Investor’s Outlook

Quarterly edition of investment ideas from the research experts at Francis Investment Counsel

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Welcome to this quarter’s edition of Investor’s Outlook

The research team at Francis Investment Counsel is a busy group of investment professionals. The depth of our investment research, however, goes far beyond what is seen in quarterly reports and heard in meetings alone.

For this reason, we created the Investor’s Outlook. The vision of this quarterly newsletter is to climb up, zoom out, and provide a higher level view of investing trends, philosophies, and practices that formulate our investment discipline. It’s our goal to give you a deeper understanding of the capital markets, share research resources we find particularly useful, and to deliver to you a source of new ideas.

In this issue, you’ll read:

- **The Arrival of Modern Monetary Theory**

  Stephanie Kelton’s 2020 volume, “The Deficit Myth,” outlines the tenets of Modern Monetary Theory (MMT). We review economic history to appraise comparable efforts and consider an investor’s response to the potential ramifications of increased deficit spending.

- **Research Review**

  When Money Destroys Nations - How Hyperinflation Ruined Zimbabwe, How Ordinary People Survived, and Warnings for Nations that Print Money
  Authored by Philip Haslam with Russel Lamberti

  Discover lessons to be learned from the Zimbabwean government’s mismanagement and corruption, including the far-reaching impact of hyperinflation on Zimbabwe’s citizens.

- **Idea Generation for the Future**

  Technical analysis, studying charts and patterns, is an often overlooked component to an investment strategy. We take a moment to examine where it could be profitable.

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THE ARRIVAL OF MODERN MONETARY THEORY

The Arrival of Modern Monetary Theory

Famously known as the "dot.com" period in the 1990s, an impeccable combination of accommodative monetary policy and technological innovation produced U.S. GDP growth rates surpassing even those of the mid-1980s expansion. At its zenith, the new economy joy ride brought forth suggestions that the woes of economic cyclicality were possibly no more. Alas, the business cycle proved itself irrepressible and the slowdown hit big time. Moreover, ever since 2000 the U.S. has yet to achieve even one year of the higher GDP growth rates notched in the 1990s.

The economic underperformance of late versus those glory days from over 20-years ago has brought forward a host of policies to stimulate growth and address growing inequality. One such idea gaining interest in the conversation of economic egalitarianism is Modern Monetary Theory or MMT. Let's unpack MMT's tenets, look back at economic history to appraise comparable efforts, and consider the investor's response amidst an inflationary environment spurred by growing deficit spending.

What is MMT?

Economist Stephanie Kelton outlined the details in her 2020 volume, "The Deficit Myth." MMT seeks to empower elected officials with the fiscal tools to create an economy geared to help all people with the government taking the lead allocating resources. Like the U.S. government pouring its means into landing a man on the moon, MMT suggests that the same kind of determination can be harnessed to address broader challenges.

Sovereign entities – such as the United States, Japan, and Australia – are "currency creators" that MMT economists maintain can never go broke, ceteris paribus. Government budgeting can consequently move away from the traditional paradigm of pursuing a balanced budget, a virtue that MMT finds illusory. Plus, they note that several large scale government programs are already perpetually funded irrespective of identifying legitimate ways to pay for them.

If currency creators like the U.S. cannot go belly-up, these governments can and should aggressively deficit spend to stimulate economic fairness. Within the MMT model, deficits are not problematic so long as they don't fuel harmful levels of inflation. If an inflationary upswing needs some tamping down, progressive taxation or slowing down the pace of spending should be enough to do the trick.

MMT furthermore advocates enacting a federal jobs guarantee serving as an employment back stop when the private sector runs into trouble. This mechanism would also set a minimum wage for public sector employees that could serve as a baseline for employee remuneration across the entire economy.

"Within the MMT model, deficits are not problematic so long as they don't fuel harmful levels of inflation."

What can history teach us?

Though the phraseology sounds novel, MMT is simply financial engineering applied to the implementation of fiscal policy. The pages of economic history offer us the ability to conduct a learned critique of MMT because some of MMT's proposals have been implemented previously.

Weimar Germany, Zimbabwe, and Venezuela are some of the most notorious examples of unfettered government spending running afoul. Kelton is aware of them for sure, but dismisses the three catastrophes as almost being irrelevant in the discussion. She also highlighted Argentina's substantial employment and spending efforts to prop-up the economy from over 20-years ago but doesn't address the subsequent debt default in 2001 as the hoped for economic progress faltered.

A key principle of MMT is for the capacity of a country to function autonomously in order to deploy fiscal policy on a colossal, top-down basis. So perhaps the aforementioned economic calamities don't apply here because they were too dependent on other countries.

The Arrival of Modern Monetary Theory Continued

However, there was a state that had the necessary components favored by MMT: the Soviet Union or U.S.S.R (Union of Soviet Socialist Republics). Its currency was the ruble and everybody was given a job accompanied by wages or work credits to exchange for goods. When the economic archives could officially be studied following the downfall of the Soviet Union, the data showed ballooning deficit spending just prior to its demise in 1991. Maintaining autonomy wasn't a problem for decades as the Soviet state was absurdly resource rich, and the military built-up a stock pile of armaments to defend its borders.

Despite the Soviet's promising set-up, its economic fortunes continuously lagged the gains made in the United States from the 1940s onward. For example, by 1990 U.S. GDP per capita was just over $20,000 while Soviet per capita GDP amounted to around $5,000.[1] One historian noted:

> *"It [the Soviet Union] was a shortage economy, in which producers had little incentive to economise on inputs and constantly sought to employ more workers…This tended to generate excess consumer demand at established prices and therefore queues, shortages, unintended savings and black markets."* [2]

While the story of the Soviet economic expiry is widely available, there's no mention by Kelton about it in her book. When so much of the Soviet economic model mirrors the proposals of MMT, and was a currency creator that did go bankrupt, the advocates for such sweeping economic policy owe it to the world to explain why "it's different this time."

From the practical to the philosophical, take a few moments to reflect upon the concept of money. It's more important than you might at first think when evaluating the impact of MMT policies.

Governments that are too casual in creating and spending money expose their economies to more risks than otherwise. Money in due course ultimately represents a unit of wealth creation exchanged between two entities that are confident the transaction is mutually beneficial. The benefits come from increased utility be it an experience like a vacation or an investment into an asset that generates greater returns in the future.

The simplest way to assess the breakdown of the confidence in transacting is the emergence of higher inflation and the development of unsanctioned markets such as what transpired in the Soviet Union, Zimbabwe, and Venezuela. But there's another critical question to ask, why were there ever fewer goods produced in these economies?

If money is debased and no longer credibly represents the wealth created by its citizens, incentives to produce and innovate become casualties which eventually asphyxiates total economic output. MMT seemingly disregards this crucial role that money expresses amongst members of society. Should people lose confidence in the fiat currency so much so that it becomes worthless, citizens will abandon it in favor of something else that holds its value.[3]

Taking Action

Today, I suggest the U.S. has already embarked on an MMT-like path with respect to government spending. The tax-cuts in 2017 plus the fiscal stimulus deployed in response to COVID-19 have pushed the Federal budget deficit to 19% of U.S. GDP, the highest since World War II when it surpassed 25% of GDP. Regardless of your views, higher levels of government spending in combination with an economy about to go back to work full-time squarely points to higher inflation in the future.

Across the board, we hear a growing chorus of companies experiencing significant price increases for inputs such as a lumber, energy, chemicals and agricultural products. The charts for these commodities unmistakably confirm the anecdotes.

To position your portfolio for this higher growth, higher inflation environment, a 3-5% allocation to commodity-linked investments in a diversified manner is appropriate. There are other assets to keep in mind like Treasury Inflation-Protected Securities (TIPS) in your fixed income allocation (5-10%) and real estate. Your home, though illiquid, likely represents your largest inflation hedging asset. Making improvements to it, assuming you can find the skilled labor and materials for a fair price these days, plays into the theme of rising inflation. In terms of equities, emerging markets have historically performed very well for U.S. investors during runs of higher inflation. Our models call for all investors to have some EM exposure ranging from the conservative allocation at 2% to 10% for the more aggressive investor who has a longer-term time horizon.

Big picture, the discussions around MMT have once again raised the question as to how society can provide the daily necessities for the masses yet offer the opportunities to gain the rewards of laissez-faire capitalism. As that debate continues, another era of big government spending is upon us, the likes of which has not occurred relative to the size of our economy in decades. Investors know from history that such actions initially lead to reawakened growth and then higher levels of inflation following thereafter. Prepare accordingly.

The Arrival of Modern Monetary Theory Continued

Summary

- *Modern Monetary Theory or MMT has been popularized in discussions about economic egalitarianism. MMT suggests that a combination of both federal deficit spending and enacting a national job guarantee can position the economy favorably.*

- *Though the phraseology sounds novel, MMT is simply financial engineering applied to the implementation of governmental fiscal policy for spending and taxation.*

- *Historically, countries that embarked on an MMT-like approach have incurred difficulties in containing inflation and maintaining a suitable level of economic output.*

- *An era of big government spending is upon us, the likes of which has not occurred relative to the size of the U.S. economy in decades. Inflation-sensitive assets like commodities, TIPS, residential real estate and emerging market equities are suitable investments in the current environment.*

[1] *Philip Hanson, "The Rise and Fall of the Soviet Economy," p. 244.*
[2] *Hanson, p.88.*
[3] *See this quarter's Research Review,* "When Money Destroys Nations - How Hyperinflation Ruined Zimbabwe, How Ordinary People Survived, and Warnings for Nations that Print Money."

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RESEARCH REVIEW

WHEN MONEY DESTROYS NATIONS

When Money Destroys Nations

How Hyperinflation Ruined Zimbabwe, How Ordinary People Survived, and Warnings for Nations that Print Money

Authored by Philip Haslam with Russell Lamberti
Summary by Edward McIlveen, CFA

Philip Haslam and Russell Lamberti's 2015 volume details the dramatic hyperinflation that ravaged the Sub-Saharan African nation of Zimbabwe. Throughout their dissertation, the authors detail how the Zimbabwean government's mismanagement and corruption contributed to its economic capitulation in 2009.

Using traditional academic techniques, interviews from those that lived in Zimbabwe, and questions to stir the reader into a contemplative mindset, the authors create a virtual classroom experience by deploying the Socratic Method.[4] The aim of the material is not to merely think about the problems of Zimbabwe as being an isolated incident, but one that offers lessons warning of the destructive dangers associated with unscrupulous policy.

Several chapters contain a section titled "Think about It" with questions effectively moving the average reader's mentality from complacency to consummate paranoia. For example, Chapter 2 ("Storm Warnings") ends with the reader posed with the following: "If your government wanted to take your land and assets, what would you do?" Following Chapter 7 ("The Economics of Hunger") the authors ask: "Would you be able to kill an animal for food?" Chapter 8 ("Government Shutdown") raises this: "Do you have alternative options for water supply?" These questions are hypothetical for many. But the citizens of Zimbabwe – who never imagined their predicament in the first place – had to find solutions in order to preserve their savings and to obtain daily provisions via unconventional routes.

"At its culmination in 2008, the inflation rate in Zimbabwe ran at an annualized 89.7 sextillion percent."

Everyday life turned away from working and enjoying the fruits of labor to a frenetic plight for subsistence. Citizens faced shortages of all kinds and were forced into subverting an ever more onerous and oppressive set of governmental rules. The CEO of a manufacturing company stated that:

> *"Hyperinflation made everyone a criminal because you had to break the law to survive. We are a nation of law-breakers, forced on us by hyperinflation."*

The normal economic activity pursued to produce value added goods all but stopped with its participants switching over to obsessive hoarding, trading and speculating. The economy was producing less, and it was a scramble to get what one could.

At its culmination in 2008, the inflation rate in Zimbabwe ran at an annualized 89.7 sextillion percent. This is incomprehensible for us to grasp by numbers alone, so much so that the authors' shrewd staging to intertwine abstracts from those that endured the chaos tell the tale far better than merely looking at charts.

A Zimbabwean economic commentator also recognized how studying these mind-boggling numbers failed to convey the overarching power of inflation on the populace:

> *"Few people can understand hyperinflation without living through it. It isn't a dry topic to be studied by academics. It affected everyone. Even the taxi drivers in Zimbabwe could tell you about the details of hyperinflation."*

When the printing presses couldn't keep pace with the demand, the Reserve Bank of Zimbabwe (RBZ) just started adding zeros into the denominations. In quick fashion, the zeros grew unwieldy for merchants and customers in their commercial endeavors. The RBZ soon realized that all of the zeros were indeed a problem, and therefore started removing them in concert with putting expiration dates on newly issued currency. This made matters worse as the old notes without any expiration were still in circulation.

Despite the government mandate to utilize the increasingly debased fiat currency, the masses turned to unusual ways of conducting commerce that included an emphasis on real assets. Food, fuel, and foreign exchange formed the basis of the underground economy that helped locals procure tangible needs. Long-lasting canned food and raw agricultural commodities held their value. "Food boxes" emerged as a suitable wage for workers instead of paper money. Unofficially, petroleum coupons, U.S. dollars, toilet paper, cleaning equipment, whiskey, and pre-paid cell phone cards all replaced the currency printed by the central bank.

Similar to the hyperinflation collapse in Weimar Germany in the 1920s,[5] Zimbabwe underwent a decline of social values simultaneous to the near vertical increases in prices.[6] Though societal values shifted in ways that were detrimental (i.e. theft, bribery), several communities fashioned bartering networks to take care of each other. In some cases, as the problems grew in magnitude, the sense of resolve within the community to overcome it all rose as well. In fact, the authors included a chapter dedicated to the emergence of this phenomenon, "Strength in Community." Millions left Zimbabwe but for those that couldn't leave or chose to stay, it was noted that survival came down to the relationships contained in the community.

In wrapping-up, the authors contend there are a handful of lessons to be learned from those that have experienced the plague of inflation. For one, take heed that hyperinflation could materialize anywhere given the right mix of corrupt politicians and unfavorable global financial conditions. Keeping a healthy amount of suspicion over government actions is warranted, and even more so when the printing presses are fired-up to remedy a crisis. Second, prepping for worst-case scenarios should include being alert as to where your savings and property are invested and how protected they are from confiscation. And third, take the time now to cultivate relationships in your community as it would quickly emerge as your refuge in the event of a national emergency.

"Everyday life turned away from working and enjoying the fruits of labor to a frenetic plight for subsistence."

Summary

- *The Sub-Saharan African nation of Zimbabwe was ravaged by hyperinflation, which at its culmination in 2008 ran at an annualized rate of 89.7 sextillion percent. The plight of the millions impacted is retold in various ways here, often through quotes by everyday citizens that lived through the bedlam.*

- *Hyperinflation demolished confidence in the country's fiat currency where citizens eventually discarded it in favor of food, fuel, and foreign exchange to procure daily necessities.*

- *The lessons learned that the authors hold out include first recognizing that hyperinflation could materialize anywhere. Second, take measures to safeguard assets that could be subjected to confiscation and third, cultivate relationships in your community as it will quickly emerge as your refuge during a hyperinflationary episode*

[4] *The Socratic Method is a tool to engage a large group of students in a discussion, while using probing questions to get at the heart of any subject matter.*

[5] *See the Research Review of* "When Money Dies" *within the Investor's Outlook published by Francis Investment Counsel in January 2021.*

[6] *Ironically, the German and Zimbabwean inflation stories shared another commonality as both central banks engaged the same German minting company, Giesecke & Devrient, to source the higher grade paper needed for printing money galore.*

IDEA GENERATION FOR THE FUTURE

THE CHURCH OF TECHNICAL ANALYSIS

The Church of Technical Analysis

Early on in my career, I distinctly recall when it was explained to me that there were two ways of thinking when it came to investing.

The first one taught that the investor should focus on fundamental analysis. The exercise involves understanding the key economic drivers of a business model and making estimates about its future. Once the future is determined, the analyst formulates a valuation model to see if a stock is trading at a discount to an intrinsic value. If you find a sufficient margin of safety between the stock's current price and your longer-term estimate, go ahead and key-up a trade. If you're right, the stock price will eventually converge to your price target based on improving fundamentals.

As for the other method, technical analysis, I learned it's all about understanding price momentum, long-term and short-term trends, and incorporating rules of thumb around charts. With this scheme, one need not get into the minutiae of developing financial models for every single company as the behavior of the masses in buying/selling patterns provides enough information to alert you to opportunity or steer you away from a potential problem.

Which is better? The person that outlined both of these to me was a zealous follower of fundamental analysis and thought that pretty much anyone that used technical analysis as one of their investment tools to an extent was a total crack pot. Certainly, I wouldn't want to be one of those people, right? No, of course not.

Over the years, I've come to appreciate this matter can readily stir-up a fight amongst two people who would otherwise enjoy each other's company. The passion around these two schools of thought reminds me of how a good old fashioned argument over religion usually goes down: in the end, winning the argument is more highly prized than actually trying to win a convert.

After a while, I decided I needed to get more information about technical analysis just given intellectual curiosity. Besides, the charts always looked interesting, much like maps, as there's something captivating about them.

"In my view, using fundamental or technical analysis or a combination of both is perfectly fine."

In an attempt to take the potential edge off of the conversation, I jokingly referred to this endeavor with my friends in the industry by saying, "I've been attending a few services at the Church of Technical Analysis." Some people chuckle while the fundamentalists at heart seem at least a bit disarmed.

Where did I begin? I picked-up "Deemer on Technical Analysis." I recommend it. Written by Walter Deemer (2011), his experience is considerable having started at Merrill Lynch in 1963, spent some time at Putnam in the 1970s, left to start his own firm in the 1980s and retired in 2010. The volume is an easy read so don't worry about getting bogged down by jargon or a cumbersome amount of statistics. If that's what you are ultimately looking for, Deemer points you to other resources for those so inclined.

From the way Deemer sees it, technical analysis and fundamental analysis, in so far as they relate to the specific common stocks and to the stock market at large, can properly be regarded as complementary and, in fact, interdependent. The tendency of price trends to persist and of investor's behavioral patterns to recur enables the technical analyst to recognize…"extremes of investor psychology"…and "history never repeats itself exactly, but human behavior does." Technical analysis is one way to observe human behavior.

But can this be used to make money and give an edge to your portfolio? According to Deemer, a technical approach could have been employed to keep you out of market extremes. For instance, if you had been out of the market its 20 worst weeks and also missed out in its 20 best weeks from Jan 1, 1990 to May 20, 2011 (100 weeks) you would be up cumulatively 380% whereas a buy-n-hold investor would only be up 278%.

Idea Generation Continued

Deemer also offered this technical insight when it comes to stock picking, “So all you need to do at the beginning of the new bull market is to buy stocks making new all-time highs…any stock that generates well-above-average long-term relative strength at the beginning of a bull market is very likely to lead the entire bull market.”

There are two things you need to know to make this work: 1) identify the start of a new bull market, and 2) pinpoint which stocks are hitting their 52-week highs at that time.

On item one, Deemer notes that a new bull market can be linked to what he calls “breakaway momentum” or a “market breadth thrust.” Breakaway momentum occurs when 10-day total advances on the NYSE are greater than 1.97 times 10-day total NYSE declines. According to Deemer’s calculations, the last time this occurred was on June 3, 2020. You can find out when he’s identified a new bull market by going to his website: https://www.walterdeemer.com/bam.htm

As for the stocks hitting their 52-week highs, you can find them here: https://www.barchart.com/stocks/highs-lows.

Many brokerage accounts now offer substantial tools and screens to help you learn and deploy technical strategies. A word of caution: trading is so cheap nowadays that it’s easier than ever to get oneself into a mode of excessive trading. For that reason, make sure you set out your decision rules and put into place proper risk controls. If you don’t take time to learn and implement a discipline, the likelihood of inflicting damage to your hard earned savings goes up substantially.

In my view, using fundamental or technical analysis or a combination of both is perfectly fine provided you are disciplined and thoughtful in your strategy. How you are hard wired to accept risk and relate to different kinds of analysis will dictate what is best for you.

Finding an investment strategy that works in all market environments is illusive, but adding some technical analysis into your repertoire if you already haven’t done so provides some informative viewpoints worthy of consideration.

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