Luke Groman: The "Dollar End Game" has already begun!

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Erik: Joining me next on the program is Forest for the Trees founder and Chief Investment Officer Luke Gromen.

Luke prepared a slide deck for today's conversation. I strongly encourage everyone to download it. You'll find the download link in your Research Roundup email or if you're not yet registered just look for the red button labeled Looking for the Downloads next to Luke's picture on our home page at macrovoices.com.

Luke, it's been too long. Thanks for coming back on the program. You've had some very, very outspoken views. And when you first started writing about this stuff years ago, everybody thought you were completely crazy. Now what I'm hearing from a lot of people is maybe they think you're early, but they don't think you're crazy anymore.

For people who aren't familiar with your views, why don't we just go ahead and dive into your slide deck? Tell us why you see the whole situation around the US dollar, US Treasury market, and so forth a little differently than the mainstream that you hear about on CNBC and Bloomberg.

Luke: Thanks for having me on, Erik. It's great to be back again. I think we have a different counterintuitive view than a lot of folks, which is to say, ironically, the dollar is rising due to foreign central bank refutation of Treasuries. And that seems pretty counterintuitive. As it stands for our positioning now, we're overweight cash in dollars, we're overweight gold, we're overweight Treasuries. The biggest differences driving our view and others' views is underlying motives and timing.

If you go to Slide 3, you can see as early as the second quarter of 2014 you began seeing Russia and China working to transact in trade, and in particular energy, outside of the dollar.

Go to Slide 4, this was the headline of a report that we wrote back in September of 2014, so almost five years ago now, asking is the dollar so strong precisely because it has begun losing its 40-year-old monopoly on pricing the global oil trade.

Go to Slide 5 and you can see a quote from a speech in October of 2014 from [Lawrence Wilkerson] the former Chief of Staff of US Secretary of State Colin Powell noting that what you're seeing right now in the supposed strengthening of the dollar is really a false impression being driven by an attempt by Russia, China, and others to transact in energy outside of the dollar system.

And on Slide 6 you can see this start to manifest in the behavior of foreign holdings – foreign central bank holdings in particular – of Treasury bonds. And go to Slide 6 and you can see China's holdings of US Treasuries peaked in late '13 and have been on a downward slope ever since.
You can see Russia, of course, this year has been a year where they, basically, in the last six months have sold all their Treasuries. The blue line on Slide 7 is Russia's holdings of Treasuries. The orange line that's going up and to the right at an ever-steeper angle is their holdings of gold.

And this makes sense because, ultimately, if Russia and China are transacting in energy outside of the dollar-centric system, their need to hold reserves in dollars shrinks over time.

The question we've often got as we go through this is, well, what would Russia do with renminbi or yuan if they get paid in renminbi or yuan? And you can see on Slide 8 that, as far back as 2009, China was advocating both more gold reserves for itself as well as leading the way for other nations to reserve more gold instead of dollars as a way of promoting the internationalization of the renminbi.

And, importantly, as you go to Slide 9, you can see in 2010 central banks started following what China was saying. They began buying gold in the most amounts in decades. And, actually last year bought the most gold since 1967.

What this really all funnels back to can be seen on Slide 10. And this, to us – we highlighted on Twitter a week or two ago this chart from the *Wall Street Journal* we think is absolutely a critical moment – the yellow line is foreign investors holdings of Treasuries, the green line is US investors.

And in 2014, foreign central banks, foreign investors in total led by central banks, stopped buying Treasury bonds on net. You can see it very clearly.

Erik: Okay, hold on a second, Luke, because I'm still trying to catch up – you've got excellent data here showing that a lot of people are ditching the dollar and no longer using the dollar in trade, particularly for oil. And also, therefore, not needing to hold as much dollar reserves.

How do we get from there to the dollar appreciating? You said it was counterintuitive. I agree on that. Explain.

Luke: Absolutely. On Slide 10 we see this divergence. Central banks stop buying Treasuries and so foreign investors stop buying Treasuries.

When you go to Slide 11, this is a chart of the real trade-weighted dollar. And you can see it clear as day. When they stopped buying Treasury bonds, the dollar took off like a scalded cat.

And the reason why it's taken off, why a cessation of foreign central bank and foreign investor buying of Treasuries drove a higher dollar, can be seen on Slide 12. Now this chart is US Treasury holdings by investor type. And you can see here foreigners – the top line, again – tops out at $ 3 trillion, that's foreigners. And then you can see Federal Reserve. And then you can see households, which, in the last two years alone – US household holdings of Treasury bonds have risen 40% CAGR and in the last 12 months they've risen 70% CAGR.

Now, obviously, this isn't really a sustainable dynamic. But this is why the dollar's been rising once foreigners stopped buying Treasuries. Somebody had to finance those deficits. And it was Americans financing their own deficits for the first time in 50 to 70 years.

Now, unlike central banks who have an infinite balance sheet and are simply politically motivated relative to relative currency valuations etc., households, private investors in the United States have a finite balance sheet. So they can buy Treasuries or they can buy stocks. Or they can buy Treasuries or they can buy iPhones.

But the bottom line is that, effectively, you start having this crowding out effect where private sector demand US dollar exports start shrinking because we have to start financing our own deficits for the first time in 50 to 70 years.

So what is actually, in the long run, a very bearish development for the dollar is, in the near time, what drives a huge short squeeze that you can see clear as day begin in 2014 in that real trade-weighted dollar. And that's where we come into the point that we think we're a lot further along this path than a lot of other folks might otherwise think.

You can see how this works on Slide 13. We talk about this US balance of payment vicious cycle. So you start at the top. US deficits rise. That drives an increase in federal borrowing.

You go to #2, foreign central banks aren't buying so we have to finance it ourselves.

Since the amount we're borrowing is rising by a significant percentage of private sector income growth, federal government borrowing crowds out the global private sector. So you get LIBOR up, dollar up, Treasury yields up.

And then, as that crowding out happens, rates rise. That slows the US economy so US deficits rise. As deficits rise, we have to borrow more.

And you just keep this spiral going. And basically this spiral is five years old. It drives the dollar higher and higher and higher. And rates higher and higher and higher. Until either the whole system collapses or the Fed basically prints it off.

Erik: Luke, at MacroVoices Live in Vancouver, we missed you. It was great seeing you in

Toronto. And, curiously, even though you weren't able to join us, your name came up in our panel discussion. It was actually the hottest topic of discussion of the entire weekend. And the subject was your view. Basically the question that was posed is: Is the Luke Gromen view really going to happen?

And what was most fascinating to me is when you first started writing about these ideas five or six years ago, most people thought you were crazy. But now, unanimously, our entire panel – and it was super-smart people – Julian Brigden, Juliet Declercq, Jeff Snider – really, really smart people on that panel. All of them unanimously agreed that your view about the dollar is going to play out in the end game.

The thing is, most of the people on the panel think that you're early. They think that everything that you predict will happen someday. And I thought that unto itself was incredibly newsworthy because they didn't think that a few years ago. But they don't think it's time yet. You do seem to think that it is time.

So how do we understand the timing dynamics of this whole story?

Luke: There's a couple of things I'm watching. Clearly, as I led off with, right now we're positioned as positive on the dollar, positive on gold, positive on Treasuries. So it's not quite time yet. But this is coming far sooner than most people think, in our view.

And the reason we think that is – you can see on Slide 19 where we start to lay out the difference in timing. I have two different we'll call them greybeards, very seasoned veterans – if I told you who they were everyone in the audience would know who they are – veteran macro guys. And they both in separate conversations told me, historically, once it becomes apparent that a nation is going to have to print the money to pay the interest on its sovereign debt, markets tend to begin to discount that reality into that nation's currency pretty quickly.

So we wrote that back in September in one of our "Mr. X" pieces. And what we noted in the analysis of that is that we compared it to the movie *Moneyball*. The concept of the movie *Moneyball* is that guys that hit a lot of singles get paid a lot more than guys that walk a lot, even though there's no functional difference between a walk and a single in baseball.

What we said is that, as you can see in the quote here: "US debt is 100% of GDP" is a *Moneyball*-esque stats distortion. The $22 trillion in US federal debt is akin to hits in *Moneyball* but the $100–200 trillion in US entitlements are akin to walks in *Moneyball*.

So the real US debt number is actually closer to 500–1,000% of GDP. But nobody ever counts that because it's always been off-balance sheet and it's always been tomorrow. It's always been a cash-flow positive. Entitlements, up until a couple of years ago, were cash-flow positive.

Well, for the first time, starting about five years ago, six years ago, the US demographics mean that that off-balance sheet stuff is now coming on-balance sheet. It's being, as we noted earlier, funded entirely by the US private sector. And it's increasingly being funded at the short end of the curve.

So if you talk about going from off-balance sheet to on-balance sheet being funded by a more fickle customer at the front end of the curve, that's a Lehman problem. We've seen this movie before. We just haven't seen it at this scale.

So what we did with those statistics is we said, okay, if the problem for a currency comes once the central bank has to print the vig, print the interest, then we need to define US interest expense properly. And the true US interest is not whatever the number is, 2.5–3% of $22 trillion. The real number is the gross interest expense (3% times $22 trillion) PLUS the annual pay-go portion of the entitlements.

Because the entitlements are just debt. They are off-balance sheet, they're coming on. But that's effectively the interest expense for $100 trillion plus in entitlements.

So we said, okay, let's add gross interest expense plus the entitlements pay-go portion and let's look at that relative to US tax receipts, see where we are, and see where that could go. What you can see – the chart we used on Slide 20 – in terms of trying to gauge when this is going to become a problem, you can see here that US total interest expense, the true interest expense, hits 100% in 2021. Sort of our base case.

In 2021, early 2021, US gross interest expense plus entitlement pay-gos will be more than 100% of US tax receipts.

Importantly, this assumes no slowdown anywhere in the world. It also assumes three more rate hikes this year which is, of course, not looking as likely at this point.

But what's interesting in this chart, as you can see, the ramp from 70% of revenues to 85% of revenues from 2017 to 2018 was driven almost entirely by the Fed. And so the interest rate differential argument that the Fed's going to keep raising rates to defend the dollar or drive the dollar higher, there's a maximum marginal utility to that.

In other words, if they keep raising rates, they're going to bring this day forward. Because the economy is going to slow, receipts are going to fall, interest expense is going to rise.

And so we run the numbers again on Slide 21 – and this is a minor slowdown case like we just described – and what you can see there is – again, this also assumes some interest rate hikes as well, which, again, have probably been pushed out. But when we ran these numbers in September of last year, what you can see is that true total interest rate expense goes over 100% in mid-2020.

And the markets are likely going to discount that well in advance – 6 to 12 months in advance. This is sort of your if-there-is-a-slowdown-anywhere-in-the-world case.

Our thought process that this is probably well under 24 months from now is based on this math where, if the macro guys that we've talked to are saying, look, whenever a central bank has to print the interest, that's when the currency really starts to get hit as the markets begin to discount that. And when you run these numbers, that's what you come up with.

What's really interesting is we had published this for our customers and, literally, the day before, as we were typing it out, if you go to Slide 16, Ray Dalio laid out the exact thing. He laid out the whole thing. And it was health care, unfunded pensions. We've got to sell a bunch of Treasuries, Americans aren't going to buy them all. The Fed is going to have to print the difference, and the dollar could fall 30%.

It was very eye-opening because this is not a dragon that Ray Dalio needs to chase. And his point is that this probably happens within two years. And, like we said, it's a moving bogey. If the Fed stops raising rates, it buys time.

But that also puts downward pressure on the dollar, all else equal. If the Fed accelerates, that brings it forward. If there is a problem in Europe, if there is a problem in China, if there is a problem in Latin America, that brings us forward.

So that's where we really come to in terms of what's driving our thought process that this is all likely to play out much sooner than people think.

Erik: Let's talk a little bit about what specifically plays out. Because, to summarize your thesis, you're saying that, for a number of reasons, foreigners are abandoning the use of the US dollar. There is no suitable alternative to replace it as the world's global reserve currency. But they're using other currencies to settle as much trade as they are able to and they're divesting their Treasury holdings.

And your conclusions from all this are that, at some point, there are going to be markets really putting downward pressure on the value of the dollar as they start to discount the realization that, hey, we've got a really serious problem with the United States government not being able to finance its own operations.

Now the doomsday crowd would say, okay, so we wake up one morning and martial law has been declared and people have got machine guns in your face. I don't think it's really that.

What is it that happens? Is it just a slow gradual decline where the US dollar starts declining in a gradual way for the next 20 years and slowly fades into oblivion as some other currency takes its place? Or is there some kind of an event where everything goes topsy-turvy and crazy for a while?

Luke: Just to clarify, our case is not that people are stopping using the dollar in trade. I think the statistics show that it continues to be used. Maybe it's lost a little share. It's lost a little share of reserves. But our case is not that it's not being used and it won't be used in the future. Quite frankly, using it doesn't really matter. You can use whatever.

The key is settlement. And what is clearly happening in the data is foreign central banks have stopped settling in dollars. They've stopped settling in Treasury bonds, specifically. And so that is critically important.

Because that is a statement of everyone is ending up with the same dollars they used to have. But instead of buying Treasury bonds, which funds the US government, which is over 100% of US tax receipts are entitlements, defense, and interest expense – so instead of paying for defense, for interest, and for entitlements, what China, for example, is doing is taking these dollars and buying up ports, buying up real assets, making loans in Africa, buying Syngenta, GMO seeds. They're buying gold, they're buying copper mines, they're buying iron ore, they're buying basically anything but Treasuries.

That is ultimately a problem for the US government because they still have to find someone to buy this. What this ends up doing is we end up funding our own deficits.

That's what Dalio lays out on Slide 16, where you say, okay, if this was happening, what would be something I would expect to see? I would expect to see LIBOR rising. All right LIBOR bottomed in 3Q14. It's been, up until just recently, pretty much one way up.

I'd expect to see bid-to-cover ratios in the Treasury markets falling steadily. They've been falling down into the right for five years.

I would expect to see geopolitical tensions rise with the US sanctioning the parties involved. We've been sanctioning Russia for four years – Iran, Turkey, Venezuela.

I would expect to see the United States – a possible strategy would be to get involved in a trade war with China, because ultimately you could make a bet that maybe if we get involved in a trade war we can break the Chinese before we break. And if they break before we break, maybe we end up with more bargaining leverage in this deal.

The point, of course, is that all of these things have been happening for five years – as far back as five years up until the last 12 to 18 months in the case of China – I think we're seeing these things but they haven't been fully mark-to-mark yet. And, ironically, all of these things serve to drive the dollar higher, to suck dollar liquidity out of the market.

Ultimately, though, the higher the dollar goes, the more disruption there is, the more all of these problems get pulled forward, US deficits rise faster instead of slower – we're seeing that.

So, really, the way it plays out is ultimately you have a big risk-off and the Fed has to reverse course. And now is the fourth quarter it? That's not what we think. Quite frankly, I would have thought that we would have needed a bigger crisis, a bigger problem. But it's certainly possible that that's the case.

But I think ultimately the way this plays out is – if you go to Slide 23, you can see there's a chart here: US federal balance sheet as a percentage of GDP against the Bank of Japan's balance sheet as a percentage of GDP (except the BOJ data has a lag of 10 years). And so you can see, all these things are conspiring to drive the dollar higher.

But, ultimately, the US government needs to get funded and the Fed is a fiat currency and a printing press. And we've seen this movie, right? And I note it there. Strong dollar "nickels" are laying on the ground. And just to the right of that, US entitlements "steamroller" that Dalio and Seth Klarman most recently have been warning about.

I think ultimately the way this plays out is – you know, another sign you might expect to see is the US president vilifying the Fed, saying that they're choking off growth, that they're making things difficult for the US government.

Of course, we saw Trump beating on the Fed in the second half of last year. And I think ultimately, at some point, you basically get the Fed to reverse course much more drastically in response to a slowdown or in response to a "sloppy" auction, whatever the case is.

And the Fed over some period of, I don't know, months, years, takes it balance sheet from – you can see there, the first step is from 20% to 30% of GDP over a couple of years and then from 30% to 100% over the next four or five years. My guess is it will happen much faster for the US than for the Bank of Japan, whenever it's reversed, because the US has twin deficits and Japan doesn't.

The point is, a lot of the things we'd expect to see we've checked the box on starting five years ago, four years ago, three years ago, two years ago, six months ago with Trump beating on the Fed about the Fed's not helping us, they're hurting us. John Bolton talking about that the US debt is the biggest risk to national security.

All these things are signposts that kind of go whizzing by. But I think it all speaks to the same thing, which is this is probably coming and it's likely coming sooner than a lot of people think.

Erik: Let's talk about some of the trends that are going on in society. Because what you're saying here is US entitlements are basically unaffordable, something we've known for a long time but have been ignoring. And it's all coming to a head.

And you think in the next few years it's going to come to a head to the point where we cannot finance the federal deficit anymore because there's not enough foreigners to buy up all that Treasury debt. What happens then?

Because it seems to me that the social backdrop right now, it's not only that people expect to keep their entitlements, but we're seeing a really strong trend of populism and, in the younger generations, an adoption of socialist values where people, many of them, really feel that we need a lot more entitlements. Universal basic income, for example.

How the heck is that going to work when we can't afford the stuff that we already can't afford?

Luke: You know, it's not going to be good for the currency. It's one of these challenging things. And this is something I've said in meetings a lot – I've heard from lots of people in very high-profile seats (off the record in terms of their names) – but this is the problem with the way 2008–2009 was handled with the bailouts.

And, by that, I mean I'm with you: Socialism isn't a good thing. It's not going to work out. The system has failed over and over and over.

That said, in 2008–2009 we overtly had a system where it's socialism for the wealthy and capitalism for the poor. The poor lost their houses and bank CEOs got to keep their stock options, got their full bonuses, got their contracts honored, etc., etc.

And at the time there were some voices saying maybe someone should lose their job. Maybe someone should lose their net worth. Maybe we should let capitalism work. Right? But the problem with the way 2008–2009 was handled is that the moral authority of basically anybody that has been around Washington and New York for the past 15 to 20 years to say, well, no, socialism doesn't work and we shouldn't do it and these things you're proposing are bad, they have no moral authority to say these things because they partook in it in '08 and '09.

The answer should have been bank management's gone. Options wiped out. Save the banks and then get them smaller. And then do like a classic restructuring as has been done in a number of different places, I think most recently in Sweden around the turn of the century. But it wasn't done that way. And so it hasn't been that big of a surprise to me to see this populism erupting.

One of the more fascinating experiences that I had surrounding the crisis came way after, when I went to go see the movie *The Big Short*, based on the Michael Lewis book. I went and saw it on opening weekend here in a very upscale area in Cleveland, Ohio – that may sound like an oxymoron but they do exist. And the end of the movie happens and I literally grabbed my coat, grabbed my wife, pulled my hat down, walked out, and got to my car and left. Because there was literal, visceral yelling at the theatre screen – anger.

Because it was at that moment – by the end of that movie, even people – average Joe Blow working class guys in Cleveland – go, wait a second, this was just a street hustle, that's all this was. This was a fraudulent street hustle.

So the moral authority to say we can't do these things had been taken away by the way '08–'09 was handled. And that to me is – I agree with you, it's an unnerving thing.

Erik: What would you say – if I try to play the other side of this – it's one that I don't personally agree with, but my job here is to play devil's advocate – I think that the same people that feel that we need universal basic income would introduce this concept of modern monetary theory (MMT).

And they would say, look, Luke, for the last umpteen years we've had no trouble with inflation. That means that we basically can just print all the money that we need. It's not going to be a problem. What are you worried about?

How do you respond to that? And I know that it's pretty easy for you to explain why maybe there's some fallacy in that logic, but what are we going to do as a society when a whole bunch of people who are still pissed off about '08–'09 decide that's the right answer? Because I think that's coming.

Luke: I agree it's coming. And I don't think it's a pure coincidence that all of a sudden MMT is gaining the traction in the mainstream narrative that it is. I think some version of it is coming.

I said to someone the other day, my thoughts on MMT are, we'll say they're complicated. Which is not to say they're elaborate or anything. I just, I'm of two minds of it in a couple of different ways.

But, ultimately, my opinion on MMT doesn't matter. If we didn't want to do MMT, we either need 75 million baby boomers to vanish by the end of next week or we need to get in an '83 DeLorean with a flux capacitor and go back to 1937 and stop FDR from passing social security and then make a stop in 1968 and get LBJ to not pass Medicare and Medicaid.

But you look at this – people have been saying – well, ever since Trump got elected there'll be stimulus. The US will do stimulus. Something I wrote shortly after Trump got elected and this stimulus happened was, look, the US has already promised $100–200 trillion in stimulus. It was promised by Franklin Delano Roosevelt. It was promised by LBJ. And it was promised by George W Bush with Medicare Part D – and that's a smaller part of it.

But the bottom line is there are 75 million people who overspent and under-saved for 80 years because they were told the government would take care of them in the end. And the bill is due.

This is not that different from AIG picking up nickels in front of a steamroller and writing mortgage insurance. And it was a great business – right up to the point it wasn't. This is sort of the same thing. The US government was collecting these premiums and spending them elsewhere. And now the bill is due.

The bottom line is if we didn't want to get to MMT or something like it, that was a decision that should have been made 80 years ago, 50 years ago, 20 years ago with Medicare Part D.

But it's human nature. Politicians like to spend and people like free stuff and particularly free stuff that's not going to show up until "someday." It sort of stinks for the people who are there when "someday" arrives. But it is what it is.

Erik: I'm going to make a bold prediction here, which you probably agree with, which is, even though it's probably not the right thing, what I think is going to happen over the next few years is that this populist, socialist, whatever you want to call it, it's going to get bigger and there are going to be more demands for helicopter money of some form. QE for the people, call it what you will.

If there is another major economic dislocation and anybody is proposing anything remotely similar to QE – back in '08–'09, the left didn't know what all of this stuff meant. They've done their homework now. They know exactly what's going on.

And I think they're ready to say, look, no more bailouts for Wall Street. We're going to conjure money out of thin air. Let's give it to the people who need it. That, I have to believe, is inflationary.

Let's suppose, whether or not you and I think that's a good policy choice, that what happens is we're instituting universal basic income and we're giving out helicopter money in order to stimulate in response to the next economic recession or downturn (which feels like maybe it's already starting).

How does it play out? What are the consequences? And what happens as a result if you make those kinds of policy errors?

Luke: Slide 18 – this is sovereign debt as a percent of GDP going back to 1900, from Carmen Reinhart and Ken Rogoff. The orange line is advanced economy debt and the green line is emerging or developing market sovereign debt as a percent of GDP.

What you can see in this is we're at the highest level for advanced economies since right after World War II, except we haven't fought a war this time. So there's not a rebuilding period that needs to happen and there's not been a tragic loss of life that has worked down the workforce.

Erik: There's another aspect of that too, which is right after World War II GDP was depressed. So you change the denominator and you artificially accelerate that graph. If you used steady-state GDP from before the War it wouldn't look that bad. But, as you say, it's real this time.

Luke: Well, yes and war is really, really good for – it's very inflationary at least, so it's good for at least nominal GDP. But, yeah, the consumption side of the economy was definitely depressed and rationed.

But I think if we just use this as a potential reference point for "Where do we go from here?" How is this going to play out over the next call it five years? From 1942 to 1951, US Treasury bonds did not fall in price at all. The Fed said that they would buy every 10-year Treasury the US issued at 2.5% no questions asked.

And those 10-year Treasury bonds fell 80% against the S&P. In other words, the S&P outperformed by 5x nominally. Those Treasuries underperformed CPI by about 75%. The bottom line is holders of Treasury bonds got killed on a real basis. And that's going to happen again.

Which is really interesting because guess who the biggest marginal buyers of Treasuries have been over the last three years since foreign central banks, or five years since foreign central banks stopped buying them?

It's US households, it's US commercial banks, and it's US pensions – who most listeners will recognize as the usual suspects. They were the biggest players in housing; they were the biggest players in the tech bubble. They're, unfortunately, the people who get hit, the groups that get plugged with this stuff.

So last time, at the end of World War II, to work down that bubble – as you can see, the orange line – as we de-levered, that required negative 15% to negative 60% real rates for anywhere from four to nine years.

If you hold a sovereign bond and the real rate falls at negative 15% rates, your money is gone on a real basis in 3-4 years. At 60% it's gone in a year and a half. And that's what's going to happen again. It's either that or they nominally default on entitlements and they slash defense spending by probably 2/3 to 3/4. I don't think either of those two things are politically likely.

So, ultimately, usually the way these things work out are high rates of inflation. And you can see from Rogoff and Reinhart's piece here, it's default, restructuring, and a few hyperinflations. Default, restructuring, and a few hyperinflations. Every time these numbers get here.

They say it's never different this time. I doubt it's different this time. That's why I think the key is how do they do that and what are some of the social ramifications of doing that? As you know, which I think is the great point.

Erik: Let's talk about how gold plays into this story. Because when you and I first started talking about this – in our first interview more than a year ago, you described this long-term vision of the dollar weakening dramatically as it falls from favor as everybody's favorite reserve currency.

But I also felt like, look, the dollar is going to be rising relative to other currencies in the short term. I think you'll be right in the long term. But, as long as the dollar is rising, that can't be good for gold. And I was right about that for a while. It wasn't good for gold.

But now we've got the dollar rising and gold rising at the same time. What do you think changed to bring that about? And do you think it's set to continue?

Luke: I think we're at a critical moment to see if it's set to continue. If we see gold break out from, I don't know, call it $1,380–1,400, then I think we've really got something. Until then, I'm on record a number of times saying I don't think gold's been a real market since at least 2013. It's basically been pegged to the dollar at around $1,150 to $1,350 for six years. So I'm watching for interest.

Now, that said, is this it? Is this the breakout? To me it makes perfect sense that, as the crisis – you know the next crisis is going to be the popping of the global sovereign debt bubble that we're in, which only happens once every 80 to 100 years, and usually it doesn't happen until everyone that lived through the last one is dead.

And as we get nearer the next crisis, gold should rise with the dollar, with rates. And that, I think, will puzzle a lot of people because, ultimately, as we get nearer to it, the more the dollar rises and the more rates rise, it's going to bring forward the date when the Fed is going to print it off.

If we go back to those slides I showed where, if rates rise or the dollar rises from where we are, then 2021 becomes 2020 becomes late 2019 – to when, if they rise enough, the Fed is going to have to print the interest expense. By the interest expense [I mean] it's the true interest expense, it's printing entitlements and it's printing interest expense.

So I am skeptical. I've been beaten over the head enough watching gold hit $1,350 and then go back to $1,150 and then back to $1,350 for six years that I'm holding judgment. But I'm also really aware, acutely aware, that this is exactly what we'd see as we near the global sovereign debt bubble starting to burst.

And it's interesting, because global central banks just bought the most gold in 50 years. In the last six years, global central banks have sold on net $130 billion in Treasuries and they've bought $140 billion in gold. And so these are people that, for them, it doesn't really matter if they're right, right away. It just matters that they're positioned for whenever it happens. They don't have to market-to-market etc.

I'm telling you, that, to me, continues to be one of the biggest underappreciated signs that nobody really has a great answer for which is: Why in the last five years have central banks sold $130 billion in Treasuries and bought $140 billion in gold? And I think the answer is they see everything we're talking about here, Erik, which is this crisis is coming.

It will come sooner if the dollar rises. It will come sooner if interest rates rise. But, to me, it's really a positive setup for gold. Because if the way you stave off this crisis from coming is you weaken the dollar, well, if you weaken the dollar that's good for gold. And if this crisis comes, ultimately that's really good for gold too.

So it's one of these times where – I don't think institutions own or are heavily positioned in gold away from trading accounts at a time when it seems like gold is one of the few assets that is one of the cheapest on the board. It's still cheap, relative to historically speaking. And it looks like it wins either way.

Erik: Luke, let's talk about what kind of crisis is coming and what the scope of it really is going to be. Because I think you just said something very important a few minutes ago when you said that it's only once every 80 to 100 years when most of the people who remember the last one are dead that you resolve a sovereign debt over-indebtedness crisis. I would say it's not just sovereign debt, it's also corporate and private debt are also at ridiculous levels.

Does that mean that Alexandria Ocasio-Cortez comes riding in with a flag and announces that what we need is a global debt jubilee? What happens? What's the range of possibility as to how we might resolve this confluence of crises?

Because it's bigger than just the dollar and Treasury bonds. We're really talking, as you said, about a global debt crisis. How do you think this gets resolved?

Luke: Yeah, it is. And the dollar and Treasury bonds have been the center of the global financial system for 50 to 70 years. So it's interesting, because one of the biggest straw man arguments people say to me is that, well, there's no replacement for the dollar. There's nothing to take the dollar's place.

And that's not a case I'm making, it's never a case I've made which is that something else is going to replace the dollar. The problem, as we noted before, is that if other central banks won't sterilize our deficits, if they won't hold our Treasuries, then we have to fund it ourselves. And we're going to basically collapse the economy by basically funding our own deficits, paying for our own entitlements.

So what that suggests the crisis is going to be is you're going to have this – there will be a slowdown somewhere, there will be a crisis somewhere. Just is it a Deutsche Bank problem? Is it a China problem? Is it a US recession? The crazy thing is that it doesn't really matter.

People say, well, Europe is going to go first. Okay, let's take Europe first. Let's pretend Deutsche Bank blows up. Boom. You're going to get a selloff in Europe. The European authorities will say, you know what? We're going to shut markets down for a week and sort this all out. Guess what happens then?

Then the asset that we have here in the US – we have the deepest, most liquid markets in the world – becomes a liability. Because guess what? All the selling in the world going to come. Europe is closed. And I've got to lay off that risk. I'm coming to the US and I am selling everything I can get my hands on.

US authorities go, we're done here, markets are closed. We do something like we did in

September of '08 where they said, uh, short-selling ban on financials, can't short sell financials.

Except they'll say, you know what? We're closing it all. We're going to shut it down for five days and we're going to sort it all out. And then, of course, they would do that in China as well.

And you'd wake up in five days and you'd probably have some sort of reset of currency levels. You'd probably have a reset higher in gold. And you'd basically just continue on from that point. I think it would likely be fairly brief and I think it would be fairly dramatic.

And one thing that I think people are really underestimating is the likelihood that it would be discontinuous or nonlinear. In other words, there is this expectation that I'm going to own dollars, I'm going to own dollars all the way up. And then at the right moment I'm going to go from the one side of the boat to the other side of the boat. And it will all be great and then I'll take my really expensive dollars and I'll buy really cheap assets and it will all work out great.

And the history of it all suggests that you can do that for a while, but it's a sort of pigs get fat, hogs get slaughtered sort of a thing. Because the history books are very clear that these things happen nonlinearly. They'll shut the markets down.

Jim Rickards talked about this in one of his recent books *Road to Ruin*. One of the most fascinating passages in the book is he quotes a senior-level Black Rock executive at the beginning of the book. And she tells him in the third quarter of 2014 that the US government had already approached Black Rock about selling bans – in other words, in the next crisis Black Rock would not be allowed to sell. And if Black Rock couldn't, nobody could.

I actually floated that around to some other places and said, hey, is that crazy? And people I talked to said no. No, it's not crazy. That's a much greater likelihood of happening.

So to me what would that crisis look like? It would almost look like a whoosh down and then a dislocation of markets and then a reset higher. So hey, S&P 2,700 whoosh, S&P 1,900, markets shut for five days, S&P 4,000. Dollar 95, dollar 110, markets shut down, dollar 50. That kind of thing where I just don't think it's going to be linear all the way through.

To your point, it's not just a sovereign problem. It's a corporate problem. It's a personal debt problem. The whole system is so levered, the wiggle room is so – it's going to be really hard to fix things on the fly.

So it speaks to my point that a nonlinearity or a discontinuity in markets, that they'll shut markets for a period of time – I wouldn't go all the way to base case, but I don't think it's a tail risk. I think it's somewhere between a base case and a tail risk.

Erik: Well, if the proverb holds true, one thing is certain, which is that these will be interesting times in the next few years.

For the benefit of our listeners who need to navigate financially through these interesting times, tell us a little bit about what you do at Forest for the Trees.

Luke: Thanks ,Erik. We are an investment research firm. For institutions and sophisticated individuals we have a number of different research products and you can check out more about what we're up to and different product options at fftt-llc.com.

Erik: Fantastic. Thanks for joining us, Luke. We look forward to having you back again soon. Patrick Ceresna and I will be back as MacroVoices continues right here at macrovoices.com.