INTL FCStone

A CRAZY BUT LOGICAL CALL FOR STAGFLATION

Bottom Line:
1 – Covid-19 is a generational crisis: the disease kills the old and the economic cost of the cure is borne by the young
2 – The great political divide of the 2020s will be generational: the old fear inflation, and the young need it
3 – The market expects a deflationary recession *à la* 2008, but the policy response is very inflationary
4 – Oil supply destruction and geopolitical tensions set the stage for a commodity supercycle in the 2020s
5 – A decade of stagflation would be disastrous but investors, but salutary societies on a demographic suicide

Rubens' *Saturn Devouring his Son* is the Flemish master's most disturbing painting as it horrifyingly expresses societies' subconscious fears: the terror of death of the old, the vulnerability of the young, pagan rituals of cannibalism, and the sometimes conflictual relations between generations.

The painting's brutality and generational theme reminded me of the Covid-19 pandemic. Contrary to prior plagues which killed indiscriminately, Covid-19 kills the old almost exclusively. On the other hand, its "cure", **social distancing and economic lockdowns, is borne almost entirely by young generations**. Our locked-down societies have passed an implicit **contract whereby the young give up, or at least postpone, their dreams of home ownership, household formation, and steady employment in order to save the lives of the old.**

This Faustian pact comes at a time of strained generational relations ("OK, boomer") and will not be forgotten by Millennials and Gen-Zers who feel that their interests have been sacrificed once again. The great political divide of the 2020s will not be conservative versus liberal, rich versus poor, urban versus rural, "somewhere" versus "anywhere", minority versus WASPs, globalists versus nationalists, but young versus old.

Inflation will be the tug of war between generations. Boomers need low inflation to preserve the purchasing power of their pensions and low rates to maintain the sky-high value of their assets. Conversely, Millennials and Gen Z-ers need inflation to cancel their student debts, high rates to build wealth, and low house prices to start households. **Demographic forces will eventually force the transition from the deflation of the 2010s to the great inflation of the 2020s**.

The great inflation of the 2020s will be borne from the deflationary shock of 2020. Inflation-sensitive assets trade at generational lows. A massive oil glut will keep a lid on prices in 2020. Massive bankruptcies and layoffs suggest that the 2020 shock could be even more deflationary than the post-2008 recession.

However, the policy response has been wildly different: **the CARES act stimulus will send actual money to people, rather than bailing out banks.** A majority of the laid-off workers will make significantly more money in forced unemployment than they did working. The scale and global coordination of monetary and fiscal stimulus is simply unprecedented.

The first data points coming out of East Asia suggest that inflation should surprise to the upside when the lockdown is over. The velocity of money may pick up once consumers rediscover the pleasure of shopping while supply chains remain disrupted by restrictions on the movement of labor.

Last but not least, $20 oil will destroy a lot of supply: **bankruptcies in the U.S. shale patch and political chaos in the Middle East may drive the next commodity super cycle**.

Inflation, or stagflation, will have a disastrous impact for investors, but the conclusion will show that it will eventually save the economy from its current demographic suicide.

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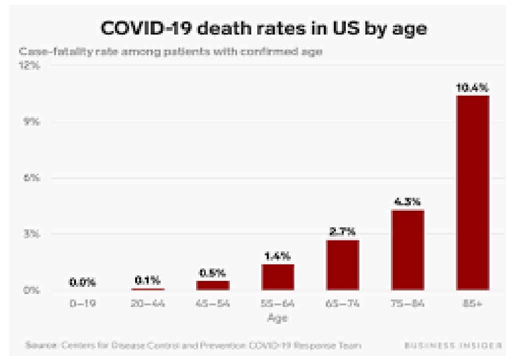
A Generational Case for Inflation

Analyses of the long-term political and social consequences of the current crisis have focused on Covid-19's role as an agent for de-globalization, authoritarianism, and populism. Economists have watched with a mix of terror and excitement Modern Monetary Theory, a fringe heresy a few months ago, become official policy in all Western economies.

A world which is no longer "flat" led by populist governments who have rediscovered the magical powers of the printing press is inherently inflationary. This political case for inflation is self-evident and can be easily studied from the experience of most Latin America countries in the second half of the 20th century. Hence, I will instead focus on what I believe is an under-appreciated effect of the pandemic: **generational politics**.

Covid-19 is a generational disease: it kills the old disproportionally and spares the young almost entirely. **Conversely, the cost of its "cure", social distancing and economic lockdowns, is borne almost entirely by young workers**.



The social contract of "social distancing" implicitly demands that the young give up, or at least postpone, their dreams of home ownership, household formation, and steady employment in order to save the lives of the old. This may be the ethical choice, but the fact that this contract was decided without any debate, or much consideration for its cost on young workers, will leave deep political scars.

Millennials and Gen Z-ers, who will make up a majority of the electorate in the next elections will remember the sacrifices that were asked of them: their pre-existing preferences for socialist policies and high taxation will be reinforced. Because **the generational divide will dominate Western politics for decades**, I will discuss it a bit more with the parable of Joe-the-boomer and his daughter Alexandria.

The Parable of Joe-the-Boomer and his Daughter Alexandria

Joe-the-boomer was conceived on V-Day, as his father returned from his heroic deployment in Europe. He grew up in a thriving middle-class industrial town, attended a quality public school, and benefitted from the full attention of his stay-at-home mother and the loving care of his nearby grandparents. Joe roamed freely in his neighborhood as crime was non-existent and everyone knew each other from well-attended Sunday services.

After graduation, Joe took a summer job at the local factory in order to pay for room-and-board and tuition at the state's public university. Generous public funding ensured that he received the best education in the world, but Joe rapidly developed other interests. Richard Alpert and Timothy Leary were teaching college students to radically expand their minds with lysergic acid diethylamide (LSD). Joe actively engaged in the revolutionary politics of his time by skipping classes and letting his hair grow long. The only revolution which took place Joe's marijuana smoke-filled dorm room was sexual in nature: Joe was fortunate to come of age after the FDA approved the contraception pill in 1960 and before the first case of HIV/AIDS was discovered in 1981.

The rapid expansion of the service sectors created an endless demand for college graduates. Joe joined a rapidly growing ad agency, offering boozy lunches, business class travels around the world, a defined-benefit pension, and a spectacled typist he eventually married. The oil shock and foreign competition inflicted irremediable damage to the small industrial town of his childhood but had little impact on the rapidly expanding managerial class Joe was now a part of. Depressed asset prices allowed Joe to buy his house for less than twice his annual income and double-digit inflation effectively paid his mortgage.

By the early 80s, Joe's rapidly ascending career put him in a high tax bracket: Joe reneged the revolutionary socialism of his youth and enthusiastically adopted the Reaganite government-slashing consensus of his time. Of course, government spending had to be cut to finance lower taxes on high earners: tuitions at Joe's university exploded. Public services all but disappeared in the small town of Joe's childhood. Public debt, which Joe's parents had patiently reduced, exploded.

By the 90s, Joe worried about the sustainability of social security. In a rare moment of fiscal responsibility, Joe voted to close his firm's defined-benefit pension plan to new entrants. Economists assured him that his kids' pensions would be paid by the stock market, which was known to never go down.

Unfortunately, the stock market did go down after the internet bubble burst. However, the ensuing rate cuts allowed Joe to take a large mortgage to build the mansion of his dreams in Scottsdale. The Arizona housing market was so hot that Joe's wife became a realtor and earned a six-figure income for a couple of years. The housing crisis was fatal to the family's house-flipping business, but Joe and his wife had just become eligible for social security. In his retirement, Joe enjoys golfing, cable TV, and lecturing his daughter Alexandria about hard work and personal responsibility.

Alexandria was born in the early 80s. She had a normal and relatively happy childhood, which unfortunately meant that she lacked the international leadership positions and humanitarian experiences that Joe's university now required of its applicants. She settled on a second-tier private university and took a large loan to cover the exploding cost of tuitions. After graduation, one of her Dad's friend got her an entry-level job as a paralegal in a large New York law firm. Her salary barely covered the cost of her one-bedroom apartment, and she was let go during the great financial crisis. During this forced unemployment, she enrolled in law school, working as a bartender at night to pay for a (small) fraction of the tuition.

By the time Alexandria passed the bar in 2013, the economy had slowly recovered and Alexandria finally became a lawyer. Long hours at the office and the burden of college debt delayed her plans to start a family, but she finally took the plunge in 2018, bought a small house, and gave birth to a beautiful little girl. The delivery by C-section cost $80,000, and her deductible was $10,000. With no family nearby and no public option for childcare, Alexandria pays about $1,600 a month for a spot at the local daycare. In order to avoid the local underfunded public school, Alexandria's daughter will attend an expensive private school.

With the economy shutdown by Covid-19, Alexandria must now work from home. She and her husband take turns to watch over the baby. Both parents are terrorized to miss the required work meetings on Zoom as their employers have already announced massive layoffs. Alexandria tries to schedule regular "face time dates" between her daughter and her parents in Arizona, but her attempts have failed because Joe has not learned to use Skype. As he never tires of repeating, "kids these days spend all their time on their God#&!n phones – no wonder the economy is doing so bad!"

The moral of this humorous parable is that the great political divide of the 2020s will not be between conservative and liberal, rich and poor, urban and rural, "somewhere" and "anywhere", minority and WASPs, globalists and nationalists, but the young versus the old.

For now, older generations have kept their hold on political power thanks to their higher turnout at the voting booth. The next election will be disputed between two ageing boomers, but it will be this generation's last gasp: the frail health and increasingly obvious cognitive decline of the Presidential candidates and Congressional leaders painfully illustrate the twilight of the boomer generation. As a predominantly rentier class, boomers adopted policies designed to boost asset prices and suppress inflation, and they cut all social programs that were not exclusively spent on the elderly.

The interests of Millennials and Gen Z-ers who will seize power in this decade are antithetical to boomers' priorities: asset prices must drop so that houses can be bought and families started. **Inflation will be required to cancel burdensome college debt**. Government spending will be redirected towards the new generations' priorities, such as childcare, Medicare for all, and the environment, and away from the entitlement programs which benefit the old.

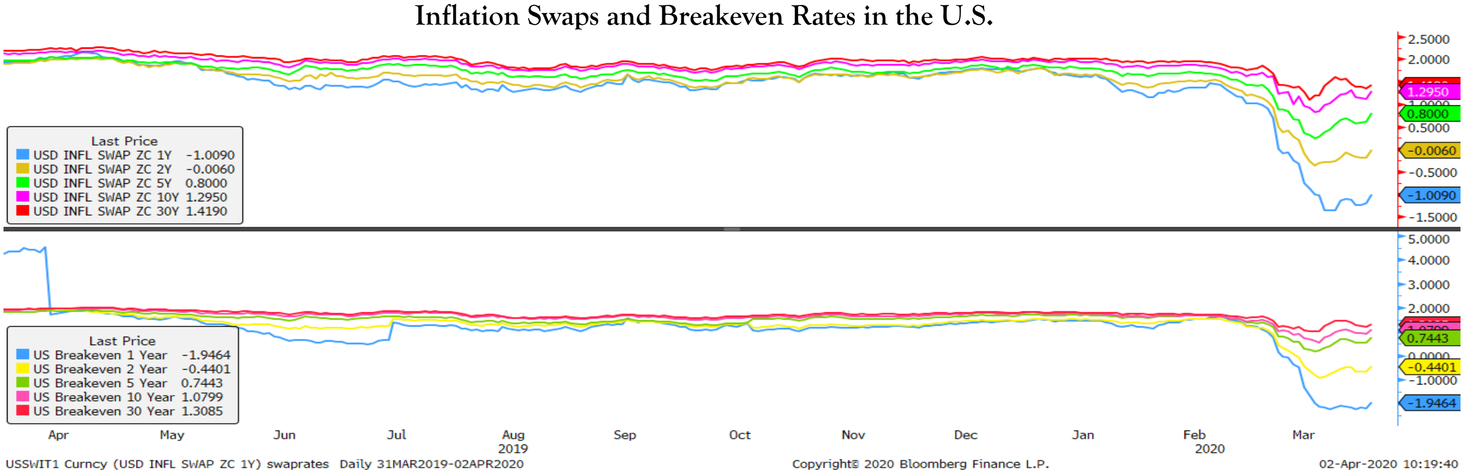
The World's Most Underappreciated Risk

Taking a long-term view on generational politics is illuminating – Neil Howe and William Strauss have written the most insightful books on the topic and I recommend that investors use their forced isolation to discover or re-read the Fourth Turning, which greatly inspired the parable of Joe-the-boomer and Alexandria.

Yet, generational analysis is unfortunately too vague for most investors. "Turnings" can happen every 80 to 120 years, generations overlap, and investment implications are not really analyzed. Hence, I will try to complement my generational case for inflation with a plausible financial and economic scenario for reflation.

First, I must acknowledge that the market completely disagrees with this view. **The rate on a 10-year inflation swap has fallen to about 1.2% from 2% at the beginning of the year**. Inflation-protected two-year notes yield more than regular treasuries. I struggle to understand the concept of a *negative* breakeven rate since TIPS come with a deflation floor: TIPS guarantee either the inflation-adjusted principal or the par value at maturity – whichever is greater.

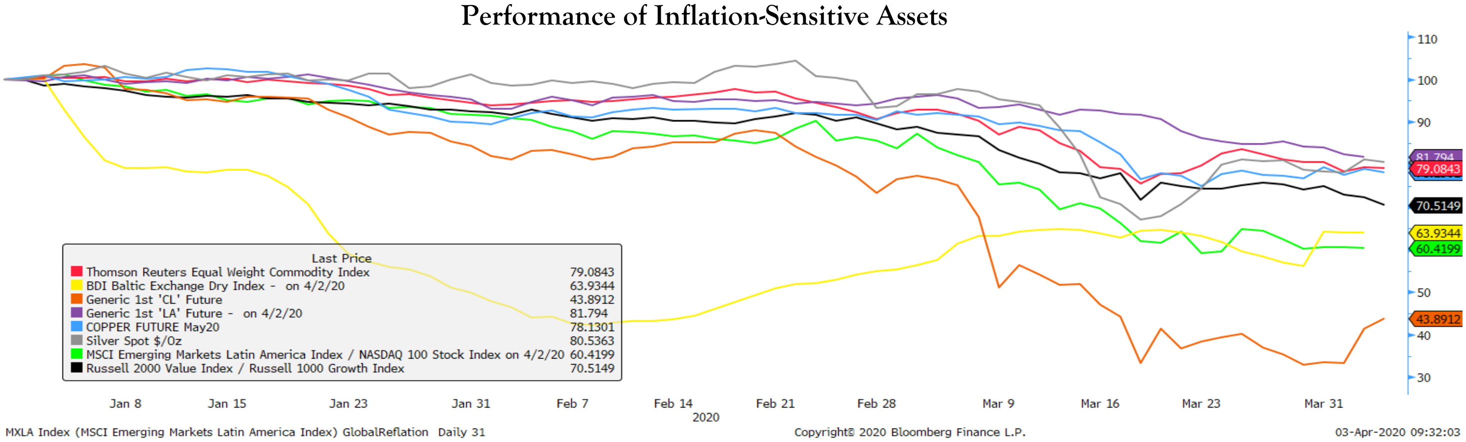
Inflation Swaps and Breakeven Rates in the U.S.



Similarly, inflation-sensitive assets have been liquidated this year:

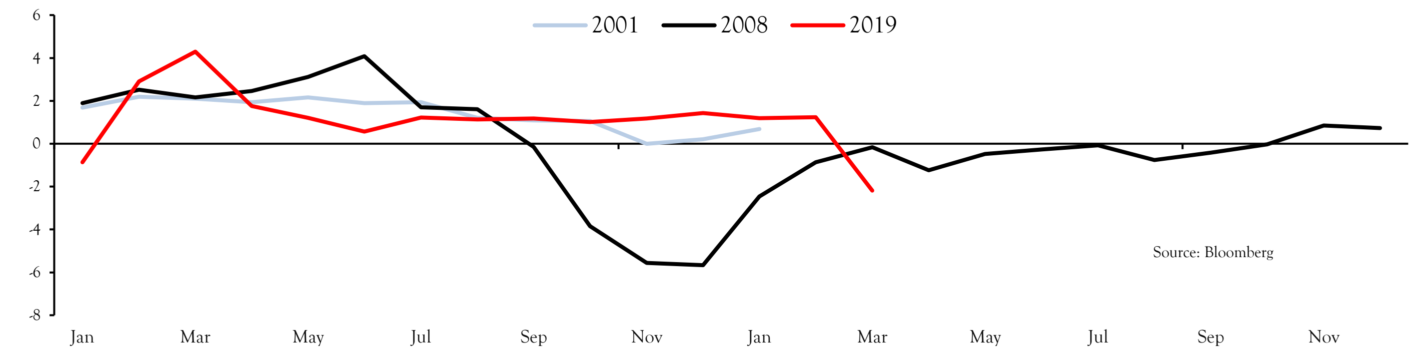
- Oil, copper, aluminum, and silver prices have plummeted by 57%, 21%, 19%, and 20%, respectively.
- Latin American stocks have underperformed the Nasdaq 100 index by 39%.
- The Baltic Dry Index has collapsed by 37%
- The Russell 2,000 index has underperformed the Russell 1,000 growth index by 30%.

Performance of Inflation-Sensitive Assets

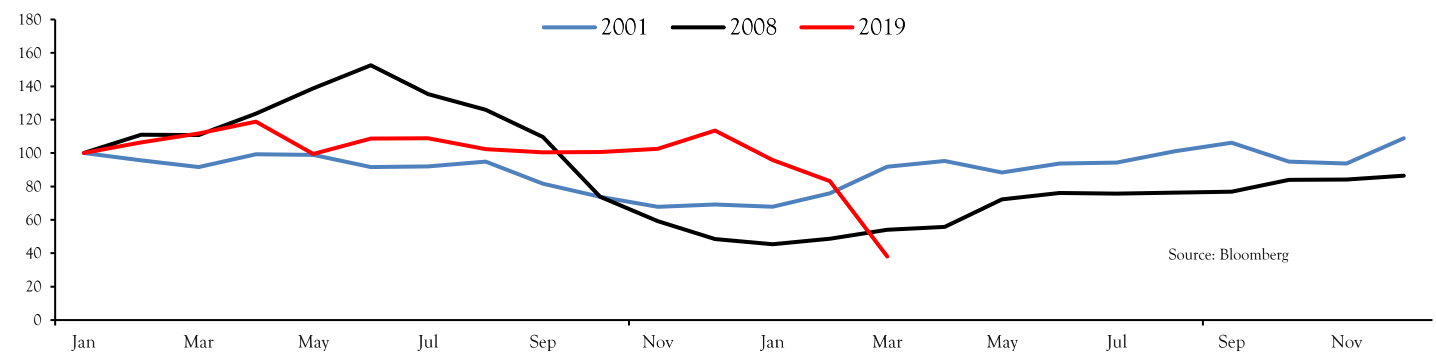


Investors seem to expect that the post-Covid 19 recession will resemble the post-2008 economy. For example, 1-year breakeven inflation also turned negative in September 2008, while they remained positive during the shallow recession of 2001 and 2002. Oil prices fell by 77% between July 2008 and December 2009, which is comparable to the 68% drop in oil prices between January 6, 2020 and the March 30 low. The rise of jobless claims has obviously been faster this time, but the job market carnage will likely be comparable to that of the great recession of 2009.

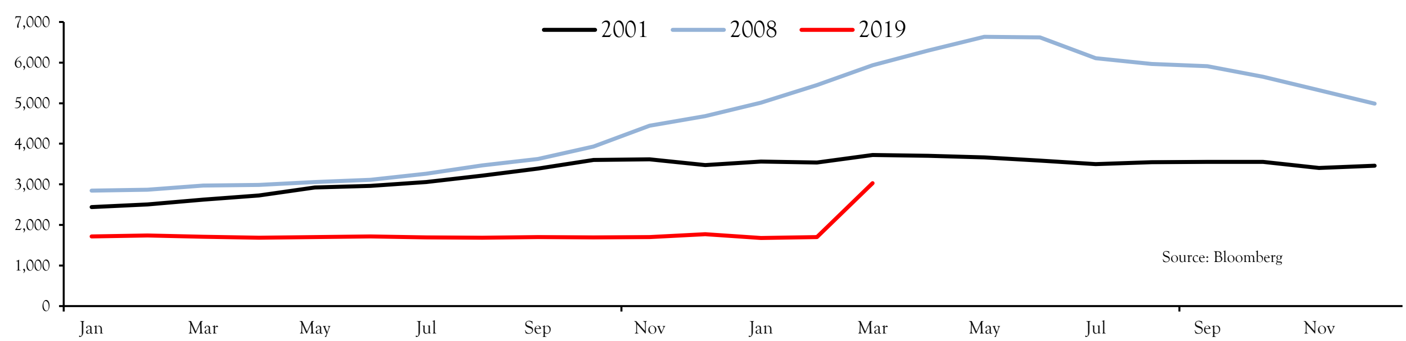
1-Year Breakeven Inflation Rate going Into Recessions



Oil Prices going Into Recessions



Jobless Claims going Into Recessions



If this recession follows the 2008-2009 playbook (and I do not believe it will), investors should remember that deflation expectations had massively overshot in 2008: the one-year breakeven inflation rate fell to *minus* 5.6% in December 2008, while the consumer price index contracted by just 0.3% in 2009. The overshoot was even more painful at the long end of the curve: 10-year TIPS and 10-year Treasuries offered the same yield in December 2008, implying that investors expected *zero* inflation over the next decade.

Inflation ultimately averaged 1.8% between 2008 and 2018: **investors massively mispriced Treasuries Inflation Protected Securities during the deflation scare of 2008.**

A Plausible Path Towards Reflation

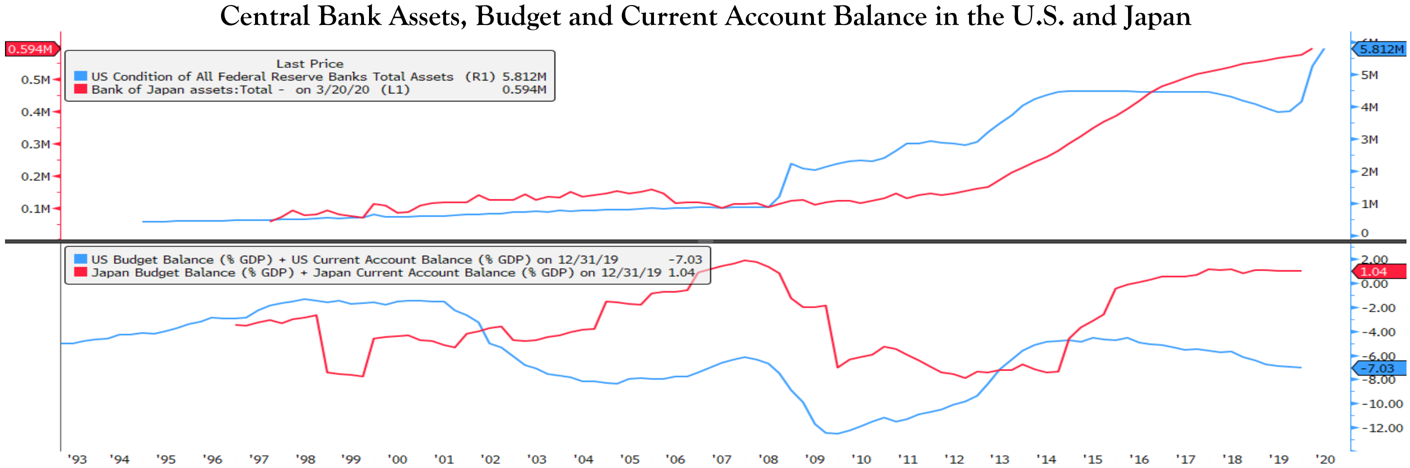
The main reason I do not believe that the Covid-19 shock can be compared to the 2008 financial crisis is because the policy response is entirely different: **the CARES act stimulus will send actual money to people, rather than bailing out banks.**

- Unemployment benefits will increase by $600 per week, on top of the $384 per week national average. That's equivalent to a total US$25 per hour for a 40-hour week. For reference, the highest minimum wage in the country (Washington State) is just $13.5 an hour, and the median personal income for all full-time workers was $21 per hour in 2017. **A majority of the laid-off workers will make significantly more money in forced unemployment than they did working.**
- Adults earning less than $99,000 a year (or 90% of households) will receive checks of up to $1,200 and $500 for children, for a total cost of $290 billion, or about 1.5% of GDP.
- Businesses should get about $300 billion in assorted business tax breaks, such as net operating loss carrybacks.
- State governments will receive an extra $150 billion.
- Federal agencies will get an extra $300 billion to help state and local governments, hospitals, law enforcement, and educational systems.
- $100 billion (on top of the prior two relief bills) will go to cover health care providers' losses, pay for medical research and equipment.
- Small businesses who keep their employees on staff will be eligible for $349 billion in "Paycheck Protection" forgivable loans from the small business administration.
- Airlines and "national security businesses" will receive about $51 billion, and the Federal Reserve's $454 billion in asset purchase programs can be leveraged up to $4 trillion. Wow!

As the shutdown lasts longer than initially anticipated, a second stimulus will likely be announced. D. Trump already called for a VERY BIG AND BOLD $2 trillion infrastructure package, and house speaker N. Pelosi will likely use the next spending bill to push for Democratic priorities , such as renewable energy credits, bailout for underfunded pension plans, and deductions for state and local taxes.

Of course, deflationists can always retort fiscal deficits and quantitative easing have failed to generate inflation for three decades, but *Japan has never tried anything as radical as the policies currently implemented across developed markets.* The Fed's balance sheet has increased by $2 trillion in just seven months. If Fisher's monetarist equation holds (mv = pt), the velocity of money will have to collapse in order to maintain price stability. Also, Japanese government deficits were compensated by excess private sector savings. Japan's current account balance usually exceeded its budget deficit, while the U.S. will experiment with the largest fiscal stimulus in its history with a large current account deficit.

Central Bank Assets, Budget and Current Account Balance in the U.S. and Japan

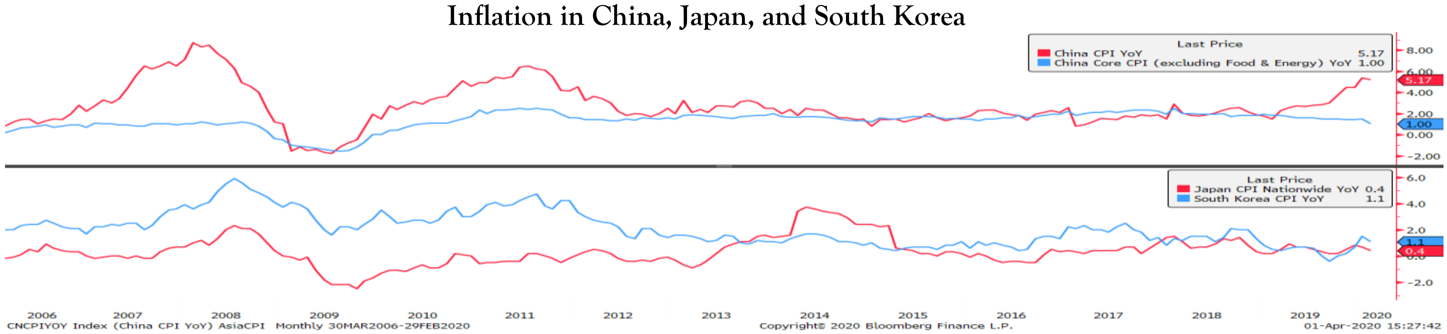


Juggling with trillions is all good and fun when everyone is under lockdown and politicians must be seen as bold and decisive, but no one knows how the economy will react when it re-opens. **Japan and South Korea, which have mostly contained the pandemic, have not experienced a deflationary shock**. China's inflation actually *accelerated* to 5.2% last month. Furthermore, East Asian countries have refrained from the wild fiscal packages voted in the U.S. and, to a lesser extent, Europe.

A "L"-shaped recovery is indeed entirely possible. Bankruptcies, the collapse of commodity prices, and massive layoffs are indeed deflationary. **But most households Americans will come out of confinement with a lot of stimulus cash in their checking accounts**. Some may feel a burning desire to splurge after months of forced austerity – I know I badly need a vacation and have promised my boys trips to Disneyland, Legoland, and all sorts of European adventures to buy a minimum of calm and cooperation during the shutdown.

Similarly, no one really knows the effect of the shutdown on food prices: **what will happen to California's crops this summer if seasonal workers have been forced to return home?** For example, Germany's asparagus are currently rotting in the ground as Ukrainian and Polish workers can no longer cross the border, as reported in this week's edition of the Economist.

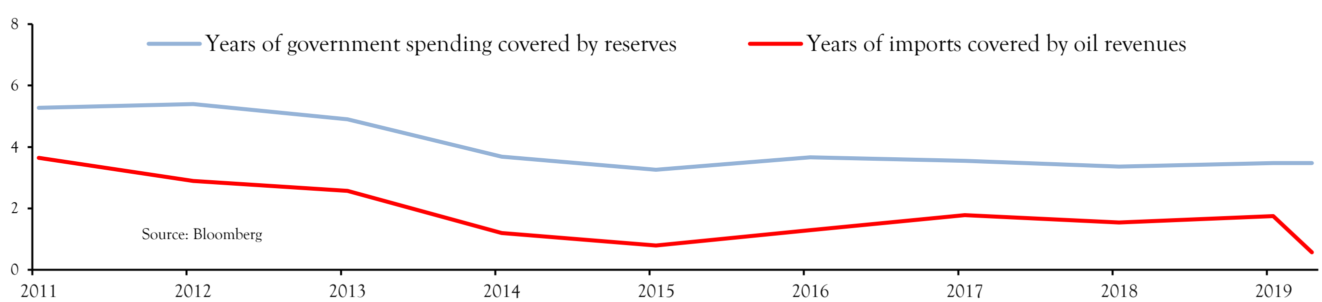
Inflation in China, Japan, and South Korea



Last but not least, **the oil market carnage has planted the seeds a new commodity super cycle**. Sure, the collapse of demand and the price war between producers will lead to a massive glut of oil, which may soon exceed the world's storage capacities. Clearing this glut will take months, if not years, which means that not a single dollar will be invested in new production. The U.S. shale industry, which was already burning trillions of investors' cash when oil prices were in the mid-50s, will be devastated. Bankruptcies will far exceed the post-2016 bust, with one key difference: production from existing wells, whose base rate is already declining, will not be able to make up for the absence of new investments.

Furthermore, **the price war may eventually create havoc for its instigator - Saudi Arabia**. Due to the cost of the Yemen war, a huge demographic bulge, and massive losses on the Vision fund, Saudi Arabia's ability to withstand low oil prices has greatly diminished: official currency reserves (most of which are not liquid) only cover 3.4 years of government spending down from the 5.4 in 2012. At today's prices, oil revenues cover only 7 months of annual imports – a huge political and social risk in a country which imports more than 80% of its food requirements. A revolution in Riyadh or full-out war between cash-strapped Saudi Arabia and Iran could play a similar inflationary role as the oil shocks of the 70s.

Saudi Arabia's Unsustainable Economics

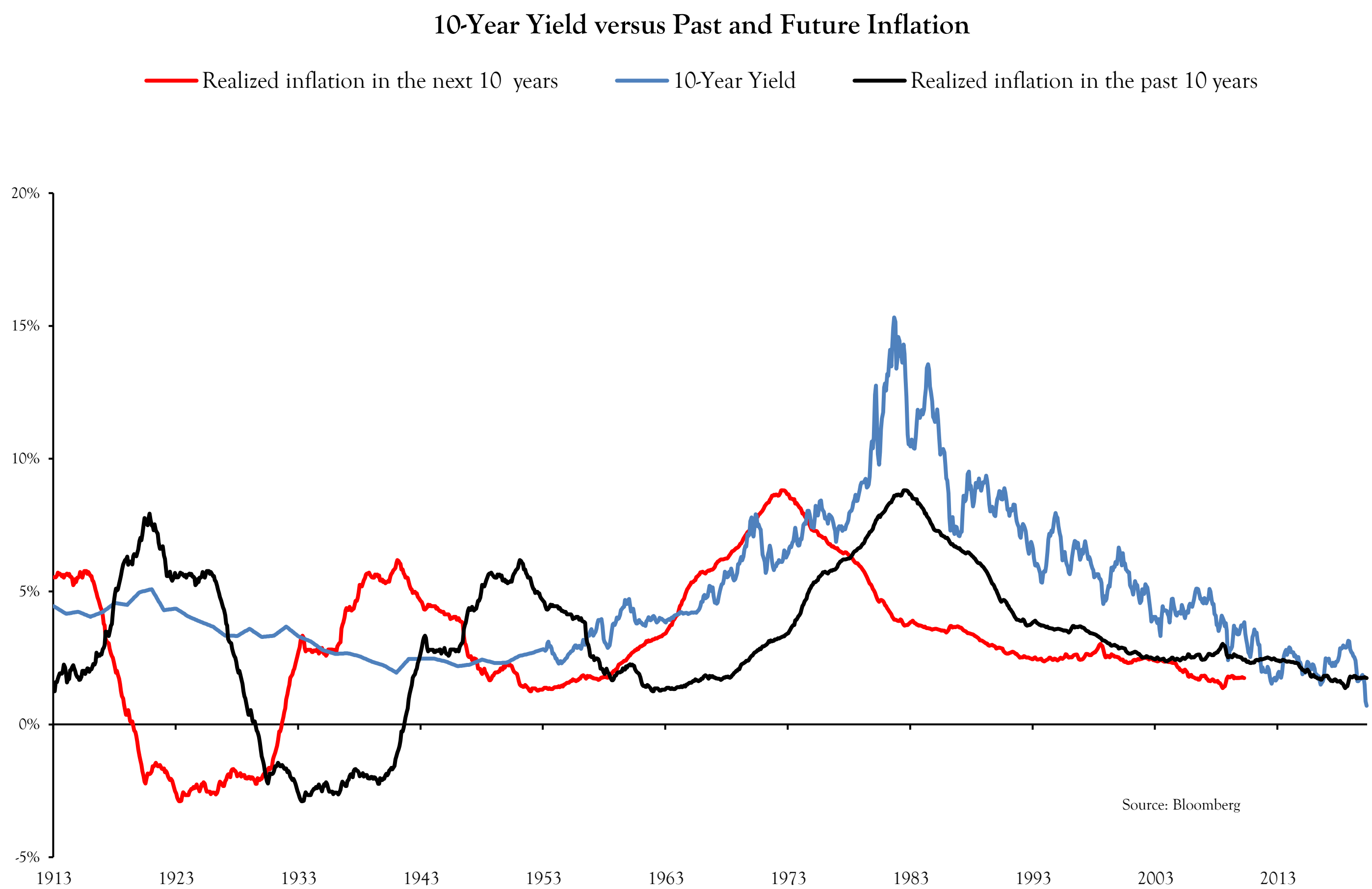


Ultimately, it seems to me that the current deflationary consensus is driven by the low levels of yields in a reflexive loop. Inflation must have disappeared because yields are at a record low … and yields are a record low because inflation is dead.

However, trying to forecast inflation with government bond yields is a fool's errand:

- As shown in the chart below, there is almost no relation between the current level of yields and the trajectory of inflation over the next ten years: the regression coefficient of determination (r-squared) is just 8%.
- On the other hand, yields are strongly correlated with past inflation: the current low level of yields is much more likely to reflect the low inflation in the 2010s than a deflationary bust in the 2020s.
- Inflation has averaged 3.1% annually since the creation of the Federal Reserve in 1913, and 10-year realized inflation fell below the current level of 10-year CPI swap rates of 1.3% for only two months in 1962, after a decade of balanced budgets under the Eisenhower administrations.
- Yields are especially bad a predicting inflation turning points: the great inflation of the 70s took the bond market by surprise. So did the great dis-inflation of the 80s, during which bond yields remained far too high.

Last but not least, Treasury yields forecasting powers are likely greatly blurred by constant central bank interventions. The Bank of Japan explicitly controls its yield curve. The Federal Reserve and the European Central Bank do it implicitly via large asset purchases. As I argued in "the Biggest Mistake You Can Make in the New New Normal", bond yields have become a policy target, rather than an economic indicator.



Conclusion: a Necessary Evil

Markets may initially cheer the return of inflation but its persistence would force investor to consider in the worst-case scenario for asset prices: **a decade of stagflation**.

Bonds would suffer the most, but equities would not be immune, as shown during the painful bear markets of the 70s. Profit margins would be eaten by creeping wages and rising rates as most companies would lack the pricing power to fully pass rising costs to customers.

The correlation between stocks and bonds would turn positive: asset allocation funds and target-date funds would realize that the diversification they took for granted was only a brief anomaly caused by the overshoot of real yields in the 80s. The implosion of highly leveraged risk-parity hedge funds would cause massive market dislocations and fire sales across asset classes. Banks and REITs investors would be stuck with portfolios offering deeply negative real yields. Pension funds and insurers would suffer massive write downs. Cities and states may have to renege their promises to their workers, or file for bankruptcy.

This stagflationary scenario is rightfully terrifying for investors, but it will eventually save the economy from its current suicidal path. A decade of quantitative easing and negative rates may have avoided a repeat of the Great Depression by engineering an "everything bull market" of epic proportions but these policies have come at a massive long-term cost.

Savings have been misallocated everywhere: European indices are filled with failed banks and zombie companies whose agony was delayed by constant liquidity injections. The two great American investment booms of the 2010s, shale oil and tech unicorns, destroyed trillions of capital. An orgy of buybacks and leveraged buyouts has taken a toll on "old economy" firms and left them completely vulnerable to demand shocks.

The greatest costs of the bull market of the 2010s may have been social, political, and generational. **Soaring property prices have kept an entire generation in limbo**. Four straight years of decline in births have brought the U.S. total fertility rates to a record low of 1.7 children per woman. Europe, East Asia and even Brazil are in terminal demographic decline. San Francisco has more dogs than babies and raising children has become an exotic luxury for young urban professionals.

Young generations have developed ideologies to rationalize their demographic suicide. Emma Watson is not single: she is "self-partnered". Gwyneth Paltrow enlightens her goop-ers on the benefits of "conscious uncoupling". Instagram influencers celebrate child-free lifestyles, filled with sunrise yoga meditations, spiritual journeys to exotic destinations (#vanlife) and pampered pets, which have advantageously replaced rambunctious children in pretty much every aspect. Everybody seems to have internalized our childless future in their own ways: the Atlantic analyses the socio-economic consequences of the sex recession of the 2010s, birthstrikers refuse to have children until climate change ends, and men of the /FIRE movement have found that not having children is the quickest way to reach the *nirvana* of financial independence and early retirement.

Without some sort of a great reset, which I hope comes with an inflationary shock, the world would be trapped on a vicious spiral of low growth, constant "stimulus" to generate the rising asset prices required to keep pension systems afloat, and low births. This report took the side of younger generations, whose ability to start families was indefinably postponed by crushing debt, a two-tier job market, and sky-high real estate prices. But the deflationary "equilibrium" was also unsustainable for older cohorts: the "wealth effect" of rate cuts came at the expense of bond portfolios' future income. Central banks' purchases of sovereign and investment grade bonds forced retirement savings into wildly inappropriate investments, such as venture capital for loss-making unicorns, junk energy debt, and emerging markets bonds.

Ultimately, houses must be bought, assets will need to be transferred, households must be formed, and true prices must be restored. A decade of inflation will devastate portfolios, but eventually save the economy.