Storming of the Bastille, Jean-Pierre Houel 1789

A Tale of Two Eurodollars – 3 July 2021 Dispatch No. 16

France, 1788

The world was a volatile place following the Seven Years War (1756-1763).

If you've ever seen *Last of the Mohicans*, set in colonial America during the French and Indian War, that was only one front of a global conflict between British and French empires spanning five continents in a pre-industrial world war.

From the Americas to Europe, Africa, and India, the two empires battled nine years for global dominance with the British emerging as the victors while France lost colonies, tax revenue, and was burdened with high debt.

Decades later as the economic hardships intensified for the French, radical elements ran printing presses full speed blaming the monarchy and promising people a better life through enlightenment.

These Pamphlet Wars gave people an easy target to hate for their economic woes - their neighbor.

The Reign of Terror descended on France instead of the promised enlightenment as the Bastille burned and envy masqueraded as justice in the streets.

Tens of thousands were murdered to the cheers of mobs as the guillotine's blade dropped for social justice and heads dropped with a dull thud into blood soaked wicker baskets.

Tired of chaos and living in fear their neighbor would name them an enemy of the new republic; the French welcomed tyranny for stability when Napoleon executed his bloodless coup in 1799.

After anointing himself Emperor, over one million French sons lost their lives as the 19th century dawned over Europe in the Napoleonic Wars.

Fast forward to today.

Over three billion screens now glow into our faces, showing us content driven by artificial intelligence algorithms which target us at vulnerable moments based on our interaction with our phones.

We are in the midst of our own 21st century Pamphlet War.

Waged on us by robots, which constantly improve on how to manipulate us for additional profit, adjust our behavior, and shape our reality in a 6.1" screen.

Meanwhile our politicians and bankers continue to suppress volatility in the market and say they have nothing to do with the social consequences happening around us as people lose faith in our institutions, reevaluate what they value, and society fractures.

This is the world cryptocurrencies, dollar stablecoins, and central bank digital currencies are inheriting.

A world where billions of phones will soon be currency voting machines in the hands of people who no longer trust their institutions as they suffer from inadvertent inequality driven by central banks.

The Road So Far

When volatility strikes global markets, financial institutions are unsure what their exposure is to other firms who might become insolvent.

None of them know who owns what or has exposure to who, specifically in the derivatives market which is $1 quadrillion, or $1,000 trillions.

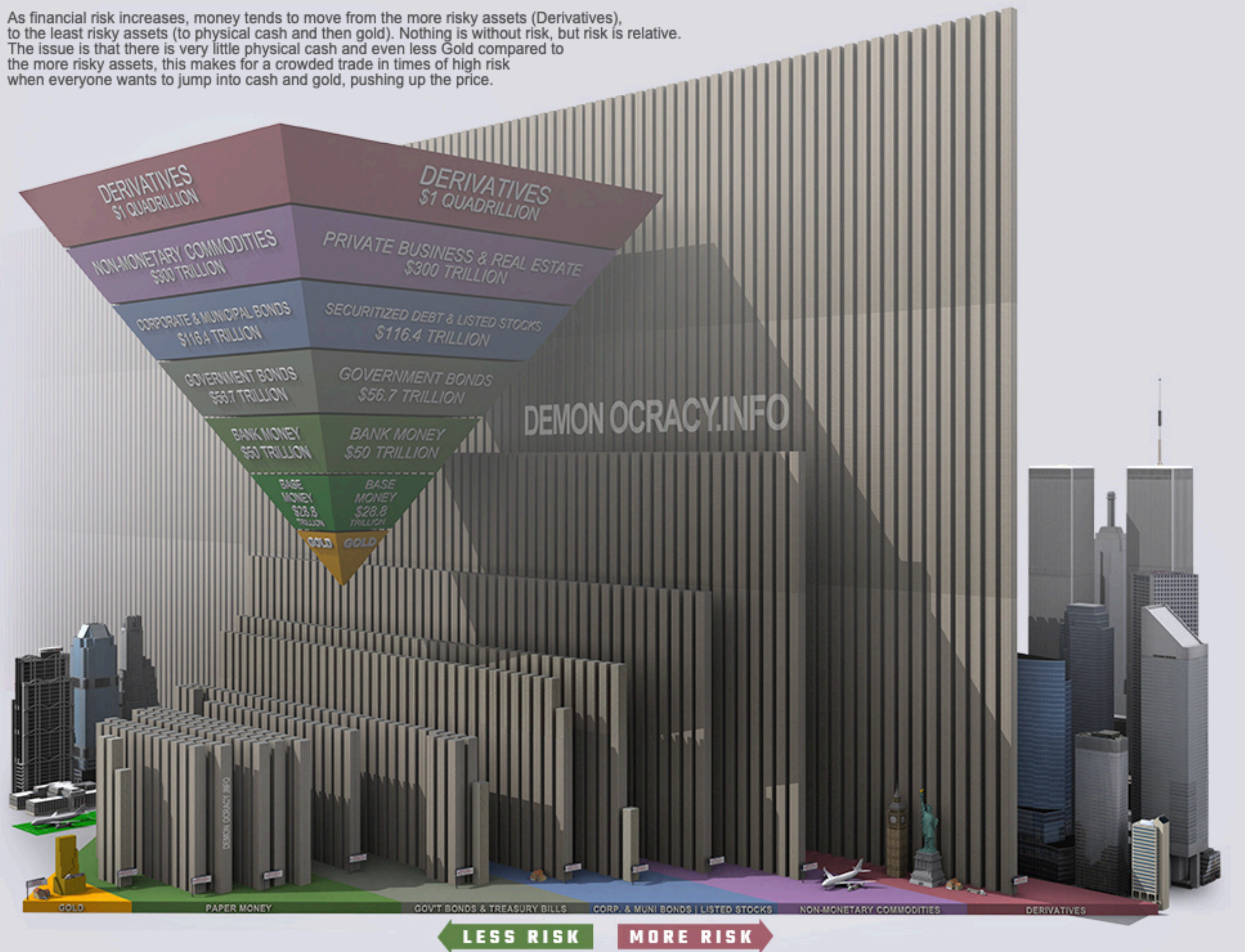
A derivative is a bet between two financial institutions, which they use as collateral for other bets in the derivatives market with other institutions.

During times of market volatility, institutions will stop lending money and hold tight to whatever high quality capital they have until they see what their exposure is to bad bets they may be holding from other institutions which might go to zero in the volatility.

When financial institutions do this, it causes liquidity in global commerce to stop flowing, and the capital pyramid starts to melt down, as suddenly everyone now wants safer assets.

This process causes riskier assets to be revalued lower and safer assets to be revalued higher as people who are overleveraged and need money now start selling assets at fire sale prices to raise capital.

Equilibrium is once again reached in the capital pyramid as those who were wise and had savings in safer assets are rewarded with being able to buy assets which people need to sell who were overleveraged.



https://demonocracy.info/infographics/world/lqp/liquidity_pyramid-zoom.html

In 2008 when politicians and central bankers did the first round of Quantitative Easing (QE1) worth $800 billion, backstopped trillions of dollars worth of mortgage backed securities in the bond market, and additional rounds of QE in the following years, they abandoned capitalism for suppressing volatility.

By 2020, quantitative easing (QE) became unlimited.

Global QE for 2020 is now well over $20 trillion, and the central bank backstopped the bond market again, this time corporate bonds.

The central bank now provides additional reserves to financial institutions with accounts at the Fed and convinces the bond market they are willing to buy all the bonds they need to support the market.

Financial institutions do not sell assets to buy safer collateral further down the capital pyramid in times of volatility now since they are receiving risk free reserves from the central bank. Financial institutions are then supposed to lend money into the economy, creating dollars through debt.

What actually happens is the largest corporations get loans at zero or near zero interest rates from these financial institutions while small businesses and individuals remain cut off from lending during times of volatility or are forced into much higher interest rates.

Large corporations and hedge funds, now with a war chest of free money, begin to buy assets from small businesses and individuals who are now forced to sell since they remain cut off from lending or cannot pay the higher interest rates.

This is how suppressing market volatility increases inequality in our society. It is not intentional, just an inadvertent effect of central bank and political policy since 2008.

As Stan Druckenmiller, billionaire macroeconomic investor recently said at USC Marshal business school graduation,

“I don’t think there’s been any greater engine of inequality than the Federal Reserve Bank of the United States the last 11 years.”

Central bankers and politicians in effect have unintentionally been transferring market volatility like stored energy into society for over a decade as inequality increases.

We see this all around us, views on money, trust, values, and risk have changed since no person can work hard enough to outpace a central banker hitting zeros on the computer.

People now see those who already own assets being rewarded with higher asset prices from suppressed market volatility while those who do not own assets are forced to work ever harder, trading more of their time for decreasing amounts of assets.

Realizing this, people are now buying assets with increasing levels of debt and those who depend on income from their investments are forced to take on ever increasing higher risk investments to maintain their return on investment as both money and time lose their value.

The end result is people are now individually more financially fragile as society fractures around us.

People understand the scales of capitalism are being held down on one side with those closest to central bankers and politicians doing better than the rest of society, and they reach different conclusions on what to do to fix the problem.

One group thinks the answer is suppressing all volatility, not just market volatility. They see their health insurance going up 25% in the last two years, rent is up another 10% in 2021 alone, the average house price jumped 24% for 2020, and they are treading water at best financially with no end in sight paying 50% of their take home pay in rent to hedge funds who received free money through PPP loans.

Others go the exact opposite direction, embracing the 21st century enlightenment of decentralization. They think the answer to institutions and leaders repeatedly breaking our trust for over a decade is to use technology to build a trustless society. After all, who would ever trust the same people that nearly broke our world in 2008 and continues to suppress volatility while denying the effects it has on society.

Some study history and think eventually the insanity has to end, when it does, the best thing to own is the safest asset in the entire capital pyramid, a form of capital which has been used since before Rome razed Carthage to the ground, and is physical, not dependent on computers, and has no counterparty risk: Gold.

Another group, who I think of as the modern day Cato and Cicero, fight valiantly to hold the republic together as forces beyond their control continue to put pressure on all of us. This group knows the damage massive social and political volatility will do and try to get people to work together, to help fix the system, instead of splintering.

Then there is the majority of society, partying this summer, buying luxury goods, living for the weekend, and oblivious to all this. They will simply vote for whoever makes them feel comfortable and safe.

Depending on how the future plays out, while the journey along these paths are different, I think the destination can be the same.

For example, it is not coincidence financial institutions prefer Proof of Stake protocols like Ethereum and Solana to Bitcoin.

Proof of Stake protocols allow financial institutions to buy up large holdings of coins, then hide behind a decentralized network while keeping centralized control through coin cartels, similar to how JPMorgan's metal desk manipulated markets and federal prosecutors charged them and other traders with RICO as a criminal enterprise.

The only difference between oligarchs running a state controlled economy and financial institutions hiding behind decentralization in the potential future is how they convince the majority of society it is for their best interest.

A Divided World

A Eurodollar is a US dollar held outside of the US banking system by a foreign bank or institution. Since most dollars originally held outside of America used to be held in Europe, they became known as Eurodollars.

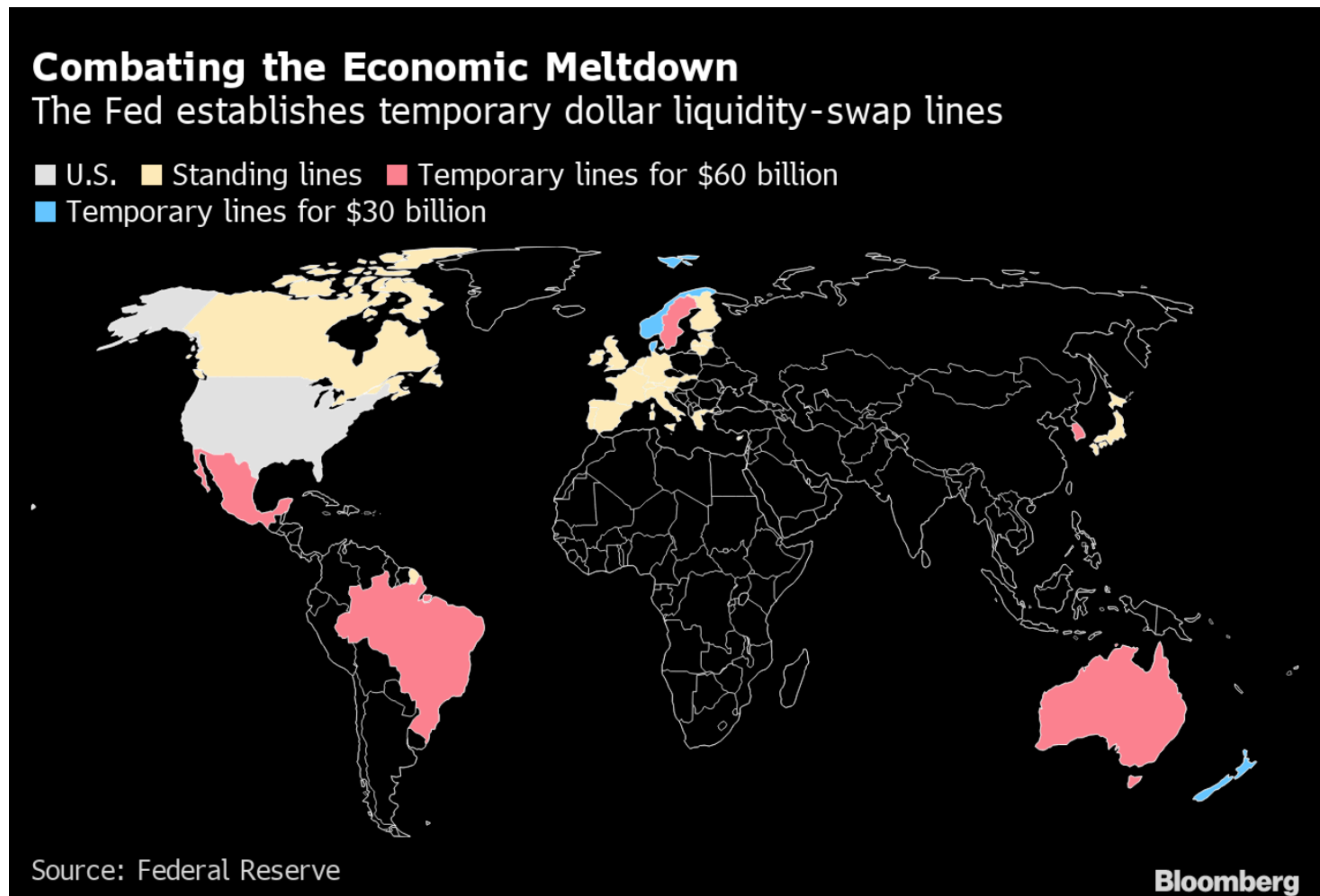
If you want the deep dive, recommend Eurodollar University by Jeff Snider at Alhambra Investments.

Foreign banks set their own interest rates for Eurodollars off the LIBOR (London Inter-bank Offered Rate) since they are outside the US dollar system.

Typically the LIBOR interest rate is higher than the US interest rate.

If you have access to the US dollar system during times of market volatility, like through a swap line with the Federal Reserve, you do not need to borrow Eurodollars from a foreign institution on the open market during times of volatility.

Swap lines are the soft side of US power. Countries we have a strong military, geopolitical, or stability interest in get swap lines for dollars.



A swap line works like this:

The European Central Bank asks to swap euros for dollars with the US Federal Reserve.

US Federal Reserve swaps dollars created on the computer at no interest for the euros the ECB just created on their computer.

European Central Banks then credits dollars to European banks, which lend dollars out to keep global liquidity flowing during times of market volatility to prevent the selling of riskier assets for safer assets further down the capital pyramid.

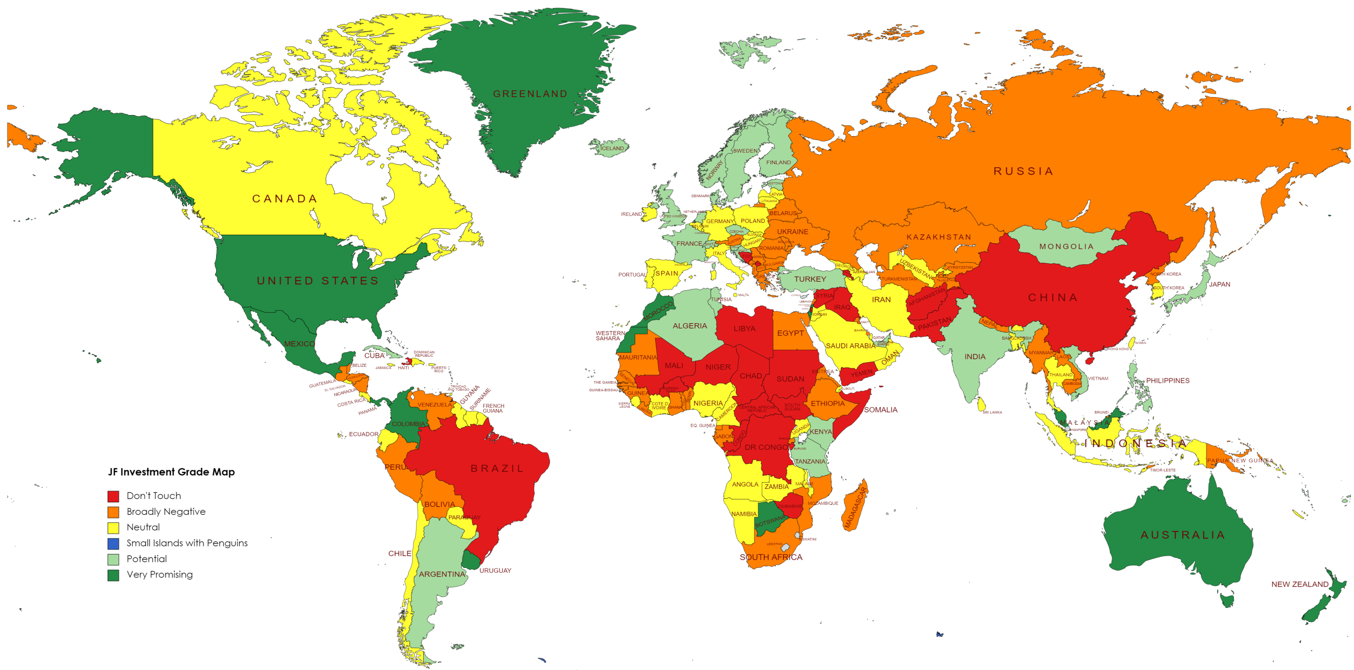
When foreign banks lend dollars out, this creates more Eurodollars because of the interest charged on the loans as additional dollars are created through debt.

Now look at all the countries blacked out on the map. During times of volatility everyone in these countries need dollars and safe assets just like everyone else in the world, only they do not have direct access to no interest dollar swap lines with the Federal Reserve.
This creates a divided world.

Countries without access to swap lines make hard choices during volatility.

They can borrow at higher than LIBOR rates if they can get a dollar loan from a foreign institution, possibly get a loan from the IMF, pledge pieces of their country as collateral to China for a loan through their Asia Infrastructure Investment Bank, or inflate their currency, seize assets, and deal with the social and political volatility this causes.

Billions of people live in these countries, with this reality, and it reinforces in their mind the dollar is the strongest currency in the world.



Stability and Stablecoins

The investment map above is John Fadool's, an Air Force officer and geopolitical analyst who unlike me actually went to school for geopolitics. He has done in depth analysis on geography, climate, politics, finances, and perhaps most importantly next to geography in the future, demographics by country and region, reaching much of the same conclusions as Peter Zeihan did in his latest book *Disunited Nations*.

We connected over questions I had concerning Argentina since I have never worked in South America and was evaluating an American and Norwegian company which were expanding operations into Argentina.

When I overlay John's map with the swap line map, and combine with my experience, mostly in countries John wouldn't touch for investments, I think there is a real possibility 3 billion smartphones get turned into currency voting machines in the future and dollar stablecoins will be the preferred currency people want to use and spend, particularly in parts of the world without access to swap lines for dollars. I have personal experience in countries cut off from dollars. I was in Sudan when bread prices increased 100% overnight and the protests started, as people decided they'd rather fight with riot police and risk being shot than sleep in their car for four days waiting for gasoline.

All of which lead to the overthrow of Omar al-Bashir.

Similar to the Arab Spring, where grain prices jumped 30% in Egypt 2010-2011 with bread price up 37%, then the uprising began in January 2011.

While asset holders in the first world benefited from suppressed volatility, the last decade has been chaotic in a lot of places and only served to reinforce in people's minds who are cut off from dollars in these countries the importance of saving in dollars whenever possible.

To them dollars are like the gold standard, it can be a matter of life and death during volatile times as their own money devalues.

For an idea of how important dollars are to people overseas, Germany's central bank estimates over 65% of all physical US dollars are held overseas.

Depending on location, some people may not see the need for new dollar stablecoins because they rate the possibility of their local bank cutting off access to dollars as remote while doing most of their business in dollars already.

Others, particularly in Asia, are already using dollar stablecoins because it speeds up commerce, turning what used to be a cross border dollar settlement taking days and exposing companies to counterparty risk into a local settlement transaction which clears in minutes with less risk.

Then there are places like Lebanon currently, where people are being cut off from their bank accounts, inflation is 110% per year, and since they cannot access dollars, are buying used BMWs and anything else they can find which they think will hold its value better than the pound.

After seeing what my guys and their families dealt with on a daily basis living through inflation and social volatility in Sudan, I can't imagine trying to explain counterparty or liquidity risk in stablecoins and how a dollar stablecoin is not a real dollar to someone who risked being beaten by secret police for trading Sudanese pounds to US dollars to buy medicine for his daughter.

I know and care for people whose life will be infinitely better when they have access to dollar stablecoins on their smartphones, and I also understand what people in the first world are saying about the problems they have with the products and the speculation.

Dollar stablecoins are a new cryptocurrency product where each coin is supposed to be pegged 1:1 against the US dollar. Different stablecoins are backed by a different mix of assets and varying degrees of transparency, and there is most definitely risk to using a dollar derivative product, if people believe the assets backing the stablecoin are not worth what they are supposed to be, the peg can break and people lose money. But people can also be beaten just for trying to buy dollars on the black market to get medicine for their family in some places. All risk is relative to the situation.

To build an ironman argument on the legitimate concerns stablecoin skeptics have, listen to the episode with Rohan Grey on Hidden Forces Podcast.

Rohan is correct stablecoins are trying to be Eurodollar 2.0, built on top of public infrastructure and there are problems with this approach, especially due to lack of regulation on what assets will be allowed to back a stablecoin to make it worth a dollar.

This is a legitimate concern, especially looking at recent history from 2008. One of the major problems from that crisis is mortgage backed securities (MBS) were rated by their holders as safe assets, being further down on the capital pyramid. Only they were not at all safe and as assets backing those products went to zero, institutions that thought they were safe found out they were insolvent.

This is the concern currently with dollar stablecoins, what are the assets backing the stablecoin to maintain the value of the product at a dollar, and during times of volatility, will the value hold at a dollar?

The high interest rates, between 7.4-9.5% depending on platform and product, being paid on dollar stablecoins I look at in two ways.

First, the market's answer to the question of will the value hold to a dollar in volatility is the interest rate I am currently being paid over a standard high yield savings account.

Currently, my American Express high yield savings account pays 0.40% interest.

My Gemini interest account currently pays 7.4% interest on Gemini dollars (a dollar stablecoin).

7.4% - 0.40% = 7.0%

The market is paying me a 7% premium to hold dollars in stablecoin form over traditional dollars, so while there is a possibility for the dollar stablecoin peg to break, the market currently values the possibility and amount by which the peg would break as no more than 7%.

There are no free lunches. Yes, I am being paid 7.4% interest on a dollar derivative savings account, but I am taking risk for that return as dollar stablecoins are not US dollars.

Skeptics of stablecoins will point out two things.

First, most people do not look at stablecoin interest like I do in terms of risk and they afraid people are playing Rumpelstiltskin, thinking they are spinning straw to gold in a safe investment so are putting their emergency savings accounts, money they can't afford to lose and certainly need during volatility, into dollar stablecoins for the higher interest.

Second, skeptics would say the chance of stablecoins not holding their peg to the dollar is higher than 7% so the market is not accurately pricing in the risk of the peg breaking during volatility because of the lack of transparency in the assets backing the stablecoin. The skeptics will point to 2008 with MBS when it was assumed those were safe assets and turned out during volatility they were not.

My answer to the first is we all get to decide what we are comfortable with and if we misjudge risk then we get to live with the consequences. That is life and pain is usually the best teacher.

For the second, I've put a lot of thought into if high single digit interest is the right value for the risk being taken. The unknown for me is the demand already in place overseas with dollar stablecoins.

While 7-10% interest on dollar loans seems high to us in the first world, remember, we have the world reserve currency and swap dollars for euros, pounds, and yen with most of the first world to suppress volatility which keeps interest rates lower.

In the parts of the world I worked, people would gladly pay 10% interest for dollars because they are accepted by everyone, hold their value, and depending on what they are doing with them, can easily gain the productivity boost to make the math work.

If you owned a bread store, and needed a new oven because you run out of bread by 9:30am every morning, more than likely that oven has to be paid for in dollars and imported. If you knew you could gain 25% more sales with a new oven, you would be willing to pay 10% for dollars so you can buy, import, and ship the oven across the one road from the Red Sea to your bread shop in the capital.

This is not an uncommon story in parts of the world, but I have no way of knowing to what degree people cut off from the current Eurodollar system are now using dollar stablecoins.

All I know is in places where the friction of getting dollars and doing cross border settlement is incredibly high, high interest rates are the norm, not the exception like we see in the first world.

I would also break tether apart from other dollar stablecoins. In full disclosure, I do not use tether, but I am an American in the dollar system who has the luxury of not needing to use it.

For the rest of the dollar stablecoin world, personally I prefer Gemini dollars (GUSD). After reading both Gemini's and Circle's audit reports, I will use Circle's dollar stablecoin (USDC) if I must, but prefer not to as I do not like how they write their audit reports. Based on my experience, when reports are written in such a way to say a lot while carefully saying nothing firm, there is a reason they are writing that way. Whereas I found Gemini's audit reports to be more clearly worded, and while I wish both would break down by asset allocation the assets backing their stablecoins, Gemini at least hold dollars and short term treasuries as they qualify for FDIC insured accounts, which Circle does not.

Accept No Substitute

It is not coincidence that Australia, South Korea, and Japan all have dollar swap lines.

They form a pacific rim of dollar soft power to help contain China geopolitically by letting our allies in the Pacific swap dollars with us during times of volatility.

China is circumventing this with Tether, an unregulated dollar stablecoin that is being adopted for cross border trade settlement in Asia.

Think of it like making knock off Louis Vuitton purses and selling them at full price, only applied to US dollars and geopolitical interests.

With the technology to turn 3 billion cellphones into currency voting machines, and a world of people who have been conditioned for the last seven decades to think of the dollar as the strongest currency on the planet, I would not be surprised to see US policy makers provide clearer guidance on US dollar stablecoin regulations.

This would give everyone in the world that wants to use dollars on their phones a regulated US dollar stablecoin to use, while also nuking the Chinese dollar counterfeiting operation happening in Tether out of existence.

After all, if you can have a real Louis Vuitton at the same price as the fake, you get the real thing.

Doing this to counter China will also open Pandora's Box on every weak central bank in the world, some of which are friendly to the US.

As billions of people have access to a regulated US dollar stablecoin on their phone, they will consistently sell their local currencies to save in dollars.

This will lead to weak currencies around the world all being devoured by the US dollar as every central bank from Lebanon to the Central Africa Republic tries to defend the value of their currency against the dollar and fails to stem the tide of the consistent selling.

While this would be unfortunate collateral damage on weak central banks, some of which are allies to the United States, it would still be a very possible outcome I will be looking for if US policy makers do indeed start to clarify regulations and pave the way for a regulated US dollar stablecoin in the future.

At some point policy makers will have to address the dollar stablecoin market due to the high quality collateral being siloed in the system. The same high quality liquid assets that companies use to back dollar stablecoins are the same assets central banks like to buy (bonds) in order to continue suppressing market volatility.

The rate at which dollar stablecoins value is growing is staggering. In Quarter 3 2020 alone, the total market capitalization of all dollar stablecoins nearly doubled.

Currently, dollar stablecoins have a market capitalization of $100 billion with many analysts expecting the stablecoin market to grow to $1 trillion valuation.

Policy makers and central banks will have to decide at some point to fight against dollar stablecoins or provide regulation clarity and bring dollar stablecoins into the traditional system.

My best guess is they choose regulation clarity and bring dollar stablecoins into the traditional financial system.

This approach would solve a few problems.

People around the world get a dollar stablecoin regulated and backed by the US.

The Federal Reserve gains the monetary velocity of dollar stablecoins that is orders of magnitude higher than M2 money supply; giving the central bank a new tool for providing liquidity during times of volatility with possibly less quantitative easing required since monetary velocity is higher, which reduces the inequality effects of their efforts.

In addition US policy makers would have not just a Pacific rim of soft dollar power, but now entire countries made into defacto dollar economies through billions of smartphones which would make it harder for China to be the lender of last resort to desperate countries needing dollars in exchange for Chinese naval bases on the Atlantic ocean side of Africa.

The Game Continues

Looking at how suppressing volatility works in the market, I think people and companies are loading up on cheap debt and trusting policy makers with their lives, most probably without realizing it.

People and companies who are leveraged, in debt, or dependent on low interest rates to remain profitable are depending heavily on central banks continuing to suppress volatility in order to not lose their current quality of life.

Combining this view with dollars remaining important for people in parts of the world without swap lines, and the decision US policy makers have in front of them concerning dollar stablecoins is why I continue to focus on companies whose leadership have been steady at the helm, ignored the wailing calls of cheap debt, and focused on continuing to build their business with a combination of efficiency and durability to weather whatever volatility the future may hold.

See you out there, Radigan