Transcript: Praying for a Miracle: Coronavirus' Black Swan Risk

Featuring: Raoul Pal

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Synopsis: Will the coronavirus cause the everything bubble to pop, trigger a global economic depression, and be the impetus for major systemic changes? Raoul Pal of Global Macro Investor argues that the current coronavirus outbreak could be the "biggest economic event of our lifetimes." He reveals his analysis of the real risks presented by the coronavirus outbreak and the ensuing response for people, markets, and institutions. He compares the COVID-19 outbreak to the Spanish Flu from a century ago – pointing out the important similarities and differences. He connects his doom loop thesis to the Black Swan risk that coronavirus represents to the indexification of markets, the coming retirement crisis, and the everything bubble. Finally, he shares his thoughts on the impact a global event could have on gold and cryptocurrencies and shares his hope for a better future bourne of the COVID-19 chaos. Filmed on March 4, 2020 in New York.

Video Link:

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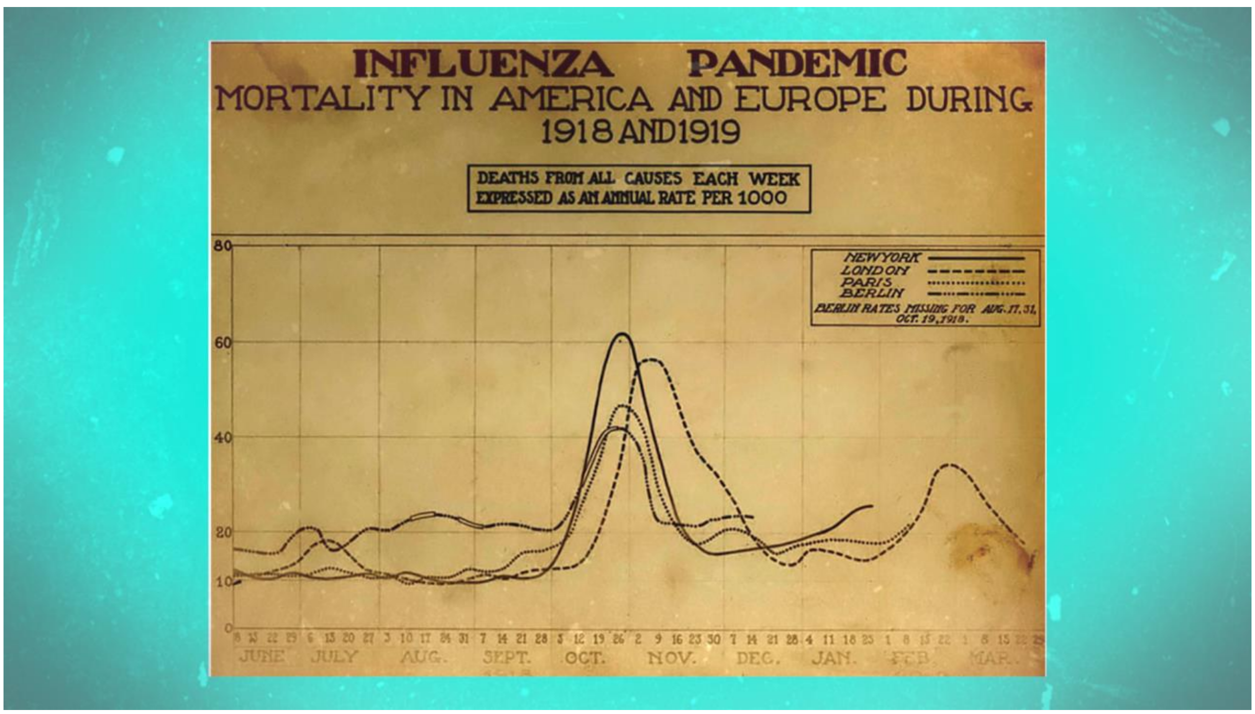
RAOUL PAL: Hi, I'm Raoul Pal, the CEO and co-founder of Real Vision. Today, I'm speaking you as Raoul Pal, CEO and founder of Global Macro Investor, my research business. I'm not really a superstitious man, but I'm actually praying for a miracle. You see, I'm concerned that we are going into what may be potentially the biggest economic event of our lifetimes. I don't say that with some sorts of sensationalism, I'm saying it with a reality of what's happening on the ground.

You see, there's a narrative that's going around about the coronavirus, which is that split off is it's just the flu. That's not strictly the case, because its death rate is obviously much higher than the flu, in fact, 20 times higher. It's not about all of that. The comparison, the arguments about it being the flu is something completely wrong. You see, it's a pandemic. It has known attributes in terms of its spread rate, its death rate and a number of other factors.

We can compare it to the Spanish flu. There's a number of reasons why it's similar, but there's some differences as well and key differences. In 1918, there was a pandemic of the Spanish flu. The Spanish Flu infected 27% of the world's population at the time, and it killed about 30 million people. If I look at the numbers, that was about a 6% death rate that came out of that. There were different estimates around it.



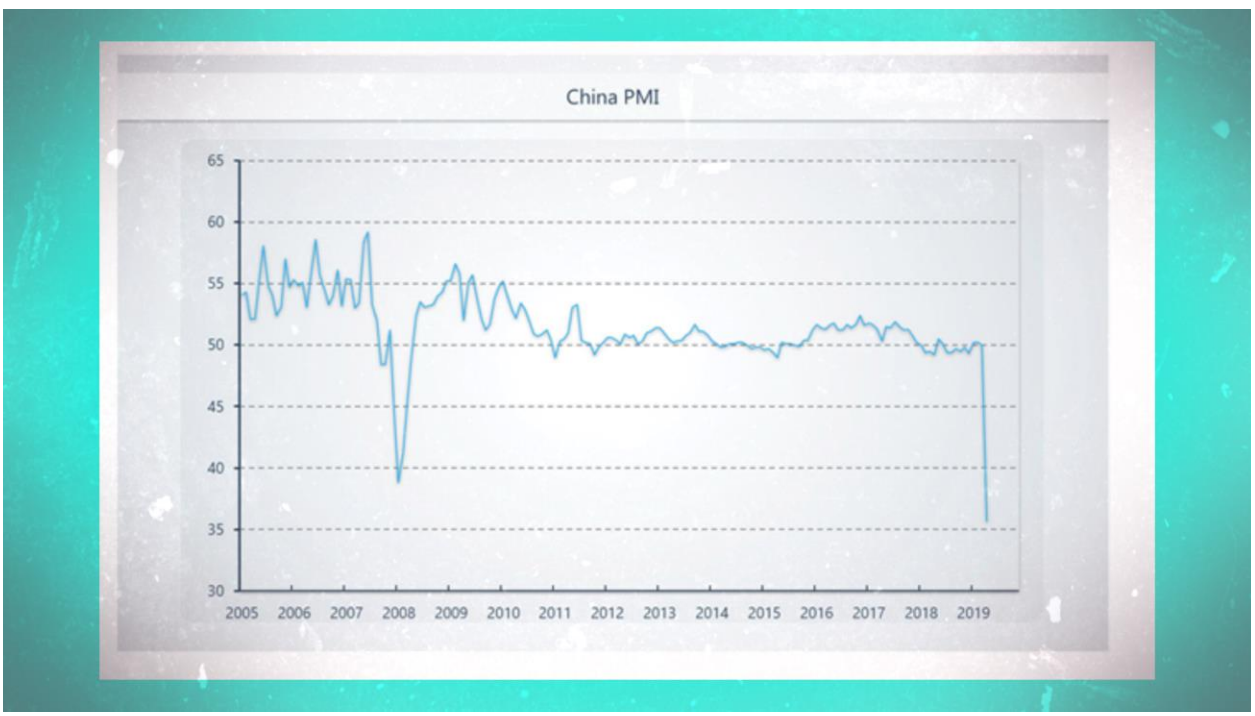
At the time, we know that conditions were terrible after World War I, the medical situation was stretched, troops were returning home so there's big mobility of people and that was what caused a lot of the spread. We didn't have the modern medicines, but here we are with the coronavirus. The coronavirus has a death rate, as of yesterday, of 3.5%. That is taking into account all of the modern medicine that we have, and all the treatments that are available.

The coronavirus spreads faster than Spanish flu, the Spanish Flu spread with an arrow of somewhere around 2, the arrow of the coronavirus is somewhere closer to 3, maybe 4. We're not even sure of the numbers, but it's much more virulent as an epidemic and a pandemic. The numbers back out that if the same situation were to occur, considering we're in a less rural, we are in a hyper mobile globalized world of plane travel, if we will back out those same numbers, then some 2 billion people will catch this flu and 68 million people would die. That is a truly terrifying outcome.

We can assume that's the worst case situation, because that's what happened in the Spanish flu. From that, we can look at, okay, what's going on in China right now is that the rate of spreading is falling. That's a really positive sign. Why is that? Why is it falling in South Korea now, and why is it falling in Singapore? It's pretty simple. It's because the Chinese took truly extraordinary measures like nobody's ever done before I think in world history where they basically closed down the largest nation on Earth and stopped people moving around for about three weeks.

The truly extraordinary measures of building new hospitals treating as many people, testing people as possible meant that they were able to keep the rate of the virus growth under control. We all think that the numbers are not factual, that they're much worse but the death rates seem to have been backed out from hospitals. That seems to be accurate. What seems to be inaccurate was the number of people infected.

The Chinese, what seemed to be an extraordinary thing, realized that how fast this was spreading, this is a very, very fast spreading virus, that if they didn't do this, they would end up with something much worse on their hands, something that they couldn't politically deal with as a nation. Those extraordinary outcomes led to the shutting down of China. What they decided essentially, is they were going to take the utmost economic pain for the benefit of the population, and they've set the precedent.



That meant that the Chinese economic indicators, stuff like this just come out like the PMI showed the largest fall of any economic indicator I've ever seen in my working career or any time before it through when I look back in history. The complete halt of the Chinese economy was something truly extraordinary. It's going to take a long time to recover because there is a human element where people don't trust each other. They don't trust getting together in large groups. They don't want to shop as much. They will do the necessary, some of the factories will reopen but not everybody's going to return to work in the same way. It'll be slow to restart.

While that's happening, something worse is happening. China could have dealt with this on her own, but then it spread. It spread, as we saw, to South Korea who's done a truly extraordinary job to test thousands of people a day, quarantine them, sorted out, get the medical system fired up. Singapore has been truly extraordinary with this.

Then it spread to Iran, and Iran was unprepared. It didn't know the virus was there, it had no links, and it truly exploded and it continues to explode. I think there's something like some 20% to 50% of the government itself, now have the virus, and something like 10% of all government officials have the virus. Doctors are being infected, the death rates are exploding and the WHO have had to raise the death rate because of what's going on in Iran.

Then it went to Italy. We think it came from Iran, and it may have come from China as well. The rate of growth in Italy has been again, extraordinary, exponential growth rates. It's starting to tail out but it's still growing at about 50% a day right now. Italy infected Spain, France, and that's been going on and they've also had infections elsewhere. It's spreading fast. It's spreading in the UK. It's exploding in Germany right now.

We have an economic situation, firstly, a health situation that is turning somewhat dramatic. The worst thing is the economic situation, the only outcome if you go back and remember what the Spanish flu did, and those would be incremental deaths, on top of all the deaths that we have from car accidents and wars and the flu and cancer, there's incremental deaths of 68 million. To avoid that, every government has to take extreme actions, and they haven't started yet.

When I look at where we are, and I'm going to bring this back to markets, is I've been driving this narrative for a while as you know, I said that this is one of the worst things that I'd seen and the market hadn't understood, that people were going to panic. I've been writing about him in Real Vision Pro and Macro Insiders and also the Global Macro Investor. I've been active on Twitter talking about how the panic phase needed to come first.

What the panic phase was, was people understanding that the Chinese impacts were a global economic slowdown, they will going to knock the world into recession of some shape or form. That was what the bond market was sniffing and I already thought the world was going into recession, as you know, hence was very positioned in bonds but when I saw this, I knew that this was going to drive rates to zero. That seems to be playing out rapidly as we speak.

The situation now is that each country is going to start upping its testing and it's going to start having to quarantine large groups of its people. Boris Johnson said the right thing yesterday in the UK when he suggested that they may have to quarantine the entire country to try and shut this down as fast as possible. He's talking that their worst case scenario planning is 80% of the population get it and that 20% need hospitalization. Hospitals can't deal with this. Nobody can deal with this.

This period of testing is the key element that I want you to focus on now. We've had that fear moment. We all know it's bad. We're all starting to wash our hands more. We're all starting to be a little bit more cognizant of the environment that we're in. The markets reacted initially to that. Then as expected, and something I've talked about, the Federal Reserve came in and cut rates, the RBA cut rates. I think the Bank of Canada cut rates today as well.

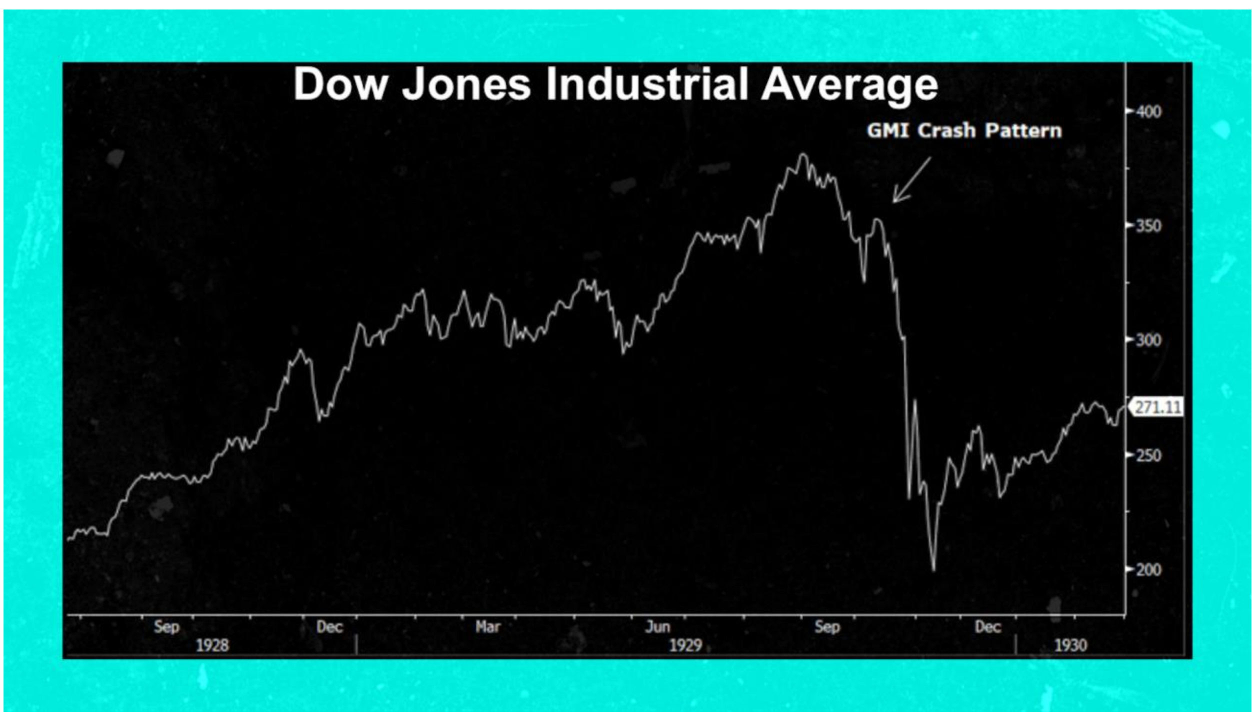
There's a monetary stimulus to try and stop the panic in the markets. The problem is the panic is real. The next thing that has to happen is the United States has to come to understand the role it is about to play in this. The US, up until last Friday, had done 500 tests for coronavirus. They've not screened at airports except direct people coming from flights from certain affected countries.

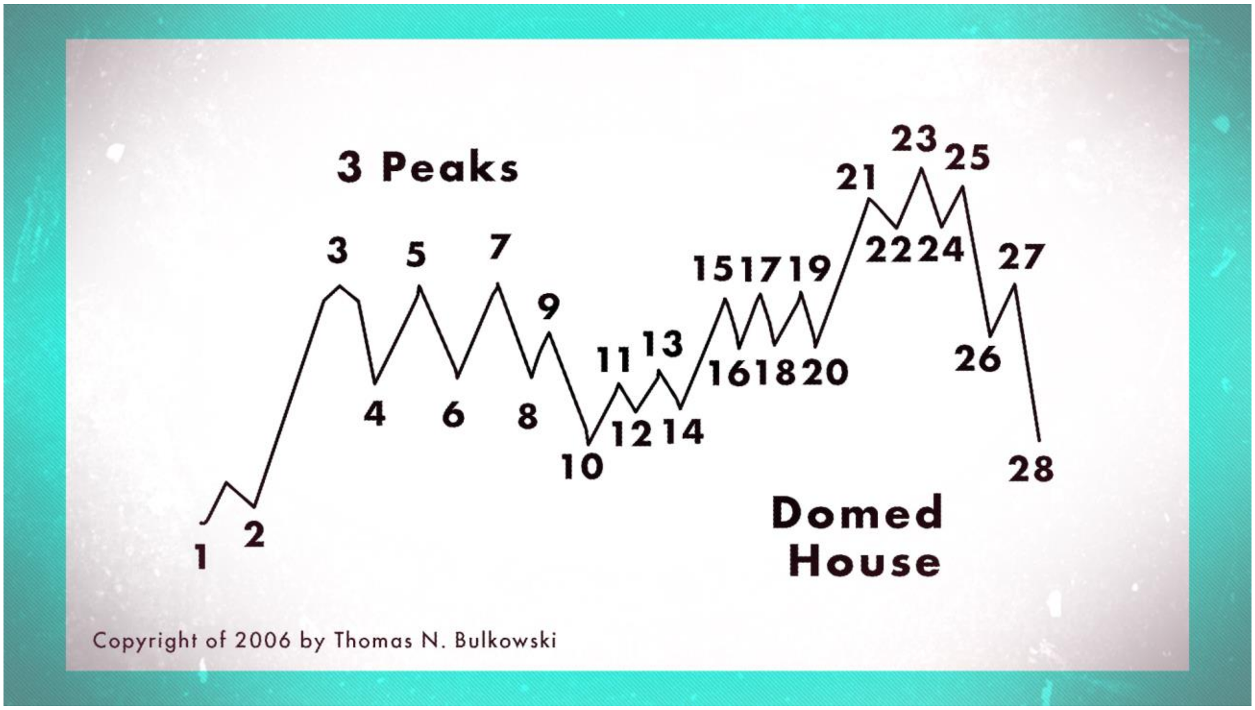
Suddenly, we're finding unconnected cases all across America, and mutations of the coronavirus that suggest that it's been here for at least three weeks and its numbers are pretty big and growing fast. Yet to the day, there's still not a lot of testing. Why is that? Well, let's see, there's an extraordinary situation of regulation between the CDC and the FDA, you had to approve the tests. When it was announced that this was a national emergency, it meant that only the CDC were allowed to approve the testing. They only had one testing center in Atlanta, and that was immediately overrun.

Then, kits were issued to hospitals, but they weren't able to use them because they were found to be faulty. Then they allowed a larger group of hospitals to be able to start doing the testing that again, they didn't have the kits to do it so that only some testing took place. The CDC was basically having to control all of the testing still and approve it all. Only on Saturday, did they changed that ruling to allow hundred or more places to start testing for coronavirus, not everybody has the kits in place, that's being rolled out.

When they start testing over the next two to three weeks, and Italy starts testing further, Spain needs to start testing. The UK needs start testing. When all of these tests are swinging into action as everybody is doing, we're going to see the cases explode and potentially in America more than anywhere else, because they've been the slowest to do anything about this. I think the irresponsibility of first passing the narrative around that it was the flu and then not resolving a simple regulatory issue is one of the biggest mistakes that a government could ever have made.

When the testing starts, we're going to see the numbers explode and the markets are going to shift themselves. The setup currently is what I refer to in the equity market is the GMR crash pattern. That's when you have a sharp fall, you then have a rally back that fails to take out the previous high and then the rally peters out and takes out the recent low and then escalates.





The most classic example of this crash pattern was 1929. Again, I'm not necessarily saying this is 1929 all over again, but I don't think that that would be a bad example of what could take place. Again, these are not necessarily forecasts, I just want you to understand the magnitude of what I'm talking about.

The next phase of this goes to the really difficult phase, which is true panic. I'm in New York right now. There's nobody wearing a mask, and nobody taking any evasive action. That started in San Francisco, started in Seattle, nowhere else yet. That is going to change everybody's behavior pattern overnight. We're going to go to less restaurants, people are canceling flights already, conferences are being canceled, people aren't going to travel.

The economic impacts are starting and they're only going to grow. That will bring a sense of panic. That sense of panic in an election year creates a sense of we have to do something. Governments have to take outsized actions. We're going to suddenly see these numbers exploding and governments are going to be under pressure to start quarantining whole parts of the country. Whole parts of the country going to be shut down, all businesses are going to end up with people working from home, self-quarantining.

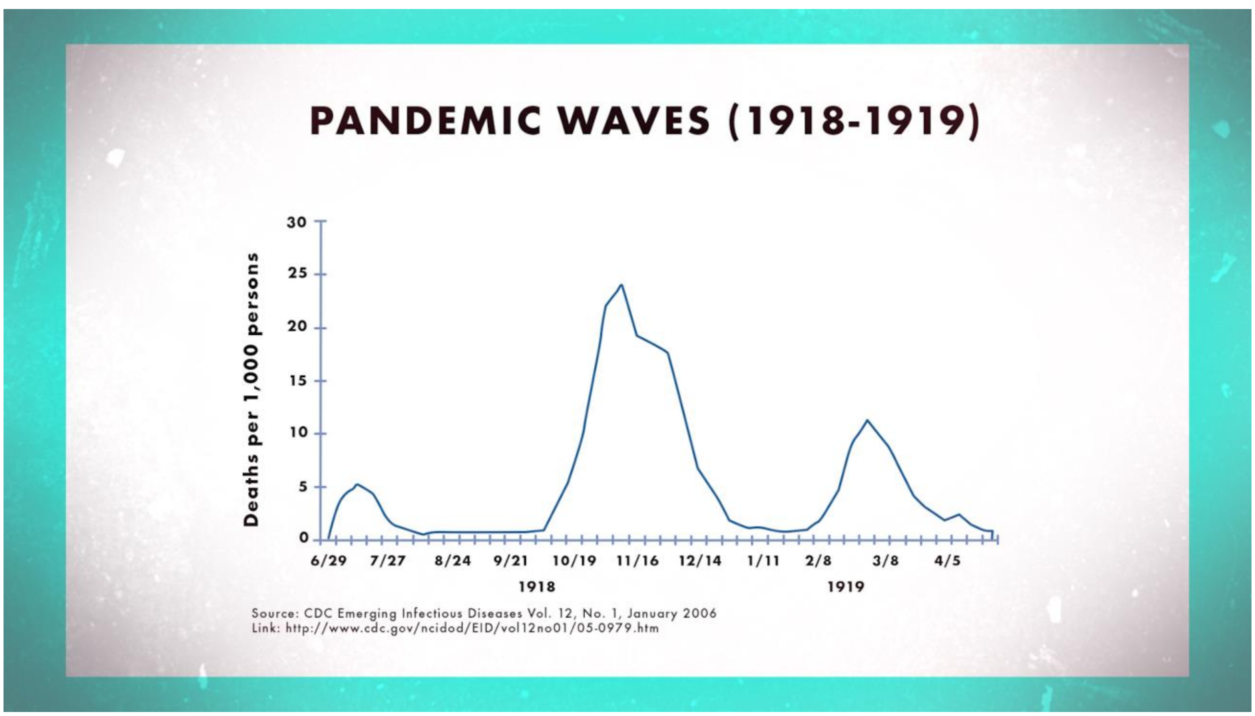
It's going to be one of the largest potential economic shutdowns the world has ever seen. I don't see a way around it. There's going to be a reality also coming up in the next few weeks of the data from February starting to filter out into the economic data. People are going to start to get a sense of how bad this already is economically, but not including where it's going. When you take into account what has to be done to stop this virus killing so many people, we're set up for what is, I think, probably the biggest economic event of our lifetimes.

That brings me back to the beginning of why I talked about a miracle. There are potentials for a miracle to take place here. The miracle in SARS was it didn't spread as fast and it was highly seasonal. The problem is CoVid has shown to still have an arrow above 1 in one countries like Singapore, the arrow above 1 means that even in hot times, it can still replicate and move forward through the population.

Over the summer, you could start to see a low, we could have a miracle, and the seasonality could suddenly kick in so strongly because we get a really hot summer, and it kills off the virus, and we escape. Between now and the summer starting, the governments are still going to take action. We've got a really horrific economic period to come, where nobody's going to fly, nobody's going to travel, restaurants are going to close down and it's going to be economic pain, like we have not seen for a long time.

This first phase would be the economic pain that we saw at the height of 2008. That's the level of pain of this first phase. If we don't get a miracle, then we got to something different which is it goes into something much larger, which I would refer to as a global depression. Because if the arrow does not diminish over the summer, if there is some miracle that doesn't spread across America for some unknown reason that it remains contained. If that doesn't happen, then the next phase kicks in behind that.

The next phase is where the southern hemisphere breeds the virus over their winter and developing countries breed it, because it continues to grow with an arrow of over 1, while the West has been trying to shut it down. Western populations with this old population are particularly at risk here, hence why the outsized responses. As this starts to take place, the likelihood of a repeat of the Spanish flu comes front and center where it came back in the late summer with a vengeance and exploded across the world, and that's when the death rate exploded. That's when it really covered most of the world and reach 27% of the entire population.



The problem is these are tail risks that I can't price. I just don't know, what is the probability of that miracle. I do know the probability of between now and the summer of having a truly awful period of global economic growth, where the world shuts down, where there's panic and fear amongst people and where the markets collapse, where bond yields go to zero, as all interest rates are cut to zero to try and stimulate, and governments scramble to try and think about how they can get together a fiscal stimulus that can actually have any impact in a situation like this.

I fear in that situation, if it's short enough, we won't lose most of the world's airlines, some of the world's insurance companies, and some of the others that had its tourism industry, the cruise industry, the restaurant industry and several others. We might be able to save them if it's short and sharp, and something recovers. The markets were going to have to discount a really severe slowdown. We don't know how it's going to affect the southern hemisphere over their winter. Maybe Australia gets it badly. Maybe South America gets it badly. Maybe it rolls around the world.

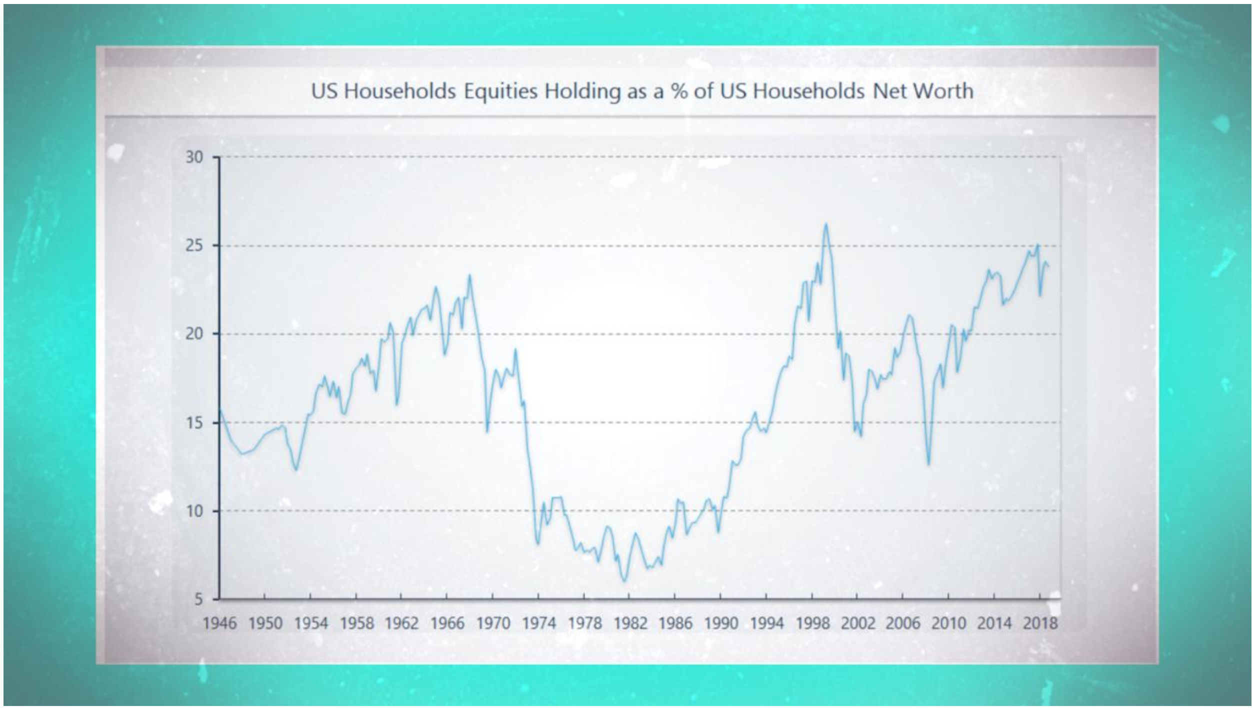
If it does, then we come into the late summer. I think the markets will have figured it out at some point over the summer that this is going to be worse than we expect and we will see a much larger economic outcome where we really see governments having to do everything possible around the world as growth shuts down to essentially zero. That is my fear. It's not a situation I ever thought I'd talk about or even consider. This is a true Black Swan event.

We all knew a pandemic was due, and we thought, yeah, that'll be terrible because lots of people die. Here, we've got one where in theory, not that many people die, because it's only 2% but the numbers add up so quick because we're a big world right now. We're so global that it spreads incredibly fast. It's very latency is something that we didn't quite imagine.

We've got a situation that markets just simply cannot deal with. We as humans can't deal with the probabilities and outcomes of this, even here at the Real Vision offices, we've been talking about this. What does it mean for us? What does mean for our business? What does it mean for our parents? We are going to have to start working from home. What does it mean?

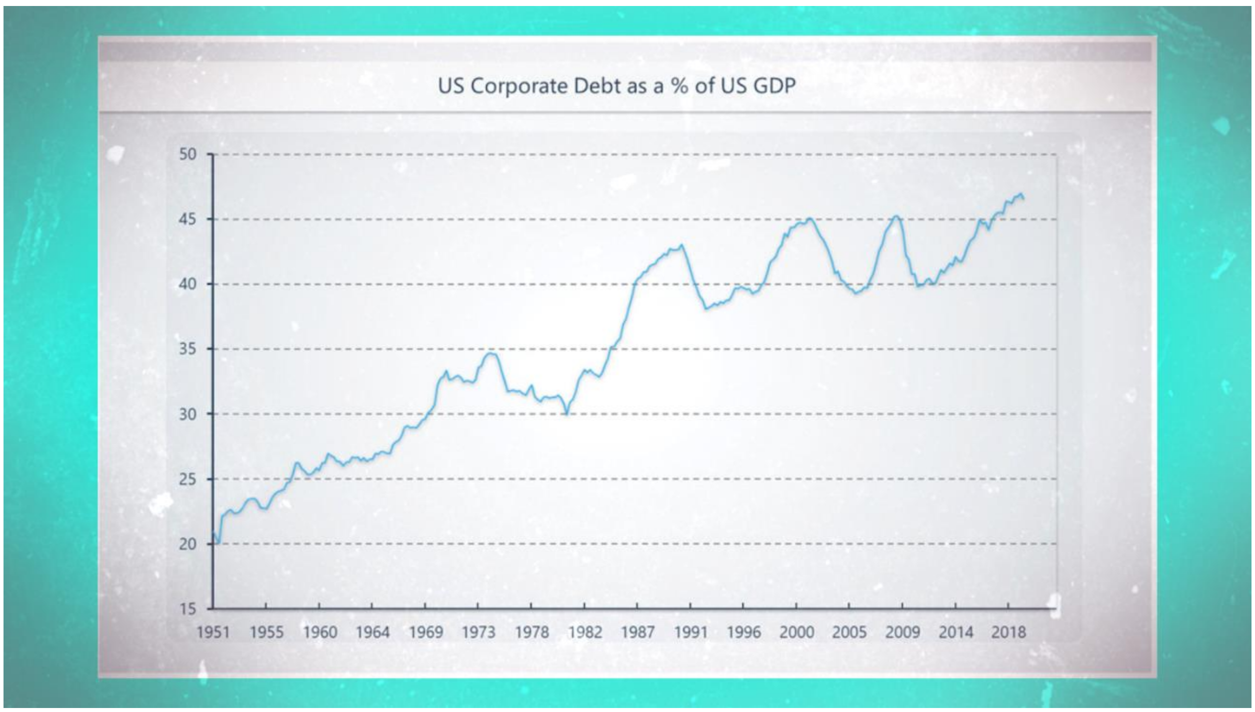
That uncertainty is not what drives markets. What does that lead to markets? Because I've talked about the rate trade, as you all know, the reality is that this sets up I think, the doom loop and the pension crisis and obviously, I have spent a good few years of my life trying to prepare you for this. If there is a probability of this event happening, it is now.

The pension crisis, if you have a virus that affects all the people, age over the age of 60 and they are our baby boom population of 76 million the United States and have several hundred million around the world, it is a virus that affects them the most so the fear is the highest amongst them. We already know that they own too much equity and too much credit, far too much and so the markets are likely to fall sharply over the next coming months.



The propensity for them to want to protect their life savings so they can retire it's going to be extremely high because they're going to be extremely nervous. That kicks off the selling that I didn't really want to see, which is as the pensioners panic out of positions and then have to crystallize losses, which has a forward economic impact, which is very large that I've talked about in the past. It means that you lower the trend rate of future growth as retirees crimp consumption going forward for the rest of their lives, as they realized they don't have enough in their pension savings.

There's another dynamic at play here, which is the doom loop which concerns me even more greatly because it hits the pensioners yet again. The doom loop is essentially that US corporations, due to a ridiculous tax regime, buy back their own shares and issue records amounts of debt. They're the most indebted private sector economy in the world, it's the US corporate sector. The amounts of debt outstanding are staggering, but it's been serviceable because hey, they've been making supernormal profits because they haven't been paying people a lot.

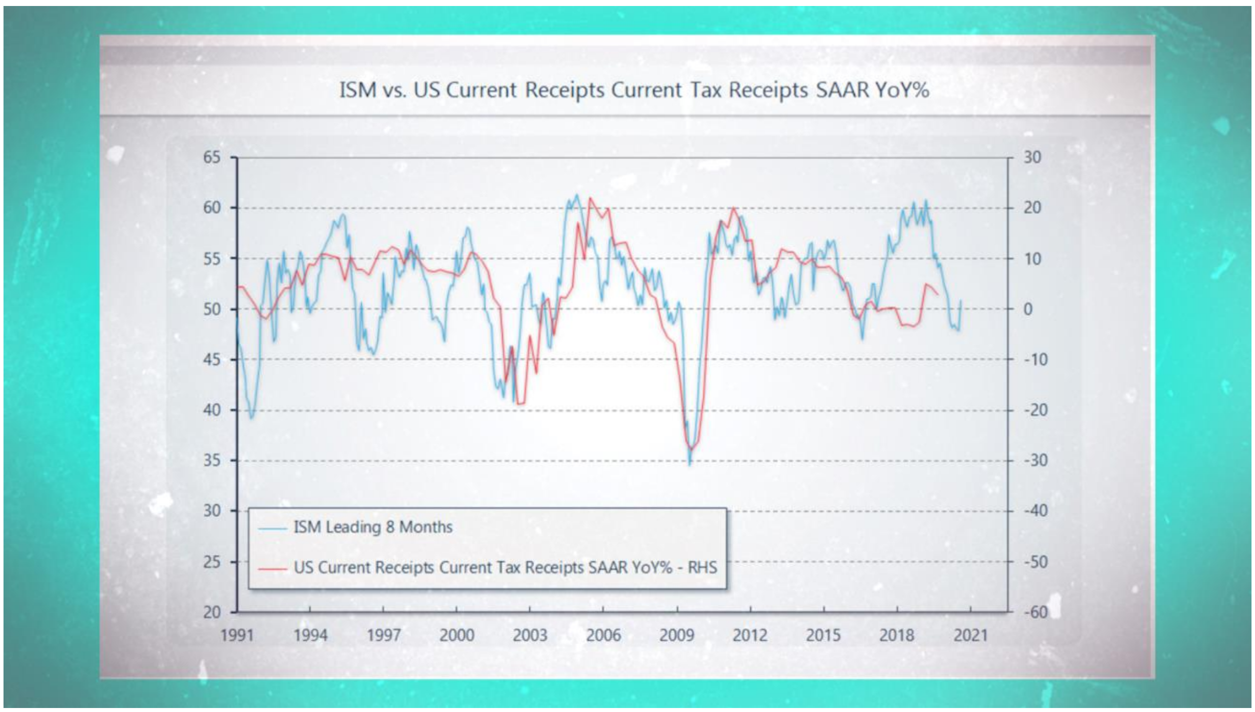


They've been making supernormal profits. They've also been issuing themselves stock options, the management teams, and then driving up their own share price making themselves rich, patting themselves on the back while issuing more and more debt. It's the fact that we were in the upstage of the business cycle meant that they could service this debt. The problem is corporate cash flows and corporate profits are almost entirely correlated to the business cycle. In fact, they are the business cycle.

As the business cycle turns negative, which at 100% is turning negative, then corporations are the only buyers of equity in the entire market. Every single other sector of the equity market is divesting of assets. These guys are the only buyer, their profits and their cash flows are going to go negative, and they're going to leave the building. There is no buyer of equities into a panic selling by the baby boomer generation and general fear from market participants overall, into an economic slump of some magnitude, which could be a really enormous magnitude.

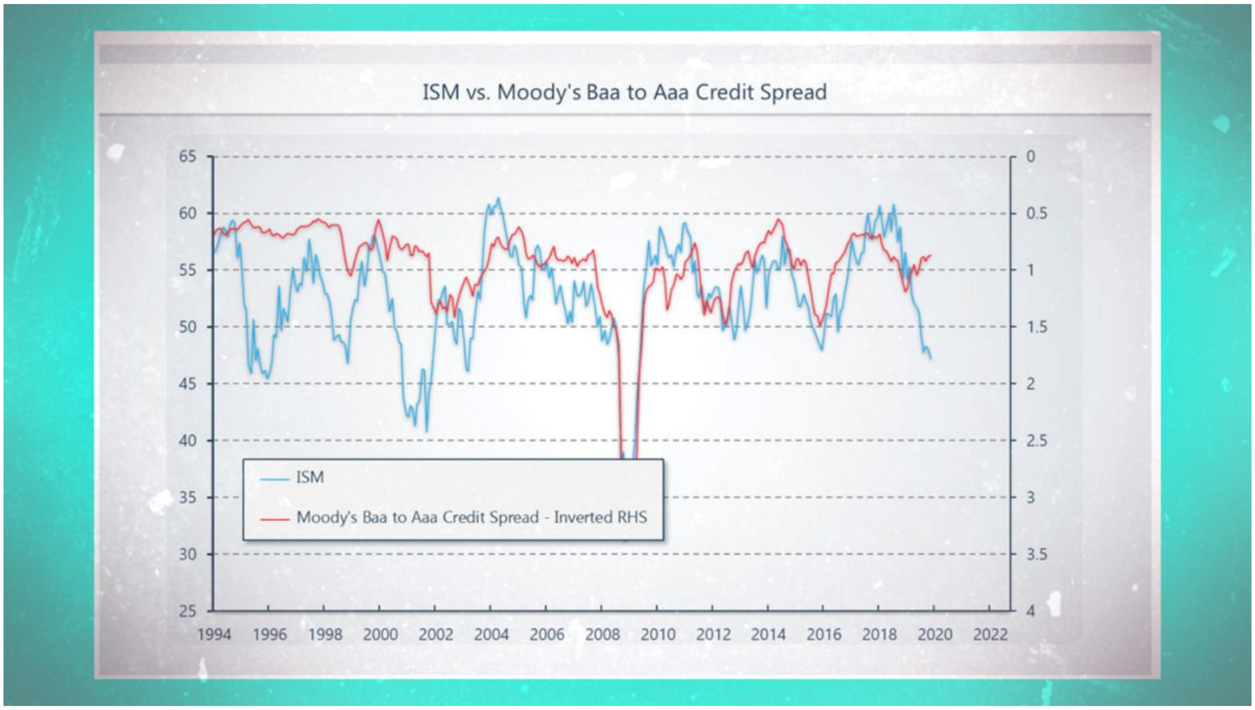
We've set ourselves up for that event that so many people in Real Vision have talked about for so long, which is the liquidity of markets and when the inflows tend to outflows when indexation goes from being the great thing that lowers your cost of your pension plan by 0.2% to suddenly becoming the asset you can't get out of. That's one side.

The other side of the doom loop is the corporate credit market. The corporate credit market has one main buyer, the main buyer in that market is the state pension plans. The state pension plans have increased their taxes to pay for the holes in the pension system. Those taxes are going directly into the pension plans. Those managers are buying corporate credit, because it has some safety, apparently, and it has some yield over treasuries. They're desperately trying to close the funding gap, and then they're taking risks elsewhere. This is a core basis of an older person's portfolio, is in corporate credit, it is in Europe, too.



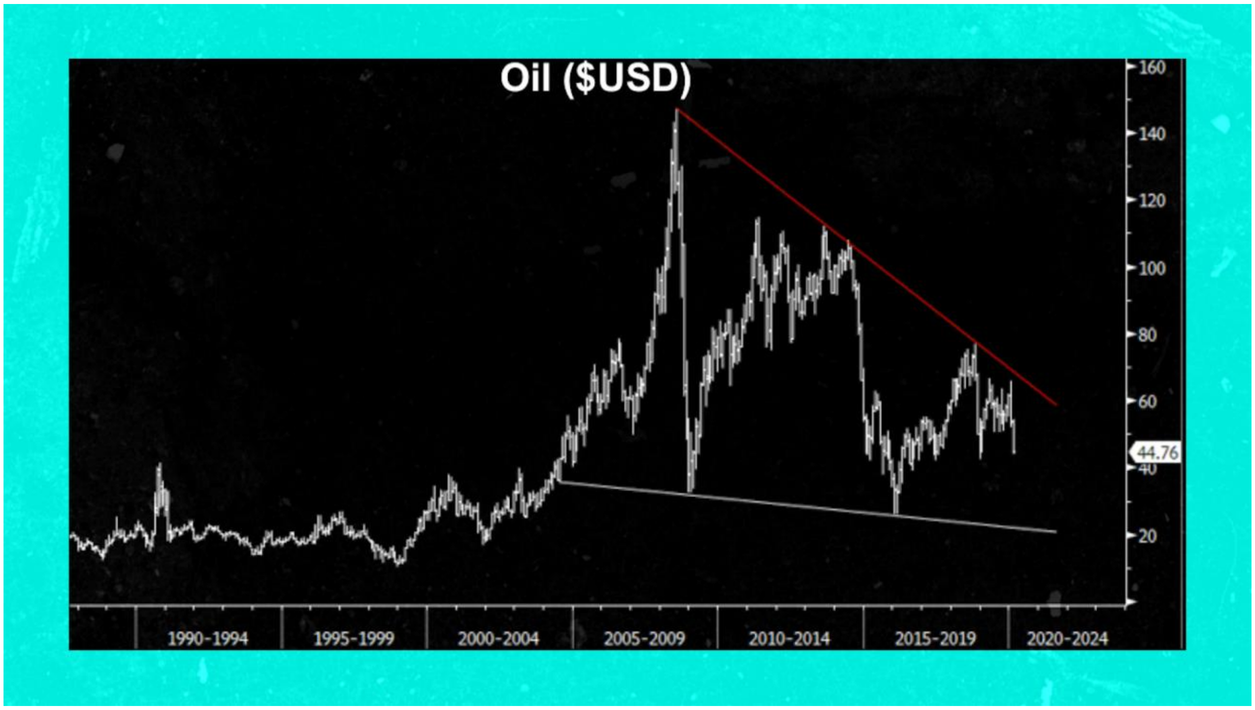
The problem is the buyer of this is the tax receipts. Tax receipts are correlated to the business cycle. When the business cycle goes negative, people lose jobs so people earn less. What happens is tax receipts fall, and tax receipts falling means no money goes into those pension schemes, because there's no money to go into them.

If that's the case, there's no buyer of corporate credit. You have no buyer of a equities and no buyer of corporate credit, corporate credit becomes extremely risky because the amount of credit outstanding and the fact that so many of these giant companies are teetering on the edge of being downgraded from BBB into junk bond status. Something I've talked about before, where the junk bond market is not able to cope with the amount of downgrades that could come.

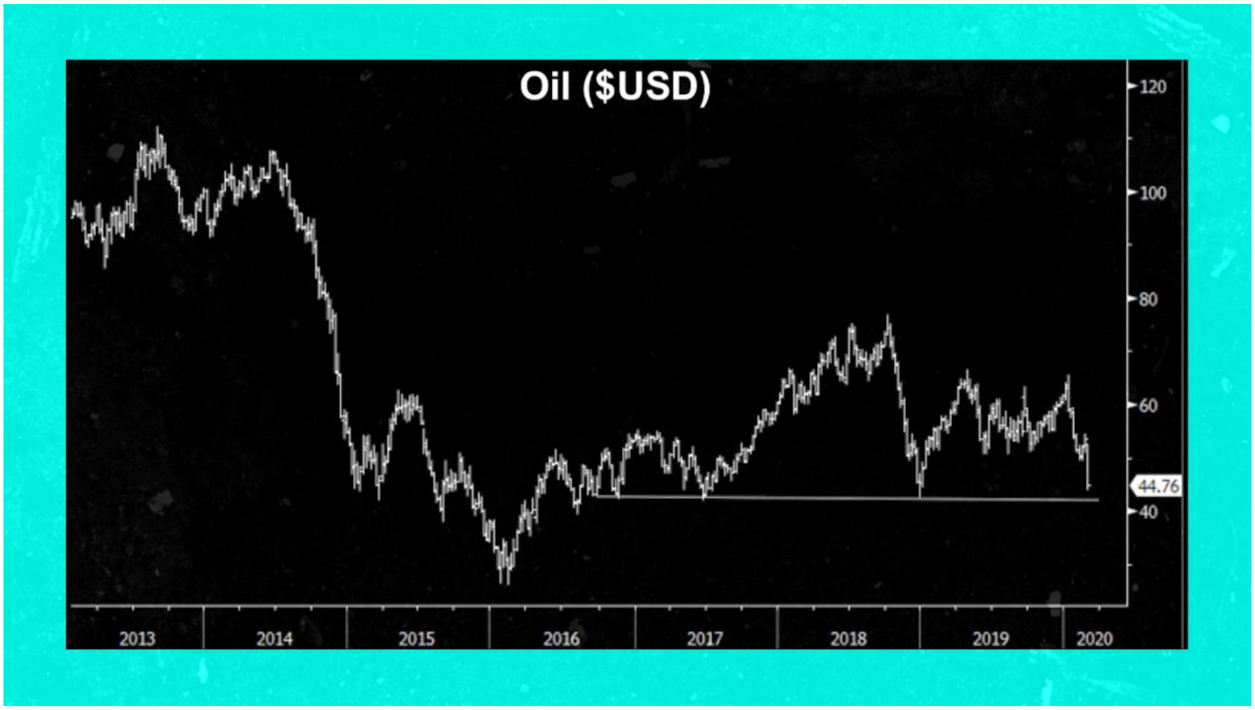


The other problem is if we look at the people who are in the main BBB sector, we're talking to two car companies, Dell, General Motors, General Electric, those five company, and AT&T, six companies. These are really big companies. The chances of them getting caught out in the selling wave that comes from what's happening on the equity side of the equation means that as their share price falls, they get closer to getting downgraded. Their market cap and debt equation starts getting scary and their cash flows dry up.

The car companies are going to get absolutely killed in the environment that's coming. Car sales in China were down 90%. I think that's about two months running. Also, just the use of cars collapses over this period. The price of oil obviously would collapse over this period, and I think oil probably goes to $20 a barrel, which is something I've talked about for a long time.

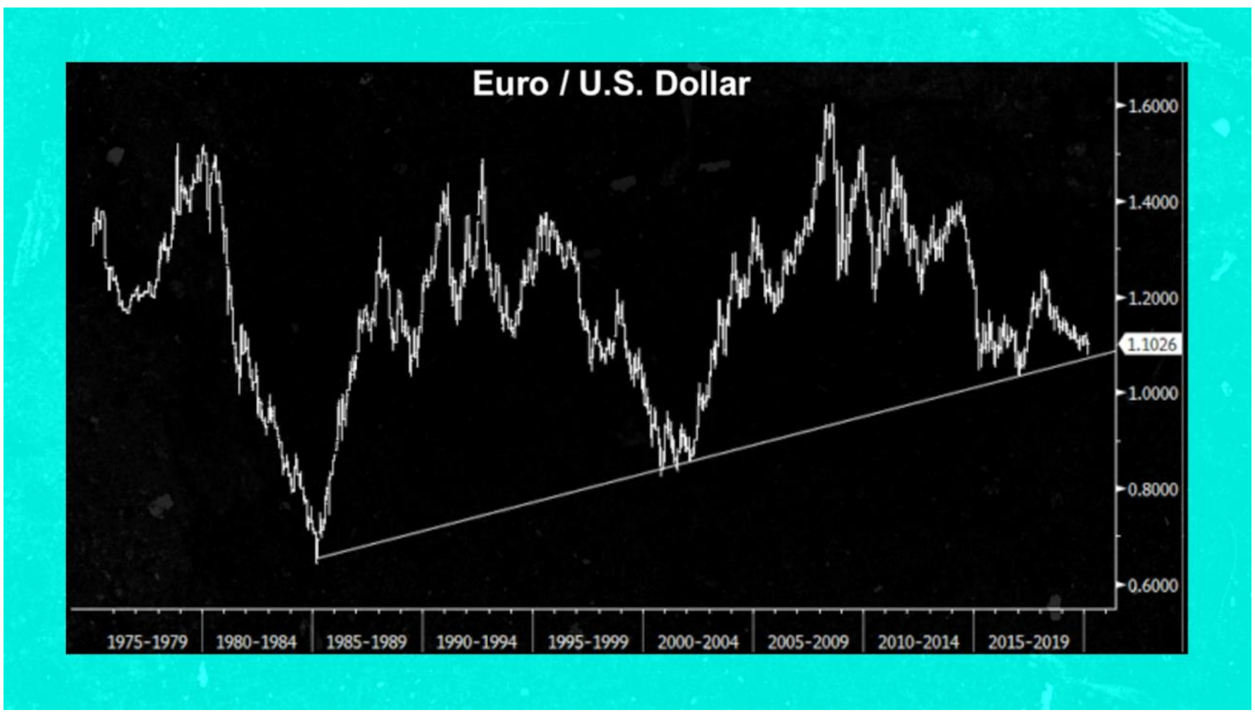


We have a very, very, very dangerous setup coming out of the doom loop, out of the retirement system, and out of the downgrades of corporate credit, and that's a precarious situation because we have markets like the oil market, which recently tested its $42 head and shoulders pattern. If that goes, then all goes to $20. If all goes to $20, all the shale guys are out of business. Their business model has been pumped more as the oil price goes down just to cover cash flows. That suddenly gets to bankruptcy very fast and we'll see the junk bond markets explode on the back of that because many of those players are junk already.



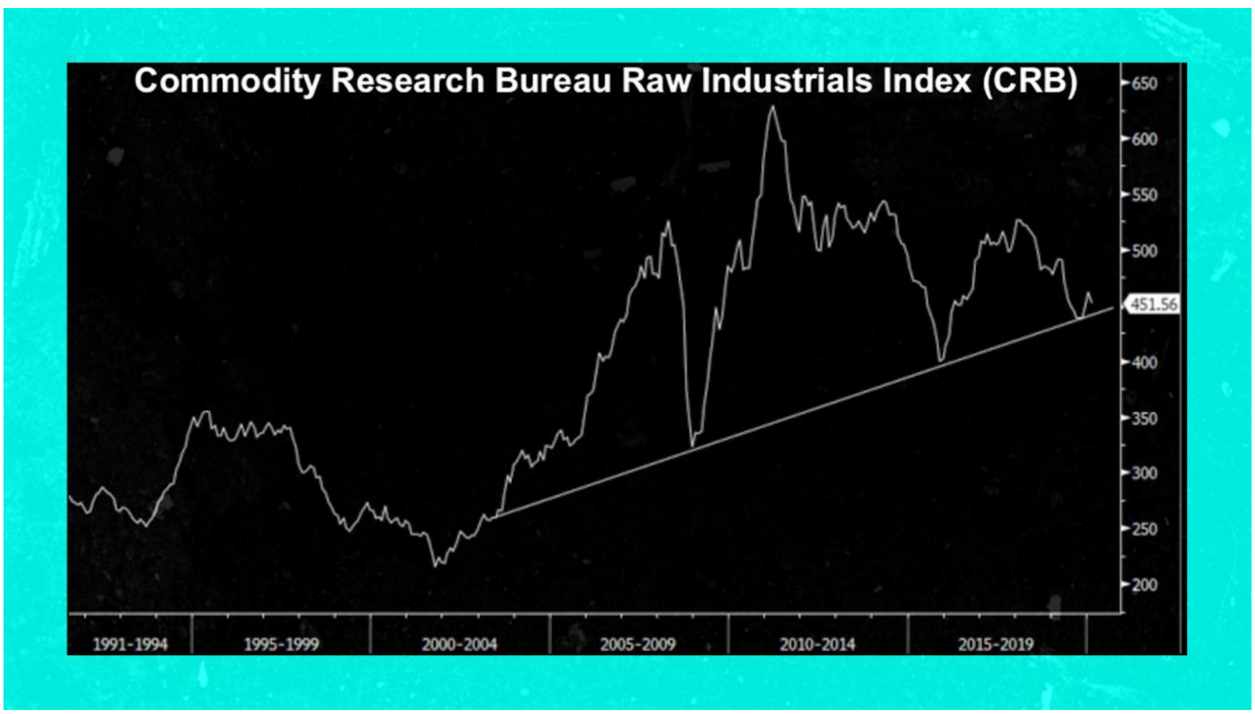
That's a big problem to come. I think that if oil drops, then that is going to start putting pressure on many other economies, whether it's Brazil or whether it's the Middle East. I think that's a big issue that could come out of this. I think the World Trade slump is a huge dollar funding issue. The dollar has been thrashing around for various reasons, including the fact that the Euro has been part of the funding trade, the carry trade where people have borrowed euros and bought other currencies, something like that got unwound, but I have a tendency to believe that this is very bullish for the dollar and dangerously slow because I think the dollar is a global wrecking ball where if the dollar goes higher, it kills global growth.

I'm worried about that dynamic in the middle of this. I think that while there's speculation that the G7 is worried about the same situation, and can they do anything about it? I honestly don't think they can, but let see. As I said rates go to zero, I worried that the equity market forms the crash pattern, and that we have a horrific period from now into the summer. Then we can see past that. Let's see what the economic growth is like, let's see the spread of the disease. Let's find out what we know.



I think there is a huge trend line in the Euro that it retested at 1.07, if it breaks 1.07, I think that's the biggest level in the history of the Euro and the Euro probably goes to 80 cents or 70 cents. I think we're seeing equivalent breakdowns across many of the currencies. Things like the Brazilian real, the Korean won are all breaking very serious levels. I think it's almost impossible for China not to lose control of their currency or devalue it. The reason being is they managed to do it when they had a crisis, domestic demand crisis because dollars were not flowing out of the country because China was in shutdown to actually help them.

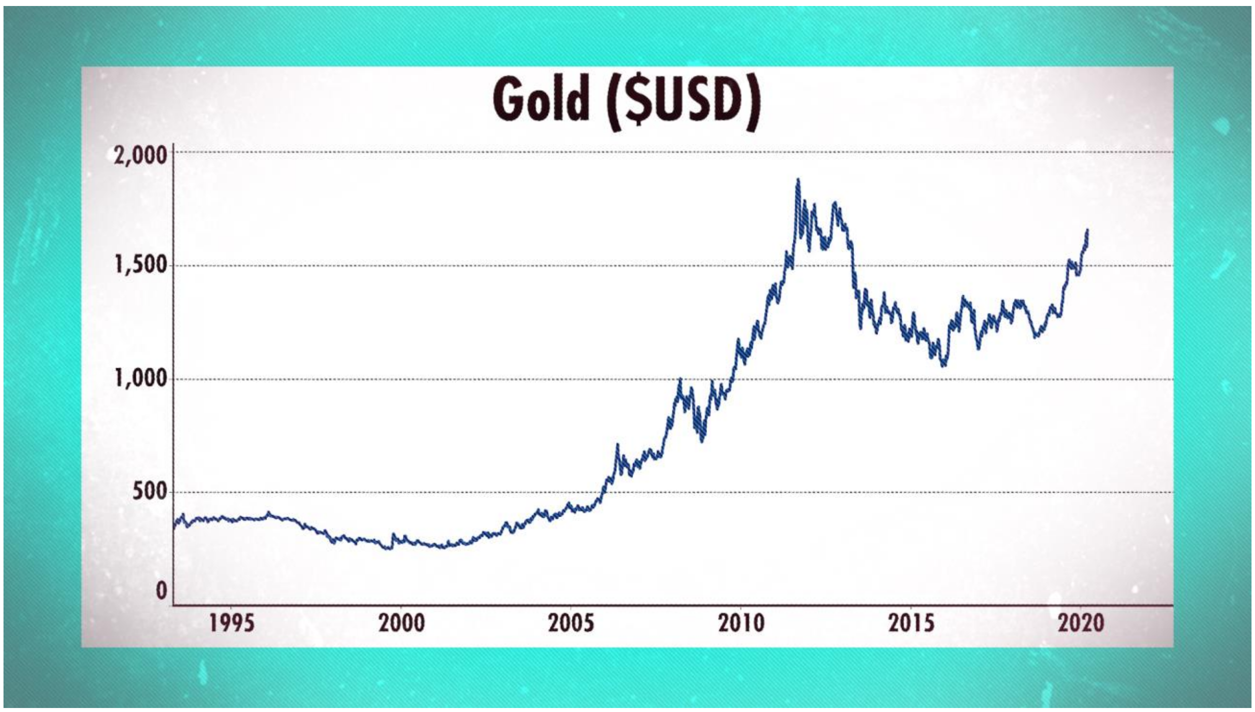
The problem is they are now starting to open up and they want to export because they need dollars. They need them fast. The rest of the is about to go into recession. There won't be as many orders. The ability of China to maintain its currency here, I think is close to zero now.



I think that gets interesting. I think the industrial metals complex is very interesting. I think that copper will break lower. If I look at the CRB index, it's breaking the largest head and shoulders top I've ever seen in the industrial complex and suggests that the whole commodity complex is going to go through a huge deflationary bust. There's more of these and I think I don't want to overwhelm you with stuff that I could show you, but the point I wanted to get across here is that we are looking down the barrel of a gun of what could be the biggest economic event of all of our lifetimes. We better start praying for a miracle, and you also better start planning around your retirement savings or what you're doing.

If you want to trade this, I think they will shut markets at some point. We've all seen that before. They shut them in China at some points, but they're probably going to do it again. Just be cautious but there is money to be made out of this, which will help cushion for any other losses you'll get overtime. Good luck out there. I'm sorry, it's a bit grim. I'm not trying to be grim. I'm just trying to be realistic.

It's the problem is I didn't expect what I thought was going to be a recession that had a tail risk of something bad to now be a bad recession with a tail risk of a full depression and the full blow up of everything that we know. I'm just going to leave with gold and Bitcoin because those are the two other assets I talk a lot about. Gold struggles when it comes to people needing to liquidate positions, it is still very overpositioned. That worries me.



It is trading well after the recent correction. I'm not sure. I'm a little bit cautious myself on gold. I don't really know. I have some longer term gold positions, but trading is not my clearest bet. I could be wrong, because obviously fiscal stimulus and massive monetary expansion is clearly closer than I thought. I thought that was going to come in next year after the election, but I think we're going to be talking about it in the summer.

Maybe that is the thing that ignites gold. I also think the role of cryptocurrency in this world I think, I've talked for a long time, as you know, that I think there is a parallel financial universe being created from the hive that is creating everything the digital revolution in everything from FinTech to ownership to legal and everything that's going on in that crypto world. We call it the Bitcoin world, but it's clearly 50 times bigger than that. There's a parallel universe being it's not quite ready to take him the financial system, but it's being built. I think Bitcoin is that call option on that. I think even seeing pictures of the Chinese burning physical notes, because of infection rates, will drive people towards the digitization of money much faster than we imagined. Because in this modern world, it's the way forward.

Yes, there's going to be digital currencies from governments. There's going to be independent currencies like Libra and corporate currencies like Libra and there's going to be truly independent currencies like Bitcoin. All of these will co-integrate into a whole different world. Even though this could be a catastrophic event, I do think at the end of all of this, there's a whole new future for us. I think there's a lot of good change that can come out of this. I think a lot of the fiscal stimulus, if done right, can develop the framework for the future to create a world where we're not burdened by the mistakes of the past.

It's big, long term thinking. Again, just to reiterate, that is all the unknown, foggy, gray stuff that I'm trying to peer through, where the odds are lower of understanding. The odds of the next three months or two months in particular, being extraordinarily bad, about as high as I've ever seen, I think we have literally a week's window max before the markets roll over, and they realize what the hell is going on and we start to see the rise of the virus in the US and elsewhere at a much faster pace, as the testing rams up.

Good luck out there. We'll have as much as we can on Real Vision for you as well so just keep your eyes peeled. We'll do the best we can to keep you informed. Thanks.