Drobny Guest Research

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Steve Drobny's next book comes out towards the end of Q1 next year. We thought DGA members might enjoy an early release of some of the chapters. Here's his interview with Andres, which took place in late November 2009. - David Berry

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Invisible Hands: Rethinking Real Money
Chapter 2

Andres Drobny
Drobny Global Advisors

To get a handle on where we are in today's markets - the issues, drivers, and looming uncertainties - I headed across town to sit down for another session with my business partner and resident guru, Dr. Andres Drobny (no relation). When we sat down to conduct his interview for *Inside the House of Money* in 2005, his central premise was that it all ends in tears.

His roots as a trained economist led him to point out building imbalances and disequilibrium in the global economy during the past few years, factors which pointed to an impending crisis - although the timing or exact cause eluded him. In late 2008, I witnessed him buy equities for the first time since I have known him – and not just any equities but emerging market equities.

How did you know it would end in tears?

It had to end in tears because there was too much private sector debt buildup. It is ironic now that people talk about government debt as being a problem. Private sector debt is the real problem. The government can almost always fund its debt if it decides to print money, the private sector cannot. Private sector debt just kept growing and growing, but my timing was way off. I thought it was over in 2000, after the equity bubble burst, but the Great Macro Experiment restarted it. The next leg up, especially the 2005-2007 phase, really surprised me. We are now onto the second phase of the Great Macro Experiment. (*See Figure 2.1.*)

IT ALL ENDS IN TEARS
My main hypothesis has been that it all ends in tears. Ultimately, if there is a sufficient recovery, interest rates go up to a point that assets get knocked and we head back to deflation. Or assets on their own give up and burst. The only other way out of all this debt is to devalue it via genuine goods price inflation, but that seems hard to

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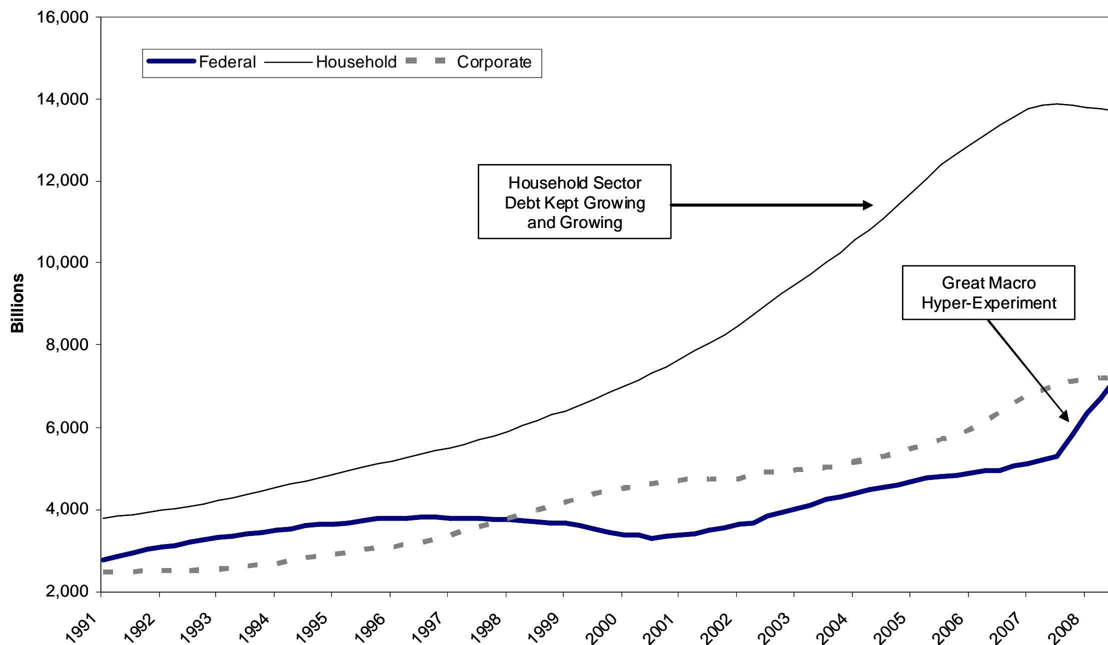
(Figure 2.1) US Debt by Sector, 1991-2008



Source: Bloomberg

achieve. If the authorities are lucky, they will be able to muddle through with lowish inflation, stable asset values, and okay growth over a long period, but during that process the world economy will be very vulnerable.

It's never been accomplished before, but maybe this time things are different. Today, the pessimists are actually now the optimists. The pessimist says house prices are going to collapse. Think about it. It's actually not that pessimistic, because if assets give without interest rates going up, then interest rates can stay low, helping cushion the process. So, oddly enough, the optimistic case may turn out to produce the worst outcome. Interest rates will have to rise more than is priced into the markets, which could cause a nasty tumble in assets and, ultimately, the global economy.

Source: Inside the House of Money, 2006

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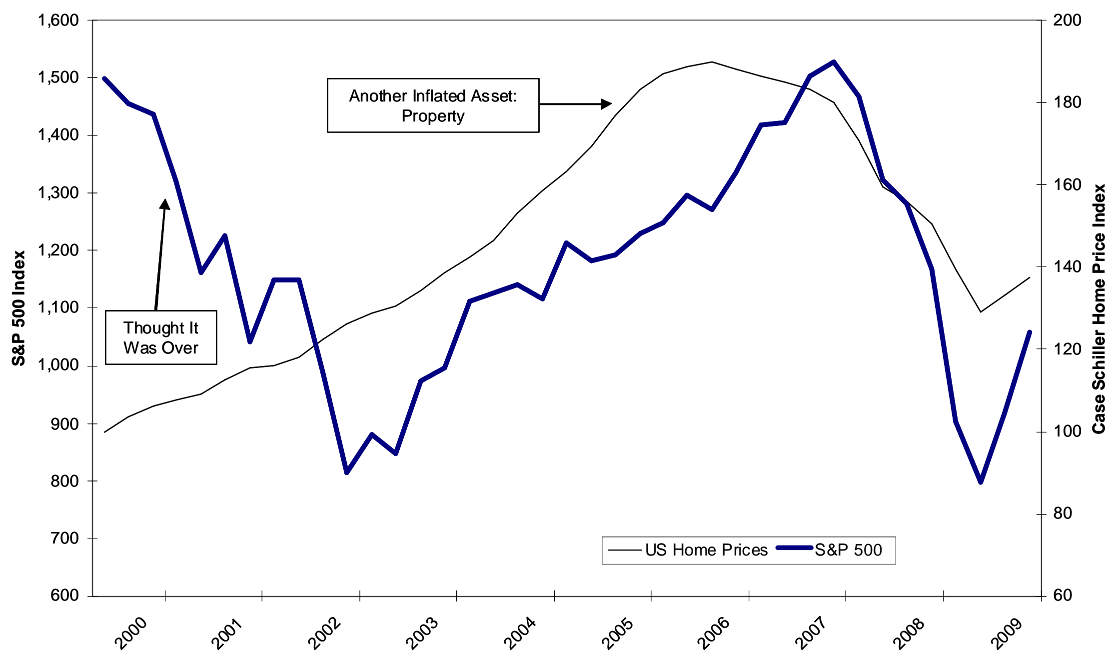
Explain what you mean by the Great Macro Experiment.

Debt-fueled over-consumption has historically resulted in a depression, a deep and prolonged recession, or in the case of Japan, a very long stagnation. The common argument, put forward especially by monetarists, is that these episodes occurred and persisted because monetary policy was not eased fast enough or far enough. The Great Macro Experiment, therefore, is an attempt to use aggressive reflationary policies to overcome the effects of debt deflation after the equity bubble burst. We still seem to be in the midst of the Great Macro Experiment, although it is the next phase. It is a hyper-experiment now.

The Experiment started with Greenspan, who preemptively and aggressively cut interest rates to head off the looming recession/depression in 2001-2003. It was a real-time experiment; it had never been done before. From 2003 to 2007, it appeared to have worked as easy money helped fuel another leg to the property and asset boom. I underestimated the potency of easy money when asset deflation emerges, perhaps because there was still another asset to inflate: property. (*See Figure 2.2.*) The hyper-experiment today, which includes the use of quantitative easing (QE) and bailouts, is a renewed attempt to prevent a cascade of defaults and preempt a deepening recession and possibly a prolonged depression.

(Figure 2.2) US Home Prices and S&P 500 Index, 2000-2009



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It is very important, however, not to neglect the role of fiscal policy. The conventional argument is that Greenspan's monetary policy was too easy, which created conditions for the equity bubble of the mid- to late 1990's and the housing bubble of 2002-2007. But fiscal policy also played a role, especially in the housing bubble. The Bush tax cuts early in the decade accelerated a redistribution of income towards the rich - the investing classes – and this redistribution added fuel to the original asset bubble. Greenspan takes most of the blame, but the fiscal element is often overlooked in the analysis of these events. Fiscal policy matters. Keynes taught us that, although the monetarists led us to forget it.

Look back at the Great Depression. The popular explanation is that tight monetary policy and the gold standard produced and prolonged the Great Depression. But few seem to be aware that taxes were progressively cut during the first half of the 1920's, which culminated in big tax cuts in 1925, especially for higher income earners. (*See Table 2.1.*) When taxes were cut in 1925, an asset bubble and spending boom ensued, ultimately leading to the crash of 1929. (*See Figure 2.3.*)

More recently, Bush cut taxes at the start of this decade, culminating in the big cuts of 2003. Again an asset bubble ensued and a crash emerged in 2008. (*See Figure 2.4.*) This redistribution towards the investing classes helped maintain and arguably added a new leg to the bubble in both episodes.

(Table 2.1) US Tax Policy

Income ($)	1922	1925	1932	1936
5,000	8%	3%	8%	8%
25,000	18%	12%	18%	21%
50,000	31%	18%	31%	35%
100,000	56%	25%	56%	62%
200,000	58%	25%	58%	66%

However, in 1931-32, taxes were increased and spending was cut as Hoover tried to balance the budget. Simultaneously, monetary policy was tightened. The monetary and fiscal measures combined to send the US economy into another deeper downturn in 1932, just when there was hope that things were starting to improve. Monetary and fiscal policies were eased aggressively when FDR was elected and took office in 1933, and recovery ensued. Given the depth of the downturn, the recovery was especially vigorous during the first few years. The Great Macro Experiment, then, is both an attempt to avoid a 1931-32-style downturn and an effort to prompt an FDR-type vigorous recovery. It is not an easy task to do both.

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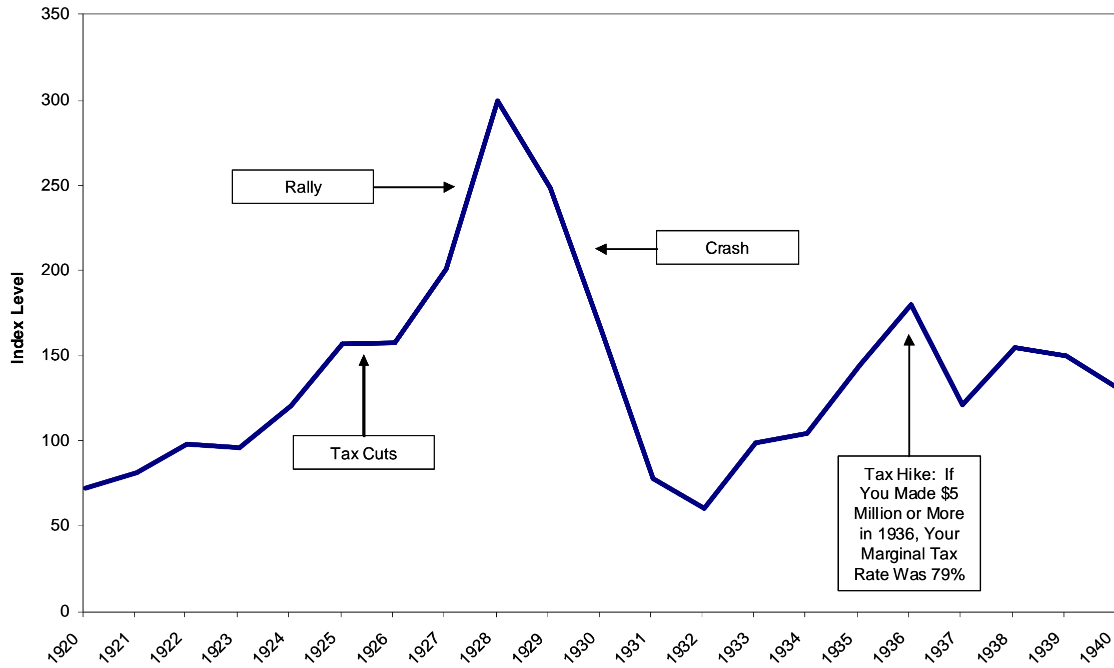
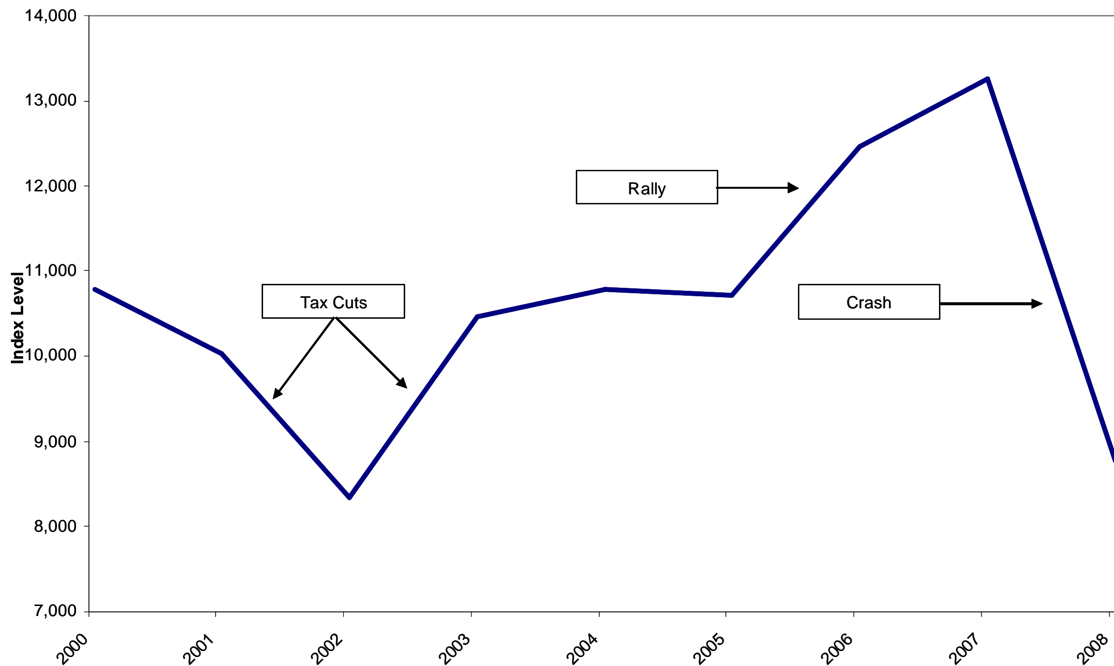
(Figure 2.3) Dow Jones Industrial Average, 1920-1940



Source: Bloomberg

(Figure 2.4) Dow Jones Industrial Average, 2000-2008



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Isn't all that private sector debt still out there?

Sure, the excess debt is still out there, and it will not go away quickly. But it is getting smaller, not bigger - it is a stock versus flow issue. Although the stock remains very high, it is falling rather than increasing because households are paying back debt or defaulting. That is a critical difference. It is the equivalent of saying that the savings ratio in the debtor countries has increased. So yes, there is still excess debt out there, but it is probably falling now. Because of this, although things feel worse now, the situation is actually improving compared with two years ago. This is a crucial element in making investment decisions and in part explains why I am no longer bearish equities.

Is there any exception to your claim that government debt can always be funded through printing money?

Many people think there is a limit on public debt, but I am not so sure. Apart from a country constrained by a gold standard or fixed exchange rate, the only scenario where the government might not be able to fund its debt is an inflationary scenario. However, that scenario only seems likely to emerge after the policies succeed in promoting growth. One of the reasons that a much-anticipated financing problem has never materialized in Japan is that reflationary policies failed to stimulate a sustained rebound and a return of inflation. Interest rates have remained low and funding the deficit has been surprisingly easy.

Consider what happens if the public debt and financing fears prove correct and bond markets start to tank. This is an issue that came up during a debate at our recent conference in London (see box below). Without inflation, rising nominal bond yields push up real yields and deflate the economy; bonds become more attractive again and buyers bring yields back down. Without inflation, it is hard to get a bond rout. It is only when inflation rises that government financing becomes a real and sustained problem for bond markets. That is when bonds no longer get cheaper as they sell off and nominal yields rise, which is when you get a real bond crisis.

DROBNY LONDON CONFERENCE OCTOBER 2009

The day ended with a new event: the first ever Drobny Debate. Niall Ferguson (Harvard University) and Hugh Hendry (Eclectica Asset Management) squared up to make the case: bullish or bearish bonds? Oh wow! It produced many good laughs. And, several powerful moments. One still reverberated at the bar after the event. Niall was asked whether his bear bond view is predicated on rising inflation. He answered 'no'; it is fundamentally a supply issue. Hence real yields should rise as bonds sell off.

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The questioner responded sharply: in such circumstances, a rise in price will beget demand. Lower bond prices and higher real returns will bring out more buyers, and an equilibrium will be found at a higher real yield. Hugh Hendry's face suddenly lit up and he pronounced, 'Then Niall and I agree!' This is precisely what happened in 1931, he argued, when real rates rose in a downturn, which became the catalyst for the next steep decline in financial markets and the global economy.

Now, whether rising yields today would produce a 1931-type crack is an interesting question. In 1931, real interest rates rose as fiscal policy was being tightened. That proved a disastrous combo. But, fiscal policy today is aggressively stimulative. That may make the global economy more resilient to higher real yields. As long, that is, as the fiscal stimulus is sustained.

But, what about the other tail? The bond collapse, the old Latam type of default and devaluation scenario? The question revealed that the bear bond story ***must*** incorporate a view on inflation. ***For bond markets to truly collapse, and a Latam type financial crisis to ensue, you need both rising nominal yields and steady to lower real yields.*** That is, rising inflation. That's how you get to a bond crisis, since bonds don't actually get cheaper as prices fall. That's the disaster scenario. Without this, rising bond yields leads to higher real yields, which attracts more buyers and/or increasingly restricts borrowing and thus economic activity. Notice, then, that the simple hedge to the bond disaster scenario is to buy break even inflation. That option wasn't really available in Latam- type bond defaults.

Both participants are to be congratulated for taking the event seriously, doing it with humor and, most of all, for helping deepen our understanding of a topic that is all too often handled in a cavalier and sloppy manner. Hugh acquitted himself well against a genuine international heavyweight. Niall is also highly commended for taking on Hugh on his own turf. And, for defending a view initially expressed back in April, when yields generally were 50-100bps lower. A very well played 'away' game. Bravo!

Source: Drobny Conference Review, Drobny Global Monitor - October 30, 2009

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What, then, happens if we have inflation or hyperinflation, as some are predicting?

These are the new bond vigilantes. They have a point, but you do not want to skip any steps here. The path to hyperinflation may well involve an initial period of healthy-looking recovery. It takes a long time for hyperinflation to take root. Things can look good for a while at first. Hyperinflations typically start when a fiscal deficit gets monetized, so the vigilantes are right to be alert to the dangers. But, the bond disaster story has to go through the path of better growth and a better outlook for some time. The process, even if the vigilantes are right, is likely to take a good deal longer than generally assumed.

BOND VIGILANTES

Bond Vigilante is a term given to bond market participants who, in reaction to inflationary monetary and fiscal policies, effectuate a "protest" in US Treasury markets, pushing up yields. From the fall of 1993 to the fall of 1994, 10-year Treasury yields climbed from 5.2 percent to over 8.0 percent, in part because of concerns about the federal deficit. James Carville, one of Clinton's top political advisors said, "I used to think that if there was reincarnation, I wanted to come back as the president or the pope or as a .400 baseball hitter. But now I would like to come back as the bond market. You can intimidate everybody."

Can the Hyper-Great Macro Experiment - with quantitative easing, bank bailouts and other creative measures - have a happy ending?

Perhaps, though this may have more to do with fiscal policy than monetary issues from here. It is critical that an expansionary fiscal policy is maintained for long enough. Monetary stimulus may become less necessary over time and be slowly withdrawn, but fiscal stimulus will have to be maintained for longer to make sure overall demand growth is sustained as household debt repayments proceed. That will likely depend on the political will of the population. In a democratic society, the population may have limited appetite for sustaining a fiscal stimulus. The key is to take away fiscal stimulus at the right time: after it starts to work and the multipliers are taking over. The US authorities seem to be looking at 2011-2012 to remove some of the stimulus, which is the timing set by the Bush tax cut sunset provisions. Their hope is that the stimulus starts to work, growth resumes, and the deficit starts coming down, allowing for a modest fiscal tightening without threatening the recovery. It is a delicate situation. Meanwhile, there are people out there right now saying that the US government should be balancing the budget. Oh wow! That is precisely what they did in 1931-32, which was a disaster.

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They argue that it was monetary tightening that created the second wave of the Great Depression. Although it is true that monetary tightening made things worse, fiscal policy was also being tightened at that time, and that is precisely the wrong thing to do when the private sector is retrenching.

If the economy has a double dip, it seems as though it could be significantly worse than the crisis of 2008 because all of the bullets have been fired. Interest rates are at zero, and fiscal stimulus, TARP, and other programs are unlikely to get additional support.

That is possible, which leads to one of my concerns about what Obama and other policy makers have done. One of the lessons from the 1930s and the New Deal is that it is much easier for fiscal policy to succeed after you have gone through a really nasty downturn. The question is whether the downturn of 2008-2009 was nasty enough. Obama keeps using the phrase "save or create jobs," but you never get any credit for saving jobs. It is possible that he did not let things get bad enough early on, limiting the potential for a strong rebound, in which case the danger is a loss of credibility and a possible rebellion against additional fiscal stimulus. This is also part of the Great Macro Experiment. It is not just whether the policy authorities did too much or too little, but whether they acted too fast and too soon to retain popular support for the stimulus efforts.

What are the implications of the crisis and the recovery outside the US?

That is one of the things I got very wrong. Look at how well many countries outside the US are doing; it is the decoupling theory. I thought a crisis in debtor countries would drag down surplus countries as well. Not for long, it seems. China is the most obvious example; their fiscal stimulus was huge and so far pretty effective. With perfect hindsight, it makes sense; in an environment of a global savings glut, when interest rates stay low, you want faster domestic demand in the high savings/creditor countries. That leans against contracting demand growth in the debtor economies. As the US consumer spends less out of income, the Chinese consumer spends more. That helps absorb excess capacity in China and helps limit the global downturn. Increased savings in the US - leading to a narrowing of the US current account deficit - is matched by increased spending and a narrower surplus abroad. I underestimated this possibility before seeing it happen in 2008-09, and it enhances the potential for the global economy to muddle through this crisis.

So when you say fiscal policy is often underestimated or underappreciated, you are not just speaking about the US?

No, it is everywhere. Again, China is a great example. Their stimulus was largely fiscal; monetary policy was relatively passive through all this. China did not cut rates aggressively, nor did they have to bail out the banking system all at once. They never faced a potential domino effect of failing banks. The same is true for much of non-Japan Asia. Countries that did not face a banking crisis did not have the same type of monetary policy response. Aggressive monetary stimulus generally occurred in the debtor

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countries, such as the US and UK. In the Euro region, monetary policy stimulus occurred mainly because Spain, Ireland, and several Eastern European debtor countries were in deep trouble. And while Switzerland is a creditor country, they needed an easier monetary policy mainly because it has a finance-based economy and their banks were in trouble as well. China, however, remains a good example of how powerful and effective fiscal policy can be in this type of environment.

That being said, it is not clear what happens next because it depends in part on future policy actions and in part whether the Great Macro Experiment succeeds. What I can say, though, is that the risk of inflation has increased compared to a year or two ago. Again, we are better off today than we were two years ago, just before the crash of '08. A process of adjustment is underway, and that increases the risk of inflation. But a lurch back into deflation is very possible as well, especially if the policy makers take their feet off the fiscal accelerator.

What exactly do you mean when you say we are better off now versus two years ago?

I am not saying that our wealth or income is higher. Rather, I am saying that the world is now in an adjustment period, where a process towards solving the underlying problems is underway. This compares with pre-2008, when we were creating bigger and bigger problems. Because debtors are deleveraging and creditors are spending more, we are moving towards a more sustainable equilibrium. There is a better chance now that things will work out, especially given the policy response. Hence, the probability has increased that the outcome will be inflationary rather than deflationary. Whether you think that the absolute probability of inflation is high or low, you should admit that it has increased in favor of inflation. There is also a higher probability of a middle ground outcome, whereby we muddle through with four to five percent nominal growth in the US for a prolonged period. Such a scenario is possible because decoupling has greater potential than I originally thought, and because the authorities have responded aggressively as the private sectors in debtor countries are rebuilding savings. The savings ratio has been increased in the debtor countries and this has involved a painful adjustment in consumption levels. That makes the outlook better, not worse.

Speaking of things getting better, you went long Asian equities in late 2008 during the heart of the crisis. I thought you were an equity perma-bear. What made you buy stocks?

I went from bearish equities - especially emerging market equities - to neutral, which meant I had to buy some. I bought Asia for several reasons. The first reason is price - prices came down hard even though stimulus was already starting. That struck me as an opportunity simply because policy might buoy the market. Second, Asia already had cheap currencies, and many became even cheaper. But most importantly, I had to admit that I had been wrong. My bearish view on emerging market equities since 2004 had been very painful. Emerging market equities exploded. And look at one of my

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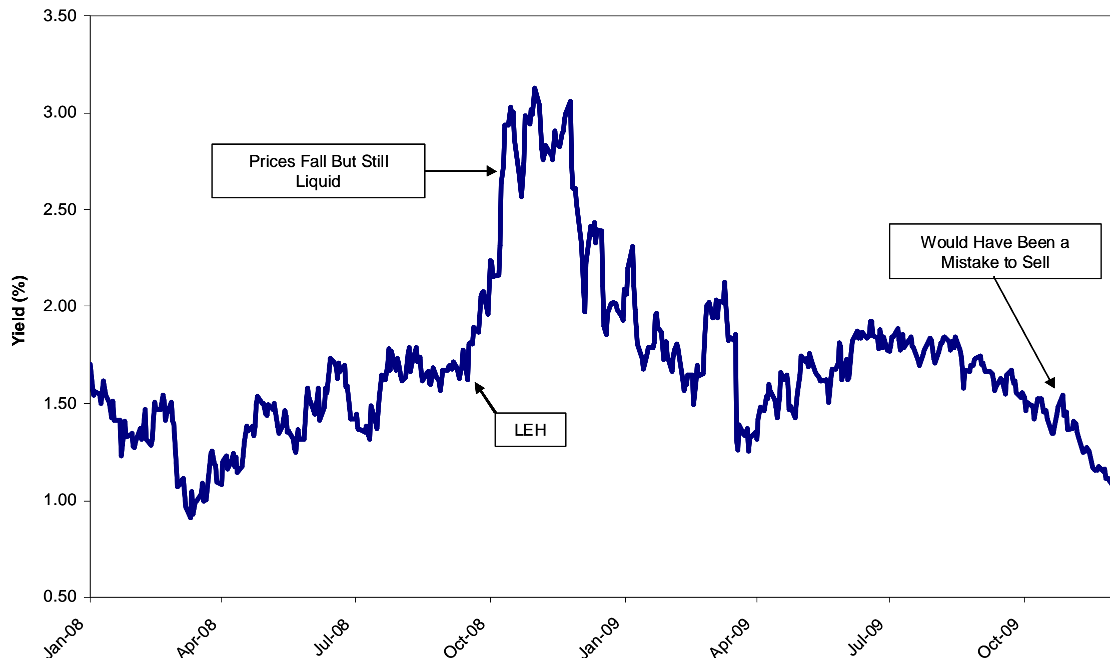
conclusions today: that the decoupling idea might actually prove correct. So part of it was recognizing that I might have been very wrong about emerging markets and the sustainability of decoupling. When we got the price adjustment, I saw the opportunity to correct what increasingly seemed a mistake.

What lessons did you learn in 2008?

The primary lesson was the value of liquidity - I learned how important it is to have liquid positions. Liquidity helps avoid making bad decisions in a crisis, and provides funding potential to take advantage of extreme prices. The lesson of liquidity relates as much to owning a house at the personal level as to owning assets in a hedge fund or having exposure to a fund that is invested in illiquid assets. As we saw during the crash, markets can totally shut down. I am not talking about prices just going against you, which is what happened with TIPS. You still could have sold TIPS during the crisis, even though it would have been a mistake. (*See Figure 2.5.*) Some assets became totally illiquid; you could not sell them at virtually any price. I cannot remember a time when that happened in our lifetimes. The lesson of the importance of liquidity will be remembered by the survivors and will likely not be forgotten for a generation.

(Figure 2.5) Ten Year TIPS, 2008-2009



Source: Bloomberg

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TIPS

Treasury Inflation-Protected Securities (TIPS) are inflation-indexed bonds issued by the U.S. Treasury. The principal is adjusted to the Consumer Price Index, the commonly used measure of inflation. The coupon rate is constant, but generates a different amount of interest when multiplied by the inflation-adjusted principal, thus protecting the holder against inflation. Inflation-indexed bonds in foreign countries are also referred to as linkers because of their link to inflation rates.

How do you value liquidity?

I don't know how to value it per se, or what the excess return should be for holding an illiquid instrument. I do know that the position has to be exceptionally small and nonmaterial to make it in my portfolio. In general, I want to be in instruments that I can get out of quickly if I have to. You cannot hedge illiquidity in any way other than staying liquid. I suppose you can sell correlated liquid variables to cover the illiquid assets that you own, but that creates additional risks. This, by the way, was another reason why I had the confidence to buy equities: I knew that some people were selling to hedge illiquid holdings, which meant that equities were probably overshooting to the downside.

Another lesson learned from 2008 is the importance of good risk management techniques. You could have had the right view but missed the move, or worse, got run over in the crisis. Views sometimes count very little, whereas good risk management always counts a lot. The top performers in 2008 were able to put on good risk-versus-reward bets at the right time, and had the liquidity to do so due to good risk management.

The old style of risk management suggests establishing a 'diversified' portfolio with different asset weightings based on risk tolerance and time profile, which does not really work in this environment. If you are 60 years old, you are theoretically supposed to increase your bond weighting. But if you did that at the beginning of 2009 - decreased your equities and increased your bonds - you virtually committed suicide. And if the inflation hawks are right, this may prove to be a really bad trade for a long period, even if your timing is reasonably good. People still seem stuck on what worked from 1980 to 2000 and arguably until 2007. That was an amazing period and I am not at all sure that what worked then will continue to work going forward.

Does the real money management world have to change as a result of the crisis?

Yes, because again, the crash has given us new information. People were introduced in real-time to what economists call the 'corner solution'. In the idealized, perfectly

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functioning world imagined in traditional economic theory, economic agents optimize subject only to a budget constraint such as maximizing profits or investment returns. That is a first best solution. But 2008 revealed the dangers posed by extreme investment losses and the potential for default and bankruptcy. This suggests the optimization exercise should incorporate an additional constraint of avoiding losses and drawdowns so large that they imperil the existence of an economic entity (e.g., banks and insurance companies) or cause a very severe dislocation in spending of entities with fixed spending commitments (pensions, endowments, foundations). That implies a solution to the optimization exercise where risk-adjusted returns and volatility play a role. It is a second best solution, but one that helps reduce the potential for a catastrophic outcome.

This was neatly illustrated in a recent discussion I had with Larry Bacow, President of my alma mater Tufts University. He mentioned that the universities with large endowments suffered disproportionately in the crash and now face significant cutbacks in spending as a result. Universities with smaller endowments experienced smaller losses and thus felt less pain in the crash. Bacow concluded that the more a university relies on endowment returns to fund its spending, the lower the risk profile of that endowment should be. Yet, in practice, the opposite seems to have been the case: the bigger the endowment, the greater the risk it assumed. The experience of 2008 reveals that this needs to change, he argued. His idea is a powerful one and it applies to pension funds as well as university endowments. For a pension or endowment, the greater the dependence of the operating budget on investment returns, the lower the risk profile should be, not the other way around. That helps avoid the 'corner solution' of bankruptcy and default, and reduces the eventual need for draconian spending cuts.

If you had to put on one trade right now for the next 10 years, what would it be?

I guess it would have to be TIPS. I am tempted by Asian equities, but the safety margin of TIPS is what drives my decision. I am painfully close to the age of 60 so I need to consider safety first. TIPS have been an undervalued asset class and some of the smartest guys I know have been bullish since 1998, when these instruments first came on the scene in the US. In those days real yields were pretty high, so I could see how TIPS worked then because of the potential for a decline in real yields. But, until monetary policy is tightened aggressively, TIPS still look pretty good, even with real yields down considerably. If you are afraid of a bond catastrophe, then you want to own break-even inflation; that is, you want to be long TIPS against nominal bonds. As we discussed earlier, the path to a bond crisis must involve higher inflation, so break-even inflation should adjust. Another beauty of TIPS is the principal guarantee in the event of deflation. You get a floor in a deflation scenario and protection in the case of a bond rout due to rising inflation. Because TIPS offer a positive yield over inflation - more than what is offered by short-dated Treasuries - they seem a decent place to hold wealth.

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BREAKEVEN INFLATION

Break-Even Inflation is the difference between the nominal yield on a fixed rate investment and the real yield, where the latter is reflected in the yield spread between nominal bonds and an inflation-linked investment of similar maturity and credit quality.

Source: Inflation-Linked.com

What do you think about real estate?

Real estate is a spread trade now. The great trade, if it were liquid and you could do it, would be to buy repossession property in the US and sell high-end property, like oceanfront. That trade has both legs going in its favor right now. Repossession property has fallen back near 2000 price levels, at least here in California, and is now trading in pretty high volume. The price of oceanfront property is still three to five times 2000 levels, and precious little turnover is taking place these days. This trade also captures the notion that widening income dispersion - a trend that has been running since 1980 and supported higher end property prices - has run its course and has started to reverse. And, by selling oceanfront, you own an implicit call on global warming! Obviously, and unfortunately, this is not a trade that you can really put on, although it does suggest renting oceanfront rather than buying until prices adjust.

What about the US dollar - is the dollar's status as the world's reserve currency on the wane?

The idea that the dollar's reserve currency status is disappearing is something I used to believe in, but now I am not so sure. In order for that to happen, the public sector would have to begin dumping its dollars, or at least no longer accumulate dollars. If the underlying US trade deficit has fallen, then the public sector will likely be accumulating fewer dollars. In other words, faster consumption growth in China and Asia is an alternative to both reserve accumulation and nominal currency appreciation.

My view on the direction of the dollar has also changed. I have been bearish the dollar for a long time. It has been in a downtrend since 1970. But that downtrend was associated with excess US growth, insufficient US savings, and a growing US trade deficit. That process could well be reversing. The dollar looks terrible right now because the US has zero interest rates, which certainly weighs it down, but the underlying elements of the dollar are better now than they have been for a generation. It is already pretty cheap and the US trade deficit is narrowing as households retrench. Further, a US recovery based on infrastructure spending and redistribution of income towards the lower income segments of the population is a growth model that has more domestic spending

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absorption and less import leakage. Add to that the accelerated growth in China, and all of it points to a trend narrowing US trade deficit. So the structural factors for the dollar have improved significantly. The cyclical issue is that interest rates are at zero, so the US has no interest rate spread advantage anymore. The day that you get a rebound in the US economy sufficient to change interest rate expectations is the day that you could get a very powerful move up in the dollar. I abandoned my longstanding bearish dollar stance back in 2004 or 2005 and have been both long and short the dollar since then. I am still officially neutral, but I am leaning towards a bullish bias going forward.

The following is from your chapter in *Inside the House of Money*: "I find it hard to believe I'll ever be bullish the dollar […]. The only reason to be bullish the dollar is if real US interest rates get very high. That would both attract capital inflows and hold back spending and thus the excess demand in the economy..."

Yikes! That is also something we can put on the list of lessons learned: never say never. The crash of '08 created an additional dimension by reducing the US trade deficit without the inhibiting effect of higher real rates. I may have underestimated the power of the crash in turning around the US trade deficit, and thus helping to correct the big underlying structural problem for the dollar. We still most likely need higher interest rates to get a true bull market in the dollar, but the upside potential is much better now than it has been in a long time.

It seems as if there is a big global dollar carry trade going on whereby everyone is long something and short the dollar. As such, could a big dollar rally cause a double dip?

I do not think so. First, the US has a trade deficit, so there has to be a long dollar position out there. Somebody owns a lot of dollars and we know who that is: many of the world's central banks. It is correct, though, that the private sector now likely has a short dollar position, but the public sector is long dollars. Whether any dollar rally is associated with a double dip depends on why the dollar has turned. If it is the 2008 model of falling growth, renewed asset deflation, and a falling US trade deficit, then sure, that sounds like a scenario for a double dip. But if the USD turns because fiscal expansion in the US leads to stronger growth, and an unwind of the friendly Fed policy, then a dollar rally will probably not be associated with a double dip.

The fundamental point here is that the US trade deficit fell in 2008 by considerably more than ever could have been expected, which is new information. Moreover, the decoupling idea seems to have a higher probability than before. Initially, that can create a dollar downdraft for cyclical reasons, whereby the rest of the world grows faster than the US. Structurally, however, it is a big positive for the dollar.

Has anything else changed as a result of the crisis?

Many, many things have changed because of the crisis. In the big picture, it is certainly a mistake to believe that it's business as usual or that little has changed. Some have argued

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that we have experienced a shock and will now return to good old tried and tested models. I don't believe this at all. Rather, the path ahead remains very unclear to me and it depends critically on the outlook for fiscal policy.

If you were a deflationist before the crash, then you really have to accept that the speed and extent of the policy reaction may have changed the outlook. It has to have changed things at the margin. Holding on to old views and failing to acknowledge this change seems rigid and dangerous. Equally, those who were caught bullish growth and long equities into the crash should also have learned a valuable lesson. Being proven wrong provides great information content. This is perhaps the greatest lesson of all from the crash: change your views as facts change. It is important to recognize and accept when things don't work out as you expect. If you are proven wrong, adjust your outlook accordingly. To persistently hold on to views, regardless of changing reality, is a recipe for failure and constant distress.

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