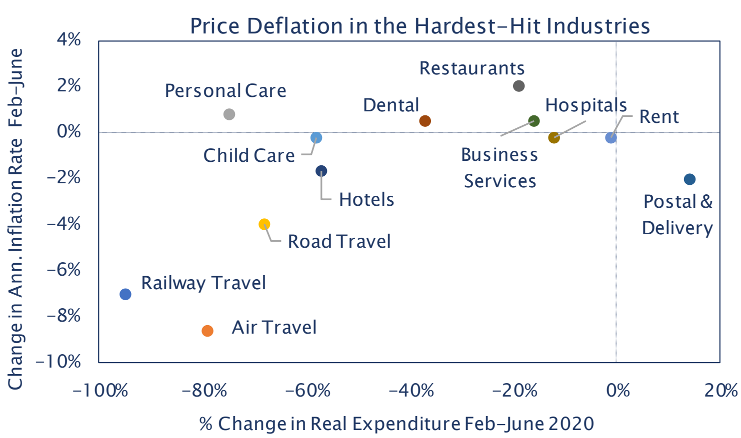
AUGUST 2020

INVESTMENT UPDATE

One question we've been getting from clients—and it's one that we've been asking ourselves—is whether the enormous amount of money being pumped into the US economy over the past few months will eventually show up as higher inflation. As you know, essentially every developed economy across the globe (including ours) has seen consumer price inflation falling over the past couple of decades, a big contrast to the Bad Old Days of the 1970s and 80s when inflation ran amok, eating away at household buying power, and sending interest rates skyrocketing.

It's hard, especially for bond people (i.e., the kind of people you avoid at family gatherings) to not worry about inflation, since inflation is the mortal enemy of bond holders. It's even more unusual to find the Federal Reserve studying ways to try to boost core inflation above the 1%–2% range it's been stuck in for the better part of 25 years. This is the same institution that in 1980 intentionally sent the US economy into the worst recession in 50 years by imposing strict anti-inflation policies. How things have changed.



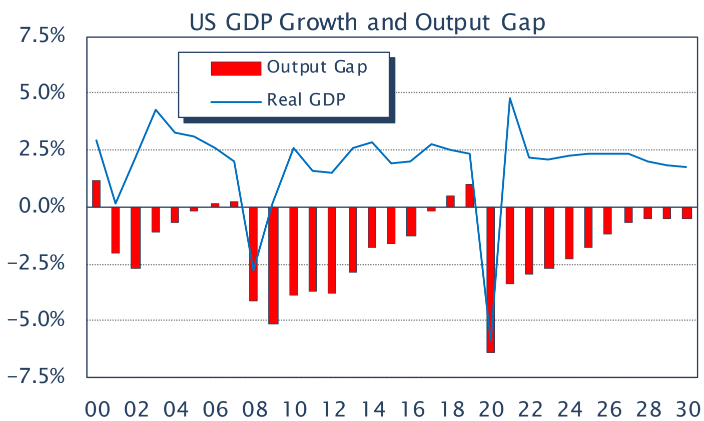
These days (even before COVID threw policymakers a giant curveball), central bankers around the world are far more worried about deflation than inflation. The Japanese economy tells the cautionary tale of what happens when an aging population that's more inclined to save than to spend comes face-to-face with a virtually limitless global supply of goods and services. Consumer prices fall, which further incentivizes savings, since prices will be lower tomorrow, and lower still next week. If left unchecked, a modern economy can be sucked into a deflationary vortex, with economic growth grinding to a halt; with sales and profits drying up, companies are forced to lay off workers, depressing household spending even more, and the economy spirals downward.

Policymakers, especially in the US and Western Europe, have been desperate not to repeat the mistakes of their Japanese counterparts, and have devised various programs over time to keep their respective economies growing, as they face many of the same factors (including aging populations) that have been so disastrous to Japanese economic growth. In the US, the Fed was forced to re-think its traditional monetary policy measures during the global financial crisis. In 2009, with its overnight lending rate at zero, the Fed began to engage in quantitative easing—large-scale purchases of government bonds. Fast-forward to 2020, and now the Fed's QE program has been expanded to purchases of government bonds, corporate bonds, municipal bonds, and corporate bond ETFs. These purchases effectively reduced the available supply of US high grade bonds, driving their prices up and pushing down interest rates for households, corporations, and municipalities. QE has allowed the Fed to more directly control interest rates beyond just those for overnight lending to banks. Depending on which maturities and sectors the Fed purchases, it can affect changes in rates for specific areas along the yield curve, and for every major category of borrower.

What the Fed has not done—and claims it will not do in the current environment—is to implement negative interest rates. As in the US, the European Central Bank (ECB) has been buying up government and corporate bonds, but the ECB also set its official lending rates at levels below zero. Over the past few years, European government bonds have also fallen into negative territory, in some cases for maturities out to ten years. Today, with economic growth struggling across the continent due to the pandemic, it's not just Germany and Switzerland with negative rates, as even the weakest government credits—Greece included—have seen yields drop below zero. At this point, it appears that the ECB is tolerating negative rates more than targeting them and is looking for alternative strategies. Negative rates have been largely ineffective at stimulating growth, and they've put significant downward pressure on the profits of the European banking system.

Some economists were expecting that the pandemic would lead to disruptions in the global supply chain, and thus lead to shortages of goods and increased worldwide distribution costs, leading to broad increases in consumer price inflation. That has not happened. While there have been increases in certain non-durable goods (food prices, in particular, have run up in recent months), by and large, the pandemic has only reinforced what's been in place for years: productive resources are abundant, and any fall-off in demand leads to deflation.

That's obvious in the chart on the front page (data courtesy of Goldman Sachs), which shows that, since February, those areas of the economy where business has dropped off the most due to the virus (e.g., anything related to travel) have seen significant price deflation. Instances of increasing consumer prices are few, and (as expected) tend to be either price-insensitive service items or in areas where there have been supply disruptions or temporary shortages, as with some food categories.



Economists refer to the "output gap" to help explain the current state of affairs. The output gap measures the difference between what an economy is capable of producing and what it's actually currently producing. With so many people currently out of work, and with factories, mines, retailers, restaurants, etc., still closed or operating part-time, it's obvious that the current output gap here in the US is extremely wide. The chart on this page, with data—both historical and projected—from the US Congressional Budget Office (CBO), shows that the current output gap is as large as any in recent memory, with expected 2020 US GDP growing nearly 6% below its potential. The chart also helps to explain why inflation has been so low over the past 20 years; the US economy has had a persistent output gap, and has rarely operated up to its potential. That means that there's plenty of excess productive capacity, and little strain on the system. While that's good in many ways—we have plenty of room for growth—it's a formula for persistently low inflation.

When we expand our view across the world, it's equally apparent that global GDP is currently a fraction of what it would be if we weren't in a global pandemic. It is virtually impossible for core inflation to rise when the output gap is well below zero, as there is little upward pressure on input costs when resources are ample and demand for those inputs is relatively low.

The CBO projections point to strong US growth in 2021 and 2022, but indicate that despite a rebounding economy, the US will still be operating with a large output gap over much of the next decade. Like the recovery following the global financial crisis, this one is predicted to result in relatively modest annual growth of approximately 2.5% as we claw out of this recession. The output gap, however, is not expected to close up until 2028, strongly implying that US economic growth is unlikely to lead to higher inflation any time soon.

The Fed has demonstrated that it can re-liquify the financial system and shore up investor sentiment. The Fed can take credit for encouraging risk-taking and even for helping to boost capital investment and construction by pushing interest rates down. But what the Fed has not been able to do to any measurable degree is to increase demand for goods and services. The Fed, even after flooding the market with cash, cannot direct where that money goes—whether it stays in deposit accounts, is put into the stock market (hello, 2020!) or is spent by consumers. And with global productive capacity easily able to meet all current demand, the Fed (and its foreign counterparts) will continue to flirt with deflation in the years ahead.

In case you haven't heard, Agincourt announced on August 14th that we are partnering with Guardian Capital Group, headquartered in Toronto, Canada. Guardian will be making a 70% equity investment in Agincourt, which will provide long-term organizational stability for us, while providing Agincourt with additional financial resources. Out name will remain the same and we will continue to operate independently from our office in Richmond, Virginia. Importantly, Agincourt's entire investment team and all support staff will remain intact, and there will be no changes to our investment decision-making process or client service functions. Moreover, Agincourt's employee/partners will retain a 30% ownership share, insuring that our interests continue to be aligned with those of our clients.

We are very excited about joining forces with Guardian and are confident that this transaction will serve the best interests of our clients in the decades to come.