March 30, 2021

The Headwinds Facing Gold

Another Market Narrative Is Depressing Gold

- Vaccines and reopening of the economy are risk-on
- Real growth this year will range up to 8%
- There will be some temporary inflation from base effects
- The surge in yields is primarily due to growth, not inflation, has peaked and will subside
- Who needs gold?

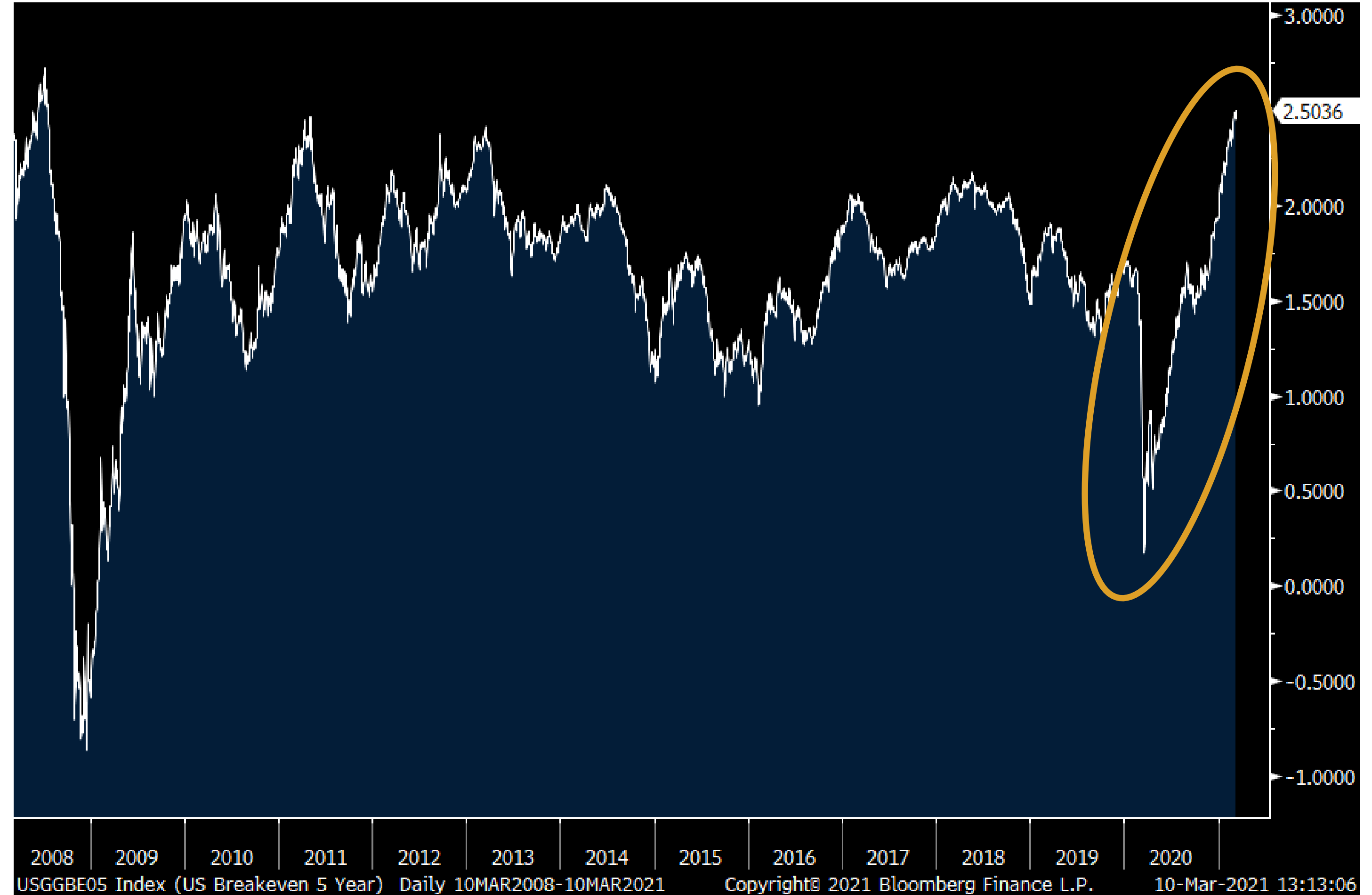
Markets Believe the Fed's Latest Fairy-Tale Forecasts

- Fed upgrades 2021 real growth forecast to 6.5% (driven by stimulus)
- Growth to slow in Q4 2021 and there is no upgrade to 2022/23 growth projections as stimulus ends (no escape velocity)
- 2021 inflation of 2.4% is transitory. Inflation rate will fall in 2022
- The Fed does not fully achieve its 2% inflation target until 2024 and will exceed it until maximum employment is achieved
- But the Fed is committed to anchoring inflation expectations at 2%
- No actions are needed to curb rising yields
- QE of US$120B per month (more than QE3) will continue
- Increases in the FFR won't happen until maximum employment and inflation targets are actually met (projected to be in 2024)
- Unemployment predictions: 4.5% (2021), 3.9% (2022) and 3.5% (2023) – Amazing!

Inflation Expectations Have Already Pushed Above 2% Benchmark

- The Fed wants inflation but not the inevitable effects of inflation
- The Fed says inflation rates can be managed with pin-point control
- History shows inflation cannot be easily controlled when it arises
- Anchoring inflation expectations at 2% is already lost: the 5-year breakeven is at 2.5% (see chart)
- Inflation is the Achilles heel of Fed policy. We think inflation has been unleashed
- The Fed will dump its forecasts within four months and implement yield curve control
- Gold will soar to +US$2,300

US breakeven 5-year inflation rate currently at 2.5%



The Four Drivers of Inflation
1. Demand-Pull Inflation

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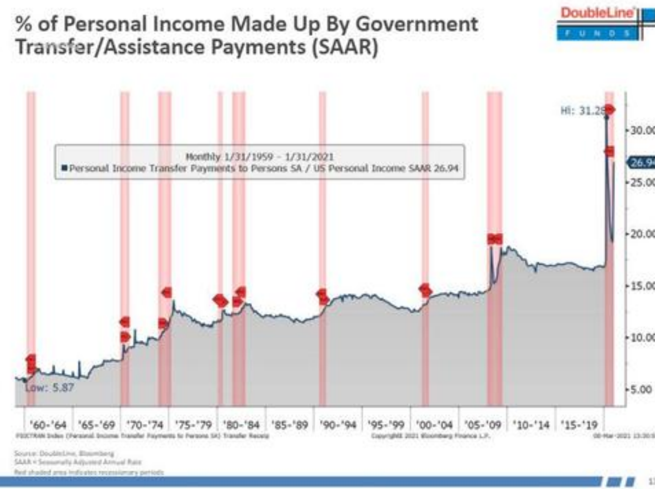
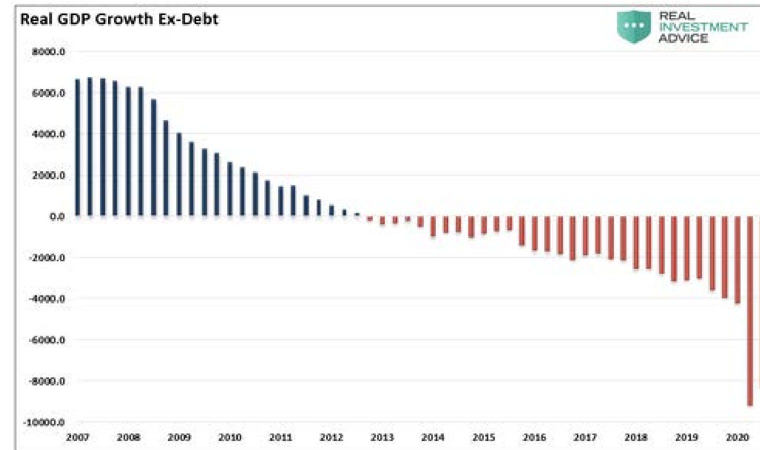
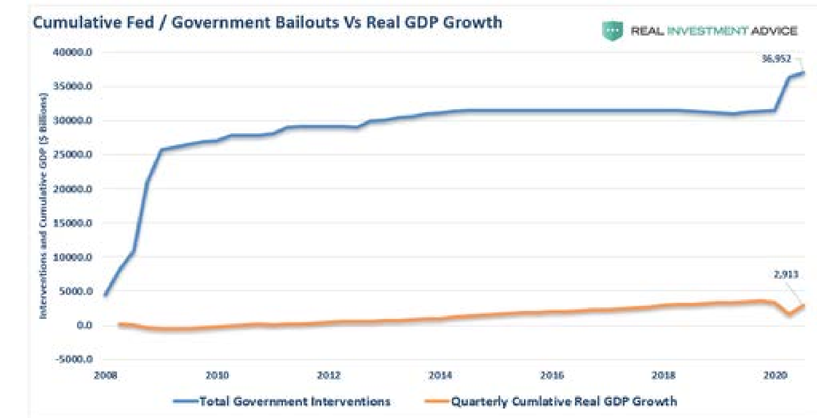
- Thanks to Treasury-Fed efforts to boost demand during a recession, people are spending money who are not working to generate goods and services



- US economic growth would have been "negative" since 2007 without increases in Federal debt



- It now requires roughly $12 in support to generate $1 of economic growth



"*If the Biden Administration follows through with its desire to be like the FDR or LBJ administrations, inflation may prove to be far less 'transitory' than current consensus appears to believe.*" Luke Gromen

Ray Dalio calls it Monetary Policy 3: "*When interest rate policy doesn't work anymore because you are at zero and growth has slowed because of the debt load, monetary authorities always print money by monetizing debt to help those who need it and that brings inflation.*"

"*A solution some countries with high levels of unsustainable debt have tried is printing money. In this scenario, the government borrows money by issuing bonds and then orders the central bank to buy those bonds by creating (printing) money…History has taught us, however, that this type of policy leads to extremely high rates of inflation (hyperinflation) and often ends in economic ruin.*" Source: Federal Reserve Bank of St Louis.

The Four Drivers of Inflation
2. Cost-Push Inflation

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- "*We wonder to what extent people are taking their time getting back to work with the ever growing generosity of the federal government and their transfer payments. The demand for labor is there but I think the supply side is not going to come back as fast…It will take higher wages to do so.*" Peter Boockvar

- "*Of note was the jump in average hours worked…Combine this with a 0.2% rise in average hourly earnings and out comes a 1.1% m/o/m increase in average weekly earnings and a 7.5% y/o/y jump.*" Peter Boockvar

The Four Drivers of Inflation
3. Fiscal Inflation

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- Keeping track of Treasury stimulus: US$3.1T from Trump + US$0.9T during the inter-regnum + Biden's US$1.9T, to be followed by US$3T in infrastructure/green investment. That's US$8.9T in addition to regularly scheduled operating deficits
- Luke Gromen: the US now occupies the position occupied by Germany in 1931: all payments and no receipts (on a net basis). Given this, the US has the same three options that Germany had in 1931:
  1. Come up with a miraculous productivity-enhancing technology and deploy it in record time (unlikely)
  2. Massively slash government spending (austerity). Politically-untenable and economically-untenable (Federal government spending is >20% of US GDP)
  3. Fed finance the US government in increasingly large amounts (only politically-and economically tenable option)
- Monetary and fiscal stimulus, coupled with the upcoming surge in monetary velocity as the world's economy emerges from lockdowns, could lead to unprecedented economic overheating…
  - or rather precedented as BofA's CIO Michael Hartnett reflects on post-WW1 Germany which he says was the "*most epic, extreme analog of surging velocity and inflation following end of war psychology, pent-up savings, lost confidence in currency & authorities*" and specifically the Reichsbank's monetization of debt and extrapolates that this is similar to what is going on now

"What history shows is that inflation is often a collective behavioral phenomenon. A loss of confidence in a government's ability to service and repay its debt results in a repudiation of the country's bonds and an inflation caused by currency weakness. A confidence crisis like this occurs suddenly, rather than in a predictable, mechanistic manner. Think tipping points." From Jim Grant's Interest Rate Observer March 5 2021

The Four Drivers of Inflation
4. Dollar Ownership

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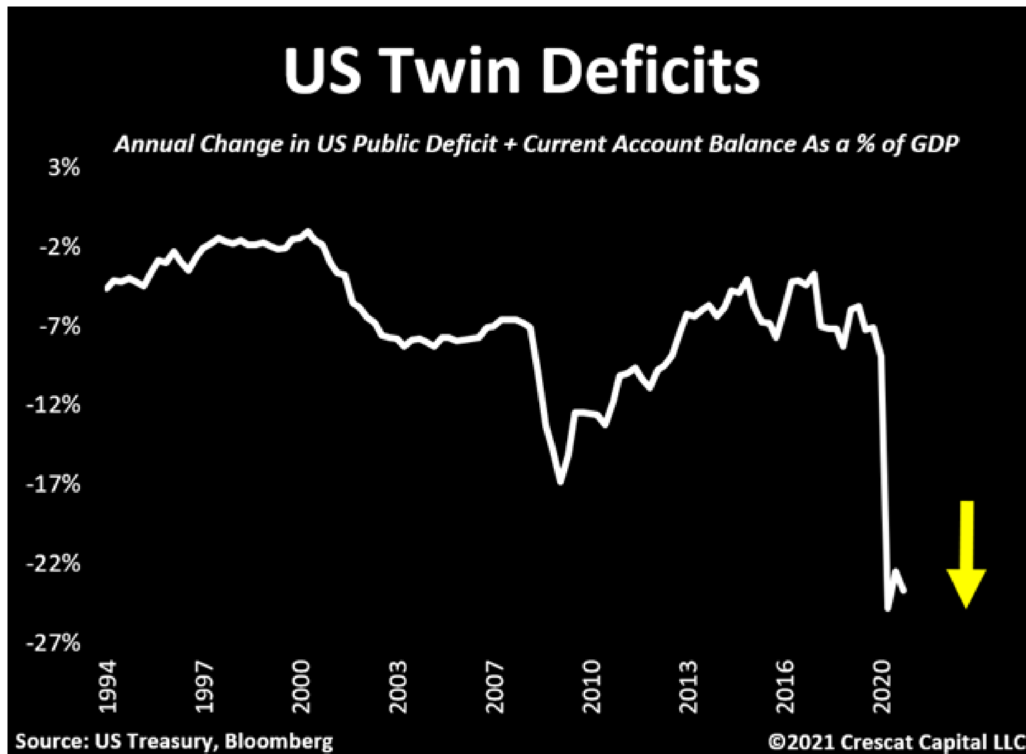
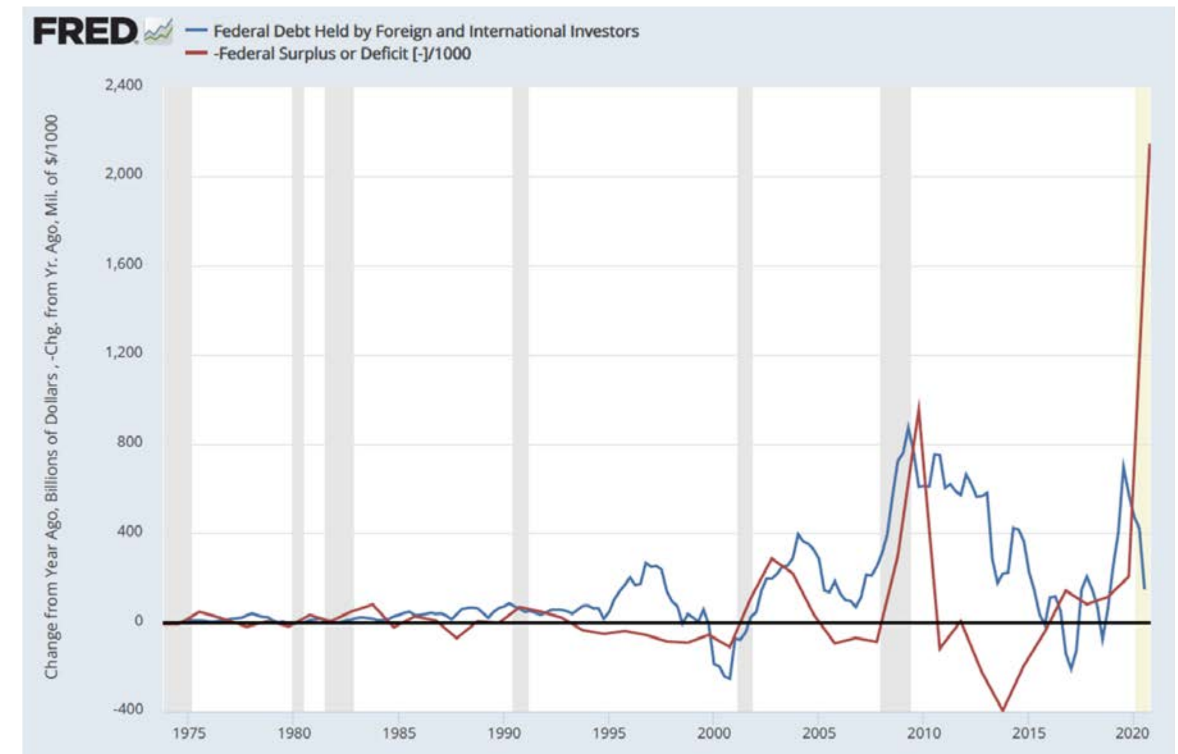
- If foreign investors no longer want reserve-currency denominated Treasury debt, the Fed will have to buy trillions more of Treasury debt and the dollar will collapse
- Rising twin deficits as a percentage of GDP signal dollar weakness

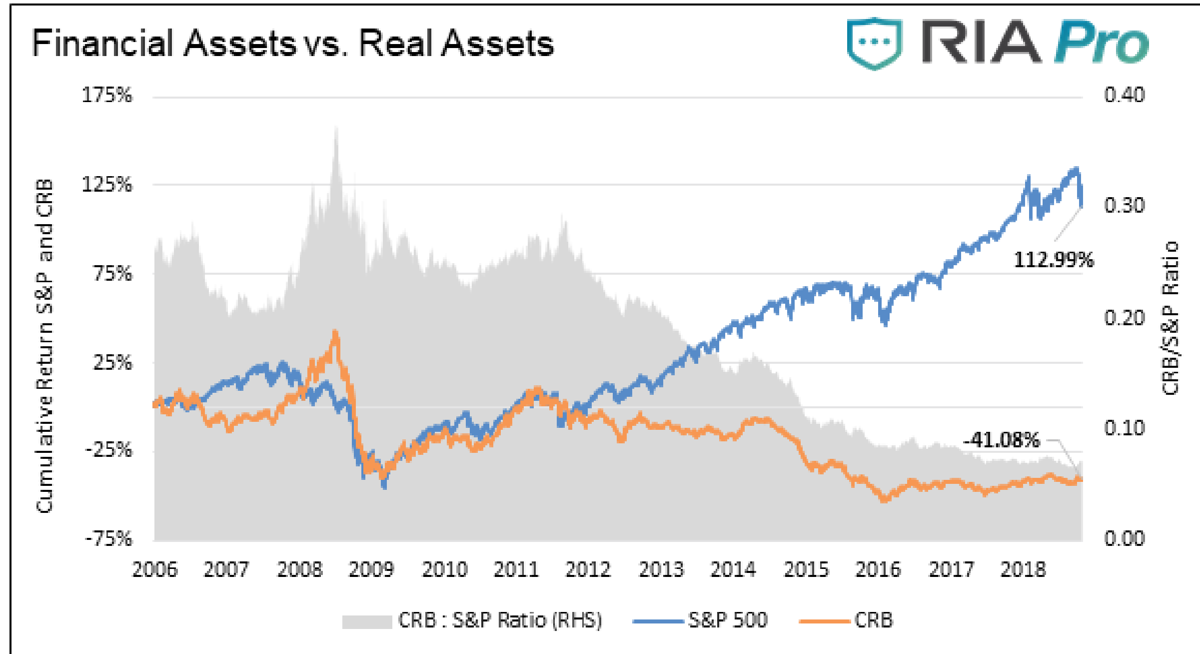




The Last Rodeo … or … back to the 70s

- The Fed is out of options: it must hope for transitory inflation
- Tightening financial conditions to fight inflation will crash markets and the economy
- Market driven increases in long rates will crash markets and the economy
- Suppressing long rates (yield curve control) will collapse the dollar (Louis Gave)
- Get ready for a 20% drop in DXY

Assets in a time of disinflation



A real gold bull market … when disinflation shifts to inflation