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The Plan:

... Five-Year Plans and New Deals, wrapped in golden chains
And I wonder, still I wonder, who'll stop the rain

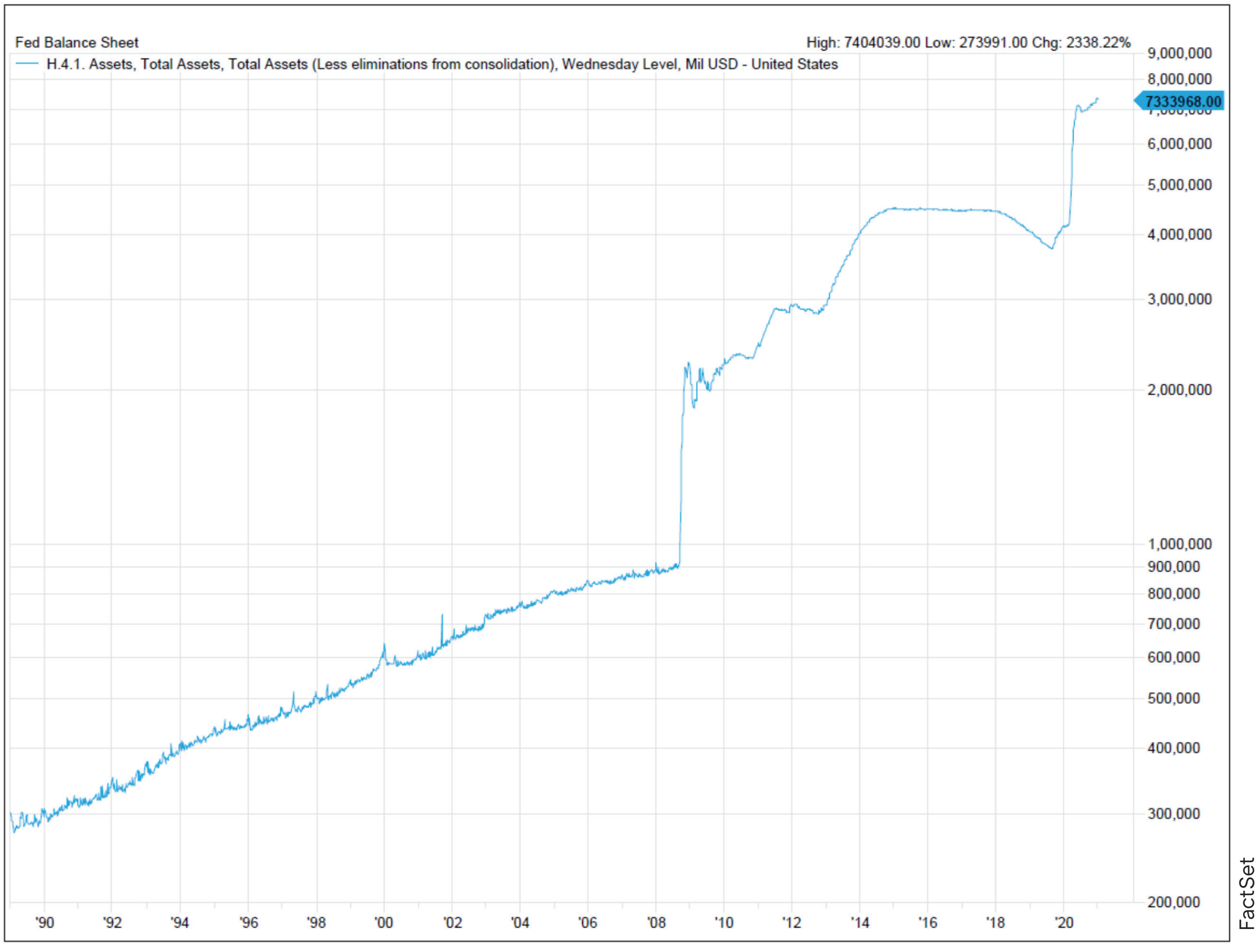
Creedence Clearwater Revival - July 25, 1970

The "Plan" seemed so simple. The fear was deflation. The fear was an economy grinding to a halt due to COVID. The *plan* was to fight that terrible deflation with its polar-opposite, *inflation*. The plan was to simply print so much money (measured in trillions), that the economy would have no *choice* but to rebound strongly. Prices would have no choice but to rise. This time, the government would skip the old and slow method of injecting capital into the banking system, where it would *eventually* find its way to the consumer. This time they would go with a direct infusion to the consumer! Just create some money out of thin air and then send it straight to the people.

Simple.

But wait a minute! Can money just be created out of thin air? Yes and no.

You can create more money by simply increasing its supply. Well... YOU can't... but the Federal Reserve (the Fed) can. And they did... a lot! The chart on the next page shows the increasing balance sheet of the Fed over the last 20 years. The blue line shows the creation of money by the Fed. The graph is in millions, and since a million millions make a trillion, it shows the latest spike up of about 3 trillion new dollars being created. (The previous spike, in 2008, by the way, was to stop the Great Recession from becoming another Great Depression.)



So, the government *can* create money merely by decree (**fiat** currency). But technically they are, in effect, just sucking the value out of the existing money that people already own. The Fed is taking the value out of the money that the populous has worked for and saved. Then they are *returning* that value to just some individuals, some families, and some businesses, but not all. That's sort of what the government has done for the last century if we are being honest - it's just that over the last year or so they have kicked it into a much higher gear.

Think of it this way - if the government decided to give everybody 10 *times* the amount of money that they currently have - no one would really be any richer. The prices of everything would also go up tenfold. It would be a wash. Why do this then? The common thought is that a little bit of inflation helps people "decide" to spend money rather than just hoarding it. *Better buy something now before the value of my money decreases.* And buying stuff pushes up economic activity – which is their objective. This kind of thinking is probably true to some degree, although it can be argued that there would be other benefits accrued to a country that kept its currency stable. Alas, we will never know because there is not a government in existence today that has any inclination of pursuing a sound fiscal policy, let alone a sound monetary policy.

Sometimes gain comes from losing,
and sometimes loss comes from gaining.

-Lao Tzu

(Lao Tzu sculpture at the foot of Mount Qingyuan, China)

So, in reality, we would not expect all this money printing to make us any wealthier as a collective, but merely to devalue the money itself. You can see this effect when you fill up your newly more expensive car with newly more expensive gas, in order to drive to the store to buy newly more expensive food. I'm sure even the prices of the hypothetical widgets, from our high school economics class, have risen dramatically over the past year!

So, like we said in our last update six months ago, we would expect to see *higher prices, lower quality goods,* and *shortages* due to the excess money printing. We have. We also expected to see a lot of gambling in the markets. And have we ever?! There have been many, many examples of the stock prices of otherwise unremarkable companies rising tremendously over the last 12 months. But what goes up...

Many of these speculative rocket-launch type stocks have been unceremoniously brought back to earth in the past few weeks by quick and dramatic drops of 40, 50, or even 75%. Many still are up in the stratosphere.

It's always fun when one of our holdings gets caught up in a feeding frenzy. If and when the "herd" starts running up one of our stock positions, way beyond its true value, it's up to us to quickly say thank you and sell. It helps that we've seen this story unfold many times over the years. I've personally witnessed the 1991 speculative craze in the biotechnology stocks which rose 3, 4, and even 10-fold in a year or less. However, if you waited even a few weeks to admire your newly found wealth, you'd find it had evaporated quicker than it had formed. The same thing happened again with the "dot.com" stocks in 1999. Most of you remember that story.

Almost every year there is some kind of crazy buying stampede into something or another. Pamplona has nothing on Wall Street for the annual running of the bulls. I would wager however, that Pamplona is a lot safer!

New Stock Market Highs...Ya Think?

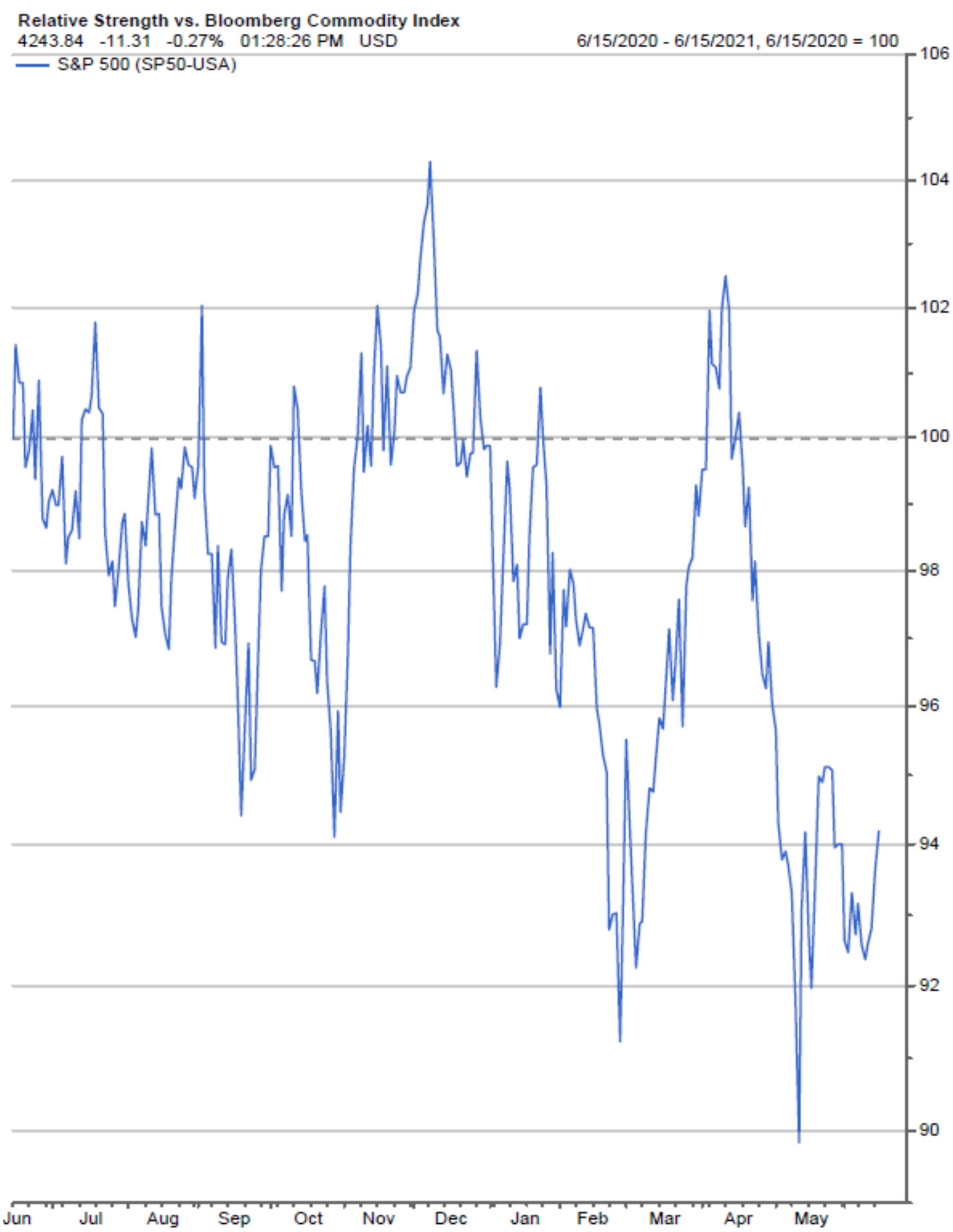
So the stock market is on a tear and we find ourselves in the midst of a strong bull market. Investment accounts across the country are rising nicely in 2021, notwithstanding a few speed bumps along the way. Few things other than bonds are down year-to-date. Investors are wealthier than last year. Or so it appears. But appearances can be deceiving. The markets are only up if your profit calculation uses a denominator of small green paper rectangles i.e. if you are measuring wealth in terms of dollars. What if, instead, we look at the stock market gains based on something more tangible like food or maybe a basket of goods - something *real*.

In feudal Japan, wealth was measured in koku of rice, a year's supply for one person. Workers, bureaucrats, and samurai alike all received payment in the form of the country's most important commodity. This practice survived in a few rural areas all the way up to World War II.

I got to thinking, what if we measured the recent stock market move against something tangible? If not rice, then perhaps the proverbial "basket of goods" – let's say the commodity index. After all, the purpose of investing is to accumulate more buying power. It doesn't really matter if you have a lot of money if that money doesn't buy anything. And yes, this IS the kind of thing financial geeks like us think about for amusement… so exciting!

What we see in the chart to the right is a far cry from the exciting bull market we thought we were

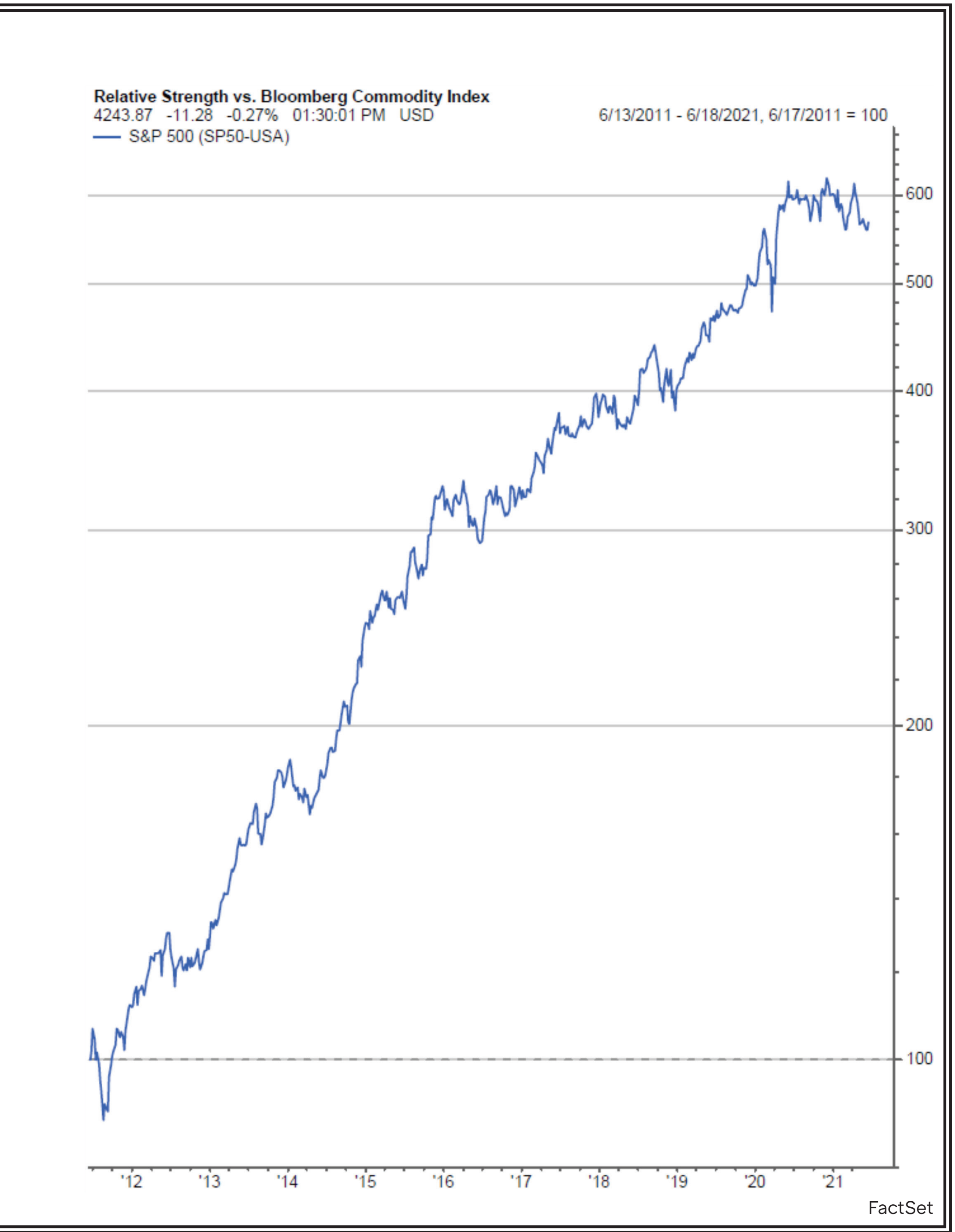
The stock market priced relative to commodities (6/15/2020 – 6/18/2021)



FactSet

witnessing. The move, when seen in this light, is much to do about nothing. We are gaining no *real* ground. It may look good to our dollar-counting eyes, but it sure doesn't feel good to our reality-weighing wallets.

Relative to purchasing power, we have actually lost about 6% in real terms over the course of the last year (through mid-June). That doesn't necessarily mean that stock investing didn't work. Had we left our money in cash, we would have lost a lot more purchasing power.



If we run the same exercise for the past 10 years we see a very different picture.

Wow is all one can say.

Relative to things that we must buy like gas, food, and utilities, the stock market gained nearly six TIMES one's original spending power! That's about double the price move of the stock market in dollars (the way we usually look at it). This is what happens when the stock market goes **up** and commodity prices **decline** - you can buy much more "stuff."

Notice the recent downtick in the trend of this chart and you will see why some investors are thinking that perhaps enough is enough. Perhaps a reversal is in order. We might be entering a period where stocks do *worse* than commodities; a period of inflation.

New Kid in Town:

There's talk on the street it sounds so familiar
Great expectations everybody's watching you
The people you meet they all seem to know you
Even your old friends treat you like you're something new
Johnny come lately
The new kid in town

The Eagles - 1976

There *is* a new "kid" in town that all the investment community seems to be talking about:

Inflation

Even long-time commodity investors (old friends), as beat-up and bloodied as they have become over the past decade, are treating the recent uptrend as "something new." Something bigger. A *supercycle* as some are calling it. The expectations are great to say the least. Many of the most respected names in the investment world have been warning that the time may have finally arrived for a massive changing of the guard. Names such as Paul Tudor Jones, Ray Dalio, and Michael Burry have all been very worried about the next decade. They think that there is a good chance that inflation comes roaring back. Not since the days of Jimmy Carter has the U.S. had to worry about such a condition. Yet, it's quite difficult for the average investor to be bothered by warnings about some unfamiliar bogeyman from yesteryear.

The head of JPMorgan, Jamie Dimon, recently commented that "I think you have a very good chance inflation will be more than transitory." [1] "Transitory" is the new buzzword that Fed Chairman Jay Powell has been using regarding inflation. Don't worry, it won't last. That's the government's messaging.

But inflation and its major ramification – rising commodity prices – is the big topic of the day and will be an extremely important subject for investors to grapple with over the next few years. It could potentially be the *most* important subject that we will need to consider. After all, it would change everything. Up would become down. What worked in the past decade would un-work. Bonds would go down, commodities would go up, value stocks and energy plays could take the baton away from the darling technology stocks. Simply put – it would upset the applecart.

We wrote about this over a year ago when we made our once-a-decade prediction of what the "big mistake" would be for the next ten years. We said that ***paper money*** would be that mistake, which is the same thing as saying that prices and inflation would be on the rise. In the last six months there seems to be countless Johnny-come-latelies worried about the same thing. Of course, that just makes us think that it may be time for a breather – a pause in the move. We have made many anti-dollar trades in client portfolios over the past 18 months (think: commodities, inflation protected bonds, and select foreign currencies) but we have taken some profits recently. The trade is "crowded" all of a sudden. Don't get us wrong, however, long-term we still believe in the thesis.

Corroborating evidence and anecdotes:

As food prices rise, we are starting to notice pass-through price increases at certain restaurants. That's natural. What is abnormal however, was the online post that we saw a few weeks ago from one of our favorite eating establishments stating something to the effect that "Sorry, but we are closing for Saturday night service because we cannot find enough employees to work and we are all exhausted." The ongoing free-money experiment is starting to have some negative consequences and it will be important to see how long the effect lasts in the labor market.

There are many national anecdotes as well, including American Airlines' recent cancellation of hundreds of flights due to a "staffing crunch." [2] One could argue that our country's laborers are long overdue for a pay raise, but be that as it may, the inflation implications will be felt in every consumer's budget. Additionally, on the supply side, the tremendous global push towards green energy is making it much less desirable for traditional energy companies to invest in oil and gas exploration, pipelines, or refinery projects. That decrease in potential output is having a dramatic effect on the price of oil (lower supply plus increasing demand equals higher prices). Crude has risen to over $70 per barrel from basically less-than-free during the heart of the COVID crisis, when demand was ostensibly shut off. Back then, there was no room left to store any of the additional production and sellers were paying buyers to take delivery. Times have changed.

Also consider that the electrification of the world's auto fleet is going to take a lot of copper (at least with the current state of technology). But starting a new copper mine is on the green no-no list. Once again, if you increase demand for something at the same time you are decreasing the supply, economics 101 will tell you that it's double pressure on the price. If you weren't paying attention in your high school economics class, that pressure, in this example, is in the **upwards** direction.

So inflation is already on the march, but investors can be a fickle lot. One day they're clamoring to buy a certain asset class, and then the next day they are rushing to sell. They are a fair-weather sort. To lift one last line from our highlighted Eagles' song:

They will never forget you till somebody new comes along.

So today it's all about inflation, but tomorrow, investors could revert, change their minds, and move on to some different theme. We always maintain a healthy skepticism about any so-called trend - even a trend in which we strongly believe. The frustrating thing about the current macroeconomic landscape is that there are plenty of arguments for the very opposite of inflation – deflation! And deflation (falling prices and usually an economic downdraft) would bring about a very different set of investment winners and losers.

> *Contradictions do not exist. Whenever you think you are facing a contradiction, check your premises. You will find that one of them is wrong.*
>
> **Ayn Rand**

On May 14th, I listened to a very interesting YouTube video from Stansberry Research on the inflation/deflation debate. The interview was with a retired investment manager named Rick Rule.[3] I thought that his summation of the issue was about as good of an argument as I have heard. When asked whether the future holds inflation or deflation, Rule said:

[There are] lots of arguments for both. The overall economy I think is deflationary. We have too much debt, and the way that you normally solve a circumstance where you have too much debt is a default cycle. And defaults are very deflationary. If you take a bunch of money that was lent to somebody, saved by somebody else, and that money goes to money-heaven… [laughs]… it's deflationary.

…we have built up a debt which is a bunch of things. It's a transfer of wealth to old fat guys like me who voted themselves a bunch of services, from young people like you, who want to expect those services in the future. We have also built up a debt that is truly unserviceable. It has to be rolled over. That, on the face of it, is extremely deflationary. But you could have a different kind of default - the kind of default we had in the 70s, where you inflate away the value of the medium that the debt is denominated in. In other words, if you've promised somebody $100,000 you inflate away the purchasing power of that $100,000 down to $20,000 or $30,000 and make that debt more manageable.

We think that Mr. Rule is probably correct. It seems very unlikely to me, with the way the government is currently constituted, that they would ever default on their debts the old fashioned way. They have no need to! They control the printing press. All the bureaucrats need to do is print their problems away. It's the least awful thing on the "awful choices list" that they have available. And that is why we think paper money has got some major problems ahead of it in the next decade. During the Carter years, which was the last time we had a truly major problem with inflation, bonds did not do well, stocks did not do well, and cash did especially poor. The winners of that era were commodities and gold. Those may be the same winners this time around. At a minimum, all investors should be exploring those investments. We should all be considering whether the typical 60/40 stock to bond ratio of the last 40 years will be adequate in the possibly changing environment.

New to the asset allocation scene are the cryptocurrencies, the leader of the pack being Bitcoin. If you thought that the commodities allocation debate was contentious, you ain't seen nothin' yet. For the last few years there had been plenty of Bitcoin skeptics trying to debunk the prognostications of the "true believers." Our opinion is that the technology is quite real, and some of the crypto-coins solve real-world problems. But like any other new technology, there are many new and unique risks that come with the new and unique territory. Even if everything that the Bitcoin evangelists are forecasting comes to pass, there can still be massive price swings. Remember the dot.com craze in 1999? The internet was *indeed* world changing, but that did not stop the NASDAQ index from crashing 80%. It was almost two decades before investors got their money back from those high prices. We can, however, imagine a future where most investors (including ourselves) will have some of their assets allocated to cryptocurrency. We will tackle that subject matter in a future update. In short, the risks are high, but the goal of the Bitcoin community is commendable: Establish a decentralized new currency - one that cannot be printed willy-nilly nor controlled by any one country. One that is safely encrypted and has a finite supply such that savers are protected from those that would steal their money either through theft or dilutive "printing." OK that's also theft!

Counterpoints to The Inflation Forecast:

If we have learned one thing over the past 53 years in the investment business, it is that macroeconomic forecasts must be attempted with caution. Investors must be humble and flexible. There is a high probability that many of your forecasts will be wrong. The trick is to structure your investments in such a way that even if the forecast is imperfect you still have a decent probability of making money. One of the methods that we use to help make that possible is to buy companies that generate growing cash flow. That way, overtime, it might not matter too much if your macro-economic forecasts are correct or not. The companies in your portfolio are each run by intelligent human beings, all trying their best to grow the companies' businesses. In a sense you are tying your fortune to the best ingenuity humanity has to offer. And that has been a *very* good bet over the ages. Commodities on the other hand are always fighting this human ingenuity - and that's a loser's game over the long run.

Many centuries ago, the heating needs of most people were met by burning wood. When wood prices in England rose dramatically due to shortages, some ingenious soul figured out that you could burn coal for heat. In turn, years later, the supply of coal dwindled, and the price started to rise unacceptably high. Spoiler alert: humanity won again. The price spike in coal acted as a signal to the innovative individuals of the day. The signal "said" go invent a substitute and you will make a lot of money. It was not long after that, oil became the standard fuel source. In each case, the high prices of the older fuel commodity dropped substantially as the new source came into favor. My point here is that in a free society, human brainpower will eventually defeat higher commodity prices.

Thus, we do **not** want to be commodity investors under normal conditions. However, there are brief windows of opportunity where you can make quite a profit buying commodities or other *real* assets. Those timeframes generally come once every 10 to 20 years. Prices burst higher, and then society's engineers and innovators figure out their way around those higher prices. The up cycle typically takes anywhere from five to seven years and if you are on the right side of that trade, your capital will advance while others' capital is in retreat.

One of the major drivers of inflation and higher commodity prices is wages. Some think that without wage increases, significant inflation cannot happen. There have been some major sticking points on wages over the last few decades. Globalization has increased the competition for jobs - cheaper labor in China and India, among other places, has made it hard for U.S. workers to get major salary increases. Combine this with the technological revolution automating away many good jobs and downward wage pressure was a given. What changes this? Some say nothing. Others strongly disagree, pointing to three main factors: last year's test run for basic income (pay to stay home), the inequality problem pressuring wage increases, and the demographic shifts towards much slower population increases. These factors could very well send wages, and thus inflation, higher.

So, what's it going to be? Are the next five to seven years going to bring inflation or deflation?? It sure seems like the odds of inflation are much higher than they have been in decades, with the amount of money printing, social experimentation, and supply disruptions presently. These factors combined seem to give "real assets" some wind at their back... gale force perhaps. We will stick with our warning about paper money over the upcoming decade. We will also do our best to preserve client purchasing power and real capital while the windstorm runs its course.

History shows that once enormous debt has been incurred by a nation, there are only two ways to solve it: one is simply declare bankruptcy, the other is to inflate the currency and thus destroy the wealth of ordinary citizens.

Adam Smith (1723-1790)

(Adam Smith wrote the classic 1776 book The Wealth of Nations.
His statue is near St. Giles Cathedral in Edinburgh, Scotland)

As always, please call or email with any questions and/or comments. On behalf of Tony, P.J. and the rest of Morgia Wealth Management, thank you for your continued confidence.

Sincerely,

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1. CNBC, Jamie Dimon says JPMorgan is hoarding cash because 'very good chance' inflation is here to stay. Hugh Son, 6/14/2021
2. CNBC, American Airlines cancels hundreds of flights due to staffing crunch, maintenance issues, Leslie Josephs, 6/20/2021
3. Stansberry Research, Rick Rule: Why you need cash to survive as the Fed Turns Manic Depressive, Daniela Cambone, 5/14/2021