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DEATH, TAXES...AND INFLATION

With inflation measures at 30 year highs, Bruce Fraser, Managing Partner of Elkhorn Capital, shares his views on the current fiscal climate, asset class selection and why history is bound to repeat itself.

DEATH, TAXES . . . and INFLATION

"Riches do not exhilarate us so much with their possession as they torment us with their loss."

-- Epicurus 342-270BC

A lot is being written right now about inflation. To be clear, I am not just some 'social media influencer' reposting talking points that you have seen a hundred times. Instead, I have taken the time to put together some facts and a brief monetary history which will allow you to discern what is happening on your own and not be dependent on headlines.

Why should you listen to me? I ran a successful hedge fund for over a decade during some of the most tumultuous periods of recent history, including the great financial crisis of 2008/2009. During this time, I executed our strategy and risk management exactly how I told investors I would, resulting in our investors being at their all-time highs during the troughs of the crisis while many other portfolio managers had lost 50%-60%. This was accomplished by being thoughtful about the data I was seeing and discerning probable outcomes.

It is important to note that based upon my analysis, I also sold all of my investment real estate in 2007 . . . all of it. It is safe to say that I understand business cycles and dig for what is really happening in the world, my views are not simply formed by ingesting the official narrative. If you have been investing for a while, you may recall Fed Chair Ben Bernanke claiming the housing crisis was 'contained' . . . it didn't quite turn out that way, did it? If you invested based upon that official guidance, you lost a lot of money. The definition of insanity is 'doing the same thing over and over, yet expecting a different result' . . so why would you look to the Fed or mass market financial press for guidance? Let's instead look at the data and think for ourselves.

Cognitive dissonance is the belief that everything is fine and will continue to be fine in light of conflicting information or evidence – i.e. people assume things will stay as they are currently. What many do not know is that our current currency situation is an anomaly in history, not the norm. Assuming things will continue as they are is actually irrational in this context.

All currencies that exist today are 'fiat currencies'. A fiat currency is a monetary exchange that is backed by 'the full faith and credit' of the issuing country's government – for whatever that is worth – and nothing else. The only thing that gives it value is the willingness of others to accept it as payment, otherwise it's just a piece of paper.

If we take a look at history, there have been many fiat currencies to reference as examples. A study of 775 fiat currencies shows there is no historical precedence for any fiat currency that has succeeded in holding its value over time. None. . . not even one throughout all of history. Let that sink in . . .so, is it reasonable to assume US dollars will act as a store of value or should we expect dollars to consistently lose purchasing power? Wouldn't it actually meet the definition of insanity to not expect inflation, knowing that outcome is virtually certain?

Some studies find that the average life expectancy for a fiat currency is forty years. Even if we adjust this average for some biases in the study, it is clear that the average fiat currency completely fails within the span of one generation. The British pound Sterling is the oldest fiat currency in existence. Being 318 years old, it is often highlighted as an example of a highly successful fiat currency. Success is relative. The British pound was originally defined as twelve ounces of silver. It is now worth less than 0.5% of its original value. In other words, the most successful long-standing currency in existence has lost 99.5% of its value. No fiat currency has lasted forever. Eventually, they all fail. Those of you with cognitive dissonance might say – 'those things happen to other countries,' assuming currency failure has only happened to third-world countries. Actually, looking at the historical facts, there was no discrimination as to the size or perceived stability of a nation's economy; the common characteristic is that the leaders abused their currency and the country ultimately paid the price. So, that begs the

question, “Has our government abused the currency by issuing too much debt and/or debasing the currency through inflation?”

The quick answer can be found by simply glancing at the attached graph of the US national debt from 1900-2021. Not only is the magnitude of debt truly stunning, the rate of increase is actually accelerating – in spite of the all the talk by politicians about budgets and the Fed’s constant rambling about ‘tapering.’ Don’t listen to the words, look to the actions to see the reality. The reality is that the US government has abused the dollar on a scale that has never before been seen in history – by any country. Looking at this graph, wouldn’t a reasonable person expect ongoing currency debasement and resultant inflation?

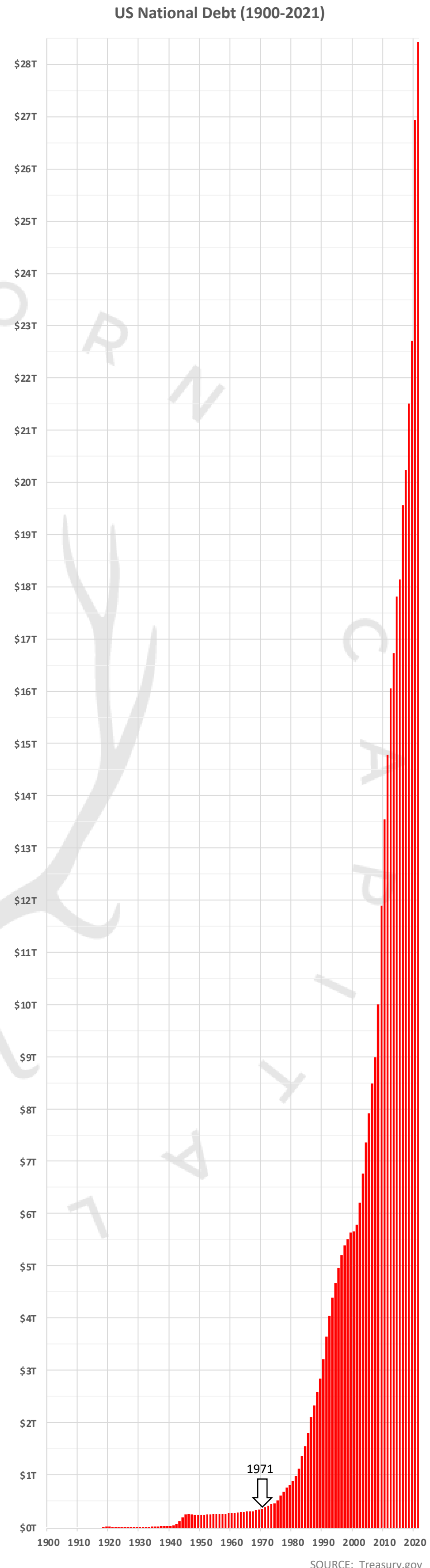
There are some important historical milestones that gives us background on answering the big question of ‘How did we get here?’:

<u>Bretton Woods</u>
Preparing to rebuild the international economic system from the impact of WWII, this was the first example of a fully negotiated order intended to govern monetary relations among independent countries. The United States, which at the time controlled two-thirds of the world's gold, insisted that the Bretton Woods system rest on both gold and the US dollar. Under the Bretton Woods System, gold was the basis for the U.S. dollar and other currencies were pegged to the U.S. dollar’s value. This agreement helped to establish the US Dollar as the primary world reserve currency, thus creating significant demand for dollars. The IMF and World Bank were also created with this agreement.

<u>Petro Dollar</u>
The origins of the petrodollar system go back to the Bretton Woods Agreement, which replaced gold with the U.S. dollar as the world reserve currency, since it was backed by gold. That led to the creation of the petrodollar system, where the U.S. and Saudi Arabia agreed to set oil prices in U.S. dollars. That meant any other country that purchased oil from the Saudi government would have to exchange its currency into U.S. dollars before completing the sale. That led the remaining OPEC countries to follow suit and price their oil in U.S. currency. The petrodollar greatly helped to elevate the U.S. dollar's standing in the financial markets, as the price of the most important commodity in the world, oil, was linked to the dollar. With the decline in the purchasing power of the greenback, some nations have started to abandon the petrodollar system. China, Iran, Russia, and India have already shifted the base value of their exports into their own currency rather than the U.S. dollar. This has caused a significant reduction in demand for US dollars.

<u>1971</u>
The United States unilaterally terminated convertibility of the US dollar to gold, effectively bringing the Bretton Woods system to an end and rendering the dollar a fiat currency. Note how of the elimination of this monetary control (being tied to gold) on the government’s ability to issue monumental amounts of debt affected debt issuance levels.

<u>Basel 3</u>
Allows gold to be held / counted toward reserve requirements. This offers a more stable value alternative than the US dollar. It is likely this will increase demand for physical gold and reduce the demand for US dollars.



The US dollar's status as the dominant global reserve currency, as formulated under Bretton Woods, was a crucial enabler for the US government to keep ballooning its public debt. In spite of printing more and more dollars, global trade established under these agreements forced demand for dollars. Since the beginning of the COVID pandemic, we have witnessed the greatest monetary binge in world history. When the value of money is tied to nothing, 'more money' is always a tempting solution for those in power in order to placate voters. It is not that these endeavors and causes are not 'good causes' or well intentioned, it is just that our country can simply not afford them. Through the first six months of fiscal 2021, the US government ran a record $1.7 trillion budget deficit (for those six months alone) - there seems to be no end in sight to the borrowing and spending. The US debt currently stands at a staggering $28.5 trillion – prior to the additional $5-6 trillion in 'social infrastructure' being proposed.

As shocking as these numbers are, this is 'only' the money that the government has explicitly borrowed. It doesn't include any measure of 'unfunded liabilities' - money the government does not have, but nonetheless promised to pay. To be clear, any corporation would be required to list these obligations as debt. But, due to governmental accounting magic, they are allowed to exclude them from their official debt numbers. When you include unfunded liabilities (such as Social Security and Medicare), the actual US debt stands at $123.11 trillion! The federal government has $5.95 trillion in assets and $129.06 trillion in total liabilities. To put this into proper scale, the entire annual income of the US government is only about $3.5 trillion. If it were a private company, the US government would have been considered insolvent long ago. So, how does the US get out of this mess created by continually spending beyond its means?

Simple Realism—Inflation is a Planned Necessity Rather than actual Debate

Even if the US had the strongest growth period in our nation's history, there would not be sufficient money to pay back this extraordinary level of debt. Thus, central bankers are desperate to reach higher inflation to inflate their way out of debt (they pay back the debt with future dollars that are worth less) without admitting the problem.

This is nothing new for policy makers who once 'targeted' 2% inflation as a ceiling, but are now effectively 'allowing' 2% inflation as the new floor. As an aside, a 2% inflation target is nonsense since it doubles prices over 36 years. Just as Nixon said the closing of the gold window was 'transitory' in 1971, or as Bernanke promised that QE would be transitory in 2009, the current lie that 'inflation is transitory' is no less a lie than those other lies were in 1971 or 2009.

Not Many Options Other than Inflation

In this realistic light, let's consider their options. Policy makers have four tools to address the unwieldy debt: raise taxes, cut spending, declare bankruptcy, or devalue the currency through inflation. There are incessant political efforts to raise taxes and beleaguered 'talk' of cutting spending, both are politically difficult options. Taking bankruptcy off the table, this leaves devaluing the U.S. Dollar as the favored option, which is achieved by deliberately taking real interest rates (real rates = current interest rate less inflation rate) to extreme negative levels. Allowing inflation to run while keeping rates low reduces the number of dollars needed to repay the debt. In other words, by decreasing the value of the U.S. Dollar, the U.S. is effectively paying off its current debt with devalued money. There are no permission slips needed from Congress, nor taxpayers (voters).

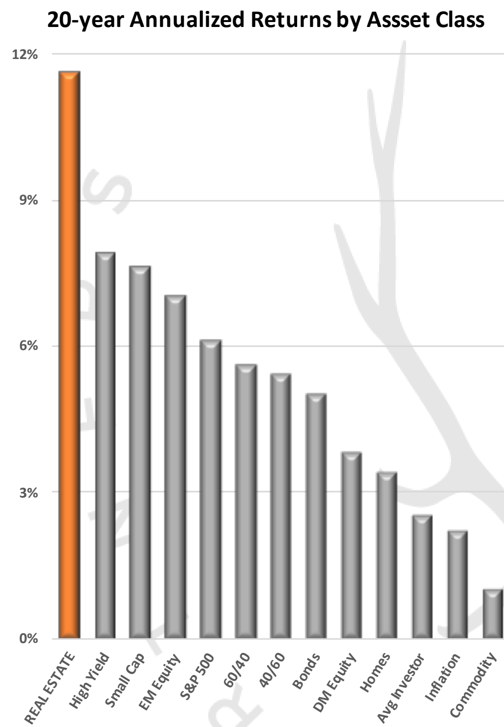
Within this context, let me be clear: inflation is not, nor will it be, 'transitory.' Instead, institutionalized policy-driven inflation is an inherently and deliberately necessary tool used by the same 'leaders' who saddled us with this debt burden.

While we see the Fed perhaps raising rates nominally in an attempt to 'talk down' / prevent much higher inflation, when adjusted by deliberate but denied inflation, 'real rates' (interest rate minus inflation rate) will fall further negative as inflation rises higher. Based upon the government's own numbers, we have been experiencing an annualized rate of inflation that is in the double digits already.

What's the good news?
So, that's the bad news . . .the *good* news is that there are some tried and true ways to protect the purchasing power of your hard-earned dollars.

How do you protect yourself from what we know is happening?
Investors would do well to consider the long-term effects of rising inflation on their portfolios. Both cash and fixed income instruments are typically negatively affected by inflation, as prolonged increases in the price of goods and services ultimately erode the value of consumers' purchasing power. Equities can also be volatile throughout inflationary periods, as the rising cost of materials and wages may negatively impact profit margins.

Real assets - and real estate in particular - maintain their value or potentially see value increase during inflationary environments. Commercial real estate owners have the ability to seek increased rents on shorter-duration contracts, such as residential leases that are typically one or two years in duration. Longer-term leases typically have escalation clauses that increase lease rates over time, which help preserve owners' purchasing power against inflationary trends. Real estate owners are able to directly pass expenses through to their tenants, potentially limiting the negative impact of rising costs. Inflation also helps owners that finance with long—term fixed rate debt.



An historical study by Fama and Schwert demonstrated that a 1% increase in the rate of inflation caused bond prices to drop by 1.54% and stock prices by 4.23%. In contrast, inflation may have a positive impact on real assets. **The <u>only asset class</u> Fama and Schwert tracked in their study <u>that was positively affected by inflation was real estate.</u>**

Historically, equity and bond markets tend to be ineffective hedges against rising inflation—for different reasons. As inflation rises, unless companies are able to pass all of their cost increases through to consumers, they will see their profit margins shrink - this can cause the value of their stock to go down. The risk to bonds, however, in a rising inflation environment is driven more by the specter of rising interest rates. As inflation picks up steam and gets ahead of Fed target rates, the market expects the Fed to increase those rates in order to slow down the economy. As rates move up, the price of bonds issued in lower-rate environments come down. Bonds that pay a fixed coupon also expose investors to the negative impact of inflation through the diminished value of fixed payments. Bond prices, therefore, are inversely correlated to interest rates.

Commercial real estate, however, has historically proven to be an attractive hedge against inflation. It holds intrinsic value, is available in limited supply, offers owners the ability to increase rents in response to rising inflation, and may also be shielded from inflation-driven cost increases. Additionally, higher inflation typically occurs during times of economic growth. During such periods, property owners are generally able to find tenants more easily and may be able to increase rents commensurate with the rate of inflation.

Blackrock CEO Larry Fink (who actually manages more assets than the Fed) countered soothing talk that soaring prices are transitory, and said that investors may be underestimating the potential for an extended spike in inflation. "Most have only seen declining inflation over the last 30-plus years. So, this is going to be a pretty big

shock", Fink said. Fink began his career in 1976, during runaway US inflation. **Guess where Blackrock is voraciously allocating investment capital . . . rental housing . . . by the billions.**
There are two critically important concepts to understand when determining how to position to protect your hard-earned money – they also have significant impact on real estate values; 1) 'nominal rate' vs 'real rates', and 2) 'cap rate spread.'

Nominal rates are simply the interest rates quoted on CNBC or in the WSJ - for example the 10-yr Treasury is approximately 1.5% right now. So, 1.5% is the *nominal* rate. The 'real rate' simply takes the nominal rate and deducts the inflation rate. Irrespective of which inflation rate you choose to use, it is clear that real rates are actually negative by nearly double digits. Therefore, in spite of all the discussion about low (nominal) rates, *real* rates being sharply negative stands to drive property values much higher.

The second critical factor to understand is the cap rate spread. This is defined as the difference between the interest rate on the 10-year treasury and the cap rate on a property. In spite of recent cap rate compression, when valuations are viewed in context of the cap rate spread versus the decline in interest rates, we get a picture that is different than what many pundits declare – in fact, many markets are no more expensive on this basis than they were years ago. When interest rates are low, then cap rates *should* be low. Now that you understand that real rates are actually negative, then you can see that cap rates have a lot of room to go lower (driving higher valuations) in many markets.

Conclusion
The value of money, of course, has no intrinsic value. Money's value is based on the amount of goods and services it allows you to purchase. What happens to the value of money when a government prints lots of it - to spend or to simply hand out to people - is that the money becomes less valuable because there is more money per unit of things to buy with it. The expectation that this trend will continue then triggers a continuous process of increasing prices, called inflation, while the resulting expectation that the rate of inflation will continue to increase can trigger hyperinflation.

Instead of calls for prudence and responsibility, we have cries for major expansions of social programs and unprecedented discretionary handouts like student debt relief and the "Green New Deal." These actions are going to unleash an inflationary storm and the Fed is not going to do anything to stop it. In fact, the Fed has already stated explicitly that it has no plans to raise rates or taper its QE program until 2023! Which means, inflation will likely rage out of control for years. There will be frequent discussion about the 'inflation rate being down' when the rate of price increase slows for periods. But, again thinking about the data, even lower rates of inflation in the future will still be compounding on top of the already accelerated levels. Growing at a reduced rate does nothing to revert prices.

After reviewing the historical precedence of fiat currencies, the policy makers' options, and the graph showing the ballooning US debt, does anyone honestly believe inflation will be transitory? Ironically, even the Fed doesn't believe it - their updated economic projections have revised their own 2022 inflation forecast notably higher. The Fed has suggested that they might start raising interest rates in 2023 – over a year away. Reviewing the Fed meeting notes, only half of the voting members even think that's a good idea. Again, pay attention to actions, not public narrative.

They say two things are certain - death and taxes. The saying should be revised to death, taxes, and currency debasement (inflation). It doesn't roll of the tongue quite as fluidly, but inflation caused by currency debasement due to governmental profligate spending is just as certain.

In the recent words of Michael Burry (billionaire investor profiled in 'The Big Short') related to inflation, "you have been warned."

Position accordingly.

Thoughts from some of the most influential financial minds & successful investors in the world:

“Risks to inflation are to the upside . . .inflation is half of our mandate”
Chairman Powell, speech July 31, 2021

“ . . .the producer price index presents ‘cooked numbers.’ The real inflation rate is more like 12%--almost double what’s been reported. What this means is that any cash you stash away in a bank account will lose up to 12% annually. There is no reason to store money in any place where it will lose value, gradually at first, and rapidly in the near future as inflation accelerates.”
Kyle Bass, June 2021

“you want to own productive real estate. . .I’d rather own hard assets than equities today because I think we’re only seeing just the beginning. . .”
Kyle Bass, June 2021

“I would say that my overriding theme is inflation relative to what the policy makers think.”
Stanley Druckenmiller, February 2021

““If they (Fed) say, ‘We’re on path, things are good,’ then I would just go all in on the inflation trades. The idea that inflation is transitory, to me ... that one just doesn’t work the way I see the world . . . the central bank’s inflation views put its credibility at risk.”
Paul Tudor Jones, June 2021

“There's a perception in the market that this inflation is transitory. Investors bought the Fed line that it's just temporary due to the restart of the economy and it's eventually gonna subside. Our viewpoint is the markets are currently too complacent regarding inflation. We have inflation coming well in excess of what the current expectations are.”
John Paulson (of The Big Short fame), August 2021

“History books will not say that inflation was transitory. Transitory will be continually redefined to be a longer time period. We are looking at a roadmap that is clearly headed towards the US dollar losing its sole reserve currency status.”
Jeffrey Gundlach, September 2021

“People say I didn't warn last time. I did, but no one listened. So, I warn this time (about inflation and risk of hyperinflation). And still, no one listens. But I will have proof I warned.”
Michael Bury, March 2021

"Data from multiple sources point to these (inflated price pressures) lasting longer than most initially thought. By this definition, then, the forces are not transitory."
Raphael Bostic (Atlanta Fed President), October 2021

“I think this is the least responsible macroeconomic policies we’ve had in the last 40 years.”
Larry Summers (former Fed Chairman), 2021

“Hyperinflation is going to change everything. It’s happening. It will happen in the U.S. soon, and so the world.”
Jack Dorsey (co-founder & CEO, Twitter), October 2021