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THE MIKE ALKIN SHOW
TALKING STOCKS OVER A BEER

Ep. 7 The Mike Alkin Show: An Insider's Perspective on Where the Markets are Headed

Speaker 1: Free and clear of the chatter from Wall Street, you are listening to Talking Stocks Over a Beer, hosted by hedge fund veteran and newsletter writer Mike Alkin who helps ordinary investors level the playing field against the pros by bringing you market insights and interviews with corporate executives and institutional investors. Mike sifts through all the noise of mainstream financial media, and Wall Street to help you focus on what really matters in the markets. And now here's your host, Mike Alkin.

Mike Alkin: Welcome to the podcast it's Monday, March 26, 2018. Hope you had a nice weekend, a very volatile week last week, market volatility continued for the second week in a row. It's been like this I think for the last six weeks or so. Equities got pounded last week it was a second straight week of losses. It was the usual concerns at least of late; we saw a lot of investor uncertainty about rising interest rates, tariffs and trade wars were front page news. Then you added to the mix the Facebook data scandal. For the SMP the Nasdaq and the Dow, losses range between 5.7 and 6.5%. That was a selloff since the big one we had in early February.

On Monday last week Facebook got the week off to a pretty rough start though, they fell 7%, following reports that research firm Cambridge Analytica mined the data of 50 million Facebook users without their consent. Then they went on and used that to deliver targeted pro Trump ads during the presidential campaign. I remember a time when data privacy was, before Twitter and Facebook where people were really concerned about their data being private but now everyone puts so much out there for the world to see, but we do have a certain reasonable expectation that the data we share with these companies stays within them. I guess with the news that we saw so much for that about your data being private.

On Wednesday monetary policy last week was at the fore, the feds raised rates again, which is the overnight rate that banks lend to each other. They raised it by a quarter a point, to a target of between 1.5 and 1.75%, which wasn't a big surprise. What should have been viewed as positive news the fed's forecast was that there'll be three rate heists this year. Some people were expecting four but they held it at three, but the market is looking forward and it's anticipating and it's going to need to keep raising and tightening policy over the next couple of years throughout 2020. As you've had me say before rising rates scare equity investors.

Then the trade wars, we've talked a lot about that so I'm not going to spend too much time harping on it. On Thursday, President Trump signed a presidential memorandum allowing for tariffs of up to 60 billion dollars worth of Chinese goods. The Chinese came back and said they are going to levy duties on three billion of US imports. Now, I'm recording this it's Monday morning and over the weekend there was news that the Chinese want to seat at the table and talk to the US about avoiding a trade war, and the markets are reacting well to that so far. Market's just opened a little bit and I think the Dow opened up 400 points, but we'll see, a lot can happen in any week.

For the week 11 SMP sectors finished the week in negative territory tech got pounded down almost 8%. Financials didn't fare well either they were down about 7%, and healthcare normally a more conservative group and one that's more of a safety group was down almost 7% as well. Energy held up though for the most part down barely 1%, the energy group benefited from a jump in the price of crude as West Texas intermediate advantage mark was up almost 6% to about almost 66 bucks a barrel. That's the highest it's been since January. A lot going on in the markets, a lot of volatility it continues and as I continue to tell you I would use these opportunities when you do see lifts in the market to continue to lighten equity exposure.

Today I want to spend some time talking about something that I think is very critical for you to think about, when you think about long term investing success. I mean obviously you need to have more winners than losers, and hopefully your winners are bigger than your losers. I want to talk about how you determine which stocks you choose, because I think that's key to determining which stocks will go a long way towards helping you achieve what you are hoping to achieve. The internet and social media when I think about that and the role it played in investing, I mean it's changed our lives forever.

I don't think there's any going back; it's here to stay, and I think the uses and utility are only going to increase. Podcasts are a great example of that; think about the utility of podcasts. I mean you could be listening to me right now you could be seating on a plane, on the runway you are up in the air, you might have downloaded the podcast before you took off. I could be keeping you company on the drive in to work, you could be seating in bumper to bumper traffic. If you are, as a New Yorker, I totally feel your pain. You could be listening to me on your laptop or you're doing something else.

Wherever and however you are listening to me it's courtesy of the internet, and as a listener you had to hear me somehow. You might have seen something I tweeted @footnotesfirst on Twitter. You might be a subscriber to mine or Frank Curzio's newsletters, subscriptions driven likely courtesy of hearing about me through the internet. You might have watched one of my conference presentations or interviews that appear on YouTube courtesy of the internet. You are listening because you have an interest in getting investment ideas or becoming a better investor. I am just one of countless number of people who do investing podcasts, talk about stocks, talk about the markets, the equity markets, the bond markets.

My goal is to educate you about it, so if you are doing yourself you might have some more tools in your investing toolbox. I was a hedge fund guy for 20 years I worked for some big hedge fund, so I think that experience and insights I have can help you get there. People have said to me I get some nice feedback and email saying I have a way of breaking down complex financial topics so that the layperson can understand that, I hope that's the case. Like I said at the end of the day I am just one of a lot of voices in this big sea of investment podcast. What I try and do because I like to bring on guests who I think are very smart, they could educate you about different sectors, companies, macro issues.

A lot of things that and I try to bring a different perspective to it and hopefully my guests do as well. We talk about different topics, because I want you to learn I want you just to have exposure to different areas, different ways to make money. To think about things in a more broader context. When I bring these guests on I think they have incredibly valuable insights for you. None of them nor do I know what your unique goals are, we don't know what your time horizons are, we don't know your personalities, we don't know your circumstances. While I or my guests can educate you on something, it doesn't mean that you need to act on it, it doesn't mean that it's good for you, it means just something for you to think about.

What hopefully I'm bringing to you is the beginning of a potential investment idea. You can get your investment ideas from a myriad of places, it could be newsletters, it could be independent research firms, sell side brokerage firms. It could come from your own reading your experience, your contacts, but that's just a start. What I have found is that successful investing over time requires having a repeatable investment process. That all requires having an investment framework, now my framework is centered on looking for market inefficiencies.

I look at sectors and classes that are in extremes, their highs or lows, I'm looking for potential ideas where the narrative has created such a false sense of security, and the investors supporting that narrative are plenty in either the sector or the asset class or the stock. I hold the view that a lot of good news or bad news is baked into the prizes at extremes. What I do is when I see extremes I search for change that's occurring below the surface, that may not be noticeable because consensus thinking gets so entrenched in investor minds. They tend to carry that concurrent narrative into the future and into their forecast.

In my view my framework is about looking for market inefficiencies, getting to that market early before the changes are understood, before they become popular, before they become respected. Howard Marks the co-founder of Oaktree Capital has said this and I think it's so true he says, "It's far easier looking for market inefficiencies than trying to be the smartest guy in the room, playing a game everyone knows and wants to play, that's consensus." Having a contrarian view, that's my framework.

On today's interview, we're going to speak to someone who's got a fascinating investment framework, and one who I think is worth paying close attention to. He's the co-author of The New York Times bestseller “Endgame: The End of the Debt SuperCycle.” He's a Rhodes Scholar from Oxford; he's got Wall Street experience as a proprietary trader at a couple of big Sell Side firms, as well as one of the biggest hedge funds in the world, SAC capital. He's the father of Variant Perception, which is an independent research firm whose clients are institutional and high net worth investors.

He's had some huge calls. I think back to 2009 in Variant

Perception he published a report that described Spain as the hole in Europe's balance sheet and man, he got hammered for that; journalists, analysts, government officials. He was even described I think at one point as the enemy of Spain, but he was prescient. As he predicted and as Spain experienced a very high unemployment level for an industrialized economy, and a real estate collapse and general banking insolvencies, so he nailed it. He has a Variant view, he thinks contrary and he's a contrarian. Let's get to my guest Jonathan Tepper, founder of Variant Perceptions. Jonathan Tepper, welcome to the podcast.

Jonathan: Thank you so much for having me.

Mike Alkin: It’s a pleasure to talk we spoke a few weeks ago we were talking about a different topic than what we are going to talk about today. Just before I brought you on I spent a lot of time talking about where you came from and what you are doing now. Why don’t you let our listeners here that in your own voice. Tell us how you got to where you are in Variant Perceptions; give us a little bit of your background?

Jonathan: Sure. Thank you very much, it’s a pleasure to be on the podcast. I started Variant Perceptions with a couple of colleagues back in 2009. The origin of Variant Perception was really somewhat accidental in the sense that I used to be a prop trader in London back during 07 right before the recession in US I was at bank of America at the time. I was trading interest rates and currencies but really spending an enormous amount of time looking at the subprime crisis in the US, which I thought was blowing up. I was writing essentially weekly notes, which I was circulating internally in part trying to figure out what was going on, and I found the writing process very helpful. Also in part try to get permission to trade certain things.

We were limited in terms of what instruments we could trade, and I just really enjoyed the experience and though that it was one, very good for research purposes. Two, it helped clarify a lot of my thinking and I ended up leaving the bank they wouldn’t really let us trade many of the things that we wanted to trade, regarding mortgage, stocks or indeed the trenches and the subprime trenches. Or European periphery trades, so I left but I kept on writing this weekly and monthly notes. What was very clear to me I was trying to predict when the next recession might happen, because I thought a lot of those trades would really start to move, once the economy shifted and a recession started.

As I was doing research I had a degree in economics, I thought if I found the right research paper, it was going to tell me how to forecast recessions. I realized that nine out of 10 economies have missed the last four recessions. That's sort of research from the IMF and so it's not that economists are stupid or don't know what they are doing, almost all economists I meet are fairly bright people. They have PhDs in very good universities so clearly something else is at play, and what I realized is that most of the commentary that you might read, whether it's in the papers or even a lot of economic blogs, focuses on inflation and employment. Those clearly are very significant but they are fairly backward looking.

If you think of someone who runs a real business, the CEO they don't start firing their workers just because they have a bad month or two in sales. Likewise, they don't start hiking their prizes just because they have a good month or two in sales. They don't start raising wages for about a year. Wages are generally determined on a yearly like a roll in yearly negotiation process. In a way inflation and employment are very backward looking yet this are the two things that most people spend their time working on. Most of the things that lead the economic cycle get very little attention. When you are investing, when you are buying stocks or bonds, what you really are doing is making a bet about the future, not about the past.

I realized that most economists and most models effectively are fairly backward looking. Then even more importantly another aspect that's even less understood or discussed is the vintage data prop. A lot of economic data gets revised, and so if you see a number in the Wall Street Journal or Reuters or you download it on Bloomberg, it doesn't mean that data point, say a few years ago, was the data point that it was later revised to. Jobs numbers are notorious for example, not some payroll, with being changed, and the problem with the vintage data issues that the training points, so the revisions are big as the training points. Meaning that the errors are largest when they are more than most, and that's one of the issues.

What I realized is that I had to focus on leading economic indicators using unrevised data. If you are a trader you don't have the luxury of revising your trades six to 12 months later. You can't just go back at the end of the year and figure out what a more appropriate trade might have been, if you'd had better information. Traders every day are making informed decisions with limited information. The question is how can you become better informed? My colleagues and I started basically building leading economic indicators using unrevised inputs. One of the things we cared about a lot was liquidity. Part of that is that clearly stock markets have major moves when economic data starts turning down, or when it becomes less worse i.e., the second derivative starts turning up at the end of the recession.

Generally because stocks are discounting mechanisms and many other asset prices are too they'll start to move slightly before the economy itself turns down. What you really and all stocks go into many of the traditional leading indicators themselves, what you want to do is get an even better advanced freedom, where asset prizes are going. I know we'll touch on specific trades and things later, but for example if you are looking at commodity prizes, they are very heavily dependent on global liquidity. Commodities tend to do fairly well when global liquidity is ample, and they tend to do very poorly when global liquidity is tightening. The same is true for example merging market equities.

Emerging market equities in a way are the marginal importers of capital, so what ends up happening is that you end up with, you know when monetary policy's tight like 1997 or 1998 for example, with emerging markets the fed had been hiking essentially earlier and we are looking at 2007/2008, almost all central banks were hiking in a collective coordinated way. You ended up with a lot of the emerging markets ultimately doing fairly poorly, so we've created global liquidity measures. We know that your curve leads gross and it does lead a lot of other asset prizes and relations we build global leading indicators. We build global finance rates, and a lot of this is because money is tangible.

What matters in terms of global liquidity is not just what's happening in the US, but the fed that rather what's happening back in Japan with the PCB, back in China even the RVA or New Zealand. There's quite a lot of information that can be gleaned at the margins, and so my colleagues and I started building this tools to identify turning points. The name of the company we borrowed it from sort of the expression that's in common use among hedge funds it comes from Michael Steinhardt, Variant Perception. What you're really trying to do is to find when this tools might disagree with market positioning, so we look at sentiment and valuation.

To the extent that our tools disagree, then there's a great trade and that might be on the negative side where our tools turn down, or it might be on the positive side where everyone's really negative, money flows by speculators have them pulling out, and valuations are quite cheap. For example in 2016 our top trades for the year is not the top trade was well in Brazil. That was a very clear case where money had been flowing out of ETFs and out of mutual funds for three years. Which is truly extraordinary generally it makes a year or two but not three. At the same time variance leading indicators and the quitting indicators for Brazil had turned up and were improving a lot.

You had cyclically low valuations that were in line with 1998, 2002 and 2009 in Brazil, you had very negative assessment positioning, and if you remember the economists had research from the [inaudible 00:20:32] cover in Brazil, which is essentially a data basket case, and our leading indicators were turning up. If you fast-forward a year you then see the Brazilian market has essentially doubled in dollar terms. Likewise, on the negative side if you are looking at for example our leading indicators we are turning down very strongly on China in 2013. A lot of people I spoke to in the commodity complex are still fairly bullish on China, Chinese growth.

All of our tools are telling us there is quite a lot of tightening going on, and our China indicator leads commodity prizes. Those are two examples one up one down, I'd say that one of the benefits of this approach in terms of what I said dong with my colleagues, is that I do have great admiration for some economists who are fairly well known. You could think of half a dozen of them right off the bat probably the most famous one a while ago was [inaudible 00:21:31] but what I wanted to do is to make sure that my perception really was not a guru led mode. I am not a guru and it's not like I have some crystal ball that other people don't have. Rather, I think that if Variant could create a set of robust repeatable and scalable tools, then that was going to be helpful across cycles.

Then they would then mean that there would be an objective agnostic way of applying those tools to make money across time in different business cycles. Over time those liquidity and leading indicators have been a key part of the process, then we've also built debt and currency crisis scores. The reason for that is essentially to also find outliers so you are able to find countries that will have a debt crisis, those are often tied to excessive lending on the household mortgage side. Then currency crises, those are fairly well understood, although a lot of people don't track the key metrics, but this often tends to be driven by countries that have high reliance on external funding.

A lot of that funding might be short term in nature meaning a hot running air portfolio flows. When things turn around turn bad owners can sell local assets pretty quickly, which lead to a currency crisis. A lot of the borrowing is done in US dollars or fine denominated debt. What we are really doing is trying to find outliers in terms of the business cycle and then outliers globally in terms of debt and currency crisis, and pair those assessment position valuation. That's really essentially the essence of Variant Perceptions framework, which is not driven by me or a guru or crystal ball but rather by a robust set of tools.

Mike Alkin: It's amazing when you think back to the guru model if you will how many guys had big market calls on something. It's just hard to repeat it over and over again those big calls get those big trades right all the time.

Jonathan: I completely agree and I think it creates a second problem, which is if you do make a very bold call, well clearly like events move forward right data changes week to week and month to month. If you are married then to a very big call, and that's how people think of you, it creates a very strong psychological aversion to changing for you, and almost all the people I know who are great investors or traders, have very open flexible minds, and when there are changes they change their mind. I think that it's very easy to paint oneself into the corner if you follow the guru model or as if you are using data, and they are very data dependent and agnostic, which I think is what the tools that Variants built are designed for.

Then as the data changes you change your mind because you follow the tools. That generally means that because these are leading indicators and leading liquidity indicators, might be a little bearish and likewise be positive when other people are extremely bearish in the case of Brazil. I think if you are known as let's say a bearer on Brazil [inaudible 00:24:45] you change your mind. That's I think the benefit of having tools rather than being essentially a guru it forces you in a way to stick to that known position.

Mike Alkin: You mentioned something earlier, talking debt, you are talking currencies and equities, how do you use those to form your view? Some people and I try to tell a lot of listeners listening to the podcast that don't just focus on the equity prizes because there are many other things that could signal what's going to lead the equity prizes with regard to debt and currencies. How does that form your framework or how does that form your view when you are thinking about it? Are they intertwined or do you look at them in a vacuum?

Jonathan: I think that is another reason why my colleagues and I started Variant, which is that before I worked on the top desk, which is essentially 2005 to 07. I worked at SAC Capital in Connecticut doing equities long shots. It was a very strange transition going from bottom ups to essentially trading interest rates and currencies. I had a degree in economics and I thought that would be fascinating. Well what was very interesting is moving from one to the other, so going from only talking to equity guys to only talking to currency and fixed income guys. I realized that almost everyone didn't even look at the same stuff, so the kinds of things that you would track is the government bunk trader, and you wouldn't an equity guy might never look at and likewise.

If there were problems in one corner of the market in a way it was pretty easy to be blindsided by them, because people weren't aware what was going on. To me that really came to the core in 2007/2008 and 2009, where if you'd paid attention to credit spreads, and you paid attention to bank funding costs it would have awarded you two huge problems in the financial system to the financial plumbing. I remember I was tracking those like a hawk because I thought that that's where our problems were. You almost always see the [inaudible 00:26:55] and things like that blow out. Immediately shortly after you'd see that there were problems in the equity market. I think that if you are doing macro investing, even if you are doing lots of just straight up equity investing, I think you have to be very aware of what's happening and approach the market.

I don't think equity investors are like dumb investors, some of the smartest people I know are equity investors. Sometimes I've heard it said like the sort of the barn market's the smarter market. I don't think that's necessarily the case, but what I do think is that there's often very good signals that come from the barn market and from credit spreads that are useful and in a way lead some of the things that we then see in equity markets. I think it all ties together, and it's really about understanding what provides the lead, and what doesn't. What's critical and what's not so what we are trying to fix on very much is on credit spreads and the credit cycle they feed into the economy. If you are a CFO, you are much less likely to be hiring people if your credit spreads are widening. That has a huge impact lead on the ISM for example, or on initial unemployment claims, that's how we try to put it together.

Mike Alkin: What are you seeing right now? Let's transition now from framework to the current environment. I mean I've been telling investors who listen to the podcast who subscribe to my newsletter that I think we are much closer to a market its happened to use any strength and sell into that strength. I'm much more bearish right now, but what are credit spreads telling you right now as you look across the landscape?

Jonathan: Sure so what's very interesting is that currently credit spreads are not really flagging any real danger, and so the bigger question in my mind regarding credit spreads is, are they correctly priced or are they mispriced? Credit spreads were fairly tight in early 2007 and it was late 06/07 and it was very similar in many regards, where credit spreads tend to follow balance sheet health. If you look at cash flow to debt that generally provides a reliable lead on what credit spread should be. When cash flow's increasing and debt's being paid down credit spreads should be falling when cash flow's [inaudible 00:29:25] or debt levels are rising, then credit spreads should be widening.

Currently we are actually not seeing very much in terms of running credit spreads, but if you look at almost all the leading indicators whether it's [inaudible 00:29:40] interest margins at banks tend to become more compressed, tends to come harder operations defend themselves and certainly more expensive. There's a remarkable correlation so the twos tens or five tens and credit spreads and equity volatility. A much flatter curve, which we've seen for the last 18 months to 24 months, tells us that credit spread should be rising and equity volatility should be rising.

Now we've seen equity volatility picking up, and it's been unnaturally low, credit spreads have been unnaturally low. I think that one of the main reasons comes from city central bank buying not in some sort of tinfoil paranoid way, but rather when I speak to fund managers, particularly fixed income fund managers, they're telling me [inaudible 00:30:40] supply of credit is restricted, that they can actually get their hands on, actually see this buying up a lot of it. Then they have to move further out the credit spectrum and buy the worst equality credits where they are not even buying hard equality credits in the past.

Or they have to then make the decision that they are going to move out to other geographies. Then they'll go over to US or they'll go into margin markets. I think it's that lack of supply effectively in credit hands that's driven the credit spreads down towards where they are. There's been a divergence between a lot of traditional leading indicators in where credit spreads should be placed. I think that as volatility is picking up now, we'll likely see the same thing happening with credit spreads. One of the things if you've done accounting introductory accounting everyone in the market even barn traders should know this one, it's assets minus liabilities equal shareholder equity.

If you were increasing your liabilities, you are going to end up stressing your shareholder equity, and they are going to create higher volatility to the shareholder equity. That's what you would expect at this point in the cycle so we are not yet seeing that in credit spreads in any significant way, but I think that is where the fundamental drivers in terms of cash flow to debt, would dictate things. We built dozens of leading indicators that look at the counting metrics at the national level, look at the leads in terms of growth and leverage, and then we've also looked at liquidity measures. Overall they all point in the same direction, which is lighter spreads.

Mike Alkin: You just brought up an interesting point with the European debt managers, maybe sacrificing credit quality a little bit to get yield. In the equity markets we talk about risk on and risk off, when risk on people are willing to accept more risks, when risk off you see them act more conservative. Then also happens in the debt markets, I was talking to a housing trader and he was telling me that his work rate because he sees people just reaching for yield, with pension plans, insurance companies that credit qualities is far further down the list of what they are worried about right now. That can come back to haunt you on down the road when you start sacrificing and it becomes [inaudible] then.

Jonathan: I completely agree and I think that we see this every cycle, where people take all sorts of risks that only later come back to bite them. I saw that certainly in early 07 when I was asking people the high yield traders whether they were pricing high yield. They were telling me that they had a correlation model SMP and SMP was rising the spread should be tighter. I was just thinking like I was scratching my head thinking that, if the SMP is going higher it tells you nothing about the cash flows of the company to keep that just [inaudible 00:33:45] pretty accurate in terms of how it's trading, but it doesn't tell you anything about whether you're going to get paid back as a bond holder. No surprise there that high yields spreads widen significantly and the other big problem now I think is that it's not just in the pricing of credit it's also the terms of credit.

When you negotiate any deal, everything's always about price and terms. The bar market's very similar it's like what's the price what are the terms? Pricing's terrible but what's perhaps even more alarming is that the terms are terrible. If you're looking at the percentage of loans that are [inaudible 00:34:24] light, it's I think anywhere from 60 to 70%, which means that the companies can run further with the whatever they are doing with the company, and so your ultimately recovery rate should go down, because you are not going to get access. You can't essentially force the bankruptcy early, and sure enough you go on to the recovery rates that we've been seeing you know default rates are low, they are terrible.

Mike Alkin: Investors when they read the mainstream watch mainstream media, they read the newspapers they watch it on CNBC, they are seeing a lot of discussion about tariffs fed raising rates big deficits in the US all this uncertainty. How much of that in what you do, are you paying attention to that, versus often your world looking at this other stuff? Headline versus data?

Jonathan: Sure Variant doesn't pay an enormous amount of attention to tariffs, I think one is this don't happen regularly enough for it to be a big issue in terms of understanding how tariffs affect markets, generally it's not very positive. If you remember George W. Bush's still tariffs at the time you had the beginning of the US recession going on, and I would argue that the moves that happened in markets, the economic growth and credit conditions, vastly outweighed any tariff considerations in investors' minds. Likewise, [inaudible 00:36:02] back in the Great Depression was not a brilliant policy, but at the same time I would argue that the credit conditions in the US were far worse and the biggest drivers of policy. To the extent that there is a trig words obviously not good.

The other issue is what Variant tries to do is to create tools that are robust, repeatable and scalable. Particular so geopolitical insight I've never found to be particularly repeatable and not necessarily robust either. To the extent that we can focus on liquidity and tools that we know work across cycles. That's what we try to do, and part of it is that if you are thinking of how politics feeds into the investing process of most people, you often end up with sort of completely paradoxical or counterintuitive results. Trump was widely perceived to be a disaster for the US market, the market went up. Obama for example when he was elected everyone thought that he was going to pull troops out of Iraq and Afghanistan, and imposed some form of socialized medicine.

So no, the obvious thing to do would have been they go out in short healthcare companies, and defense companies and insurance healthcare and defense ended up being among the best performing sectors during his presidency. It's not really obvious that politicks does well, the only area that I've seen it do well is there's an index on lobbying and therefore whatever a company spend on lobbying they tend to get a payback on. That's about the only thing I've seen and so we just stay away from that. Earlier we were talking about Brazil and [inaudible 00:37:47] was on the front cover of The Economist that was the time to buy Brazil or not to sell.

Mike Alkin: I used to work for Marti S. White back in the early 2000s, late 90s and Marti always said, "If something appears on the cover of one of the national magazines three times, go the other way." It worked quite a bit he and Joe DiMenna built a 10 billion dollar hedge fund around that so it worked pretty well. Let's talk dollar I mean the weaker dollar has contributed to easier liquidity, but as you see some of the momentum of growth outside the US begin to slow, currencies outside the US should start to struggle a bit, which could lead to a stronger dollar. What does that scenario do to your global growth scenario?

Jonathan: Sure, so the dollar has a long history in terms of causing problems, or really just impacting the rest of the world. The US has long had or experienced the [inaudible] dilemma, which is that your currency can be a reserve currency globally, but it means that you can't really manage it for domestic considerations. You always essentially have to be running kind of account deficits, and often during the deficits to be able to provide more dollars to the rest of the world. If you do too much of that, you end up devaluing your own currency and making it less stable. This is like an ongoing problem, so the world needs dollars but doesn't need too many of them. If there's not enough then no one's happy it's a fine line.

If we are looking around right now, the US current account deficits very high. More surprisingly the government deficit is very high where you would have seen at this point in the economic cycle given the expansions about nine years long, the US government should be running a minimal deficit if not a small surplus as happened under Bill Clinton in the late 90s. Whereas we have low unemployment rates and you have high capital gains, tax proceeds then the government should be fairly well funded. Instead, what we are seeing is that both here are fairly wide and so if you look at what they call the twin deficits, then I think those put together generally do map the broad dollar index.

Not on a day to day, or even week to week or month to month basis, but over one to two year period in a dual line further closely. It's the prizing of it when Clinton was running the very large government surplus the trade deficit wasn't that bad, the dollar was very strong. Just weren't a lot of dollars circulating globally in people's hands. Unsurprisingly in the late 90s, a lot of the [inaudible] were also under stress. Today, right now, what we're seeing is high budget deficit, high current account deficit, this is I think in part explaining what we are seeing with the dollar.

Mike Alkin: The last since global financial crisis the last eight or nine years, central and commercial bank liquidity has been rampant. We've seen the fed expand their balance sheet tremendously, you've had 5,000 year low interest rates. The moving stock prices kind of made sense, but the last couple of years though you've seen the feds' balance sheet remain kind of steady, yet you've seen an explosion in equity prices. Why is that do you think, especially when you bring to account the flattening yield curve and money growth that's slowing? Where's the disconnect been in the last year or two?

Jonathan: Sure so I mean there's the famous chart of the SMP versus the fed balance sheet, and once it went flat the idea was that it was a stupid chat, we shouldn't pay attention to it. As I said earlier Variant Perception builds global industries, and so looking at the US central bank balance sheet in isolation, and not comparing it to what might be happening with other central banks doesn't make a lot of sense. When you start creating a global central bank balance sheet, you get a much better picture for global liquidity, than you would if you looked at the US outright. When the US was pausing essentially then the ECB in the bank of Japan and even the bank of China went into overdrive. If you take a global central bank balance sheet I think that's more to explain global not only equity prices but global asset prices on the whole.

Mike Alkin: I was reading your work recently and I saw you did a piece on multiple expansion, and the impact it's had on stock prizes. I hadn't quantified it in my head, over the last five years it's accounted for about half the growth of equities. Talk about the role for listeners of PE multiple expansion up to this point, and what role you think it plays going forward from here?

Jonathan: Sure PE multiples there isn't just one driver there are multiple drivers, and some of it is inflation so historically when inflation's been high people have given rewarded equity markets with fairly low multiples, that was certainly true in the 1970s and the early 80s. You had higher bond yields higher inflation and lower PE multiples, and as inflation came down investors were willing to reward equity markets with higher multiples. There's also the cyclical element to it; you could argue that the further away from a recession or a big crisis you are, the more people forget that stocks can go down, and they tend to reward higher multiples to equity.

When you are nine years into an expansion you haven't seen earnings go down tremendously, people are willing to use low discount rates and higher equities higher multiples for equities. I think that's exactly the sort of thing we are seeing right now, which is further away you get from a recession the more optimistic and rosy valuation metrics become.

Mike Alkin: If you will listen to the gold bugs they will tell you that inflation is just around the corner, and I think I've been hearing that for a while from them now. I think you have a different view of inflation share with listeners how you are thinking about it.

Jonathan: Sure so we've had it on our blogs a lot of the tools that we have are only for clients, and if any of the listeners today do work at hedge funds or family offices I highly recommend that they check out Variant Perception dot com.

Mike Alkin: It's fabulous.

Jonathan: Thank you, and go to the contact form we'll be happy to speak our clients are institutional in nature. Because of that we don't tend to give away very much in terms of what our current tools and views are. We had blogged about this and so it's been on our blog, but as I mentioned before one of the things that we try to do is to build leading indicators for liquidity and for growth, and one of the areas also happens to be inflation. Earlier I was talking about how CEOs don't hike prices or fire workers just because a month or two of sales is good or bad. Because of that insight inflation typically lags the economic cycle, when you are looking at core inflation for about 18 months.

I'm headlining [inaudible] shorter lead, it's probably six to nine months, and that's driven by the elements that tend to introduce volatility into headline CPI versus core. If you know what's happened in the past because of that lag, it gives you a reasonable view on where things are going in the future. That's the beauty of being able to build a leading indicator for inflation, so on the headline core side, it's quite clear is that we're fairly late cycle, and employment rate is fairly tight, and informed employment claims are extremely low. A lot of the inputs are plenty higher, so you have higher inflation there's no doubt about that.

The issue is are we talking about sort of runaway inflation or are we talking about the standard run of the mill late cycle inflation. The answer if you go to our blog and see the chats and see that this is not a runaway inflation, this is a standard run of the mill kind of late cycle inflation. That obviously has quite a lot of implications for whether it's gold, the gold bugs I've known quite a few in my time and you can find spreadsheets for a gold fund that a former colleague had started. I think the biggest driver for gold prices is the real interest rate. You can actually find it online, believe it or not Larry Summers he was no gold bug, wrote a paper on Gibson's paradox so you can Google Larry Summer's paradox.

He talked about how the biggest driver of gold was the real rate. Why would you want to hold a shiny yellow medal when you could get a real interest on your bank account on bonds? The reason that you would hold a shiny medal is that if real rates are negative, then there is no benefit to putting your money in a bank account, or owning treasuries. People then become willing to buy things like art and gold that have no real yield and in fact might have some negative curry associated with it, in terms of storage costs or the shape of the curve. Gold the rule of thumb is essentially that investors or savers expect about 2% real rates on the cash.

For every 100 paces we are going to move away from that, gold will move by X%. It does change a little over time, but broadly you are looking at eight to 10%. If real rates are zero and you expect 200 paces points real on your cash, gold actually becomes attractive, gold becomes a terrible investment when say real rates are 4% and that's above that so 2% hurdle that you might have had. Then gold tends to go down by about 8% per year, and so the driver of gold in my mind is not ideological or the feds going to print and kill everyone. The question is would you prefer to hold a shiny medal, or get a real return? If the answer's you are not getting a real return then gold actually looks decent.

Mike Alkin: I spoke at a conference back in January and I was very bare trying to consume a stable sector for myriad reasons. One being I think it's very hard for them to get much top line growth from a volume or pricing standpoint. I think they've squeezed out all the cost savings they could get, and they've leveled up the balance sheet to buy back stock. One of the key things I talked about was demographics, and the impact on the baby boomers aging, and why it's difficult for them to get pricing and how much consumption the clients when they start to age. I know you guys have done some work on that recently, would you mind sharing your view or is that something that ...

Jonathan: Sure. A lot of the work we've done is not hugely proprietary and we are not the only people doing it on the graphics, but where its relevant we do try to tie it together and write about it for clients. What's really interesting is most of the research on demographics is related to the ratio the prime working wage to the non-working age population. Children and old people are in the non-working age group, and then the prime working age is generally their 20s to the late 40s. The ratio of those is very informative in terms of the overall inflation rate, and hence the interest rates and obviously because 10 minutes earlier we were talking about PE ratios with stocks and everything's tied together.

The current outlook is for across like multiple years, because obviously demographics don't change radically from six to 12 months, and this are multiyear cycles, and it's different for every country. Obviously like Nigeria and India have very high birth rates, whereas Italy and Japan have extremely low birth rates. Probably for US and Western Europe, it's difficult to see how you end up with extremely high inflation rates given the ratios we are seeing of working age to non working age.

Mike Alkin: Without giving away too much to non subscribers, what are you seeing of interest rate now that that's on your radar screen that you think is most important?

Jonathan: Great question, so I think right now among the bigger broader themes, goes back to what we were talking about earlier with credit spreads. Almost all lean indicators point to wider credit spreads and are already getting a higher equity volatility and that's I think one area that viewers should be paying quite a lot of attention to.

Mike Alkin: I spent 20 years 20 plus years in the hedge fund world, and I've read more self side research and I care to think that I read. Using it as just a primary a lot of the times, just getting up to speed. I had the opportunity to read Variant Perception and I think absolutely tremendous. I'm a contrarian as a contrarian you take a contrarian view point, but I think your work is just absolutely spectacular. How do if on the hedge fund family office or individual investor, how do you become a client?

Jonathan: Sure, so the way that we almost always end up with clients is word of mouth we love thoughtful podcasts we've come to dislike CNBC and Bloomberg even though I'm sure there are many fine people who work there. I know of actually quite a few, but the way we learn about podcast for example this podcast is that you can actually tease out ideas and develop them over time. You are not confined to like a two minute sound bite, so I absolutely love the ability to go over some big ideas. For the listeners of this podcast I'd say that check out the Variant website so go to Variant Perception.com. You have a contact form so slash contact, and there you can just request access.

If you do work at an institutional setting, whether it's a friendly office, hedge fund or endowment, we are always happy to share some of our material and go through a process. Generally it's more of our analysts on the road and we'll go visit clients and externally how the process works. We currently do not have a retail offering we might in the future, which will be vastly teared down but still useful set of tools. For the moment almost all Variant's clients are hedge funds and family offices. What's extraordinary what we love about podcasts is that I think the kinds of people who do work at hedge funds and family offices are like sponges for information. You find that if you are speaking to like a podcast generally that's the kind of stuff they listen to when they are driving.

Mike Alkin: When I pick up my kids at school and they hear me listening to podcast they say dad how come we are not listening to music? You wrote a book you and John Mauldin co-authored a book called Endgame: The End of the Debt SuperCycle. What's on the horizon for you from authoring another book?

Jonathan: Sure, that was almost by accident in the sense that I was writing my weekly and monthly things and I sent it to John, and he came through London and we got a drink, five hours later we'd agreed to write a book together. Endgame did very well, code red did well not as well as end game it actually sold, I think over 80,000 copies. I think there has to be a good reason to write a book because it is a labor of love.

Mike Alkin: I had Danielle DiMartino on a few weeks ago, and I was with her about a year ago right when she had just finished it and was doing her press tour, my God it's a lot of work.

Jonathan: Absolutely so after Endgame and Code Red, Code Red didn't do quite as well, it did well I think it was like 40,000 copies, it was all on unconventional monetary policy and almost everything that we were writing in terms of bubbles and asset classes ended up playing out a lot of it. I didn't really come across an idea that I really felt merited spending all this amount of time, and I am now working on another book, which I hope to finish the next month or two, and it is on monopolies so there's a website if people want to go check it out, it's called myth of capitalism.com. I use the term myth of capitalism because I think capitalism is about competition, and not just about canon capital.

Right now unfortunately many industries we've got lots of monopolies, and so there's sort of return on capital with very little competition. Particularly in the US you have extensive regulations, which tend to favor incumbents and hurt small businesses. Then you have all sorts of barriers to entry and then regulators effectively been asleep at the wheel allowing mergers to get through which never should have gone through. If you think of two companies control 90% of the US bureau market. Clearly I think it violates the letter and spear little law yet the department of justice since the Reagan guidelines in 1982.

Today it doesn’t matter whether a president's been a republican or democrat, they've pretty much have done nothing on anti-trust. The issue of monopolies and anti-trust now they are all across the board, so there’s a reason workers aren't getting pay raises, and part of that is that union levels have gone down. At the same time companies themselves are consolidated, so we have millions of people facing loss against fewer and fewer companies when they are asking for raises it doesn’t happen. There’s quite a lot of academic research that’s now coming out, looking at industrial concentration by city and county, and more concentrated counties have lower wages. If you work in New York City or Los Angeles or Chicago you are going to be much better off, because you have more opportunities and choices.

If you are working in more rural or smaller city area you might be a nurse that has only one hospital that you can negotiate with for your salaries. I think that this explains an enormous amount not just economically but also politically. How is it that Trump who was essentially a nobody politically, and Sanders who's essentially a former socialist who joins [inaudible 00:58:24] managed to do so well in a two party election? I think that if you look at it a lot of the support for both of them came from areas where people felt that their needs were not being addressed. A lot of this I think does tie with fairly stagnant wages where people at the top have done very well post crisis, and the average worker essentially is mopping [inaudible 00:58:50] line with productivity increases.

Mike Alkin: Fascinating. Jonathan I can’t thank you enough and I want to reiterate to listeners go visit the Variant Perception website, his work is fantastic and I highly recommend it. Thanks again and when the book comes out we’ll have you back on.

Jonathan: Thank you so much it was an absolute pleasure it would be a pleasure to come back.

Mike Alkin: Great thanks Jonathan. Hope you enjoyed listening to Jonathan, he and I spent about an hour on the phone a few weeks ago talking, and I thought his view points and how he looked at the world was different than what you hear in the mainstream media. I thought it would be very interesting for you to spend some time listening to him, and hopefully you enjoyed it. That's it for this podcast, I will see you next week. In the interim you can find me on Twitter at @footnotesfirst or you can email me at Mike@curzioresearch.com and I do appreciate the emails. I get some real good emails and I look forward to speaking to you next week have a good week thanks.

Speaker 1: The information presented on talking stocks over beer is the opinion of its host and yes you should not base your investments decisions solely on this broadcast. Remember it's your money and your responsibility.