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Buying Happiness with Goods?

> "Happiness is not achieved by the conscious pursuit of happiness; it is generally the by-product of other activities."

Aldous Huxley

> "Are you bored with life? Then throw yourself into some work you believe in with all your heart. Live for it, die for it, and you'll find a happiness that you had thought could never be yours."

Dale Carnegie

> "Indeed, man wishes to be happy even when he so lives as to make happiness impossible."

St. Augustine

> "To be without some of the things you want is an indispensable part of happiness."

Bertrand Russell

> "Many persons have a wrong idea of what constitutes true happiness. It is not attained through self-gratification but through fidelity to a worthy purpose."

Helen Keller

INTRODUCTION

I recently attended an event where one of the speakers suggested that investors should buy "happiness stocks", examples of which include luxury goods companies such as LVMH (Moët Hennessy Louis Vuitton), L'Oréal, Prada, and Tiffany (he also extolled high-end pleasure boat manufacturers), as well as Nestlé (because it manufactures and distributes chocolates). According to this consumer goods expert, people all around the world are trying to buy happiness, and these companies are suppliers of "happiness goods". Personally, I find this concept of "happiness stocks" quite bizarre, as everyone has a different concept of what makes them happy, depending on their socioeconomic status. Low income earners might consider themselves happy if they have enough money to buy food, pay their rent, purchase other necessities of life, and have something left over to buy cigarettes, booze, candy, movie tickets, lottery tickets, consumer electronics, clothing, etc. Wealthy people, on the other hand, might consider that happiness lies in having enough money to purchase a luxury home

Monetary Tectonics: The Tug of War between Inflation and Deflation

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Introduction: Inflation or Deflation?

"The most important thing to remember is that inflation is not an act of God, that inflation is not a catastrophe of the elements or a disease that comes like the plague. Inflation is a policy." *Ludwig von Mises*

The big question, "inflation or deflation?", has been a key bone of contention for economists in recent years. In the following we would like to analyse the problem based on the Austrian School of Economics.

Due to structural over-indebtedness and the resulting addiction to low/negative real interest rates, we are certain that the traditional way of thinking about financial markets and asset management is no longer beneficial for investors. Therefore, at Incrementum we evaluate all our investments not only from the perspective of the global economy but also in the context of **the current state of the global monetary regime**.

Nowadays, financial markets have become highly dependent on central bank policies. Grasping the consequences of the **interplay between monetary inflation and deflation is crucial for prudent investors**.

This interplay can be compared to the permanent reciprocal pressure of two tectonic plates. **Beneath a calm surface, pressure increases gradually and finally erupts into sudden thrusts on the surface.** Balancing the two heavy inflationary and deflationary forces will be increasingly difficult to manage.

What are those Inflationary and Deflationary Forces?

Deflationary Forces

- Balance sheet deleveraging: Undercapitalized banks recovering from the crisis are reluctant to lend (see Figure 1)
- Deleveraging: Over-indebted consumers are reluctant to borrow
- Regulation: Basel III
- High demand to hold money (low inflation exp. (low velocity, according to the Monetarist Paradigm))
- Productivity gains
- Defaults and bail-ins (Greece, Cyprus)

Inflationary Forces

- Zero interest rate policy
- Communications policy (forward guidance)
- Operation twist
- Quantitative easing (see Figure 2)
- Currency devaluation (currency wars)
- Eligibility criteria for collateral (ECB)

The Austrian Solution and why it will not be taken

Based on the Austrian School of Economics, a laissez-faire approach would be the right answer to the current crises. However, this **natural market adjustment process** of the current crisis would be highly deflationary. The reason for this lies within the **fractional reserve banking system**, as the largest part of money in circulation is created by credit within the commercial banking sector. The much smaller portion is created by central banks. As the financial sector in most parts of the world reversed its preceding credit expansion, overall **credit supply is reduced** significantly. This **(credit) deflation**, respectively deleveraging, is compensated **by very expansionary central bank policies**.

Based on our Austrian view, deflation is natural and healthy. However, in our highly leveraged world, price deflation is — from a political viewpoint — a horror scenario that has to be averted — whatever it takes — due to the following reasons:

- Deleveraging leads to consumer price deflation and asset price deflation. Tax revenue declines significantly. Asset price inflation is taxed; asset price deflation cannot be taxed.
- Falling prices result in real appreciation of nominal denominated debt. Increasing amounts of debt could therefore no longer be serviced.
- In an over-indebted world, debt liquidation and price deflation have fatal consequences for large parts of the banking system.
- Central banks also have the mandate to guarantee "financial market stability" and to make sure "It" doesn't happen here...

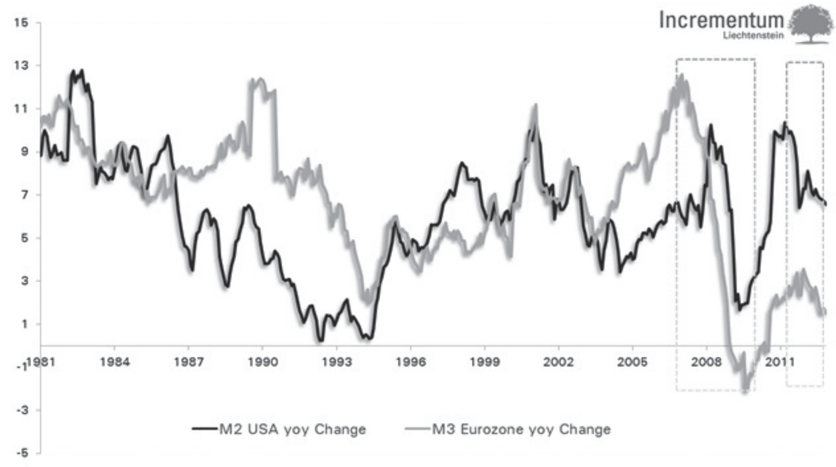
What is the Current Situation?

To measure "monetary tectonics," we have developed the "Incrementum Inflation Signal," an indicator of how much monetary inflation actually reaches the real economy. Of course, official statistics like the CPI (ex food and energy) are bogus. Therefore, we developed an inflation indicator, based on market-based data (prices) and monetary indicators. One of the most reliable and timely leading-indicators for inflation is the Gold/Silver-Ratio. Every time the ratio rises (Gold outperforming Silver), this indicates disinflation and vice versa (see Figure 3).

At the moment the indicator still **shows disinflationary pressure**. Therefore, we do not see a green light yet for inflation-sensitive assets. However, we think that due to highly disinflationary forces the Federal Reserve, and especially the ECB, will have to introduce aggressive measures to reflate the system again. Otherwise, a major market correction should be expected soon.

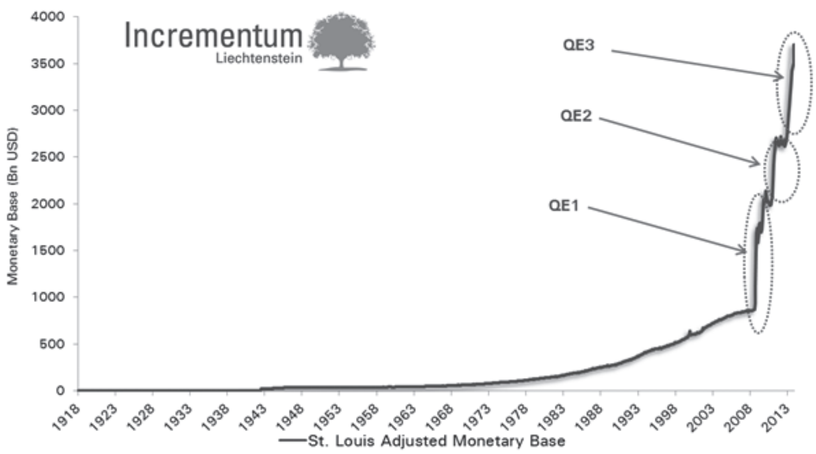
In the long run, the unintended consequences of these monetary interventions will result in increasing volatility, potentially further

Figure 1 **Money Supply Growth in US and Eurozone Trending Lower**



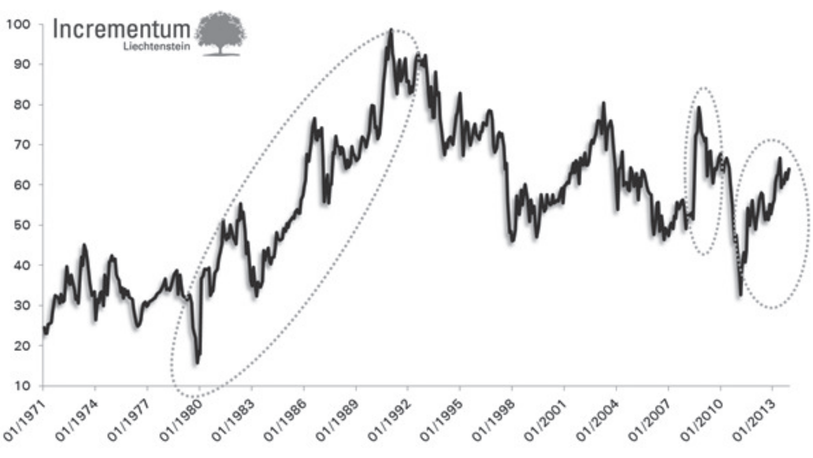
Source: Federal Reserve St. Louis, Incrementum AG

Figure 2 **Monetary Base since 1918**



Source: Federal Reserve St. Louis, Incrementum AG

Figure 3 **Gold/Silver-Ratio: Gold Outperforms Silver during Disinflationary Periods**



Source: TeleTrader, Incrementum AG

disinflationary/deflationary phases and eventually (highly) inflationary phases.

What is the Endgame? Hyperinflation or Hyperdeflation?

According to Austrian Business Cycle Theory, the prices of capital goods (= asset price inflation) increase first in the course of an inflationary process, while consumer price inflation (= rising consumer prices) only ensues later. The asset price inflation that is currently in train can be identified by a multitude of symptoms. Prices for antiques, expensive wines, vintage cars, and especially real estate and stocks, recently increased strongly. Therefore, we believe that "don't fight the Fed" is still applicable. If the Fed wants to "produce" higher price inflation, it will succeed. However, as Karl Otto Pöhl once said, *"Inflation is like toothpaste. Once it's out, you can hardly get it back in again. So the best thing is not to squeeze too hard on the tube."* Unfortunately, we believe that Mrs. Yellen will squeeze too hard on the tube.

In the end we want to quote our fellow countryman, Friedrich August von Hayek:

> ... but it is not that certain that in the long run deflation is more harmful than inflation. [...] Because moderate inflation is always pleasant as and when it is happening, whereas deflation is direct and painful. There is no need to take precaution against a situation whose unpleasant effects can be felt immediately and sharply; however, precaution is necessary for a measure that is immediately pleasant or helps alleviate problems but that entails a much more substantial damage which can only be felt later.
>
> The difference is that in case of inflation, the pleasant surprise comes first and is followed by the reaction later, whereas in case of deflation the first effect on business activity is depressive.
>
> Friedrich August von Hayek
> *The Constitution of Liberty*

This is the summary of the Incrementum Chartbook "Monetary Tectonics: 50 Slides Illustrating the Tug Of War Between Inflation And Deflation" that can be downloaded at www.incrementum.li

Fund Strategy

Ronald Stoeferle (rps@incrementum.li) and his partner Mark Valek (mjv@incrementum.li) are currently launching the first global macro fund, which is based on the teachings of the Austrian School of Economics.

The center of the investment process will be an active inflation/deflation strategy. To gauge the trend of inflation, we have developed an indicator that measures the amount of monetary inflation that is spilling into the real economy. According to the inflation momentum, positions in inflation-sensitive asset classes like gold/silver/commodities/energy and the respective stocks will be taken (long and short). Additionally, the fund aims to exploit tactical opportunities based on the Austrian Business Cycle Theory. One investment theme is the acceleration of Japanese price inflation (the Keynesian endgame). Highly regarded personalities like James Rickards and Heinz Blasnik (www.acting-man.com) serve on the advisory board of the fund.

CORRECTION:
In last month's GBD report, the e-mail address for Mark McLornan (see "Gold Mining Equities" on p. 18) should be mark@agro-terra.com.

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