the advisor

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Mutatio

(Change)

"The budget should be balanced, the Treasury should be refilled, public debt should be reduced, the arrogance of officialdom should be tempered and controlled, and the assistance to foreign lands should be curtailed lest Rome become bankrupt."

Cicero (attributed), 55 BC

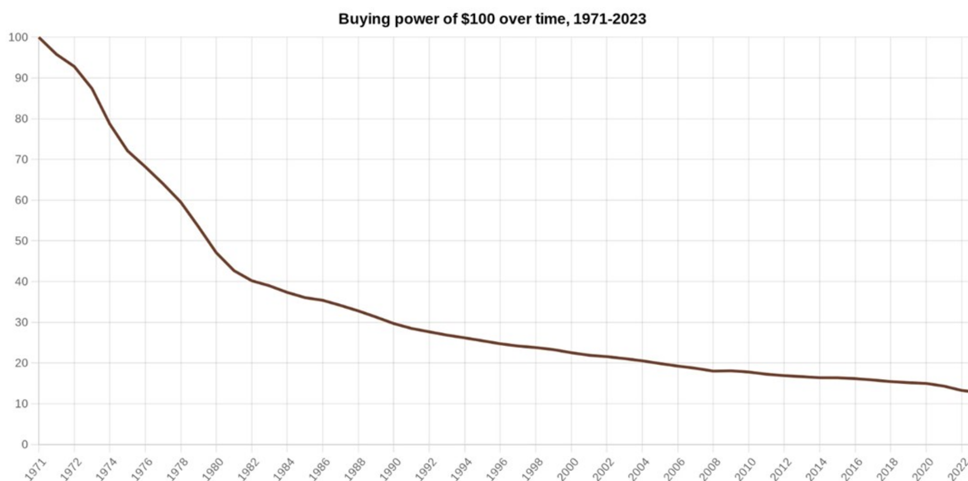
Are we experiencing a market regime change?

Across the West, sovereign debt levels were last this high eighty years ago; back then the US Dollar replaced Sterling as the primary reserve currency. Inflation was last this high forty years ago; then governments retreated from interfering in their economies. Interest rates were last this high fifteen years ago; then the sub-prime mortgage bubble burst. In all of these cases, change arrived gradually, then suddenly.

The focus these days on interest rates is understandable, but what the US Federal Reserve is doing needs to be understood in the context of the most leveraged American economy in history. The damage that the Fed and its monetary policy experiment (zero interest rates & quantitative easing) has inflicted on the American economy is incalculable.

By abusing monetary policies, the Fed has delayed and transformed the problem, worsening the situation. We are now trapped in a dynamic between systemic bubbles that are too big to fail on the one hand and the problem of inflation on the other. Government spending is also to blame. The fiscal abuse, due to the pandemic and to other "crises", is exacerbating the inflation problem.

While interest rates will rise and fall, the enormous amount of debt created over the last fifteen years will continue to weigh on the economy - until it is destroyed by default or by inflation. The debt cannot be repaid in constant dollars because the American economy lacks the productive capacity to generate sufficient earnings to do so. Ditto for other indebted Western economies. This is the world central bankers have created and cannot escape.



Because of the terrifying alternative (default & depression), we'll probably rely on inflation to destroy the debt. The process could take years. There is a template the victorious Western allies used after WWII to deal with similar sovereign debt levels.

In the 1940s it was *fiscal-driven* inflation that dominated. In the 1970s it was *credit-driven* inflation that dominated. Policies that work in one environment may backfire in the other environment.[1]

The policy successfully employed to contain fiscal-driven inflation after WWII is called financial repression. Government spending was curtailed, and interest rates were held below the rate of inflation to melt away the debt. Rates on American 10 year government bonds were capped at 2.5% while inflation ran much higher. Capital controls and regulatory restrictions created captive investors for government bonds, limiting tax-base erosion. Bond investors lost much of their purchasing power.

The credit-driven inflation of the 1970s was contained by restricting the money supply and raising interest rates above the rate of inflation. This policy was possible because the federal debt was small relative to the

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size of the economy. For the past forty years in the aftermath of these policies, inflation fell along with interest rates, giving bond investors impressive returns.

Today's inflation is largely fiscal-driven, so financial repression is probably the preferred policy choice. If we are indeed in a new paradigm, investors need to be prepared to endure higher-than-normal interest rates as well as higher-for-longer inflation.

What worked as investment strategies for the past forty years may no longer work in the new market regime. Investors will have to reposition their portfolios to hold the right investments, in the right asset classes, and in the right currencies.

If inflation is going to be with us, possibly for years, what does that mean for the value of the US dollar and other fiat currencies?

One of the functions of any currency is that it should be a store of value, something the US dollar has spectacularly failed to accomplish. Since America left the Bretton Woods agreement in 1971, the US dollar has lost approximately 85% of its purchasing power (see chart on page one).

Later this summer we are going to find out if the Dollar, along with other fiat currencies such as Sterling, Euro, Yen, etc., are poised to lose even more investor confidence.

As a step towards replacing the American lead 'rules-based order', the BRICS nations (Brazil, Russia, India, China & South Africa) have announced they are moving away from the dollar payments system and are preparing to launch an alternative: the BRICS+ currency.

The BRICS+ include additional countries, such as Argentina, Egypt, Iran, Indonesia and Saudi Arabia, joining the putative currency bloc. This currency alternative will likely be linked to gold and to other commodities.

Probably the best metric for dollar strength is the price of gold in dollars. Debasement of the dollar really means higher inflation and a higher dollar price for gold as well as for other commodities.

Higher gold and commodity prices generally favour the BRICS+. China and Russia are the world's largest producers of gold. Russia and Brazil are also commodities exporting superpowers. Because of the link to gold, this dynamic could lead the BRICS+ currency to dislodge the dollar as the preeminent payment currency more quickly than many expect.

Why drop the dollar? According to economic commentator Jim Rickards, "In no small part the answer is U.S. weaponisation of the dollar through the use of sanctions. For years, the U.S. has used sanctions to punish nations such as Iran. But the sanctions the U.S. and its allies imposed on Russia after it invaded Ukraine last year were … unprecedented.

"Many other nations began to conclude that they could be next if they run afoul of the U.S. on certain issues. And that fear has greatly accelerated the push to opt out of the dollar system entirely."[2]

As the leading reserve currency, the US dollar is used to conduct global payments for goods and services. Reserve currencies are the savings accounts (from trade surpluses) of sovereign nations. These balances are held in the form of securities, denominated in a specific currency. For 60% of global reserves, those holdings are US Treasury securities denominated in dollars. The reserves are not actually in physical dollars; they're in American securities.

Thus an alternative currency cannot be a reserve currency without having a large, well-developed sovereign bond market. No country in the world comes close to the U.S. Treasury market in terms of size, maturities, liquidity, settlement, depth and other necessary features.

The real impediment to an alternative reserve currency is the absence of a bond market where reserves are actually invested. The BRICS+ currency offers the opportunity to create a deep, liquid sovereign bond market that could challenge US Treasuries on the world stage almost from scratch.

"The key is to create a BRICS+ currency bond market in 20 or more countries at once, relying on retail investors in each country to buy the bonds. The BRICS+ bonds would be offered through banks and postal offices and other retail outlets. They would be denominated in BRICS+ currency but investors could purchase them in local currency at market-based exchange rates."[3]

If the BRICS+ currency is gold linked it would offer a store of value feature that fiat currencies lack. The Chinese in particular would find such bonds appealing since they are largely banned from foreign markets and are over-invested in property and domestic stocks. The US dollar will likely remain a safe-haven asset, but its reserve primacy would be jeopardised. Ditto for other fiat reserve currencies.

Investors will be impacted by these changes in unforeseen ways, possibly for years to come. If the economy and markets are in the early stages of a transition, it is far from complete.

Time to adjust your portfolio. Change is here, suddenly.

Sources:

1. Lyn Alden, "Do High Interest Rates Fix High Inflation?", Lyn Alden Investment Strategy, June 2023
2. James Rickards, "The Biggest Monetary Shock in 52 Years", Daily Reckoning, 20 June 2023
3. Jim Rickards, "The Coming Shock to the Global Monetary System", Daily Reckoning, 6 June 2023
4. Chart page one, Bureau of Labor Statistics Consumer Price Index, https://www.officialdata.org/

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