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No Pretense

Since 2007 our analysis has suggested the likelihood of economic outcomes that most have considered unlikely: significant and ongoing monetary inflation, policy-administered currency devaluation, substantial global price inflation, and an eventual change in how the forty year old global monetary system is structured. Most observers have viewed such outlooks as *tail events* – highly unlikely, unworthy of serious consideration or a long way off. We remain resolute, and believe last week's movements in Frankfurt and Washington towards perpetual quantitative easing confirmed and accelerated the validity of our outlook. A summary reiteration seems in order.

We all know QE began a few years ago in the US and UK with the first rounds of base money creation. This debt monetization came on the heels of Treasury's 2008 TARP bailout, ironically the broad recognition of a tail event – a credit crisis that had been quietly building for years. Since then, global central banks have been taking turns diluting their currencies through repeated base money issuance, devaluing one at a time against the others. While prices of goods and services bought on credit have since been soft, declining or rising only mildly to reflect the natural demand for credit; monetary inflation has pressured prices of unlevered items with inelastic global demand properties higher, most notably precious metals and natural resources.

(We caution against believing that an increase in aggregate global demand, bad weather, impending conflict in the Middle East, or overzealous futures market speculators have been the cause of higher commodity prices. Such conditions represent a natural and ongoing state and commodity supplies adjust. Rather, we argue there is now far more paper chasing basically the same global supply/demand equilibrium for various commodities, and so resource producers are demanding the same purchasing power in exchange by raising nominal prices.)

Logic and history do not support a correlation linking base money growth to sustainable real output growth. At best, there is a lag period that may ultimately result in temporary nominal output growth. While base money inflation may ostensibly bring forward the time until a new credit cycle can begin (because it de-levers bank balance sheets), such a policy raises global resource pricing coincidentally. Resource providers have incentive to raise prices immediately, yet there is no such market-driven incentive among consumers to increase borrowings.

The money flow today is viscous, to say the least. Against this backdrop, there should be very little pretense among objective observers that last week's perpetual QE announcement could actually provide real economic stimulation. From a policy management perspective, central bankers are no doubt aware that consumer demand is unaffected by base money inflation unless and until a new credit cycle emerges. As we have seen, newly created base money is not finding its way to debtors or to fully-reserved private sector creditors, but is instead being parked on the balance sheets of under-reserved banks (and ironically called "excess reserves"). In reality banks are de-levering their loan books with newly-created reserves they have lacked.

The specific (but not fully articulated) goal of the Fed and ECB is nominal money stock growth via unreserved bank credit growth. This is pro-leveraging in general and is usually a win/win for banking systems and broader economies; however, it is lose/lose when unreserved bank credit ceases to grow or begins to contract, as is currently the case. So, nominal base money growth, to which central banks have now gone all-in, is orchestrated with the primary goal of restoring nominal bank credit growth and, only tangentially, nominal output growth.

Is what's best for banks best for their economies? From 1982 to 2007 the two objectives were aligned, at least temporarily. Increasing unreserved bank credit growth allowed the majority of households and businesses to use leverage to build capital and the appearance of sustainable wealth in real estate and financial asset portfolios. In the current economic environment; however, it seems impossible to determine whether banks even have the ability to expand their balance sheets further, thereby providing the basis for a new cycle of credit expansion, or whether consumers have interest in assuming more debt. Nevertheless, policy makers and most professional observers see base money creation as the only option remaining to sustain over-leveraged economies, and so they seem united in looking the other way while the non-bank private sector (primarily unlevered savers) effectively bails out the global banking system, and while the takers of credit (debtors) continue to languish.

The balance sheets of non-bank creditors and debtors are not being improved and base money inflation can do nothing for sustainable real demand, real income, or real returns on most financial assets, and so the economic merit of QE is rather dubious. Simply, central banks cannot de-leverage credit systems in real terms (a relative concept) by promoting the expansion of the credit stock in nominal terms (an absolute objective).

Let’s further summarize and explore current events:

- Further base money creation through debt monetization is the most politically viable means of de-levering banking systems, which seems to be the true priority of central banks. The only economic rationalization for QE∞ is eventual flow-through credit expansion from banks to the rest of us, which theoretically could temporarily increase financial asset prices and economic activity.

- Last week, Chairman Bernanke said:

  > “The tools we have involve affecting financial asset prices. Those are the tools of monetary policy. There are a number of different channels. Mortgage rates, other rates, I mentioned corporate bond rates, also the prices of various assets. For example, the prices of homes: to the extent that the prices of homes begin to rise, consumers will feel wealthier (and) they’ll begin to feel more disposed to spend. If home prices are rising they may…be more willing to buy home(s) because they think they’ll make a better return on that purchase. So house pricing is one vehicle. Stock prices: many people own stocks directly or indirectly. The issue here is whether improving asset prices will make people more willing to spend *(i.e. more willing to borrow – Ed.)*. One of the main concerns that firms have is that there is not enough demand…if people feel their financial position is better (then) they’ll be more likely to spend…”

  To which we would inquire in response: “what exactly does Mr. Bernanke expect consumers to spend and what does he expect consumers to demand?” Plainly, the Chairman hopes easier credit conditions would bring higher financial asset prices, which in turn would induce consumers to assume more debt with which to consume goods, services and even more assets. The implication is obvious: the Fed’s only hope is now reduced to trying to re-ignite a credit bubble ahead of commodity price increases, which in turn increases input costs for finished goods, reduces economic activity, and transfers wealth to resource providers from resource consumers. As noted above, *real* growth cannot be orchestrated through this policy. (Could the Fed be guilty of relying on an econometric model that adjusts supply and demand in one currency, without considering the incentive of global resource producers to migrate away from currencies being diluted?)

- As the Fed continues monetizing MBS, mortgage and other tertiary market yield spreads (including equity dividend and earnings yields) should continue tightening to Treasuries. We would expect policy makers to greatly encourage further declines in nominal mortgage rates in the hope of a renewed housing boom. This would imply the need to further drop Treasury yields with five to seven year durations to maintain a positive spread. Financial asset markets should generally continue to rise in nominal terms (the outcome Chairman Bernanke targeted in his comments last week). Since the economic efficacy of such a financial scheme relies on both homebuyers’/refinancers’ willingness to assume more debt for larger or newer homes, and on further Treasury yield subsidies, it seems obvious that $40 billion/month in MBS purchases should be considered the minimum for future QE.

- We believe QE via debt monetization in this manner will not provide economic stimulus. Homeowners use rational cost/benefit analyses. Lower home re-financing rates or potential home equity gains would have to be perceived by the public to be worth the risks of potential illiquidity and equity losses, risks they recently experienced. Given already record low mortgage rates, low home equity levels, a zero-bound rate structure, an overcapacity of existing homes, and an aging US population, we would argue that significant re-leveraging will not occur in the US housing market. Central banks would need to find another outlet for consumer credit to successfully stimulate economic activity.

- Most of the largest global sovereign economies rely directly on a finance-based model for nominal output growth – a model wherein increasing public and private balance sheet leverage drives nominal GDP higher, which further helps to service outstanding nominal debts with the creation of incrementally new nominal debts. Output growth in more commercially-driven economies, notably China and Germany, also relies greatly on further consumer leveraging in finance-based economies.

- Without a black swan innovation that affects the capital producing potential for a great number of workers in finance-based economies, it is highly unlikely that developed and developing economies can experience *real* output growth (nominal growth adjusted for debt growth and purchasing power loss across all currencies relative to items in relatively fixed supply with inelastic demand properties).

- *We continue to believe the logical economic outcome is global stagflation* – stagnant or contracting global real output coincident with substantially rising prices of commodities and rising input costs of finished goods. A trend towards stagflation seems to have been firmly set in motion already.

- Unlike 1979-1980, monetary policy makers will not be able to resurrect the purchasing power of their currencies by raising interest rates (or this time by withdrawing base money from the system), because the balance sheets of governments, banking systems and households are already deeply indebted, impaired, and unlikely to be meaningfully improved without currency devaluation. Tightening credit in the current environment would most certainly bring on a deflationary depression.

- Once banks are deemed to be sufficiently de-leveraged through debt monetization, we believe central banks will begin monetizing *assets* as a means of explicitly devaluing their currencies. As we have argued, the asset of choice will be the only monetary asset already held by global treasury ministries and central banks and the one with recent precedent collateralizing global currencies – gold.

- The policy-administered currency devaluation we have envisioned would involve a central bank publicly tendering for gold at an increased exchange rate (i.e. price). For example, the Fed would purchase gold with newly created US dollars, which would bring the ratio of USD-denominated credit-to-base money back into line, thereby de-leveraging the system. (This inflation would increase prices and wages relative to outstanding debt balances, greatly reducing the burden of debt repayment.) Global currencies might be re-pegged to the US dollar which would in turn be exchangeable for gold at the higher price, as per the Bretton Woods system. Of course, other central banks might try to make their currencies exchangeable directly into gold at another exchange rate. (We await the arbitrage.)

- Were a USD devaluation and re-pegging to occur as of the end of 2014, following 2 ¼ years of $40 billion monthly MBS debt monetization, we estimate our Shadow Gold Price would approximate $15,000/ounce. (The SGP divides the quantity of USD base money by the quantity of US official gold holdings, as per the Bretton Woods monetary regime.) Over the weekend, Bank of America analysts implied USD base money inflation would increase much more than the Fed announced, to about $5 trillion by the end of 2014.[1] This figure would imply an SGP a bit over $19,000/oz.

We are often asked when we see our scenario playing out. Our answer has always been twofold: first, current conditions and policy responses confirm it is playing out now; second, it is impossible to say when the parabolic "catch-up" phase gets underway because that depends on the interplay between the general public's understanding of the forces behind consumer goods and service price inflation, the pressures on *real* returns in most financial assets, and the reflexive political pressures and policy responses to them. *Nevertheless, we suspect last week's events, in which both the ECB and Fed committed to open-ended base money creation – against a geopolitical environment in which China's USD reserves are being held astride an increasingly dynamic domestic political regime and in which the petro-dollar regime of the past forty years seems under attack – may be the catalyst that begins to raise public awareness of the link between monetary inflation and price inflation.*

[1] http://www.zerohedge.com/news/bofa-sees-fed-assets-surpassing-5-trillion-2015-leading-3350-gold-and-190-crude

Inflation indexes such as the CPI are contemporaneous indicators of price level changes. If our analysis is right, very little capital will be properly positioned when consumer price indexes begin to flare. The relatively tiny current universal allocation towards perceived "inflation hedges" seems to bear this out.

We believe significant *real Alpha* will be generated by those properly positioned first for significant monetary inflation and monetary regime change, and second for significant price inflation. We believe nominal returns using this sequencing will be substantial (far greater in fact than were available to short positions in sub-prime loans in 2007). We do not take responsibility for investors reading our comments that may invest directly in perceived inflation plays including real estate, precious metal ETFs, inflation-indexed structured products, or various commodities that for one reason or another we do not endorse. We take full responsibility only for the performance of our funds.

Kind regards,

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