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Kiril Sokoloff, 13D Research & Strategy with Scott Bessent, Key Square Group | 14th Annual Evercore ISI Macro Conference

Systemic Risks, Policy Errors, OPEC-PLUS Power, and Delays in the Green-Energy Transition
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Scott Bessent:

I'm so excited to interview Kiril Sokoloff. He's a unique person and I think we're at a unique moment in financial markets.

I could say that I have been a subscriber to 13D, What I Learned This Week, for 30 years, I've been close friends with Kiril for 20 years. And for the past 10 or 12 years, we've been raising our children together. We think that there's a chance they may get married, because they've been bickering since they were two years old. Kiril and I, as Ed said, are neighbors in The Bahamas, where we get to spend a lot of time together at Lyford Cay. We think that Kiril is the new éminence grise, just like John Templeton was, so it's nice to have him there.

I'll just say, for those of you who don't know Kiril, don't know him well, is it's this combination of the long arc of history, his relentless pursuit of the new, new thing, his open mind, and his ability to think non-linearly and combine that with the fact he looks at hundreds of charts every week. This isn't an academic exercise, it's a money-making exercise. And I'm very excited.

Kiril, why don't we get started? You tell me, but you've been talking about the end game for central banks for financial engineering for a long time and it looks like we're approaching it.

Kiril Sokoloff :

Scott, thank you for that wonderful introduction. And our friendship is deep and enduring. And you're right, my Natasha is probably going to end up marrying your Cole, which will bringing our families even closer together. And Ed and the ISI team, thanks a lot for inviting me onto this call, which I've done a few times in the past.

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Well, you're right, Scott. We're at the end game. We've been waiting for it, preparing for it for years. It was inevitable. And obviously, the central banks have lost control of long rates, and this has immense implications for many things, the 60/40 people who own bonds, but there are many other implications and that's because of the decade of free money.

There was massive misallocation of capital. We have an economy in the U.S. that is financialized, very sensitive to raising rates. And at the zero-bound, you had no credit risk factored in to borrowing costs. So, as the recession comes, credit risks come. Of course, those interest rates are going to rise.

You had immense concentration in technology, even greater than in the late '90s, the IT boom, and worst of all, at least 25% of the U.S. public companies are zombies. We've seen Revlon last Friday, today it's Cooper Standard. And, of course, when interest rates are at zero, you encourage people to borrow. And so, the debt around the world has just skyrocketed. Debt to GDP, I think it's 330% globally, has never been this high. So, the sensitivity to rising rates is just massive.

Worst of all, QE widened the wealth divide and that created political instability. The central banks, the Fed, sort of admits that they were responsible for that, which is nice to have them do, finally.

And then, last, we have the old-world order is collapsing. By that, I mean the hegemony of the U.S., the unipolar world, the dollar-based world, and we have a new world order that is in the process of being created. And we spend an enormous amount of time studying this. And we can get into that later, but that's sort of where we are. And when you have the new world order, you have enormous disruption. Just look at what happened after the First World War, where pretty much every king was overthrown, and you had huge turmoil. And I expect we're going to have this globally.

Scott Bessent :

Right. And Kiril, you've talked a lot about policy errors. And, as I said earlier, it looks like we had this confluence of policy errors that couldn't have come at a worse time. In the post-COVID world with high-debt-to-GDP, as you said, the

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populist tendencies as workers' real incomes are squeezed, the Gini coefficient is getting quite high. Could you share with us your thoughts on what the Fed is doing? Is there a way out for them? Are they trapped? Does all this lead to inflation, deflation, both?

Kiril Sokoloff :

Yes. It's a very important question. Well, the policy errors have been so massive, we can spend hours talking about them. I'll just talk about a few.

So the Fed is tightening into what looks like, if not a recession, certainly a very severe slowdown, and at the same time as equities are collapsing. This has never happened before. Where's the Greenspan/Bernanke/Yellen/Powell put that everybody was trained to invest for? So what a shock to the system.

Now, one of the problems is that central banks have come to believe that they can eliminate the business cycle. And that is hubris, if there ever was one. And obviously it doesn't work, so they create a boom, they create a bust, they double down and on and on and on. The cycle gets more extreme and more extreme and more extreme. And we knew it was going to end. And now it has ended.

We also had a huge complacency on the risks of inflation. Now, you may remember that I wrote a book on disinflation in 1982. I was one of four people in the world who believed it actually might happen. So I followed inflation/deflation very carefully. After 40 years, every year that goes by, you should be thinking, "when is the inflation going to come?" Not, "will this continue on?" And is the Fed trapped? I believe the Fed is trapped. And I believe that the economy is so sensitive to rising rates, they will break something, they will panic, and they will pivot once again, like they did at the end of 2018, and then the dollar will get very weak, just like we saw with the yen.

Now, what happened in inflation to me is very simple. You had the "great resignation", you had a secular shift towards labor from capital, you had supply-chain turbulence, which is ongoing and will last as far as the eye can see. Excessive money printing, under-investment in commodities, instability of food production. We've written for decades about the fragility of the food production system. Topsoil is eroding, it takes 70 years to replace topsoil. Water is in the

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wrong place, drought is in the wrong place, climate change is accelerating this fragility, so you add this all together and then of course the misunderstanding of the oil market.

You remember in the 2000s, I was the biggest bull on the planet on oil starting in 2002, believed in peak oil and here we are, we are at peak oil, what term we use or whether it's peak, low-price oil, we don't need to get into that debate, but conditions have never been this tight. And at that very moment, the Biden administration puts sanctions on the second-largest oil producer, which to me was economic suicide. I just didn't understand it.

And lastly, and it's tragic really, is the over-optimism on the amount of time it will take for the green energy transition. So, they were saying peak oil demand in 2022, that is so laughable, it's a joke.

Scott Bessent:

Kiril, when do you think peak oil demand might be, is it 10 years? Is it 15?

Kiril Sokoloff :

Well given the bottlenecks that we can talk about, in terms of making the transition, I would guess 2030 is a dream, 2035 is possible. The IEA is calculating that, conventional ICE vehicles, internal combustion engine vehicles, will continue to increase in number through 2038 and that is coming from the emerging countries. So in 2005, oil consumption peaked in the OECD, but it kept going up in the emerging countries, now these are massive countries and they all want a better life, and their countries are trying to give it to them.

Scott Bessent :

Now I think that India uses more oil than France.

Kiril Sokoloff :

Exactly, and then there is Indonesia, there's Nigeria, there's Brazil.

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Scott Bessent :

And Kiril, if I can interrupt you for a minute, just so everyone in the audience knows that you are not a rah-rah carbon person. For 20 years, Kiril has been sounding the alarm on climate change, the effects on agriculture, on climate migration, the house you see in The Bahamas, I think he plans to take off the grid soon and it'll be completely solar. So, it's not that you are a carbon cowboy, you're just a realist.

Kiril Sokoloff :

Just a realist, that's exactly right. And to continue on here for a second, I'll just give you a couple of statistics. So there are 1.4 billion vehicles in the world, and 95% of them use liquid fuel, which is petroleum. How many electric vehicles are there? 16 million. So by some miracle, if we could produce 25 million electric vehicles a year, which is a dream, how long will it take at that rate to replace the existing fleet? There's your answer. And 60% of oil demand is from transportation, this is what everybody misses. All you have to do is study it, and you will see it. I just don't get it.

So the tragedy is, and I call Mr. Market a cynic, that the ESG movement, which I'm greatly in favor of, but there has to be some realism, forced the institutions to divest their holdings in fossil fuels. And the few that were left, forced the oil companies to give back capital, which is very reasonable, and not to invest. So there's massive underinvestment, and the net result is that OPEC-plus has never been more powerful with 65% of global oil capacity. So if this is right, it's the single most important fact to know in the world today and no one seems to know it.

Scott Bessent :

Kiril, you mentioned the sanctions on Russia earlier. Russia produces about 10 and a half million barrels a day. What kind of diminution of supply could we expect if the Halliburton, Schlumberger, Siemens, aren't allowed to service those fields and the production technology?

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Kiril Sokoloff :

Well, it's an absolutely devastating picture. And you wrote very articulately about this very risk, that the wells could be shut-in. And the last time that happened in Russia was 1989, and it took 30 years to recover because you'd have to test every single foot of the pipeline. So it's an extremely precarious situation. And the Fed is not attacking the cause, it's attacking the symptoms. And until someone wakes up and looks at what the cause is, we're going to have a major crisis, but there is no near-term solution.

Scott Bessent :

Right, and as you mentioned with EVs, they're coming but the supply bottlenecks, in terms of the raw materials, whether it's copper or cobalt, lithium, could you talk about that a little?

Kiril Sokoloff :

Yes, absolutely. Let's focus on copper because I know that the best. All of the copper produced in world history, it's 700 million metric tons, and for world GDP to grow at 3%, we're going to need to find and produce that amount of copper. And the way the world is set up, that's just an impossible dream. And the EV uses 80kg of copper versus the ICE vehicle at 20kg. The solar uses seven times more copper than for conventional electricity and wind uses 37 times more. And charging stations require 7kg to 10kg of copper. There's a dearth of mining engineers, I know this because I'm very invested in the only carbon-neutral copper mine in the world and I'm a principal, so I understand this. There were few mining engineers who graduated in the last 10 years to speak of. Who wanted to go into the dirty, anti-environment industry, when there was crypto, when there was Wall Street? So, no one went in, and no one wants to go in. And these engineers are retiring. So, you got a shortage there, and it takes, best case, 10 years to bring on a copper mine, more realistically 15 years.

So, there is copper, but producing it is going to be an immense problem. And of course, the price has gone up, which means that the cost of EVs has gone up. Tesla raised prices three times in April, and substitution is possible for cobalt and nickel. They're doing it in China. But it's all going to be slow. And what people

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don't understand is at scale, you can do a little bit here, a little bit there, but it's the scale. New LNG facilities, yes, you can build them, but can you build them at the scale that the world thinks that they need? You can't.

Scott Bessent :

I think twice since I've known you Kiril, many times you've had big, important pressing calls, but twice since I've known you, you said this not a thing, it's "the" thing. One, one of them was in the early 2000s, when you said China is not a thing, it is "the" thing for the next decade. And the middle of the teens, you said the energy transition and EV and the switch isn't a thing, it's "the" thing. But how are we going to have "the" thing with all these bottlenecks? Is it just going to be more stretched out? The timelines were all wrong and that's really where the policy error is, and the truncated timelines are what's causing some of the inflation?

Kiril Sokoloff :

Well, I think each country is going to have to answer this question by itself, China, which has been criticized for its top-down asset allocation model is way ahead of the rest of the world and dominates production in every single aspect of green energy. And they're going to be exporting a lot of EVs to Europe. The problem is that there's going to have to be an admission of a mistake. The world is most likely going to double down on going green, but Europe cannot go green without China. And if there is a China and U.S. conflict, which is happening and will get worse. And Europe is asked to side with America against China. China cannot give up Russia and give up China. It's impossible. So, this is more splintering,

Scott Bessent :

Right, and as we get to what President Putin calls the Russian military action, the food shortages were already in motion. And now we see the chance that certainly this fall, maybe for the foreseeable future, we could have exacerbated food shortages, especially in the emerging world.

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Kiril Sokoloff :

Yes, it's tremendously worrisome, and we have been conscious that something like this could happen for a long time. You look at the Russian wheat failure of 2011. That was what caused the Arab Spring. And three or four governments fell. We're going to see the same thing here. And while there will be blame cast to Putin, and blame cast to the U.S., the local leader is the one who's going to really take the flak. And what seems not to be understood is that because natural gas prices have gone up so much and they have to keep going up because if you try to shut Russian gas off, that means the LNG market is going to explode in price, and higher prices. So fertilizers become almost unaffordable for many farmers.

One of my colleagues has a farm in Scotland, and there was a town hall meeting about four months ago. People never come to the town hall, but every farmer was there and they all were saying, fertilizer is up 200%. This is up. This is up. So they said, we have never seen this in our entire life. We will be unable to plant. We can't afford this. So we're either going to let it lie fallow, or we're going to plant without fertilizer. You can get away with that for a year. So the crisis is coming. What we've seen to date, is nothing compared to what's coming. And when people go hungry, then you have social unrest and governments fall and debts default.

Scott Bessent:

Kiril, let's go back a little to the lessons of history. You've been writing a lot over the past several years, but especially since Russia-Ukraine on the lessons from 1914 for the present day. In our conversations, you become increasingly worried that the leaders haven't learned the lessons.

Kiril Sokoloff:

They haven't. They never do. And Graham Allison, who was the founding Dean of the Kennedy School, and a friend of mine, wrote a book in 2017 called "Destined for War: Can America and China Escape Thucydides' Trap?" And Thucydides was, some people feel, the greatest historian and he chronicled the Peloponnesian Wars, which is Athens and Sparta, that basically destroyed Greek civilization. And Sparta could not stand the rising power of Athens. Since then, there have

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been 16 such instances of which 12 have led to war. A recent one was the rise of the U.S. Versus the UK. And of course, the First World War was very much tied into all this. But the rise of China is proving very, very difficult for the United States. And when Trump cut off electronic supplies to ZTE and Huawei, for me, that was crossing the Rubicon and that was the end of globalization, or the peak of globalization. And every country in the world was looking at it. I better be self-sufficient.

There's one thing that I would say about 1914 that is very worrisome. And I've gone back and reread some of the books that I'd read earlier because in 1914 Europe controlled 87% of the world's land mass. It was at its peak contribution to civilization. It was an unbelievable time. And yet they entered into mass suicide. So I had to understand why this would happen. So I've studied it, and there was an alliance between France and Russia, which upset Germany a lot. And Germany was flexing its powers by building a naval fleet for the first time ever. But the way it worked was if one country mobilized, the other had to mobilize—that was part of the agreement. And once you mobilized, you couldn't stop, and that is what I see happening.

It's ratcheting up. No one is trying to tone it down. And we are lucky because we know President Xi's personal website, which we read every day, what he says, what he thinks, his speeches. We listen exactly to what he's saying and what his foreign policy people are saying. We don't care at all about other peoples' interpretation. We go to the source, the same with the Kremlin. And one thing is very clear, China will not tolerate what they call a NATO expansion in the Pacific, and they will not tolerate America to arm Taiwan more than they have. It cannot be clearer.

Scott Bessent :

I would say over the years it is probably U.S.-China is where you and I have had the most disagreements. And I thought the U.S. should be a bit more preemptive, a bit more muscular, but I do take your point here. To understand what you're saying, is that I think probably front of mind for a lot of people on this Zoom is, there is Russia-Ukraine...is China-Taiwan next? And what you're saying is that it doesn't have to be, it will just be, will the U.S. provoke China by trying to make Taiwan impenetrable? Is that a correct summary?

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Kiril Sokoloff :

Yes, that's exactly right. And if Taiwan is armed to the point that Beijing feels it's at risk, it will make a move. So it would be a deliberate provocation. And you know, going back, you mentioned it was 1992, I was in China at the opening. I've been to China a hundred times. And one thing I know for sure, Taiwan is the number one issue for China. We may disagree with it, but it's just reality. And if you go back to "Kissinger on Kissinger", before the meeting in Beijing with Mao, Nixon, and Kissinger, there was nothing to be discussed, no consulate, nothing. The only thing on the table was Taiwan.

Scott Bessent :

So Kiril, we've covered a lot of ground here. And as I said at the introduction, what I've found over the years, both about the letter, about our interactions, is at the end of the road, there's always an idea. So if we were to go to the practical, and come down from 10,000 feet, to the three or five ways, or three or five investment ideas that you're thinking about here; and again, I don't want to summarize things for you, but in our conversations, it strikes me that you believe that investors should be in wealth preservation mode much more than on the offense here. What would be the three or five things that you would suggest here? Because I think you and I are in violent agreement on most of those.

Kiril Sokoloff:

Well, last December I had this overpowering intuition that I needed to be really, really careful and cautious. And the number of things that have happened to friends, acquaintances, health wise, the energy on the planet is so dangerous. So that's the backdrop and we're in a bear market and bear markets want to take your money. And look at Jesse Livermore, who made more money than anybody in history, shorting magnificently in 1929. And he shot himself in 1936 having lost it all. So the bear gets you sooner or later. And so I want to be very, very careful and cautious, and everything is going down. There's no real place to hide, but there will be an end game on the investment side.

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And I'm also thinking about real return after inflation. I do not believe that the Fed is going to defeat inflation remotely. Inflation is here to stay, and let's say inflation is really 15%. And let's say that the S&P is down what 22%, 23%. That means that people year to date in real terms have lost some 35 percentage points. That is a significant loss. So we have to look at wealth in terms of real rate of return and wealth preservation in a time of stagflation.

So I come back to gold. And gold is, of course, under owned, vastly under owned. All of the mining stocks, gold mining stocks, are valued at \$250 billion when Apple was \$3 trillion at the top. And don't tell me Apple's worth more than all those gold mines. It just isn't. And it's out of the banking system. It is movable wealth. In a time like this, governments are going to come after wealth. You want to be able to move it around. If you own a building in New York, a townhouse in London, there it is. They know you have it. And of course, gold is vastly under owned, and it will preserve value during a period like this. There are a lot of different cross currents on gold. It's algo-traded and there's manipulation by central banks. But one of these days, gold is going to burst out of the pit just like natural gas did. It won't stop.

Scott Bessent :

I think you're right, because when we saw the Russian, the Foreign Exchange Reserves the... I guess they're technically frozen. They haven't been seized yet. But I think more and more central banks will probably be moving to gold. What else are you thinking about?

Kiril Sokoloff :

Well, I think copper is attractive. If I'm remotely right on the oil situation, the impetus for developing electric vehicles is going to be massive. It'll become a national security issue. And they will be encouraging copper production. Unlike what Biden's trying to do, which is to talk about taxing excess oil profits, which is so antithetical to getting more oil production. But hopefully somebody with some sense will come along. But the copper picture is, I would say, the greatest bottleneck that I see out there. And I certainly think that that is one that you can add to the mix.

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Scott Bessent:

And does the potential windfall profit tax on oil companies make you want to be more in the drillers or the service companies?

Kiril Sokoloff :

Yes. That's exactly right. The service companies... We have to wait until money starts to be spent. It's going to have to be. And if the Republicans win in November, and certainly the evidence is strong that they will, we'll get back to an environment of really encouraging exploration and development. And so that is certainly one without any question.

Scott Bessent:

And why don't we finish up on the dollar? I'm of the opinion that... Last night we saw the dollar peak, the 75-basis point move by the Fed, and then all the signs that we're seeing of weakness in the U.S. economy. And there's still signs of strength. But as the economy slows, what I call the final napalm run, that we've just seen this big move up in the dollar, looks like we might have hit a crescendo. The Swiss National Bank this morning announced that they wanted a stronger currency, not a weaker currency. We have a very important Bank of Japan meeting this month and in July where they've been pushing a weak currency, maybe we get a policy reversal there. Why don't we finish up on your thoughts on the dollar?

Kiril Sokoloff :

Well, I think many of us have been looking for a weaker dollar for a long time. The fundamentals certainly warrant it. The only thing is the Fed. And if we're right that the Fed is going to pivot because of a financial crisis or breaks something, then the dollar will get weak. And the U.S. is a net debtor to the world of \$16 trillion. There's never been a country that owed more money to the rest of the world. And this Russian confiscation of foreign exchange reserves . . .

Scott Bessent:

Kiril, freeze. For now, it's a freeze. We haven't confiscated them yet. [Laughs]

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Kiril Sokoloff:

You're absolutely right. Freeze of foreign exchange reserves is incredibly dangerous. And we estimate there are about \$7 trillion of emerging countries' foreign exchange reserves that are in treasuries. So if you're in Saudi Arabia, you're in Abu Dhabi, you're thinking, "I do something that the U.S. doesn't like, and they're going to confiscate or they're going to freeze my holdings." So you're going to move things away. And of course the Chinese understand what's coming. And the idea that the Chinese would sell their treasuries is crazy. You don't need to. Just don't roll it over. So there's a lot of sources of supply coming.

Scott Bessent:

Right. So what you're really talking about that happens in every bear market is a diminishment of liquidity globally, whether it was in 1907, 1929, I guess in 1974, '75, and obviously 2008. The capital markets have been lubricated for the past 10 or 12 years, really since the GFC by these central banks. Everyone wanted a weaker currency. The dollar was strong. Now because of inflation, we've seen peak low cost and everything, and everyone seems to want a stronger currency. And they'll be bringing the money home.

Kiril Sokoloff :

Exactly.

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13D CONTACT
WWW.13D.COM
SUBSCRIPTIONS@13D.COM

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