Quadriga
ASSET MANAGERS

October, 2023

Geopolitics and the Bear Steepener

Dear @@firstname,

****Anti-Bubble Report October 2023: "Geopolitics and the Bear Steepener"****

The month of October was dominated by Geopolitics and higher long-term yields. The wild price action and momentum triggered technical signals and forced liquidation of wildly overbought and oversold positions, such as gold, which reacted very vigorously.

As the time of writing in early November, the tables have turned aggressively as both Geopolitics and higher yields have reversed course, with large moves in equities, fixed income, or energy markets, some of which are by now back or even beyond the levels prior to the surprise weekend attack in Gaza by Hamas.

The recent price action is a nightmare scenario for trend following strategies, which are being pulled in both directions, effectively triggering “buy high, sell low” momentum strategies that suffer in volatile mean-reversing strategies.

We expect volatility to remain high and caution investors against excessive complacency against the multiple hot spots of trouble (more details below) and recommend that they embrace volatility and take advantage of attractive tail risk and risk premia opportunities. The surge in yields has two main drivers and narratives, both dangerous for global markets:

1)“Higher for longer yields” as Central Banks try to contain inflation and inflation expectations. The sell-off in fixed income has resulted in lower equity prices, which as discussed in previous newsletter “No premia in equity risk premia” remain high both in absolute and relative terms.

Importantly, the positive realized correlations between equities and bonds is once again exposing the risk of false diversification in conventional “60/40 balanced portfolios” (60% equities “risk-on” and 40% fixed income “risk-off” rebalanced over time) where the premise of its “balance” comes from the assumption that bonds are negatively correlated to equities, particularly during hostile markets, which has not been the case recently.

Higher crude oil prices due to Saudi and Russia move to tighten the market surprised the market and add pressure to inflation. We believe Saudi is in control and will be able to take more rent from the refiners (remember consumers buy refined products, such as gasoline or diesel or jet fuel, not crude oil) and could sustain crude oil at their desired target, probably around $100/bbl. Remember Central Banks can print paper currencies, but not hard commodities.

2)“Duration bubble burst” as Japan and other Central Banks face the crude reality of higher yields and the increasing impossibility to finance artificially high levels of debt.

The problem is exacerbated by forced selling by traditional buyers and holders, such as Japan or China, both of which have turned sellers of UST. Watch out.

Both narratives raise the important questions to investors: “Is Fixed Income a Reliable Defender?” and reinforce our view that investors must look for diversified sources of protection, including volatility and tail risk, that complement other conventional sources such as fixed income or gold, which in our view can and will continue a key role.

The massive sell-off in duration will act as a “coiled spring” that can and will snap back, bringing much needed defense to the portfolios… unless yields continue to remain under pressure from credit risk and currency devaluations, as it is likely to be the case in Japan and JGBs, and other Government Bond

markets that have abused their monetary and fiscal policies for decades, and turbo-charged the abuse during the Covid crises, bringing monetary and fiscal abuse to a new level.

Short term deflation, long term inflation.

The damage, in our view, is already done. Potential deflationary pressures from a recession or economic deceleration will require more, not less, printing and debt.

We believe Yield Curve Control ("YCC") is the mechanism than transforms credit bubbles into inflation. Please refer to previous analysis, "The Frogs in Boiling Water", further below for more details.

We also expect fiscal abuse (massive fiscal deficits) will be required. Please refer to previous analysis on "The Anti-Bubble Contrarian Framework" for more details.

Will we ever see 0% nominal yields again? In my view probably not and expect 2% to be floor for nominal yields. The implication from a portfolio construction is important as extrapolating the defensive power all the way to zero or negative yields would in my view be a mistake (equivalent to "driving the car by looking at the rear mirrors") as the structurally higher levels of inflation will in my view put a floor to rates, perhaps somewhere around 2%, which can significantly reduce the potential capital gains via nominal duration moves. Food for thought. Time, as always, will tell.

Private Markets and Accrual Accounting

Institutional investors have embraced private markets in a massive scale over the past few years. The rationale a combination of 1) long-term investment horizon, 2) higher risk premia in private assets, 3) "reduced volatility", amongst other reasons, which have pushed allocations above 50% for many large instructional investors. Time will tell how this movie ends, but we are increasingly concerned about the second and third order effects in global markets and recommend investors balance illiquid risk in their portfolios with volatility and tail risk strategies. Happy to discuss customized solutions in more detail on demand.

1. Monthly Update Quadriga UCITS Strategies

1.1. Protected US Equity, Quadriga Aqua UCITS -1.0% October 23, +4.3% YTD

The enclosed Aqua UCITS October 23 Factsheet provides a detailed overview of the performance and positioning across the core equities and long 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.**

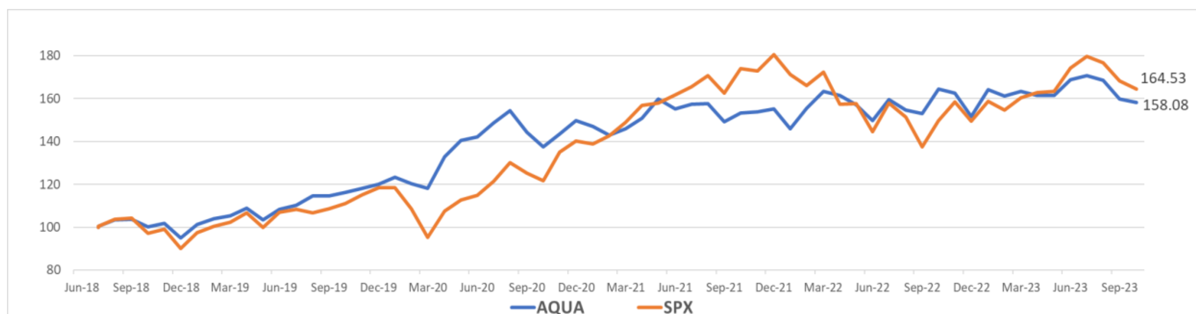
A switch from **Unprotected Equity to Protected Equity** is subject to a number of benefits and considerations, including:

- **Switch Unprotected Equity** for **Protected Equity** with **zero net cash-flow** requirement,
- **Remain invested** in US equities but **enhance protection** at expense of potential basis risk and underperformance vs passive equity markets.
- **Reduce volatility** and enhance risk adjusted returns (**Sharpe Ratio** and **Sortino Ratio**).
- **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 **enhance absolute returns (+9.8% p.a. vs +9.0% p.a.)** and risk-adjusted returns, (both return per unit of average volatility, **Sharpe 0.5 vs 0.6)** and return per unit of "bad volatility" (Sortino0.8 vs 1.3), whilst simultaneously enhancing capital preservation as **Peak to Trough (-23.9% vs -10.9%).**

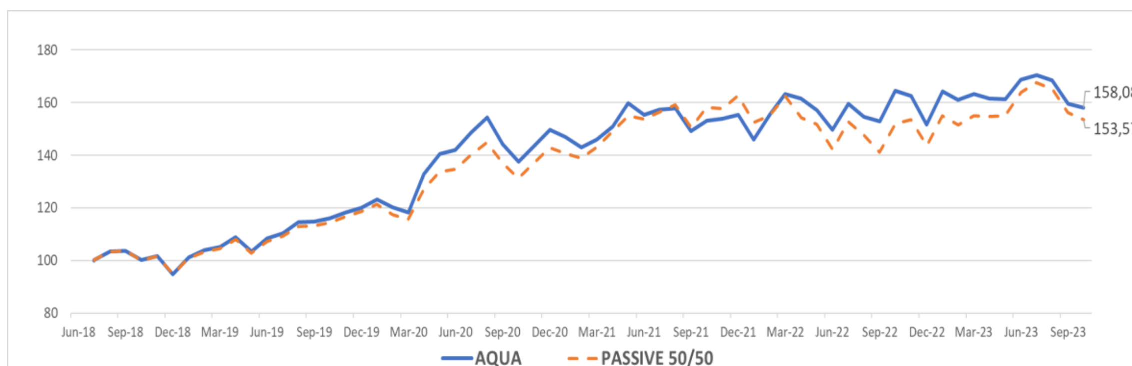
	Monthly (%)	YTD (%)	LTD (%)	LTD (% p.a.)	Vol (%)	Sharpe	Sortino	Peak Trough	NAV
SPX	-2,2%	10,5%	64,5%	9,8%	18,5%	0,5	0,8	-23,9%	164,5
AQUA	-1,0%	4,3%	58,1%	9,0%	14,0%	0,6	1,3	-10,9%	158,1
Difference	1,2%	-6,2%	-6,5%	-0,8%	-4,5%	0,1	0,4	13,0%	-6,4



Passive Basket vs Rebalanced Basket

In addition to the contribution from the Equity and Insurance Portfolios, Quadriga Aqua UCITS Protected US Equity benefits from another important consideration: **portfolio rebalancing**, a mechanism that effectively behaves like a **good unemotional investor** that **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 vs monthly rebalanced basket, where the difference represents the value of **compounding capital preservation**. 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.



1.2. Quadriga Igneo UCITS, +8.4% in October 23

The enclosed Igneo UCITS October 23 Factsheet provides a detailed overview of the performance and positioning, including closed, restructured, and new positions. The **Total Premium at Risk** for Igneo was **37.7%** as of the end of October, with a **diversified insurance portfolio 1) across asset classes** (Equity/Credit, FX/Rates, Commodity Inflation) **2) across maturities** (short dates directional gamma and long dates Vega and duration), **3) convexity and risk premia** (long vanilla bias and risk premia across the forward term-structure, volatility surface, and correlation matrix) subject to constraints on **premium at risk** (long only option) and **carry** (positive, neutral and negative), which altogether seek to generate **negatively correlated alpha** during **adverse, hostile and volatile** markets, as the strategy has consistently done since launch its launch (+12.7% 4Q18, +16.5% Aug19, +42.5% 1Q20, or +22.2% Feb22, amongst others) and as we hope to do during the hostile and volatile markets we anticipate ahead of us.

	2023	2024	2025	>2025	TOTAL
EQUITY & CREDIT	0,5%	8,2%	0,0%	0,0%	8,7%
FX & INTEREST RATES	0,0%	2,0%	0,0%	12,1%	14,1%
COMMODITIES & INFLATION	1,2%	5,2%	2,1%	6,4%	14,9%
TOTAL	1,7%	15,4%	2,1%	18,5%	37,7%

	CONVEXITY	CARRY	TOTAL
EQUITY & CREDIT	8,7%	0,0%	8,7%
FX & INTEREST RATES	13,9%	0,2%	14,1%
COMMODITIES & INFLATION	0,0%	14,9%	14,9%
TOTAL	22,6%	15,1%	37,7%

	2023	2024	2025	>2025	TOTAL
CONVEXITY	0,5%	10,2%	0,0%	11,9%	22,6%
CARRY	1,2%	5,2%	2,1%	6,6%	15,1%
TOTAL	1,7%	15,4%	2,1%	18,5%	37,7%

	2023	2024	2025	>2025	TOTAL
SPX	0,0%	8,2%	0,0%	0,0%	8,2%
VIX	0,5%	0,0%	0,0%	0,0%	0,5%
SPX & FX	0,0%	0,0%	0,0%	0,0%	0,0%
EM FX	0,0%	2,0%	0,0%	0,2%	2,2%
DM FX	0,0%	0,0%	0,0%	11,9%	11,9%
Gold	0,0%	0,0%	0,0%	0,0%	0,0%
Gold vs DM FX	0,0%	0,0%	0,4%	6,4%	6,8%
Gold vs EM FX	1,2%	5,2%	1,7%	0,0%	8,1%
USD Rates	0,0%	0,0%	0,0%	0,0%	0,0%
Total	1,7%	15,4%	2,1%	18,5%	37,7%

2.1 October 2023: What happened? What's new? What's changed?

In October, the markets were influenced by two primary factors: the conflict between Hamas and Israel, including the subsequent declaration of war and ongoing fighting, as well as the persistent trend of

higher yields extending along the government bond curves across the entire spectrum. Following the initial two weeks after October 7th, the impact on the markets that the middle east conflict had, seem to be subsiding, as the spread of the conflict in the region looks less likely. Following a 2-3% drop in global mayor indices in October, markets have now fully recovered, and volatilities are back to exceptionally low levels. Complacency is still running at full gear.

– **China at the epicenter of future problems**. 2023 had a great start for China after the end of Covid restrictions led to a rally in the local equity markets in January, only to witness a gradual decline throughout the remainder of the year. Still, the number of issues pending remains significant: from the burst of a housing and infrastructure bubble that is pushing consumption down, to developers' defaults, distress in shadow banking products, local governments overloaded with debt, or youth unemployment. During October we saw some stabilization regarding CNH depreciation, due two renewed stimulus plans and a better set of macro numbers. We still think mayor problems are ahead for China, as we know what happens when real estate related bubbles burst, especially if households have a significant part of their wealth in housing, and we think the cleanest solution for China is to let the currency go (depreciate) or face a big drop in asset prices. China has replaced the diminished demand from developed economies since GFC, but we cannot count on that anymore, which puts further pressure for the next downturn.

– **Big Tech leading Nasdaq to +30.3% YTD**. The Gen AI theme corrected its stellar YTD performance last month by -1.6% (+56.1% YTD). The Nasdaq lost -2% during October, in line with S&P 500, which closed the month -2.2%. Many factors influenced this move, 1) Renewed Geopolitical risks due to Middle East conflict after terrorist attack by Hamas, 2) higher yields in developed markets bonds due to strong issuance + QT + Central Banks still worried about inflation + investors' worries about fiscal spending. 3) Market positioning and volatility pointing to complacent markets, 4) Overall leading economic indicator pointing to slower growth especially in Europe and China.

– **Narrow Market Breadth**. The strength in the US equity market YTD has been driven by strong gains in a few stocks and has narrowed market breadth to levels not seen since 1999, leading into the dot.com bubble, as the AI driven strength has benefited large tech. During October we saw a small correction on the "Magnificent 7" stocks, after a stellar YTD performance.

– **"Fiscal Responsibility Act"** (text-book misnomer) The US debt ceiling drama was postponed until 17th of November and the expectation are for a renewed accord. Meanwhile, fiscal spending remains at full speed, 9% higher than last year and 38% higher than the pre Covid trend.

– **Large USD Liquidity drain ahead** to fund 1) budget deficit, 2) TGA rebuild, which adds to existing 3) Refinancing needs, which according to our internal numbers, add to $500b, $550b, and $4.1T over the short to medium term. The implications for risk assets are quite negative in our view. The implications for the USD are mixed but continue to expect the USD to be a strong defender of portfolios. Adding QT to the equation puts strong pressure into long term yields, after strong t-bill issuance and debt ceiling negotiations, the US Treasury is back into longer term issuance. The effect has been felt in long term yields, while the short end has remained stable, as has the USD, with higher influence from short term rates.

– **Unwind of Fed Cut Expectations**. Data in US for the Q3 has been generally very strong. But overall, the FED has entered a "data dependent" trend, and the FED rate hike expectations have been slashed significantly, now the market puts the probability of another 25bps hike at just 9% and has 4 cuts discounted for 2024 with a 55% probability.

– **US Regional Banking Crisis not over**. Regional banks index lost -5.03% during October after a 6.75% correction in August, it has recovered strongly the first sessions in November, following lower treasury yields, but is still -33% lower than the peak in February as the commercial real estate

exposure, the higher long-term rates and the flow into MMF keeps putting the prospect for performance under the radar. News about possible capital increase requirements both for smaller and bigger banks does not bode well for the recovery of credit, the profitability of the banking sector and the economy in general. FHFA has announced yesterday limitation to access FHLBs funds as a lender of last resort.

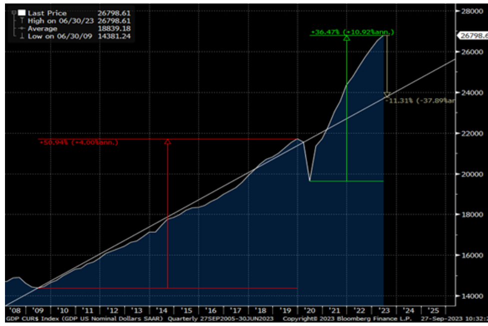
- **US bank collapse since Lehman in 2008**. Mind-blowing that the recent collapse of FRB, SVB, Signature Bank and PacWest that happened during the past few months rank amongst the top 5 bankruptcies in the history of the US. We well know financial crises tend to follow reflexive processes where "fundamentals drive prices, but prices also drive fundamentals", and neither look great for US Regional Banks.

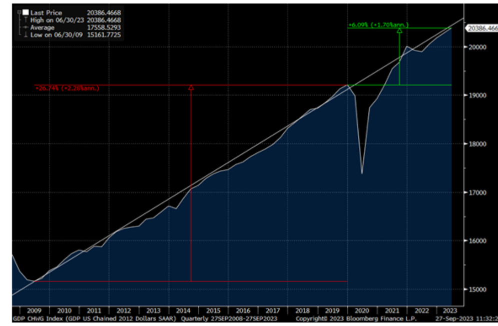
- **Mummy and Daddy (and Cousins!) to the Rescue**. During the earlier stages of the crisis, Central Banks and Governments ("mummy and daddy") were quick to come to the rescue and contain the wave of systemic risk. In the US, the Federal Reserve and the US Treasury were quick to implement "systemic risk exemption" to guarantee uninsured deposits and provide long term funding at par for non m2m assets underwater. In Europe, the European Central Bank was quick to intervene and successfully contains risk following the collapse of Credit Suisse, a 200-year-old historic bank, with a forced take over by UBS, within an environment of extreme confusion and chaos as the rules of the credit markets were changed with equity holders getting paid and AT1 bond holders wiped out, investors have already filed lawsuits. The recent acquisition of FRB assets by JP Morgan was backed by Jamie Dimon's message and narrative that the issues are isolated and contained, but those old enough may remember Bear Stearns in 2007, may see some worrying parallels as JP Morgan and UBS are willingly or unwillingly stepping-in to contain what is an extremely fragile situation as/when the "domino effect" accelerates and raises questions about the limits of further potential Public and Private bail-outs, which in our view will undoubtedly continue as/when the crisis extends. But all these issues are being eclipsed by the limelight of AI.

- **Credit Defaults Rise**. The domino effects of the US Regional Banking sector do not affect just the banks and the depositors, but also the companies that rely on their loans, such as Commercial Real Estate ("CRE"), a sector that is suffering from multiple headwinds, including higher interest rates and changes in work dynamics following the pandemic. The credit stress arising from higher interest rates may not be that widespread or evident yet, but worth noting US courts recorded 57 large insolvencies in 1Q23, the worst quarter since 2009. Whilst the US is leading the charge of monetary normalization, those paying attention will notice signs of credit stress from higher interest rates are happening across multiple other regions and sectors. Important to note the significant maturity wall that corporates are facing during 2024/25 that will increase funding costs.

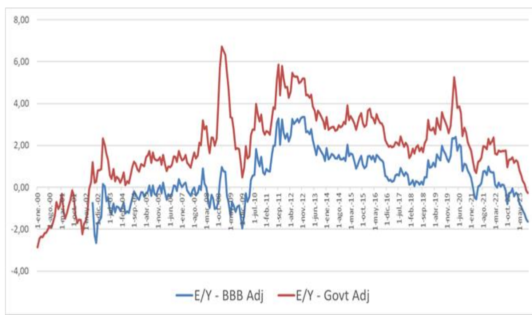
- **High Inflation Prints**. Higher OPEP production and lower expected demand from China has pushed Oil lower last few sessions, sitting now at -2.9% ytd on West Texas and +4% on Brent and +20.5%/27.2% higher than the year lows seen in June. The core inflation prints in US, Europe, and UK, even after corrections, continue to remain stubbornly high. In Japan, a country worried about deflation for decades, the trade unions recently negotiated largest wage hike in 30y at 3.76%. The oil recovery puts further pressure into inflation for the future. Lower PPI prints and input prices in corporate surveys are showing way lower prices in manufacturing but have seen increases in services, another wrong signal for core CPIs.

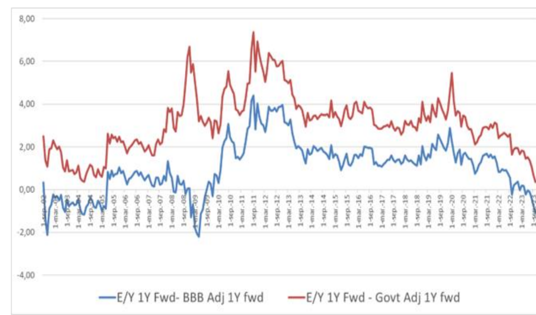
- **"Nominal" Earnings remain Solid**. As per the title of last month's newsletter, Nominal Data remains solid. I stress the attribute "Nominal" as Real performance is not as strong. While nominal growth has largely exceeded the trend since 2009, the real growth has managed just to join the trend broken by the pandemic, this is after increasing debt by 30%, massive money expansion, and unprecedented fiscal spending.





– **Equity Risk Premia vs Fixed Income (No premia left)**. Worth noting the further divergence between high equity markets and low fixed income is increasing the attractiveness and relative value of fixed income vs equity markets. Looking at ERP comparing it to investment grades corporate bond yields and government yields, we can see how equities are expensive vs yields in historical terms. These calculations consider the "equity duration" and take as comparison the equivalent point on the BBB and Government curves, we calculate it spot and 1y forward. For calculations methodology please refer to this note published in 2021([(19) No premium in Equity risk premia | LinkedIn]())





Another way to look at its vs real rates, Equity yields too low given the levels of real interest rates as discounted by TIPs.

– **More Central Bank Hikes Ahead?** The US Federal Reserved hike expectations have been slashed and the market discounts 4 cuts for 2024. The FED has moved into "data dependent" mode. ECB didn't adjust rates in October as expected and stands now at "data dependent" path going forward, although the press conference sounded much more dovish. Market has now slashed any more hikes and has 3.5 cuts priced into 2024 with 57% probability. BOJ keeps its very dovish approach after

some tweaks done again into YCC in the last meeting, the currency is underperforming again. The "data dependent" mode are consistent with the high levels of implied volatility in interest rates, which stand in contrast to the low levels of volatility in equities and FX. More on this later.

- **The Refinancing Wall in 2H23.** Looking ahead, we worry that the combination of 1) "higher for longer" nominal interest rates, 2) credit contraction following the collapse in the US regional banks and beyond, 3) deceleration in economic activity and risk of nominal recession, amongst other drivers, may result in a "refinancing wall" for Sovereigns and Corporates from 2H2023 into 2024/26 which could feed into higher yields and credit spreads, exacerbating the problems.

- **Artificial Intelligence vs dot.com**. Generative Artificial Intelligence, such as GPT3, is a game-changer technology. During a recent conference call with one of the world's leading experts, it was compared to the invention of the Printing Press by Guttenberg, as beyond the clear implications for to enhance our productivity, GenAI is set to disrupt the way we learn. The applications and disruption will be major and the speed at which the changes are happening is truly staggering. One of the most obvious examples have been coding and programming where, if you were a well-paid programmer a few months ago chances are your job may be at risk or may even not exist anymore. The narrative and impact on productivity is currently dominating technology companies but could easily translate into other sectors, extending the squeeze. But like many other technologies, there is "double-edge sword" with positive implications (productivity, education, etc.) but also negative uses (unemployment, social manipulation, cyber-crime, deep fakes, etc.) which are worrying and, in my view, pose extraordinarily difficult ethical and social challenges to humanity and has brought the debate around regulation and control of AI has come to the front of global leaders.

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

We believe global markets have entered a new paradigm that will be dominated by High Inflation, High Volatility, and High Risk, in many ways a complete reversal of the previous decade which was dominated by Artificially Low Inflation, Volatility and Risk. Whilst the order in which is presented is somewhat interchangeable, the current driver of monetary policy remains inflation, which poses Central Banks with the extremely delicate task of hiking decisively enough to contain both inflation and inflation expectations without damaging the economy and/or exposing systemic risks. The reality is Central Banks seem to have a foot on BOTH the accelerator and the break, as evident in the current US Regional Bank crisis, where they are delivering nominal hikes whilst printing money via protection programs in yet another example of Mike Tyson's eternal "everyone has a plan until they get punched in the face."

2.2.1. The New Paradigm of High Volatility

- Strong opposing forces between inflation and systemic risks, consistent with high uncertainty and high volatility.
- Twilight Zone between Nominal and Real creating confusion, supportive of high realized and implied volatility.
- Fed dots for Dec25 showing massive divergence, 5.50% high vs 2.375% low, consistent with high volatility.
- Divergence of forecasts by analysts: from Hard landing to Soft landing to No Landing = volatility.
- Fixed Income markets have regained some defensive power via duration but have lost reliability.
- Watch out for spike in volatility and correlations, particularly between Fixed Income and Equity markets.
- Low VIX contributing to short squeeze, as trend, vol target and risk parity forced to buy more with low volatility.
- Discretionary managers at historically max short in equities and fixed income.
- Disconnect between Macro Vol vs Equity Vol = Bear Market Rally, Short Squeezes.
- Geopolitical Risks on the rise. Risk of China providing "lethal aid" to Russia.

2.2.2. The New Paradigm of High Risk

- Central Banks trapped Bubbles and Inflation, both their own creations.
- High inflation and inflation expectations forcing Central Banks to hike, for now.
- Equity Risk Premia. Equities are expensive both in absolute and real terms.
- Faced with systemic risk, Central Banks will always kick the can down the road and transform into inflation.
- The US Regional Banking crisis in our view the tip of a giant iceberg. Watch out reflexivity domino effects.
- Lower credit transmission will spread to Commercial Real Estate and economic activity.
- Nominal Left Tail (equity & credit sell off) = Loss capital. Real Left Tail (inflation) = Loss of purchase power.
- False Diversification = Hidden Leverage. Slow Motion Crash. Watch out for Credit Defaults.
- Taxes, in particular Wealth Taxes, how Central Banks and Governments "square the circle", another risk.

2.2.3. The New Paradigm of High Inflation

- Central Banks trapped between Inflation and Bubbles, both their own creations.
- When inflation expectations are low, Central Banks are in control. When high, they lose control. Thus, the hikes.
- The Damage from decades of Monetary and Fiscal policies without limits may already done.
- We are currently in the "Twilight Zone" between Nominal and Real worlds.
- Economic data, such as "Growth", must differentiate between "Nominal Growth" and "Real Growth".
- We have so far avoided a “Nominal Recession” but are deeply into a “Real Recession”.
- Real Inflation in our view 2x Official Inflation. Investors and savers are not stupid. Frogs on the move.
- Labor Strikes, Social Unrest, Populism, Wars are unfortunate second order effects of Inflation and Inequality.
- Systemic risks (such as US Regional Banks) require more printing and debt, will keep inflation structurally high.
- Central Banks cannot print Energy, but can subsidize it, transforming problem into devaluations and inflation.
- Central Banks may be forced to use Yield Curve Control to contain credit bubbles in Public and Private markets.
- YCC transforms credit bubbles into inflation. Beware of the end of YCC in Japan. Gray swan LDI squared ahoy.
- From a game theory perspective, due to lack Central Bank independence, likely End Game is Stagflation.

2.3. Implications for Portfolio Construction

- There is no crystal ball. Embrace Volatility. Don't fight it.
- Fixed Income no longer a reliable defender, especially in the event of high inflation and higher yields.
- Beware of False Diversification. Balanced Football Team and Portfolio Analogy: teams need strikers, defenders, goalkeepers, and managers...
- Upsilon. Compounding on Capital Preservation.
- Unemotional vs Emotional Portfolio Rebalancing.
- Protecting Strategies vs Protected Strategies
- Long Only Options provide certainty of risk and worst-case scenario. What we call, "V@R 100".

- Long Inflation Bias. Beware of long-term implications for assets that are short inflation, such as fixed income, credit, and cash.
- Equity divergence. Equity Margins vs Inflation: Price Power vs Purchase Power.

3. Additional Supportive Information

The following section presents some of the key concepts of the Anti-Bubble Contrarian Investment Framework with extracts from previous newsletters and links to some relevant articles and podcasts.

3.1. Monetary and Fiscal Policies do NOT solve problems.

We believe **Monetary and Fiscal Policies do NOT solve problems**, but simply **delay, transfer, transform** and **enlarge** them**.** This simple framework has a wide range of applications and helps explain how Central Banks and Governments tend to deal with most of their problems, from energy subsidies, to banking bailouts, to ever-increasing debt ceilings, all of which are a combination of the following four building blocks:

3.1.1. Delay Problems via "Kick the can down the road" Spending and Debt.

A generational trade-off that benefits the current generation and the expense of future generations.

3.1.2. Transfer Problems via Currency and Trade Wars.

Monetary policy is often portrayed as a domestic policy but historically has played a very important role in foreign policy via "beggar thy neighbor" **Currency Wars**, whereby competitive devaluations seek to, amongst other benefits, attract foreign investment, create domestic employment, and import/copy technologies at the expense and risk of currency weakness and its necessary evils: inflation and bubbles. **Trade Wars** and other forms of Protectionism are natural defense mechanisms to Currency Wars whereby Governments "defend themselves" via processes such as "if you devalue your currency by 20%, I will tariff you by 20%" designed to neutralize foreign competitive devaluations and protect local players but can result in inflationary pressures. Unlike previous crises, where Governments seek competitive devaluations to fuel growth at the expense of inflation, current inflation dynamics have changed, and currency strength translates into a mechanism to **export inflation.**

3.1.3. Transform Problems into Inflation and Inequality.

Let´s not fool ourselves: Monetary and Fiscal policies-without-limits are THE primary reason for inflation and loss of purchase power. Central Banks and Governments have become addicted to money printing and debt and have taken advantage of deflationary forces in the system, such as technology, demographics, or overcapacity, amongst others, to print and borrow more money than they can afford fooled by the illusion financial stability and wealth creation.

3.1.4. 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 to protect the bubbles.

3.2. The Frogs in Boiling Water: Inflation and Inflation Expectations

The Monetary Broth. I believe we are all frogs in a "monetary broth" that has been steadily heated via money printing and debt at an official temperature of 2% per annum, where the 2% official inflation target is small enough that the frogs stay in the water, but high enough that the frogs are slowly boiled to death via compounding, "the most powerful force in the universe" according to Albert Einstein.

Why do frogs jump out? Inflation and Inflation expectations. Frogs jump for two main reasons, 1) they notice a large increase in current temperatures (current inflation), and 2) expect temperatures to continue to increase (inflation expectations). Central Banks are in control as long as the frogs stay in the water but lose control once the frogs start jumping out. The massive rise in inflation and inflation expectations forced Central Banks to panic hike at a pace never seen before hoping to entice the frogs to stay and/or return to the monetary broth.

What happens when frogs jump out? When frogs jump out of credit and fixed income, yields go up, which can put pressure on those heavily indebted and expose pockets of hidden leverage and systemic risk, which eventually may require Central Banks to intervene and print more money to prevent the collapse. The common belief is that "long-term yields go up because short-term rates go up" but the opposite is also possible, whereby "long-term yields go up because short-term rates were kept too low for too long", which effectively creates inflation and inflation.

Why 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. During period of high inflation, investments in cash, fixed income and credit have the potential to lose substantial purchase power, effectively financing the "monetary party" hosted by Central Banks and Governments.

3.3. The Three Levels of the Investment Game

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

Level 1: Nominal Returns, In Level 1 **inflation is perceived to be negligible**. The objective is to protect the capital and turn $100 into more than $100. Level 1 rewards savers via positive real yields and fixed income, credit, and cash play a valuable role in asset allocation and portfolio construction.

Level 2: Real Returns. In Level 2 **inflation is no longer negligible**. The objective changes and investors and savers must generate returns above *their* rate of inflation (which may be different from official inflation)**.** In Level 2, when inflation is substantially higher than nominal rates. 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. In the event that inflation is above nominal yields, persistent levels of negative real yields can dramatically reduce the purchase power of fixed income, credit, and cash, which transform from big winners to big losers.

Level 3: Real Returns after Taxes. As Mark Twain said, "there are two certain things in life: death and taxes". Taxes are high already, but will likely get much worse, especially **wealth taxes** and their derivatives like inheritance tax, mansion tax, etc. Higher wealth taxes is the mechanism by which Governments "square the circle", as monetary and fiscal abuse eventually results in inflation and bubbles that make the rich richer and the poor poorer, which results in inequality, strikes, social unrest, and populism, that invariably result in higher taxes on the inflated assets. The problem, as discussed in a previous section, is the circle is not a zero-sum game, but rather an vicious cycle of forced currency devaluations and inflation and defaults, as it has been the case in Argentina.

3.4. Nominal Recession vs Real Recession

The May 2023 Anti-Bubble Report, titled "Nominal Recession vs Real Recession", highlighted the divergence of perspective between those looking at the world through in **nominal terms** (through the conventional lens of negligible inflation) and those who have adjusted their perspective to **real terms** (thought the lends of non-negligible inflation), which we subscribe to.

Global markets are currently in the "**Inflation Twilight Zone**", where Nominal and Real perspectives co-exist and confusion across market participants. The distinction between "Nominal" and "Real" economic data and/or performance is no longer a choice. It is an obligation. In April ECB officials were proudly stating that Europe would likely avoid Recession as Europe grew by +1% YoY in real terms in Q1 2023, but GDP deflator was +6.2% YoY, so nominal growth was +7.2%.

As discussed in previous newsletters, we believe Real Inflation is at least twice Official Inflation, and thus why the argue that "Real Real Growth" (what we actually experience in our pockets) is much worse than officially stated.

3.5. The End Game: Stagflation?

From a game theory perspective, the game is designed to finish in stagflation, the combination of high inflation and no economic growth. At the core of the thesis lies the lack of Central Bank independence, and how every Government, when faced with problems will always favor the short-term gain at the expense of the long-term pain.

QE inflated bubbles. Whilst the list of acronyms used by Central Banks and Governments around the world to implement their monetary and fiscal abuse, Quantitative Easing stands out. In the US alone, the Federal Reserve was printing money at a pace of $120b per month, every month, for years. In Europe and Japan the experiment was pushed even further with the introduction of negative nominal yields, an aberration. There is extensive literature on this topic, including my book "The Anti-Bubbles: Opportunities heading into Lehman Squared and Gold's Perfect Storm" (BEP, 2017). The consequences of QE and other forms of monetary and fiscal abuse contributed to artificially low interest rates, artificially high valuations, unsustainably high levels of debt and, of course, inflation.

YCC transforms bubbles into inflation. In Japan, decades of monetary and fiscal abuse have pushed Government debt towards 300% debt to GDP which required the introduction of a new mechanism called Yield Curve Control that would allow the BOJ to print "whatever it takes" to keep the 10-year JGB at the artificial level of 0.10% and prevent the credit bubble from imploding. In December 2022, the Bank of Japan, BOJ, surprised the market by opening the door to **the removal of Yield Curve Control**. Whilst the general view in the market is that this would be positive for both the Japanese Yen and for Japan, there are legitimate concerns that decades of artificially low interest rates could result in a "LDI squared", where Japan could face the double whammy of credit distress from higher yields AND more, not less, printing via the re-introduction of YCC. The damage, I am afraid, may already be done, and the imbalances will show either in the form of massive devaluations and inflation, and/or credit events.

Reasons for optimism. I tend to dedicate my book with "I hope you will like it, and hope I will be proven wrong", as I feel like a doctor diagnosing a terrible disease to a friend. As a doctor, I want to be correct, as a friend I want to be wrong. Whilst I am not optimistic, there are also reasons to be optimistic about the longer-term, including a resolution of the Russia/Ukraine conflict, or an improvement in the medium and long-term outlook for energy volumes and prices. Whilst the short-term supply dynamics are constrained by lack of investment and infrastructure capacity, the major spike in natural gas prices following the Russia/Ukraine war has undoubtedly resulted in a major signal for investment in natural gas production, transportation, and storage around the world. As discussed in my first book "The Energy World is Flat: Opportunities from the end of Peak Oil" (Wiley, 2014), massive spikes in prices and volatility short-term tend to result in lower prices and volatility longer-term. It will take a few years to resolve, but some strong healthy deflationary forces may be underway and help partially or totally offset the unhealthy inflationary forces that I fear will be required to prevent the implosion of the credit bubbles in the system. Time will tell. In the meantime, I would recommend investors to continue to embrace, not fight, volatility.

3.6. Selection of Articles and Podcasts

In case of interest, please find enclosed a selection of articles and podcasts 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)

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

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