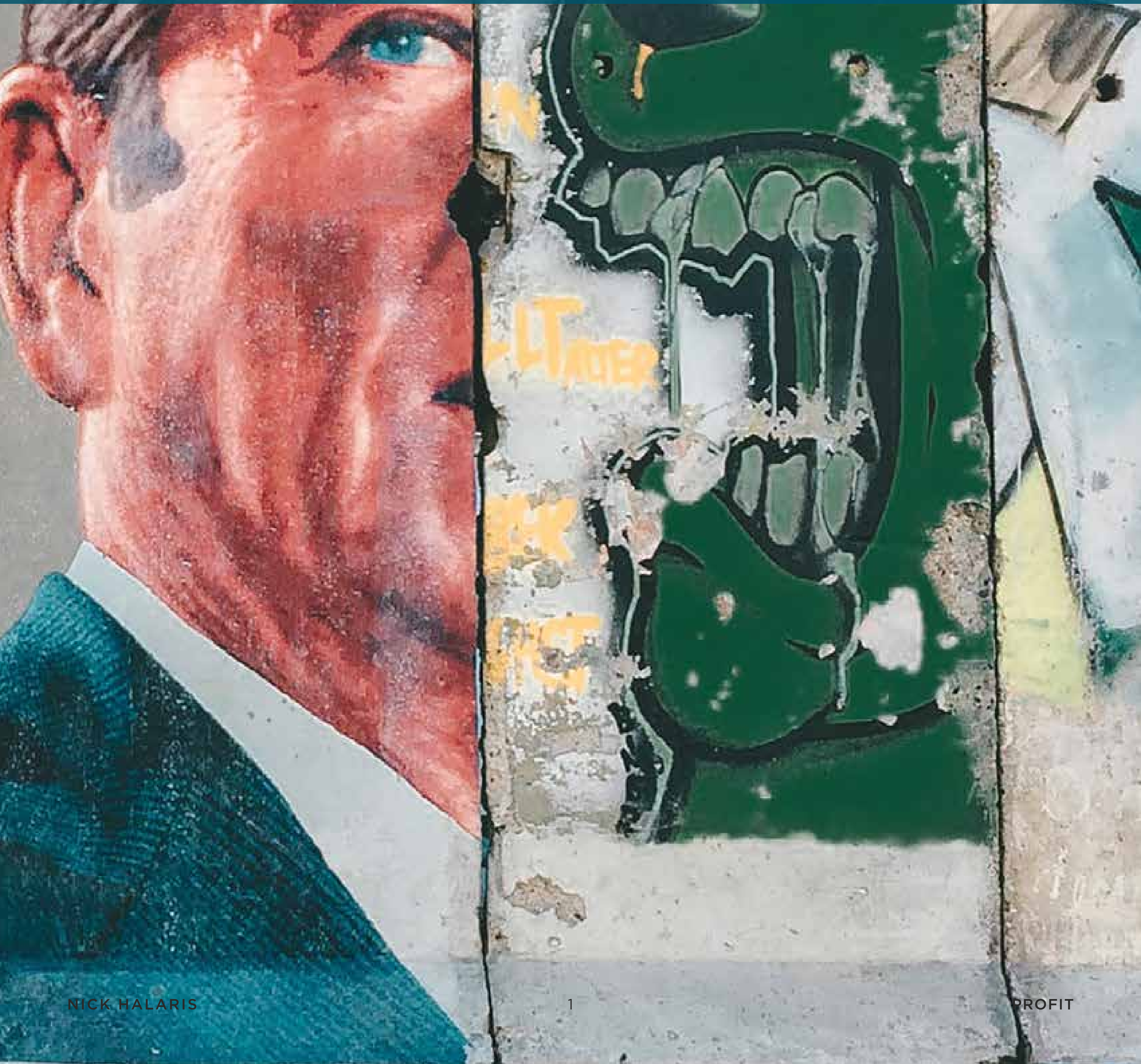
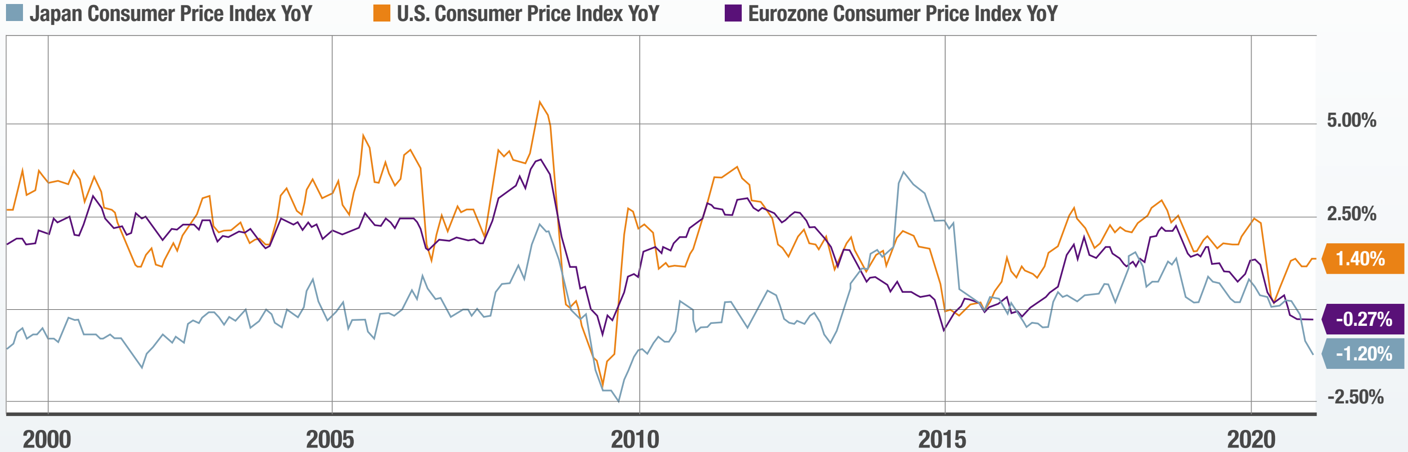
ANOTHER **INCONVENIENT** TRUTH



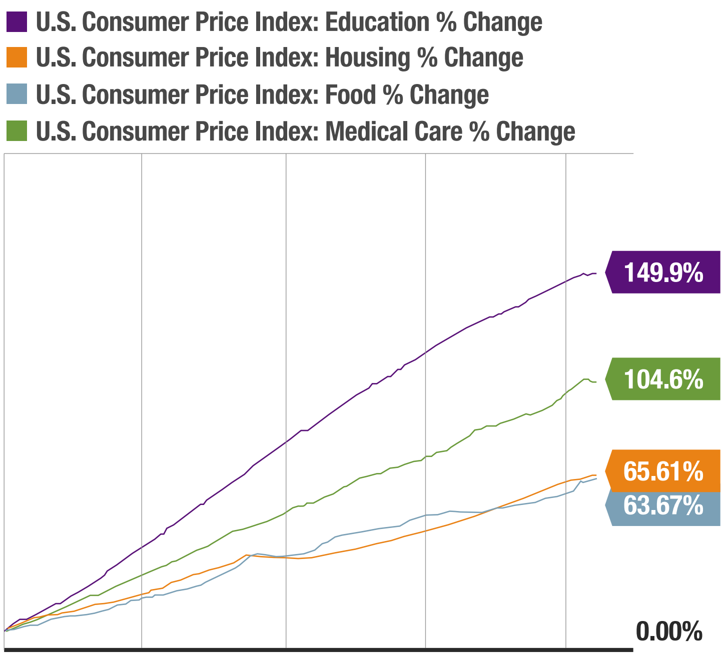
Central bankers around the world want us to believe that there is no inflation. For the past decade—ever since the onset of the era of radical Central Bank activism—they have been publishing "well" researched academic papers, appearing before legislative committees and going on television to discuss the curious phenomenon of low inflation. Their message is something like this: "Despite our unprecedented interventions in markets and our policy of extremely low interest rates (in some cases, negative), we just cannot generate enough inflation." They talk about things like the "deflationary effects of technology" and the "disinflationary impacts of ageing demographics in the developed world." And they have been really selling this narrative. So much so, that this coordinated global PR campaign has essentially worked. Meanwhile in the real world, inflation has been raging.

If you start to examine the financial experience of ordinary families over the last decade, you cannot help but question the low inflation narrative.

Is there any basis for the low inflation narrative? Central bankers around the world are using the headline consumer price index as their main source of "evidence." And by historical standards, inflation has been running quite a bit lower since the Great Financial Crisis. In the US it's been averaging slightly less than 2%, in Japan less than 1% and in Europe zero or even below zero:



So maybe there is some basis in the data for the truth of the low inflation narrative. But if you take a step back and start looking seriously at what's been happening in the real world, you will quickly realize that something isn't right. Consider for a second some of the other narratives dominating our collective political discussion—the housing affordability crisis, the health care / insurance debates and the student loan debt problem—aren't all these issues manifestations of the same thing: the problem of rapidly rising costs (in other words: inflation!)? If you start to examine the financial experience of ordinary families over the last decade, you cannot help but question the low inflation narrative. In fact from this (alternative?) vantage point, inflation seems to be raging. Interestingly, this actually even shows up in the data:



Inflation in education has been averaging 7.5% a year, medical care 5%, and housing and food about 3.25% over the past 20 years—all way higher than the less than 2% headline number. How are we in a low inflation environment? Don't these categories make up the bulk of spending for the average household? Why isn't this showing up in the headline number?

Now, I am not one for conspiracy theories but the more I look into this inflation story, I cannot help but start to question what's going-on here. From the perspective of an average American household, inflation is not only an established fact (there's no doubt here) it's a serious problem. We've been facing persistently rising prices in the areas where, as a society, we can least afford. And this has been going-on for a while, slowly, inexorably eroding away at the standard of living for ordinary Americans.

For whatever reason this inflation isn't showing up in the headline CPI number. It isn't even being discussed let alone taken seriously by central bankers and politicians around the world. And it's bizarre how it all works. Take, for example, inflation in the cost of housing. This is something I've got a lot of real world experience with and I can tell you that even the reported number from the BLS of 3.25% (over 50% higher than the headline CPI number) is a severe underestimation of the true inflation in the cost of housing. Rather than measuring housing cost inflation by looking at actual data (like Case-Shiller indices or Costar rental data), the BLS uses this strange concept of "owners equivalent rent." Believe it or not, the entire number is based on a survey of consumers that relies on two questions:

1. For homeowners: "If someone were to rent your home today, how much do you think it would rent for monthly, unfurnished and without utilities?"

2. For renters: "What is the rental charge to your [household] for this unit including any extra charges for garage and parking facilities? Do not include direct payments by local, state or federal agencies. What period of time does this cover?"

Are homeowners really equipped to answer this question intelligently? How clued into the market are they? As someone who is a fulltime, professional real estate investor, even I would have to do some serious market research and talk to some of the active brokers in the neighborhood before I could give a legitimate answer.

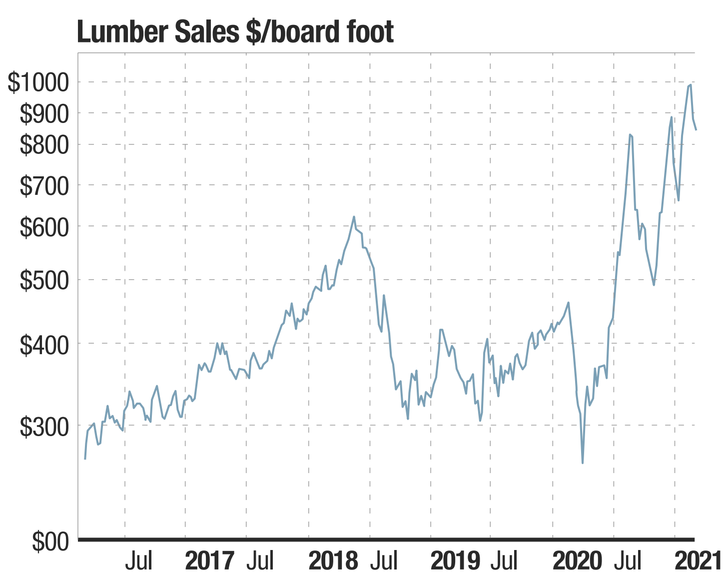
And on the rental side, I don't know what's going-on. In the past decade, in big urban centers across the country, where a huge percentage of our population resides, rents are up over 100%. I have no idea how or why the survey isn't picking this up.

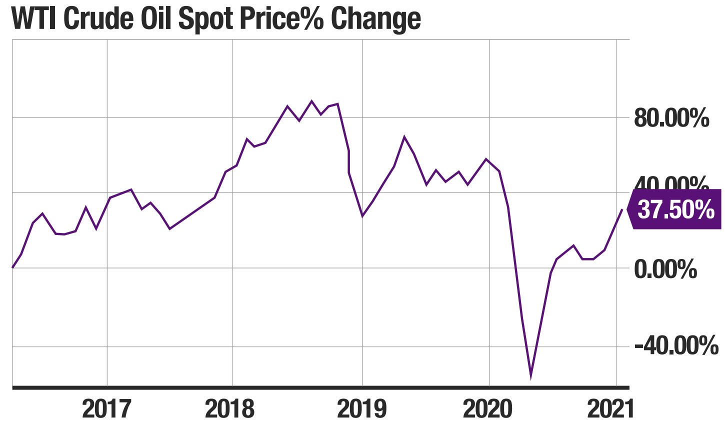
Why does this all matter anyway? As I've been thinking through the issue and trying to understand just why the Fed is inclined to ignore and contradict something that seems just so obvious, I've come to a dark place. At best, it's a severe case of collective cognitive dissonance. At worst, it's a deliberate lie. I'm inclined to believe it's more of the former than the latter. The Fed and other central banks around the world are staring in the face of an impossible policy conundrum. If inflation is real, then the policy response is clear: we have to raise interest rates. We learned this already with Volker in the 1980s. But if we raise rates, what's that going to do to our economy? And what about government deficits? We've gotten to a place where our governments are so heavily indebted that they cannot stomach higher rates. It wouldn't take much of a move in interest rates before governments would face runaway deficits just from the servicing costs of existing debt.

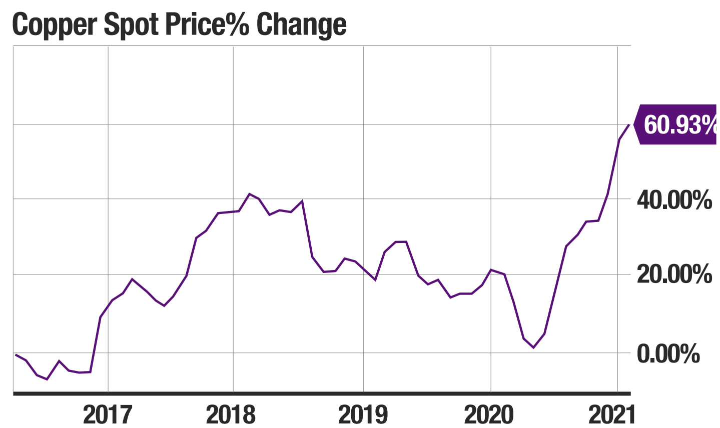
So, I empathize a bit with the central bankers and understand why they might want to let actual inflation run higher than reported. It's a very human reaction: rather than face some really hard situation in the moment, let's just ignore the truth for now and hope that in time we can get some economic growth to make up for any loss in standards of living. In all truth, this probably wasn't a bad strategy for dealing with the post GFC world but then came COVID-19. And the problem with the pandemic—well, one of the problems—is that it forced the hands of central bankers and governments around the world into even more radical interventions in the economy. They dropped rates back to zero or near-zero in most countries and did so basically all at once rather than via a series of cuts like in a usual cycle. They embarked upon quantitative easing programs at a scale and pace unlike anything in history, injecting trillions into bond-buying schemes and other market interventions. Governments have done their part too, passing massive deficit fueled relief packages that include extended unemployment benefits, large grant and loan programs and even pilot programs for Universal Basic Income. What's interesting about the situation here in America is that if you look at the various measures passed last year when Trump was President and what may pass in the early days of Biden, we're essentially implementing almost the entire policy platform of Bernie Sanders, something unthinkable in the pre-pandemic days.

What's happening today is that these radical interventions are manifesting in pro-inflationary ways. It's like all of a sudden the inflation genie is out of the bottle and the central bankers are losing control of the inflation narrative. I have to believe that the architects of these policies knew this was a risk. You cannot throw this kind of money this quickly at a market and an economy and not expect there to be some real consequences or changes in behavior.

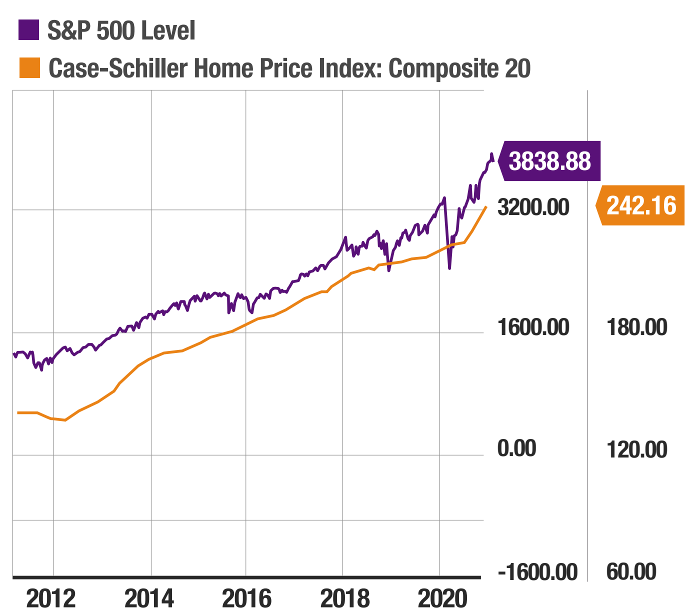
Inflation is manifesting today in places like lumber (a result of the housing boom), industrial commodities (supply chain problems due to COVID) and energy (reopening optimism):







More importantly though, it's manifesting in rising housing costs (remember housing affordability was a huge problem of the pre-pandemic world) and rising asset prices (the main driver of rising wealth inequality in the world):



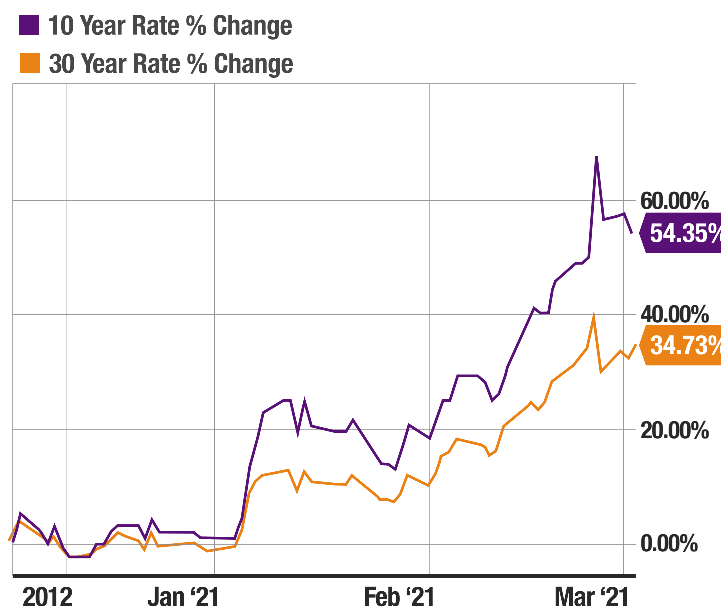
I think that the pandemic, the lockdowns and these radical policies may have done something really unexpected and very meaningful to the future of America: they have awoken lots of people to the truth about inflation. I believe what we are seeing in home prices and the stock market is a recognition that the only way to keep pace with inflation in a QE world is to own assets. I believe a bunch of Americans have finally figured this out, something that the elite have known for years. Now, I don't know if they have "figured it out" in a conscious, rational sense but definitely subconsciously. Psychologically, I think what happened is that in the early days of the COVID crisis the stock market became suddenly much more interesting to people both because of the volatility and the simple fact that many people were stuck at home with nothing to do.

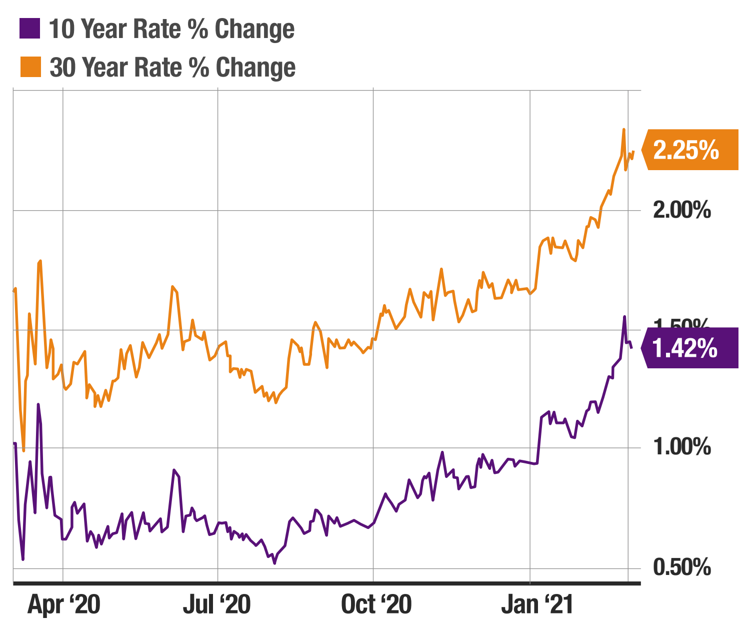
Then, something really important started to happen. Rather quickly, the policy measures started working (i.e. causing markets to go up), and new investors saw their accounts start to go up. For the first time, they experienced the magical feeling of the "wealth effect" (the original basis for the entire QE program). Despite the pandemic, rising account balances made people feel more financially secure. You started to hear things from people who lost their jobs or their ability to earn income like: "It's ok. I've been trading so I'm doing just fine," or "Yeah, I'm not really making any money right now but it's ok, I've been investing in Bitcoin." As the stories spread, more and more people started to look to asset markets. Investing in the market has become so popular that over 10M new brokerage accounts were opened in the US alone. Europe experienced something similar, even in Germany, a place where speculative activity at the retail level is much more uncommon.

Look, you could argue that maybe this whole phenomenon is really just a function of mass boredom and our propensity to gamble. But I'm convinced that something more serious is going on here. I think people are looking to asset markets as a way to offset losses in their standard of living. And it's not a crazy idea at all. In a world where every major central bank is pursuing quantitative easing, owning assets is a good idea.

But to get back to our discussion on inflation, here's the issue: the inflation narrative is something that presents a real problem for markets. It's like the one big thing that, given the state of affairs in the market and the economy and how things look with government finances, we just cannot afford to see. Just when I thought that there might be nothing to stop the narratives of exuberance in the market, a real threat has emerged. The whole rationale (or most of it anyway) for our elevated markets is based upon the belief by the market that interest rates are going to stay low for a very long time. But if you have high inflation you cannot have low rates. And if rates have to go up to deal with inflation, I know what comes next…

This is particularly dangerous at this moment in time given all these new entrants to the asset markets but also just in general. Our whole system is reliant upon asset prices—that's the consequence of the decisions we made during the last crisis. I believe that central bankers are going to aggressively try to wrest back control of the inflation narrative. They are going to downplay what we are seeing in the data and try to convince us that they are all just short-term anomalies due to COVID. They are also going to make sure the bond market doesn't move too far in the wrong direction. In the last 30-days or so, the bond market has moved quickly in the face of this inflation threat. The 10-year rate is up over 50% and the 30-year up over 30%:





Even though nominal rates still look low (the 10-year is still only around 1.5%), these are big moves for the bond market. I expect that the Fed will announce a new bond buying program to try to address this very soon.

What does this all mean for us? I think the main takeaway is that we have to remain cautious. The uncertainty introduced by the sudden emergence of the inflation narrative is probably a net positive for things gold and Bitcoin and I still like our bullish calls on housing and apartments. The entire fixed income market though is a mess and should be avoided. In fact, bonds might be the most overvalued segment of the whole market. Fixed income has been addicted to low rates and for way too long. When you start to do the math on how bonds work, scenarios where interest rates move higher produce equity-like losses in bond portfolios. It's no surprise that people like Warren Buffett have been very publicly advising investors to stay away from the bond market.

As for the equity market itself, I believe inflation is one of the few narratives that could unwind this entire bullish run. If the inflation narrative does in fact take hold, there will be short term rotational opportunities (e.g. selling out of technology winners to buy beaten down commodity and energy companies). In fact, this is already happening. Eventually though the entire market will suffer because the Fed will be finally forced into an impossible corner (of its own making). It will have to choose between maintaining its credibility or maintaining the market. You see, underpinning the market's amazing run higher over the last decade has been the implicit widely held belief that the Fed will always be there to support the market from crashing (like it did during the GFC and again in March of 2020). For better or worse, the Fed has convinced the market that it will not sit quietly in the face of a rapidly falling market. This is the dangerous consequence of pursuing a policy based on the wealth effect. Once you start you can never stop. ▫

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