MACRO Voices
with hedge fund manager Erik Townsend

Julian Brigden: Stocks collapse under own weight or Fed/yields do it for them

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Erik: Joining me next on the program is MI2 Partners (Macro Intelligence 2 Partners) founder, Julian Brigden. As always, Julian has prepared an outstanding slide deck for us. You'll find the download link in your Research Roundup email. If you're not yet registered, just go to macrovoices.com and look for the download and registration instructions next to Julian's picture on our home page.

Julian, I know last time we spoke it was a very similar market environment. You had made some money for your clients on a short Treasury trade. You had then told them to cover, and were waiting for a bounce to put that back on. I think that, since then, you have put that back on. You've made some more money for them. And I think, at least partially, you've started to take it off.

So, how do things look as we start to look into your slide deck here, in terms of what we're seeing in today's market?

Julian: Thanks very much for having me back on the show, Erik. It's been way, way, way too long.

Talking about the Treasury market, big picture, we firmly believe that we saw the lows in Treasury yields in 2016. And that we're structurally in a bear market. But we did recently – having been pretty aggressive shorts into Q4 – recommend that clients back off on those a little bit. Not fully, but to some extent. And it's just because we've come up to some very big levels.

If you look at the chart pack that we've attached to this, you can see in 10-year yields, this 3.00/3.05 level is a very big level in the Treasury market. And we're sort of sandwiched between the low 2.60s and that 3.00 level. I think we sort of continue to mess around in that level.

And 30s is actually even bigger. We've put in here a chart that takes you right back into the early '80s. You can see that we've got this inverse head and shoulders pattern, which has built over the last four to five years. That neckline comes in at around this 3.15/3.25 level.

We've also got a very long-term trend line. And a number of people have used this one 30-year trend line. I'm not really a big fan of taking something over that long a period. But the one that I really love, which is one that one of my partners uses, is this simple moving averages – 100-month simple moving average.

This has held the bond market all the way since 1985. And it comes in at around 3.25/3.26. We've actually never, ever closed above it since 1985. We opened above it once, in '94, but we closed below it. And, to me, this is a big level.

So these are big, big levels in the bond market, which is why we recommended taking some cash off the table in the shorts. But, bigger picture, as you can see on Slide 4, the models are still telling us that this is a highly distorted market. This is a market where 10-year yields on balance should be about 100 basis points higher.

What's really driven this is, despite what the Fed may believe – I think it's interesting that, just before Janet Yellen retired, she gave a speech where she said QE had lowered Treasury yields. We frankly just don't believe that. We don't think it stacks up to the evidence. In fact, if you look at the bouts of Fed QE, you'll see that.

If you look at this chart here, where you look to the real interest rate differential between CPI and 10-year yields, you'll see that real yields didn't fall at all. Well, if QE lowered bond yields, that's what should have happened. You should have gone into negative territory. In fact, the only policy that did that was Operation Twist.

What actually lowered Treasury yields through almost all the period of QE was falling inflation. It was disinflation. And I use that term because I'm not a big believer in deflation. Deflation is falling aggregate demand and falling prices. What we had was falling inflation. So it's disinflation. And that's really what lowered yields.

What's been interesting, though, is, since the end of 2015, inflation has actually been rising, relatively significantly in the US. It's gone up a whole 2%. But yields (real yields) have fallen. Why? Because other central banks have come in.

And they have – because of the nuances of their policies (particularly NIRP, and particularly regulatory requirements that require European investors to be fully invested and match assets with liabilities) – you've had this tsunami of cash that's come out of Japan and Europe and suppressed our Treasury yields.

Erik: Let me interrupt you there for a second, Julian, because we've heard so many views on inflation, ranging from: *Yeah, yeah, 2% inflation is back, but it's not a big deal, it's all contained*, to Hugh Hendry telling us: *Okay, this is 1965, we're about to see an epic inflation as big as the '70s*.

Is it somewhere in between? What is your view, in terms of what could be on the horizon for inflation?

Julian: Well it's funny that he brings up the '60s, because that's something that we've been talking about for the best part of two years. And, if you look at the slide, you'll see our immediate forecast for inflation.

So our corporate pricing model, which tends to lead headline PCE, is just hoofing it. And we haven't been this high since 2011, when headline PCE was close to 3.00. I put a quote in there from the Markit PMI Composite for the US. You can see we are not the only people who are seeing this pressure.

I think I highlighted on this chart the drop in oil prices. It was this drop in oil prices that caused this deflationary scare. As I said, I don't believe it was deflation because aggregate demand, even in the US with a bloody large oil industry, didn't actually fall. What we had was a disinflationary pressure.

Actually, the problem was that the central banks panicked and they threw the kitchen sink at the problem, particularly the Japanese and the Europeans. And now they're going to pay the price for that. Because we've overcooked the goose. And we are slowly starting to get these inflationary prices. We think they will start to emerge.

If you look at the next slide here, you'll see CORE CPI. These are the lows, according to our work. So by early next year we are going to be well above target in the United States. And even in Europe we're seeing some input pricing models that we've built where we took 2,800 input costs, and we filtered them and found a bunch that were leading.

Our work suggests that you are potentially on the cusp of a big increase in these input-led prices. Now, it's possible – if the equity market just implodes, fine. Then companies won't pass these price increases on. But these prices are already in the system, and this is what I fear, Erik.

I think we've already got some inflation, some nascent inflation. I think the dip in inflation was a panic, caused by an oil price cycle. We talked about that, I think, actually, last time I was on the show.

And this is even before we spend all the money that we're going to. I think people forget that the budget this year has to be spent by the 30th of September. So we have got a lot of money to spend in the US – courtesy of Trump's budget – over the next six months.

We've obviously got the tax cut. It would be classic if we got a little bit of an equity wobble, say a 20 percenter, that would set you up for a big infrastructure spending package. All of this exactly what Hugh talked about – reminds us of the '60s.

And if you look on this slide here, you'll see. Back then we had this incredible period of low inflation. Incredibly stable. Six years where inflation basically oscillated around 1.3. You had a Fed that thought they could run it a little hot because they believed in the Phillips curve (unlike this lot that don't believe in the Phillips Curve) and you did. You heated the economy quickly with a bunch of spending. Well, you've overcooked the goose.

And I'm not even showing in this slide the '70s. I'm not interested. But, in those five years, where inflation goes from 1.6 to the upper 3s, then back down again as they aggressively try to heat again, and it then breaks out again and goes up to almost 6.

Treasury investors lost 36% of their money in real price terms. 36%. A third. And you never got it back. Never got it back. So I do think the analogy is relatively similar.

Erik: Julian, let me ask you a question about this inflation that you see coming. As I look at Slide 8 here, it looks like you see things heading quite a bit higher. People have talked ever since 2009: Did they really fix anything? Or not?

I've always said that it's when inflation starts to run away that we really find out what the scary part of this story looks like. Because, whether you want to call it disinflation or deflation or whatever, if you don't have an inflation problem you can conjure money out of thin air to solve almost any problem.

When you're fighting an inflation risk, the Fed's hands are tied suddenly. And it seems to me like that's really the big risk where you get to the point where the government can't do anything about the problem.

Would you agree with that? And, if so, how far are we away from that scenario?

Julian: I would agree wholeheartedly. In fact, as far back as 2016, middle of 2016, we wrote a piece called "The Real Risk Is Economic Strength, Not Weakness." In theory, growth in inflation is exactly what these guys have been aiming for, these central banks.

The problem, Erik, is in the process of trying to create that economic strength, and inflation, they have so distorted financial markets by nailing risk assets to the ceiling, and yields and rates (and I draw a distinction between the two: one being the bond market, one being official rates) to the floor, that they've essentially created a Gordian knot for themselves. This inescapable circle. Vicious circle.

So what happens on the day where we get – and we had a glimpse of this when we got that high wage number a couple of months ago – what happens on the day when you get that high inflation or that wage number? And you walk in and the bond market is down, yields are up hard? And the equity market, rather than greeting this as a positive sign, is actually down hundreds of points. Then what does the central bank do?

And I think we've already – from my discussions with friends of mine who used to work with me at Medley Global Advisors in DC, we already have a central bank that is going through a high degree of navel-gazing.

With the likes of Mester, and now Powell, talking about their concerns about – it's obvious to most of us, but it's not obvious to central bankers initially, that the QE and all their policies may have aggravated social inequalities, may have been responsible for massive economic allocation.

Which should not be their job.

So I loved it at the end of last year where people – you know, we had that wobble in the equity market and people were saying: Oh, well, the Fed's got to be in when the market is down 5%.

You're dreaming. You're smoking the strongest stuff that I can buy down the road in Colorado. Because that's just not even close. Not even close.

So, yes, I absolutely agree with you that the easy markets, Erik, are when you have economic weakness, when that ISM is pushing 46 or 47, and these central banks can talk about printing more money and levitating assets while keeping risks and rates and yields nailed to the lows.

The problem occurs – and there has been no test of this since '09 – when yields and rates have to start to rise.

Erik: Now, let me make sure that I'm assimilating what you're telling us here correctly. We've come down to flirting with 3%. It sounds like you're saying, hey, that's a logical very strong support level in yields. We probably should expect at least some kind of bounce off of that.

But you think, then, it's going to be inflation coming into the picture that will eventually push us through that 3.05 level on the 10-year yield. And it sounds like you're saying maybe that's where all hell starts to break loose, but it's really through 3.25 where you're talking about a game changer in the sense of breaking that long-term moving average. Which, as you said, has not been closed above in decades.

Is that pretty much the picture so far, as far as what I'm pulling together for this?

Julian: Exactly. So, we've come – yields have risen a decent amount. They are – and we'll talk about this in a second – they have an impact, right?

But our gut is that we are not going back to 1.5%. That would take a calamitous collapse in equities. While I'm bearish on equities at the moment, and I think there are lots of structural problems (which we'll come to in a second), I think that there would come a point, obviously, where, irrespective of inflation, central banks would calculate that there is going to be enough of a drop in equities that it would undermine the economic growth, and they will step in and try and catch it again.

But every time they keep doing this, Erik, they keep supporting the cycle in inflation. And that's actually what happened in the '60s and the '70s. You go from the period of super-low stable inflation, inflation starts to break out a little bit. The central bank thumps it. But it doesn't go back to the previous low. And then when the equity market wobbles, or the housing market wobbles, as it did in 1966, they back off. But then inflation comes through again.

And you build this oscillating cycle. Which in science and in all sorts of things, flow dynamics and whatever – we referred to it last year as this accelerative oscillation. The oscillations get bigger and bigger. And policy era begets policy era. That's kind of where I think we are.

But we've hit some big levels. So, if I go back to the slides again, you can see we've raised the question on Slide 12 – high yields – it won't be linear. There are consequences. We talk about two steps forward, one step back.

So we know there are sectors of the economy which are suffering a little bit. If you look at Slide 12, we've already seen car sales top out at around $18 million. It's a sine wave, believe it or not, in the US. Irrespective of how many people we have in the country, irrespective of how much finance we throw at them, we pretty much base around $8 or $9 million and we top at around $18 million. The contribution of this sector, now, towards GDP is zero.

And we have to ask ourselves, if you were to spike rates that much more, particularly at the short end where a lot of the financing goes on, how much damage would it do?

Another big area which I am particularly watching at the moment is housing. Housing is generally led by mortgage application for purchase, which you can see on Slide 13 here, in red. That has dipped into the low single digits. When rates were on their low, back in 2016, mortgage application for purchase was running at about 15% to 16% year over year.

So a third of that, right? There really are consequences. And let's not forget this is all occurring in an environment where, given where median house prices are, this has a material impact on affordability.

If you look on Slide 14, you will see the cost of buying an existing home in red, or a new home in yellow here. These almost – well, in new home cases it definitely is above the highs of 2005 and 2006, but in existing it is pretty close to it.

I know we hear great stories about the demographics of all these millennials living in Mum's basement, gagging to go and move into a new house. I don't care. They can't afford it.

So any further tightening of rates is going to really hurt the housing sector. We may have already done a fair bit of damage. And certainly the stocks in that sector suggest that we have.

Finally, in the real economy, you're starting to see some signs of late-cycle credit stress. Now, if you look on Slide 15, what I've done here is I've charted all the defaults rates of the big credit cards. And I think it's interesting that Cabelas – the sporting goods store – clearly, it's indicative of their client base not exactly being the highest credit out there. They picked the lows in 2005 when credit stress started to appear. They did it in 2014 again.

But I think it's more interesting when you look at people like Discovery. You know, mainstream credit card, you're starting to see the highest default rates you've seen since 2014. So there are definitively in the real economy, Erik, big potential problems.

But it's the equity market which really worries me. I have to admit.

Erik: I'm glad you came to that Julian, because there are so many different views. We should let our listeners know we are speaking on Wednesday afternoon, a day before this podcast will be released. The market just closed at 2608 on the S&P.

What is your outlook, as we have basically a flat day, very slightly down. Just barely off of the 200-day moving average. What comes next for equities?

Julian: We try to maintain a relatively bullish stance. But there have been some things that have increasingly worried us since the end of last year. In fact, for the last – well, really, since the middle of February – we've been hedging our short bond position with a short position in European equities. Which were the – just, technically, the ones that we really didn't like the price action in.

But, clearly, in the last couple of weeks, things have started to look increasingly questionable here in the United States. And I think – it's not the macro story that worries us per se, Erik.

It's this dichotomy between rates and yields and equity valuations which really worried us. And we saw, obviously, as yields started to break higher and the Fed started to get more hawkish, that the equity market has been challenged.

But there are some structural things that really keep me awake at night.

The first thing is that, when you look at some of the flow, and there are various different ways to measure this, but one of them we have on Slide 17. It does appear that retail has got sucked into the market, which would classically be the case, at the wrong time.

And one of the metrics we look at, to look at that, is the divergence between the DOW and this index called the smart money flow index. The smart money flow index was created by Investors Chronicle. It looks at times of the day, basically, by excluding the first hour or so of the trading day where they think there's a lot of retail money and orders that come in overnight. And concentrating on the last hour of the day.

And then it recreates the index. The idea is to parse out what they call smart or, really, institutional flow. And what you can see here on Slide 17 is this massive divergence, since the election, between the overall DOW and the smart money flow index. Implying that it's retail money that has got sucked into this market at the height.

The second structural concern we have is when we look at some of that smart money – now, I think I've shared this with your clients in the past – but we created this what we call Ammo Index. It doesn't tell you anything about timing, nothing about timing whatsoever. It is just designed to give you an idea about how much ammo, what is the ability of institutional money (or leveraged, in this case, institutional money), to absorb some sort of shock.

And if you think about it like on a video game, the lower the ammo the worse scenario/case you are in. So, the lower the index, the worse case the situation is.

What you can see here is that the ammo index is actually very recently, at the end of last year, went through the lows of 2000 saying that the ability of leveraged players to absorb any sort of exogenous shock via their value at risk models – or VAR models as people refer to them – is exceedingly low. They are exceedingly vulnerable. And it's in that context that the chart on Slide 19 worries me the most.

We have had a market where – and you know how this works, Erik – where you could assume very large amounts of risk because volatility was so incredibly low. But, as we all know, we've all heard the stats about how unusual it is for the VIX (which is emblematic of that) to trade at 10 or below, which is what we were doing at the end of last year.

Well, we flagged this to our clients. And we said, we're worried. In fact, we gave them a very simple metric to watch (which I haven't put in the chart pack). Which is just the spread between the VIX and the VXN or the NASDAQ vol. And we said, whenever that spread gets to the NASDAQ VIX and trading over the VIX by about 6.5 to 7.5 vol spreads, watch out. Because it can't stay there.

One of two things happens. Either the NASDAQ vol relaxes and we roll over and everything is fine. Or the VIX is going to start to accelerate. And it flagged it very well. You know, going into 2007 we've got this kind of move. It flagged the ETN blowup, which we had in February. And once again, as of the close today, that spread is at 7.3 to vol spreads.

It just worries me. We're in a higher-vol environment, Erik. And, as you know, the way that that works in the risk models is that reduces the amount of risk that you can buy. And so, in a falling market, the ability of leverage to buy – institutional money to necessarily buy dips is going to be severely constrained in an environment where retail is already long. These are the structural things that worry me.

And while over the next ten years, fine, I'm okay. When it comes to equities, I think, certainly, if we're in an inflationary environment they'll outperform fixed income. They're in for a bit of a shock, I fear.

I fear we're on the cusp of a 20-percenter. It could be potentially worse. And I do feel, personally, that we've put the highs in. I've said either the market has to collapse under its own weight, for whatever reason (higher vol, trade talks, whatever), and then the Fed backs off.

Or, faced with the inflation picture, the Fed is just going to keep hiking until they eventually crack the market. It won't be intentional. It's never intentional. But it's what always happens. So I fear that the highs are in.

Erik: Now, I'm very curious to probe a little bit on that idea of the highs being in. Because everything you've said about the structural direction being towards higher Treasury yields, which is clearly not going to help the stock market – I'm with you on that. I think there's a lot of reasons for concern. But there's one specific scenario that I've been toying with that I'd like to run by you and just get you to grade me on it, so to speak.

As you said earlier, we just got to a resistance level in Treasury yields on the 10-year yield at around 3%. We got to, I think, 2.95 or 2.96. We've come off of that. And I know that you had told your clients to go ahead and take profits on their shorts there.

It seems to me, with the incredible record short positioning that we see in the Commitment of Traders reports, that we're set up, potentially, for a short squeeze in bonds that could bring Treasury yields down substantially. Maybe, just maybe, I would think opening the door to one last hurrah higher, to new all-time highs in the stock market, let's say into the middle of the summer, and then things really, really get ugly in the second half.

It seems like we started with all the same ideas that got us into this. Your view is the high is already in and that's not happening. Why is that?

Julian: The first thing I would say is that I think that's always a risk. But I would – personally, I think that, if you're going to get significantly lower bond yields, through those 260 levels which I've flagged in the chart, I think you're going to need a major risk-off event.

So, in other words, really significantly lower equity market. It's possible we're on the cusp of that now. But, in that case, that's the driver. So at this point I do think that bonds are a little bit of a hostage to the equity market.

I do think if the equity market were, however, to rebound and remain resilient, I don't see any way possible – given my macro backdrop for higher inflation – yields are going to come down a lot. In fact, I would imagine with a strong equity market we'll be pushing the upper ends of those: 3.05 in 10-years and 3.25 in 30s.

And, in fact, I have to say that the price action, for those people who – someone who is looking for those shorts to get squeezed – that the price action of the bond market, in the face of a 10% correction in the equity market, is bloody appalling, to be honest, Erik. We have dropped a whole 20 basis points off the highs.

Erik: Am I correct to interpret that the really big signal that you're waiting for (it sounds like you think it's pretty darned close at hand) would be a close – let's say it's a weekly close, or at least a daily close – above 3.05 on the 10-year Treasury. Or 3.25 on the 30-year.

That’s where it’s a different game that’s on at this point. Is that right?

Julian: Yeah, I think so. Certainly the 3.25, 3.26 on the 30-years is a monthly signal. So I really would want to see that confirming monthly. But, obviously, a month is a long time to be waiting for price action. So, yes, those initial breaks above those levels would be, to me, significant. And, I think, one of the things, beyond just that, up-moving yields.

Even as we sit here, Erik, and the equity market is down. Because, remember, the equity market can come down even if yields don’t rise. If they think that the Fed is going to deliver into a down-market because inflation has risen. Maybe the curve is still flattening, so yields actually don’t rise. It is a tightening of financial conditions. And, to me, that is definitively a clear risk.

We are just in a very different environment. We’re in an environment where, up until the end of last year, the equity markets had not been challenged since ‘09 by any tightening of either yields or rates.

And that, to me, that picture has now changed. So they can’t just willy-nilly rally back up to the highs, and not – with this macro backdrop of higher inflation – and not expect the end result if they try to, to be either the Fed hiking more aggressively, or bond yields breaking out.

And I think this inability for fixed income to hedge an equity portfolio, to me, is dire. Even if bond yields just – I mean, so far they haven’t really acted as a hedge since the beginning of the year.

And I think it must be – most of your clients, in fact most investors in the world now, are in what we would call these modern balanced portfolios. These portfolios where, essentially, you have been perfectly hedged by owning a pool of risk assets and a pool of fixed income. But that’s really only worked since 1998. And it’s one of the things that we’ve been stressing to our clients since the central banks came in and introduced the “Greenspan put”, which has been carried on via QE and so forth.

In other words, this ability (whenever risk assets wobble) to intervene and lower rates and boost bond prices has only worked in the last 20 years. For 230 years, according to the Bank of England, prior to that it never worked.

And the defining difference was, prior to ‘98 we were concerned about inflation. Post-’98 we have been concerned about deflation. And I certainly think that, for the next year or so, and years going forward, if the Trump thing really keeps rolling through, we have to be concerned about inflation.

And that’s just going to change that whole relationship between bonds and equities. Both can go down together. You can lose money on both. And you have, in that scenario, no hedge.

Erik: Let's talk about that, specifically. Because so many people are not only protected against that, but they are levered up in these risk parity profiles. They've levered up the bonds, and they are not prepared for the situation where both bonds and stocks are selling off at the same time. If that begins to happen, it seems to me it potentially becomes self-reinforcing.

And one of the things that I wonder about is where the money goes if they're both selling off and people are liquidating institutionally. They can't stay in cash. Institutions, by mandate, have to go someplace. Where does what's left of their assets go as it comes out of both equities and bonds?

Julian: Well, the first thing to say, if you use the '60s analogy, it is true that it's a slow process. So, as I said, it's this two steps forward, one step back. So this is a multi-year process we're talking about, if we do try and finally engender some inflation into the system.

So, to some extent, while money does slosh about, a lot of money gets (like the proverbial frog) boiled in the hot water. The bond investor doesn't notice that, in real terms, he's getting crushed. And, let's be honest, we all know that societally we need to inflate away the value of this debt. So I think it's important to just make that note.

Now, short-term, what you would expect to see is you should expect to see some of the commodity markets start to outperform – and here is the proviso – on a relative basis. All right? On a relative basis.

So, versus the equity market, commodities should start to do well. I think it's overdue. We haven't yet advocated that to our clients. But we got word to our retail client base who subscribe to the Macro Insiders piece, where at the end of last year we actually allocated – I suggested they allocate, for the first time in a very long time, some money to precious metals.

It's not a big aggressive trade. We think it's got, perhaps, potentially a bit more further downside, as we think there's one more leg up in the dollar. But, yeah, the commodity sector on a relative basis, typically, in higher inflationary environments does better.

The equity market is much more volatile. So, like, 1960 to 1965 you made 80% at investing in the S&P. You made money in the bond market, everything was great. 1966, the equity market drops 20% as the bond market starts to break out and yields start to rise. It then rebounded. You only made, from the previous high, another 15% over the next four to five years. But you did make money.

It was more volatile, it was more difficult. You had to be a more active trader. All this passive would be classic – if everyone's got passive investors right at the cycle high, and the cycle low of volatility. That would be classic wealth destruction. But you did make money. You got killed in the bond market.

So the thing that you can't be invested in is bonds, and you have to manage your risk now in equities much more aggressively.

Erik: Let's come back to the US dollar. You mentioned it briefly. We haven't gotten to that at all yet. What is your view on the dollar?

Julian: When we look at the dollar, there have been three structural things that have worried us, big structural issues – I think I've discussed this on previous episodes with your clients – is this low US current account deficit, relative to global GDP. Now, just very briefly, essentially, as the reserve provider of the world, we have to supply the world with those reserves. And the way we do that is running a current account deficit. It has to increase roughly in line with the growth of global GDP.

Since 2006, courtesy of shale, where we've substituted imported oil for domestic oil, the current account deficit in the United States has collapsed. And someone needs to tell the Trump administration if they want the dollar to be the reserve currency they can't keep harping on about lowering the current account deficit.

Now, we've had episodic bouts of dollar strength in that period, most notably when the Fed tapered in 2014. And the dollar, like a ball that's been pressed below the surface of the water and you just take your hands off it, shot up to the surface. That was a shortfall of dollars in the system. Because the way that we have filled the gap left by the collapsing current account deficit is through capital exports from the capital account.

So hot money has flowed overseas. If you go and look at things like shares outstanding in European equity ETFs, you'll see that we've been doing it increasingly over the last few years, and unhedged. In other words, US investors own European stocks in Euros.

That's the fundamental instability at the heart of the system. And it is horribly unstable. Horribly, horribly unstable. We've relied on this capital outflow, but a lot of that capital outflow has been linked to the Fed's QE. So, as they start to accelerate QT in Q2 and Q3 of this year, the risk is that that capital outflow will get constrained.

The second issue that we've been worried about has been the repatriation story. Not so much because we think there's a lot of Euros to be sold to buy dollars, but because we are concerned that the changes to things like Basel 3 and the Volcker rule have changed the plumbing of how you take a dollar in the United States and lend it overseas.

So, if a dollar that is sitting in Dublin, or sitting in Geneva in a corporate account, up until now has not wanted to come home, suddenly comes home and goes back to New York and is used for buybacks, that money isn't there to fund the dollar liability overseas. Not immediately. Eventually it will seep out of the system, but not immediately.

So we've been concerned that the dollar is highly unstable. And there are these factors: Fed contracting the balance sheet, US investors balancing the equation but heavily invested in overseas currencies, and this repatriation could create this tipping point.

And I see the LIBOR tightening as indicative, partly, of that effect. The low on the LIBOR–OIS spread actually occurred in mid-December, I believe. And it was at the point at which the Fed's balance sheet went negative year over year.

The second big jump came on the passage of the corporate tax bill.

Both of those, to me, are indicative of tightening overseas dollar liquidity. It's yet to feed through itself into the dollar, but I'm worried that if this equity selloff accelerates, that US investors – and this, I think, would be the triggering – we see this sort of dollar move as the last move of a risk-off dollar move.

US investors look at their Euro stocks investment in Euros and go, ooh, I don't like the Euro stocks anymore. They sell it. As they sell it, they buy dollars, bringing their money home. And so the dollar move is going to be the laggard of the risk-off move.

But, when it happens – and we know this Erik – when the dollar rallies at the same time as you get risk-off, it turns things really vicious, really quickly. And, given this massive hole created by a low current account deficit, with the whole world depending on the hot money flows, in a world where you can click and bring that money home, it could be really vicious.

Now, once that's happened, we've reset it, I believe the dollar sinks for the next decade or so. What the Trump administration is doing is tantamount, I think, to undermining the long-term value of the dollar in a system where it's very different from cycles in the past.

We're trying to fight a new cold war. We're going to try and spend a lot of money and we can't afford it. It's not like the '60s when the big buyers of our debt were our friends, the Germans and the Koreans, who we were providing military umbrellas to.

Now it's the Chinese. Things are just not structurally good long-term out for the dollar. But we still live in a legacy dollar system where there is a structural shortfall.

And if we trigger that by causing capital flight back to the United States, God help us.

Erik: Now, conventional macro wisdom says that, as Treasury yields increase and therefore the yield becomes more attractive relative to other sovereigns, that's supposed to cause a lot of international capital flow into the dollar, strengthening the dollar. But I'm seeing a lot of smart people – what you just said.

I listened to Jeff Gundlach's forecast. He sees higher Treasury rates, but he also sees a structural lower dollar. It seems like that correlation is just broken down.

Is it because of these other flows and the effect that you've described with Trump's policy on the current account deficit that's causing that traditional correlation to break down the way that we're starting to see?

Julian: I think – let's be honest. Up until now we've had loose fiscal, relatively loose monetary. Right? It's only changed in the last couple of months. And arguably even since Powell has come in. We've had central banks that have – and I think, big picture, they still want to – the expression we like to use is "run it hot." They want to boil bond investors slowly. They want to run nominal GDP hot.

This is how we eviscerate the value of the debt in what are aging and very indebted societies.

So, yeah, loose fiscal, loose monetary is disastrous for a currency. Things are changing a little. As I said, I think the Fed will be forced, relatively, to become more hawkish. But, bigger picture, what I'm talking about is an episodic, final, nasty, destructive dollar rally.

I think it's a dollar rally that ends up resetting the system. I think after the dollar has rallied and destroyed a lot of things, more people will abandon it. You'll see more use of the renminbi. We are in a cyclical, I think, decline of the dollar.

And I just think that there are imbalances now which strike me as very dangerous. You can't be the reserve provider and not structurally provide the world with reserves, which means via the current account deficit, and just totally rely on hot money to be the balancing item in a world where that hot money, Erik, can just click and come home.

Erik: In this last hurrah that you envision for the dollar, do you have a target in mind? Either dollar index or dollar Euro or any other measure?

Julian: No. We're watching levels. It's difficult, because at some point central banks come in, right? And they'll just, whether they extend swap lines again or whatever. So it's really, it's a pain level. I don't know whether there is a technical level that I would see per se. It's a pain level.

If we look at – and everyone focuses on the Euro; I'm not really sure it's necessarily the one to focus on – but if I looked at – I'm sitting in front of my computer now. Based on today, the trend line that we're watching comes in at around 122.40 off the July lows. It's a pretty clear trend line.

There's another decent support at 121.55. If you could break through that, and if you're looking at the dollar index, it's around 91. So you know we've been watching these things. We haven't put any of our clients – with the exception of a punt that we took in dollar Canada, which was a nice trade – we haven't put any of our clients into any of the long-dollar trades.

And, as I said, I think it's the final shoe to drop.

You get bond pressure and rate pressure and equity problems, and then the dollar. And the dollar comes in and is just the final napalm run into the risk-off move, and then we'll kick off again.

Erik: You said earlier that you've covered your bond shorts and taken profits because we hit some target levels. As we see a bounce in price or a dip in yields it makes me wonder. With what you have in mind for the equity market, is the next bond short another Treasury short? Or is high-yield the place to focus on shorting bonds?

Julian: We've taken partial profit on the Treasuries. We've still got some. We've advocated keeping some. And that's because we still see those higher inflation prints to come. And, if we broke through 2.60 I think we'd be out. But we haven't got there, not even close yet.

In an equity risk-off environment, I think there's a lot of things that are just vastly mispriced. We were looking at some of the spreads between Treasuries and B double A spreads, and those things. We're just seeing super-nice downtrends, tightening credit, tightening credit. And they've blown. And they are showing no signs of coming back. So I would be very wary of spread products at this point.

As I said, longer term, if you take that '60s analogy again, in the second half of the '60s where they ran it hot, yes, yields rose, Erik. And I think this is a big point, because people have always said to me, oh, but yields can't rise, there's too much debt, the whole world will blow up.

And I say to people, look, there's a difference between nominal yields and real yields. Nominal yields can rise. In the '60s they rose from 4% to 8% 10-year Treasury yields. But real yields fell. Because they just didn't keep up with the nominal inflation and growth story.

And I think that is great, in a way, for indebted companies. Provided they have pricing power. And this is when we talk to credit funds. This is the thing they always said to us: If you are right, we're going to get some real pricing discrepancy in the high-yield bond market.

Because the company with pricing power, the one who can raise their prices in an inflationary environment, their credit is going to be pristine. Whereas, the company that can't – let's say the retailer, with lots of debt around there – leverage themselves up, and lots of stores that they have to finance, they go bankrupt.

So it becomes a much more binary story. Initially, in the risk-off period, yes, they'll all go down. Great opportunity to pick up some stuff that you like: names, but with pricing power.

Erik: Well, Julian, it's a real pleasure for me, finally, to sign off one of these interviews when we're not going to get everybody upset with me. Our institutional listeners have always enjoyed your interviews. And, of course, they can contact you with respect to MI2 Partners and your institutional advisory service.

For many, many interviews, you had no retail offering, which just infuriated our retail audience. That has changed. You have partnered with our friends at Real Vision around something called Macro Insiders. Tell us about it.

Julian: Macro Insiders is a joint venture that Raoul, who produces his own institutional product, GMI, and I decided to come together and offer for, exactly, retail clients. And the idea was to keep them abreast and try and help them manage some of the big macro risks.

Now, we've gone through a very boring period in macro. And I think that was obvious in the first couple of months of offering the product. But, really, since the end of the year things have started to pick up. We're on the cusp of some of these trades. We're on the cusp of some of these risk factors that we had been shadowing to people.

We wanted to offer people a way to manage these risks, because they're not usually what your equity broker or your guy who is managing your muni portfolio will keep you attuned to. And that's really what we've been trying to do.

Erik: Well, Julian, I cannot thank you enough for a fantastic interview. Patrick Ceresna and I will be back as MacroVoices continues right here at macrovoices.com.