January, 2023

The New Paradigm of High Inflation, High Volatility, and High Risk

Dear Subscriber,

Positive News (re-send)

As announced in December, I am pleased to inform you of my appointment as **Member of the Investment Committee** at **36 South Capital,** the $2 billion AUM industry-leading investment manager with a 21-year track record specialized in global macro, volatility, and tail risk. I joined 36 South in **January 2023** at the firm´s headquarters in **London**, reporting directly to **Jerry Haworth**, CIO and Co-Founder of 36 South, where, in addition to my new responsibilities, I will remain dedicated and focused on the **UCITS offering**, namely **Quadriga Igneo UCITS** and **Quadriga Aqua UCITS,** together with **Alfonso Torres**, Senior Portfolio Manager.

My appointment is a positive development for both 36 South and Quadriga, as **36 South** expands its investment team and range of investment strategies it manages and advises, and **Quadriga** continues to host and support **Igneo and Aqua** within its **Luxembourg UCITS umbrella**. For the avoidance of doubt, there are no operational changes to any of the strategies, which remain available via the Quadriga platform and with the exact same terms and conditions. Current investors do NOT need to do anything. Prospective investors continue their due diligence as normal. Any questions or clarifications, please contact me directly anytime. Thank you!

1. Monthly Update Quadriga UCITS Strategies

Protected US Equity, Quadriga Aqua UCITS +8.6% Jan 23

The enclosed [Aqua UCITS Jan23 Factsheet] provides a detailed overview of the performance and positioning, including positions closed, restructured, added new insurance, and rebalanced across equities and insurance portfolios. The Protected US Equity Strategy combines the benefits of a core long 100% US Equities protected with a long-only Insurance Program where both components are rebalanced monthly to their neutral weights. The long only insurance has a target of 10% to 15% in **premium-at-risk** and is **managed pari-passu with Igneo UCITS.**

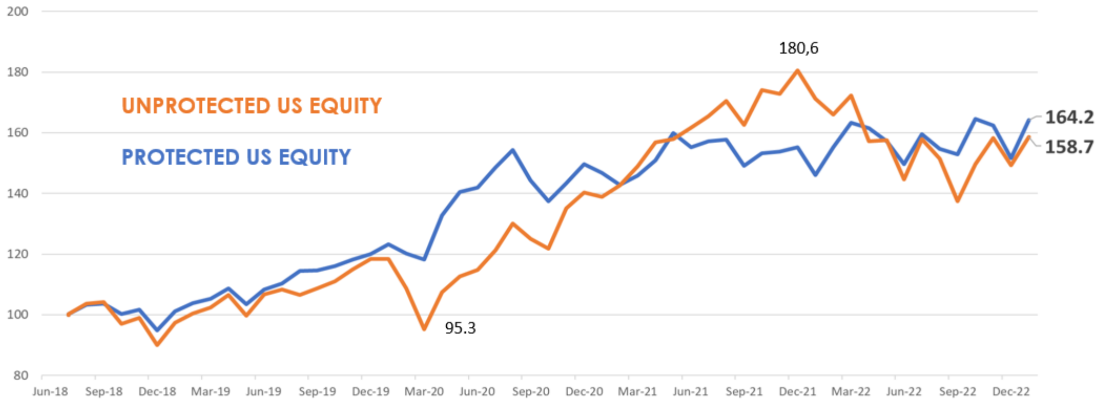
A switch from **Unprotected Equity to Protected Equity** is subject to a number of benefits and considerations, including:

- Switch from Unprotected to Protected Equity with **zero net cash flow** requirement.
- **Enhance protection** at expense of potential basis risk and underperformance during bullish equity markets.
- **Reduce volatility** and enhance risk adjusted returns (higher Sharpe and Sortino).
- **Reduce "noise"**. One line item, instead of two. Less emotions during extremes tend to produce better decisions.

- **Embrace hostile markets**. Buy cheap equities financed by profits on insurance.
- **Embrace complacent markets**. Buy cheap insurance financed by profits on equities.
- **Monthly Rebalancing**. Incremental Returns from Negative Correlation and Mean Reversion.
- **Attractive Entry**. Current valuations in US Equities and Insurance offer attractive entry for protected strategies like Aqua.
- **Seeding terms** class A USD **ISIN LU1871084460** a 1.5% management fee, 0% performance fee, daily liquidity at NAV.

As per the graph below, Protected US strategies can help simultaneously enhance absolute (+11.4% p.a. vs +10.6%) and risk-adjusted returns, both return per unit of average volatility (Sharpe 0.8 vs 0.5) and return per unit of "bad volatility" (Sortino 1.7 vs 0.9), whilst simultaneously enhancing capital preservation as Peak to Trough (-10.9% vs -23.9%).

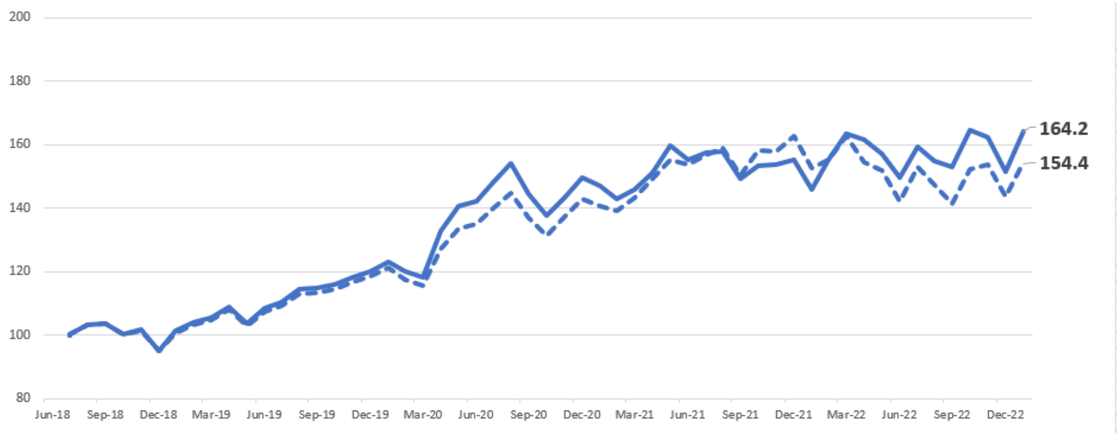
	Monthly (%)	YTD (%)	LTD (%)	LTD (% p.a.)	Vol (%)	Sharpe	Sortino	Peak Trough	NAV
SPX	6.3%	6.3%	58.7%	10.6%	19.4%	0.5	0.9	-23.9%	158.7
AQUA	8.3%	8.3%	64.2%	11.4%	14.6%	0.8	1.7	-10.9%	164.2
Difference	2.0%	2.0%	5.5%	0.8%	-4.8%	0.2	0.8	13.0%	5.5



Passive Basket vs Rebalanced Basket

Another major consideration is rebalancing, the mechanism that effectively behaves like a **good unemotional investor** and systematically accumulates cheap insurance during complacent markets (such as today) and systematically accumulates distressed assets during hostile markets (such as March 2020). Those investors managing the long equity and long insurance via separate legs tend to suffer from emotional distress and make the wrong decisions at the wrong time.

The following graph compares the performance of a passive basket (weighted average) with the rebalanced basket (incremental returns from monthly rebalancing), which effectively embraces and monetizes volatility and mean reversion. No crystal ball. No magic formula. Just unemotional systematic rebalancing, which in our view can be a valuable source of compounding and incremental returns in general, and during the high volatility regime we anticipate ahead.



Quadriga Igneo UCITS, -4.8% Jan23

The enclosed [Igneo UCITS Jan23 Factsheet] provides a detailed overview of the performance and positioning, including closed, restructured, and new positions. The **Total Premium at Risk** for Igneo was **21.5%** as of the end of January**, with diversified asset classes and underlyings** (cross-asset insurance, asset class agnostic), **diversified maturities** (from 1 month to 30 years, which combine directional and gamma in the short dates with rates and vega in the longer dates), **diversified pay-offs** (we favour vanilla long volatility insurance, but also monetize risk premia across the term-structure, volatility surface, and correlation matrix via exotic and hybrid options), and **diversified carry** (positive, neutral and negative), altogether designed to generate **negatively correlated alpha** during **hostile and volatile** markets, as we have consistently done since launch (+12.7% 4Q18, +16.5% Aug19, +42.5% 1Q20, or +22.2% Feb22, amongst others) and the hostile markets we anticipate ahead of us.

2. Real Conversation with Hedgeye Keith McCullough

Please find enclosed the link to my Real Conversation with Hedgeye Keith McCullough yesterday, Mon 6th Feb 2023, that complements and expand the analysis discussed further below, including some interesting topics such as

- The new paradigm of "**high inflation, high volatility and high risk**". The next decade will be very different from the previous decade.
- Why Central Banks are **trapped between bubbles and inflation**, both their creation.
- Why **Central Banks will print more, not less**, as they will forced to intervene to contain credit bubble collapse created by higher rates.
- **Yield Curve Control** is the mechanism that **transforms credit bubbles into inflation**. Watch out for Japan.
- The "**Frogs in boiling Water**" analogy. Implications for global markets and portfolio construction.
- How Currency wars has shifted from "beggar thy neighbour" to "**export inflation**" and thus why stronger USD is a wrecking ball for global.

- How the investment game has 3 levels: 1) nominal returns, 2) **real returns**, 3) real returns after taxes. We are now decisively in level 2.
- Why **China a credit time bomb**, likely to eventually implode via weaker CNH. Watch out for HKD peg.
- Energy subsidies another example how Governments don't solve problems, simply **delay, transfer, transform, and enlarge problems**.
- Why **Geopolitical risks remain high**. Mind the tail risk from miscalculation and nuclear escalation in Russia / Ukraine.

3. The Anti-Bubble Report: The New Paradigm of High Volatility, High Inflation, and High Risk

As discussed in previous updates and the Real Conversation with Keith, we believe we have entered a **New Paradigm of High Volatility, High Inflation, and High Risk** that will dominate global markets for the foreseeable future. Our view is supported by our long-term **Strategic Macro** analysis presented later in the report, which is complemented by our short-term **Tactical Macro** analysis (what's new? what's changed?) that reviews the latest developments and new or emerging narratives driving the markets since the previous update.

3.1. Tactical Macro: What's new? What's changed?

From "Hard Landing" to "Soft Landing" to "No Recession"...

Market data was very strong into month end, both employment and ISM, which according to some analysts is dramatically reducing the risk of recession and has shifted the previous narrative and debate of "hard vs soft landing" to a much more complacent "soft landing vs no recession at all". Goldman Sachs has recently brought down the probability of recession to 25% vs consensus 65%, but continue to believe they are on a "narrow path towards soft landing". Their constructive stance is based on inflation easing both on the wages (private sector employment wag growth down to 4% from 5-5.5%) and prices (GS analysis expecting CPI down to 3% by end 2024). We believe the Terminal Rate is linked to the fate and path of equity and credit markets. The higher the equity and credit markets are likely to bring higher terminal rates, and a major sell-off is likely to pause and reverse the hikes and bring rates lower.

One possible explanation for the current confusion and reversal in the markets is the fact that we are judging growth using our "level 1" (nominal) brain, conveniently ignoring that much of the growth may be inflation induced and in real real terms (not using official inflation, but rather the actual loss of power we are suffering) growth is negative in real terms. One way or another, the Central Banks are gaining time and have for now successfully regained control by re-anchoring long term inflation expectations and keeping some of the frogs in the boiling monetary broth.

From "Monetary Divergence" to "Monetary Differentiation"

Monetary divergence, a key driver for the USD strength and outperformance during most part of 2022, partially reversed towards year-end due to a combination of a more dovish Fed and more hawkish ECB, BOJ, and EM FX. The ECB has stepped up its rhetoric to fight inflation and surprised the market in Dec with a more hawkish tone than expected, with a combination of 1) more hawkish forward guidance and 2) a larger and sooner QT program, with a new base case that for further 50bp hike in March, and respected analysts revising their terminal rate to 3.25% On QT, the indicated the start of APP unwind in March 2023 with declines of 15 billion/month in Q2 and expectations of subsequently increases to 20 billion/month in Q3 and 25 billion/month in Q4, to a total estimated run-off for 2023 at around 134bn. As a result, net duration supply in 2023 is estimated to be significantly higher than any other time in the last 12 years which is consistent with yields drifting higher for the Bund and posing a real risk to Italian BTPs and other Governments that were vulnerable already. Overall, we remain bullish USD and believe we are at "**the end of the beginning**" rather than the "beginning of the end".

Inversion of the Yield Curve: Recession vs Goldie Locks

The Bond market is pricing lower long-term rates than short-term rates. As of mid-Dec, 2y US Treasuries are at 4.70% (at 14-year high) with 10y UST around 3.60%, resulting in **the most inverted US 2s10s since the early 1980s**. The Bond market tends to be a much more reliable indicator of recessions that equity markets. Two main interpretations on the inversion. On the bearish side, the markets expects weakness in risk assets that will force the Fed to unwind some of the hikes. On the bullish side, which seems to dominate at the moment, the Bond market is telling us that inflation will ease and the Central Bank will be able to take the foot off the breaks, which has supported the "goldilocks" rally in Jan. The bullishness from the China re-opening that was a catalyst for the initial strength is however quite inflationary and in our view contradictory to the scenario of "free growth without inflation".

Bank of Japan: The End of YCC?

During the month of December, the Bank of Japan, BOJ, surprised the market by opening the door to a major change in monetary policy that could result in **the removal of Yield Curve Control**. BoJ said that the move is "designed to enhance the sustainability of monetary easing, as market functioning had worsened recently". The 10y yield range expanded to ±50bp, whilst at the same time **BOJ increased JGB purchase size massively across the curve** (including the long-end), in what seems like a move from YCC to traditional QE, which in our view is a step in the right direction but perhaps too little and too late and Japan has built levels of debt that in our view are unsustainable in a high yield environment such as the USD or even the EUR.

The short-term reaction in the FX market has been very notable, with a much stronger Yen, USDJPY trading below 130, a major reversal vs the 150 levels seen earlier in the year. The large reversal is consistent with the narrowing of the interest rate differentials and the positive deflationary impact via a stronger JPY, but in our view, it is not necessarily sustainable in the longer term as we expect Japan to face **credit distress from higher yields that will eventually result in more, not less, printing** and possibly the re-introduction of YCC, albeit at a higher level of nominal yields, more in line with what we expect in Europe.

Our long-dated insurance via USDJPY options that we have accumulated offers in our view very attractive asymmetric risk-reward as we are effectively long 30-year UST, short 30-year JGB, long 30-year USDJPY Vega, long USDJPY skew, and long USDJPY delta, all of which in our view can perform strongly in the event of a deterioration of the credit markets in Japan, as we believe will be the case.

Looking ahead, the BOJ will appoint a new governor early Feb. We wish him the very best of luck. He will need it.

China Re-Opening faster than anticipated

China reopening much faster than expected, with cases and fatality falling sharply and most people have already been infected. The China reopening trade has resulted in a major shift in investor positioning and flows. As of writing, China second phase, what some analysts described as a "reality check", where the market will focus on how quickly and how much Chinese activity can recover, has surprised many participants with faster recovery than anticipated, with high-frequency domestic travel data suggests bottoming out of activities in major cities. Property transactions are “very weak”, but seasonality is weak anyhow, so hard to reach much into it. Chinese equities continued to rally on growth recovery expectations and bearish position unwind, but the foundation for a sustained rally is missing. Our long-term view remains unchanged and believe the **CNH** and **HKD** could devalue significantly vs USD over the medium term. More on this later below.

The Chinese re-opening is likely to be a key swing factor in commodity markets, and in particular could push crude oil back into deficit in 2H23, which could bring crude oil prices back above $100/bbl fuelled by monetary supply growth vs physical scarcity and bottlenecks.

Weak Growth now. Weak Earnings ahead

The strong start to equity returns in 2023 has pushed absolute and relative equity valuations to even more inflated levels. Looking forward, we believe earnings expectations are too optimistic and are yet to correct lower. In other words, **so far we have seen a correction of the “P” in the P/E ratio and now comes the time of the “E”**. According to Goldman Sachs research, assuming no change in expected revenues, the margin compression due to higher commodity prices would reduce the median stock's expected 2023 EPS growth from +10% to 0%. Not good news for equity valuations.

Equity analysts expect S&P 500 earnings to grow by about 10% YoY in Q4 and next year despite the slow-down in economic activity, as they expect a “soft landing” and the ability for corporates to pass inflation through to consumers. We disagree with the market consensus and see major risks to earnings and margins, which will have an impact on valuations.

Higher borrowing costs: Watch out for leveraged players

Rising interest rates mean higher borrowing costs, which will likely continue to pose a headwind for net corporate profits, even if S&P 500 companies generally have strong balance sheets and long-maturity, fixed-rate debt, rising interest rates will nonetheless put upward pressure on borrowing costs.

Fixed Income performance during 2022 experienced one of the worst drawdowns in recent history. The massive sell-off has been driven by panic hiking and complacent expectations, which are resulting in a massive widening of government and corporate credit spreads. Looking forward, **we believe nominal yields are capped by excessive debt** and current levels offer a good entry point for duration plays such as long-dated US Treasuries, which can generate significant gains in absolute terms and offer negatively correlated alpha to equities. Our preferred implantation is via long-dated options which cap the maximum loss to the premium spent and offer potential appreciation both via rates and vega.

How about Housing?

By hiking interest rates aggressively to combat inflation, Central Banks are adding pressure to the housing market, one of the primary sources of wealth effect following massive increases over the past few years. 30-year Mortgages broke 7%, a massive level that is likely to put pressure on the market via lower sales and prices. Whilst the path will be very volatile, and possibly much lower short term, my personal long-term view on housing is constructive LONG TERM, as I believe we are headed into a long period of deeply negative real rates, which favour real assets.

How about Volatility and the VIX?

Investors that were hoping/expecting/positioned for the VIX to protect them against the equity drawdown risk suffered a double whammy in 2022. The "slow motion" crash of the markets has resulted in poor performance of the VIX, trading back below 20% (!). Current levels of implied volatility are consistent with daily break-evens in the SPX is around 1.25%, which seems low in our view vs realized price action and in our view does not capture the true risk in the current markets. The other major consideration when trading the VIX is the **negative risk premia** from the contango in the term structure of the futures and the steep call skew in the VIX options. We are currently positioned via call spreads in Dec which offer 20x risk-reward.

3.2. Strategic Macro: The New Paradigm of High Volatility, High Inflation, and High Risk

The following section presents the Anti-Bubble contrarian investment thesis and framework, the "big picture" of global macro, which includes new and updated analysis posted in previous newsletters that remains highly relevant, in our view.

Monetary and Fiscal Policies without limits do NOT solve problems

We believe **Monetary and Fiscal Policies Without Limits do NOT solve problems**, but simply **1) delay, 2) transfer, 3) transform** and **4) enlarge problems.**

1) Delay problems via spending and debt. "Kick the can down the road". A generational trade-off that benefits the current generation and the expense of future generations.

2) Transfer problems via Currency and Trade Wars. Monetary policy is often portrayed as "domestic policy" but has played a key role in "foreign policy". **"Beggar thy neighbour"** is the most common form of currency wars, whereby competitive devaluations that seek to attract investment, employment, and technology at the expense of inflation and bubbles. Other wars defend themselves and why I argue that **"Trade Wars are the mirror image of Currency Wars"**. as Governments defend themselves via "if you devalue by 20%, I will tariff you by 20%", a dynamic that in our view is only going to get worse as Globalization unwinds towards the current trend of bi-polarization.

Export Inflation. Unlike previous crises, where Currency Wars have taken the form of "beggar thy neighbour", this current inflation crisis could result in a period of more prolonged USD strength as effectively works as a tool to export inflation. Put differently, Europe and Japan are suffering the double whammy of higher commodity prices and higher USD. A credit crisis could result in lower USD rates, as discussed before, but would have a two-way force on the currency, thus why the USD could remain stronger for longer.

3) Transform problems into Inflation and Inequality. Let´s not fool ourselves. Reckless and negligent monetary policies without limits are the primary reason for inflation. There are deflationary forces in the system (technology, demographics, overcapacity, etc) but these have been more than offset by money printing, creating an illusion of financial stability. There are also bottlenecks in the supply chains and investments that have contributed to shortages and price increases, many of which are more structural and persistent than the Governments and Central Banks have made us believe, but the fundamental reason for inflation (loss of purchase power of money) is and has always been, monetary. Inflation creates inequality between the "haves and have-nots", which in turn leads to social unrest, populism, geopolitical conflicts, and worse. The Covid crisis was a game-changer as the money printing was put directly into the consumer´s pockets (instead of the banks' balance sheets via QE), showing the close link between monetary and fiscal ("the left pocket lends the right pocket").

Historia Magistra Vitae and those who chose to ignore it are doomed to make the same mistakes as our predecessors. Really sad and infuriating, especially since those who suffer inequality are not aware of who is causing it and are to blame: Central Banks.

4) Enlarge problems via Bubbles Too-Big-To-Fail and Stagflation, or worse. It is very simple: artificially-low interest rates create artificially high valuations. At 0% nominal interest rates, the Present Value of $100 cash flow in 1 year, 10 years, 100 years or 1000 years is $100. No wonder all assets that are valued via discounted cash flow models have greatly benefited from the "duration" impact of artificially-low interest rates. The Wealth Effect (which I define as the illusion of wealth created by unrealized gains that cannot be realized) creates a virtuous reflexive cycle (fundamentals impact prices and prices impact fundamentals) on the way up, but a vicious reflexive cycle on the way down. We believe the normalization of monetary policy is "science fiction" as the burst of the debt and equity bubbles would create systemic havoc and thus why we believe Central Banks are trapped between inflation and bubbles and will invariably be forced to let inflation go in order to protect the bubbles.

The Frogs in Boiling Water: Inflation vs Inflation Expectations

I believe we are all frogs in a monetary broth that has been steadily heated via money printing and debt. The boiling frog refers to the well-known apologue describing a frog being slowly boiled alive. The premise is that if a frog is put suddenly into boiling water, it will jump out, but if the frog is put in tepid water which is then brought to a boil slowly, it will not perceive the danger and will be cooked to death. Now change the rising water temperature with rising inflation.

Who is heating the water? Central Banks and Governments fuel the misconception that Monetary and Fiscal policies without limits can solve problems. They don´t. They incentivize and reward debt and artificial valuations, which can only be sustained via ever-increasing money printing and debt, which they hope to dilute via inflation whilst boiling the frogs to death via inequality, taxes, and whatever it takes.

How much heat is applied? For decades, Central Banks made us believe that the heating rate was capped at a "negligible" 2% per annum, which many complacent frogs accepted and stayed in the broth of fixed income, credit, and cash. Central Banks, taking advantage of "exceptional circumstances" and the complacency of frogs, decided to remove the 2% heating cap, increase the fire, and overheat the water under the narrative of "transient/temporary heating rates" that resulted in the accelerated loss of health/wealth. Quantitative Easing/Heating in the US was printing $120b per month, every month. Yield Curve Control in Japan is applying "whatever it takes" to keep the 10-year JGB at 0.10%. This month was historic, as for the first time since the introduction of YCC the BOJ was forced to intervene at 0.25% nominal yield to try to control the temperature/yield.

How fast is the water temperature rising? Important to note that inflation is subject to base effects, meaning the x% inflation is applied to a higher base, and therefore subject to compounding. Compounding at lower rates may seem negligible but adds up. As Einstein once said, "compounding is the most powerful force in the universe". Compounding at higher rates is exponential and can lead to the loss of purchase power very quickly, effectively boiling the frogs to death.

Why do frogs jump out? Inflation expectations. Frogs jump because they 1) notice a large increase in current temperatures, and 2) expect temperatures to increase notably. It is therefore not so much the past heating but more about the current and forward-looking heating that may get the frogs to jump. Since Central Banks need the frogs to stay in the water, and frogs will reach mainly inflation expectations, it is therefore clear that Central Banks' current actions (to increase interest rates and reduce liquidity/heating) are aimed at re-setting inflation expectations. The question is whether the interest rates will be enough to 1) control inflation and 2) prevent the frogs from jumping.

Why do some frogs never jump out? Benchmarks. Many frogs stay in the water despite the obvious rise in temperature because they are literally tied to the bowl with handcuffs called Benchmarks. To our surprise/horror, we are witnessing many institutional investors continue to hold disproportionately large amounts of fixed income and credit for two main reasons 1) they are still playing the game in nominal terms, by the rules of Level 1, and 2) even if they know/believe/agree we may already be in level 2, they can´t change their behaviour because of restrictions imposed by the Prospectus, Mandate, and/or Board, which are not easy to change. Sadly, in our view, those investors are the ones who are and will finance the "monetary party" that continues to dominate global markets. Some investors are able to adjust their holdings and effectively "underweight" (long position, but lower than benchmark) which I compare to "taking 4 cyanide pills instead of 5 prescribed by the Board". Not a great idea, in my view.

Where do frogs jump? During a meeting last week, I was asked this question which made me think of the joke of the guy who wins a trip for two people to the Caribbean. "Who would you like to take along with you"? the presenter asks. "Option A is your wife", to which the guy quickly responds "B, please, B". Something similar happens with very high levels of inflation where, bad jokes apart, investors may be willing to jump from the boiling broth into other frying pans, such as equities, or colder surfaces, such as gold or real estate or other long-biased inflation alternatives.

What happens when frogs jump out? When we, frogs, decide to jump out of credit and fixed income, yields go up, which put pressure on those heavily indebted, which poses a risk to the credit and equity market and in our view will force Central Banks to print more money and buy the debt to prevent the collapse. As a result, we challenge the common belief that "long-term yields go up because short-term rates go up" and hold the contrarian belief that "long-term yields go up because short-term rates do NOT go up". That is, by keeping short-term rates "too low for too long" Central Banks have fueled inflation that cannot be controlled and that forces the frogs to jump out. During low inflation, Central

Banks are in control. During high inflation, Central Banks lose control. And thus why the Central Banks are forced to act now, even if they expose the bubbles and may need to unwind the hikes later.

The New Paradigm: Real Returns vs Nominal Returns

If Investing were a video game, it would have 3 levels.

Level 1: Nominal Returns

The goal was to protect the capital and turn $100 into more than $100. Over the past few decades, the Developed World has been playing the investment game at Level 1, where **inflation was perceived to be negligible**. Not anymore.

The 2% official inflation target was 1) low enough that most investors neglect it, 2) high enough that over 10 years it would dilute our purchase power by 20% + compounding and over 20 years by 40% + compounding. A huge theft, especially at my age, 48 years old, when I can conclude that "20 years is not what it used to be".

As discussed before, we are all frogs living in a monetary broth that has been steadily heated via money printing and debt whereby: i) official Inflation gives the illusion that inflation is one single universal number. It is not, ii) official Inflation is conveniently manipulated with a strong bias towards underestimation, and iii) the Loss of Purchase Power is at least twice Official Inflation, in our view. The weight of housing in the European index is for example 7% of the index, substantially lower than other parts of the world and the real impact on our cost of living.

Level 1 rewards savers via positive real yields, thus why fixed income, credit, and cash have played an important role in asset allocation and portfolio construction.

Level 2: Real Returns: Protect Purchase Power, not just Capital

Investors must focus on generating returns above *their* rate of inflation (which is different from official inflation)**.** In Level 2 inflation is no longer negligible. In fact, when inflation is substantially higher than nominal rates, as is the case across most Developed Markets today, inflation becomes a critical component of investment decisions. The situation is aggravated by artificially low levels of nominal interest rates, as is the case today in the US or Europe, with nominal rates around 0% and inflation around 8%, levels not seen in decades.

Emerging Markets investors have been playing in level 2 for most of their lives and therefore have a big advantage over those who have not experienced extreme levels of inflation and/or currency devaluation.

Level 2 penalizes savers via negative real yields, and thus why the role of fixed income, credit, and cash dramatically changes from big winners to big losers during high persistent inflation environments, with and without nominal rate hikes.

Level 3: Real Returns after Taxes

axes have always been an important component of our lives. As Mark Twain once said, “there are two certain things in life: death and taxes”. The reason why taxes feature as a new higher level is because, whilst they are high already, they will likely to get much worse on a global scale, especially **wealth taxes** and their derivatives like inheritance tax, mansion tax, etc. Ironically, taxes are the way in which Governments and Central Banks square the circle. As discussed in the following section, monetary and fiscal policies without limits do not solve problems, but rather they delay, transfer, transform, and enlarge them, whereby the inflation we suffer in level 2 creates inequality and bubbles that make the rich richer and the poor poorer, whereas the ever-increasing taxes from level 3 try to address inequality by applying taxes to the inflated assets their policies created on the first place, so there is nowhere to hide.

Level 3 incentivizes spending. How much of our wealth will be passed on to our children in a world of ever-increasing taxes? Who knows, but they better don’t count on it as they may never get it.

Official Inflation vs Real Inflation: Introducing "Real Real Rates"

In our view, **Official Inflation is not a fair reflection of the Real Inflation** that we, consumers, investors, or savers, experience. This is a very important concept because it drives our behaviour, and thus why I think it is important to differentiate between:

1) Official Inflation, such as CPI. Governments conveniently use and abuse official inflation baskets as if "inflation was a single absolute number, the same for everyone” which is obviously not the case. These baskets are conveniently manipulated and, in our view, dramatically underestimate the loss of purchase power that we, consumers and investors, experience. Moreover, Official inflation such as CPI is used as a reference across many labour contracts and may give the impression that employees are fully protected against rising inflation when the protection is partial and exposed to negative compounding, which is extremely damaging, particularly during periods of high inflation.

2) Break-Even Inflation. Derived from Nominal US Treasuries and Inflation-Protected Treasuries "TIPS", and therefore not subject to a conveniently chosen basket. Break-even inflation is harder to manipulate since there is no index, but in our view is still massively underrepresenting the real inflation most of us face. The problem, in my view, is that the Inflation Break-even reflects some kind of "institutional inflation", somewhat similar to LIBOR, which represents some kind of “institutional borrowing rates”. So, just like private borrowers reference their loans to LIBOR + x%, private savers should reference their inflation at Break-Even + y%, where the y% spread can be very large.

3) Real Inflation, Defined as the true loss of purchase power we suffer in our pockets. Mindful that each person may have its own unique inflation basket, we believe as a proxy “guestimate” that Real Inflation is at least twice Official Inflation. Based on our view that 1) Nominal Rates will increase, but not much, and 2) Real Inflation is likely to remain very high.

Thus, I believe "**Real Real Rates**" (Nominal Rates minus Real Inflation) are likely to remain deeply negative for the foreseeable future.

Inequality, Strikes, Social Unrest, Civil Wars, …

We know from history that inflationary crises put enormous pressure on food, energy and the cost of living in general, which is likely to result in labour strikes at best and possibly riots/civil wars at worst. Whilst I believe inflation is largely a monetary phenomenon (inflation is not about asset values going up but about the value of money going down), we are currently experiencing additional externalities, such as the Russia-Ukraine war that if not resolved will continue to add massive pressure on inflation, inequality and its nasty derivatives.

The End Game: Stagflation

Should the recession materialize into something bigger, and systemic, as we fear could be the case, there is a non-negligible probability that we may see zero nominal rates, QE, and even Yield Curve Control "YCC" in response to distressed global markets. Faced with systemic collapse and inflation, Central Banks will always choose inflation.

False Diversification = Hidden Leverage

As discussed in a previous newsletter, **"Chronicle of a Crisis Foretold"**, hostile markets tend to follow mechanical processes where 1) **volatility** explodes higher, 2) **correlations** polarize to plus one or minus one, and 3) **liquidity** dries out, which altogether result in exponentially higher value-at-risk (V@R) and mechanical processes of **forced liquidation** and **deleveraging** that expose the **hidden leverage** in the portfolios (investors had more risk than they thought or wanted) as has been the case during all hostile markets.

These mechanical processes are both a risk and an opportunity.
- A risk via hidden leverage and **false diversification**, whereby investors confuse "portfolios with many things with diversified portfolios".
- An opportunity to accumulate **artificially cheap insurance** during complacent markets (remember, "insurance tends to be cheapest when we need it the most", one of the corollaries of the Anti-Bubble contrarian framework).

Looking forward, we expect the volatile and hostile markets to continue as multiple risk factors collide (detailed discussion below, including hawkish Central Banks, high inflation, systemic bubbles, hidden leverage, energy crisis, weak global economy, slow-down in China, geopolitical escalation, inflation, industrial disruption, growing social unrest, etc) and thus why recommend caution and allocations liquid defensive volatility anti-bubble strategies that can generate **high absolute returns with negative correlation** during crises, when the rest of the portfolio needs them the most.

Investing in anti-bubble strategies such as Igneo and Aqua help investors **embrace volatility** (instead of fight volatility) by actively rebalancing a balanced portfolio of "strikers" and "defenders" to generate incremental returns. The idea is simple: buy cheap insurance during complacent markets and monetize it during hostile markets to buy distressed risk assets. These **Incremental Returns from Portfolio Rebalancing** are NOT about having a "crystal ball" to guess where the football will go. It is about building a "team" that will do well regardless of where the ball goes. Good asset allocation generates superior long-term returns due to the combination of 1) capital preservation (defence) and 2) compounding on capital preservation (offence). Yes, long-term returns are a team effort, where the team performance is greater than the sum of individual performances.

Portfolio Construction with Inflation Bias

In addition to positioning for an environment of high volatility and high risk, we believe investors must also position for **high inflation** bias and beware of fixed income, credit, and cash (which are short inflation) and focus on real returns instead of just nominal returns (we are in level 2, no longer level 1), approaching level 3 (higher wealth taxes).

Additional information. In case of interest, please find enclosed additional information about our contrarian ideas and framework:
- Gold's Perfect Storm (Financial Times Insight Column, front page written edition 8th Aug 2016)
- The Energy World is Flat (Financial Times Insight Column, 18th April 2016)
- Real Conversation with Keith McCullough (Hedgeye, 6th Feb 2023)
- China is Running out of Options (Macro Trading Floor, 24h July 2022)
- How to hedge Inflation (Kitco News, 30th Sep 2022)
- Bitcoin: Bubble or Anti-Bubble? (The End Game Series, 9th Feb 2021)
- Portfolio Construction Masterclass (Real Vision, 3rd Aug 2020)
- Hmmminar with Grant Williams (Hmmminar #15, 21st May 2020)
- False Diversification (MacroVoices podcast, 11th June 2020)
- The Perpetual Search for Extreme Optionality (The Felder Report Podcast, 1st Sep 2019)

We hope the ideas and strategies will be of your interest and remain at your disposal for any additional information or clarification you may need.

Quadriga Strategy	Class	MTD	YTD	LTD	Factsheet	Newsletter
Igneo UCITS (USD)	A	-4.8%	-4.8%	-16.2%	**Igneo Jan23**	**Subscribe**
Aqua UCITS (USD)	A	+8.3%	+8.3%	+64.2%	**Aqua Jan23**	**Subscribe**

Best regards and much health to all!

Diego Parrilla