Mark Yusko: US Dollar in secular bear market

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Erik: Joining me now is Morgan Creek founder and CIO, Mark Yusko. Mark sent us a fantastic 146 page slide deck to accompany today's interview. Now obviously we're not going to have time to touch on every single slide, but I strongly encourage you to. So, please, download the slide deck and peruse the whole thing. Registered users will find the download link in your Research Roundup email.

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Mark, I can't believe it has been almost a year since we had you on the show last October. And, at that time, all the smart guys that we had on the program were super-uber-bullish on the US dollar on a secular level. Then you came along and you proclaimed that the dollar was topping. You held a bearish view – not just as a trade, but you articulated a secular bearish view about the dollar gradually weakening over a long time horizon as its hegemony in the global financial system comes into serious question.

Now, as of the time of our last interview, holding a bearish view on the dollar was extremely unfashionable in macro circles. A year later, we're about 10% lower on the DXY. So if there's anything I've learned in this business, Mark, it's that you don't want to pay attention to the guy with the most eloquent explanation of what already happened. You want to pay attention to the guy who got it right when it was unpopular to be right. And that clearly is you in this case.

So, for the benefit of our newer listeners who may not remember that interview, let's start from the beginning. Please explain your view. How did you know a year ago that the dollar was topping, and what you saw was not just a pullback or something but a secular change in direction.

What is this all about? And what can we expect from here for the US dollar?

Mark: Erik, it's great to be back and it is hard to believe it's been a year. And I appreciate the kind words.

One of the keys to investing generally, right, is, if you're thinking what everyone else is thinking there's usually not a lot of thinking going on. So, if you want to make the big returns, you've got to come up with variant perceptions. So that's something that's different than the consensus. And you've got to play that out. And then you've got to be right.

Michael Steinhardt had a great quote about this. He says all of our big money came from variant perceptions that turned out to be right; it doesn't do you any good if you've a variant perception and you're wrong.

So when we go back a year – and actually I'll go all the way back a year – a little over a year and a half – this all started to come together for me in January of 2016. And what had happened is the Fed had just raised rates, and everybody then was uber-bullish, because the dollar had run hard in 2015 into the beginning of 2016 and the Fed had raised rates that December. And everybody was convinced that the dollar was going up.

Now, if you actually look at history, that's not what happens. The dollar tends to anticipate the moves of the Fed. So it tends to rally in advance of hiking cycles, and it usually starts down after the second raise in rates.

Now, she took her own sweet time to raise rates. She waited a whole other year. So in January of 2016, I came out with my usual Ten Surprises – I borrowed (or stole) Byron Wien's Ten Surprises thing – and my first one there was that King Dollar had been dethroned.

And that came from the fact that we were in for a cyclical peak in what I believe is a secular decline. I think the secular decline in the dollar started in the '80s, and I think the dollar's been in decline since then. And it's a combination of "demographics is destiny" – so we just have an aging population. And we have too much debt. And then we have this persistent deflation that's being caused by technological advances.

And so when you put all that together, I said King Dollar is dethroned, and we're going to start moving toward more of a multi-polar world and the ascendency of the renminbi. And I took immeasurable grief in '16 about that.

And it started to play out, and the dollar actually did start to fall in the summer of '16. But then, Draghi did his usual "whatever it takes" thing in the July meeting, and Kuroda said that he was going to weaken the yen even more. And sudden the dollar was back in vogue and it kind of recovered most of those lost – so it was flat for most of the year.

And then we have the election. The election comes and, basically, everybody jumps on this reflation trade. That Trump somehow magically was going to create GDP growth out of thin air, that that was going to allow interest rates to rise dramatically, and we were going to have four rate hikes any time now.

And so it came to January of this year, in ‘17, and the cover of *The Economist* magazine (December whatever it was, 5th or 6th) was, the Big Buff, you know George Washington basically saying the dollar was ruling/ruining the world. And I’m like, okay, that’s the peak.

And that literally was the peak. DXY at 103. We’ve been downhill ever since. And I jumped on in January of this year saying okay, now I’m putting the pedal to the floor on this bear dollar bet, and we’re going down from here. And that was King Dollar’s last stand.

And, what I loved about it is I got absolutely blistered on Twitter and everywhere. Really smart people who I have a lot of admiration for, people like Raoul Pal and others who – he’s a friend – I mean, he was just saying, Mark, you’re out of your mind and there’s just no way this is happening.

And my view (to answer your question) is, look, the world is just going to have less dollars in it.

You know, we cut a deal in 1971 with the Saudis and we said we’ll protect you. In exchange we’re going to close the gold window, create a real true fiat currency, but we need something to back it. So we need oil to always be priced in dollars. And as long as you agree to do that, we’ll buy your oil and we’ll protect you, and everything will be great in the Middle East.

And we’ve been doing that faithfully. And any time someone threatened to price oil in anything other than dollars we actually invaded. Iraq tried to price in Euros – invaded them. Libya tried to price in gold – invaded them.

So we’ve had this petrodollar world. And with oil prices at $26 instead of $147, we’ve less petrodollars. With oil prices even at $50, there’s less than there were at $147.

But the real thing that people missed – and this actually came from a trip to Hong Kong in January, right before wrote my Surprises – everyone, including a lot of your guests in the past, and others, were absolutely convinced the renminbi was going to collapse, it was going to have to devalue, and the dollar therefore was going to be ascendant and the renminbi was toast.

And everybody was trying to get short, and they were buying options on these things. And when I was in Hong Kong in January I went to this Merrill Lynch round table – CIO round table – and there were 40 of the best investors, largest investors all over Asia. And pretty universally in that group people were like, no chance does the renminbi weaken this year. In fact it should actually strengthen. Which was just total heresy in January.

And so I kind of had a tangent to my thesis, which was, not only is the dollar going to fall, but the renminbi is actually going to rise. And that got as much criticism too.

So that's a very long, twisted way of saying that the dollar is on its way out as the world reserve currency. The renminbi has become a world reserve currency – it's included in the SDR now, as of August last year. And MSCI has now said they're going to include Chinese equities in their indices, which is a huge thing, which means there's going to be more demand for renminbi-denominated assets.

So we're in this transition, just like we were in a transition from 1913 when the pound sterling was the world reserve currency and they invaded Mesopotamia, incurred a bunch of debt, the pound sterling collapsed, the dollar ascended. But it took 31 years, until 1944 Bretton Woods, where we actually became the world reserve currency. I don't think this is going to take 31 years for the renminbi to ascend, but I think it's coming.

Erik: Now, as much as that was a long answer, I have at least three follow-up questions because this is such an important topic.

First of all, you talk about ascendance of the renminbi as a world reserve currency. Reserve currency really has two definitions. One is the trade settlement currency. That's pretty easy and we see a lot of signs of that.

But the other thing is US Treasury bonds are the preferred reserve asset of central banks. And – something I've struggled with for a long time is – wait a minute, you can't replace US Treasuries as the reserve asset of central banks until there is another bond market in the world that's deep and liquid enough to absorb central bank–sized capital flows.

So, do you see that that is going to be ascendant as well? That there will be a Chinese renminbi treasury market which is offshore yuan and which is big enough to become the new reserve asset? Or do central banks go back to gold? How do you see that aspect of it being addressed if it's not the US dollar and US Treasuries?

Mark: I 100 percent agree that that's going to happen. It's just going to take a while.

And the thing that people miss – I was just in Shanghai last week, we have an office there, we've had an office there for a decade, I've been investing there for 20 years. And I don't even recognize Shanghai when I go back there. It's just – Pudong used to be a rice paddy, literally. And now they've got three of the tallest buildings in the world, sitting right next to each other, and they make the Empire State Building look like a little toy soldier. But what people miss is that China plays "go" while the rest of us around the world argue about how to set up the checker board.

They're just playing a different game. And they plan in 10-year increments. They don't do anything for six months or a year; they do everything for a decade. They're about to have this 19th Party Congress to come up with the next five-year plan, but it's really a 10- and 20- and 30-year plan.

And they said very clearly five years ago that their goal was that the renminbi become stable. They didn't really care what the value was relative to any single currency like the dollar. What they cared about was, relative to a basket of global currencies they wanted it to be stable. And, Erik, just as you said so brilliantly, what they want is for it to become an asset relied on by other central banks around the world as a portion of their assets.

And so, people say, well, that's not possible: They don't have a deep treasury market. Well, of course they don't. But they will. And it may take a decade, but they don't care because they're looking at multiple-decade time horizons.

And whether it's two years from now, five years from now, ten years from now is really not that important for a secular move. For cyclical moves it certainly is, but for a secular move, decades are a short duration. So, I do think they're going to get there.

I do think that stability is job one. And they are – they have made inroads into central banks. There are people starting to dip their toe into these SDRs and –

Is it a long-term goal? Absolutely. Is it going to happen overnight? Definitely not. But I think it's going to happen. And I'm not wed to the idea that it becomes the world reserve currency any time soon, because the is very different from a.

And the has historically been reserved for the country with the best navy. If you go all the way back, that was Portugal. Imagine that: Portugal had the world reserve currency in the 1600s. People are like, that's impossible. Well, that actually was true. Why? Because they had the tallest trees which meant they had the fastest ships.

And then ultimately the UK took over the land all over the world. They had their colonies all over the world and they grew taller trees and then they had faster ships.

And then the steam engine came along and America ascended to have the best navy. And today we have naval superiority. Therefore we have the world reserve currency.

I do have a thesis on this, though. People say, well there's no way China will ever have a better navy. Have you seen any of these pictures of the South China Sea lately? They've got a pretty good navy, actually. But I actually don't think it's about that. I think ground wars and human wars (hopefully, touch wood) are a thing of the past – I was also in South Korea last week, and we can talk about that – but I think that's a thing of the past.

I think the new warfare is cyber. And in cyber warfare and technology warfare, I think China's a pretty formidable competitor, or combatant. So, could hegemony change to meaning that it's the person who's most in charge of AI machine learning and all the things that are going to evolve out of that – edge computing and quantum computing and all these things?

Again, long answer to a simple question: Yes, I think they're on their way to creating a deep and liquid bond market. And, yes, global central banks around the world will own renminbi-denominated bonds. They probably won't be called – well definitely won't be called Treasuries. I don't know what they'll be called. In fact, I have a hashtag on Twitter for a lot of this stuff: **#YuanAPieceOfMe**. Actually, Kyle Bass and I are going to debate this on Friday the 13th down in Dallas at an ALTS Texas event. So that should be fun too.

Erik: Wow. Well to be sure, China is building out its deep-water navy. And, you know, it blows my mind: People will tell you, oh, China only has one aircraft carrier they bought secondhand. The US has 10. Yeah, but the aircraft carrier battle group is kind of a dated technology. If you look at submarine-launched nuclear missile capability, China is right there with the United States.

Mark: Exactly.

Erik: It is a scary thought.

I want to go back, though, and follow up specifically now on the petrodollar aspect of this that you alluded to a few minutes ago. A new development since our last interview is the pending introduction of a crude oil futures contract that will trade on the Shanghai Futures Exchange, will be denominated in Chinese yuan, and will also be convertible to gold for the benefit of oil-exporting nations who might prefer gold over yuan as a final settlement currency.

Now, the mainstream media has dismissed this as completely irrelevant. Because, after all, who other than China wants to buy oil with yuan? But when I interviewed Luke Gromen recently, he actually thinks this has the potential to be a game changer. Specifically, he thinks this contract was intentionally engineered to be a petrodollar killer, to give the rest of the world a mechanism to stop transacting in dollars for oil.

What's your take Mark? Is this new de-dollarized crude oil contract something that's important? Could it be a game changer? And how does it affect your outlook for the dollar generally?

Mark: Yes, important, incredibly important. Absolutely a game changer. Absolutely designed specifically to kill petrodollars. And, no question in my mind, it bolsters the thesis of the decline of the dollar. So, King Dollar has clearly been dethroned. Whether the renminbi ascends into that throne right away, we'll reserve judgment on that. And whether it stays open for a while – like it's abdicated and just stays open –

I love the Western media. We all suffer from this thing called home market myopia. We all think that all the smart people live where we live. So, if you look at people's portfolios around the world, people in the US have more US equities. People in Korea have more Korean equities. People in China have more Chinese equities. People in the UK have more UK equities. And we think all the smart people live where we live. And that's just clearly not true.

And the leadership group of China – and I'm not ashamed to say this – is way more intelligent, way better at leading and managing, than our administration in the United States. It's not even close. I like to say it's like Major Leagues and Double-A or Single-A, but I'm not even sure it's not [just] a good college team in the US.

But the leadership group – particularly the financial leadership group – in China has for the last decade and a half, two decades, been leagues ahead of our Treasury group in the United States. We're so focused on the US – and making sure that all of our banks get preferential treatment, and that they can make excess profits, and it's all for one and one for all, and I'm too big to fail.

China's been figuring out ways, again, to displace the dollar as this global reserve currency. Clearly the way to do that is to get at this link between us and the Saudis and the pricing of oil in dollars around the world. And this is not just a shot across the bow, this is –

Look, make this even bigger (and we can talk about this topic too) is OBOR, the one belt one road – which is maybe the biggest thing that we're going to be talking about for the next two or three decades, which is the reconstruction of the silk trade routes – is a clear and purposeful attempt – not even attempt, a plan – to move the center of the economic universe back to its rightful place, in Eurasia.

And it's got clear partnership with Russia, India, North Africa, parts of Europe – Holland, of all things, is on board with this. And it's all about the fact that, for 1,800 of the last 2,000 years, China and India ruled the world. And only the last 200 was this failed experiment with Communism. And, now they've figured it out, they've gone back to capitalism in the '80s. And they are on track to ascend back to the global dominant powerhouse, and the center of the universe is going to move back to Eurasia.

And Russia clearly would love to X out the dollar in oil transactions. I mean, they would love to sell all kinds of stuff directly to the Chinese, back and forth.

So, this is not only ***not*** a small thing; it's a monster thing.

Erik: Now, since you're the guy who's been right about the dollar and, frankly, I'm the guy who's been wrong about the dollar for the last six months, I'd like to ask you to help me sort out my views on this. For more than 10 years now, I've had a view which is very consistent with yours. I felt that the US dollar has to – not just might but has to – lose its reserve currency status. Definitely in our lifetimes. I don't know when, but sometime.

Mark: Right –

Erik: And that has to lead to a fiscal crisis in the United States, possibly a US Treasury bond crisis.

When I first developed those views a decade ago, I became extremely bearish on the US dollar, I'm shorting the dollar. I was tempted to short Treasuries; thank heaven I didn't. What I eventually realized, though, is that, as bad as the US financial situation is, it's worse in Europe and it's worse in Japan. And that led me to a new view where I said, okay, wait a minute, the dollar is going to have an endgame.

But the way this plays out – the way it's trying to fool me – is what's really going to happen is there's going to be this flight capital into – because everybody in the world thinks the US dollar is the strongest currency on earth – the fact that you see that as changing, you're way ahead of the pack.

So, I came back to this view that, okay, what's really going to happen is there's one final blow-off top. There's going to be real problems in Japan. There's going to be real problems in Europe as the whole Socialist system breaks down there – they can't make good on all the promises that they had made with other people's money. It all falls apart, there's flight capital out of Europe and Japan into the US dollar – that's the blow-off top. And then eventually the endgame starts.

So, I was thinking the US dollar – it keeps getting better for the US dollar, ironically, because it's the way we get to the eventual endgame. That was sort of going my way for the last few years.

So, what, is it that we hit the blow-off top already? Or did I just not see the picture, right? It sounds like you think that phenomenon of flight capital coming from the rest of the world into the US dollar is not going to save the dollar as I was thinking, at least in the short term.

So where did I go wrong in my thinking?

Mark: I actually don't think any of your thinking is wrong. At all. I actually think it's very cogent, very logical, and very well thought out, and makes perfect sense. And we have seen it, right? I mean, every wealthy person in the world – I guess that's too strong, I speak in hyperbole, but that's what I do – so probably not every wealthy person in the world, but the majority of wealthy people in the world find a way to get a portion of their wealth into the US dollar.

But then, if you think about it, that's no different than all the wealthy people in the United States who find a way to get a portion of their wealth into some other currency, whether it be euro or yen or gold or whatever it is. You know, there's plenty of gold buried in Swiss vaults in Switzerland that used to be dollars. So, this movement of capital into the perceived safe haven asset I think is real.

But, what I actually think is kind of curious is: How can the Japanese yen still be a safe haven trade, right? When the equity markets are tanking, what happens to the yen? It doesn't go down, it actually goes up. And so, there are still people all over the world that are putting capital in yen when they get afraid. So, it's not just dollars.

I think where maybe the argument breaks down just a little bit – because I think the argument is sound – is that quietly – and almost like the old story about you can't put a frog in hot water because he jumps out, you have to turn up the heat slowly – is I think the way currency markets have been functioning of late is incrementalism. And then people suddenly are shocked at what's happened.

And there's so many examples of this, from when there's a crisis in a currency like, you know, the South African rand. Or like the Asian crisis back in '98. Or whether it was the ruble crisis when oil collapsed. But what happened incrementally up to that point I think is always very interesting.

And so, let's look at the big currencies around the world. There's the big three: There's the euro, the yen, and the dollar. I will argue – and it's a little bit different than your argument, but not really that different – I'll argue that those big three are locked in a race to the bottom. Based on a combination of bad demographics – you have rapidly aging populations –

And the great thing about this is we can see how this is going to play out by looking at Japan, because Europe is nine years behind Japan and we're 10 and a half years behind Japan. And so, everything that happens in Japan happens nine years later in Europe and 10 and a half years later in the US, whether it's a downgrade of debt, whether it's a collapse in the currency, whether it's reneging on promises.

Eleven years ago, the Bank of Japan said they were going to cut their balance sheet. At the time, their balance sheet was 23% of GDP and they said they were going to cut it. And they actually did cut it a couple of percent for about two years. Today the Bank of Japan's balance sheet as a percent of GDP is 93%. Nine three.

So, yeah, the ECB said, oh, we can't possibly do QE, and we can't possibly increase our balance sheet. Suddenly it's 39% of GDP on its way to 90% of GDP, just like Japan.

And look at the US. Here we are at 26%–25% saying, we're going to cut the balance sheet. What a joke. There's no chance we're going to cut the balance sheet. Maybe we cut it by .5% or something over the next couple of years, but then we're going to start buying more bonds and we're going to start buying equities, just like the Japanese did.

The Japanese didn't start buying equities until 10 years ago. I'm sorry, not even 10 years ago. It was seven years ago. So, we've still got three years before we probably start buying equities in the US.

So, all these things happen in slow motion. And I think the subtle difference between my view and your view and Raoul's view and other smart people's view is I think that the drip, drip, and people using renminbi and people using rupee is outdistancing the demand for dollars.

Partly because, what does the US make today? We make cars. We make some airplanes. We make oil and we make refined petroleum product - gasoline. That's kind of it. And there are a whole bunch of countries around the world that make lots of stuff, and now they're trading more with each other than they are with us.

And, one of the things that I found really interesting, and another reason I am confident that the dollar is secularly in this decline, is when Trump got elected it was all about, oh, I'm gonna start a trade war with China. No, you're not. Because you do realize that, since they were admitted to WTO, our exports to China have grown five times as fast as our imports from China.

And I tell this little story about this friend of mine. Maybe six seven years ago, his daughter came up to him at Christmas time and said, Daddy, I thought you said Santa Claus makes the presents. He says, well, honey, Santa Claus does make the presents. Why? She says, well they all say made in China.

And it used to be about made ***in*** China. Today, again, having been there last week, it's all about made for China. People in China now have wealth. They've taken 50% of their population – just let that number sink in for a second – they've taken 50% (five zero) of their population out of abject poverty since 1983 when they converted to capitalism. That's an astonishing number.

They urbanize 20 million people every year. That means they construct five cities the size of Philadelphia every single year. The scale at which some of these places operate is just not something that we, sitting over here with our home market myopia and view, and our Western media that can never get it right – Because half of the people that comment in Western media have never even been to China, which is just comical to me: They have all these views on China and they have actually never even been to see it.

So anyway, again, long rambling answer to what was a pretty simple question.