Lyn Alden: Shifting from Monetary to Fiscal Dominance

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Erik:

Joining me now is Lyn Alden, founder of Lyn Alden Investment Strategy. And the title of Lyn's slide deck, which I strongly encourage you to download is Fiscal Dominance.

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Lyn, before we get into the slide deck. I want to start with the big picture. We've been looking for a deflationist. I got a feeling that's not you, because you've been on the inflation theme for quite a while. But I'm curious. I know you listened to the show. What do you make of all the prominent deflationists flipping to inflation seems to me, like this is kind of a sign here. What do you make of this?

Lyn Alden:

Well, I think there's a couple of factors. And you know, first of all, thanks for having me. So the two main things I think are one is there's no doubt that we're clearly in a cyclical upswing in inflation. And so I think one of the deflation is counterpoints would say, okay, we're of course in a cyclical deflationary bounce. But then the bigger question is, is this going to turn into something longer term and more structural? Or is it just this kind of bounce we're having because we're having, you know, we're coming out of a pretty deep issue. And so that's kind of the first point.

And I think the second point is that we actually have had some really big changes compared to how previous recessions were handled. And we have to pretty much go back to, you know, as far back as the 40s, to kind of find similar fiscal and monetary situations as we're seeing now. And so I think that's led a number of people to see that that the inflation theme is pretty real subject to certain things going forward.

And so, you know, one way I would describe it is that, you know, I think inflationists and deflationists agree in a lot of the same facts. Which is that we do have very large deflationary forces in the economy. And so that's very high debt levels, that's growing technology, and that's the trend of offshoring. It's also demographics and in a top heavy, you know, slowing population and aging population situation in most of the developed world. And so we have these deflationary forces. And then the big question is, you know, will the governments come in with with large fiscal spending QE for the people that you've been talking about for a while, things like that. And if they will override those forces or not.

I think that's kind of the big thing that kind of differentiates deflationists from inflationists and I think some of the people that switched are showing that no, this time, the fiscal authorities are pretty serious about kind of, you know, trying to override those deflationary forces.

Erik:

Lyn let's move on to your slide deck. Slide number two is titled fiscal spending, not just QE. Tell us more.

Lyn Alden:

Yeah, so we know one of the things we've noticed over the past cycle was a lot of people thought that QE would be hyperinflationary. And that, you know, the expanding of the amount of base money in the system would basically result in too much money chasing too much goods, and therefore you'd have inflation. But you know, the shortcoming with that analysis was, there was no way to get that money out into the broader economy. It just stayed in bank reserves. And it didn't really, you know, the average Joe or Jane on the street didn't get more money in any of their bank accounts.

And that's because, you know, when you increase the base money, there's really two main reasons or two main ways that it can get into the broad money supply. One is the banks can lend it, which they haven't been doing very much. And, you know, partially because there's not a ton of demand or the demand is kind of spread out. Or the government can run very large fiscal deficits, and basically go around the banking system, and inject that capital into the broad money supply. And so back in the 2008, 2009, 2010 period, we didn't really see that happening.

So this chart shows, this is the year-over-year change in dollar terms of the broad money supply of the Federal Reserve balance sheet and government transfer payments. And so what we saw was that, you know, during those periods of QE from the past decade, they weren't combined with no fiscal spending to any significant degree. And so that QE just stayed in bank reserves and just, you know, increased base money without really having much of an effect on broad money.

And then what we saw, however, this time was that when you combine that QE with very, very large fiscal injections, that puts all that money right into the broad money supply as well. And so we've seen, you know, in the United States, we've seen more than a 25% year-over-year increase in broad money supply, which is a rate that we haven't seen since the 1940s. And that's because, you know, when you have that combination of fiscal spending, and the Federal

Reserve buying a lot of the bonds associated with that fiscal spending with brand new base money. That does put it into the broad money supply that we haven't seen in several cycles.

Erik:

Let's talk about how far this can go and where it's headed. Because there have been times in the past where there just wasn't political will to do a whole lot more, you know, government deficit spending, because there were enough people voting against it and so forth.

It seems like the tide has changed. The political will is there for as much government spending and stimulus spending as anybody wants to contemplate. And the usual arguments for what can go wrong if you use too much deficit spending are it can lead to runaway inflation and it can lead to potentially a crisis in bond markets if you get to an over indebted situation where markets think it's impossible for that money ever to be repaid, which I would argue we're already there.

It seems to me though, the other side of this is the MMT argument that says, hey, as long as you can print money and borrow in your own currency. You're not going to have a problem repaying the loans because you can repay them with printed money, and therefore you're never going to have that bond market crisis. I don't think it's truly never I think it's, you can stave off the bond market crisis for quite a bit longer than a country that's unable to borrow in its own currency. How do you see this? Lynn? How far could we go? How many years of excessive deficit spending, massive fiscal injection that you're talking about here, can be sustained before something breaks.

Lyn Alden:

So that'll partially depend on some of the other inflationary and deflationary forces. And so for example, if you combine this massive fiscal spending with a shift in globalization, so we've had this, you know, multi-year, multi-decade period of globalization, which has been, you know, largely deflationary for the developed world.

If you start to reverse that, if you start to say, you know, for national security purposes, or for no kind of a change in what we're optimizing for, if we're trying to create more domestic manufacturing jobs, for example, you start to reassure supply chains, that's an inflationary force. In addition, you have to look at the commodity cycle, I think, a lot of inflationist and deflationists, because they focus heavily on the economy part of it, they don't really look at the commodity CAPEX cycle. And so obviously, when there's a period of commodity oversupply, you can you can get away with, you know, you basically have that extra capacity to print more without having as tangible consequences.

But if you run into periods where there hasn't been a lot of commodity spending in a while, and you're actually pretty tight with your supply demand characteristic. if you start to run hot, that'll show up in commodities a lot quicker. And so those are some of the forces, I think that overall determine it.

But really, what it comes down to is that, you know, the argument about monetary sovereign is correct, in a sense. And so basically, you know, unlike a country that's not monetary sovereign, like, for example, emerging market that borrowed in dollars, or, you know, the countries in the Eurozone, you know, they actually, you know, those types of countries have a risk of actual nominal default on their sovereign debt. Whereas countries that are monetary sovereign, you know, they have the option to transform that into currency weakness. And so that's kind of the big choice they have is that, you know, instead of nominal defaulting, they can just default in real terms, which is, you know, kind of a polite way of defaulting.

And so, if you look at slide three, for example, you know, the United States has gone through this before, when we've had extremely high sovereign debt as a percentage of GDP. And of course, that was back in the 1940s. And it's interesting, because when we have these long term debt cycles play out. They've followed this general pattern where first you have a private debt bubble, you know, that's the more deflationary one because you have a destruction in and you have a deleveraging, that happens in the economy, and you kind of push a lot of that debt up to the sovereign level. And so that's kind of that that long period, and there's usually a stagnation associated with that both the 1930s, we had, obviously a very slow economy. And in the 2010s, by most, you know, ways of measuring it, were in some ways a mild depression, you had basically a very, very slow growing economy by most metrics, and you had a, you know, particularly in the industrial sector.

And whereas the 1940s kind of came around and the external catalysts, the war forced the government to basically ramp up massive deficit spending. And that was, of course, on, you know, domestic manufacturing and training and all sorts of industrialization. But that, of course, caused a lot of inflation because you ran into commodity scarcity, you basically, you know, used every bit of capacity that you had, and you increase the broad money supply a ton, because the Federal Reserve is buying a lot of those bonds. And so what they had to do was institute yield curve control, which is basically that they kept yields below the inflation rate for roughly a decade.

And I know you talked to Kevin the other week about it as well. I thought that was a great discussion, because there's actually a couple ways to do it, you can just peg the short end of the curve, and then the government kind of refinances this debt to lower duration. Or they can cap the whole end of the curve. But the ultimate, you know, kind of the endgame there is that bonds spend a long period of time failing to keep up with inflation. And so even though they're all paid back in nominal terms. They lose a lot of purchasing power in real terms. And I think one of the concerns that we're probably heading to one of those environments where sovereign debt levels are high enough, and the Federal Reserve has shown a willingness to hold rates at zero and let inflation run hot. And so that's not generally an environment you want to be holding a lot of paper assets in.

Erik:

Moving on to slide four, you're distinguishing fiscal from monetary dominance, explain what that means.

Lyn Alden:

You know, people often point out that if you don't have bank lending, you can't get a growth of the money supply. And that's not quite true because ironically, the biggest year-over-year increases in the broad money supply are periods where banks aren't lending such as the 1940s and then in 202. And that's because as I previously mentioned, the fiscal authority can go around the banking channel by basically sending out checks or directly spending on projects, and having a lot of those bonds financed on the secondary market by the Federal Reserve with new base money creation.

And so you know, these two charts, one shows on the left there that shows short-term interest rates and the orange line. And it shows the monetary base as a percentage of GDP. And it shows that, you know, once you hit the zero bound, the Federal Reserve gets, you know, starts to get more limited in their options. And you can do things like you know reduce the dollar relative to gold, or you can do things like QE to increase the monetary base as a percentage of GDP.

And, of course, that's what we saw there. But even then, that starts to run into issues because it's not really circulating the money around, you start to get a collapse in money velocity, and you're not really increasing the money supply the broad mind supply enough. And that's where eventually, you know, the situation gets painful enough that more and more people demand larger fiscal spending, or there's some sort of external catalyst, whether it's a pandemic or a war or something like that. And we kind of shift over to fiscal dominance, which is basically whether or not inflation comes largely depends on if they're going to devalue their currency, and essentially print.

And so the second chart there shows is a similar chart, it shows the monetary base and the deficits, but it shows the money multiplier, you know, empty compared to the monetary base. And it shows, you know, a lot of people like to show the chart that we've had for the past 2040 years of collapsing money multiplier. But we actually been in a similar situation before, if you look back to the 30s, and 40s. And we're kind of seeing a similar deficit response there. There's basically, again, that goes to the point where, when banks aren't lending, know, the indirect way they can lend is that they buy a lot of treasuries, and, you know, the Treasury spends, and that's kind of what we're seeing.

Erik:

Lyn let's talk about how long this can last and what the big picture consequences are. Because if I understand you correctly, and by the way, we're very much in agreement on this. It seems like there could be a period of many years of lots and lots of fiscal stimulus, lots of deficit spending, that is going to have the effect through financial repression of essentially inflating away the real purchasing value of the national debt.

And the consequence of that, as you said, is it's kind of the more polite way of defaulting, you're defaulting in real terms, but not in nominal terms. So the bonds all get paid back. But the fiat currency that they're being paid back with has less purchasing power than the fiat currency that was borrowed when those bonds were created. If that's the long term outlook, and I agree with you, I think that it is. What does that mean, in this devaluing of fiat currency? I think happens across the board. It's not just the US dollar, it's all fiat currency. Most people would say, okay, real assets is the place to be things like real estate and precious metals and so forth. Is that the right way of thinking about this? Or how should we, as investors, think about what this whole inflation and financial repression, this whole big picture that you've laid out here, fiscal dominance, and then the shift that you see coming? What does it mean, in terms of big picture, macro asset allocation strategy?

Lyn Alden:

Yeah. So historically, if you look at the 1940s and 1970s, which are the two inflationary decades over the past century, you know, both instances, of course, commodities did very well. That's almost a requisite for having inflation is high commodity prices. And so that's kind of one of the key places to be. Real estate with fixed rate debt is also generally does pretty well. Value stocks can do pretty well. The big trouble areas you run into are with long duration bonds, and with growth stocks, and that's because, you know, if you look in these two periods, even though of course, again, bonds all got paid back in nominal terms. And in terms of, you know, their devaluation, compared to official CPI was 30% to 40%, in both of those decades, depending on you know, exactly what what time period you start from, and what what portion of the curve you're looking at.

And so those are kind of the trouble areas to be, whereas being in value stocks, being in commodities, those generally hold up better. And I think, you know, going forward, multiple fiat currencies are going to devalue, but not necessarily all at the same rate. And so, you know, we have kind of different countries around the world that have, you know, some of their indices have more value exposure, some of them I think, have slightly better currency fundamentals than others. And so there's kind of ways to, you know, kind of pick your equities in such a way that you have a little bit less inflation risk compared to some of the names that would might be more impacted.

And, for example, on chart five here, one of the risks we're facing now and I've been writing about this in an article or newsletter recently, and this week, in particular, we're kind of getting a lot more narratives about it. Is that higher yields are putting pressure on growth stocks in particular. And so we've had this, you know, multi-year period where tech stocks and growth stocks have largely outpaced other types of investments. But that's in big part because of valuation. And so it's not as though their earnings grew. And we've had this kind of doubling in, you know, growth stocks over the past, you know, two-three years because of their earnings. That's obviously been a part of it. But a lot of it was just due to valuation expansion.

And so the chart I have here is Apple as an example, which is that, you know, their earnings have done fine, you know, large part because of buybacks, but also just because their business was fundamentally strong against the pandemic. But you see that their valuation just absolutely skyrocketed over the past couple years. And so their earnings growth hasn't really, you know, the overall earnings trajectory hasn't really changed that much. But the market has been much more willing to pay a high multiple. And so you see the black line skyrocket, that's the stock price. And then you see, you know, what the stock price would be at historically normal valuation multiples in blue and orange there. And that just shows that we've had a big decoupling in investor expectations from what earnings have been and what analysts expect those earnings to continue to be. And that's been largely predicated on super low interest rates.

And so we've started to get an uptick on the long end of the curve, which we've been seeing recently, that can put a lot of headwinds on growth stocks. And we saw that back in the 1970s, as well, where, you know, you had those nifty 50 stocks that came into the decade with very high valuations. And they were companies we know today, like Coca Cola, and Disney and Xerox and things like that. And even though they all went AWOL, went on to do very well, fundamentally, over the next several decades. They ran into significant headwinds over the next, you know, 10 to 15 years from those high valuation points because they were up against much more inflationary pressures.

And their very high valuations came into issue because, you know, when you run the discounted cash flow analysis, companies with more of their earnings deep in the future, more growth oriented companies, they're the ones that are more interest rate sensitive. And so that's why we're seeing more and more pressure on, you know, some of these growth stocks in particular. And Apple, of course, is not even the most extreme example. The most extreme example would be unprofitable growth companies that are even more highly valued, and they're the ones that are getting hit even harder.

Erik:

Let's talk a little bit more about that uptick in long term yields. There's a narrative in the marketplace, that kind of makes sense. But boy, if it was wrong, it leaves a lot of room for a lot of people to be very sorely disappointed. And the narrative goes, look, those long term yields can't move much farther than they have already, because there's just too much to lose for the US government if they go too far. And the Fed has the tools to contain them. So they're going to do yield control. We don't have to worry about long term yields backing up too far. Does that sound logic? And if not, why not?

Lyn Alden:

So I have it somewhat of a flowchart that I put in my last newsletter, which is, I think, in some way, they're going to keep a large portion of the yield curve below the inflation rate, but there's no guarantee they're going to keep the long end of the curve below the inflation rate.

I think you had a great discussion with Kevin, on, you know about that before. Which is that, you know, one of the options for keeping government financing costs low, even if you know, the long end of the curve increases, is that the Treasury can decrease the average duration of their treasuries and therefore, they can get the benefits of having basically the pin near zero yields, even if the long end goes up to 2%, 3%, 4% or more.

Now, I think the big question is, what will that start breaking in the market? And so, you know, historically, the Fed is not a particularly proactive organization. They kind of respond in the sense of putting out fires. And so for example, if you look at Q4 2018, there was a famous Power Pivot, you know, they were talking about, you know, letting the balance sheet run off on autopilot, they were hiking rates, and then eventually that cause, you know, we saw that big growth stocks sell off in Q4 2018. But I think more importantly, under the surface, is that there were you know, there were no junk bonds issued in like a six week period there. We pretty much had a freezing in some of the risk section of the credit markets.

And so Powell had to come out and say, oh, we're just kidding. We're data dependent. You know, of course, we're gonna adjust as needed. And so the market cooled off, and then later that, that, you know, year in 2019, the Fed started cutting rates. And we saw a similar situation again, in late 2019, where once the repo rate spike happened, that forced the Fed to begin expanding their balance sheet again, to quell that fire.

And so I think, you know, my base case is that, you know, the feds not going to intervene over handily more than they're already doing. I mean, they're already holding rates at zero. They're already buying at an 80 billion monthly rate for treasuries. And so I think, you know, their plan is to pretty much let long-end yields kind of continue to go up until it breaks something and if it starts to break something, they might have to step in and do something. But I wouldn't expect them to necessarily kind of rush in and put out a fire proactively.

Erik:

Lyn, we got some interesting feedback from that conversation that you mentioned with Kevin last week. Where a couple of listeners wrote us and said, Look, the point that you're missing is the reason the Fed can't let the long-end of the curve move much higher is if they did that it would just clobber residential real estate, which depends on those 30 year bonds to price 30-year mortgages. And that's the reason they can't do it.

And I had to think about that I thought, Wait a minute. If the Fed were really into prudence and responsibility and supporting the American public with providing the right backdrop for responsibility, that might be true. But what's to stop them, as you say, from letting the long end of the curve go? To the point where people are priced out of doing what you said just a few minutes ago, was the smart thing to do in this economic environment, which is to look at real estate with fixed interest rates? What if fixed interest rates 30-year mortgages are basically priced out of reach to most people, and they have to look at short-term variable adjustable interest rate loans, because that's the only way to get an affordable payment to buy real estate.

And of course, that's a setup for when rates ultimately do change, that it creates a crisis, is that something we should be concerned about? How do you think about that argument that real estate would be the reason that the Fed can't afford to let the long-end of the curve go too far?

Lyn Alden:

Well, I think that's an overall good argument. It kind of touches on what I pointed out that, you know, they basically would would wait for something to break most likely, and that could be the real estate market, that could also be, you know, credit market. Especially, you know, some of the companies that are, you know, on the riskier side of the spectrum.

And I think, you know, from a free market standpoint, we'd want to see that we want to see, you know, kind of rates go up and kind of, you know, businesses that can handle that probably shouldn't be in business anyway, or they should be restructured and, you know, that's on them. We should see kind of rational pricing in equity markets and real estate markets. And so, you know, a lot of us would hope for that.

But I think from you know, from kind of a macroeconomic standpoint, when you start to have too many things like that start to break. And that kind of threatens the growth narrative. That's what I think there's a higher probability of the Fed stepping in and potentially, you know, putting downward pressure on the long-end of the curve. And they might or might not do, you know, hard cap yield curve, but for example, they might increase purchases in the long-end, or they might, you know, use various ways.

I know, Russell Napier has gone into a couple of things that they can do to increase buying in the long end through financial repression. And so, you know, there are, I think, both sides of the argument, I think, have a point, which is that, you know, we don't exactly know where the pain points are. And I think that the feds gonna kind of fish for those and see, you know, where the pain points are hits. And you know, as at that point where they might step in and do something a little bit more heavy handed. And that, you know, that's it's not just for for federal financing. It's also to your point about real estate markets and credit.

Erik:

Moving on to page six in your slide deck. I'm fascinated here to see that since 2000, US Dollar broad money supply has more than quadrupled. In a period when Japanese Yen money supply has less than doubled. It's not exactly like the Bank of Japan has a reputation for being stingy about expanding its money supply. What's going on here then?

Lyn Alden:

Yeah, so one of the reasons I'm showing this chart is because there's always kind of the question that pops up. Is well, what about Japan? I mean they printed a ton of money, and they had no inflation for decades. So can't we print a ton of money and turn out like Japan, and there's a couple key differences. So one is they run a current account surplus, a pretty structural one. And so that kind of gives them somewhat of a natural floor to their currency.

But you know, another point is that they actually have had very slow broad money supply growth. And so all of the printing fast we've seen going on in Japan has been in their base money, rather than their broad money. And that goes back to the point of, you know, just because you increase base money doesn't necessarily put that into broad money unless either banks are lending or the government's running very large fiscal deficits. And in Japan's case, it's kind of a modern sense, because, you know, the government has run pretty significant fiscal deficits. They are the highest debt-to-GDP country in the world but it's not quite the same as people would expect.

And so the average Japanese budget deficit during this 20-year period was something around 5% of GDP which is significant, as you know, it's that's a pretty sizable average deficit. But that's nothing like the 15% to 20% deficit that we're seeing now that are kind of outright, you know, money printing.

And that was also offset by a very significant structural, corporate de-leveraging that happened in Japan, that they've been going through for decades now ever since they had that massive bubble in the you know, the late 80s. And, you know, kind of letting out of that, that bubble throughout the 90s. And we've seen this kind of massive, ongoing structural de-leveraging. And so, you had about, you know, 2% of GDP per year reduction in corporate debt during this time.

And so, you know, overall that really kind of offset some of the government money printing. You basically transferred debt from the private sector more to the public sector. And so overall, we've actually had pretty slow broad money supply growth in Japan, and it averaged something like 2.9% per capita. And so even when you adjust this for the fact that, you know, the United States had higher population growth than Japan, even when you account for that difference, you know, you've had a much smaller broad money supply growth, both in absolute basis and per capita basis in Japan. And that's, I think, one of the reasons why Japan is not a very accurate comparison for what the United States is going through now. Because again, there are structural current account surplus nation, and also they were actually growing money supply, you know, broad money supply very slowly.

Erik:
Lyn, let's move on to page seven, what's going on here, it says Japan's quiet bull market.

Lyn Alden:
So this focus is on, you know, some of the previous things you talked about, which was their explosion in base money. And so, you know, a lot of people point out that Japan's been in a 30-year bear market, which is totally true, but it's not been a totally linear process. And so there's been a couple different phases that they've gone through. And another way to describe it really is that their bear market pretty much went from 1990 through about 2012. And that was where, you know, their stock market indices, they kept hitting lower lows, lower highs, and it was just a very terrible time to be in Japanese equities.

But ever since late 2012, you've actually had one of the strongest bull market in equities, both in their local currency and in dollar terms, you know, around the world. And so, you know, they've pretty much been second to the United States in terms of how strong their markets been over the past, you know, eight or nine years. It's funny, because that correlates heavily with when their central bank balance sheet started going vertical. And so prior to that, they were, you know, expanding their balance sheet, but it was really in Q4 2012, where they really started ramping up their balance sheet. And of course, they're famous amongst central banks for buying some of their own domestic equities. And so of course, that had upward moves on price as well.

But the interesting thing is that if you look at most valuation metrics, even after this pretty strong run, that Japanese equities have had, they're not really expensive, by most metrics. If you look at price-to-earnings, price-to-book, price-to-free cash flow, things like that. They're actually you know, reasonably valued compared to some other markets. And so it's not as though they've they've caused another bubble. At least not in kind of Japanese, you know, equity valuation terms. They might have caused a currency bubble, they might have caused other issues. So it's just kind of an interesting thing to watch is that we've actually, you know, no one's really talking about the bull market in Japan. But we've actually been in a pretty strong one ever since late 2012. And we've also seen a period of basically improving corporate governance.

And so if you look at slide eight, for example, these are the Japanese trading companies. And they made headlines last year because Warren Buffett of Berkshire announced that Berkshire accumulated like a $6 billion position in these companies. They actually bought 5% of each of the top five companies. And so that was an interesting choice. Because, you know, in many ways, they're classic Buffett stocks. They're low price-book, low price-earnings, they pay dividends, you know, they're kind of out-of-favor at the current time.

But if you look deeper into it, there's actually I think, more going on there. And so, you know, these were kind of part of the classic bubble over the past several decades, in Japan. Their overall debt levels were extremely high. But over the past several decades, they've been part of this corporate de-leveraging process in Japan, where they have massively improved their balance sheet and reduce their debt loads. And it's something we've seen in other companies as well. We've also seen, you know, kind of more qualitative shifts. And so you've seen the way that they handle their board of directors over time as shifted. They have more outside directors, including non-Japanese directors because many of these companies operate globally. And you see kind of more of a shift towards, you know, kind of high returns on capital, improve shareholder returns, rather than emphasis on growth, or, you know, it's kind of this passive investment strategy.

And so overall, it's just kind of an interesting thing to watch because, you know, a lot of people think that Japan's been rather kind of stagnant for the past 30 years. But again, it's really in the past decade or so, there's actually been a lot changing under the surface. In addition, some of these companies, you know, Japan's kind of famous for their conglomerates, and that's what these Japanese trading companies are. But they've actually, you know, they started to make a lot of changes, and in recent years, to kind of shift and be more proactive with their portfolio. And so, you know, one of the examples I've used is Hitachi, you know, they're kind of the GE of Japan, you could say. And they've been divesting a lot of their non-core areas of business, their lower margin businesses and kind of, you know, streamlining their company to kind of focus on their core competence. And a similar thing here with the trading companies, they've really kind of shifted around their assets a little bit, they started focusing more on dividend growth, more on improving the returns on equity, and really about having a more reasonable balance sheet.

And so, if you look on slide nine, for example, I highlighted one of those trading companies, this is Mitsui. And so, you know, this one's not particularly special among them. It's kind of like the medium sized one, but I just wanted to show that you know, because they're, you know, if you look at what these Japanese trading companies do. They're heavily into commodities. And so they do commodity you know, they finance commodity exploration around the world. They, you know, many of them have energy exposure, they have copper exposure, some of them have uranium exposure. All sorts of different metals and energy. But they also do industrial. So they, you know, many of them are involved with plant construction around the world, kind of infrastructure projects, supply chains, manufacturing, things like that. And so, you know, they've actually done quite well considering that, you know, they've been an environment that was not very favorable to them.

And so, if you look at Mitsui here, for example, I have the earnings per share and the dividends in Yen. And, you know, they had a really big run up in the 2000s. Because that's, of course, when we had a very strong commodity market. So that was a great environment to be a commodity and industrial company. You had the growth in emerging markets. But then, of course, we had that big shift, we had the global financial crisis. And we've been in like this 12-year commodity bear market. And it's been really rough for the companies. But at the same time, because they've had such a strong improvement in their corporate governance, and that the way they handle their business. They've actually been able to continue growing dividends and they've been able to hold their earnings pretty much in a sideways trend, despite the you know, the kind of the pain points we've had in commodities. And so I think that a lot of these companies actually have a really good base to build from, you know, where they've had kind of a rough decade, but under the surface, they've improved a lot.

Erik:

Lyn, let's move on to gold, a subject that is near and dear to many of our listeners hearts. I see you have a couple of charts here on page 10. You know, I find it fascinating. Intuitively, it would seem as if reflation ought to be good for gold, but actually, if you look at history, reflation is awfully bad for gold, particularly for gold mining shares. Is that because you tend to have during reflation a picking up of the back-end of the yield curve, and the result of that is higher real interest rates, which are an enemy to gold, or why is it that we're not seeing strength that intuitively associated with inflation of any kind you might expect in gold.

Lyn Alden:

So that's the strongest correlation that Gold's had over the past 50 years is real rates. And so people often look to the dollar or other factors. And those all influence some of the moves that gold can make. But really, the strongest one over the past 50 years has been real rates. And specifically, the, you know, the 10-Year has been kind of the key one to watch. And so what we saw from late 2018 to mid 2020, is we saw a really significant reduction in real rates from positive 1% to negative 1% for the 10-Year Treasury. So that, of course has been a you know, like rocket fuel for gold. We've had a massive bull run from you know, about 1200 to, you know, over 2000 briefly in gold, and it's been a very good environment for it.

But ever since August 2020, we've actually been in this kind of choppy sideways pattern for real rates, because even though inflation expectations are rising, we're also of course, getting a sharp uptick in 10-Year and longer duration yields. And that's kept up with inflation, and in recent weeks, it's outpaced inflation. And so we've actually had, we've come off the lows in terms of real rates.

And so this is not super uncommon when you look at reflation scenarios. Which is that gold, you know, tends to do very well in a disinflationary environment, ironically, when you have nominal yields falling faster than inflation expectations because that's another way to get lower real yields. Whereas, when we come out of that, that's when you see things like silver and copper and energy do well. And so if you look at things like the gold-to-silver ratio, or the gold-to-copper ratio, you know, they really bottomed or top I should say, in early 2020. And since then we've really had some of these other more reflationary commodities take over from gold in terms of kind of carrying the torch forward in terms of returns.

However, of course the major variable to watch, I think, if you were to get some sort of yield curve control, or some sort of inflation spike, that kind of drives real yields lower again. That's when gold would do very well. And so even if you look back, for example to the 1970s, which we think of as you know, the amazing bull market for gold. That really kind of came in two big spikes, there's one in the mid-70s.

And then, of course, the final one at the end of the 70s. And those two periods had negative 4% real yields. And so even within a structural bull market, Gold's movements are largely dependent on what's happened with real yields. And so we've had this period where we got a little bit overbought this summer. And since then, because we've had real yields stabilize, and even back off from their lows. Gold's been under some pressure. But I would still arguably say that it's pretty much done its job because it has increased over the past couple years about as fast as broad money supply.

And so basically, according to the models that I follow, I classify gold as roughly fairly valued at the current time. And so it's neither really underperforming expectations or outperforming expectations. I think the key thing to watch going forward is that if we're still expecting pretty significant broad money supply growth, which is some of these stimulus packages continue to materialize is likely, then gold should eventually catch a bid. But it will largely depend on what happens with with the long-end of the of the rate curve.

Erik:

Let's talk a little bit more about that and what could happen with the long-end of the rate curve. Because it seems to me that if you think the reasons that the back-end of the yield curve is already turning up, have to do with reflation, and that it's likely that inflation measures are soon going to catch up with that, well, then this is a gift. It's time to buy gold hand over fist on its weakness, expecting inflation, to overtake the increase in long-dated Treasury yields.

Of course, the way you could blow up on that trade is if it turns out the inflation doesn't really get registered, at least in terms of the measures that people use. But the back-end of the curve continues to increase anyway. What are the scenarios that could cause the long-dated Treasury Yields to continue to back up and move higher without any inflation coming into the system? I don't really see any, am I missing something?

Lyn Alden:

Well, I think the main one is that if you look at the 10 year rate. It's even after the nice run up it's had, it's still below 10-year breakevens. And so that's, you know, pretty unusual over the past 15 years or so. And so, you know, based on just pure logic, you'd expect that even if inflation were to stay relatively flat, the nominal yield should increase a little bit just to you know, basically stop having negative real yields.

And so I think that that's one of the things to watch out for is that, you know, even if you get kind of this flat inflation environment. If the market just stops expecting more and more disinflation and start saying, okay, we might get inflation in the future, or we want to make sure that we're, you know, earning a yield that's higher than inflation, you basically could have, you know, demand weakness until yields get high enough to warrant people to come back into the market. And so, I think that's one of the biggest concerns to watch out for.

And in many ways, Gold's been kind of tracking along with growth stocks, ironically, because they're, you know, those are kind of the duration trades. Like we've seen, kind of a growth to value rotation around the same time as gold started underperforming. And that's, you know, Gold's largely been in this defensive bucket along with, you know, kind of tech and growth stocks and things like that. And it's been, you know, kind of weak compared to some of the other things like copper and silver, and, you know, platinum even taken off lately. And so I generally find that one of the best ways to play this is have somewhat of a mix. And so I've liked gold, I like silver. I've liked copper and energy and Bitcoin and busy uranium, kind of a spectrum of different sort of commodities. So, that weakness in one or two of them doesn't really throw off the portfolio.

Erik:

Let's drill down on Bitcoin because when I had Mike Green on the program a few weeks ago, there was an outcry from listeners saying, you got to have somebody who likes Bitcoin on the program. Actually, we scheduled Mike and you at the same time, knowing that we would get both sides of the argument. Tell us the other side of the argument, feel free to criticize Mike's arguments. I know, he won't mind if you do that. What did Mike and I get wrong in our discussion of Bitcoin? And where do you think it's headed?

Lyn Alden:

Well I don't necessarily want to touch on Mike's arguments in particular, but overall, I think, you know, if you look at the long term history of what bitcoin is doing. it's still largely on track to what it has done in every cycle. And so, you know, people often try to find what exactly Bitcoin is correlated to. And in some ways it changes over time, I mean, sometimes it's correlated to the dollar, sometime it's correlated to the S&P 500 or sometimes it's not. And you know, the biggest correlation, kind of like any growth stock is that it's correlated to its own kind of adoption profile. Like how much that kind of particular thing is taking off. And so, you know, as Bitcoin has been used more and more, it's gone up in price, obviously.

But the key thing to follow historically has been its supply halving cycle. And so, you know, everybody knows about Bitcoin's 21 million hard cap but if you look at how we reach that hard cap, it's not in a linear line. And so, in the beginning, when Bitcoin was created, 50 new bitcoins were generated every 10 minutes on the blockchain, you know, as as a gift to miners for verifying the blockchain. And you know that keeps going algorithmically, every 10 minutes. But once you get to about four years, which is block 210,000 you have a pre-programmed supply flow halving. Which is that the number of bitcoins generated every 10 minutes drops to 25. And then four years later drops at 12.5.

And generally, what we see during the supply halvings is it causes kind of a classic supply shock, you know, kind of similar to what you see in any commodity. Which is that if demand remains relatively persistent, but if the new supply gets reduced for one reason or another, in this case, because it's pre-programmed. Then you generally start to see upward pressure on the price.

And then when you have that upward pressure on the price, you have momentum traders come on board. It reaches more people, you kind of have more awareness of it, and eventually you have a blow off top, and then you have a crash and a consolidation. And then four years later, the same thing happens again and creates like an another kind of adoption period. And so far Bitcoin has, you know, kind of behave in this oddly algorithmic way, which is that it's bull markets and bear markets have been largely predictable, you know, rounded supply having cycle, and their, you know, their variety of kind of on chain indicators to look at. And so a lot of people just look at the price. But you can dive into the protocol, and I included one slide here. But you know, any analyst that kind of covers this is looking at dozens of these.

And so this this chart, for example, shows the the HODL wave, which is it's analyzing the behavior of long-term Bitcoin holders. And so, you know, there's a lot of trading activity on exchanges. But one of the big questions is, you know, the long-term whales or the long term holders, what are they doing with their coins because that can sometimes give us a signal for what's happening in these bull or bear runs that we're having. And so, if you look at the cycle, when we have these really big bull runs in Bitcoin, you start to get a gradual selloff among long-term holders, which is the yellow line. Basically, that the percentage of Bitcoin that are held for more than one year starts to decrease, because when people have life changing money from

5X or 10X gains, they start to sell into that. And you start to get that, you know, kind of shift on to newer buyers. And we've seen this in every bull market cycle so far.

And basically, you know, the summary here is that most indicators suggest that Bitcoin is probably still within its Bull Run. We've had a couple corrections which are normal within these cycles. And of course, there's no guarantee going forward. But if you look at, you know, what's happening with Bitcoin's leading exchanges. If you look at the behavior of long-term holders, if you look at kind of the supply demand characteristics, we've looked at how many Bitcoins were mined this year, compared to, you know, how many Grayscales and MicroStrategy's and NYDIG's and things like that kind of soaked up coins and put them into cold storage. Overall, it's still pretty bullish for the protocol probably extending, you know, maybe out to the second half of 2021. And if true, that could also continue to put pressure on Gold, at least in this particular year.

Erik:

I'm fascinated by the left-hand chart, the market price chart on slide 11. It seems to me that where you're showing this correlation to the pre-programmed supply flow halvings here. You could apply, it's not quite a measured move technique in technical analysis, it's more like a logarithmic measured move.

But it seems to me you ought to be able to at least project where that next blow off top peak approximately happens just by using the last few cycles on the log scale in order to do something like a measured move. Is there such a number, is there a number in your mind for where the next blow off top happens?

Lyn Alden:

So this is something I've thought about, and I try not to give specific price projections, especially because some of those spikes can be kind of illiquid. And so that can really depend on what's happening with a pretty small number of traders and kind of that that euphoric blow off top phase.

But overall, there are some models that show this. And so, you know, if you look at that first peak there, you know, that was a pretty significant run, of course, because you pretty much went up from Bitcoin not being priced at anything to Bitcoin being priced at about $20. And so the next run up, reached over $1000. And so that was about a 50 fold increase from peak to peak. And then the the peak that happened in late 2017, was about $20,000. So that was a 20 fold increase over the previous one. And so we've generally seen a pattern, where each one of these cycles is explosive, but each one is a smaller percent move than the previous one, which is naturally what you would expect from a larger, you know, starting point, because, you know, it's the law of large numbers, you can't move a big asset as much as you can a small asset.

And so the kind of the big question is, will that pattern continue. So my base case is that this cycle would have smaller percent gains than the previous one, even though it still be quite big. And you know, the kind of the crazy thing with the numbers is that even if you have something that's only 10 times the previous peak, that gets you to a number like $200,000. And so there are basically numbers out there, they range from, you know, $120,000 up to $400,000 or more for where this particular blow off top could end. But of course, that will largely depend on what happens with demand because supply is known, demand is not, but if it follows anything like the previous time, I don't think a six figure price, you know, kind of endpoint would be surprising.

And so that's kind of how I'm looking at it. And it's funny, because it's so far, it's outperforming my base case a little bit because, you know, so far, it's actually doing better than that 2016-2017 Bull Run. it's a little bit ahead of where we'd expect it to be at this point in time. Whereas my base case, it would probably lag a little bit. And so, you know, it's possible that it could be proven wrong and that Bitcoin has a stronger run than last time. But overall, my base case would be a big gain, but a smaller percentage gain than last time.

Erik:
Lyn, I can't thank you enough for a terrific interview. But before we let you go, tell our listeners a little bit more about Lyn Alden Investment Strategy. What you do there and what they can expect to find on your website.

Lyn Alden:
Sure and again, thanks so much for having me. My website, a lot of it is free material. I publish public articles, I publish a free newsletter every six weeks. And then I also have a low-cost paid research service for retail and institutional investors. One of the major goals is to kind of take macro information and kind of distill it into something that is easy to understand. And I also cover individual stocks in that particular service. You know, for example, I went into some of the detail on these Japanese trading companies and things like that. And so overall, my view is kind of an equity focused macro view.

Erik:
Well Lyn, we look forward to getting you back on the show in a few months for another update. Patrick Ceresna and I will be back as MacroVoices continues right after this message from our sponsor.