



You Have Questions, I Have Answers

By John Mauldin | December 6, 2015

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Hong Kong, Hollywood (Florida), and the Cayman Islands

Every week when I write letters to you, I face the question of what to write about and where to start. I actually had a story finished for you early Friday (and it was unusual for me to be done so early).

As luck would have it, the one time I finished early, some minor loose ends prevented me from using that story just yet. This unexpected turn socked me back in front of that intimidating blank screen this weekend, the one all writers who face regular deadlines dread. Usually I explore a single topic in depth; but, this weekend, staring at the screen, I was inspired me to try something different.

Rather than dive deeply into a single topic today, I will weigh in on some of the week’s top financial stories. I recently did a webinar debate with my friend Frank Trotter, hosted by Robert Huebscher of Advisor Perspectives, on whether the Fed should raise rates in December. I argued they should, for reasons I’ve written about before, so we won’t go into that. But we did get a number of incisive, timely questions during and after the webinar. I will try to answer most of them in this letter.

Warning: if you have questions, I have answers. But you must remember, I am often wrong but seldom in doubt. Still, even I take my own answers with a grain of salt. Let’s start with a preview of the questions.

1. You’ve been predicting the euro would go to parity with the dollar for quite a long time. This week, Draghi took interest rates even further negative and extended their rather aggressive QE. Instead of falling, the euro went higher. Do you still think we’ll see parity? Or is the market telling us something?

2. How low can European rates go?
3. The Chinese renminbi has been accepted into the IMF's SDR (Special Drawing Rights) basket. How long will it be before China's currency replaces the US dollar as the world's reserve currency?
4. Will the Federal Reserve raise interest rates in December?

“Insider Trading” at the ECB

The euro ripped higher after Mario “We’ll Do Whatever It Takes” Draghi lowered interest rates to -0.30% and extended QE deep into 2017. Everybody said the market was disappointed, as it was expecting more – nothing new in that story. *So why did the market expect more? I have seen the answer in only a few places.*

First, the story was not just the euro's moving by four big figures in just a few hours. The German DAX plunged 4.5%, and interest rates rose, not just on German bonds but across the European Union. It was total carnage. *So why did this happen?*

The basic reason is that everybody doing the trading, at the prop desks of investment banks and in the hedge fund world, had piled onto the same side of the boat. The market was indeed expecting a deeper interest rate cut into negative territory, and that expectation was dashed.

There is a rule in trading: the first loss is the best loss. Sometimes doubling down on a losing trade can work out, but the wisdom behind the rule is that it doesn't work that often. The way you avoid a 20% loss on a trade is to cut the loss at 5%.

The selling wasn't coming from retail investors: it was all traders and hedge funds. Some sold immediately, triggering more losses, which triggered more sell signals, which spun into more losses and resulting sell signals, and pretty soon the market was experiencing severe whiplash. There were red screens everywhere.

Why was everybody on the same side of the boat? Because the ECB (read Draghi) told them to expect more. “Wait a minute,” you say, “what do you mean Draghi told them?”

I mean just that. The ECB conducts regular conferences with what they call “market participants”:

The ECB has a special relationship with hedge funds and banks that includes closed-door meetings where it hands them privileged information, allowing them to trade in advance of ECB moves. When this popped on the front pages, Draghi, rather than pretending to be shocked and appalled, *defended the practice*: “Direct exchanges with ... specialised audiences form an essential part of the ECB's communication policy,” he wrote. They were

“integral to its transparency policy.”

The ECB has enriched hedge funds and banks every way it could over the years since the euro debt crisis and bailouts. Stocks and bonds started selling off even before Draghi spoke at the press conference, as hedge funds were reacting to the ECB’s [statement](#). ([Source](#))

The ECB did in fact cut rates and increase the amount of QE that it would deliver. But I’ll bet you a dollar to 12 doughnuts that, in the “private communications” the ECB had with various “specialised audiences,” the indications were that it was going to cut even deeper.

Why would hedge funds buy 10-year German bonds at very low rates using extraordinarily high leverage unless they thought those rates were going to go lower so they could sell the bonds at a profit? They were pricing in a minimum of another -10 to -20 basis points when they bought those bonds. Depending on when they bought the bonds, they may even have had some profits they sought to protect by selling. Additionally, they were expecting the €60 billion a month of QE to be increased, not merely extended. Given that the ECB has bought most of the bonds already, it really should have pushed bond interest rates lower.

I have sat with traders in Europe who were deeply confident about what the ECB would do. Now we know the reason why: they are getting the straight poop from deep within the bowels of the ECB.

Except that this time, contrary to his expectations, Draghi could not get enough of his fellow ECB board members to go along with him. I am sure he could have gotten a majority of the vote, but support that weak would have raised too many eyebrows – it would have been like the FOMC’s approving a new policy with five dissenters. I fully expect that at some point we will see even deeper cuts in Eurozone interest rates – perhaps even cuts into negative territory on the refinancing operations as well as further cuts in the marginal lending facility.

The ECB under Draghi has been willing to hype its moves and then, when the moment comes, deliver more than it promised. This meeting tells us that there is now considerable resistance among the Eurozone member states to taking rates even further into negative territory. It is clearly not just the German Bundesbank that is saying “Nein!”

I still think the euro goes to parity against the dollar, but the timeframe for that has been pushed out. Once-bitten, twice-shy traders and hedge funds may hesitate to go all in against the euro in the near future, allowing the euro to rise even further over the next few quarters, unless Draghi musters a surprise announcement that fulfills expectations at the next ECB meeting in March.

Draghi has to be frustrated: he lost some credibility last week. Now, when he re-utters the words “We will do whatever it takes,” the market will remain skeptical until he actually delivers. Until this last meeting, everybody in the market thought he could deliver on whatever he promised in his “private consultations.”

Europe now faces great difficulty generating any real inflation, and it won't be long before another nation besides Greece begins to have troubles. The ECB must step up, and the euro is again going to come under pressure.

How Low Can They Go?

This last week I shared with my [Over My Shoulder](#) subscribers [a fascinating analysis](#) by David Zervos, who is chief market strategist for Jefferies & Co. David says we should all pay close attention to the Swiss National Bank's Dec. 10th meeting. It may well be more important than what came from the ECB this week.

Why? Because the SNB is the negative interest rate trailblazer. Their below-zero deposit rates are the world's lowest and headed lower still. David says their plan is actually working, too.

[As] we look back on 2015, the negative rate experiment has worked out surprisingly well thus far for the Swiss. Recall, back in Dec. 2014, the Swiss first moved to negative rates. Then in January 2015 they dropped the 1.20 EURCHF peg and moved rates further into negative territory, to -75bps. Of course the initial market reaction to the abandonment of the peg dominated the negative rates. But slowly, over the course of this year, the negative rates reestablished dominance. In fact USDCHF is now at its highest level of 2015. And over half the January CHF gains against the EUR have been unwound. Importantly, this has all occurred WITHOUT massive increases in the SNB balance sheet.

The world has not noticed how aggressive Swiss authorities were. The SNB balance sheet at the beginning of 2015 was about equal to Switzerland's GDP. We have all seen the Fed, the ECB, and the Bank of Japan pumping out liquidity like there's no tomorrow. But relative to the size of the Swiss economy, the SNB has left other central banks in the dust.

And, says David, it's working well for them. He thinks the SNB can and will go much deeper into negative territory. In so doing, they will give Mario Draghi cover to do the same. How low can they go? At some point it is more cost-effective to build your own vault and store cash than to pay your bank negative interest for the pleasure of keeping your money. David thinks - 1.25% deposit rates – or even lower – are feasible.

If Draghi follows the SNB's lead, we should see a weaker euro and stronger European stock prices. The Fed lift-off won't change this. The Swiss may even create what Zervos calls a "Y2K moment," when anxiety disappears and everyone celebrates. We'll know on Dec. 16 if he's right.

(Zervos will be at my conference next May. I find him one of the more thought-provoking analysts in the markets today, even though I don't always agree with him. At a conference last month in Florida, both he and David Rosenberg argued that we could and would see an inverted yield curve in the US before we had a recession. I called them on it during the session, and then we

took the discussion out into the hallway afterwards. (Wine glasses at two paces.) Maybe we can revisit that enlightening hallway discussion at my conference. My basic question? How in the name of all that's holy can you get an inverted yield curve with interest rates at the levels where they are today? I think it's a reasonable question, and they had a reasonable answer. I don't think what they envision is likely, but their answer opened my mind to the possibility. Which is why I bring the best thinkers to my conference, to make us look hard at possibilities we aren't aware of just yet.)

The IMF Welcomes a New Reserve Currency: the Renminbi

Question: The Chinese renminbi has been accepted into the IMF's SDR (Special Drawing Rights) basket. How long will it be before China's currency replaces the US dollar as the world's reserve currency?

I don't see the renminbi dethroning the US dollar anytime in the next few decades. My crystal ball gets fuzzy after 2036; but for right now, while the Chinese renminbi has a reasonable chance of becoming *a* reserve currency, it comes nowhere close to meeting the basic conditions for becoming *the* major reserve currency.

The SDR previously consisted of the US dollar, the euro, the British pound, and the Japanese yen. These currencies represent the developed world's most stable economies (at least in theory), so having China's currency join them is a nice compliment to Beijing. It is not, however, an earth-shattering move in other respects.

China may well come to regret winning this honor – over the next two years at least. Sometime before the SDR change takes effect next October, the renminbi must drop its dollar tie and become convertible to other currencies. In that transition, the RMB will lose value, possibly a lot of value.

A weaker renminbi won't be entirely bad. It will make China's exports somewhat more affordable for the rest of us and may help some Chinese manufacturers stay afloat. At the same time, China will pay more for what it imports from other countries. We don't know how that will work out. Beijing is trying to build internal supply and demand, but it isn't clear how ready they are for a floating currency.

I actually would be surprised if the Chinese government decided to float the currency all at once. If you think the euro ripped higher on last week's announcement, you can't imagine what the markets would do to the renminbi if Beijing allowed it to truly float. I expect that the Chinese government, which never wants to rock the boat, will simply continue to widen the trading bands, allowing the currency to slowly find its own level.

That's the background, but we haven't yet answered the question of whether the Chinese currency will ultimately become the world's reserve currency. So let's think about what you

actually have to do to be *the* reserve currency.

First, you have to become part of the reserve currency club, and China is now a bona fide member. All that really means is that countries that employ the basic formula of the SDR will begin trying to accumulate Chinese renminbi as a portion of their reserves.

When we talk about the US dollar being the world's reserve currency, what we really mean is that the bulk of global trade is denominated in dollars. And yes, China is doing one bilateral agreement after another in order to trade in its own currency. For instance, London banks can now hold Chinese currency. If China buys a product from a company in England, the London bank can take the currency in payment and allow a customer to use it to buy a product from China. Since there is a lot of trade between Great Britain and China, that arrangement makes sense.

However, you are not going to see Mexico wanting to take the renminbi for its sales of products to Great Britain. Mexicans want dollars they can readily convert back to pesos. Any country that does a great deal of trade with another country can create a bilateral currency agreement to be able to trade in a particular currency, but the great bulk of global trade is still in US dollars.

For a country to deliver the currency in which most global trade is done, it must supply that currency "in size" to enable the trading. The United States runs a massive trade deficit, pushing dollars all over the world to circulate among the economies of other countries.

China, by contrast, has a trade surplus. It is taking in dollars and many other currencies, although it does run trade deficits with some countries. But it is going to be a long time before China runs a net trade deficit. A long, long time. An extraordinarily long time. That reality makes the reserve status of the renminbi a moot point as far as I'm concerned, because the renminbi is not going to come close to figuring into any of my transactions and investments, even those that are of the very longest term.

I suppose that in some alternative future the Federal Reserve could act massively irresponsibly – and by that I mean dramatically more irresponsibly than it has already been acting – and completely destroy the credibility of the US dollar. I also suppose it's possible that countries around the world could tire of selling products to the United States or find they can sell everything they make in countries other than the US. But if you're more interested in reality than a parallel universe, I would make the assumption that the US dollar is going to remain the global reserve currency for a long time.

I mean, really, did you see the reaction of the Chinese authorities when their stock market went into reverse? They totally ignored the market and overrode the results. Do you really want your reserve currency controlled at the whim of a few unelected men? (I don't see many – if any – women in the photos of the Chinese leadership.) So first things first: the Chinese will have to allow

their currency to float and somehow figure out how to inject more of their currency into global markets.

It took a century and finally a world war before the US ended up with an outsized majority of the world's gold and the Bretton Woods Conference could place the world on a dollar standard. If the world had tried to revert to a gold standard after World War II, trade would have slowed to a trickle, because the rest of the world didn't have all that much gold.

Oh, and by the way, the SDR will never be a global reserve currency, at least not in my lifetime. First of all, there simply aren't enough SDRs to actually conduct trade in. I mean, the SDRs amount to a few tens of billions of dollars. What do you do for trade in the second hour?

Second, the United States or England or (pick a country) is not going to conduct trade in an SDR. In the case of the United States, we could create only the equivalent of about two to three months of our trade deficit in SDRs. Seriously. Then we would have to somehow find tens of billions of dollars of SDRs each month to maintain our current deficit, which means we would have to go out and buy currencies, shoving even more money into the world, which would decimate the value of the dollar and throw the US into a depression. You'd want to dust off your post-apocalyptic science fiction novels were that to be the case.

I know this will drive the tinfoil hat crowd nuts, as they really do want to see the United States punished for its profligacy and the irresponsible actions of its central bank. And I do hold a certain sympathy for those who think the Federal Reserve should be reined in. But there is a world of difference between what should happen and what will happen. I have argued that the Federal Reserve and other central banks should be restructured. But the case I've made is just that, a theoretical argument, with not all that many people paying attention. For the time being – that time being a very long time – the dollar will remain the global reserve currency and the primary currency of global trade.

As an aside, I see a much greater probability that Bitcoin 2.0 will become a major reserve currency. And by Bitcoin 2.0, I mean the block-chain currency software restructured to create a sufficient amount of currency without Bitcoin 1.0's inherently deflationary bias. I could see a basket of commodities, equities, currencies, and bonds being used to back a new version of Bitcoin that would actually make eminent sense for global trade. Of course, Bitcoin 2.0 would have to be transparent so that governments could collect their tariffs and taxes, but it would solve a host of other problems.

As a second aside, the boon that I can see from the Chinese enacting a truly convertible currency would be to make Donald Trump, Lindsey Graham, and all their fellow China haters move on. They would then have to argue with the market, which would say that the Chinese currency is overvalued.

What will cause the Chinese currency to fall? Let's just say that there might be 100 million Chinese who would want to diversify their holdings if they had the opportunity. Over time, the Chinese currency might very well rise back to where it is today and even beyond. The markets will tell us that.

Yellen Drops Some Hints

In an ideal world we would not have to scrutinize for policy hints every word Federal Reserve leaders utter. (In fact, in an ideal world, central banks would not resort to activism except during a major crisis, but we'll discuss that subject another day.) Back in the real world, Janet Yellen gave us a lot of material to chew on this week.

On Wednesday, Yellen addressed the Economic Club of Washington on "The Economic Outlook and Monetary Policy." If you weren't there, you can [read the transcript](#) and scan all the footnotes. You will learn almost nothing new about the economic outlook or monetary policy. You might save money on tranquilizer prescriptions, though.

In her testimony to Congress the next day, she telegraphed the clear message that she fully expects the Federal Reserve to raise rates at its December meeting. What you have to understand is that when she gave that testimony she had already seen the next day's employment figures.

That's right. The Fed has data the rest of us don't get to see. The Fed, along with top White House officials (specifically, the head of the Council of Economic Advisers), sees the monthly employment report a day or two before its Friday morning release.

Think about what this means. Yellen testified to Congress Thursday, ahead of the November jobs report. When she answered questions about the jobs outlook, she likely had in her head data the rest of us would see only the next day. It should surprise no one that the report backed up Yellen's testimony. If the new-jobs number had been below 100,000, you can bet she would have been walking a rate increase backwards.

I look on my calendar and don't see any pending release of economic indicators that would dissuade the Fed from raising rates at their December 15–16 meeting.

Hong Kong, Hollywood (Florida), and the Cayman Islands

The schedule in the subhead above sounds hectic, but it's not really. I'm not scheduled to fly until early January, when I will spend five days in Hong Kong speaking at a private conference for BAML. I'll take time to look around the area for a change. In late January I will be the keynote speaker at the big ETF conference (ETF.com), where a few thousand people will gather to talk about portfolio design in the world of ETFs. I'm really looking forward to that. Then I'll return to the Cayman Islands for a speech in early February. I know I have to get to New York and maybe Washington DC sometime betwixt and between; but for me that is a rather sedate travel schedule – which is good, because I need to be spending most of my time researching and writing my new

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book.

I interrupted the writing of this letter for something far more important than any of the above: my oldest granddaughter Lively's sixth birthday party. They grow up so fast – or maybe I'm growing old faster. Actually, both seem to be the case.

Lively is going to grow up in a world of technological marvels. In researching the book on what the world will look like in 2036, I'm reading up on a wide range of technologies. What is on the books today – I mean, what is out of the labs and someone is trying to turn it into a product we can buy – is pretty awesome. What we are going to have in 10–15 years will be amazing. Then again, some of the things I see promised, even by the likes of Elon Musk, will probably happen, just not on the timetable they think is possible.

Sure, Google has its cars driving around Northern California, but they have mapped 2000 miles of road to where they actually know the curb height on every foot of that terrain. There are still about four million more miles of road to go. There's more code in these cars than is used to fly a 787, by a long shot. And they're still writing and figuring out "issues." I totally believe we get there, I'm just not sure that five years from now I will be able to buy a car that will drive itself in Texas.

I am perfectly content with the car I have today, which is over four years old and has only 32,000 miles on it. It should easily get 150–200,000 miles, so at the rate I'm going it's good for another 20 years. I would, however, buy a new car if I could get a totally automated car. I'd buy it in a heartbeat. While I like my car (an Infiniti SUV), I'm really not all that enamored with driving. I would rather sit and read and work or do something much more fun than sitting in traffic tapping the brake and the gas.

Besides, the world would be safer if I were in a totally automated car. You know those surveys where 80% of people say they are better-than-average drivers? I am one of the 20% that admit they are not. Of course, I have no choice: my seven kids would never allow me to claim otherwise. They do force a certain honesty.

It's time to hit the send button yet again. You have a great week. It's the opening of the holiday season, when we will all be seeing friends and family. I like this time of year.

Your ready to take a day off analyst,

A handwritten signature in blue ink that reads "John Mauldin". The signature is written in a cursive, flowing style.

John Mauldin

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