GMI.

THE PANDEMIC CRASH · 2020

The COVID Crash

A real-time call on the biggest economic event of our lifetimes – the Black Swan warning, and the multi- phase framework for how it unfolds.

FROM THE REAL VISION ARCHIVE · EXCERPTS
EXCERPTED FROM TWO REAL VISION EXPERT VIEWS:
"PRAYING FOR A MIRACLE" · 6 MARCH 2020
"THE UNFOLDING" · 8 APRIL 2020

GLOBAL MACRO INVESTOR

RAOUL PAL

PART ONE

Real Vision Expert View

Praying for a Miracle

FILMED IN NEW YORK, 4 MARCH 2020 · PUBLISHED 6 MARCH 2020

PART ONE

Praying for a Miracle

The Black Swan warning – delivered from New York, days before the world shut down.

EXCERPTED FROM

Real Vision Expert View – "Praying for a Miracle: Coronavirus' Black Swan Risk."

Filmed in New York, 4 March 2020 · published 6 March 2020.

Hi, I'm Raoul Pal. I'm not really a superstitious man, but I'm actually praying for a miracle. You see, I'm concerned that we are going into what may be potentially the biggest economic event of our lifetimes. I don't say that with some sort of sensationalism – I'm saying it with a reality of what's happening on the ground.

There's a narrative going around about the coronavirus, which is that it's just the flu. That's not strictly the case, because its death rate is obviously much higher than the flu – in fact, 20 times higher. It's a pandemic. It has known attributes in terms of its spread rate, its death rate and a number of other factors.

The Spanish flu comparison

In 1918, there was a pandemic of the Spanish flu. It infected 27% of the world's population and killed about 30 million people – about a 6% death rate. At the time, conditions were terrible after World War I, the medical situation was stretched, troops were returning home, and that was what caused a lot of the spread. The coronavirus has a death rate, as of yesterday, of 3.5% – and that is taking into account all of the modern medicine that we have.

The coronavirus spreads faster than Spanish flu. If we back out the same numbers, considering we're in a hyper-mobile, globalized world of plane travel, then some 2 billion people will catch this and 68 million people would die. That is a truly terrifying outcome. We can assume that's the worst-case situation, because that's what happened in the Spanish flu.

China set the precedent

What's going on in China right now is that the rate of spreading is falling. Why? It's pretty simple. The Chinese took truly extraordinary measures like nobody's ever done before – I think in world history – where they basically closed down the largest nation on Earth and stopped people moving around for about three weeks. What they decided, essentially, is they were going to take the utmost economic pain for the benefit of the population. And they've set the precedent.

The Chinese PMI showed the largest fall of any economic indicator I've ever seen in my working career, or any time before it when I look back in history. The complete halt of the Chinese economy was something truly extraordinary. It's going to take a long time to recover, because there is a human element where people don't trust getting together in large groups. It'll be slow to restart.

Then it spread. To South Korea, who've done a truly extraordinary job. To Singapore. Then to Iran, which was unprepared – it truly exploded. Then it went to Italy, growing at about 50% a day. Italy infected Spain and France. It's spreading in the UK. It's exploding in Germany right now.

The panic phase

I've been driving this narrative for a while – that the panic phase needed to come first. The panic phase was people understanding that the Chinese impacts were a global economic slowdown that was going to knock the world into recession. That was what the bond market was sniffing, and I already thought the world was going into recession, hence was very positioned in bonds. But when I saw this, I knew it was going to drive rates to zero. That seems to be playing out rapidly as we speak.

The next thing that has to happen is the United States has to come to understand the role it is about to play in this. The US, up until last Friday, had done 500 tests for coronavirus. Suddenly we're finding unconnected cases all across America, and mutations that suggest it's been here for at least three weeks. The irresponsibility of first passing the narrative that it was the flu, and then not resolving a simple regulatory issue around testing, is one of the biggest mistakes a government could ever have made.

When the testing starts, we're going to see the numbers explode, and the markets are going to shift. The setup currently is what I refer to in the equity market as the GMI crash pattern – a sharp fall, then a rally back that fails to take out the previous high, the rally peters out, takes out the recent low, and then it escalates. The most classic example of this crash pattern was 1929. I'm not necessarily saying this is 1929 all over again – but I don't think that would be a bad example of what could take place.

The biggest economic event of our lifetimes

The next phase goes to the really difficult phase, which is true panic. I'm in New York right now. There's nobody wearing a mask, nobody taking any evasive action. That is going to change everybody's behavior pattern overnight. We're going to go to fewer restaurants, people are canceling flights, conferences are being canceled. Whole parts of the country are going to be shut down. It's going to be one of the largest potential economic shutdowns the world has ever seen. I don't see a way around it.

This first phase would be the economic pain that we saw at the height of 2008. That's the level of pain of this first phase. If we don't get a miracle, then we get to something different – something much larger, which I would refer to as a global depression. The miracle would be seasonality: a really hot summer that kills off the virus, and we escape. But CoVid has shown it can still replicate even in hot climates like Singapore. The problem is, these are tail risks that I can't price.

A true Black Swan

We all knew a pandemic was due, and we thought, that'll be terrible because lots of people die. Here we've got one where, in theory, not that many people die – because it's only 2% – but the numbers add up so quick because we're so global that it spreads incredibly fast. We've got a situation that markets simply cannot deal with. This is a true Black Swan event.

The reality is that this sets up the doom loop and the pension crisis – the thing I've spent a good few years of my life trying to prepare you for. If there is a probability of this event happening, it is now. It's a virus that affects the over-60s the most – our baby boom population of 76 million in the United States, and several hundred million around the world. We already know they own too much equity and too much credit, and the propensity for them to protect their life savings is going to be extremely high.

The doom loop

The doom loop concerns me even more, because it hits the pensioners yet again. US corporations, due to a ridiculous tax regime, buy back their own shares and issue record amounts of debt. They're the most indebted private-sector economy in the world. As the business cycle turns negative – which at 100% is turning negative – corporations are the only buyers of equity in the entire market. Their profits and cash flows are going to go negative, and they're going to leave the building. There is no buyer of equities into a panic.

The other side of the doom loop is the corporate credit market, whose main buyer is the state pension plans, funded by tax receipts. Tax receipts are correlated to the business cycle. When the business cycle goes negative, people lose jobs, tax receipts fall, and no money goes into those pension schemes. So you have no buyer of equities and no buyer of corporate credit – just as so many giant BBB companies are teetering on the edge of being downgraded into junk. The junk bond market is not able to cope with the amount of downgrades that could come.

The car companies are going to get absolutely killed. Car sales in China were down 90%. The price of oil would collapse – I think oil probably goes to $20 a barrel, which is something I've talked about for a long time. If oil tests and breaks its $42 head-and-shoulders pattern, then all the shale guys are out of business, and the junk bond market explodes on the back of that.

The dollar wrecking ball

I think the World Trade slump is a huge dollar-funding issue. I have a tendency to believe that this is very bullish for the dollar – and dangerously so – because I think the dollar is a global wrecking ball: if the dollar goes higher, it kills global growth. There is a huge trend line in the Euro that it retested at 1.07. If it breaks, that's the biggest level in the history of the Euro, and it probably goes to 80 cents or 70 cents. It's almost impossible for China not to lose control of their currency or devalue it.

Praying for a miracle

The point I wanted to get across is that we are looking down the barrel of a gun of what could be the biggest economic event of all our lifetimes. We better start praying for a miracle – and you also better start planning around your retirement savings. It's the problem is, I didn't expect what I thought was going to be a recession with a tail risk of something bad to now be a bad recession with a tail risk of a full depression and the full blow-up of everything that we know.

I'll leave with gold and Bitcoin. Gold struggles when people need to liquidate positions, and it's still very over-positioned – I'm a little cautious myself. But fiscal stimulus and massive monetary expansion is clearly closer than I thought. Maybe that is the thing that ignites gold. And I think Bitcoin is the call option on the parallel financial universe being built – the digital revolution in everything from FinTech to ownership. Even though this could be a catastrophic event, I do think at the end of all of this there's a whole new future for us.

That is all the unknown, foggy, gray stuff I'm trying to peer through. The odds of the next two or three months being extraordinarily bad are about as high as I've ever seen. Good luck out there.

PART TWO

Real Vision Expert View

The Unfolding

PUBLISHED 8 APRIL 2020. “ONE OF THE MORE IMPORTANT PIECES OF RESEARCH I’VE EVER WRITTEN.”

PART TWO

The Unfolding

One month on, the warning is playing out. Now comes the framework: a multi-phase unfolding of the entire global system.

EXCERPTED FROM

Real Vision Expert View – "The Unfolding," based on the GMI Monthly of the same name.

Published 8 April 2020. "One of the more important pieces of research I've ever written."

I know some of you want to hear how my views are evolving. This piece is based around my last monthly research piece for Global Macro Investor, called The Unfolding, which I think was one of the more important pieces of research I've ever written. Don't forget – just because I've been very, very right recently doesn't mean I can't be spectacularly wrong. I'm trying to peer into the future here.

How we got here

Let me start at the beginning. Back in 2016, rates had been rising. The rise in Libor was the fastest ever in the history of interest rates, and that alone caused the economy to start to slow. The US is the world's biggest importer; its business cycle is the world's business cycle. Then something unique happened: a trade war, which pushed world trade negative as manufacturers scrambled for new supply chains, and pushed up the dollar. Then the oil war – suddenly the price of oil collapsed. And then, at the same time, the Black Swan: COVID. When I last came on, I warned this was going to be the biggest economic event of all our lifetimes. Now, that is playing out.

The Unfolding · Phase one: liquidation

The first part of the unfolding is the liquidation phase – the phase we're still in now. As the markets grappled with this tail risk, volatility exploded, and as volatility explodes, everybody has to reduce risk. What was really fascinating to me is that this risk-reduction episode had an eerie similarity to 1929. It's been playing out almost perfectly – a bit faster this time, but the magnitude and structure of the moves have been extraordinarily similar. Not that I expect it to play out perfectly, but it gives us a contextualization of how this might play out over time.

The next part was credit spreads widening – the fear, the panic, the risk reduction coming through the credit markets, before there are any defaults. We even saw gold get hit, and Bitcoin too; everybody was liquidating anything they could to realize cash. Then bond yields collapsed as the financial plumbing seized up. The Fed came into action. But it's not truly stimulus here – it's just trying to get the plumbing going. Putting more money in the system right now is not going to save a restaurant.

Phase two: the bounce

The liquidation phase ends when the market starts to have some optimism – when they see the European case count peak and extrapolate that New York, and therefore the US, will peak soon after. That optimism – maybe we can reopen, maybe there'll be a vaccine – is what drives the bounce. 1929 to 1930 had a six-month bounce phase, up about 48%, built on a false narrative: hope that the US economy was going to get better.

I think playing the long side of this – the relief rally, the optimism rally – is interesting. But that's a rally you rent. It's not the rally you invest in. All of the bears are going to be scratching their heads, getting fed up that none of their trades work – surely the world's falling apart, can't you see it? Yes, they're right, probably. But the market's still going to rise.

Phase three: insolvency

The next phase is the phase that concerns me, and I call it the insolvency. I think we're about to face the largest insolvency event in all recorded history. People are looking for a V shape. Maybe a U. Maybe an L. I think of it more like a lightning bolt – after the bounce, we slip-slide lower and lower, with GDP growth generally negative year-on-year, quarter after quarter after quarter.

You may have guessed by now that what I'm actually talking about is the thing the Fed fear the most, the thing they've been fighting for the last 20 years: a debt deflation.

The rise in interest rates and the slowdown in the business cycle, followed by trade wars, followed by the oil crisis, and followed by COVID – the probability is extraordinarily high that this is the big one. The big debt deflation.

The real issue in the world is debt. There is far too much of it. US corporate debt to GDP is at all-time record highs. A lot of that debt is in the BBB sector – about three trillion in the US, against a junk bond market of one trillion. I'm guessing maybe a trillion dollars gets downgraded, so the size of the junk bond market doubles, and there aren't enough buyers of junk. The market freezes. That's part of the doom loop I've been warning about.

I don't believe the economy is going to open the way people think. Look at China: they've reopened factories, but people are going to work to create goods to sell to nobody, because the rest of the world is closed. China's building inventory for no purpose except to put people in jobs. That, my friends, is how you go bankrupt. Human behavior has changed so dramatically that I don't see anybody going back to their previous patterns for a while. Singapore, having warned it couldn't reopen, went back into lockdown on Friday. Economies can't get going because of the virus.

THE PROBABILISTIC CALL

~60% probability of a full debt deflation

The down-80% depression market, as opposed to a recession. I'm not predicting it as a certainty – I'm giving a probabilistic framework. But it is the highest-probability case, and I'm immensely concerned by it.

The charts of truth

A few charts highlight what I think is going on. The Reuters Commodity Index shows one of the biggest head-and-shoulders top patterns of all time – an enormous commodity price collapse. The chart of 10-year bond yields in its regression channel – what I refer to as the chart of truth, basically my whole career in one chart – suggests yields are going to zero, and probably negative. This is the debt deflation: CPI is going to go massively negative, which pushes real yields up, and that's what destroys the economy. And the Dow Jones, in its trend channels going back to its inception, should go to the green line – the 80% collapse. That's what depressions do.

It's a story about the dollar

It's not only commodities and yields. It's a story about the dollar. The dollar is what's going to break the global system. There is too much dollar debt and not enough dollars. A dollar in New York is not fungible with a dollar in London. The dollar swap lines go to the central banks and don't flow through to the corporates – in South Korea, India, Brazil – who are desperate for dollars. It's a game of musical chairs: the best creditors get the dollars, the worst scramble, pay higher prices, and go insolvent. Everybody is short the dollar. It's like a short-gamma trade – the higher it goes, the more people need to buy. It's a terrifying setup, and I do not see a way out of it.

It's written all over the currency charts. The ADXY – the Asian Currency Index – is the biggest head-and-shoulders top I've ever seen in any currency chart: the Chinese are going to devalue and the rest of Asia with them. The Euro is resting on its 30-year support and should start its final leg down to 80 or 75 cents. Dollar/yen, in the end, explodes to 150, 200, even 250 as Japan moves to a debt jubilee. And the RMB – once we break through 7.5 or so, we hit eight, nine, maybe even 10 in a hurry.

The everything crisis

These are all hyper-deflationary events, and they lead us into what I refer to as the everything crisis. This crisis has elements of the Asian crisis, which was a debt crisis. It has the elements of 2000, an equity bubble. The elements of 2008, a liquidity crisis. And the elements of 1929 – all of them, plus a currency crisis and a solvency crisis.

We've got the largest equity bubble of all time, the largest wave of retirees of all time, the largest corporate credit bubble of all time, the doom loop, the student-loan bubble, the auto-loan bubble, the indexation bubble, the foreign-borrowings bubble – the dollar-standard bubble – a bubble in monetary policy, and a probable EU and Japanese banking crisis.

This is a generational shift. This is the Fourth Turning that Neil Howe talks about. That change leads to everybody going bust – and in the end, we'd have to abandon the dollar standard as the dollar skyrockets, and move towards a different world.

Before you despair: the final resolution of 1929 to 1933 was a devaluation of the dollar by 40% off the gold standard, the largest fiscal stimulus in US history, and a massive shift of allocation from the rich to the poor. People thought that would be a terrible economic event. Actually, the reverse happened – it was the largest boom period in the history of the United States. The dollar didn't fail because it stopped being the reserve currency; it failed because it became the super-reserve currency. The dollar ate every other currency, and then it began to eat itself.

Where to hide

What does that mean for us? Bonds still work – the central bank is going to buy them before they collapse. Cash is safe too, but mind the FDIC insured limits, because there are going to be banks that go under. The solvency crisis is the one nobody can solve, and the answer is direct monetization – MMT. It's coming. There's no other way of dealing with this, and it's going to weaken the value of money itself. In all of this, something is going to shine: gold. If you can, buy some physical gold. That's certainly what I'm doing with my money.

And then, it's all about Bitcoin for me. Bitcoin is short form for the entire digital space that's coming – the world's biggest hive mind is building out an extraordinary financial system in front of our eyes. The real issue is that the dollar standard doesn't work; the world is too reliant on dollars, and there aren't enough. We're going to move to something new – a basket of digital currencies, much like the Libra construct. I think gold may have a three-to-five-times upside; Bitcoin may make you rich. I think it goes to $100,000 and eventually on to a million dollars and beyond. That's the upside I've never seen from any asset class, ever.

This unfolding would be a much-needed reset. There's plenty of room in gold, in bonds, in cash, in Bitcoin. We're all in this together – we are a community, and we're stronger and better as a community. Stay safe, and flatten the curve.