*Grant Williams:* Welcome to day two of the Stansberry conference. It's great to see you all in here so early. My name is Grant Williams. I'm the author and publisher of *Things That Make You Go Hmm* and the host of the Grant Williams Podcast. I'm here today to introduce you to a conversation I had recently with Mohamed El-Erian. Mohamed will probably be familiar to most of you. He's been around for many years in finance and held some incredibly senior positions. He's currently the president of Queens College Cambridge. He's also a senior economic advisor to Alliance, the parent company of his former shop, PIMCO, where he was the co-CIO alongside Bill Gross and the CEO. He's also been the former CEO and president of the Harvard Management Company and a five time member of the top one hundred most powerful people in finance. And you're about to see exactly why. So please enjoy my conversation with Mohamed El-Erian.

 *[Applause]*

Joining me now for what I'm sure will be a fascinating conversation, Mohamed El-Erian live from Cambridge in the U.K.

*Mohamed El-Erian:* Thank you for having me.

*Grant Williams:* It's great to see you. Now how are the bats? I know you’ve got some bat problems. I don’t see any flying around your head at this point in time, but are we in danger?

*Mohamed El-Erian:* We're not in danger and they're protected. Even if we were in danger, there's nothing we can do about it.

*Grant Williams:* All right, fantastic. If we do see any bats, we'll just have to ignore them. Look, it's a fantastic opportunity for me to have a chat with you. There's so much going on right now. It feels like we're at a point of inflection at the moment. We've seen plenty of points like this over the last 10, 15 years, but we seem to be at a point in – of change in something that’s been really important. That’s the inflation deflation narrative. There's always consensus, Mohamed, but you're someone who's made a career out of trying to pick points where consensus might be wrong and help people understand where they might be wrong and how to deal with that. So let's talk about the consensus, what you think the consensus is, and where perhaps you think people might be getting it wrong right now.

*Mohamed El-Erian:* The consensus is inflation is still transitory. It may last a little bit longer, but it is temporary and reversible. That central banks will be able to ease the foot after stimulus accelerator without any major problem and that there's nothing fundamentally wrong with global economic growth. So that is a consensus. Where it underestimates the complexity is in two areas. One is the nature of inflation. We have transitioned from a world of inadequate aggregate demand to a world where the supply side is a problem and will remain a problem for a couple of years. And secondly, consensus underestimates how tricky the central bank policy outlook is and that the probability of a policy mistake in particular is significantly higher than where consensus has it.

*Grant Williams:* There's been ample opportunities for policy mistakes as we've seen over the last day, particularly in Europe. But what kind of policy mistakes do you think we're most susceptible to? Is it tightening too soon? Is it not tightening? What's the one that worries you the most?

*Mohamed El-Erian:* When you look at the two most important central banks systemically, the ECB and the Fed, the most likely policy mistake is tightening too late. And having to tighten much more aggressively than what would have been possible otherwise. I've been of the view for a while that there was a window to start easing your foot off the accelerator, which was the taper, and that window opened wide in March of this year. And the longer you waited, the harder it becomes to distinguish taking your foot off the accelerator, taper from hitting the brakes interest rate hikes. And now we are positioning our self where the two will come very close together and that complicates the policy transition.

*Grant Williams:* We've had a taper before and we all remember how markets reacted, the Fed particularly. Do you think they're running scared of markets at this point? And if so, how do they get over that and get over that fear and just maybe let some pain take place?

*Mohamed El-Erian:* It depends how charitable you want to be. If you were being dead honest, yes, they're scared and for good reason. You mentioned what happened in May and June of 2013. And what was scary about that wasn’t the adjustment in asset prices. It was the malfunctioning of markets and central banks do not like markets to malfunction because you get a whole host of unintended consequences and collateral damage. They also had the same thing happen again – and people forget – in the fourth quarter of 2018. So there's good reason why the central banks and the Fed in particular is worried. However, the cost of waiting could exceed the risk you would take. The marketplace is ready for taper. They understand what it is unlike May 2013. I remember being on the trade floor. I remember Ben Bernanke being on the screen. I remember him saying the word taper and how we all \_\_\_. What does taper mean? We've been socialized to expect taper and expect a very gradual taper. So I'm less worried than the Fed is, but I understand why they're so worried.

*Grant Williams:* It's interesting because this brings up a point about the conditioning of markets. We think of markets around here as a rational, sentient being almost around decisions like this and that the market will be more rational around a taper. Ultimately, if you look at any charts, you see how high everything is and how inflated asset prices are. Is it possible for markets to be rational in the face of even a gentle lessening of the amount of stimulus that have taken them to those levels? Or are people gonna be desperate to get out before everybody else does?

*Mohamed El-Erian:* First, markets were irrational in pushing the everything rally as high as can be because of this ample and predictable central bank buying. If I tell you that whatever assets you buy, the next buyer after you who is gonna legitimize your purchase by pushing the price higher, and also provide you liquidity in case you change your mind. If I tell you that buyer has an infinite balance sheet, a willingness to use it and is noncommercial, they will buy at any price. You will front run that buyer all day long. The market has acted very rationally. They’ve understand that with so much high powered money coming into the system, it cascades throughout the system. The marketplace also understands that as you withdraw it, you're gonna have to have some sort of adjustment. The bet the market is making right now is on what Bridgewater, in another time, called the beautiful normalization. That somehow you can calibrate it just right and if it's not just right, the Fed will err on the side of more liquidity than less. Inflation complicates that story enormously.

*Grant Williams:* I want to come onto inflation in a second, but this idea of rationality. It feels as though the market is also rational in believing that the Fed will blink. If they do start to taper and markets wobble, it feels rational to me that markets would say we're gonna put the pressure on you. They’ve given every evidence over twenty odd years that at the first sign of any real pain, as you pointed out, is too really difficult to take right now. The market will blink. So that feels like rational behavior as well on the part of the market.

*Mohamed El-Erian:* It is and that’s why the market tends to front run the fed. I hear three things over and over again: buy the dip, there is no alternative, and then FOMO. If you don’t do it, someone else will do it. So yes, the market has absolutely been conditioned to believe that if the Fed causes a market disruption, then the Fed will reverse course. It's a little bit more complicated than that because there are other things going on in the system, but undoubtedly that’s what the market believes.

*Grant Williams:* Let's talk about inflation because you're right. That’s the thing here that is different this time. Certainly over the last twenty odd years, we've had a couple of five percent spikes in inflation, but nothing really meaningful. And given the amount that rests on rates staying low in terms of the leverage in the system, it really does put policymakers in a bind to be able to take the steps necessary to perhaps arrest this. So talk about how inflation complicates this and how policymakers might be thinking about that.

*Mohamed El-Erian:* Inflation complicates this in two big ways for marketplace. One is policy. What the marketplace and the economy cannot afford is what Andrew Haldane, who used to be the head of research at the Bank of England, calls the hand brake U-turn. You’ve gotta do a U-turn very quickly in policy or less elegantly, slamming on the brakes. We have no historical episode where the Fed was late, then had to catch up with reality through rate hikes and we didn’t end up in a recession. That’s the first issue. If the Fed mischaracterizes inflation and then has to move, it will have to move in such a way that could sacrifice economic growth unnecessarily. That’s issue number one.

 Issue number two for the marketplace is the composition of inflation. So let's reduce the whole U.S. economy to one company. Right now, you as a company are increasing your consumer prices at about five percent and you're having your producer prices, your inputs increase by eight percent. That’s your reality. In a perfect world, the supply constraints would be relaxed and producer prices would come down and everything would be fine. I don’t think that’s gonna happen any time soon. There's two possibilities. Possibility number one is you as a company, you eat it in your profit margin. You simply continue with PPI up here, CPI down here. Possibility number two is you use your pricing power to increase CPI. We're gonna see a combination of both and what we're not gonna see is what we all want to see, a relaxation of the supply constraints. The marketplace also has to think about what's gonna happen to profit margin and how different companies with different pricing power are gonna react.

*Grant Williams:* So at what point do you think the market is forced to price this in? I absolutely agree with what you just said there, but we're still getting this T word. Transitory is still the defense against this. That look, just hang on and the exact conditions that you just talked about are going to ease. The comps will get better. CPI will come down and everything will float back to something more normal. It may be above two percent, but it'll be more normal. But at what point do you think people have to start pricing this in?

*Mohamed El-Erian:* If only I knew. You're not asking me an economical market question. You're asking me a behavioral science question and I don’t know.

*Grant Williams:* Look, that is the inflationary problem. It's the mindset aspect of it. That’s the bit that we really struggle with and of course one of the things that we find around us today are very few people who have experienced double digit inflation. You have to be 65 years old to really have experienced as – in your life as an investor to experience double digit inflation. So that mindset component is so ephemeral and so difficult to pin down as you rightly point out. But it feels to me from anecdotal evidence, from a lot of the stuff you read in some of the media now that it's starting to take root a little bit, particularly as we come into the end of the year and holidays and Christmastime.

*Mohamed El-Erian:* Survey inflation expectations are going up and they're going up not just for one year, but for three years as well. So the person in the street gets it. They understand what's going on. They're being hit both on prices and quantity. Interestingly, the market measures are not because the marketplace has been so distorted by $8 trillion plus of buying by a noncommercial buyer. I was talking to someone today who deals with machine learning. He was telling me how they have the machines as we know, the one that beat the world champion, the Korean \_\_\_ that learned. They learn. I asked him what happens if you introduce an irrational player. What happens if you bring in a player that is maximizing a completely different objective? And he looked at me and said, "Oh, that’s not good." It distorts everything.

 I do think the person in the street gets it. We have been wired – we in the marketplace – to look at market measures. And the market measures are not really flashing yellow as yet. So there is a sense of it's gonna be okay and then we get reinforced by this narrative that everything is transitory. I laugh when people say everything – the latest phrase I heard Grant, which you'll love, is it's persistently transitory.

*Grant Williams:* Everything is transitory if you make it open ended. We're all transitory in nature, but it does bring us back to the position that policymakers are in, Mohamed. Obviously, they’ve really been in the crosshairs now for almost 20 years, fighting the last fire and trying to prevent chaotic outcomes really. We saw that beginning with arguably Black Monday, but maybe long term capital, maybe the dotcom bubble. There were so many milestones along this last two decades where there's been a chance for a miscalculation. Some would argue they’ve made them and some would argue that we see asset prices where they are because of those mistakes. And we're expecting the policymakers to put out the fire after having started it, as Jim Grant famously references.

 But when you look at the options of available and if we look at the stresses that rising interest rates would put on people, a lot of people are talking about yield curve control as an option. The Japanese Bank of Japan have done that. It was tried back in 1942 to 1951. I spoke to Russel Napier about this not too long ago. He made the point that it was a great success in 1942 to 1951 if you looked at the yield curve. However, if you look away from the yield curve at capital controls, price controls, mandatory purchases of government bonds, there were all kinds of things that had to be put in place in order to stabilize that yield curve. So when you think about this potential of yield curve control, which might be almost necessary, how do you frame that within your own mind and within conversations with investors?

*Mohamed El-Erian:* We will be repeating the mistake that we made coming out of the global financial crisis. I characterize the mistake as winning the war but losing the peace and ending up in this artificial peace that is inherently unstable and that eats at its own stability. If I go back to 2008, we won the war. The financial crisis was gonna tip the whole world into a multiyear depression and our policymakers made sure that did not happen. But coming out, they didn’t recognize that we were facing structural issues relating to demand. And because of that, the cyclical mindset took over and continuously GDB growth was overestimated for the next five years. Continuously till this notion of the new normal, secular stagnation became accepted. But by then, you had distorted the system enormously because you basically enforced the peace by relying on central bank balance sheets.

 Now we're coming out of the second big hit in the last 13 years and we've won the war. We have restored balance sheets after a massive, sudden stop created by Covid that could have been a depression. However, we're not winning the peace because our mindset hasn’t evolved from thinking that this is deficient aggregate demand to thinking this is deficient aggregate supply. So if you take the policy of yield curve control, that – if it works, it works on the demand side. It does nothing to supply. In fact, it makes the supply side problem worse. So it would be a tragedy if in addition to mal-diagnosing what's problematic – which is we need to get the supply side to work again. Demand is fine. It's the supply side that’s a problem. If we then add another distortion on top of many distortions, it ultimately will undermine the functioning of the market system.

*Grant Williams:* This is the essence of the quandary that policymakers find themselves in. Everything is now predicated upon lower rates and the tolerance, as we've gone through this lengthy cycle and the debt has built up and the reliance upon those low rates has rippled through everything – not just housing, but now into equity markets and into bond markets, into private equity. It's really difficult to see how rates can go up in a meaningful way. And so you get to this point where to protect the man in the street, you need rates to go up to try and curb this inflationary policy if it isn’t transitory, but what that does to asset prices could very quickly become problematic.

 And if you look at the chart of household wealth to GDP, you can see that it's gone almost vertical since the pandemic. And it feels there's a lot of money there that has been channeled into asset prices. If we wanted to get egalitarian about this, it wouldn’t be difficult to make a case that’s where the pressure valve should be. It should be asset prices if they're allowed to fall to enable rates to go higher to correct things for the man in the street. But again, it – there is so much predication on this that it becomes a very difficult thing to pull off.

*Mohamed El-Erian:* I agree. The longer it lasts, the harder it is. You're absolutely right. Now we don’t know at what level of yields interest rates the economy can bear. We don’t know that. We haven’t experimented. In a perfect world, you would have three simultaneous policy measures. Number one, you ease your foot off the stimulus accelerator. There is no reason why the Fed should still be buying $120 billion every month and there's certainly no reason why $40 billion of those should be mortgages when the housing market is doing just fine and is pricing Americans out of the market. There is no economic or social reason to continue buying mortgages. So the first thing you would do is you'd ease your foot off the accelerator and do it quickly so that you don’t have to hit the brakes.

 Second issue is let's deal seriously with the supply side. We know we have a physical infrastructure problem. We know we have a digital infrastructure problem. The only thing that’s being debated is whether we have a human infrastructure problem or not. And we can debate that, but let's at least move on the physical and digital. I certainly think that we should do something with our human productivity, but I understand why that’s politically more difficult.

 And then the third issue is, have you head anybody talk about macro potential policies recently? There's been nothing done, absolutely nothing done. And risk has migrated from the banks to the non-banks and we have avoided three near accidents this year alone that no one had on their radar screen or no one I know. Certainly, no one in the public sector because I had to explain to them what was going on. GameStop and the fact that had there not been a change by Robinhood, we would have \_\_\_\_ some of the hedge fund. And remember, we had a five percent hit in the S&P in one day. Imagine what would've happened had that continued. You know what it's like when people smell – taste blood in the water. And let's not forget what happened with Archegos and how a $10 billion loss was imposed on banks when so much leverage was provided to a family office. So we know that there are excesses out there and yet we hear very, very little about potential regulation.

*Grant Williams:* Why do you think that is? Because it's a great point you bring that up, the GameStop, the AMC phenomenon. It was couched in very combative terms. It was the man in the street fighting back against Wall Street or whatever it may be. There's more to it than that, but is that whole episode emblematic of a shift? Both in the tolerance of Wall Street by people who are feeling the pinch in the pocketbooks – or was it just a moment in time, a situation that was exploited by people that didn’t perhaps know what they were doing, but managed to exploit something that was particularly painful?

*Mohamed El-Erian:* This was your wonderful David versus Goliath story. It is made for Hollywood. A bunch of retail investors who get a check in the mail come across Robinhood, something that is interactive, facilitates their trading. They coordinate through Reddit. They find a situation where a name is ridiculously shorted and it is – it's written for Hollywood. So it was a particular moment in time, but let's not forget what's going on. And that is significant innovations that are lowering the barriers to entry for non-banks to financial markets. That’s what's going on. Through Robinhood, you can get significant margin debt. You can figure out pretty quickly what other people are doing and it appeals to the younger generation, and human history is what it is.

 When you suddenly lower a barrier to entry, even if it's a really good thing long term – and I think border participation in the financial markets is a good thing. But when you suddenly allow people to do something they haven’t been allowed to do, the inclination is to overproduce it and overconsume it. I can take you one innovation after another starting from the steam engine or even in finance, securitization. It allows you to do wonderful things, but be careful because round one is often associated with overproduction and overconsumption.

*Grant Williams:* It's a great point. One of the other things that has been mooted as a potential solution to a lot of this is central bank digital currencies. This is something that is gaining more and more traction as an idea. It feels almost inevitable this is the way we will end up going. How do you view it? Do you view central bank digital currencies as a panacea that will give central banks and governments ultimately the tools they need to stave off a lot of these problems through some pretty Draconian measures? Or do you think these things are gonna come in and actually be a huge benefit to everybody in the financial community?

*Mohamed El-Erian:* So that’s a really tough question because you can have different models of how that evolves. I can tell you, you can just see what's happening in China versus what's happening in the U.K. versus what's happening in the U.S. I do think we're ending up where there will be central bank digital currencies. We are going to adopt the underlying technology, which is gonna make the payment system much smoother. It will reduce the power of people right now who are allowed to be within the payment system. It's gonna decentralize that, but I don’t think it solves excessive risk taking. It doesn’t solve it. It just makes the system smoother, but it doesn’t solve it. People often forget that risk has a way of migrating. It moves and migrates. So when we compress the risk taking ability of the banks and declared victory, we ignored that risk actually migrated elsewhere. And that the end users became much bigger than the banks and that’s why every time we've had a big unanticipated shot – the latest one being in March of 2020. The core of the system could not – did not have the risk absorption to accommodate the change in paradigm. And that’s why we had the malfunctioning of markets and that’s why central banks had to come and say I am your counterpart. I'm putting the money on the table. I am your counterpart.

*Grant Williams:* It's a great point about the risk migrating because it tends to migrate into places that we don’t recognize until it's too late. But when you think about central bank digital currencies, my concern for those is ultimately do give central banks powers which while they may not intend to use them at the outset, when we get into the next crisis, there are all kinds of tools available to people who've produced central bank digital currencies. That given the reaction function we've seen in the last twenty years and the increasing stakes of them making a policy mistake, it seems difficult to believe that the problematic tools that central bank digital currencies offer won't be used.

*Mohamed El-Erian:* I'm with you and I think of China as being a leading indicator in that. They’ve understood exactly what we've said. They’ve understood that and they’ve realized that for all sorts of reasons, they want the phenomenon of digitalization to be a very centralized top down and not have private sector adoption beyond what they decide. I totally understood what you’ve said and the work at the BIS is also consistent with exactly what you said.

*Grant Williams:* This idea of social credit that they have in China, what we've read about that in western media over the last three or four years, there's almost an audible gasp when people read about not being able to buy train tickets or plane tickets depending on your social credit scores. But ultimately, central bank digital currencies almost at the flick of a switch offer the ability to flick that switch in the U.K. or America or – we've seen Australia's response to the pandemic. We've seen some of the footage of things that are happening down there. And I just wonder where the – given the stuff we talked about at the beginning of this conversation and the stress in the system and the severity of that stress, are we heading into a period of time where more authoritarian governments are almost a necessity at this point?

*Mohamed El-Erian:* So I would hate to think that they are a necessity. That’s a really strong statement and I would hate to think of that for my daughters.

*Grant Williams:* Yeah, me too.

*Mohamed El-Erian:* That’s the only thing. I do think that the pendulum is swinging. We decentralize a lot of things. Health is an example and now we're realizing that a bit of centralization is a good idea. We have a massive burden sharing collective responsibility problem. We really do and it's – it exists not only at the individual nation level, it exists globally. Vaccines today is a perfect example of that. The fact that Africa has had less than four percent of its population vaccinated is a problem. Even if you don’t care about people in Africa – which I do – but even if you don’t care about them, that’s how new variants evolved. That’s how your vaccines become ineffective. So I do think there is a swing back. I would hope it doesn’t go as far as you’ve suggested.

*Grant Williams:* One thing is for certain, we will find out. Either way, we'll find out. Let's switch a little bit and come to the energy squeeze we're seeing at the moment. If you go back to the seventies, the last period of real inflation, that began with an energy squeeze. Now it was for different reasons obviously, but it was that energy, that core component of everything we do as human beings being squeezed led to this rush in inflation. It had been building in the sixties, but when the energy crunch came in the early seventies, it lit the spark. Do you see the energy crisis becoming a little milder over time or is this something that is gonna be with us through – as we're coming into the coldest months in the year?

*Mohamed El-Erian:* So if you're saying mild in the next few months, it's gonna get worse in the next few months. Let me explain what's going on. You're having significant demand. Demand is not a problem. People have significant purchasing power. You mentioned accumulated savings and virtually everything that we spend money on has an energy component on it. So that demand factors aren’t gonna go away. Secondly, you have hoarding going on. Countries are trying to secure their energy independence. You have people who have advanced their purchases of energy to today because they're not sure it's gonna be there come Christmastime, come the winter. So you have an additional component of demand coming in.

 Supply side we have underinvested in energy supply and traditional energy supply, and we're trying a massive substitution at the same time. When I hear people say transitory, I say which bit is transitory? Just explain to me which bit is transitory. We're not gonna stop the transition away from fossil fuels, so the substitution effect is not gonna be there. We can't possibly catch up on investing that we haven’t done for a few years. Unless you get demand destruction – which is likely to happen, but it happens at a much higher price than it is now. Again, I'm a little bit baffled that people think that these things go away quickly. Maybe it's because you and I have lived through the seventies and we understand the dynamic of multiple equilibria. You cause a certain phenomenon and the most likely next step is further away from whatever equilibrium you came from. Supply disruptions have these multiple equilibria until you get to either far in time when new supply can come on or you get demand destruction.

*Grant Williams:* It's interesting. That mindset is so important and the millennial, the Gen Zs, they have a very different mindset to us. There's a lot of talk in recent years about this idea that the millennials and the Gen Zs, Gen Ys, they don’t want to own a house. They don’t want to own a car. They want to live this sharing economy. How much of that do you think is price dependent? A lot of people are basing a lot of decisions they're making on the fact that going forward, people won't want to own houses and won't want to own cars. But I would contend that if house prices were cut in half, I'm sure there are an awful lot of millennials and Gen Zs who would want to own a house.

*Mohamed El-Erian:* I totally agree. I look at it within my kids. I have a 24 year old, a 25 year old, an 18 year old. Develop their thinking a little bit and it's not that far away. It's exactly like the whole debate we're having about work. If you think it as scale, ten was very rigid. Five days a week, clock in, clock out, et cetera. Call it 20 is do whatever you want. A lot of people who honestly think it's gonna be 19 or18. I'm willing to bet you it's more likely to be a 14 or 12. There will be flexibility, but we're not gonna dismantle everything. So I do think there's realities that impose themselves. I smile when I hear them say we're not gonna own a house. I say wait and see.

*Grant Williams:* How do investors think about this? Because obviously, we've had a four decade long period of pretty simple decision making in the overall construction of a portfolio. We've had these gentle deflationary tailwinds and if you have that and a central bank cabal who are willing to jump in every time there's a problem to that, it's the best setup possible for asset prices. So we've had this fantastic tailwind. Now we may or may not be at a secular inflection point, but it's clear now that people have to start at least thinking that through. So if you have that legacy portfolio that you’ve had for all of the last 40 years or 10 of the last 40 years, it doesn’t really matter. How do investors need to think about this to work out whether – okay, we do need to make some fundamental shifts to our locations?

*Mohamed El-Erian:* That legacy portfolio, if you simplify it to three characteristics, one was bet on central bank liquidity. Just bet on liquidity. Two was don’t worry about correlations because whether you have your risky assets or your risk free assets, they're both gonna go up in price. So correlations are gonna break down, but they're gonna break down in your favor. I haven’t heard a single person complain about correlations breaking down when they’ve made money on both risk free and risky. And then the third one was passive is not such a bad idea because you save management fees and everything goes up. It's the everything rally. So do it in a simple form and the more liquid you go, the better because central banks are liquifying everything. And had you pursued that approach, you would've made a ton of money.

 And a lot of smart investors, so called smart money, gave up. They said our skill set is now redundant on this. We're entering a world in which we can no longer rely on ample and predictable liquidity where we have to go back to differentiating. We have to understand which characteristics are gonna make you a winner and which characteristics are gonna make you a loser. There's gonna be a lot more active investing than there is and then there's gonna be a lot more focus on exploiting distortions in the marketplace on either side. We're slowly moving to that. To go back to what we were discussing earlier, Grant, it's very hard to change the mindset of a marketplace overnight. So you don’t want to be too early in this because you can be frustrated. Cane's famous saying that the market stay irrational longer than you can stay solvent.

*Grant Williams:* It's very true and you’ve led me perfectly to a place I wanted to go to next. That’s this – the twin threats of correlation and passive. We have seen this tremendous move towards passive. It's now 40 percent and climbing volume. And that has understandably created much more correlation in markets, which is a structural flaw. When you look at passive and you look at what it's done to markets, and you think about this potential shift from inflation to deflation – which if – sorry, from inflation to deflation – which if it is taking place really requires 180 degree flip in everything. What happens to passive? Because as you say, a lot of the active managers have picked up their balls and gone home. How does that resolve itself if we find markets that wanna either go sideways or go down for a while?

*Mohamed El-Erian:* It becomes more problematic for passive. Let me give you the extreme example of passive, which is ETFs. Because we've been living in a world sloshing with liquidity, ETFs have been offered on more and more peripheral asset classes. You can buy an ETF right now on \_\_\_\_\_. You can buy an ETF on slices of the high yield market. Now what does an ETF promise you? An ETF promises you instantaneous liquidity at reasonable \_\_\_\_. Now that makes total sense when you are in a highly liquid market, but what if you're in an inherently illiquid segment of the marketplace? And we saw that example with Third Avenue a couple of years ago. That you’ve gotta be careful. So the passive element has not only encouraged a lack of differentiation, it has mispriced liquidity completely. So you’ve gotta be really careful that when you assess the different interest rates – the minute you put interest rate risk in play, liquidity risk starts getting to be in play. Credit risk starts getting to be into play and counter party risk gets into play. Depending on which segment of the market you are, these things could be flashing yellow or red in a world in which the paradigm changes.

*Grant Williams:* That’s a great way of thinking about it for people watching this. It really is. If we think about politics now – because politics has become more and more important in terms of trying to make market based decisions. It's always been important, but recently it's become more important. And I think one of the big reasons for that is it's very difficult to look anywhere in the world really, certainly the developed world, and find a stable government that has a strong enough mandate to be able to make tough decisions, to be able to put things through that need to be done rather than are gonna be popular. Is that weakening of the political bases in the western countries – is that a major problem or are we not quite at that point yet?

*Mohamed El-Erian:* So it's a major problem in terms of taking timely decisions and we've seen that. And the other issue is that the world – the distorted world we've lived in has not just made the focus on income and wealth and equality much sharper. It really has been a split between Wall Street and Main Street. But Covid also added a third inequality, the inequality of opportunity and that issue has massive political connotations that we have to take seriously. Also let's not forget that inflation and the possibility of the emergency U-turn – the handbrake U-turn is really problematic for governments because the electric gets hit on both sides, both on the income side and the price side. So I do think that the policy will get more complicated.

 Now if you are a distressed investor, if you are an investor that understands that markets go through contagion and that everything is – it's what's called the market for lemons, a wonderful theory that got the authors a Nobel Prize. That when you have a major change in paradigm, individual companies, sovereigns, opportunities cannot signal strongly enough because there's so much noise in the system. If you're an investor that does the granular analyses, this is gonna be a wonderful world for you. We will overshoot just like we've overshot and there will be contagion, but it is a different investing world.

*Grant Williams:* It used to be that investing, you would invest in a company, not necessarily a market or a share or a stock. And nowadays, everything's become all about the stock market. It has become almost gamified. A lot of people that I've spoken to are looking at private investments to be able to invest in companies without being hostage to fluctuations in the stock market. And while they realize that – they may not get the kind of multiple expansion that they get which reduces their returns, they also will find much more stable holdings. Is this something that when you speak to investors, you find people looking – trying to look away from listed securitized markets and look for private deals where they're less hostage to headline risk?

*Mohamed El-Erian:* Absolutely. It's migrating from the developing countries and for good reason. You’ve cited that secondly people wanna go to places that are less crowded. The issue is what is your exit. You’ve gotta be really clear on how you exit because I can – you can have some really powerful numbers until it comes time to exit and then reality could strike. But yes, absolutely, that is a tendency that’s gonna continue and continue for good reasons.

*Grant Williams:* Can you give any advice to people who would like to do that, would like to look into diversifying their portfolio in terms of private businesses? Not necessarily the sectors they should look at. Obviously, that’s gonna be different for everybody, but how should you go about vetting a business? Because that’s – it's almost a lost art, which seems amazing to me. But it is because investors now tend to buy based on recommendations, based on charts. It's become a very old fashioned thing to kick the tires of a business and understand what's important when investing in something like that.

*Mohamed El-Erian:* I'll tell him go read *The Cult of We*, which is this book on WeWork. And just read it and understand how smart investors valued a real estate company at $64 billion because the real estate company kept on repeating it was a tech company. Anybody who's gonna go into the private space should read that book because that book is a wakeup call. Bad Blood was \_\_\_\_, but WeWork is even more extreme. It's so extreme. Basically what happened is WeWork was packaged to investors as a tech company. People started giving tech multiples to a real estate company. Unlike a tech company, you don’t get the economies of scale in real estate that you do in tech. Whenever people say we're going into private markets, I'll say two things. One is, are you sure you have an edge? It doesn’t mean you personally. Are you able to select the managers who can do well? Because it's not all – quite a few managers don’t do well. That’s the first thing. And secondly, as I said earlier, what's your exit? Make sure that this is not liquidity that you'll need because exits are not guaranteed.

*Grant Williams:* A friend of mine, Lee Robinson, said something to me once. I was interviewing him and he made a great point, which was almost a throwaway line, but it was so simple. But he said professional investors know how to sell. That’s the difference between professional investors and private investors, and it's so true. And I think the point you make is absolutely valid. I'm gonna stick on that *Cult of We* 'cause I read that book, too. The strange thing for me about the WeWork story is even as it was unfolding, there were many of us that were just baffled at how nobody could see what was happening here. And yet it carried on in the full light of day to reach that $64 billion valuation. And then when you read the story, I just found myself saying yeah, this was obvious this was going on. So what is it about the times we're in that allows that mindset – even though it was very clear to anybody paying any real attention what was happening. What is it about the times we're in that allows that sort of thing to happen and is that something that you think will come to end? And how big a problem will that be if it does come to an end?

*Mohamed El-Erian:* It may just be human nature. Go back to the mortgages that were being produced in 2005 and 2006 and 2007 and who would be able to borrow. It was obvious to everybody that if you have no income and no prospects of income and you're gonna have to refinance your mortgage, there's a chance you're not gonna be able to do it. And let alone what was happening to houses and yet this whole thing continued for much longer. So it's part of human nature that we often believe that this is exceptional. Exceptionalism is something that people tend to believe in, but history is full of this.

 The reason why I brought up the book, and I'm glad you read it, is that it's stunning because so much money got poured into this. It's absolutely stunning. The comparison with other people who are doing exactly the same thing, wondering why is their valuation a third or a fifth or a tenth of WeWork. It's exactly the same thing and yet the marketplace gave it a different label. It gave it a different packaging. It's like putting two wines in different bottles and selling them for completely different price simply because the bottles look different.

*Grant Williams:* That whole thing really came down to the personalities of the three main characters \_\_\_\_ and Adam Neumann. It was really three cults of personality that fed on each other, but I interviewed Sam Zell recently and he made a point of bringing this subject up. As a businessman, as someone that’s run businesses, he looked at that and he said, "I've been in the real estate game. I knew exactly what that was from day one." And he couldn’t understand how anybody fell for it. It's remarkable.

*Mohamed El-Erian:* It is remarkable.

*Grant Williams:* Let me take a little sidebar because we brought up a book that I thoroughly enjoyed reading and I would recommend it to anybody to try and get inside the mindset of this. But if we are at an inflection point, are there any books that you’ve read that you think offer really good either historical accounts of times that might be important for understanding this? I just find there's so much in historical books that really help people going forward.

*Mohamed El-Erian:* So I don’t know as much as historical books. What I have found really helpful is reading books on behavioral science and how we tend to frame things in a particular way, how we can have blind spot evolve. And best of all, this notion of active inertia. That we recognize that we should be doing something different, but we end up doing more and more the same thing. The example I use – I could give you very sophisticated example. Don Sull at M.I.T. has done great work on this. Why did IBM not dominate the PC revolution? Why did Goodyear have the issues?

 I'm a peasant, so my simple example is the American tourist in Paris. If they go up to someone and ask something in English, and the French person either doesn’t understand English or doesn’t want to understand English and just shrugs, the most likely response of the American tourist is to say the same thing in English but louder. Now the active part is I've gotta do something different, but they go louder and still in English. And that example is really striking because unless you understand this behavioral aspect, you will make repeated investment mistakes. And a time when there is some sort of dominant – what the economists call global common factor, something that dominates, something that puts aside all other considerations. Those mistakes can multiply a lot. So I encourage a lot of people to read some of the behavioral science books. And if you want to get really scared and I wouldn’t go that far, read a book on surveyance capitalism.

*Grant Williams:* That difficulty in overriding our natural tendencies, particularly in times where – you mentioned FOMO earlier on. It's such a difficult thing for people to do, but if you want to be a successful investor, particular at turning points, you have to be able to step outside the narrative, step outside everything you're being bombarded with and think for yourself without inputs from other people. You have to be able to process that information and come up with your own way of dealing with it.

*Mohamed El-Erian:* But it's a lonely place. I've experienced it a few times. It's a very lonely place because you're there on your own. I discovered it. I came late to the investment world and I was investing in emerging markets. And go back to 1999. It was clear to most people that Argentina had a debt problem. I remember we would sit on panels and we would be asked as manager, how do you feel about Argentina? And everybody would respond negatively. Then we would be asked, how are you positioned towards Argentina? And everybody would respond underweight. And then the question would become, how underweight are you? Now Argentina at that time was 22 percent of the index because it had issued so much debt that it had become that large. And people would say I'm really underweight. I'm three percent underweight. I'm four percent underweight. And they would come to us and we would say we don’t own it. And they called that irresponsible. Of course, Argentina defaulted.

*Grant Williams:* Mohamed, we've got a few minutes left and so what I'd love to do is just get a few pointers from you on the things you think are important for investors to focus on right now. We've covered a lot of areas. We've covered a lot of topics, but I'd love to know almost your hit list that – the advice you'd give people. Here's the things that you need to really pay attention to and have a plan for.

*Mohamed El-Erian:* Conviction and foundation matter and I'm gonna start there. Today there's a lot of conviction and little foundation. And the marketplace has accommodated pretty well every positive story out there. So I would say to people if you can have conviction, make sure you have foundation behind it, both positive and negative. So positive is there are a few themes that are gonna play out and play out in a meaningful way. We are going through some very beneficial transformations and that’s gonna provide massive opportunities for investors. That’s your secular story. There's also structural problems. That means that there is excess returns in certain market segment. We talk about private credit. Private credit in the developing world is an example of that. There's a failure of bank flows, et cetera. So make sure that you have clearly some of the positive things.

 Secondly, remember – and you used one sentence about the investors don’t want to sell. Rockefeller was asked once how did you become so rich. He said by selling too early. Any surfer will tell you that a liquidity wave breaks at some point. Be careful not to think that you can time it exactly. I do think that we are changing liquidity paradigms. So I do think that taking some money off the table and just sitting there and recognizes that you're not gonna time it perfectly. And then thirdly to have the courage to go back in because when the marketplace realizes that we have changed liquidity, there will be a lot of people looking for the exit. And at that point, you're gonna get contagion and that’s – these are once in a ten year opportunity. It's picking up really good assets at depressed prices.

*Grant Williams:* Fantastic. That’s such great advice and I know that people watching this are gonna be able to make notes and take that to heart and use it to their advantage in what I suspect comes next, which looks like a period of change and perhaps more volatility. And so to be armed with advice like that is gonna be hugely beneficial, so my thanks to you for joining me today and taking the time. It's been a real thrill for me to get the chance to talk to you finally. I've been looking forward to this for a long, long time. So thanks very much for making the time.

*Mohamed El-Erian:* My great pleasure. Thank you for having me.

*[End of Audio]*