The Boy Who Cried Wolf: Is An Inflationary Decade Ahead?

"...though the Villagers heard the cry, they did not run to help him as they had before. 'He cannot fool us again,' they said. The Wolf killed a great many of the Boy's sheep and then slipped away into the forest."

Æsop

Key Takeaways

- **Recent developments – politicians' growing control over credit creation, average inflation targeting policy, and the historic expansion of the broad monetary aggregate – suggest the 2020s could become a stagflationary era.**
- **The vaccine breakthrough could bring back pre-Covid-19 spending habits. Such a return will increase monetary velocity and drive up inflation.**
- **The gargantuan credit expansion in 2020, recent months' bond, real estate, commodity, and equity rallies signal that we have likely entered a crack-up boom.**
- **The global economy's new inflationary paradigm requires a thoughtful re-examination of traditional portfolio theory. In light of recent developments, investors must have increased concern about the risk of inflation.**

Know Your Enemy: Understanding Inflation

The extraordinary events of 2020 have motivated us to release an *In Gold We Trust* special on the heightened risk of rising inflation rates.[1] **The leitmotiv of this report is the classic children's fable *The Boy Who Cried Wolf*, by Æsop.**[2]

The wolf killed a great many of the boy's sheep and then slipped away

Why have we chosen this? As the story goes, a boy guarding over sheep jokingly cries wolf, twice. After returning to the village twice, the locals decide not to respond when the boy cries again. Little did the villagers know that this time the wolf *was* attacking the sheep.

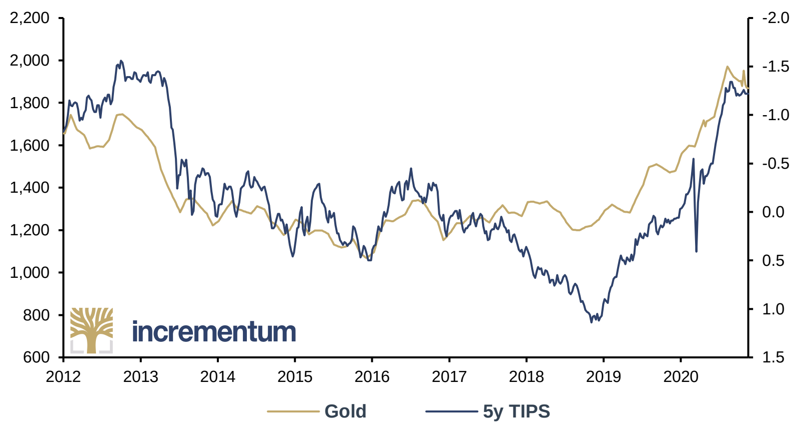
Similarly, the global paradigm of recent decades with its repeated warnings of inflation has consistently reinforced disinflation. Now, as trust in public institutions continues to erode, populist policies could serve as the bedrock of a new inflationary paradigm. **We suspect the monetary developments of 2020, coupled with the recent paradigm shift, could push inflation rates significantly higher. Policymakers and investors at large are reluctant to acknowledge this possibility. Decades of the deflationary paradigm have rendered them wholly skeptical of a potential wolf attack: spiking inflation.**

Having a little inflation is like being a little pregnant.
Leon Henderson

Already, a collective shift in mindset is detectable across asset prices. Markets appear to be adjusting for the risk of inflation. Inflation expectations are signaled through Treasury Inflation-Protected Securities (TIPS). Between March 23rd and August 28th, the day after the Federal Reserve's average inflation-targeting policy announcement, TIPS yields fell 140 basis points to -1.4%.

At the same time, gold has been rallying. Though it has now entered a correction phase, it is significantly higher than at the outset of the recession**. Because of the ongoing economic uncertainty and rising inflation rates, gold could be poised for another rally.**

Gold (lhs), in USD, and 5y TIPS (inverted, rhs), in %, 01/2012-11/2020



Source: Reuters Eikon, Incrementum AG

[1] We are especially grateful to Kalon Boston for his outstanding contribution to this *In Gold We Trust* special.
[2] See Æsop: "The Boy Who Cried Wolf"

As regular readers know, at least one section of each *In Gold We Trust* report is dedicated to the insidious dangers of inflation.[3] **In this *In Gold We Trust* special you will find a thoughtful re-examination of recent inflation dynamics.** We explain why inflation rates – particularly across consumer prices – were kept at bay in the post-GFC economy. Then, we look closely at the developments of recent months which may have accelerated the shift to a new inflationary paradigm. **We conclude that investors should carefully re-assess the risk, which inflation poses on traditional portfolios, and prepare to hedge against it.**

How to Think About Inflation

True knowledge is known by causes.
Sir Francis Bacon

To understand the global economy's recent developments, we must acquaint ourselves with the proper definitions. Our readers know that we adhere to the Austrian School of Economics' definition of inflation. Inflation is defined as an increase in the currency supply in an economy beyond any increase in the stock of specie, i.e. gold, in times of a gold standard.[4] Because the last remnants of the gold standard were abandoned in 1971, all increases in money supply since then should be considered inflationary.

Today, the mainstream defines inflation as a rise of the general price level.[5] **There are three severe problems with this definition:**

- **Problem 1:** The Consumer Price Index (CPI) has been redefined fundamentally at least twenty times since 1980. Even if a price level index were the proper definition of inflation, its calculation has been altered so much that *inflation* simply does not have the same definition it did fifty years ago.

- **Problem 2:** Hedonics, or hedonic adjustments, are changes in price calculation which attempt to factor in the qualitative improvements of technology. Hedonics falsely suggests that qualitative improvements in a television could somehow offset the inflation occurring in food or healthcare prices. Research suggests these calculation changes lead to a depressed account of inflation.

- **Problem 3:** Understanding inflation as CPI or the "price level aggregate", generally, makes the concept less useful for investors. The CPI is calculated exclusively using historical data. CPI looks through a rearview mirror: It aggregates price level trends across an index of consumer goods. However, investors attempt to discern the market through the windshield. Necessarily, CPI gives little information to individuals seeking to benefit from forecasting, such as investors.

Because of these problems, the proper analysis of monetary developments begins with a classical understanding of inflation dynamics: inflation is the increase of an economy's money supply. Therefore, an increase in an economy's price level is just a common consequence of inflation.

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[3] All previous *In Gold We Trust* reports can be found in our archive at https://ingoldwetrust.report/archive/?lang=en.
[4] *See* Taghizadegan, Rahim, Stoeferle, Ronald, and Valek, Mark: Austrian School for Investors: Austrian Investing Between Inflation and Deflation
[5] An example of the mainstream definition in action https://www.investopedia.com/terms/i/inflation.asp

Insights from Monetary History

"The law of unintended consequences is the only real law of history."

Niall Ferguson

To understand the present and anticipate the future monetary environment, it is of utmost importance to be familiar with monetary history**. Economic policies are invariably defined by historical paradigms. Ever since stagflation in the US was defeated in the early 1980s, the global paradigm has been disinflationary. We suspect the Covid-19 crisis represents the beginning of a new inflationary paradigm. Those who heed not the signs of inflation may be ignoring a genuine cry of wolf.**

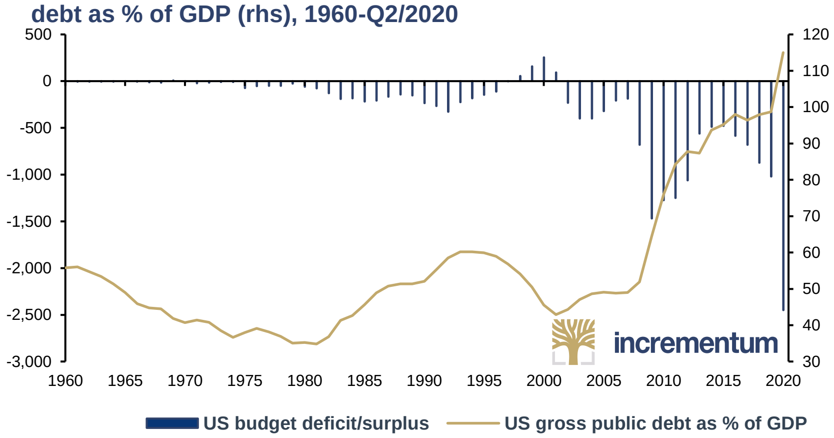
From the Gold Standard to the Debt Standard

In 1971, the Bretton Woods system was terminated by US President Richard Nixon.[6] Though Nixon's decision was initially to *temporarily* suspend the dollar's gold convertibility, the US never returned to a metallic or bimetallic standard.

The wicked borrow and do not repay, but the righteous give generously.
Psalms 37:21

Consequently, the US economy was transformed from a metal-backed regime into a debt-backed regime: **The US public debt-to-GDP ratio grew steadily from 33.7% in 1972 to 105.7% by the end of 2019 and is forecast to increase sharply to 120%** this year. Pandemic policies have driven the US budget deficit to USD 3.1trn in fiscal year 2019/2020.[7] **This is triple the amount it grew in 2018/2019 and now amounts to roughly 16% of the economy.**

US budget surplus/deficit (lhs), in USD bn, and US gross public debt as % of GDP (rhs), 1960-Q2/2020



Source: Reuters Eikon, Incrementum AG

Blessed are the young for they shall inherit the national debt.
Herbert Hoover

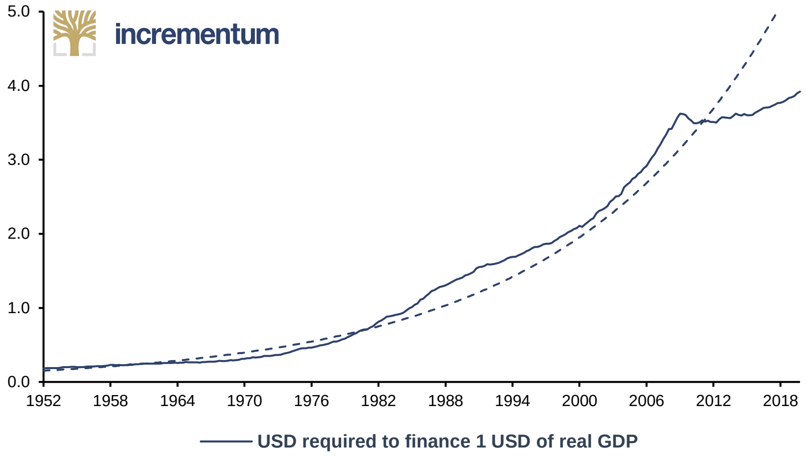
A historical comparison illustrates the magnitude of the recent debt explosion. In June 2020, the United States created approximately the same amount of debt as it did during the first two centuries of its existence. From 1776 to 1976, the United States issued debt in the amount of a little over USD 1trn (nominal).[8] In June 2020 alone, the US Treasury took on USD 864bn in debt.

[6] *See* "Nixon Ends Bretton Woods International Monetary System"
[7] *See* CBO: "An Update to the Budget Outlook: 2020 to 2030"
[8] For more on these historic numbers, *see* Pantera Capital: "Two Centuries of Debt in One Month: Pantera Blockchain Letter", July 2020

The fragile wants tranquility, the antifragile grows from disorder, and the robust doesn't care. Debt always fragilizes economic systems.
Nassim Taleb

Even before the Covid-19 pandemic, many economies around the globe resembled the Red Queen in Lewis Carroll's *Through the Looking Glass, and What Alice Found There*. **To avoid contraction and "just stay in one place", they require ever more debt.** Illustrative of the diminishing marginal return of debt is the jump in debt-to-GDP ratio from 45% in 2001 to 76% in 2019 for the advanced economies alone. **In particular, the US stands out with a great bifurcation between GDP growth and debt growth: Debt has grown at four times the rate of GDP.**

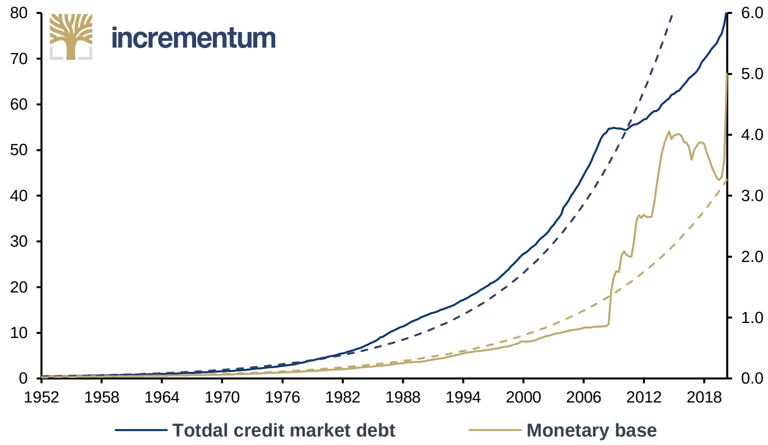
USD required to finance 1 USD of real GDP, Q1/1952-Q4/2019



Source: Reuters Eikon, Incrementum AG

The US budget deficit rose from USD 2.8bn in 1970 to a hair under USD 1trn in fiscal year 2018/19. 2020's policies have driven the deficit to USD 3.3trn. Total credit market debt grew from USD 1.6trn in 1970 to over USD 80trn in 2020.

Total credit market debt (lhs), in USD tn, and Monetary base (rhs), in USD tn, Q1/1952-Q2/2020



Source: Reuters Eikon, Incrementum AG

The global explosion in debt – particularly the US's deficit spending – is the key to understanding policymakers' fearful attitude towards deflation. While we have warned that the true wolf of the story is inflation, policymakers insist that the real predator is deflation. The popular story posits that consumers – upon the anticipation of lower prices at a later date – will postpone their consumption and depress aggregate demand. This story is abstracted to the point of nonsense.

What is certainly clear is that again and again, countries, banks, individuals, and firms take on excessive debt in good times without enough awareness of the risks that will follow when the inevitable recession hits.
Carmen Reinhart

How might the global economy exit from its extraordinary debt predicament? Essentially, there may be one good way out of debt and many bad ways out. The good way out of debt is real growth. For this you need 1) an under-levered consumer with lots of pent-up consumption demand; 2) a demographic dividend with rapid growth in the working age population; 3) a productivity boom so that higher inflation does not result in high unit labor cost growth, which in turn could kill the recovery; 4) political control of the central bank, so that borrowing costs are not forced higher by bond market vigilantes.[9] Unfortunately, we do regard "growing out of the debt problem" as highly unlikely.

Inflation as Taxation

Given Western economies' indebtedness and the anti-deflation narrative, where does the interest of the state, by far the biggest debtor, lie? Are statists the real wolf in this story?

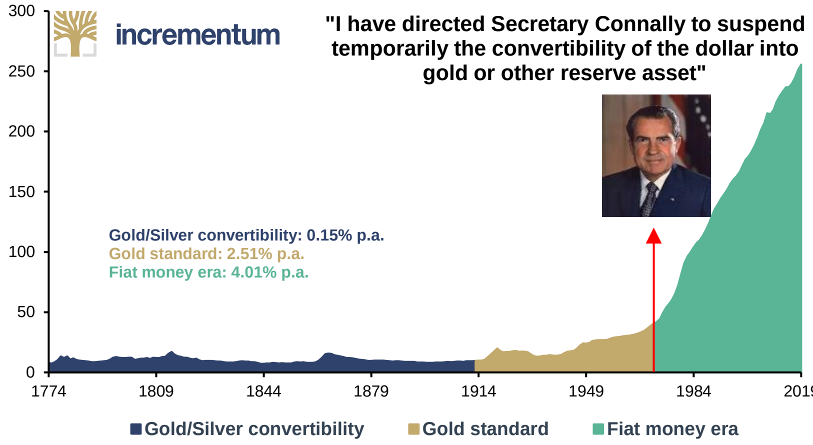
Since the state is heavily indebted and sometimes applies – implicitly or explicitly - pressure on monetary policy, the psychology behind inflationism must include the dynamics between indebtedness and inflation. As price levels rise, each previous year's load of debt becomes a smaller burden on the debtor. Thus, inflation can serve as a political tool to lower real interest payments by quietly taxing savers. The US economy's structural reliance on debt is a key factor in politicians' aversion to deflation. Under our post-gold regime, budgets deficits are financed in part by inflation.

It is a way to take people's wealth from them without having to openly raise taxes. Inflation is the most universal tax of all.
Thomas Sowell

This dynamic also explains why politicians exert substantial psychological pressure on central bankers and why Donald Trump has been so publicly critical of Jerome Powell. **An analysis by Bloomberg shows a count of 60 public criticisms made by Trump towards Powell or the Federal Reserve.**[10]

[9] For a comprehensive overview of this debt framework, *see* Man Institute: Inflation Regime Roadmap, June 2020
[10] For the complete list of the critiques, *see* "Key Trump Quotes on Powell as Fed Remains in the Firing Line", Bloomberg, December 17, 2019

CPI across monetary regimes, 1774-2019



Source: Measuringworth, Reuters Eikon, Incrementum AG

The United States had years of on-and-off deflation/inflation before the Federal Reserve's establishment in 1913. During this period, the average annual inflation rate was only 0.5%. Between its establishment and before the termination of the gold standard in 1971, the average annual inflation rate was 2.5%. Finally, since the termination, the US has experienced an average annual inflation rate of 4.01%.

Why Now?

Governments are likely to continue printing money to pay their debts with devalued money. That's the easiest and least controversial way to reduce the debt burdens and without raising taxes.
Ray Dalio

As the title of this *In Gold We Trust* special suggests, we are known for our concerned stance toward inflationism. We have frequently called attention to the possibility of rising inflation rates across Western economies, their impacts on traditional portfolios, and the actions investors can take to guard against high inflation, and offer extensive expertise and investment solutions in this area.[11] While the 2010s witnessed asset price inflation, disinflation dominated consumer prices.[12] We suspect this to be a characteristic of the disinflationary paradigm. **Many of the structural dynamics across economies have reinforced the disinflationary paradigm for several decades:**

- **Digitization:** Transforming labor into capital by automating previously manual processes.
- **Globalization:** Supply chains are increasingly interconnected beyond domestic borders and overseas, as many countries, with China at the forefront, have promoted growth policies and opened their economies.
- **Monopsony:** In urban areas, there are relatively few employers compared to the labor force. This dynamic depresses wages.[13]
- **Demographics:** Western economies are becoming increasingly composed of aging populations that consume less and demand more cash.

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[11] Incrementum AG: Incrementum Inflation Diversifier Fund
[12] *See* Koyfin Research: "The Key Macro & Equities Themes of the Last Decade In Ten Charts", December 16, 2019, particularly chart three detailing the performance of equities.
[13] *See* Tepper, Jonathan and Hearn, Denise: *The Myth of Capitalism*, 2018

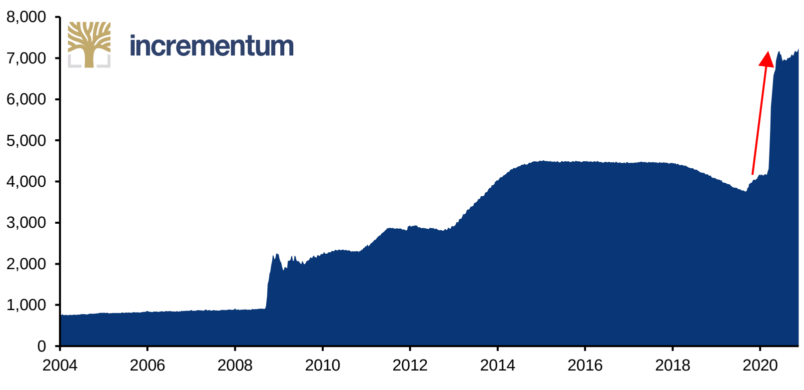
- **Lower Velocity:** From the monetary perspective the demand to hold currency increased and so velocity fell. The newly created currency did not find its way into the real economy but rather was trapped in financial markets.
- **Capitalism:** Western economies are semi-capitalist regimes. Capitalism drives technological progress and innovation. Thus, the natural tendency of capitalism should be deflation.

Negative rates would not help fight deflation but withdraw liquidity from the market because people would rather hoard cash than invest or deposit it in a bank account.
Jeff Gundlach

These trends are ongoing and will likely continue exerting deflationary pressure. However, an economy's paradigm is essentially rooted in public sentiment and policies. History suggests that paradigm shifts are reinforced by policy shifts. As we have pointed out in the past, collective mistrust in institutions has reached a fever pitch. We suspect that mistrust is at the root of the ongoing paradigm shift.[14]

The concept of economic paradigms can be used to explain the dynamics of the post-GFC economy. The policies meant to counteract the GFC seemed like they might restart inflation. The US federal funds target rate was set to 0% from 2008 to 2015. As "conventional" monetary policy failed to stimulate the economy, the Federal Reserve pursued "unconventional" monetary policy: quantitative easing (QE). **QE is the purchasing of longer-term assets by the Federal Reserve. It pushed the Federal Reserve's balance sheet to hitherto unseen levels.**

Fed balance sheet, in USD bn, 01/2004-11/2020



Source: Reuters Eikon, Incrementum AG

Today, many investors are what my late father-in-law used to call "handcuff volunteers". They are doing what they have to do, not what they want to do.
Howard Marks

The Federal Reserve's balance sheet began Q2/2008 with USD 891bn in assets. Six years and three rounds of QE later, in Q4/2014, Federal Reserve assets had almost quintupled to nearly USD 4.5trn.[15] **Despite the magnitude of these programs, QE failed to stimulate the real economy. A significant portion of the money generated by QE ended up as banks' reserves. Over the same period, excess reserves exploded by 1,215% from USD 1.9bn to USD 2.5trn**.

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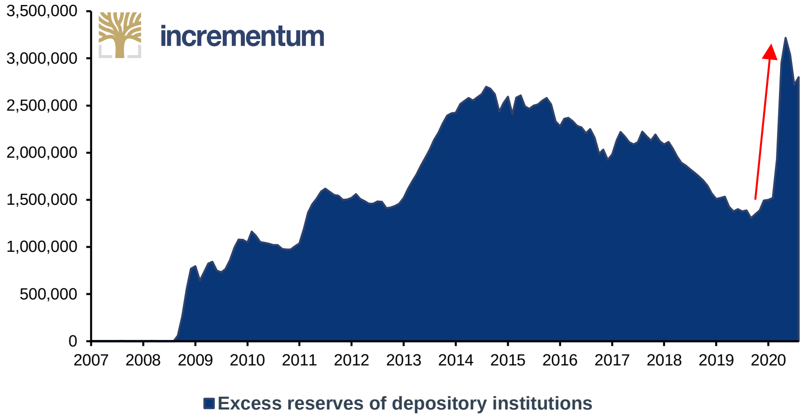
[14] *See* "Quo Vadis, Aurum?", *In Gold We Trust* report 2019
[15] *See* Federal Reserve Bank St. Louis: "Quantitative Easing Explained", *Economic Information Newsletter*, April 2011

Excess reserves of depository institutions, in USD mn, 01/2007-08/2020



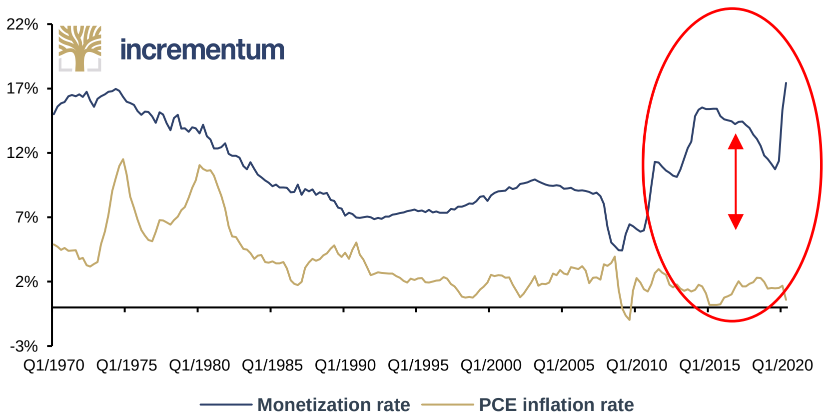
Source: Federal Reserve St. Louis, Incrementum AG

Effectively, QE's money supply injections boosted commercial banks' reserves but contributed less to overall output. Because of the unintended effects of monetary policy, the 2010s brought disinflationary forces across consumer prices. **In fact, the Federal Reserve has failed to meet its inflation target of 2% every year since it announced its targeting policies in 2012.**[16]

Blaming speculators as a response to financial crisis goes back at least to the Greeks. It's almost always the wrong response.
Larry Summers

The failure of monetary policy can be further understood through banks' preferences, the monetization rate (percentage of debt held by the public converted into legal tender), and the PCE inflation rate. Historically, the monetization rate has been correlated with the PCE inflation rate. As the monetization rate climbs, money supply increases. Assuming the interest rate spread between reserves and government debt remains significant, commercial banks will prefer holding yielding bonds over non-yielding reserves**. In the early 1970s when the U.S. 10 Year was yielding between 6-8%, the correlation made sense. Since the GFC, the yield on the 10 Year Treasury has remained most of the time next to zero and the correlation has broken down.**

Monetization rate and PCE inflation rate, Q1/1970-Q2/2020



Source: Federal Reserve St. Louis, Incrementum AG

[16] *See* Macro Musings Blog: "Is Low Inflation Really a Mystery?", April 16, 2019

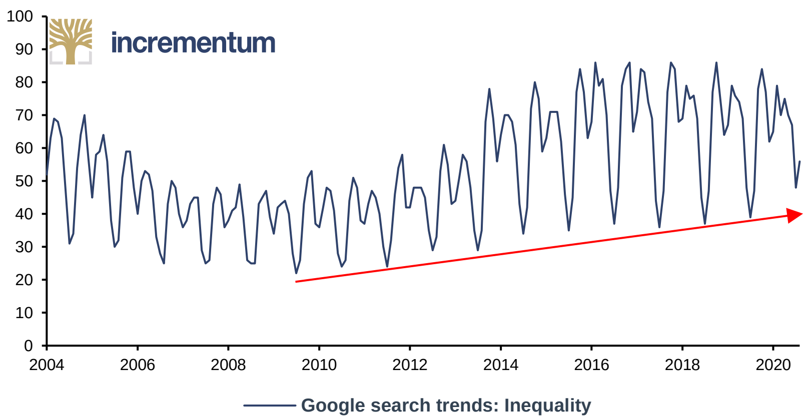
Understanding these dynamics, we must consider how QE may have contributed to disinflation across the consumer price level. This unintuitive relationship has its roots in *excess capacity*. Because QE was contained to a few sectors, it stimulated investment disproportionately, benefitting rent-seeking big businesses and banks at the expense of John Q. Public. **In turn, the capacity to create goods in some sectors surpassed their demanded quantity, increasing the relative demand for cash.**

I think the main continuity across the populist uprising is that they're all democracy movements. They're all people who correctly, actually, who correctly see that structures have been built up over the last half century that remove certain questions from the scrutiny of the voters and deliver them to regulatory bodies, bureaucracies, courts.
Christopher Caldwell

The uneven distribution of monetary policy's effects also has grave consequences for economic inequality. Inequality is primarily described by the "Cantillon Effect". 18th Century Irish-French banker and philosopher Richard Cantillon explained that money printing has distributional consequences that operate through the price system. Money, in other words, is not neutral. Those who benefit the most from an increase in the supply of money are those with access to credit and assets, or those who supplied products and services to those who did. **QE in particular harms savers and those who lack access to financial assets. Thus, inflation is a source of the wealth disparity seen in nations with comprehensive central banking systems, i.e. all modern economies.**

This dynamic leads us back to the roots of the recent paradigm shift. The inequality wrought by dysfunctional monetary policy is politically unsustainable. The public is becoming increasingly dissatisfied with the status quo. **Beyond public mistrust in institutions, a quick look at Google Trends shows that the term *inequality* itself is included in twice as many searches today as in 2010.**

Google search trends: Inequality, 01/2004-08/2020



Source: Google Trends, Incrementum AG

Growing inequality is a primary driver of populism. Trump's trade war with China symbolizes the new deglobalizing, inflationary paradigm. The return of protectionism and an increase in trade barriers, export bans, punitive tariffs, etc., will structurally reinforce price inflation. Supply chains are becoming shorter and more robust, but also more expensive. Such a relapse into protectionism will have considerable negative consequences for global prosperity.

Conclusion

You almost feel like capitalism died in this last month.
Chris Cole, April 2020

The rise of populism, anti-globalization attitudes, and the Sino-American economic cold war create a beneficial environment for a new inflationary paradigm. Now, the Covid-19 crisis has resulted in policies and dynamics which further reinforce the inflationary paradigm shift:

- **Historic expansion of the broad money supply**
- **Average inflation targeting**
- **Financial repression**
- **Heightened/accelerated indebtedness**
- **MMT and "people policies" gaining popularity**

We suspect that these developments amount to a third, well-founded cry of wolf. As deflationary forces retreat and new inflationary forces replace them, it is worth returning to the village once more to review and reconsider the possibilities of an inflationary decade.

Inflation on the Horizon? Inflation on the Horizon!

> *"History shows that the economy and financial markets are dominated by long-term regimes that at some point come to a break point, where one regime gives way to a new one. This shift may not be easy to detect. Trapped in their comfort zones, with a short-term perspective, few may see it coming."*
>
> Pascal Blanque

It follows that the coming-to-be of anything, if it is absolutely necessary, must be cyclical – i.e. must return upon itself. For coming-to-be must either be limited or not limited: and if not limited, it must be either rectilinear or cyclical.
Aristotle

Every economy is founded on a long-term paradigm. Sooner or later every paradigm inevitably falters, giving way to a new and different paradigm. Since the defeat of stagflation in the early 1980s, we have been living under decades of a 'Volckerian' paradigm of deflationary, globalizing forces. With a brief exception in the 1990s, disinflation has dominated the global regime for almost forty years. It is challenging to determine precisely when these long-term paradigms shift, but the shifts invariably occur when societies lose tolerance for political dysfunction. **We suspect that the ongoing policy and sentiment shift has sown the seeds for a new inflationary paradigm. This seed is now beginning to sprout in the wake of the Covid-19 crisis. More and more often one even gets the impression that all the dams are threatening to break.**

The Inflation Cycle

To situate our analysis in a rigorous framework, we will be borrowing from the theories of famed Austrian economist Murray Rothbard. In his *The Mystery of Banking*, Rothbard detailed a three-phase cycle of inflation that is helpful in making sense of our own dizzying times.[17]

- **In phase 1, there is a significant injection of new money into the economy: Money supply goes up.** Prices may rise a little. However, the overall sentiment of individuals is that prices will inevitably drop as the economy begins functioning normally again; in this sense, inflation expectations remain stable at a low level. Thus, demand for the currency remains steady.

- **Phase 2 of the inflation cycle can be thought of as the key transition period.** It is characterized by a shift in public sentiment: Inflation expectations pick up significantly. Phase 2 should be understood as a gradual process. As prices remain high and the money supply continues to increase, individuals begin to realize that price levels are not coming back down and will likely continue to climb.

An economy can exit from phase 2 in one of two distinct scenarios. The first way is through a period of natural deflation, allowing malinvestments and

[17] *See* Murray Rothbard: *The Mystery of Banking*, 2008 [1983]; the inflationary cycle is illustrated on pages 66-74

Courtesy of Hedgeye

overextensions of credit to adjust to more reasonable measures. While initially painful, the first scenario is good in the long run. Anything else prolongs the inevitably worse outcome. In the second scenario the expansion of money supply continues up until (or even beyond) the time at which public sentiment expects higher – in extreme cases ever higher – inflation. In theory, either scenario is possible. However, recent developments in our monetary regime point to the second scenario as the likely outcome. Onward to phase 3.

- **Phase 3 is what is known as a crack-up boom or a *highly* inflationary period.** After public sentiment is sufficiently converted from deflationary to inflationary expectations, consumers understand that the value of their currency is plummeting every second they are not spending it. With reference to the German hyperinflation of 1923, Rothbard described this phase as follows: "*A frantic rush ensues to get rid of money at all costs and to buy anything else. In Germany this was called a 'flight into real values'. The demand for money falls precipitously almost to zero, and prices skyrocket upward virtually to infinity.*"[18] At this point demand for the currency collapses along with its purchasing power.

...we have the first bank credit book in a recession in history, because the state has taken over a portion of the bank's books. That portion of the book is divorced from any considerations of credit quality and divorced from any relation to the shape of the yield curve.
Russell Napier

The inflation cycle does not provide a scientific case for when deflationary expectations will convert to inflationary expectations. **However, the gargantuan credit expansion in 2020, recent months' bond, commodity, and equity rallies and soaring real estate prices signal we have likely entered a crack-up boom. The period's highly inflationary after-effects could take a toll on living standards.** Von Mises explains the aftermath of the crack-up boom in his *Memoirs*: "*Austria's currency did not collapse, as did Germany's in 1923. The crack up boom did not occur. Nevertheless, the country had to bear the destructive consequences of continuing inflation for many years. Its banking, credit, and insurance systems had suffered wounds that could no longer heal, and no halt could be put to the consumption of capital.*"[19]

Politicians Steering Credit Creation

The most significant inflationary development of 2020 could be the recent policy shifts surrounding the money creation process.[20] Fiscal policymakers have effectively circumvented monetary policymakers in what is essentially a form of financial repression. Financial repression occurs when there are intense capital strictures in place that enable governments to direct private capital allocation. On March 27, fiscal policymakers in the US created USD 350bn in loans to small businesses and USD 500bn in loans to corporations. The loans are directly backed by the Treasury but are geared to unlock a broader set of funds from the private sector amounting to about USD 2–4trn.

The chart below illustrates the success of these inflationary policies. Total commercial and industrial lending was approximately USD 2.4trn at the beginning of March. It quickly rocketed by 25% to USD 3trn by mid-May of 2020. **The**

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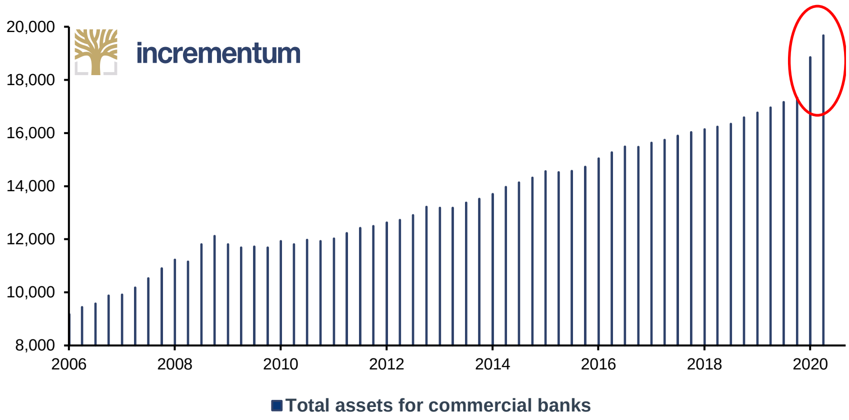
[18] Murray Rothbard: *The Mystery of Banking*, 2008 [1983], p. 72
[19] Ludwig von Mises: *Memoirs*, 2009 [1978], p. 63f.
[20] For an insightful interview with macro strategist Russell Napier centered on the problem of financial repression, *see* "Central Banks have Become Irrelevant", *The Market*, July 14, 2020

government's new control over credit creation is inflationary on one hand, but it also creates zombified businesses.[21] This additional effect will keep economic recovery sluggish and turn inflation into stagflation.

Total assets for commercial banks, in USD bn, Q1/2006-Q2/2020



Source: Federal Reserve St. Louis, Incrementum AG

New York Fed's recent publication on its Liberty Street blog of a short (and instructive!) history of yield curve control in the post war period. It is a veritable "how to" manual of financial repression, and it is very unlikely that it was posted without a broader subliminal message being published with it: "Treasury Department, we at the Fed have got your back".
Ben Funnell

Financial repression has unfolded on this side of the Atlantic as well. The UK for example, has created a Bounce Back loan initiative. Fiscal stimulus has been unleashed on the broader, supranational level as well. July 2020 saw the creation of the EU Recovery Fund. The fund amounts to over EUR 1.82trn and will be focused on rebuilding a "green" and "digitalized" post-pandemic EU. Due to the uncertainty wrought by the pandemic, financial repression could continue indefinitely, overtaking larger portions of the global economy.

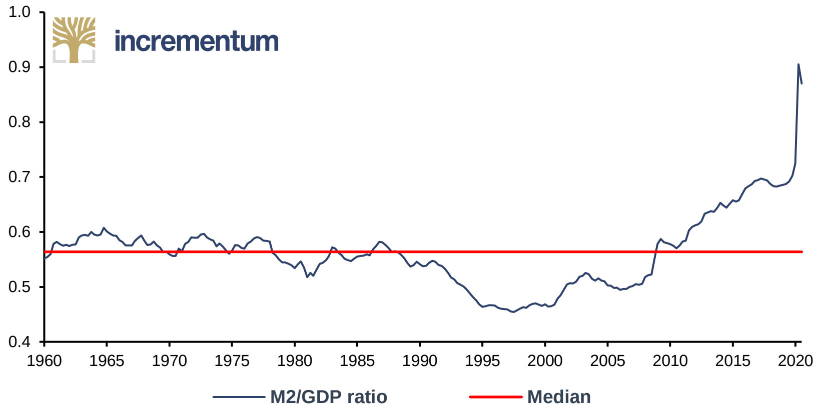
Investors should remain vigilant about this transition from financial to fiscal QE. During financial QE, borrowing remained low relative to the spiking money supply. However, under a regime of fiscal QE, the government treasury taps central banks, the debt is monetized, and the credit is extended to households directly, skipping over commercial banks in the process.

Historic Expansion of the Broad Money Supply

The measures taken to combat the 2020 downturn go well beyond those of the GFC. The first round of QE in the US ran from November of 2008 to mid-April of 2009. It did little to increase circulating currency, let alone stimulate output. The post-GFC economy can be described as a M2/GDP treadmill, similar to the debt treadmill referenced at the beginning of our report. As evidenced by the chart below, monetary easing has grown significantly less effective since the GFC.

21 A detailed representation of this phenomenon offers: Hochreiter, Gregor, Stoeferle Ronald, and Taghizadegan, Rahim: *The Zero Interest Trap*, 2019

US M2/GDP ratio, Q1/1960-Q3/2020

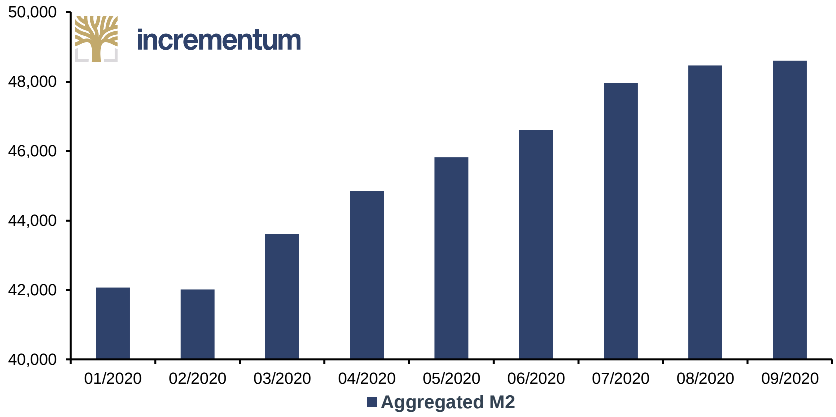


Source: Reuters Eikon, Incrementum AG

Monetary policy does not work like a scalpel but more like a sledgehammer.
Liaquat Ahamed

Because of the policy's diminishing marginal utility, QE – initially framed as "*unconventional* monetary policy" – has been *conventionalized*. The Federal Reserve announced their intentions for **USD 700bn of QE in mid-March, at the outset of the Covid-19 crisis. From the beginning of March through October, M2 expanded by 23.3%, from USD 15.5trn to USD 18.8trn**. Coupled with the recent jump in consumer prices, the explosion of the US's money supply should provoke concern about inflation. The economies of the euro area and Great Britain were subject to similar, yet not as pronounced, policies. In the euro area M2 increased by 7.4% from February to September. During the same seven-month period, the M2 money supply in the United Kingdom grew by 10.3%.

Aggregated M2 of the USA, Euro area, Japan & UK, in USD bn, 01/2020-09/2020



Source: Reuters Eikon, Incrementum AG

As shown above, the M2 aggregate across the global economy is climbing sharply. Between February and September, the M2 monetary aggregate grew by 15.7%. **Despite these historic monetary developments, central banks are still more concerned about deflation than inflation.** When QE was used during the GFC, spiking inflation rates provoked some concern. In 2012, the Federal Reserve announced it would target a 2% annual inflation rate. In the case of the Covid-19 crisis, we have seen precisely the opposite: Inflation averaging has been substituted for inflation targeting. To speak to our motif, central banks are wholly skeptical of the latest cry of wolf.

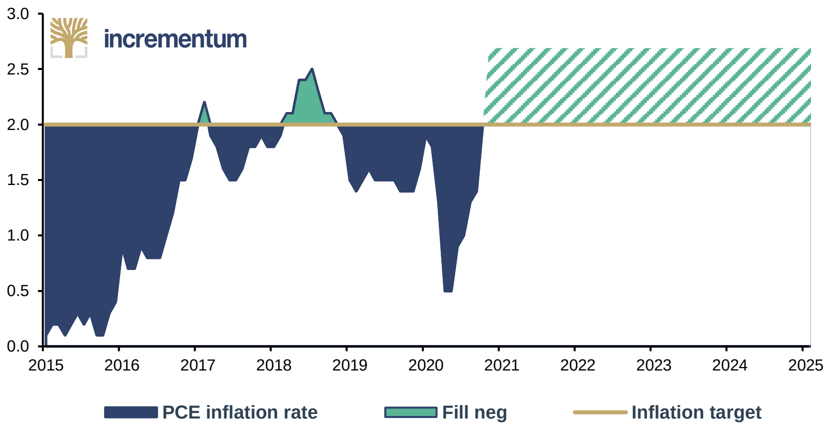
Bye-Bye 2% Target, Hello Averaging

The definition of a central banker is someone who will permit inflation in anything except wages.
Russell Napier

While fiscal policymakers are expanding their power by taking over the credit creation process, it appears monetary policymakers are relinquishing their role with little fight. On August 28th, 2020 at the (virtual) Jackson Hole conference, Federal Reserve chairman Jerome Powell formally announced that the Federal Reserve is abandoning inflation rate targeting in favor of a more relaxed average inflation targeting (AIT) policy.[22] **This has severe implications for how the Federal Reserve will respond to spiking prices in years to come.**

AIT means the Federal Reserve will aim to stabilize inflation rates so they average 2% over a set of years as oppose to them targeting a 2% inflation rate each and every year. Allow us to demonstrate what AIT entails. **Previously, under its targeting policy, if the economy had an inflation rate of 1.5% in year 1, then in year 2 the Federal Reserve would start from scratch in its attempts to reach 2%: It would still aim for a 2% inflation rate in year 2.** Under AIT, the Federal Reserve can use the difference of 0.5 percent from year 1 to exceed the inflation target in year 2 by just that amount. Even with an inflation rate of 2.5 percent in year 2, the Federal Reserve would still have met its inflation target. Where it would otherwise have had to tighten its monetary policy, it can continue its loose monetary policy under AIT.

Inflation balance of the Fed, in %, 01/2015-03/2025



Source: FvS, Reuters Eikon, Incrementum AG

AIT becomes more problematic as the timeframe of averaging expands. For example, suppose the Federal Reserve decides to average 2% inflation across the decade since the introduction of the 2% target. The target was established in 2012, so we will take the years spanning 2013 through 2022. From 2013 to 2019, the US inflation rate averaged approximately 1.5%. If the Federal Reserve aimed for a 2% average inflation rate this decade (2022) and 2020 finishes with its projected 1.1% inflation rate, **we would need to have a "reasonable" ceiling of 4.2% inflation over the next two years ending in Q2/2022. We may**

[22] To read the reasoning policymakers provide for the AIT policy update, *see* Federal Reserve: "Why does the Federal Reserve aim for inflation of 2 percent over the longer run?"

conclude that the Federal Reserve will certainly follow through with its promise of "not even thinking about thinking"[23] of a rate hike.

It is well enough that people of the nation do not understand our banking and monetary system, for if they did, I believe there would be a revolution before tomorrow morning.
Henry Ford

Because it views the economy mainly from the perspective of monetary policy, the Federal Reserve fundamentally misunderstands inflationary dynamics. In the present situation, the Federal Reserve has assumed the environment is entirely deflationary. As we have shown, there is reason to suspect that the structures of today's economy reinforce inflationary forces. We suspect that, much as with its reaction to the GFC, the Federal Reserve has fundamentally misidentified the inflationary dynamics of early 2020. **While the Federal Reserve has been preoccupied with phony cries of deflation, it has grown oblivious to the lurking wolf: spiking inflation.**

The Dangers of Modern Monetary Theory

As trust in our institutions continues to erode, the ideas and movements that retain the most adherents are radically statist. **Modern Monetary Theory (MMT) is an inflationary set of ideas that has grown unsettlingly popular. MMT has sparked tremendous interest among the United States' far left politicians and their supporters.**

But what is MMT? According to Wikipedia,

> *"MMT is a heterodox macroeconomic theory that describes currency as a public monopoly for a government and unemployment as the evidence that a currency monopolist is restricting the supply of the financial assets needed to pay taxes and satisfy savings desires.* ***MMT is seen as an evolution of chartalism and is sometimes referred to as neo-chartalism. MMT advocates argue that the government should use fiscal policy to achieve full employment, creating new money to fund government purchases.*** *The primary risk once the economy reaches full employment is inflation, which can be addressed by raising taxes and issuing bonds, to remove excess money from the system."*[24]

In reality, if we do get MMT, it will creep up on us.
Ben Funnell

The term *Modern Monetary Theory* is something of a misnomer: Printing money to finance government deficits has been used throughout the history of civilizations. Therefore, it is not "modern". This is why it is disturbing to read about its increasing popularity in the Western world. Yet, MMT was already growing popular before the Covid-19 crisis, as evidenced by Google Search trends.

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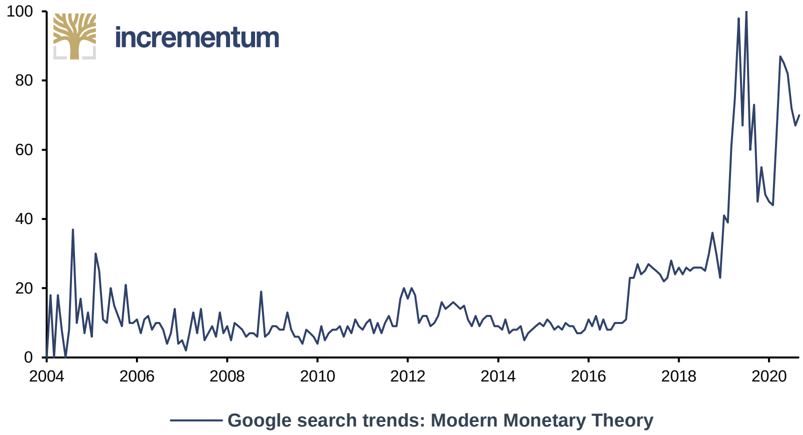
23 *See* "Powell says Fed 'not even thinking about thinking' about rate hikes", Financial Review, June 11, 2020
24 Wikipedia entry "Modern Monetary Theory"

Google search trends: Modern Monetary Theory, 01/2004-09/2020



Source: Google Trends, Incrementum AG

This discovery of the 'magic money tree' allows governments to push funds to smaller businesses and households. This, ultimately, will be seen as the route to fund all sorts of politically necessary ventures including green initiatives, because guarantees cost governments nothing beyond a contingent liability, should the assets turn bad.
Russell Napier

The political fantasies of popular politicians are one thing, but what are the cornerstones of MMT which, if fully implemented, would fundamentally change everyday economic policy? For MMT representatives, the demand for money, or more precisely for credit, determines the supply of money. In contrast, monetarists and advocates of a commodity theory of money claim that the money supply to the economy is provided either by the central bank or by the supply of the commodity used as money.

The following practical conclusions about MMT can be drawn:

- The level of government debt is irrelevant as long as it is denominated in the domestic currency.
- Because, according to MMT, the state is the creator of money, taxes do not finance the state, but the expenditure of state money enables the payment of taxes in the first place.
- Since tax policy is mainly used to control inflation, the presently important factor of revenue generation is only of secondary importance.
- **The danger of misusing this approach and generating excessive debt is obvious.** The MMT's postulate that sound finance is important for households, businesses, and local authorities but not for states that are able to print money, will be perceived by politicians as a call to run up debt, in the foreshortening typical of politics. The Pandora's box of debt-making would inevitably be opened, even if MMT representatives wanted to see government spending policies limited to avoid excessive inflation. In real policy terms, spending cuts under MMT would be much more difficult to implement than additional expenditures, financed by debt.

A legal hurdle is currently still preventing the application of MMT in the USA. The liabilities of the Federal Reserve would have to be made legal tender. **This could be achieved by the Treasury Department selling Treasuries directly to the Federal Reserve. The proceeds would be credited to the Treasury, and the Treasury Department would then issue checks against these deposits. In this case, the Federal Reserve would de facto finance the**

Treasury Department's expenditures directly. The recent developments makes this more likely than ever.

The MMT people aren't really Keynesians. They're a blend of Keynesian and Marxist.
Cullen Roche

The combination of financial repression and the election of Joe Biden has increased the likelihood of MMT-inspired policies in years to come. On the face of things, Biden appears moderate. However, to appeal to the far left Democratic voters, he promised that Bernie Sanders, a self-described *socialist* American senator, would be consulted for policymaking. As a gesture in fulfilling his promise, Biden created a Biden-Sanders Task Force. The team includes Stephanie Kelton, whose book *The Deficit Myth* was published during the Covid-19 crisis as a proposal for rebuilding the US. The book's proposed fiscal/monetary policies borrow from MMT. It is astounding how fringe theories – practically unheard of in recent years – have possibly found a home in the free world's most prominent public office.

Early Signs of Inflation

Since the breakdown of the gold standard, all increases in money supply are beyond the stock of specie. Thus, questions of inflation are not 'if' but rather 'where' and 'when'. Drawing again from the lessons of the GFC, inflationist policies ultimately led to a rise in asset price levels. This time, however, we will be witnessing the effects of such policies spilling into consumer prices.

Courtesy of Hedgeye

Already in July and August we saw a spike in consumer prices, including grocery prices. In April, US food prices increased by 2.6%, the largest month-over-month jump in 46 years, representing the highest inflation volatility of the past 30 years.

During the month of July 2020, the United States saw the greatest month-over-month spike in core CPI, i.e. aggregate price level less food and energy, since 1991. This was a predictable outcome, but the obvious signs were ignored by the majority of economists and analysts. The forecast was around 0.2%, compared to the actual 0.6% leap. **The year-over-year prediction was just as startling, coming in at 1.6%, 0.5% greater than the expected 1.1%.[25] So, why the surprise? The misestimation is likely rooted in outmoded thinking that assumes that a stagflationary scenario is utterly impossible. As we shall see, it is not.**

High unemployment is commonly assumed to keep inflation rates low. The "impossible stagflation" argument disregards reality in favor of an old construct known as the Phillips curve. **The Phillips curve posits that there is an inverse relationship between the unemployment rate and inflation. While the relationship held true for a period prior to the 1960s, it broke down after the 1970s, when the government began using it to inform policy decisions.**

Because of the construct's breakdown, predictions of future price level movement should attempt to factor in recent events. **Do most inflationists' arguments really account for developments like financial repression, historic**

[25] *See* "US Inflation Exceeds Expectations in July", Forex News, August 12, 2020

expansion of the broad monetary aggregate, and rising protectionism? We view the persistent concern about deflation as completely outmoded. The shift in policy and paradigm suggests the 2020s might become a stagflationary decade.

Conclusion

We now have the worst of both worlds - not just inflation on the one side or stagnation on the other, but both of them together. We have a sort of 'stagflation' situation.
Iain MacLeod

Given the recent explosion of money supply, the new inflationist regime of financial repression and inflation averaging, we suspect Western economies may be due for a bout of inflation in the 2020s. The developments of recent months trace a path with uncanny resemblance to those we have observed at the outset of devastating inflationary cycles. **For this reason, investors should be on the lookout for price movements and carefully consider the following investment principles for guarding one's portfolio against the possibility of rampant inflation.**

Inflation and Your Portfolio

> *"In the absence of the gold standard, there is no way to protect savings from confiscation through inflation. There is no safe store of value..."*
>
> Alan Greenspan

The expected returns and correlation dynamics change in different inflation regimes. In (hyper) inflationary regimes, in fact, both bonds and equities have not delivered well in real terms and have exhibited higher correlation.
Pascal Blanque

The wolf of our global economy is practically howling at this point, but nobody seems to take notice, yet. However, based on our research, a resurgence of inflation has become significantly more likely and will increase in probability as governments control larger amounts of the credit-creation process. The risk that inflation and financial repression pose should now be thought of in the context of portfolio management. **While much of our attention has centered on the wolf lurking at the outskirts of the village, we have said little about the precious sheep: our portfolio.** According to a recent survey, the average age of a portfolio manager is 49. The implication being that they were not managing portfolios during earlier periods of serious stagflation. The majority of investment managers could therefore be caught off guard in a paradigm shift towards inflation or stagflation.[26]

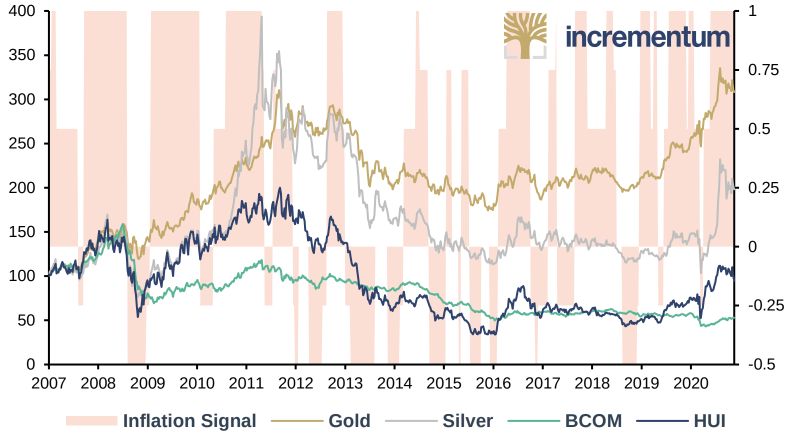
The Incrementum Inflation Signal

In the past couple of decades, the 2% inflation target behaved like a ceiling. In the next twenty-years, the 2% inflation target will become a floor.
Kevin Muir

If you want to obtain a picture of global inflation trends, we find it helpful to look at the price development of inflation-sensitive asset classes such as gold, silver, gold mining stocks, and other commodities (BCOM). These provide forward-looking statements on the inflation trend in the short and medium term, while conventional inflation statistics only ever show past inflation trends, i.e., they look in the "inflation rear-view mirror". Such statistics are largely insignificant for the investor, who always tries to anticipate future price development. **Over the last couple of years, we have therefore developed a proprietary inflation signal with which we analyze the current inflation trend. The inflation signal thus obtained is a key element of our asset-allocation process in our Inflation Diversifier strategy.**

[26] *See* "Young investment guns: Ranking the world's top portfolio managers, age 40 and under", yahoo!finance, March 7, 2017

Inflation sensitive assets (lhs), indexed 01/2007 = 100, and Incrementum Inflation Signal (rhs), 01/2007-11/2020



Source: Reuters Eikon, Incrementum AG

As can be seen in the chart above, the following periods of inflation have been observed over the past 13 years:

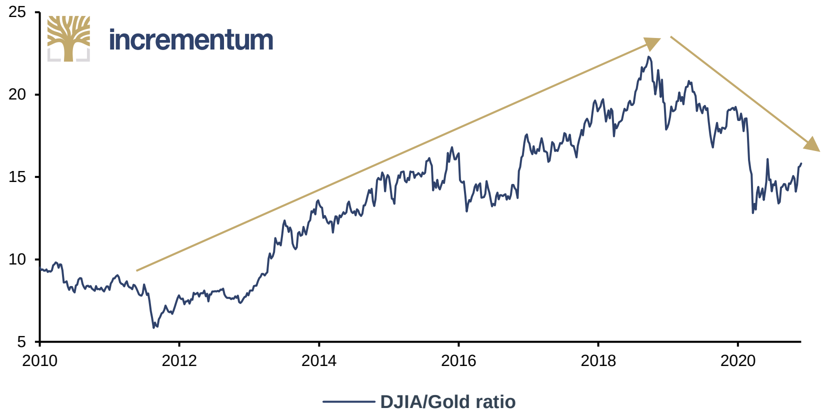
- Inflationary phase until August 2008
- Disinflationary/deflationary shock in the wake of the major financial crisis until March 2009
- Reflation until 2011/2012
- Disinflationary trend until the end of 2015
- Sideways phase since the beginning of 2016
- Short deflationary shock, Q1 2020
- Rising inflation since April 2020

Whether initially deflationary or ultimately inflationary, this profound shift ends the long period of disinflation, but it also creates the necessity for much more aggressive financial repression in the developed world.
Russell Napier

Before the Covid-19 crisis, our inflation signal, in connection with the "risk-off" movement in the fourth quarter of 2018, correctly indicated the last pronounced deflationary market movement. The stock market correction at that time proved to be a harbinger of the increasing economic slowdown, which gradually became more pronounced in 2019. **The decisive factor, however, was that this market movement was the reason for the turnaround in US interest rate policy, as the Federal Reserve had to abandon its much-invoked monetary policy normalization. The turnaround in interest rates not only led to a recovery on the stock markets, but it has also resurrected inflation-sensitive investments.**

From our point of view, Q4/2018 ultimately marked the last high in the Dow/gold ratio, which has been falling ever since. Inflation-sensitive investments such as gold, silver, gold mining stocks, and commodities had a strong 2019 and outperformed the broad equity indices for the first time in a long time. Our inflation signal indicated that strength early on and prompted us to clearly overweight inflation-sensitive investments in our Incrementum Inflation Diversifier. **Early into the Covid-19 crisis the inflation signal weakened dramatically. The renewed "risk-off" initially also affected the crisis-resistant commodity, gold.**

DJIA/Gold ratio, 01/2010-11/2020



Source: Reuters Eikon, Incrementum AG

Tough times helped many commodities producers become lean and mean through consolidation, mergers and cost-cutting. All that excess supply has been sopped up.
Jim Rogers

As we have discussed in detail, the massive deflationary tendencies were countered with extreme monetary and fiscal measures. However, it is remarkable that the broad commodity market has continued to underperform inside inflation-sensitive investments, both before and since the Covid-19 crisis. **We interpret the outperformance of gold and gold mining stocks as harbingers of significantly higher inflation in the medium term. Silver has been a relative underperformer until recently. With the onset of stronger inflationary tendencies, we would expect silver to continue outperforming and the broad commodity indices to start a major bull run.**

Now we will show exactly how a typical portfolio may suffer from the consequences of the wolf attack should one ignore the village boy's cries. The success of the 60/40 portfolio is predicated on the negative correlation between stocks and bonds. However, in the past 100 years overall, the two classes have been primarily positively correlated. It is only in the past 20 years that we have seen the negative correlation, and thus the success of the classical 60/40 portfolio.

I do not think it is an exaggeration to say history is largely a history of inflation, usually inflations engineered by governments for the gain of governments.
Friedrich August von Hayek

However, during each paradigm shift, the dynamics of returns and correlations change fundamentally in accordance with policy and mass sentiment.[27] **The various inflation rate contexts from the 2010s show that real assets performed better under higher inflation rates, compared to other assets and sectors. Commodities, energy, and materials all fared generally better as inflation rates rose.**

[27] For more information on some of the ideas we focus on in this section, *see* Blanqué, Pascal: "The Road Back To The 70s Implications for Investors", Amundi Asset Management, June 11, 2019

Correlation Coefficient Between the YoY Change in the 10-Year Breakeven Inflation Rate and YoY Change of Various Sectors/Asset Classes Over the Last 10 Years

Sector/Asset Class	Correlation
Commodities	0.70
Energy	0.67
Materials	0.54
Industrials	0.48
S&P 500	0.48
Financials	0.45
Consumer Discretionary	0.40
Technology	0.27
Communication Services	0.22
Real Estate	0.13
Health Care	0.08
Consumer Staples	-0.04
Utilities	-0.11
U.S. Dollar	-0.44
Long-Dated Treasuries (Return Basis)	-0.50

Source: Bloomberg, Rosenberg Research

If you impose inflation on stagnation, you get stagflation.
Alan Greenspan

Besides the risk of inflation, we should also prepare for a stagflationary scenario. There is reason to suspect we could be in for multiple years of stagnating output. The most infamous period of stagflation was the 1970s. However, applying the definition of stagflation, *"high inflation rates* coupled with *low/negative output",* to history yields four periods of general stagflation.

Historical Asset Class Performance During Stagflationary Periods

Start	End	S&P 500	US Dollar	Agri-culture	Gold	Silver	WTI Oil	US T10Y (bps)
Q4/1969	Q1/1971	13.2%		8.9%	10.5%	-10.1%	6.3%	-198
Q4/1973	Q3/1975	-5.7%	11.6%	10.0%	37.2%	64.7%	158.9%	158
Q2/1979	Q2/1981	32.7%	22.6%	22.8%	77.4%	4.3%	139.7%	472
Q1/1982	Q1/1983	42.9%	6.8%	1.6%	29.7%	48.7%	7.5%	-356
Avg. nominal return		**20.8%**	**13.7%**	**10.8%**	**38.7%**	**26.9%**	**78.1%**	**19**
Avg. real return		**7.0%**	**-0.1%**	**-3.0%**	**24.9%**	**13.1%**	**64.3%**	

Source: Bloomberg, Rosenberg Research

One may say that, apart from wars and revolutions, there is nothing in our modern civilizations which compares in importance to inflation.
Elias Canetti

History teaches that the best assets during stagflation are precious metals. Moreover, gold has outperformed silver both in terms of volatility and real return. It is generally assumed that commodities should perform well during periods of stagflation. However, commodities had a mixed performance overall. Oil jumps out as a worthy alternative, but we must recall that half of these periods were influenced by oil embargoes. **We can further compare new winning assets with those which won under the old regime by applying our "real assets" principle.**

	New Winners	Old Winners
Types of Funds	Alternative Risk Premia	Traditional Risk Premia
	L/S Vehicles	L/O Vehicles
	Alternative Multi-Asset Funds	Traditional Multi-Asset Funds
	… with a special emphasis on inflation	… 60/40, risk parity, or other proportions
Assets	**Real Assets, such as:**	**Nominal or Paper Assets, such as:**
	… Inflation-Linked Bonds	… Nominal Bonds
	… Commodities (e.g. Gold)	
	… Asset-Backed Securities (RMBs, CLOs)	
	… in FX, long commodity producer vs. importer (e.g. AUD/JPY)	
Equities	Value	Quality / Growth / Low Beta / MinVol
	Pricing Power vs. Margin Pressure	Financial engineering through leverage and buybacks
	High Fixed-Rate Debt	Multinationals with global supply chains and optimal tax structures

Source: Man Institute, Incrementum AG

For investors today, with long term bond yields at historic lows, it is a reminder that real assets, including stocks, real estate and precious metals can serve an important, although long redundant role, in protecting a portfolio against the risk of inflation.
David Kelly, JPMorgan Funds

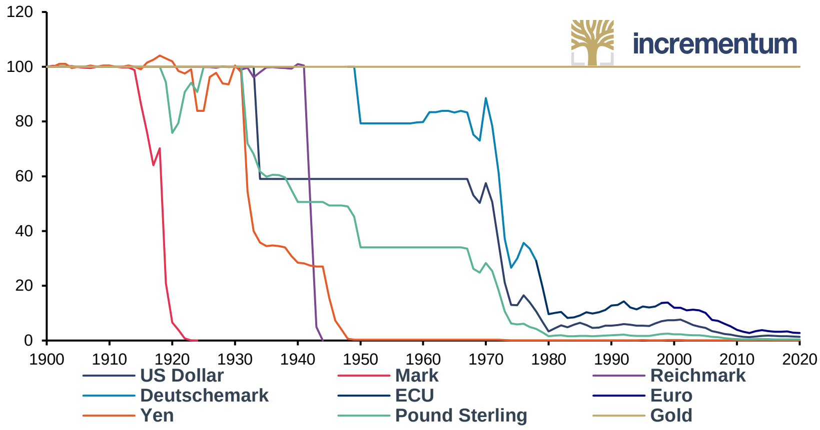
The winners of the old paradigm were exposed to the forces of globalization and financial engineering. The gains were primarily nominal. The winners of the new paradigm will be real assets that capture value from more-expensive supply chains, rising commodity and precious metal prices, and cost flexibility. This is the "real asset" principle of the new global paradigm.

Inflation and Cash

History suggests cash is the second worst-performing asset during periods of high inflation. Cash's lackluster performance may be intuitive, but it is worth tracing the arc of currency depreciation to gain a sense of how destructive inflation really is. **Measured against an ounce of gold, the US dollar has lost approximately 98% of its original value since the establishment of the Federal Reserve in 1913.**[28]

[28] *See* "Visualizing the Purchasing Power of the Dollar Over the Last Century", howmuch.net, September 5, 2019

Exchange rates against gold, 1900 = 100, 1900-2020



Source: World Gold Council, Incrementum AG

Currencies don't float, they just sink at different rates.
Clyde Harrison

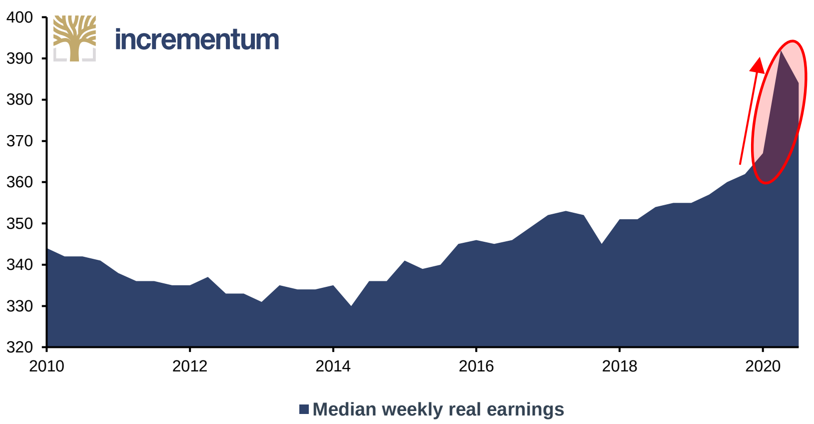
Looking through history, one finds that currencies have consistently been debased, oftentimes to finance exorbitant amounts of public debt.[29] **Gold is better thought of as the ultimate currency rather than as commodity.**

However, other than gold, currencies are a problematic store of value in a modern, inflationary economy, even when they are not collapsing completely. As mentioned above, sudden injections of new money often inspire an illusory sense of wealth in individuals. It is likely that the early phases of this process have already unfolded: The Covid-19 crisis briefly drove down the consumer price level, and the US's median wages have risen. In 2019 median weekly earnings were around USD 360.

When all the experts and forecasts agree – something else is going to happen.
Bob Farrell, Rule #9

By Q2/2020 this number had jumped to USD 392. This strange dynamic is a consequence of the lower-income workers who were laid off coupled with the benefits of the CARES Act. These factors will turn out to be illusions in the long run, and they will harm market responsiveness and economic performance.

Median weekly real earnings, Q1/2010-Q3/2020

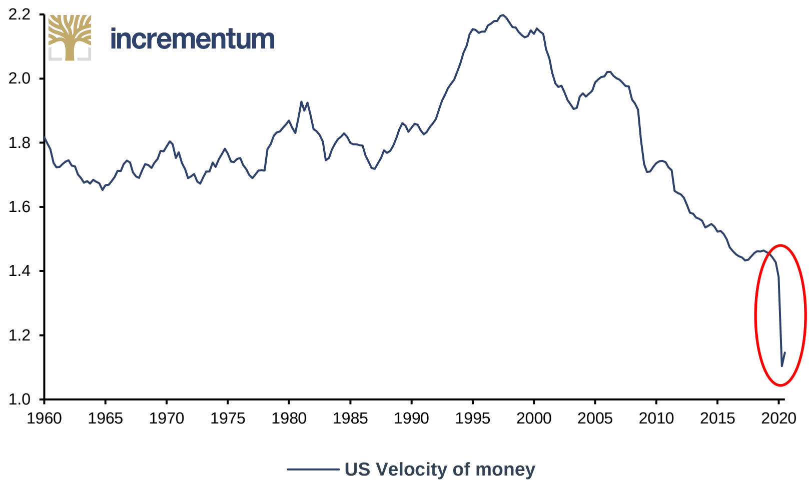


Source: Federal Reserve St. Louis, Incrementum AG

[29] *See* Taghizadegan, Rahim, Stoeferle, Ronald, and Valek, Mark: *Austrian School for Investors: Austrian Investing Between Inflation and Deflation*, p. 97-100

We must also consider the recent decline of monetary velocity. Since the GFC, US M2 velocity has fallen swiftly. However, the decline has proceeded more rapidly since the lockdown policies of 2020. During Q3/2020 M2 velocity was just 1.15, though it had averaged between 1.45 and 1.53 since 2015.

US velocity of money, Q1/1960-Q3/2020



Source: Reuters Eikon, Incrementum AG

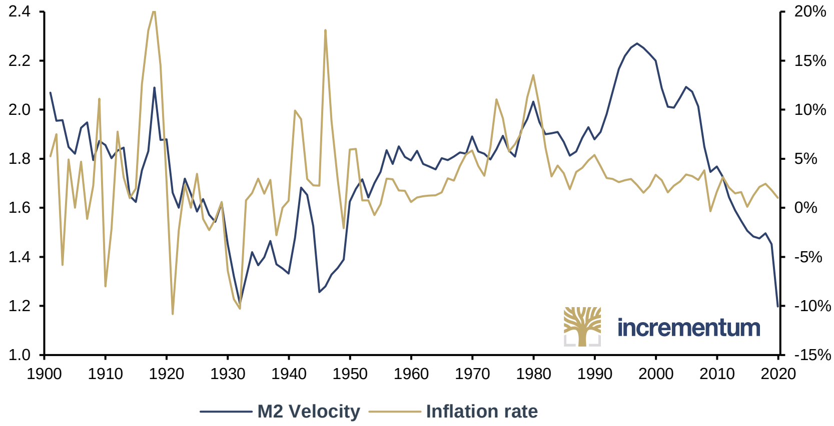
The abstraction of monetary velocity has been best explained by the Austrian School of Economics. In his foundational treatise *Human Action*, Ludwig von Mises characterizes monetary velocity as a rigid formalization of human behavior abstracted from human intention.[30] "Velocity" has no causative, mechanical influence over purchasing power. The connection between purchasing power and consumer spending – like anything else in economics – is *purposeful* human behavior.

All rational action is in the first place individual action. Only the individual thinks. Only the individual reasons. Only the individual acts.
Ludwig von Mises

In an economy with an increasing money supply, individuals will prefer real goods to the increasingly abundant and, therefore, relatively less valuable currency. To frame velocity as a mechanical construct which drives up prices is to apply backwards reasoning. **A proper understanding of "velocity re-normalization" recognizes that as soon as economies will permanently emerge from lockdown, individuals will resume their spending habits with a larger supply of cash.**

30 *See* Mises, Ludwig von: *Human Action*, 1949, p. 396-398

M2 velocity (lhs), and inflation rate (rhs), 1900-2020



Source: Lyn Alden, Nick Laird, goldchartsrus.com, Reuters Eikon, Incrementum AG

The age of disinflation that has lasted forty years is over. All the financial market relationships that we have all relied upon for our entire careers are not just invalid but dangerous.
Russell Napier

Lockdown policies have driven down monetary velocity: On the one hand, consumers lack opportunities to spend money and businesses to make investments. On the other hand, increased uncertainty about the future leads to a significant increase of precautionary savings. However, the global sense of certainty may soon be restored. On November 9th, Pfizer announced a breakthrough in its development of the Covid-19 vaccine. **A vaccine implies a restoration of certainty and the return to pre-pandemic behaviors.** However, the spending habits of old will be coupled with a massive increase in liquidity. Together these pose a risky dynamic which could drive up price levels.

The picture could change very rapidly if demand picks up faster than expected, particularly because the supply side is heavily disrupted. Central Banks should become more hawkish as certainty is restored and remove liquidity from the system. However, in our opinion, this would be an extraordinarily unlikely change of heart.

What will be different compared to the economic environment before the crisis when consumer spending picks up again? First of all, M2 will have increased by more than USD 3 billion, while loan guarantees will be at least almost USD 900 billion higher. Thus, the psychological dynamics of the inflation cycle will reinforce itself: Individuals will experience greater prosperity, but production will remain low. As a result, individuals will spend relatively more, and prices will rise. The demand for cash will continue to fall as consumers recognize the relative loss in value. This will probably be the decisive milestone on the way to phase 3 of the inflation cycle.

As economies emerge from lockdowns, there will be ample opportunities for investment, for example in currency pairs: long commodity producers, short commodity importers, could be advantageous in a portfolio. One example is the AUD/JPY. Because of Australia's significance as a commodity and gold producer, the Australian dollar could be more robust in the inflationary paradigm, at least compared to other currencies. Conversely, Japan has relatively few natural resources, so it imports large amounts of industrial commodities. However, aside from minor opportunities like these, FIAT-currencies overall will be impacted negatively by an inflationary paradigm. We must turn elsewhere to determine which assets' performance will dominate in the coming months and years.

Inflation and Stocks

2020 has added yet another chapter (perhaps even two or three!) to the history of stock market manias. The S&P 500 closed with a record high of 3,386 on February 19th. The following day it entered freefall. On March 23rd it closed at 2,237, its lowest value in over three years. Of course, this occurred in the context of both deflationary and inflationary forces: the inflation rate fell by 2 percentage points from February to April, while the aggregate money supply expanded rapidly.

It is commonly understood that moderate inflation increases the performance of stocks. The question we should be asking ourselves is, **how high can inflation rates go before they negatively impact stocks?**

During the era of stagflation, profits from stocks were split 30/70 between price gains and dividends. Warren Buffett wrote about this dynamic in a 1977 report. He noted that as inflation rates rose, dividends remained stagnant or even declined in tandem with economic output. In this sense, stocks function as a kind of "equity bond", with their "yield" burned away by rising price levels.[31] **A rate beyond the 3–4% threshold coupled with stagnating output is a recipe for worsening "equity bond" dynamics.**

The fact that an opinion has been widely held is no evidence whatsoever that it is not utterly absurd.
Bertrand Russell

To extrapolate further into the future, what should we expect from stocks if stagflation persists throughout the decade? Most investors do not remember the era before the Federal Reserve "defeated" inflation. Over the course of his career as the Federal Reserve Chairman, Paul Volcker started two recessions trying to tame the beastly wolf of inflation. Since his time at the helm of US monetary policy, inflation has been less problematic. This temporary defeat was also likely the paradigm shift that ushered in the deflationary period we are now rapidly exiting.

Perhaps the most famous moment in the history of deflationary policy occurred on October 6, 1979, when Volcker unleashed his Saturday Night Special,[32] imposing a cap on the US money supply. This sent interest rates soaring and led to a great public outcry. Because of the high rates' impact on automobile loans, Volcker received coffins filled with keys of unsold cars. **It is also important to note that Volcker was on a mission to kill inflation. Contrast his mission with the inflationary mission of central bankers today, "whatever it takes".**

Alongside the recent spike in inflation, the Eurozone and United States have seen their GDPs contract 9.5% and 12.1%, respectively, while their unemployment rates have reached at 14.7% and 7.6%. Current forecasts show that economic output will not ascend to pre-Covid-19 levels prior to the end of 2022.[33] This means that an inflationary scenario likely entails

[31] *See* Buffett, Warren: "How Inflation Swindles the Equity Investor", Fortune, May 1977
[32] For an example of a virtuous, Hayekian public servant, *see* Medley, Bill: "Volcker's Announcement of Anti-Inflation Measures", Federal Reserve History, November 22, 2013
[33] For an article from Reuters detailing a poll of economists about their output recovery timeline expectations, *see* "U.S. economic outlook darkens, job recovery risks reversing: Reuters poll", Reuters, July 24, 2020

stagflation. Most equities are not a sound portfolio bedrock during periods of stagflation. However, the equities that do prevail will likely adhere to our "real asset" principle. Winning stocks would belong to companies able to adjust to inflation. This would manifest primarily through the "pricing power vs. margin pressure" dynamic. **The dynamic is expressed in the following ideas:**[34]

- Average profit margins (high is good)
- Labor share of costs (low is good)
- Herfindahl index (a measure of market concentration)
- Commodity producers (pricing power) vs. commodity buyers (margin pressure)
- Nominal debt levels are inflated away by higher inflation; therefore businesses with high fixed-rate debt/equity ratios could stand to benefit
- Sectors: Cyclicals will lose to Defensives.

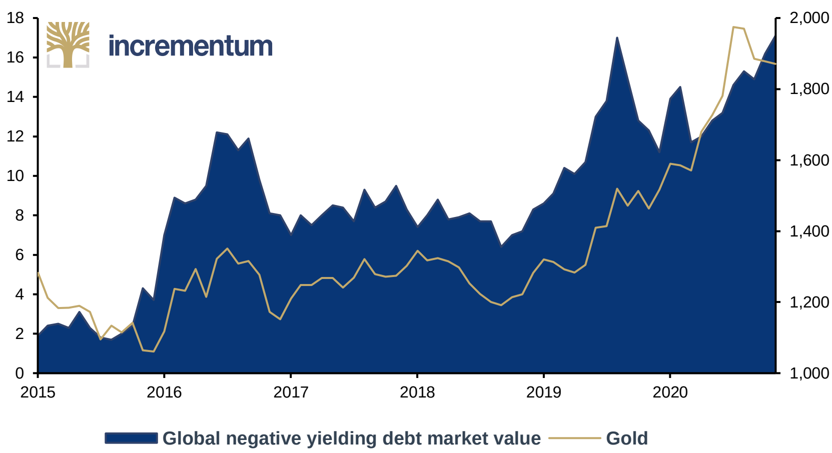
Equities with these attributes should be able to protect against the hazards of the recently heightened risk of inflation while also driving decent returns throughout periods of stagflation.

Inflation and Bonds

Courtesy of Hedgeye

Next, we turn our attention to bonds. Textbook portfolio theory recommends holding a combination of stocks and bonds in a 60/40 ratio. However, our current far-from-textbook times call for equally far-from-textbook measures. As we have shown, traditional theory fails for stocks under the stagflationary paradigm. It is likely that the fundamental problem of traditional, "nominal" assets is even worse for bonds. Because gold and bonds – specifically the US ten-year – are seen as safe havens, the arrival of the Covid-19 crisis earlier this year saw gold and Treasuries reach new heights.

Global negative yielding debt, in USD tn, 01/2015-11/2020



Source: Bloomberg, Reuters Eikon, Incrementum AG

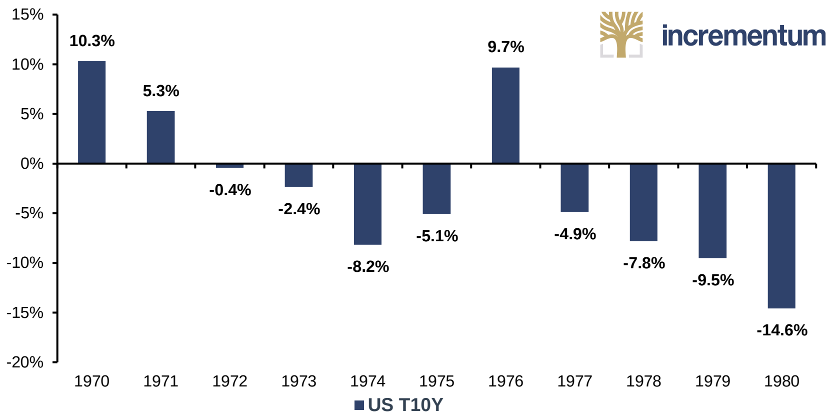
However, aside from TIPS, bonds are simply not the safe haven they once were. They may be "safe" for the issuer, but the buyer could be taking a surefire loss.

34 For more on the attributes of winning equities, *see* Man Institute: Inflation Regime Roadmap, June 2020

Successful financial repression requires a widespread belief that conventional government bonds are safe.
Peter Warburton

The next chart shows that the US 10-year Treasury bond performed poorly during the decade of stagflation. After inflation set in in 1972, 10-year Treasuries had only one year of positive returns over the course of an entire decade. This should serve as further evidence that if the upcoming decade is a stagflationary one, investors would be wise to reconsider traditional portfolio theories regarding bonds that trade at or close to their all- time highs.

US T10Y real annual returns, 1970-1980



Source: Stern School of Business, Incrementum AG

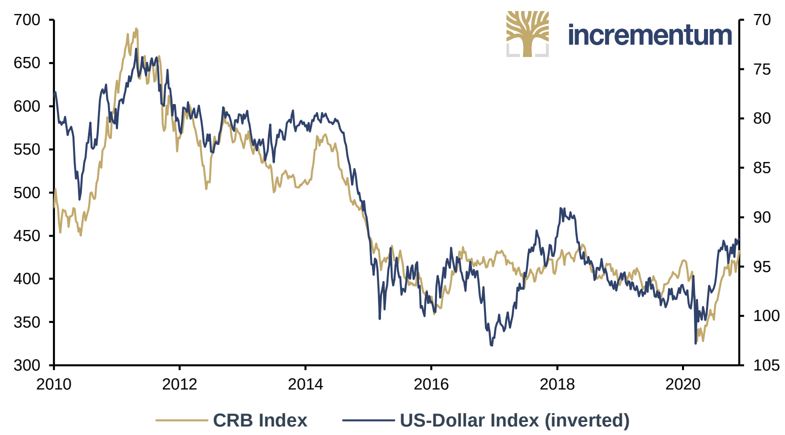
Inflation and Commodities

Commodities tend to zig when the equity markets zag.
Jim Rogers

One dynamic investors can still trust is that between commodities and the US dollar. The US dollar is generally negatively correlated to commodities: A weakening US dollar means an increased value in a broad index of commodities. To put it crudely, the well-being of commodities is intricately linked to the US dollar.

From January to March 18th the CRB lost approximately 35.5% of its value, and fell further in April, to almost -45%. Then from the beginning of June to the end of July, the DXY fell by 6.14%. Only by the end of September did it begin to stabilize. Since then, it has fluctuated between 91 and 94.5.

CRB Index (lhs), and US-Dollar Index (rhs, inverted), 01/2010-11/2020



Source: Reuters Eikon, Incrementum AG

As the US dollar has fallen, commodity prices have risen, something we called in our *In Gold We Trust* report 2020. **However, comparing the CRB's present value to its ten-year high reveals that commodities are still in something of an anti-bubble.**

In our view, commodities will follow gold in its trajectory through the inflationary cycle. With that, we turn to what we believe to be the safest, most enduring asset in a modern, inflationary economy.

Inflation and Gold

To be ignorant of what occurred before you were born is to remain always a child.
Cicero

Gold may have the world's most unique portfolio characteristics, and it will likely serve as the central and primary store of value in our new inflationary regime. As we have done in several previous *In Gold We Trust* reports, we want to analyze the advantages of gold in the context of portfolio diversification.[35] Due to its unique characteristics, we are firmly convinced that gold – especially in the current environment – is an important asset for any investor's portfolio.

Let us once more summarize gold's major advantages:

- Increased portfolio diversification: Gold's correlation with other assets is on average 0.1.
- Effective hedge against tail-risk events
- Highly liquid asset: Gold's liquidity is significantly higher than that of German Bunds, UK Gilts, US Treasuries, and the most liquid stocks.
- Portfolio hedge in times of rising price inflation rates as well as during strongly deflationary periods (but not in times of disinflation!)
- Currency hedge: Gold correlates negatively with fiat currencies, especially with the US dollar.

Gold's function as a hedge against inflation and tail events may turn out to be the best component of one's portfolio in the coming years. 2020 has been dominated by three tail events: the pandemic, the ensuing economic crisis, and widespread social and political turmoil.

Because silver and gold have their value from the matter itself, they have first this privilege, that the value of them cannot be altered by the power of one, nor of a few commonwealths, as being a common measure of the commodities of all places. But base money may easily be enhanced or abased.
Thomas Hobbes

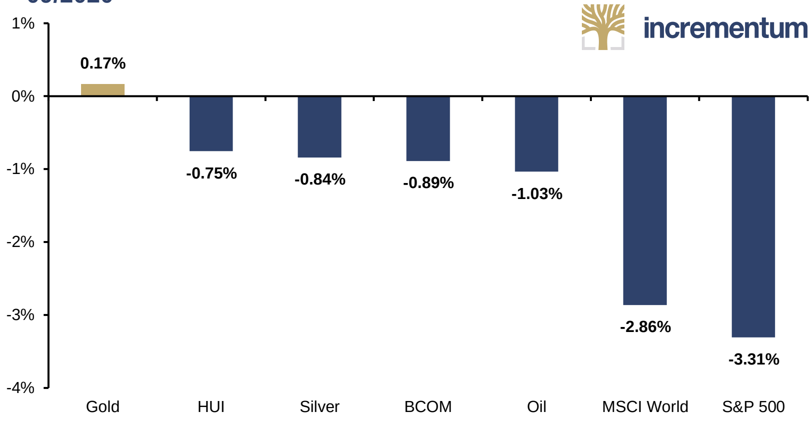
Gold's robustness against uncertainty is also attributable to the sheer number of historical events it has survived and institutions it has outlasted. **Gold is an extraordinary example of the "Lindy Effect".** The Lindy Effect postulates that an idea's future life expectancy grows positively with its age. That is, the longer an idea has been around, the more likely it is to live even longer. Gold has been around as a currency for thousands of years and is one of the oldest cultural institutions. Because it has been reliable for thousands of years, no modern asset class performs so well during times of uncertainty because they simply have a lower life expectancy. [36]

[35] On gold's significant portfolio characteristics, *see* "Gold in the context of portfolio diversification", *In Gold We Trust* classic

[36] To better understand how gold emerged as the first currency, *see* "Regression theorem explains why gold equals money", *In Gold We Trust* classic

Now we compare the performance of different asset classes during the weakest 20% weeks in the S&P 500 for the period 01/2000 to 09/2020. Only gold exhibited a positive performance during this period.

Asset performance during 20% weakest S&P 500 weeks, 01/2000-09/2020



Source: Reuters Eikon, Incrementum AG

Gold should be the bedrock of all portfolios.
Brent Johnson

Gold is also a reliable hedge against inflation. It has performed exceptionally well during periods of inflation and stagflation. The chart below details a sampling of performance across real estate, stocks, bonds, and gold. By far, gold is the greatest performer. During the decade of stagflation, bond and equity investors saw overall negative returns, and those who counted on the stability of housing saw next to nothing. In contrast, gold delivered strong returns.

Asset Class Returns During the Decade of Stagflation

1972-1981	Annualized nom. return %	Annualized real return %
House price	9.4	0.1
S&P 500 Index	5.2	-4.0
US Treasury Index	5.5	-3.7
Gold price	22.5	13.3

Source: Bloomberg, Incrementum AG

While gold's value is driven partially by its historical and currency primacy, gold's inflation immunity is also a significant source of its value. It is essentially immune to inflation because of its relative scarcity. Gold's supply is increasing at a slow and steady pace. Compare it to paper currencies: Central banks can print currency at will. There is no difference between the (digital) costs of printing a 100-euro note or a 10-euro note. There is, however, a substantial difference between producing 100 ounces and 10 ounces of gold – the former takes 10 times the effort. **This relative scarcity is the main advantage of gold compared to fiat currencies. Gold is essentially immune to inflation because of its relative scarcity. Therefore, it makes sense to include it as an inflation hedge as the global economy trudges further into an unprecedented monetary morass.**

Gold is bitcoin without electricity.
Charlie Morris

It is also worth mentioning the "digital gold": Bitcoin.[37] Bitcoin is commonly known as digital gold because of its many similar attributes to the yellow metal. Most important of all is its relative scarcity. Many Bitcoin proponents suggest that it may rival gold's market capitalization. We are not quite there yet: In November of 2020, Bitcoin has reached a market cap of approximately USD 330bn compared to gold's USD 11.5trn. However, Bitcoin proponents are not entirely off base. Perhaps the best valuation model of Bitcoin is based on its relative scarcity measured by stock-to-flow ratio (SFR). Since Bitcoin's halving in May of 2020, it has had a SFR of 58. However, when Bitcoin is halved again in 2024, its SFR will be 121 – almost two times greater than gold's SFR of 62.[38]

Conclusion

New investment strategies will be needed in inflationary times. The general rule of thumb should be "real assets instead of paper assets". The following asset classes should do well in an increasingly inflationary environment:

- Precious Metals, esp. Gold and Silver
- Mining Equities
- Crypto Currencies, esp. BTC
- Industrial Commodities (GSCI, BCOM)
- Real Estate
- Currency pairs of commodity producers vs. commodity importers
- Within equities: Value instead of Growth

37 You can learn more about Incrementum's investment solutions for digital and physical gold and sign-up for our quarterly research-letter here: http://noninflatable.com/en/
38 See "Gold vs. Bitcoin vs. Stablecoins", *In Gold We Trust* report 2019

Conclusion

> *"For in every country of the world, I believe, the avarice and injustice of princes and sovereign states abusing the confidence of their subjects, have by degrees diminished the real quality of the metal, which had been originally contained in their coins."*
>
> Adam Smith

Fighting depression through forced credit expansion is like trying to heal an evil by its own causes.
Friedrich von Hayek

In the *In Gold We Trust* report 2019 we noted the attitude of institutional mistrust that had swept across the world.[39] Since then, global sentiment has moved further towards instability. After all, 2020 will be marked by a pandemic, a stock market crash and the worst recession since the Great Depression.[40] In particular, the measures taken to contain the pandemic are leading to social unrest in some countries. In addition to these developments, monetary policy has been extended beyond its historical boundaries into new and unknown territory.

We believe the following developments are key determinants underlying the potentially stagflationary decade unfolding ahead of us:

- **From Monetary QE to Fiscal QE:** Fiscal policymakers have effectively circumvented monetary policymakers in the money and credit creation process. **Across the US and Eurozone, there has been upward of USD 875bn and EUR 1.1trn of loans granted to firms, respectively.**

- **Average inflation targeting:** While fiscal policymakers are expanding their powers, monetary policymakers are relinquishing their duties. The Federal Reserve has substituted *inflation targeting* with *average inflation targeting*. Rather than aiming for an inflation rate of 2% each year, the Federal Reserve has opted to shoot for 2% inflation averaged across several years. While a 2% inflation rate was the ceiling of last decade, it could very well be the floor of the 2020s. The ECB is still in the middle of the review process of its monetary policy strategy. However, some economists have already expressed the view that the inflation target should also be interpreted symmetrically.

- **Expansion of the broad monetary aggregate:** All Western economies have experience unprecedented M2 growth, especially the US. From the beginning of Feburary to the end of October, the US M2 aggregate grew from USD 15.4bn to USD 18.8bn; a staggering 22% increase. In aggregate, the US, the Euro area, UK, and Japan had a 15.7% increase in M2 from February to September 2020. These developments should call attention to the possibility of inflation.

- **Inflation-sensitive assets already signal rising inflationary expectations:** Inflation-sensitive assets are surging. Since March 20th, gold

[39] See "Quo Vadis, Aurum?", *In Gold We Trust* report 2019
[40] …and probably the tragic death of Diego Armando Maradona…

rose from USD 1,440 to the new all-time high of USD 2,065 and has just sunk to USD 1,800–1,900. Silver skyrocketed from under USD 12 to in the meantime over USD 28 during the same time period. Since then it has fallen to below USD 25. Inflation-linked bonds have dropped 141 basis points, mining stocks have seen a strong surge, and the Gold Bugs Index has almost doubled since its lows in March. These developments all suggest that market participants' expectations may have turned inflationary.

- **Heightened/accelerated indebtedness due to "Fiscal Populism":** Global debt has surged as countries scramble to support economies destroyed by their own lockdown policies. The USA saw its national debt increase to USD 26trn, the Eurozone to EUR 10trn, the UK to GBP 2trn, and Japan to USD 11.7trn. Structural indebtedness only makes inflation a more appealing option to policymakers. With many of the safeguards removed, inflationist politicians are poised and incentivized to set up increasingly risky economic experiments.

- **MMT gains in popularity:** Because of the phantasmagoric rhetoric of many politicians on the far left, MMT was already growing in popularity in 2019. However, the economic destruction caused by the Covid-19 crisis has drawn public discourse further toward MMT. If MMT is implemented, the central bank's balance sheet will grow exponentially. We quote Stephanie Kelton's dictum "*to the extent the United States has an unemployment problem, there's too little money in the world; to the extent it has an inflation problem; there's too much money in the world.*" Either way, there is going to be a lot more money in the world from our point of view.[41]

The lesson is clear. Inflation devalues us all.
Margaret Thatcher

We are concerned witnesses of one of the biggest money experiments in human history. It seems that we have reached the tattered end of the monetary banner and must now resort to further unconventional, not to say brutal, measures to push through rising price inflation. Overall, this trend is driven by the ongoing paradigm shift across our global economy. As deflationary forces cede ground, new inflationary forces and populist sentiment will expand, tremendously influencing the rebuilding of the post-Covid-19-world.

A humble look at our monetary past teaches us that neither mainstream economists nor central bankers can control the specifics of inflation dynamics. The pitifully failed attempts to regulate the level of inflation as one does a thermostat bear witness to our hubris and ignorance over the course of monetary history. Waves of inflation occur unexpectedly and can wreak their vengeance quickly. **To ignore the warning signs and continue with the strategies of the past is to ignore the third, crucial cry of wolf.**

Is your portfolio prepared for inflation?

[41] *See* Man Institute: Inflation Regime Roadmap, June 2020

About Us

Ronald-Peter Stöferle, CMT

Ronni is managing partner of Incrementum AG and responsible for research and portfolio management.

He studied business administration and finance in the USA and at the Vienna University of Economics and Business Administration, and also gained work experience at the trading desk of a bank during his studies. Upon graduation he joined the research department of *Erste Group*, where in 2007 he published his first *In Gold We Trust* report. Over the years, the *In Gold We Trust* report has become one of the global benchmark publications on gold, money, and inflation.

Since 2013 Ronni has held the position as reader at *scholarium* in Vienna, and he also speaks at *Wiener Börse Akademie* (the Vienna Stock Exchange Academy). In 2014, he co-authored the international bestseller *Austrian School for Investors*, and in 2019 *The Zero Interest Trap*. Moreover, he is an advisor for *Tudor Gold Corp*. (TUD), a significant explorer in British Columbia's Golden Triangle, and a member of the advisory board of *Affinity Metals* (AFF). Moreover, he is an advisor to Matterhorn Asset Management, a global leader in wealth preservation in the form of physical gold stored outside the banking system.

Mark J. Valek, CAIA

Mark is a partner of Incrementum AG and responsible for portfolio management and research.

While working full-time, Mark studied business administration at the Vienna University of Economics and Business Administration and has continuously worked in financial markets and asset management since 1999. Prior to the establishment of Incrementum AG, he was with *Raiffeisen Capital Management* for ten years, most recently as fund manager in the area of inflation protection and alternative investments. He gained entrepreneurial experience as co-founder of *philoro Edelmetalle GmbH*.

Since 2013 he has held the position as reader at *scholarium* in Vienna, and he also speaks at *Wiener Börse Akademie* (the Vienna Stock Exchange Academy). In 2014, he co-authored the book *Austrian School for Investors*.

Incrementum AG

Incrementum AG is an independent investment and asset management company based in Liechtenstein. Independence and self-reliance are the cornerstones of our philosophy, which is why the four managing partners own 100% of the company. Prior to setting up Incrementum, we all worked in the investment and finance industry for years in places like Frankfurt, Madrid, Toronto, Geneva, Zurich, and Vienna.

We are very concerned about the economic developments in recent years, especially with respect to the global rise in debt and extreme monetary measures taken by central banks. We are reluctant to believe that the basis of today's economy, i.e. the uncovered credit money system, is sustainable. This means that particularly when it comes to investments, acting parties should look beyond the horizon of the current monetary system.

Our clients appreciate the unbiased illustration and communication of our publications. **Our goal is to offer solid and innovative investment solutions that do justice to the opportunities and risks of today's prevalent complex and fragile environment.**

For his outstanding contribution to this *In Gold We Trust* special we are especially grateful to Kalon Boston.

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