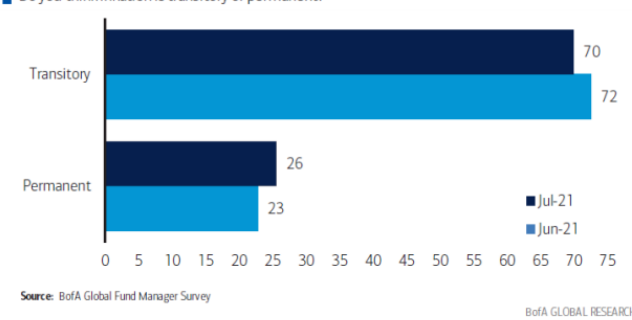
2021 Second Quarter Review:
The Great Inflation Debate

> *Inflation is always and everywhere a monetary phenomenon in the sense that it is and can be produced only by a more rapid increase in the quantity of money than in output."*
>
> *— Milton Friedman*
>
> *The Counter-Revolution in Monetary Theory*

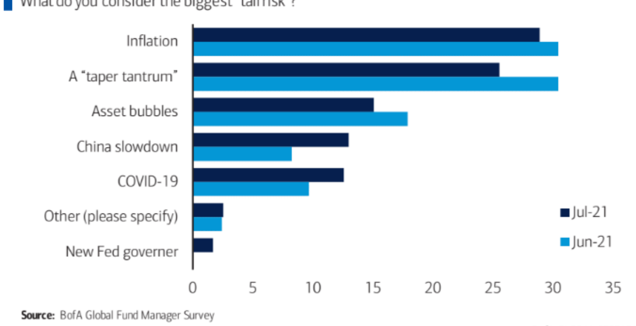
One of the most critical and hotly debated issues in markets today centers around the question of whether the current elevated levels of inflation are transitory or persistent. The majority of market participants believe inflation will be transitory.

Chart 6: 70% of investors think inflation is transitory
Do you think inflation is transitory or permanent?

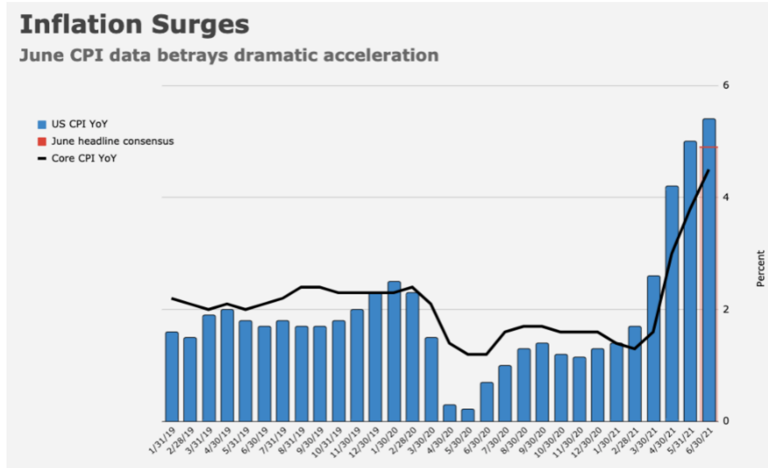


We think that market participants are underestimating the likelihood that higher inflation will persist, primarily because of the impact of a massive increase in the money supply, and secondarily because of the unprecedented levels of fiscal stimulus being pumped into the system. The most recent US Consumer Price Index ("CPI") came in at an annualized rate of 5.4%, the fastest pace in almost 13 years.

Chart 27: Inflation remains the biggest "tail risk"
What do you consider the biggest "tail risk"?



On the chart below, we can see that CPI began increasing significantly in March of this year and has continued to increase in subsequent months. After a record high retail sales number in February, we saw an inflationdriven market rotation as commodities surged, long-term Treasury yields climbed, interest-rate-sensitive large cap tech stocks deflated, and value[1] stocks outperformed growth[2] stocks.



Source: US Bureau of Labor Statistic, Heisenberg Report

We were well-positioned for this market rotation, and as a result the US Risk Managed Equity strategy was outperforming the S&P 500 by more than 5% (since inception) by mid-May, while running at about two-thirds the risk level of the market (portfolio beta 0.67, downside capture 64%).

Somewhat paradoxically, it was after the May CPI announcement of high annualized inflation of 4.2% that the market reversed course and started to rotate out of value stocks and back into growth stocks. The market appeared to be bracing for the possibility that the Federal Reserve would try to reduce inflation, and in so doing undermine economic growth. As the pendulum swung back, long-term Treasury yields declined, the US dollar rallied, and growth stocks outperformed value stocks. By mid-June the US Federal Reserve recognized that inflation was above their 2% target but suggested that inflation pressures were “transient.” Federal Reserve Chair Jerome Powell conceded that they were now “thinking about thinking about” tapering their quantitative easing “QE”[3] asset purchases and raising short-term interest rates. The expectation of the majority of the Federal Reserve members was for one interest rate hike in 2022, and two rate hikes in 2023.

This apparent hawkish[4] shift of the Federal Reserve caused the decline in longer-dated Treasury yields to accelerate as the market anticipated tighter financial conditions would cause the nascent economic recovery to falter. The flattening of the yield curve contributed to a reversal of market conditions which had previously allowed US Risk Managed Equity strategy to outperform the market with less volatility.

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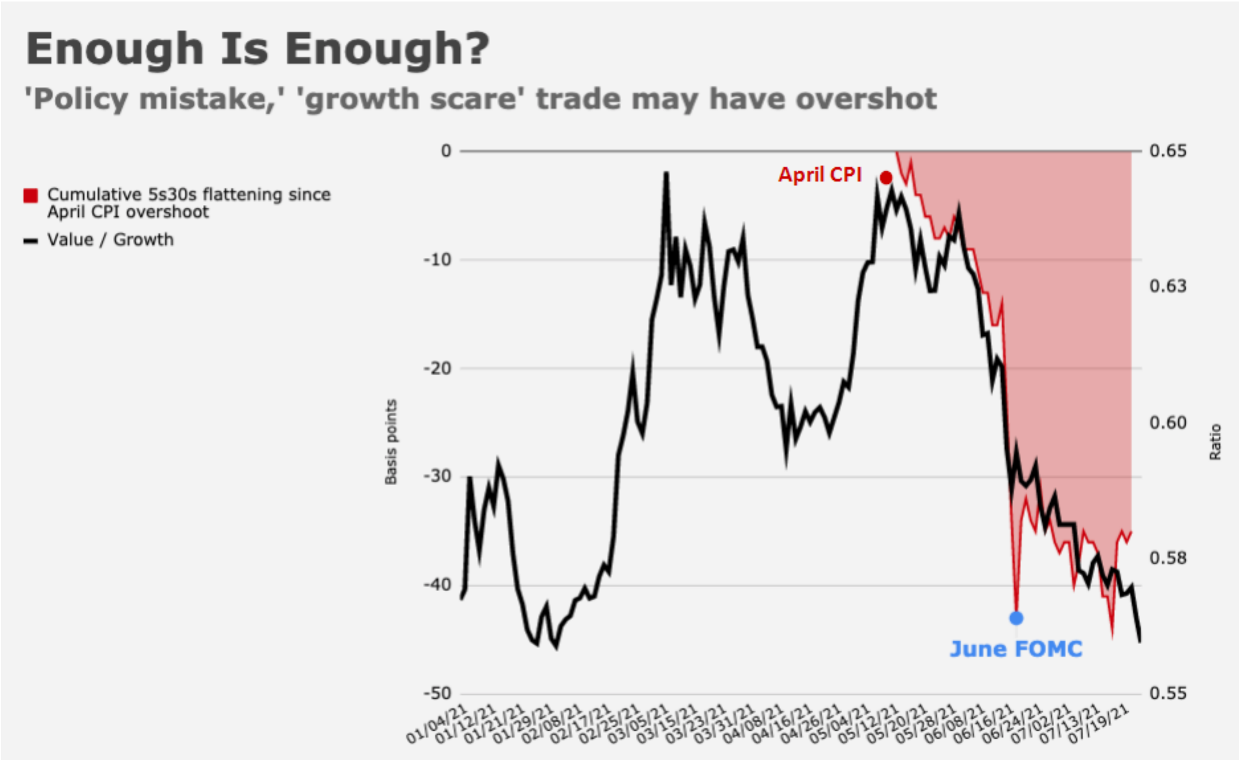
1. Value stocks are stocks with a price that appears low relative to the company's financial performance, as measured by such fundamentals as the company's assets, revenue, dividends, earnings and cash flows.
2. Growth stocks are stocks of companies expected to grow sales and earnings at a faster rate than the market average.
3. QE refers to quantitative easing. In this iteration, the Federal Reserve is purchasing $120bn of mortgage-backed securities and Treasury bonds from the market each month, or $1.44 trillion per year.
4. Hawkish policymakers tend to focus on controlling inflation as a primary goal of monetary policy. Dovish policies are more concerned with promoting economic growth and job creation. Hawks and doves both use interest rates to achieve their policy goals.



Source: Heisenberg Report

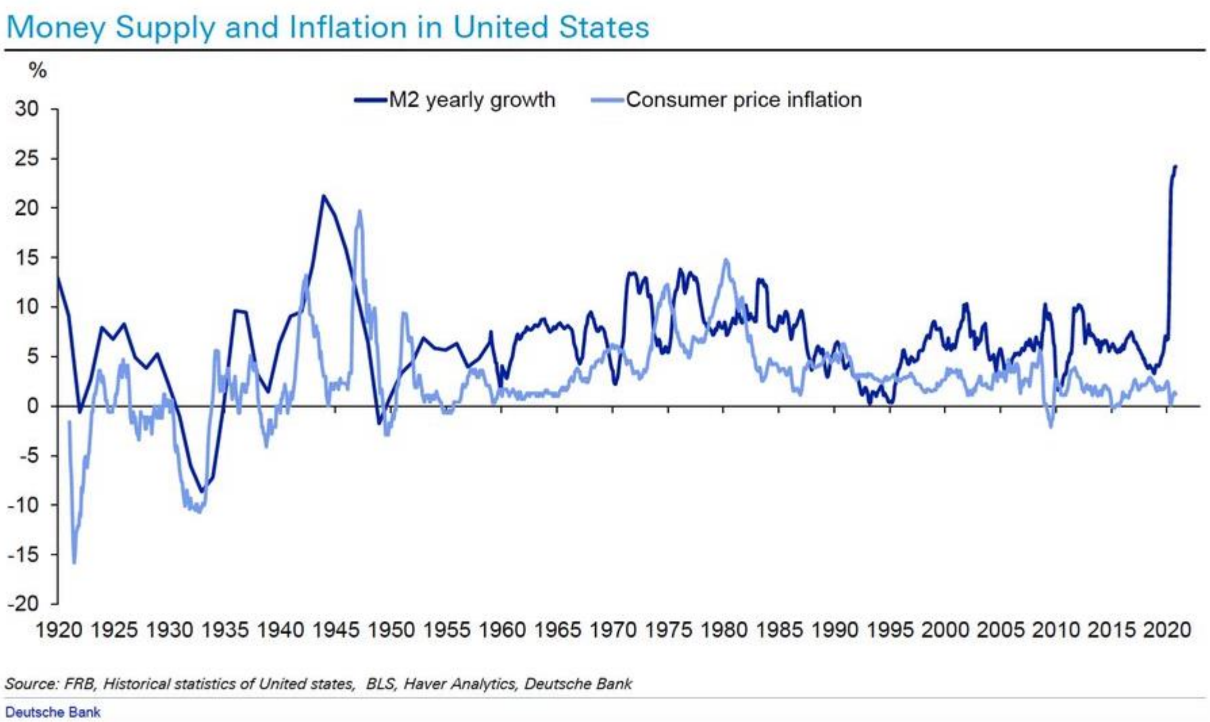
The US RME strategy, largely positioned with value-oriented, quality companies that would benefit from a more normalized economy, has lagged its benchmark, the S&P 500, since May. The primary reason for the lag is that high growth companies benefitted more from lower interest rates as the US Treasury yields fell. Value also underperformed growth during this period since many value-based companies would do better in an improving economy, and the outlook for economic growth was clouded not only by the prospect of tightening financial conditions from a more hawkish Fed, but also due to concerns around the pace of global growth, with Delta variant concerns and slower growth out China weighing on sentiment. Lastly, growth tends to outperform value during periods of low inflation, and the market seemed to believe that the current high levels of inflation would be short-lived.

We think this rotation was an overreaction and short-sighted because inflation is likely to persist, and the Fed's hands will be tied on tightening monetary conditions (slowing down QE or raising interest rates), as any meaningful tightening will undermine a delicate economic recovery and might cause an outsized reaction in markets, especially given the amount leverage and margin debt in the system. The Fed may talk tough, but with margin debt, corporate debt and government debt at historic highs, the market will be extremely sensitive to any attempts by the Federal Reserve to tighten monetary conditions. Since overstimulating is the lesser of evils from a political standpoint, we expect the Fed to kick the can on tightening as long as possible, and if the market has a negative reaction to an eventual tightening, we expect they will be quick to reverse course at the first sign of trouble as they did after the market declines of late 2018.

The Case for Persistent Inflation

While some of the price increases of items comprising the CPI may in fact be "transient," we expect high inflation to persist because of excessive expansion in the money supply, which is the dominant factor affecting inflation. The ongoing accommodative monetary policy and large fiscal spending support our view that the broad money supply will expand at a level that causes high inflation to persist.

Massive growth of money supply – According to traditional monetary theory, the US requires an annual money supply growth rate of approximately 6% to induce stable price inflation of 2%, which is the Federal Reserve's target annual inflation level.[5] However, in 2020 the US money supply was increased by 24%, or four times the amount necessary, and it is still growing at roughly twice the amount needed to support 2% annual inflation. The growth in US money supply has reached levels that haven't been seen since the middle of WWII.[6]



The impact of increasing the supply of money has a lagged impact on financial markets (asset prices), the economy and inflation. Professors John Greenwood and Steve Hanke lay this out in their July Wall Street Journal article, "Too Much Money Portends High Inflation":

"According to monetarism, asset-price inflation should have occurred with a lag of one to nine months. Then, with a lag of six to 18 months, economic activity should have started to pick up. Lastly, after a lag of 12 to 24 months, generalized inflation should have set in. That's the standard monetarist sequence, and it's been followed to a T."

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[5] John Greenwood and Steve H. Hanke, "Too Much Money Portends High Inflation," Wall Street Journal, July 2021
[6] John Greenwood and Steve H. Hanke, "The Money Boom Is Already Here," Wall Street Journal, February 2021.

Based on the level of money supply growth we have seen and continue to see, and given the lagged impact of money supply growth on i) asset prices, ii) economic activity and iii) generalized inflation, Hanke and Greenwood expect that by the end of 2021 we will see inflation rates rising even higher than their already elevated current levels. This is a very meaningful difference from what the Federal Reserve has indicated and what market positioning is signaling will happen with inflation.

It's also worth noting that no country in history has ever consistently run a broad money growth rate above 10% without inflation of 4% or higher.[7]

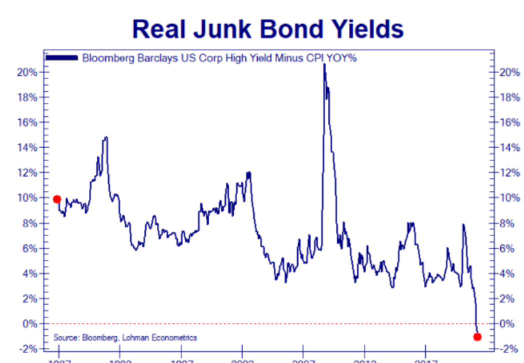
Massive fiscal spending – Between the CARES Act, Phase 3.5, the $900B stimulus & relief package attached to the budget bill in December, and most recently the American Rescue Plan Act, the US has committed about $5.5 trillion in fiscal packages to support the economy, with more to come. The combination of large fiscal deficits and very easy monetary policy suggests to us that inflation pressure is likely to continue for some time.

We believe in Milton Friedman's view that "inflation is always and everywhere a monetary phenomenon," and believe, based on that principal alone, that we are likely to see persistent high inflation for the foreseeable future. There is other noteworthy evidence that supports the idea of higher future inflation, which we expand on in an appendix to this note. While we have also considered the other side of the argument (i.e. the deflationary views espoused by Dr. Lacy Hunt and David Rosenberg among others), we think they are underestimating the impact of the money supply on future inflation.

Portfolio Implications

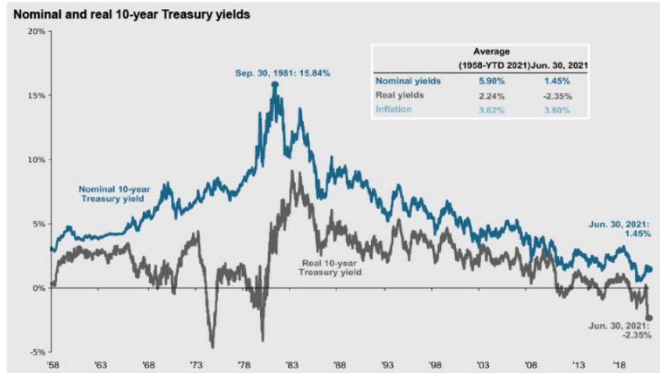
While positioning for reflation was quickly rewarded in the first half of 2021 given the global vaccine rollout and expectation for economies to reopen, we expect things to be choppier and more challenging in the second half of 2021. We can see this choppiness in the push and pull of market prices as the inflation debate continues. We suspect that it will take several more months of high inflation reports to convince the market and the Federal Reserve that they should take the threat of high persistent inflation more seriously. One wildcard in all of this is the impact that future waves of COVID could have on the supply and demand of goods around the world. We will need to keep an eye on future data to fully analyze how that is progressing and the potential impacts.

Traditional 60/40 portfolios are likely to perform poorly in this environment, with inflationary pressures and historically low interest rates. In an environment with negative real yields (including negative real *junk bond* yields!) and a combined earnings/coupon yield of 3.23%, the implied 5-year annualized future returns for a traditional 60/40 portfolio is a paltry 3.6%.



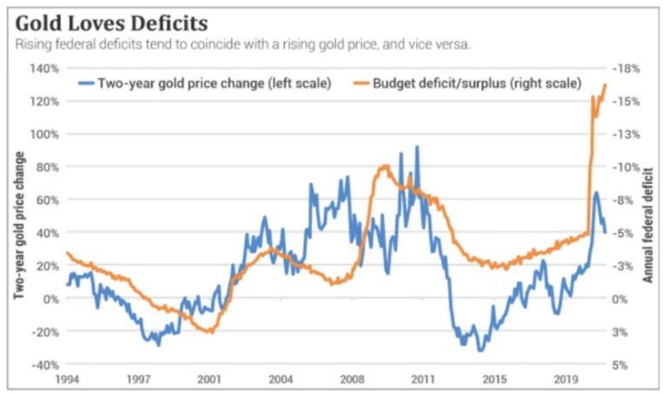
[7] Russell Napier, "We Are Entering a Time of Financial Repression," Interview with The Market NZZ, July 2021.

The current high levels of debt and deficits are only sustainable if governments keep real interest rates negative. However, the level of indebtedness cannot continue to grow indefinitely without serious consequences. If inflation persists, as we believe it will, the Federal Reserve is limited in how much they can raise interest rates because higher rates will cause significant turmoil in an overindebted system.



Source: BLS, FactSet, Federal Reserve, J.P. Morgan Asset Management.

We have therefore included some exposure to gold and gold miners in the portfolio, since gold historically performs well when inflation is rising and real yields are low or negative. Gold is also an effective hedge against fiat currency devaluation, and the price of gold is highly correlated with the level of budget deficits. Gold is an effective store of value and provides diversification benefits to the portfolio as it tends to move independently of stock market prices and performs well relative to stocks in both inflationary and deflationary scenarios.

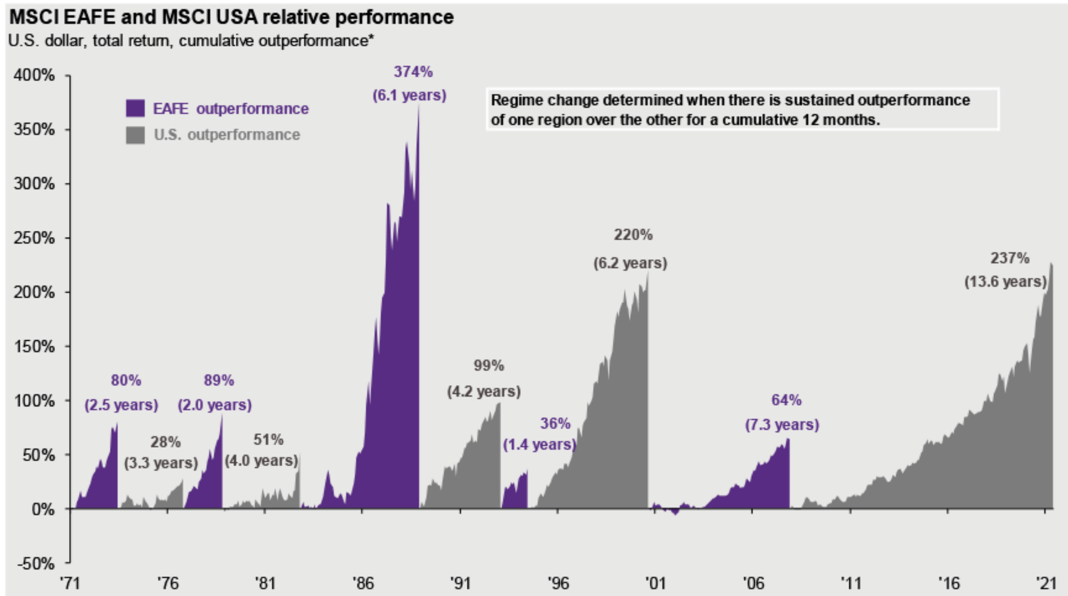


Source: Investor Place

There are sectors with very expensive valuation metrics, some of them rivaling those of the dotcom bubble. As a result, we think there is currently substantial price risk in broad index exposure. Fortunately, we can still find pockets of value in the US stock market and have positioned US RME accordingly. Based on our recent study of the historical impact of high inflation on equity markets, we believe that our portfolio positioning toward value will be rewarded over time.

Source: FactSet, FTSE Russell, NBER, J.P. Morgan Asset Management.

We have added some global value stocks to the portfolio, both for diversification benefits and due to their attractive valuations relative to their US peers. Global equities have had their longest period of underperformance relative to US equities since the early 1970s, and are now trading at a record discount on a price-to-earnings basis, as well as being at the upper end of the relative dividend yield differential. The chart below shows the relative performance of the US market vs EAFE (Europe, Australasia, and Far East) in percentage terms and length of time.



Source: FactSet, MSCI, J.P. Morgan Asset Management.

We have also increased the level of index Put protection in the portfolio. With monetary and fiscal spigots flowing and economies still reopening, markets may move higher. However, with speculative excess and rising leverage, there is an increasing risk of serious volatility. Also, the Fed is still the main market-moving player, and the timeline for unwinding QE and raising interest rates is unclear. If the Fed is forced to tighten, a "taper tantrum" has the potential to lead to a sharp correction, so we think it's prudent to include some portfolio protection at this stage considering the possibility of a negative reaction to Fed tapering. Put options also provide protection against volatility caused by other "known-unknowns" such as US-China tensions, COVID variants, cryptocurrency volatility spillover, antitrust pressure on megacap tech companies, as well as protection against the ever-present risk of "unknown-unknowns."

Kind regards,

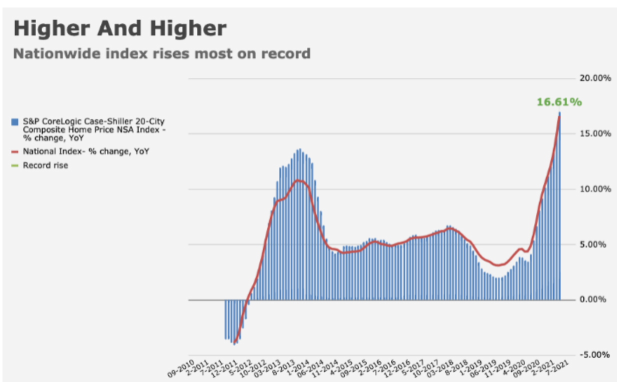
Ian Johnson, CFA
Co-Chief Risk Officer
Oak Bay Capital Inc.

Appendix

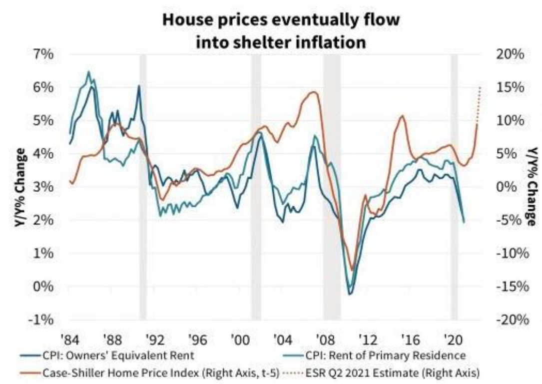
Additional Factors Contributing to Persistent Inflation

Rising home prices

The rising cost of real estate will have a lagged impact on the shelter portion of the CPI. Shelter makes up 33% of CPI, its largest component. Housing prices have risen by almost 17% since last year, and the shelter portion of CPI has only seen modest increases. A study by Fannie Mae (the Federal National Mortgage Association) showed that house price gains historically lead changes in the CPI shelter costs by about 15 months. So, the lagged impact of higher housing costs portends higher future inflation.



Source: Heisenberg Report



Source: Federal National Mortgage Association

Wage Growth

According to the US Bureau of Labour Statistics, average hourly wages rose by an annual rate of 6% from April-June this year[8]. Government stimulus cheques are making it more difficult to entice the unemployed back to work, leading to labour shortages and historically high levels of wage growth. If inflation persists and consumers' expectations for inflation increase, this could lead to a wage-price spiral involving increased spending, further higher prices, and an increased push for wage increases.

Deglobalization

In the 1990s, China devalued its currency, triggering a wave of cheap exports from China, which has been a massive global deflationary force for the past couple of decades. Now, the cost of labour in China is rising significantly and we are entering a new era of global tensions which will involve trade wars, tariffs, strategic industries and increased onshoring of global supply chains, all of which will be inflationary.

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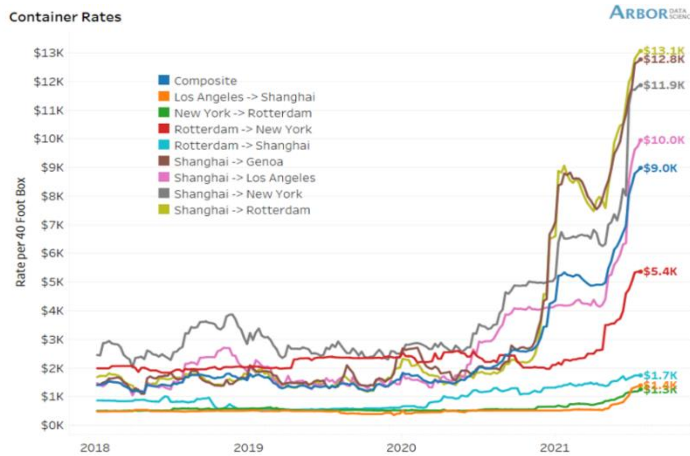
[8] Gad Levanon, Why Wages Are Growing Rapidly—Both Now And In The Future, Forbes, July 2021

Rising Energy Prices

Record low oil prices in 2020 led to steep losses among energy companies and, combined with the ESG trend, has led to significantly reduced capital expenditures in exploration and development. Aggressive policymaker plans to invest in infrastructure will lead to increased demand for oil and other commodities in the medium-term. With constrained supply and increasing demand, energy prices could continue to rise (or at least stay elevated) in coming years, putting upward pressure on costs across a wide range of goods and services.

Record High Shipping Costs

The cost of sending a container from China to the US has increased almost tenfold since 2019, and remains elevated.



Source: Arbor Data Science

Inflation Expectations

As inflation begins to take hold, inflation expectations can become unmoored leading to a self-reinforcing feedback loop as expectations for higher prices lead to increased spending, and the wage-price spiral discussed above. Former Fed president Jeffrey Lacker made the point in a recent [Bloomberg interview] that, at the core, inflation expectations are really about the credibility of the Federal Reserve.

"The important thing to remember and that I think people neglect about inflation expectations—people talk about it as if it's some exhaustion in an external force of nature or some collective psychological whim or something—it's really expectations about what the Fed is going to do in the near future. And so, when you look at inflation expectations, that's really the credibility of the Fed, and that can change. And the process by which that shifts and changes over time is not one that's deeply understood in the economics profession."

Record Levels of Debt

Policymakers' hands are tied, so financial repression (i.e., keeping interest rates below inflation rates) will be the policy game plan. High debt and deficits are only sustainable if governments keep real interest rates negative. Financial repression means pushing policies (yield curve control, rules that force institutions and commercial banks to hold government bonds, capital controls) that suppress interest rates to levels below the rate of inflation, allowing the government to reduce their debt in real terms. Financial repression is essentially a "stealth tax" that is largely paid by savers and retirees. As Russell Napier puts it, the whole point of financial repression is "to steal money from old people slowly…and the slowly bit is important, because you don't want to frighten the horses."