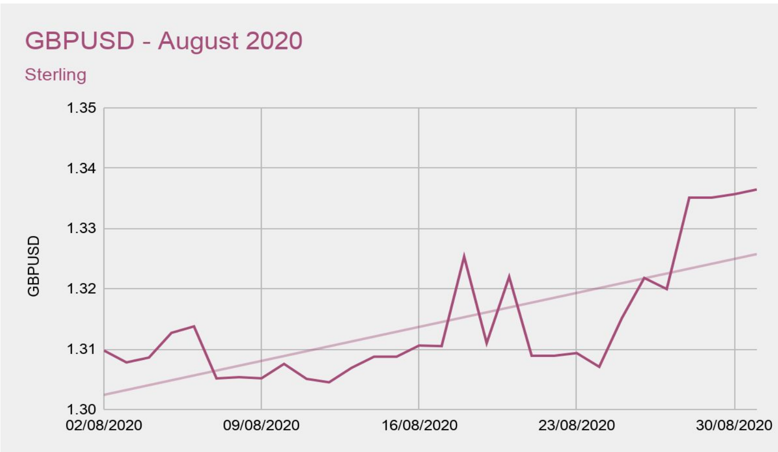
RTEGA The Market Wrap August 2020

Introduction - This will be our first issue of our monthly summary of the market. We shall give you the price action across asset classes and offer our insights and opinions. We hope these will aid your understanding of markets and the complex system that is the global economy. We shall generally use ETFs in our market appraisals as these are easily accessible and liquid entities that are now in very common use and reflect most facets of the markets. We hope you enjoy and if you have any questions please visit our website: www.toiip.com or contact us at: info@toiip.com - Thank You and enjoy !

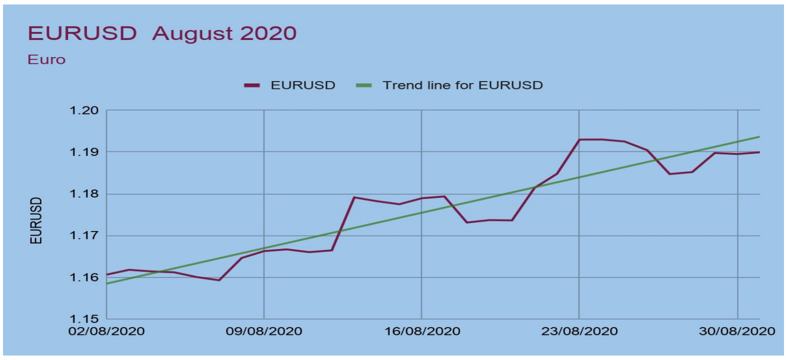
Currency

August, in usual times is a very quiet month with many market participants on vacation, even in these strange times the markets have been quiet, with low volumes. This month saw the weakness of the USD continue but maybe find a bottom. DXY entered into the 92 handle but has since stabilized. We feel that the USD is oversold here and look to see it strengthen in the future. The market reached its historic short positioning on the USD so our opinion is not the market consensus. Sterling seems high to us, at 1.35 levels with no deal with the EU in sight. Several emerging market countries are struggling to gain access to the USD ; Turkey, South Sudan, Brasil. These could see their currencies heavily devalued. Knock on effects could occur.

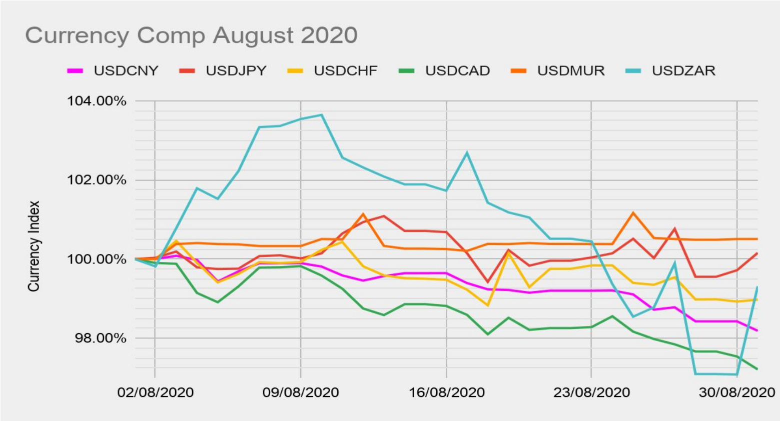


From the lows of around 1.16 against the USD to where it is now, seems a long way to have travelled on what we feel are weak fundamentals. As we believe that the USD is reaching a base, then selling the GBP at these levels does not really give us sleepless nights.The UK economy has many hurdles to overcome in the coming months and even if Mr. Biden were to move into the Whitehouse; we still feel comfortable selling this pair here. The Bank Of England has not yet ruled out negative rates, 2 & 5Y already there

The Euro may have further to run but again we feel the USD has bottomed and so if anything we would look to sell Euros around the 1.20 level, though many see this rate creeping to 1.25. Europe as an exporter would like a weaker currency. As Europe has now been able to issue mutualised debt the redenomination risk has all but disappeared. However there are still many systemic problems with the Euro.

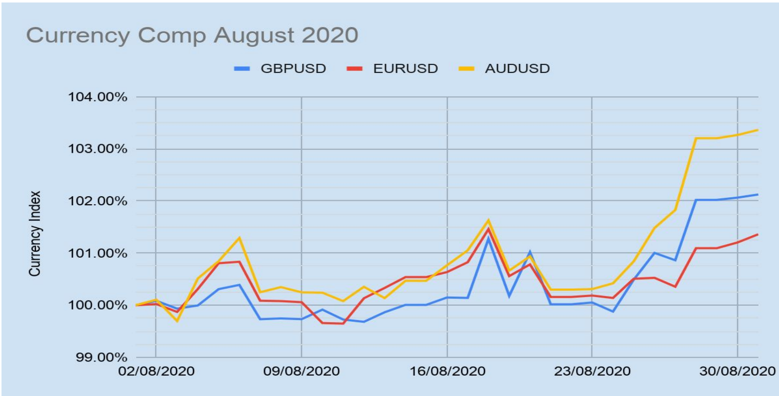


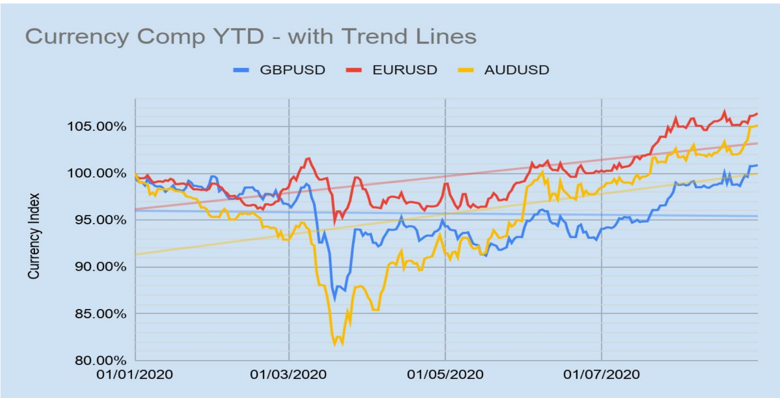
Fiat currencies are a relative game, and you can only get the full picture by comparing currencies to each other or other base materials. Below we shall take a comparative look at the currency markets.



This shows that over the month generally the USD had a downward trajectory against most currencies, with the exception of the South African Rand which was very weak at the beginning of the month. We feel that the smaller currencies will struggle to maintain parity with the USD as this crisis unfolds. The countries generally struggle to access USD and do not have the internal resources to defend against any currency depreciation. We generally see a dollar shortage persisting.

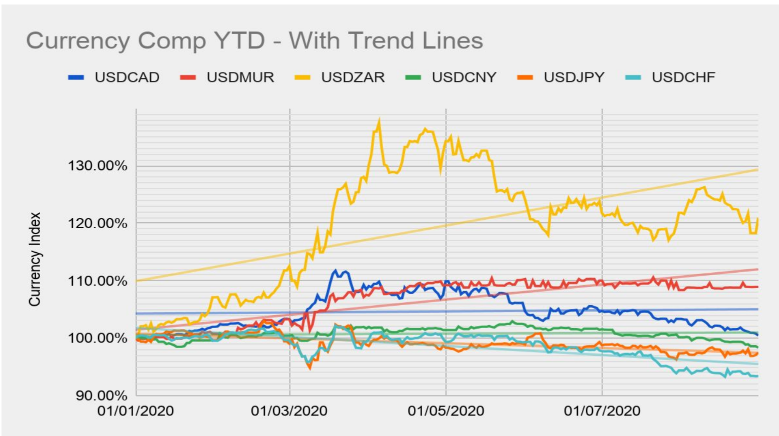
The USD in this graph again shows a general weakness over the month with varying degrees to these currencies. The rise of GBP we feel has more to do with the weakness of the USD rather than the strength of the UK currency and their economy. Of these currencies we think that the AUD will hold up better overtime as it is a commodity based currency. August has a very low trading volume,.so movements this month may not be truly indicative of markets





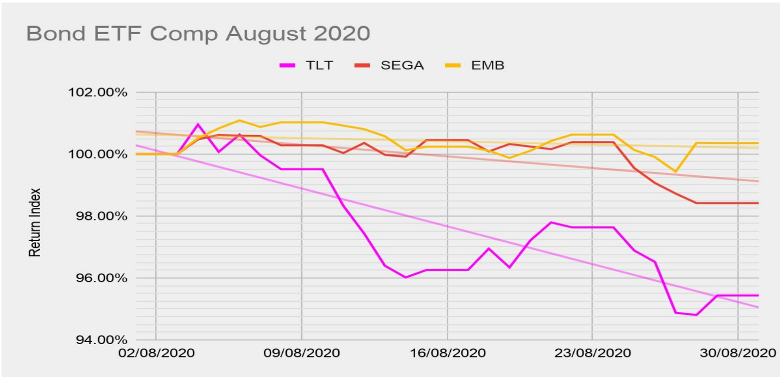
This shows the relative currency performance from the start of this year, with both the Euro and AUD being in uptrends against the USD and GBP being in a downtrend. GBP has risen lately with the weakness of the USD but we do think that this will continue as the UK economic situation is not very strong and many uncertainties lie ahead. The market narrative says the USD will continue to weaken, we are not so sure.

Over the YTD the USD has been neutral to slightly weak against other currencies. The smaller currencies such as the Mauritian Rupee and the South African Rand have been weak against the USD. This ties in with the smaller countries not having the access to USD or the capacity to defend against any weakness in their currencies. Devaluation leads to inflation, and inflation is a remedy to debt. So it looks like we could be in a race to the bottom. Hence our long term bullish call on Gold.



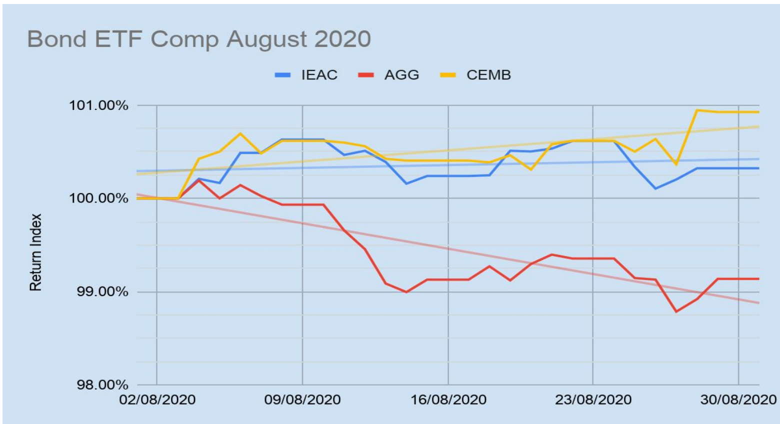
Fixed Income / Bonds

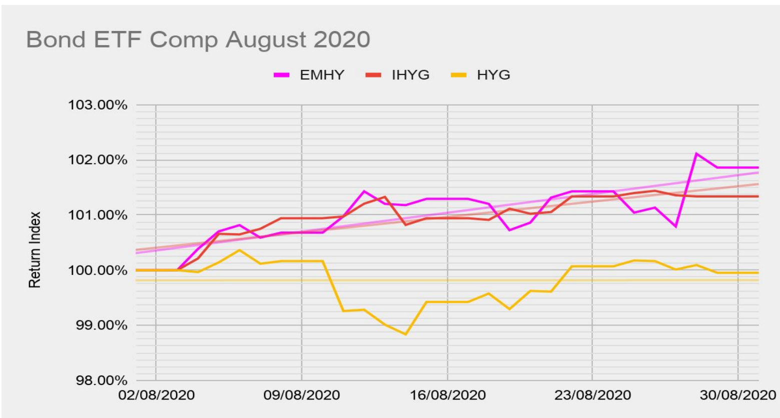
US 10 Y yield was between 0.5 and 0.75 this month, With the treasury issuing quite large amounts in the longer duration. Prices of bonds dropped heading into the auctions, but slowly rose thereafter. We feel this was a bit of market manipulation from the primary dealers as they tendered heavily on the auctions but were still left short of their requirements. We see yields heading lower over the coming months and any dips in bond prices should present a good opportunity to top up.



US Govt. bonds were weak in August, many feel this was due to the quantity of new issues by the treasury. As mentioned above we think it was market manipulation by the primary dealers. European and emerging market bonds were steady in quiet trading. We would look to add to TLT at around the 160 level. Markets are positioning themselves for rising US rates. The FED have now stated they will allow inflation to run hot, to average out, good luck with that.

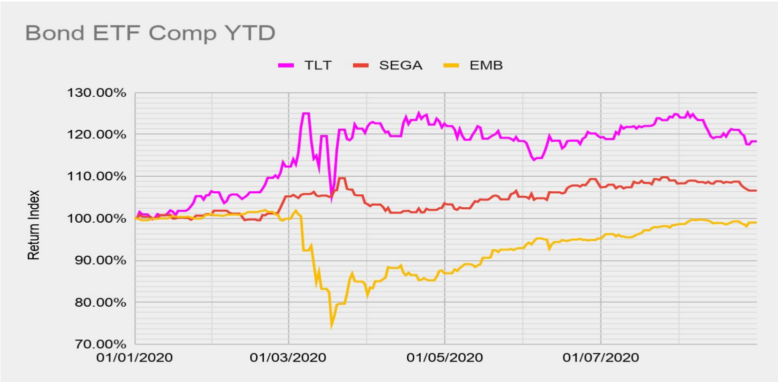
Same story in the Corporate bond market with the US bonds showing weakness over the month and Europe and EM appreciating in a small way. With Central Banks buying these bonds all over the world we do not see any great price movements in the near future. We would look for the US bonds to work back towards their European and EM counterparts over the coming months. The corporate space in the US is still very attractive with lots of demand. There will also be more QE coming.





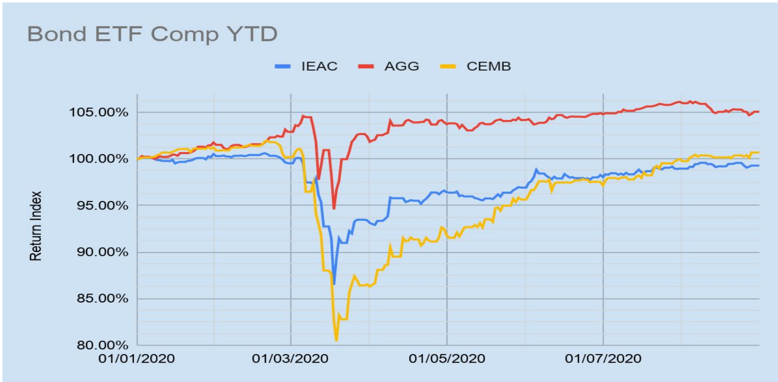
In the High yield market US HY was about flat for the month with again European and EM outperforming on the month. Trading was quiet as per normal for the tie of the year. We would look for US HY spreads to blow out a bit more over the coming months with insolvency issues coming to the fore. So if anything, we would favour a short position in HYG at these levels or just above. High yield is very close to equities and we feel both these markets are fully valued at the moment.

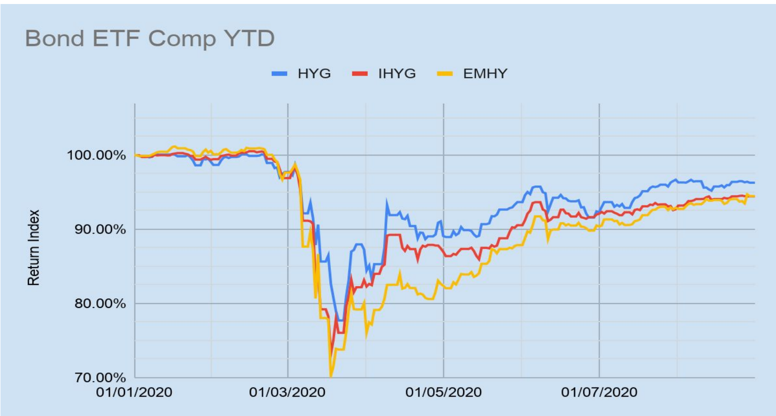
The underperformance this month of US bonds, is not consistent with the story since the start of this year. We shall take a closer look at their performance Year To Date (YTD).



US bonds have significantly outperformed their European and EM equivalents YTD. The selloff in US and EM bonds, late March early April, was an excellent buying opportunity if you were underweight. Euro bonds have been remarkably steady throughout the year, providing a solid steady return. EM bonds have underperformed YTD with the largest drawdown.US bonds sold off recently and there may be value at these levels

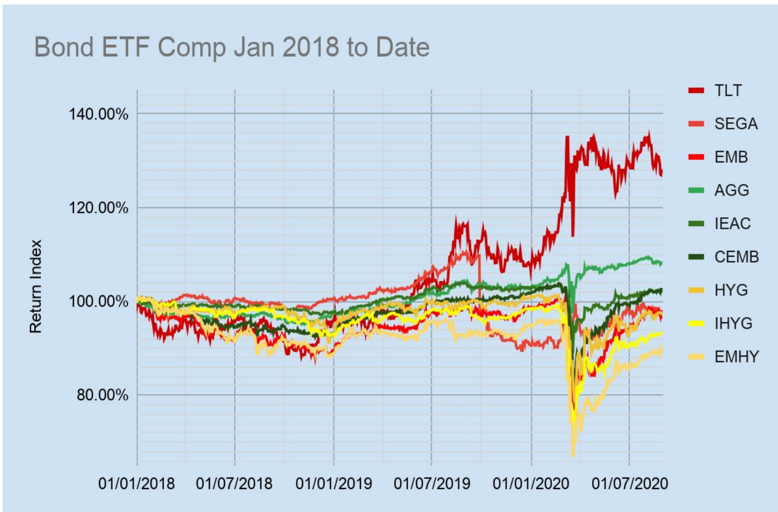
Roughly the same story in the corporate bonds but with Euro corporate bonds also being sold off in the March crash. This plainly demonstrates the risk profile of the relative markets. Timing these markets can offer great returns but is easier said than done. The magnitude of the drawdowns also reflect the risk profiles of these assets, along with their rebounds. Both Euro and EM have struggled to regain their starting levels.





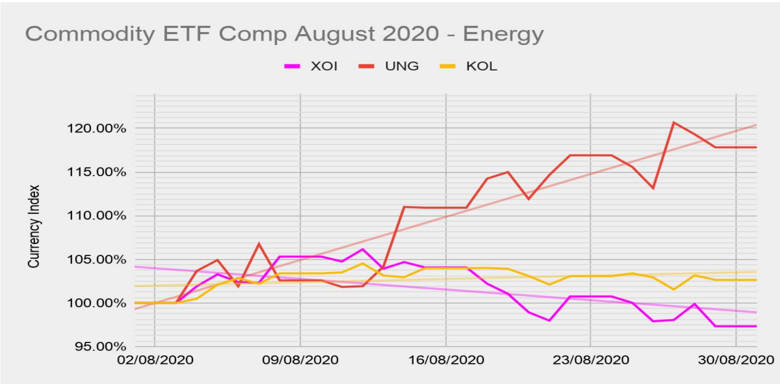
In the High Yield (HY) space there was a greater correlation between all regions and their performance over the year. With there being more perceived risk in the EM region. It may be wise to limit exposure in this asset class to the US and European markets. Generally the Governments in these areas are more capable to offer assistance to these markets if there is distress. With the US being the more liquid market, in a space where liquidity is an issue, our preference would be here.

A busy chart, but it shows Govt. Bonds in reds, corporate bonds in green and HY in yellow. It is clear to see that from the beginning of 2018, US Govt. bonds have been the clear outperformer, and this really started from the end of 2018 when the FED pushed too far and over tightened. Since then they have been playing catch up. Are they now ahead of the game, or still chasing the ball? Only time will tell but we feel they still have some work to do. Let's hope they know what they are doing. With US bonds dipping recently we feel there is value here as we see US rates moving lower.



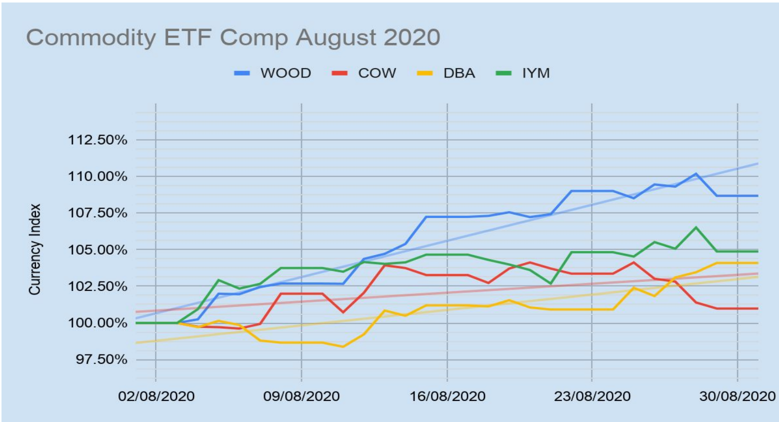
Commodities

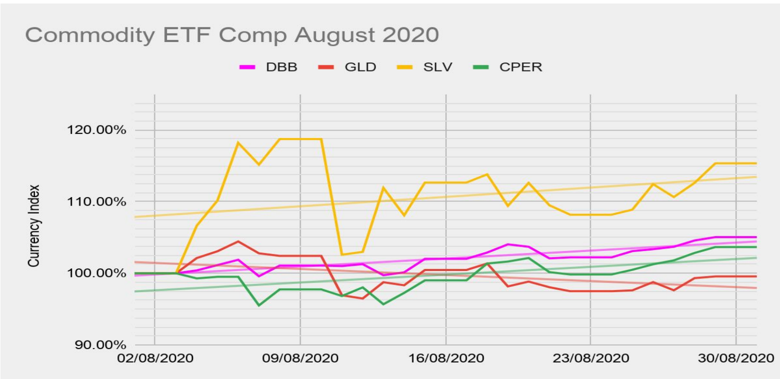
The oil price remains in a quiet trading range, however we have seen some commodities explode to the upside such as lumber. For us this does not reinforce the inflation narrative around the markets.Oil seems to be struggling to move higher and without this movement the inflation narrative seems hollow to us. Gold moved up but has seen some retracement, again not in line with the inflation story. We remain long term bullish gold. The dollar weakness has helped commodity prices.



Natural gas took a leg up this month, with coal rising less so. Oil was flat to down on the month and is still stuck in this tight trading range. In the near term we see more downside risks to the oil price but into next year we envisage it rising as US production is curtailed and may be slow to come back. The gas price seems to have run out of steam for now. Inventory has started to build on natural gas and this may lead to a pullback in the near future.

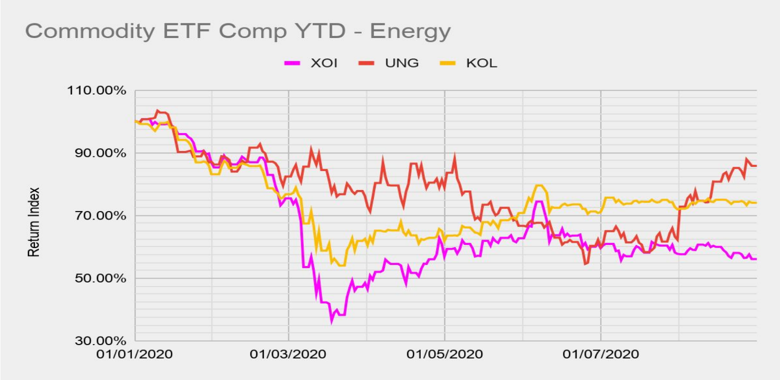
Lumber prices were on fire this month probably aided by supply issues and strong demand from homebuilders. Meat and agricultural goods were both higher on the month but nowhere near the extent of lumber prices. Once supply issues have been resolved we should see a leveling off in these rises as supply and demand equalise. Longer term we see demand issues ahead. We await China to fulfil their promises to buy more goods from the US to see if this can raise agricultural prices.





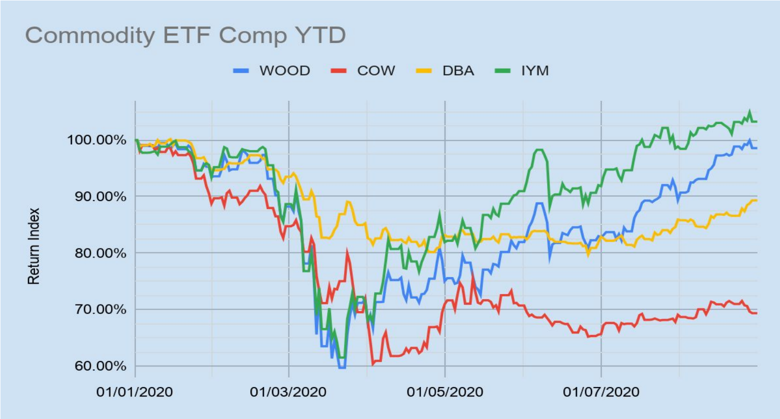
Metals have been mostly flat to slightly up on the month, silver has risen the most along with being the most volatile. The big question remains: what is coming next, inflation or deflation? We shall examine this in the last section of this report. Gold has pulled back from recent all times highs and is seemingly consolidating. Its next move will be in line with the answer to the inflation question. Copper and base metals are appreciating slowly for now.

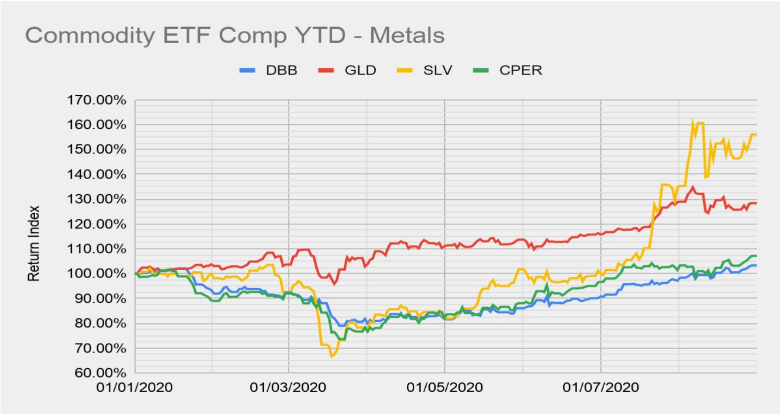
Viewing these monthly figures would seem to indicate that there is some inflation occurring at the moment, but let us try and put this in context by looking at a wider perspective looking back to the start of this year.



When looked at from just before the pandemic/crisis, we see that all of the energy sources have not recovered their prices from the start of the year. This does not imply to us that inflation is an immediate concern. With the exception of gas,they have severely struggled to regain their starting prices and are around 75% of them. Prices may rise further in the future, however there is still quite a lot of room for them to rise before inflation is an issue.

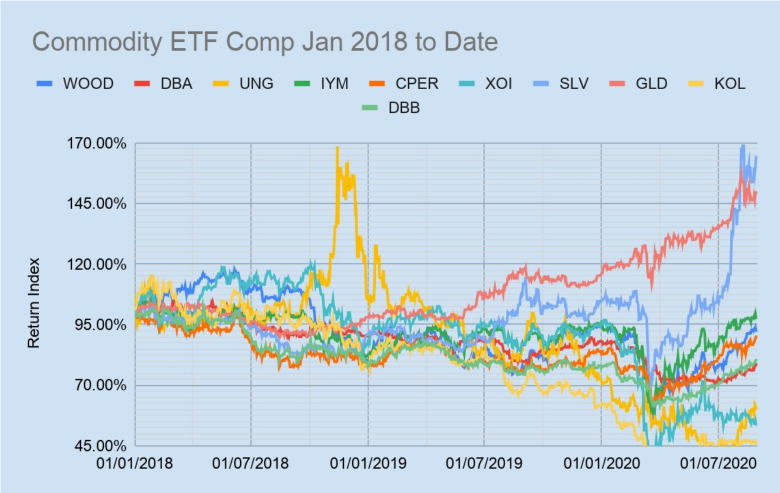
In basic materials, agriculture, meat and lumber the recovery has been more prominent, and basic materials seems to have exceeded their price at the start of year. Meat though is struggling to recover despite consumer prices reportedly higher at retail outlets. This probably points to supply issues which should work out over time. So again here it does not seem to lead us to believe that inflation is an imminent problem. The FED would like it to be but it seems for now that they are doomed to fail.





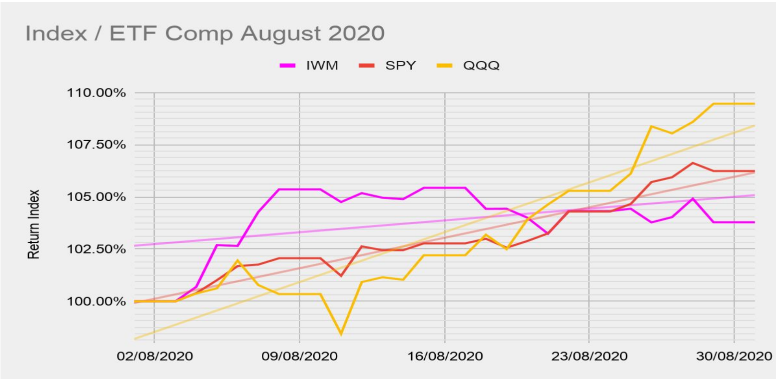
Silver and Gold have had a great year to date, with copper and base metals taking a long time to recover their initial price levels and now only exceeding them slightly. Gold and silver both saw heavy selling pressure immediately after the crisis, probably due to the global demand for USD but have risen greatly from these lows. The fact that copper and base metals have not risen greatly again seems to us to indicate that inflation is not an immediate issue. Perhaps Gold and silver can retrace a bit from here.

Although this chart is very noisy, it does show that only gold and silver are about the levels that they were at the beginning of 2018 (2 year 8 months ago). All other commodity ETFs are below those levels. Most of these are generally in a downtrend. Now the crisis has shaken things up but has it really changed any of the fundamentals, certainly not for the better. Once again we feel that there is a good chance that both gold and silver will come down a bit in the near term. This will present a good buying opportunity in the long term as we are bullish for both of these assets



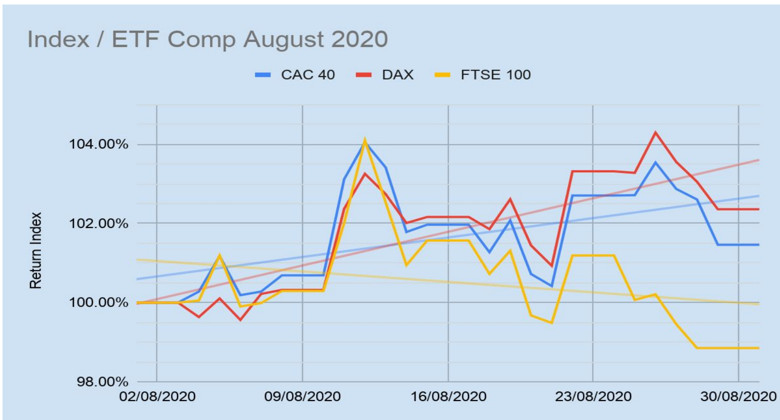
Stock Indexes

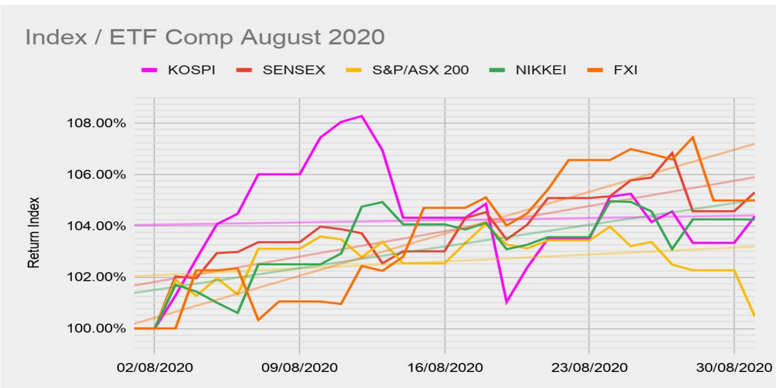
These are the local indexes of varying countries reflecting the value of the companies quoted on them, importantly in their local currency. We must always bear in mind the Index performance and the currency performance against other localities. Investing is a relative game and we like to show comparative charts to identify this and point out the opportunity cost of choosing one investment above another. For risk aspects we prefer developed markets, and prefer to enter smaller markets via investment vehicles that are located in developed markets. Liquidity can be an issue.



US markets all saw a very strong month in which must be reiterated, was a very low volume month. The Nasdaq out performed both the S&P 500 and the Russell 2000.The small cap Russell was the weakest, as it has been since the recovery started. The breadth of this rally has shrunk as we continue to rise and now along with market internals do not look strong. This may indicate that we are running out of steam. Option skew is also very high. Be careful.

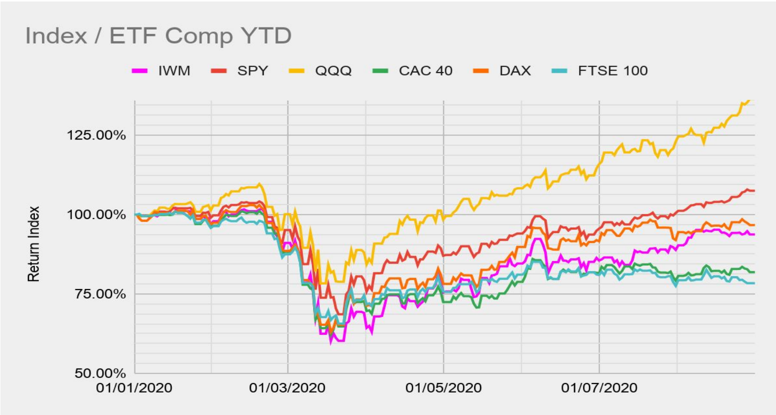
Mainland Europe also saw a string month, again in a low volume environment. The UK market was sideways to down slightly. The strength shown by the currency may explain some of this underperformance. The French market tracked closely the German market but at somewhat lower levels. The german index heavily depends on a strong performance of China and as stimulus wanes in China we might see the German index rollover. The UK has many challenges in the near future, Brexit primarily.





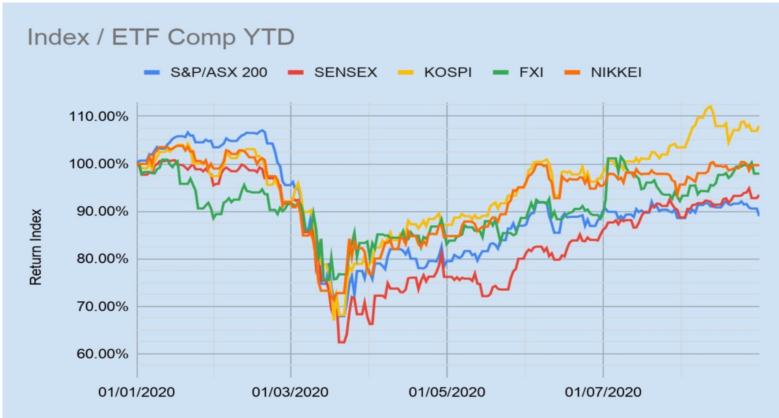
Other equity markets around the world showed widespread strength throughout the month, with China and India being the top performers for the period. If energy prices start to rise these indexes may start to slow as they both import large amounts of energy into their economies. As the virus maybe having a resurgence we could see a pullback in indexes as we head into the fourth quarter. Light volume in markets may hide the truth of markets, time will tell.

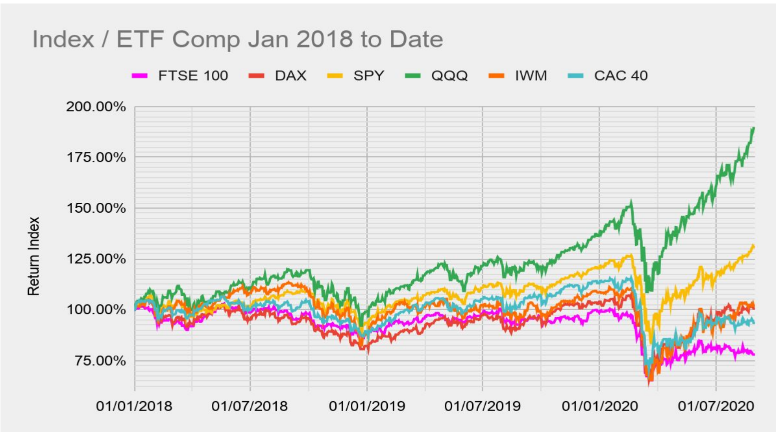
Let’s take a look at a larger context timeframe to get some more perspective on the markets.



Since the beginning of the year US and European markets have widely struggled to get back to where they started the year, with the exception of the main two US markets : S&P 500 and the Nasdaq. The Nasdaq has really out performed all year and the strong have only got stronger. However now with Nasdaq earnings falling but the prices still rising, this may not be a trend that has much longer to run. Europe does not have many tech companies in their indexes and therefore have suffered underperformance.

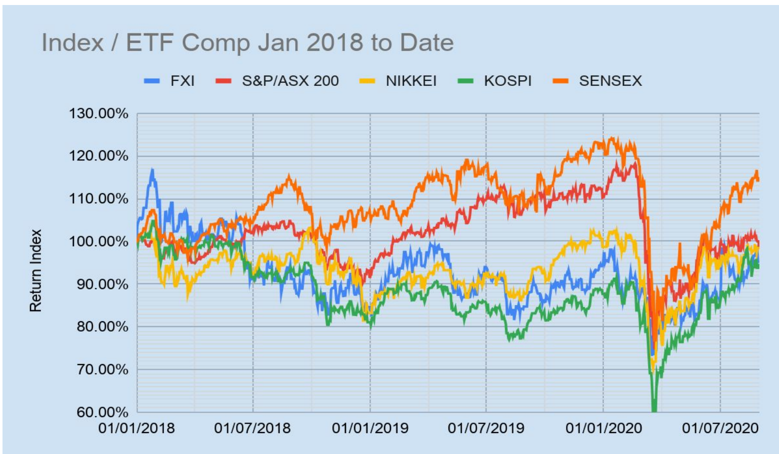
For other indexes spread around the world they have also struggled to get back to where they started the year, With the Korean index being the exception here. Korea has quite a high component of tech companies in their economy and this probably helps explain their annual performance so far. India had the deepest fall but have steadily progressed to almost regain their starting point. We feel that now progress will be more difficult from here. The virus;s path will influence all of these.



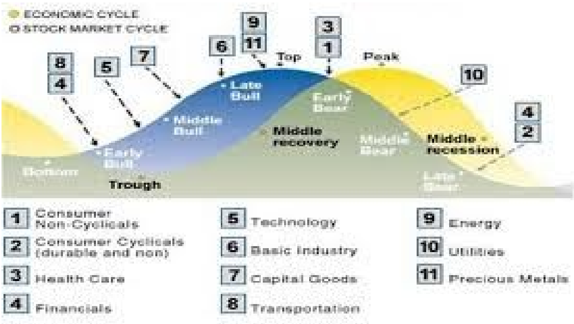


On a larger time scale you see the same pattern for the US and European markets. The underperformance of the UK reflects the issues the country has had with uncertainties over their exit from Europe. We feel that this will continue until there is some clarity as to their path forward. Europe still has many structural challenges that need to be overcome before they can challenge the US in terms of economic growth. We still see the US as the best place for investment moving forward.

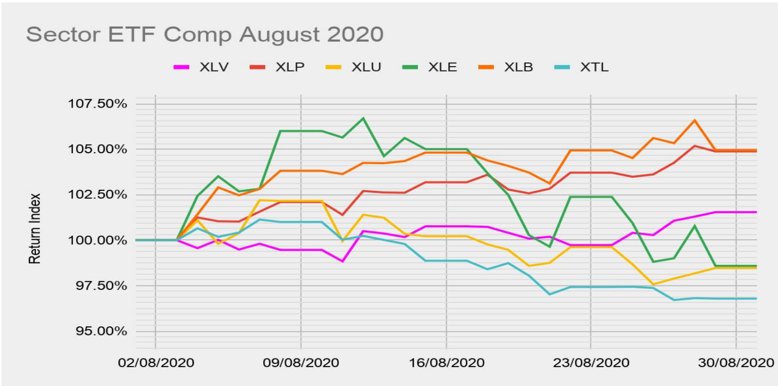
Over the longer time frame the indian index has been the constant out performer. The other country indexes have all been unable to recover their levels from the start of 2018. This again reinforces the thesis that the US is the place to have equity exposure especially if you believe that the USD will hold its relative value overtime. We do like India over the long run as they have preferential demographics. As more time passes and we understand the virus and its effects more, clarity will emerge and so will winners and losers.



Sectors

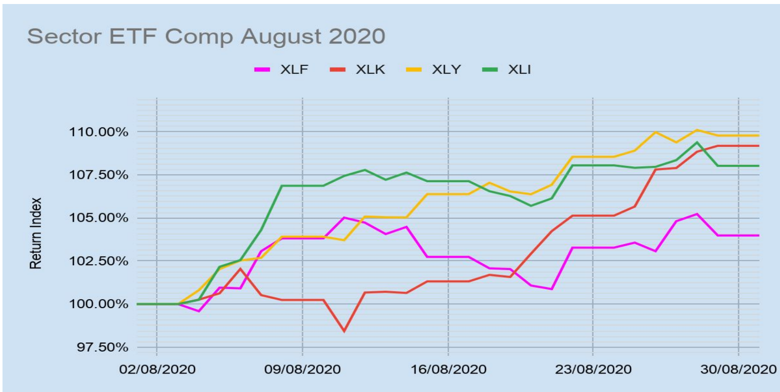


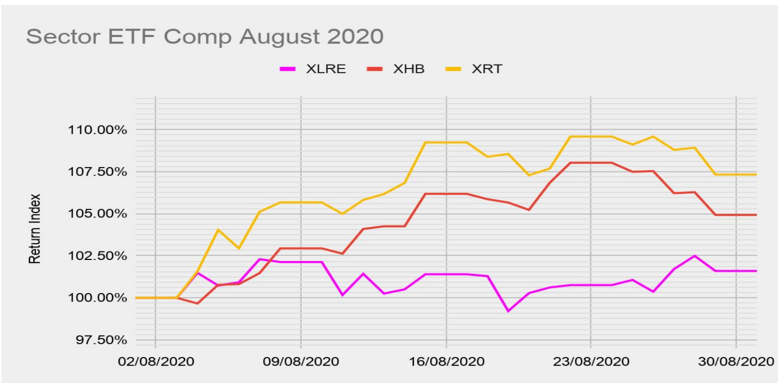
We use sectors to place stocks and other investments into categories such as technology, healthcare, energy, utilities and telecommunications. The different sectors have diverse risk profiles and perform at varying degrees throughout the business cycle. Here we shall contrast and compare the performance of the different sectors over time to help our understanding of their relative virtues with the target of augmenting our investment returns over time. We generally use US markets as these are the largest and most liquid.



A mixed sectorial picture over the month, with MaterialsStaples and healthcare being positive and telecoms, utilities and energy being negative. Energy has underperformed for a longtime and is symbolic of an economy that is not growing. If the economy was growing we would be consuming a lot more energy. Materials were the top riser and telecoms the biggest loser. On the face of it this seems to be somewhat of an anomaly, markets are strange.

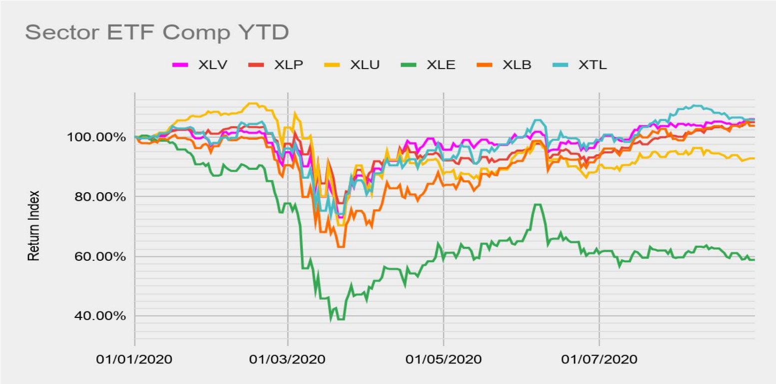
Consumer Discretionary, Industrial and Tech were top performers, with financials lagging a bit over the month. The yield curve did steepen slightly which helped financials, how long this persists is debatable and we feel that it will not last long. Cyclical stocks are appreciating as the market is believing the narrative that we are in recovery. This in our opinion is a false narrative, there is no “v” shaped recovery. As this unfolds we think this narrative will be proved untrue.





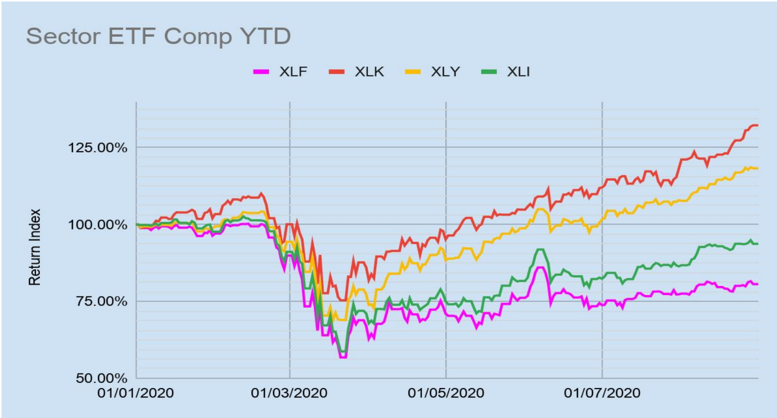
Retail and home builders had a strong month, with Real Estate rising but not to the degree of the other two. The whole US market had a very strong month but on very low volume. This leads us to believe that the market is running out of momentum and could be due for a pullback in the near future. It is a good time to book some winners and get some dry powder. The professionals will be looking to do this but they need someone to sell to. Be a seller.

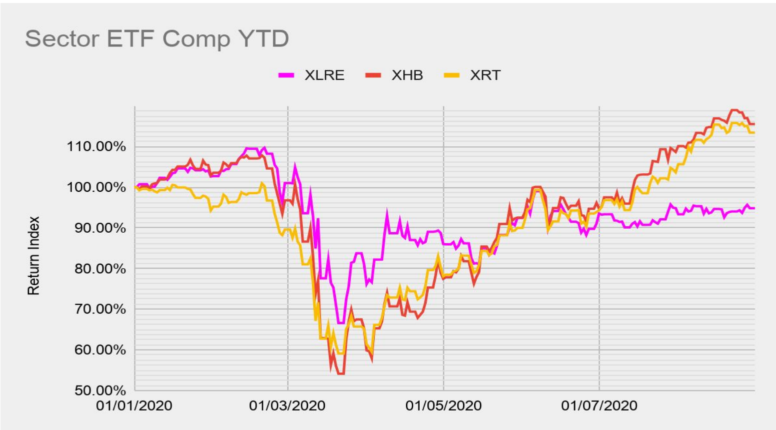
Most people are now long of stocks and the people looking to take profits need the volume to come back into the market so that they can exit their positions. Volume should rise in September. For a bigger picture look let's examine some larger time frames and see how each of the sectors look.



So over the course of this year most sectors are fairly flat with Energy being the large underperformer. This being due mainly to the collapse in oil prices in March and April. Utilities, a defensive sector, has also underperformed which indicates the risk on state of markets which we feel is overdone. If the USD devalues this will be bullish for commodities and we should see a recovery in the Energy sector as solvency issues are resolved.

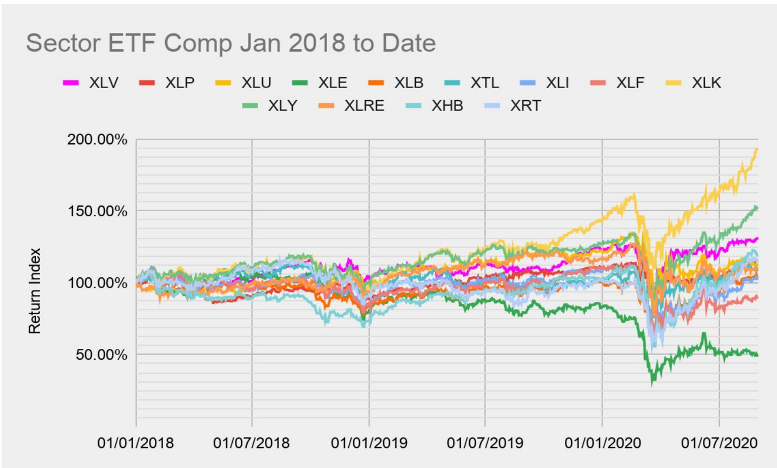
Here there is a large divergence over the year, with tech leading the way and financias bringing up the rear. Consumer discretionary has done well, it seems the wealthy always have disposable income no matter what the economic circumstances. Or maybe it is the fact that Amazon is in this sector and is a large part. The financials' poor performance is a big concern for the economy at large. The profits are now mainly being derived from their trading, which is an issue for the smaller players.





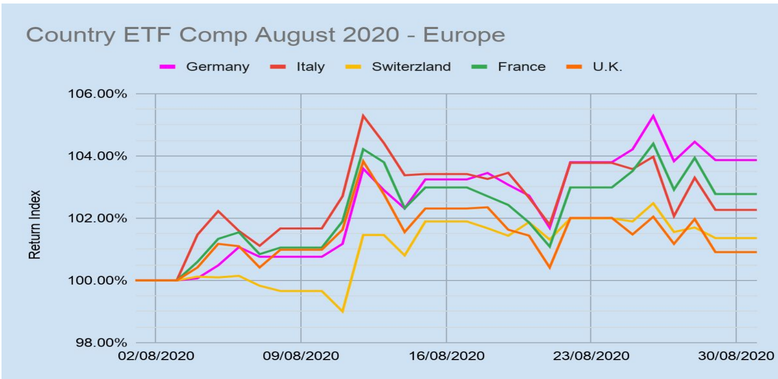
Homebuilders and retail had a storming year to date, even though both had a precipitous fall. We feel that both now may be overdone to the top side and would look to book profits at these levels. The real estate sector is actually down on the year, and certain parts of it does face challenges moving forward, however other parts have good potential value and could be a good place to invest as they are hard assets and offer income. Rates are going to be low for a very long time. We feel opportunities exist here.

From the start of 2018 certain trends emerged and the pandemic/crisis seems only to have emphasized these trends. Tech has been the big winner and the crisis has hastened this story and we see this trend continuing into the future. Financials have lagged the general market and the challenges they face have not gone away. We see them continuing to struggle as rates seem to be anchored for years to come. If the dollar is devalued then we see opportunities in the real estate and energy sectors. We also like utilities here.



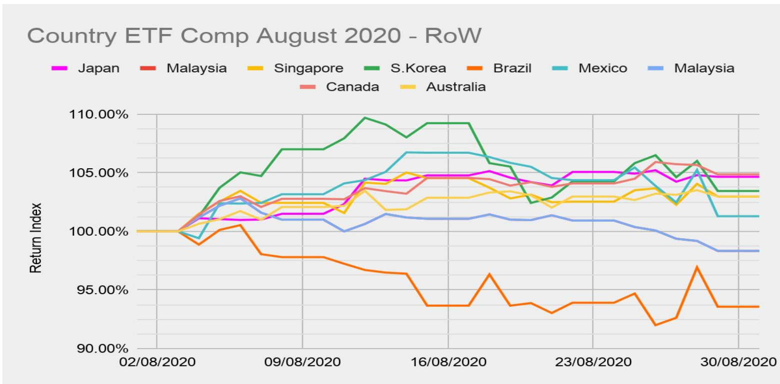
Geographic

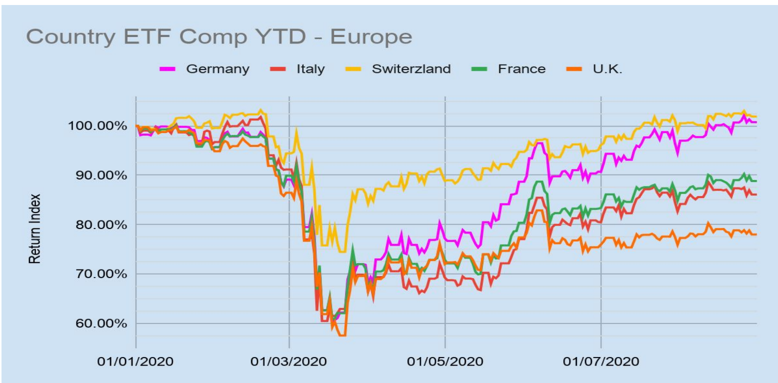
Certain countries or regions around the world will be experiencing different economic circumstances at any given time, usually. Therefore it is important to access these differences and utilise them in order to create greater returns on your capital. In this section we shall look at a range of ETFs, all quoted in USD covering varying countries around the world and look to analyse their differing performances and where they are in the economic cycle so that we may look to add value to our investment decisions



Europe has seen good growth this month in these ETFs. The two laggards have been the countries outside of the EU. The weakness in the dollar has no doubt helped their performance this month. With respect to the laggards it could account for all of the rise. The market sentiment at present is to rotate from the US markets into European markets, but with the reemergence of the virus in Europe this may be short lived. We prefer to stay with US markets.

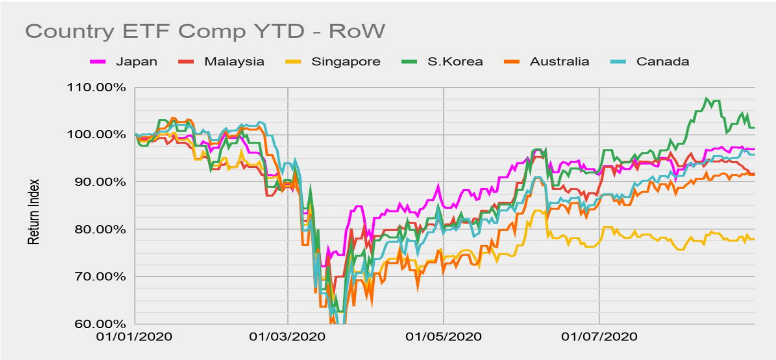
The rest of the world has not seen such good growth but still there has been some rise. Brazil has underperformed recently due to the issues it has coping with the virus and internal difficulties. Also their relative currencies have not been as strong as the European currencies against the dollar. We need to see how the virus behaves over the coming months to develop a thesis how these countries will perform moving forward.EM are challenged moving forward.





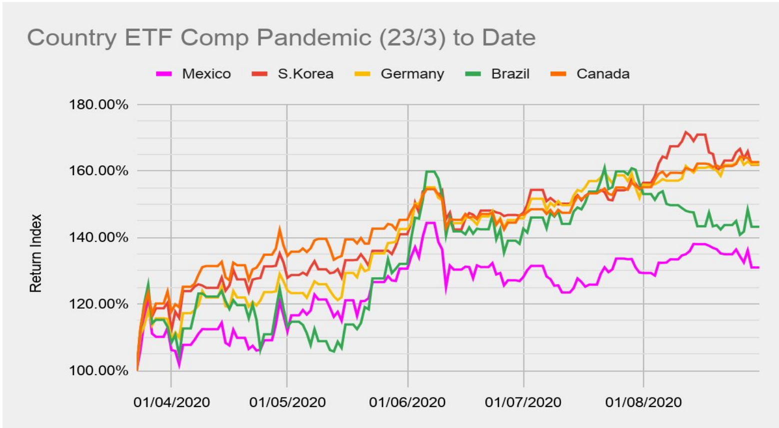
From the start of the year Europe has had issues recovering their starting levels, and some countries have failed in quite a large manner, namely UK,Italy and France. Switzerland and Germany have shown to be the strongest this year so far. We think that these trends are likely to continue moving forward. If the UK can emerge from the Brexit debacle and put their house in order there could be some value there but only time will tell if this is possible.

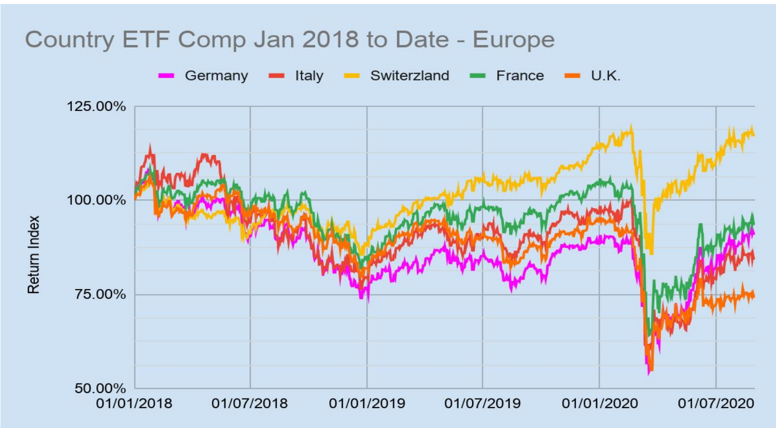
There are many outstanding issues that need to be resolved or come to conclusions for any clarity to come to the global situation: US elections, Virus progress and vaccines? The world economy was slowing before the pandemic hit the world and we feel that trends that existed before have a high likelihood of continuing after, but this depends on policy.



The rest of the world has seen a fairly consistent recovery, with Singapore lagging somewhat and S.Korea leading the way. All with exception of S.Korea have not yet been able to recover their starting levels. As there was a downtrend in place before the pandemic it may be difficult for them to achieve these levels again for quite some time. How governments spend the money that they create will govern outcomes.

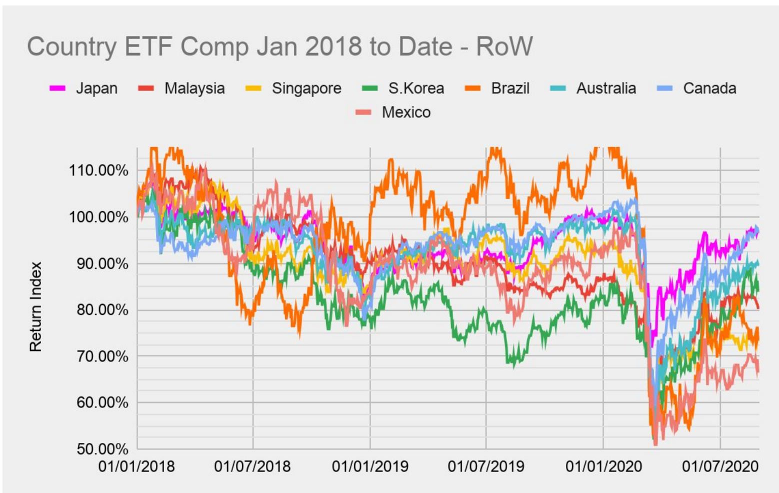
From the pandemic bottom the countries that have had problems with the virus have understandably underperformed. This we feel shall hinder their recovery moving forward. Mexico may benefit from shortening supply lines in the future but this is not a story that will happen in the short term. Currency issues have also hurt Brazil but are a reflection of their internal problems. Opportunities may present themselves as the situation reveals itself but for the moment we are neutral.





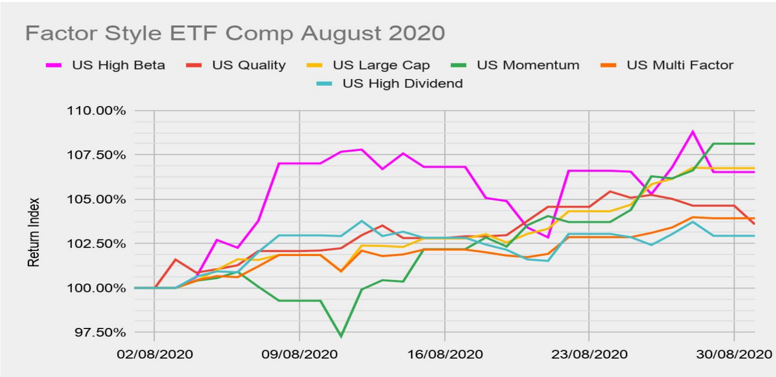
Over the longer run it is clearer to see the larger trends and as the market has issues (late 2018 FED over tightening) and then March this year, these trends become more transparent and reinforced. With the abundance of cheap money in the system at the present time we believe that these trends will continue and become and be reinforced with this liquidity. Other opportunities may develop with time but for the present we do not see the need to fight the market consensus. Momentum is here.

The rest of the world over the longer time frame has not managed to produce positive returns with the exception of Brazil until they ran into their issues. Demographics will pay a large role in the investing sphere moving forward over the long term and should always be at the back of your mind when looking to make long term investment decisions. There may be some chance in our opinion for Singapore if the issues with Hong Kong exacerbate. But this is not a position to consider until early next year. The US election outcome will define many decisions to be made thereafter.



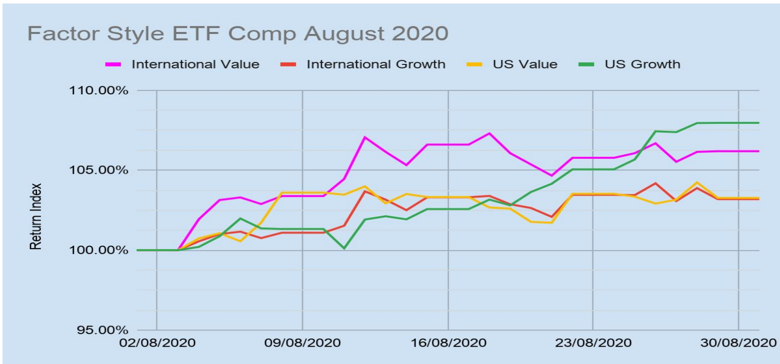
Factor Styles

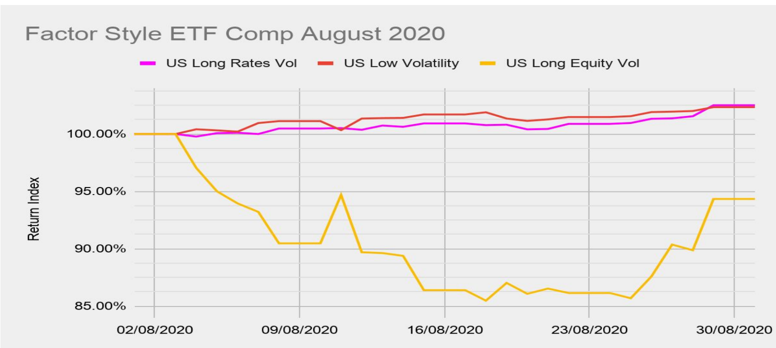
Factor investing is a strategy that chooses securities on attributes that are associated with higher returns. There are two main types of factors that have driven returns of stocks, bonds, and other factors: macroeconomic factors and style factors. The former captures broad risks across asset classes while the latter aims to explain returns and risks within asset classes. Macroeconomic factors include: the rate of inflation; GDP growth; and the unemployment rate. Microeconomic factors include: a company's credit; its share liquidity; and stock price volatility. Style factors encompass growth versus value stocks; market capitalization; and industry sector.



All of these styles saw a positive return over the month with the High Beta style leading the way. The markets are light in volume at the moment but are in a general melt up that is being driven by many factors.Once we start to see volume come back to the markets we may see a change in the market structure. However this may not actually happen until after the US election and there is clarity for all to start making some longer term investment decisions.

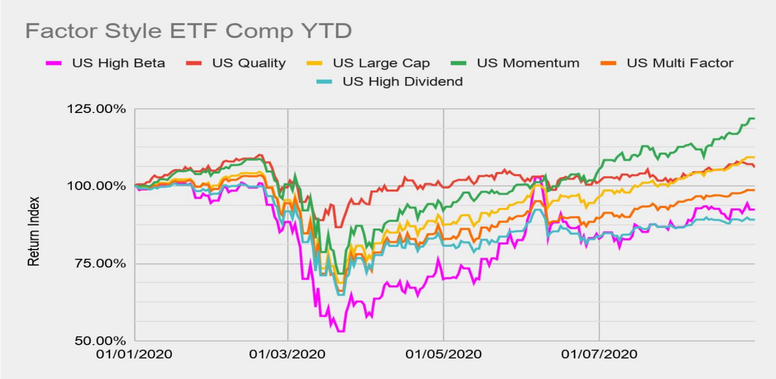
Again these style factors were positive for the month with the US factors outperforming the international ones. International value beat international growth and its US counterpart. The market still has an ongoing discussion whether now is the time to switch from growth to value. At some point this will be the case but for now we do not feel it is the time. But Int. V beat Int. growth shows there are buyers of Int. V out there.





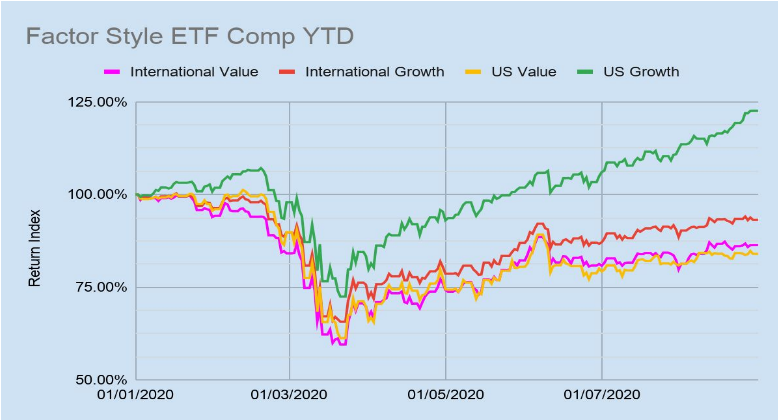
A small positive return for long rates vol and low vol with long equity vol having a big drawdown as the equity markets rose strongly this month. With the skew in the options market now being high hedging costs are expensive even though volatility fell this month. The markets are all fairly fully valued at present by most traditional metrics so being long of volatility may be a wise choice at present.

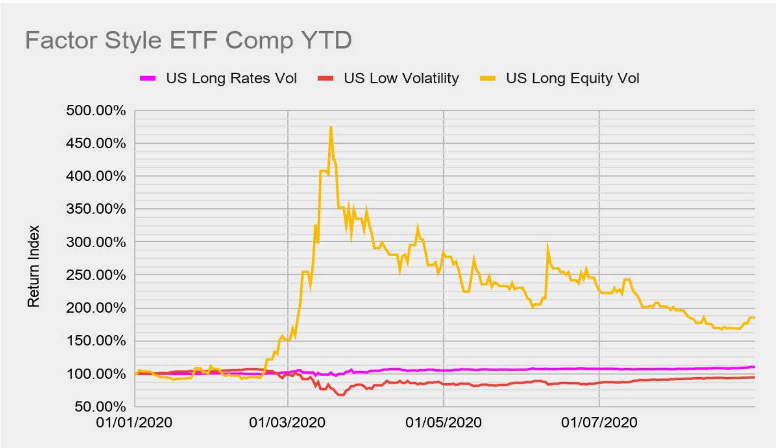
To own volatility now, the main question is how to own it and minimize your cost and your carry. This has always been the issue and there are many people out there that offer varying solutions, some better than others.



The YTD perspective on these factor styles shows that momentum is the best performer which is on a parallel with its close style factor:growth in the chart below. The only other positive returns for the year were quality and large cap. This pretty much sums up the market so far this year with investors going into the same stocks; large cap high quality growth stocks i.e. TECH. For the foreseeable future we do not see this changing.

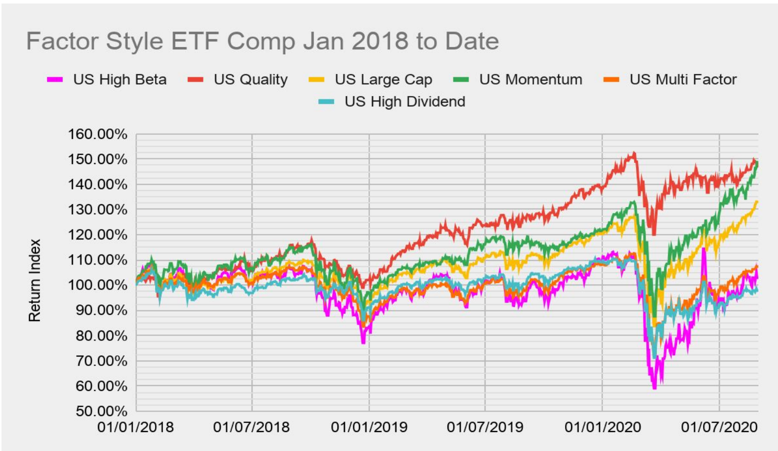
This again very clearly shows the story of the year so far, US growth the place to be. Value is not working so far this year and its time is probably not yet, you look to enter now but remember being early can be just as bad as being wrong. International stocks continue to underperform US markets. These trends we feel shall remain true for the near term and we shall constantly review markets to see if there is a fundamental change to instigate new or differing trends.

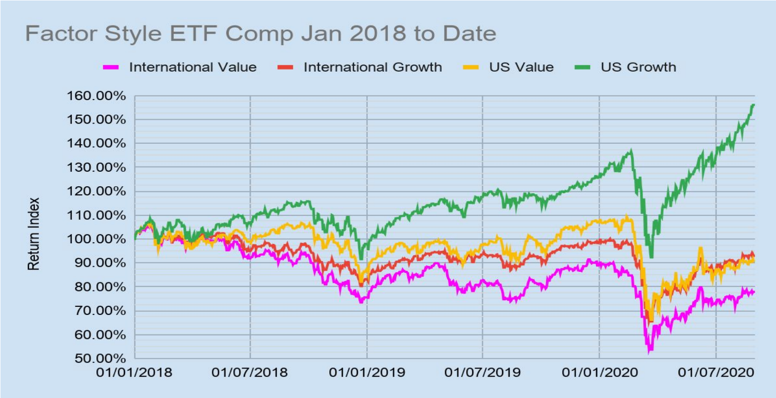




Due to the market panic in March and April Long equity vol exploded here and since has slowly been retracing, while long rates vol and low volatility have had small appreciations with low volatility drawing down in April. It is patently clear how long equity vol provides protection in your portfolio against equity drawdowns, but this does have a cost associated with it. This cost can cause you to lose money in periods where there are no equity drawdowns. Volatility is the only true protection against equity losses in current markets.

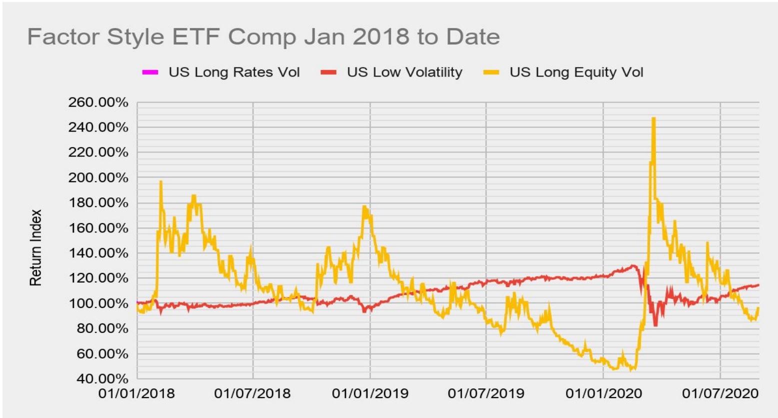
Over a longer time frame the same factor styles are confirmed as being the best performers; large cap, quality and momentum. One possible explanation for this would be passive investing. Which is a self fulfilling process where the strong get stronger. However this can produce issues for the market in general. Briefly the market begins to be governed by flows where the buyers are no longer price sensitive and this leads to over exaggerated moves in the price. We shall look more closely at this in the coming months.

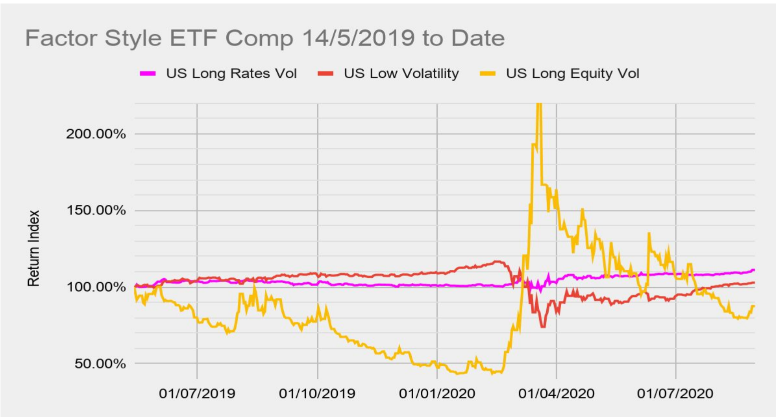




The trend we identified over the shorter term is confirmed here over the longer term. Value investing has not been performing over this period of time. Even international growth investing has not been working over this period. Only US growth has performed and performed very well. If this is because of passive investing, and passive investing continues to grow in size, where should you put your money. This is why it is important to comprehend passive investing.

This demonstrates the cost of long equity vol. Over periods of time where equity markets do not fall. Throughout 2019 the equity markets went sideways or rose and the long equity vol lost around 60% of its value. So when you own long equity vol is important. The low vol factor style had a small appreciation over time with a couple of small drawdowns, when equity markets fell. Long rates vol does not appear on this chart as it did not come into existence until May 2019. Thank you Nancy Davis.





Here we have charted The long rates vol performance since its inception. It has been very stable but has appreciated when there has been market turbulence. It will not give you protection against large equity market drawdowns but that is not its function. In modern markets it would seem that the only truly uncorrelated asset is volatility, so to find a cost efficient way to own this is very important to protect your wealth. Timing markets is very difficult but without an attempt to do so it is highly improbable.

Summary : August, generally a quiet month, has been very quiet indeed, more so than usual. Thus any moves we feel have been somewhat exaggerated in very thin markets. “Robin Hooders” buying call options like they were going out of fashion, has caused delta neutral market makers to go and buy the underlying assets and this has driven price action sometimes wildly. That said the melt up continues in equities. US treasuries still seem to be range bound (0.5-0.75) even though the FED has told the market they are willing to let inflation run hot. This does imply that they actually have some control over inflation, which is at least very debatable. The FED basically stated that they were erroneous in believing the employment figures from 2015 to 2019 and have amended their mandate so there can not be low enough unemployment. Their error was not to realise that the participation rate was relevant. I hope soon, they realise that they cannot generate inflation by the means they are trying to do. They have failed dismally for 15 years and still do not understand why. They are not central to money creation and the sooner they realise this the sooner they can look to effectively try and manage the economy. September should see volume increase and with that markets should reveal more of their direction.

Inflation Or Deflation ?

To start with answering this question we feel it is important to qualify what is Quantitative Easing (QE) and its effects on the market place. There is a common misconception that QE is “money printing”, here we would like to explain why this is not true.

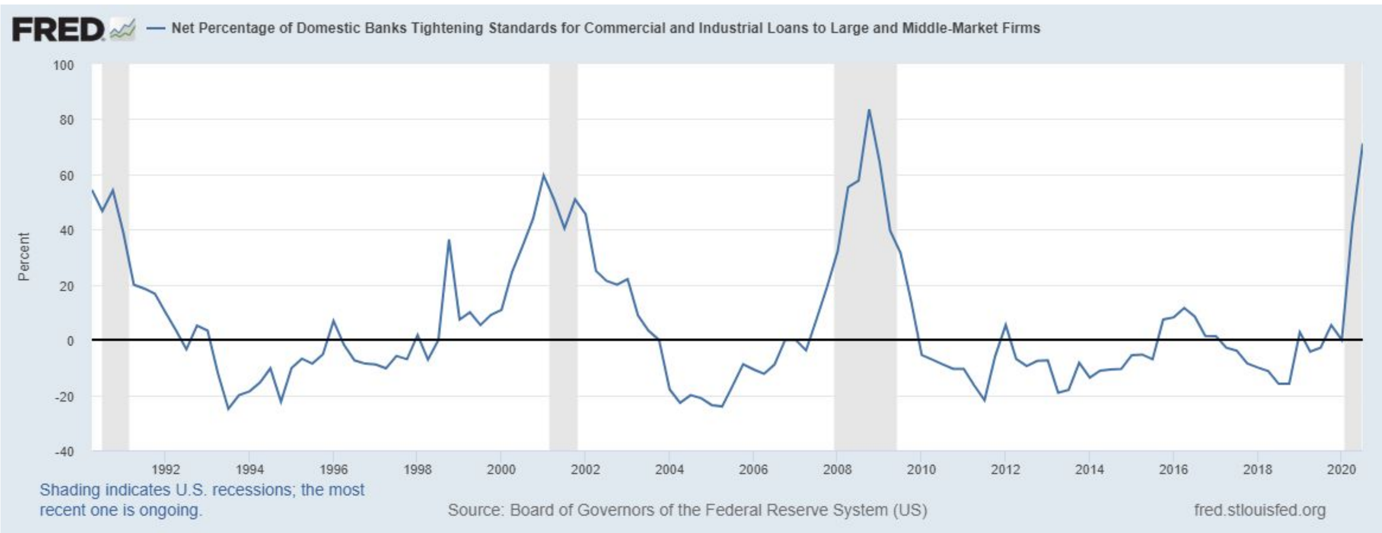
In QE the FED buys financial assets from the market place, usually bonds: Government. Now they are also buying corporate bonds. They also buy Mortgage Backed Securities (MBS). The misconception is that in return for the bonds the FED gives the sellers of those assets money. What they actually give the sellers is credits, to the sellers reserve accounts held at the FED. These reserves cannot be used by the sellers, their sole function is as reserves, or collateral.
The reserve accounts of the sellers, the large commercial banks (primary dealers) act as collateral to lend to other financial institutions. If their reserves increase then the amount that they may lend increases. This does not necessitate that they lend more money to the system. Under current market operations, the amount that they lend to the market is at their discretion, within the bounds of their reserve requirements.
The definition of money has three facets:

1. Store of value
2. Unit of account
3. Medium of exchange

The reserves created by the FED **do not** meet the third facet; so they cannot be “money”

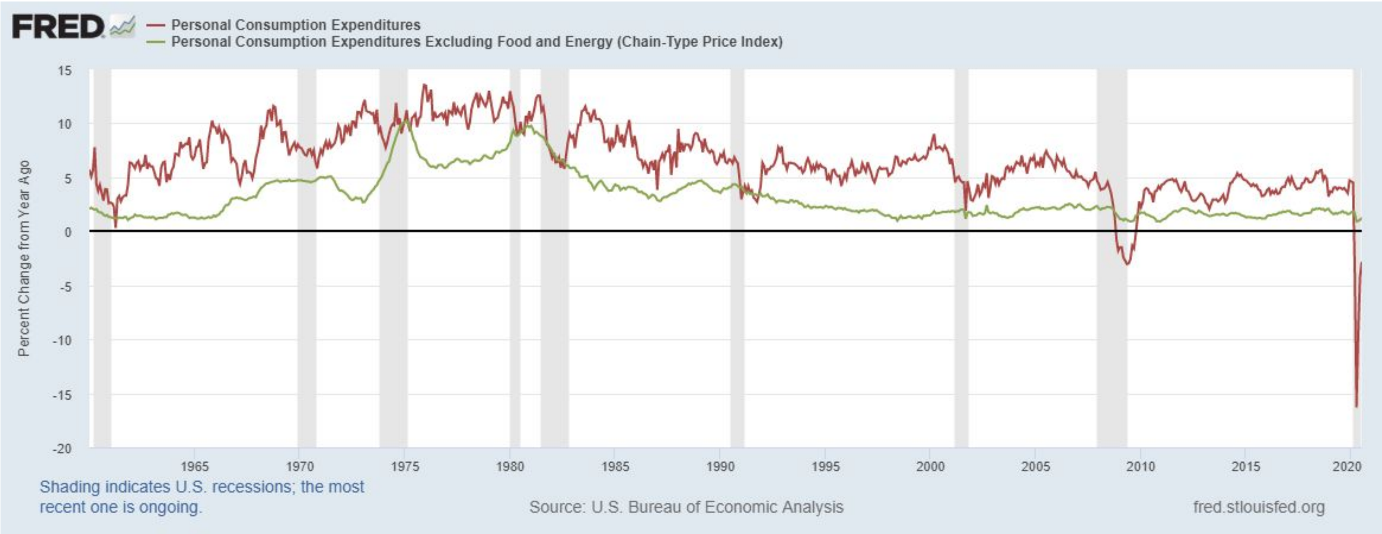
Money creation can only be done through bank lending, or from the government issuing new treasuries, which are purchased by the FED and then the government spending that money.

In current economic circumstances the banks have a low propensity to grant loans, so even though their reserves have risen giving them the ability to lend more money they are not inclined to do so.

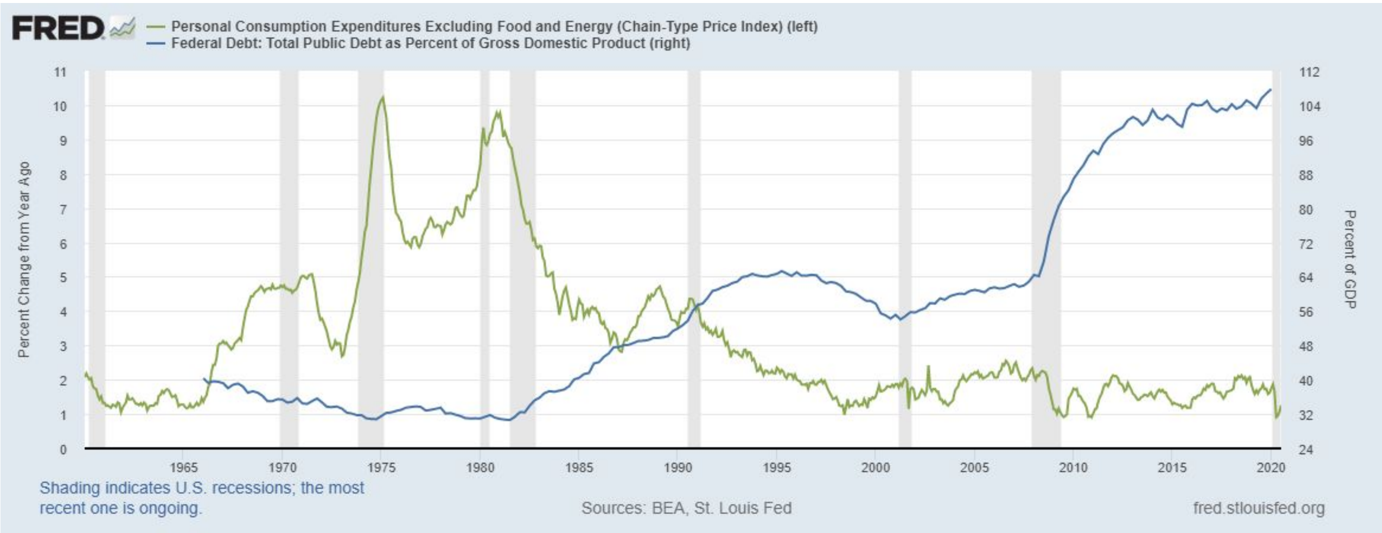


This clearly shows that at present banks have tightened their lending standards and are not inclined to freely grant loans. If there is a limited loan growth then there is limited money printing. It is not the FED that decides how much money is printed via QE but rather the commercial banks and their lending practices. This can be resolved by the FED with what is commonly known as “window dressing” such as happened in Japan in the late 1980s, but at present the FED does not utilise “window dressing” This term basically means that the FED would tell the commercial banks how much to lend.

Now back to the original question of whether there will be Inflation or Deflation. With it being clarified that QE is not "money printing" just the mere perception that QE is "money printing", by the markets has been enough to convince them that there has been immense "money printing". Therefore the perception by markets of this could lead to further inflation. Main Street has seen inflation in many of the products and services that they consume everyday. Though many of these are not included by authorities in the metrics they use to measure inflation. This is shown in the graph below, with two differing PCE indicators. The authorities chose to use the green line as their metric of inflation.

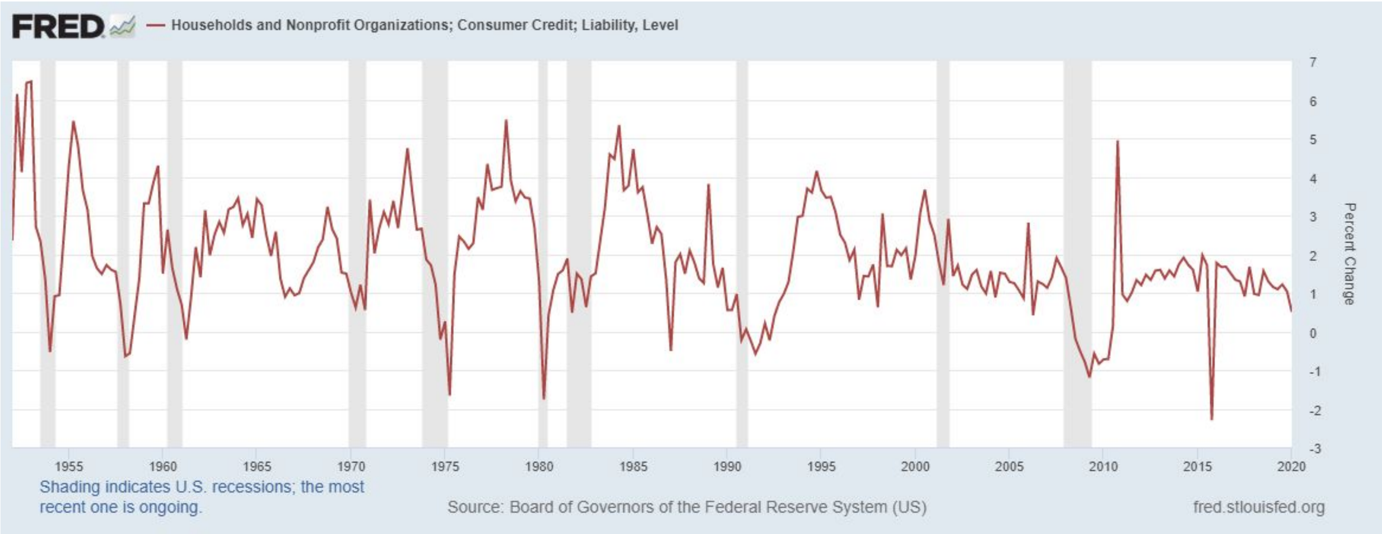


The green line is almost constantly lower than the red line. It suits the motives of the authorities to understate inflation in a debt laden economy. As their chosen means of reducing debt, is to inflate it away. The less main street are aware of inflation the longer the authorities can run it hot to reduce the debt.

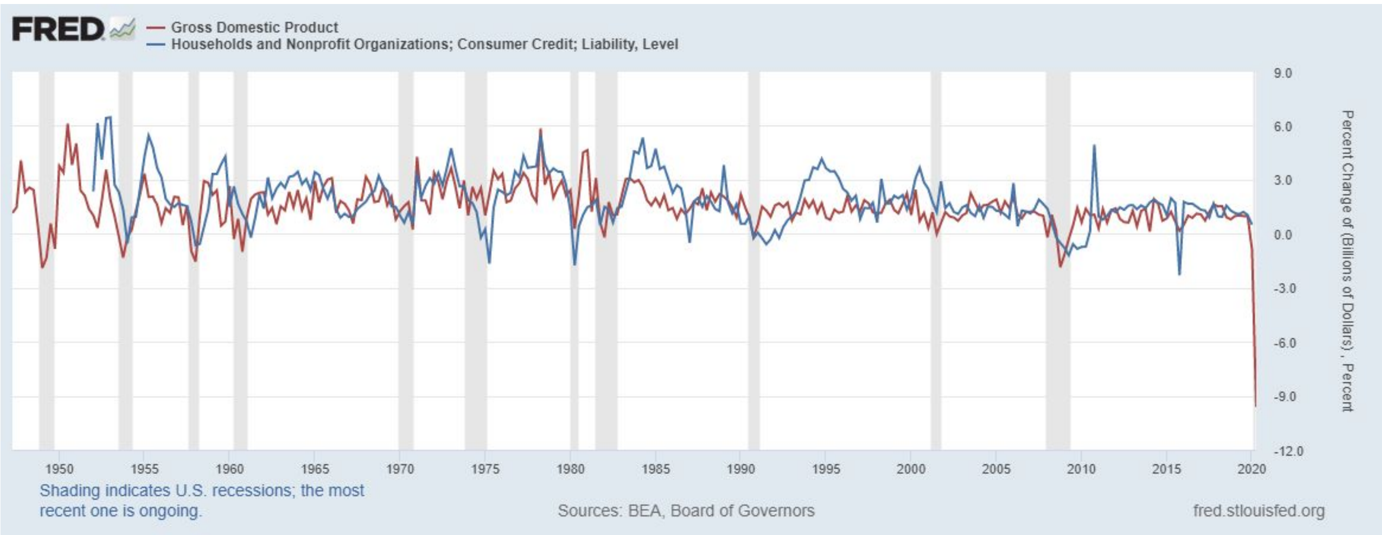


The graph above demonstrates this, as the inflation rate was rising in the 60s through to the 80s, the national debt remained under control. However as Volcker fought inflation (raised rates) and the rates started to fall so the national debt grew to the level it sits at today. So inflation could be viewed by authorities to be the desired outcome, and they have since GFC been trying to create it without much success. They also have not had much success in creating growth. Growth would also be another means to lessen the debt burden. However now with their latest policy review they are moving from symmetrical inflation target, to an average target where they will allow inflation to run hot to make up for all the years they undershot.

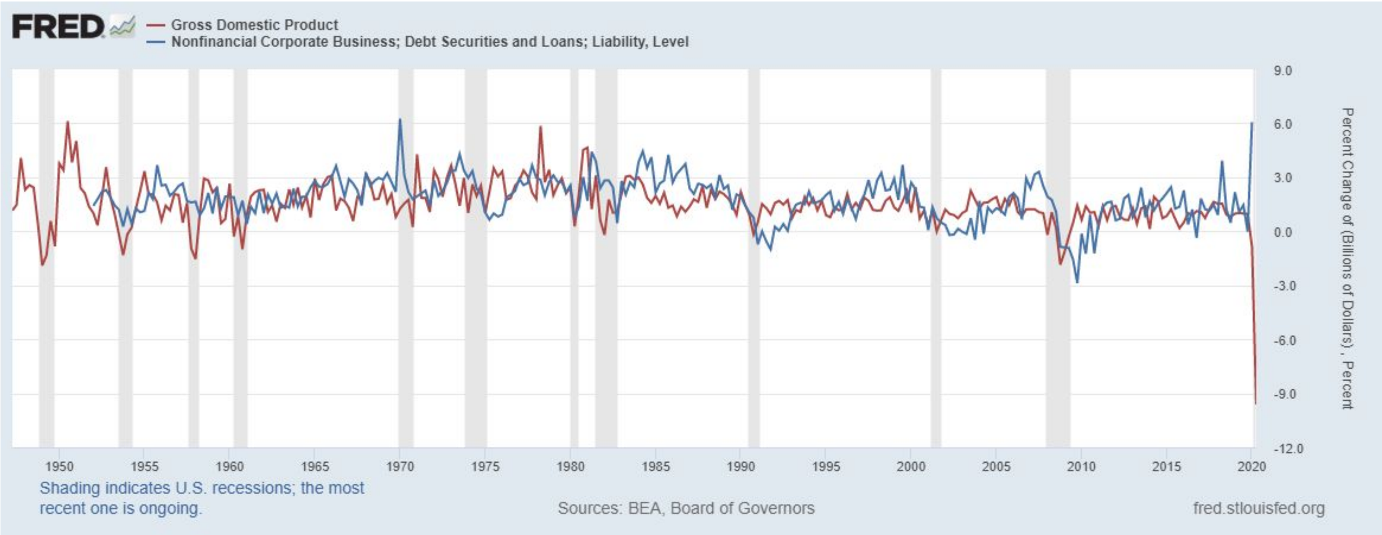
Well surely if they have any ability to create and control inflation they never would have undershot in the first place. The FED successfully managed to crush inflation through the forceful and decisive actions of Mr. Volcker, but presented with the challenge of creating inflation they have abjectly failed. So do we now think that they have magically found the recipe to create something that has eluded them for the last 12 years, by simply stating they will allow inflation to run hot. They are still under the misapprehension that they control money creation. What hope is there, that they can deliver inflation if they still do not have any inclination of their limitations. It would be interesting to ask them what created inflation in the late 60s and 70s. If they could answer that, perhaps they can then recreate it now.



As illustrated above, consumer credit is decreasing, by definition credit is new debt and in our debt based system this is new money. We have already defined money as being created by bank lending.and or government spending.



There is a high correlation between consumer credit and GDP as well as corporate credit and GDP as we show underneath. However corporate credit has exploded as the GDP has shrunk, generally speaking corporations have in the past reduced the leverage and debt burden as we have gone into recession. This time however due to the sharp unheralded fall in GDP the corporations were hungry for finance as they had lost considerable proportions of their revenue. With the FED actions:QE, the capital markets were willing and able to meet their needs and then some. However as shown in the first chart, banks have tightened their lending standards; so why were they so willing to lend in the capital markets?



The answer to the above question is risk management, In these times lending to small private businesses and individuals is generally more risky in the banks eyes than lending to a corporation where they know they have a backstop in the FED to buy that debt if things go wrong. Again, it is the banks that are deciding where and who to lend the money to.

Another common misconception is that the money printed is used by the banks to purchase financial assets. This can only be the case if the seller of the assets also has an account at the FED. Then the reserves stay with the FED but are just switched around from account to account.

"Deposits of Depository Institutions

More than 5,500 depository institutions maintain accounts at the Federal Reserve Banks. They hold balances in those accounts to make and receive payments or to meet reserve requirements. The total amount of balances in their accounts is shown in the line "depository institutions" under "Deposits" in tables 4 and 5 of the H.4.1 statistical release."

https://www.federalreserve.gov/monetarypolicy/bst_frliabilities.htm#:~:text=More%20than%205%2C500%20depository%20institutions,or%20to%20meet%20reserve%20requirements.

The banks can at their own choice, decide to lend money to other financial institutions secured with collateral, in the Repo market. The borrowing financial institution will more than likely use these funds to buy financial assets. If the lending financial institution wants to borrow money he can always ask the borrower to lend him some money in a reciprocal agreement, you scratch my back and I will scratch yours.

Another issue with QE concerns the Repo market. When the FED gives reserve account credits in return for Treasuries, MBS, or bonds, those assets go onto the FED balance sheet, and are no longer available in the market. Therefore if the FED are buying large amounts of these assets, there are less available for the market. If demand is at least constant for these assets then the price will rise. Treasuries remain in high demand, as they are pristine collateral, especially "on the run" treasuries and are needed in the repo market to access cash. Through QE the FED are removing these from the market and thus making it more difficult at the margin to gain access to cash, tightening liquidity.

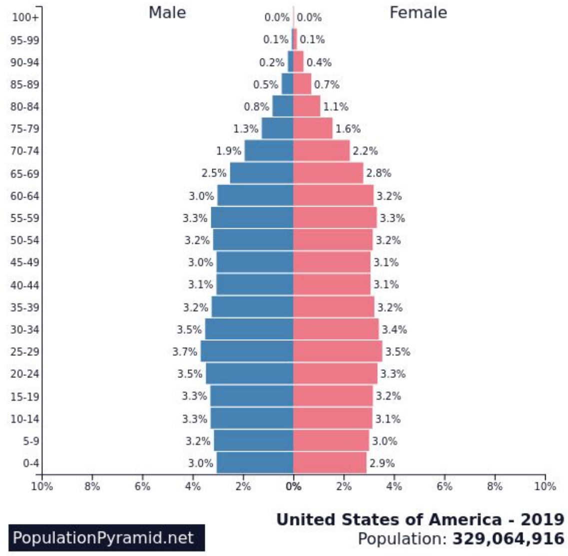
The pandemic and the governmental response to the pandemic has caused an economic shock to the world. Both a supply side and a demand side shock. The supply side shock may in the short run cause some inflation pressures, as we have seen already and these may persist for a while. However we believe that the demand side shock is the more difficult issue to solve and this will take much longer than people envisage at present. We are still yet to see any clarification as to the duration of the pandemic and until there is clarity to this situation, it will be near impossible to completely assess the impact that this has had. The longer that this situation drags on the more damage is being done to the real economy.

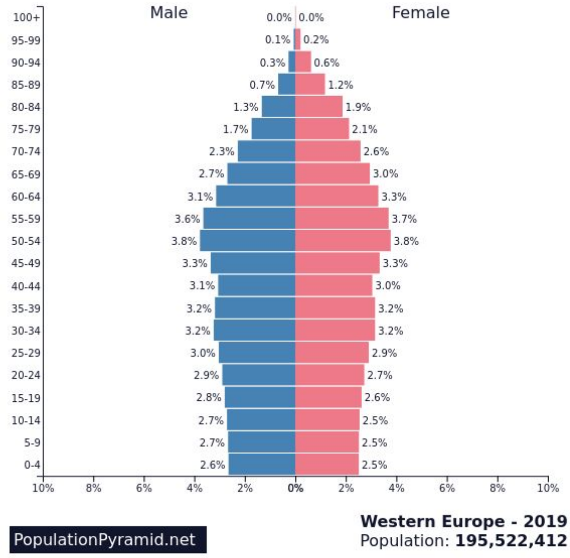
In our opinion the FED does not comprehend its limitations in the modern economy. It is a complex system and there are using linear analysis to try and evaluate it. They have misinterpreted their own unemployment data and its meaning over the last 4 to 5 years, by their own admittance. They have completely failed to give the market any specifics, about how they intend to deliver inflation. They do not have control over money creation, unless they utilise”window dressing”. This is why they are basically begging the government to increase fiscal spending. The banks are not lending to the people and places the FED wants them to, so the government is the only other option left to them.

They are also desperately trying to create the narrative where people believe that inflation is coming, as it is a self fulfilling philosophy.

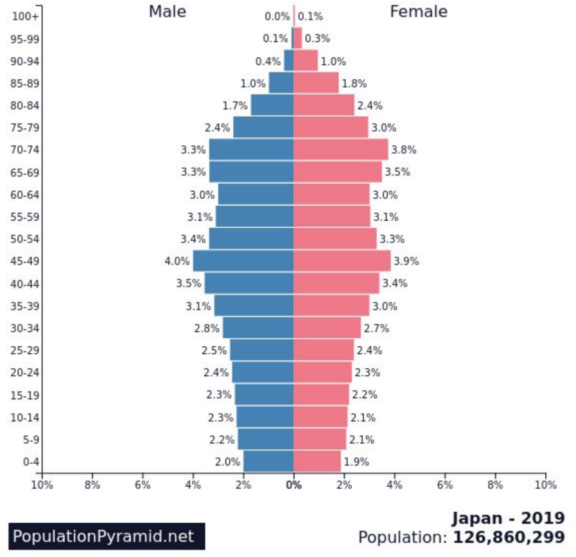
With the loss in aggregate demand and unfavourable demographics in many developed markets we certainly see deflation as being the overriding challenge ahead.

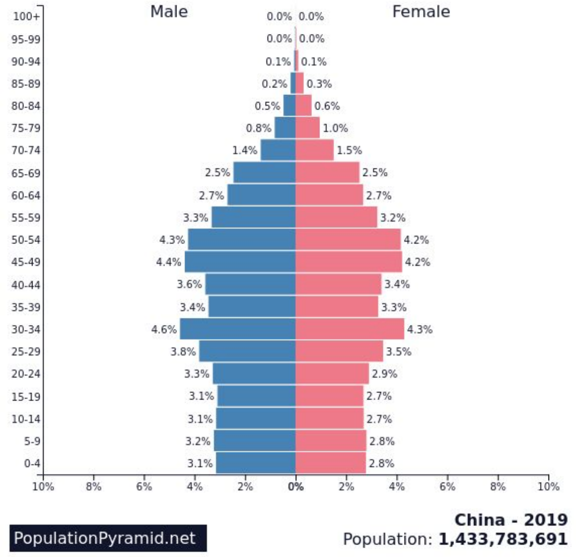
The pensions system and the underfunding of it, are a very troublesome issue that will take a huge amount of “money” to solve. The developed world has some structural issues that will challenge governments moving forward and we need to understand the bigger picture in order to make better informed investment decisions.





The US in comparison to Western Europe has a slightly better demographic pyramid with fewer people reaching retirement age in the near future. Also they slightly more people in the younger age brackets moving up through the system. These are issues that need to be included into long term investment plans.





Japan has very few young people moving up through the system and may in the future need to redress their immigration policies in order to keep up their productivity. China on the other hand, has a large number of people that may be leaving the labour force over the next 10 to 15 years.

We hope that you have enjoyed our opening monthly Market Wrap. We wish that you have found it informative and perhaps educational and that it will bring value to your investment thought process.

If you are not on our list of recipients and would like to subscribe to "**The Market Wrap**" please contact us at info@toiip.com for details.

Once again thank you for your time and see you again next month.

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