HEY! – What's Up With the Economy (Oct 2022)

2022 has been a near-record year for all the wrong reasons: One of the fastest stock market declines in a 6-month period, highest – ever – interest rate increase in a 6-month period, and the Highest inflation in 40+ years.

Let's take a deep dive and try to piece it all together.

For decades we printed dollars ad libitum. Normally this would be inflationary, but with globalization ramping up, we could effectively export our inflation by sending printed dollars overseas and in turn flood our domestic markets with low-priced goods. We also had the privilege of harboring the world's reserve currency.

Then came COVID-19, finally upending the long streak of low inflation. We printed an unprecedented 7 trillion dollars in two years, some of which we doused across the nation in the form of stimulus checks. Supply chain issues and a regime shift toward de-globalization further fanned the flames of inflation.

The inflation could have been curbed early on, but the Federal Reserve - notoriously behind the curve - kept the money spigots open, even as housing and stocks went well above trend lines.

Inflated stocks and housing will return to their long-term growth trend. This reversal is well underway (with housing being the stickiest and last shoe to

drop). The reversal is deliberately engineered by the Federal Reserve by raising interest and by unwinding some of their huge balance sheet by selling off treasury bills and mortgages accumulated during prior years' monetary expansion known as QE (quantitative easing). A practice that enticed and allowed banks to keep lending at low rates.

Those balance sheet reductions, currently taking place at 90 billion a month, and in combination with much higher interest rates are what are sucking dollars back out of the monetary system, reducing M2, and causing asset valuations to drop.

At some point, the Fed will have caused enough demand destruction to force inflation down. They will likely recognize this too late, leading us into a deepening recession. But they will pivot, and assets once again climb north. Rinse and repeat.

But there is a much bigger problem, lurking beneath the surface.

The debt the Federal Reserve is selling, 90 billion a month, plus another 80 billion from new bond issuance just to cover the government's monthly deficits - has few takers. In other words, there is too much debt on offer, but not enough buyers to absorb. This is not only in the U.S. but also in Europe and Japan - What we are staring at is a sovereign debt crisis, in which a deflating world economy is trying to finance enormous debts, at interest rates they can't afford.......unless they print more.

No one can predict the end game, but the old playbook by governments carrying enormous debts is to inflate their way out. This is done by overtly buying their own debt with printed money. This “monetization” works by having the left hand (the federal bank) print money to buy debt from the right hand (the government). No taxes are raised, and no foreigners are owed. Only printed money is at work. This practice is inflationary in a slow grinding way as it debases the currency against all real assets: lumber, copper, oil, meat grain, real estate, etc.

The debasement of fiat currencies has always happened, it is just the nature of the beast - the reason your grandpa could tell tales of 10c gas and $4500 dollar

homes. On average this debasement cuts the dollar's purchasing power in half, roughly every 18 years.

Given the debt loads, we have built up in the U.S we should expect debt monetization and the resulting debasement to accelerate. Voters may be paid off here and there by loan forgiveness, stimulus checks, and other programs, but underneath the surface, our dollars are eroding at a faster rate. The question is not if we will receive the social security that we were promised by the number – we will - but rather how much will we be able to buy with that.

The antidote is to invest in assets that are most likely to respond to debasement which includes real assets, but also stocks that can outgrow debasement or stocks with pricing powers – bonds are a bad place to be if the currency underneath them erodes faster than the interest rate they carry, effectively giving them a negative yield. (exactly how governments inflate away debt)

The other thing we can do is to be keenly aware of this erosion and adopt an efficient lifestyle, now and for the future. We should look into boosting our earning potential while educating ourselves on assets and investing as if it were a mandatory curriculum in life.

Journey well, Tom