

They brought a gun to a knife fight

Ok we all panicked in the initial stages of COVID-19, myself included. I made a basic data error... I assumed that ALL COVID-19 sufferers went to hospital and a good percentage of those were not making it out, especially in the earlier stages in Wuhan (if all intel that managed to escape before it was informationally cauterised was accurate).

In reality the virus, though lethal, was not nearly as lethal as we all initially thought.

The markets took fright and a liquidity crisis ensued.

That was the knife fight.

Governments around the world brought a liquidity machine gun and went into a frontal assault armed with a combined \$25 trillion or so of new money. We are still feeling the dizzying effects.

Inflation is now in clear view. Initially labelled transitory, it now looks not only permanent but accelerating. Who knew (except librarians) that inflation was a snowball?

And so we may be entering the terminal phase of a super cycle experiment, underpinned by the most grand, sophisticated and elegant delusions...

Governments can run increasing deficits without consequence.

Central banks can bring money into existence without inflation.

Interest rates can be held artificially low without distorting the financial system and ultimately society.

It was good while it lasted... they did all of the above... many times, in increasing amounts and it felt like it was the ultimate free lunch... too much of a good thing can be wonderful right?

In fact it has worked so well, it's going to be hard to face ANY new reality, especially one that involves behaviour consistent with its price stability mandate.

The greatest predictor of human behaviour is that humans will try to be consistent with their past behaviour. Central banks are run by humans, so I expect they will be consistent and try and outspend this inflation too, hoping against hope that productivity and economic growth will bail them out one last time.

So how could this possibly play out in 2022?

If central banks are serious about not anchoring high inflation expectations, surely they need to get in front of inflation, not track it from a distance? This means they have to raise interest rates a lot faster than they are expected to, shooting the equity and property markets in the foot at the same time. This is something they do not want to do, as the eye-watering rise of these markets has been responsible for much of the increase in consumer spending indirectly due to the wealth effect they have created.

Between 1997 and 2006 consumers withdrew \$9 trillion out of their home equity according to Soros in his book "The New Paradigm for Financial Markets: The Credit Crash of 2008 and What It Means"¹. I believe the total market cap of the banking system at the time was \$7 trillion.

¹ George Soros, The New Paradigm for Financial Markets: The Credit Crash of 2008 and What it Means

So in that 10 years, the US Government (through its guarantee of the Fannies and Freddie's) underwrote a hidden-in-plain-sight stimulus of gigantic proportions. Nothing changed in the next 15 years, except perhaps that the stimulus has gotten bigger. Equity markets have the central bank put, which seems ironclad after 2020.

The combined effect of trashing both the equity and property markets seem too great and it would take a very courageous central bank to risk it... unless something frightened them more? Something that creating money would only make worse.

Perhaps that something would have to be a geopolitical event, a crisis of confidence (credit), rapidly depreciating currency or snowballing inflation or all of the above.

So it seems likely central banks take the road most travelled and will track inflation at a distance until a more frightening boogie man appears.

And with this implicit decision comes a veritable "Banquet of Consequences" as Satyajit Das called it in his book of the same name describing "The Reality of our Unusually Uncertain Economic Future"².

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² Satyajit Das, A Banquet of Consequences