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Quarterly Economic and Market Comments
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The second quarter of 2021 was another positive one for world financial markets as 33 of 38 non-currency assets tracked by Deutsche Bank advanced in local currency terms. Nevertheless, as the quarter unfolded, there were tentative signs calling into question trends that had been in place since November when Biden was elected and Pfizer announced it had developed an effective vaccine. As in the previous three months, commodities led the way; indeed, the first half gain was the best since 1973 and the fifth best in the past 100 years. Still, as the quarter progressed, the price of lumber, which had been rising exponentially to record highs, collapsed by 60% and, in June, copper, another star performer, experienced its worst monthly decline since March 2020. One thing that didn't change is investors' willingness to embrace risk. The real yield on U.S. junk bonds, which had never before been less than 3%, crashed into negative yield territory. At the same time, the yield spread between municipal bonds and U.S. Treasuries fell to a record low as did the spread between Greek and German bonds, with 5-year Greek debt trading at a negative yield for the first time. Equities rose in line with their first quarter performance as inflows into U.S. common stocks in the first half were, on an annualized basis, greater than in the previous twenty years combined and June witnessed the largest daily net purchase of U.S. equities by individual investors on record. At quarter-end, Bank of America's private client equity weighting was a record 65% compared to 56% at the 2007 peak and 39% at the 2009 low. Nor was fondness for riskier assets strictly an American phenomenon as the shares of Asian companies with weak balance sheets have far outperformed those with strong balance sheets over the past year. Then there's the fact that trading cards have enjoyed a great six months as the price of a Larry Bird card, for instance, tripled. However, some of the more speculative sectors did get hit; Bitcoin, for example, fell by more than 40%. Then, too, long-term Treasuries rose in price after suffering their worst quarterly decline in forty years in the first three months. Finally, one of the main themes since last October, the resurgence of so-called value stocks relative to growth stocks, stalled out in mid-May from which point growth rallied by more than 9% while value was flat.

This summer marks three important milestones. The first is the 100th anniversary of the founding of the Chinese Communist Party and the second is the 50th anniversary of the debut of the first stock index fund. While both of these have had far-reaching consequences, arguably more important than either is the 50th anniversary of Nixon closing the gold window. While there will no doubt be a few articles in the Wall Street Journal and similar publications in August looking back and pondering the consequences of Nixon's act, it will largely go unnoticed. Yet, it has profoundly changed the course of financial and economic events - and, therefore, just about everything else - ever since and recalling it seems more relevant than ever today. Throughout most of history, gold and silver were money. Looking at Britain, for example, from the restoration of Charles II in 1660 until World War I, with the brief exception of the Napoleonic era, Britain operated on an unqualified gold standard. While, of course, paper was used extensively for convenience and for commercial purposes, there was full internal and external convertibility into gold. Nor was this just a British phenomenon. The U.S. dollar was convertible into gold between 1873 and 1914 to the point that the famous financier, J.P. Morgan, stated in 1912, "Gold is money. Everything else is credit." The timing of his quote is ironic since, over the next two decades, the creation of the Federal Reserve Board, World War I, and the Depression brought the gold standard to an end. Still, such was the attraction of gold that, under the post World War II Bretton Woods monetary regime, nations could demand gold at the fixed price of $35 an ounce in return for their U.S. dollars. As the expression went, the U.S. dollar was as good as gold. This is what was arbitrarily ended in 1971. While central banks continued to hold gold as part of their foreign exchange reserves, for the first time the world was operating on a paper or fiat money basis. The experience throughout history has been that money linked to gold has been good money. Turning again to the British example, consumer prices were roughly the same on the eve of World War I as they had been 250 years before. In contrast, the record of currencies divorced from a metallic standard has been one of price inflation, often explosive. For example, during the revolutionary war in the U.S., the non-gold backed currency, called Continentals, issued by the fledging government, was undercut by inflation leading to the money being called “shinplasters” and currency similarly issued by the North during the Civil War led to the song “I don’t give a heck about a greenback dollar.” Gold had another related feature in that it placed limits on political agents and provided a system that tended automatically towards equilibrium. Countries that overspent lost gold which forced them to retrench and vice versa. However, this feature of gold was seen as a bug through the centuries by those in power who often saw gold as a straight jacket thwarting their agenda. And not just authoritarians. At the Democratic National Convention in 1896, William Jennings Bryan, in a speech that led to his nomination as the party’s presidential candidate, thundered, “You shall not crucify mankind upon a cross of gold”. Of course, he wanted silver, not paper. However, such was the prominence of the U.S. dollar and the sophistication of the American and world financial system in 1971 that Nixon was able to cut the umbilical to gold and he did.

The story of the post-gold world has played out in three phases to date and a furious intellectual debate is underway over whether the world has moved into a fourth and possibly final phase. Initially, after the gold window was closed, those who assumed that a world of irredeemable paper currencies would be an inflationary world appeared to be right. Consumer prices, which were rising at about a 3% pace, began to spiral upward, ultimately peaking out at a rate of more than 14%. Gold, now trading freely, rose from $35 to $800 and the yield on long-term U.S. Treasuries, dubbed “certificates of confiscation” by some, rose to an unheard of 15%. Then it all changed.

A new Chairman of the Federal Board Reserve Board, Paul Volcker, engineered a brutal credit crunch, sending interest rates from less than 5% to 20% and leading to two recessions, but he succeeded in bringing the rate of inflation back to 3%. At the same time, a transformation was taking place on the fiscal front. While the oft-used expression of the time, “inflation is always and everywhere a monetary phenomenon”, has some merit, it is also woefully incomplete as we have discovered over the past 40 years. Conservative politicians such as Thatcher and Reagan came to power in the early 1980s pledging to break the power of labour unions, to reduce the size and scope of government spending and regulation, and, in general, to encourage the private sector. They were a lot less successful than their supporters would have hoped; nevertheless, concern about the size of government and budget deficits lingered on until recently. Meanwhile, Volcker had been replaced by Alan Greenspan who was a libertarian gold bug until he became Chairman of the Federal Reserve Board. Except under Volcker, “the Fed” had typically had an easy money disposition since Benjamin Strong, the Fed’s first leader, decided to give a “coup de whiskey” to the stock market in the late 1920s, but Greenspan realized that, in the post-gold era, monetary policy could be even more lax than before. In the wake of the 1987 stock market crash, and subsequent financial crises, the Greenspan Fed eased monetary conditions quickly and aggressively, ultimately contributing in part to the dot.com bubble, the bursting of which led to Greenspan’s biggest monetary easing and the creation of a new bubble, this time in housing and commodities. While the twenty years from Volcker’s defeat of rising consumer prices to the 2008 financial crisis was a period of monetary looseness with numerous consequences, one of those consequences was not faster consumer price inflation; rather, prices rose at a slow and stable rate.

The Global Financial Crisis ushered in the third phase of the post-gold era. The shock to the world economy in 2008 was severe and the new Chairman of the Federal Reserve, Ben Bernanke, a student of the Depression, was obsessed with avoiding at all costs what he considered to be the worst possible outcome - deflation (i.e., falling consumer prices). While Greenspan had certainly been an easy credit man, he operated within the traditional central banker playbook which included allowing interest rates to rise as a business expansion matured. Bernanke and other central bankers, particularly in Europe, took a more unconventional approach. Not only were interest rates dropped to zero - and, in Europe and Japan, even negative - and kept there even as the economy recovered, but the central banks also undertook massive purchases of securities, not only bonds, but in some cases equities, as part of an approach called quantitative easing (QE). Quantitative easing was not new. It had been underway in Japan for the better part of a decade as the Japanese tried to no avail to extricate themselves from the deflationary funk that followed the bursting of their unique real estate and equity bubble in 1990. The ineffectiveness of QE in Japan was attributed by Bernanke and others to an inept or inadequate implementation of the program, but the result in the U.S. and Europe between 2010 and 2020 were not radically different. Many, including the Fed, thought of QE as printing money and assumed it would lead to stronger growth and a real pick-up in consumer price inflation, but it was not to be. Bernanke's successors made a half-hearted effort to normalize monetary policy in 2018, but a 20% drop in the U.S. stock indices caused a quick retreat. Then came Covid, a financial panic, and a big hit to the world economy and the world's central bankers were on the case with another tsunami of QE. The Federal Reserve's balance sheet, which was $700 billion in 2003, stands at $8.1 trillion today. This compares to an increase in nominal GDP from $11 trillion to $22 trillion over the same period. The disproportionate growth of the Fed's balance sheet relative to GDP is completely unprecedented apart from the World War II experience. When Greenspan was trying to reflate in the wake of the dot.com crash, the Fed's balance sheet stood at 6.5% of GDP not far above the historic 4% level that had prevailed during the previous 90 years. Today, the ratio is almost 37% and other world central banks have been following suit.

The experience of the past forty years and the past decade in particular has taught us that central banks bulking up their balance sheets is not enough to generate higher rates of consumer price inflation or, for that matter, stronger economic growth. It merely sets the table. A banking system flooded with reserves needs to lend that money out. The velocity, not just the supply of money, needs to pick up. So far it hasn't. Yet, today, many of the investment world's greatest minds believe that the inflation train, post-Covid, has, this time, left the station and that the Federal Reserve has fallen seriously "behind the curve". What has changed? To some degree, it's the fact that monetary policy has been that much more extreme and that central bankers are determined to allow inflation to run well above their preferred long-term rate of 2% before any tightening moves. However, it's also fiscal policy. "No generation has a right to contract debts greater than can be paid off during the course of its own existence," George Washington wrote to James Madison. This sounds really extreme, but, in fact, for years a balanced government budget was considered the right and prudent thing to do. In the Keynesian, post-Depression world, the idea of actually paying off the debt faded, but a conservative approach to government finances remained the hallmark of serious economies; whereas, big deficits were associated with banana republics and rampant inflation. Things have been changing, however. Taking the U.S. as an example, the national debt first reached $1 trillion in 1981 at which point it represented 31% of nominal GDP. Over the past 15 years, the national debt has increased at an 8.6% rate compared to nominal GDP growth of 3.2%, so that today the debt is equivalent to 130% of GDP and is fast approaching $30 trillion. Most worrisome, the philosophical notion that running chronic budget deficits was both wrong and imprudent has been replaced by Modern Monetary Theory (MMT). The central idea of MMT is that governments with a fiat currency system under their control can and should borrow and print as much money as they need until all unused resources are employed and the economy has become inflationary as a result. The fiscal actions of a number of governments during Covid, including Canada and the U.S., have been consistent with MMT. For example, in the U.S. in the fourth quarter of 2019, at the peak of the alleged "Greatest Economy Ever", total government transfer payments were 14.3% of GDP compared to 10.0% in 2000. In the first quarter of 2021, it stood at 37%, meaning that nearly two-fifths of every dollar spent was taxed from current producers or borrowed from future producers. As a result, real personal income increased by 4.9% during the recession year of 2020 compared to a drop of 3% in 2009 and this increase was bigger than in every expansion year since 2000.

This is what has so many informed investors concerned - the combination of monetary authorities prepared to do whatever it takes to create higher levels of inflation and fiscal authorities spending with little restraint. And there's more. Two huge deflationary factors over the past twenty years have been globalization and the entry of China into the World Trade Organization with its export of low-priced goods. In the twenty years prior to the pandemic, prices of services rose at a 2.8% rate in the U.S., but inflation in core goods prices was zero. In the post-Covid world, goods inflation is likely to be more than zero, even as the price of services may rise as employers are forced to pay higher wages. Furthermore, we are seeing right in front of us surging shipping rates, unprecedented shortages of semiconductors, rising housing costs, and a host of other inflationary indicators. As the astute Louis Gave asks, "Should we worry about inflation? If not now, when?"

Whether a new cycle of higher sustained rates of consumer price inflation has begun is probably the key question currently facing investors. Most investors today have only known a world in which interest rates went relentlessly downward. Over the past four decades, long-term U.S. government bonds had a cumulative return of 888% after inflation; in the previous four decades, they lost 51% of their value. Nor is it just bonds. While moderate inflation does not guarantee high P/E ratios, P/E ratios inevitably get slammed in a deflationary environment or when consumer prices start to rise at a 4% pace or more. This is why the Dow Jones Industrial Average lost 73% of its value after inflation between the 1966 high and the 1982 bottom. On the other hand, real assets, including commodities and gold, do well in an inflationary environment as do cash equivalents which benefit from rising interest rates.

So, we know what types of investment are likely to do well or poorly in a more inflationary environment, but is such an outcome inevitable? The counter argument could be summed up simplistically in one word - Japan. The Japanese pioneered QE and have taken it to the point where government bonds scarcely trade and the Bank of Japan is a major owner of equities. On the fiscal side, the government's debt to GDP ratio is far beyond anything contemplated in Europe or North America. Yet, still, the country remains stuck in a non-inflationary slump that has lasted for years. This raises a related point that many of the inflationary data points that people find worrisome seem less relevant to much of the rest of the world than to the U.S. More substantively, the world economy remains in the grip of some powerful deflationary forces which are growing stronger, not weaker. Of these, rising debt levels are the most important. Scholarly research, from the 19th century to the present, indicates that high debt levels undermine economic growth and global non-financial debt relative to GDP increased to a record high in 2020. Total debt in the U.S. amounts to about 400% of GDP compared to the historic leverage ratio of about 150% which was pretty constant throughout history until the amount of debt began to take off after the gold window was closed. From 1870 - 1997, real per capital GDP in the U.S. grew at an annual rate of 2.2%. In 1997, debt relative to GDP reached a level consistent with the beginning of economic decline and, since then, the rate of GDP growth has fallen by 45%. Furthermore, if interest rates on 10-year Treasuries merely went back to their 20th century average yield, the budget deficit would widen by $1 trillion. It is difficult to see how inflation and interest rates can really get going on the upside in the face of massive and growing debt levels. Indeed, the three debt bubble peaks of the 19th and 20th century were followed by deflation and the Global Financial Crisis of 2008 has, so far, been followed by disinflation. As the longest-serving British Prime Minister of the 19th century, Lord Liverpool, noted, “The tendency of an inconvertible paper money is to create fictitious wealth, bubbles, which, by their bursting, produce inconvenience.” No mention of inflation. A second major deflationary force at play is demographics. Births and family formations are positively correlated with spending and investment. Birth rates are at record lows and populations are ageing in all the major economies which will place downward pressure on economic growth and consumer price inflation. There are, in addition, reasons to think that the current uptick in consumer price inflation will prove transitory, but the reality is we just don’t know at this point. What we do know is that 50 years ago the world embarked on a historic monetary experiment. William Rees-Moog in his book, “The Reigning Error’” helpfully defined inflation as “a disease of the inordinacy of money. It is money without order.” By this definition, we clearly are in the midst of a giant inflation already, but must this ultimately lead to accelerating consumer price inflation and significantly higher interest rates? From an investment point of view, this probably means not assuming the answer to that question is, “yes”, but, on the other hand, it probably also means being leery of investments (for example, most medium to longer-term fixed-income securities and equities with above-average P/E ratios) which offer no protection if the answer turns out to be “yes”.