MAI VIEW

VOL. XVII, NO. XVI www.macro-allocation.com APRIL 18, 2017

Counting Cards

Since last October we have been raising our long allocations to gold and long duration Treasuries, reducing our exposure to DM equity, and increasing our short positions in high yield credit, the consumer discretionary sector and the home building industry. Most of these positions have worked well or are beginning to gain traction. We think they have substantial further potential.

The onset of *stagflation* that elicits hyperinflation is the macro theme driving our allocation model. Such a scenario is clearly off the run and unexpected. While this is one of many potential economic scenarios, and not on the radar screens of most career economists and investors influenced by more cyclical outcomes, US economic data suggest stagflation be given serious consideration today. In fact, *stagnant growth and rising inflation* expectations are already here. We await the markets' recognition of it, and then the necessary global policy response from central banks - hyperinflation.

What it might look like

It might help to look at an illustration of what such a scenario might look like in economic and market terms. The table below is one most gainfully employed analysts are loath to publish, five year projections:

Table 1: Ridiculous Projections?

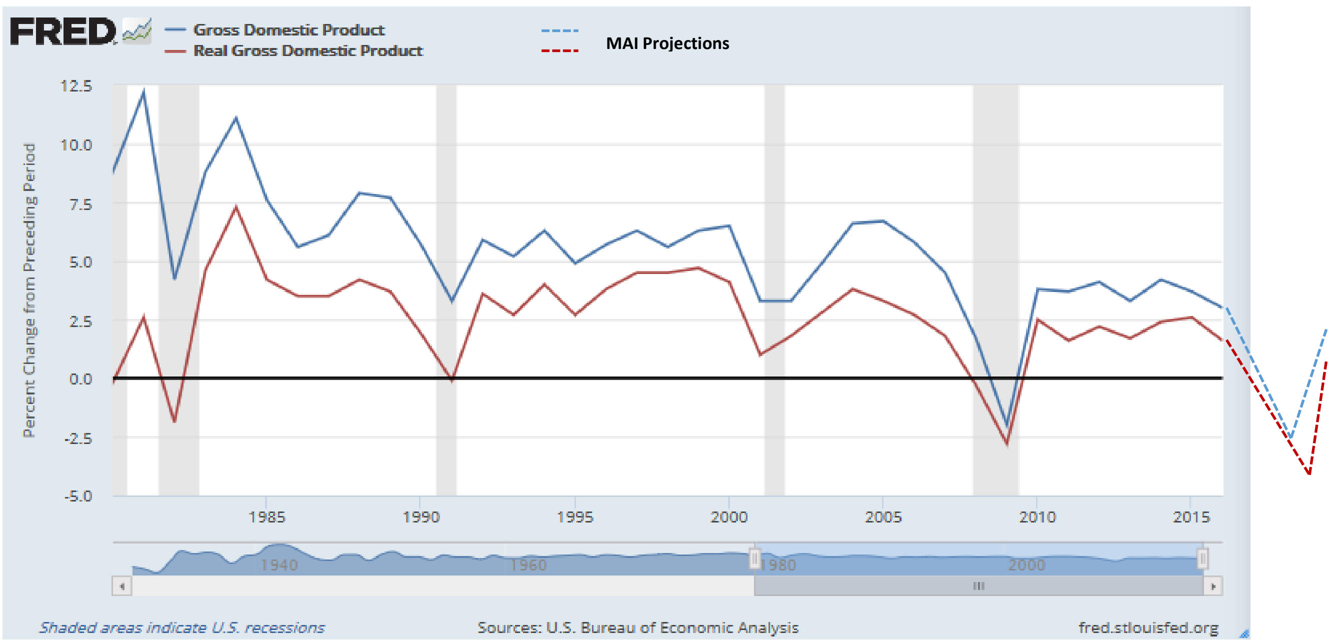
	2017	*2018*	*2019*	*2020*	*2021*
US Nominal GDP	+2.4%	0.0%	-2.5%	+0.5%	+2.5%
US Inflation	1.6%	1.0%	1.3%	5.0%	2.0%
US Real GDP	+0.8%	-1.0%	-3.8%	-4.5%	+0.5%
S&P 500 Return	-5.0%	-20.0%	-50.0%	-10.0%	+30%
30-yr Tsy Yield (Trough)	2.4%	1.5%	1.0%	2.0%	2.75%
Gold Price Return	+20.0%	+35.0%	+100.0%	+150.0%	-25.0%

Source: Macro Allocation Inc.

Table 1 is both silly and meaningful. It is silly because we are sure its specific projections are wrong (and we don't know by how much or in which directions). It may be meaningful to readers because it includes an unpopular trajectory for US output growth (down and then rebounding) and inflation (down and then rebounding more than output). It also includes investment scenarios that would accompany such an economic scenario. Clearly it is one most investors are not expecting.

We kept the economic figures in Table 1 within the realm of most analysts' sense of reasonable-ness, as can be seen in Graph 1 below. It shows past nominal & real GDP growth in the US. We also tacked on the projections we used in Table 1 implying the imminent onset of stagflation followed by hyperinflation. It is interesting to note that our projection for the growth leg of stagflation does not seem *that* radical. We also chose to tamp down the rate of hyperinflation as most have come to think of it – as a runaway train obliterating the purchasing power of currencies and driving interest rates skyward. (Please see our discussion of hyperinflation below.)

Graph 1: US Nominal & Real GDP & MAI Projections



Sources: St. Louis Fed; Macro Allocation Inc.

Below, we provide brief synopses of US growth and inflation, as we see them, and then the logic behind the necessary onset of hyperinflation.

Weakening Growth…

Current trends are already headed in the direction of declining output growth. Consider first that production growth in advanced and developing economies has been trending lower since 2011:

Table 2: Global GDP

Gross world product growth rate by region (%)

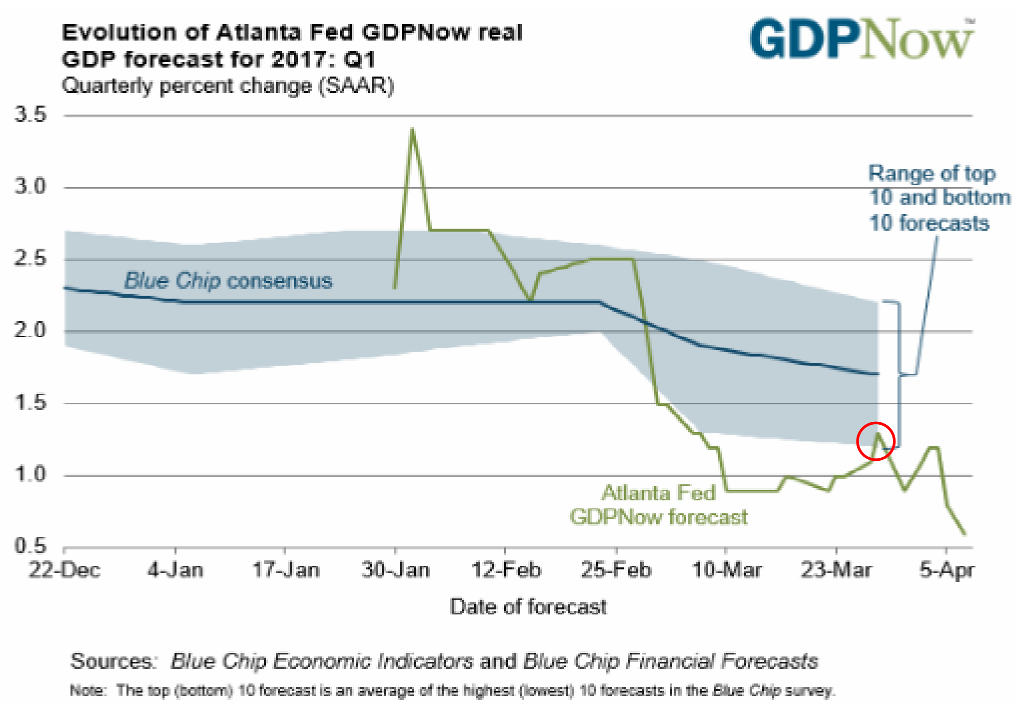
Region	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
World average	5.5	5.7	3.0	-0.1	5.4	4.2	3.5	3.3	3.4	3.2	3.1
Advanced economies	3.0	2.7	0.1	-3.4	3.1	1.7	1.2	1.2	1.9	2.1	1.6
Developing countries	8.1	8.6	5.8	2.9	7.5	6.3	5.3	5.0	4.6	4.0	4.2

Source: "Report for selected country groups and subjects"; World Economic Outlook; International Monetary Fund; 2016.

As Table 2 above shows, output growth in developing economies – the past driver of global growth – has dropped almost 50 percent in the last ten years from 8.1 percent to 4.2 percent. Meanwhile, the economic boost advanced economies enjoyed from higher growth in developing economies has had to be replaced with central bank asset purchases and hope-filled monetary communications policies. We find it difficult to be optimistic about future global output growth, however, especially given the Fed's new rate hike regime and the ECB's stated intention to taper QE and then normalize rates.

As we know, the US economy expanded only 1.6 percent in 2016, far below previous estimates, and more recent data continue to confirm further disappointment. The Atlanta Fed's latest GDPNow forecast of real US output in Q1 has fallen like a rock recently and now estimates only 0.6% growth. This is in line with our projection for 2017 in Table 1, which, as the red circle on Graph 2 below shows, is a full percentage point lower than the most pessimistic "Blue Chip consensus still guiding investors.

Graph 2: Atlanta Fed GDP forecast for Q1 2017



Could weak US growth in Q1 be just another hiccup in a long line of weak first quarters that will be followed by a stronger second half? Perhaps, but the frequency of surprisingly weak quarters is increasing and accompanied by ever-weakening higher frequency economic trends, like declining jobs growth and home rental prices. As ZeroHedge noted after this week's homebuilder confidence report: "After reaching 12 year highs in March, homebuilder confidence dipped in April led by a notable decline in the Northeast and Midwest regions. All four underlying components dropped in April with future sales expectations back near post-election lows. Current and future sales indices dropped as did prospective buyer traffic."[1]

[1] http://www.zerohedge.com/news/2017-04-17/homebuilder-confidence-dips-april.

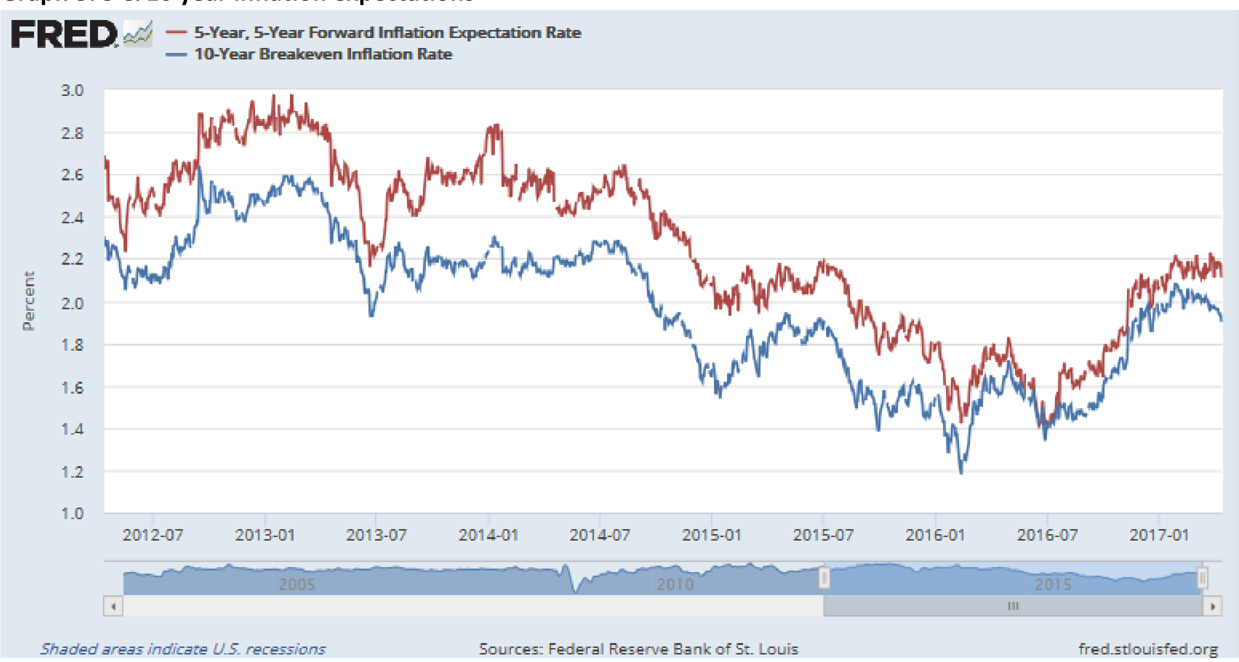
Housing starts for March also disappointed this week, dropping 6.7 percent, almost twice expectations, and an upward revision for February does not make up the difference. Stagnant home prices and rents are consumers' most influential sentiment driver and lead to reduced overall economic activity. One need look no further than the impact declining home prices had on the economy in 2008.

…Higher Inflation

We expect relatively sticky prices to accompany the further decline in output growth and the attendant increasing expectation for recession. We then expect surprisingly higher inflation, derived from global central bank efforts to support their economies through hyperinflation.

Graph 3 below shows general expectations for inflation over the next five and ten years. At about 2 percent, give or take, expectations are in the middle of a five year range between 1.2 and 3 percent. We can assume that this range corresponds to consensus expectations for median real output growth, which, as the GDPNow forecast shows (Blue Chip Consensus line in Graph 2), is about 1.7 percent.

Graph 3: 5 & 10 year inflation expectations



Source: St. Louis Fed

Thus, the markets have already implicitly accepted 2.2 percent US goods and service inflation and 1.7 percent real (inflation-adjusted) output growth in the US over the next five years. This implies 3.9 percent nominal output growth, up from 2.84 percent in 2016. Put another way, <u>the markets today are un-interested that macro signals already anticipate flat to negative growth in real terms</u>. Does anyone really expect Trump initiatives to reverse this reality sufficiently, especially as the Fed threatens higher rates?

We believe there will be a relapse into Quantitative Easing in the US within the next two to four years, and that, this time, it will be accompanied by sticky inflation against a backdrop of slower growth.

Hyperinflation

We expect the next threat of US recession – whenever it might come, but our call is soon – to elicit direct liquidity infusions by the Fed and other global central banks. Bank regulatory reform was the structural change that occurred last time; global monetary hyperinflation will be the structural change next time.

Global debt needs to be re-structured so that economies can once again produce and trade efficiently. Hyperinflation is the necessary policy response to restructure global debt. The most politically expedient and market-friendly way to do this would be to de-value the dollar and other currencies in which debt is denominated. Debt covenants would be spared in nominal terms. The purchasing power value of currencies would be sacrificed – not against each other, but against the value of resources and production.

Most economists and investors are now very aware of the power of central banks to provide direct liquidity to the banking system, and the theoretical potential for higher goods and service prices derived from it. Most, however, have viewed the most recent experience – from 2009 to today – and have concluded that high rates of inflation do not necessarily follow policies like QE.

Hyperinflation is a political construct derived from money creation. It is exogenous to ongoing economic supply and demand functions. This is not part of classic economic theory because classic economic theory presumes stable purchasing power among currencies (i.e., currency exchange rates fixed to a finite monetary asset that cannot be quickly diluted). In a flexible exchange rate monetary system, however, banking systems (including central banks) have the power to dilute the purchasing power of their currencies when it serves their economies.

We expect the next round of central bank base money creation to be accompanied by commercial bank incentives to purchase outstanding debt from all types of creditors, including sovereigns, local governments, corporations, and mortgage, consumer and student loan-backed investors. Central banks would backstop banks buying up these assets, and offer to re-purchase their newly acquired bonds in exchange for newly-created base money.

Credit risk would be transferred from bond holders to banks to central banks. Once the debt sits on central bank balance sheets, treasury ministries would be able to re-structure it through the political process. Central banks would assume the risk of debt curtailment and purchasing power loss that would occur from new bank credit expansion. This hyperinflationary restructuring process would increase both the lending power of banks and the system-wide demand for credit. The production function of economies would be enhanced, not diminished.

This expectation drives our asset allocation model, and its trigger would be the onset of recession in the US and elsewhere.

Conclusion

We expect “economic dis-equilibria” in the US and around the world to play out as follows:

- Fundamental weakness in US output growth, 70 percent of which is consumption based, will decrease global trade, which in turn would increase the volatility of the dollar in the FX markets
- A decrease in global trade would pressure global output growth further and accelerate a vicious cycle of heightened currency wars among major trading powers
- Cheaper imports into the US would not be offset in-kind by increased domestic consumption and job growth, given already record levels of consumer, corporate and homeowner debt as well as the overwhelming influence of aging asset holders producing less and expecting to live off fixed-income
- Asset weakness would trigger liability weakness, which in turn would trigger the unexpected renewal of significant Fed QE
- A relapse into Fed QE would accompany an unspoken policy of hyperinflation, which would further weaken the dollar and all currencies explicitly or implicitly tied to it
- Goods and service inflation coincident with lower production would prevail until systemic debt is greatly reduced via hyperinflation
- As the 2009 experience shows, the timeline of the process would be condensed because central banks and political dimensions around the world would be pressured to right their ships quickly

The markets anticipate a zero percent chance of this scenario occurring and so we expect volatility to begin rising meaningfully.

They say the onset of stagflation and hyperinflation is not in the cards. *They* are wrong, in our view. Investors holding equity and real estate with high valuations and low IRRs, this scenario are betting big on being dealt a three to total twenty-one when the deck is full of high cards. Our position is that investors that don’t fold soon will bust.

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