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Be careful what you wish for…

What continues to absolutely amaze me is the propensity for pretty much everyone to assume that inflation and deflation are ALWAYS mutually exclusive.

It is true that when the real economy tanks, inflation often falls away due to demand destruction. However, there are times when inflation increases exponentially alongside a precipitous fall in real demand.

Let’s look at the US situation currently.

Interest rates are rising and the real economy is cooling, leading everyone to assume the Fed will pivot as inflation goes back to 2%.

When the economy starts to splutter, what do you think the government response is?

Exactly what is happening now in the UK and the EU. Borrow money to give out to people to ease their hardship. Both the EU and the UK subsidise energy bills to ease the “inflation burden”.

Then the recession starts to really bite the number of unemployed goes up and so does the cost to the state which, in turn, borrows more money to help them out.

The amount of government borrowing doesn’t go down, it goes up. The problem eventually becomes untenable as buyers of government debt get swamped by supply, driving interest rates up.

That in turn becomes untenable, so central banks have to step in and buy the bonds with printed money in turn creating monetary inflation, ***in spite of*** a recession or depression in the real economy. They also print more money to pay the high interest rates now being demanded.

A well-trodden path by developed and developing countries alike.

I think Reagan had it right when he said “government does have a problem, government IS the problem”.[1]

So, inflation numbers depicted graphically will start to emulate the harmonic motion of a bridge which is about to collapse. A rising trend with bigger volatility.

Currency is the asset class which may feel the brunt of this volatility, as this is the risk vector through which this volatility can most easily find expression. This is fortunate for us, because the most convex and liquid positions are to be found in the currency space.

I also fully expect the biggest macro grey swan, the Chinese property market, to land sometime this year. The biggest asset market (and bubble) in the world, Chinese authorities will do ‘whatever it takes’ to avoid a price meltdown, but that might involve an extraordinary amount of credit extension and money printing, especially if overseas export demand is going to be as mooted as we expect.

This is not going to help the global inflation reduction cause.

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[1] https://www.reaganlibrary.gov/archives/speech/inaugural-address-1981#:~:text=In%20this%20present%20crisis%2C%20government,by%2C%20and%20of%20the%20people.

We are living in interesting times and long volatility exposure is one of the few asset classes that can shield one from uncertainty or unknown risk. The very risk which has negatively affected compound returns in a major way in 1987, 1994, 1997, 1998, 2000, 2001, 2008, 2020 and 2022.

Disclosure