

Dr. Enzo von Pfeil – Old Boy Scouts Are Always Prepared

written by GoldSwitzerland | June 26, 2016

THE MATTERHORN INTERVIEW – June/July 2016: Enzo von Pfeil

Being an old Boy Scout I say *“To be prepared is always a useful thing”*

On behalf of Matterhorn Asset Management and pre-Brexit, Lars Schall spoke with asset manager and global economist Dr Enzo von Pfeil who is based in Hong Kong. They talk about the Far East Market, why the Renminbi is unlikely to become a reserve currency for at least a number of decades, gold of course, amongst several other current topics.

[Video/Podcast] 28 mins

“Being an old Boy Scout I say: To be prepared is always a useful thing”

Transcript

Lars Schall: Hello ladies and gentlemen, I am now connected with Dr. Enzo von Pfeil, a global economist from Germany who's based in Hong Kong, where he works as investment strategist for the investment management firm Private Capital. Dr. von Pfeil, you've moved to Hong Kong in 1989. Do you like living in that particular region of the world?

Enzo von Pfeil: Absolutely. I was schooled and worked both in Germany and in the UK and in the US. So I have been around for a while, but I have also been here for 25 years, and what I like is that it's very efficient in Hong Kong. It's the world's growth spot, in other words despite all of this talk about China it is still a very strong economic area. I am a true foreign out here and I have been chief regional economist out here for Smith New Court Far East, that was the dependence of N.M. Rothschild, as well as for SG Warburg Securities Far East. So it's a great place to travel from.

LS: And isn't it some kind of a luxury to be a foreigner in a place?

EVP: Well, it is because you don't have to conform and I am not very good at conforming. So one can pretty much when one is not expected to conform to the British society here to the French society, of course not to the Chinese society – it gives one a lot of degrees of freedom.

LS: Seen from Hong Kong, what are your biggest concerns these days when it comes to mainland China?

EVP: Well, the main one has to be that the locals are very, very scared of people, and so they keep trying to second-guess what China wants. Now the

second-guessing is making us implode and this is entirely of our own doing. The standard of English, for instance, is rotting by the day, and I just don't know how we can be globally competitive if in fact our English is not up to standard. The fiefdoms are thriving, the doctors, for instance, have created a closed shop here since hand over in July 1997. So that is not very good, the doctors are overworked and overpaid, the cartels are alive and kicking. The third point is that we have a lacking set of priorities here. No visioning by the local government. What I mean by that is that the local governments instead of spending on schools and hospitals and locational training, they are spending billions on another cultural hub, on an airport runway, on a bridge to nowhere, and things of this nature, just white elephants, they are not necessary.

Then we have the youth which seem to be infected with entitlement thinking. Maybe that's third generation stuff that it isn't doing or can't do the attitude in Hong Kong any good. We are also afflicted with a dysfunctional Parliament. The Parliament here is not like the Bundestag that gets things done. It is very much a Parliament of squabbles here. Our system is rotting from the inside. So there are plenty of things that aren't good here. But again underlying all of this it's still a very good place to live. But you ask me about the problems of Hong Kong and those are very key issues. They all of our own making, they are not because of bad China.

LS: What could be done about those problems?

EVP: Well, the key thing has to be just to get a vision of competitiveness re-instilled here. There is a lot of navel-gazing going on, which goes to say that people are not really focusing on trying to make the place move ahead. They are too worried about their own pocketbooks. One thing for instance would be they are making English a mandatory language. That is an absolute must for the young people especially. Because, and I am talking about 19 to 25-year-olds where the unemployment rate is a staggering 27%. Now, we need also firm a leadership at the top and in our Parliament. We have to lessen this glaring income inequality that we have here. And that can be done quite easily by focusing on the truly poor. And finally, much more of a vocational training. What we have in Germany with that whole "Lehrsystem – Ausbildungssystem" (system of training and education), I think that is absolutely fabulous in Germany, in Switzerland, in Austria. Now, I wish they would institute more of that here in Hong Kong. That would solve a lot of problems.

LS: Yes, and what is one of the main problems that you see generally related to China.

EVP: I think that the popular one is that growth is slowing. But that is a little bit of a myth. It's not a reality. Yes, I mean the number, the headline number is slowing, but also the economy, the base effect is very much alive and kicking. The economy is 100 times the size of what it was under Deng Xiaoping, and so of course the growth rate is slowing. But what I do see with some concern is that Beijing is having more and more difficulties in reigning in the provinces, in other words, it is decentralizing it's this tag for war between centralizing and decentralizing in China. And I think

from that one, one can then derive a lot of other issues such as some social unrest, some rust belts in China that need to be addressed. But the key thing of it is decentralizing, and Xi Jinping is very much now trying to re-centralize. But if he is having much luck, I'm not so sure.

LS: When one is interested in China, we hear quite a lot about the "One Road – One Belt" project. What is your thinking on this?

EVP: Not a lot to be honest with you. I think it is a great headline grabber, but I don't think that the actual implementation of this is going to be as important – and I stress this for us here in Hong Kong, remember we sit as the very tiny city of 8 million people on the outside of China, in the east side of China obviously, so for us in Hong Kong it doesn't mean a lot. I think it may mean a lot if you go to the actual "One Road – One Belt" system. But we are too far removed from that. Our opportunity would be of course to be the financier of that whole project. But given the way that things are going here I don't see that really happening anymore. Because people seem to have gone fatalistic and they seem to have given up a little bit.

LS: Talking as two Germans, should Germany be interested in this "One Road – One Belt" project?

EVP: Well, I would have thought with all of the infrastructure that is going to go with it, the airports, the ports and all this, the natural German strength of engineering, of mathematics, of organized projects, I would've thought that it would have been of great interest to them. Again to be honest, I am not close enough to the German community as pertains to the "One Road – One Belt", truly I see any greater insights though.

LS: Yes, okay. In the West we hear meanwhile more and more officials are open to negative interest rates to cope with the problems. What is your opinion about negative interest rates in the US and in Europe?

EVP: I actually think that's negative interest rates are bad for growth. They are not good for growth. The reason is because in an aging population – which is what you really have in the West and also of course in Japan, and even in the beginning in China –, you have people having to save more and more money just to keep up with the pension restocking. So, because the interest rates have gone from 6% to 0%, people have to save ever more money just to make their pensions work. And that means of course, if they save more they have to consume less. On top of which the second negative effect of low interest rates is that the wrong companies are kept afloat and that means that the real economy is not being given the finance that it needs because that money is being used to prop up companies that shouldn't be really around in the first place. And finally, this could be a problem of tomorrow, which is I don't know how the money market funds are going to cope with negative interest rates. I just don't know how this is going to play out.

LS: Yes, would you go a little bit into detail why this could be a problem?

EVP: Well, money markets aren't really a concept in Germany but in the West, they are very well known and that is kind of where you park your money.

Normally, these money market funds used to consist of short-term treasury bills, of certificates of deposits and things of this nature, but they used to still yield something. And so it was a very good liquid, safe tool with which people could park the money as opposed to getting nothing at the bank. Nowadays however, with the money market funds yielding zero to negative rates, especially in Europe and also in Japan of course, as you know, you just aren't going to find people putting money into these funds. Meanwhile, the banks may have been relying on the money market funds to do some lending. So, I think there is going to be a whole lot of problems that emanates from that such as liability, mismatches, maturity mismatches in particular.

LS: Yes, what are your expectations: how will the US Dollar development going forward and how will this affect the emerging markets?

EVP: I think it's always easily forgotten that the reserve currencies always decline, particularly sterling in the US. So just to go back historically a little bit, back in 1973 at kickoff, the US dollar was worth 400 Yen and four Swiss Francs. Now the value is about 100 Yen and about one Swiss Franc roughly. So, but having said all of that with the Dollar interveinal decline, it does represent the world's deepest capital market. And when I wrote my book on how multi-internationals influenced trade balances, I established that the dollar bond markets are seven times larger than all our bond markets combined. To repeat, seven times bigger than all other bond markets combined. That means that the Americans had a great deal of capital market clout, and that is going to remain just because of the sheer size.

I do not expect this Renminbi to become an international reserve currency for many decades, because they don't have the software of a functioning legal system in China that welcomes the rule of law. And if they don't have the legal system to underpin the currency, then they can't become a reserve currency. So I think that the dollar will remain. On a trend basis it will continue softing, but in the near term of the next six or nine months, it probably will strengthen just because the Fed funds will be raised, and I think I am not being very original there.

LS: With the Renminbi, what are your thoughts that the Chinese are trying to prop up the credibility of their currency by buying quite a significant amounts of gold?

EVP: There are two fronts here, there is a huge policy dilemma. They are not trying to prop up the currency nor trying to give the currency credibility. What I mean by that, if they were propping up the currency, they would be doing what they did until May of this year, which is to remove Renminbi from the system to reduce the supply of Renminbi and thus push up the price of the Renminbi. But quite the opposite has happened, as you well know. Since May, a guy I call "Deep Throat", some high policy wonk in China decided that they actually should let the currency go in order to perhaps help exports move along to fan imported inflation and to stop in the context of our economic clock to continue creating an excess demand for money by shortening the supply of Renminbi. On the story of gold however, I think that they are probably diversifying their reserves to include more gold perhaps at the expense of dollars, although dollars are of course the currency of gold. So

there is not really much of a swap going on. I just think that they want to have more of that hard stuff in the reserves, because they know that ultimately with the central banks being so profligate in their printing habits that at some point it is going to be a massive currency implosion worldwide, and that's then where gold as the insurance policy comes into its own.

LS: Yes, and now talking about gold, you like this precious metal in general. Why so?

EVP: Because it's an insurance policy, nothing more nothing less. No one can predict the future, so everyone must have that insurance policy in their portfolio. People say 2%, I say about five or 10% at this stage, not of the cycle but the global geopolitics that we are seeing, the problems in Turkey, the problems with NATO, with Russia, in the Middle East, in the South China Sea, in the East China Sea.

Now, we also have the debasing of local currencies going on, what we just eluded to with by virtue of the central banks continuing to print more and more money to quantitative easing. And that of course means that the local currencies get debased, and that then again means that people will be looking for something more valuable than a worthless piece of paper – and that's going to be gold. And I think that finally with the Asians in particular, they seem to like gold, they like jewelry, they like tangible assets; those alternative investments as they are called these days, in particularly gold and jewelry, will thus take off quite considerably.

LS: Does gold possess qualities that you consider of critical importance in our times?

EVP: Well, it's a timeless insurance policy. In other words, it will just not go away. Ultimately, when people get worried about things whether it's war whether it's famine, gold comes into its own. So, I would call it a timeless insurance policy, and I think that's the critical value of gold.

LS: Yes, but would you say in our times it is more necessary to have this insurance than in other times?

EVP: Absolutely, more so ever since the Second World War, because we just don't now for instance with the American pivot of the Far East and the Chinese pivot to the South China and the East China Seas, we just don't know how this is going to play out. Being an old Boy Scout, I think be prepared. To be prepared is always a useful thing, so I think that gold is more necessary than ever in today's portfolios.

LS: Do you perceive the gold markets in the West as trustworthy since they are driven by paper claims and not the physical stuff itself?

EVP: No, I don't really, because I think, and that is pure speculation, perhaps too conspiratorial, but I do feel that these markets probably like so many others are rigged. It's just, without having any data to back me up, I would not be surprised that the paper claims against gold far outstrip the

actual underlying supply of gold, and that is probably because of all the derivatives that are played around with when it comes to gold, the future and the options.

LS: But if there was rigging and at one day the scheme couldn't be undertaken anymore or it would blow up, then you would expect that the price of gold would rise dramatically, right?

EVP: It would rise dramatically, and the other thing that would of course rise would be uncertainty, and that's why we get back to our point may just before that that you also reiterated – that's again what makes gold absolutely vital for any, for any grown-up portfolio.

LS: You've already mentioned it, but I would like to ask you specifically again about this: will the demand for physical gold in Asia increase in years to come?

EVP: Oh, absolutely. First of all, I mean, the key has to be that the Asian wealth as we all know is growing, so there will be a certain propensity to consume gold out of this increase of income. The multiplier effect and the elasticity will be there. Secondly, the Asians simply love gold, especially in the form of jewelry. Thirdly, their monetary systems are still very young, so with the increased wealth, they won't really have too many local assets except for property stock markets and perhaps a little bit bond markets in that they can invest in. So gold is a great sort of alternative asset for them. And finally, with this impending domestic implosion of currencies, I think that they too will want this insurance policy just to have as their safety.

LS: I hear quite often a) the causes for the financial crisis we're in are not well understood, and b) nothing has changed since we're in the crisis. Now, if both things were correct, wouldn't it be reasonable to expect that everything will continue until we will have a real big crash?

EVP: Yeah, I am afraid so, and that is what we were suggesting before this impending currency implosion. That would be one form of the crash, one Gestalt of the crash. The other Gestalt would be that you see that the market that is far larger than America's mortgage market, the car market, the car loans market, that that will implode along the lines of Lehman Brothers in 2007/08 for the very simple reason that there are many, many CDOs or Collateralized Debt Obligations being created of these online loans. So this time around it won't be as much the banks themselves that get whacked, but actually the online lenders will get whacked by this implosion, this crash in the CDO market for car loans in America. So, with greedy people chasing yields, and these instruments, these underlying bonds not being so liquid, I am afraid the derivatives will yet again fall off very, very strongly. And that is going to then again exacerbate the whole crash coming because of this implosion of the CDOs in the car loan market.

LS: As a student you've visited lectures given by Friedrich August von Hayek. What are the main takeaways that you could share with us?

EVP: There are really two. The first one has to be his fabulous Nobel Peace Prize lecture, which is called "The Pretense of Knowledge." If your listeners have not ever heard it, "Die Anmaßung des Wissens" in German obviously, it is a really, really important document because it teaches one the humility of knowledge and that one doesn't really know anything, and it says in the paper, "I know that I know nothing", but he specifies that very, very clearly by saying that one must not forecast; one can do pattern predictions to overall trends, but no more individual forecasting, and that's what I have taken on board myself and I get to that in a second maybe, because you can never be correct consistently. So that is the first takeaway, "The Pretense of Knowledge."

The second takeaway is that one must have much better regulations worldwide, not more regulations. What happened is that Hajek has been kind of confused with the Wild West Rodeo, where people say, well, he didn't want any regulations. That's not what he wanted at all. What he wanted was very, very good clear regulations, a little bit like traffic laws where everybody knows the rules of the game and people will then play according to those rules once they know them and once they master them by getting a driver's license basically. So, I think these are the two key takeaways, the "The Pretense of Knowledge" and better regulations, and that's really what Hajek taught me.

LS: So you would say that free markets do need in fact regulations, but it's the quality...

EVP: It's the quality, it's not the quantity, and what's happened now, for instance, there are apparently in the EU, there seem to be some 3000 regulations just for a toaster. Now, that's about 3000 regulations too many for instance for the old toaster, and that's what I mean by bad regulations. There is kind of a regulation inflation going on at present, and one really wants a regulation deflation but with a few very, few good regulations.

LS: What did spark your interest in economics in the first place, and why is it that economics and finance are perceived as rather boring in the general public when in fact the truth is quite the opposite?

EVP: Well, my interest was sparked because I am an analytical thinker. I get my structural approach very much from my firm grasp of music that I learned in Hamburg and in Freiburg. I get my global view from a global upbringing in the US, Germany, the UK and Asia. And I get a very multifaceted approach by analyzing things that my parents taught me to look at – from science down to music and philosophy and psychology. So, I had to choose a subject that gave me some sense of this holistic thinking, but yet keeping it realistic. And that's where I think economics comes in because as Hajek would teach one, it is a complex phenomenon that is full of psychology, sociology, philosophy and all the other things that need to be looked at as opposed to just simple simplistic mathematical models.

Now, I myself have chosen the path of applied economics, how to make money out of economics, because I think that people need to worry more about how to apply the theories – and the reason is and that was the second part of your question people are not listening that much to the economists because too

many of them tell you the time by looking at somebody else's watch. What I mean by that is they just don't really relate to the reality. I sat with a professor today, these economists in academia are full of theories, but they have never been in the real world. So what they teach is totally unreal. So instead of the demand and supply curves crossing as they should, they are like cut through your dinner table, they are parallel to each other.

LS: Yes, but since you mentioned it, how important was music for your development?

EVP: Oh, very important, because it taught me a structural approach to things. You see, when you're looking at musical scores, "die Partituren," then you have to of course understand the structure of where the music is going, and having played quite a little bit of piano myself, again, I needed to understand the structure, I needed to understand the structures, everybody does, whether it's jazz or classics, to understand where the thing is heading. Now, the same thing applies to economics. A very simple case is for instance inflation rises. The person who is not aware of that, will say the central bank has to tighten. The person who is aware of the structure of inflation will know that the basket in Malaysia for instance consists to about one third of palm oil prices. Well, those are functions of sunspots, El Niño and La Niña, they have absolutely nothing to do with demand and supply. So, unless you understand the structure of something, we get back to "The Pretense of Knowledge" with a pattern of predictions; you cannot really authoritatively play it, music, we talked about it, and economics.

LS: Coming back to another thing that you have mentioned, how did the training from Hajek influence your thinking and action when it comes to active versus passive asset management?

EVP: Very, very clearly the abhorrence for the whole forecasting and the active management, because most active management is based on forecasting. I used to service clients as the chief regional economist for Smith New Court over here for years, and so I know that they were always looking for forecasts and then try to pin a bet on the forecast. Nobody can be correct consistently, and that's why I have gone into this what I call non-forecasting structural asset allocation, which is based on a person's lifestyle, risk and their natural investing habits, and that then based on those kinds of approaches alleviates, there is not, it just makes unnecessary the role of forecasting per se because one is giving more of like how her doctor would with the here and now of the actual structure or something. So that's where Hajek very much comes in with "The Pretense of Knowledge" that one is just quite humble in front of the market; I don't know where it is going to go either we don't even know where it is going to be this evening, so it's again it's this whole aversion against forecasting itself, and then the practical replacement is what I call the structural asset allocation.

LS: To wrap up our conversation, one last thing maybe, one thing that we know in the West about China is the saying "May you live in interesting times." Do you think the saying has never been as true as today?

EVP: No, I think it has always been quite true to be honest with you. I mean,

Mao Zedong's "Great Leap Backward", Deng Xiaoping's philosophy of getting the economy going again, I think that those were very important, very active, mentally very fertile times that we have had here in Asia. Then we had the rise of Japan in my career, the fall of Japan, the rise of Vietnam is now coming, the fall of parts of the, or the problems of democracy that we have in Taiwan, and this very nascent childlike democracy that we have in Hong Kong. So, I don't think it has been more interesting but it is very interesting what we are going through at present, but it has been just as interesting in the past.

LS: Isn't it true that the word for crisis in Chinese is also the word for opportunity?

EVP: Well put, absolutely. And that's again comes into something else which makes the Chinese very interesting people to me, because they are very pragmatic people, they are very organized and very pragmatic, and that's again what makes life out here in Hong Kong, in China very easy, because people can get things done. And people have more of a can-do attitude than I have seen in some parts of the West.

LS: Thank you very much for this conversation.

EVP: Thank you.

Sources:

Based in Hong Kong with Private Capital Limited, Dr. Enzo von Pfeil is a commission-free discretionary asset manager focusing on ETFs. He studied Economics inter alia under Friedrich von Hayek and worked inter alia for J. Henry Schroder Wagg in London, Smith New Court Far East Ltd. in London and Hong Kong, SG Warburg Securities Far East and SBC Warburg in Hong Kong, and ABN-Amro Asia Ltd. in Hong Kong. With more than 30 years of experience in global investment economics and as the author of five books on global macro-economic and investment issues, for example "Trade Myths: Globalization and the Trade Balance Fallacy" (2008), he is also a high profile media commentator in Asia with interviews in TV networks like Bloomberg, Reuters Television, CNBC, and RTHK. Having lived in Hong Kong since 1989/90, he has developed a very high level corporate and government network across the region. At Private Capital, Dr. von Pfeil does a free Strategic Allocation blog under <http://www.private-capital.com.hk/>.