Felix Zulauf: Government Interventions Are Making Things Worse

Welcome to the first Global Gold podcast. My name is Claudio Grass and joining us today is Felix Zulauf, Founder and President of Zulauf Asset Management. He is here to share with us his outlook on the state of our economy, recent developments in the financial markets and his views on current political changes.

Mr. Zulauf, you have based your investment philosophy on the idea that the economy moves in cycles, and for almost 40 years your theory has been successful in predicting and anticipating significant turns in the markets. What is your assessment in this moment in time for the world economy? In what stage of the cycle are we in now, and what comes next?

Well, that’s a very complex question. There are all sorts of cycles, and cycles are a very imprecise science, so to speak. There is the very long-term, two-generation cycle of convergence, there are the 18 to 20-year real estate cycles, the capital goods cycles, according to Juglar, the French professor and scientist and there is the inventory cycle of Kuznets.

My assessment of the big picture is that the Industrialized World and a large part of the Developing World or Emerging World are in a difficult period, in a down cycle. Structural issues force growth patterns further south, and we are having difficulties in continuing the prosperity growth that we have enjoyed for so many decades, particularly in the ‘80s and ‘90s and early part of 2000. That has all changed now.

Governments are having trouble with their efforts to get us back on a growth track, not the least because their strategy of intervention and manipulation of the markets is making things worse instead of better. Thus, I believe that the next few years will be very difficult. My hunch is that the world will somehow muddle through for another few quarters. However, significant risks are arising from China, and that could trigger a downturn for the world economy. I think it will get really ugly starting sometime within the next 3-4 quarters and the years thereafter could bring us another major economic crisis and turmoil.

You mentioned China as a possible major influencer of the future of the economy. What role could their monetary policy decisions play in the coming months? Is a devaluation of the yuan a plausible scenario, and how would it affect the US and European markets?

China is indeed a big and influential player on the economic world stage. As you remember, China was not part of the world economy until the late ‘70s, when they started to experiment with free economic trade zones. From then on, China experienced a dramatic growth of its economy, with rising prosperity levels and rising widespread wealth, and has been transformed into the second largest economy and largest exporter of the world.

In 2008, when the world was faced with the biggest crisis there was in a very long time, the Chinese bailed the world economy out by launching a phenomenal fiscal stimulus program; in fact, the biggest mankind has ever seen. It really helped the world economy to get back on track, although growth rates remained, for the world as a total, very low.

China has, however, gone too far. Their fiscal and monetary stimuli that were gigantic, have led to the biggest investment and credit boom ever seen on this planet. Every boom, creates an excess, and the excess translates into overcapacity of dramatic proportions.

The excess steel capacity of China is as big as the total production of Japan, the European Union and the US, combined, just to give you an example. There are many empty real estate buildings, and at some point, this will inevitably have to be corrected.

Last year, the Chinese decided that they would let their currency float freely. They were shocked when it devalued within the first few days, by around 3% and they immediately started to intervene.

I think we are now at the point where any fiscal and monetary stimulus programs have gone as far as they can. The credit bubble needs to be financed and the banking system is running out of lending capacity. Therefore, at some point, they will have to support the restructuring and elimination of overcapacity. In fact, President Xi himself recently stated in a speech to the Communist Party of China that he wants to address this excess capacity and the restructuring.

If they indeed do so, and that is by no means a certainty, it will slow down their economy. It will require substantial liquidity for the banking system to support the write-offs that are necessary. That liquidity must be created by the central bank and could actually lead to a lower renminbi or yuan in the currency markets; that would be seen as a devaluation of the Chinese currency.

A devaluation of the yuan could have all sorts of implications. Most significantly, China is the largest exporting nation of the world and if they let their currency drop by, let's assume, 20% or so, it would have serious ramifications for the pricing of globally manufactured and traded goods. It would probably put pressure on earnings of its competitors throughout the world and on profit margins, and it would increase the deflationary pressure and strain on those economies.

So, these are important developments in China, and we have to monitor them carefully because it is, in my view, the most decisive variable for the whole picture of the world economy.

So you see a lot of risk, volatility and misallocation of capital... That brings me to the next question. After a long period of bad press and bearishness on gold, we're once again seeing signs of investors' renewed interest in precious metals. Can that easily be explained by the fact that in uncertain times, people, historically, seek to protect and to preserve their wealth through safe vehicles like gold? Or are there more reasons behind it this time?

Historically, gold was favored, as you mentioned, in uncertain periods as a protection against government interference, against currency devaluation, against banking failure, as a hedging vehicle against geopolitical conflicts, or as a shield against inflation.

What we have seen in recent years, since the last great financial crisis of 2008, is monetary excesses by Central Banks around the world of an unprecedented scale. Nobody really knows what this will lead to. These excesses are too high, too frequent and too widespread, and the degree of institutional manipulation of the financial markets is the highest the world has ever seen.

Now so-called experts and Central Banks are talking about making cash illegal, about switching to electronic transactions only, for the sake of “transparency”, or to track every citizen and what he or she does with their money. In Europe, they are now abandoning the 500-euro bill as of 2018, and several advisors and experts are calling for the elimination of cash altogether.

This creates a lot of uncertainty: All of this combined, the monetary excess first, and then the attempts by the establishment to restrict the use of cash or to make it illegal or the abolition of the large bank bills, is creating uncertainty in the markets and, therefore, capital is very concerned.

Thus investors are taking part of their capital out of the credit system and the banking system, and gold is one of the safest ways to do this. I think that has something to do with the recent developments in the gold market that we have seen in recent months.

We see exactly the same picture here at Global Gold. Given the recent steps taken by the ECB to stabilize the European recovery, the intensity of their interventionism and the poor outcomes of their strategy, what are the policy trends that you foresee for the short and long term? Could we expect to see the US to follow suit and will the election outcome make a difference, in your view?

Well, the world economy faces several problems, and some cannot be addressed by the governments, like the demographic situation, the aging and the slowing population growth and things of this nature.

Then we have the accumulation of huge amounts of debt, which is a restraining force in the world economy because more and more economic actors and private households are hitting their debt ceiling capacity. That means they cannot go further into debt and therefore, they can only spend what they earn as income; and income is not growing much anymore. The world is oversupplied with labor and that prevents good increases of wages.

In fact, disposable personal income for the median private household in the Western world, after taxes, inflation, necessities like healthcare, et cetera, has been actually going down for 15 years. As long as this is the case, we are stuck in the situation we’re in today.

What could the authorities do? The best thing would be to restructure the bad debt that we carry on the books in our system. That would be very important. Another vital step is to reduce the red tape, the regulations that often make no sense and are excessive, and to reduce the size of the government. That is, to reduce government services to some degree, for example certain entitlements, but also reduce tax rates.

I think these would be good steps in a supply side attack on the problems to get us back on the right track. Such a process, of course, would be painful for the economy at first and therefore we would need some fiscal support. That fiscal support could come in the form of necessary infrastructure investments, or something along those lines.

Of all the politicians that are part of the establishment, I don’t see anyone coming up with such proposals. There are a few new ideas being put forward by so called “outsiders”, for example Donald Trump in the US, but no member of the establishment presents any idea that makes sense.

As long as the political leaders are not willing to talk about these fundamental problems and tackle them, we will continue to go the way we have been going in recent years. It’s more of the same and therefore, we will not solve any of the underlying issues, and the economy will not do well. Until something bad happens, of course, until we have another recession, a crisis. Then we will probably see some fiscal program coming forth, because money policy stimulation is simply at the end of its rope.

It has been proven in recent years that monetary stimulation does not lead to the results our authorities sought. Monetary stimulation cannot create growth and prosperity. It only creates bubbles and over-valuation of assets that are very risky for the system as a whole. Therefore, I think some of the Central Banks are realizing that their policy has come to the end of the dead-end street. The US is right at that point now and that's why they want to hike and “normalize” rates, so to speak.

We're already beginning to see the unintended consequences of the European turn to negative interest rates. As you mentioned before, investors and companies are choosing alternative vehicles like cash or gold, and prefer to stay away from banks altogether to avoid being penalized for their deposits, while even private citizens are actively being discouraged from saving. Would you expect this move to indeed stimulate spending as was the stated aim of this policy, or is this likely to backfire?

It is already backfiring. It is absolute nonsense: Negative interest rates are a tax, either on the banks or on the banks' clients. European banks are already in major difficulties because they have too much bad debt on their books and do not earn enough money after the intense regulation introduced after the financial crisis, to be able to write those bad debts off.

So, this is making the banking system, the center of the credit system, even weaker. As the center of the credit system gets weaker, one cannot expect the banks to lend more to create more economic growth. Because at the end of the day, we need borrowers and we need lenders: If the lenders cannot lend and the borrowers cannot borrow, as I explained before, central banks cannot create the growth that they are aiming for.

Moreover, low, zero or negative interest rates are detrimental to the world economy, because this means for actuarial purposes, so to speak, that citizens cannot save as much capital as they need for their retirement. Therefore, the lower interest rates go, the more they have to save to keep up with their retirement plans or savings plans for retirement. Therefore, it is a restraining factor for growth, it is counterproductive.

President Mario Draghi doesn't seem to understand this. He's from the old school. He thinks the further he goes this way, the better the outcome will be. Eventually, he will have to admit that he's on the wrong track.

Let's switch to geopolitics. Let's talk about Brexit. What is your prediction on whether Britain will remain in Europe or not, and do you believe the UK is better off outside the EU or inside the EU? What effect do you think Brexit would have on the market?

Well, I really do not know what the outcome will be. But when you look at the current political landscape in Europe and also in the US, you see that more and more political parties and politicians are popping up that were not part of the establishment before.

For instance, in the US, it was a big surprise for most that Donald Trump took the lead in the Republican Party and will become the Republican Presidential nominee. It was also a surprise to many that Bernie Sanders did as well as he did against the established Hillary. I see this as a reflection of people being completely dissatisfied with the establishment in general, for all the economic reasons I explained before.

The same is true in Europe. For the last few years, we have seen new parties popping up all of a sudden in Italy, in Spain, in Portugal, in the Netherlands, in France and so on. Those are all parties, regardless of left or right political inclinations, that are against the establishment. The historically established parties are losing ground and that is because people want change. They are dissatisfied with the results of politics over the last 20 years, and they simply want to see change.

I think we have to look at the Brexit question in the same way. The British will vote on whether they want to be part of the European Union or not. As you know, the European Union was designed to function as a Greater Europe entity, but it only functions well when the sun shines. When it starts raining and problems pop up, it simply stops functioning and everything grinds to a halt because every nation has its own agenda priorities.

This is further proof that the smaller an entity is, the better it works and functions. I think the EU has overstretched itself, because they tried to centrally plan and to define every little part of everyone's life, and that is just too much.

Of course, it's not all bad about the European Union. Cooperating and uniting political or economic forces in certain issues of shared interest and in dealing with other trading blocks are, in theory, not bad ideas. However, introducing the common currency, the Euro, was a terrible mistake. A common currency, for economies of completely different structure, created a lot of economic stress that is then solved via socializing the problems, which in fact leads to more and more centralization. That's exactly what we should not have and what we should move away from. Instead of centralization, the EU should move towards more subsidiarity.

Looking at the Brexit scenario from that angle, it's probably a good thing for the UK. As a small entity, they could function and react much better and do what is right for their own country in economic and political terms, within the world. It will probably be a very bad thing for the EU though, because it might stir the appetite of further secession throughout the Union.

We see already that according to polls taken in Italy, in France and in Portugal, about 50% of the people want to leave the Union, because they are dissatisfied. So the main risk faced by Brussels, is that a secessionist sentiment is growing, and at the end of the day, the EU has two choices.

Either to continue on the same path they have followed in the last 15 years, until the Union breaks apart and unravels into smaller entities. Or to change and adapt to the new situation, introduce changes and move away from centralization. It would probably also mean that the Eurozone will have to be restructured, with less participants and members. Those who cannot live with a sound money based monetary policy would have to exit.

So this Brexit vote will be a decisive moment for Europe's future. My hunch is that I see a slightly better chance of the UK leaving than remaining in the EU. I believe that the markets would take it well. Maybe in the first few hours, the Brexit news would hit the pound sterling and UK asset prices, but I think that they would recover very quickly. Whereas, I think, for the EU, the markets would look closely at the Eurozone, what their next steps will be and how they will react to it and whether that will change the thinking in Brussels.

I believe a Brexit scenario would be more damaging for the European Union than for the UK because the project of Greater Europe would have failed with Brexit.

Let me shift the focus to Switzerland. As you know, the Swiss have a referendum of their own coming up in June. The idea of a universal basic income, a minimum 2,500 francs monthly sum guaranteed by the government for every Swiss citizen, is for the first time being put to the vote. The polls indicate that this proposal will most likely be rejected. However, many other countries are launching experiments and are debating the concept, for example, Canada, Finland and the Netherlands. In your view, is the rejection of the basic income proposal the right way to go for the Swiss, or are there any merits to this idea?

Well, at first glance, it's a silly idea, but when you think about it, the changes that are taking place in the world economy with the mass digitalization and automation, will probably lead to a dramatic shrinkage of the middle class. It will probably divide the world much more into the haves and have-nots than used to be case in the last 50 years.

From that angle, it's justified to think about a program, or about a way to dampen the negative impact of those structural changes that could come through. So, I think it is worthwhile to debate these issues. On the other hand, I must say, I do believe in self-responsibility. All citizens that are freed from self-responsibility eventually become a burden for all others, for a nation and for a mutual entity.

Therefore, it is necessary to create a system to help the needy in a way that they also, as far as they can, help themselves. Just spreading money throughout the whole population, I think is a silly idea. I'm very convinced the Swiss will, with a wide majority, reject it.

The process of debating, however, is vital and the basic problems the world and particularly the Industrialized World faces, with the role that the new technologies play in our economy and what this means for the middle class, and the changes in our societies, these are all subjects that will surely be discussed over many, many years to come.

Let me close with one final question. Given the current economic climate, what would be your advice and your outlook for a sustainable, effective investment strategy?

Oh, it's a moving target. World markets are moving targets, so one cannot really give static advice. But I think in the next five years we will see vast changes in the world economy and financial markets. I believe the biggest asset one can have is an open mind and adjust constantly to the developments out there.

In my view, it doesn't hurt if you have a basic skeptical view. Preservation of capital should be the most important factor, because it will be very, very difficult to earn a decent return and make money over the next five years with the traditional assets like equities, bonds and real estate.

Therefore, I would hold a lot of cash. I would have an open mind. The way I do it, is through a diversified portfolio of top-quality stocks, bonds, commercial real estate and gold, and I manage it in the futures markets and with ETFs with overlays in this highly volatile world that we are in.

My view is that equity markets will hang around at high levels and swing on a medium-term basis until something breaks in the big picture. If an investor has the ability, he could trade medium-term but always close to the exit door, because at some point within the next 3-5 quarters, I expect another crisis to begin with negative implications for many traditional assets. So capital preservation is very important.

I cannot be more specific than this, since there are so many factors, in different economies, different currencies, different economic situations, different ages, et cetera, and one strategy does not fit all. But in general, if you err, try to err on the conservative side.

Felix, thank you so much for being with us and for this interesting conversation. I wish you all the very best and hope we can speak soon in the future again.