Howard Simons

Pondering the laws of financial gravity in the post-meltdown market landscape.

BY MARK ETZKORN

Roughly a year after the depths of the 2008 market collapse, we spoke with contributing editor Howard Simons, president of Rosewood Trading and strategist with Bianco Research, about a wide range of market issues, with special focus on the plight of the U.S. dollar, monetary policy, and the massive stimulus packages enacted in the wake of the meltdown.

Our initial conversation took place on Nov. 19, a day the three-month LIBOR fell to a then-record low of 0.26656 percent.

"If we're supposedly in an economic recovery — things are looking up, and green shoots are springing up, and so on — why are we at an all-time low in the three-month LIBOR?" Simons asked. "Shouldn't we be seeing interest rates rise at this point?"

The U.S. equity market had fallen fairly sharply that day (the S&P 500 closed down around 1.3 percent), but stocks were still very near their highest levels in more than a year, and were up more than 60 percent from the March lows. The LIBOR situation provided a departure point for discussing various market relationships — and apparent contradictions — and their implications for several markets, including currencies, bonds, and stocks. When looking at the pieces of the puzzle, Simons notes, you have to remember that fashions will change in market analysis and market relationships.

"What's dominant today — and notice I say what's 'dominant' rather than what's 'true' — may change as policies change and the situation changes," he says. He uses a couple of analogies to illustrate his point.

"First, various forces are always there, but you can defy them easily," he says. "Right now, for example, gravity wants to pull you to the center of the earth. But you're not at the center of the earth. Why not? Because you're defying gravity — you're in a chair somewhere, on a floor. Gravity is still there, but it's easy to defy. If you don't believe it's working, go over to the window, step out, and you'll find out it still is."

Second, Simons explains, the results you get from analysis depend on how you weight the different factors.

"The analogy here is you can have a can of blue paint and keep adding yellow to it and it won't start to turn green for a while. The blue will dominate until you've added enough yellow, and eventually the paint will look green," he says.

"So whenever you hear someone say, for example, 'Low interest rates are not good for stocks,' that's complete and utter nonsense," he continues. "Low interest rates are *always* good for stocks. We've had lower interest rates and lower stock

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prices over the past few years because another variable, expected earnings, have fallen faster than interest rates have. The intermarket relationship looks different because you've weighted the factors differently — in this case, earnings growth more than declining interest rates."

That doesn't mean, Simons emphasizes, the eternal verity of low interest rates being good for stocks is false.

"You always have to think, what's the weight here, what's the mix? When something is an apparent anomaly, why is that? Why is gravity being defied?"

AT: *What's being weighted incorrectly, then, in terms of the disconnection between the three-month LIBOR and stock prices?*

HS: The three-month LIBOR being driven lower is an unnatural event. What we've done is over-weight monetary policy. So much money has been thrown out there — here, in the UK, Switzerland, Japan, China. All this cash is being created — and when I say created, I mean literally with a stroke of the pen. "Quantitative easing" is just a more polite term for counterfeiting your own currency.

AT: *Just to be clear, quantitative easing occurs when the central bank buys financial assets such as government bonds, as the Fed has been doing, in lieu of cutting interest rates, because they can't push them below zero, correct?*

HS: Actually, you can cut interest rates more — you can put a penalty rate on a savings account.

AT: *Has that ever been done?*

HS: The Swiss put a penalty rate on foreign deposits in 1979 when so much money was flowing into Switzerland because it was perceived the Swiss franc was, in essence, a proxy for gold. It was distorting their financial structure, so they essentially said to foreigners, sure, we'll let you open a Swiss franc account — but you'll have to pay us. People still did it.

Look at what Brazil did recently — taxing foreign portfolio holdings. So much hot money is coming into Brazil to invest in their markets, they're afraid it's going to distort everything. Also, they've seen this movie before — where the money that comes in hot one day leaves just as hot. Remember what happened in the Asian crisis with the Thai baht, and what's happened in Mexico. A whole slew of hot money just says, "See you later!"

[The Fed] *could* actually drive interest rates negative, but they're not going to. Remember, T-bill rates were briefly negative in December 2008 — people were paying more than par value. Why? Well, it's an insurance trade: You're willing to accept a loss now to prevent a potentially bigger loss later. Also, banks were putting money in four-week T-bills at zero percent just so they could show they had Treasury securities on their books rather than some pile of garbage. It's absurd.

AT: *Getting back to quantitative easing ...*

HS: Quantitative easing is adding reserves into the banking system when there's no demand for those reserves. This is what Japan [has done], and we actually did it in the post-WWII era. The theory behind it is that you will forestall deflation, which you accomplish by creating money. And you need to create money because the banking system is not creating credit. Why not? Right now, the Fed is printing money — they're creating reserves and putting them in the system — and the banks can borrow those reserves near zero. And they're turning right around and lending it back to the Treasury (*through purchases of government securities*) at some rate greater than zero.

We're starting to push the limits of this game. The 2-year/10-year yield curve is starting to run out of gas (i.e., *not steepen any further*), but you can borrow a shorter rate, the LIBOR rate, and keep the trade going. But it's a very unstable situation, because when it turns around — that is, when the carry narrows — you find borrowers have shortened the maturity of their debt and lenders have lengthened the maturity of their portfolios, so when they raise interest rates one day, both borrowers and lenders are wrong at both ends of the yield curve — and that's going to be a very unhappy day. Borrowers, or "floating-rate payors" in swap terminology, at the short-end will see their payments rise and bondholders, or "fixed-rate receivers," at the long end will see their principal disappear.

AT: *Is that unavoidable? What would have to happen for that not to happen?*

HS: Well, you can keep going a long time. One of the things I looked at recently was what happened in Japan when they started quantitative easing — or let's put it this way, when they started driving interest rates lower.

Let's take a forward-rate measure — the three-month rate between six and nine months, which tells me the rate at which I can borrow money for three months, starting six months from now. If you compare it to the actual three-month rate six months later, you find that in Japan there's been a long gap: They kept expecting rates to rise — the three-month rate was higher in the forward-rate structure than it was in reality.

We've done the same thing, and our expectation gap is now bigger than it ever was in Japan (*Figure 1*). Right now, three-month rates are lower relative to the expectation that existed six months ago for three-month rates than they were in Japan. You can keep up a perma-expecta-

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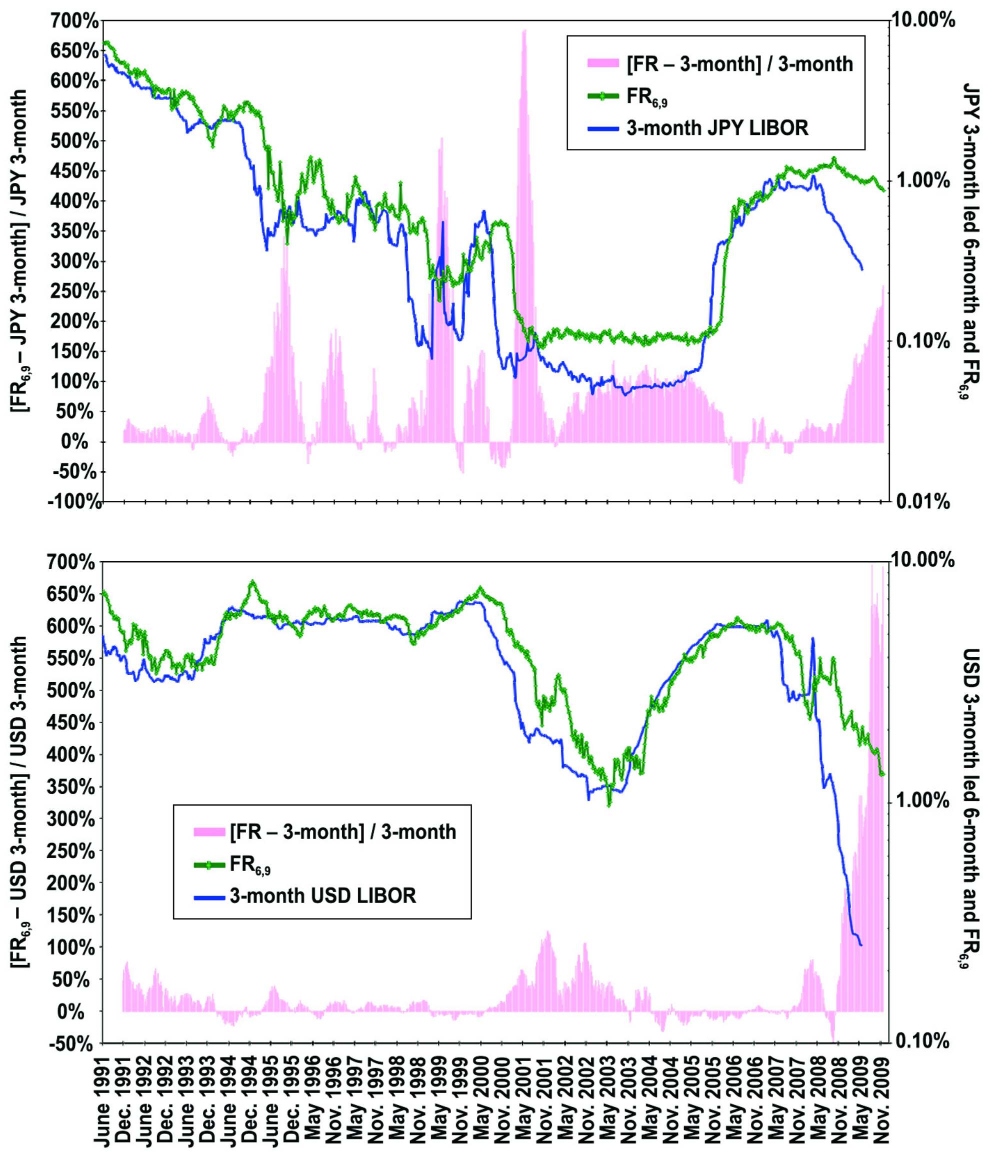
FIGURE 1: EXPECTATION VS. REALITY



There's been a longstanding gap in Japan (top) between the expected three-month interest rate six months from now ($FR_{6,9}$, green line) vs. what the rate turned out to be (three-month JPY LIBOR, blue line). In the U.S. (bottom), the gap between expectation and reality is currently bigger than it ever was in Japan.

tion — keep tricking the market into thinking some day these rates are going to rise, and they never do. Japan went for 10 years convincing people rates were going to rise, and they never did.

AT: *Why wasn't there wasn't inflation in Japan?*

HS: My answer has been, the [excess] money reserves got carried out of Japan — through the yen carry trade — and lent elsewhere. The Japanese banking system wasn't creating credit, so there was a great deal of reserve creation and very low interest rates.

All that money created an asset bubble. Is it an accident that after Japan started its low interest-rate policy in 1995 we had this rip-roaring bull market around the world for four years? Is it an accident that after we, the Swiss, the British, and Japan started [quantitative easing programs], a huge financial asset bubble [was reignited]? The Japanese actually went back to quantitative easing in December 2008, but they didn't announce it.

AT: *Are you talking about the current equity rally, and rebound in some commodities?*

HS: Yes. It's true we don't have price inflation; the CPI (*Consumer Price Index*) and PPI (*Producer Price Index*) aren't going up. People have said to me, "You said excess money leads to inflation." And I respond, yes, it does — and it did. Well then, they ask, where is it?

Now we're back to the idea of defining the forces that are at work. It's not showing up in prices because we have slack capacity, low demand, and we can import disinflation from China. The inflation is showing up in assets — stock prices going up, commodity prices going up, currency values going down, credit spreads coming in, risk-taking going back up — in a complete disconnect with the economy, which still hasn't recovered.

It just depends on how you define inflation. If you define it as the price of food and clothing going up, we don't have inflation. But if you use a more inclusive definition of money chasing goods, we do. Right now the money is chasing financial assets. This is a bubble, just like the bubble we had in the late 1990s, which popped. We had another bubble between 2003 and 2007, and that popped. Now we're inflating another one, and frankly, I can't believe it's so soon after the last one burst. What didn't we learn?

The other reason we aren't seeing inflation is the commercial banking system is impaired — it isn't turning all those reserves into credit. Once that happens, we will get a massive outburst of price inflation. Policymakers are congratulating themselves for the lack of inflation when they should be giving credit to the impaired banking system — pun intended fully.

AT: You've mentioned the idea of learning lessons in more than one article you've written. Can you think of any instance in the past generation, for example, where we *have* learned our lesson?

HS: Most of the time, generals fight the last war. For example, the inflation of the 1970s was commonly understood as being caused by mismanagement of the money supply: Central banks went from a fixed exchange-rate regime in the 1960s to a floating exchange-rate era in the 1970s, and they didn't know how to handle it. Everyone let their money supply grow. They were raising interest rates [while allowing the money supply to increase], resulting in higher interest rates along with inflation because there was more money chasing the same amount of goods and services. Paul Volcker (*Federal Reserve chairman from 1979 to 1987*) realized what was going on, and he made a big change. He withdrew all the liquidity from the system, pushing interest rates even higher and causing a severe recession. But for the next 20 years in the U.S., we learned you don't start printing money.

In that case we did learn a lesson, but then we fought that war again a few times over the next 20 years. For example, many people argued the Fed had learned the lesson too well when they started raising interest rates again in 1988 and 1989. It took them a long time to establish their inflation-fighting cred, and they didn't want to lose it.

Now they've kind of swung the other way. I think to a certain degree (*current Fed chairman*) Ben Bernanke sees 1937 in his sleep — when the Fed made the mistake of withdrawing interest credit, and we raised taxes (*creating another economic downturn and arguably extending the Great Depression*). The Japanese did the same thing in 1997. They're fighting the last war, too.

Bernanke regarded the Great Depression as being an error of not easing aggressively enough and fast enough. He also had Japan's "lost decade," which is now in its 20th year, in the back of his mind. Remember, the Nikkei hit its peak in 1989. The Fed is fighting the last war, having learned the lesson that if you're going to try to stem a financial crisis, you can't tip-toe into it, you have to stomp in like Godzilla on steroids — and they did.

But in doing so they had to unlearn the lesson of the 1970s. They had to make a choice: Do we risk another deflationary depression, where the banking system and asset prices collapse, or do we pump money out there, creating this "money illusion" that things are better — which is what's going on right now — and risk the inflation they believe they know how to fight?

But as I mentioned before, when they raise interest rates and start withdrawing liquidity to fight it, everybody's going to be wrong on both ends of this trade.

AT: It sounds like walking a tightrope.

HS: Well, you never want to bet on everything going right. When you play poker, the guy who's always trying for the inside straight is not going to walk away the winner at the end of the night. Or if he does, he was right for the wrong reason, and he shouldn't do it again.

AT: It seems as if — and this would seem to be human nature — that whatever the bill was going to be, we wanted it to come due at a later date: "We don't know how we'll get out of this, but we have to avoid calamity right now at all costs."

HS: Yes, there's a lot of rolling the problem forward and figuring that maybe we'll grow our way out of it.

What's one of the first rules of first aid? Stop the bleeding. Well, we stopped the bleeding, didn't we? As much as I might want to quibble with what they did, we are not in 1932 right now, and I had no particular desire to see us in 1932.

AT: But my impression from some of your writing is that the cure might end up being worse than the disease.

HS: I think it will be, and the reason is very simple. You have to ask yourself, when was the money lost? My argument is, economically the money was lost with the misallocation of resources during the bubbles. When we shifted a lot of money — first, let's say into stocks in the late 1990s — we ignored investment in real plant and equipment economic value-added endeavors, such as manufacturing, and just shoved paper around. When the stocks disappeared and went to zero, where did that money go? It actually goes to money heaven — it's a deadweight loss. It's not a zero-sum game in stocks — the money actually just disappears. That's where the money was lost the first time.

AT: What you're saying leaves the impression you think the past decade or so in the financial markets has been smoke and mirrors — a rearranging of the *Titanic* deck chairs when the ship basically went down with the collapse of the 1990s bull market.

HS: The problems started much earlier than the 1990s, but we can trace a lot back to two events in 1994. The first was the Federal Reserve was able to raise rates gradually and, for the first and only time in its history, create the mythical "soft landing." I said at the time this was quite dangerous because it would make them

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believe they knew what they were doing.

The second was the rescue of the big Wall Street firms that lost big during the December 1994 Mexican peso devaluation. That created the cycle of moral hazard that culminated in the 2008 crisis.

Next, what happened to all the money invested poorly or even fraudulently in the real estate bubble, and all the mortgage securities? Well, that went to money heaven, too. And it went there [when] the financial system was leveraged to real estate. The banks' collateral on these loans was real estate. Once the price of real estate fell, the collateral disappeared and the loans were not only non-performing, but they were for amounts greater than the market value of the underlying real estate. This had to be reflected on their balance sheets and left them undercapitalized.

After a bubble bursts, you do the accounting: where to distribute the losses, to whom, and over what period of time. Regardless, the losses have already been created — they are sunk losses, as opposed to sunk costs. They exist. You cannot, no matter how hard you try, go into a time machine and change the past.

In a way, what we have been doing is trying to pretend the money has not been lost. But it *has* been lost; now we have to face reality. If you write yourself a check and say, "I'm rich," it's more a sign of a mental disorder than an economic policy. If you and I try it, we get arrested. We frown on that for good reason (*laughs*).

AT: But you could find no shortage of finance professors — not to mention Wall Street professionals — who would say, that's not true, you *can* do it.

HS: Remember what money is: a representation of value-added. You work, you add value, you get paid for your work, and you can exchange that representation of what you did — money — for what somebody else created. This is the way we avoid barter; we give a money price to our value.

If you create money that has no representation of economic value behind it — that is, if you create it out of thin air — you can't barter it to someone. They're going to look at it and say, "Hey, that's actually worth nothing. That's a handful of magic beans."

If monetary creation *ex nihilio* fails at the barter level, it has to fail at the more complex multiple goods and services level. If you create reserves that don't represent anything, that money eventually has to erode the value of the existing money, which is traded at par. In other words, if I take $100 that actually represented value-added and add $20 that represents nothing, now I have $120 but I have no additional representation. Haven't I just caused the value of the dollar to go down? In this case it's now worth 84 cents. If anybody believes that money illusion, God help them.

"You never want to bet on everything going right. When you play poker, the guy always trying for the inside straight is not going to walk away the winner at the end of the night."

AT: But everybody does — that's kind of the whole point, isn't it?

HS: You can believe it in the short term, but in the long term, it never holds. You simply get inflation out of it. And that's actually one of things that's going on with the dollar right now: If you create a reserve currency, everyone else has to accept it at par. You know you get to spend 100 cents worth 100 cents, and you kind of know that at the end of the year it's worth 95 cents, but everyone else in the world has to accept it as being worth 100 cents, and they don't like it.

The dollar is the reserve currency. When a new dollar is created, everyone has to accept it at the market rate even though the prospect of further dollar creation creates a rational expectation that it will be worth less. Or, you take it at par and then sell it immediately, turning your expectations into a self-fulfilling prophecy.

AT: What do you think of the longer-term fate of the dollar in the context of this scenario?

HS: What we've been doing is very serious, and we've been doing it for pretty much the entire Bretton Woods era. Go back to one of the very first articles I wrote for *Currency Trader* — maybe the first article — that reviewed a long history of the dollar, and showed it's essentially been going down in a straight line, with only minor interruptions, since 1973 (*Figure* 2).

AT: A generation, and then some, of devaluation.

HS: Yes. Also, we have to remember that everyone else has a paper representation, too. Here's an analogy: Say you and I jump out of an airplane with parachutes. Both of our parachutes fail, but at a different point in time. One of us is going to hit the ground first, the other is going to hit second. The guy who hits the ground second has momentary bragging rights, but the fact of the matter is, we both failed and we're both dead.

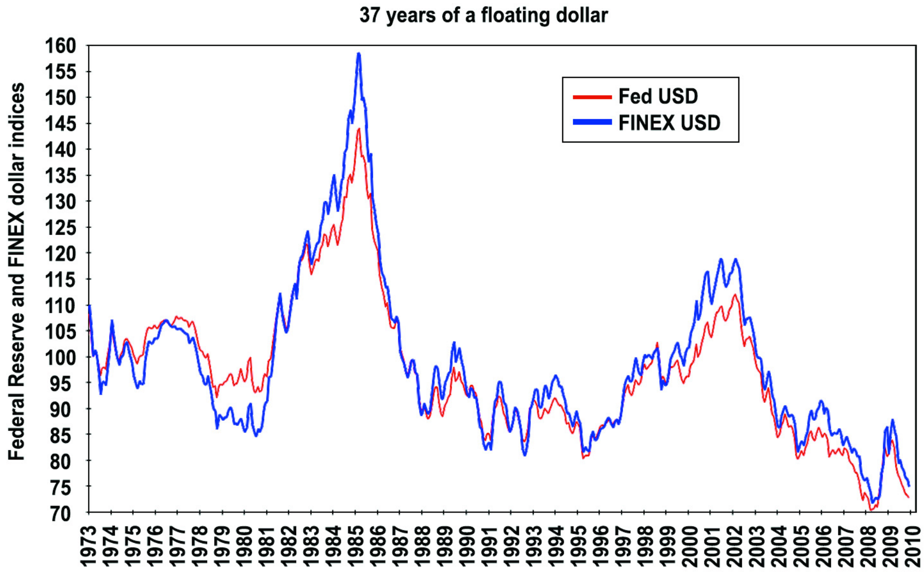
This is what's been going on with paper currency for 35-plus years. Paper has been depreciating; we're in a race to see whose paper depreciates the slowest. On an absolute basis, everybody's currency has been getting weaker because we keep pumping out additional units. It doesn't matter whether it's dollars, pounds, Euros, or yen — they're all worth less on an absolute, intrinsic basis. Everybody has had systematic inflation over this period of time.

It angers me that they call this a disinflationary era. My older son was born in 1983, which is when they say the CPI was 100. The CPI is now — what, 215? It's lost more than half its value in his lifetime. And they call this disinflation?

AT: In other words, even if consumer prices remained exactly the same, if your currency loses half its value, you're paying twice as much.

HS: Right. I think right now, from a trading standpoint, the minute the market senses the Fed is going to end this little game of monetizing Treasury debt (*buying Treasuries*) — remember I was talking about the day when the banks can borrow at zero and lend at some number greater than zero. We're financing this $1.5 trillion federal deficit essentially out of thin air, and you cannot show me an instance in human history where you haven't seen inflation result from financing government debt by printing money. It always happens. That's the law of gravity: Step out the window and you'll find out it's still working.

FIGURE 2: THE STORY OF AN ERA



The dollar's recent travails are not a new phenomenon. The currency has been on a downward slope for more than 35 years.

AT: What are the most notable examples of this?

HS: The hyperinflation in Hungary in 1946, and Germany in 1923. Argentina has had several hyperinflations. Brazil, before they finally got their act together in 1994 had hyperinflation a couple of times. Israel had hyperinflation in the 1970s.

Every time you finance government debt by printing money, [the currency] becomes worthless. Again, if money doesn't represent economic value, you're trading nothing for something, so that has to erode the value of the "something." You increase the dollar price of that economic worth.

AT: Is the U.S. saying "It's different for us" anything more than hubris?

HS: (*Pauses*) It's nothing more than hubris. The laws of economics apply, regardless of where you're living or under what form of government, and what color your piece of paper is.

The Romans had inflation under the emperor Diocletian; they kept making the coins smaller. You take the same amount of silver and produce twice the number of coins — that's monetary creation. The emperor spent them first — the "reserve" currency, what is called the right of *seigniorage* — and after that you get inflation.

AT: He got to spend before the devalued currency was spread around everywhere, meaning he got to spend pre-inflation?

HS: Yes. When the Spanish and Portuguese looted the gold [from the Americas], they brought it back to Europe, and that triggered inflation. What's really interesting is they were aware price levels were rising throughout Europe at the time, but they didn't associate it with bringing this gold back and making gold coins out of it. These were not the sharpest knives in the drawer. And this inflation, along with the feudal social structure in Spain and Portugal, bankrupted the incipient middle class. You couldn't save or form capital because the money was continually worthless. It's one of the reasons Spain and Portugal were the first European powers, but also why [they peaked so soon]. They bankrupted themselves with all that gold.

Think of Adam Smith's observation: You have gold, so what? If I put you on a desert island, which would you rather have, a handful of gold coins or a loaf of bread? That point is lost on many.

AT: Isn't the implication of all this if the Spanish and Portuguese were dull knives, we must be dull spoons, since we've had several more centuries of lessons to learn from?

HS: I'm not a conspiracy theorist by nature. You don't need a conspiracy theory when normal stupidity will suffice. We do make the same mistakes twice. Has there ever been a trader who didn't make the same mistake twice? It's part of being human. What you learn from history is that we don't learn from history very well.

It's really easy to take the expedient course each step of the way. I think in his heart of hearts, Bernanke sees 1937 out there. And Mervyn King of the Bank of England has actually said that weakening the pound is a good idea. No, it's not.

What is the road to hell paved with? Each step of the way you take what looks like the low-pain, low-cost, most expedient response to a crisis, and in the end, the sum of those solutions gives you a higher pain outcome. We do this to ourselves all the time. We know we're making a mistake, but it's very hard politically not to. After all, you cannot look back at the response from, say, August 2007 onward and say there was a plan. By the admission of people such as Tim

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Geithner, then at the New York Federal Reserve and now at the Treasury, they were making it up as they went along.

Think of the old saying — no battle plan survives contact with the enemy. Once the shooting starts, events will take over. After that, it's like a broken play in football. You have to plan knowing that it's going to be wrong. As Eisenhower said, "Plans are nothing, planning is everything."

Clearly, if anybody had it to do over, myself included, as Libertarian as I am, you have to realize now that letting Lehman Brothers go after creating the expectation they would be bailed out [was a terrible decision]. It wasn't so much that they let Lehman go, it was that they let Lehman go when everybody in the world expected it to be Bear Stearns 2.0.

I remember that Friday afternoon, it was Sept. 12, and someone from an exchange asked me if they were going to let Lehman go. I said, "They should, but they won't." Well, they did, but because everybody thought there would be a bailout up to last minute, they caught everybody flat-footed — and that's when the whole thing just blew apart.

There was no long-term plan because at each step the short-term pain overwhelmed it. Last year, if they had come out and said, "Look, the money has been lost. We're going to have to take our losses now. Whatever assets get sold, get sold; whatever bankruptcies occur, occur. We'll clear the rot out of the system and we'll start over — and there won't be any bailouts." You wouldn't have the obscenity of these guys paying themselves outrageous bonuses again.

If you have traveled, you know people are people world-round, and I think people have been people down through the generations. Doesn't everybody at some point say, "Oh my God, I sound like my mother or my father?" It's human nature.

Why do stories from the Bible and Greek myths ring true? Because we're people — we make the same damn mistakes over and over again. Should we be perfect? It would be a nice thing, but I don't think it's going to happen any time soon.

> "In a way, we've been trying to pretend the money has not been lost. If you write yourself a check and say, "I'm rich," that's more a sign of a mental disorder than an economic policy."

AT: *It seems like once the genie is out of the bottle — in terms of the debt from the financial stimulus and the interest-rate corner we've painted ourselves into — there's really no way to get it back in.*

HS: I titled the chapter on currencies in my book (*The Dynamic Option Selection System*, *John Wiley & Sons, 1999*), "The original sin." Once we got out of the Garden of Eden, we've been lurching from one [mistake] to another. This is not a new problem in human history. I wrote that book around the time of the Asian Crisis and the LTCM (*Long Term Capital Management*), Russian default, and all the rest. Ten years ago, I was looking at this and thinking, we only shift to a new regime after a disaster: We went from the gold standard to the pound standard after the Napoleonic wars — pound/gold. We stayed on the pound until WWI, then it became dollar/pound/gold. After the Great Depression, it became dollar/gold. After WWII, dollar/gold. After Bretton Woods, a fiat system. You need a disaster to change it.

AT: *What might the next disaster be?*

HS: I don't like shouting "Fire!" in a crowded theater, but we have evidence that every time there's a lot of slack capacity in human affairs, we destroy that slack capacity, literally: we go to war and we blow it up. You have too much labor? Well, you kill a few million young men on each side. Too much production? You bomb a few cities.

This is very anthropological. It's probably been going on since we got out of the trees. We find better ways to produce things, and suddenly there's a bunch of people sitting around with nothing to do, prices are falling, and we go bop each other over the head.

The problem is, the U.S. has essentially been in a low-level war since 1991. A lot of people forget this. How much capacity have we destroyed? Right now we're bombing a pile of big rocks into a pile of small rocks in Afghanistan. So what? Ditto in Iraq. We didn't really take out much there.

You always have to think, how do things shift politically? There's no question the U.S. is losing relative dominance economically, and Europe is not an ascendant power. China is an ascendant economic power, but it's not an ascendant political power. Russia is descending on both counts. Nonetheless, the center of economic gravity is changing, and somewhere along the line that always represents a threat.

AT: *Doesn't economic power ultimately translate into political power?*

HS: It depends. The Chinese think of themselves as the "Middle Kingdom." They've never been an imperial power. As a matter of fact, China's big problem is it's too big, physically, as it is. We have a linear concept of history, while they have a cyclical conception. We look at where we are on a ruler, they look at where they are on the face of a clock; it's a cycle. Right now, they have what amounts to a hundred-million-plus day laborers, and they're all young men because the one-child policy exaggerated the male-female ratio. They have to keep these guys employed, because if you have a hundred million unattached men, you know...

This means they have to keep [churning] out the garbage to sell to us, which means they have to keep buying our bonds, which means we keep borrowing money from them. How long can that one go on? The answer is, probably longer than we think, but at some point it will end, and it's probably going to end with internal tension in China between the haves and have-nots. That may be where the next big disaster comes from. Then you destroy a lot of productive capacity, because southern China now is essentially the world's factory district. And if that happens, then you start to rearrange the global economic power, you change the political [landscape] — like what happened after the 30 Years War, the Punic Wars, and World War I. None of this is actually new. We just keep changing the names.

The next regime change will probably be after some frightful level of destruction; the dollar will remain the reserve currency until then. But at some point we're going to get a cease-and-desist order from our foreign creditors — "Hey, we know what's going on: Quit printing these things out and paying us in inflated dollars" — but we haven't gotten it yet because they need us, too. China needs us to buy their stuff at Wal-Mart, otherwise they will have a bunch of unemployed, unattached young guys running around the cities.

AT: *But isn't it significant that China has actually voiced concerns about the dollar and U.S. debt, even if it's only rhetoric?*

HS: Actually, what they've done more than anything else is highlight how there's no alternative to the dollar. If you bitch and moan, you better be prepared to walk out of the room, and they can't.

What is the alternative to the dollar right now? It can't be the Euro. There you have a currency without a central fiscal policy. And we have several hundred years to suggest Germans are not Italians, Portuguese, or Greeks. In a way it's almost remarkable they've been able to hang together as long as they have.

It can't be the yen; that sun is going down, not coming up. It's not going to be Brazil, India, or anything like that. It's certainly not Russia.

China is doing to us what we did to the British last century. After WWI, a rational person would have said, okay, the U.S. is the most important country economically now, they're the ones on the way up, the British are on the way down — [the reserve currency has to] be the dollar. But we didn't want that responsibility and the British didn't want us to have it. We were very happy in the 1920s to let the pound remain the reserve currency, and we lowered our interest rates to prevent a run on the pound, which helped finance the 1920s financial bubble. Same mistakes, over and over again.

> **"If you create reserves and they don't represent anything, that money eventually has to erode the value of existing money."**

AT: *But they did, actually, suggest the idea of using the IMF's Special Drawing Rights earlier this year, didn't they? Why even bother doing that if the last thing they want to do is rock the boat?*

HS: The notion of the world's national governments turning over control of currencies to a supranational organization beholden to no one politically and without the ability to run a fiscal policy was, and is, absurd. Besides, the SDR is 44 percent the U.S. dollar, anyway.

And the timeliness of the IMF is amazing; their last reweighting of the SDR was in late 2005, and it will not be re-weighted until 2010.

AT: *Why wouldn't the U.S. have wanted the responsibility in the 1920s?*

HS: We were an isolationist culture. We didn't want Europe's wicked, wicked ways. After WWI a lot of people thought we were bamboozled into that war. The two largest non-British ethnic groups in the U.S. at that time were the Irish and the Germans. Remember that neither population in the U.S. were particularly enthusiastic about fighting on the side of the British — that was asking a lot (*laughs*).

The people running the show here were basically Anglophiles and they deferred to the British, and the British naturally walked around like they're supposed to be running things. It was kind of a mutual decision.

Turn the clock forward 90 years: China is ascending economically; we're descending. A rational person would say the Chinese have to take some central responsibility. But they don't want it. They're the ones who insist on pegging the yuan to the dollar. Right now, we would like the Chinese to revalue the yuan, but they don't want to — they really don't want to have to deal with this.

AT: *What would you tell Ron Paul about his call for a return to the gold standard?*

HS: The problem with the gold standard is similar to the currency original sin — you have to keep finding more gold, otherwise you have deflation. Gold is worth something because it's useless. It's rare commodity that doesn't get consumed. Just remember this: Every barrel of crude oil taken out of the ground is gone. All the gold is still here. We don't use it. It's weird thing: You take it out of the ground to bury it in a vault.

AT: *Do you think there's any chance for a "soft landing" for gold?*

HS: Not a soft landing. If the price explodes higher, governments will do what they always have done, and that is outlaw monetary gold like Roosevelt did in 1933. U.S. citizens could not hold monetary gold again until 1974. The next iteration will be global.

Yes, the gold standard is absolute, but that also means your money supply is hitched to the physical stock of bullion. If you look back at the 19th century, there was deflation before we found gold in California, Alaska, and South Africa. There was inflation after we found gold in California, Alaska, South Africa, and later in Australia. Is this any way to run a railroad?

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There's a finite amount of gold in the earth's crust, and the global economy can keep expanding, which means you have a smaller amount of money to cover a larger amount of goods and services, which means the price level has to fall. Since deflation and falling prices penalize debtors and reward creditors, you have a problem in a democracy where there's always more debtors than creditors.

AT: So what alternative is there to a fiat system, then?

HS: (*Pause*) Another mistake. The original sin. There is no answer. You could put somebody's else's picture on [the bills], maybe.

The idea that you can have some kind of "supranational" currency is flawed. The Euro has had good points and bad points. The problem is, it's a case of a central bank disconnected from a Treasury; it has no underlying fiscal policy or even a genuine electorate, the pretenses of various organizations such as the European Parliament notwithstanding. If you go to a global system, what do you do — have a world central bank and tie everyone together with a single paper currency?

The real solution ultimately is to have somebody put Milton Friedman's maxim — that the money supply should be allowed to grow at the capacity growth rate of the economy — into practice on a global scale. No more monetary manipulations, period.

The problem with monetary policy is the results are not deterministic; you cannot tell me what the economic or market response to any action will be. And if policies diverge globally, the currency market, and quite possibly national bond market yield curves, will trump the central banks' intentions.

Friedman was right: The Federal Reserve has had almost 100 years to prove it knows what it is doing and has failed, as have all its sister central banks. They fire incompetent baseball managers after three years, and you won't go to an incompetent auto mechanic a second time, will you? At what point should enough be enough? How about now?

But because we keep pretending there are deterministic outcomes, we keep erring on the side of greater leverage and greater inflation to the point we are so dependent on excess liquidity that any small rise in short-term interest rates is going to produce a catastrophic reaction in both the bond and currency markets. From a short-term trading point of view, I think you're actually much better off right now being long the dollar instead of short because any uptick in our short-term interest rates will unwind these carry trades. Remember what it was like when the Japanese carry trade unwound in 2006? Multiply that by about 50.

> "Has there ever been a trader who didn't make the same mistake twice? It's part of being human."

AT: It would be like late-2008 again, when everyone piled into the dollar.

HS: Yes, except they're also going to unwind the carry trades to the long end of the yield curve — that is, sell long-term bonds and close the short-term borrowing. The projected outcome is catastrophic — the dollar goes straight up and bonds go straight down. Whoa — a good time will be had by all.

AT: Is the stock market collateral damage in that scenario?

HS: The stock market will have an initial shock down — it always does — but remember, the stock market doesn't care whether the dollar is up or down, it only cares whether the dollar is fairly valued. As long as rates are going higher because earnings expectations are going higher, you'll get a situation similar to 1994 or 2004 — an initial shock in stocks, and then they'll sort of flatline for about a year.

AT: What do you think of the current stock market rally?

HS: It's come back stronger and faster than I thought, and because of that, until you take away the free money, it could actually surprise to the upside.

AT: Has anything surprised you over the course of the past year, given where we were in fall 2008 and what you might have thought then about what could happen in the markets?

HS: The big surprise for me is how well the quantitative easing has worked in restoring some semblance of stability, for now, in both the economy and the financial markets — that we've been able to print money like this without having some sort of immediate negative result. I would have thought we'd have higher inflation, and higher interest rates, and the bond market wouldn't take it.

AT: But you still think the piper has yet to be paid?

HS: Remember, we've lost the money, now we're arguing about the accounting. We've shoved it forward in time. What we're doing here, incredibly, is asking the people who had nothing to do with the loss to finance the people who had everything to do with the loss, and it's *working*. Somehow, the chickens are letting themselves be plucked. That's been a surprise.

I'm amazed that people would pile into these risk trades — we're only seven months after it looked like the world was coming to an end. I'm amazed there hasn't been greater rebellion against what I consider to be pretty irresponsible fiscal policies, and the deficit spending, and things like cash for clunkers and the homeowner tax credit. I mean, if you can't scam the government right now, you're not trying.

We're better off than I thought we would be, and I suppose I have to say I'm pleased with that because, you know, you sort of get worn out by the perennial crisis, don't you? There were days last year reporters were calling me on Sunday nights with the full expectation I was working Sunday night — and I was.