

Regime Change Ahead: Why I've Changed My Core Thesis From Disinflation to Stagflation

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Executive Summary

For about 10 years now, I have repeated endlessly, to whomever would listen, that the trend in interest rates was about “lower for longer” than anyone would think possible, that rates would go to zero, then negative and stay there. I refuted the claims that “interest rates will have to go up” as nonsense, pointing to Japan with decades of disinflation as more representative of where the world was headed than any other normal recovery. For years, people thought I was nuts, and dismissed my thesis, until Europe went into crisis and Mario Draghi (president of the European Central Bank), promised to do “whatever it takes” to save the Euro, and European interest rates plunged to zero, and then negative, and the whole yield curve flattened out as the ECB monetized national debts.

I argued that Canadian and U.S. interest rates would follow as the same forces were at work globally. Here we are, with interest rates at almost zero in Canada and the U.S. all along the yield curve.

I postulated that this would go on, until a Minsky moment, when everything snapped, and we went from disinflation to rapid inflation that would come from reckless money printing. I had assumed that this end game was further in the future, with Japan as the example of how long and how far low rates, huge government borrowing, and disinflation can be pushed.

However, the trend toward disinflation is over. COVID-19, and more importantly, the poor government response to it, has accelerated what may have taken another decade or two to play out otherwise. Stagflation (at best) is what lays ahead. In this whitepaper, I will lay out how my original thesis has played out, what has changed my mind, how I believe real asset strategies can be used to protect portfolios, how I anticipate Centurion's strategies will fare, and argue why now is the time to reposition portfolios if you haven't already done so. **Time is running out to move into real assets.**

My Original Thesis

I have argued for almost ten years now that interest rates were going lower, ultimately to zero and then negative, and that they would stay lower, longer than anyone thought possible. I pointed to Japan as the example of what I believed would happen. Japan is going on almost 30 years of fighting deflation. I believed that we were in for the long-term struggle with deflation as well. I have never believed we would see actual sustained deflation, because ultimately, governments will print enough money to keep inflation above zero. The core ideas behind my thesis were:

- 1) Robotization and Softwarization
- 2) High and increasing debt combined with declining productivity of debt
- 3) The relationship between interest rates and saving rates had flipped driven in part by an aging society
- 4) Globalization

I had argued that while nominal rates would be low, real rates (after inflation and taxes) would be near zero to slightly negative. This would be hugely beneficial to owners of capital that could access cheap debt and equity to invest, and for years this trend has played out.

Robotization and Softwarization, I theorized, would render many, in the global workforce, irrelevant. Robots and software would do more and more things, work 24x7x365 with no breaks, days off, or wage demands. Some studies had suggested that in developed countries in excess of 30% of jobs could be eliminated in this decade alone, and I believed that this would put a cap on wage growth and ultimately demand because if people don't have jobs or financial security, they can't buy anything.

I argued that much to the chagrin of investors, this would not be good for corporate profits in the long term. The first order effect (the obvious one) is that robots and software would make companies more efficient, reducing costs, while increasing productivity. But the more important second order effect was that this would dramatically increase competition and reduce profitability.

A simple example is, let's say you can buy a robot in your factory to make cars. Sounds like you'd save money, and it's true. However, your competitors will do the same too, likely buying from the same robot manufacturer. Worse, new competitors enter the field because now all you need to do to build a car is to have the capital to buy the robots and put in the designs and now you have a car company.

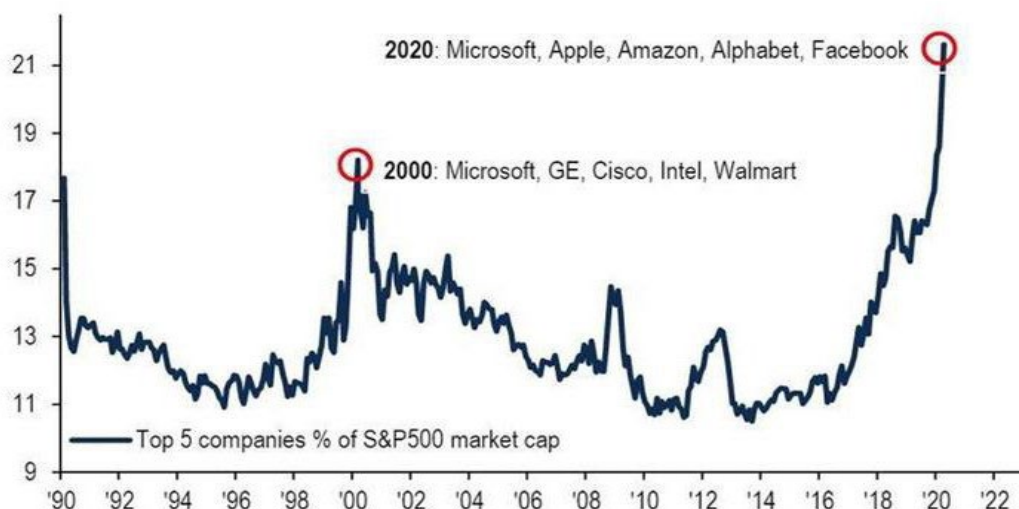
While this is obviously a stylized example, meant to demonstrate a point, and ignoring all the other aspects of starting a car company, the idea really is that the benefits of this robotization go ultimately to the technology provider and not the manufacturer.

Another important second order effect is that in destroying high paying jobs, in the absence of replacement jobs, government transfer payments, or increased consumer debt, the final demand and prices would have to go lower (i.e., disinflation/deflation). This trend has played out pretty much as I believed it would.

The following charts 1,2, and 3 show the dramatic difference in performance of tech, primarily big tech, versus the rest of the market. The five largest tech stocks now make up over a record 22% of the entire capitalization of the S&P 500. The NASDAQ has outperformed the Dow Jones by a factor of two, and this outperformance has gone through the roof in 2020 due to COVID-19. In fact, without the mega cap tech stocks, the S&P is down on the year. In other words, almost all the gains of technology, via robotization and softwarization, have flowed to the mega cap tech companies, who provide these tools, while everyone else has not performed anywhere near as well.

Chart 1 – Concentration of the 5 Largest Stocks in the S&P

S&P500 now more concentrated in the 5 largest stocks than ever



Source: BofA Global Investment Strategy, Bloomberg

Chart 2 – NASDAQ to Dow Jones Ratio



Chart 3 – Divergence between the 5 Largest Stocks vs. the Rest

The five largest stocks have returned 35% YTD; the other 495 stocks have declined by 5%.



Source: FactSet, Goldman Sachs Global Investment Research

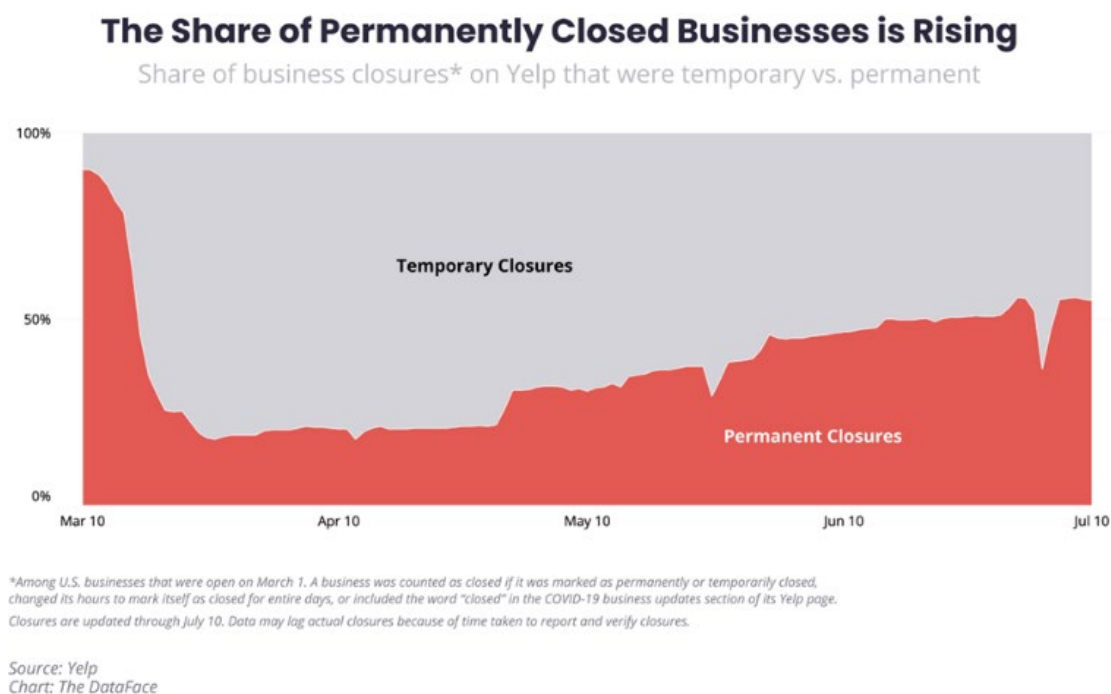
This has disturbing implications for the economy. We can generally break the COVID-19 experience of companies into three groups:

- 1) The mega cap tech companies
- 2) Other public companies
- 3) Private small and medium-sized businesses

The mega cap tech companies have benefitted strongly due to COVID-19. The other 495 companies have held ground, but non-public, small- and medium-sized companies, and low wage employees (i.e., Main Street) have been absolutely crushed. In the most recent S&P500 Q2 earnings, mega cap tech earnings increased 1%, while non-info tech companies saw earnings per share decline 41%. In the Russell 2000 index (of small listed companies), Q2 earnings per share declined a whopping 97%. This is a stark illustration of what is happening in the broad economy and is wholly unhealthy for economic recovery.

Further, according to Yelp, an increasing number of businesses are throwing in the towel and closing permanently versus just being temporarily closed with reports that about 55% of all closures on their site are now permanent (see chart 4). This is one of the things I warned about in my note on [April 14, 2020](#), that unless the economy opened soon, the damage to small business would be devastating and significantly impair the economic recovery. In other words, the increase in the stock market is not a good barometer of how the economy is doing, no matter what Trump says.

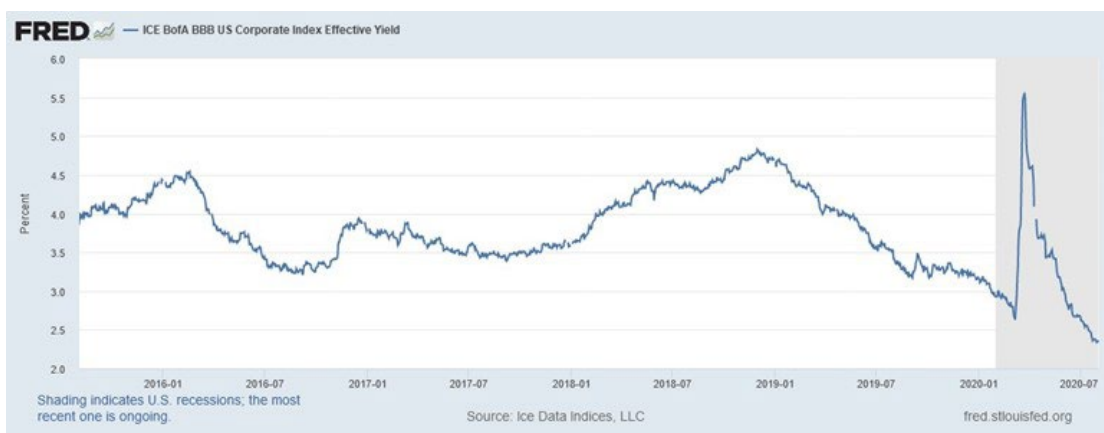
Chart 4 – The Share of Permanently Closed Businesses is Rising



This has profound implications for the economy. One, in assuming that since the stock market is doing well means that things are getting better (though only five stocks are doing well). This gives a very false impression of the true state of affairs. Two, it is even worse that access to liquidity is largely flowing to large, public, and/or well-connected businesses, and not to everyone else. This can be seen most dramatically in the announced economic stimulus and Federal Reserve programs. The Fed is buying corporate bonds, keeping yields on corporate debts low.

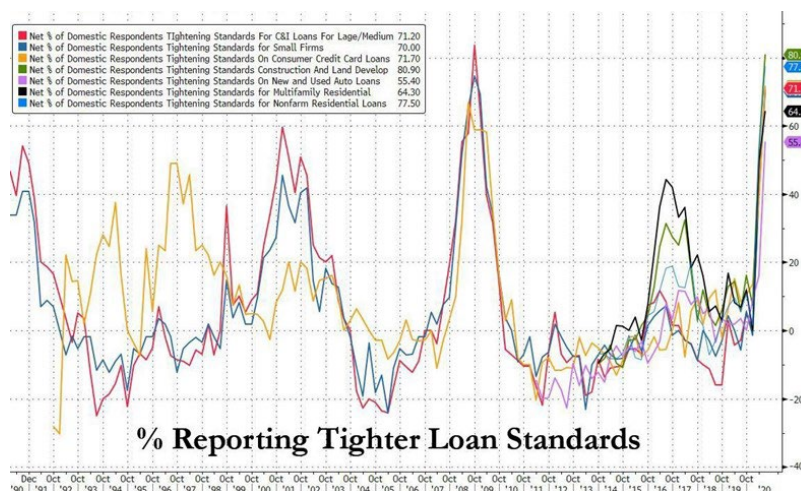
Chart 5 shows that corporate debt yields are lower than they were pre COVID-19, even though business conditions and fundamentals are worse than ever. This allowed public companies to access record amounts of cheap debt and equity.

Chart 5 – Investment Grade Corporate Bond Yields



However, if you are a small- or medium-sized business (SMB), your access to reasonably priced credit has collapsed. See chart 6 which shows that banks are tightening credit across the board.

Chart 6 – Federal Reserve Senior Loan Officer Opinion Survey (SLOOS)



Further, many of the government programs for SMBs require personal guarantees. No CEO of a large public company is having to guarantee their debts. Given that SMBs in both Canada and the U.S. are the largest part of the economy, the prospects for SMBs and the people they employ are poor.

In 2018, the Canadian economy totaled 1.2 million employer businesses of which 97.9% were small businesses, 1.9% were medium-sized businesses, and 0.2% were large businesses. SMBs in Canada employed 89.5% of the private workforce.

Similarly, the experience of workers can largely be broken into two groups:

- 1) Generally better educated and better paid workers capable of working from home who stayed employed; and
- 2) Generally less well educated workers, disproportionately minority groups, incapable of working from home, who lost their jobs (more on this later).

The Cantillon Effect on Full Display

The above is a perfect example of the Cantillon Effect. The Cantillon Effect is a monetary theory proposed by Richard Cantillon, an 18th century French Banker and philosopher. The theory can most easily explain why Wall Street gets bailouts and you don't. Cantillon's basic theory was that who benefits when the state prints money is based on the institutional setup of the state. In the 18th century, this means that the closer you were to the king and the wealthy, the more you benefitted. The further away you were, the more you were harmed. Some perfect recent examples of this in action are:

- Quantitative Easing. The money goes to the banks, who get cheap debt to buy investments. If this money "trickles down", it goes to the best clients only.
- TARP (Troubled Asset Relief Program of the 2008 Financial Crisis) in which the U.S. government bought bad loans, well above market values from the Banks. If you were an SMB with uncollectible receivables or loans, you got nothing.
- Corporate Bailouts. Ever notice that the bailouts are always for the big guys and never the little guys? GM, AIG, banks, airlines and recently Kodak. They get bailouts because they are connected.
- The Fed currently buying corporate bonds, non-recourse in massive scale. If your business needs a loan, good luck with that. See Chart 6.
- The Liberal government gives almost a billion dollars in a sole sourced contract to the WE Charity, a real estate holding company, with a giant fee attached, purportedly to run a student program which could easily have been administered by the existing civil service, until they got caught... of course.
- The Liberal government proposed to attack Canadian SMBs with new taxes in 2017, exempting larger public and foreign companies. Of course, the Finance Minister's family business will be exempt. What are the odds?

- Tax havens. Ever notice that large international corporations, like Amazon and Google, pay virtually no tax. Why? Because their products are largely "intellectual property" and they can move that IP to a tax haven, dump their profits there, and pay no tax. An SMB, being local, has no ability to do that and will get attacked, and lose, if they try. So, how does an SMB that pays tax, compete against a global low tax behemoth. You know the answer... they don't.

These are just some examples, but they are everywhere. The Cantillon Effect is distortionary, not often talked about, and is distinctly unfair. It has governed my economic and investment philosophy for years. If this effect was better understood, I doubt many people would have the enthusiasm to start new businesses, knowing how much the odds were stacked against them. It is the single largest explanation in my opinion of the widening wealth gap.

That said, I believe that COVID-19, for the first time in a long time, is going to open the spigot of cash to people and SMBs, and this is a game changer for the inflation picture (more on this later).

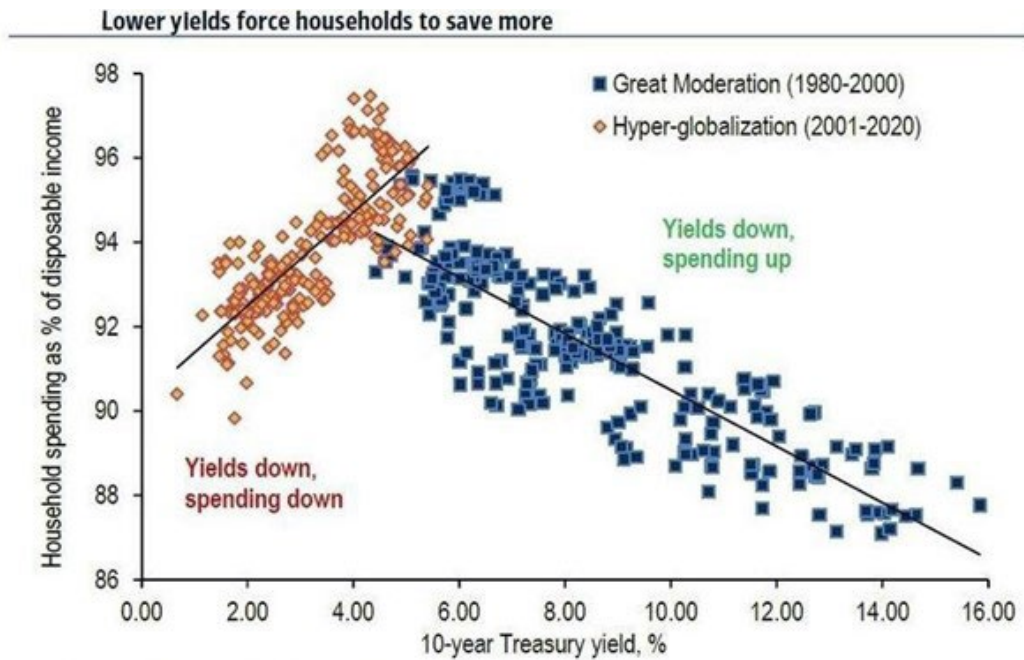
I have argued that the growing debt/GDP, made possible by low interest rates, would be a drag on growth and consumption, and that the historical inverse relationship behind low rates and consumption was broken. Why? Because, with an aging society, low rates would not make persons in or nearing retirement spend more; they would be forced to save more.

This was recently demonstrated from a study which can be summarized in Chart 7 below which shows that once rates go below a certain number, that households flip from saving less (and consuming more) to saving more (and consuming less). This is because at high rates of interest, retirees have the ability to finance their lifestyle with less savings (i.e., at 10% interest rates, a person with \$1 million of savings earns \$100,000 per year towards their lifestyle, and at 1% they only make

\$10,000 per year; so instead of living off of just the interest, they need to burn the principal to survive). This means that you need to save more as more rates decline.

Thus, interest rate declines, beyond a certain point, cause a negative feedback loop, and at the zero bound will become a trap for highly indebted consumers, corporations, and governments. Interest rates could not go up because it would bankrupt consumers, corporations, and governments who had record debt levels and crash the economy. The central banks would do everything in their power to keep rates low to prevent this implosion (more on this later).

Chart 7 – Lower Rates Means Higher Savings and Lower Spending



Source: BofA Research Investment Committee, Haver

Further, as the global economy has become more indebted over decades, growth has slowed and it takes an increasing rate of debt to produce the same amount of growth (see Charts 8 and 9). Debt also acts to further constrain growth, and GDP growth rates have been in structural decline for decades as a result. As such, it seems unlikely that increasing debt even further will reverse the trend and may make it worse.

Chart 8 – It Takes More Debt to Create Economic Growth Than Ever Before

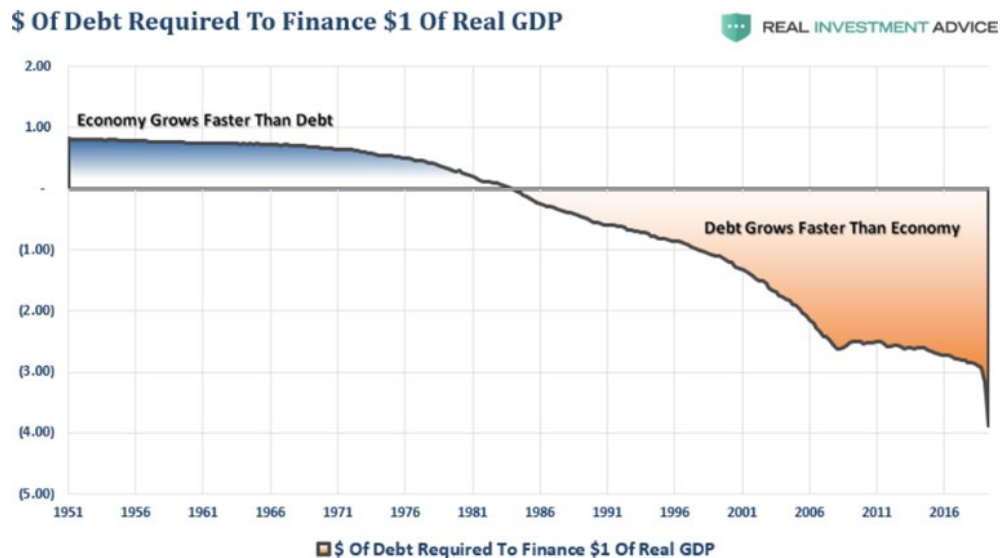


Chart 9 – Increased Corporate Borrowing isn't Creating GDP Growth

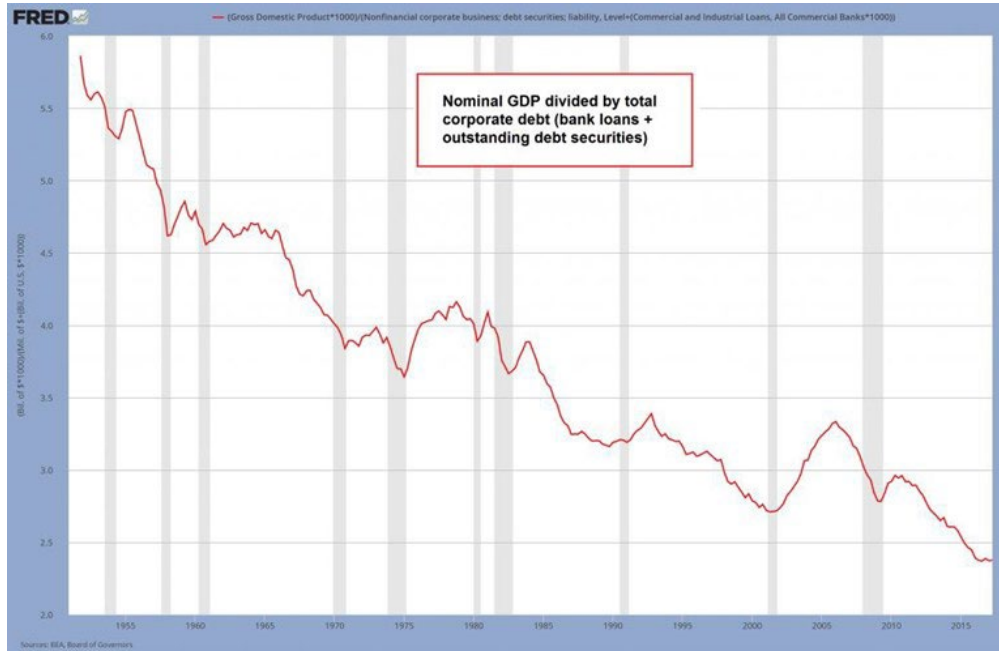


Chart 10 – The Rate of GDP Growth is in Structural Decline



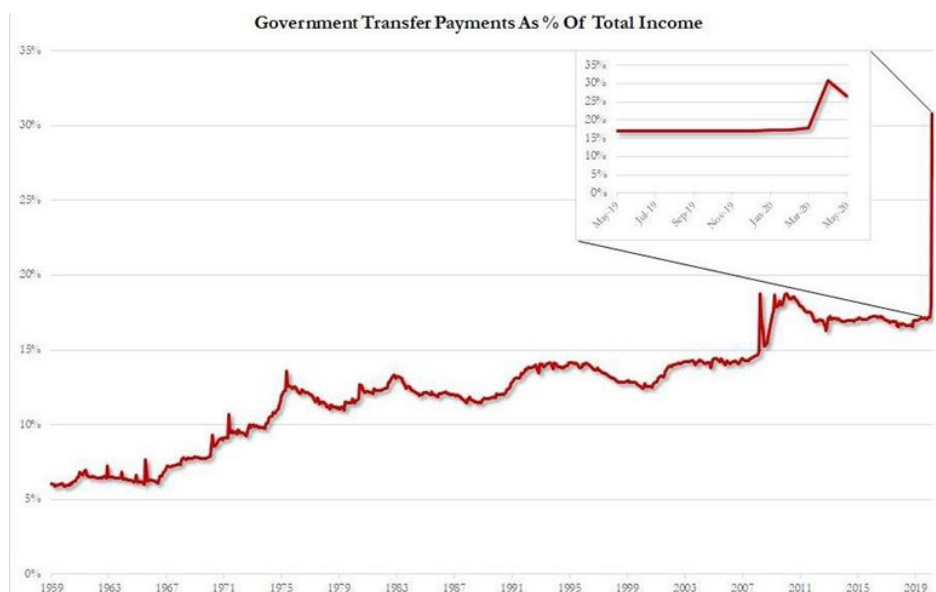
Globalization has worked to lift billions of people out of poverty, but has hollowed out the developed economies as good paying jobs are overseas. This has been deflationary not only because products could be made cheaper, imported, and sold for less than if they were domestically made, but also

because demand would be lower due to outside government transfers and increased consumer debt to finance spending.

Many have argued over the years that the jobs lost through technological progress (robotization and softwarization) and globalization would be replaced with higher quality jobs. That has not happened and has been obviously the case for a long time. The fourth industrial revolution (the current one) is fundamentally different than prior ones. In prior times, jobs like horseshoe-making would be redeployed into other industries (like making cars). Today, if you replace people with robots or software, there are not enough high-quality replacement jobs available. After all, not everyone can “learn to code”.

The jobs are destroyed, and along with it, the ability of those workers to buy and so they must rely on government transfer payments to get by. This can be seen in Chart 11 of government transfers as percentage of total income, which was reasonably stable post GFC but has been creeping higher for decades and has rocketed to over 30% during the pandemic. It is surprising that given it has been 12 years of recovery since the GFC, along with an epic stock market boom, the narrative has been that things have never been better. The fact that government transfers, even pre COVID-19, are higher than they were pre GFC says otherwise and further demonstrates that the benefits of technology have largely accrued to a small segment of the population (Wall Street as opposed to Main Street).

Chart 11 – Government Transfer Payments as % of Total Income



In summary, the forces of disinflation/deflation that has dominated the past two decades has largely come to an end, earlier than I had anticipated, due to COVID-19.

What Has Changed

- The COVID-19 response was handled very poorly globally and this has severely damaged the economy and the ability to rebound.
- Central Banks have given up the reigns on monetary stimulus to politicians.
- Given very high debt levels, central banks will likely let inflation run hot.
- Globalization, already stalled, has gone into reverse.
- Robotization and softwarization is accelerating even faster than anticipated.
- Work from Home will have long-lasting positive and negative effects.
- The real economy is detaching materially from the financial economy, worsening the wealth gap, eroding social cohesion, and crushing the SMBs that will be needed to create employment in a recovery.
- Government deficits and debts are exploding.
- Real interest rates are collapsing.
- The wealth gap, already at record levels, has just gone elliptical.
- Social cohesion is breaking down.
- The traditional 60/40 model, which has protected portfolios, has broken down.
- The lockdown was bad, another lockdown will be catastrophic
- A vaccine, to the extent one is ever available, is likely still a while away, may not be safe, may not offer permanent protection, and may be avoided by people and by then, debts could be so high and the economy so damaged that recovery, in the traditional way, will not be possible.
- Global tensions are accelerating

I will try to expand on each of these ideas below.

The COVID-19 Response Was Terrible

As I warned in my paper of [April 14, 2020](#), the economy had to open quickly to prevent severe and long lasting damage to the possibility of recovery. Governments created havoc with severe shutdowns, slow re-openings, renewed shutdowns in some cases, lying to the public to manipulate behaviour (e.g., masks do not work but now they do and are mandated? And by the way, they lied about it to begin with). Worse they have created fear that has changed behaviours, which are harder to reverse.

The severity of the lockdown caused massive unemployment, crashed the economy, destroyed a huge number of businesses, and to avoid an even larger collapse, governments had to print massive amounts of money with virtually no oversight, limited infrastructure to do so responsibly, and racked up massive debts. They will continue to build massive debts and this has huge implications for the sustainability of the debts being incurred, and this is a key part of my change in thesis. That is, low rates on government debt were sustainable because we were in a disinflationary period and rates were both below the growth of GDP and real rates were negative.

While I believe real rates will head even further into the negative territory, it will only be possible due to central bank manipulation of the yield curve (i.e., Yield Curve Control), which is another way to say financial repression (i.e., stealing from savers to give to governments and well-connected borrowers). As bad as our government's response is, it could have been much worse, because Canada is at least a wealthy country, with the resources to respond. Some recent estimates are that COVID-19 will throw an additional 100 million people into extreme poverty. Unfortunately, politicians rarely have to pay the price for their incompetence, malfeasance, and preference for choosing the politically correct, rather than hard but correct choices.

Central Banks have ceded control of the money supply to politicians and are now relegated to monetizing this debt at low rates (i.e., printing money). This is probably one of the most important aspects of the COVID-19 response and what is different now and driving my change in outlook.

In prior economic crises, both fiscal and monetary policy responded, but most of the heavy lifting was via central banks via monetary policy (i.e., cutting interest rates). That has changed. The programs being put out by the politicians are staggering in scale. In the U.S., it will be trillions of dollars in spending. For the first time, we have the people's QE, with the CERB in Canada, and the CARES Act in the U.S., just as examples, providing generous, near universal basic income to those affected. It is hard to conceive that politicians, once given a limitless and blank cheque book, will ever choose to put down this tool to buy votes and to willingly hand the power of the printing press back to central banks.

With all the talk in the U.S. of a Green New Deal (estimated to potentially cost \$100 trillion), free health care to the world, free education to the world, student loan forgiveness and any other numbers of giveaways, it will be tempting for politicians, and many in the public, to believe that there is no limit to how much money can be printed into existence. No country in history has been able to print itself to prosperity. Just ask Venezuela and Zimbabwe, because if money printing equaled prosperity, they would be the richest countries on earth.

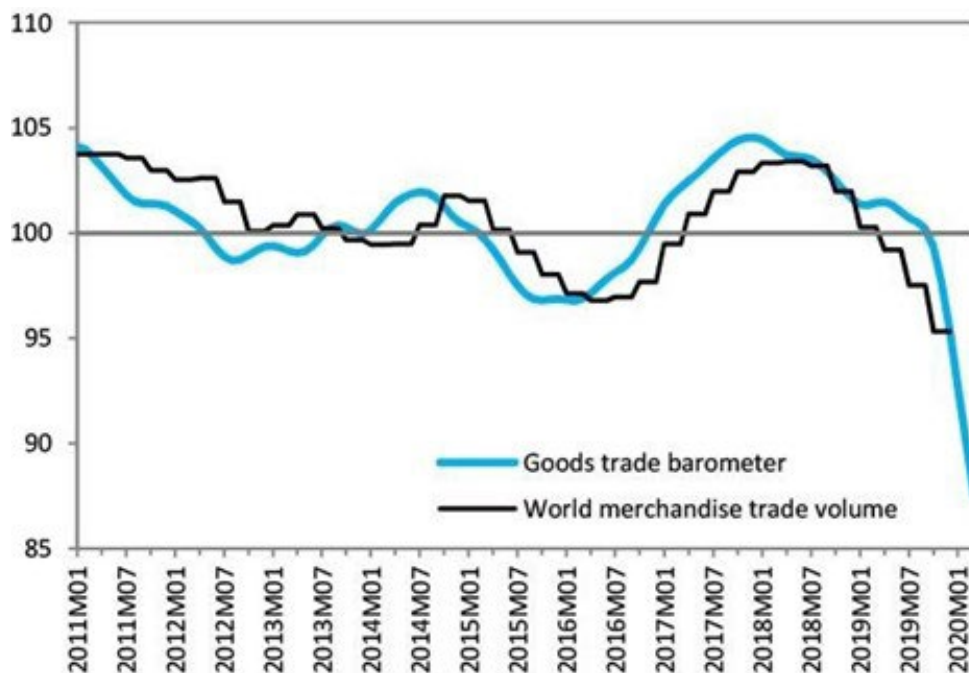
Inflation Will Be Allowed to “Run Hot”

Given the dramatic amount of debt incurred to deal with COVID-19 and the recovery, it is my thesis that central banks will have little choice but to allow inflation to “run hot” (i.e., be above target) for longer than they would otherwise. There is no choice. With global growth slow, high debt levels, the need to finance a rapid realignment of onshoring supply chains (maybe a Green New Deal or two etc.), and tax rates already at high levels, inflating the debt away will be “the solution”. It has been “the solution” to every monetary crisis in history.

Deglobalization is Accelerating

Globalization was already in reverse (Brexit and Trump's election were indicators of this). Global trade peaked in 2018 and has been declining since. During COVID-19, it has plummeted (see Chart 12). The decline is more than the result of slowing economies and will not likely recover. Why? Trade tensions were already running high with Trump waging trade wars around the globe with various levels of tit for tat retaliation. COVID-19, however, was a game changer as the whole idea of globalized supply chains came into question, particularly for critical items like masks, medicines, microchips, software, rare earth materials, etc.

Chart 12 – WTO Barometer of World Trade



In the not too distant past, countries, companies, and citizens were complacent about supply chain risks. It is not just that shutdowns can cause disruptions. More importantly, it is that foreign countries will take care of their own citizens first, and if that means to hell with everyone else, then so be it. We saw this in the global scramble to get personal protective equipment (PPE) for medical staff. Friendly countries were not so friendly, when push came to shove. Countries now realize this and are working hard to bring back production of critical goods to their home turf.

Some examples: Ontario has sworn to never again have shortage of PPEs needed by health care workers; the U.S. has given Kodak (a failed camera and film company) a US\$765 million loan to produce pharmaceutical ingredients in the U.S. (because the vast majority of world supplies today are produced in China); Japan has offered its manufacturers grants to move factories out of China; the U.S. is on a mission to reverse Chinese technology in 5G and in the app universe like Tik Tok and WeChat.

Protectionism is rising and the last significant time we had trade wars in the 1930's had significant impacts in worsening the depression.

Aside from leading to loss of trade, reversing globalization is inflationary. Why? Globalization was deflationary because goods were cheaper to import than to produce domestically and because the loss of quality jobs that accompanied offshoring suppress consumers' ability to pay. Even in the absence of tariffs, moving to protect domestic industries and bringing back the supply chain will mean higher prices (i.e., inflation).

China sees this coming and is already making efforts to make itself less dependent on exports. As such, this is a global phenomenon. All nations are turning inward. **Global Tensions are flaring** and the relationship between China and the U.S. has turned into a new cold war. You can see this in the rhetoric and aggressive actions increasing from both sides. We will be lucky if we can avoid this new cold war going "hot". This deglobalization and increasing cross border tensions are destabilizing and a drag on the global growth needed to recover from the shock of COVID-19.

Robotization and Softwareization Are Going to Accelerate and Spread to More Industries

Robotization and Softwarization was a theme in my prior core thesis and remains in my revised thesis. I believe that given the COVID-19-related acceleration of this trend, it will obliterate millions of jobs in short order. Why will this trend accelerate? COVID-19 has forced numerous industries that previously had employees in close contact with one another or with customers, to consider automation. Meat processing is just one example. There have been numerous plant shutdowns because workers, working in close proximity, became infected. While humans are better at these tasks for now, robots have become a strategic priority to reduce COVID-19 transmission because they don't get COVID-19. Expect COVID-19 and "keeping people safe" to be the excuse for rapid automation.

The tech mega caps like Amazon have done so well because they have inserted themselves as the "safe", socially distant shopping option. Why go to a mall when you can safely click on what you want on your couch? The destruction of neighbourhood and even major retailers was a trend pre COVID-19, but the pandemic has dramatically accelerated the destruction of these businesses, jobs, and the support infrastructure that relies upon them. Had these trends played out over 10 years, as I expected pre COVID-19, maybe there was a chance for workers and companies to adapt. It's too late now. While the obliteration of jobs is a deflationary force, the rapid acceleration of these trends will take it from being a decade long headwind, into a gale force hurricane that, when combined with other deflationary factors I discuss in this paper, will likely add to the demands for, and increase the likelihood of a permanent Universal Basic Income, and/or Modern Monetary Theory, which I believe are inflationary, because the money will be printed.

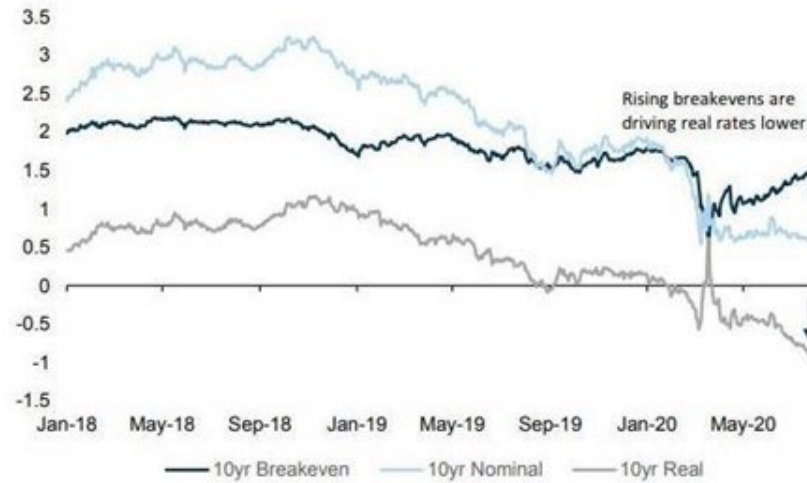
Work From Home (WFH), while seemingly beneficial for many, will only be so, until the next round of evolution that is deflationary for wages, e.g., Facebook allowing WFH but cutting compensation if you move away from expensive cities. This is the 1st round effect. The 2nd round will be when WFH includes

far remote workers like foreigners. WFH, when combined with robotization and softwarization, are major headwinds to employment; but the hits will now start to hit the white-collar jobs, whereas previous rounds mostly impacted blue-collar jobs. I suspect that those cheering most loudly about their improved work-life balance with WFH will be far less enthusiastic about it in two years. While disinflationary both in terms of wages and reduced employment opportunities, and reducing aggregate demand, the response will likely be for more and increasing income supports from government because more and more people will be left without employment opportunities.

The real economy is detaching even further from wall street and tech from physical businesses (see Charts 1, 2 and 3). Tech employs few, main street many. Not a healthy trend. Also, listed versus private company access to capital is stark. Banks in the U.S. are no longer focused on “at risk” lending, preferring to hand out government guaranteed loans. For example, JP Morgan has suspended commercial lending and will only give out government guaranteed loans, no more home equity lines of credit, increased mortgage down payments from 5% to 20%, and increased credit score requirements from 620 to 700. On the other hand, the Fed is buying ETFs, which will buy the bonds of large companies, keeping it super cheap to raise debt and equity capital... for them. If you are a private SMB, you need to borrow at high rates, if you can get it, to survive. All the benefits went to the tech mega caps.

Government debts and deficits are exploding, and no one seems to care. Canada's recent fiscal update revealed a projected deficit of \$343 billion this year alone. A slow recovery or W-shaped recovery likely means giant deficits as far as the eye can see. Central banks are monetizing these debts at a rate not seen since Weimar Germany. Bond yields are not dramatically higher because the central banks are supporting prices and will continue to do so just like they did in the post-World War 2 period. Real interest rates have turned heavily negative (see Chart 13). As bond yields are held around zero and inflation picks up, that means real rates will likely head even lower. That means, IF you can access cheap, long-term, fixed rate debt, you are being paid to take it, even before factoring in taxes, which makes it even cheaper. This will be extremely bullish for asset prices.

Inflation expectations have driven real rates lower
USD Treasury Real and Nominal Yield, and Breakeven Inflation



Source: Bloomberg, Goldman Sachs Global Investment Research

The Wealth Gap is Exploding

For 20 years, perpetually low interest rates, and central bank interventions, like quantitative easing, have caused the wealth gap to explode as those with access to capital (see the section on the Cantillon Effect below) saw their incomes and net worth grow dramatically, while economic opportunity and security for the bottom rungs on the ladder worsened. COVID-19 laid bare the differences between (1) those able to work from home and those that were not and became unemployed; (2) those with access to capital and those without; and (3) technology companies and companies that actually make things.

The breakdown in social cohesion is one consequence of a widening wealth gap. Mass unemployment and stressful and long lockdowns alongside COVID-19 economic damages mostly visited upon the young, less well-educated, and minority groups was a toxic combination. The death of George Floyd was the spark that lit the flames of the recent street violence and protests, but it was years of quantitative easing that led to a historically wide wealth gap, which was the tinder and COVID-19 was the gasoline. Frankly, I am shocked that so many are calling openly for Marxism in America, but these are the consequences when a large enough group believe that they do not have a chance under capitalism.

The historical precedents are ugly for what happens when social cohesion breaks down, particularly due to widening disparity between rich and poor and/or people who feel victimized by an injustice.

Politicians are only too happy to exploit these divisions to advance their own power. The Russian Revolution in 1917, Nazism in the 1930's, and both of the communist revolution in China in the 1940's and the Chinese Cultural Revolution that started in the 1960's are just some examples. In all these times in history, small, ideologically "pure" groups sought to change the political system and succeeded, because "cancel culture" is not a new phenomenon. These movements succeeded because they used intimidation, violence, and social humiliation to obtain compliance. Sound familiar?



In my opinion, one of the main reasons we will move to a universal basic income and MMT (for the record I'm not in favour of either, but see it as an inevitable consequence) will be to shift quantitative easing from a Cantillon-esque type model, where only the rich and connected benefit, to direct payments to citizens, to forestall violence. It is the least bad option. Make no mistake though, this does not mean that the Cantillon effect will be suspended. Far from it.

As we saw with the WE scandal, when governments give away billions or trillions of dollars with limited oversight, there will be plenty of the well-connected and corrupt gorging themselves at the public trough. The only difference now will be that the little guys (i.e., the people) are going to get a little taste to try to keep us in line (i.e., opioids for the masses).

60/40 is Dead

Traditional model portfolios of 60% equity and 40% bonds are highly vulnerable in this environment. Bonds were traditionally held not only to provide income, but because bond values tended to move in the opposite direction to equities which helped lower the overall volatility and risk of investment portfolios. However, bonds can no longer provide much of a hedge to a downturn in equity prices given that rates are near zero. They not only provide no income, but if interest rates are pegged here, there will be limited or no value upside in bond values from here.

In other words, bonds now provide negative return with heavy downside risk. It is basically a one-sided bet. This has dramatic implications for portfolio diversification because if you cannot hold bonds to hedge your equities, what can you hold? I will argue that gold and silver are the new bonds and will

take on an increasing role in portfolios as equity hedges (more later). Equities are also massively overpriced according to 17 out of 20 valuation metrics (see Chart 14).

Chart 14 – The S&P is Overvalued on 17/20 Metrics

S&P 500 Valuations - red/ green borders denote metrics trading above/below their historical average (as of 7/24/20)

Metric	Current	Average	Avg. ex. Tech Bubble	Min	Max	% Above (below) avg	Z-Score	History
Trailing PE	20.3	16.2	15.6	6.7	30.5	24.9%	0.9	1960-present
Trailing GAAP PE	27.6	19.3	18.5	6.7	122.4	43.2%	0.7	1960-present
Forward Consensus PE	21.8	15.4	14.5	9.8	25.1	41.8%	1.9	1986-present
Trailing Normalized PE	21.7	19.1	17.8	9.2	33.9	13.6%	0.6	9/1987-present
Median Forward P/E	20.7	15.2	14.9	9.7	20.8	36.1%	2.5	1986-present
Shiller PE	30.0	17.0	16.4	4.8	44.2	75.8%	1.9	1881-present
P/BV	3.69	2.54	2.34	0.98	5.34	45.3%	1.2	1978-present
EV/EBITDA	14.3	10.2	9.8	6.0	15.0	40.5%	1.9	1986-present
Trailing PEG	2.11	1.45	1.43	0.93	2.21	45.3%	2.8	1986-present
Forward PEG	2.27	1.23	1.21	0.82	2.27	83.9%	5.0	1986-present
P/OCF	15.2	10.8	10.1	5.4	19.0	40.9%	1.5	1986-present
P/FCF	25.7	27.9	24.8	12.9	65.7	-7.8%	-0.2	1986-present
EV/Sales	2.58	1.89	1.81	0.86	2.91	36.7%	1.3	1986-present
ERP (Market-Based)	789	488	504	136	880	61.6%	1.6	11/1980-present
Normalized ERP	482	312	355	-91	965	54.4%	0.8	1987-present
S&P 500 Div. Yld. vs. 10yr Tsy. Yld.	2.96	0.65	0.64	0.17	3.07	358.3%	5.8	1953-present
S&P 500 in WTI terms	77.8	25.1	22.6	2.7	175.3	209.8%	2.9	1960-present
S&P 500 in Gold terms	1.69	1.61	1.37	0.17	5.48	5.2%	0.1	1968-present
S&P 500 vs. R2000 Fwd. P/E	1.26	1.00	0.95	0.72	1.71	26.0%	1.4	1986-present
S&P 500 Market Cap/GDP	1.19	0.62	0.58	0.22	1.30	93.4%	2.0	1964-present

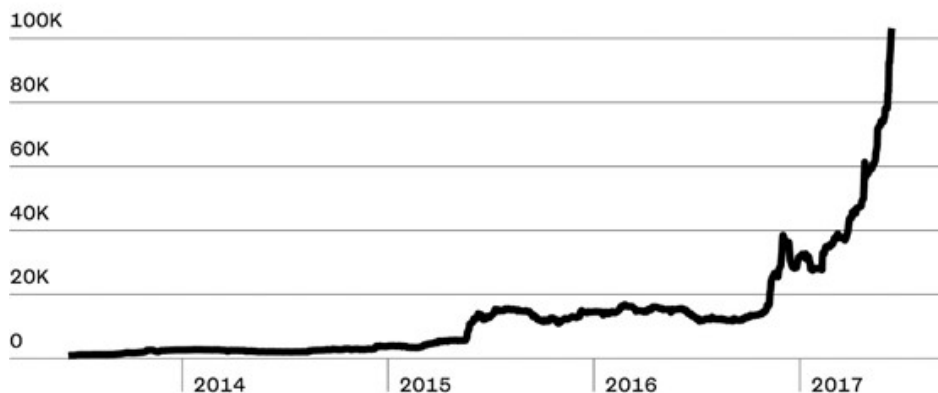
*Above average implied equities are attractive relative to bonds. Note: Trailing P/E based on GAAP EPS from 1960-77, Operating EPS from 1978-87, Pro forma EPS 1988-now.
Trailing GAAP P/E based on GAAP P/E for entire series. Market-based ERP based on DDM-implied S&P 500 return less AAA corp bond yield. Normalized ERP based on normalized EPS yield less normalized real risk-free rate. **Shiller PE is as of August 2019
Source: S&P, Compustat, Bloomberg, FactSet/First Call, BofA US Equity & Quant Strategy

While stocks are overvalued, it is impossible to short them. Why? Because unlimited money printing and inflation could send prices elliptical (see Chart 15 of what happened to Venezuelan stocks when inflation, and NOT prosperity, exploded higher in 2016 and 2017). So although I'm not a fan of stocks at these levels, I would not take the risk of shorting them at a crucial juncture like now.

Chart 15 – Venezuelan Stock Prices During Hyperinflation

Venezuelan stocks

— Caracas Stock Exchange index



Source: FactSet

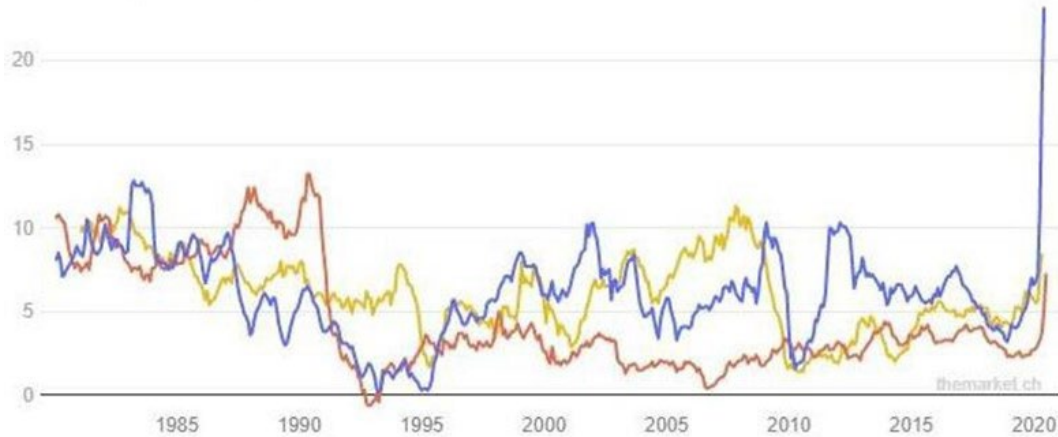
Given that bonds are no longer a decent hedge to equities, the market has turned to precious metals. Gold and Silver are soaring. Why?

- 1) Gold, unlike bonds, does not have an upside price limit (i.e., they have positive duration still), so gold can increase in value if equities decline.
- 2) Real interest rates are below zero. This means that gold, which provides no yield, no longer has an "opportunity cost", in terms of lost yield, to hold.
- 3) Stagflation picking up will show up in commodities, which are extremely cheap on a historical basis.
- 4) Gold hedges BOTH inflation AND deflation. How is that possible? In severe deflation, a credit crisis ensues and gold and silver are the only counterparty free asset in the world. In inflation, it tends to hold its value in real terms.
- 5) Gold holdings today are about 0.5% of global financial assets at today's prices, less than 1/10th of what it was in 1960. Since it is not widely held, and as the world wants it now, and there is not much freely available supply, the price is exploding. It is worth considering that there is less than 1 ounce of gold per person in the world; but after subtracting central bank reserves and jewelry (since granny is unlikely to melt down to sell her wedding ring to get at the gold) there is only about 0.2 ounces per person, a staggeringly small amount if you want to buy some to protect your portfolio.
- 6) Money printing has taken off on a scale not seen in generations in developed markets (see Chart 16) and is highly inflationary. Pundits have argued that monetary velocity (how fast money circulates in an economy) is at record lows (see Chart 17), and as such, money printing will not result in inflation. I believe velocity is low right now because disinflationary expectations are built into the public psyche. Inflation has been trending lower for 40 years, and humans are linear creatures subject to recency bias. This means we look back to the recent past, and assume that the future will mean a continuation of the trend. Trends are like rubber bands; they expand until they are stretched so tight that they must snap back or break. Once the confidence in continued deflation/disinflation snaps, monetary velocity could go dramatically higher and carry inflation with it.

Broad Money Aggregates Rising Sharply

Growth rate of M2 (yoy, in per cent)

— USA — Eurozone — Japan

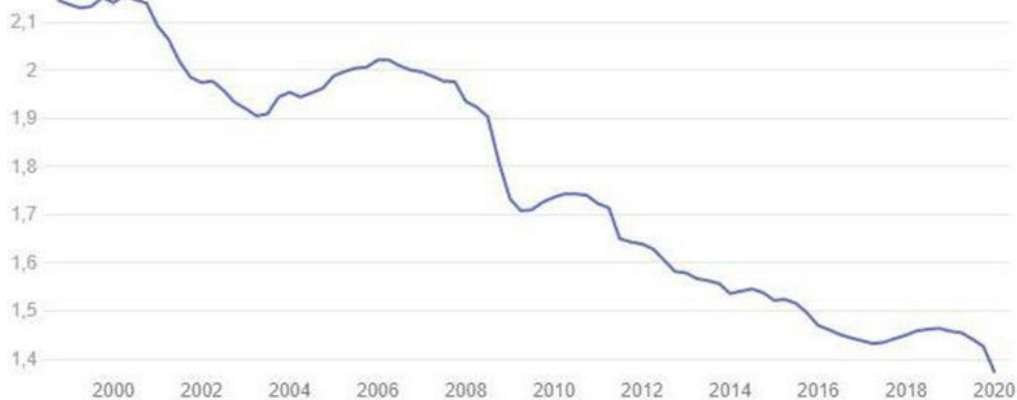


Grafik: themarket.ch, @NomeDelRosa • Quelle: Bloomberg

Chart 17 – Inflation Caused by Money Printing is Constrained by Low Velocity of Money

USA: Velocity of Money at a Record Low

Velocity of Money (nominal GDP/M2)

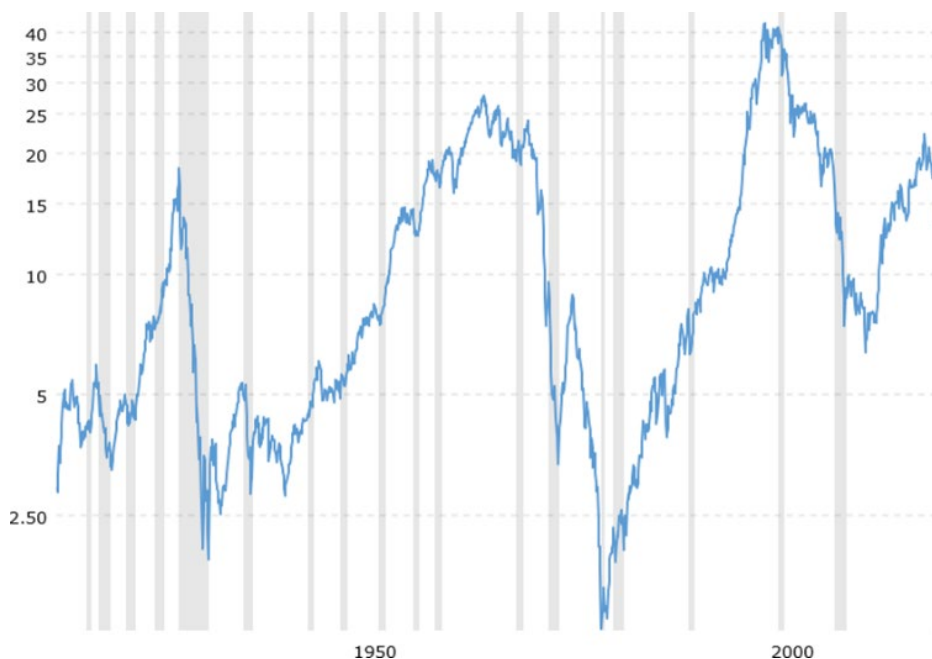


Grafik: themarket.ch, @MarkDittli • Quelle: St. Louis Fed

I will go so far as to say that stocks are in a bear market in gold terms. Remember that stocks are priced in fiat currency. If that currency loses value, stocks may appreciate in nominal, currency terms, but lose value in real terms. In Chart 18, you can see that in gold terms, the Dow peaked during the dot con bubble (yes, I mean “.con” not “.com”) when the fed eased aggressively. Stocks bottomed in 2011 once the market began to believe that the worst was over but stocks rolled over and started heading lower rapidly in 2020. These types of moves can be like large sine waves (notice that pattern in the

chart) and last for periods of 10 years or more. I believe this move is only just beginning and stocks in gold terms may decline $\frac{2}{3}$ or more from here. That could mean gold goes up, stocks go down or some combination. Given the excess money printing, my bet is both go up, but gold much more so.

Chart 18 – The Dow Priced in Gold



The stock market rally is giving investors a do-over. Everyone hates selling at a loss, even if it may be the best decision. With stocks back to previous highs, the decision is much easier now. With stock indices near record highs, it certainly doesn't feel like a bear market, unless you value stocks in real money terms, like I do.

The Lockdown Was Bad, Another Lockdown Will be Catastrophic

As I argued in my [April 14th, 2020](#) whitepaper, the lockdown was a bad idea because it would destroy the economy and make recovery next to impossible, as small businesses were destroyed or crippled by slowly bleeding losses and reducing their ability to bounce back. Fear of a second wave and a future lockdown would (1) incentivize businesses to permanently close seeing that there is no way out; and (2) keep new businesses from forming to replace them due to fear that a second wave would force a closure and cripple them before they got a chance to achieve profitability and stability.

Ford and Trudeau most certainly knew, from the start, that the lockdowns would last longer than two weeks. As I said to my executive team on the day Ford announced the first lockdown lasting a few weeks, that he was lying, and he knew it, and it was deeply unethical. Many businesses held on, hoping it was weeks only, borrowed money to stay alive, and bled while closed, only to have a chance to

open months later, with severe restrictions, rendering many business models impossible. If they had known, if they had been told the truth, many more would have closed and saved themselves huge losses. Ford most certainly knew this, which is why the truth was not told. His intentions may have been to keep businesses hanging on, so that there was a chance at recovery, but he ruined many small businesspeople financially. So many small businesses have been severely weakened.

It was only a few years ago when the central bank and the finance minister talked about “dead money”, and the Trudeau government moved to tax the reserves of small businesses. Times like now is why businesses and people need reserves, to be able to survive a downturn. Now we have one, and too few businesses have the resources to last through slow reopening's or worse, a new shutdown. The next shutdown, if there is one, will be catastrophic, will crush the businesses that managed to hang on by the skin of their teeth, and will send government spending through the roof for the long term as no one will start or reopen a business with the risk of a further lockdown.

We also need to remember, that there may never be an effective, safe, or lasting vaccine.

Even if there is one, and soon, the economy, consumers, governments, and corporations are too leveraged to be able to recover normally.

According to a recent survey, 70% of Americans plan to wait on taking the vaccine when it becomes available or will not take one at all. Very few people, as it turns out, want to be the guinea pigs for an experimental vaccine. You do not have to be an anti-vaxer (and I'm not, for the record, an anti-vaxer) to be worried that not all drugs are safe, particularly ones that are not tested. Doesn't anyone remember thalidomide? I suspect that governments have done significant damage to the public's trust and their sense of safety over drugs when they have spread fear about the anti-malarial drug hydroxychloroquine that has been considered safe and has been in use since 1955.

While I'm not intending to get into the debate about its effectiveness on COVID-19, my point is that the fear mongering that it was a dangerous drug may have damaged the public's trust of approved drugs. Combined with other massive public trust breaking episodes like (a) there is no danger from COVID-19, to COVID-19 will kill us all, to COVID-19 is just a bad flu; (b) from there is no reason to close the border, to we must close the border; (c) from masks do not work, to masks work, to you must wear a mask and by the way we lied to you about masks because we did not want you buying them for yourselves; and (d) walking alone on the beach is unsafe, reckless, and anti-social behaviour, but thousands protesting together in close proximity is just fine. Too many examples to mention. The point is that trust in government is very low. It will not recover for a long time.

Why MMT and UBI Are Here to Stay

QE was never about bailing YOU out. It was for bailing out the well-connected (see section on Cantillon Effect). This is now more widely understood than before, and there are now politicians that want QE

“for the people”, otherwise known as MMT (Modern Monetary Theory). We have already had a taste of this in the past few months with wage and income subsidies.

COVID-19 has made tens of millions of people unemployed. Worse than this, it destroyed so many businesses permanently, so many of these jobs will not come back and new business formation will be impaired due to fear of future lockdowns. Street violence has exploded and inequality, racial, income, and wealth, is front and center of political focus along with COVID-19. It will be impossible to take these subsidies back, without street violence exploding, and the economy going into an even deeper downturn.

More importantly, central banks gave a book of blank cheques to politicians, and no politician will be the one to stop handing out free money. COVID-19 broke the back of resistance to deficits among the citizenry. In prior years, these three groups (central banks, politicians, and the citizenry) had diverging interests. Politicians want to get elected and will vary between giveaways, deficits, and debt as talking points. Central banks want low inflation and will sometimes work counter to the wants of politicians and the citizens to achieve it, which helped maintain balance. The citizenry is also balanced between getting free stuff on one side, and debt/deficits/taxation on the other. It was a delicate balance but has largely worked, albeit imperfectly, for generations. All those groups are now leaning in one direction. Citizens demand bailouts, politicians want to give those bailouts to buy votes and central banks are all too happy to print the money to finance it.

As such, I believe that monetary discipline has gone out the window, and it is not coming back, not for a while. Money will be printed, interest rates may not go up due to financial repression by central banks, and stagflation will follow.

The Election in the U.S. Will be Bad No Matter What Happens

I do not see a situation where the fall election provides resolution to the tearing of the U.S. social fabric. The electorate is hugely dividend and polite, political discourse is no longer possible, let alone tolerated. No matter who wins, one side will accuse the other of rigging it, whether true or not. If Trump wins, the street violence will likely explode, as the radical left protestors will take this as “proof” that the system is rigged, and the Democrats and media, who hate Trump, seem to prefer to let America burn than try to calm the situation. Trump has not done much good to try to calm things either so no side is without blame here.

The Democratic party has taken a lurch dramatically to the left, and “the squad” seems to be in control of the narrative and the party’s vision of America. A democratic win could see a green new deal, dramatically higher taxes, the reimposition of regulations which Trump reduced, and an explosion of social spending with free college, health care, and UBI for all. Money does not grow on trees, but who needs trees when you can just print money electronically with a push of a button.

The situation in Canada, while better, is also problematic. Trudeau has spent an absolutely incredible amount of money and parliament has been shut. There is no budget, only a fiscal update projecting a staggering \$343 billion dollar deficit. But given the damage to real businesses, the slow opening, and reduced revenues, the prospects for lowering of the deficit for years will be near impossible. Debt at all

levels of government is going to explode further. Only inflation can fix the levels of debt we will have, and high debts will make rapid growth impossible.

Smart Money is Leaving the Room

A large number of the world's smartest investors with the longest track records are stepping back from the equity markets and retail money is taking over. David Portnoy (of Barstool Sports fame) picks stocks with scrabble letters and argues stocks never go down and has an army of followers. In some sense he is right that the central bank monetization means the market could rise dramatically in nominal terms. But in real money (gold terms), we are undoubtedly in a bear market (see Chart 18). While I am all for retail investor participation in the markets, it is deeply concerning to see the explosion of retail speculation and it reminds me of my days in late 90's when even in trading rooms, no one was talking about what was happening in the markets; we were being paid to trade for our employer. All everyone was talking about was the next dot con (and yes, I mean ".con" and not ".com" as most of these companies were absolutely a "con") to buy.

I have been asked many times from non-financial market friends about how to get into day trading. I have begged every one of them to ignore the stories of their friends making \$50k/day trading stocks from home. I tell each of them a story of one of my (former) friends who I ran into at a party in 2008 who was learning to day trade using a platform which had a simulator sandbox (where you could put in practice trades to see how you would do). He was astounded and encouraged by his "success" and determined to take his family's life savings and put them into day trading. In horror, I told him that the vast majority of professionals cannot even beat their benchmark indices, with the benefit of training, systems, risk controls, and vast intelligence networks. I told him that these training simulators only build false confidence because you never trade real money the same as you do in a game where you do not lose real money, your house, or retirement fund as a result.

There is also selection bias. Make some paper trades that win, and now you think you are a genius and start to bet real money. It does not mean that you are a genius; you just have the illusion of it, without the long, hard-won battle scars of being a professional trader. Amateurs have no chance. Just like you can "win" in a casino on any given day, it is a mathematical certainty that you will have your pockets picked clean if you go repeatedly. He told me in no uncertain terms, and less politely than this "to mind my own business".

Six months later, he called and asked to take me to lunch and wanted to understand what I was doing. He had lost quite a bit of money in the markets in his escapade into day trading. We were not taking money at the time and I urged him to be patient. We planned to launch the REIT in the fall of 2009, so he only had to wait a few months. He had no patience, and sunk everything into a known Ponzi scheme.

I met him at a friend's party when he told me what he invested in and my face turned white. I told him what I knew and he was angry... again... at me. He insisted that his capital and high returns were guaranteed (they were not), that there was a large insurance company to guarantee them (there was not), and knew what he was investing in (he did not), so I should just back off (he was less polite in his

language than that). It was not long before the scheme collapsed and investors, including my ex-friend, lost all their money. The point is, day trading speculation only benefits wall street, not investors. Ignore the noise, invest with the fundamentals, get good advice, be patient, and in the long term you will be fine.

Many of the top analysts and professional investors I follow are warning about the same things that I do and are positioning accordingly. Not that I am a follower, but if I am forced to choose between "the smart money" and the Robinhooders and Portnoys of the world, the choice, I think, is clear.

The Battle Between Deflation and Inflation

Throughout this paper I have mentioned numerous deflationary and inflationary pressures so it is logical to ask why these forces just do not balance out and we continue on a path of low inflation, just as we have for the past few decades, and in line with my prior thesis. I believe that the deflationary forces in some sectors of the economy are so strong (like mass unemployment and economic damage from the shutdowns) and have come so suddenly, thereby providing little adjustment time and requiring a broad-based monetary easing. Had the pressures been less extreme, there may have been a chance that policy makers could have just let the market adjust, i.e., manage to the average performance of the economy. It is my view that since the dispersion of outcomes has been so large (i.e., some doing extremely well and others crushed), that it is no longer possible to manage to the average outcome, and that the policy stimulus has shifted to try to get almost everyone above the water line. This is a giant break from prior recessions and the implications are inflationary. Add to this, that politicians have taken charge of the cheque book and central banks have enabled them, which will be very difficult, if not impossible to reverse.

What About Hyperinflation?

Given my above analysis, what are my conclusions on whether stagflation turns into hyperinflation? This is a tricky question. Today, I believe that the plan is to create stagflation as cheap money needs to be created to avoid collapse, but there is knowledge that given the current levels of corporate/personal and government debt, and that GDP will be slow to recover and grow slower than ever, inflation is the only way to make that debt go away. No one wants hyperinflation as the damage is always horrific. If money printing and inflation worked, Venezuela and Zimbabwe would be the richest countries on earth. The risk is that the attempt to engineer strongly negative real rates, so that the debts are affordable and can be paid because the economy grows fast enough to outpace the cost of the debt, that central banks lose control and then it becomes a currency crisis as faith in fiat currency is lost.

This is what gold and silver are telling us. See Charts 19 and 20. Not only are investors looking for an alternative to bonds to hedge their equity portfolios, but they also want a hedge against fiat currencies. It bears mentioning that we are only in year 50 or so of fiat currencies while the last 5,000 years have been on some kind of real money system and no fiat currency in history has ever lasted. Even currencies

that most people have considered stable are anything but, when measured in real, inflation-adjusted terms (see Chart 21). My call right now is that we will not have hyperinflation, but that we will have stagflation, because there is no choice. In either case, real assets will do better at protecting wealth than zero yielding bonds and overpriced equities.

Chart 19 – Gold is Doing Better Than Fiat Currencies Due to Fears of Monetary Debasement

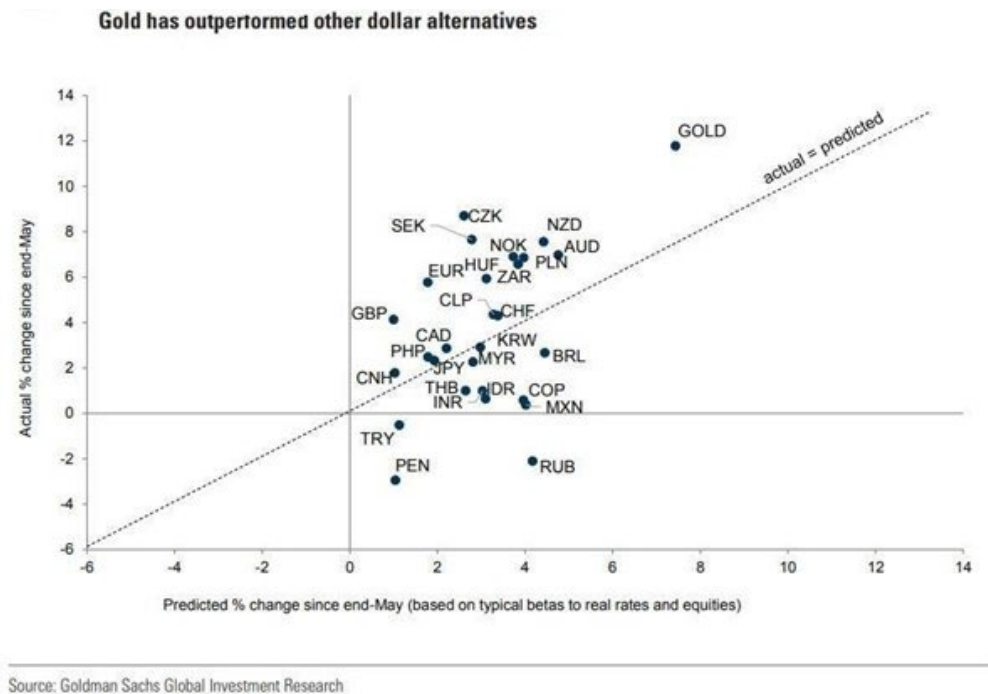


Chart 20 – Gold Has Been Heading Higher Since Fall 2019 and Went Parabolic Post COVID-19



Chart 21 – All Currencies Have Dropped in Real (Inflation Adjusted) Terms

THE CURRENCY RACE TO THE BOTTOM					
GOLD PER OZ	1971	2000	2020	DROP IN CURRENCY 2000-2020	DROP IN CURRENCY 1971-2020
USA	USD 35	USD 288	USD 1900	85%	98%
UK	GBP 15	GBP 177	GBP 1485	88%	99%
GERMANY/EUR	EUR 65	EUR 286	EUR 1630	82%	96%
SWITZERLAND	CHF 148	CHF 458	CHF 1750	74%	92%
SWEDEN	SEK 182	SEK 2448	SEK 16770	85%	99%
CANADA	CAD 35	CAD 417	CAD 2550	82%	99%
AUSTRALIA	AUD 31	AUD 438	AUD 2675	84%	99%
JAPAN	JPY 12K	JPY 31K	JPY 201k	85%	94%
ARGENTINA		ARS 288	ARS 136k	99.99%	GoldSwitzerland
VENEZUELA		VEF 180	VEF 472M	99.99%	

What Assets Will Benefit?

Since governments will have no choice but to continue income schemes, possibly permanently, to ensure against economic collapse, homelessness, starvation, and mass unrest, they will print money and rack up previously unthinkable levels of debt to do so. Stagflation must be engineered to provide hope of paying this debt off (by stealing from savers via inflation). Real assets generally do well in stagflation. Commodities are historically and extremely cheap relative to stocks (see Chart 22), nearing levels not seen in 80 years and in absolute terms are as cheap as they were in the early 1970's when inflation began to shoot higher (see Chart 23).

Chart 22 – Commodities are Extremely and Historically Cheap vs. Stocks

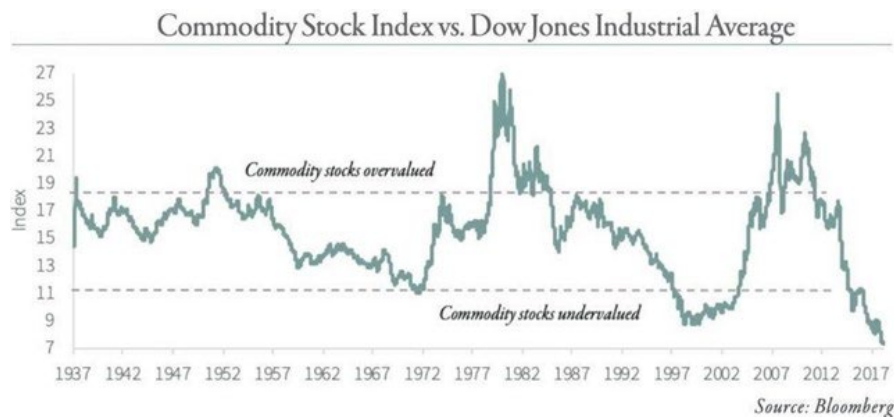
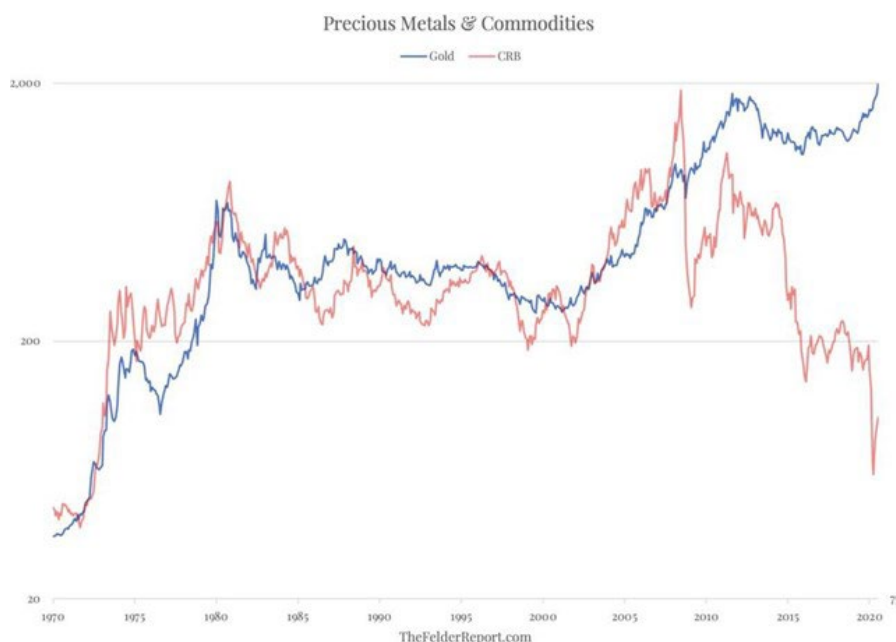


Chart 23 – Commodities are Cheap in Absolute Terms



Apartments, with access to artificially engineered low interest rates will benefit and as a protected and strategic industry should do well. Could rent controls come? Yes, this is possible, just like there were general price controls during the 70's, but the income streams will be secure, and grow, unlike bonds.

For years, along the lines of my earlier view that rates would head to zero, and then negative, I joked (half seriously) with my bankers that a day would come when they would pay us to borrow. They laughed it off as nonsense and yet... here we are. Today, Centurion can borrow 10-year fixed rate debt in the range of 1.5% to 1.8%. This is less than the rate of inflation, meaning while we pay a positive coupon rate in nominal terms, **in real terms, we are being paid to borrow money**. Let that sink in for a moment.

In normal times, we would buy apartments as income generating assets (i.e., income), and then pay part of this income as interest on mortgages (i.e., an expense) we used to finance part of the purchase. **I believe, if I am correct that inflation will continue to exceed the rate of interest (i.e., negative real rates of interest), the REIT would be in the position of earning income on its assets, which income would increase with inflation and earn income on its liabilities (as its mortgages are inflated away).** Let that sink in for a moment too, getting paid on both sides of the balance sheet (assets and liabilities). That is why I believe apartments are a strong play for the times ahead.

Loans on real assets should perform well too. Why, in a world of QE and CB buying of debt and equity, where I say those will not perform and loans on real assets will be okay? (1) because there is a massive disconnect between the public markets that CB monetize and transmission to private SMBs, which means that they will have much higher rates of interest, cushioning the impact of inflation; and (2) loans at reasonable leverage, against assets that are appreciating due to inflation will have collateral that will appreciate and maintain the security of these loans.

Loans to private businesses who are unable to access credit will be a lenders market, with high rates, good security, strong covenants, possibly equity kickers, will also be good, but you must pick sectors carefully.

Precious metals, and other commodities, while up, are still very cheap in inflation adjusted terms, particularly on a relative basis. Additionally, they are so deeply out of favour (and have been for so long) and they not widely held, so it is easier to understand how a change in regimes could cause their values to rise.

What Will Not Do Well?

Long term government bonds and publicly traded corporate bonds bought by central banks. They are overpriced because the prices are manipulated by central banks, and have very little yield. Their prices may hold up, or even increase a little, but will provide poor inflation adjusted returns. The spreads for the risks taken will not be worth it. There is no positive duration left (i.e., the ability to go up as rates are at the zero bound), so they will not provide the traditional equity portfolio hedge of old.

Equities are overpriced on most metrics, technology stocks especially so; however, they may still rise due to central bank supports and money printing, so are not worth shorting.

What About Bitcoin?

Central banks around the world have been watching Bitcoin with increasing concern. Why? Not because of concerns about money laundering and tax avoidance, although those are certainly real issues. Governments do not like the idea that they do not control money. They cannot print gold/silver, so they abandoned real money in favour of fiat currencies, which they can print at will to buy votes. Just like gold, governments fear that if Bitcoin or some other decentralized monetary alternative became widespread, they would lose the ability to spend freely and lose power as a result. So, central banks around the world are looking at their own digital alternatives. Digital coins and MMT flow naturally together. Just create coins, distributed to everyone's online wallet or benefits card and there you go.

That is why I am not a fan of BTC. Because government coins will come, will be mandated, will be usable (unlike BTC) and accepted, will be insured against hacks, BTC will find itself on the outside. BTC, unlike gold, and just like fiat, has no "intrinsic value". Above ground stores of silver and gold are limited to less than 1 ounce per person in the world. BTC can be replaced by government alternatives. If threatened, governments could ban BTC from interfacing to banks, using the argument that it is the conduit for terrorists, money launderers, and tax evaders. Could BTC go higher with gold? Sure. May I even trade it as a speculation? Maybe. But in the long run, I have no interest in BTC in my portfolio.

How I Expect Centurion Funds to Perform and How We Plan to Position

CENTURION APARTMENT REIT

As I have stated in previous papers since the outbreak of COVID-19, apartments were well-positioned, as a basic needs industry, to prosper in this environment. UBI will keep money flowing to individuals and keep the citizenry able to pay for food and housing. We have already seen this play out, and it will continue. As we shift to potentially dramatic negative real interest rates, and an increasingly inflationary environment, real estate, particularly apartments, seem well-positioned to be stable investments with income and capital growth to protect against inflation. The ability to earn returns from both owning the real estate but also from being able to borrow at or near negative real rates of interest is extremely compelling.

CENTURION REOT

Centurion REOT is a high interest rate lender and development equity investor. I anticipate that as banks continue to restrict lending and central banks, via the capital markets, provide ample liquidity to large public corporations, liquidity to small- and mid-sized companies will tighten even further, providing excellent opportunities. Since interest rates on government and high grade public company debts will be suppressed by central bank manipulation, and few institutional mechanisms exist to get money from central banks to SMBs (see previous discussion on the Cantillon Effect), I anticipate that interest rates in the private debt space will remain high, and provided inflation does not skyrocket, provide one of the few ways to generate positive real yields in a stagflationary environment. The credit squeeze on SMBs is going to be epic as they are forced to turn, like never before, to private markets to obtain capital. While economic disruptions may increase the intensity required to monitor and manage the portfolio, keeping loan maturities short and having coupon rates structured to benefit from increases in interest rates, should inflation pick up, will also benefit the strategy.

CENTURION FINANCIAL TRUST

As a private debt lender, the upcoming environment provides similar opportunities as for Centurion REOT. SMBs will have few choices in the new environment. There will be liquidity everywhere, except for them, meaning that their borrowing rates are going up, and not down. The opportunities as a lender will not be evenly spread though, as some types of businesses will not be financeable at any rate due to COVID-19 vulnerabilities and will fail. Success will depend, as it always does in the long term, on the ability to pick good companies in resilient industries, with excellent management teams. If CFIT was an investor in investment grade debt, being bought up by central banks at artificially low rates, I would not be very optimistic about returns at all. However, as I have gone to great lengths in this paper to explain, those on the outside of the system (i.e., SMBs) are going to have the least access to this largesse, and thus, will have to pay more than ever, on a relative basis, to borrow money. Because of these rate premiums, I believe it will be possible to generate reasonable inflation adjusted returns that will be unavailable in traditional bond portfolios.

Summary

The disinflationary and “lower for longer” trends I have discussed many times for the past decade have now moved into the next stage where the monetary and fiscal response has become, and will stay, so extreme that it will finally break the back of disinflation. In my opinion, due to the poor government response to COVID-19 and the resultant damage done to people and the real economy, there is no alternative but to continue to print money on an extreme scale, for the purpose of preventing economic and social collapse, and also to inflate away the debt required to do so. For the first time in my lifetime, central banks, politicians, and the public are aligned in providing liquidity and disregarding debt and deficits as relevant. Politicians, now empowered with the printing press to show that they are “doing something”, will use it to buy votes, and will not willingly return that power to the central bank.

This is a paradigm shift.

Real assets are set to outperform traditional portfolios in this environment. Stocks may rise on the tsunami of liquidity, but depreciate in real, inflation adjusted terms. The stock market, having rallied to previous highs, provides investors an unprecedented opportunity to realign their portfolios for a trend that is likely to play out over at least a decade in my opinion. This is the financial market equivalent of a “do over”, which is rare, and even more rarely, so obvious with analysis and a long- term lens. Traditional bonds, with yields already at zero, provide almost none of their traditional hedge against a decline in equities, and will likely even provide negative real yields. Once this becomes understood in the mainstream, I expect real asset prices will roar higher, at a minimum on a relative basis, given how cheap they are on a historic basis.

At Centurion, we are fortunate that all our funds have performed well in the environment of the last few years. Being real asset based, I believe that we are properly positioned for what lies ahead.

■ **Greg Romundt**

