Transcript: A China-Based Gold Trade

Featuring: Alexander Campbell

Published Date: August 12, 2019

Length: 00:19:31

Synopsis: Alexander Campbell, founder of Black Snow Capital, focuses on systemic risks and the banking sector. In this interview with Alex Rosenberg, Campbell dives into the problems facing the Chinese banking system, and argues that history points to money-printing as the most likely outcome. He also explains why he would be buying gold denominated in Chinese Renminbi, if possible, before laying out an alternative strategy using options. Filmed on August 9, 2019.

Video Link: https://www.realvision.com/rv/channel/realvision/videos/4457dda62163483ca35ed4a2310dad1c

The content and use of this transcription is intended for the use of registered users only. The transcription represents the contributor’s personal views and is for general information only. It is not intended to amount to specific investment advice on which you should rely. We will not be liable to any user for any loss or damage arising under or in connection with the use or reliance of the transcription.
ALEX ROSENBERG: Welcome to Trade Ideas. I'm Alex Rosenberg, here with Alexander Campbell, founder and CIO of Black Snow Capital. Alex, welcome to the show. And since you're new to our viewers, tell us maybe a little bit about who you are, what you do and what Black Snow Capital is all about.

ALEXANDER CAMPBELL: Yeah, definitely. And thank you for having me. Black Snow is an attempt to combine a couple of different experiences I've had as an investor. I got my start as a prop trader, convertible bonds guy at Lehman Brothers, saw what it looks like for a financial system to disintegrate from the inside. After that, I was fortunate to work with Bridgewater for a handful of years directly for the top three guys as the commodities guy, and learned a lot about systemization, a lot about how to use modern data infrastructure to take a process and systemize that process. And so at Black Snow Capital, what we're trying to do is bring those two experiences together, and take a systematic approach, take a macro approach, but look at markets that are a little bit more niche, look at more options structures, that kind of stuff. And so, yeah, that's what we're trying to bring to the market.

ALEX ROSENBERG: All right, very good. So, let's see how you do it here. Because it's been a crazy week, we're at the tail end of what's a really shaky news centric week, two weeks, actually, if you go back to the Powell press conference. And when you look at this market environment, where do you see the biggest opportunities for investors now?

ALEXANDER CAMPBELL: Yeah, we look a lot of history, we try to look at what we call deep history. And part of that Lehman experience made me very focused on banking systems. And so, we've done a lot of work on historical financial crises, and they all look the same, have the same characteristics, you have a technology, or a new market opportunity that creates a bubble, capital flows into that, you get leverage flowing into that system, the financial systems that support it tend to get over levered and brittle. And when you get tightness, either in reserve currency, or in that liquidity pool, small banks start to go under. And when small banks start to go under, then the medium size and the big banks that have lent them money tend to create systemic risk. And this prompts a conversation between the political system and the financial system about who's going to get bailed out when, how and in what order.

The reason Lehman failed wasn't necessarily the market, the market was punishing all the banks, it was that they were the one that the Fed decided could go. And so when we look at the world, we see the biggest risk and also biggest opportunity coming out of China, coming out of the huge leveraging that they've had, the degree to which they have a bunch of sketchy banks very, very interdependent on the bigger banks providing liquidity. And we think it'll play out in a historical fashion, where liquidity events due to losses in the periphery go to the core and the state has to make some hard decisions. And that in that moment, we think that they'll print, we think that historically, governments print, and they print a lot. And that actually, what's happening now and what we're seeing in the market today in the last even couple of months, is the question is not will the Chinese print, it's will the Americans print, it's will the dollar print to follow them down?

And so, we really like gold, on a basis of there are $30 trillion of deposits in Chinese banks right now, it's about double the deposit base of the US. And if you just take the net new credit creation, the new money creation that comes out of that, if just one in 10 of those dollars goes into- or RMB go into gold, go into
Trade Ideas: A China-Based Gold Trade

buying gold, which they have historical demand for, that's all of last year's gold demand. 1% of the deposit base is all of last year's gold demand, 10% of the new money creation is all of last year's gold demand. So, we see a huge potential for the outflow of capital from the banking system in China into liquid, small diversified bars of gold, essentially.

And then from a Western perspective, the question becomes, well, do we print? And if we print, do we follow them down? And so if you can get it, we like gold denominated in RMB, trading about 10500. It’s up 10% since the Trump tweet about a week ago, and then the deval, we think it has a lot of legs, there’ll probably be a little bit of a consolidation. But we think that you win on the gold if the US prints and you win on the currency if China prints.

ALEX ROSENBERG: And so, help me understand the mechanics here a little bit more, because it strikes me that if the Chinese economy is doing well, more people might have money that they throw into gold. So, if you’re worried about a liquidity event, it might tamper down certain forms of gold demand. So, help me understand that part of the gold demand is going to be increased by an adverse event in China.

ALEXANDER CAMPBELL: Yeah, it depends on where the money goes, where the capital flows. And we think that in moments of panic or an institutional worry, that if you talk about capital flight, gold is a great way to have capital flight, because it's a physical object, you can buy it, it's hard to prevent the import and export of it. And so, we think that some of the people who get burned by WMPs or sketchy bank in Liaoning Province, some of them say, I don't know what's going on, I want to diversify a little bit out of RMB and into gold and into dollars as well. But into both.

ALEX ROSENBERG: China is not famous for letting people choose their own path when it comes to their money and gold benefit that people often turn around gold is that it's less government controlled. It's the government often doesn’t know how much gold you have, et cetera. Is that even a possibility for Chinese in math to really to import a ton of gold and throw a lot of money into gold? It’s harder to track them in some things, but it’s easier to track. Then Bitcoin is the obvious way that the Chinese seemed to be getting money out of the country or out of the financial system. So, just help me out with that mechanics there.

ALEXANDER CAMPBELL: Yeah, I think Bitcoin does provide an alternative. It's a lot more risky, a lot more technical, you’re now dealing with a whole set of different quasi financial institutions. And it is possible to try to restrict the flow of metal. During the Great Depression, I think it was the President basically banned private ownership of gold. So, it is hard to totally prevent the trade of that thing, though, because it is so valuable relative to its weight, and relative to its mobility. This isn't to say that we think that everyone's going to put all their money in gold, it's that people don't appreciate how big the stock of money is, and how just a small change in people's- investors' households preferences for where they denominate their savings is just such a big flow.

ALEX ROSENBERG: And so, it's interesting, because a lot of people are looking out for some kind of adverse event in China. Some people, and perhaps in the US, perhaps leading to recession, and there's are two camps among those people that I think there's some folks who think that central banks can go to
zero rates or below and really try to save the system, whereas other others think that it's a bit of an endgame situation, which camp would you say you're in?

ALEXANDER CAMPBELL: When I first started looking at China, and first started looking at the financial system, I thought that maybe they would take the tight path, and they would, they would allow banks to fail, and they would draw a hard line. And that the system has enough control in it and enough ability to stimulate monetary and fiscal outside of the worrying banks that they could carve out the cancer as it was. And deal with the problem that comes as a result of that. I realized over time that I didn't know enough about China, and I didn't know about the history of China and the culture of China.

And we went and looked at things like the history of conflict in a bunch of different countries. And of all the major powers, China's the only one that's been way more time in Civil War than an external war, they have this historical legacy of the central will not hold, you have this expansionary impulse. And then whether they lose the mandate of heaven, or rice prices go up by 50%, the people realize that the autocracy doesn't have as much legitimacy as they thought it did. And you have an internal system reboot. And I think that if you're a policy- I don't know. But I think if you're a policymaker in China, that's the first thing you worry about. And then Taiwan, Hong Kong, Japan, Korea, and America are the second thing.

And with that lens, it becomes much more obvious that of course, you're going to bail everybody out, you can't risk that downside. You shouldn't risk that downside. And so, you should print money and paper over the problem. They have enough assets to do that. I think the thing that people miss, and the thing that hasn't really been well understood is that were they to do that, they probably have to let the currency go. And not only probably do they have to let the currency go, they probably want the currency to go at that point, they probably want depreciation, they probably want their exports to regain competitiveness and to reset wages relative to the West, it would be good thing for that for the Chinese people if their currency was lower.

You see Trump fighting that on the other side and saying, no, they're going to be a manipulator. But we think to the degree that they need stimulation that falling currencies and depreciating currencies are pretty way of doing that. Does the system get out of control? I don't know. I don't know exactly the whole system. I just know that I see an economy that needs simulation, had some tools, but the size of the problem they're about to deal with, and they're slowly trying to deal with, you see Shengjing Bank, who we've been short on for a while, get bailed out by Evergrande and then go suspended. Bank of Jinzhou just went under, Baoshang went under. They're providing liquidity while trying to take out the small guys.

There's some big guys coming up. Industrial Bank looks fine. But by all of our metrics, it's the sketchiest big bank. Minsheng is not that far behind them. If you start to get those banks under question, the liquidity that they have to provide to offset the deleveraging, the negative liquidity from bank runs will be so big that I think the question of do you want to keep seven is obvious. And you say, no, who cares? Like, let's have it go down. And let's stimulate the economy. I think the cruxy thing, and the thing for the trade then is will do we print money as well? Does the dollar then follow them because they're the bigger economy almost now, and financial wise, and in some sense, like PPP wise. And in that case, you think about negative interest rates, you think about the fact that interests go back to zero. And that's a great bull case for gold.
ALEX ROSENBERG: Let’s lay out that in a little more detail in terms of is it- which part of the situation you’re playing? Because it rises in times of fear as it’s risen for the past two weeks, some say it rises in times of inflation, I think the jury’s a little more out on that one. And then of course, it maintains its value well over time if everything really goes away, and gold bars will become less valuable at the time, but probably maintain some of that value through the crisis as well. So, what gold play, which flavor of gold play you have?

ALEXANDER CAMPBELL: Yeah, so I’m a volatility guy. So, I think in distributions, and I think that you look at gold, and you think of it as probably a negative carry asset, but one that has a unique property and that it prepares your portfolio for very inflationary and very deflationary environments, that it’s actually a tail hedge on both sides of the inflationary spectrum. And when you look at the data, and you look at the charts, it’s a little bit hard to sass out, mostly because gold is denominated in dollars. And so, the dollar flow- in and out of dollars as people panic and as they have to make do on their emerging market dollar debt can obscure what gold is doing relative to everything else. That’s why we like to strip out the dollar from looking at gold. And if you look at like 2008, gold in dollars actually didn’t do that great. Deleveraging, people selling assets, but the dollar was going so well that relative to other currencies, gold is doing great.

ALEX ROSENBERG: If you did want to play this just by using gold, which is easier to play and use options around than Chinese currency, how would you lay out that trade tactically?

ALEXANDER CAMPBELL: Yeah, so we were in that position, actually. When we put on an option structure to basically take advantage of upside to gold, and be a little bit different between staying put and downside, we did it through a call butterfly, where we buy a call option a little bit higher than the spot price, we sell two call options further out. And then we buy the deep tail all the way back. For GLD, we did a 145, 160, 175 Jan, call spread, call butterfly. And we did that with about a year plus maturity on it. Partially because you can actually, it has really nice properties, partially because you get long term capital gains.

When you do longer than a year option, that option is now almost at the money. So, we’ve come up a lot, we’ve got a lot of pew out of it, it’s no longer like a 15, 13 to one, it’s probably like a seven to one. So, we recommend people new to this theme to look at those kinds of trades, look at trades where you’re buying a little bit of upside, selling some further, deeper upside, but covering your max loss to the premium that you’re paying. So, you could look at 150s, 155s on the first strike, and then move the whole structure up.

ALEX ROSENBERG: So, it sounds like it was very good trade because the gold options, just the implied vol of gold options has risen dramatically, almost more than the gold price over the apples and oranges, but has risen dramatically over the past few weeks, few months even. So, would you still look at buying, basically being long Vega and options in gold or at this point, would you look to maybe just buy the outright at this point rather than-

ALEXANDER CAMPBELL: Well, that’s why I like the buying one and then selling two, because you can actually get your Vega almost flat. I think we had- it depends on where you are relative to strike, but our
faith is very, very low, because you’re selling that in our case, 160, I feel pretty good right now being shorter 160. And so, I’m actually not even hedging the delta, I’m just letting it ride. and hoping that I get to that point where my theta goes super positive, and I crawl up to that 160 strike, you have to do a little bit of the math to know that you’re not taking the huge vol bet, I think people who aren't vol experienced shouldn't - you must be licensed to drive this car.

But call spreads are another way to do it, where it's not too crazy. You put down $1, you make $4. You put down $1 to make $5, and you probably going to lose money but the thing that's nice about these kinds of structures is that in the last- we've had a great last week, and for some other people, they've had the worst week of their year, worst week of their career in some cases. That's diversification, that's a thing that if you have exposure to US equities or tech or emerging market, you want in your portfolio, you want something that does really well when everything else is hitting floor as it were.

And so, I don’t think people should put their entire portfolio on this. We put a small, measured percentage of our book in this and more so than we think most people should because we have conviction. But I think that the case for it to even just a gold long in your portfolio, watch the positioning, it’s getting a little bit fluffy. But that's what you get when you're buying gold. You get big run ups, you get a little bit of crack and some consolidation. And then if you don't pay attention, it's running up again like Bitcoin.

ALEX ROSENBERG: And so, just to, let's give people a little that five-hour course you need before you get a license, so call butterflies, you're buying one call, you're selling two higher strike cycles, and then you're buying any-

ALEXANDER CAMPBELL: You get further on, so you get like a triangle. So, you're just buying a triangle where you say, if it goes to 160, I make 15 bucks, and I can buy the first call for three bucks and the 160, I can sell for like a buck 25. And then I buy the third call for like 50 cents or something. And so, you have a ton of exposure to it going to that point, and you have to be willing to be like 155, 165, I'll be okay just with the payout, but you actually, you don’t get into a situation where if you do a like a one by two, where you buy one call and you sell two more calls up, where if it really starts going, then your margins guys are coming after you or your risk people are coming after your- there was a Deutsche Bank guy back in the financial crisis who was right on the credit spreads, but one by twos can get you carried out. So, it's a little bit of just precaution just to get that deep, deep call. And you say look, the worst thing I can do is table stakes, I can lose what I brought in.

ALEX ROSENBERG: Yeah, I would say to the viewers, don't sell naked calls unless you really, really know what you're doing, because the price can run up to infinity and then your owe infinity, which is taking me at least a week to make that back. And in terms of the expiry, maybe talk a little bit about why you chose Jan? And if you were putting on the trade now, is that still what you would look for? Would you roll it out a few months? Or how would you think about that?

ALEXANDER CAMPBELL: Yeah, I think for this kind of trade, you want maturity actually. When we first put it on, it was a year and a half. As you go to expiry, you will get a theta burn, you will get negative carry when you're out of the money. But if you take a deep out, out option, something that’s a year, 18
months if you can get the liquidity, you really don’t pay that much theta, you don’t pay that much negative carry for quite a long time. It's most of the negative theta comes in like last three months from a trade like this.

ALEX ROSENBERG: The risks to the trade are very well laid out, because we know exactly what we’re risking going in. And if it’s a five to one winner, we only need it to work out-

ALEXANDER CAMPBELL: Four times and you can be at the money.

ALEX ROSENBERG: So, you can do math too, which is even better. So, what are the risks, perhaps to thesis? Is there a risk that China data improves? We do have a trade deal. And then maybe this was an insurance call? What do you think about on the economics are the risks?

ALEXANDER CAMPBELL: Yeah, I think things don’t look that bad, actually from the economic machine plays in China. It’s not like activity is crashing, the prices of financial assets are going down, but they’re not going down super-fast. They’ve been pretty healthy over the past year and a half. The biggest risk to this diversifying trade is return enormously, growth goes up. We don’t have any inflation, easy monetary policy can continue to be easy, and that most traditional financial assets go for a ride.

I think most investors already have that in their portfolio in some way or another. If they don’t, you should get some. You should have some exposure to positive growth outcomes, positive risk outcomes. And so really, we like to think about this as this is the part of a portfolio which is protection. This is the part which is the cookie jar for when everything else is cracking and you get a little bit of a green on your screen, that makes your day a little better.

ALEX ROSENBERG: Makes a lot of sense. Well, Alex, thanks so much for bringing us this idea. And thanks for joining us here on Real Vision.

ALEXANDER CAMPBELL: Absolutely. Thanks for having me.

ALEX ROSENBERG: So, Alexander likes buying gold here. Specifically, if you’re able to buy it denominated in renminbi, that’s the best way to do it. If not, you can just buy call spreads on the GLD ETF with a long expiry. And for Trade Ideas, I’m Alex Rosenberg.