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A SPECIAL REPORT ON MODERN MONETARY THEORY (MMT)

Here come the alchemists

"We are about to experience the greatest debt expansion in history."

That's what a friend and very well known fund manager said to me the other day.

If you think it about it, it's quite a statement considering that we've **already seen** *"the greatest debt expansion in history".*

What my friend was referring to is the monetary and fiscal policies being put in place as I punch this out for you, and which will undoubtedly be enacted in the coming months and years ahead. It's no longer a debate. It's happening….we're all in the car and it's being driven whether we want to be part of it or not. This report examines the options available to policy makers, the path we believe they'll take (hint…MMT) and why.

We may be a tad early on this and part of me wonders why…even though it's been openly discussed by academics prior to Wuhan Zombie flu plonking itself on our doorsteps and even pushing its way into the house to squeeze onto the sofa beside you. Nobody is doing much of anything to prepare for the inevitable consequences of its implementation.

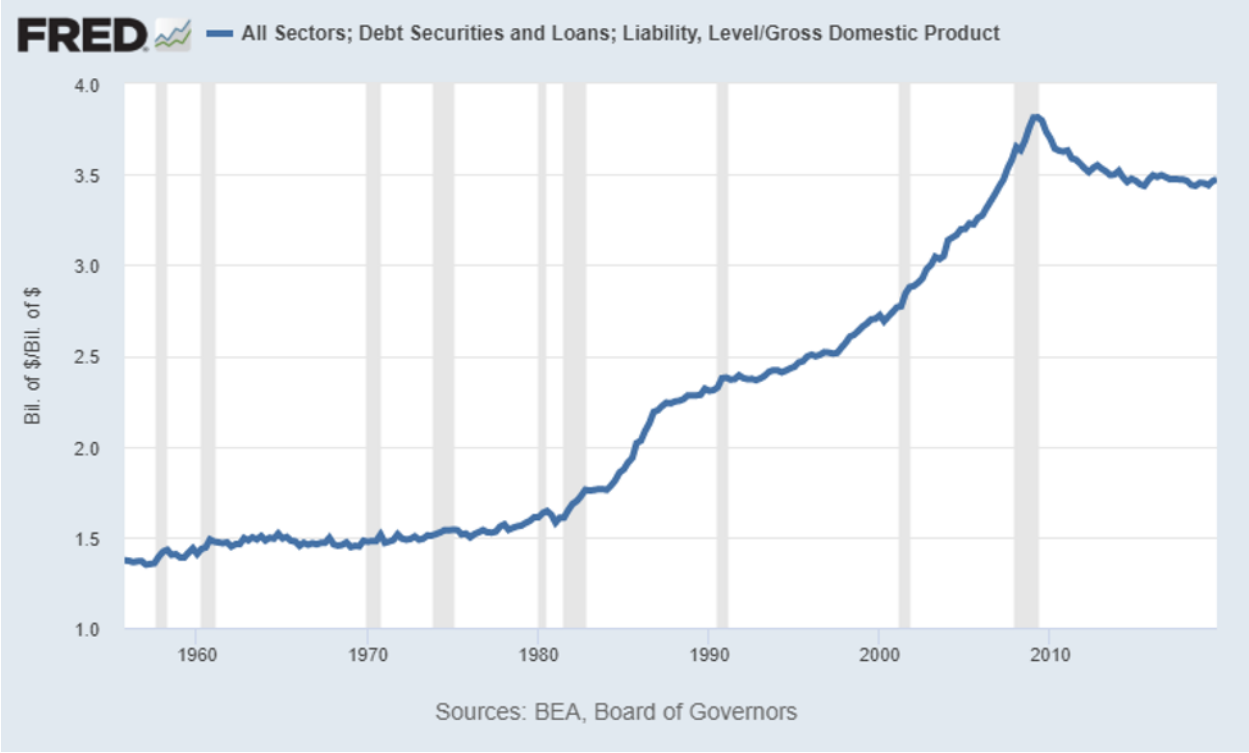
My concern is that all of a sardine we'll wake up and it'll be upon us. And then it'll be a mad scramble to

A) Figure out what it actually is and
B) Figure out the implications of it and profit accordingly.

Like going to a buffet at the Four Season when you know the Russian tourist bus is arriving shortly, it's better to be ahead of the crowd, because in short order there'll be no sausages left, the scrambled eggs will vanish in minutes, and even though there was no vodka on the buffet table… that too will be gone…maybe forever. I speak from experience.

Life before Corona

But back to where we've come from. Consider. Here is total debt both publicly and privately held in the US, expressed as a percentage of GDP.



We all know how we got here. The magic bullet of QE designed to push down treasury yields had the effect of forcing investors into a desperate "hunt for yield". No wonder investors piled into corporate credit like Uni students into a free beer hall. Coupled with stupid "passive" capital algo strategies, and "low volatility" structured products, capital poured into some of the dumbest ideas cloaked as real companies, that we've ever seen. Active asset managers such as ourselves and our friends in the space collectively shook our heads in wonder. Which of course didn't matter a jot... because algos will do what algos are programmed to do.

Hence the debt bubble you see above. Problem is with the corporate debt bubble now bursting, guess what's going to happen? Why yes the government is going to bail them all out...via as many different hairbrained schemes as possible. Which simply takes what was already a truly amazing sovereign debt bubble and blows it up to levels that are guaranteed to make blood shoot from your eyes.

While this is happening, guess what's happening to GDP. It is about to go into a freefall.

Part of me says...whoa this couldn't possibly have come at a worse time. Debt to GDP levels were already at the point where any sane person would question how on God's green earth Governments were ever going to escape this mess. And now here we sit and they're about to get worse - much worse. It's like taking an already obese 80 year old who having spent the last decade binge eating KFC and mainlining fizzy drinks who is now forced to compete in the worlds crossfit champs.

He.is.screwed

At this point the debt expansion is as inevitable as the sun rising tomorrow, and what's obvious even to a little child is that the revenue side of things for Governments (taxes, which are tied to GDP) are collapsing like a teenager after downing a bottle of Absolut on spring break.

Let's take a look at a sample of what we've seen thus far.

Life now - during corona

United States

$2 trillion plus another $6 trillion over the next 9 months...and we're probably going to hear more as the days and months pass. Oh and BTW for context the Fed's balance sheet is $4.5 Trillion. Stop...I just checked it's now $5.5 trillion since I began writing this. Really? Really? Mmmm. And to put this all into context $800b was the number thrown at the Global financial crisis. Now a trillion is the new billion.

And in case you think this is a US centric thing....don't' be fooled. Everyone is getting on the bandwagon of "stimulus".

Yes...everyone.

Europe

The most severely tanned woman in Europe, now heading the ECB

Lagarde said the ECB was considering all of its options before its meeting on Thursday, when it is widely expected to cut interest rates and expand its quantitative easing programme, according to Bloomberg.

Those options include monetary stimulus tools that would provide "super-cheap" funding for banks to make sure loans are readily available across the bloc and that cash continues to flow through the EU economy.

However, she warned that the policy tools would only work if they had full backing from EU governments. She said leaders needed to ensure banks continued lending to businesses affected by the virus outbreak, and ramp up their own fiscal stimulus measures. Lagarde added that the economic shock could be temporary if met with the right response.

That she looks alarmingly like a photoshopped version of Freddy Kruger is simply God's way of warning us, because what she will bring to the table is something more disastrous than good ol Freddy could have ever conjured up.

Japan

The BOJ is now buying the snot out of ETF's. They've been doing it for donkey's years in the bond market. To that extent I may add that the Japanese bond market now isn't a market at all. Nobody turns up. Why bother - You know what's going to happen. So it's only natural that a government after having successfully destroyed the normal functioning of their bond market now looks back at the carnage and says....."hey why don't we give it a whirl over here in the equities market?"

Why? The answer is simple. Because they're morons.

Australia

$11.4 billion. That's the last number I heard. Now I'm talking about global stimulus. By the time you read this it'll definitely be higher.

South Korea, Honk Kong...even the Thai's have thrown $400 billion at this thing.

This pandemic is a wonderful opportunity and dare I say it, justification for over indebted governments and their Central bank counterparts to unleash a tidal wave of liquidity into the market, to do what none of us could quite figure out would be both possible and politically acceptable. And yet here we are and it's happening.

Policy tools used thus far?

Considering that interest rates are already at the zero bound, that particular tool (slashing rates) is now (finally) widely acknowledged by those within the community of pointy shoe'd academics littering central banks, as being ineffective, and hence taking rates into negative territory is now acknowledged as - not the answer. We'd say it's about bloody time they realised that. After all, Japan and Europe have both tried NIRP (Negative interest rates)...and the results weren't materially different. So we think zero it is.

Which leads us to QE. We note that the FED just came out with QE infinity. That's a silly name. Why? Because infinity means they can do it forever. Which ...they can't. They can for as long as folks choose to place value in the paper they call money. This is true of any country...always has been. That the US holds reserve status simply means that they have much more leeway than others, but infinity? No.

You're left wondering where this all leads to.

Firstly QE doesn't work in this sort of problem. We've a unique combination of both supply and demand destruction. AT THE SAME TIME.

QE won't fix that. But they'll try it anyway.

And when they try it they'll find that bigger budget deficits actually slow down the economy. Furthermore they'll find that slashing rates down to zero won't make a toss of a difference to mainstreet. And this is a mainstreet problem...not a wall street problem.

Going into battle in your underpants.

The western world's governments, notably the US, UK, Europe and yes...Japan (yeah I know they're not "west" but they've followed very similar government debt expansion) have gone into this crisis with unsustainable debt financed government expansion.

Consider that the US now has roughly $55 trillion of non-financial debt outstanding (this figure is probably higher by the time you read this as we've truly entered crazy land). This is serviced by what used to be a $21.7 trillion economy. I say "used to" because Wuhan zombie flu and the resultant shutting down of the economy both in the US as well as elsewhere will absolutely 100% negatively impact GDP growth. So that $21.7 trillion economy is going to be less, not more. Current estimates as I write this are that the shutdowns in the US will blast a $3 - $4 trillion hole in the side of the US economic ship.

But those are estimates, which, if we're to be honest is the word economists use when they're guessing.

What's not guesswork however is that the federal debt held by Joe Sixpack grew at a compound annual 7.7% from 2018 through year end 2019. Worse still, net interest expense (the bill to be paid less the principal) grew at a whopping 19.5% compounded annually. Over this same timeframe net GDP (all the money the country earned) grew at a 4.4% annual rate. So Federal debt has been growing at almost **twice** the rate the economy is growing at, and the interest bill (net interest expense) is growing at over **4x** net GDP. Jeezuz!

This.is.unsustainable.

And that folks, was BEFORE we all hunkered down behind walls of toilet paper, which of course means that the denominator (GDP) is definitely NOT growing. It has in fact, gone into freefall.

Un-sus-tainable.

But Chris this sort of loopiness has been going on for a long time. Surely it can go on for much longer?

Well what we've been enjoying is of course QE which will clearly not solve the current massive credit contraction, nor will it solve the coming wave of bankruptcies across the US and indeed the world.

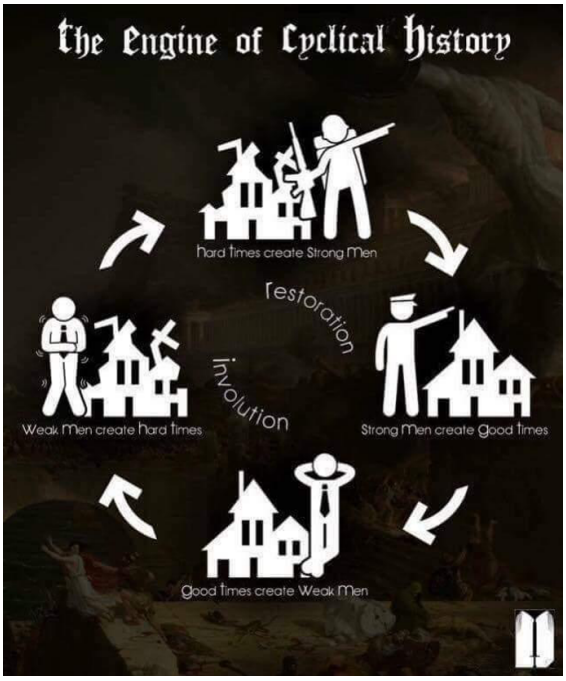
Two things

> 1. QE was deflationary or I'd prefer to say disinflationary because that money borrowed was held in the banking sector. We can see that in the growth of excess reserves. Also the portion of capital that did find its way out of the banking system was directed into financial assets. Stocks, bonds and real estate. Which is where banks can make a profit. No surprises then.
>
> 2. The second thing to think about is that central bankers are well aware of the great depression. Generals always fight the last war and the last great financial war was the great depression. So they'll do whatever it takes to not have that.

Enter MMT

Prior to the pickle we now find ourselves in MMT (Modern Monetary theory) had been increasingly finding favour with the pointy shoes in gleaming office towers from Brussels, to Manhattan and beyond. It is unsurprisingly wildly popular amongst leftists. That's because over in the US folks like Bernie Sanders and that crazy Cortez woman can see that it provides legitimacy to turn the country into a giant welfare police state. It shows just how detached from reality the general public is that folks like this are even given the time of day.

I am reminded of this.



The basic premise behind MMT is that debt and deficits don't matter.

What I find fascinating about MMT is that the explanation given to this theory is so convoluted, illogical and bizzare that it actually renders it somewhat impervious to criticism.

Have you ever been in a situation where you're completely out of your depth? Maybe you were involved in a conversation with two car enthusiasts and they were rabbiting on about torque and traction and a hundred other things that are completely meaningless to you. Well you realise they could be making shit up and you'd be no wiser. Unfortunately that's where this lands today. I and many of my friends, folks who live and breathe the investment world find this entire thing puzzling. Not because we don't understand it, but because quite frankly it upends basic immutable laws of logic. MMT itself isn't particularly new or unique. It is quite simply a radical version of fascism whereby the premise is that the state knows better than the market how much of anything (in this instance debt and money printed) should be created. Twisting some attributes such as "aggregate demand" to enable "stability" and a host of other nonsense distracts one from the basic premise. Which is as wrong as Myley Cyrus swinging naked on a wrecking ball. What's unique is the popularity and acceptance of it in academic circles.

Show me any country in the history of mankind where the decision making process around how much of anything to produce or supply sits in the hands of a bunch of old fogies in government and actually works. You can't, can you?

The question isn't whether or not MMT will work. Of course it won't. Sadly that's not the point. The question is will it, or will it not, be implemented. We think it's now both inevitable and imminent

How would it work?

Practically, the Treasury would issue zero maturity and zero interest rate IOU's to the Fed, who in turn, would increase the Treasury's balances at the Federal Reserve Banks. The Treasury, in turn, could spend these deposits directly to pay for all manner of stupidity the government can conjure up. We'll just call it pork for ease of understanding.

What is important to understand is that the Fed, which if we are to be honest about the new relationship - becomes a child of the government. Any sense or pretence of independence would be forever lost. So the child (Fed) would be funding Mum and Dad (Government) with a worthless IOU. And the government would then spend it on pork.

To be clear if any country other than the good ol US of A were to try this, I can guarantee you that there'd be a run on their bond market faster than I'd run from a group of Jehovah's witness coming my way, and their currency would get beaten like a KKK member in Harlem.

It is ....monetization of debt. So don't let the jargon confuse you as to what is taking place.

Even if the pointy shoes manage to do this without folks realising what exactly is taking place the results won't take too long to be felt. Since there'd be no increase in actual services, products or productivity while simultaneously there'd be government and FED in an unholy alliance creating more aggregate demand, it wouldn't take too long before Joe Sixpack turns up to the bottle store to drown his sorrows, only to find that his real purchasing power aint what he thought it was. And so instead of a bottle of fine Scotch he'll be opting for cheap vodka. In other words...inflation. Or actually more accurately a decrease in his purchasing power with those dollars in his pocket.

To be honest I find it somewhat surreal and absurd that I'm sitting here writing this report to you because the entire idea is preposterous and outrageous, and yet I see no other way out for them. I hate it. It's bad. Bad for everyone, especially society. I wish it wasn't so but I see few palatable alternatives. You see when you've a developed world that's drowning in debt it is politically unpalatable to tell folks to take the pain and not only save but to take away the credit punchbowl. So it will be creditors that are sacrificed in favour of debtors. I rate the probability of this north of 80%.

Not simple

When we look at historical examples of debt eradication, it is clear that countries never default on their domestic debt. They do default on their external, usually dollar denominated debt and then print the required money to "pay" for their domestic liabilities.

And this brings us to what is a whale sized issue. If the US goes down this path, the entire global monetary system would begin to readjust violently. Because what it would amount to is a synthetic default in both external and domestic liabilities. It would completely destabilize trade, it would destabilize the flow of goods and services, not to mention create extremely violent swings in the swap market. In short it'd be chaos and once unleashed very difficult, if not impossible to reign in. I don't pretend to know what that would look like and I don't think anyone does.

Inevitable and now imminent

My kids hate doing the dishes. They bitch and moan, arguing over who's washing and who will dry. And they delay...oh boy do they delay. "No Dad I'll do it after I've fed Pixie" - She's the money burning four legged hayburner in the paddock that people call a pony.

Anyway both my kids know that they'll never get out of doing it (Dad's a hard nosed bastard). Why they procrastinate is probably the same reason I wait till the very last minute to do my taxes every year. Because it sucks. But as bedtime nears we all know what HAS TO be done. So it becomes imminent.

This is where we're fast moving towards. The dishes have been piling up for far too long. There's a veritable mountain of them now but bedtime is around the corner and they WILL get done.

To be clear when this happens in the financial markets it's going to be a shitshow with snot flying and much gnashing of teeth. I want to be nowhere near it and I sincerely hope that with our work here we can ensure that you too...are out of the proverbial kitchen.

Outcomes

If we are even half correct about all of the above we're about to experience the greatest wealth transfer in all our lifetimes and possibly the greatest in the last century.

So let's look at outcomes.

Spending programs

Government will enact these measures whether they do MMT or not. But MMT will make it much easier to implement. Bridges, airports, highways...all that sort of infrastructure build out. It's coming. NOT bearish for commodities. Oh and you do realise that we're just coming out of a decade long bear market in commodities. Nice!

Pensions

My apologies to you if you're old. Your old age just got cancelled. The very idea that an already bankrupt entity that is now being forced to borrow truly ungodly amounts of money, while seeing their serviceability of debt disappear like a stack of Hillary Clinton emails...is preposterous. Pensions may be paid...in nominal terms. In real terms they're done for.

Like you (probably) I have an elderly mother and elderly in-laws. And unlike some...I actually like my inlaws. Which is why I really really wish it wasn't so, but hope is an awful strategy.

Free healthcare. Free education, basically all the social spending pork will be difficult to maintain. I do suspect myriad social programs to be ramped up substantially as MMT is implemented and it'll take a while for the imbalance of productivity (falling) to meet headlong with the demand (rising) from the MMT free money spigot to manifest. When it does the scramble to protect oneself from the stagflationary outcome will make the bat flu induced panicked rush to stock up on bogroll look positively orderly. Orderly this will NOT be.

What about equities Chris?
You may think it sounds crazy but I don't want to be short equities. Equities (those that are left standing) represent real tangible value with cash flows. I could make a strong case for being long equities but I don't need to get too complicated for now. Below I list some of the most amazingly cheap and thus asymmetric assets/sectors available to us as of this writing.

This right here is a gift. And BTW we're just a smidgen over a month away from the halving.

As is this

A decade hence and folks are going to marvel at how absurdly cheap Platinum was.

And no I'm not going to leave it out. Here it is.

I don't want this report to be an endless list of deeply undervalued asset classes so I'll leave you with just one more.

You do realise that you can today buy a barrel of WTI for the same price as a large Domino's pizza. Stick it in your shed and I guarantee you that in 10 years time you'll look like an absolute genius. And yes I do think over the next few months oil can actually go to zero. Nutty but true. Try look out further and realise what's happening so that any price drops no matter how they make your butt clench will be understood within context.

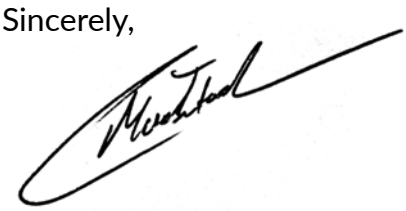
Ok I lied. One more...

I will leave you with another comment that a different fund manager said to me this morning.

"I think Chris we are going to go through the greatest wealth transfer not of this generation but of every generation on earth today. THIS is it."

I concur.

Sincerely,



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