Aviator Update – May 2021
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Inflation, GDP and other things…

It seems that in finance-land, everywhere you turn lately people are talking about two things – inflation and crypto. I've had some very interesting discussions with people and listened to some interesting points of view. Today we will try and connect a few dots and get a sense of what's really happening in the economy and markets at the moment.

What's the narrative?

The "*as long as the Fed is doing Quantitative Easing and supporting asset prices, the market will not fall*" narrative remains alive and well.

There's another narrative the bulls are now clinging to – the "*the economy is re-opening and about to boom!*" narrative.

Now, obviously this narrative has fairly limited relevance to Australia given our economy has largely been back to "normal" for many months now. Seems to me that the only remaining area of "pent up demand" here in Australia is for overseas travel! Of course, when that once again ramps up, it won't be a positive for our economy.

"Passing the baton"

A problem exists with the booming economy narrative – the economy really hasn't imploded the way in which many seem to think.

Australia's GDP in USD terms looks something like this:

We’re not very far from record levels of GDP. Other major economies such as the USA look very similar to this.

Many people – including economists – have expressed a certain amount of surprise about how quickly our economy has bounced back from the Covid hit. It shouldn’t be too much of a surprise. We can visualise what’s transpired as follows:

GDP = C + i + G + (exports - imports)

This is our trusty GDP calculation formula. What happened during Covid? The economy shut down. The “C” (private sector consumption) and “I” (investment / business expenditures) collapsed. But the government responded with massive stimulus – “G” (government expenditure) skyrocketed.

The government stimulus response here in Australia was somewhere around 17% of GDP. 17%... one of the largest in the world. The USA out-did us – their response was closer to 20%.

These are really staggering numbers.

Thankfully, for many countries including Australia, the UK and USA, we seem to be largely on the other side of Covid. More than half of Americans are now vaccinated. There’s light at the end of the tunnel and local economies are heading back towards normal – or perhaps a “new normal”.

And with that, stimulus measures are trailing off.

Referring back to our GDP formula, what does this mean?

It means that “G” is in the process of collapsing!

There’s much excitement and enthusiasm about a boom on the horizon in major economies including the USA. But let’s be a bit more specific and put some context around this.

Yes, predictably there will be a boom in the private sectors of the US economy – “C” and “I”. We sure better hope so because with the pending collapse in government stimulus, if the private sector doesn’t grab the baton from the government, we’re in for a rough ride.

For what it’s worth, I believe the private sector will bounce back strongly in the US and other places, just like it seems to be in Australia. But the point is this will substitute for the decline in government spending. Data points will probably remain a bit more volatile than normal for a little while longer but what I don’t see is a durable uptick in the GDP growth rate for most major economies compared to where it’s been in recent years which, for most developed countries, has been on the decline for some time now.

Government spending and deficits

This last year has provided some excellent real-world case studies for us to use in trying to understand how the economy “works”. Let’s have a look at government spending and deficits.

All that government stimulus we were just talking about? It's true that the by-product was a big jump in government debt. It has to be – it's the only way it can have any effect.

Think about that for a moment. How could the government spend more without a resultant increase in debt? It would need to balance those expenditures with added income. What's their source of income? Well, taxes.

If the government wants to spend more without an increase in debt, they need to raise more in taxes. So during Covid, with the private sector imploding, if the government wanted to assist with stimulus measures without increasing debt, they would have needed to raise taxes on, well, someone…

This is an important concept; the government cannot create "wealth" – it can only re-distribute.

Now, much is being made about the reality that governments here in Australia as well as the USA are projected to continue running deficits for some years to come. Gasp… How reckless! Commentators and politicians are keen to try and paint a picture of how this risks destroying the nation – endangering our kids futures, bankrupting the nation and stoking inflation.

An incredibly complex concept that most of us have difficulty with is the reality that a nation is not an individual. A nation such as the USA and Australia that is the issuer of their own floating fiat currency cannot become insolvent with respect to debts issued in their own currency.

We, as individuals, we are restrained. For us, if we get into too much debt we face the risk of becoming insolvent – unable to meet our repayments. A nation such as Australia and the USA doesn't have a solvency restraint.

"So Lindsey, you're saying deficits don't matter?"

Well, yes and no… To repeat, a nation such as Australia, the UK and USA that have their very own floating fiat currency cannot become insolvent with respect to debts they issue in their own currency. They can always "create" the money to service these debts.

"Ahh yes… money printing… governments are going to destroy their currencies and economies with all these debts… resulting in runaway inflation…"

Okay we need to break this into two parts:

1. **Can government deficit spending be inflationary?**

Let's begin with a very simplistic definition of inflation;

"too much money chasing too few goods and services"

During Covid, one of our government's stimulus responses was JobKeeper – basically paying people $1,500 per fortnight if their business suffered a downturn.

Was this inflationary? No – and a simple explanation as to why was that it wasn't a huge amount in the grand scheme of the economy and largely replaced lost income.

What if it was $1,500 *per day* available to every Australian - no strings attached?

Well then – that's a bit different. All that money chasing the same amount of goods and services. Of course that's inflationary. In fact, it wouldn't even be "the same amount of goods and services" as many individuals would stop work if you paid them that amount and thus would stop producing goods and services for the economy.

The point is that government deficit spending is not in and of itself inflationary. It depends on the size of the deficit relative to the economy and how the spending is targeted. For example, spending money on useful infrastructure will be far less inflationary than simply giving people money.

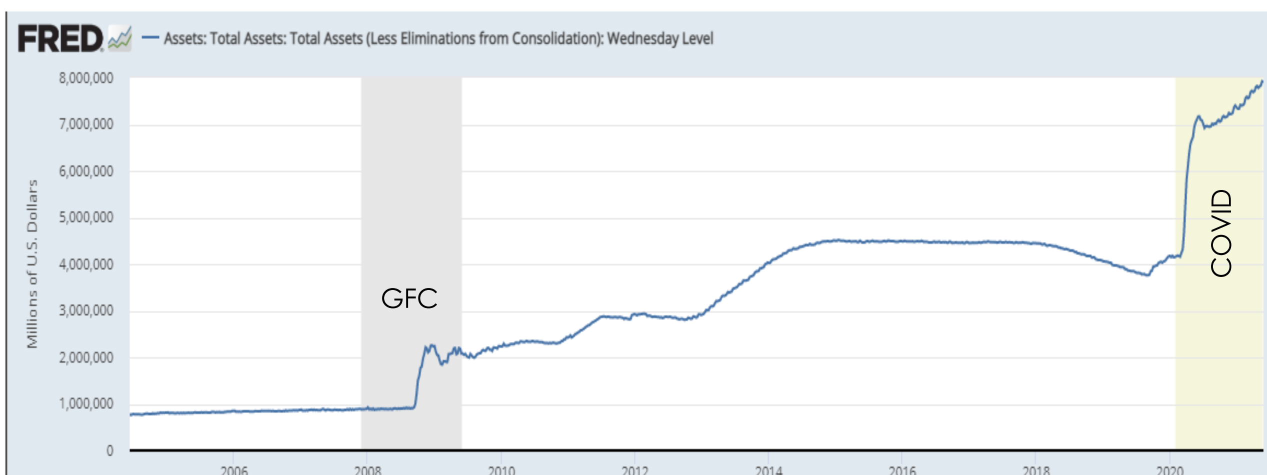
In most nations, Covid-related stimulus spending is quickly disappearing. Yes, governments continue to run deficits and we're still seeing some discussion about major infrastructure projects in the US and elsewhere. However, my suspicion at the moment is that the size of deficits isn't large enough to cause major inflationary pressures.

Also, read the fine print and not just the headline – whilst the announcement might be "$50 billion infrastructure package"… the fine print might be that this is over 10 years.

Spending like this is a "flow". Every day, every year there's a certain amount of spending taking place on such projects – if you're not tipping more into the future "pipeline", the economy suffers a negative impact when existing projects finish up but aren't immediately replaced with new ones. This is a challenge the Chinese are grappling with at the moment – how to ween themselves off a reliance on massive infrastructure spending… but I won't digress into that today…

2. "Money-printing"

Here we go again with this one. Commentators are insistent on pointing at this (being the US Federal Reserve balance sheet):



…and concluding "inflation is about to explode!"

Most of the assets held by the Federal Reserve are government bonds. The huge uptick during the Global Financial Crisis as well as the recent Covid crisis are, to generalise, the result of “quantitative easing”.

During these transactions, the FED buys government bonds from the private sector and issues them in return new base-money. It’s an asset-swap. The newly-printed money sits in the banking system as bank reserves – “excess reserves”. It has to be held by someone at all times until its retired.

Repeat after me: *banks don’t lend from reserves*.

In essence, the “money printing = inflation argument” is underpinned by the idea that banks lend from reserves. Flood the system with reserves and banks will try and “rid” themselves of these reserves by lending them out.

They aren’t and they don’t. Banks lend to creditworthy borrowers with an eye on their capital requirements. Loans create deposits and the bank seeks out reserves after the loan is made. Indeed, a key feature of the banking system in most developed nations with their own floating fiat exchange rate system is that the central bank pledges to supply as many reserves as the banks demand at their set target interest rate. The banks are never “reserve constrained”.

“Quantitative Easing” is stupid – its distorting people’s perceptions and markets. But it’s not about to unleash uncontrolled inflation. There’s no transmission mechanism to the real economy.

Commodities

Next stop in our search for inflationary pressures is commodities. The CRB index containing 19 commodities across energy, agriculture, industrial/base metals and precious metals provides a good snapshot of the sector.

The 12-month chart is impressive:

The 25-year chart isn't quite as impressive:

According to many, the recent surge in commodities highlights that inflation is here and about to get worse.

There's a bit of a problem with this narrative. Yes, there's surely been an uptick in demand for commodities along with some Covid-related supply disruption. But people are forgetting how "financialised" commodities are in today's world.

Much of the trading activity within the commodities markets isn't by producers and end-users. It's due to investors speculating on prices. It follows that influential pundits are encouraging investors to buy commodities due to rising inflation… whilst simultaneously pointing to rising commodities as evidence of rising inflation!

Very circular logic.

Crypto

Okay here we go… The crypto space has been grabbing a lot of attention of late. And why not – some people are getting very rich and in their pursuit of clicks, financial media outlets and commentators have been keen to deliver the investing public what they crave and showcase the craziness in all its glory.

A popular narrative within the crypto space is that it stands to be a good hedge against inflation. Using the same circular logic as commodities pundits, many crypto commentators are keen to point at the rising prices as evidence runaway inflation is here.

I want to tackle this from a slightly different angle.

Here's the gold price in USD:

… doing not much really…

I've seen many commentators note that "crypto is the new gold". In my view, I think they're right on a certain level.

Many investors think gold is silly. The reason they think it's silly is that, in their mind, an investment must produce cash flows. Warren Buffett has been very critical of gold as an investment in the past and has been even more critical of crypto in recent times.

Understand where he's coming from. He's a fundamental investor. His focus is on identifying companies that stand to reliably produce growing cash flows from their business operations. Assets that produce no cash flows cannot be valued in any traditional sense and are therefore of no interest to an investor.

Gold and crypto are for the speculators. You buy them because you think the price is going to rise. Sure, you might have some "fundamental" basis for this view – historical correlations or similar such views – but ultimately, it's a speculative punt that the price will rise.

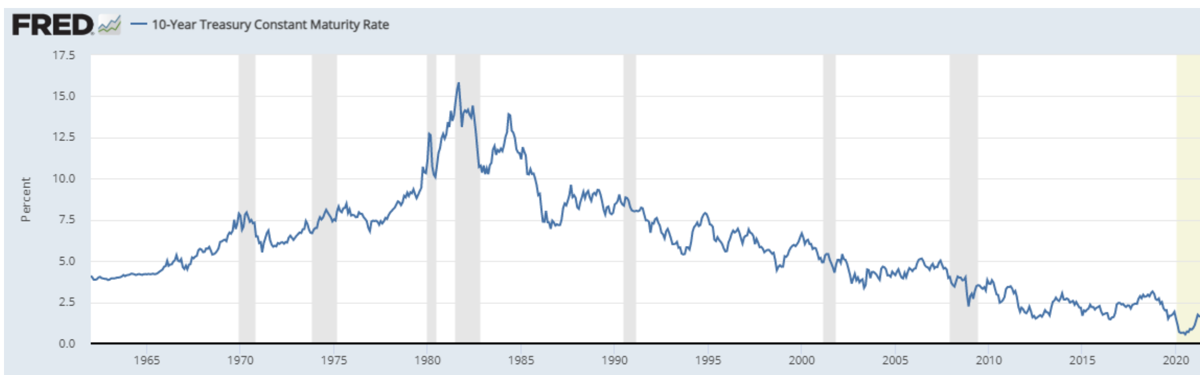
The fact that crypto has gone ballistic compared with gold that's done little is, in my view, evidence that these are run by speculators eager to make a quick buck (or quick few million bucks) rather than any kind of evidence of inflation or anything else.

Bond market

There's been a number of times in the past few months where a rise in bond yields is all anyone wanted to talk about. It's true – bond yields have risen. Here's a few years' worth of yield pricing for the benchmark US 10-year treasury bond:

Certainly a significant increase over the past 12 months… back to where it was prior to Covid.

For some long-term context, here's 60 years' worth:



If there's significant inflation around the corner, somebody forgot to tell the bond market.

And no, please don't say that this is due to FED intervention - the FED doesn't control the 10-year.

It's interesting… People are cheering higher asset prices and also an economy they think is set to boom… yet bond yields returning to pre-Covid levels are somehow out of place and cause for concern. As far as I'm concerned, the bond market is currently suggesting a return to the anaemic levels of economic growth that existed prior to Covid.

Conclusions:

There's clear inflationary pressures present in the US economy and to a lesser extent the Australian economy. Europe remains a bit too much of a mess to really judge.

Further, it seems evident that there's meaningful wage inflation in the US – average hourly earnings have been on the rise for a number of years now.

Inflation is a complex beast. There's certainly inflation currently being experienced in raw materials. This will result in higher production prices for finished goods. Will that result in

higher prices being passed through the supply chain down to the end consumer? And will the increases be somewhat of a one-off or a spiral of higher prices?

The debate is whether the inflation is “transitory” – This is the view the FED is taking – or set to become more pervasive and longer-lasting. I’ve heard some very well-articulated arguments for both these cases.

As described above, economies face a big challenge as the economic activity baton gets passed from the government to the private sector. My best guess at this point is that this handoff will be largely successful, but we won’t see explosive growth. Following on from that and with an eye on the bond market, I’m suspecting that the “inflation is transitory” viewpoint has the best odds of playing out.

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