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INTERVIEW

«The Big Quake Is Coming»

Larry McDonald, founder of the investment research service The Bear Traps Report, expects that the ongoing rotation out of tech stocks will cause tectonic shifts in global financial markets. He is betting on the comeback of value and commodity stocks.

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The mood is testy. Yields on Treasuries are rising, the dollar is trending stronger, and major tech stocks are under pressure. Accordingly, tensions are high when the Federal Reserve decides on the future course of its monetary policy this Wednesday.

«The Fed has its back against the wall,» says Larry McDonald during a conversation via Zoom. The internationally renowned macro strategist and former senior trader at Lehman Brothers warns that the Federal Reserve has little time to mitigate the explosive situation in the bond and currency markets. Otherwise, he says, the global economy is at risk of another crisis.

Since last spring, the founder of the independent investment advisor The Bear Traps Report has been recommending investments in the commodity sector, where he believes a new super cycle has begun. He reiterated his recommendation during his last conversation with The Market in late 2020. Today, his call for a big reflation trade has become the consensus on Wall Street.

In this new interview with The Market/NZZ, which has been edited and condensed for clarity, Larry McDonald tells why he expects the Federal Reserve to resort to yield curve control fairly soon and what that will mean for gold and silver. He also explains why the rotation into commodities and value stocks is only just beginning and where he currently sees the best opportunities for investments.

After the turmoil of the past few weeks, all eyes are on the Federal Reserve. What can investors expect from Wednesday's Fed meeting?

> We're at a point where the market is moving way ahead of the Federal Reserve. The Fed is on «outcome-based guidance», but the beast, that serpent in the market, wants more than that. Basically, the market is saying: «The US economy is going to grow 6 or 7% this year, and that will force you to taper in Q3 or Q4.» As investors are pricing in a tapering of the Fed's asset purchases, financial conditions are tightening; especially in emerging markets, where spreads on credit default swaps are rising. So far, financial conditions are nowhere near extremely dangerous levels. But the problem is everybody thinks we're in a similar situation as back in 2018.

What do you mean by that?

> Once again, the Fed is playing «Tough Guy»: The market demands a policy pivot, but the Fed is trying to hold on to its path, essentially signaling to investors: «No way, relax». We had a similar set-up in 2013, 2016 and 2018. These were the three most significant monetary policy shifts where market pressures broke the Fed's desired policy path. The problem is that back then the Fed had far more rope to play Tough Guy since the economy was stronger. In 2018 for instance, the US economy was creating hundreds of thousands of jobs a month. In contrast, today's employment-to-population ratio is 3.5 percentage points below January 2020 levels. This means 13 million Americans are outside the labor force. To get back to pre-pandemic levels, the economy has to create more than 540,000 jobs a month for two years.

So what does this mean for this week's Fed meeting?

> The Fed is planet earth's central bank. Every time they tried to play Tough Guy, they've blown up the global economy. This time, the

Fed's Tough Guy window is much smaller. In 2018 or 2013 that window was nine to ten months. Now, it's like two months because the economy is so weak. If they let financial conditions tighten further, they risk a major default cycle. The negative multiplier effect of a stronger dollar is much higher to the world economy than the Fed anticipates. They can't afford to let the dollar rip higher, because there is so much dollar denominated debt in the world, so much trade tied to the Greenback. If they blow that up, it will just blow back to the US and force the Fed into a policy shift anyway. It's like with an oil change at the car repair shop: You can pay now or you can pay later. That's why the Fed has to pay now.

Why?

The Fed's back is against the wall, all points to proactive action on March 17. They must suppress taper fears and cut these risks off, or else they blow up the global economy for the 4th time since 2013. We're hearing that they're already getting incoming calls from emerging market central banks right now. If Fed Chairman Jay Powell plays Tough Guy by staying with the current path, without offering further assurances of deeper, more sustainable accommodation, the beast inside the market will keep pushing him until he breaks. We will see a repeat of Q4 2018 and Q1 2019, where the Fed was forced into an utterly embarrassing pivot. One of those is enough for Powell's legacy, he doesn't want two.

What kind of measures can be expected?

Eventually, we will get the taper, but the overwhelming point is other weapons have to come first. A Federal Reserve offering insufficient accommodation places markets in the crosshairs of a risk-off event. The first thing they will try to do is give some hard data points. For example, the US economy has to create 10 million jobs for the Fed to do anything on the balance sheet. Another way they can get out is calendar guidance, but that's a more sophisticated weaponry. Bottom line, they should just say: «From now until the end of the year QE will continue at $120 billion a month, and we want PCE-inflation to get to between 2 and 2.5% and stay there for 24 months.» With that in place, all they have to do is open the door two or three inches for yield curve control, and they can contain the dollar.

The last time the Federal Reserve used yield curve control was during the time of World War II. Why would it resort to such a radical measure?

> Here's the dirty little secret: Too many Treasury bonds are for sale. There aren't enough buyers, and that will force the Fed to step in. More than $3.6 trillion of US government paper was issued in 2020 versus $2.9 trillion in the prior year. With the new $1.9 trillion fiscal package coming from Washington, issuance in 2021 is slated to rise to $4 trillion. That's a lot more than the Fed's Treasury purchases through QE, so the spread between QE and debt issuance gets much wider. Washington is doing so much fiscal stimulus, I'm confident that this is going to force the Fed into yield curve control by September. If that's the case, it will pressure the dollar lower and put commodities, value stocks, global cyclicals, materials and emerging markets into rotation overdrive.

How come?

> Yield curve control deployment is the tactical nuclear weaponry. If the Fed throws out yield curve control just as a threat, it will suppress Treasury rates and real yields will go much more negative. Over the last couple of months, the issuance has overpowered inflation expectations. Think of it as a car race: Treasury issuances were driving up yields faster than inflation expectations rose. But if the Fed starts to acknowledge that they are going to bring out new weapons like calendar guidance and yield curve control, then they're suppressing nominal yields. So if inflation expectations continue to rise, then real yields go big negative – and that's when gold and silver will take off. I think silver can double from here until early next year. Gold could be up 50%.

How can investors best position themselves in this environment?

> In terms of emerging markets, we're long Chile and Brazil. In Asia, South Korea looks attractive. We also like the KWEB ETF which consists of the big Chinese tech stocks. In the commodity space, we have a position in the XME ETF which owns mainly copper and steel names. One of the best companies we own is Teck Resources. This stock is almost like a commodity mutual fund, because the company has exposure to copper, nickel and even energy. Another favorite is Mosaic because in a commodity cycle where you have

weather problems around the world, agricultural plays are a good bet.

What about precious metals?

When it comes to precious metals, we love silver miners like Hecla Mining. When the Fed eases its policy, the silver miners will outperform the underlying metal, and they will outperform gold because there is more leverage there.

The gold price is down more than 15% since its all-time high in August. What's the problem?

Everyone thinks it's 2013, so taper fears are sky high for gold. But the Fed cannot repeat its mistakes. They must cap yields if they want to preserve the global economic recovery. Thus, the convexity with gold is very attractive. Every leg lower in real yields will act like a slingshot higher for gold. That's why we love Newmont. The stock trades at 6x EBITDA with a 4% dividend yield which gives you some downside protection. And remember: The 2011-2016 commodity bust has made the balance sheet of these high quality gold mining companies a lot stronger.

President Joe Biden has just signed off on a $1.9 trillion economic program. What are the chances of a second stimulus bill, aimed at infrastructure?

It's important to note that a second fiscal deal for 2021 is not a slam dunk. To pass the present $1.9 trillion stimulus bill, the Democrats used reconciliation. It's a very special trick in US politics, because with reconciliation you don't need 60 votes to pass a bill in the Senate. All you need is 50 votes. Yet, reconciliation has to be tied to a budget year. This means the next time the Democrats can use it is probably in the fourth quarter, late November or December, and tie it to the following year's budget. So the only way to do an infrastructure bill in the next six months is with a traditional piece of legislation.

Is that even possible, given how wide the rift between Republicans and Democrats has opened in recent years?

For that you need essentially ten Republicans. Right now, the centrists on the Hill, people like Mitt Romney on the Republican side or Joe Manchin on the Democrat side, are the most powerful people in Washington. They want to do an infrastructure program, but they want to finance it with tax revenue. They don't believe in things like Modern Monetary Theory where the Fed is financing the deficit. So you are going to need a tax hike. And in this regard, we're hearing they could go after some type of flat tax on the FAANGs, the big technology companies.

What does this mean for Apple, Google, Facebook and other tech heavyweights?

Keep in mind, we're in a populist revolution: The risk of inequality leading to social unrest is high, and that puts pressure on politicians to pass bills to tax the rich. But a wealth tax is extremely complicated, it would take years. The simplest way to do something in terms of taxes is to tax larger companies. In the eighties, the top 100 companies in the US maintained about 45 to 50% of total profits. Today, the largest 20 companies command about 85 to 90%. In addition to that, close to 40% of the S&P 500's market cap is related to tech. So tech is the low hanging fruit for the populists in Congress to go after.

One more reason why tech stocks remain under pressure?

We run a bunch of models. For example, we look at Berkshire Hathaway's share price versus the Nasdaq 100 or the Dow Jones Industrial versus the Nasdaq. March 8th was the second time in 2021 that the Nasdaq closed down 2% with the Dow closing higher. We haven't seen this type of data since the dotcom crash. It's a very rare event which historically coincides with a longer-term rotation out of technology stocks. That's a very encouraging signal for value stocks. In this regard, we like the EWU ETF. It's a wonderful basket of stocks because it's full of financials and world class names like BP, Rio Tinto or Glencore. Officially, it's called the United Kingdom ETF, but it's more like a global value ETF.

Does this mean that the rotation towards cyclical stocks has only just begun?

Many investors around the world are long a portfolio of stocks that was designed for the deflationary environment of the previous decade. The decade ahead of us - with all what's ahead in terms of fiscal and monetary stimulus, populism, regulation and taxes - will push investors toward more globally value related stocks. That's where the best returns are going to be.

So the previously successful «buy the dip» strategy of simply buying more tech stocks after every decline no longer works?

The potency of dip-buying is in decay mode. Global value is really starting to kick tech in the teeth, and when that happens, it wakes up what's called «real money». Keep in mind: There is fast money, mostly hedge funds which are nimble and make quick moves. In contrast, real money moves slowly. Those types of investors don't make asset allocation decisions quickly. They base their decisions on committees and all kinds of meetings. As a result, tectonic plates are shifting beneath our feet. We've seen tremors after tremors where value is starting to crush growth, and now the earthquake is coming. At Bear Traps, we have a Bloomberg chat with 650 institutional investors, and I can tell just by these conversations, that the real money is starting to move. And when the real money moves, that's when the big quake happens.

What kind of dislocations will this cause?

Tech will probably be down 30 to 40% sometime between now and the end of October. Today, the market cap of the Nasdaq 100 is close to $17 trillion, but most large-cap tech stocks are unchanged since July last year, while commodity and value-related equities are up 20 to 50%. In the US, if you talk to a hundred high-net-worth families, every one of those families owns Apple, Google, Facebook and Amazon. But look what's happening: Amazon's stock is flat since the 4th of July 2020. That's $1.5 trillion of dead money. Last Friday, Amazon failed at the 200-day moving average again. This is like Mike Tyson getting defeated by Buster Douglas, one of the greatest upsets in sports history. This psychology is moving through the market, pushing the capital migration process into value and commodity plays.

However, investments in commodities are mostly not compliant with the trend towards ESG standards; especially when it comes to CO_2 emissions.

The best ESG trade on the board is nuclear power. The largest uranium company in the US is Cameco with a $7 billion market cap. Think about that relative to Elon Musk's net worth! I support the Green New Deal, but this needs time, because solar and wind are still too far away to produce the amount of energy needed around the world, especially in India and China. The only way to meet that demand is through nuclear power. Uranium is coming out of a ten-year bear market, and it's going into a massive new bull market. All the contracts between power plants and uranium producers are going to be adjusted. That's why we like the URA ETF which owns companies like Cameco. I see some of these companies as six baggers: 500% upside potential and 30 to 40% downside risk, because uranium is still a risky commodity.

In our last conversation, you recommended investments in the energy sector. Since then, names such as Chevron, Royal Dutch Shell or Exxon Mobil have advanced 25 to 60%. What do you advise investors to do now?

For now, we've cut our energy book: We've sold half of our shares in Chevron, and we've sold two thirds of our positions in Exxon Mobil and in the XLE ETF. What happens when you get into the fourth, fifth and sixth innings of a commodity cycle, tertiary sectors like metallurgical coal become more attractive. Sure, met coal, also known as coking coal, is not ESG friendly, but there is no way around it for steel production and hence the construction of skyscrapers, bridges and things like that. So coming into this infrastructure boom all around the world, coal has plenty of upside. That's why we own names like Arch Resources and Peabody Energy. They're low-leveraged, and really cheap, once again, on a risk/reward basis.

What are the biggest dangers to watch out for in the coming weeks and months?

One spot to watch are all these forbearance deals in commercial real estate. When we come out of Covid and the vaccines and the stimulus money are juicing through the economy, the market will be forcing the release of the forbearance on a lot of these loans. So if people don't come back fast enough to the cities, these commercial real estate loans are going to get reset. This would mean some big defaults, and the banks own a lot of these loans. Also, a lot of leveraged loans are really rich. And then, there is potentially a fiscal cliff: The sustainability of the $1.9 trillion stimulus package isn’t that great because a lot of it is just transfer payments replacing lost income for people staying at home. That’s why the US needs a second stimulus bill. If we don’t get a second bill, we are going to have a problem in about a year from now.

Lawrence McDonald

Lawrence McDonald is the founder and editor of The Bear Traps Report, an independent macro research platform focusing on global political and systemic risk with actionable trade ideas. The firm offers also a live institutional Bloomberg chat with over 650 Institutional Investors. As a former vice-president of distress debt and convertible securities trading at Lehman Brothers, he wrote a book on the fall of the investment bank, titled «A Colossal Failure of Common Sense». Published in 2009, the book hit the New York Times Best Seller's list upon release and is now translated into 12 different languages. Prior to working at Lehman, he was the co-founder of Convertbond.com, a website that provided convertible securities information and was acquired by Morgan Stanley in 1999. From 2011 to 2016, he was Managing Director and Head of US Macro Strategy at Société Générale. Mr. McDonald grew up in the Cape Cod region. He attended The University of Massachusetts Dartmouth and received a degree in Economics in 1989.