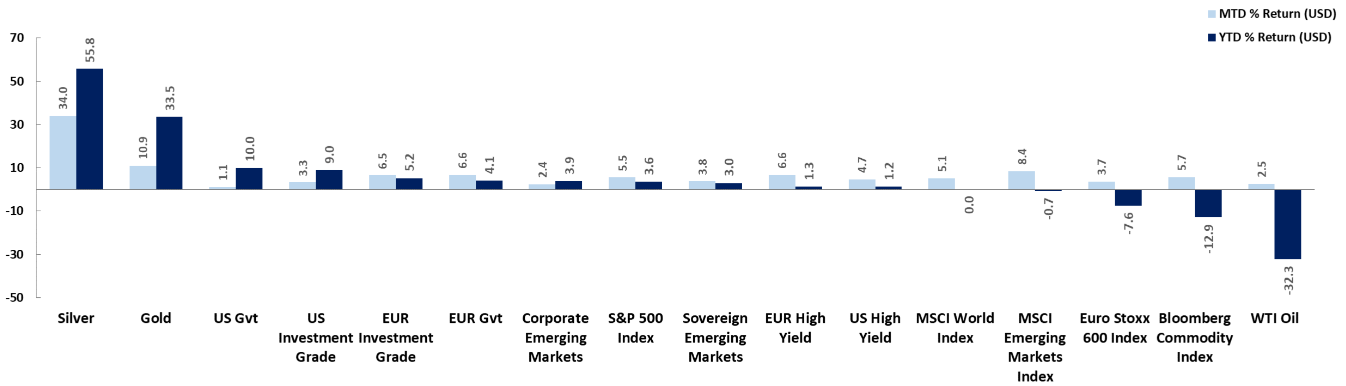
MAM Insights

In the years following the financial crisis, numerous economists and market observers warned of rising inflation in the face of the unorthodox monetary policy by central banks. They were wrong time and again. A world of low inflation, low growth, and low rates for more than 10 years has been formidable for financial markets and growth stocks in particular. Most people would dismiss the risk of inflation since it has failed to show itself for so long. Most investors today would not be aware of the impact of inflation on portfolio management. We believe the events of the last six months are creating tectonic shifts in the macro-economic environment. While these changes take time to materialise, their impact can be sudden. Preparation will be of the essence. We believe we are at the onset of a new era of financial repression, in which government will make sure that inflation rates remain consistently above government bond yields for years. This is the only way to reduce the crushing levels of government debt. In this note we explain our view on inflation and what it means for portfolio management. A focus on Silver prices is also added to provide colour on the recent rally.

Chart 1. Asset Class return YTD (USD Base)



The Return of Inflation

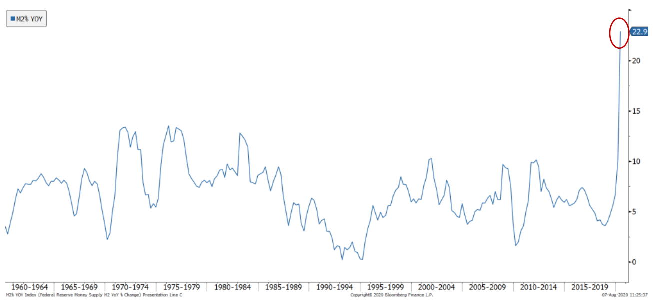
We are living through the worst recession since World War II, yet we observe the fastest growth in broad money in at least three decades. In the United States, M2 is growing at more than 23% **(Chart 2)**. We need to look all the way back to the Civil War to find levels that high. In the Eurozone, M3 is growing at 9.2% **(Chart 3)** and we think it is only a matter of months before we reach the previous peak of 11.7% seen ahead of the great financial crisis in 2007.

So far, investors do not seem to believe the growth in broad money matters with markets likely seeing it as a short-term resultant of the Covid-19 shock. However, we believe the creation of money growth is now very different from that of the Quantitative Easing years. Today, broad money growth is driven by governments and politicians intervening directly in the banking system with governments guaranteeing the loans banks grant to companies.

In our view, the shift in the control of money supply from central bankers to politicians has deep market implications. Politicians have a very different agenda and incentive than central bankers. They need inflation to pick up to reduce the high levels of debt accumulated through years of historically low interest rates. Now, they have a grasp on the mechanism and tools to create inflation so they will create it.

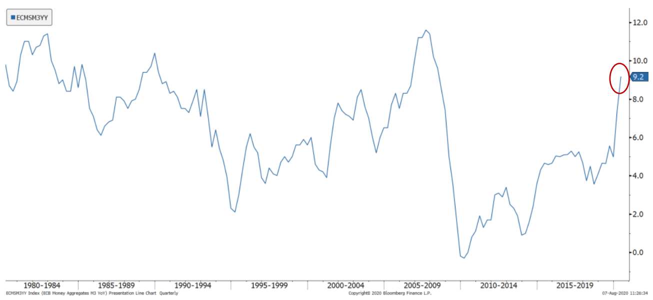
Arguably, central banks started quantitative easing policies to try and create inflation yet never succeeded so why would it be different today?

Chart 2. M2, Broad Money Growth in the US (Quarterly)



Source. Bloomberg, MAM Research

Chart 3. M3, Broad Money Growth in Europe (Quarterly)



Source. Bloomberg, MAM Research

In the past decade, central banks created a lot of non-bank debt which kept interest rates low, inflated asset prices thanks to a significantly lower discount rate, and permitted companies to borrow cheaply in the bond markets. Central banks never succeeded in triggering commercial banks, the true drivers of money creation and inherently money growth, to issue credits and loans. As a result, we experienced an unwelcomed trifecta: no broad money growth, low nominal GDP growth **(Chart 4)**, and high growth of debt **(Chart 5)**. Now, governments are exercising control over commercial banks and issuing credit guarantees which were not in place back then. Consequently, banks will now give credits freely.

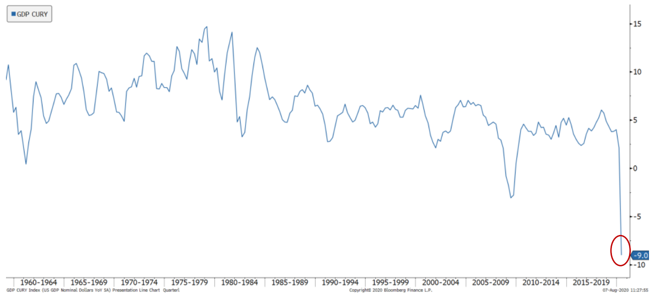
As a result, we could potentially see a repeat of the financial repression seen in the decades after World War II in Europe and a repeat of stagflation seen in the US throughout the 1970s. In a financially repressive environment, the goal is to achieve a higher level of nominal GDP growth than the growth of debt, meaning the spread between the two must be greater than 0 **(Chart 6)**. Following basic macro-economic theory, to achieve higher nominal GDP growth relative to the growth of debt, we need to increase the velocity of money. Simply put, this is the measure of how rapidly a dollar bill changes hand in the economy. The higher the velocity, the larger the amount of nominal GDP produced for each dollar.

Today, velocity in the US is approximately 1.0 and the lowest recorded number before that was 1.4 back in December 2019 **(Chart 7)**. Quantitative Easing was a key driver of shrinking velocity. The money was landed to savings institutions but never found its way into the economy (i.e. businesses and consumers) because all those institutions could do with it was purchasing financial assets rather than buying goods and services. The money could not directly affect nominal GDP.

As mentioned above, this has changed fundamentally with governments now issuing loan guarantees to commercial banks. The money banks are loaning out is finding its way directly into the pockets of businesses and consumers. Velocity should rise progressively and consequently so will inflation. While these changes take time to materialize, tectonic shifts are underway. Surely it may not appear in CPI numbers for some time just because of how it is constructed, but we are starting to observe signs of inflation elsewhere like financial markets and in our everyday lives.

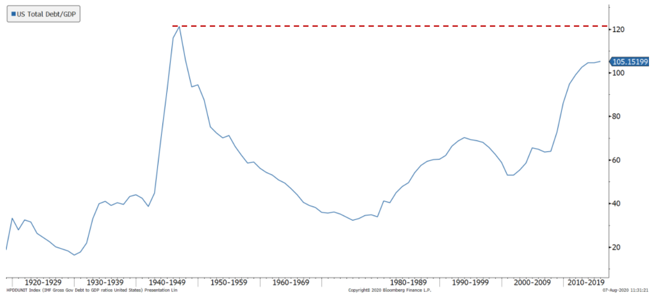
Global trade tensions and supply chain disruptions will only exacerbate an increase in prices. We believe a rise of inflation beyond the Fed's target rate of 2% is very likely. While some may justify a low-inflation thesis with a high unemployment, we point out to the 1970s. During that time, the US had both high unemployment and high inflation **(Chart 8)**. These two are not mutually exclusive.

Chart 4. Nominal GDP Growth (Quarterly)



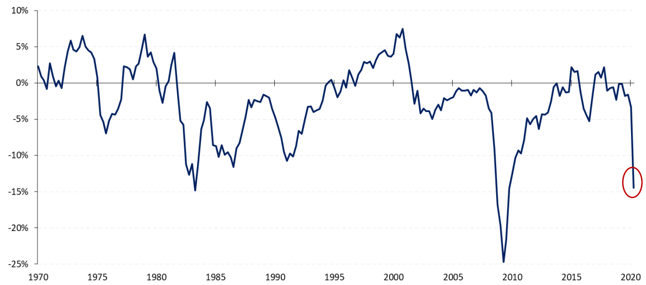
Source. Bloomberg, MAM Research

Chart 5. US Total Debt/GDP (Quarterly)



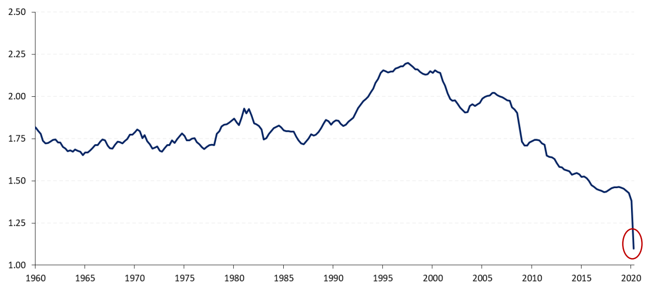
Source. Bloomberg, MAM Research

Chart 6. US Nominal GDP Growth - Growth of Debt (Quarterly)



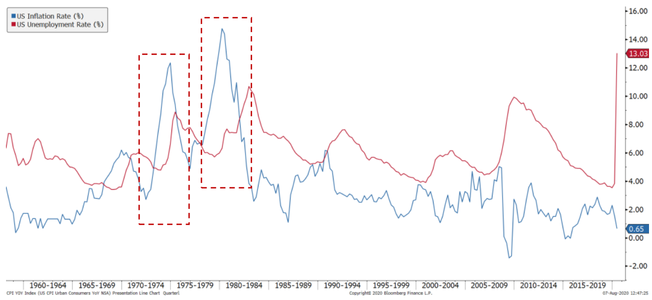
Source. St Louis Fred, MAM Research

Chart 7. US Velocity of Money (Quarterly)



Source. St Louis Fred, MAM Research

Chart 8. US Inflation vs. Unemployment Rate (Quarterly)



Source. Bloomberg, MAM Research

Market Indicators of Rising Inflation

The most common gauge of inflation is the US CPI (US Consumer Price Index), a monthly series with several quarters of time lag, currently standing at +0.6% YoY. Real inflation will be felt in markets and everyday life well ahead of its impact on the US CPI data. At present, a number of market-based indicators of inflation have started to confirm our thesis:

US 10Y inflation expectations have moved up to +1.7% from a low of 1.08% in March 2020, and still rising **(Chart 9)**. This measure of inflation expectations is a leading indicator. During the Great Financial Crisis, inflation expectations bottomed 6-months ahead of US CPI data. This shift in fixed income investors' sentiment with regards to inflation can be seen in the record inflow into inflation protection ETFs **(Chart 10)**.

The US yield curve has moved from 0 to 41bps in the last one year **(Chart 11)**. While the Fed's likely yield curve control may cap the usefulness of this metric, it still suggests higher inflation longer-term.

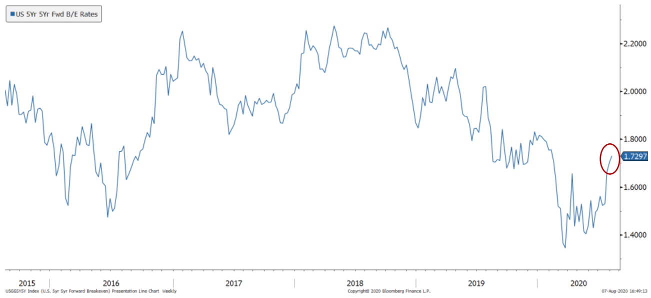
The USD weakness has accelerated over the last 2 weeks. The USD Index is -3.15% YTD and has technically broken down the uptrend initiated 10 years ago **(Chart 12)**. A weaker dollar usually drives up the price of commodities, which are priced in dollars, and the price of imports from foreign manufacturers. This creates room for price increases by domestic manufacturers; and therefore higher inflation.

Gold prices, historically a good inflation hedge, have moved +35% YTD **(Chart 13)**. Other commodities are starting to follow gold and silver higher; namely natural gas and silver prices. Years of under-investment in commodities and ever increasing demand is a perfect recipe for much higher commodity prices long-term as prices start to recovery from a 12-year bear market **(Chart 14)**.

There is also anecdotal evidence that inflation is starting to pick-up for other reasons than monetary ones. Indeed, the pandemic has dramatically impacted trade and supply chains globally. The ISM Prices Paid Index reflects a change in prices paid by industry representatives for products or services received. The Index in July reached 53.2 which is the same level as January 2020 when the economy was seemingly running "hot" **(Chart 15)**. This "V-shaped" recovery in prices paid is in sharp contrast with the lack of economic activity recovery. It suggests inflation is appearing in supply chains. This will ultimately be transferred to the consumers down the line.

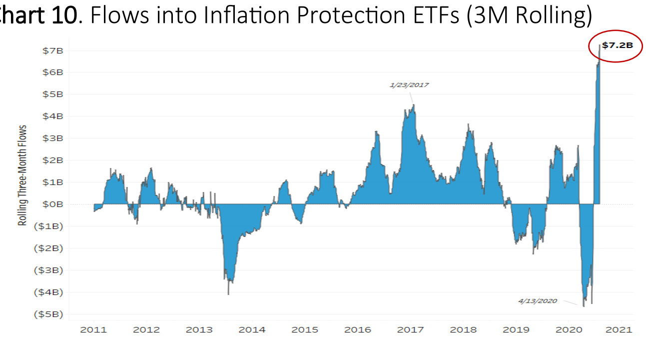
Using a combination of capacity utilisation data, US unemployment rate, Commodities Index, and ISM Prices Paid Index, this leading indicator of inflation is stabilising. This stabilization in the leading indicator of inflation is important because it signals that bond yields have limited downside from here. This has significant ramifications for financial markets.

Chart 9. US 10-Yr Inflation Expectations (Weekly)



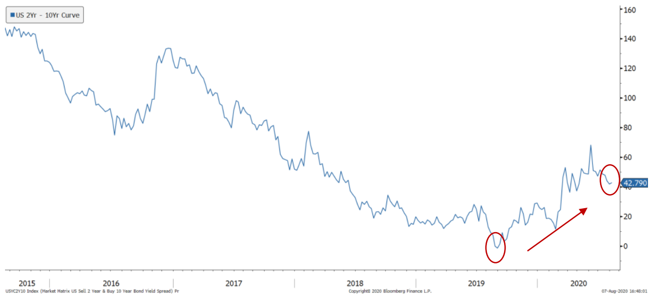
Source. Bloomberg, MAM Research

Chart 10. Flows into Inflation Protection ETFs (3M Rolling)



Source. Bloomberg, Arbor Research & Trading

Chart 11. US Yield Curve (Weekly)



Source. Bloomberg, MAM Research

Chart 12. US Dollar Index (Monthly)

Source. Bloomberg, MAM Research

Chart 13. Gold Spot Index (Monthly)

Source. Bloomberg, MAM Research

Implications in Asset Management

Very few people managing money today have experienced or are aware of how to deal with inflation. We did not have any runaway inflation over the past 10 years. Most financial markets have benefited from low inflation, low growth, and low rates. Not only has it pushed bond yields to record lows, it has also crowded capital into high growth areas of the market such as technology stocks. What does a comeback in inflation mean for financial assets?

It will severely shake up the status quo. Mounting inflation expectations is negative for fixed income markets in the US and Europe, and will put pressure on bonds prices. Creating near-term upside risk for nominal bond yields. In the US, 10Yr bonds yield 0.55% **(Chart 16)**. In the absence of yield curve control from central banks, investors should expect nominal yields to rise sharply over time (i.e. US 10-Yr bonds at 2%+).

Many, if not all roads, are leading to a weaker dollar in the next economic cycle. Unlike last year, the greenback is no longer benefiting from higher interest rates with US real rates now below those of many partner countries. The currency has lost its relative carry attractiveness which fuelled its strength the last decade. Downside risk prevails and a rise in bond yields would only exacerbate the pressures. Despite the recent 5% appreciation of the Euro vs. the Dollar **(Chart 17)**, we could to see the union's currency trading back at 1.25 against its North American counterpart in a couple months.

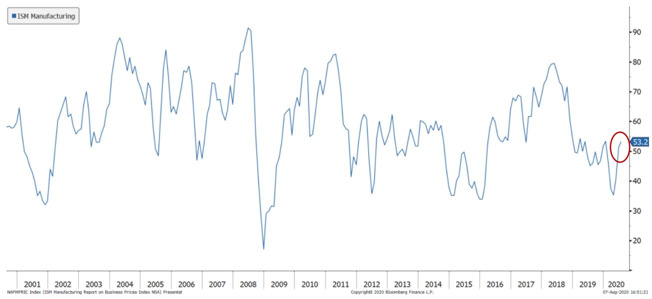
Commodities may find the light at the end of a multi-decade bear market. A weaker dollar and lower real yields both have a direct stimulative impact on the global economy, from which the commodity complex should benefit from. For as long as current market dynamics hold, precious and industrial metals will remain attractive to investors. Gold and silver have the potential for a multi-year bull market in the making. As we mentioned in our latest MAM Insights, we could see prices reach $2,300 for Gold and $35 for Silver. Soft commodities may suffer some headwinds from rising trade tensions with China and energies are facing some short-term downside risk with shifting mobility trends, but overall the landscape remains supportive to broad commodities **(Chart 18)**.

All of the above should also be very supportive and positive for emerging markets. Equities and local currencies still trade at historically cheap levels whether we look at it from a P/B or REER basis, respectively. EM bonds should also continue to benefit from falling real yields in developed markets with investors seeking inflation protection in regions with higher yielding assets on both a nominal and real basis. We continue to hold a positive view on broad EM equities **(Chart 19)** which believe could trade above their 2017 highs. We favour Chinese, Brazilian, and Mexican equities at the moment. Among EM currencies, we prefer exposure to the Brazilian Real or

Chart 14. Broad Commodity Index (Monthly)

Source. Bloomberg, MAM Research

Chart 15. ISM Manufacturing (Monthly)



Source. Bloomberg, MAM Research

Chart 16. US 10-Yr Bond Yields (Monthly)

Source. Bloomberg, MAM Research

Chart 17. USD/EUR Spot Rate (Weekly)

Source. Bloomberg, MAM Research

Chart 18. Broad Commodity Index (Weekly)

Source. Bloomberg, MAM Research

Mexican Peso which both trade over 2 standard deviations cheap on a REER basis. In fixed income, we continue to recommend a local currency bonds exposure **(Chart 20)**, they seem set to outperform on a wedge pattern breakout.

Ultimately, higher inflation should ring the closing bell to a decade long tech bull market. Even in the 1990s, the tech sector could not withstand higher inflation. It quickly started to underperform the market **(Chart 21)**. The tech sector's business model is optimized for a deflationary environment and so are its valuations. Technology companies valuations are driven by the terminal value which is highly sensitive to the discount rate which is positively correlated to inflation. If inflation rises so does the discount rate, thus lowering terminal value. Climbing real rates will therefore be disproportionally harmful to growth stocks. Today, the 5 companies named FAANG (Facebook, Apple, Amazon, Netflix, Google) account for 18.9% of the S&P 500 index's total market cap. When accounting for Microsoft, this number rises to 24.7%. At the peak of the bubble in 2000, Microsoft was c.3.8% of the S&P 500 Index. Today, it represents almost c.6% **(Chart 22)**. We often see days in US markets where Apple and Amazon account for 75% of the Nasdaq's move on the day. We are reaching peak exuberance when it comes to technology stocks. As inflation comes back, the dispersion between value and growth stocks should narrow **(Chart 23)**.

Focus on the Outlook for Silver

As per the "MAM Q3 Investment Outlook", we have been bullish on precious metals for a while. While our focus initiated with Gold, it quickly moved to Silver as fundamentals were pointing to a potential outperformance of Silver vs Gold over time. Silver spot prices have moved +144% from the their bottom in March 2020 **(Chart 24)**; outperforming gold by +70% in the same timeframe. So what now? Short-term technical are looking overbought. This suggests a potential pull-back in Silver prices of 5-10% which has started today. Yet, this is only a bull-market correction worth taking advantage of. Indeed, we are moving our target price on Silver from $30 (+8% upside potential) to $45 (+62% upside potential) in the next 1-2 years. What is driving our price target change? A combination of increased speculative demand for Silver combined with minimal supply growth. Silver could repeat the bull market between 2008 and 2011 which saw prices +490%.

On the demand side, rising inflation expectations will have a negative impact on the USD and boost commodity prices; especially Gold and Silver. We are at the early stage of the speculative demand for Silver. The most traded ETF on Silver is the iShares Silver Trust ETF ("SLV") **(Chart 25)**. The SLV has seen its holdings of Silver rise from 380m ounces in March to 617m ounces today. This 237m ounces increase in Silver

Chart 19. EM Equities (Monthly)

Source. Bloomberg, MAM Research

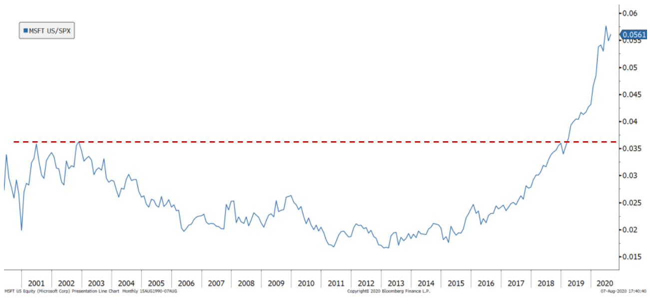
Chart 20. EM Local Bond Currency Index (Weekly)

Source. Bloomberg, MAM Research

Chart 21. Tech Sector / S&P 500 Index (Monthly)

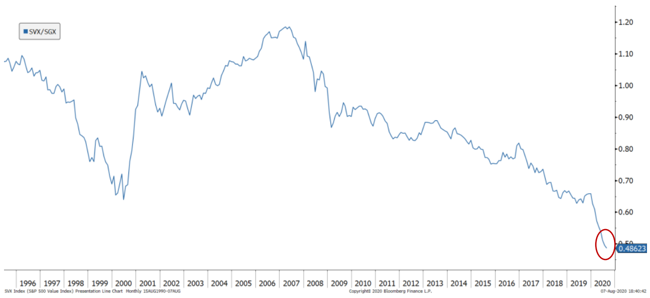
Source. Bloomberg, MAM Research

Chart 22. Microsoft % of the S&P 500 Total Mkt. Cap (Weekly)



Source. Bloomberg, MAM Research

Chart 23. Value / Growth (Monthly)



Source. Bloomberg, MAM Research

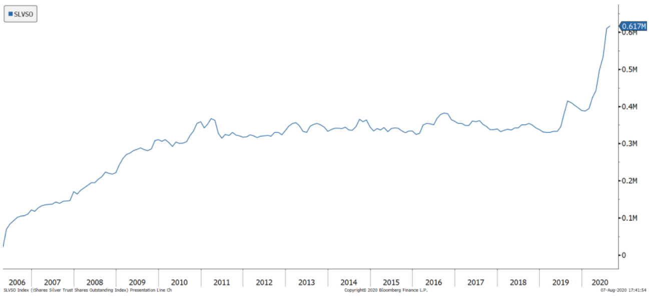
physical holding, in the time span of 4 months, represents 30% of the expected yearly production of 810m ounces of Silver. This speculative demand is happening at a time when actual industrial demand is increasing. Solar investments are accelerating worldwide which will further increase the demand of Silver in the photovoltaic production process. As such, we believe that an incremental increase in Silver demand from ETFs can create significant shortage and a bull market in prices akin to 2008/2011 . This would bring Silver spot price to our target of $45.

Our target for Gold remains $2,300 (+12% upside potential) for now. This target is likely to be increased in the near future in light of our positive views on commodities and Silver.

Chart 24. Silver Spot Index (Monthly)

Source. Bloomberg, MAM Research

Chart 25. iShares Silver ETF Physical Metals Holdings (Monthly)



Source. Bloomberg, MAM Research

Investment Implications

Portfolios have already been adjusted to reflect our macro-economic view, but please find below some additional details on the construction of portfolios:

Fixed income markets. We will keep limited exposure to fixed income markets with preferred exposure to local currency emerging market debt (recent addition of the BlueBay EM Unconstrained Bond Fund). We recently identified the Muzinich High Yield Long/Short fund as a potential investments when credit investments are required. This fund helps to gain exposure to the US high yield market while reducing the downside capture in case credit markets sell-off again. We are looking at various asymmetric ways to play rising inflation via a steepening of the US yield curve or via straight inflation swaps.

Equities. Our allocation to equities is unlikely to change dramatically from what we have been advocating for a few months. We will continue to favour exposure to cyclicals/ value stocks over growth stocks based on the risks mentioned above. We will continue to hold investments in technology stocks via specialists funds (such as Atonra) as they should be able to navigate better any potential draw-down. In the MAM Macro Hedge Fund we have initiated a trade that will benefit if Value stocks start to outperform Growth stocks over the coming months. Geographically we will continue to overweight Emerging Markets with a focus on China, Brazil and Mexico via specialist funds and ETFs.

FX. The EUR/USD exchange rate is finding significant resistance at 1.185. A short-term correction is underway. We will take advantage of 3-5% pull-backs to further reduce USD exposure in EUR accounts and vice-versa increase EUR exposure in USD accounts (via forwards or options).

Commodities. We will continue to keep sizeable exposure to broad commodity ETFs on top of Silver and Gold. While we are taking some partial profits on some silver positions after the recent rally, we are also selling some put options on silver to take advantage of the record high volatility. We have benefited from a Long trade in Natural Gas in the MAM Macro Hedge Fund as Natural Gas prices rallied +35% in the last two weeks. We will continue to trade Natural Gas and look for additional opportunities in soft commodities. We have also identified two Commodities hedge funds on which we are currently doing due diligence.

Hedge Funds. We continue to favour exposure to hedge funds which have demonstrated the ability to generate alpha in different macro-environments such as the Io Macro Fund.

As always, please feel free to reach out to us should you have any questions or comments regarding this research.

Kind regards,

MAM Investment Team

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