The Convexity Maven

at

Simplify Asset Management

A Commentary by Harley Bassman

April 26, 2022

"Let Them Eat Cake"

Queen of France - Marie Antionette - 1775

Much ink has been spilled over the years by the erudite punditry detailing two different types of Inflation. The first is driven by excessive money creation, a concept advanced by the Nobel prize laureate Milton Friedman who offered that "…inflation is always and everywhere a monetary phenomenon".

The second is sourced from temporary supply/demand imbalances that are self-correcting over the medium-term and are therefore not "real" inflation. It is claimed by (whom I will call) "Team Transitory" that this is the type of inflation presently vexing society.

This is a difference without a distinction when the average consumer now spends $342 more per month (NBC). I would dub this: "Let them eat cake" economics.

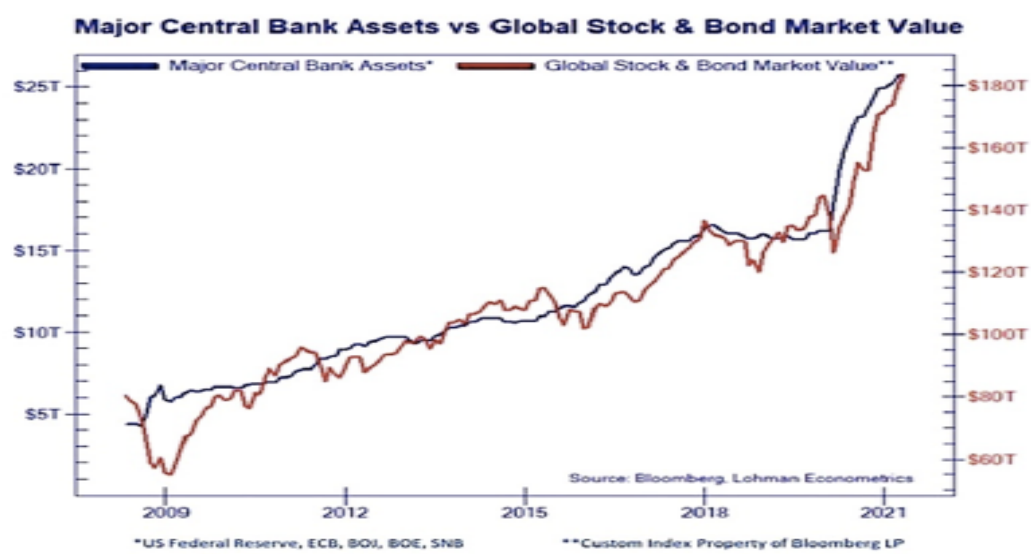
For those of you who are a bit rusty on your late Eighteenth century French history, Marie Antionette was the daughter of Francis I, the Holy Roman Emperor, and Maria Theresa, ruler of the Hapsburg Empire. Marie became the Queen of France by marriage to King Louis XVI, the last of the Bourbon monarchs whose reign was cut short (literally) by the French Revolution.

Exemplifying the monarchy's disconnect from the plight of their citizens, when Queen Marie was informed that the peasants had no bread, it is claimed she infamously suggested to "let them eat brioche (cake)"; which was soon followed by her own trip to the guillotine.

Circling back to the top, this rhymes with our present-day financial aristocracy arguing over which First Cru French Chablis is best paired with the grilled Hiramasa at Le Bernardin while the average American civilian is struggling over the decision between asada or pollo at Chipotle for date night.

The Inflation Genie

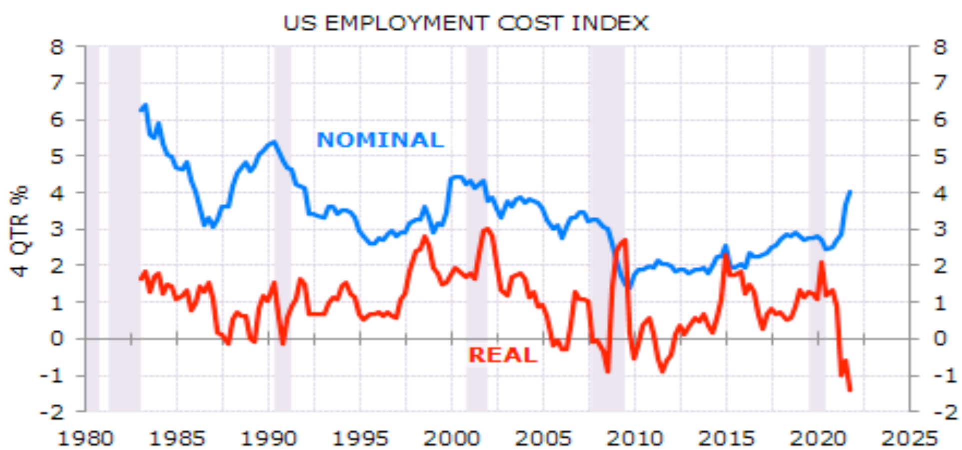
As a first order of business, let's stipulate that the -Riesling line- increase in Major Central Bank assets found their way into -Bordeaux line- Financial Assets. This chart should unquestionably settle the falsehood that a Central Bank cannot create inflation if it so desires, with the caveat that rate targeting can be inexact.



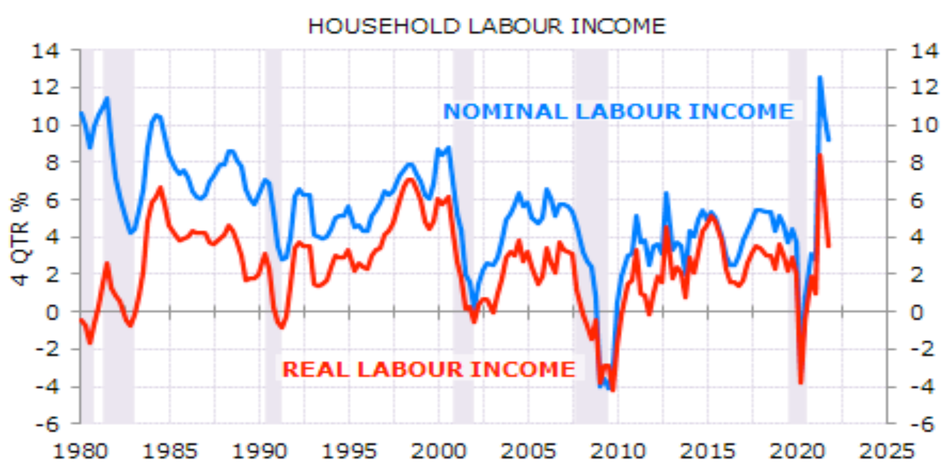
<u>Inflation was a feature</u>, not a bug, in the US Federal Reserve Bank's (the FED) policy of Quantitative Easing (QE). The goal was to elevate wages for Labor to offset the recession that followed the Great Financial Crisis (GFC); unfortunately, it jumped asset prices, a public policy mishap that has played a large part in our current disorderly politics. The reversal via Quantitative Tightening (QT) is the FEDs primary policy tool to jam the inflation Genie back into the lamp.

It is said that "the cure for high prices, is high prices"; and this makes sense. All else equal, if goods cost more yet income is unchanged, in aggregate there will be less demand for such goods, and thus price increases should temper. And as a reasonable corollary, reduced incomes should also dampen prices.

Team Transitory has noted that prices seem to be increasing at a faster pace than wages, and thus our current bout of inflation should soon peak. Using the FED's benchmark Employment Cost Index (ECI) notice that while -trimbach line- nominal wages are increasing at the fastest pace since 2002, inflation-adjusted -Languedoc line- real wages per person are losing ground.



However, using aggregate national data, total -Beaujolais line- real labor income has been rising. This difference can result from a change in total employment, a change in hours worked, and/or a change in the composition of the workforce.

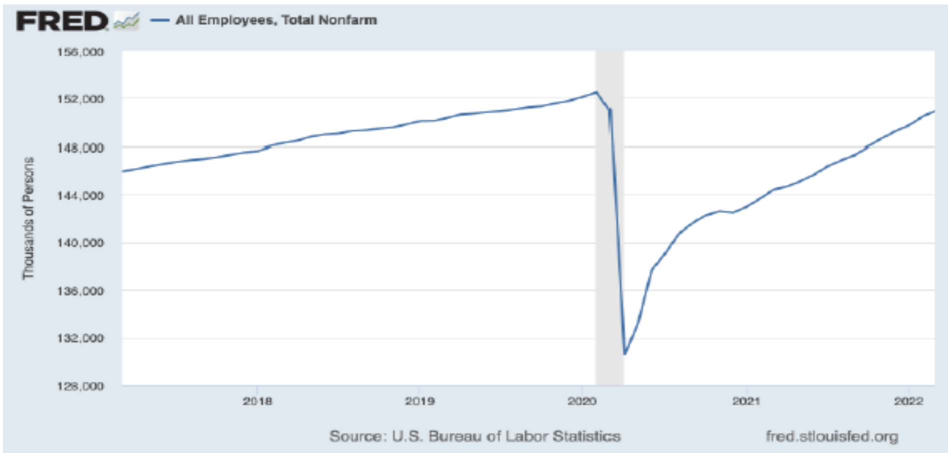


Source – Gerard Minack; www.minackadvisors.com

But don't expect inflation relief anytime soon - rising total income will act as a (demand) tail wind for continued rising prices.

Of course, inflation can also be stanched by supply rising quicker than demand; and Team Transitory has hung their hat on the notion that supply chain and work force disruptions would resolve soon after COVID was tamed.

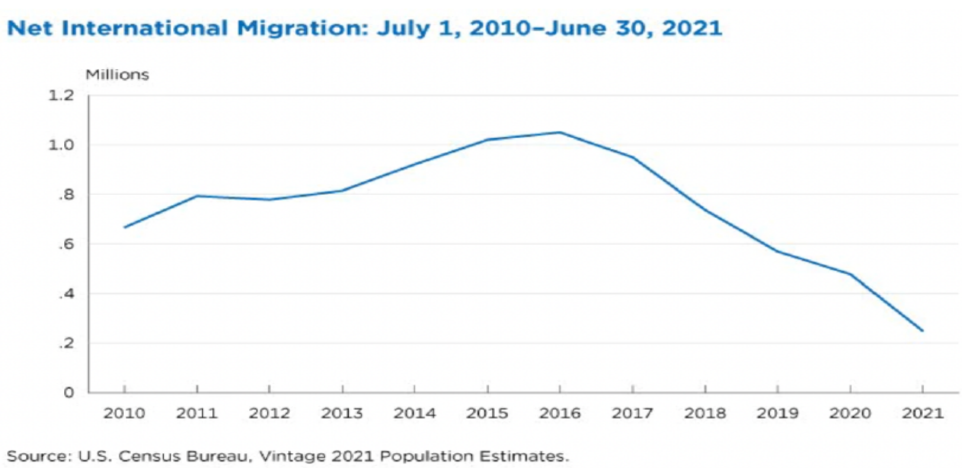
They will likely be disappointed even after the Port of Long Beach clears its backlog. Despite a near record 3.6% unemployment rate, the -sohne line- total labor force still falls short of its February 2020 peak. It likely reflects Boomers, sidelined because of COVID, who decided to retire with their expanded 401Ks.



But the "Great Resignation" so penned by pundits is eye candy to distract one from the real source of our labor shortage – specifically, <u>declining immigration</u>.

At the outset of the new administration in 2017, I offered that policy errors with unintended consequences were possible in taxation, trade, regulation, and immigration. And of these, <u>reduced immigration would be the most dangerous</u>.

Since 2016, -Hogue line- net immigration is plunging to epsilon, and the consequences are now being felt across a wide range of goods and services.



I am loathe to step into the Culture Wars over immigration, but let's be clear:

GDP ≡ NUMBER OF WORKERS * HOURS WORKED * PRODUCTIVITY

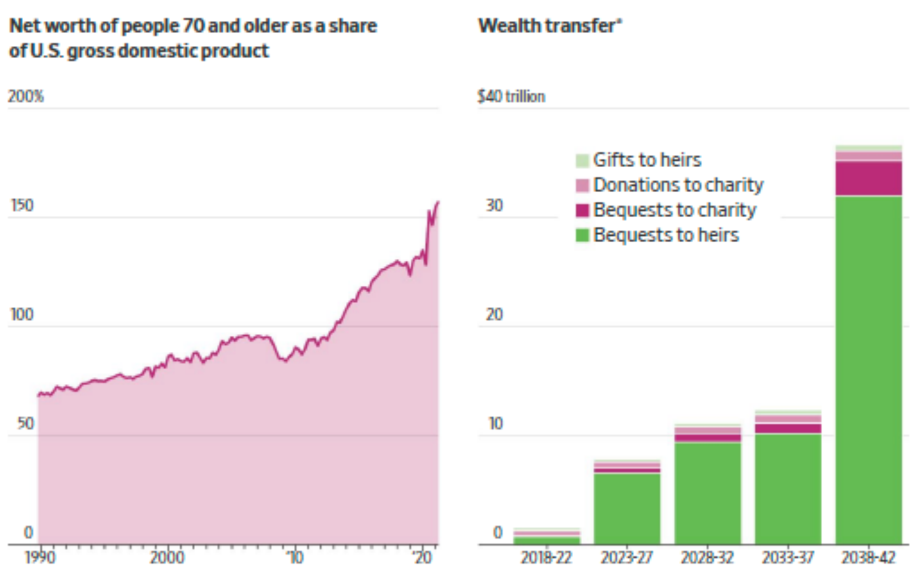
While I am NOT advocating an open border policy, I will note that US economic outperformance is surely linked to our ever-expanding working age population, in contrast to Japan's which peaked in 1997 and Europe's which peaked in 2009.

[Comprehensive immigration reform is our most important economic policy decision as our fertility rate of 1.64 has fallen below the 2.10 replacement rate.]

The Next Helicopter

As my children have left the nest and collected jobs and spouses, it occurs to me that the prices for NYC apartments and private schools have increased at a faster pace than wages over the past thirty years; which makes me wonder why there are still bidding wars for condos and waiting lists schools.

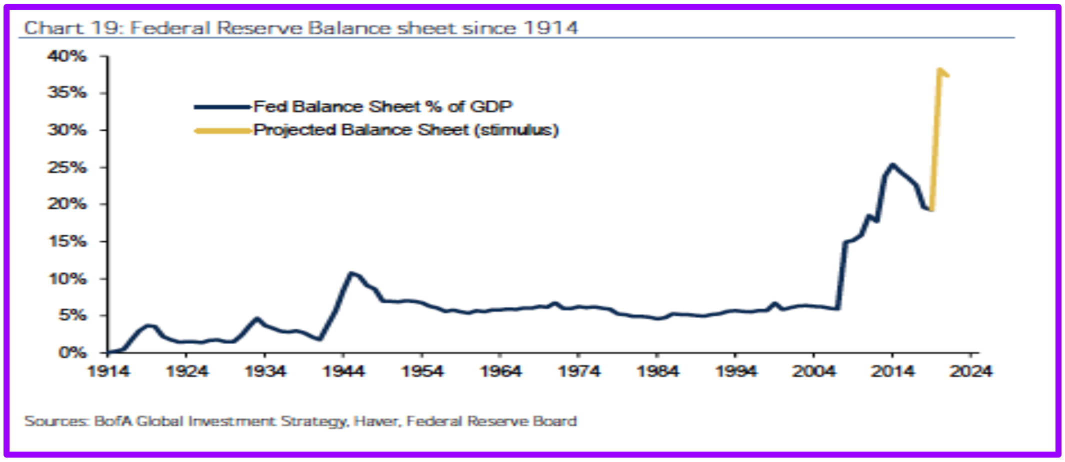
One explanation could be that Boomer parents are supplementing their Millennial children's income from their -Alsace line- wealth enhanced by the FEDs QE.



It seems the spigot may soon open even wider as the Boomers accelerate the transfer of ~$70Tn of wealth-citrus bars- to their heirs; at an annual rate that could equate to 5% of GDP. The FED's policy of QE, which expanded asset values, was supposed to goose spending via the "wealth effect". Perhaps wealth transfer will be the alternate mechanism for this policy to finally be effective.

Comments

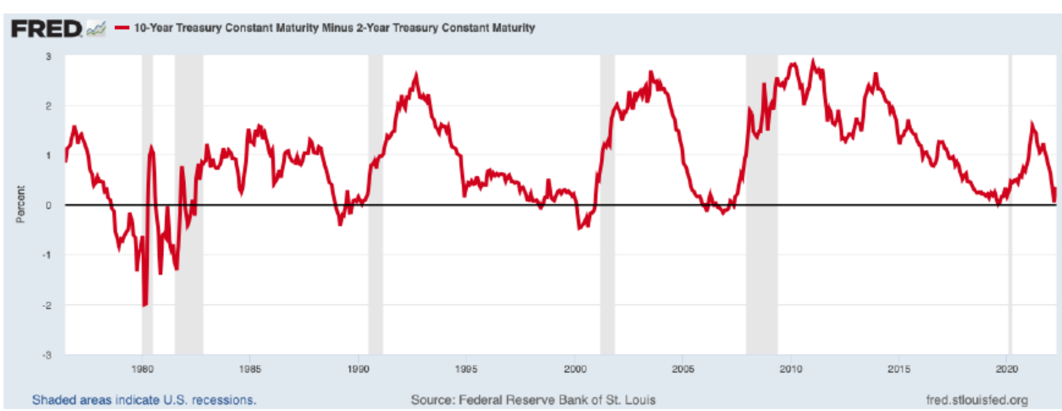
The Monetary crowd has been alarmed about the risk of inflation since the FED's first round of QE to counter the impact of the GFC; and has been apoplectic since the FED doubled their -Dijon line- balance sheet during COVID.



Team Transitory has said this was not money printing, as evidenced by a decade of stable prices; to the contrary, us Monetarists saw a haystack of money looking for a spark.

It seems that COVID was the match thrown onto that pile of dry Benjamins.

Team Transitory has offered that we have experienced a one-time shock and that these higher prices will dampen demand that may lead to a recession. Support for this outcome is the recent -vendee line- compression of the Yield Curve which tends to occur about 16 months before an economic slowdown.



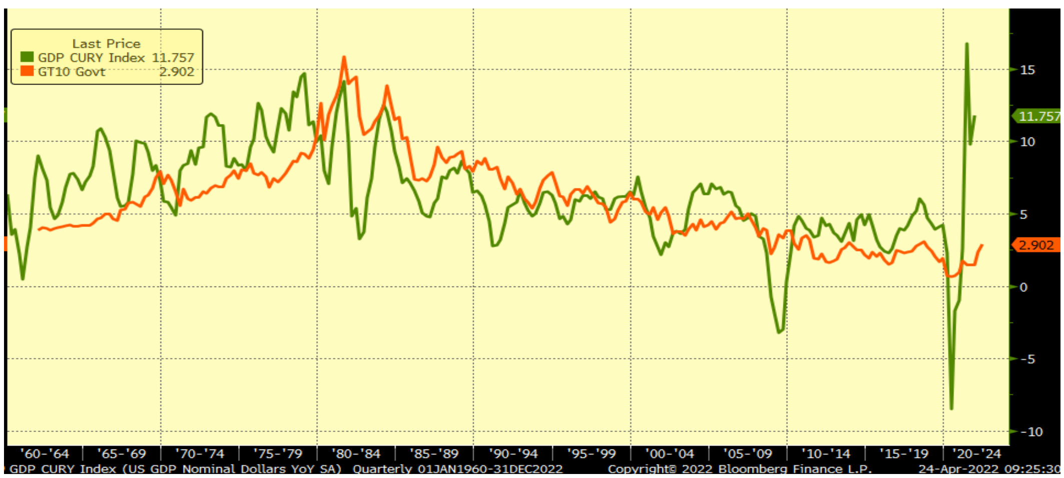
While it is true that "inflation" measures the change in prices, not the level, it is not clear that we have yet reached a stable new plateau.

We now have the simultaneous combustion of:

1) A few trillion dollars of direct deposit unencumbered fiscal largess, also known as pure Helicopter-money that has yet to be fully spent;
2) A shrinking labor force via retiring Boomers and fewer immigrants;
3) The war in Ukraine disrupting Global food and commodity supplies;
4) An asset bubble looking for a path to the general economy.

All these vectors are still in motion, and they will likely contribute further pressure for higher labor and commodity prices.

Even if a recession arrives as suggested, interest rates may continue to elevate as stagflation takes hold. Nominal -bliss line- GDP could easily eclipse 5% during a recession, which could pull up -wolfskill line- ten-year Treasuries.



Fair Warning: The correlation between stocks and bonds will likely flip if long-term interest rates exceed 4.25%; by no coincidence, the strike level of the Simplify Interest Rate Hedge Strategy. This means instead of hedging each other, stocks and bonds will move in the same direction. This will hurt the standard 60/40 portfolio and totally crush levered Risk Parity strategies. You have been warned.

Remember: For most investments, sizing is more important than entry level.

Harley S. Bassman
April 26, 2022

Follow me on Twitter: **@ConvexityMaven**

SIMPLIFY

Your comments are always welcome at: harley@bassman.net

If you would like to be added to my distribution, just ping me.
For reference literature on the financial markets - particularly about options and derivatives - I will immodestly direct you to my educational archive at:

http://www.convexitymaven.com/themavensclassroom.html

If you still have kids in the house, please take a vacation that is more interesting than the Four Seasons, Costa Rica – life is not a dress rehearsal. Turn off the Crackberry (did I just date myself ?) and explore with the family. You don't need to break the bank, rent an RV and see the U.S. We traveled with our four kids on five incredible RV trips.

http://bassman.net

Special credit to Gerard Minack, the best macro analyst on the planet.

Program Note: As noted in my title page, I have joined Simplify Asset Management [https://www.simplify.us/investment-philosophy]

I will not become a corporate shill, and I will continue to write independently; that said, Simplify has an investment philosophy that mirrors mine. Moreover, they presently offer a suite of ETFs with embedded options.

Careful readers will recall that I have hinted at finding a platform to offer my best ideas to the non-professional (civilians)…. **this is it.**

If you want to torture the GME shorts on Robinhood, have at it; but don't bother me. If you want to build a long-term investment portfolio that accelerates the gains and dampens the losses with a low fee structure, then ping Simplify.

I am placing my name on Simplify – That is a statement by itself.

"I'm looking for a hedge against my hedge funds."

Robert Mankoff – The New Yorke