaking, ok! I don't have my chart up, I'm in trouble.

Axel: Probably, whatever you've said, somebody is leaking it to the Press, no, but seriously, let's talk and mention here oil briefly, OPEC has been obviously trying to get the fracking folks out of business. These are all little guys, they are the marginal producers, and if you look carefully at the rig count in the US has been steadily increasing, and it appears that in due course the US production will make up and then some for the cuts of OPEC, so OPEC is becoming less relevant, and that means supply will continue to increase, and from that point of view, I'm not surprised, that as we talk, the West Texas oil is at under $46. I wouldn't be surprised if it's going to head lower. Overall, yes, the industrial commodities have been coming down, it's very compatible with the flattening yield curve, very compatible with the Federal Reserve tightening into a weakening economy, and the reason why, and gold has the least industrial use, it does have some industrial use, but the least industrial use of any of the metals, and so it's more of a monetary instrument, and as I indicated earlier, we're going to get, probably one late hike next year. Now, in the meantime, have you looked at the inflation of prices building up on the wage side? We're going to be behind the curve. We are behind the curve. We have negative real rates, in the way that I looks at real rates anyways, and so yes, in that sort of environment, the biggest competitors in the price of gold is cash that pays a real rate of return.

Going back to your earlier question about kind of fiscal sustainability and things like that, I don't see how we can have positive real interest rates a decade from now, sure, in the short-term we get a new FED chair coming in, and they say, oh my god, we're going to hike rates, we're going to do all kinds of great things. Yea, that might be competition to gold, although, in an environment where almost everything is expensive in my view, and the gold is not particularly over or under priced, gold might shine very well if equity prices plunge. And so, gold, one of the reasons gold does well, it's one of the easiest diversifiers. If you think about it from a different perspective- you'd invest an allocated portfolio, you have a 60/40 portfolio investing in stocks and bonds. While your equity portion has gone up, if you're at all prudent, and I allege many haven't been, you take chips off the table, but where on earth do you take those chips? Historically, you do it to bonds, but they don't yield anything. Now, if you chase yield, like most people do, well the junk bond market or anything close to it is highly correlated with equities, and so, you're not getting the diversification you're historically getting. And gold is just the easiest diversifier, I'm not saying it's the necessarily always the best diversifier, but the reason I say it's the easiest diversifier is because of the long run to correlation with equities is near zero. Otherwise, what you want to do in this sort of environment is you want to go to investments that are, by design, not correlated to equities, and you very quickly, you're going into some very complex stuff like long/short equity, long/short currency, all those things that just most people don't want to deal with, and that is one of the reasons that gold is attractive to folks, because it's just an easy place to kind of get some balance to one's portfolio. It doesn't mean gold will always go up, but if you have a portfolio where everything is expensive, sure you can use cash, but if you're professional, you're not going to get compensated on cash, so you're going to choose something else for your investors.

Erik: On that note, Axel, I'd like to close with what you do over at Merk Funds, because you guys run currency funds, and as you said a minute ago, you know, the old portfolio construction theory, 60/40 portfolio stocks and bonds. Tell us not only what you do there, but where do currency funds fit into a portfolio? And what purpose do they serve in the overall portfolio construction?

Axel: Yes, so I'm not going be able to go too product specific, but come to our website at merkinvestments.com and look around, and we do things on the currency side, we do things on the precious metals side, and then we do things also on the global macro side, where we can go anywhere. Now, one of the reasons I was attracted to currencies in the first place, and I, by the way, I wasn't always on the currency side, we used to do fundamental analysis on equities in 90's, is I just didn't like anything anymore, and then it was always about diversification, how do you get diversification in a world where things are more highly correlated? And there were different issues in the late 90's, obviously and then right up to the housing crisis. In 2005, we started the hard currency fund, which was a play on a weakening Dollar that fund has been losing money for quite a few years, as late, as the Dollar rallied, but it has done what it's supposed to do, it diversified to the Dollar. We, by the way, outperformed many many years our benchmark, and so you think the Dollar is going to weaken, that might be play for people, and there's a loyal following that hasn't left, and competitors who kind of changed their focus. Their asset base completely evaporated, but the point of that was to have international exposure without the equity risk and with minimal interest risk. So, by sticking to a very short-term money market type of instruments internationally, and I happen to think there's value in that. Now, one of the things we do, is we do a long/short currencies, where we combine both macro and more quantitative analysis. We do a lot of risk sentiment analysis. We think in an era where fundamentals are just distorted so much, you've got to look at other things. So, when fear flares up in the currency markets, these markets tend to move down- we have a whitepaper on that. And you can create a portfolio that has fears moving around the world is rebalancing in a way that you would go say, short the Swiss Franc, and long the Australian Dollar, or whatever it might be. The returns you generate are almost certainly uncorrelated, and so in that sort of world, if you think that equity prices are not giving you diversification, then that's something to look at. And then we have, we do something purely on gold, and again, look on our website what we do there, and everything else, I can probably not discuss here what else we do, but the short of it is, that we've increasingly done things in-house to just be able to get ready for markets that we expect, and the markets that we expect don't look pretty, and we think you've got to be very flexible and nimble, and the traditional ways of diversifying don't cut it simply because the asking prices are too high.

Erik: Well, Axel, I can't thank you enough for another fantastic interview. It's always a pleasure to have you on the program. You already mentioned merkfunds.com is where people can find your product offerings, but that's not all that's there. I think you've also have, I don't know if you call it a blog or research notes or whitepapers, but what other free stuff can our listeners find there?

Axel: Free stuff, don't we love it all. The best thing really to do is to follow me on Twitter. Twitter.com/AxelMerk and the reason I say Twitter is a fantastic news outlet because you get into instantaneous interpretation of news, not just from me, but other folks that honestly you might appreciate. Sometimes I blog a lot, tweet a lot, sometimes very little. When there's a press conference I'm taking notes, I tweet live, so if you look me up on Trump/ECB press conference times, you'll probably see a dozen or so tweets. Otherwise, a little bit more sparingly. And then we do have a newsletter at merkinvestments.com that's also free. Our primary goal and mission is to manage money for investors, and so we don't have a strict scheduling but when we publish something, we publish it as we get to it, but we hear that people appreciate those. By the way, we do publish cartoons in these sometimes, and some people only sign up because of the cartoons.

Erik: Well, again, I can't thank you enough. Again, folks, Axel is on the web at merkinvestments.com and on Twitter at @axelmerk. Thanks again, Axel. Patrick Ceresna and I will be back as MacroVoices continues right here at Macrovoices.com