MACRO Voices

with hosts Erik Townsend and Patrick Ceresna

Simon White: The Dawn of A New Financial Order

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Erik: Joining me now is Simon White, macro strategist for Bloomberg, and for those of you lucky enough to have a Bloomberg terminal, also the author of the MacroScope column. Simon prepared a slide deck to accompany today's interview. Registered users will find the download link in your Research Roundup email. If you don't have a Research Roundup email, just go to our homepage macrovoices.com, look for the red button above Simon's picture that says, *looking for the downloads*. As we get into the discussion of treasuries in just a few minutes, just follow along with us in the slide deck.

Simon, feels to me like one of those weeks when decades happen. We're recording this interview early on Tuesday morning, so you and I have only experienced one day of this week. On that day, we had, at one point, a 5.5% move up on the S&P500 futures in the course of six minutes, followed by a retrace of those 300 points up, we came back down 200 points in six minutes. Took another 15 minutes to get the remaining 100 points for a complete retrace. That was after somebody third hand, hearsay, said they thought they heard somebody else say something about what might be on President Trump's mind, and then the White House said it was fake news, and that all retraced. Needless to say, it's a headline driven market. Then we had Keir Starmer basically announce the end of globalism, kind of a profound thing to say, and that was just Monday. I can only imagine what happens between now and Thursday, when our listeners actually hear this interview. What's going on? What should we make of this? Obviously, President Trump's tariffs are kind of the key driver in it. But how should we think about these markets with just so many crazy things happening all at once?

Simon: Well, thanks for having me on again, Erik. I think we actually spoke, not the last time, but the time before the last time, just when the pandemic started. So very similar circumstances, and I think the Lenin quote about decades in weeks was being used then, and it's certainly appropriate, the amount of uncertainty has ratcheted up by a huge amount, and it's hard to tell really exactly what the main aim is. I mean, my initial thinking was, when the tariffs were announced, the aim was to reduce trade deficit, for the US to reduce the trade deficit. But I'm wondering really, if they want to close them all together, which is obviously a very different set circumstances. If that's correct, then Keir Starmer's notion about the end of globalization is right too. But again, we really don't know. I think there are definitely some more ideological people within the Trump administration, obviously, Navarro for one of them, and they maybe do look to close the trade deficits altogether. Whereas, Trump obviously is renowned for being open to deals, and perhaps if the right thing comes his way, he won't be quite as ideological.

But nonetheless, these are big changes, and I think one kind of analogy that's fairly relevant right now is Brexit. I mean, it was almost 10 years ago that UK voted to leave the European Union, and the principal motivations behind Brexit were a renegotiation of the relationships with your trading partners and taking back control of your borders. And that's really not dissimilar to what's happening in the US right now. The fundamental difference is it didn't work out well for the UK, certainly in the first couple of years, because capital started to leave. But the fundamental difference with the US would normally be that the US is insulated from such effects, because the US has the reserve currency and there's always a demand for its assets. But I think, like many things that we are used to taking as rules of thumb, I really don't think we can take that as for granted anymore. So, I don't think we can take that for granted anymore, that there's going to be the same requirement for, or desire for US dollars and dollar assets as there once was. Now, there's a few things here that make it even more interesting. As in the last few years, the US has been running enormous current account deficits. So normally, the sort of the rule of thumb, if you like, that the dollar rallies in sort of risk off events is based on the fact that dollar is normally essentially a funding currency. People tend to borrow the dollar, so there's a structural short in the dollar. And when you have a kind of financial shock that we're seeing similar to right now, that short is covered. But when you had so much capital coming into the US, and the numbers are huge that can easily overwhelm any short covering, structural short covering that you might normally see, and I think that's kind of what we've been seeing. So, the DXY has reversed most of its post-election (before the election and after) rally, can reverse most of that. And I think there's a sign that the dollar is no longer what it once was. And as I say, the current account deficits are huge. Now, most of that money coming into the US has not been for bonds. In recent years, it's really been equities. So, most of those deficits have been funded by equities. So, we've had something like $9 trillion of inflows into US equities since the pandemic, you know, doubling its size. And there's now over $18 trillion that foreigners hold, something like 16% of the total of US equities outstanding. So that's a lot of potential capital that can come out.

Now, equities are kind of in the heat of the storm right now. But it was kind of clear, I think, certainly to me, that why should treasuries be exempt from this? Now, the demand for treasuries had slowed. Certainly, reserve accumulation really began to sort of gradually ease after the financial crisis. But that really accelerated in the wake of the Russia-Ukraine war, after Russia's assets, reserve assets were seized, and then that confidence in the dollar was kind of further undermined with the recent rumblings we've had about a Mar-a-Lago accord. Essentially, you cannot take it for granted that the dollar is a politically kind of meddle-free instrument anymore. So that's really kind of scared the horses, not just amongst emerging markets and people that might be considered flows of the US, but also amongst friends too. So, there's a real fundamental kind of rethink here about what the dollar is about, whether people need to hold as much as they once did, and obviously that applies to treasuries, and that's compounded when it comes to the US by the massive fiscal deficits that the US has been running. So already, I would say that treasuries were facing a demand problem. You know, US has been running 7% fiscal deficits, treasuries aren't particularly attractive with a 7% fiscal deficit. Then, if we get a recession, I can get into that in a bit more detail later on, if we get a recession, I mean, the fiscal stabilizer alone would take that fiscal deficit into double digits. Now, inflation is already elevated,

and when inflation is elevated, the yellow rule of thumb that people are probably quite used to is that Treasuries are a recession hedge. I mean, when inflation is elevated, that's just not the case, and you tend to get bonds and stocks moving positively correlated.

Erik: Simon, let's talk a little bit more about the fiscal deficit. How wide can it get?

Simon: Well, it's a very good question. I mean, automatically, fiscal stabilizers, so that alone, I think, would take it clearly into double digits. If you go to the slide deck, on slide 3, the chart on the left shows what the fiscal deficit has done in previous recessions in the US. And you can see there, just on average, it drops about four percentage points. So, with us already at 7%, that takes us, just based on that average, to 11% and that's a massive, massive number. I mean, I think the only time that's been exceeded was in the pandemic, as post war. So, these are really, really big numbers. And as I say, already the market was becoming hesitant about funding the government at 7% deficit, it's probably going to be even less happy about funding an 11% deficit. So this is something that's problematic. And when inflation is elevated, stocks and bonds tend to be positively correlated, which means they can fall together. And that's something we've already seen this week, we had this massive move in Treasury yields. So, treasury yields saw the second largest open to close rise again since the pandemic. You have to go back to the 17th of March that was a 30-basis point rise. It's really close to unprecedented. So, these are massive moves. And the kind of axiom that treasuries and the dollar are safe havens, and I don't think we can take that as read.

So how is this going to play out? I think the key thing to watch right now is not so much the stock market, all that is important, it is the dollar. And the administration has made quite clear that the reason why they're less interested in the stock market than people would have thought we were as ultimately, the stock market is owned by way fewer people in the US, so the vast majority of stocks are owned by like, the richest 10% of households. If you look at what matters to, you know, what are probably more likely to be Trump's base? There are sort of middle income bracket. It's small businesses, it's real estate, and that's clearly where the administration are putting their focus on. So, the dollar, if it carries on weakening, will amplify the effect of tariffs. And you can see, again, going back to the deck on slide 3, the chart on the right, you can see there that the dollar leads import prices. So, if the dollar continues to weaken, that's really going to be an effect on US consumers. And it's way more US consumers than people that own equities in the US. And obviously that ultimately translates into votes. So, I think you want to keep an eye on the dollar for how much, if you like, political pain the administration is willing to take. And the thing is, if the dollar keeps selling off, it might give them a convenient off ramp, because if the dollar is weaker, that means the Euro's stronger, the Yuan’s stronger, and the Yen’s stronger. And the administration can say, you know what, we've kind of got some of what we want here. Your guys currencies are stronger, ours are weaker, and therefore we're not going to have some of the more onerous tariff rates. But as I say, it's really not clear what the plan is here, whether we're going for the ideological, let's close the deficits altogether, or there really is the potential here for making a deal and trying to come up with some sort of happy medium.

Erik: I think you hit the nail on the head when you said that the issue is that it's not at all clear here. And it seems to me that what's going on, you look at something like fiscal deficits, and you say, okay, so maybe the President is really trying to build a very large revenue stream around tariffs. Okay, we'll try to grok that possibility. Oh, wait a minute, no, he was just trying to get people to come to the negotiating table. And the market says, Mr. President, you got to tell us what to expect. You got to tell us what the plan is, because the markets hate uncertainty. And it seems to me, President Trump is saying, no, I don't have to tell you anything. It's the art of the deal, baby, I'm not showing my cards. So, you'll have to guess. That's not what markets like and it's not what markets are used to. Am I right to think that that's what's going on here is the President doesn't want to give markets the kind of policy forward guidance that is normally expected in previous administrations?

Simon: Well, whether that’s his intention, that's certainly what's happening. And as you say, Erik, the markets abhor uncertainty. They find it's impossible to price in. You know, the classic black swan, unknown unknowns, all these sort of things are extremely difficult for markets to price in and this is kind of what we're seeing right now, that tariffs were kind of worse than people expected. And the notion of a Trump put is clearly, the strike price is not kind of near where people thought it might have been, and that probably also applies to the power put. He's just focused on the economy right now, which, by the way, is always lagging. So, the economy looks okay now, but this is the kind of where we are right now, really, right? So, we're seeing these sort of cascading falls in markets. We're seeing the stock market as, on an intraday basis, it's gone into correction mode. It's not done that on a close basis quite yet. But we're really in that period where economies and markets are becoming highly entangled. And that's a very kind of dangerous time, because that's the time when you can have these negative feedback loops that develop very quickly between the economy and the market, where the stock market sells off, that does a huge amount of damage to sentiment. People end up pulling back spending investment that feeds into the real economy, and then the real economy data starts to deteriorate. The stock market then looks at that data, and then sells off again, and you have this kind of self-reinforcing feedback loop that often culminates in a recession.

And if we go back to the slide deck, go to slide 6, is really kind of a misunderstanding, I think, how the market thinks recessions work. The market tends to think that economies kind of go from, it's a linear process. They go from a non-recessionary state to recessionary state in a very linear way. They actually do so in a very non-linear way. And the chart on the left, on slide 6, really kind of demonstrates that quite well. So, the top part is what actually happens, and the white line is kind of what the market thinks happens. And the top part is probably one of the best real time based on hard economic data indicators of a recession, and that's the percentage of US states with significantly rising unemployment claims. And you can see that number is either very, very low or it's very, very high. It's rarely in between. And when it goes past a certain threshold, that tends to rise almost all the way, and that tends to coincide with a recession. And that's, again, how economies actually work. Recessions are regime shifts. What the market tends to talk about is recession probabilities evolving smoothly. So, the bottom part of that chart shows the NY Feds probability indicator, which I think is based on the yield curve, and you can see that more kind of smoothly moves up and down. Where we are right now is we're at that

point where the flux point, where in the probability can go from being still quite low. So, from an organic perspective, you look at what's happening in the real economy, the probability of kind of recession next four months is still fairly low, purely looking at the economy. But given what's happening in the market, that can rapidly rise very quickly, and it would go from maybe being like a 10%-20% probability to like an 80%-90% probability. So, we're in this kind of maximum time of uncertainty and maximum time of danger, where you really have to keep an extremely close eye on the soft data. And the soft data is the market data, but it's also the survey data. So, the ISM the PMIs will be extremely important in the next couple of months, because they will tell you how bad sentiment has been impacted. But not only that, they'll tell you exactly what the market's going to be, they're going to be looking at the ISM and the PMI to see how badly sentiment has been impacted, and if that is deemed to be too bad, the market will sell off even more, and we'll get one of these negative feedback loops. And very quickly, we're in a recession. And, you know, the market is down roughly 17%-18% now, like peak to trough, as I say, on a close-to-close basis. The average recession, equities will sell up more than that. The average is, at least 30%-40% that sort of range, certainly more than 17%, so we really are at this time of peak uncertainty and peak kind of fragility for the market.

Erik: Tell me if I'm assimilating this correctly. But it sounds like what you're saying, if I think about how we got here, you know, it's not really recession risk that got us into this sell off. It's President Trump not being willing to give the market a clear indication of what was coming next and give that forward guidance that markets need to avoid uncertainty. So, it would be very easy to write this off and say, no, no, we don't have recession risk. This is just a market event that's brought on by a president with very unconventional forward guidance policies, if you will. But then that feedback loop that you talked about potentially kicks in, and the big sell off that we've already had of 17% or 18% is very possibly enough to catalyze the recession and becomes a self-fulfilling prophecy at that point. And it sounds like we're right on the hairy edge of that happening. Is that a fair way to interpret what you said?

Simon: That's exactly right. As I say, we're at this point where market and economy are highly entangled, and one can drag down the other very, very quickly. Which is why, as I say, that for me, the key data points are the ISM and the PMIs, to gauge sentiment and the unemployment claims, because that's your kind of most frequent hard economic data point, given it comes out weekly. And so, I would look at that by state, not just the headline number, but also what's happening by state. So, we really are literally, in the next three or four weeks, is kind of like, we'll know what's going to happen, whether sentiment has been damaged past the point of no return, if you like. This is even if Trump came out and reversed a significant amount of the tariffs that have been announced. There’s too much damage being done, and we can still go into recession, but we're right in that flux point where we just don't know.

Erik: Now, I noticed that you're talking about the Trump put, in terms of trying to discover a strike price on the Trump put. I've heard a lot of other commentators use the same kind of language. It seems to me that President Trump has actually been very clear saying, and actually, Secretary Bessent as well have said, look, we've got a certain set of goals. We want to get the dollar down. We want to get long term treasury yields down. We don't care what

happens to the stock market. So, it seems, if you took him at face value, there is no Trump put at all. Do you think that that's just a bluff, and there really is a Trump put and the strike price is a secret? Or what do you think?

Simon: Well, clearly, I think it was totally wrong to expect that Trump 1.0 in his first presidency, was going to be like Trump 2.0. And the whole notion that everybody, again, a rule of thumb people jumped on was that the stock market was his scorecard. But I remember looking at this back in January, and before this really kicked off to the extent it has. And there was a really interesting chart, unfortunately, I don't have it in the deck, but it looked at the NFIB small business optimism versus the essentially proprietors equity in small business. So essentially, even though these companies are unlisted, the Fed measures essentially how well they're doing as if they did have equity that was on a market, and there was a huge gap. So, the NFIB small business optimism has a huge Trump, not really Republican, it's more like a Trump bias. So, both times when he was elected, NFIB jumped much higher. And when Biden was elected, it actually dropped in 2020, but it's going in the opposite direction to this, the actual equity of these businesses. And so that was a real kind of hope, reality gap. And I think this is an issue, when most of your base are in the middle income brackets. So the two cohorts that voted for Trump more than any other cohorts were those in the middle income brackets. And these are people that are going to be more impacted by either they own a small business, or they work for a small business. I mean, something like one in four of the workforce are working for businesses with fewer than 10 people. So this is much more significant. And you look at who owns the equity market, it's the top 10% and it's hugely skewed towards that top 10%. And funnily enough, in recent weeks and months, you've had Bessent, to be fair, going down this line, talking about small business, talking about that's what matters, talking about real estate. That's what matters, because the middle income and the middle wealth cohorts, but most of their wealth is in things like real estate, so they're much more focused on that. That's not to say that there is no strike for the stock market, but I think it was obviously misguided to think that it was as high as people thought it was. So, we're in that kind of, you know, to borrow the meme that has been used a lot on Twitter as we're in the kind of muck around and find out, that's the more palatable version of the meme, of course. But we're kind of in that phrase now where the stock market is trying to probe, perhaps, where this put lies. But as I say, we're in a very point of peak flux, where, by probing too deeply, it could well trigger the recession, which kind of puts as a certainty that the market's going to sell much more, so it's going to create more damage than perhaps it bargains for.

Erik: Simon, moving on to page 7 in the slide deck, the liquidity screw is now tightening. I think we noticed that in terms of the what's happening in the market. What's driving it?

Simon: Yeah, I mean, 100%. But what's really interesting about this is liquidity thing had begun to tighten, really, before this all happened, as in, before the last few weeks, developments with tariffs, etc. So, lots of people have many different ways of measuring liquidity. I always stick to what I think is one of the best, because it has the most leading properties when it comes to actual asset prices, is excess liquidity. And that's the difference between real money growth and economic growth. And the notion behind it is quite intuitive. You know, what money has created

in excess of the needs of the real economy is excess, and it tends to find its way into real assets. So, the chart on the left in slide 7, you can see there that excess liquidity has a very good lead for about three to six months with equities, and that's kind of what you'd expect to see. So, it's not just a case of liquidity being created. That's not enough. Because banks create liquidity, the central bank creates liquidity. But it's only when that liquidity is growing in excess of what the real economy is eating up, that it then leads to higher asset prices, risk asset prices. And this really was kind of back in early 2023 is when it began to turn up. So the market bottomed in late 2022 and there was obviously a lot like any bottom, there's a lot of hesitation, is this the bottom? Will the market make another bottom? And it kept on sort of creeping higher and higher. But then around early 2023, excess liquidity started to turn up, and really since then, that's been your probably best medium-term guide of the rally continuing, is this rise in excess liquidity. But at the beginning of this year, so I'd say mid-January, you really started to see a kind of fairly sharp decline in excess liquidity, partly based on the fact that liquidity is in money growth and in the excess liquidity measure, you look at M1. It wasn't growing quite strongly as it was before, but because it's based on that, it's used as a trend basis. That caused quite a rapid turnaround. So, you had the kind of ex ante conditions for weakening in stock market before all this tariff stuff happens. Because excess liquidity is really like a safety net.

So, we're now in a sort of worst of all worlds that, okay, we're getting this terrible tariff news, which would be bad one way or the other for stock markets. But in a way, it's kind of worse, because excess liquidity is not there to provide the safety net as it once did. And on top of that, it's not just volume measures of liquidity. Excess liquidity is really a volume measure, price-based measures of liquidity are also declining. So, the chart on the right is the global financial tightness indicator, which is essentially diffusion index of central bank rate hikes. Again, that had been indicating more loosening conditions for most of the last year and a half, two years, and that too has started to turn down, which means rates are becoming more restrictive. and that's basically on the back of global central banks have really stopped cutting. So, they've stopped cutting, one or two actually started to hike. Now, we'll see what happens with this going forward to know what central banks are going to do in terms of responding to these tariff announcements. But the problem again, is that inflation is much more elevated than they would like. So, we've got that in the US this week. In fact, we have the latest CPI data, but that's really a problem for central banks. They cannot probably cut as much as they would like to, and so that means that rates are probably going to remain more restricted than they otherwise would be. And as always in life, things happen at the last point when you really want them to happen. So, this is the last time you really need liquidity to be tightening, those rates to become more restrictive. But yet, that's where we are. So, we've had this brewing inflation for a while. We've had this massive surge in excess liquidity, and it's all started to turn down, just in a couple of months before the sort of huge change that President Trump has announced with these very onerous tariff announcements.

Erik: Tell me about the death of the fiscal cheat code on page 8.

Simon: This is the other thing that is not working in stocks' favor as well. The elephant in the room for most of the last two or three years, again, going back to is this massive fiscal deficit.

It's impossible to get away from the fact that it's been hugely supportive for assets. So, in one clear way, it's probably supported profit margins. There's the Kalecki-Levy profit equation, which basically shows that the savings of households and governments, along with corporate investment, dictates corporate profits. Now, households have been on net saving, but the government has been doing the opposite. And obviously, if it wasn't for the government after COVID, after the pandemic, we would be in a very, very different situation. But the government has been spending hand over fist to say it's been running these very large deficits, and that's enabled profits and profit margins to be larger than they otherwise would have. So that's really what we've seen in terms of keeping stocks elevated. But second derivatives are what matters for risk assets, and already that fiscal impulse is fading.

So, the chart on the left there shows how the fiscal deficit is changing. The fiscal deficit is still high, but it's not getting much, much higher, and that's why you've got that second derivative has dropped back down. And you can see there it's got a reasonably close relationship with equities. But the other side of this is very interesting as well. The chart on the right shows gross issuance of treasury bonds and bills versus the stock market. Now, before, in a sort of pre-GFC world, you didn't really see this relationship, but what's happening now is, obviously the government is expanding its fiscal deficit, which means issuance has risen markedly as well. But at the same time, we've had this huge kind of revamp, or re-haul, or overhaul, if you like, of the repo market. So, repo is now the kind of principal money market instrument, and we've seen this massive, huge increase in repos and the repo market, repos are now much more money like than they once were. So, they are much more fungible in the way that their collateral arrangements are much more seamless, so in many different ways, they can be much more used as a substitute for high level money. And I think it's impossible to get away from that. That has to be part of the reason why, when the government has been expanding its fiscal deficit and has been issuing so much more debt that that is not like what would happen before, that would sit idle in balance sheets, the velocity, if you like, of that debt would be quite low. But the repo market enables what was once sort of idle, if you like, money sitting on people's balance sheets, to be used in another forms and ultimately support the market. So, I think that's kind of what goes behind that chart on the right there, you see a fairly good leading relationship between ups and downs in gross issuance and the stock market. And now, of course, that fiscal impulse is fading. Yes, issuance overall are still high, but again, second derivative, it's turning down. So this, again, is all coming at the backdrop with the tariff announcement. So we had the liquidity, things were already tightening at the beginning of the year, fiscal is already tightening. So monetary and fiscal tightening, and the whammy, if you like, is now these much worse than expected tariff announcements. So it's really kind of the worst of all worlds for markets.

Erik: Moving on to page 9, you talk about the swelling basis trade, which has grown to a trillion dollars, starting to unwind. For anyone who's not a fixed income person, the basis trade refers to traders who are exploiting disparities between the cash bond price and the futures implied bond price. So in the futures and the cash markets don't line up, you arbitrage that difference out. Why is that grown to a trillion dollars, and why is it starting to unwind? And why could that get nasty?

Simon: It's a great question. The basis trade has been around for, obviously, a long time, but it's probably still the key kind of source of potential financial instability. And you only have to go back to look at what happened in March 2020, so in the very early days of the pandemic, it was almost certainly a basis trade unwind that really pushed the Fed to have to come and backstop the Treasury market. We saw that the fastest and largest buying of Treasury debt the Fed has ever embarked on, something like end up being over $4 trillion. And the reason is that the market obviously just couldn't absorb the unwind of that trade. Now, the problem today is that the trade is probably twice the size. It's probably of the order of something like a trillion dollars. And the second thing is that dealer balance sheets, primary dealers, are more congested than they were back then. And these primary dealers, they are, if you like, the first line of defense to try and help absorb any of this basis trade unwind. But given their balance sheets are so congested, they won't really be in a position to do so. But the reason why the trade, as I say, almost doubled in size, is there's been this kind of symbiotic relationship that's opened up between bond funds and hedge funds and the primary dealers. And it's very interesting. It was something I wasn't actually aware of, and I was looking at just general sources of demand for bonds. And someone got in touch, and he said, have you looked at bond funds? They are not buying as many bonds. They're buying futures now. And it's very interesting.

So again, the elephant in the room is the fiscal deficit is massive government issue. The government has been issuing so much debt, the aggregate bond indices, which are made up of corporate debt and government debt, have been filling up with government debt. So, if you look at the chart in the right there, the blue line, this is on slide 9, shows that the percentage of the aggregate index which is government debt, that's now close to 45%. The problem is that depresses the return of the aggregate index. So, bond funds have been trying to enhance their returns by buying more credit, so high yield credit, investment grade credit, these have much lower duration than the aggregate index, but they want to be duration matched, so they have to buy a duration hedge. Regulations have changed, normally they would have to go and buy like an off the run bond off a bank, but now they don't need to. They can just go ahead and use futures, Treasury futures, and that's what's been happening. So, the chart on the left, on slide 9, you can see asset managers, which are basically bond funds, their longs in futures has risen markedly, and that's been almost exactly matched by hedge fund shorts, because the hedge funds are happy to take the other side of this. So they are happy to basically provide this balance sheet service for a fee, of course, which is the basis and they've been doing that in ever greater sales. They basically short the futures against the bond funds, and then what they do is the repo in the treasuries, the cash treasuries from the primary dealers.

And if we go to slide 10, we can see this whole carousel in play. In the chart on the right hand side, you can see that the asset managers net long in Treasury futures has risen roughly in line with the primary dealer, repo, and likewise, the leverage funds, the hedge funds short in futures, has risen in line with the repo as well. So, we've had this symbiotic relationship between these three parties. Now, that's great when things are benign. The problem is, of course, when things become like they are today, the risks rise markedly. And as I say, the problems today versus March 2020, are that twice the size that the trade is much, much bigger, and primary dealers are not really in the same position to even help try and absorb as much of this unwind as they

would have done in March 2020. And even that, of course, wasn't enough. The chart on the left there shows that dealer balance sheets, there are now a lot of inventory on their balance sheets. I think, I'm not quite sure 100% the reason, but it's partly to do, I think, with less foreign demand for bonds. So, they obviously have to go there, and they have to backstop the auctions, and also the illiquidity and off the runs as well. Maybe they're getting lumbered with more off the run debt. But whatever the reasons, we can see that their holdings of Treasuries and other bonds are much higher, and that's leading to their balance sheets being congested. And this is to say, a big issue. Brookings Papers came out with a very controversial suggestion that maybe the Fed has to introduce explicit facility to backstop the basis trade. So, either they would go into the market and take the other side of the basis trade if there was a systemic event, or they could give hedge funds direct access to the standing repo facility. But either way, it's kind of crossing the Rubicon. I mean, the Fed has obviously done indirect bailouts of hedge funds, LTCM being one of the most famous examples. And you obviously can argue what happened in March 2020, was an indirect bailout, but they've never done a direct bailout of hedge funds. But the costs are potentially vast. I mean, if you don't backstop this basis trade, it has the potential to do a massive amount of damage, and the longer term costs of, say, just doing more QE, especially when the Fed's been trying to run down its balance sheet, really wouldn't want to do that. You know, that's probably not something they would like to do. So something that seems highly unlikely and would be deeply controversial is something that you cannot rule out, because this trade, as I say, is so big and where we are right now, in this very kind of fluid environment, things could potentially unravel quite quickly.

Erik: Simon, before we close, I want to touch on a piece that you recently wrote for Bloomberg, talking about the alternatives to US markets. I think this is a really important point, because, for really as long as most anybody can remember, the US market was pretty much the place to be. If you were an international investor who had the physical ability to invest in any market you wanted, it was really hard to beat US markets. Why do you say that there are now alternatives? Is this about the potential loss of dollar hegemony? Or is there something else driving it? What's going on, and what does it mean for investors?

Simon: I think that's exactly right. I mean, what prompted this piece was a lot of what we've discussed today in that the dollar is no longer what it was. I'm not saying people can completely divest out dollars. Obviously, it's still the biggest market, but it's TINA does not apply anymore, that there is no alternative to the US does not apply anymore. So, it was worthwhile looking at other markets, given that when, as much as there's a lot of volatility and flux right now, it also offers opportunities, and this is the sort of time when you really want to try and take advantage of those opportunities. First of all, obviously the concentration risk in the US was so high. And so, the MSCI World got up to 75% US weighting, which is obviously just vast, it's huge. There was a huge amount concentration risk. So, that reason alone would be a reason for thinking about diversification. And then we had the prospect of fiscal stimulus in other parts of the world. So, the US was talking about fiscal tightening, and the rest of the world was talking about fiscal stimulus. So that, I think, started to trigger, if you like, a flow of capital from west to east, and therefore you're like, okay, so where should I put my capital? Obviously, Europe is the obvious place, and I think, you know, obviously it's outside the US, one of the deepest and most liquid

markets. But there might be other places too that offer more diversification, because at the end of the day, Europe and the US have been pretty much tied at the hip.

So first of all, I looked at, essentially, correlations of different markets and which markets popped up as being the kind of the most anti correlated to the general markets. By general, I just mean the overall global markets, which are mainly dictated by US and Europe. And the ones that popped up were things like Indonesia and China, Korea, and also Latin American countries too. And so, I think these are interesting. And a lot of these as well, they have much cheaper valuations than the US. Just looking at things simply, like PE ratios, again, like Indonesia, Colombia, Korea, China, much cheaper than the US and European markets too. And the second thing as well is that currency effects often boost emerging market terms. When you have money, a lot of the return you make is actually on trying to find, if you find a currency that looks structurally cheap, then you've got a much better chance of enhancing your returns. And again, some of the cheaper currencies that popped up there, Korea, Indonesia, Chile. If you look at this is from a structural perspective, so looking at the real effective exchange rates on a long-term basis, these currencies are very cheap, unlike the US. Again, the US is currency is quite rich on a structural basis. And then you're looking at current account vulnerability. So again, in the current environment, you probably don't want to be running too big a surplus. And so, you want to be looking at countries that are fairly balanced overall, and things like, again, Indonesia and Latin American countries like Chile and Colombia come up. And Latin America, I think it's actually interesting in its own right. From more of a geopolitical perspective, they've been rising lately. I think there's a sort of a notion that we're going to have a kind of, you know, ‘you mind your backyard, I mind my backyard’ kind of world where China has its backyard and Europe has its backyard, and the US has its backyard, and part of the US is backyard, is Latin America. So maybe there's the kind of notion that these countries might kind of ultimately end up benefiting from US trade in the way that other parts of the world aren't. So, I think this is definitely the sort of time you want to be looking at these alternatives. And these are the ones that popped up, as I say, Indonesia, Korea and some Latin American countries that looked the most interesting.

Erik: You're talking about how someone who has the latitude to choose their markets would make intelligent decisions as, I think, maybe bigger picture about the way that Keir Starmer and Scott Bessent are talking about the end of globalism. Are we headed back to, you know, not for the last few decades, but way back when it used to be that European asset managers invested in European markets because that was their mandate, that's what they were allowed to do, and North American asset managers invested in North American markets because that's what they were allowed to do. Are we headed toward that? Is that kind of globalism going away? Are we only talking about trade globalism as we talk about this trend shift?

Simon: Yeah, I mean, it's the flip side, isn't it? I mean, I think trade nationalism and capital nationalism are two sides of the same coin. So, there probably will be more capital that will be invested at home. There'll be more things to invest in, like if other parts of the world are boosting their fiscal stimulus. I mean, we talked about the military spending in Europe, but now we've got this global tariff shock potentially, it's going to really encourage other countries to think about

boosting fiscal stimulus. So, there'll be more reasons to bring capital home. And I think capital doesn't come home willingly, then you're going to see more financial repression. So, we're going to see more insistence that, essentially, capital comes back to help this fiscal stimulus, the borrowing that will be needed to run this fiscal stimulus. So it will be definitely a lot more siloed world, and things like financial repression will be a tool that I think governments will use. And maybe ultimately, the US itself will have to use that if the US, the overvaluations there, cause more downturns, and the fiscal deficit 11% that pushes even the US to look at financially repressing, to try and bring capital home. But yeah, capital nationalism, I think, is definitely something that's going to be a flavor of what's going to happen in the next few years, and that really is the flip side of this trade nationalism. The big question is whether these deficits are zeroed or not. I don't think that's the case. I think that's basically impossible, unless we all go back to autarky. But it just depends on how far these deficits are closed, how much of these imbalances are resolved that really will dictate how the world will actually look like.

Erik: Simon, I can't thank you enough for another terrific interview. Before I let you go, tell our listeners a little bit more, for the benefit of those who do have a terminal subscription, what they can find on your MacroScope column on the terminal. And for people who don't have the terminal, where can they follow your work?

Simon: Thanks Erik, again, for having me on. And as I say, pandemic to global tariff war, we seem to have a good form and picking the most volatile times. I write the MacroScope column on Bloomberg. I also write for the Markets Live blog, which is also on Bloomberg as well, so that they are my main contributions on the Bloomberg terminal.

Erik: Patrick Ceresna and I will be back as MacroVoices continues right here, at macrovoices.com.