Anatomy of the US Dollar End Game Part 3 of 5

Hosted by Erik Townsend and starring Jeffrey Snider, Mark Yusko and Luke Gromen
December 28, 2017

Erik: MacroVoices episode 97 was pre-recorded back in late November, 2017, to air on December 28th, 2017. I'm Erik Townsend; happy holidays!

This special edition of MacroVoices will not include a market wrap or postgame segment. Instead, the entire episode is dedicated to Part 3 of our 2017 year end special, *Anatomy of the U.S. Dollar Endgame*, featuring Alhambra Investments' CIO Jeffrey Snider, Morgan Creek founder Mark Yusko, and Forrest for the Trees founder Luke Gromen.

You definitely want to listen to Parts 1 and 2 of this series first, so if you missed them, please go to MacroVoices.com and start with Episode 95 which aired on Dec. 24th. You also want to be sure to download both Mark Yusko and Luke Gromen's slide decks, as they provide the outline and reference material for this entire episode. MacroVoices registered users will find the download links in your Research Roundup e-mail, or if you're not registered yet go to MacroVoices.com and look for registration and download instructions on our home page.

Now let's go back to the conversation with our guests. We finished the discussion over Jeff Snider's slide deck in the last episode, but only after using up ALL of our planned two-hour time budget for this project. So I want to publically thank our guests who agreed to put in the extra time and effort to do justice to the subject matter – an undertaking that would take several more hours.

In the interest of time, Mark Yusko volunteered off-the-air to just present his slide deck with minimal group interaction. Mark told us there was plenty he wanted to discuss with the group, but he had already reviewed Luke Gromen's slide deck, and knew every one of his hot topics would come up again there. So the first 20 minutes of this episode will be Mark presenting his slide deck. The next 20 minutes will be a group discussion with reactions to Mark's deck. Finally, we'll jump into the beginning of Luke Gromen's slide deck, which we'll finish in the next episode airing on Dec. 30th. Let's start with Mark Yusko…

Erik: Gentlemen, I'm going to suggest that we shift gears here. We've had Jeff Snider in the hot seat for quite a while now, a little bit longer than we'd originally planned. And I think that we should probably move on to Mark Yusko's slide deck next.

Just to summarize, it's very interesting to me. I think we really are all in agreement that what's going on here is we're seeing the US dollar end game beginning to play out. And the only place we disagree is how the details of that are going to work out. And whether that might create the short squeeze effect, which Jeff and I think could be dollar bullish in the short term.

But I think we all see it as part of a process which is the US dollar's hegemony over the financial system is ending.

So, on that note, let's go ahead and move into Mark Yusko's slide deck. Mark, take it away.

Mark: Thanks Erik. We'll start off with some fun cartoons on the cover here, The Not So Almighty Dollar. And I think it's amazing, the curse of the Economist cover. You know, literally, the peak in the dollar at 103 last December, DXY, the week of the Economist cover showing the buff George Washington there. I like the guy on the right with the renminbi knocking out the dollar.

So we'll talk about a bunch of different things. I like these words of wisdom on the second page here, on the Morgan Creek deck. "The almighty dollar is true divinity, and its worship is universal..." Pretty amazing from the first person, the first woman inducted into the National Geographic Society.

"In a word, the almighty dollar is a great object of universal devotion throughout our land, seems to have no genuine devotees in these peculiar villages..." Washington Irving noticed that in certain villages that he visited they didn't care about the dollar, they didn't care about that means of wealth transfer. So it is worshipped universally around the world, but not necessarily in all places.

I read Yogi Berra recently: "A nickel ain't worth a dime anymore…" That's the devaluation of the currency over time. And who woulda thunk I would have paid $8.50 for a cup of coffee in Switzerland a couple of months ago, crazy.

"I'd as soon leave my son a curse as the almighty dollar..." from Andrew Carnegie. I love that one.

So, look, back in January of '16, we actually made the case the first time, used this term, that the King Dollar would get dethroned. And we really thought that the Chinese currency was beginning its ascension into *a* world reserve currency, ultimately, we think, *the* world reserve currency.

And one thing that I think people forget is that the dollar peaks when the Fed actually raises rates. Historically, it's around that second hike when the dollar tends to head down. The dollar anticipates the Fed in other words. So it actually is contrary to what most people think, that the Fed raising rates here again in a couple of weeks is going to be good for the dollar. We actually think it's negative.

And you can kind of see it in the slide on the left here on Page 5 – that bottom line is the dollar – we think it really did peak back in 2016. You had the little Trump bump, which was just the lunacy around all of his promises about the trifecta. And on the right hand side, the trade-

weighted dollar clearly has been in a down trend, we think, and made a nice double top.

So, if you think about just the dollar in a secular sense – the left hand side of Page 6 – we think it's been in secular decline, really, since the '80s. And this is just the race to the bottom in the developed world as all of us – 10,000 people every day in the United States and Europe turn 65. That's 10,000 each, that's 20,000 people every single day turn 65. For the next 17 years.

And stability is really the watchword with the renminbi.

And I love this box in green on Page 7 which – basically, there's a lot of stuff up there from Larry at TIS Group. But I think what people miss is that the Chinese play a long-term game. And here's the word we've been talking about over the last few hours, is hegemony. It is: China's objective is not to follow the devaluation route of other countries, but for the renminbi (or the yuan) to be seen as a stable unit of appreciation that central banks and financial institutions feel comfortable holding in their portfolios.

That is a profound statement. That they actually think that central banks and financial institutions will hold renminbi as a stable unit of appreciation. That is a huge shift from a decade ago or two decades ago.

So in January of this year, we said the King Dollar was making its last stand. And the DXY would weaken. I got absolutely ridiculed for this. And, as I've said many times, the height of good investment ideas is when you're being ridiculed soundly. So the ridicule to goodness factor is a pretty good indicator to watch.

But what was interesting is you had a DeMark 9 count the same week as the Economist cover. That's on Page 9. But we felt that the dollar was in this cyclical pattern within a secular down trend. That it made its cyclical peak intra-period and now it was going to head back down on its secular path (on Page 10).

The dollar bulls, though – and there are many – thought that Trump was like Reagan. And the white line in this chart (Page 11) was the dollar was going to go much, much higher. And at least some were more, oh, he may not be Reagan, he's probably more like Bush. And so we just kind of meander and maybe we'll go up a little bit.

We think he's neither. We think he's more like Herbert Hoover. You know, he's only the third president elected with no experience. He came in making huge promises, like in the upper right hand of Page 12. And we think that the stock market to ride was going to be this bubble top because of all the things that people believed Trump would deliver.

And, what's really kind of frightening about that is (on Page 13) we know exactly what happened when Hoover was elected. You had this spike in the markets, everybody was bulled up, currency was strengthening.

And then things started to happen. We had a little recession and then a bunch of really bad decisions. Like the Mexican Repatriation Act where we tried to kick out Mexicans back to Mexico, even though some were US citizens. To try to save American jobs. That was a bad plan. Just like it's a bad plan now. And then Smoot-Hawley, which was the killer.

And so what we saw was this trade war. They called it a war for a reason. There are no winners in a trade war. So, as you see on the left-hand side of Page 14, the CPI just absolutely collapsed along with the markets. And it was an ugly period.

And we kind of meandered along, we had a little debt cat bounce, and then we came up to '37. And in '37, that's when the really bad stuff started. That's when the Fed tried to raise interest rates, tried to get us out of zero interest rates and QE – by the way, QE is not new, we did it all throughout the '30s.

And what people forget is in a trade war everybody lost. But the US lost the most. Our exports went down the most. Why? Because everybody else fought back. They're not going to lay down and take it.

And gold – which was equivalent to the dollar, because the dollar was good as gold, and backed by gold – collapsed. And so we had a massive devaluation in our currency.

So, coming into this year, 85% (on Page 17) believed the dollar would be strong this year. Pretty much if 85% of people believe something, you should do the opposite. Pretty simple.

The dollar went into freefall starting in December. And we said in September – we do these monthly around the world calls – we said in September that it was looking really oversold. And people had flip-flopped, and people had gotten a little bullish, and we thought there could be a cyclical little mini-rally. So there was one more rally that was likely to happen. DeMark signaled that as well. And it actually bottomed on the day that Trump cut the deal with the Democrats.

Now, there was no actual deal. But he said he cut a deal because he always cuts a deal. Because he's the "Art of the Deal" guy. The dollar made a bunch of divergences that signaled that there could be, and likely would be, a short-term rally from 92 up to as high as 95. The dollar was getting thrashed (here on Page 21). And what's really interesting about that is it turned on a dime. On that September 8th day. And I think that was a problem.

So traders reversed. Page 22 shows that, that traders really did go from being super bulled-up to actually pretty bearish. And now we're back to neutral today.

Jeff: If I could just interrupt for a second, Mark. You talked about the dollar reversing in early September. That's the exact same time that we saw the repo market fail spike.

Mark: That is very interesting.

Jeff: Just something to keep in mind.

Mark: Yeah.

Jeff: It was the week of September 7.

Mark: Now, Luke, you have any thoughts on that either?

Luke: No, go ahead, keep going.

Mark: I think, Jeff, you bring up a really important point, that these things are all interconnected. You know, all these markets and all these activities – and I think what happens is somebody makes a statement, or somebody makes a policy move, and then it gets picked up and it gets exaggerated in the media. And then, suddenly, people actually start acting. And then people have trades that go against them, and things actually happen in the real world. And trades start to fail, which is your point.

I think it's really – I don't want to say disconcerting, because I'm not so worried. You know, the UK is still a pretty cool place, even though they haven't been the world reserve currency since 1944. So it's not like you go away if you lose world reserve currency status. And Portugal is still a great place, even though they were the world reserve currency for most of the 1600s, because they had the most powerful navy, because they had the tallest masts, because they owned the tallest forests. Until the UK took them over – or Spain, actually, first, and then the UK.

But what I think is interesting is this chart on Page 23 that shows that 50% of the world's population live in this pivot area, the cradle of civilization. And it's really interesting, when you think about that's where they put all the oil.

It's really been kind of a cruel joke, if we think about it, that this thing that we all fight over and people have died over all sits under this sand in the middle of the desert. And a certain small number of people are in charge of it. And, yet, we all make it our whole purpose of our life to get close to it.

And I think there's an interesting dynamic going on here in that China is now the biggest importer of Saudi oil, not the United States. So there's going to be a lot of yields that I think happen around this pivot area and this natural seat of power. And what I think that does, at least for me, is – on Page 24 you see this collapse in emerging market currencies.

And, again, that appeared as dollar strength, but I'm going to argue that what it was, was we're all in a big race to the bottom. And the dollar was just the least dirty shirt. I hate that term, but we'll use it. And that the EM currencies were just collapsing more. And so they collapsed all the way from 11 to 16.

But starting in '16 they got cheap enough to change. And so, where I think we are is very much like we were in 2000. And a whole series of slides that I borrowed from Raoul Pal, who I think has been on this show a couple of times.

On Page 25, the GMI is that, if you look at global trade and what happened in '94 to 2002 – and really in that 2000–2001–2002 period – you had this little mini-spike around the last part of the bubble in '99. And then you had just a collapse.

And, sure enough, we're collapsing just as we would be in 2000–2001–2002. US leading economic indicators did the same thing. US consumer confidence, it always peaks at the top, that's the way it works. It's actually really bad at the bottom and it peaks at the top.

You've seen – that was Page 26. On Page 27, something that makes me very nervous is people are dipping into their savings to finance a lifestyle that they probably shouldn't be trying to finance. And what we know is that future GDP growth is inextricably linked to decreases in savings. So decreases in savings cut about 2/3 of a point of GDP for every 1 point decrease in savings.

So we know that there's going to be lower GDP growth in the future because people have been trimming the savings rate from 8% right after the financial crisis, coming up on 3% now.

On Page 28, rates might not rise as much as people think. There was this little blip up in 2000, and then we had to cut rates in 2001 when the recession hit. And I think we could see a repeat of that sometime next year, in '18, or maybe it's the first quarter of '19.

Page 29, bad demographics. They lead to deflation and lower interest rates. And I think the lows in the ten-year interest rate are far ahead of us, not behind us. And the great bond bear market is not over.

2000 and 2002, the dollar was very strong. So here's where I get cognitive dissonance. There was, on the right hand side of Page 30, this very nice inverse head and shoulders and a breakup in the dollar.

And here's where – on top of Jeff's views I have to say, boy, it's definitely possible that the short run, like the next year, we could see a very strong dollar, and then you get the big crack at the end of next year into 2019. And that would correspond, interestingly, with W.D. Gann in 1909, based on his reading of this book by Samuel Benner that he put together in 1902.

So think about this. These two charts were put together over 100 years ago. And they mapped out what would happen every year in the future for the next 100 and plus years. And, actually, Gann's chart ended in 2008. He predicted the 2008 turndown. Benner's went all the way out to '20-'21. And it basically says that we're going to have the next crisis (red box and red circle) in 2019.

And that actually lines up well with Jeremy Grantham coming out and saying the bubble's going to run for another 15–16 months. And so that would put us right in that first quarter of March timeframe of 2019.

So, pretty amazing to think that this guy could write a book in 1902 and that it could be accurate out for over 100 years. So if history rhymes, that inverse head and shoulders pattern that we saw in 2000 did actually repeat here. And so we should have this move up.

Instead it moved back down to 93.67. Now it's back to 94, so maybe we are going to have that move back up. DXY is hanging by a thread on that 200 day. If it bounces off, and it is upwardly sloping, it is possible that Jeff's situation could play out here.

Now, counter to that, a guy I respect a lot, Larry Jeddeloh at TIS Group follows this thing called the Coppock curve, and he's saying that DXY is actually targeting much lower lows at 75 to 85. And then again, something I like is – if you look at inflation in the G7, it's been accelerating modestly, which would tell us that the DXY target would be somewhere between 80 and 85.

So, to summarize, the dollar just doesn't fare very well if you think about the fundamental and monetary factor of – what are the fundamental factors that drive (here on Page 36) whether a currency should be strong. So countries with strong growth have strong currency. We do not have strong growth. Contrary to popular belief, sub-2% is not strong. Stability of a currency –

Jeff: It's not growth either.

Mark: It's really not growth. Exactly. Thank you, Jeff. It's really not. It's stall speed at best. And, you know, stability of the currency, and having a current account surplus – we have a current account deficit in the US, not a surplus. Countries that have higher interest rates are attractive. I think we're going to end up with lower interest rates, not higher interest rates.

So all three big Xs. Now, from a monetary policy perspective, yeah, okay, fine, I call that neutral. And capital flows and risk aversion, we are still viewed as a safe haven although I don't really understand why. But we still are.

So hashtag #kingdollardethroned, Welcome To The Multi-Polar World. And, again, Larry sums up for us what does it mean to have this monetary reset? We had the new SDR basket, we had all these countries playing around with negative yields. We are moving to this cashless society, demonetization. We've got the Fintech – we could spend a whole nother two hours or four hours, probably, talking about bitcoin, but we won't do that today.

But I think there are real implications for where we're headed. And the time is now to get ready.

Erik: Reactions from Jeff and Luke to Mark's deck?

Luke: You know, Mark, it's interesting, you highlighted that 2000 to 2002 timeframe. And that's something I'll touch on. But I talked about, you know, it's all fun and games until US tax receipts fall. When you look at that dollar strength from 2000 to 2002 as sort of the analog, US tax receipts were on trailing a 12-month basis, were still running up over 15% in early '01.

They were still up 10% as late as mid-'01. They didn't fall until very late '01. And by the time they were down year-over-year about 3%, it would look to be about December '01 or January of '02. After which point, my point, the dollar got hit very quickly.

And I don't remember if that was Fed cuts or if that was – I think the Treasury secretary was Snow at that point – if he started talking about a weaker dollar. But the point is that it was interesting to see that chart and that analog about 2000 to 2002, because at least from my look through that lens of they'll let the dollar strengthen until they start choking out the US government, it didn't dissuade me from that. So I thought that was interesting.

Mark: I think you're dead right on, Luke. It's really interesting. If you go back – you know, everybody wants to compare Trump to all these other people, they want to compare him to Reagan. There's no comparison. Demographically, there's no comparison. Culturally, there's no comparison. Personality-wise, there's no comparison. There's no comparison.

Then they want to say, well, he's like Bush. Well that actually works in the sense that 2000 and 2002 we had the same kind of challenges. The difference is – and it's a massive difference – is economic growth was running 4%–5% back in 2000.

Luke: And the US had a surplus when he took office.

Mark: Yeah, we had a surplus. Yeah, and it wasn't running at 2% with a massive deficit. And so your point on tax receipts is – tax receipts were going great up until the shallow recession.

You know, the funny thing about the '01 recession is first quarter was negative, second quarter was positive, third quarter was negative – so we didn't even have two consecutive quarters. We had a very mild recession. And tax receipts were starting to roll down a little bit.

But then what happened was 9-11. And then you had the big collapse in the economic growth. And that's when, I think, to your point, I think Snow and everybody else had to start talking down the dollar because tax receipts were collapsing, budget deficit was squarely in sight.

You know, that's what the government does. That's why I just don't get how they can backtrack from what they started saying, you know, both Mnuchin and Cohen, about three or four months ago, over the summer, they were starting to jawbone down the dollar. Because they knew that tax receipts were already falling, even before they talked about this lunacy of cutting taxes on the rich.

It just makes my skin crawl.

Erik: I'd like to introduce a thought of my own to all of this and get everyone's reactions. I don't have Jeff's depth of understanding of the Eurodollar system, so my dollar-bullish argument is a little bit different than Jeff's. And it's simply that I don't think the world is ready to let go yet of the US dollar and US Treasuries being the safety trade. And I don't think that it's because everybody's in love with US Treasuries and the US dollar, but simply because there's no viable alternative.

I think there's a lot of things wrong in the world, particularly in Europe and in Japan. And as things go bump in the night, I think there will be, eventually, a recession or another financial crisis that will result in – I don't think the safety trade's going to be into European sovereigns, even at the expense of currency risk. I think that European institutions, wherever their mandates allow them to, if a crisis starts their safety trade's going to be in the US Treasuries.

And I think that's the reason that I see the dollar benefiting from the next thing that goes wrong in the world. And not because of any fundamental strength in the currency, but because we don't have an alternative as the safety trade.

I think you alluded to that a little bit, Mark, where you said you don't think it's really going to be the safety trade anymore. I think that was one of your last points. I guess my question is, what would it be instead then?

Mark: Yeah, that is one thing, Erik, where I am compelled by your logic. Which is I don't think we're ready to call China the safe haven. I don't think we're ready for it to be the world reserve currency. Bitcoin's not the place either. I like it for lots of other reasons, but I don't think it's ready to be the safe haven. I've never understood, quite honestly, why the yen was considered safe haven, and the yen seems to strengthen when things get ugly.

So I am compelled by the fact that, if there is some really bad bump in the night, the dollar will strengthen. I don't have any illusions that the dollar's going to keep weakening in that area.

With one caveat: If it happens to be a bump in the night in the Middle East, then I can really get on the other side of, look, if oil prices were to suddenly rise sharply, and we still have a petrodollar system out there, then I'd have to really jump back and say, okay, I can't be short the dollar here. I'll just have to wait for a better entry point.

But I can't argue with you that we have a better solution at this point as a safe haven.

Luke: I think the safe haven trade's already on. And it's interesting – there was an article in the New York Times – if you remember back this summer you had UAE and Saudi get into it, and the dollar fell. You had trouble in Saudi, and the dollar fell. And so the New York Times actually ran an article under "In The Trump Era, Dollar No Longer Safe Haven".

And it was basically just quoting all these longtime traders noting that all this bad economic

news, geopolitical, and the dollar kept falling on that. And, to me, if we go back to the point of the chief economist of the IMF saying the US is on the clock, they've got to fix this, this was an emerging market problem, they need to take emerging market steps. And if they don't the next one's going to be worse.

Well, if you lay out all these statistics in the United States, if this was any other nation except the United States, what you do is very straightforward. You sell the currency and you put it into dollars, you put it into Treasuries. But the problem – to Jeff's point – is the dollar. And everybody knows it's the dollar. They don't know what to do about it, but how do you get out of the dollar? There's nowhere else big enough to go.

Well, the one area that's big enough to go that can hedge your currency risk – I think election night 2016 was extraordinarily instructive to a lot of people. Oh my gosh, this was a surprise, the DOW's down 1,000 points for six hours. Can you trade that? Most people can't.

And so what do you do if the dollar has a problem? I know what I'd do, if I am running – you know, if I can't trade 1,000 point move in six hours in my sleep, you know what I'd do? I sell – if I'm running a sovereign wealth fund, $400 billion, I go – from 65% equities 35% bonds I go 70/30 equities to bonds.

Because at the end of the day, you look back at all these big currency system transitions, they're extraordinarily inflationary to the currency that's losing status, and there's nowhere else to go. Gold's not big enough. And certainly you've seen physical flows move tremendously over the last five years. But no one watches physical flows.

I think what you're seeing in equity markets, and what you're seeing in bitcoin, and what you're seeing in da Vincis, and what you're seeing in real estate – the everything bubble – is a completely rational response to the dollar bubble. The response that, yeah, we could have another crisis, sure. And it's probably going to last – you know, if you look at the last two years, each crisis has gone from, like, two weeks to one week to two days to six hours – so why would I ever sell?

The next crisis, we know how it's going to be resolved. Reflexivity. Does anybody think the Fed isn't going to buy everything that's not bolted down?

Mark: Yeah.

Luke: I think you're seeing the flight to safety. But you're seeing the flight to safety that you're seeing in Venezuela. Where do they go in Venezuela for safety? They go into stocks. Look at the stock market. Where do they go in Argentina? Where do they go in, you know Weimar, Germany? They go into the stock market.

Mark: Great point.

Luke: You have to. It's the only place you can go that's liquid enough.

Erik: Any other reaction from Luke or Jeff to Mark's deck before we move on?

Jeff: I would just say that there's a lot to be said about, Erik, your point. There's definitely something like institutional inertia, where people are either in denial or they just don't think it's a big enough problem, so they talk themselves out of it. And that's one of the reasons why the system has lasted as long as it has. It's almost recency bias.

Luke's point about the stock market, I think there's some of that there as well. There's a lot of rationalizations about why stocks are the way they are. I'm not sure that anybody has any real idea what that is. It could be that investors are trading for massive growth that's going to show up out of nowhere. That's sort of like the dot com bubble, where the promises of the new economy were supposed to be delivered to the 21st century, and of course they are dead.

And it could be just that people are preparing for something other than the dollar to be in the position that it's in. But, whatever the case is, I think there's a whole lot of mistaken expectations about where we are right now. And I think that's exactly what our discussion has been here, is trying to figure out what that might be.

I think the four of us are relatively smart individuals who are pretty well plugged in to these markets and these places. Can you imagine what it's like to be a lay person on the street right now? It's very a confusing time. And I think, as it's confusing for regular folks, they're going to make a lot of mistakes in what they do.

Luke: And it's fascinating, too because, as incredible as it is to say that the stock market rising is simply a safety bid – if you look at IRS statistics for the United States, if you add net capital gains and IRA distributions, those two line items last year were over 200% of the year-over-year growth in US personal consumption expenditures. Or PCE. PCE is 65% of US GDP.

And that 200% number does not include stock options, which is included in – or incentive stock – both of which are included in ordinary income. And so the point is that if anything happens to stocks on the downside, the US government's funding problem becomes instant.

And I think Mr. Market starts to figure things out. You know, sort of wisdom of crowds before – I think there is also starting to be the understanding of this reflexivity that the stock market has become the most important fundamental to US consumption, which is the most important fundamental to the US economy.

And so you get into this chicken and egg problem. But at the very least, if I'm the US government, I don't feel bad about a bubble. I hope the thing goes to $100,000. If it goes to $100,000 on the DOW, like Warren Buffett said, two years from now – Because that's the only way the US government can generate enough receipts to pay these entitlements.

Jeff: Yeah. And what's the flip side of all that? Who else is buying stocks but the companies themselves? And that's certainly a liquidity move. That's definitely a liquidity preference. Because if you're a company and you have internal cash flow – which hasn't been great by the way, earnings aren't really rising, cash flow's not really rising – it's less risky to buy back your own shares than it is to invest in new facilities.

Luke: Absolutely.

Jeff: You know, cashbacks and things like that. And so, that's the inverted nature of this kind of position that we're in, where we stand here and think, well, buying stocks at this level is the most risky thing you can do, but from inside the boardroom it looks the opposite way.

Luke: Absolutely, and it looks that way from the central banks too. I mean, you've got the Swiss national bank printing money and buying US stocks.

Jeff: Exactly. You're right.

Luke: At the same time that – oh yeah, look who the biggest buyers of Treasuries have been since 2008, right? The biggest marginal buyers have been (#1) US retail investors, (#2) US commercial banks, essentially forced by the US government to buy, and then US pensions.

And you go, when was the last time those three guys were on the right side of a big macro trade? Together? Ahead of time? You know, I've been at this business for almost 25 years, I struggle to recall a time when they were. And, you know, that's harsh to say, but, unfortunately, it's just the nature of the beast.

And you go, okay, so the Swiss national bank is buying stocks, and the counter indicators are buying US Treasuries. How do I think this movie is going to end?

Mark: The only one I'll poke you a little on, Luke, the banks buying Treasuries. Totally logical. If I could borrow at 25 basis points or 50 basis points and buy Treasuries risk-free, I'd lever the hell out of that and I'd make a lot of money. Which is what the banks are doing.

So I would take the banks out of there as a counter indicator. But you're right, the pension funds – you know, this big announcement recently that CalPERS was going to sell all their stocks and buy Treasuries has to be the biggest counter indicator I've ever seen. I mean, crazy.

Luke: Yeah, it's a fair point.

Erik: Luke Gromen, let's move on to the Forest for the Trees slide deck next. Why don't you take it away from here and tell us your perspective on this.

Luke: Thanks, Erik. I think the overriding theme that we're going to talk about in this is – and we sort of have touched on it in a couple parts of the discussion thus far – is there's a

geopolitical and historical angle that, generally speaking, most market participants don't pay much or any attention to. And so we're going to highlight some of those and start tying some of that back in to our lens of what we think it drove and what it implies going forward.

If you go to Slide 2, the quote here that's on the title, and it's included in the body as well: "With this concentration of financial and commercial power comes the ability to wield American dollars as weapons." As an American citizen, I'm scratching my head a little bit about just the epic hubris of such a statement.

This was from a book called *Treasury's War* by Juan C. Zarate, who was a former US Treasury official. But to basically say we're going to use the dollar to beat you over the head any time you do something we don't like, and not expect rivals or enemies of the United States to react, to me seems misguided, to be kind.

And so, of course, as you go to Slide 3, guess what happens? Chinese General: "Contain the United States by Attacking Its Finances" – "to effectively contain the United States, other countries shall think more about how to cut off the capital flow to the US…"

Importantly, this general in the Chinese PLA, the People's Liberation Army, he wrote a book called *Unrestricted Warfare* in 1999 talking about these strategies. It's often thought that China only plays defense. But, if you broaden out the reading list a bit, you start to see real evidence that they're not just playing defense over the last couple of years.

This same general gave a speech two years ago. What's fascinating is the second paragraph on Slide 4, noting that the most important incident in the eyes of this PLA general, the most important incident in the 20th century, was not World War I, World War II, not the collapse of the Soviet Union. The most important event of the 20th century was the decoupling of the dollar from gold on August 15, 1971.

And at the bottom he says exactly what the implications are: "To put it simply, Americans can get physical wealth from all over the world by printing a piece of green paper. There has never been such a thing in human history."

So you can start to infer how China actually feels about this.

If you go to Slide 5, they refer to the United States as colonizing the world through the dollar.

And then on Slide 6 he goes on and talks about that the United States needs – they basically outsource so much of their real economy that it's a hollow economy, so financialized it requires the United States to make sure capital moves into the United States at the right times.

And in this speech he goes on to talk about how they have incited and/or used a variety of different geopolitical moves, including the US military, to make sure that money is moved to the safe haven dollar.

So, when you look at it that way, what's happening in North Korea starts to look very auspicious.

That takes us to Slide 7. Back in 1999 a gentleman named Sergei Glazyev, who is now a senior economic advisor to Putin, wrote a book. In it, he said that the US-led IMF shock therapy policies in Russia in the 1990s had approximately similar results in terms of losses of national wealth and losses of Russian population as the biggest tragedies in Russian history. Which were, in his words: "Napoleon's invasion, the fascist aggression of the Hitlerites, the fratricidal Civil War…" – which was the Russian Revolution.

He goes on to say, this was coordinated by Treasury Secretary Larry Summers and IMF Deputy Managing Director Stan Fischer (who just resigned as vice-chairman of the Fed).

Whether you agree with his [Glazyev's] assessment or the Chinese general's assessment or not, you understand where their red line is by reading this. You understand that they're willing to go to the mattresses on the dollar. And that what they are doing is not just some random activity, that they're playing strict defense. There is definitely what is tantamount to currency war.

If you go to Slide 8, you can start to see some of the tactical steps. This was a headline from Reuters, August of 2014: Putin's going to start selling oil and gas in rubles globally, the dollar monopoly in energy trade is damaging the economy. And, as we noted, I think during Jeff's talk, oil was still about $100 a barrel at this point.

Erik: Let me stop you there and just ask a couple of questions. I've followed Sergei Glazyev for a long time. And, you know, he's been talking about this de-dollarization thing for a long time. And, until very recently, he was pretty much ignored by everybody outside of Russia.

Is it your contention that his desires are finally catching on? And, certainly, with what we're seeing with this yuan-denominated contract, it seems like maybe even Glazyev is starting to lean towards, okay, the ruble is not going to make it. We can't try to assert ruble-denominated oil across the world. Maybe the yuan is a better place to start.

Do you think that that is what's going on?

Luke: It's interesting. When you want to understand if the United States thinks somebody is serious, see how we treat them. In the rash of sanctions of individuals in early 2014, if you recall, we generally were sanctioning wealthy men in Russia and their bank accounts, in response to the Ukraine.

We sanctioned one economist. It's the only economist I've ever seen sanctioned by the United States. Guess who it was. Sergei Glazyev. Why would the United States government sanction Sergei Glazyev unless they thought he was a serious person making real tracks?

And, to me, that is a huge clue that he was absolutely making headway with that view.

As far as the ruble, yeah, I don't disagree. Ultimately, I think, if you see what Russia has been doing with gold that whole time, I think Russia is able to accomplish the same thing by doing what they're doing, which is re-denominate their FX reserves – control of their FX reserves – with their biggest economic output. The more gold they have, the more economic independence and freedom and monetary independence they have from dollars.

So I think it's a move in the same direction on a slightly different path.

Jeff: Here's a question for you. If this statement from Putin was from 2014, again, I come back to what are they waiting for? Because, between the time he said that statement and now, the Russian economy has been decimated again by another ruble crisis. If there was an alternative to do this, if they had the opportunity to do this, to replace the dollar in any significant way, what are they waiting for?

Luke: I think some of it is diplomatic/geopolitical. But I think if you start pricing oil in non-dollars that makes perfect sense. The dollar should skyrocket, right? Because you're talking about against a very large installed base of dollar demand from the outstanding offshore debt and the Eurodollar system itself.

If you start choking off at that point, at $100 a barrel, shoot, you're probably talking almost $3 trillion a year in oil flows alone, let alone natural gas. So if you just start whittling that down just a bit, you would think that the announcement that, hey, we're dumping the dollar on oil trade would be really bad for the dollar. It's not. It's really good for the dollar. In the short run.

Jeff: Yeah. But they haven't made any progress in actually denominating oil in rubles. In other words, they say that this is bad, it's hurting us, we intend to do something. Then, nothing.

Luke: Yeah, I think that they are – to Mark's point – I think they're playing more of a long game. So if it's just Russia, as big as they are in oil, they need their friends coming along. Iran was on board right away. Of course, Iran was sanctioned. Again, if this wasn't a threat, why would the US sanction Iran? Why would the US sanction Russia?

Why are we sanctioning Venezuela's oil industry as people are starving to death? It doesn't make sense unless it was a threat.

Jeff: Sorry to interrupt, but I guess my point is – let's just for the sake of argument agree that they're playing a long game here.

Luke: Yep.

Jeff: But in the short term, they're getting killed. Can they afford to play a long game? I guess that's what I'm saying, is can they afford to play a long game when their economies are taking

massive damage because of what's actually happening today? Can you afford to be that patient? And why wouldn't they be, I guess, more impatient? Is where I'm trying to get at.

Luke: I think the reason they're being more patient is they're Easterners, right? At the end of the day, they can't afford to stay on the dollar. If they stay on the dollar, then by 2030, when we print a big chunk of this $100 trillion of entitlements, they will have a pile of 0%-yielding paper, and all their oil will be pumped out, and they'll be done. It's over.

They have to take the pain now. Because, as much pain as it is – and it is pain, there's no question – it's less than the pain of, hey, ship all your oil to the Americans, or ship all your oil out for dollars. And those dollars are made worthless in real terms, then all of a sudden you have to be importing oil back in at $1,000 a barrel that you were selling at $50, 15 years ago.

Mark: Yeah, and I think the other piece of it is this statement was made in advance of the Saudi/Turkey announcement a few months later, which, basically, singlehandedly collapsed the oil market by cutting production. So you can argue and debate why they did that. Were they going after US shale? I have always believed that they were going after Russia. It was no surprise to me that the president of the United States was meeting with the Saudis the week before the big announcement. Or big non-announcement.

And I think that this, it's all gamesmanship. And, I don't remember who said it, but if the difference – maybe it was Luke that said it – the difference between whether you get attacked and whether you get sanctioned is whether you have nuclear weapons or not.

So the reality is, Russia really wanted to move in this direction and were trying in lots of different ways. But they got their legs cut off, literally and figuratively, by the Saudis pushing prices down. And then everybody lost control.

When oil hit $26, they clearly had lost control. And that's when they had to take the desperate measures in China and pump the trillion dollars of stimulus in and, literally, buy up the futures market activity in commodity futures – oil futures in particular – in the (whatever it was) third week of February of 2016 was ten times the normal volume. They clearly were saving the oil price.

Luke: You know, if you look at it – I think Russia was dictating terms the whole time. I think Saudi was reacting. If you go into that Turkey meeting, that non-decision, everyone on Wall Street except for us was saying OPEC was going to cut production. And what we were saying was, why would they? Because, ultimately, Russia was going to win share in China. The only market that's going to grow for oil in any real way over the next 25 years is China and Asia.

And so it really came down to, you know, China. And, really, China is driving this with Russia. Price in oil and we'll give you market share.

And, interestingly, the Saudis said, all right, even if we cut, all we're going to do is cede share to

shale. So we're not going to do that. We're just going to run full out. And so, it's interesting, about eight months later, when Kazakhstan devalued their currency, and they flat out said Russia is selling in yuan and forcing us to do this, the prime minister of Kazakhstan said the Russians are on the free oil system, the free currency oil system.

Basically, it became less about supply and demand of oil and what is the Fed doing, and it became supply and demand of oil and what's your currency doing?

Because the ruble collapsed and all of a sudden, with the yuan down versus the dollar, ruble down versus the dollar, Russia's the cheapest guy in the world and they're doing deals in yuan to China, they're gaining a lot of share.

And how did China benefit from this? To your point, Jeff, this bought them time.

The price of oil collapsed. Their current account surplus blew out. The pressure that they were feeling on the dollar shortage eased markedly in 2014. It bought them time. And so I think this is China and Russia mutually looking at this. And, importantly, it shifts the reference point of oil from the dollar to gold.

Russia bought gold this whole time – unlike '98, unlike '08 – and the price of gold priced in oil, from the fall of '14, doubled. It went from 13 barrels of oil per ounce to 30 barrels of oil per ounce. So if Russia's got 1,000 tons, guess what happened to the value of their FX reserves of gold in terms of their biggest economic output, oil? They're richer. Their reserves rose.

So you see what they're doing makes their economy unsinkable and away from the dollar in the long run. And I think they're playing the long game. They know that all they've got to do is just keep doing this and the dollar will collapse under its own weight. They don't need to be aggressive.

Jeff: Well I guess that's my point. If they're playing the long game, what that says to me is that there is no viable alternative on the horizon. Because if you're stuck facing all of those kinds of factors, and they're all negative – and I get what you're saying, Luke, about gold and oil and valuing the reserves – but the reality of the situation is you do need dollars. That's the way it is. The way the world works today is you have to have dollars.

And I have to believe that if there was a viable alternative to that system, it would be up and running. 2015 was the perfect time to do it, to do it before the damage hit. Late 2014, before everything started to really go bad for everybody.

If there was an opportunity to do it, I think they would have. I mean, that's what we've been talking about the last few days, is they've had every incentive to do that. And because the system doesn't work – it doesn't work for even us, let alone China or Russia – and if you're going to take on a massive economic damage, if you're stuck playing a long game with that, then that just means you have no short game.

Luke: I think the alternative is ready to go at a moment's notice. I just think, to your point, I don't know why they haven't. If China and Russia agree that the value of the gold sitting on all their books is 1,000 barrels per ounce, not 25 barrels per ounce, I assure you there's plenty of dollars out there. Supply of dollars is simply a function of the gold price, if you look at where the gold is now sitting.

And why they haven't done that yet? I don't know. It could be any given Sunday. Maybe they're just – well, again, in terms of the non-confrontational style of China, as opposed to Russia who tends to be more confrontational, it gives you a sense of maybe who's driving the boat. Why be the bad guy when you can do the math on the US entitlement picture and what'll happen to tax receipts, and you'll know that the Fed's going to have to cry Uncle first.

It's a mathematical certainty. There's really no mystery to it. You can do the math because – unless 75 million baby boomers disappear in the next six months, the math is very, very clear.

Erik: Hang on a second Luke. Because when you say that there are alternatives that are ready at a minute's notice, I don't understand what you mean. Because it seems to me that the US dollar stays the world's reserve currency and at the center of the financial system for as long as the favored central bank reserve asset around the world is US Treasuries.

Now there's no other bond market around the world that's deep and liquid enough to absorb that amount of capital. So how can you say that there's ready alternatives?

Jeff: It's not just that, Erik. To add to that, there's infrastructure that needs to be done. There needs to be markets, there needs to be protocols of how banks translate trade into each other's systems. I mean, it's not like you can just say tomorrow we're going to stop using the dollar and start using something else. That's not how banking works.

Luke: Oh, no, you're not going to stop. You'll never stop using the dollar. What you're talking about is, if you want to settle your deficits in your own sovereign debt, if you want to be the dollar, the price is very steep. It's a very simple, straightforward thing. You get – in the short and medium term, you get a debt-fueled government and consumer spending party. And in the long run you get a bankruptcy of your country. That's Triffin's dilemma. He laid it out very clearly.

If you look at how both China and Europe have structured their currencies, that is not politically acceptable to either of these nations. They are not going to settle deficits in sovereign debt, which are claims on your nation. You're bankrupting your nation in the long run. They don't want to outsource production of Mercedes and BMW to China or to Africa. They want to keep them there.

And you can see that with how the Europeans structured the Euro. So back in '99 when the Euro was launched, right at the last second they announced, hey, we're putting 15% of Euros on

reserves into physical gold and we're marking to market quarterly. And it was shocking to people. What are they doing?

If the Europeans were so star-spangled happy with the dollar, they never would have put 15% of their reserves into the anti-dollar, mark-to-market quarterly. They would have just put them in Treasuries and they would have tied their fortunes to the US. That was a direct nod to we are a net oil importer and a net exporter of goods, and so we want to start creating a currency that gives comfort to the Arabs that will hold its purchasing power through the mark-to-market of the gold quarterly.

And right away Saddam moved over to Euros. And the rest is history. China is setting up the same system to do that. And so –

Jeff: But it didn't work in Europe though. I mean, the Euro – I agree with you, I think that's exactly what the Euro was intended to accomplish – but it didn't. The Euro never supplanted the dollar.

Luke: It didn't accomplish it because they were shocked, we went to war. Remember, were Germany and France in favor of the second Iraq war? They voted against it, remember?

Jeff: Oh, they were vehemently against it.

Luke: Vehemently against it. Why? Because they knew what that war was about. It was about the denomination of Euro/oil war. That's what that was. And so, why did it not matter then? Well, it didn't matter then because we went to war to defend it.

Now, at the time, again, at that point we had no deficits, we were running a surplus, our debt was much lower, we were a younger country. And if you look at what happened to the United States' funding, Europeans stopped funding the US, basically, at that point. In terms of meaningfully increasing their deficits, their FX reserves to fund our deficits, they really kind of walked away from that.

And, you know, my pet theory is that that is why Larry Summers said to Brooks Lee Bourne, we need to not regulate the interest rate derivatives market. Because, in theory, that should have driven rates up then. But how did we deal with that? We wheeled out interest rate derivatives to expand from $50 trillion to $800 trillion. And that kept interest rates down.

Jeff: Yeah, but that was European banks. I mean, most of the Eurodollar supply in the middle 2000s came from Europe. So, even if the European government wasn't willing to trade in dollars, European banks were more than happy to do so. In fact, that's how they expanded. All of the European banks got massive on dollar businesses.

Luke: Right, they –

Jeff: And that's why you had nationalizations in 2008 and 2009 over a US housing bubble.

Luke: Right. Now, to get back to the original question of where can they create the market, you can create the market if you make either gold or SDRs big enough. That's the end game to the whole thing. You know, my point is that the Europeans and the Chinese have been creating a neutral settlement asset for, starting 18 years ago, with the launch of the Euro.

If you make gold big enough, if you make the SDR big enough, then that is the way you transition away from the dollar, where you start selling oil. It's not so much that the dollar loses share, it's that the Treasury loses share. The US Treasury bonds stop settling trade and it starts being settled in either gold or in SDRs, or something of that nature.

Jeff: Again, we're getting to the A to B problem. All of us agree that we want to get to B. But how do we get to B? And I think the problem is that nobody has any idea how big the problem is.

Luke: You can get to B overnight.

Jeff: Not without disruption.

Luke: Talk through what happens if Saudi and Russia come out and say we value gold at 1,000 barrels per ounce, tomorrow.

Erik: Well, but wait a minute. I think that in terms of the global financial system, if you're suggesting that we replace the dollar with gold, it seems to me that there's a very, very clear trend that – gold bugs love that idea, but central bankers like the ability to arbitrarily create fiat currencies. So going to either –

Luke: No, no, no, you won't replace it with gold. No, no, no, that's not what we're talking about here. It's – you are talking about a neutral settlement asset.

Jeff: No, we're talking about a transition to a neutral settlement asset. The transition is not crisis-free.

Luke: No, the transition probably is the crisis.

Jeff: Because you have to revalue everything else in order to achieve that.

Luke: The transition probably is the crisis. I mean, you think about it, 2013 up until about three months ago (I haven't checked the date in probably three or four months), global central banks bought more physical gold than they did US Treasuries. For four years. It's a fact. You can see it. The transition is the crisis, in my opinion.

What's the implication if Saudi says, hey, we're pricing oil in yuan and we value gold at 1,000

barrels an ounce? And that's probably too big a number for illustrative purposes. But the point is, at its core, the petrodollar is a low gold/oil ratio.

This is very important. It's a low gold/oil ratio. Gold is kept low by the big, highly-levered paper markets so that it doesn't compete with Treasury bonds. Oil is needed to be kept expensive to generate the dollar surpluses to fund the US government deficits. And so when you have cheap gold over expensive oil, you get a low gold/oil ratio.

What you would do by doing this, if you had Russia and Saudi come out and say, hey, 1,000 barrels an ounce is the new number, not 25 barrels an ounce, the United States has been able to have their cake and eat it too. You've got cheap gold and expensive oil.

Now the United States will have a choice. You can have expensive gold and expensive oil, or you can have cheap gold and no domestic oil – you'll be importing all your oil. Because, you know, again, 1,000 barrels an ounce – if you say gold is $1,200, great, oil's a $1.20, shale's bye-bye. And that's great.

You basically have created – what that situation will have done – it sounds crazy – it's exactly what the World Bank president called for – Robert Zelik, who left the World Bank and went to Goldman – called for in 2010 in the Financial Times. We need all five currencies and we need – we should consider using gold as a reference point. Gold's a reference point in that – it is not backed by gold, that's not a gold-backed dollar, it's not a gold-backed Euro – that is a gold reference point.

In 2011 you had DSK (Dominique Strauss-Kahn), the IMF, they wrote a white paper – we should consider pricing oil and gold – oil and gold – in SDRs. Again, it's a roundabout way of doing the same thing. But you could revalue what's the price of oil and what's the price of gold, and what's the relationship between the two, through the SDR.

And then all five currencies in the SDR you can infer, okay, that's what that implies for the price of gold and the price of oil in dollars, and in Euros, and in yuan, and in yen, and in pounds.

And of course, three months after he did that, he just happened to get, as I put before, unceremoniously deposed.

So, what I'm talking about sounds incredible, but the people that matter have been talking about it for over half a decade.

Mark: But it's not incredible at all. In fact it's entirely logical and it proceeds from the sequence of events.

Luke: Absolutely.

Mark: Right? I mean, going off the gold standard in '71 and closing the gold window, and

cutting a deal with the Saudis to basically exchange protection for pricing the new reference commodity in dollars. So anybody who threatens that by either elevating gold or elevating another currency like the Euro – or elevating now the renminbi, or tomorrow bitcoin – anyone who talks about these things is going to be unceremoniously deposed.

And it's not a pretty thing.

And the question is, has the power shifted enough such that we, the US, can't control the final decision? And it appears –

Luke: And that may be the answer to Jeff's question, what are they waiting for? Every day that passes makes the US weaker and –

Jeff: You know, I think that's it exactly. The balance of power hasn't gone far enough, and I think the reason for it is that there are logistical and infrastructure issues that have not even been close to addressed.

Luke: I think it's less that, and I think it's more the military side.

Jeff: Because, no matter how you value anything, it's just from one reserve currency to another that creates winners and losers. And you don't know how much the losers are going to lose and what that could possibly do.

Especially in a system like the Eurodollar. We have no idea how many Eurodollars there are. The BIS just last month, or two months ago, looking in the footnotes of bank balance sheets, found $12 to $14 trillion in dollar-denominated offshore FX that was every bit as useful and is used as the cash market.

And so that's my A to B scenario, is how do you get from a place where you have no idea how the system really works to a system that you hope you know how it works?

Luke: Isn't that just Putin's retirement fund?

If you were moving in that direction you'd expect to see things like – you would need the new reserve asset, you would need that to move to the right people, right? A big problem a lot of gold investors make – gold bugs, however you want to call it – is everyone wants to think of gold as actually like a market asset. It is not. It is a political asset. And so –

Jeff: And it's concentrated in very few hands. It's not distributed widely.

Luke: Exactly, right? So if you were going to resolve this issue the way I described, the way the World Bank hinted at, the way the IMF talked about, you would expect to start to see things like gold flowing to those nations. If that's going to be a new reserve asset, then the United States needs to have a lot. The Europeans need to have a lot – and when I say the Europeans,

the Germans need to have a lot.

And what have the Germans been doing? They've been asking for their gold back, haven't they? You would need the Chinese to have a whole lot. And how do you do that? One way to do it is you make sure the price of gold doesn't move in dollars, because Americans don't buy something that's not rising – it's cultural. Chinese buy more. Indians buy more when it falls. Americans, they won't buy something that's not moving in price.

In addition to these very powerful institutions, Western institutions advocating for these things, you're seeing actual movement since they advocated for them of things that would support that. Now, again, is gold it? Is it gold going into the SDR? Is it SDRs getting revalued much higher and that filters through to gold? I don't know. But it has to be a neutral settlement asset to fix the system.

And – to your point, Jeff, of we don't know how big it is – that just tells you how big it's eventually got to be. Like, you know, what we've been saying is gold is the credit default swap trade of this cycle.

Jeff: Right.

Luke: Like it's going to be thousand, thousand, thousand, 1,200 thousand, people playing with the paper back and forth Europe. And then you're going to wake up one day and it's going to be like 13 thousand, have a good day. And physical only, by the way.

Because if you look at, the GLD, there's all this language – hey, sorry, we can cash settle you, we'll cash settle you, you know – It'll be like CDS, right? If Goldman's long paper gold when it happens, everyone long paper gold is going to get paid. If Goldman and the systemically important banks are short gold when it happens, anyone who owns paper gold ain't gonna get paid.

Mark: Well, that's a problem for JP Morgan, isn't it, since they're short theoretically two times the world's gold production.

Luke: Theoretically. The way I think it'll really work if something like this happens we'll wake up and JP Morgan and Goldman will be like, hey, in this room we have all this physical gold over here, we never knew we had it –

Erik: This was such a great conversation that it was hard to choose a point to cut things off for this episode, but we had to leave it there. Don't worry, we'll pick up right where we left off in Part 4, which airs this coming Saturday Dec. 30th. Please tune back in then, as we'll finishe Luke Gromen's slide deck, then dive into our conclusions and predictions about how the dollar end game will play out, how long it will take, and what the landscape will look like after the dust settles. All of that is coming up in Episode 98, airing on Dec. 30th, 2017.