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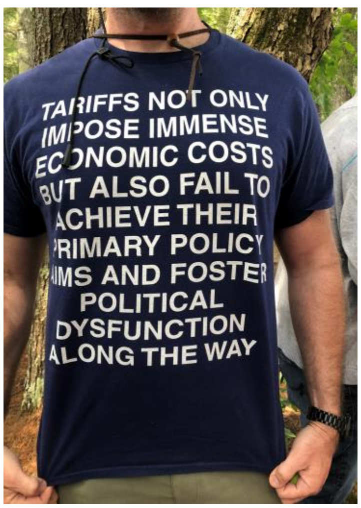
Brent Donnelly, Spot FX Trader
1 (212) 525-8469
brent.x.donnelly@us.hsbc.com



Seen at Camp Kotok

Current Views

1.90% before 1.49% in US 10-year yield

Tuesday, August 13, 2019

Notes from Camp Kotok 2019

Last week I attended my sixth "Camp Kotok" near Princeton, Maine. The event is a gathering of economists, asset managers, traders, research heads and journalists that takes place each August deep in the Northeastern US woods, near the Canadian border. In past years the conversation and formal debate / discussion centered around Fed policy, trade wars, the stock market, inflation and other short and medium-term economic factors. This year the conversation was more super macro and focused on three key long-term themes which discuss one by one. The three themes were:

1. A future where global rates remain permanently near zero
2. Modern Monetary Theory (MMT) and US fiscal strategy
3. A fundamental change in the US/China relationship

A future where all rates on every yield curve are below 1% forever

There was a group conversation about what it means to be in a world where global interest rates stay permanently near zero. In other words, if every point on every yield curve in the developed world is set to remain permanently below 1% for the rest of our lifetimes... What are the implications? (Note: The idea wasn't to argue whether or not this will happen, it was to assume it happens then discuss the implications).

I think this is a great question since most people still tend to view the current low and negative rates environment as "crazy" or "stupid" or "insane". As opposed to "normal" or "permanent". What if demographics and technology have created a new reality where rates are never going up again in our lifetime? Japan has showed us that it is possible for demographics to keep rates pegged near the ZLB for decades. Japanese 2-year rates have not been above 1.1% since 1996 and Germany has not cracked 1.1% since 2011. Imagine a world where US rates are heading the same way. For good. Takeaways:

- This is probably good for bonds (obviously), good for long duration equities and bad for cyclicals and financials. Look at what happened in Japan and Europe. Modern banking systems are somewhat reliant on positively-sloping yield curves (at least most of the time) so banks are likely to struggle if the yield curve is flat near zero.
- The pension fund shortfall situation gets worse. Then much worse.
- Once some of the negatives of this scenario were laid out, the conversation turned to a related question: What is the benefit of central bank rate cuts at this point? Below is a (somewhat aggressively editorial) excerpt from the most recent NFIB report which captures the zeitgeist on Main Street. I think most people at Camp Kotok leaned toward the skeptical view on the usefulness of further rate cuts. Here is the quote from the NFIB:

...continued on page 2

> "The Federal Reserve Bank of the United States caved to Wall Street and delivered the quarter point cut that the market had "priced in," meaning the rate cut was needed for the "bets" made by Wall Street to pay off. This will inflate the stock market, creating even more "wealth" that will buy less and less per dollar because output has not grown nearly as fast as wealth (claims on that output).
>
> The impact of any quarter point reduction in borrowing costs will be negligible. Small business owners were asked in the July survey if a 100-basis point reduction in borrowing costs would change their capital spending plans over the next 12 months. Twelve percent said "yes" and 21 percent said "no." Twenty-four percent were not sure and 43 percent were not planning on borrowing money. But Optimism is in the "stratosphere," sales and profits look good, job openings go unfilled, so a 1 percentage point reduction in the cost of capital is a "biggie." A quarter point – not so much.
>
> And when the economic outlook deteriorates at some future date, the Fed will have little room to spark spending. Future quarter point cuts will have greatly diminished impacts on spending and inflation. The Fed is dribbling away its "ammo" as we head to the 0 lower bound."

Jim Bianco of Bianco Research, who recently interviewed for one of the open Fed Governor seats, put it this way in our chat[1]:

> "If you could put Mario Draghi under truth serum… And then you asked him whether or not he thought rates at minus 40 basis points were helping, he'd say no. If you asked him if cutting rates to minus 50 would help, he would say no. But then he would say that his job is to do something. And so that something is to keep stimulating.
>
> He feels pressured or compelled to keep 'doing something' which forces rates more and more negative under the idea that the central bank is acting and trying to stimulate.
>
> He can NEVER stop and say 'I've done all I can.' So he has to keep going, against his better judgement."

So there is plenty of skepticism about lower rates but also nearly-universal sentiment that US rates are on the same path as global rates. Down, down, down. A few campers thought this US cycle would be more like 1995/1998 and the Fed will be in a new hike cycle by mid-2020, but most seemed to feel the race to zero would also suck in the USA.

This naturally leads to the next subject, which started with a four-person debate about MMT.

[1] The conference is operated under Chatham House Rules but Jim gave me the OK to quote him (twice).

Modern Monetary Theory (MMT) and US Fiscal Strategy

First of all, I chuckled when one panelist called MMT: Magic Money Tree. Lolz. Another funny quote after someone said MMT could be used to fund universal health care and Space Force investments… From Jim Bianco, channeling John F. Kennedy:

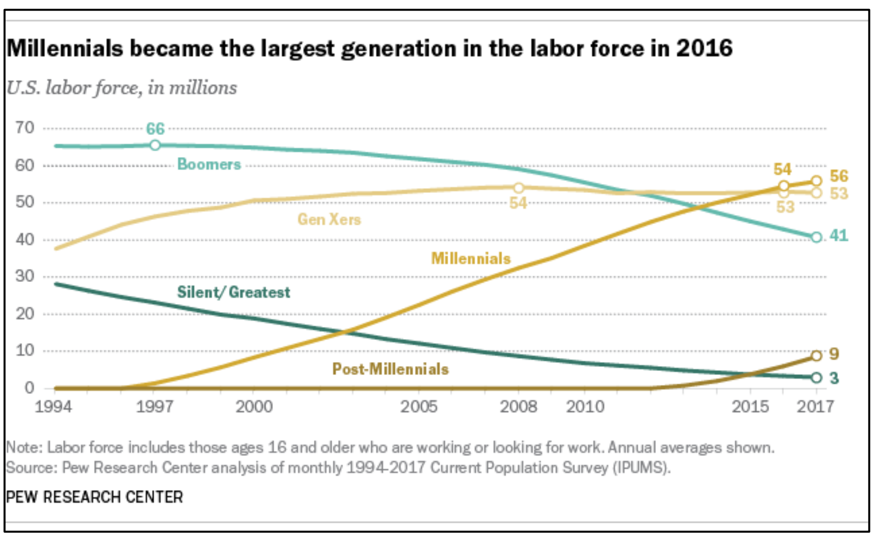
"We choose to go to Mars, not because it's easy, but because it's free."

The debate involved four separate speakers, and was a bit all over the place[2]--plus, there were many, many follow-up conversations—so I will do my best to summarize the whole weekend MMT debate and conversation in five bullets:

- The overall vibe was negative towards MMT but strongly positive towards fiscal stimulus such as infrastructure, education and student loan reform. The main beef when it comes to MMT is the timing / methodology of how fiscal stimulus is delivered. On the other hand, some argued that no matter how you deliver increased fiscal spending, it's all very similar to MMT anyway, the only question is how fast the Fed monetizes the new debt.

  If you sell a $2T infrastructure bond and then the Fed buys it via QE during the next crisis… Is that really all that different from MMT where the Fed/Treasury transaction is done on Day 1? All roads seem to lead to more spending which is eventually purchased by the Fed so the arguments feel a tad semantic / theoretical to me.

- Some felt MMT is inevitable given the weak to negative impact of lower and negative rates and bipartisan support for larger deficits. With demographics turning bad to very bad in most developed nations and technology also pushing inflation lower, a few argued that disinflationary forces are so strong that MMT will not generate inflation for a long time anyway. You can see from the next chart how the rise of the lower-paying Millenials and the fall of the higher-paid boomers is not offset by Gen-X due to its smaller size (HT Sam Rines).



https://www.pewresearch.org/fact-tank/2018/04/11/millennials-largest-generation-us-labor-force/

- A lot of the feeling of MMT inevitability also arose from many opinions that the next round of QE cannot be perceived as "bailing out the banks". References were made to Corbyn's "QE for the people" and Sam Rines called the next QE / MMT policy "Reaganomics for the People". It is not politically palatable for the Fed and Treasury to boost stocks and banks or for the Treasury to cut tax rates further. The next stimulus has to help Main Street or there will be pitchforks.

[2] Full audio transcript here: https://twitter.com/biancoresearch/status/1160908306736697345?s=11

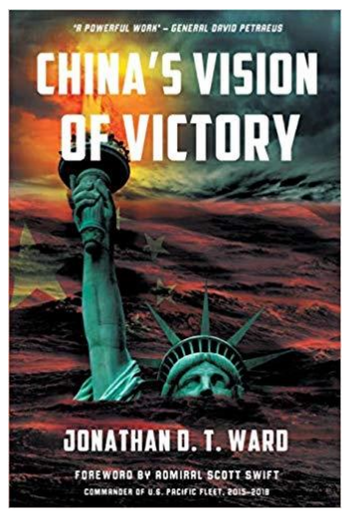
- One strong counter to MMT is that it debases all work done and income earned in the past while punishing savers and thus it is a potential moral outrage. There was definitely disagreement in the room on whether debt is a moral or economic issue. I think that is an interesting debate. Mises vs. soft money schools.
- Debt is not a problem until it's a problem. The US has been wringing its hands over the national debt since at least 1989 when the big ugly debt clock was installed in Times Square. Maybe the problem from MMT will not be high debt levels, but a supply side shock as MMT-financed projects lead to a dramatic shortage of skilled workers, cement, steel, etc. and inflation skyrockets thereafter.

A fundamental change in the US/China relationship

It was interesting to hear how it now seems to be almost universally accepted that the United States is in a multi-year, multi-front (so far, non-military) war for global supremacy against China. No trade agreement is going to change that. The first challenge to US hegemony since the USSR. Attendees at Camp Kotok run the entire political spectrum but this issue seems almost totally non-partisan.

It was notable how even while many did not agree with the US escalation strategy against China, there was broad agreement that China should be challenged. The China/US long-term decoupling is an issue that will continue post 2020, whoever wins. A rare bipartisan issue.

A good part of the discussion centered around the book "China's Vision of Victory", written by Jonathan Ward, one of the attendees. Ward, a US citizen, told remarkable stories of boarding container ships, learning Cantonese and pidgin Indonesian, living in rural and urban China for several years and translating every document publicly released by the Chinese Communist Party to better understand China's motivations as it rebounds from the Century of Humiliation. Below are a few blurbs to give you a sense of Jonathan Ward's gist. I look forward to reading the book.



"The extraordinary rise of China is unprecedented in world history and the biggest geopolitical development of the first two decades of the 21st Century; it is likely to continue to be so for decades to come. Jonathan Ward is very well qualified to document China's extraordinary growth, and he describes it superbly in *China's Vision of Victory*, a powerful work that is sure to provoke thought and serious reflection."

- **General David Petraeus**, US Army (Ret.), former commander of coalition forces in Iraq and Afghanistan and US Central Command, and former Director of the CIA

"Dr. Ward tells an absorbing and well-researched story about China's grand strategy to achieve 'supremacy among all nations' by 2049 and the role of Western capital in fueling China's rise. *China's Vision of Victory* is a must-read for Western policy makers, intelligence agencies, chief executives, global investors, and globally-minded thinkers. It is a real-life page-turner, if ever there was one."

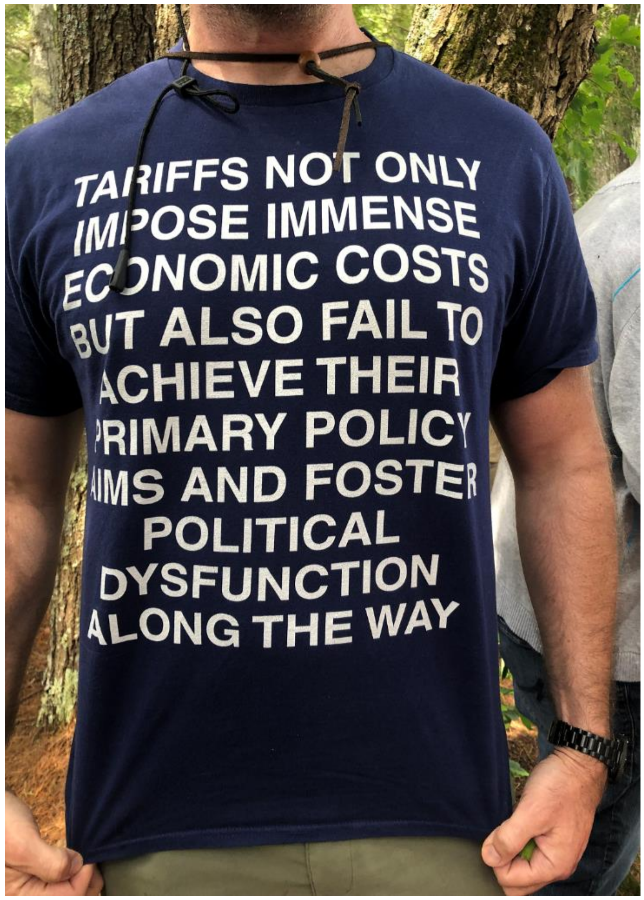
- **J. Kyle Bass**, Founder & Chief Investment Officer of Hayman Capital Management

"*China's Vision of Victory* is insightful, compelling, and long overdue. Whether your interest is business, economics, diplomacy, or politics, Jonathan Ward's assessments and analysis are on target. More importantly, his book will help you understand the complexity and interconnection of all facets of America's relations with China. Jonathan has given us a new take on the many challenges we face in addressing Chinese power and its relationship with the world."

- **Admiral Scott H. Swift**, US Navy (Ret.), Commander of US Pacific Fleet, 2015-2018

Thanks for reading so many words. Tomorrow is Forexplainer #6. Have a tariff-free day.

Good Luck ↕ Be Nimble



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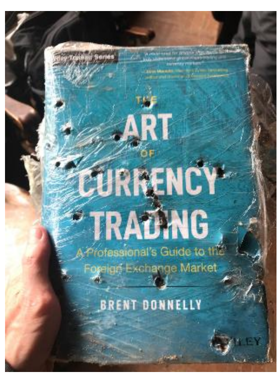

There is a tradition at the event where any book recently written by an attendee is brought out to the shooting range

Photo credits (in order from top): Sam Rines' phone / book cover image used with permission from Jonathan Ward / my phone / my phone

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