MAI VIEW

VOL. XVII, NO. XX www.macro-allocation.com MAY 10, 2017

Another Voice

"For last year's words belong to last year's language
And next year's words await another voice."

- T.S. Eliot, Four Quartets

This piece may provoke some to question their investment portfolios, others to question their life expectations, and still others to look for something lighter to read. Let's start here: Investment markets will soon become unreliable and the general perception of wealth will be turned on its head.

Markets & Wealth

We stopped using the term "capital markets" years ago, preferring the term "financial markets", which more accurately describes their practical function.[1] Identities matter greatly and it was a rhetorical distinction we could not ignore.

We bring this up because Warren Buffett observed this week that the largest US businesses no longer require capital. Unlike the largest industrial companies of yester-year, Apple Alphabet, Microsoft, Facebook et al. do not have to tap the markets for capital to sustain and grow their businesses with new plants, equipment and employees.

Mr. Buffett's acknowledgement was stunning. The godfather of value investing seems to believe the markets no longer form, price, or necessarily represent capital, which further implies their market values are ephemeral – priced only relatively and untethered to anything permanent.

We would agree. In a monetary system in which: 1) debtors use equity as collateral for their liabilities; 2) banks and bond investors use liabilities as assets, and; 3) money itself is a liability of central banks, the nature of capital (and capitalism) has become greatly distorted.

Accounting identities don't lie. Credit, which drives output growth, is a claim on money, not a claim on assets or production. For every unit of credit issued by banks and bondholders there is a unit of money owed. The rub is that there is four to ten times less money than credit in existence today, depending on how we count. In an economy where there is more credit than money, capital cannot be reconciled.

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[1] Merriam-Webster defines *capital* as relating to or being assets that add to the long-term net worth of a corporation, and *finance* as the system that includes the circulation of money, the granting of credit, the making of investments, and the provision of banking facilities.

In short, our assets and liabilities are not yet fully funded, and so their nominal values today are not their real (inflation-adjusted) values tomorrow.

Should irreconcilable balance sheets matter to investors? It depends on one's investment horizon and sense of how markets would be impacted by the necessary future decline in the purchasing power value (PPV) of the currencies in which their equity is denominated. If governments and banking systems want to remain central to the perception of wealth, then their currencies will have to be greatly diluted so creditors and debtors remain liquid and solvent.

Post-Modern Money

The post-modern global economy is digitized and increasingly non-sovereign. Programmable money and payment systems are making everything that can be tracked and bartered a potentially fungible unit of account between willing parties. The perception of value – for money, credit, assets and liabilities – is becoming indistinguishable from each other.

PayPal, Stripe, Amex, JP Morgan, Amazon and their competitors will soon warehouse digital savings and transfer fiat or crypto currencies, and assets like stocks, bonds and receivables, in exchange for goods and services. It will all be traceable and secure without the need for a centralized marketplace or authority.

Many of the dynamics we are observing today neatly tie into this trend, including the decreased influence of central bank policies on output growth, the increased interest in passive investing, and even the ability of insurgent politicians and referenda to upset established political institutions.

Interest rates within a reasonable range no longer determine credit availability, thanks to the market's principal need to produce assets that match liabilities – not to provide a positive real rate of return for investors. Equity valuation metrics, like price/earnings multiples, matter little to investors who have come to intuit that mere market participation is analogous to saving in a currency with a better future exchange rate than dollars, euro, yen, etc.

The advent and permanency of crypto currencies like Bitcoin, as well as its block chain technology that allows far superior bookkeeping capabilities than anything before it, further threaten established monetary and credit systems overseen by central authorities.

Fiat currencies are government-endorsed crypto currencies, but unlike Bitcoin, they are managed by centralized monetary authorities and governments with control over their pricing (interest rates), supply and even demand. People and businesses produce goods and services in exchange for whatever legal tender their taxing authority demands.

Liabilities denominated in a currency, like the US dollar, also generate demand for that currency. Ironically, the demand for US dollars and its foreign exchange rate relative to other fiat currencies are high because most global liabilities are denominated in them. This is ironic because there is nowhere near enough physical dollars and bank reserves (known as "base money") to repay dollar-denominated debt, which implies substantial future dilution and a falling exchange rate.

Unlike demand for fiat currencies to pay taxes, demand for certain currencies to service and repay debt may be amended by agreements between private sector counterparties. If I owe principal and interest on a mortgage to a bank or to shadow bank investors, they and I may choose to re-work the character of the obligation into any form in which we mutually agree. The technology already exists. (Could debt re-characterization be the next growth business on Wall Street? It would seem to logically follow the swaps market.) Broad interest and participation in fiat currencies should naturally fade over time.

The broadening out of direct counterparty exchanges to include currencies, assets and liabilities implies a high-tech global barter system. The expansion or restriction of fiat credit no longer determines overall economic liquidity for asset holders.

The dis-intermediation of money is already upon us and banking systems, monetary authorities and parliaments around the world are already losing influence. Institutions set up to manage bordered wealth and governing policies to protect and grow it are quickly becoming superfluous.

The perception of value and wealth will soon shift dramatically to better reflect human needs, wants and incentives. Maybe the timing of all this will be in line with driverless cars. Why not, the technology's already here?

Post-Modern Investing

How will the necessary PPV decline of fiat currencies and re-characterization of global debt affect wealth in general and fiat-denominated asset classes, sectors, industries and assets specifically?

This is a subject on which we have written volumes so we will not discuss it here. We will reiterate, however, that the principal investor objective today should be the pursuit of positive real (inflation-adjusted) returns in highly dynamic pricing environments. *As it stands, equity is perceived to be a better currency and store of value than fiat currencies banking systems manufacture and oversee. This flies in the face of historic valuation metrics discrete to the equity market*. Mr. Buffett seems to get this.

Preserving and creating wealth will be determined by how investors position portfolios comprised of fiat-denominated assets. There are two parts to this execution: 1) absorbing the impact of dynamic currency values on asset prices and 2) positioning specific assets that will prosper in absolute terms and outperform benchmark indexes in relative terms amid such currency volatility.

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