OUR VIEW ON GLOBAL INVESTMENT MARKETS

May 2021: Californication

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IMPORTANT:

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The opinions and views expressed in this publication are those of the firm and the author.

If you want these kind of dreams, it's Californication.

Dionysus was quite the party animal. The infamous Greek god would simply arrive with a kegger, and then the party started. His free flowing drinks, tricks, and stories hypnotized his friends and carried them off into a carefree world of indulgence and gratification.

Years later, a California-based rock band the Red Hot Chilli Peppers also took upon the free-flowing attributes of Dionysus. The band immortalized the Greek god in their lyrics, concerts, and social gatherings.

One of their best tributes to Dionysus is “Californication”. The hit song perfectly encapsulates the spirit of the Greek god, as if he was living in modern-day Hollywood. Today, no matter where you gather, many social influences were born in Hollywood basements.

Meanwhile, David Duchovny's character, Hank Moody, has also been deeply influenced by Dionysus. The hit TV series “Californication” also feasted on the absurdity of experimenting, experiencing, and rolling life into the nth degree at levels that would have made even Dionysus blush. This Los Angeles-based story allowed audiences the opportunity to see life inside the machine that influences so many of today’s global social and entertainment drivers.

Still, it gets better.

Today, Dionysus and Californication have also spilled over into the world of financial and economic markets.

Yet, instead of Dionysus, the Red Hot Chilli Peppers and Hank Moody leading the charge into irrational gratifications, we have the European Central Bank, the US Federal Reserve, and other central banks leading the charge towards unlimited financial pleasures.

Yes, apparently the world’s monetary elite are living vicariously as Hank Moody, on the edge of the world in all of civilization, all while wallowing in Dionysus’ sweet wines.

After all, how else can you describe the financial and monetary world created by these central bank party animals?

Over the years, the central banks have slowly added a few pick-me-ups to the economic punch bowl. Yet the concoction has only yielded unflattering party results.

But then the pandemic struck the world with the force of Zeus’ lightening bolt, providing the central banks and their fiscal frat house friends the opportunity to raise the party all the way up to level 11.

Financial prudence and good governance be damned.

Investors everywhere have been seduced by the Dionysus-like stimulus provided by our central banks and governments. Yet, while the financial party escalates into the late hours, most investors are seemingly completely unaware of any inhibitions.

In Hank Moody’s Californication, in the end his best friend Charlie, managed to “out-Hank” Hank. And THAT was a feat.

And as the world progresses through these monetary parties, we completely expect the central banks to also attempt to out-Hank each other.

Financial Indulgence.

In other words, investors should fully expect central banks and governments trying to outdo each other by cranking up monetary and fiscal polices to even more absurd levels.

Eventually the party will end, it always does.

Yet, until that hour arrives, seemingly every investor, government, corporation, household and central bank will continue along these paths of financial indulgence.

Let's get this party started!

Like all great parties, they have to start somewhere.

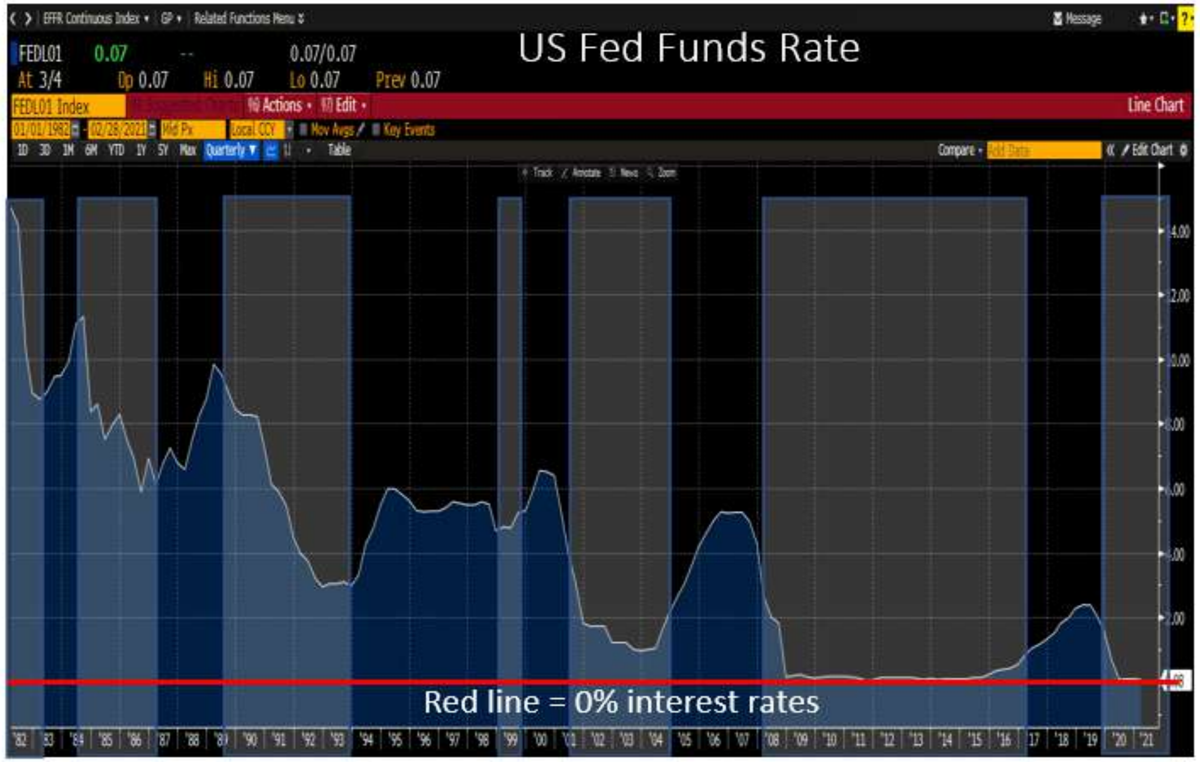
And usually within that somewhere lies the spirit of Dionysus, providing the atmosphere and limitless abilities to unshackle your inner-constrained self.

Within the investment world, Dionysus clearly has a permanent seat at the US Federal Reserve. And it was nearly 40 years ago he decided to slowly sow the seeds for an eventual financial party, unlike anyone in the world had ever experienced.

Initially, he subtly encouraged the world's most important central bank to provide more party favours whenever it seemed like the party was hitting a lull.

Whether knowingly or unknowingly, other members of the Federal Reserve easily and quickly obliged. And obliged they did.

Chart next column details all the times Dionysus and his mates at the US Federal Reserve recognized the financial party was dying and they needed to juice it up a bit.



During the 1980s, the party almost ended several times. Yet, the recession, the Plaza Accord and the '87 crash gave Dionysus and the Fed plenty of reasons to cut interest rates to keep the party going.

Next came the 1990s and the Savings and Loan crisis, followed by the Asian currency crisis and the Russian Ruble crisis, which ignited the Long Term Capital Management (LTCM) crisis.

Zzzzzzurich.

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Not one to worry, once again Dionysus and the interest rate revelers slashed rates all to ensure the music kept playing.

Towards the end of 1999, the Federal Reserve was quite pleased with itself.

After all, the Tech Bubble was in full swing and with $Billions being thrown at unprofitable companies simply because they had a website, the party of the century was sure to continue for millenniums to come.

Of course, the Tech Crash followed by the Housing Crash was again a nothing-burger for the Federal Reserve. Both crises were exponentially larger than the previous party crashers, and both created the biggest financial hangovers ever to be felt by mankind.

But no worries, Dionysus had a plan—cut interest rates all the way down to 0%, and then to really pick up the mood, throw in some quantitative easing, money printing, and bailouts, just to be sure. That would certainly keep the party humming into eternity.

But then came the pandemic with the MOAB of financial crises.

This time, however, the party was knocked out cold, and on the verge of never waking up.

Yet, what seemed like a serious situation was once again another opportunity for Dionysus to turn up the music as loud as possible, serve as many personality boosters that existed and ensure all of the party animals came to enjoy themselves.

And came they did.

While Dionysus was running the parties at the Federal Reserve, the Red Hot Chilli Peppers were clearly breathing life into the staid European Central Bank.

Yes, while the rest of the world was bopping and weaving to the tunes from the big guy, the ECB themselves had started their own little party.

Between rescuing the Irish, the Portuguese, the Spanish, the Italians, and even dudes in Dionysus' homeland, the ECB became quite good at keeping their party going.

Meanwhile, the ultimate chilled party animal Hank Moody was also rather busy having a good time. While Dionysus and the Red Hot Chilli Peppers are THE life of the parties, Hank Moody kinda enjoys himself in the background.

Yes, while others were appreciating the stamina and imaginations of the US Federal Reserve, and the European Central Bank, Hank Moody revelled with the lower tiers of the central bank world.

London, Ottawa, Sydney, Copenhagen, Stockholm, and even the sleepy banker town of Zzzzzurich began appreciating the financial fun to be had—simply by living carefree.

Yet, like every party circuit, the challenge is trying to determine exactly who is throwing the best party.

Truth be told, since the Americans run the largest economy with the largest stock and bond markets, and with the largest media markets, Dionysus and the Federal Reserve attract all of the attention, both good and bad.

Perspective.

It is also true the Federal Reserve has twisted and distorted its financial and banking system to levels never before seen or even imagined.

And because of these monetary extremes, calls for the USD to crash have become loud and boisterous into the late nights:

The US is facing a dollar collapse by the end of 2021 and an over 50% chance of a double-dip recession, economist Stephen Roach says

Admittedly, this is a sensational and spectacular headline.

However, it is also false.

One of the single, biggest errors investors (and yes, even by the veterans such as Mr. Roach) make is viewing the investment world through a singular lens and perspective.

Yes, by itself the US monetary and fiscal positions are not particularly pleasant. But we'll show you how other countries and economies are in even worse shape.

Charts on the next page provide clarity and perspective as to the real monetary and financial threats to the world's financial structures.

Sure enough, you'll see how the US Federal Reserve has now run out of interest rates to cut. Put another way, after 40 years of extending the party with interest rate cuts, the US Federal Reserve has astoundingly run out of interest rates. Yes, even if they wanted to, the Americans have no more interest rates left to cut. The cupboard is dry.

But the cupboards are also bare for the Canadians, the British, the Australians, and the Kiwis. They too have cut rates all the way down to 0%.

And for an even more dire comparison for the financial world - the Europeans, the Japanese, the Danes and the Swiss have cut interest rates to negative %.

The other metric used by USD Bears, measures the ultimate monetary party trick - quantitative easing (or money printing as somewhat erroneously referred to by some).

By this measure, the Americans certainly have gone on a monetary bender. Charts on page 7 show how America's money printing machine has produced enough stimulus equivalent to 33% of their total economy (GDP).

To put this in perspective, consider that during the darkest days of the 2008-09 Housing Crisis, the Americans increased this metric from near 0% to only 5% of GDP.

So, yes - with the current number equal to 33%, the Americans are definitely on the road to financial exuberance.

Looking at the American's financial position in this light, then one should conclude that the American empire is indeed at the cusp of becoming known as an historic era similar to that once enjoyed by the British, the French, the Spanish and the Romans.

Note the past tense.

ALL major central banks have cut overnight rates to 0 or negative %.

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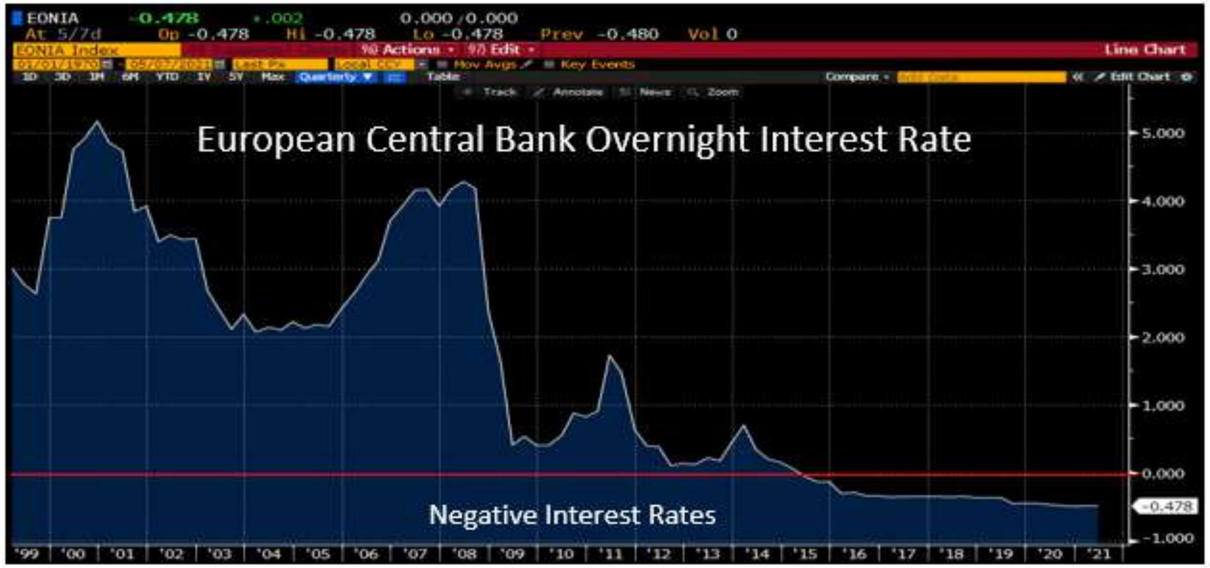
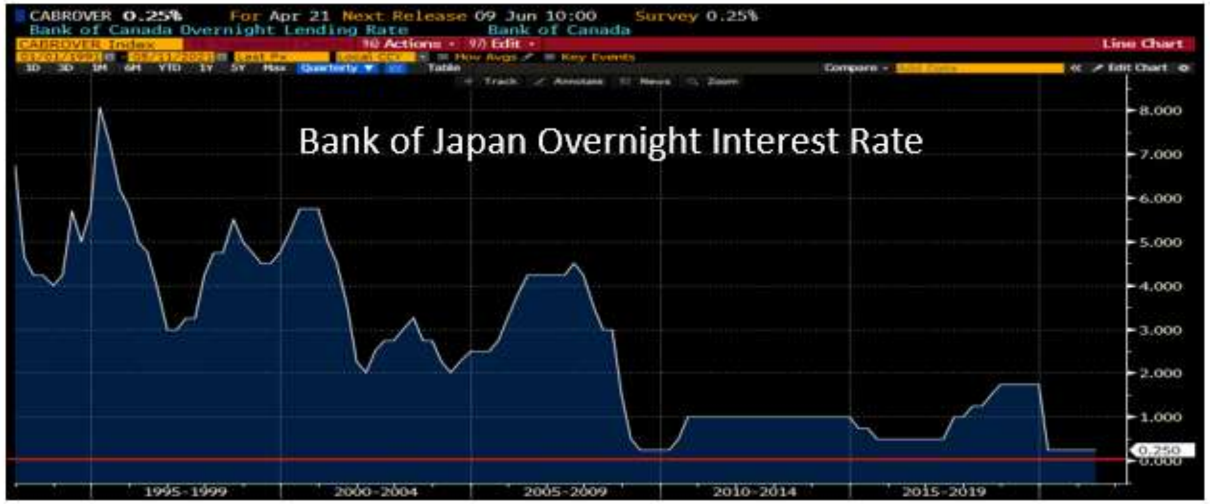




American monetary stimulus is LOWER than that of Japan, Europe, and China.

Maybe the USD and the American economy really is on its death bed and will hand over the party lamp shade to the next great power.

The flaw with this perspective, however, is that it lacks relative perspective.

Referring to the same chart, note how awesome the Chinese, the Europeans, and the Japanese have become at doing the exact same thing that is causing the Americans' financial superiority to be so quickly dismissed.

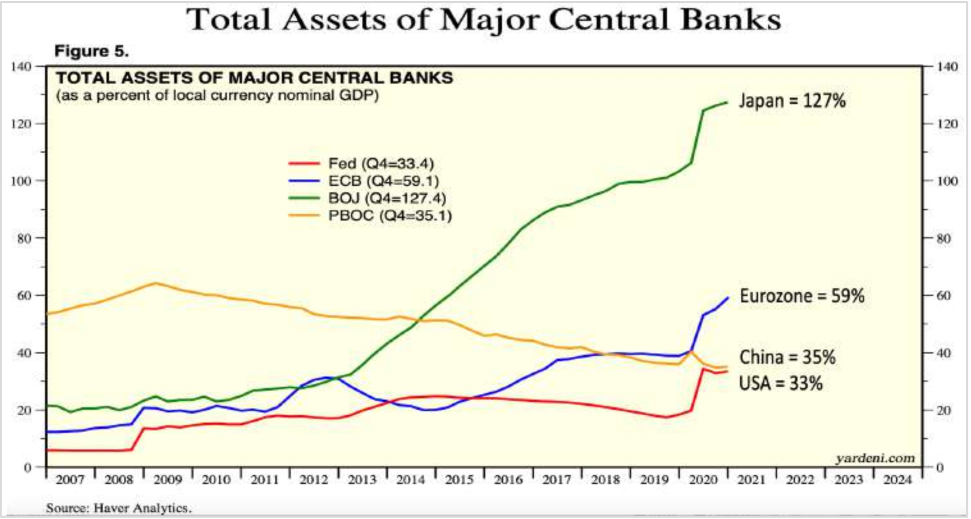
While the investing world is in a frenzy over the Americans running up their monetary assets to 33% of GDP, it has somehow completely missed the Europeans running their monetary base to 59% of their GDP.

Yes, if the Americans have destroyed their financial freedoms at 33% expansion, then using the same metric must mean the Europeans have destroyed their financial freedoms nearly two times now.

And when it comes to the ultimate financial and monetary party, the Japanese have everyone beat with their balance sheet expanding to 127% (or almost 4x that of the Americans).

And next we have the Canadians. **Chart next page** details the vertical growth of stimulus from the Bank of Canada.

Yes, even those friendly faces from the Great White North have managed to out-Hank the Americans.



And that's just from a monetary policy perspective.

Shifting your focus to the fiscal side of the party produces the same results.

While the US-focused money world has laser-eyed in on President Biden's spending spree, they are kinda missing an even bigger picture being painted by other countries.

News headlines on the next page detail how ALL countries are spending incredibly more money than what they are collecting in taxes.

Naturally, the ONLY way to spend more money than you earn, is to borrow.

Charts on Page 9 detail this borrowing binge.

Every country is running extreme fiscal stimulus.

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REBOOT-LIVE OCTOBER 6, 2020 / 12:49 AM / UPDATED 5 MONTHS AGO

Australia to run record budget deficit as government cuts tax, boosts job support

U.S. MARKETS SEPTEMBER 25, 2020 / 11:10 AM / UPDATED 6 MONTHS AGO

Italy hikes deficit targets, sees debt around 156% of GDP in 2021: sources

Plunging revenues and sky-high deficits could turn catastrophic for Canadian governments, report warns

'Governments in Canada will struggle over the near and longer terms to dig themselves out of this gigantic fiscal hole'

Jesse Snyder
Feb 18, 2021 • February 18, 2021 • 5 minute read • 708 Comments

Eurozone budget deficits rise nearly tenfold to counter Covid-19 pandemic

Draft budget plans published by member states on the European Commission website indicate the 19-country bloc will slide to an aggregate fiscal deficit of €976 billion

Topics
Eurozone economy | European Union

Agencies
Last Updated at October 19, 2020 21:52 IST

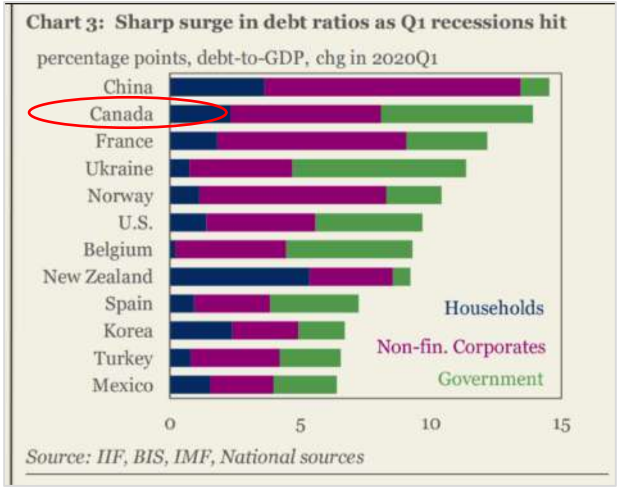
Covid pushes UK government borrowing to record February high

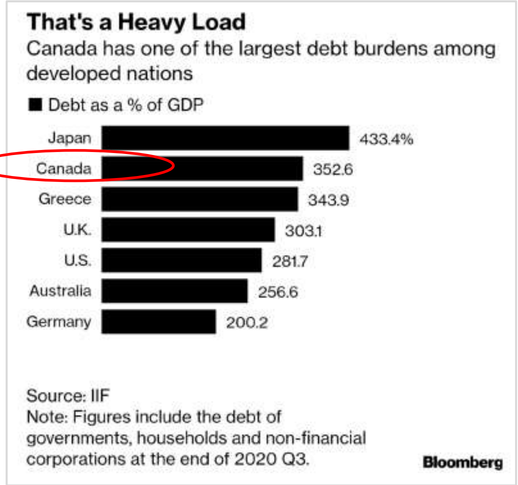
Canada.

As you can see below, yes the Americans absolutely have been borrowing money left right and center. But so too has everyone else.

When it comes to covid monetary and fiscal stimulus, the one country that has out-Hanked the Americans is Canada.

No matter how you slice it, the Canadians have completely embraced the idea of building back their economy by leveraging 0% interest rates to borrow as much as possible.





So, on a comparable basis, the American monetary and fiscal positions are no worse than anyone else.

The other USD crash narrative continuously floated by those betting against America is the Twin Deficits.

The Twin Deficits refers to America's budget deficit and their trade deficit.

There is no doubt that President Biden's fiscal budget will create the largest budget deficit in the history of the United States.

Yet, with countless other countries doing the exact same thing, this is where cognitive dissonance has taken over every financial soul in markets.

The world NEEDS the American trade deficit.

To demonstrate these conflicting monetary beliefs, let's specifically examine the American's trade balance.

The trade balance simply measures the value of everything the Americans SELL to other countries, and subtracts the value of everything the Americans BUY from other countries.

The exact same calculation is used for the German, Chinese, Mexican, Canadian and all other economies in the world.

When the trade balance is calculated for the world, the net number is always zero - hence the word "balance".

In other words, one country's trade deficit is another country's trade surplus.

This is important - take note.

Chart next page we share the data detailing America's Trade Balance in the Top Panel and the US Dollar Index in the Bottom Panel.

Several observations:

First, note how the American's Trade Balance has effectively been in deficit (below the red line) since the early 1990s. Put another way, the Americans have always been buying more stuff from other countries, than what other countries have been buying from them.

Next, also note that trends and changes with the Trade Balance has no correlation with trends and changes in the US Dollar.

Yet, this doesn't stop the many macro tourists from proclaiming the twin deficits (trade deficit and fiscal deficit) spell the end of the US Dollar.

To dive even deeper into this cognitive dissonance, let's also use some good ole common sense.

If one believes a deteriorating Trade Balance is deeply negative for the US Dollar, and when combined with a deteriorating budget deficit and surging debt, will ignite a devaluation of the US Dollar, then by default you also believe in a complete collapse for the entire global economy, especially the banking sector.

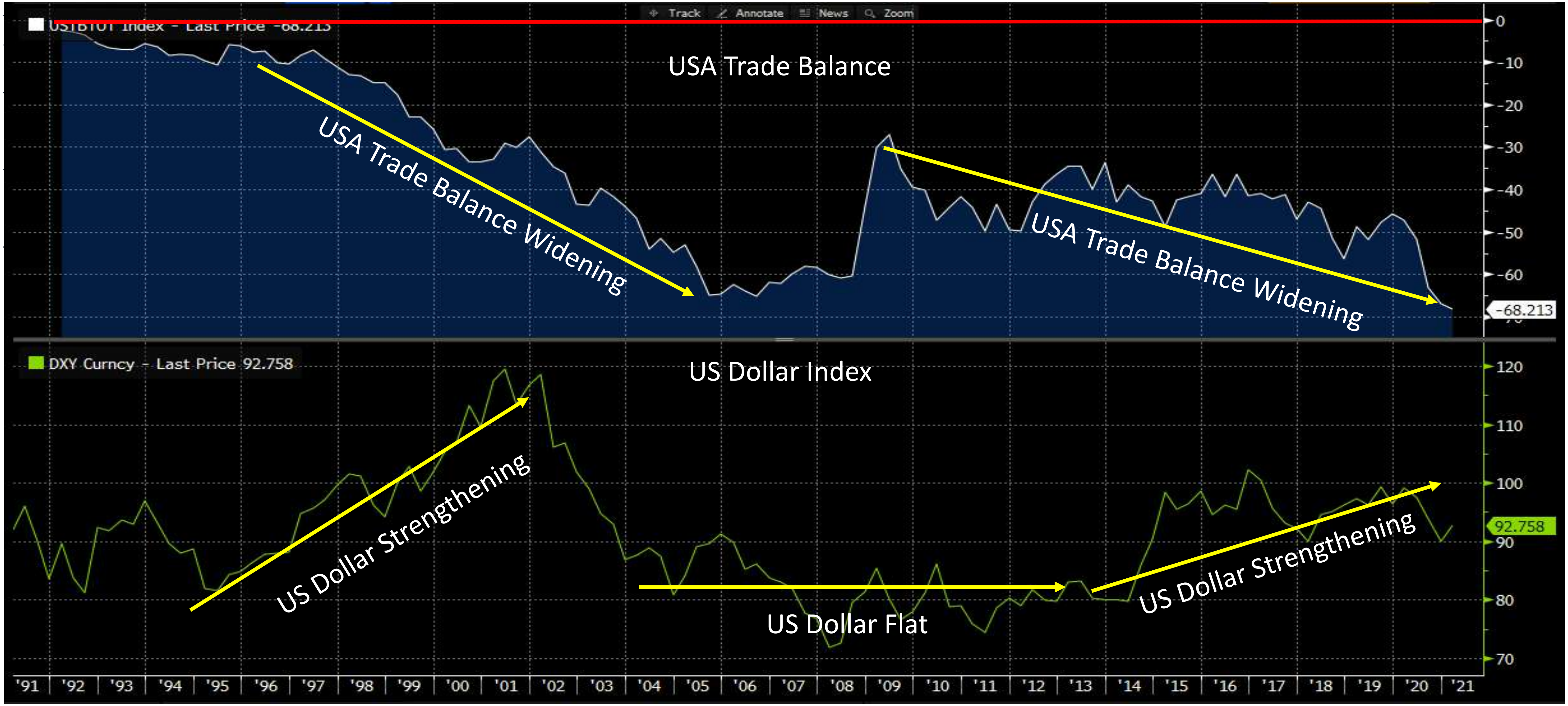
Let us explain.

Let's say for example the above narrative occurs and the US Dollar is devalued by 30%. Prepare for the following:

1) US Trade Balance improves, meaning the Americans buy less stuff from other countries.
2) With the US buying less stuff from other countries, it automatically means other countries are now selling less stuff to America.
3) All of this less buying and less selling guarantees slower economic growth which means job losses, less money available for people and companies to pay debt, and less tax revenues for governments to provide services and pay debt.
4) It also means debt defaults occur and here's the big one - banks will be forced to raise enormous sums of new equity to keep their doors open.

To further expand upon the world's dependence of American's buying stuff from other countries, consider **the illustration and table on the page 12.**

US Dollar vs Trade Balance.



China is incredibly dependent upon American spending.

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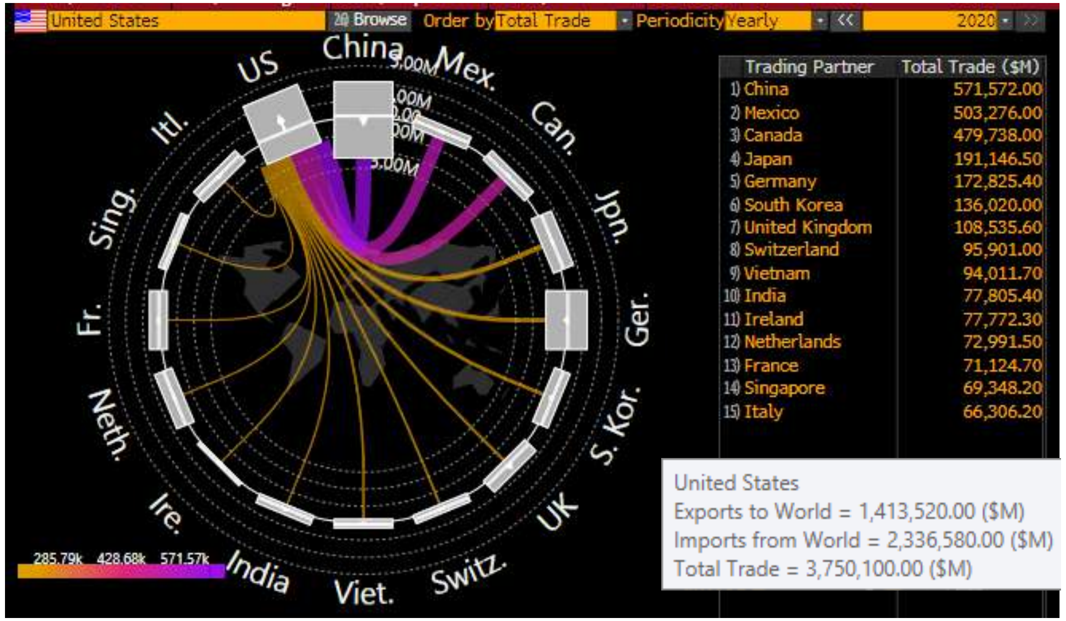
Below we show America's trade flows with the rest of the world. First, notice how China is America's biggest trade partner, and their trade flows are as follows:

United States -> China = 136,123.00 ($M)
China -> United States = 435,449.00 ($M)

This means China's economy (and central bank) is extraordinarily dependent upon Americans buying "Made in China" products. The Chinese trade surplus with America creates millions of local jobs and injects billions of USD into the Chinese banking system.



Trading Partner	Total Trade ($M)
1) China	571,572.00
2) Mexico	503,276.00
3) Canada	479,738.00
4) Japan	191,146.50
5) Germany	172,825.40
6) South Korea	136,020.00
7) United Kingdom	108,535.60
8) Switzerland	95,901.00
9) Vietnam	94,011.70
10) India	77,805.40
11) Ireland	77,772.30
12) Netherlands	72,991.50
13) France	71,124.70
14) Singapore	69,348.20
15) Italy	66,306.20

The same is true for Mexico, Canada, Japan, Germany and on and on and on.

The old adage of "if America catches a sniffle, the rest of the world catches a cold" was important years ago.

Today, due to everyone's economy, government fiscal balances and household debt levels being at extraordinary levels, the adage carries even more importance.

The reason for the increased importance, is due to the systemic risk of any sovereign entity or financial institution experiencing a re-escalation in stress.

And one of these trigger points would undoubtedly be a devalued US Dollar.

A lower US Dollar means less global trade, less USD flowing through the system, declining bank reserve assets, higher long-term interest rates, higher loan losses etc.

That's the bad news.

Now, here's the good news – the USD is not on the verge of a rapid decline.

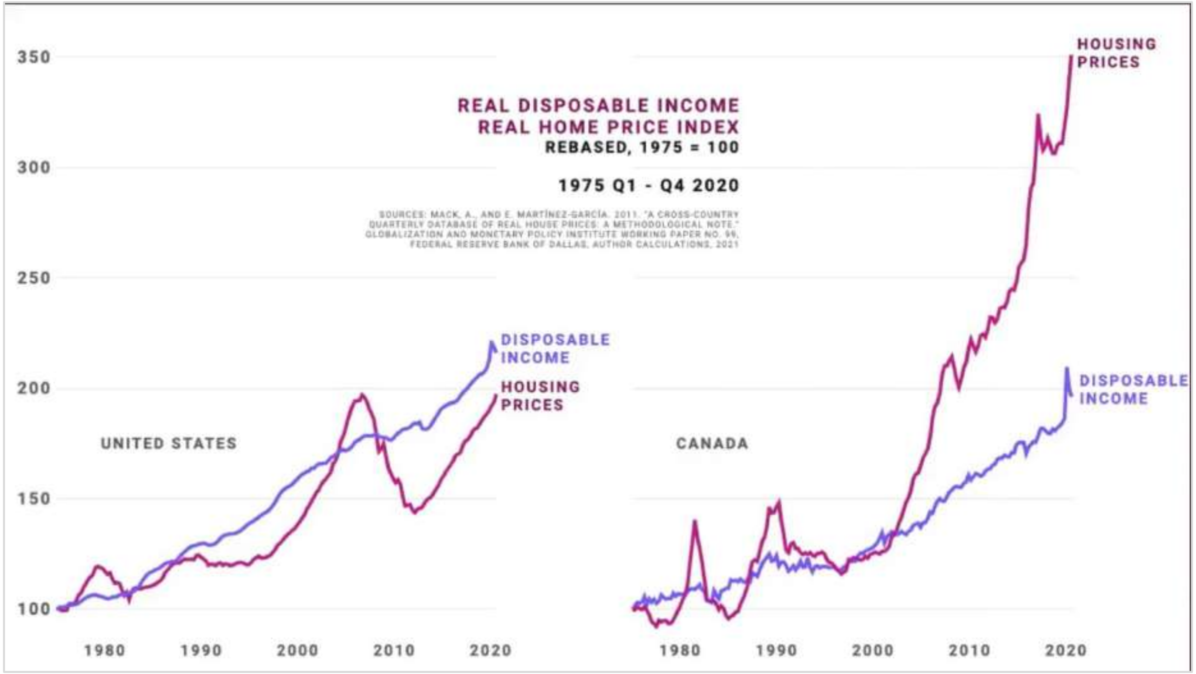
In fact, monetary and fiscal positions have reached the point where the opposite may occur; a surging US Dollar.

Yes, IceCap has spent considerable time communicating this point, and that's the point.

Investors, media and armchair social media pundits are all positioning themselves nice and cozy on the same sofa. Yet, they are seemingly unaware of how crowded it has become, and better still, amazingly unaware how other currencies and countries compare on a similar basis.

Canada.

For clarity, here's a snapshot of the Canadian vs. American housing markets.



Clearly, the Canadian market appears to be a wee out of whack. And this is just one metric. There are countless other metrics that tell the exact same story – the Canadian housing market is in a clear bubble.

The only way for this bubble not to break, is for housing prices to stabilize at these levels and wait for Canadians to begin earning a lot more after tax money.

Yet, this cannot be a 1 or 2-year catch-up, it will take multiple years of above average wage growth combined with the Government resisting the urge to tax this increase in wages.

At the same time, Canadians (and their banks) have to hope that inflation doesn't ramp up, nor are there any financial stressful moments outside of Canada. Either of these will also put a hard lid on the housing market, as well as bank earnings and other spin-off sub-industries.

Of course, it isn't just the housing market that should tilt your head, let's compare the Bank of Canada with its peers.

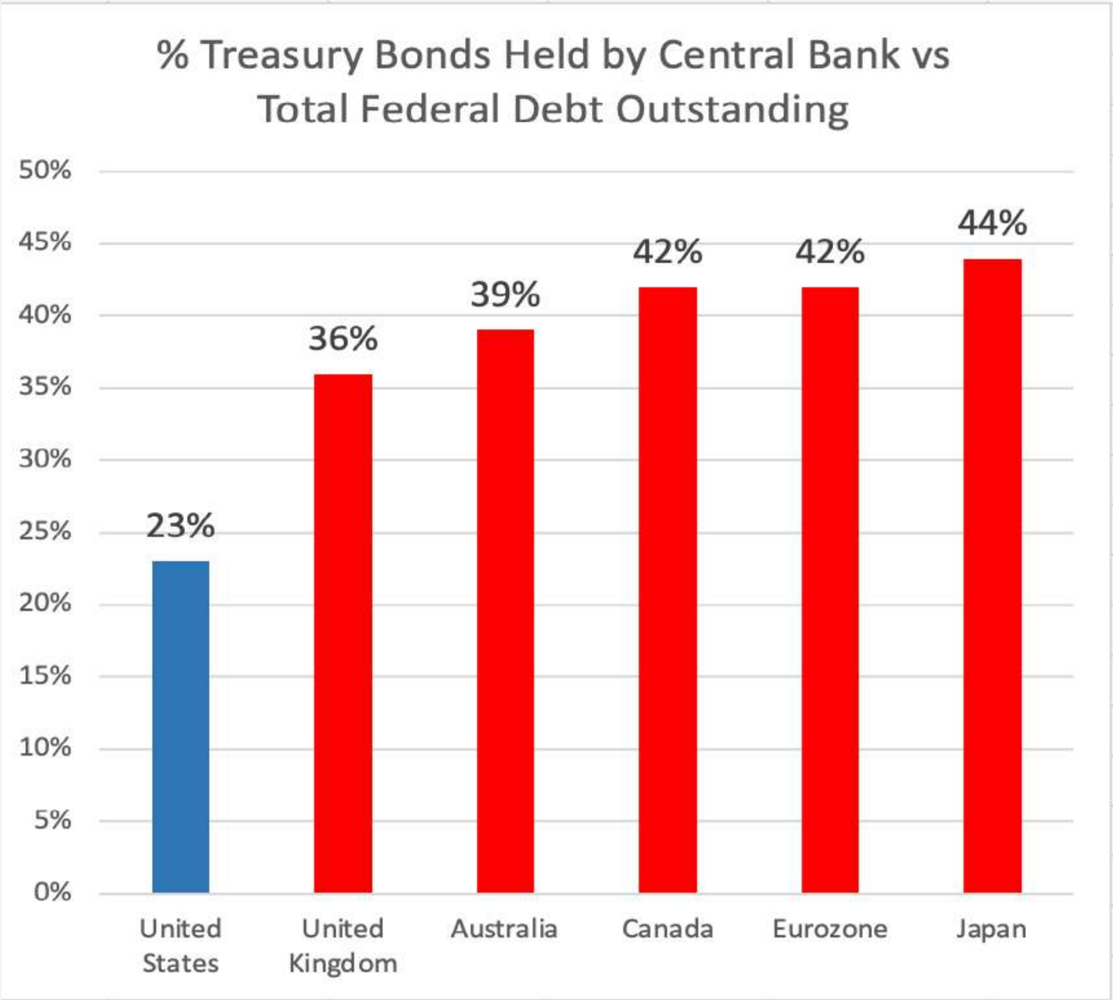
Chart next page compares the world's major central banks and the mess they've all made of their bond markets.

In previous publications, IceCap explained how central banks are indirectly buying bonds from their respectful governments using a process called Quantitative Easing, or QE.

Recall how each time the central bank executes QE, they are actually buying federal government bonds from the market place.

Also recall that the objective with doing this is to artificially supress interest rates. Put another way, keep interest rates a whole lot lower than they would normally be, so that people and governments will borrow - and this is exactly what is happening in the Canadian housing market.

American QE is weak on comparative basis.



Two things should jump off the page when looking at this **chart**.

1. The USA has purchased the lowest amount of outstanding treasury debt compared to all of the other central banks. For everyone screaming how the US Federal Reserve is destroying the US bond and currency market, they are either not looking at what is happening in other markets, or maybe they are simply ignoring other markets because it doesn't fit with the USD is collapsing narrative.

2. These other countries have completely destroyed their local bond markets. With the central banks owning nearly 50% of outstanding debt, they have completely eliminated the most basic tenant of capitalism and free markets - price discovery.

In fact, QE has gotten so out of control, the Bank of Canada recently announced they would begin to do less QE. Yes, they're still buying government bonds, but in smaller amounts than what they were originally doing.

Market pundits proclaim this is due to inflation surging and it's now time to reduce the stimulus being hosed into the economy.

IceCap disagrees – the real reason the Bank of Canada is starting to taper their QE purchases is due to them acknowledging that if they don't stop now, they'll never again have an opportunity to stop the destruction of the Canadian bond market.

This is a big difference. Please take note.

Which of course, brings us to the real elephant in the room.

The Inflation Story.

The Elephant in the Room

Since we now know the extreme monetary policy implemented by the Americans is actually less extreme when compared to the Japanese, the Europeans, the Chinese, the Canadians and others, then there must be something else happening to create all of this (nonsensical) drama about the US Dollar being on the verge of collapsing.

And this is where the reflation trade comes into play.

Monetary theorists have always proclaimed that if you produce excessive stimulus via interest rate cuts, balance sheet expansion and especially when combined with excessive stimulus, then inflation is going to storm back with vengeance.

And since it has been over 40 years since inflation was a problem for the developed world, most have become either dismissive about the potential for inflation, or have simply become ignorant towards this monetary demon.

Here is the long-term showing core inflation in the USA.

Inflation isn’t everywhere.

It’s true how every picture tells a story, and this picture of American core inflation tells so many stories, that like many stories, they tend to become distorted over time.

For starters, economic purists will forever proclaim that inflation is a phenomenon created by monetary policies.

In other words, if a central bank prints money or does other excessive things, then inflation is right around the corner.

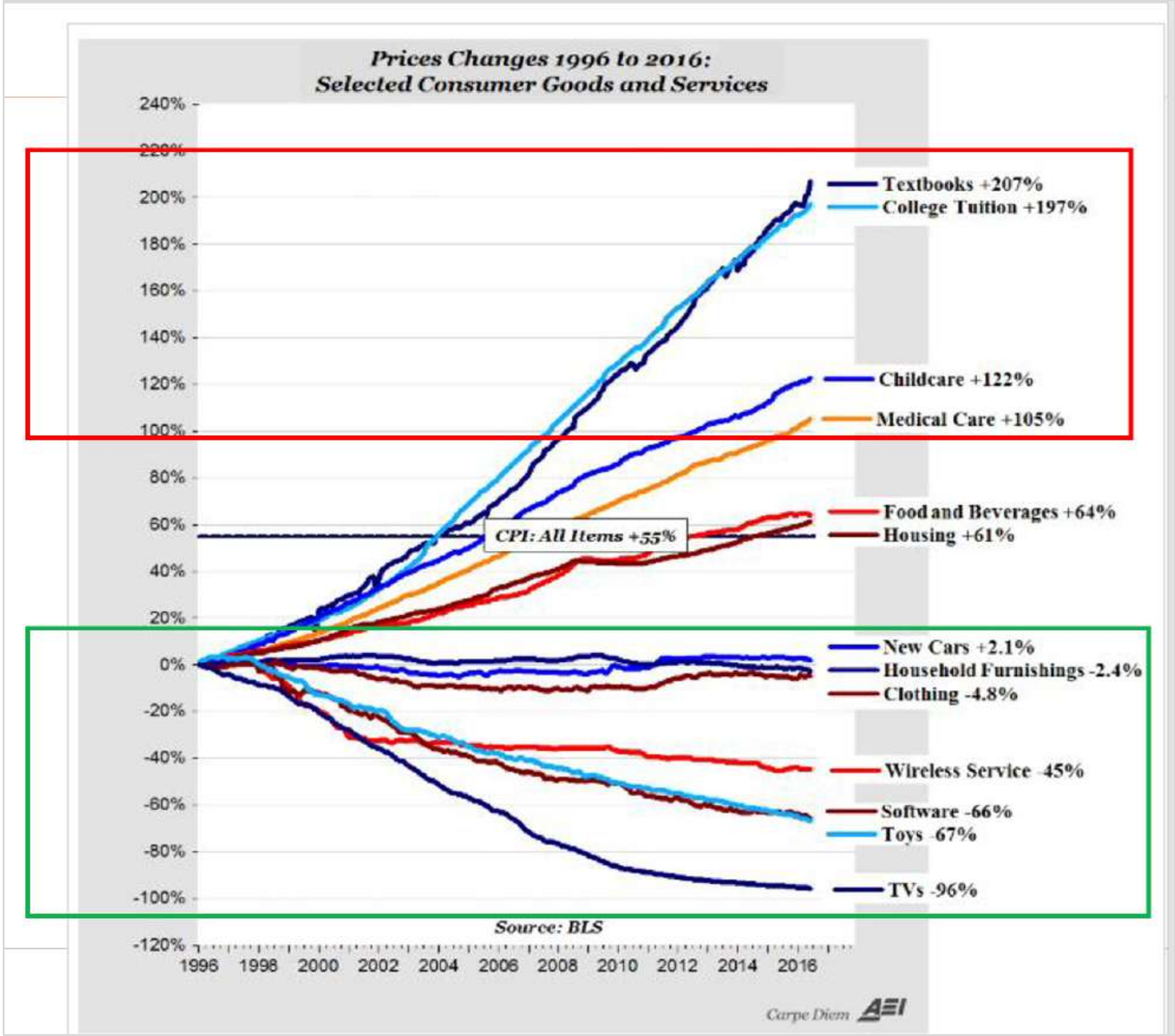
And since no one wants to run into anything around any corner - this must be bad.

Yet, a casual view of this US inflation **chart** clearly shows how from the late 1980s to present day, inflation has never been a challenge. And perhaps more importantly (or embarrassing for the inflation purists), inflation has not once jumped out from around any corner.

Absolutely there were times when inflation was maybe about to become a concern – but those concerns were quickly swished away, not by the magical, deep thinking, parlour smoking, cognac drinking central bank economists - but instead simply by the explosion of the global economy.

Yes, the great equalizer to any inflation concerns was globalization. The inclusion of increasing more emerging market economies into the manufacturing supply chains of the developed world did wonders for keeping prices lower.

Have a gander at the **chart next column**.



Inflation can be complicated.

While the prices of some items have exploded upwards, the prices for other items haven't budged.

While some people dedicate their entire lives to studying inflation, and can support or refute any discussion about inflation - one incredibly important fact will always remain about inflation. The vast majority of people fall asleep at the mere mention of the word.

And since **IceCap Global Outlooks** are not in the business of putting people to sleep, we'll cut straight to the chase.

To start with, and in our opinion, runaway inflation across the education and healthcare industries in the USA (and other countries) is a function of union powers for compensation and retirement packages across universities and colleges, and a function of the American approach to providing both private sector and public sector offerings across the healthcare sector.

Put another way – these two very large and vitally important economic services are structured to GENERATE strong inflation. Price increases in these sectors have little to do with low interest rates and quantitative easing.

The remaining items in the **chart** clearly show a lack of inflation over time.

While computer costs have mostly remained the same over the years, and this would be thought of as a positive contributor to inflation, the productivity powers within these computers have expanded exponentially. In other words, consumers are absolutely getting more bangs for their bucks.

This is also true for many other items within our shopping baskets.

At the same time, we are not oblivious to the obvious concerns with the exclusion of house prices from most inflation calculations.

For those who are not aware, the rapidly rising price of homes in your neighbourhood is excluded from inflation calculations.

Yes, you heard us right.

Economists have instead decided to use Owner Equivalent Rent (OER) as the factor to represent housing within inflation calculations. Let's just say this metric kinda understates the true impact of housing on the average Joe's wallet.

Another interesting inflation phenomena is the central bankers' keen focus on trying to foster an economy that produces inflation at an average annual rate of 2%.

What we find so incredibly ironic about this 2% target is how it was calculated, or deemed to be appropriate.

Despite extraordinary volumes of publications, millions of hours of lectures, armies of PhDs, and lifetimes of tobacco filled pipes and bourbon enjoyed near gentle simmering fires; the 2% target is simply a number magically created out of thin air.

The other interesting thing about our central bank power brokers, none of them can answer why inflation hasn't been booming over the last 20 years.

Central banks have failed.

Since the 1999-2000 tech bubble burst, we've lived through nearly 15 out of 20 years with interest rates near 0%, while also having central banks implement quantitative easing.

Yet, during these same 20 years, core inflation has been greater than the magical 2% target rate a grand total of 3 years.

Alan Greenspan failed.
Ben Bernanke failed.
Janet Yellen failed.
Wim Duisenberg failed.
Jean-Claude Trichet failed.
Mario Draghi failed.
David Dodge failed.
Mark Carney failed (twice).
Yasuo Matsushita failed.
Masaru Hayami failed.
Toshihiko Fukui failed.
Masaaki Shirakawa failed.
Sir Mervyn King failed.
Mark Carney (again) failed.

Yes, all of these highly respected leaders of the central banks for USA, Japan, Eurozone, Canada, and Britain all failed to produce the 2% target rate of inflation.

And just as these past central bankers failed with their primary objectives, it is highly likely their successors will also face an F on grading day.

The reason for our confidence is rather simple - in the eyes of these past (and now current) central bankers, the reason for this complete lack of monetary success was due to one thing - our central bankers simply didn't cut enough rates or print enough money.

Yes, this is the point where Einstein would make a casual observation.

In our minds, the IceCap observation is rather obvious - the reason inflation hasn't soared to the moon is due to all of this central stimulus actually creating the opposite effect than what was intended.

Instead of historic stimulus resulting in companies and households going on historical spending and buying sprees, it has had the opposite effect - larger amounts of private capital has decided to not participate in the economy.

The irony of central banks inability to generate inflation lies in their solutions to generate inflation.

For starters, central banks believe lower interest rates are good for everyone. Even suggesting otherwise will earn you scowls from those in charge.

Yet, consistent and continuous low interest rates has absolutely massacred the risk-adverse saver's ability to receive basic income levels to sustain their living standards.

Remember, there are two sides to every interest rate story.

One side is borrowing to either make a long-term investment, or to fund short-term needs - note that both actions are simply borrowing from future income streams.

Quantitative Easing explained.

The other side is receiving interest for lending to the borrower. For this individual, this represents cumulative past savings being used to fund current consumption.

When these two sides are in equilibrium - it is adding value to the global economy.

When these two sides are in disequilibrium - value is detracted from the global economy.

By stacking the interest rate deck in favour of borrowers over savers, central banks today have created a period of disequilibrium. In other words, it shouldn't be a surprise that our economies and financial systems are acting in unusual ways.

In addition to the zero % interest rates, there's another elephant in the central bank room. And while most people are now aware of this large, slow moving and space eating animal, most do not understand just how destructive it has been on the global economy.

This elephant of course, is quantitative easing, or QE as the central banks like to say.

In its very simple form, QE is an indirect attempt by central banks to suppress interest rates and keep them low everywhere for as long as possible.

To achieve this non-capitalistic outcome, the following occurs:

1. Government spends more than it collects in taxes
2. Government must now borrow to make up the difference
3. Government issues bonds which are bought immediately by the country's largest commercial banks
4. These large commercial banks, then immediately sell these very same bonds to the central bank.

This process achieves two immediate outcomes:

1. Central banks are in effect (in)directly funding governments budget deficits (and debt rollovers)
2. These central bank purchases are so large, that they influence the price of these bonds, as well as all other bonds in the world. The net effect is lower interest rates.

That's not the whole story. There's much more.

To start with, in order for central banks to "buy" government bonds from the commercial banks, it needs money.

Exactly where do they get this money?

They simply create it out of thin air - they print it, using their keyboard.

Now, this is the point where QE and money printing gets a bit confusing.

Many refer to them as being the same. This isn't true, there is a difference.

It is true the central bank "prints" money" out of thin air.

Yet, it is untrue that this printed money is unleashed into the economy and intentionally create inflation.

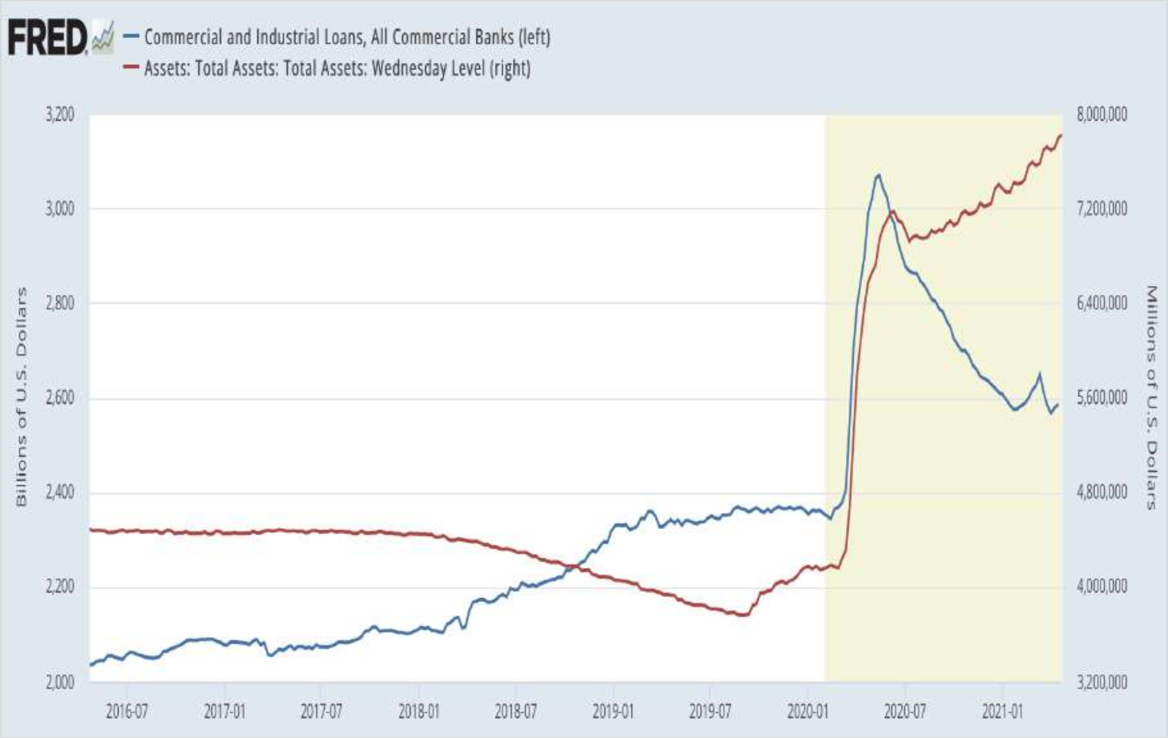
Instead the following happens:

1. Commercial bank buys new bonds from the government
2. Central bank buys these same bonds from the commercial banks
3. Central bank pays for these bonds by crediting the commercial banks' RESERVE account at the central bank

Credit creation remains weak.

Note that these new reserves cannot be withdrawn by the commercial bank.

In effect, QE (or money printing) actually remains clogged in the banking system and can only be released by the commercial bank via new loans or credit creation.



It is this "clogged-up" portion of the entire QE process that makes us question whether the surging inflation story is really occurring due to QE.

If QE was working as intended, bank loans should be surging in line with QE.

Instead, the opposite is happening.

Of course, if QE is not being directly injected into the economy - what else is the reason for surging prices across housing, commodity and stock markets?

To begin with, one needs to look at the other side of the Keynesian Economic Theory gambit.

By this of course, we are referring to the fiscal stimulus, or "stimmy" as it is now so un-eloquently known.

Yes, seemingly everyone around the world has either directly or indirectly received their stimmy from the government.

Initially, these cheques were intended to act as income replacements due to the pandemic shutdowns. Yet, today it is now widely known that stimmy cheques are actually for amounts greater than what people were receiving as wages for pre-pandemic work.

As a result, many stimmy cheques have been spent (or invested) on housing, renovations, DoorDash food, stock markets and crypto currencies.

Supply chains have been greatly affected by pandemic shutdowns.

Make no mistake, this fiscal flood has been the driver of the rapid recovery.

At the same time, pandemic shutdowns have also had the effect of stopping manufacturing and production of many items and goods needed for a normal economic cycle.

Here's an example of price increases resulting from supply constraints. This table from Tyson Foods shows significant price increases, yet volumes are down across the board.

	Second Quarter			
	2021	2020 [1]	Volume Change	Avg. Price Change
Beef	$ 4,046	$ 3,979	(5.8) %	7.5 %
Pork	1,477	1,266	(0.5) %	17.2 %
Chicken	3,553	3,397	(3.2) %	7.8 %
Prepared Foods	2,164	2,080	(4.2) %	8.2 %
International/Other	487	465	1.2 %	3.5 %
Intersegment Sales	(427)	(299)	n/a	n/a
Total	$ 11,300	$ 10,888	(3.7)%	7.5 %

When the shutdowns are combined with the stimmy cheques, the final outcome is lower supplies smacking directly into higher demand for goods and services.

The result is increasing inflation.

The question of course is whether this is a temporary or permanent increase in inflation.

Currently, practically every investment house and market pundit is warning that inflation is about to sustain itself, not inline with the 1970s experience, but rather inline with the German Weimar experience from the 1920s.

And they claim it is all because of the US Federal Reserve printing money.

As markets always move in extremes, the question to ask is "what happens if higher or hyper inflation isn't around the corner?"

The answer "a sharp reversal of the reflation trade."

Of course, another way to quickly offset all this talk and forecasts of inflation is a quick and sustained correction in equity markets.

A 20% decline would very quickly take the oomph out of the inflation expectations game. Any sudden loss in paper wealth can very quickly change all of those house purchases, renovations, and big ticket purchases.

The point we make is whenever the vast majority of the market is in agreement with any market movement, theme or future expected event - the probability of an unexpected event can very quickly create a scene where everyone is suddenly running towards the other side of the boat.

The story of the year.

We acknowledge this whole inflation story is a bit unusual for many investors, yet it is absolutely THE story facing markets today.

Let’s finish by squaring the inflation peg and how we believe this story will play out:

1. central bank monetary policy is not creating inflation.
2. Fiscal policy and especially stimmies, is creating inflation.
3. Global shutdowns during 2020 April May June created disinflation and these data points will cause a base effect producing higher year over year inflation for these same months in 2021.
4. Shutdowns and other pandemic responses has created supply disruptions. Unless these disruptions turn permanent, these effects will wane as supply comes back online.
5. Any severe (-20% or more) equity market correction will have a negative wealth effect and will also reduce inflation expectations.
6. Longer term Inflation will likely be driven by commodity prices and supply effects driven by non-pandemic factors.

Current Markets

Imagine a year ago, you were told there would be a pandemic so severe that the entire global economy would be completely shuttered for several months, and then not returning to normal capacity 12 months later.

Also imagine, you were told that the social and political reaction to the pandemic was so severe that all travel for business, vacations and education would be effectively halted.

As well, imagine you were told that all central banks reduced interest rates to 0% or negative %, printed unlimited amounts of money (quantitative easing) and bailed out federal, state, and provincial governments.

And finally, take a few minutes to imagine you were told that governments would mandate temporary deferment of debt, rental and lease payments, while also paying workers who lost their jobs and businesses who closed their doors.

Considering the above, imagine you were then asked how would financial markets perform 1 full year out.

Most objective people would disbelieve how a pandemic could have this effect on the world. And these same objective people would believe global financial markets would be a rather unpleasant experience.

Instead, we have the opposite.

We have a non-financial world where many of the day-day changes in our lifestyles are slowly becoming the new (and expected) norm.

In addition, we have a financial-world where practically every market has gone parabolic.

Whereas many people refer to the year 2020 as the year from hell, 2021 may eventually be referred to as the year from disbelief.

Maybe Dionysus, the Red Hot Chilli Peppers and Hank Moody actually did infiltrate our global economic and financial systems.

Or maybe, we are all simply experiencing a cognitive dissonance.

Remain prudent and rational.

In financial markets, there will always be a disconnect between the real, economic world and financial markets.

There are times when this disconnect is minimal, and there are times when this disconnect is maximal.

Yet, one thing that is consistent with this disconnect is an eventual reconciliation.

With all the market rage currently focused on a pedal-to-the-metal recovery, it's sometimes useful to be a party pooper and point out the obvious.

If this recovery proceeds like every other recovery has proceeded, then it is highly probable that long-term interest rates have one final push lower.

After all, since every single US recession since 1970, there has ALWAYS been a subsequent disinflationary echo several quarters after the recession has ended.

Put another way, it's only a matter of when not if, either the economy catches up to markets, or markets retreat back to the real economy.

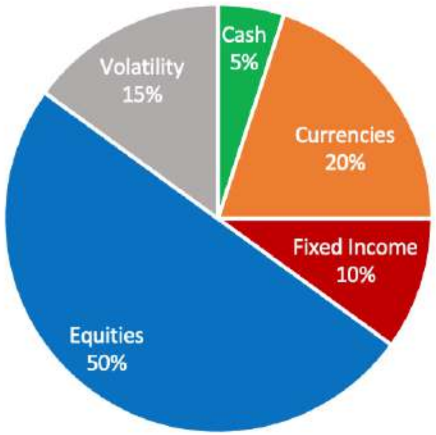
Naturally, there are always strong arguments and data points to support the perspective that this disconnect is either just right, or down-right whacky.

From the IceCap perspective – it clearly feels like the world has fallen into the whacky camp.

Now, this doesn't mean our portfolios have done a turtle and sold everything not bolted down. Nothing can be further from the truth.

In fact, throughout the last year our long-only portfolios have mostly been structured as follows:

Portfolio Asset Mix (long-only portfolios)



As you can see, despite IceCap developing a view that there is a rather significant disconnect between the real world and financial markets, our portfolio strategies are structured to respect this disconnect.

Naturally, this kind of portfolio strategy allocation effectively ensures 2 outcomes;
1) it is unlikely to shoot to the moon when equities are shooting to the moon.
2) it is unlikely to fall out of the sky when equities fall back to earth.

The point we make is that despite extreme market conditions created by the world's central banks, remaining prudent and avoiding the lure of the tempting party tricks by these powerful groups, medias and groupies will provide your portfolios with the opportunity to avoid whipsawing experiences.

And as we know, it's only a matter of when, not if, one central bank will try to out-Hank the other.

Our Strategy.

Currencies
Our long-term expectation for a strengthening USD remains on track. The global recovery is predicated upon extraordinary monetary and fiscal stimulus. As these effects wind down, global markets and economies will be exposed as being structurally weak which increases the probability of a re-escalation of risk, and therefore driving foreign capital into the USD for safety and liquidity.

Fixed Income
Credit markets remain valued at all-time highs. We view incremental value across credit as an asymmetric risk-reward opportunity, with limited upside and significant downside. And end or softening of the reflation trade provides opportunity to be long duration. Yet, beyond this initial market reaction, we view the long-term opportunities as quite limited across the fixed income space.

Commodities
We remain interested in the commodity complex and believe opportunities will become available as soon as supply constraints have been relieved due to supply chains re-opening.

Equities
Our portfolios remain agnostic towards equities. We are concerned about valuations and social media driven capital flows, yet we also appreciate our trend and momentum models which have yet to trigger any signals for a significant correction.

Volatility
Volatility continues to be suppressed across many markets, creating the potential for explosive movements during an unexpected market event. Fixed income volatility is our preferred market.

As always, we'd be pleased to speak with anyone about our investment views. We also encourage our readers to share our global market outlook with those who they think may find it of interest.

Keith Dicker, CFA founded IceCap Asset Management Limited in 2010 and is the Chief Investment Officer. He has over 25 years of investment experience, covering multi asset class strategies including equities, fixed income, commodities & currencies.

Keith earned the Chartered Financial Analyst (CFA) designation in 1998 and is a member of the Chartered Financial Analysts Institute. He has been recognized by the CFA Institute, RealVision, MacroVoices, Reuters, Bloomberg, BNN and the Globe & Mail for his views on global macro investment strategies. He is a frequent speaker on the challenges and opportunities facing investors today and is available to present to groups of any size.

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