Felix Zulauf: "A Decade of Roller Coaster Markets"

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Ed D'Agostino:

What could go wrong? That's a question you should ask yourself before making any major investment decisions. And today, there's a lot that could go wrong. From massive government debts to rising interest rates and incredibly high geopolitical tensions... there seems to be risk everywhere investors turn. And how you position yourself, how you position your portfolio, and how all of these risks and tensions play out over the coming years could make the difference between you being a winner or a loser in this global macro drama we all seem to live in today.

There's no one better [for] parsing all of this information out and formulating a forecast than my next guest, Felix Zulauf. Felix was the global strategist for UBS Bank, and he was the head of their institutional portfolio management group. He served on the executive board of Clariden Bank, and he founded Zulauf Asset Management.

Today, he manages Zulauf Consulting, where he consults for some of the world's largest and most influential institutional investors and family offices. I can't tell you how proud and happy I am to be bringing to you today in *Global Macro Update*, a detailed, thoughtful conversation with Felix Zulauf.

Felix, it is always such a pleasure to be with you. You're one of the, really, the top macro investors of our era. And I don't want to embarrass you, but I will say—because I know firsthand—that your research is truly coveted by the top echelons of global finance. And I know that because I hear that from our Strategic Investment Conference attendees who operate at that level, and you're always one of the top-rated speakers. So, really appreciate you taking a few minutes to be with us today. It's good to see you.

Felix Zulauf:

It's an honor to be with you and thank you for inviting me. You make me blush. Of course, it's very flattering, but I have made my mistakes during my career, and the future is always difficult to forecast, but I'll try my best.

Ed D'Agostino:

Fair enough. Let's jump into it then, Felix. There's a question that Sam Zell asks during his due diligence process that I think is really so elegant and simple. And the question is, "What could go wrong," right? It's a question I think every investor should ask, and I know you ask that of yourself when you're building your views on market direction and different asset classes.

So, today, we sit here in an environment where pretty much every investor is focused on one thing, and that's central banks and what they're doing to fight inflation. And my question for you is, what comes next? What are the possible outcomes of interest rate hikes, and what are the paths that could follow those outcomes?

Felix Zulauf:

I think we have to take one step backwards and see that the world has changed a lot over the last two years—and particularly since February, when the war in Ukraine broke out. Not because of the war in Ukraine, but because of what it means for the geopolitical landscape. And I think this is an accelerator for dividing the world into two major blocks again and for pushing the world into a Cold War... at the very least into a Cold War, if not more than that, over the next few years, let's say in the second half of the '20s of this decade.

And therefore, you cannot analyze the market solely as we did in the past 30 years, when we had accelerating globalization, when we had a free capital movement, when we had free movement of people everywhere.

This is all changing. And it's changing the world quite dramatically because it will disrupt supply chains. We have seen some of that during the lockdown period of the pandemic. But I think the geopolitical situation, or the change in the geopolitical situation, will disrupt supply chains in the future. And the US is almost self-sufficient in energy. Europe is not. Europe depends on others.

And now that Russia is off the table because of sanctions and boycotts, we depend on the Middle East. And the Middle East used to be an ally, or the Saudis used to be an ally of the US, which is not the case anymore. The Saudis are closer to China these days than to the US. So, the whole equation is much more fragile than it used to be. That's a different setup.

So, something going wrong in the geopolitical landscape changes many things in the world of investments, and it changes capital flows. And the other thing is that our system is more levered than ever—and therefore, if something goes wrong, something could go *awfully* wrong. We do not know the exact amount of derivatives and how [many] derivatives are out there, who holds all the bags and all that... we do not know.

So, we do not know the distribution of the risks in our system. We know some, but we do not know the whole truth, because it's hidden. And therefore, if something goes awfully wrong—let's say China and the US would intensify the conflict—that would change the world quite dramatically. And that would lead to further supply disruptions. It would lead to more inflation, higher prices, less availability of many goods, et cetera. And it would change many business models of companies. And that changes the whole equation.

I mean, in a world where every analyst has a business model in his computer of all the companies he follows, and he just needs to turn a little bit here and turn a little bit there to come up [with] what the earnings will be next quarter or the quarter thereafter... all of a sudden, this is all worthless. And something in the geopolitical thing situation could go wrong. I think that is the biggest potential problem that I see. And then from there, it deducts to other problems.

I think central banks are less of a problem. The central banks have led us into a situation where the industrialized world developed an economic model that governments underwrite the economy and support this with extensive fiscal stimulus whenever there is a problem.

And the amount of debt didn't create any problem, because interest rates were low, and therefore the central banks could underwrite it, and interest rates did not react to it. And that was the world we come from. But that world is over. From now on, I think... And we saw that in the UK for a moment this summer, when Liz Truss came out with a fiscal stimulus program and cutting taxes, all financed by increasing debt. And the bond market reacted, sharply. I think we will see more of that in the next two, three years going forward. That means we cannot use the same model as we did in the past—or only with consequences that are very painful.

Ed D'Agostino:

So, Felix, you bring up a lot there. And the thing that catches my eye, if you will, is you spoke about the Saudis and their changing alignment from the US to China. You talk about a sort of a global decoupling in terms of manufacturing. I hear all that, and I think about what does that mean for the US dollar, the current world reserve currency?

It seems like there are a lot of actions happening that would make the world want to move away from the US dollar as a reserve currency. Probably for good reasons, certainly from their perspective. Do you see that process in play? Do you see it accelerating based on actions of some of the other actors, and how concerned are you about that?

Felix Zulauf:

The process is in play. When you look at the world map, and you take red for China and blue for the US—in the year 2000, when you painted in blue all the countries that had a bigger trade with the US and all the countries that had a bigger trade with China in red, the world was blue. Red was only China and North Korea, and that was basically it. The rest was blue. When you look at the map today, all of Asia is red. Africa is red. South America is red. More than half of Europe is red. And what's left is Great Britain, US, Canada, Mexico, and maybe the Netherlands—and that's it.

It's a completely different world. And we Westerners still look at the world through the eyes of the year 2000, when the US was the dominating factor in the world and our currency system was based on the dollar. It still is. It's a dollar-based system, and actually it's a no-system because it has no firm rules, but the dollar has been the main reserve currency. The Biden administration has used the currency and also the SWIFT payment system as a political weapon.

All those countries that are in red have seen that. And that means that if they are not very close and very friendly with the US that they could potentially run the risk of having their assets frozen in the US dollar, which means the importance of the US dollar as a reserve currency will go down. There is no question about it. The Biden administration has made a blunder on that topic. Probably, it will be in the history books in 20, 30 years that this was the major mistake that the US administration was making.

So, I do not believe that the dollar will decline and collapse right away—but I think it's a process. And the process will accelerate as soon as there is an alternative available. Right now, there is no other currency that could fill the shoes of the US dollar. All of the currencies have some handicap. Either the amount is too small, or the government is not the free-capital-flow government, or whatever. And there is a project, what I understand, undertaken by the Chinese to create a new currency together with a few other countries in the BRIC states.

Saudi Arabia will be part of it. Russia will be part of it. Iran may be part of it. India may be part of it. And that currency will be—unlike all other currencies—not be a fiat currency, but a currency backed by commodities these member nations produce. And what I hear is, I think, it will come to the market in the mid-'20s or something like that. So, in a few years' time. It's another two to three years away.

Once that comes and becomes reality, then I think this is an important source and currency unit to settle trade and to store certain reserves for countries that are not very close friends with the US. And once that currency unit gets established, that could be a big problem for the US dollar.

I don't think it will happen overnight. I think it will happen step by step, but it's a first step. So, I'm concerned that the US dollar is in a topping process. They could stretch into next year and then begin a decline. I do not believe that the decline will be dramatic in the first next few years, but I think from the second half of the '20s onwards, I think we could see the dollar in an accelerating decline, yes.

Ed D'Agostino:

That is a concept that very, very few people in the West have ever entertained, would be my guess.

Felix Zulauf:

We usually work the way we worked yesterday, and we take that as a given. And we do not think too much about what could be the major change. That could be minor changes, but this would be a major change. And I think there is a need, by investors also, to have a currency unit that is stable. The other thing in this context I like to mention is, because the US dollar has become a non-reliable currency to put the foreign exchange reserves to.

I think the Chinese and the Russians, and the Indians, and the Saudis will eventually move away from the US dollar and will store their reserves in hard stuff—in commodities. This is also a major change that I see coming. And commodities you can store in your own country within your own boundaries, so nobody else could freeze those assets. You see?

And this is another important thing, if the dollar begins to decline for the cycle... and then, this is the positive for commodities. And commodities, many commodities have seen underinvestment in recent years because there was a 12-year bear market in commodities, and the prices were not high enough to make investments valuable. And therefore, there was an underinvestment. There is a scarcity. And in certain commodities, the China bloc—meaning Russia in particular—is a large producer of many commodities. And therefore, they could keep its costs, just to keep the value up, as a tool, as a weapon in the economic fight, in the economic war that we are in.

I mean, our economies are already in sort of a war economy. In a war economy, you suffer scarcities. You do not get on time what you were used to get on time. In my home in the US, I recently had to buy a new washing machine, and then they told me, "Well, for the top brands, international brands, 12 months waiting time." And for the US brands, six months waiting time.

So, in the past, you could have that within a week. You see? So, this is a big change. And the same thing is happening over here in Europe. This is a big change, and I think we in the West do not fully realize the changes that are going on in the world. As I—

Ed D'Agostino:

I think that's the crux of the issue, Felix, right? The Federal Reserve, or central banks, raising interest rates... it might slow demand, but it is not going to impact all those things that you just spoke about.

Felix Zulauf:

That's quite right. The central banks, I mean they have a lot of power, but they have limited power. They cannot increase supply. All they can do is, they can reduce demand. If they tighten enough, they can reduce demand and bring supply and demand into balance at the lower price. That's what they can do. But that means a recession. That means hardship. And nobody wants to do that if it's not necessary. I think the Fed is trying to, and we will probably get some sort of mild recession in the US in '23, particularly in the middle two quarters.

I think we are facing a very serious recession outside the US. We are facing a very serious recession in the Eurozone and in the UK. And probably the most severe recession we are already facing and in is in China. China is in a deeper crisis than in 2008, and most people think this is due to the lockdowns.

I think that the lockdowns are sort of a camouflage to not show the world how structurally weak China has become. Because the Chinese economy has hit the same point as Japan in the early 1990s. It was exhausted after one of the biggest investment and credit booms of mankind, so to speak. And the credit system of China cannot finance high growth. Therefore, they cannot push and stimulate for high growth as they did in previous years. They cannot do so.

And I think instead of showing the world what their structural problems are and how weak they are, they have decided to use the lockdowns as a camouflage for internal and external showing that "because we care so much about the health of our people, we have economic weakness to deal with."

But I think the true factors are very different in nature. And let's say the Chinese would go for a big stimulus program. If they did, and they could, they could just throw on the printing press... if they did that, they would create a currency crisis. The renminbi would collapse, and they would then trigger something very similar to the Asian Crisis in 1997. And if they did so, they would jeopardize their long-term goals in trade and politics in Asia and the rest of the world.

So, I think they are trapped, and they cannot move. They cannot really do what all the analysts are telling on the daily TV shows, that the Chinese are going to stimulate and turn the machinery on, et cetera. It's not going to happen that way. What we will see is, they will support the system, they will prevent it from breaking down hard, which means it will take longer.

So, my guess is at least 10 years to get over this restructuring of the economy. It took Japan 20 years, and the excess is real small. So, I think, China you can forget as a locomotive for the world economy. And it has been *the* locomotive for the world economy in the last 15 years.

Ed D'Agostino:

So, what I'm hearing, Felix, is that nobody in particular is doing all that well. Every major economy is having serious, serious problems, simultaneously. Is that a fair assessment?

Felix Zulauf:

Yes, I think that's correct. Of course, there are individuals in the individual companies that do well in this environment. Let's say a defense contractor probably does very well. Or an energy company may do very well. But in general, I think your assessment is right, yes.

Ed D'Agostino:

So, with that, is the—

Felix Zulauf:

It's a big challenge. It's a big challenging environment. And the challenges are different from the past because in the past it was basically a temporary cyclical problem that had to be solved, and it took two quarters, and then we were out of it. This is a structural challenge that we are facing.

Ed D'Agostino:

So, Felix, how would you explain to an individual investor what they're up against and how they should be thinking in terms of their portfolio? I'm not asking for specific advice, but just in general, your clients and you personally are highly sophisticated. You're able to employ unique structures and strategies. But if you're speaking to a friend that you meet on the street, what do you say [to] them in terms of caution or direction?

Felix Zulauf:

Well, the world is very complex, as you say, but we have to try to break it down and come out with the essence of it. And the essence is always simple. The essence is, we will most likely go through a decade of roller coaster markets. Ups and downs like probably a whole generation has never experienced before. And if you want to go through that roller coaster with a passive portfolio—whatever it is, 60/40 or whatever—you may end up with an unsatisfactory return or with a very disappointing return.

And you may even lose in real terms and end up, in real terms, poorly. And I think what you have to understand is that you have to make important decisions in that roller coaster environment—to buy and hold for a certain period, and to sell and be liquid and preserve capital, to buy again later on. And of course, sophisticated investors can go short during the down cycle, which is not for everybody's taste, of course. But if you can take out, let's say, 70–80% of the bull cycle in magnitude, and you can preserve that for the next bull cycle, you come out as a winner.

If you go up and down, you come out as a loser. If you can go short and take out, let's say, 50% of the decline by going short, then you really come out as a winner. But I think what's important to understand is that the society will come out as a loser. So, the average Joe will probably be poorer in 10 years' time than he is today. And if we can beat the average Joe by a wide margin, then we have a better starting position in the next cycle, when we have sorted out all the excesses that the system is suffering from right now.

Ed D'Agostino:

Felix, how are you feeling about the markets in general? When I say the markets... the European stock market, the US stock market, commodities, bonds... the big, big asset classes?

Felix Zulauf:

Well, I think '23 looks pretty bright to me. I told our subscribers in June and also in early October, "Be ready for a counter-trend move to the upside, and be aware that counter-trend moves are here to change the sentiment from bearish to bullish." And that is what will happen. And once they are bullish again, the next decline will come.

I think we are in for the final decline in the cyclical correction from the peak early this year. And that decline will likely go to new lows. I said a year ago, I said we will probably decline about 30% from the top in the major indices. I think NASDAQ 100 was down more, 35. S&P was down 25 at the lows, et cetera. So, I think whether it's 3,000 on the S&P or 3,300 on the S&P doesn't matter really that much. But I'm looking for a decline that is a decline due to earnings disappointments.

We have so far had a correction in valuation due to the rise in interest rates and bond yields. But earnings held up pretty well. And actually, it's surprising how well the corporate sector could defend its profit margin. In several countries—like in the UK, in the Eurozone and in the US—profit margins increased during the cyclical correction, which is a new phenomenon.

Not in Germany. Germany was different. But the corporate sector took the chance to use this difficult period to increase prices, and that's why their profit margins went up. I think as the economic problems increase and the recession in Europe intensifies, and also in China, then I think that corporate profits will come under pressure.

We have at the present time too much inventory in the system in all three major zones—in Asia, in Europe, as well as in the US. And as they get rid of the involuntary inventory, you will see price cuts. That will be good for inflation, but it will be bad for profit margins and profits.

And I think that's why earnings and earnings guidance by the corporate sector during the first quarter will likely disappoint. And as that happens, we will then have a final down leg that is a profit-driven correction. And that should conclude the whole cyclical correction.

From then on, I look for a brighter rest of '23 into '24 because I think that the bond deals are where they have been recently over 4% for 10-year treasuries. I think that's a temporary topping, and I think we go back there over the next few weeks into the first quarter because of the huge issuance of treasury paper that is ahead of us.

And the treasury is a seller, the central bank. The Fed is a seller. The banking system is a seller, and the foreign central banks are a seller. And therefore, I think there is going to be a big bounce again in bond yields. And that will then drive the market down together with the earnings.

And that, I think, leads to a situation where we have a cyclical correction ending in bond yields on the way up, as well as in equity prices on the way down.

I think from then on, we will see a huge rally, big bounds in the bond market for six to nine months. I don't think it will last longer than that, because I do not believe that inflation goes to 2% or below. It will stay higher.

And as the central banks ease up—due to the pain in the markets and the pain in the economies, they will ease up—and that easing up means that the money, the excess liquidity in the system flows to where scarcities are, and those are commodities again. And then we have the next rally in commodities beginning.

And as commodities fly higher—and I could see oil, crude oil trade near $200 in '24, which would then mean we will probably see 10% inflation in '25 in the US. And that means that from late '23 on, bond yields go up.

In the '70s, we had the first wave up in inflation rates. The bond market suffered, but not by that much. In the second wave of the inflation, the bond market was decimated. And I think that we will see something similar to that—that bond yields all of a sudden... I could see 10-year treasuries by the middle of this decade going to 8%.

Ed D'Agostino:

Wow.

Felix Zulauf:

Something like that. Something very dramatic. And that would be triggering of another down cycle from '24–'25 on in the equity market. And most likely a systemic calamity in our economic and financial systems.

Ed D'Agostino:

Systemic calamity in our financial and economic system. Can you put a little color around that?

Felix Zulauf:

Well, you will see that, if that happens, the biggest market there is, is the market of real estate. Real estate is probably worth $400 trillion around the world. And if bond yields go up the way I just described, we will have a real estate crisis. And real estate is, as a rule of thumb, 70% debt financed.

So, of course, a big part of debt will go belly up, and that backfires into the banking system. And therefore, the banking system that looks okay right now will have problems.

If that happens, the balance sheet health of everybody—the corporate sector as well as the consumer sector, the household sector—will weaken. And therefore, when your balance sheet weakens, you have a tendency to save. All of these things working together will create a big crisis.

This is not the end of the world. The planet will continue, and it's not the end of our civilization. It's just a washout period where we will probably go through some turmoil of things we have never seen before.

We could see some currencies disappear. We could see currency capital controls, currency controls, currency reforms. A lot of things that everybody who lives today has never experienced in his life but only knows from reading the history books. It's something similar to the 1930s—but in the 1930s, the whole correction went through the real economy because we had a stable currency system backed by gold.

This time, the correction will go through the currencies because we will save the economic system. And therefore, the whole adjustment process goes through the currency system, which means that several of the currencies that are known to everybody today will disappear over time. And then we start anew; that has happened again and again in the history of economies. We know that from Argentina; [it] goes bust every year, 10 years, or 15 years, or so. We know that and we live with that, but it's now coming to the industrialized world.

Ed D'Agostino:

So, Felix, last question for you. What would you call a good store of wealth? Given everything that you've just described. Would it be low-leveraged real estate or no-leveraged real estate, gold, other commodities? It feels like hard assets certainly will play a big part in that. What are your thoughts on where to store wealth?

Felix Zulauf:

Yeah. I'm not the gold bug, but I do believe that gold has not performed the way the gold was expected over the last 10 years or so. When you would tell somebody what the central banks have done—how they expanded their balance sheets, how the governments went into debt like mad—you would be disappointed to see gold only trading at $1,800.

Ed D'Agostino:

Right.

Felix Zulauf:

But I think gold has been tested through history, and I think that is a period that I described just before, where gold would do very well. And it's not to get rich. It is a way to preserve your savings, your assets, your value. I also think that, with shares and stocks of good companies, you can go down 50 or 60%. But the companies will still be there if there is a new currency put in place. The company will still be there, and if it's a good company and a solid business model, it will continue to make money later on.

So, you could say... I go with productive assets. That's another thing. I think what is really the big loser in the whole game are nominal assets like bonds.

Ed D'Agostino:

Felix, it's always a masterclass speaking with you. I really, really appreciate you taking a few minutes for our Mauldin Economics viewers today. Great to see you.

Felix Zulauf:

It’s been a great pleasure. Thank you very much for having me, Ed. Thank you, and all the best.

Ed D’Agostino:

I hope you found this week’s *Global Macro Update* interesting. If you did, please take a minute to subscribe to this YouTube channel. This is the channel where I’ll be interviewing every week the world’s top economists, investors, and analysts—all with an eye to helping you and I become better investors. And I’d really love it if you’d come along on this journey with me. My name is Ed D’Agostino from Mauldin Economics, and this is *Global Macro Update*. Thanks for watching. See you next week.

For more details on Felix Zulauf’s unparalleled macro analysis, visit his website.