

DISCUSSING GLOBAL MACRO WITH RAOUL PAL AND MARK DOW

Jeremy Schwartz — Global Chief Investment Officer

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Last week I sat down with Raoul Pal, founder of Global Macro Investor and Real Vision TV, and Mark Dow of Dow Global Advisors, who is also a contributor to the "Behavioral Macro" blog, to discuss global growth, a strong dollar, rising rates and emerging markets.

U.S. Outlook Both Mark and Raoul subscribe to a story of modest recovery in the U.S. and low growth globally. Mark believes that the recovery cycle will be longer and weaker than historical standards, in part due to the household and financial debt burden. He had an interesting view that people display "disaster myopia," where everyone is afraid to take risks and make major investments or ramp up hiring in the real economy, which can result in low growth but also a fairly low risk of recession. There are a few secular headwinds in the U.S., primarily concerning the demographic cliff where the baby boomers are exiting labor markets and female participation is dropping off. One silver lining is that millennials are joining the workforce in greater numbers. In short, Mark believes globalization and technology impede the ability of the U.S. to return to the growth rates experienced in the Reagan era.

Raoul: Strong Dollar to Continue Raoul highlighted two periods of U.S. dollar appreciation: the early '80s and the late '90s. In the 1980 rally the dollar appreciated 90%, and in 1990 that number was closer to 50%. Today Raoul expects a further 30%–40% appreciation in the dollar and for this present dollar strength cycle to rival that of the '90s bull market. He attributes the strength of this rally to the massive unwinding of the global carry trade that is pegged at \$9.5 trillion. Raoul believes this is likely to have a negative impact on emerging markets (EM).

Emerging Market Outlook Mark believes that EM is not going to be the tragedy many are predicting. China, Korea, Turkey and Brazil are being driven by domestic credit growth instead of [commodities](#)—even though they correlate to commodities on the risk spectrum. However, Mark is expecting slower-for-longer growth and has been less optimistic on EM since 2011, despite its attractive valuations. The EM rally earlier this year was primarily a function of enthusiasm at the beginning of the year due to expectations for mean reversion. Instead, what happened was tremendous outflows as a result of weak fundamentals lagging the [mean reversion](#) hypothesis.

Lower Commodity Price Beneficiaries Mark believes that the benefits of lower oil prices to global economies are largely overstated. In the U.S. the coefficients of the '70s are no longer relevant, in that oil intensity on [gross domestic product \(GDP\)](#) has been cut in half over the past 30 years. Oil at \$150 did not hurt as much, and oil at \$40 will not help as much either. The EM nations that are less energy efficient are likely to benefit more, and perhaps countries such as India that have higher oil intensity can benefit. Commodity prices are as much a function of speculative forces as about fundamentals. Mark states that lower commodity prices are not a harbinger of bad demand but rather about excesses in speculative demand. For example, in 2008 advisors were selling the concept of 7%–8% allocations to commodities, and there was a big ramp-up in allocation. This cycle is simply the unwinding of such speculative excesses.

Global Currency Wars—Beggars Thy Neighbor Both Mark and Raoul believe that the benefits of [FX](#) weakness on exporter nations might have run its course, given that global exports have been shrinking due to weak demand and sluggish global economic growth. Additionally, developments in the Asian block have been fascinating, with Japan launching unprecedented [quantitative easing](#), while China has crippled itself by pegging the yuan to the U.S. dollar.

Meanwhile, Korea, the nation with the largest private sector debt in the world¹, has not done enough to allow its currency to weaken in order to regain competitiveness.

Rising Rates—When Does the Fed Let Its Balance Sheet Roll Off? Mark pointed out that while the two-year rates have been rising, the long end of the [curve](#) has remained relatively anchored. He attributes this to a scarcity issue: the Federal Reserve owns a large portion of the long end of the treasury [yield curve](#). Mark believes that we will probably see long end rates rise when the Fed allows its treasury holdings to mature without reinvesting proceeds. At present, the long end is not telling us much about the current state of the economy, and the short end will do most of the talking.

Positioning for the Future: Long U.S. Dollar and Long Bond Raoul believes that the best places to seek exposure are to the U.S. dollar and to be [long bonds](#). From a sentiment perspective, the investor community is shunning bonds, but from a fundamental perspective, low commodity prices are

keeping a lid on [inflation](#), which tends to be good for bonds. From a positioning standpoint, mutual funds appear structurally under-weight in fixed income and over-weight in equities. Raoul believes the fund community that tend to allocate in and out of bonds are underweight bonds and will eventually become buyers. *Read the Conversations with Professor Siegel Series [here](#).* ¹Bloomberg as of 7/30/2015.

For standardized performance and the most recent month-end performance click [here](#) NOTE, this material is intended for electronic use only. Individuals who intend to print and physically deliver to an investor must print the monthly performance report to accompany this blog.

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DEFINITIONS

Commodity : A raw material or primary agricultural product that can be bought and sold.

Mean reversion : The concept that a series of returns has a tendency to return to its average level over longer periods, even if shorter periods can exhibit wide swings.

Gross domestic product (GDP) : The sum total of all goods and services produced across an economy.

Foreign Exchange (FOREX, FX) : The exchange of one currency for another, or the conversion of one currency into another currency.

Quantitative Easing (QE) : A government monetary policy occasionally used to increase the money supply by buying government securities or other securities from the market. Quantitative easing increases the money supply by flooding financial institutions with capital, in an effort to promote increased lending and liquidity.

Curve : Refers to the yield curve. Positioning on the yield curve is important to investors, especially during non-parallel shifts.

Yield curve : Graphical Depiction of interest rates on government bonds, with the current yield on the vertical axis and the years to maturity on the horizontal axis.

Long (or Long Position) : The buying of a security such as a stock, commodity or currency, with the expectation that the asset will rise in value, the opposite of Short (or Short Position).

Inflation : Characterized by rising price levels.