## E = mc²

*'When a man sits with a pretty girl for an hour, it seems like a minute. But let him sit on a hot stove for a minute – and it's longer than any hour. That's relativity.'*
*Albert Einstein*

*'What the caterpillar calls the end, the rest of the world calls a butterfly.'*
*Lao-Tzu*

*'In heaven, an angel is no one in particular.'*
*George Bernard Shaw*

Between February 19th and March 23rd of this year, the MSCI World Index lost over a third of its value. What has followed must rank as the most extraordinary recovery on record, leaving the index up over 10% overall for 2020, with the traditionally buoyant December still to come. Here is to hoping that investors have been good this year.

The meteoric rise of risk assets at a time when fundamentals have seldom looked more dire over the short term has caused yet another existential crisis amongst those finance professionals, and there are still a few, that rely on 'old fashioned' fundamental analysis to formulate their view of the world. They would question whether, even with what is highly positive yet fairly early stage vaccine news, the underlying economic fundamentals justify a rise in global equities that at the time of writing leaves them 7% above their previous all time high.

**What is going on?**

The chemist Antoine Lavoisier in 1789 discovered that in any chemical reaction mass is neither created nor destroyed; atoms themselves just move through chemical compounds in cycles. This same logic can be applied to the financial world. If one assumes that the mass of assets in total remains fairly constant (in the absence of productivity growth), and perceived value flows seamlessly between the different assets that make up that total mass, then the fact that value is looked at through the prism of fiat currency – 'how many dollars does it cost me to buy asset X?' – means that as the amount of dollars in the system is increased, those assets will cost more dollars to balance the equation; asset prices goes up.

This is the basis of monetary theory; inflation is seen in terms of how much the growth in the money supply exceeds the growth in the real level of GDP, in other words whether more money is being created to chase a fairly fixed, or at least slow and linearly growing, amount of things.

**Money Supply Matters**

The world finds itself in an unprecedented environment of ultra-loose monetary policy. Central banks are printing more money, at a faster pace, than ever before. The adoption of Modern Monetary Theory in the CARES act, under which the US Federal Reserve monetised $2.2trn of fiscal spending, means the printing presses are remaining firmly open for the foreseeable future, and possibly into perpetuity. This past week Jerome Powell called on the US Government to increase fiscal spending dramatically.  MMT is here, it just passed through congress under the political cover of a pandemic.

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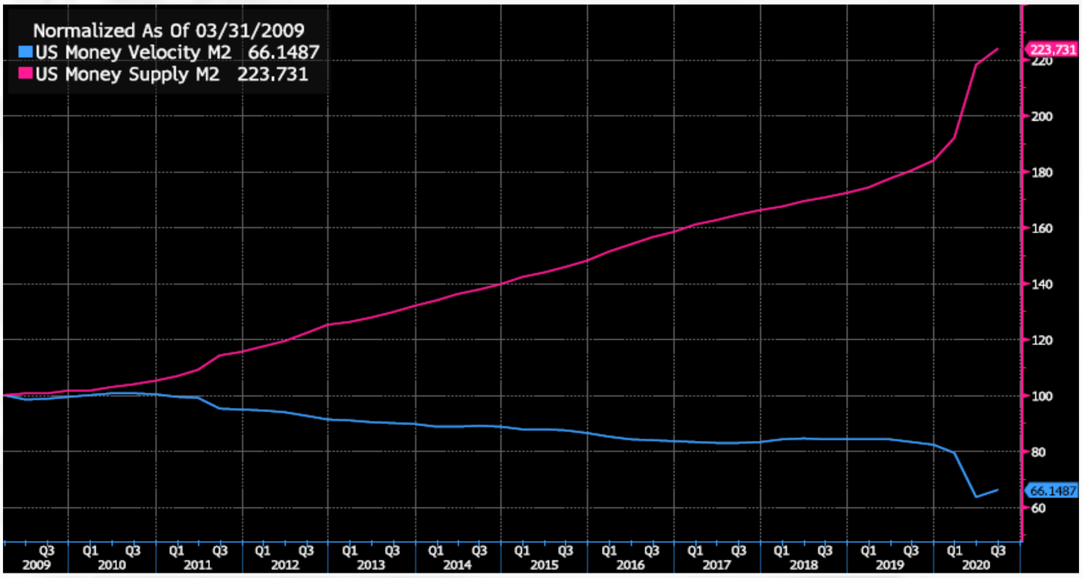


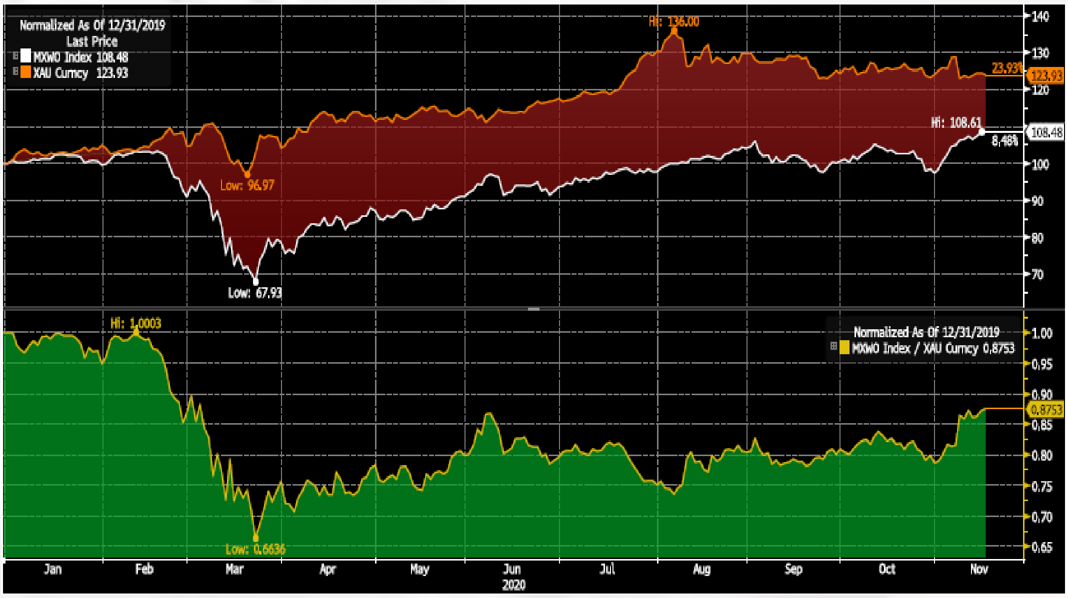

*Source: Bloomberg*

Just how great the increase in US money supply has been post-GFC is illustrated above. The accompanying decrease in money velocity (how often those dollars are circulating around the system) goes a long way to explaining why CPI has not risen; the money is stuck on Wall St and has not found its way to Main St. However, in order to balance the equation, dollar inflation must be expressing itself somewhere. And it is; on Wall St, in asset prices:


*Source: Bloomberg*

Rather than thinking in terms of 'how many dollars does it cost me to buy asset X?', but instead 'how many dollars can I buy with asset X?', it becomes far more reasonable, when considering the incredible central bank action to make dollars less scarce, that equity has risen to the levels it has. But the crucial thing to appreciate is that this is specifically relative to dollars.

Looking at the 2020 return of the MSCI World in terms of a currency which has finite supply, gold, paints a different picture of how the market has fared this year:




*Source: Bloomberg*

Priced in gold, the MSCI World is down over 10% YTD, and back to the same level it was in the mid 1990s. The narrative around stockmarkets being at all time highs completely depends on what they are being measured against, it is all relative. Looking at a newer perceived finite store of value in Bitcoin (21 million can be mined in total), the MSCI has plummeted:


*Source: Bloomberg*

The fact that the global stockmarket index is at a record high against the dollar therefore says as much about the dollar as it does about the perceived prospects of the underlying companies. And the dramatic increase in the likes of gold and digital currency that have been seen this year are undoubtedly in part an expression of investors' views on fiat currency as an attractive store of value moving forward. Tell a citizen of Venezuela, Russia, Brazil etc that gold is an ineffective inflation hedge. The dollar has simply not been there in terms of debasement, yet.

**What now?**

The pandemic, and the fiscal and monetary reaction to it, could well mean that the Rubicon has now been crossed. Further money printing, coordinated with increased fiscal spending, is set to characterise the next period of policy. Increased money supply means that a continuation of asset price inflation is likely. Add to this increased fiscal spend funnelling money into the real economy, alongside what Fed Vice Chair Richard Clarida calls ‘an enormous quantity of pent-up saving’, means that reopening is likely to bring about a rise in consumer spending, with the end result being the long awaited rise in CPI too. Fiat currency is likely to continue on its downward trajectory, that is the aim after all.

Despite the moniker of ‘long-only’, most multi asset portfolios are in fact, for the most part, long various asset classes and short fiat currency; one sells their dollars / pounds / euros to buy assets.

Therefore, holding the right types of equity, equity-linked investments, commodities, gold and alternatives may be no bad thing. ‘How many dollars will I be able to buy with the above assets?’ Likely more than now, the equation needs to be balanced. But, the ride will be a lot bumpier for some assets than others.

It is the bond market that should be giving real cause for concern, as here the investor is effectively long fiat currency. Real yields have never been lower and negative yielding debt has reached a record $17trn. ‘How many dollars will bond X buy me at maturity?’ the same number as when it was bought (credit risk aside) and, with yields and credit spreads being at record lows, the income on offer is minimal and the ride could get bumpy. What is more, those dollars at maturity could be worth a lot less than they are today.

It is all relative.



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