# A "Checkmate-Like" Situation: Zoltan Pozsar Says Fed Will Restart QE By The Summer Of 2023

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2022 was a blockbuster year for commentators at the intersection of geopolitics and finance, and none more so than former NY Fed "plumbing" expert and repo guru, Zoltan Pozsar, whose comprehensive and unique insight into the more opaque workings of the financial world has made him into a household name and one of Wall Street's most closely followed contrarian commentators and strategists. There's a reason for that: two years after Pozsar first correctly predicted the historic monetary and fiscal shock that would emerge as a result of the covid lockdowns, warning correctly in early March '20 - just days before the US financial system nearly collapsed due to covid lockdowns - that the pandemic would lead to a major funding crisis (see "Covid-19 and Global Dollar Funding") and that the Fed should be launching a massive preemptive QE (the Fed did just that, but it first waited for stocks to crash by a third in a matter of days), Pozsar shifted his attention to the multi-polar world resulting from the Ukraine War, a world which according to Pozsar would see the birth of a new Bretton Woods regime, and where the death of the US dollar would coincide with the birth of the petroyuan.

As Pozsar recounts in his first must-read note of 2023 titled "**War and Peace**" (*available to pro subscribers*) the events of 2022 inspired him to write four "war" dispatches: War and Interest Rates, War and Industrial Policy, War and Commodity Encumbrance, and finally, War and Currency Statecraft. In these, he identified six fronts (or "hot wars") in "macro-land" (a "cold place") where Great Powers were going "at it" in 2022:

- the G7's financial blockade of Russia,
- Russia's energy blockade of the EU,
- the U.S.'s technology blockade of China,
- China's naval blockade of Taiwan,
- the U.S.'s "blockade" of the EU's EV sector with the Inflation Reduction Act, and
- China's "pincer movement" around all of OPEC+ with the growing trend of invoicing oil and gas sales in renminbi.

Looking back, Zoltan writes that "those were six geopolitical events in one single year, that is, a geopolitical curveball to deal with every two months." And that's ignoring the complete mess that was the market.

Alas for those hoping that the Hungarian repo guru sees 2023 as being a less "exciting" year, we have bad news: as he writes in his latest note, the Credit Suisse strategist does not "think 2023 will be different: in a number of regions in Europe and Asia, the threat of a hot war is real; the BRICS are set to expand with new members ("BRICSpansion"), which means more de-dollarization of EM trade flows; CBDCs are spreading like kudzu, with Türkiye the latest country to launch one; and with the launch of every new CBDC, the potential of Project mBridge to **diminish the role of the dollar in FX transactions and trade invoicing will rise as it interweaves BRICS** (and soon BRICS+) **central banks into a global network to rival the global network of correspondent banks on which the dollar system runs**."

Expanding on this gloomy worldview, Zoltan writes that war "in one form or another – was a theme that defined macro not only last year, but basically every year since 2019: ***trade war with China; the war on Covid-19; war finance to deal with lockdowns; war on inflation, as we overdid war finance; and war then spread to engulf Ukraine, finance, commodities, chips, and straits as discussed above.***" This also bound the world's monetary and fiscal reactions: these were "responses to mother nature and geopolitics – **and with geopolitics getting more complicated, not less, investors should remain mindful of the threat of non-linear risks in 2023.**"

Needless to say, few financial commentators can get away with being this apocalyptic and still have a job, but then again, Zoltan's isn't anybody: in fact, it is his job to demonstrate why the prevailing worldview is wrong and how finance professionals should be looking at the world after cataclysmic events such as, well, everything that happened in 2022. This is not lost on Pozsar, and as he noted in his most recent report, "investors are not particularly well trained to deal with geopolitical risk, because for generations geopolitics didn't matter – anyone who traded securities or ran a portfolio since the end of World War II, did so in the cocoon of a unipolar world order, under the cover of Pax Americana."

But as he argued a month ago, the unipolar world order is again being challenged, and as he echoes in his latest report, "**war has been and will likely remain a theme until the quest for world order (that is, "control") is settled.**"

Not surprisingly, this is increasingly not just Pozsar's perspective: when Henry Kissinger writes about how to avoid another world war (see here), and Niall Ferguson writes about the risk of Cold War II spilling into World War III in an op-ed on Bloomberg (see here), you know that something is definitely up; this is how he frames it:

> *Henry Kissinger's year-end essay and Niall Ferguson's new year essay are not the types of essays that you normally read alongside sell-side outlook pieces, which suggests that this ain't your parents' "global macro environment", and it ain't your grandparents' either. We have to go way back in history for direction…*

Zoltan's point is that when financial historians look back at 2022, they will put it alongside 2008 in terms of its impact on conventional thought (and wisdom). As he says, "during the Great Financial Crisis (GFC), events forced us to abandon using the term "post-WWII" in the context of recessions and business cycles. Of course, that was because the GFC threatened to unleash a second Great Depression, which was a "pre-WWII" event that rendered "post-WWII" comparisons irrelevant, and turned Kindleberger's Manias, Panics and Crashes and, via Paul McCulley, Minsky's Stabilizing an Unstable Economy into required reading."

Similarly, in light of the events of 2022, to Pozsar it is "prudent for investors to abandon the idea that the post-WWII world order will remain stable, or at least won't be challenged. Pre-WWII parallels are once again relevant, with a new reading list: Mackinder's The Geopolitical Pivot of

History, Brzezinski's The Grand Chessboard, and Herman's Freedom's Forge. The last one is about two industrialists who oversaw the production of the "arsenal of democracy" that underwrote Pax Americana, which, to use Ferguson's term, is challenged today by the "arsenal of autocracy".

Summarizing the above, in Pozsar's "war" dispatches, he had stressed four themes:

- 1. War is inflationary.
- 2. War means industry.
- 3. War encumbers commodities.
- 4. War cuts new financial channels.

Which, after a lengthy preamble, brings us to the the main topic of Zoltan's latest dispatch, in which he adds a fifth theme:

- **5. War upsets all four prices of money**

What does Zoltan mean by this? As he first noted several months ago, referencing the lessons from his mentor Perry Mehrling, money has four prices (par, interest, foreign exchange, and the price level), and as Niall Ferguson noted in his essay, "*we forgot that war is history's favorite driver of inflation.*" Not surprisingly in his first "war" dispatches, Zoltan was talking mostly about inflation: "war is inflationary", so is the embrace of industrial policy at full employment, and so is commodity encumbrance

Inflation is critical in the context of Mehrling's framework because **for the first three prices of money (par, interest, and FX) to be stable, the fourth price has to be absolutely stable.** Here is Zoltan's explanation for why it is so critical for inflation to be at the Fed's target level, whether it is 2% or higher:

> *It's simple: **if the price level is stable, i.e., inflation is 2%, the Fed can "casually" manage business cycles and clean up crisis situations using QE**. With stable prices, there is a fairly narrow range in which policy rates will move up or down, and hikes have a predictable pace (typically 25-bp increments). **But if inflation is above target and off the charts, all bets are off.** That's been the story of 2022: no hikes; hikes; string of hikes; string of 25 bps; string of 50 bps; string of 75 bps; string of 75 bps first with forward guidance, and then without. **Unstable fourth price = instable second price, and unstable second price means an unstable first price and an unstable third price.***

The inflationary wave prompted by the various wars of 2022 has sparked a what Zoltan calls a "polycrisis" in which all four prices of money are having a crisis:

- the collapse of stable coins is a crisis of par;
- an unprecedented pace of hikes with a (still) uncertain level for the terminal rate is a crisis of policy rates (OIS);
- the volatility in the price of crypto, DM, and EM currencies are crises of FX;

As noted above, all these crises are due to a crisis of the price level – a crisis of inflation, which, in turn, has been driven by both mother nature and geopolitics. The silver lining is that in the domain of the second price (interest rates), spreads around OIS have been fairly quiet to date: only credit spreads had blowouts, but not swap spreads.

**But with Treasuries, Zoltan sees a problem brewing.** Which brings us to the punchline of today's note, and the latest striking warning from the Hungarian which may well prove to be as prescient as his forecast from early 2020 that the Fed will have to unleash a tidal wave of QE to stabilize the financial system.

As Pozsar writes, "just as war is becoming more entrenched as a macro theme, **the Fed continues to do QT, and so it does the precise opposite of "war finance".** Picking up on what Bridgewater's Bob Prince said in October, when he warned that **"the amount of government debt that will need to be absorbed by the private sector in [2023] is larger than at any time outside of world wars",** and then again what Michael Hartnett warned on Friday, that "with US/Japan/EU/UK governments all set to issue $6 trillion in bonds in 2023", the Fed will either step in and resume monetizing this debt, keeping yields manageable, or it won't suggesting that QE will have to come back, Pozsar says "*he can't disagree...*"

And while Pozsar agrees that there is still $2 trillion in the surprisingly sticky overnight Reverse Repo facility to absorb some of the Treasury supply to come, there is little natural interest in buying this coming debt onslaught:

- Treasuries will have to cheapen a lot relative to OIS (tighter swap spreads) to bring in RV funds, which won't run positions larger than $25 billion each so they won't have to report their positions."
- Meanwhile, banks are unlikely buyers too, as they hold lots of underwater bonds in Hold To Maturity books, and with their reserves down, they are closer to tapping the funding market than funding the Treasury through Available For Sale books.
- FX-hedged buyers are unlikely buyers too, as they got priced out, and the BoJ - which just expanded its YCC band - will soon "feed" them duration at home;
- Finally, geopolitical events last year have fundamentally re-shaped global financial flows and reduced large FX reserve managers' appetite for U.S. Treasury debt too…

So, **"if the "classic" marginal buyers won't buy, who will?"**

We all know the answer, of course, but here is a roundabout way of getting there: as the strategist explains, "*if there is a sell-off in equities, credit, and EM, risk sellers would buy Treasuries, but if there will not be a sell-off, the lack of "classic" marginal Treasury buyers means that **Treasuries will be at risk of tailing at auctions,** which, in turn, would drive sell-offs in equities, credit, and EM.*"

To Zoltan, this is a **"checkmate-like" situation:** the Fed won't pivot and the terminal rate may have to go higher still (see here), which is negative for either risk assets (sell-off, then into Treasuries) or Treasuries (rates sell-off, then risk sell-off, then into Treasuries). Or as he puts it, *"Hot wars in cold places and cold wars in hot places" need "war finance", not QT."*

Of course, **there is a solution to the coming poor demand for Treasuries, which is QE under the "guise" of yield curve control -** similar to what happened around the end of World War 2, which Zoltan believes "**will come by the end of 2023 to control where U.S. Treasuries trade versus OIS.**" Or as he puts it, ***"The put is dead, long live the put!"*** But it's not the stock market put: that one is, for now at least, dead as "Powell didn't mention stocks at Jackson Hole."

Instead, if Pozsar is correct and he usually is (just early) **the put under government bonds is about to be born:**

> *the "baby" conceived already in a CGFS report, titled, Market Dysfunction and Central Bank Tools. The report says that if government bond markets become dysfunctional, central banks should provide a backstop. I assume that tailing Treasury auctions will qualify**, as***

*will any large increase in the deficit that will have to be funded “on the fly”.*

Pozsar's forecast is certainly contrarian: not even his biggest intellectual peer, BofA's Mark Cabana, himself a former employee of the Federal Reserve, has gone that far; instead as we noted in July, Cabana predicted that the Fed will have to end QT far sooner than expected but did **not** make any predictions on what the Fed will restart QE: *only Zoltan has done so*.

That said, don’t expect the put under government debt to prop up risk assets: unlike QE in the context of low interest rates and a risk asset put, **the coming QE will be in the context of Treasury market disfunction.** In other words, the coming QE will aim to police swap spreads at high levels of interest rates, not to depress yields to inflate risk assets, or as Zoltan puts it, "***The next round of QE will aim to “keep the wheels on the cart” amid high inflation, growing geopolitical tension, and an ugly financial divorce between the West and the global East and South.***"

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In closing the fifth and final “chapter” of Zoltan's “war” series, the Hungarian asks readers to consider this quote from Tolstoy (here he is indirectly addressing many of his critics who have never had an original thought in their careers)...

> *“The most difficult subjects can be explained to the most slowwitted man if he has not formed any idea of them already; but the simplest thing cannot be made clear to the most intelligent man if he is firmly persuaded that he knows already – without a shadow of doubt – what is laid before him.”*

... and says that finance is about discounting the future, and in finance you can’t get personal. And yet, his message to readers is that war is deeply personal, and it naturally forces you to take sides. But taking sides can’t blind objectivity and judgement when it comes to your portfolio: "*Don’t be Tolstoy’s “intelligent man” who “knows” that today’s world order is the only possible world order because Francis Fukuyama said so, and, similarly, that U.S. dollar hegemony is the end of financial history. So keep an open mind, or get financially repressed.*"

Pozsar adds that he intended his “war” dispatches to be a series of dispatches that would provide clients of Credit Suisse with a “framework” to navigate the Great Power conflict that he thinks will define the macro and investment landscape this decade as "Great Power conflict is not a “joke”. It is quite real. President Xi refers to it as a “struggle”, a word which he used 22 times at the latest congress of the CPP. In the West, we tend not to think of what’s coming this decade as a “struggle”, but we should."

To that end, Zoltan suggests reading his “war” dispatches in this order:

1. War and Peace (this note, which explains how “war upsets all four prices of money”)
2. War and Interest Rates (“war is inflationary”)
3. War and Industrial Policy (“war means industry”)
4. War and Commodity Encumbrance (“war encumbers commodities”)
5. War and Currency Statecraft (“war cuts new financial channels”)

What does all of this mean for one’s portfolio and the price of various instruments? Here Zoltan concludes with a rare prediction of which assets classes will work in the coming year(s) and which won't:

1. 60/40 won’t cut it anymore and should be 20/40/20/20 instead, with the weights representing **cash, stocks, bonds, and commodities.**
2. Cash, while the curve remains inverted, is “king”. It provides a nice yield, has no duration risk, and, as Warren Buffet said, it has an option value.
3. Commodities should include **three types of gold: yellow, black, and white**. Yellow gold is gold bars. Black gold is oil. White gold is lithium for EVs.
4. Commodities should also include a range of other stuff like copper, cobalt, et cetera, and the general theme driving commodities is that…
5. …after years of underinvestment, supply became extraordinarily tight, just as we re-arm, re-shore, re-stock, and re-wire the grid (see here).
6. The U.S. dollar won’t be de-throned overnight…
7. …but on the margin, de**-dollarization and digitization (CBDCs) by BRICS+ central banks will reduce dollar dominance** and demand for Treasuries.
8. The dollar’s strength or weakness should be thought of in the context of the four prices of money (that is, par, interest, FX, and the price level):
9. The U.S. dollar will remain “FX” strong versus other DM currencies…
10. …but will be become “price level” weak (that is, outright devalue) versus commodities and “FX” weak versus most BRICs currencies, **which will guarantee plenty of volatility in all four prices of money this decade.**

*Zoltan's latest must-read note, as well as his full series of "war" reports, are all available to professional subscribers.*