The Most Dangerous Time in U.S. Financial History

The Julia La Roche Show (March 14, 2024)

Host: Julia La Roche

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[Brian Hirschmann, Managing Partner of Hirschmann Capital]

I agree with what Jim Rogers said on Julia's show: the next crisis should be the worst of our lifetime due to high debt levels. But I would add that very large asset bubbles will also make the crisis much more difficult. But the silver lining is this should be an incredible opportunity for gold investors.[1]

[Julia La Roche]

Brian Hirschmann, Managing Partner at Hirschmann Capital. It is so great to welcome you on the show. Thank you so much for taking the time to join me today, Brian.

[Brian]

Thanks, Julia. It's great to be here.

[Julia]

Well, I'm excited to have you on. And I've got to say, I see your name all the time in the guest-request comment section. So I know some of the viewers are going to be really happy to have you on.

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[1] Statements regarding future recessions, government-debt crises, inflation, interest rates, equity valuations, real estate valuations, gold prices, gold mining equities, Fund holdings, or potential Fund outcomes are forward-looking opinions as of the recording date. Actual outcomes may differ materially. Gold mining equities involve substantial risks, including commodity-price risk, financing risk, permitting risk, operational risk, political risk, currency risk, liquidity risk, and the risk of permanent capital loss. Historical market data and comparisons are based on Hirschmann Capital research using sources believed to be reliable. Definitions, time periods, index composition, and methodology can materially affect results.

And I'm excited to introduce you to this audience. And Brian, I would like to start where I always start with my guest, and that is to get their big picture, the macro view of the economy. We could throw markets in there as well.

And one of the things about this show, Brian, is that you can take all the time you need to set the stage for the macro picture.

[Brian]

Sure. Thank you. In short, I think this is probably the most dangerous time in U.S. financial history, because this is the first time and probably the first time in world history that a major economy has had three very large bubbles all at the same time. And right now we have bubbles in U.S. equities, U.S. real estate, and global bonds. And as we'll probably talk about today, I think all three of those bubbles are likely to burst at the same time. And of course, nobody can predict exactly when the three super bubbles will end.

But I think there are good reasons to think they might end soon. But the good news is that this should be the opportunity of a lifetime for gold investors. But before I talk about the bubbles, I wanted to share a quick analogy that I got from Mark Spitznagel, who Julia spoke about with Nassim Taleb on her show last year.

And that is that current U.S. and global economic policy is similar to a discredited firefighting policy. What do I mean by that? Well, for most of the 20th century, forest managers in the U.S. thought that forest fires should be suppressed as soon as they occurred. But they eventually learned that suppressing forest fires is actually a bad idea because it leads to a buildup of tinder and dry brush in the forest, which makes the inevitable forest fire far worse than it otherwise would be. And a tragic example of that was the 1988 Yellowstone fire, which was 44 times larger than any previous recorded fire in the National Park. But economic policymakers across the world have not learned the same lesson because, for the last 40 years, we've been zealously suppressing every recession, every minor crisis, with bailouts, aggressive fiscal deficit spending, and aggressive monetary policy in the form of rate cuts.

And to give some examples from the U.S., we had the rate cuts after the 1987 stock market crash. We had rate cuts after the 1991 recession, after the 2001 dot-com crash, during the global financial crisis, and in response to the COVID recession.

And it's similar with bailouts. We had the S&L bailouts in the 1980s. We had the bailouts of Continental Illinois Bank in 1984 and Mexico in 1994, and we were involved in the bailout of Long-Term Capital Management in 1998. So the list goes on and on.

And the problem with this is similar to forest management. Always suppressing crises increases the severity of future economic crises because it encourages reckless behavior by lenders and borrowers. Because if you're a lender or a borrower and you think the government is always going to be there to bail you out, then why not take more risk and lever up? The government will always prop up the private sector.

And we can see that increased recklessness in the growth of global total debt-to-GDP, and total debt includes both government and private debt. And for the 100 years leading up to 1980, global total debt-to-GDP averaged around 125%. But since this era of bailouts began, the global total debt-to-GDP ratio grew to around 200% in 2008.

And today, it's probably more than 250%. And this crisis-suppression policy has also created the U.S. equity bubble, since low rates have forced investors into equities as the Fed has tried to prop up the economy through a wealth effect by propping up the stock market. Aggressive fiscal spending and aggressive deficits have also juiced corporate profits. And if you look at pretty much any valuation metric for U.S. equities that has a reliable track record of predicting long-term equity returns, it says we're in a bubble right now. You can look at market cap to sales, market cap to GDP, market cap to replacement cost, market cap to cyclically adjusted earnings, which is the average earnings over the prior 10 years. All those metrics indicate the market needs to fall by around 50% to return to a normal valuation. And as we'll probably talk about today, I think it's very, very likely that we'll have an inflation crisis soon in the U.S. And if that happens and U.S. equities return to the cyclically adjusted price-earnings ratio that they had during the last inflation crisis, then the valuation of the U.S. stock market would need to decline by around 85%. And it's a similar story in the real estate market, where we've had this aggressive stimulus in the form of rate cuts, which has driven up home prices. And it's incredible to me that the price-to-rent ratio and the price-to-income ratio for U.S. residential real estate are now higher than they were during the 2006 housing bubble. And to me, this is a great example of what the economist J.K. Galbraith called the eternal brevity of the financial memory, because investors have forgotten all the lessons from the last housing bubble, even though it was less than 20 years ago. But the key point, I think, is that this age of bailouts is probably over or is almost certainly over, because all this fiscal stimulus for decades and decades has pushed the government's finances to the breaking point. If we take the U.S. as an example, right now we have this toxic combination of high deficits, high government debt-to-GDP, high inflation, and high borrowing from foreigners. And high deficits and high government debt-to-GDP are a problem because they mean our government debt is growing much faster than our capacity to pay it.

And the high inflation is a sign that the U.S. government has already started to default through inflation. And borrowing from foreigners is a problem, because foreign investors tend to be more fickle and they're tougher to control with regulations. And many studies show that countries with heavy borrowing from foreigners tend to have more debt crises and default sooner.

In fact, there have been 21 instances of this combination of these four toxic factors since 1914. And all 21 of those countries defaulted within two years, and their median average annual inflation over the subsequent four years was 18%. So, in fact, none of them were able to avoid sustained inflation through some central bank policy or through a recession.

And another problem we have right now is that we have a lot of short debt maturities in the U.S., which means we have a lot of refinancing risk. And that's a big reason why our government interest expense is increasing very rapidly. But another very important point is that this government debt problem isn't limited to just the U.S. It's a global problem. Global government debt-to-GDP is near an all-time high, and the government debt level in many countries is at a level that has almost always led to default. Examples include Japan, Italy, France, the U.K., and Brazil. The U.K. had a mini-debt crisis in 2022, which might have been a preview of what's to come, and Brazil had one less than a decade ago. And so, what this means is that when we inevitably have a government debt crisis in one country, it could spread across the world due to globally high government debt levels. And in fact, we could be seeing the beginning of that now, since interest rates have been steadily rising across the world since 2020. But probably the most important point that I want to get across is that everything is changing.

Because for the first time in the last four decades, governments will probably be the cause of the next crisis, not the cure. They'll be the source, not the savior. Because if a government is in a debt crisis and defaulting through inflation, then cutting interest rates leads to more inflation.

Or if it tries to bail out a bunch of banks and companies, that should make the debt crisis worse because the government would be taking on more liabilities, and that would make investors even more concerned about the government's solvency. So, what we might get instead is a doom loop in which a government debt crisis causes a private-sector recession, which in turn makes the government debt crisis even worse.

And we saw an example of that in Greece after its debt crisis roughly 15 years ago. And we're seeing something like that in Argentina right now. And of course, if the U.S. government has a debt crisis, then the valuations of equities and real estate should collapse, which would be similar to what happened to U.S. equity valuations during the 1970s, when we last had high inflation. But it could also go the other way.

If the U.S. housing bubble starts to deflate, it could cause the U.S. government's budget deficit to explode, precipitating a government debt crisis. And that's similar to what happened in Ireland and Spain 15 years ago. But the difference is that our debt metrics look much worse than theirs did before their crises.

So, to sum it up, I agree with what Jim Rogers said on Julia's show: the next crisis should be the worst of our lifetimes due to high debt levels. But I would add that very large asset bubbles will also make the crisis much more difficult. But the silver lining is this should be an incredible opportunity for gold investors.

[Julia]

And that's a great frame-up to the conversation. Real quick, did you say equities would need to decline by, did I hear, 85%?

[Brian]

Sure. Right now, the U.S. cyclically adjusted price-to-earnings ratio, which is market cap relative to average earnings over the prior 10 years, is around 34-35x. And when equities were at their lowest valuation around 1982, the cyclically adjusted price-to-earnings ratio was only around 6.

So that would be around an 85% loss. If you were to use other reliable valuation metrics, you would probably arrive at a similar number. And so, in some ways, that's a somewhat pessimistic statement, given that it was the low valuation.

But on the other hand, there are many reasons to think the next inflation crisis will be far worse than the 1970s. For example, in the 1970s, our government debt-to-GDP ratio was around 40%. And that gave us a lot of flexibility to raise interest rates. For example, the Volcker interest rate hikes.

But now our government debt-to-GDP ratio could soon be above 150% if we enter a recession or interest rates rise. And so there are many reasons to think the next inflation crisis will be much more severe than the one in the 1970s. And so maybe a 6 CAPE multiple at the low isn't crazy.

[Julia]

Okay, so Brian, I want to hear more on why gold is poised to perform well. But before we go there, can I get your take on gold today, even with gold hitting all-time highs?

And the reason I'm curious is: how is it hitting all-time highs when stocks are also hitting record highs, and Bitcoin is at a record high? It feels like such a perplexing environment. Can you help us understand what is going on in the markets, especially gold, right now?

[Brian]

Yeah, sure. Maybe I'll address that question as part of the discussion of my longer-term outlook for gold. And of course, with gold, like any asset class, you need to be careful not to read too much into the day-to-day fluctuations.

But one factor that can affect gold is interest rates: when interest rates fall, gold looks more attractive relative to money market funds or bank deposits. And recently, as I think markets have become more concerned about the risk of a recession or slowdown, expected future interest rates have declined. And so, gold, like crypto, has been benefiting from that.

But that's not the only thing that can affect gold’s valuation. For instance, another major factor affecting gold’s valuation is inflation. Inflation reduces the value of fixed payments in the future.

So that's a big problem for bond investors, since bonds depend on fixed coupon payments in the future. But gold doesn't lose value when inflation rises because it doesn't depend on coupon payments far in the future. Thus, when you get an inflation crisis, investors tend to shift from fixed income assets, such as bonds, to gold.

And that impact can be really big, because the value of all the world's debt is around 20 times the value of the world's gold. So if you have just a small shift from bonds to gold, it can cause a huge increase in the gold price. We saw that happen in the 1970s, when inflation increased and gold increased dramatically.

The other thing that can increase gold's value is when concerns about defaults increase, which usually happens when risk aversion is also increasing. And of course, increased defaults are generally bad for equities and for many types of bonds. But as the cliché goes, gold is the one asset that is nobody's liability and is thus immune to default.

And we saw examples of how gold could benefit from increased concern about defaults in the European debt crisis 15 years ago, and also when we had the mini banking crisis last year, and gold popped a little bit. But I think the two factors that matter most are concern about inflation and concern about defaults. Because in the 1970s, you often had rising interest rates, which you would think would be bad for gold.

But gold actually did incredibly well because concerns about inflation had a much greater impact on it, leading to a large shift of capital into gold. And then conversely, in the 80s and 90s, you had a diminishing concern about inflation, but you often had falling interest rates. And gold did very poorly then, because again, that concern about inflation is much more important than fluctuations in interest rates.

Although right now, we're most likely seeing gold's price being driven primarily by interest rates since inflation expectations have been steady over the last few years. But I think the big point for your listeners is that gold's valuation right now is around its 50-year average. And for all the reasons I mentioned earlier, I expect defaults and inflation to increase a lot over the next few years.

And that should be incredibly positive for the gold price. In fact, if gold returns to the same peak valuation it reached in 1980, it should rise to more than $7,000. That would be a peak valuation.

So if gold were at $7,000, I would probably have sold all my gold mining investments by then. But as I mentioned earlier, there are many reasons to think that the next inflation crisis will be much worse than the 1970s. So perhaps gold will go much higher this time.[2]

[Julia]

Even higher than the $7,000 that you think it could go to?

[Brian]

Yeah, the $7,000 assumes gold returns to the same peak valuation it had in 1980. And so, it would then be well above its historical average. And so, I certainly wouldn't be buying it at that point.

But yeah, I mean, there are many reasons to think inflation this time around will last much longer. As I was alluding to earlier, the government isn't going to be able to hike interest rates the way it did around 1980 to lower inflation expectations. Because if it did that, it would literally default outright because our government debt is so much higher.

And also leading into the 1970s inflation crisis, we didn't have these huge asset bubbles in equities and real estate that we have now. And our corporate and consumer debt are far higher now. And so for all those reasons, I think the next inflation crisis could make the great inflation from 1965 to 1982 look relatively mild.

But again, that should be incredible for gold investors.

[Julia]

Okay. All right. So I want to hear more on the thesis around inflation because of the Fed's policies right now- the rate hikes- is it just futile at this point?

Are they making a mistake, or is it just not much they can do? I want to hear more about your views on the Fed's policy decisions and this thesis of more pervasive inflation, because sometimes you see headlines that we're going to beat inflation or inflation's coming down. Just want to get your perspective.

[Brian]

Yeah, I think my perspective is a little bit different because, of course, when you talk to almost any Wall Street strategist or any broker, they're very, very focused on what the Fed is going to do. But I don't think the Fed matters much to a long-term gold mining investor. Ultimately, the Fed will be trapped.

And this was similar to what you discussed with Professor Calomiris a few weeks ago. Ultimately, the Fed will be trapped and will lose control of interest rates because if the U.S. government is having a debt crisis, inflation will be very high. And then if the Fed lowers interest rates, that would cause more inflation.

And if the Fed raises interest rates, then that'll make the government's debt problem even worse. And that would also lead to more inflation. And so ultimately, we're heading for a situation where the Fed is trapped.

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[2] Price targets and asset-price forecasts are subjective opinions as of the recording date, based on assumptions that may prove incorrect. They are not guarantees, are not recommendations to buy or sell any security, commodity, cryptocurrency, option, or other instrument, and should not be relied upon as predictions of actual market outcomes.

And I think when investors are very focused on what the Fed is going to do, they still have a crisis-suppression mentality, thinking the government is always going to save them. But that misses the point I was trying to make earlier: we're heading into a regime in which everything will change because government debt is at the breaking point.

Investors are like junkies who are addicted to these bailouts that they have been getting for the past few decades through Fed rate cuts. And so, we're heading into an environment where, instead of the Fed put people have been accustomed to, you're going to get a Fed margin call, where the government debt problem forces interest rates up and causes the private sector to sell assets and try to reduce debt.

[Julia]

Got it. Okay. So let me ask you this too.

On this notion of a U.S. government debt crisis and a potential for default, some might say we have the – our currency, the U.S. dollar, is like the global reserve. Could that insulate us, and why is that argument incorrect?

[Brian]

Yeah, no, it's a great question because I think that's the most common argument I hear for why the U.S. government won't have a debt crisis. And the answer is pretty simple. Before the last inflation crisis from 1965 to 1982, the U.S. dollar was even more of a reserve currency than it is now. For instance, in 1975, 85% of central bank reserves were U.S. dollars. Today, that's only around 58%. But despite our reserve currency status at the time, it didn't prevent the inflation crisis.

And interest rates rose to 16% in 1981. So it seems highly unlikely that our diminished reserve-currency status today will prevent the next government debt crisis. And you can also see that in the ownership data for U.S. Treasuries. The percentage of U.S. Treasuries owned by foreigners has been steadily declining since 2014. And that's the opposite of what you would expect to see if there were this huge demand for Treasuries because of the U.S. dollar's reserve-currency status.

[Julia]

Got it. And you mentioned Professor Charles Calomiris, who was on the show in December. For the folks who are watching and listening, I'll link to that episode in the show notes.

And he was talking about moving to fiscal dominance. It sounds like you watched the episode, and I'm sure you've read his paper that was published with the St. Louis Fed. How might gold be affected if we saw this scenario Dr. Calomiris painted as moving toward fiscal dominance?

And he also talked about an inflation tax as well.

[Brian]

Yeah. I would definitely encourage people to check out Julia's episode with Professor Calomiris. It was one of my favorites.

The short answer is I think the scenario he was describing, fiscal dominance and zero interest reserves, should be fantastic for gold. And I'll give a quick explanation of some of his ideas, and you can check out that episode for a more thorough explanation. And I haven't spoken to Professor Calomiris. Still, I think he would agree that U.S. government debt is unsustainable and that it's just a matter of time before the U.S.

government defaults through sustained high inflation. And I think he would also agree that this is a global problem. And so, when a default occurs in the U.S., it's also likely to occur in many other governments across the world.

And he also mentioned the fiscal dominance issue that Julia mentioned, and that is just what I was describing earlier. Ultimately, the U.S. government will face a debt crisis, which will trap the Fed. If it lowers rates, it will increase inflation, even though inflation is already high due to the debt crisis. If the Fed raises rates, then that might cause more inflation also, because it'll cause government debt to grow faster. As I mentioned before, it might even cause the government to default outright because our debt levels are far higher than when Paul Volcker was Fed Chairman.

And so, that means the government's debt problems will dominate the Fed, and hence the term "fiscal dominance". But one of the other interesting things that Professor Calomiris mentioned is: when inflation is high during the debt crisis, say 10% per year, the Fed is going to use bank reserve requirements to force banks to lend to the U.S. government at a 0% interest rate. That will mean that banks will be losing 10% of their principal each year by lending at 0% when inflation is 10%.

But that'll be good for the government, because it'll lower the government's borrowing cost and thereby improve the deficit. That also means that banks, to avoid going bankrupt, will have to reduce the interest rate they pay to depositors to 0% because banks won't be getting any interest income from their loans to the government. That means depositors would also lose around 10% of their principal each year because they'll receive no interest when inflation is 10%.

Gold is one of the few assets that can be held outside of the U.S. or global financial system. But these interest rate caps will probably be implemented by governments across the world, not just the U.S. A negative 10% interest rate would be a global problem. Gold would probably soar as investors shifted from deposits to gold. And right now, the value of all the world's deposits is around 10 times the value of the world's gold. If you saw 10% of those deposits shift to gold, that would result in a doubling of the gold price. If you saw 30% of those deposits shift to gold, that would result in a 300% increase in the gold price.[3]

[Julia]

Yeah. Okay. So, when it comes to gold, you mentioned earlier that you invest in gold mining companies.

I want to ask a couple of questions. Why play it with the gold mining companies? And can you share a bit about how that works exactly, how they make their money?

Why is that a more attractive way to express an investment in gold?

[Brian]

Sure. So, I think gold bullion is also a good investment. And historically, it has reduced portfolio volatility.

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[3] Statements regarding fiscal dominance, reserve requirements, deposit rates, depositor behavior, deposit shifts into gold, and resulting changes in gold prices are hypothetical, forward-looking opinions as of the recording date. They are based on assumptions that may prove incorrect and should not be relied upon as predictions of actual market outcomes. Actual outcomes may differ materially.

And I expect it to remain a good investment for all the reasons we've discussed. But I have two issues with gold bullion, which includes physical gold and ETFs.

The first is that its long-term historical inflation-adjusted return is only around 1%, whereas the historical inflation-adjusted return for global equities is probably around 5%. So, over the next 30 years, I would expect gold bullion to underperform.

The second issue is that although gold’s valuation is currently around its 50-year historical average, it's not especially undervalued, so if the bubbles continue for a few more years, gold might not do much until they burst. Regardless, I would still expect it to do very well when we inevitably have a crisis.

That leads me to the gold miners. I prefer the gold mining equities that my fund invests in for several reasons. First, if the gold price soars, then the gold mining equities should vastly outperform gold bullion due to operating leverage. By operating leverage, I mean that if you have a gold mine with a 50% profit margin and then gold rises 10%, the profits of the gold mine would increase by 20%, and then you'd expect the gold mining equity to go up by around 20%, which is much more than the gold price increase.

That operating leverage can be very powerful. Currently, I have companies in my portfolio trading at around $25 per ounce of gold, calculated based on gold they have in the ground that they've identified but haven't yet mined.

If the gold price goes to that $7,000 price that we were discussing earlier, then many of those companies might trade for more than $800 per gold ounce. So, that would be an astronomical return.[4]

If the gold price doesn't move, many companies in my portfolio are trading at around 30% of the present value of their future cash flows at current gold prices. I'd expect that if the gold price is flat, the equities would still appreciate as their valuations improve and move closer to the present value of their future cash flows. Of course, the most important thing is what happens if the gold price falls. If that happens, I would expect the gold mining equities to decline more than the gold price.

I would expect that to be only temporary because their valuations are very low, their production costs are low, and they have conservative capital structures. Ultimately, when the gold price soars for all the reasons we've discussed, I would expect them to rebound dramatically.

So, I think gold mining equities offer better risk-return, but they're more appropriate for a long-term investor because they can fluctuate much more than gold bullion in the short term.

Another option for investors would be gold mining ETFs, such as the GDX and the GDXJ. I prefer my fund because it's outperformed [its gold benchmarks] over the last nine years,[5] and the valuations of the

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[4] This statement was an unscripted, valuation-based opinion as of the recording date. It was based on the manager’s subjective estimate of intrinsic value for certain portfolio holdings and should not be interpreted as a target return, expected return, guarantee, or official projection of Fund performance. The assumptions underlying this statement may prove incorrect. Actual Fund results may be materially lower and investors may lose all or a substantial portion of their investment. The statement does not account for all fees, expenses, taxes, liquidity constraints, changes in portfolio holdings, changes in commodity prices, financing risk, permitting risk, operational risk, political risk, currency risk, or other risks described in the Fund’s private offering memorandum.

[5] This performance comparison refers to the period from October 1, 2014, through March 11, 2024. Fund returns are presented net of applicable Fund fees and expenses, including any performance allocation, and include reinvestment of dividends and other earnings. Benchmark and market comparisons use the

companies in the gold mining ETF tend to be higher, since it can't buy many of the smaller companies my fund invests in. It has greater exposure to higher-risk developing countries, such as China, which I don't want to invest in.

[Julia]

Got it. Okay. So, going back to the three bubbles that you shared, and they're on this path where they could burst.

My kind of question for you, Brian, is: who will be most impacted? Because I look at real estate. I'm a millennial.

I have a great job. I feel like I've done all the right things. I would love to own a house.

And personally, I feel like I'm priced out, or it feels so ridiculous, like some of these prices that I'm hoping for a major pullback in housing. I know that's selfish to say. Or even like, I don't know, equities or whatever.

Do you have a point of view on who could be most impacted, or whether it could create an opportunity down the road for folks to get in?

[Brian]

It's a bit more of an asset allocation question. So, it's not really my day job, but I'm happy to share my thoughts.

I think we can start with bonds. I think long-term bonds should get crushed by high inflation since their coupon payments are fixed and not indexed to inflation. That is why we've heard guys like Buffett advise people not to invest in long-term bonds. U.S. equities would be highly vulnerable given their elevated valuations. I would expect U.S. equities to get crushed just like they did during the last inflation crisis. I think the valuations of foreign equities in places like Brazil and the U.K. are much better. There's a strong argument that the U.S. dollar is overvalued right now. That also makes foreign equities look more attractive. Just look at how much cheaper a vacation to Japan is now than it was 10 years ago. That gives you a sense for why I think the U.S. dollar is overvalued. Thus, I would expect foreign equities to outperform U.S. equities in a crisis. Certainly, Brazil, the U.K., and Japan have their issues, but those equity markets should decline less and bounce back sooner simply because their valuations are much better. As far as real estate goes, I think if someone could lock in a 30-year mortgage at 2%, they might do pretty well. Although the price-to-rent ratio of their home should compress, the real value of their mortgage will potentially get wiped out by inflation.

For someone looking to buy real estate, I think mortgage rates will rise, and price-to-rent ratios will fall. The price of homes should decline. They'll be able to buy at a lower price. However, the mortgage rate

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benchmarks, ETFs, indices, or commodity-price series identified in the Complete Returns PDF, which may include GDX, GDXJ, and gold, and a global-equities benchmark. These benchmarks and market instruments are materially different from the Fund's concentrated private-fund strategy. Indices and commodity-price series do not reflect Fund fees or expenses, and investors generally cannot invest directly in an index or commodity-price series. Past performance is not indicative of future results. Please review the Complete Returns PDF for full net-of-fee performance, benchmark information, and methodology.

will be much higher. But then, hopefully, in future decades, they'll be able to refinance that mortgage and get a better rate.

So, I do think if you're deciding between renting and buying, it's probably better to rent. I'm currently near Los Angeles. In Los Angeles, the median home buyer (i.e., someone with the median income in Los Angeles), if they would like to buy a home with the median home price, will need to spend 85% of their income on the mortgage. That means if home prices go up a little bit more, or if interest rates go up a little bit more, they will need to spend 100% of their income on their mortgage.

I think we can all agree that that's not sustainable. That’s happening at the same time that unemployment is soaring in California and people are leaving California. It's going to be interesting to see how that plays out. But I would not be buying in Los Angeles at the moment.[6]

[Julia]

Yeah, it will be interesting. You mentioned at the top of this conversation, when you opened it, that this is the most dangerous time in financial history, and you pointed to the three bubbles. So, my question for you, Brian, is: is there anything that would change your thesis, or anything that could be done to ameliorate the situation from where you sit?

What do you see that could be done to get us off this path?

[Brian]

It's a great question. Before I make any investment, I always write down the factors that might change my thesis and prompt me to reevaluate the investment. On a macro level, one thing I always write down is that if the U.S. government starts paying down its debt and reducing its debt-to-GDP ratio, it changes the situation. But I think we can all agree the probability of that is close to zero. We haven't run a budget surplus since the dot-com bubble in 2000. Nobody in Washington will have much interest in reducing the debt until the crisis has already begun.

And by then, it'll probably be too late. And that's why countries like the PIIGS (Portugal, Italy, Ireland, Greece, and Spain) in Europe weren't able to get out of their crises on their own. They needed a bailout because implementing austerity when you're already in a crisis slows GDP growth. After all, you're raising taxes and cutting government spending.

That increases your debt-to-GDP ratio. That's why it's very hard (and potentially impossible) to get out of these situations once you get to the 150 percent government debt-to-GDP ratio that we might be at soon. So that's the one I watch out for. It seems very unlikely, but it's worth monitoring.

[Julia]

Yeah. You know, one of the things that's written on your website, Brian, is that when you first launched Hirschmann Capital in 2014, ValueWalk, a blog focused on hedge funds, called you the most bearish hedge fund. I think that was the moniker you got.

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[6] Statements regarding bonds, equities, cash, real estate, mortgages, renting versus buying, foreign equities, gold, gold mining equities, or other assets are general market commentary as of the recording date and do not constitute individualized investment, financial, tax, legal, or real-estate advice. No statement in this transcript takes into account any investor’s specific investment objectives, financial situation, risk tolerance, tax status, liquidity needs, or housing circumstances.

And some might listen to you and say, you're pretty bearish, I suppose. What are you upbeat on? What are you bullish on these days?

[Brian]

Yeah, I think gold, which we've touched on, I think it's probably the most bullish I'll ever be on gold.

[Julia]

I'll tell you, they love gold in the comments section. So come to the right place.

[Brian]

Right, I hope so. I'm also bullish on international equities. I do think the valuations are more reasonable there. In addition, there's nothing wrong with holding cash. But I think U.S. equities are very expensive. U.S. real estate is very expensive. Global bonds are very expensive. It is a very dangerous time.

In 1929, we had a stock market bubble that led to the Great Depression. That was the only bubble because we had no national real estate bubble at that time. And we had no government debt issues at that time. Yet that led to the Great Depression.

During the Japanese asset price bubble in 1989, there were real estate and stock market bubbles. Those bubbles were bigger than our current bubbles, but they didn't have a government debt problem. But that still led to a lost decade for Japan. Their real estate and equity markets still have not gotten back to their 1989 peaks (after adjusting for inflation) more than 30 years later. That shows how severe the consequences can be when you have two bubbles at the same time, let alone the three that we have right now. In 2008, we had the housing bubble. But that was just one bubble since government debt was lower, and the equity market was more reasonably priced. Yet that almost led to a global depression.

So this is a very dangerous situation. So there are some things I'm bullish on, but not a lot.

[Julia]

Yeah, I don't even know if we've mentioned it here, or I don't think I even asked you, but your base case for recession, I take it you think there's a recession coming based on this conversation. Do you have, like, an outlook on the recession? Any sort of, you know, it's so hard to do timing.

But if you have that, can you share it on the recession front?

[Brian]

Yeah, I think recessions are very difficult to predict. But I do think a recession is likely. If one occurs, I think that would probably pop all three bubbles. A recession would crush corporate profits.

It would reduce demand for homes and lead to forced home sales. It would potentially be a disaster for the U.S. government's finances. In fact, I recently conducted an analysis examining how recent U.S. recessions, such as the dot-com bubble, the global financial crisis, and the COVID recession, increased the government deficit.

If we assume the next recession has a similar impact, then that means U.S. government debt-to-GDP would probably increase from around 122% now to around 145% of GDP. That's assuming no increase in interest rates. If we had an increase in interest rates due to high debt levels, then it would be even uglier, maybe 160%.

Even assuming no increase in interest rates, the government budget deficit would probably go from around 6% of GDP per year to around 13% per year. That's a problem: if you analyze all the countries since 1991 that have had government debt-to-GDP of at least 110% and budget deficits of at least 11%, all of them defaulted within two years. So, I think if we do get that recession, it's highly likely to cause a government debt crisis.

As for why I think a recession is likely, I think three categories of metrics have predicted the last eight recessions without false positives. And they're all indicating that we're heading into a recession right now. For me, that's enough to say that a recession is likely.

The first is the inverted yield curve, which Julia discussed extensively with Cam Harvey so that I won't go into detail on it.

The second is the Conference Board's Leading Economic Index.

But the third category of indicators, which is the most interesting, is the employment market.

As Julia also talked about with Claudia Sahm, 70% of the economy is consumption. If you get a spike in unemployment, then that's going to cause people to cut back on spending. And that almost certainly will lead to a recession.

And right now, we've seen the smoothed unemployment rate increasing for the last seven months. It's been substantially above its 12-month moving average for the last seven months. And when that's happened in the past, it's always led to a recession.

Also, if you look at labor market metrics such as job hires, job openings, part-time workers, temporary workers, and average hours, all of those metrics are heading in the wrong direction. And when they've been weakening as much as they have been, we've always had a recession in the past. And so that's why I think a recession seems likely.

But I think the most important point is if you're a long-term gold mining investor, it doesn't matter that much whether the recession happens in 2024 or 2026. Inevitably, we'll get a recession. Inevitably, the bubbles will burst.

All past bubbles have burst. At some point, gold is going to soar. In the meantime, the gold mines I invest in should continue to appreciate as they generate cash, discover more gold, and make progress with permitting.

[Julia]

Yeah. Well, I've got to say, Brian, I appreciate that you listened to the show. So thank you so much for all the plugs.

And I've really enjoyed having you on. I want to give you the final few minutes here, Brian, to share more about your firm and the work you're doing there, and to let folks know where they can find your work. And also, let's leave the audience with some parting thoughts- something that maybe we didn't bring up in this conversation.

Or if you want to go back and re-emphasize something, the floor is yours.

[Brian]

Yeah. I don't tweet much, but you can follow me on Twitter at HCapitalLLC, all one word. My hedge fund's website is hcapital.llc. I appreciate everyone listening. Hopefully I've given you some good questions to discuss with your financial advisor. If they have you in a lot of long-term bonds, you can ask, why are we invested in these when we're getting paid very little and the probability of U.S. default is close to 100%? Why am I heavily invested in U.S. equities when all the valuation ratios that have done a good job of predicting past crises say the equity market is extremely, extremely overvalued?

Why am I not monetizing more of my U.S. real estate investments if real estate is at an all-time high in terms of valuation? Why don't I have exposure to gold if the probability of a debt crisis has never been higher?[7] I think those are all good questions to ask.

I would reemphasize what we've been talking about here. I look forward to keeping everyone posted because I think the next few years should be interesting.

[Julia]

Well, Brian Hirschmann, Managing Partner at Hirschmann Capital, thank you so much for being so generous with your time and ideas. I really appreciate you taking the time to come on today.

[Brian]

Thank you.

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