Luke Gromen: Secular Dollar Bear goes Tactically Dollar Bullish

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Erik: Joining me next as this week's feature interview guest is Luke Gromen, founder of the forest for the trees. Luke prepared a fantastic deck of 35 charts and graphs for us, so be sure to download those. Registered users will find the download link in your Research Roundup email. If you're not registered yet, just go to macrovoices.com and click the red button that says Looking for the Download.

Luke, it's great to have you back on the program. You have been one of our most outspoken long-term secular dollar bears. You've articulated a very coherent argument which basically says it's inevitable that the US dollar will lose its hegemony in the long term over the world financial system – and not having that artificial demand for dollars is going to weaken the dollar in the long term.

But I believe that you've actually turned short-term dollar bullish. So please fill us in. What has changed your thinking? Is it a change? Or is this just a tactical view that you have? And what do you see short, medium, and long term for the US dollar?

Luke: Hi, Erik. Thanks for having me back on. It's certainly great to be here.

We had a tactical shift a little over three months ago, really. And it was based on, effectively, what we were seeing in markets. And so, as we stand on the dollar versus where we came into the year, we think that the second half of the year is going to be really what we call on Slide 2 "A Tale of Two USD Trades."

There's dollar trade number one, which is, near-term, a US dollar short squeeze as Fed hawkishness [continues] despite softening emerging market currencies. We think is likely to continue. And we've talked about this in our research over the last three months as the Fed is potentially *shooting the hostage*. Or, in more draconian terms, *burning down the world*. And that is the near-term tactical shift you're referring to.

The second trade of the two dollar trades is this structural dollar trade that, to us, makes the long dollar look like perhaps, on a structural basis, the biggest *picking up nickels in front of a steamroller* trade since AIG was minting money selling subprime mortgage insurance in the mid-2000s.

Slide 3 – Your listeners will be familiar with this from having us on before. 3Q14 to us was a huge moment. And you had global FX reserve balances fall for the first time in 70 years. Nobody alive trading has ever been trading during a period of time when US deficits began to matter again. Yet they did.

And it's interesting, as you go to Slide 4, what that prior slide showed is that deficits have effectively been funded by foreign central banks, in large part, for 70 years. But since the third quarter of 2014 it's had to be funded by the global private sector. And, in particular, the US domestic private sector.

We thought it was really interesting – you can see on Slide 4 – this recognition that suddenly US deficits being more financed by the US private sector rather than global central banks is beginning to go a bit more mainstream. This is a chart that was available in the public realm from a Deutsche Bank slide deck.

And, of course, we've highlighted on your program and elsewhere in the past that some of this domestic purchases of US Treasuries by the US domestic private sector has been "encouraged by bank HQLA reforms," money market fund reforms – and, most recently, tax reform here in the United States.

All of this worked to help encourage the funding of US deficits by the US private sector.

Slide 5 – Everything was going well until, for the first time since 2009, you saw the US federal deficit begin to increase as a percent of GDP. And (as we've highlighted before on your program, so I'll move through it quickly) this, to us, was a real watershed moment.

As you look back, you'd only seen the deficit widen as a percent of GDP seven times in history. Six of those prior widenings were followed by a US recession within 12 to 14 months. The one time it did not was in the mid-'80s when the dollar was significantly devalued at the Plaza Accord.

So this time last year, and, really, in 4Q16 when we saw this, a lot of people were looking for a stronger dollar. Our case was – based heavily on this chart – that, unless the dollar was significantly devalued, the US economy would likely weaken pretty notably. And that would have some pretty negative implications for the system in general.

What Slide 5 shows means that what you see on Slide 6 – this vicious cycle – is now engaged. Start at the top of the chart. Deficits rise. It drives an increase in federal borrowing.

You move to #2 which is foreign central banks aren't lending to the US government "on net" [basis] anymore. So [#3] the US is forced to borrow from the private sector, because the federal government is borrowing so much it crowds out the global sector. And that drives LIBOR up and drives Treasury yields up. Which, on LIBOR in particular, we've seen rise since 3Q14 when we saw global FX reserve balances peak.

And then you get to #4 where federal borrowing crowds out the private sector, rates rise, and that slows the US economy.

And you wash, rinse, repeat.

And this is what began last year in 4Q16, once you saw deficits begin widening as a percent of GDP again. This is a subject we've been touching on, really, since late February in our research. As you can see here on Slide 7, if deficits matter again the US becomes subject to its own impossible trilemma, which is a little different from the classic emerging market trilemma in FX markets. And the US's trilemma is that the Fed can only have two of the following three things:

1 - Rising Fed funds rates
2 - A stable or rising dollar
3 - Rising stock prices

So, as we came into 2018, we thought we were going to see more of what we saw in 2017, what we just described in terms of the widening deficit. In 2017 the US saw a falling dollar, rising stock prices, rising short-term rates. And as we came into 2018, we thought this combination of the US impossible trilemma would continue.

That was until the long end of the Treasury curve sold off in February's equity market selloff. And we think that was an event that really spooked the Fed. It caught our attention. And that was really when we started to shift our view near-term tactically on the dollar.

Slide 8 – there's three charts here from the Fed database. All three are periods of time when the S&P 500 sold off 10% in a relatively short period of time. The S&P in each chart is in blue. 10-year Treasury yields in each chart are in red. In 2010: stocks down, 10-year yields down. IN 2015: stocks down 10%, 10-year yields down big.

In 2018 you can see a very different pattern, which was that stocks fell 10% – one of the fastest 10% selloffs in history – and yet 10-year yields were up. The long bond sold off on a very sharp US equity selloff. For us, that was a big moment.

I know at least one equity strategist, the Bank of America, noted that Treasuries were trading like a risky asset in the first part of 2018. And we think the reason that was, as you go to Slide 9, for the first time in 70 years the US federal deficit was widening as a percent of GDP during a peacetime economic expansion – which, all else equal, should be a negative for the dollar.

This chart on Slide 9 – it's budget balance against the US unemployment rate. And you can see that little gap back during the Vietnam War directly contributed to the dollar's weakness in the 1970s. It does beg the question, structurally: What's going to happen with this gap?

So, as we said, post-February our shift outlook on the dollar near-term and tactically began to shift. Whereas we're looking at it from this trilemma framework, we thought you'd see dollar down, stocks up again in 2018.

We thought you'd start to get – and the Fed quickly supported with their language – more hawkish to support the dollar, to support the long end of the Treasury curve. Because we think they really got spooked by that Treasury selloff in the market selloff. And that's what we've termed *shooting the hostage*, so to speak.

As you can see on Slide 10, what we mean by that is this is the first time that you have seen the Fed raising rates while the deficit is increasing as a percent of GDP since 1974 and 1978. And in both of those instances, the Fed was effectively defending the dollar, trying to stamp down inflation, when they were doing that.

So the key question for us at this point, in terms of the dollar trade #1 (us being more tactically bullish on the dollar), has been: How far will the Fed take *shooting the hostage*?

Slide 11 – The question is: Will they take it as far as Paul Volcker did back in the late 1970s? This chart is the 10-year spread. And you can see, even allowing for the fact that rates were higher on an absolute basis back then than they are now, rates were wildly negative.

And, interestingly, it was after Volcker was told by EU creditors in October of 1979 at an IMF meeting to "take stern action" to stem severe dollar weakness. So nobody thinks it's possible, as far as we can tell, that the Fed would be willing to do this. But, given the degree of de-dollarization of global commodity markets – which we've been talking about for a while and we will touch on a little bit later in this slide deck – we think it might be necessary.

Slide 12 – this was a headline from a report on March 1, 2018. We shifted our near-term view on the dollar based on what we were seeing in markets and also on risk markets – a big near-term shift in our thinking. We thought, the Fed is trying to stabilize the dollar, and so we thought that that would be ultimately probably negative for the economy. But also, probably, positive for continued volatility in rates and equities.

When you take a step back and say – why are we focused on this trilemma for the United States if deficits don't matter anymore? – You have to go to Slide 13. I think it's a very important and very underappreciated set of charts, which is the US impossible trilemma is really a function of US policy makers establishing a system over the past 25 years that has heavily tied US tax receipts to rising equity prices through consumer spending – via options, restricted stock, IRAs, etc. So this chart is really interesting. (Again, it's Fed data.)

If you take a look at the year-over-year change in US federal tax receipts (the blue line in both charts), against year-over-year change in total US equity market cap (the red line in both charts). You can see from 1974 through about 1998, there is very little to no to almost negative, slightly negative, correlation.

And then, post–'96–'97–'98 timeframe, not only are they very closely correlated, but equities lead tax receipts. And it's underappreciated on the Street how this relationship – it's also not well understood why.

And the key was that back in – I believe it was either 1994 or 1995 – President Clinton signed legislation that eliminated the deductibility of executive cash compensation over $1 million a year to the corporation, but the legislation exempted incentive comp of any kind. So, of course, what we've seen since is incentive comp has gone crazy, cash comp has not.

So what you've ended up having is – it was a big driver to the growing wealth discrepancy in this country, and that's why you ended up with this situation where equity markets now lead tax receipts.

Erik: Let me interrupt for a minute. I know you're on a roll here, Luke, but I've got a few questions, going back to Slide 9, actually – before we get further into the trilemma. It's a question that I think is so important – and everybody has got a different view on it –

When we talk about what happened with this breakdown of correlations between equity and bond yields, the first half of the question is: Is this the tail wagging the dog? Was it the bond yields that crashed the equity market? Or was it the selloff in equities that resulted in the move up in Treasury yields, the down in Treasury prices?

And the related question, Part 2: Is this potentially a very threatening correlation change? Because so many people in this risk parity trade have assumed that stocks and bonds are inversely correlated. If they start moving in the same direction in terms of price, suddenly a whole lot of risk models break down.

So is this a change that is going to persist for a while? Or was it an anomaly? And, if so, why did it happen?

Luke: Great set of questions. Yes I think it is going to persist as long as global central banks do not sterilize US deficits. In other words, as long as that first chart does not grow nearly as fast or faster than US deficits grow on an absolute basis in terms of dollars, then the correlation between equities – this risk parity trade – will likely continue to break down.

This is really the crux of the trilemma, which is that, if deficits are going to grow, and the US private sector has to pay for its own stuff, these deficits are growing a huge percentage of discretionary income and you basically get into a question of you need the equity market to try to fund the Treasury market.

That is what you really end up with. And that's a bit of a size mismatch. And so that's where we get into this impossible trilemma framework.

In terms of your question: Was it was the tail wagging the dog or vice versa? I think it comes back to the dollar *vis-à-vis* the Treasury market. In other words, if we are now in an environment where global central banks are not going to fund US deficits (and they have not done so on-net in four years), we need someone private to buy it.

And we've talked about how banks were, effectively, forced to do so, and then you had money market funds, effectively, forced to do so.

2017, look, we've tricked people. Right? Hey, buy a 10-year Treasury, clip a 2.6% coupon, it's risk-free – which sounds great until you lose 12% on the currency.

So I think, as you came into this year, as the dollar continued to weaken, as the Trump administration showed up in Switzerland in the third or fourth week of January and said, Hey, we're going to wale on the dollar some more this year – I think that was really the global private sector saying, Wait a second, you think we're going to sit here and lose a percent a month on the currency again? And clip a 2.6% coupon?

When you walk through it that way, I think it was the bond market. People say, where are the bond market vigilantes? I think that was a little mini-bond-market vigilante move where the global private sector just said, yeah, no, that's not going to happen. We're not going to take these kinds of losses on our dollar holdings again. You'd better do something.

So I think that was really the message conveyed to the Fed, either by the markets or by someone directly.

Erik: Moving on to Slide 11, anytime anybody talks about what Volcker did – Paul Volcker himself has been a very outspoken. He said that it would be categorically impossible today to do what he did back in '79–'80 because, at the time, the US federal debt was just not that big of a deal. Of course it was big, but it wasn't anything close to what it is today.

And Volcker has been outspoken in saying it's completely, totally impossible to take the approach that he took of radical increases of short-term rates because there is no way to possibly service the US debt. So those kinds of policy options, in Volcker's own words, are no longer possible.

Now, that may not be exactly what we're talking about here. So please clarify exactly what you mean by Volcker *shoots the hostage*. What kind of policy move are we talking about? And is it something that is still plausible to do today?

Luke: Volcker is right. It's not plausible. And, in the report, we highlighted this – and in others since – we've said it's not possible. It's not going to work. But that doesn't mean the US can't try.

What we equated it to in one report is if you've ever seen the scene at the end of the Oliver Stone movie *Platoon* (a great movie, a very moving movie), they're getting overrun so they call in an airstrike inside the wire, so to speak. Basically, to the guy calling it in, the risk of collateral damage to his own – in this case "soldiers" – is worth the cost, in their judgment, of being completely overrun and losing everybody. And that is the metaphor we've used.

Volcker is right. They can't do it. The financialization of the US economy is much greater. The demographics are much different. The debt levels are much different. It's just different every single way. But that doesn't mean they can't try.

And pronouncements from the Fed, even up to the last week or two weeks ago, when Powell effectively said, we don't really care what's happening to emerging market currencies – to me, this is one of these big picture views that much of the street is missing.

Somebody asked us recently: Luke, if you could have one piece of information right now for the back half of the year, what would it be? And I said, oh, that's easy. I would love to have ahead of time the degree to which this Fed tightening – is it just a standard rate-hiking cycle versus how much is it the case that the Fed is either weaponizing the dollar or being weaponized by the US government to defend increasing de-dollarization of global commodity markets.

Because if this is just a standard rate hiking cycle, they're not going to *shoot the hostage* or *burn down the world* or *call in an airstrike inside the wire*.

What's going to happen is probably by late third quarter this year, or early fourth quarter, the economy is going to start to soften. And they are going to back off the number of rate hikes. And the dollar is going to weaken. And emerging markets are going to run. And the equity markets are going to reaccelerate. And away we go.

Standard cycle. The curve will re-steepen. There's a whole bunch of trades there that you can really put on across your book, regardless of what your trade is.

The flip side of that: If this is them attempting to run the Volcker playbook, nobody is positioned for that. And you're going to want to be in dollars, and in 30-day T-bills, and, maybe, maybe, gold. Maybe. And everything else, I think, will just get absolutely waled on.

That person was basically asking that same question – can they run the Volcker game? No, they can't. But if they're willing to "kill some of their own soldiers" – and what I mean by that is US shale, US industrials, we'll take the ISM below 50 again, you're going to blow up high-yield markets – with the hope that China and some of these other EMs blow up fast and worse.

Is that possible? It's not my base case, but I think the odds of that happening – I think the Street thinks there's a zero percent chance of that happening. And I think the numbers, while still a tail risk, are above zero.

Erik: Okay, I want to come back, though, to what the policy objective is. Because a lot of people – if you think about what Volcker is known for, the fight that was going on at the time is they're fighting double-digit inflation, and the big rise up to (whatever it was) 21% short-term interest rates, was necessitated by fighting more than 10% to 12 % of annual consumer price inflation.

Now, this environment, the Fed is struggling to try to create 2% price inflation.

So where does the Volcker playbook analogy come into play? Why is this the Volcker situation, in terms of what you see as the motives for this rate-hiking cycle?

Luke: The increased hawkishness in the February 21 meeting minutes – there was a really interesting passage that caught my attention in light of this trilemma framework, which was the Fed flat-out said that last year US rate hikes did not tighten liquidity because of the weaker dollar and the rise in asset prices. And there it was. Rates up, dollar down, asset prices up.

To me, the catalyst is the Treasury market. They cannot lose the long end of the Treasury market. While they're not fighting inflation in terms of what we were talking about in the 1970s, again, taking a step back, the issue then was they were defending the dollar. The reason inflation was running the way it was was because eight years earlier Nixon has just unilaterally said "see you" to the global currency system. And you had eight chaotic years of setting up the petrodollar and a variety of other things happening that culminated –

There is this great Fed archive paper that they put out in 2005 called "The Reform of October 1979: How It Happened and Why." Volcker flew to Belgrade, Yugoslavia, and he met with a couple of different creditors. And they, basically, flat-out said you've got to fix the dollar.

And he was there for less than 24 hours, flew all the way back to Washington. Flying to London is hard on me at my age. Volcker was older then. Flying eight hours there and back couldn't have been fun. And he immediately came back and started tightening rates.

I think when you say we're not fighting those types of inflation numbers, I think that's exactly right. But what I think, why there is a similarity here, why I think it's the right analog, is back then it was flat-out: You've got to defend the dollar. The dollar is just getting killed in international currency markets.

Here it's a little more subtle, but sort of similar – they began losing the long end of the curve, losing control over it. That 10-year rate is the policy rate. That drives a lot of what goes on in this economy.

And I think that, ultimately, if they know global central banks aren't buying, they've got to get capital back here. And they've got to shake things up. And, if that means risk has to suffer, that means risk has to suffer. But they've got to have control of the long end of that curve.

That's ultimately what I think we're talking about here, which is the same sort of direction – not exactly the same, but rhyming.

Erik: Now, I want to take this from the other side before we move off of this topic.

This is a question I asked Jeffrey Sherman when he was on the program lately. A couple of years ago, DoubleLine made a projection that they could see a 6% 10-year yield. And I certainly can easily relate to why they could see fundamentals driving markets in that direction.

But I said, wait a minute, how does the United States government possibly service its debt at a 6% 10-year yield with the amount of debt that we have? We are already, right now, pretty much at the highest level of debt service cost in history, but we're also at lowest rates in history. If we were to go back to a 6% Treasury yield on the 10-year, we would double the US government's cost of servicing its debt. And it would become essentially double the highest GDP percentage that it's ever been ever in history. And I can't believe that's possible.

And Jeffrey Sherman was very quick to say, yeah, if it happens all hell is going to break loose and you would have to have some inflation.

And I thought, some inflation? Wouldn't that necessitate massive inflation?

So my question to you is, first of all, how far can the long end of the curve go from here before it creates some kind of US government funding crisis? And, whenever that point is, when you get there what starts to break?

Is it a case of we just get a fiscal crisis? Or does the government change course and stop pursuing a policy that's going to make its own cost of borrowing unserviceable? It seems like the impossible trilemma also has another dimension here, which is just how do you possibly service US government debt?

Luke: I think that's one of the big governors on this. Especially once you appreciate – we didn't quite get to the slide – but look, we're a consumer economy. We are a consumption economy. Two thirds of GDP is personal consumption expenditures.

Net capital gains plus taxable IRA distributions, annually, the total of that number is equal to 200% of annual growth of personal consumption expenditures. Now, PCE is a big, broad category. It's not just stuff you're buying at Walmart.

And I'm not saying that people are using net capital gains and taxable IRA distributions to fund all of that per se. What I am saying – as you can see in the tax receipt data – stocks are important to the economy. This is the correlation that you hear a lot of people say, well, equities are expensive.

The Warren Buffett metric says the equity market cap is 150% of GDP. And we have a chart of that on Slide 15. The corollary to "equity market cap is 150% of GDP" is "equity market cap is 150% of GDP."

No one wants to talk about it, but the equity market is increasingly the US economy. So, when you take a step back and start thinking about what are the implications of the 10-year going to 6, can it even get there?

Now you're going to be looking at a situation where why would I ever have any money in stocks if I can get 6 on a 10-year? So you've got to take equities down. Well, that's going to take your tax receipts down. Which is going to mean that whatever number you thought you needed for whatever you thought your deficit number was, your deficit number is going to be rising in two ways.

#1 it's going to be rising because your interest expense is rising. And #2 it's going to be rising because your tax receipts are falling because you're so exposed to rising home prices and other assets that are heavily interest-rate sensitive. And they're also going to be getting hit because the equity side of things is going to be getting hit as well.

So you're basically going to be coming in to weekly estimates like, hey, coming in the Monday morning strategists from XYZ Capital and, yeah, the US fiscal deficit estimate, we're taking it up another 10% this week, up another 12% – you're going to be chasing this moving bogie.

And that's why, ultimately, when you ask if my long-term structural view on the dollar changed, the answer is no. Because, ultimately, I continue to think the way this movie ends is – I don't know what the magic rate is where things start to get hairy. It's not 6, in my opinion. I feel very strongly about that. Is it 3.5? Is it 4? Is it 4.5? I don't know. 4.5 would probably be at the upper end of where I had to guess there.

But the bottom line is that history has shown the only other time in history that the US had this high a level of debt, and global central banks weren't funding that debt in terms of growing their stockpiles of Treasuries, was during World War II. And the Fed came in and said, we'll buy every 10-year you issue at 2.5%.

So the Fed ran the BOJ cap yields playbook – the last time the US was in this situation it is in today – and so can they get to 6? Theoretically, yes. Practically, no. I think the Fed caps yields like the BOJ did, well before then, to make sure that the government gets what they need. And, to me, that's highly dollar-negative, ultimately, and highly equity-market positive.

Erik: Okay, thanks so much. I wanted to clarify those points before continuing on. I think I interrupted you somewhere around Slide 15 or 16 as you were talking about the resolution of the trilemma. And I would assume that this leads us into where the trades are with respect to the US dollar and what time horizons are associated with them. So please continue.

Luke: We were on, I think, Slide 14. And there is a great quote from Alan Greenspan three years ago: "A surprisingly large percentage of US income tax receipts are tied to a rise in US stock prices. When the US stock market just stops rising…not fall, but just stops rising, that will put pressure on the receipt side of the US fiscal picture, which no one is talking about." [Alan Greenspan May 19, 2015] And they weren't talking about it then. They're still not talking about it now.

That led us to just look at some of the IRS data and you can see that chart there. It's net capital gain plus IRA distributions as a percent of year-over-year growth and PCE. The one number is 200% of the other number. And, again, that's not to say one is funding the other, but it gives you a sense of the scale of importance of the stock market.

Slide 15 – we just mentioned this Warren Buffett metric: Yes stocks are expensive but they'd better not fall because my guess is if they just stop going up, let alone fall, give it a couple of months and you'll see softer home sales, you'll see softer auto sales, you'll see softer PCE, broadly speaking.

And it's interesting – if you go to Slide 16 – in the first quarter of 2018, the dollar stopped falling for the first time in 18 months, within the framework of this trilemma. Stocks fell quarter-on-quarter for the first time in two years, as you can see in this chart.

Slide 17 – Voilà: Personal consumption expenditure has posted its weakest growth in over five year (the little blue lines – the original, and initial, and revised numbers).

Slide 18 – Within those PCE numbers, some of the bottoms up looks, the parts of the consumer that are the weakest, are the parts of the US consumer that look the most like an emerging market, the subprime side. Prime auto loan delinquencies look fine. Subprime, they're worse than they were in the crisis. Credit card charge-off rates at small banks, not so good. You're back to where you were in the crisis. Big banks, they're ticking up, but they're not to where the small banks are.

Slide 19 – The bottom line on dollar trade (#1) is, look, we think it will work until higher rates, a strong dollar weigh on US economic trends. And we think US equity markets are the likely transmission mechanism, as we talked about.

So, if we're right, we think it's going to become more obvious by late third quarter and possibly force the Fed to revisit rate hike plans. And, to date, what we've seen makes us very comfortable with our outlook. We've had this outlook for the past almost four months. We're still there. Remember Alan Greenspan's point – if stocks just stop going up, that will put pressure on the receipt side of the US fiscal picture… Other than maybe five stocks, stocks haven't risen in nearly six months now.

So that's where we are there. And that brings us to dollar trade #2. And we'll get through this pretty quickly, because some of it's pretty familiar to your listeners and some of it ties into our view. But we highlighted this.

The last time we had this gap between the budget balance and the unemployment rate, eventually it forced the US to unilaterally end the Bretton Woods system, go off the gold standard. It brought us the 1970s inflation and dollar weakness that ultimately had to be resolved with Volcker doing what he did.

Slide 21 – What we really think is going on in terms of the Fed's need to defend the dollar this time is China and other people's accelerating efforts to de-dollarize global commodity markets – which takes on a new tone in the context of foreign central banks not buying US Treasuries any longer.

There is a number of different headlines here highlighting the relatively successful versus very limited expectations of the launch of the Chinese oil contract.

Slide 22 – It still seems like it's mostly retail in Shanghai. You can tell from the gap between open interest and average volume. But average volume had been okay.

Slide 23 – To our eyes, it appears that the US has responded to this growing threat of the de-dollarization of global commodity markets by, effectively, trying to weaponize both the dollar and oil – against Russia and Iran specifically.

It's interesting, you look at US crude oil exports here on Slide 23, we highlight where Donald Trump said we're going to try to be energy-dominant. And we've seen US exports basically spike up almost immediately to all-time highs.

You can also see what's happened to the price of crude oil on Slide 24 since Donald Trump announced that. He announced that oil – let's call it 46 – it went to 72 on WTI in a little over nine months, which is a heck of a move. And, by the way, in pretty linear fashion.

That gets us to Slide 25, which I think is really some of what we're talking about. Everyone wants to look at this purely on the numbers, purely on the quantitative side. And the challenges with what we're talking about here, some of it is qualitative. You've got to look at some of what's happening. And to US attempts to weaponize the dollar and even *burn down the world* or *airstrike inside the wire*, we ask a question we had in a report a couple of weeks ago: *Has that hit a UK Suez moment for the United States?*

And, by that, we mean there was a moment in 1956 when the UK invaded the Suez and Ike [Dwight D. Eisenhower] just basically said: We're not supporting you in France; we can't throw the Arab world under the bus.

And what you can see in these headlines is that even our staunchest allies are not happy with our attempt to dictate energy policy to all of them.

There is a great quote here from Bloomberg where a UK banker said, "You f***ing Americans. Who are you to tell us, the rest of the world, that we're not going to deal with Iranians?" Now, interestingly, that was six years ago. So can you imagine the level of frustration now?

In the context of that, Slide 26 – All of a sudden things that were not allowed to be written and said about US reserve status in "serious financial media" are being said over and over and over. Here's one, two, three, four, five stories from the FT, from the Economist, from Bloomberg, from Reuters – all talking about explicitly that Iran sanctions are a threat to the US dollar's reserve status.

Which is interesting because, as you go to Slide 27, as we highlighted in the dollar discussion we had with Mark and yourself and Jeff back in December, Barrack Obama said the exact same thing three years ago.

You had Charles Gave on your show a little over a month ago. He highlighted how the Chinese are looking to, effectively, use gold to internationalize the yuan and de-dollarize at the same time. He had a great quote and we took an excerpt of that on Slide 28.

Slide 29 – Charles said if gold goes up China is winning, if gold goes down the US is winning. And, if you look here, this is the gold/oil ratio. Gold has been going up. Gold has been going up since 2009 fairly steadily, but in very volatile fashion in terms of real money or in terms of oil. It recently hit just below that critical 20 level and bounced in the last couple of weeks.

Slide 30 – same thing. If gold goes up China is winning. If gold goes down the US is winning. Something happened in 2017 between gold and real rates. They separated. And they have not come back, even with today notwithstanding – this is updated as of last week. There has been a big gap there. Something is happening.

So when you talk about how does this filter into the trades? In the back half of the year – go to Slide 31 – we're looking at this "Tale of Two USD Trades" framework within this impossible trilemma.

Near-term, we look for the Fed to continue tightening to try to support the dollar. We don't think it's a good outlook for risk assets broadly. We think it's particularly bad for emerging markets, bad for commodities. The governors on this are the *shoot the hostage*, *burn down the world* – and when do US equity markets not rising weigh enough on US GDP growth to actually begin to have a different discussion?

And I think that different discussion is really, really critical for your listeners – which is that, at some point here, if we're right, you're going to see continued slowing in the US economy. And, once we get that slowing, if equities don't rise ad infinitum at low volume, if we get that slowing, then the Fed is going to have to show their hand of that question that was asked recently – How much of this is just a Fed rate-hiking cycle and how much is this the Fed being weaponized to defend the dollar?

Because that's going to be a real interesting day. You start getting some softer US economic data (which I think is coming) and, if the Fed says, nope, we're good for two more this year and three more next year at least, then the markets may have to start to factor in that *burning down the world* or Volcker playbook.

And if they do that, that's not going to be a good day for pretty much anything except for very short-term dated US paper – I think the [Curb and Birds], notably – it will be great for the dollar.

But, ultimately, that ties back to this more structural dollar trade, which is US creditors are still de-dollarizing the global commodity trade at an accelerating rate.

The alternative to a dollar-centric system is nearly ready to go. We didn't get into it to a great degree, for brevity's sake, but there is a London Gold Pool Two, if you will, going on.

And it has been going on since 2013, which is to say China, Russia, etc., are buying ever more physical gold regardless of what the price does. And there is only so much physical gold. And there is a binary risk to that. And so we continue to be, in the longer run, very negative on the dollar.

Ultimately, this setup means one of three things must happen later this year. Either global central banks have to begin buying Treasuries again, or the US has to convince China and Russia to stop doing what they are doing – up to and including going to war with them. Or the US has to go to its baby boomers and its Department of Defense and say, sorry, we need to cut your budgets a bunch.

If they don't do that, then one of three things will likely happen. You'll either have risk assets or another risk-off stretch in the back half, the Fed will have to back off on their three rate hikes this next year narrative, or the dollar will have to weaken.

And I guess, to wrap up, as we came into this year we thought the order of these was, the dollar is weaker, and maybe the Fed will have to back off, and then risk assets would have been our third.

And, as a result of what we saw in February, with the long end of the curve selling off with stocks, that forced us to reorder this. We now think it's #1 is risk assets likely have another risk off-stretch. We think #2 is the Fed will have to back off three rate hikes this year next year. We think, at least in the near term, they're going to continue to try to defend the dollar.

So maybe I'll stop there and open it up for questions.

Erik: I want to come back to a point that you touched on with Slide 21, which is – we discussed this at greater length in your last interview on MacroVoices. At the time, the Shanghai yuan-denominated oil contract had not yet started trading. There was a lot of speculation on both sides of the fence.

There were some people saying, this is the most important thing ever. There were a lot of people dismissing it, saying it's maybe, at best, a symbolic gesture, but it's meaningless in terms of trade and actually getting any realistic amount of traction or market share.

It has actually seen more volume in terms of contract traded than a lot of people expected. But

I'd like to go maybe a level deeper, which is: What is your perspective having now seen the way this has played out so far?

Does this cause you to say, it's interesting but it didn't go quite as much as I thought and maybe the pace is going to be slower for de-dollarization? Or does it make you feel like hey, baby, it's game on and this proves it? Or is it something in between?

Luke: I think it's something in between. So, the week before that contract launched, we had a report for our subscribers and the title of it was "For Want of a Nail." You know the yuan oil contract finally set the launch. Near-term effects are likely muted, but second-order geopolitical and foreign exchange impacts could be enormous.

And "for want of a nail" is in reference to the famous poem:

> *For want of a nail the shoe was lost,*
> *For want of a shoe the horse was lost,*
> *For want of a horse the knight was lost,*
> *For want of a knight the battle was lost,*
> *For want of a battle the kingdom was lost.*
> *So a kingdom was lost—all for want of a nail.*

And that was, we though, emblematic or symbolic of how we saw this contract. I didn't think it was going to change the world instantly. Anyone that did, that was not our view. That was never our view.

But, to me, the most interesting thing – and we've written about this a number of different times – has been not so much where we've seen it in the markets yet. And the volume was better than expected (I think quite a bit better than expected) and it has been more persistent than expected.

Some of the players who trade in it surprised some people in terms of some international oil companies and some of the Swiss trading houses and etc. But, by and large, I don't think it's been that big a deal.

Where I think the biggest impact can be seen has been in the geopolitical arena – in the lead up to this being launched and since – everything we're accusing China of doing, the IP theft, the trade unfairness, all this stuff – you couldn't find someone in America who is a mid-level exec or higher who didn't know all of this stuff for the past 15 years.

We've known this for a long, long time.

We wrote a report back in March highlighting all of the news stories from the prestige Western financial and broader mainstream media where, all of a sudden, President Xi is on the cover of the Economist in a photo shot that is usually reserved for guys like Vladimir Putin. Or for

Saddam Hussein. Or for Chavez, down in Venezuela.

The narrative on China changed so fast and so violently, that it, to us, was a much bigger clue than anything we've seen in the markets yet. And, to us, the importance of the yuan oil contract – China had to openly show their hand:

> *This is what we're trying to do. We are trying to use the dollar system against itself. We are not buying Treasuries anymore. We are taking the dollars that we're earning in trade. And we are going straight to the source. We are going to Africa. We are going to Asia. We are going to Europe. We are going everywhere. We are locking up supplies and we are going to change the pricing of them in time to our own currency. And, in that way, we will have the ability to manage our own current account.*

We ran through that in this report and others since. To me, the biggest hell has been – and US trade relations since March – three months – they have gotten worse in three months than they were in the 25 years before. I think that is a huge clue.

Again, it's qualitative and not quantitative. You know, Wall Street – show me the numbers, show me the numbers. $200 billion on Monday. How's that for a number?

Erik: Luke, that is a number indeed.

I'll tell you another number that's on my mind, which is the very rapid pace at which our August 10 MacroVoices live event is selling out in Toronto. I talked to you a little bit off the air because we'd like to give our listeners a teaser. You're one of our featured speakers at that event. I want to give our audience at least an indication of what you'll be talking about.

You told me you'd kind of like to leave room to – things are moving and changing so quickly – I think that your topic is the latest greatest stuff, which you're not sure of what that is yet. But, how about at least a little bit of a teaser as to what maybe our listeners can expect?

I would imagine – we didn't really have time to finish this conversation about China and de-dollarization and Sergey Glazyev, and a whole bunch of topics. Is that part of it? What else are the possibilities as to what we might hear from you at MacroVoices Live on August 10 in Toronto?

Luke: I'm really excited to present. And I think where we're leaning, at this point, based on what we're seeing and talking about, is talking more about what's going on with the trade situation between China and the US.

And, by that, I mean I think there is a lot of really great analysis being done on the relative trade balances between the US and China and physical volumes that are moving and, all right, in a tit-for-tat trade war, US wins or China wins. There are a lot of different opinions. And, like I said, some really great analysis.

But, in my opinion, what is happening on the trade side between the US and China is not the main event. To me it’s just a symptom of the main event. What we really want to talk about in Toronto is more of the main event, which is, right now, volatility is still relatively low in markets, broadly speaking, emerging markets notwithstanding, in the last couple of weeks.

But we think a lot of people are mistaking low volatility for what we think is actually really two epic tectonic plates pressing very, very hard against each other to a standstill. And we think there is a number of things that could cause one or the other or both of these plates to slip in the back half of this year, so to speak.

And at that point it will become apparent that what was the low volatility situation was not so low vol, it was just a temporary standstill between two big forces pressing against each other.

So I think we’re going spend a lot of time talking about how this trade war is just a symptom of a broader issue. And that, given the broader issue in question, why any time someone says, well, it’s not going to get much worse, we’re skeptical.

Because there are two very structural redline tectonic forces pressing against each other and it makes for a very interesting and potentially important/explosive situation in the back half of the year for a number of different risk assets. And so we’ll be talking, I think, a lot about that. And it will be real fun to go through that with the attendees in the audience.

Erik: Well, we’re really working to design this to be as intimate an event as we can. It’s set up with a number of different speakers. And then there is a discussion panel where we can take audience questions. Then there is a meet-and-greet to give all of us a chance to meet the listeners and spend some time actually having a beer with them. So I’m looking forward to it very much. I know you are.

We’re going to have to leave it there in the interest of time. Thanks so much for a fantastic interview. Patrick Ceresna and I will be back as MacroVoices continues right here at macrovoices.com.