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Davis Hall: The Ebbs and Flows of Global Currency Markets, Gold and Other Inter-related Insights

Davis Hall has a colourful background, coming originally from New England in the US and having been educated through later high school in Switzerland, then returning to the US for his BA degree in Fine Arts and then marrying his Finnish wife and moving to work in the financial sector in Switzerland in 1992, where they lived for 34 years until moving to Hong Kong SAR in mid-2020. By his own admission, Hall has strong views on his two favourite subjects of foreign exchange and precious metals and loves to communicate his convictions to his private clients on a regular basis. As Head of Capital Markets for Asia at Indosuez Wealth Management in Hong Kong SAR, he has plenty of wealthy clients and colleagues ready to hear those views. Hubbis 'met' up with him recently by video call to quiz him on some of the key opinions he currently holds, and to learn more of the reasoning for those views. He offers his insights into the direction of the greenback, other key currencies, fixed income, equities and gold with both a strong historical perspective and also with humility, knowing that they are only opinions, that events change and that investors should see such views in the broader context of forming their own judgments. If there are two key watchwords to be gleaned from the discussion, they are 'caution' and 'patience', as the world faces immense uncertainties and asset prices, especially in equities and fixed income, are balancing on many knife edges.

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DAVIS HALL
Indosuez Wealth Management

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The first question is very simple. What do you do at Indosuez, and why did you leave Switzerland during the pandemic to move to Hong Kong SAR?

My Capital Markets team is part of the Indosuez Markets, Investments & Structuring team, and my role at Indosuez involves overall responsibility for planning and executing the Capital Markets strategy, policies and procedures in the areas of Structured Products, FX & Precious Metals, OTC derivatives and all trade execution activities at Indosuez Wealth Management in Asia. I have been with the firm since 1992, all the time in Switzerland, until my wife and I moved to Hong Kong in the middle of 2020, during the pandemic. I have had a near three-decade connectivity with Asia from a work perspective, and we had planned the move to Hong Kong before the pandemic hit, and despite the ongoing crisis globally, it has been an exciting and positive transition.

You have a self-professed and long-time passion for tracking and often predicting currency market movements and gold. The world seems to be vacillating between negativity and positivity over the formerly mighty greenback, now that Biden is in the Oval Office and delivering his policies. Where is the US Dollar heading, and what ramifications will any movements have?

There is no pithy answer. We need to see the various elements that are affecting this and that could impact its direction. I would however say that we expect the dollar strength to fizzle out within 2021 and we prefer to position clients ready for that by shifting exposures to other currencies, especially the Chinese Yuan, and selectively currencies such as the Australian and New Zealand Dollars, the Norwegian Krone, possibly the Russian Rouble, while we think the Euro might strengthen later in the year if they can get their vaccinations and re-opening back on track. We think gold will recover from current levels, but for investors to buy back in through derivatives, not simply switch from cash to physical gold. We think the safe-haven currencies like the Swiss Franc and Yen will shift back to carry trade currencies as all that plays out. We advise caution and patience, and to beware equities at these prices and also anything other than short-term exposure to bonds.

Fascinating observations, can you now paint a more detailed picture of all the moving parts that bring you to these sorts of conclusions?

Yes, I need to explain all this from a variety of angles. The US Dollar was strong from the global financial crisis until more recently when it came under more pressure during 2020 and then when Trump was replaced by Joe Biden everyone assumed his policies would be bad for the dollar. But then we saw a confluence of events and Biden's gargantuan stimulus package and that has been driving the short covering of the dollar as people suddenly see the US again as a driver of recovery and growth.

However, is the package combined with the giant US vaccination programme drawing too much money into the dollar? We saw the pound rise to 1.42 on the back of its vaccination programme, but it got too far too fast and came back down. So, in the US, is the dollar recovery sustainable? Or will the stimulus result in runaway inflation? The Federal Reserve seems to want the economy to run intentionally super-hot, but when and will they need to douse the flames? Is this the Fed's 'Hotel California' conundrum, where they can check out, but can never leave QE?

All these questions and the answers we determine will help form a view on the dollar, but it is by no means clear at this stage, that is for sure. Gold informs us on some of these issues as well. Gold was super-hot, breaking records against every currency, and now it's gone rather cold, so what is next for that?

Given all of those uncertainties, our next question must therefore be how should Asian investors be positioning themselves in relation to these issues?

Our view is that we are seeing short covering of the trend depreciating Dollar, and that we must look at the big picture of the greenback that has been structurally weakening for the last 40+ years.

While Trump and his administration were openly devaluationist, trying to get trade benefits from a weaker currency, the Biden cabinet, and Janet Yellen, are taking a very gung-ho approach with added debt, "going big now or going home". However, the Fed may be playing with fire, the bond vigilantes are getting very skittish, and we all know we have had many inflationary scares in recent years that in retrospect, all proved to be short-lived. This time around, it could be different, we cannot be sure, so the jury is still out.

Getting Personal with Davis Hall

Hall's history in the financial markets dates back more than 35 years, during which time he has built an impressive resume in the foreign exchange and commodities markets. He has developed an outstanding ability to analyse and decipher the psychology of markets and investors, with intuitive, rigorous and steadfast convictions, offering those to Indosuez clients as part of a wider perspective that he believes they will appreciate and require.

He began his banking career in 1986 with Chase Manhattan Bank in Geneva as a trainee in the Capital Markets division. A few years later, he joined Cargill's financial markets division, where he became head of the FX Proprietary Trading team. During his four years there, Davis developed key strengths such as trading discipline and a sense for well-judged risk-taking.

He joined Indosuez in Switzerland in 1992, as a manager for Foreign Exchange and Precious Metals Markets two areas he has continued to work in and enjoy ever since. His last appointment before relocating to Hong Kong SAR in July 2019 was Global Head of Foreign Exchange and Precious Metals Advisory.

Davis was born in Boston, and educated in New England, and then completed his high school in Switzerland, receiving an international baccalaureate from the International School of Geneva, later returning to the US for his BA Honours in Languages and Fine Arts from Bowdoin College in Maine, USA.

He is happily married to his wife of 31 years, who hails originally from Finland. The couple has two sons of 28 and 26 who live and work in Switzerland, where they were born. His favourite hobby these days during lockdowns and the lack of travel is street photography, something that suits the Hong Kong SAR scene ideally. He also enjoys Chinese calligraphy and painting.

"I graduated in Fine Arts and languages," he notes, "so I enjoy those activities, especially during the times we have all been going through. Another passion is sailing and skiing, both of which I normally do in Finland."

Even very recently, the Fed was extremely dovish, suggesting that we're going to have low rates for even longer than thought and that they see any inflation blip as transitory, as a year-on-year base effect from prior low commodity prices.

The Fed does not seem worried about core CPI, but the bond market will surely want to test to see if the Fed is going to intervene to cap yields. This is really important because with the vast government debt to be issued this year, there are supply concerns. The recent seven-year bond auction in the US suffered a very weak bid-to-cover ratio with demand alarmingly low.

With USD8 trillion of debt to be issued, rescheduled or restructured this year, this is a major focus of attention. We do know that many foreign nations don't have the same appetite as before, whether it be Japan, China, Saudi Arabia, or Russia, the demand is simply not there. Longer-dated bonds have been a terrible investment for the past year. So, will the Fed try to put some yield curve controls in, will they come in to stop the rise in yields? Well, whatever they do, it has implications for the dollar, gold and other assets.

Add to this another stimulus in the form of about USD2 trillion in pent-up US savings that US consumers want to splash when shops and life reopen, as Biden indicated by the fourth of July. So, you have the situation of Powell saying the inflation scare is transitory and that there's no need to overreact, and that if inflation that goes beyond the 2% target, all is fine, but what happens when we actually get there in the coming weeks?

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Can the Fed keep control of all of these variables?

Again, time will tell. The situation is that yields have been moving up faster than inflation, meaning the negative "real" yields that were really weighing on the Dollar last year have evaporated.

Personally, I believe this is a temporary phenomenon and inflation rates may continue to move up. But the question is, does the Fed stop US yields from moving higher because of the heavy issuance of new paper this year? I think this is going to be the pivotal litmus test for currency markets in the second half of the year.

On top of all this, remember that Biden has indicated there is another USD2.3 trillion of potential infrastructure stimulus as well, and all the time the safe havens have been suffering, the Yen, the Swiss Franc and gold, and everybody's been buying back into the Dollar. After all, with Dollar bond yields so much higher than a year ago, it seems logical for Yen and other investors to buy into Dollar paper, perhaps lock longer-term yields in and hold those bonds to maturity. That is also why we see the Yen and Swiss Franc underperforming.

However, our position is to look through all of this and share with our clients our belief that this Dollar recovery is an anti-trend corrective move, and that we need to be ready to diversify back away from the Dollar later on given the underlying factors in the US which are truly grave.

If you consider the amount of debt, the monetisation, all the QE, and the ongoing debasement of the US Dollar as a fiat currency, these themes will persist. Moreover, the debt servicing itself could reach USD600 billion next year alone, with Biden adding trillions more.

You seem to be saying that there are many variables out there, and that the Fed might not be able to manage yields and CPI in a delicate balancing act, in other words that things might get out of their control, is that right?

In all honesty, none of us can know for sure, and we will have to see how much CPI picks up in the next several months. But we do know that from the lowest point of negative oil prices in April/May last year, oil has raced ahead,

while gold is under pressure, in a mini bear market actually, so a roughly 10% exposure to gold now because of all the risks out there seems fair. It doesn't look like the Fed is going to reduce its balance sheet anytime soon.

You mentioned gold several times, but perhaps you could put some more colour around what all this means for gold, which is currently at around USD1755 an ounce, and therefore well off its highs?

We think gold will pick up a bit, and there'll be a new catalyst for gold at lower levels to support buying and better risk-reward probably at around USD1600 or thereabouts. But the key to all this is whether the Fed caves into pressure, like the Australian Central Bank, and like the Bank of Japan, who are explicitly targeting top-end rates for bond yields – above which they don't want to go - if for example the Fed were to see rates moving above the psychological 2%?

I myself don't think short-term interest rate hikes are anywhere near close, possibly not even next year. But we have to be very mindful of what happens, as right now they are talking the Dollar to be stable and for yields not to overshoot, and if the US continues to get better control on the pandemic and we do see a more complete reopening, and we do get real progress on herd immunity in the US, then this Dollar rally is going to last for a little bit longer, and the squeeze can go higher before it dissipates.

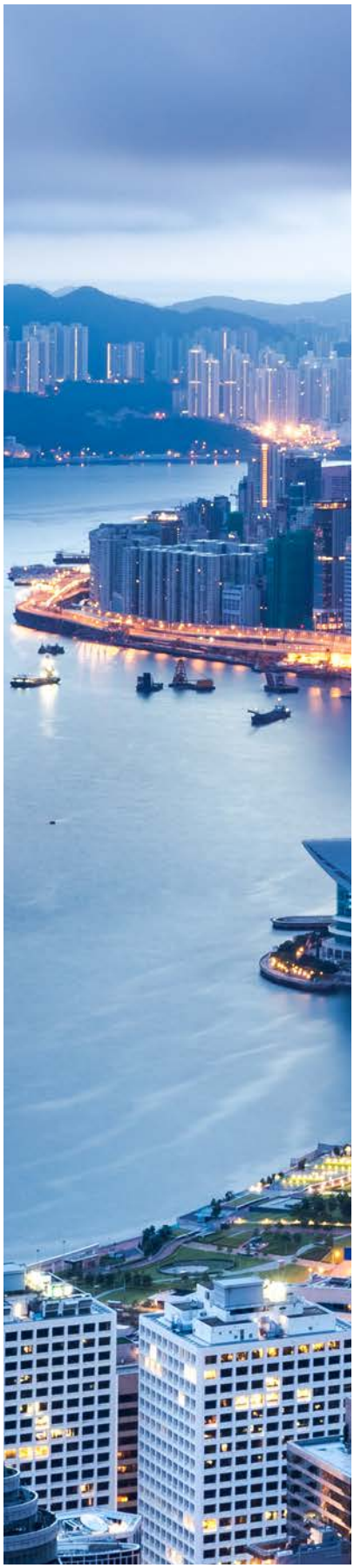
Historically, we have some guidance, as over the past four decades, any recovery in US growth aligned with global trade picking up after a crisis or a recession, sees the Dollar weakening, as the US consumer imports. We could see that alignment later this year, and when we see the trade deficit getting even worse, that is when we think the Dollar will stop benefiting.

So, you see short-term stability of strength for the Dollar, but that it will likely weaken within this year, is that right?

We are calling this Dollar recovery a correction, which could last for a couple more months, but we think it's a trap, and we're not yet convinced that Biden's GDP burst will be sustainable. People will start to focus on the trade deficit widening, and of course, the vast, vast debt, and investors will worry whether the Fed must control the yield curve. If the Fed is forced by the market to react, because of a taper tantrum, and they cave into pressure, then the Dollar will be more vulnerable; this is because if they don't allow US rates to move higher as inflation picks up, then real rates will revert negative again, and that will be the signal for alternative investments such as gold, where supply and demand factors are still extremely encouraging.

Yellen has stated that the Dollar levels must be determined by the markets, with neither an indication of support for a stronger or weaker Dollar, so she appears neutral, which is perhaps more negative in my view.

So, the issue now is how much inflation will the Fed embrace without having to intervene? And that is the 'Hotel California'



conundrum I talked about earlier. The markets have got used to the Fed bailing the markets out and they believe the Fed will react yet again if yields start to get too high, like the Bank of Japan.

We saw commentary from the BIS recently that global central bank money managers are reducing the component in US Dollars of their portfolios but that they're not increasing exposure to Euros. What about Europe, or China and other currencies?

Central banks are heading into other currencies such as the Chinese Yuan and gold, and we think that is a trend that will continue. Even though foreign flows into Chinese bonds have slowed as yields have moved up, we still believe that central banks are looking to divest from the US Dollar component, which is now below 59% of total reserves. This means the central banks are really using this bounce to reduce their exposure to the Dollar and diversify towards other liquid alternatives.

We also hope developments in the US will coincide with an improvement of the vaccination backdrop in Europe, where they also have pent-up savings and spending, and places like Germany will boost their surplus under those conditions, all of which indicates to us to look to buy cheap Euros in anticipation. Meanwhile, China is seeing the same sort of phenomenon, suggesting their currency will also ride higher. We would therefore be taking unhedged exposure for portfolios in those currencies into the second half once the Dollar strength fizzles out.

We have seen more news of corporate defaults. What are your views on those?

Yes, the names we see in the news are multiplying, in China and in the US, for example, and with the banks and hedge funds involved, fear will ratchet up. My view is that the complacency we have seen around credit risk is a mounting concern.

The bubble of all bubbles is the bond market and the amount of credit outstanding, and the inability of some of these zombie companies to continue paying and servicing their debt You may recall, Ernest Hemingway was asked what it was like to go bankrupt, and he replied, that well, it happened very, very slowly at first and then all at once. So, only time will tell.

The perception now is that there's no default risk for sovereign nations. If you look, recently, Greece issued some 30-year bonds, which were over 10 times oversubscribed, because we have so many desperate yield tourists out there. Think back a year or so when the US issued some 30-year paper, and in just one year, with the recent rise in yields, the mark to market on that paper is minus 24%! That is a cautionary tale that's important as to how quickly long-dated bonds can change in price when yields move up.

Accordingly, it is essential that we help protect our clients' portfolios and provide them with advice and caution, monitoring exposure to duration. At some point, there's going to be a price to pay for all of this excessive liquidity. Nobody

wants to be responsible for pulling the plug. Right now, Powell is being considered a maestro but so was Greenspan in the run-up to the GFC.

With the added input on these other issues, can we return to gold and what has been driving the price down of late, and what you see ahead?

Gold is actually in a long term uptrend that we believe will continue. Although at the moment, some of the hot money chasing gold has dropped out, and the Trump loss spelled the end of the strong rise for many, as buyers saw gold as the ultimate hedge against Trump's unpredictability and deglobalisation. Actually, if you look at the day he came to power and the day he left, gold prices were not far from the trough and the peak. And Biden has been fortunate in the timing of the vaccine releases shortly after his victory, further propelling the Dollar and weakening holders of gold as a hedge against the Dollar.

Gold therefore has a key role to play, but we think you want to buy and hold, not buy on margin, and you must be patient. For the past three years, we were very positive on gold, and it did indeed make a new high against every currency. We still believe in gold with no liabilities as a form of true money. Supply is limited and peaking, with strong demand especially in Asia, where the wealthier middle classes want to protect their savings as well. In short, we think gold can shine again, and we are forecasting a move back above USD2000 next year.

However, if the Fed does not intervene and US 10-year yields start to overshadow US average dividend yields– and remember we have come from 0.7% to 1.7% quickly in the 10-year paper - then we could see some switching from underweight bonds and reducing the overweight positions in high beta equities.

While the switch won't be wholesale, it could be enough to increase volatility, and all of a sudden, you get a great deal more friction within the financial markets, which could set off some safe-haven buying again, benefitting gold and safe-haven currencies.

Can you summarise all these excellent insights, observations, conundrums and uncertainties into a few key pointers for investors?

I do not profess to be the portfolio allocation expert, and actually my field is capital markets, FX and precious metals, so that is a caveat, although I do have my own convictions that I communicate regularly to our clients.

With that caveat, looking at Hong Kong SAR investors where the local currency is pegged to the US Dollar, they can think about diversifying later this year. We think the US dollar bounce will not be sustained. We think the overbought Canadian Dollar is a little ahead of itself, but we like the Aussie Dollar instead on weakness. We think the New Zealand Dollar can do well, ditto the Norwegian currency, and the Russian Rouble. However, we fear the Swiss Franc and the Yen will be pressured as financing currencies, more cheap to borrow carry trade currencies, than safe haven currencies.

We are wary of higher yield currencies such as Brazil, or Turkey, where yields are not high enough to compensate for the currency risk, and the political situation and the Covid backdrop there.

When it comes to gold, it's almost too late to sell, but as we get back towards USD1850, that could be an interesting level to consider, specifically, some covered call options as a means to extract and enhance returns from an underlying gold position. There are ways to sell covered calls, not naked but covered, which provide for an enhanced return on that zero-yielding asset with obviously the obligation forward and at maturity to potentially deliver some of the gold at a certain higher price with an even higher profit than today.

This means that clients do have ways of using a blip up in gold to enhance returns. And gold can be good for clients who have US Dollars, have Hong Kong Dollars, are cashed up but afraid of deploying that cash back into equities because they consider equities expensive globally.

There are many ways of deploying cash by using derivatives on an unleveraged basis to sell, for example, gold put options at a much lower strike level, which given high vol, a coupon, which serves to give a bond equivalent yield to that cash component within a portfolio.

Caution seems to be the buzzword, as well as patience.

Well, we are all facing many unknowns, so nobody can predict exactly how we transition into a reopening of the US, or if the positive news represents a false dawn on the global fight against the virus, we just don't know how quickly Europe can get its act together on vaccinations and reopen, and there are many things that could go wrong, and meanwhile the equity markets are priced for perfection. Even though we prefer equities to bonds, prices are high and there could be better entry levels. So, cash makes a lot of sense just now because better entry levels on equities and bonds might well be more appealing ahead.

That was really interesting. Do you find the Asian private clients you now work with in this region receptive to these types of discussions?

I have enjoyed a long career, mostly at Indosuez, and during those years, we have had a great deal of success in promoting currencies and precious metals as the standalone asset classes," he reports. "Whereas many people believe that it's a secondary by-product of portfolio management, we have proved over the decades that clients need to carefully nurture their portfolio allocations and their market timing in terms of currency diversification and benefit significantly from an informed approach to alternative assets such as precious metals.

This was a core reason the move to Hong Kong SAR. Clients in Asia tend to be much more transactional and willing to take on slightly higher risks than obviously the typical European clients, which are much more in capital preservation mode. There is more optimism and opportunism in Asia. I used to travel to Asia twice a year for more than two decades, so I had become very familiar over all those years.

I have often held contrarian or less than popular views on some markets and assets. I must say I spent many years believing in gold and was seen as somewhat of a broken record by colleagues. I was even told I was like a Swiss watch with no battery, whose time is simply correct twice a day! I kept rabbiting on saying we have to have a 10% to 15% gold allocation, but it came right in the end. I see my role in trying to perceive and then articulate a strategic vision, and I like to share my convictions with clients on a very regular basis. I must say I have been pleased to hear back from clients who followed some of our convictions; that is both rewarding and motivating. ■