Mohamed A. El-Erian & Grant Williams

Interview: Paraphrased and Abridged Notes

Is there a point of inflection? The inflation deflation narrative has changed. What do you think the consensus is?

El-Erian: The consensus is that inflation is still transitory, and that central banks will be able to ease their foot off the accelerator smoothly.

This consensus view misunderstands the nature of inflation. We are now in a world where the supply side is the problem... And it underestimates how tricky implementing central bank policy is.

What worries you most?

El-Erian: The most likely mistake by the European Central Bank and the Federal Reserve will be tightening too late. And the longer they wait, the harder it will be to tell whether they are taking their foot off the gas or hitting the brakes.

Is the Fed running scared of the markets?

El-Erian: Yes, the Fed is scared. Central banks are scared of markets not functioning. Q4 2018 is an example. However, the cost of waiting could exceed the risk. It's time for a taper. And we've been socialized to expect taper.

I'm less worried than the Fed is.

We think of markets as rational. But ultimately you look at charts and you see how high things are. Is it possible for markets to be rational in the face of lessening stimulus?

El-Erian: Markets were irrational in pushing the "everything rally." The market will front-run the stimulus by default. And as you withdraw that stimulus, you must have some kind of adjustment.

It feels as though the market is rational in thinking the Fed will blink and continue stimulus.

El-Erian: It is. And that's why the market tends to front-run the Fed. This is where terms like "buy the dip" and FOMO come from in their current forms.

The market believes the Fed will reverse course if its policy causes pain.

How does inflation complicate this?

El-Erian:

1: We have no historical episode where the Fed was late and then had to catch up with rate hikes and we didn't end up with a recession.

2: The composition of inflation. Consumer prices are increasing by X% but production prices are increasing by x+1.

So companies either eat the cost... or you use pricing power to increase CPI.

The market has to think about what's going to happen to profit margins.

But the Fed is still leaning on the transitory narrative. At what point do you think people have to start pricing this in? Nobody is willing to accept double-digit inflation. We just don't have the mindset for it.

El-Erian: I think inflation expectations are going up... not just for one year, but for three. We have been wired to look at market measures. And they're not flashing yellow yet.

A lot of people are talking about yield curve control. What do you think about this? How do you frame that?

El-Erian: We'll repeat the mistakes we made coming out of the post-2008 Great Financial Crisis (GFC).

In 2008, we won the war... But we didn't keep the peace. And because of that, the cyclical mindset took over.

Now we're coming out of the second big hit in 15 years. And we've won the war. But we're not winning the peace. We still think this is deficient aggregate demand. But really, it's a supply issue.

Demand is fine. It's the supply side that's the problem.

Everything is now predicated on lower rates. Reliance on low rates has rippled through everything. How can rates go up in a meaningful way? That could be very problematic for asset prices.

El-Erian: And the longer it lasts, the harder it is. We don't know the limit on rates that the economy can bear.

There is no reason why the Fed should be buying $140 billion every month. And there is absolutely no reason why the Fed should be buying mortgages.

The supply side is still a mess. And we're seeing excesses in the market now, too.

Look at the rise of meme stocks. Big excesses are out there and we're hearing very little about potential regulation.

Can you expand on the meme stock environment?

El-Erian: Simply put, retail traders have more access than ever.

What about digital currencies?

El-Erian: This is a tough question. I do think we'll end up with central banks managing digital currencies. It will reduce the power concentrated in payment systems right now. But it doesn't solve risk taking.

It just makes the system smoother.

Risk has a way of migrating. So, we might solve risk taking by the banks. But the risk taking will move elsewhere.

I worry that central banks will end up with highly invasive powers as a result of currency going digital.

El-Erian: I'm with you. Look at China as a leading indicator. They want digitalization to be very centralized and top down.

What do you think about China's social credit? Isn't that just an extension of digital currencies? Are we heading into a period where more authoritarian governments are a necessity?

El-Erian: I hate the idea of that. But I do think that the pendulum is swinging. We decentralized, just look at healthcare. We have a massive burden sharing problem. Look at the vaccines issue with the pandemic.

There is a swing back. But I hope it doesn't go as far as full authoritarianism.

Let's move on to the energy crisis in the UK. What do you think about that?

El-Erian: It's going to get worse in the next few months. Demand is significant, and everything that we spend money on has an energy component.

On the supply side, we've underinvested. And we're trying to pull off a massive substitution at the same time regarding renewables.

So speaking of inflation…. When people talk about transitory… I ask which bit? Which bit of demand is going away? Do you see demand destruction coming? I'm baffled that people think these things will go away quickly.

How should investors think about all of this?

El-Erian: We're entering a world where liquidity is getting tighter. It's time for a lot more active investing. You'll need to focus on exploiting distortions in the marketplace. You don't want to be too early in this... But this is the direction we're headed.

What happens to passive money in this environment?

El-Erian: It becomes a big problem for passive investing. Just look at ETFs. There's an ETF for practically everything.

And they promise near instant liquidity and a reasonable bid ask spread. But what happens to that in a market where liquidity dries up?

Liquidity should be demanding a higher premium. It's mispriced and it's possible that liquidity will become much tighter.

What about politics? It seems like politics are becoming more and more important in market decisions.

El-Erian: There are massive political implications related to inequality. And COVID has made that worse.

And I do think that the policy is going to get more complicated as a result. This is going to be a wonderful world for investors that can do granular analysis.

The stock market is "gamified." And managers are looking for investments that are more stable. Do you see the volatility of the market pushing people to private deals?

El-Erian: Absolutely. People want investments that are less crowded. But then, exiting becomes a very big issue. It all comes back to liquidity.

How would an investor diversify into private opportunities? How do you vet these?

El-Erian: Go read *The Cult of We*.

Anybody that's interested in the private space should read that book.

1: Make sure you have an edge. Are you able to select the managers who are going to do well?

2: What is your exit point? Do you need liquidity? Exits are not guaranteed in these types of deals.

Any other book recommendations?

El-Erian: Read books on behavioral science.