Wealth Advisors
Turning the focus on you.

180 Perspectives

November 5, 2021

Stock markets remain in a melt-up boom that continues to be fueled by massive liquidity from stimulative government monetary and fiscal policy. I continue to believe the most important factor to focus on remains central banks and the movement of liquidity. While many concerns remain, for now this one powerful factor continues to overpower the negatives when it comes to stocks, real estate and most other hard and/or scarce assets. It is also inflationary, which punishes bonds, cash, pensions, fixed annuities, and other assets that can't keep pace with inflation.

Someday, once when we have inflated enough of this debt problem away, central banks will finally be able to tighten monetary policy and reign-in liquidity. When we approach that point, it will likely be time to shift gears and transition toward wealth and dollar preservation mode.

Bonds may not go into an official bear market in nominal terms for quite a few more years, thanks to ongoing government bond buying to keep interest rates pegged artificially low. However, on a real basis, bonds have already been in a bear market for a while. Their yields have significantly lagged the rising cost of living, creating loss of wealth, and that is likely to only get worse over the next several years.

While there are many things to be concerned about, I continue to believe that all roads and potential outcomes for now still lead to higher inflation, so that remains front and center in my current big-picture portfolio positioning.

If you don't believe we are likely to experience an extended period of negative real interest rates (inflation higher than interest rates), just read the Federal Reserve Board minutes or listen to Janet Yellen or past or present Federal Reserve Board members. Even the Congressional Budget Office (CBO) is currently projecting negative real interest rates for the next eight years.

As we continue to navigate this bursting government debt bubble, there are likely to be periods of high stock market volatility that we need to be prepared for. In this environment, and at this stage, I continue to favor adding attractively priced sturdy ships that can weather the storms, rather than just looking for the fastest ride.

The interesting thing about a monetary-fueled bull market like this is that you get a little bit of everything. While we continue to find good values in various sectors of the market at any given time, the "whip end" of all of this liquidity is a large and increasing amount of extreme speculation and moral hazard. We see a super bubble developing in the 13,300 cryptocurrencies (with a collective value of over $2.5 trillion today). We see it in the many "meme" stocks that are trading on stories that often have no resemblance to reality whatsoever. We see it in NFT's, and in more and more SPAC IPOs at eye-popping valuations. These are areas that will experience tremendous losses when the liquidity spicket is eventually turned off. (Although as of now it looks like that could still be years away.)

The next three months are historically strong months for the stock market, but near-term performance may be heavily influenced by government actions or inactions. (When will they raise the debt ceiling, when and if they are able to pass the next stimulus bill, will the Fed or Treasury make policy miss-steps that frighten investors, etc.)

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Most of you know that I have been trying to explain this current government playbook for quite some time now…of holding interest rates extremely low, while simultaneously creating higher inflation (through money printing) to inflate our way out of our current debt danger zone. (The only politically palatable way out of a debt crisis.)

I've also been saying that the Fed Chairman and Treasury Secretary will tell us inflation isn't as high as we think, and that it is temporary or "transitory" (because the last thing they want is a bond route). So far, they have been executing the strategy beautifully while keeping the consensus believing this "transitory" narrative (while I believe the opposite). As I have mentioned before, we ran this same playbook after World War II to get out of a similar debt problem from financing the war effort. (Only back then we had a trade surplus and positive net foreign investment position. Today we have the largest budget and trade deficits in the world, and the most negative net foreign investment position in the world, which puts us in a more precarious position.)

Once the buyers of our new treasury bond issuance (to fund our deficits and debt) mostly disappeared a few years ago, the Federal Reserve had to step in as the primary treasury bond buyer, with newly created digital dollars. This was (and remains) the inflation game changer. This process of debt monetization with newly created dollars increases the money supply and inflation. Newly printed dollars are handed to the Treasury to spend into the economy. And when this monetary stimulus is also accompanied by direct fiscal stimulus (stimulus checks, forgivable business loans, additional unemployment benefits, child tax credit payments, etc.), it becomes even more inflationary, as more new money gets injected directly into the economy.

I don't think this higher inflation will be just temporary, and I don't believe the Fed will be able to fight inflation by raising interest rates very much for quite a long time (and if they try it likely won't last long).

I also still don't believe the government can abandon their stimulative monetary policy any time soon. I used to think they wouldn't be able to even taper their QE bond buying anytime soon, until last August when the Fed Open Market Committee (FOMC) established standing repurchase agreements (both U.S. and foreign). We then knew that once those became operational (this month) the Fed would be able to follow through on their tapering promise (as announced Wednesday). They can now continue to expand the money supply while at the same time convincing the masses that they have everything under control and will taper and raise interest rates whenever they need to. Brilliant execution so far.

In other words, the Fed can now taper without really tapering. The new domestic standing repurchase (repo) agreement facility (SRF) and repo facility for foreign and international monetary authorities (FIMA repo facility) basically allow the Fed to swap dollars for bonds and other assets at any time (instead of buying them through open markets). New Basel III and Fed banking rules have also now regulated banks into buying more treasuries with their reserves. These are two brilliant tactics in executing their strategy.

The current interest expense on our debt plus current entitlement obligations (Social Security and Medicare) are often referred to as our "true interest expense" because they are payments that must be made each month. And if they're not, government bond investors tend to view it as essentially being in default. Our true interest expense today is running at 111% of our total tax revenues. And since that doesn't include any of the rest of our massive government expenses and military, there is no way to cut spending and/or raise taxes enough to balance the budget without crashing the economy and tax revenues further. This makes inflating the debt away the only politically palatable option in my opinion.

Before the Federal Reserve can even sufficiently raise interest rates to fight inflation, they will have to first get the debt-to-GDP ratio much lower…based on history and multiple studies, that figure is likely at or below 70%. It has been running at 130% (all-time record highs) for most of this past year, but just recently fell to 125% after inflation ran at over 6% this last year while the interest rate on our debt averaged 1%. (We will need quite a few more years like this to get the debt-to-GDP ratio down to 70%.). Congress's inability to raise the debt ceiling or pass another stimulus bill have also temporarily restricted additional spending and debt, which also contributed to the recent decline to 125%.

In the last 200 years there have been 52 instances of a country's debt-to-GDP ratio hitting 130%, and 51 of them defaulted…most through high rates of inflation from money printing, while a few either outright defaulted on their bond obligations or suffered depressions after choosing austerity. We are there now and are choosing inflation.

The economy will likely be battling increasing inflationary headwinds from many different sources besides just Fed money printing. Energy, commodities, labor, deglobalization and a likely declining dollar to name a few. One I will touch on more here is energy prices (which also makes up about a third of food prices). Recent policies of suppressing fossil fuel production without a reasonable plan for the transition to cleaner energy, has created disruptions and shortages across the globe. Ironically, that has also at least temporarily contributed to higher carbon emissions, as scary shortages in China and parts of Europe have forced them to use more coal. Not because they aren't committed to clean energy, but because they are afraid of their citizens going without enough heat this winter.

The world was consuming about 100 million barrels of oil per day prior to the pandemic, then bottomed out at about 80 million barrels per day last year and will now soon exceed 100 million barrels per day again. Roughly 5-6% of oil reserves are depleted each year, and this last couple of years we have only been replenishing about 1% of those reserves, with no additional increase in supply yet on the horizon for many obvious reasons. Similar supply restrictions exist in natural gas production and the pipelines that move it. This is setting the stage for considerably higher oil, gasoline, natural gas, and propane prices the next few years. Not to mention input cost increases for everything made from, or produced with, fossil fuels.

I think too many people still don't realize that the investment landscape has completely changed from anything we have experienced in the last 40, and possibly 100 years. Even many of the "experts" we see and read every day in the media. I think most are probably very good at investing and managing money over the past 40 years…but have yet to fully realize how significantly everything changes when you are in a bursting government debt bubble like today (which have happened throughout history, often somewhere around 100 years apart). I'm reminded of the quote "Generals tend to prepare to fight the last war", and Eric Hoffer's words: "In times of change, learners inherit the earth, while the learned find themselves beautifully equipped to deal with a world that no longer exists."

While current supply chain problems are a source of temporary inflation, they appear likely to continue to some degree through next year, and possibly into 2023. While prognosticators continue to debate the various causes of the supply chain problems, the primary reason is there needs to be an equal balance between production and consumption, and we massively increased consumption while production was constrained. During the pandemic, trillions of dollars were dropped into American's bank accounts, which significantly increased consumption demand, while production was diminished by Covid shutdowns and additional unemployment benefits. We aren't seeing the same level of supply chain problems elsewhere in the world because nobody else flooded their economy with nearly as much new money.

A lot of that new money remains parked in U.S. bank accounts and should continue to fuel strong consumer spending again next year.

While we continue to like many growth stocks that are reasonably priced, there are pockets of exceptional looking value popping up that I have been adding in portfolios.

One asset class that has mysteriously been excluded from this liquidity-induced "everything bubble" is precious metals. I believe gold and silver are priced very attractively today, and the mining stocks are even more undervalued. I've been adding all of them to client portfolios. It may make sense for some of you to buy and hold some physical gold and silver now also.

In past bursting government debt bubbles, gold tended to get very volatile, and then eventually exploded upward in value in the later stages…especially when a currency crisis finally required a re-set of global currencies. For now, I view gold (and silver) as an undervalued asset class that should at least keep pace with inflation, that is also likely to get a big price adjustment upward eventually.

Many are viewing Bitcoin the same way, but I still believe Bitcoin and the 13,300 other cryptocurrencies are likely a temporary phenomenon, that may have a lot more upside potential near term, but eventually likely ends badly. I therefore continue to believe they are a speculation, not an investment, and should be treated accordingly.

One generational investment opportunity that we don't want to miss out on is commodities. If the chart below is anything to go by, we may have about 10 years ahead of us where commodities outperform. I have been adding exposure in portfolios. The greater risk here may be the temptation to get out too early.

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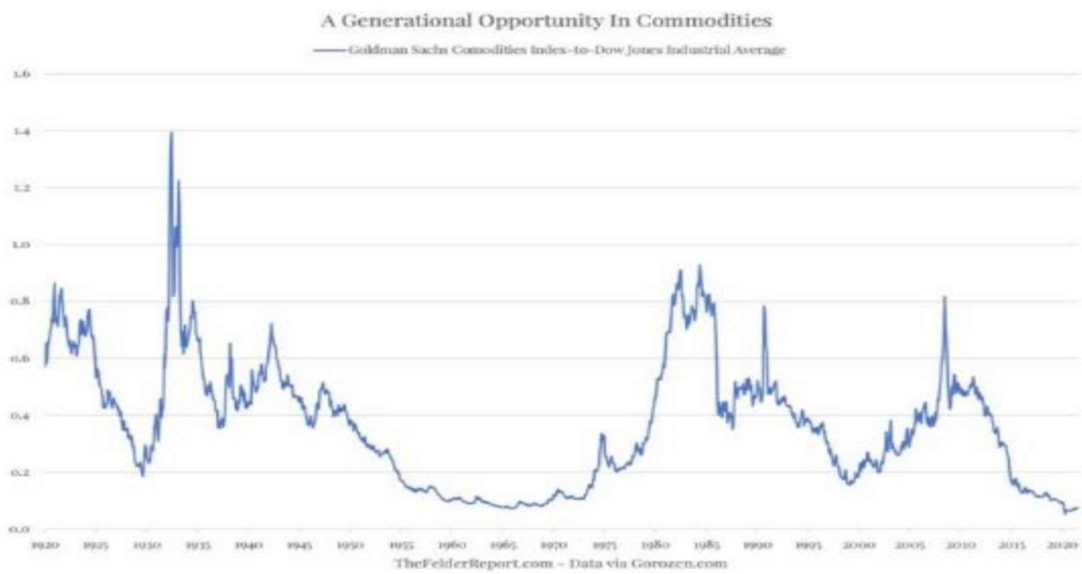

Emerging Market stocks could be another opportunity. The last times they lagged behind U.S. stock returns this badly and for this long, EM investors were handsomely rewarded over the following decade. They currently trade at near record discounts to U.S. stocks in valuation also. I am cautiously watching for potential entry opportunities.

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I also see a great value in many of the mining stocks of metals that will be needed in the transition to clean energy grids and electric cars. There seems to be a major disconnect between our global desire and intentions to transition quickly to clean energy and electric vehicles, and the world's ability to supply enough of the necessary metals and other input materials. China has a very aggressive agenda for transitioning to electric vehicles, and between China and the U.S. alone, there is nowhere near enough current supply of many of the required inputs like copper, nickel, lithium/cobalt, silver and other metals. I find a lot of those mining stocks attractively priced today. Most also have great balance sheets and many pay high dividend yields. I am adding to this sector also.

I-Bonds: In this extended period of near-zero interest rates on savings, and very few options for savers to earn anything on savings and emergency reserves, it is once again time to mention U.S. Treasury I-Bonds. After this recent spike in inflation, you can now earn 7% on I-Bonds, although they must be purchased through TreasuryDirect. Individuals can invest up to $10,000 per year, with minimums as low as $25. While you can cash the bonds out any time after a year, there is a 3-month interest penalty if you cash them out within five years. You can open an account by going to TreasuryDirect.gov. You can also purchase an electronic I bond as a gift for someone and hold it in the "Gift Box" in your TreasuryDirect account until you are ready to transfer it to the recipient. Many of you may find this a good option to park some savings or emergency reserves while the rates remain this high relative to other alternatives. At least money that you can tie up for a year or more. (Although if you have to cash out within the first year, it won't be much different than a savings or checking account anyway.)

Thanks for reading. Please let me know if you have questions, concerns, or comments, or if you want to discuss your portfolio and/or personal situation. Please feel free to call or email me any time.

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