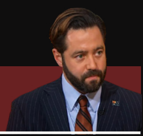
Australian Standfirst

The Unprecedented Reflation Supercycle:

Big, Bold, Strategic Moves, Surreptitious Inflation & The Incandescence of "*Swarm Trading*"

Economics

22nd February 2021



Stirling Larkin, CIO

Human nature being what it is, the archetype of the collective unconscious seeks simple but indeed powerful trends – Y2K, PokémonGo, Gamestop, Dutch Tulip Mania and even Trumponics.

But found in the in-vogue precept of ***Reflation*** lays a larger movement and self-reinforcing cognitive distortion that asset prices must always go up, whilst at the same time making people believe that the *sine qua non* of *There Is No Alternative* ("TINA") is a deep-seeded predilection to avoid complexity and unnecessary risks (whether that turns out to be objectively true or not).

The term Reflation was first coined by American neoclassical economist Irving Fisher, following the 1929 stock market collapse and it gave way to Keynesianism – named for the economist John Maynard Keynes – which in short championed the belief that expanding economic output could be strongly influenced by stoking aggregate demand, achieved by ratcheting-up total spending and ***State Interventionism*** within an economy.

Cite:- Intervention Can Distort The Markets, 5 September 2015

Cite:- Central Banks Are Now Market Makers, 22 July 2020

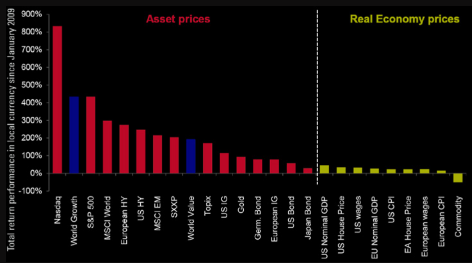
All erudite ways of saying Governments should print their way out of problems, (1.) reduce taxes, (2.) lower interest rates and monetary policies, (3.) change the money supply and (4.) invest in expensive State-led Capital and now Social Engineering projects.

The whole edifice of asset prices, from shares to homes, rests on rock-bottom interest rates, and thus on quiescent inflation. Before the pandemic, financial markets were prone to periodic growth scares (trade wars, deglobalisation) that spooked stockmarkets. Now we seem to be set for a series of inflation scares.

Cite:- Back To The 70's Inflation Pushes Sydney Out Of Reach, 12 September 2015

What allures policy makers, pundits and risk-asset investors to the ultimate narrative of Reflation is that unlike unconventional monetary stimuli alone, Reflation enjoys an inveterate feedback loop all of its own and that to advocates is simplicity defined.

In the Twenty First Century, Reflationary policies have always led to rises in equity markets as a whole (and not just individual shares) and seen equity markets benefit more so than other asset classes such as real estate, cash, fixed income or



commodities.

For example, one factor that likely explains the strength of equity returns this cycle is how anchored short-term interest rate expectations are relative to prior periods of yield curve steepening.

While long-dated bond yields are yet to fully recover from the crisis, the yield curve – 10-year bonds less 2-year – is as steep as it's been since 2016, making an increasing number of investors nervous about the outlook for equities.

Such neurasthenia leads to increased State Interventionism in response and the virtuous cycle not only continues, it leads to Greenspan's ominously dubbed, "*Irrational Exuberance*", which led to the bull-runs on the Nikkei-225, US Gamestop scrip and even foolish "***swarm trading***" around the centuries old Sterling Silver-Gold Bullion mispricing (or atleast perception of mispricing).

Before contemplating big, bold and strategic ways to front-run reflationary increases, it's imperative to first appreciate what happened to the core principle of price-inflation and what captured the market zeitgeist.

Zachary Karabell said it best, "*Economic numbers have come to define our world. Individuals, organisations and governments assess how they are doing based on what these numbers tell them. In 1977, insisting that the traditional methods of measurement were making things seem worse than they really were, US government statisticians introduced the "core CPI," which measures inflation without taking into account goods such as gasoline and food, whose prices change frequently.*"

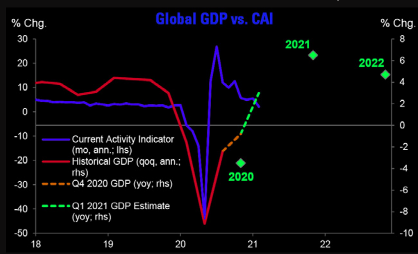
In the 1990's, the question of whether official estimates were accurate, led to more changes and on this Karabell goes on: "*the constant tinkering and rethinking by official keepers of economic numbers have always turned a critical eye on their own methods and looked for ways to improve them, but by inventing a new way to assess inflation, they created a credibility gap.*"

Cite:- It's Time For A Fresh Rethink Of Balancing Act, 3 October 2015

This credibility gap goes towards explaining why savvy investors today experience cognitive dissonance when trusting modelling of investment opportunities; no one believes "***Real Economy Prices***" (see graph) have remained subdued in actual purchasing power terms, the statisticians distort reality in two distinct ways: changing the money supply [(3.)] through Reflation to dilute previous purchasing power value and even more disturbing, ballooning financial "***Asset Prices***" (see graph) by larger multiples via (1.), (2.), (3.) & (4.).

Therefore, to strategically front-run these known reflationary pressures the answer becomes self-evident.

Not only has the significant easing of monetary and fiscal policies during the current crisis help explain why equities have recovered so quickly, the changing mix of policy support in this cycle also suggests a possible inflection point towards a combination of higher nominal growth expectations, steeper yield curves, higher commodity prices and higher operational leverage supporting a renewed rotation of leadership relative to the previous cycle seen between 2012 until February 2020.



Led by a shift in focus from the dominant impact of digitalisation and capital-light businesses that can and have thrived irrespective of Covid-19 lockdowns, long duration growth assets have risen in price the most.

At its core, the evolution of technology that we have seen has increased the substitution of technology for labour; as a result, it has reduced capital employed in many companies by making them more scalable.

Over the past decade, capital-light businesses – mainly in the technology and media space – have significantly outperformed businesses that employ heavy capital, which are often in mature industries; this has been one of the few authentic reasons that a shift down in inflation expectations parsed '***Asset***' from '***Real Economy***' Prices (see graph).

This is evidenced by the meteoric performances witnessed on the NASDAQ, MOTHERS and SX8P indices.

Cite:- A 2021 COVID-19 Vaccine Likely But Remains Underpriced: Ignore the Pollyannas & Identify The Winners, Early, 25 August 2020

While Reflation may not qualify as statecraft It does demonstrate effectiveness and those who obstinate will find no return from Exodus: take big, bold and proactive strategic steps to front-run reflationary increases today.

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