THINKING NOTES FOR FEB 17, 2023

Working title: How To Defeat Financial Repression

Subject: Saving and investing under financial repression
Theme: Saving and investing under financial repression requires a new strategy
Contrast: Most people believe saving and investing under financial repression will be similar to the recent historical pattern

Hello everyone, welcome back to Finance Friday on the ARC-UK Youtube Network. I'm HardmoneyJim speaking today from Coronado, CA. However, last week I was back in Jackson Hole to be with a family member who had to undergo a medical procedure (all went very well, by the way), and while there at our house, we had an unusual visitor on the back fence. And here he is:

We have a lot of bald eagles in the area, but they usually stay closer to the rivers and lakes. However, the water is frozen, so this smart bird is adapting to a drier landscape. It remained in this position for hours, vigilant for movement on the vast prairie, and now and then, he'd fly off to pick up a snack and then come back to wait some more. And to me, it was a perfect metaphor for what we will need to do in this new era of financial repression. We'll need to adapt to a new landscape, be smart, and be patient, and we'll talk about that today.

CONTEXT FOR TODAY'S SUBJECT

We have been discussing financial repression and how it comes into existence. Still, today I want to discuss what to do about it, that is, to provide some general direction for saving and investing in an era of higher inflation and low real interest rates. As regular subscribers know, here at HardmoneyJim, we are mainly interested in money creation and its consequences, so why am I talking about financial repression? We should ask, what is the connection between money creation and financial repression?

That connection is what I have been establishing in the last two podcasts. So to bring everyone up to date, let's reprise the relationship between the nature of money creation and today's economic predicament that we find ourselves in. I'll make five connected points.

- Modern money comes from pure credit creation.
- Money creation in a free market is productive, while money created by government influence is unproductive and inflationary.
- Excess money creation enables the government to take on unpayable debt.
- The government's unpayable debt requires financial repression.
- Financial repression requires a new investment approach.

1. Modern money is produced by pure credit creation in commercial banks. Money creation occurs when a bank acquires an asset – either by purchasing a promissory note (that is, when the bank makes a loan) or by purchasing some other security, such as a government bond. When it buys assets, banks pay for them with a promise to pay out reserve or standard money (in our system, that's Federal reserve paper notes) on demand. That promise to pay out reserve is called a bank deposit. About 90% of modern money in use today is these bank deposits. And as I have written, even the paper currency we carry around or stuff under the mattress also came from credit creation. Paper notes become part of the money supply when bank deposits are withdrawn from the bank in cash, transforming a promise to pay (the deposit) into a physical Federal Reserve note. As the economist Richard Werner has said, we live in a monetary world of pure credit creation.

2. Money creation in a free market is generally productive. The gold standard is unfortunately gone, but money creation can still be economically productive if it is done by a private, profit-seeking bank operating in a free, or mostly free, market. Money created under these conditions is not inflationary because the new money helps create new wealth; that is, you are not in a position of "too much money chasing too few goods," as Milton Friedman put it. By contrast, money created by the government, or due to government influence, is unproductive, excessive, and therefore inflationary. Over the last fifty to sixty years, but especially in the post-GFC economy, the government has played a bigger and more significant role in money creation, resulting in lots of new money placed in unproductive hands that generate little or no new real wealth. A leading example is the monetizing of Trillions of Treasury debt over the last 13 years under QE, which inflated asset prices,

shifted wealth from the middle class to the wealthy, and distorted markets through artificially low interest rates.

3. Much of the US government's borrowed money is really newly-created money. The government's abuse of money production is a major cause of the government's level of unpayable debt. As we detailed last two podcasts, we're at a point where annual tax receipts no longer cover the government's mandatory spending requirements plus interest on existing debt. This is unsustainable.

4. <u>The government's solution to this debt dilemma is financial repression</u>, a combination of high price inflation and interest rates suppressed below the level of price increases. High inflation will raise nominal tax revenues, while suppressed interest rates will reduce government interest costs. The combination will allow the Treasury to pay its debt in depreciated dollars.

5. <u>Financial repression will alter the investment landscape</u>, requiring a different approach than was required in the last 20 years. That is the subject of today's discussion. Today we define the new investment landscape and outline our approach to investing under financial repression.

So, to reprise where we are in one sentence: The government's ability to control money production has hindered real wealth creation and has encouraged politicians to borrow irresponsibly, resulting in a level of debt so high that it can only be repaid by implementing financial repression – a combination of high inflation and low real interest rates.

Today's task is to discuss what financial repression means to you and what you can do about it. First, we'll discuss what I call the "investment landscape," the general contours in the land of available savings and investment options, and how this landscape is changing from green hills and flowing rivers to a dry, rough desert. You can still make that desert bloom, but it will take more work and different survival techniques than the lush investment landscape of the last few decades. Under the old investment paradigm, you could drill a well almost anywhere and find water, but in the new one, you have to know where to drill.

So first, let's examine the new investment landscape. Then, based on our understanding, we'll narrow the field and discuss how to approach saving and investing. And the message will be that despite the bleak reality of moving from green rolling hills to the desert, the news is not all bad because you can still prosper under these conditions if you are willing to change and adapt.

HOW THE INVESTMENT LANDSCAPE CHANGES UNDER FINANCIAL REPRESSION

So, what will this new investment landscape look like under financial repression?

I first want to stress that a change in the investment landscape is always gradual, almost imperceptible, like the multi-year movement of a glacier, tough to notice if you are looking for signs of change day to day. And most people will not notice as it descends on them.

I heard a great story a couple of years ago; perhaps you have heard it also, from a writer who is now deceased. Two young fish are swimming along one day, and they happen to meet an old fish swimming the other way. The old fish nods at the two young fish and says, "Good morning, boys. How's the water today?" They all continue along their paths for a while, then one young fish looks over at the other and says, "Hey, what the hell is water?"

Few of us stop to notice the water we are swimming in.

By "investment landscape," I mean all the economic conditions that affect financial outcomes. These conditions include a complex mix of political, social, and psychological experiences that heavily influence financial decisions. This landscape influences the widely held beliefs and operating systems of savers and investors, and the actions of these investors then have a reflexive effect back onto the economic conditions. For example, as we will discuss shortly, the investment landscape is now slowly changing from one that favors passive investing to one that favors active investing. I don't think most people are noticing it.]

So my point is, just as the young fish don't notice the water they are swimming in, few people appreciate that we have been in a long secular era of declining interest rates, expanding money and credit, high and rising asset prices, and the speculative excesses that accompany such periods. Today's investors learned to swim in this water, so they may not understand that these conditions are not normal and will be slow to notice their environment changing.

Incidentally, the opposite happened to me: I started investing during a period of persistently high inflation, high and rising interest rates, civil unrest, unpopular wars, etc. It was not apparent to me when this environment began to change. It took a long time before I eventually caught up. So try to understand the kind of water you are swimming in, and don't take it for granted that the world you grew up in was permanent.

[Let's not overstate this because the world will look similar to how it has always looked in many ways. The investment waters you swim in will change slowly. Life will look normal in most ways. We'll still get up, go to work, raise families, and talk about the latest Netflix series.]

What will be the typical signs of what is happening in this new world of high inflation and low real interest rates? What will the visible investment landscape look like? What will be some economic signs that we could expect to see?

The first will be that ordinary people, already climbing a steeper financial slope, will have to run a little faster to maintain a standard of living. The average person will have a choice: work harder or become poorer. Inflation is the central feature of financial repression, and the primary point of repression is that the people with most of the wealth, the middle class, will pay for that inflation one way or another. At today's CPI inflation rate of 6.5 percent, it takes about 11 years for the purchasing power of your savings to be cut in half. And 11 years is only about one-fourth of a person's working years.

As of January 12

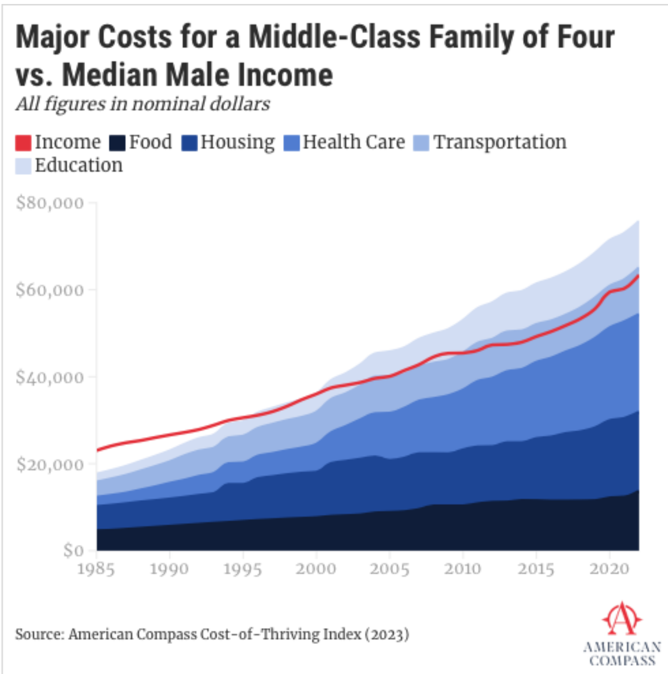
In other words, over the duration of a person's working life, at a 6.5% annual loss of purchasing power, their earnings will be cut in half at least four times. Can real wages catch up to rising prices? That is not likely during financial repression. As we see in this chart, for almost two years now, [Real wages are already declining.](#)

According to the BS, based on the CPI report on February 14, consumer price inflation appears to have peaked, and it's likely to come down some more and probably will not stay at the current rate of 6+%. Recall the Fed insists it will bring annual consumer price increases down to 2%. I suspect they will eventually change that goal, meaning the rate of "acceptable" CPI inflation will increase from 2% to something higher – high enough to eat into your savings in a world of low real interest rates. As you can see from this Bloomberg data, average wages adjusted for cost of living have been declining for almost two years, meaning wages are not keeping up with inflation, not even close. This is financial repression.

I want to offer another example to illustrate what this financial repression landscape looks like to the average person. You cannot capture the experience of financial repression on the average person by looking at government data because economists who calculate CPI, core CPI, PCE, and all the Fed's data to control short-term rates think differently from real people.

The average person does not care about CPI data. She cares about putting good food on the table, paying for a decent home, driving a decent car, and getting good healthcare. The CPI numbers might tell us these costs are going down because of the way they are calculated. For example, CPI numbers over time will tell you that because of technological progress, the quality of health care you get today or the quality of the car you drive today is so much better than what you would have gotten in 1985. They then adjust the "cost" to adjust for quality, claiming that you are getting more for your money today than in the past, and therefore they calculate a "real" cost lower than the actual money you paid.

The problem is that in calculating inflation price inflation numbers, the government uses hedonic adjustments and substitution effects that do not capture what a family is spending on the necessities of life. These periodic adjustments are always designed to make the inflation numbers look better than they are. A recent analysis in *Grants Interest Rate Observer* wrote that the Bureau of Labor Statistics has adjusted its official calculation methods for inflation no less than 25 times over its history of calculating price indexes. Guess how many of those adjustments resulted in an upward adjustment to the cost of living? Zero. They always make inflation look more benign than it is.



There is a better cost of living measure, one calculated by a non-profit organization called American Compass, that looks through these biased BLS data by computing what they call a Cost of Thriving Index, or COTI. First, they identify a specific set of goods and services that a typical household needs: a standard basket of good food as established by the US Department of Agriculture; monthly rent for a just-below-average three-bedroom house in a moderately priced housing market; a family health insurance plan of the type provided by an employer; driving a car 15,000 miles; and saving enough to fund enrolment in a public college for two children. These are not highly aspirational living standards for people in the United States of America. You need to buy these things based on what they cost in the dollars you earn, not at the BLS-calculated index price. Maybe I'll spend some time in the future explaining these price adjustments to illustrate to you how deceptive they are.

So this kind of measure, the COTI, is especially relevant to our present discussion because it identifies costs that fall squarely on the middle class, the same group that bears the brunt of financial repression. Remember, the middle class is where the wealth is, so that is where the government has to look for the wealth to pay down public debt.

Based on the COTI, starting from 1985, here is what the plight of the middle class looks like. This is what financial repression looks like in graphic form.

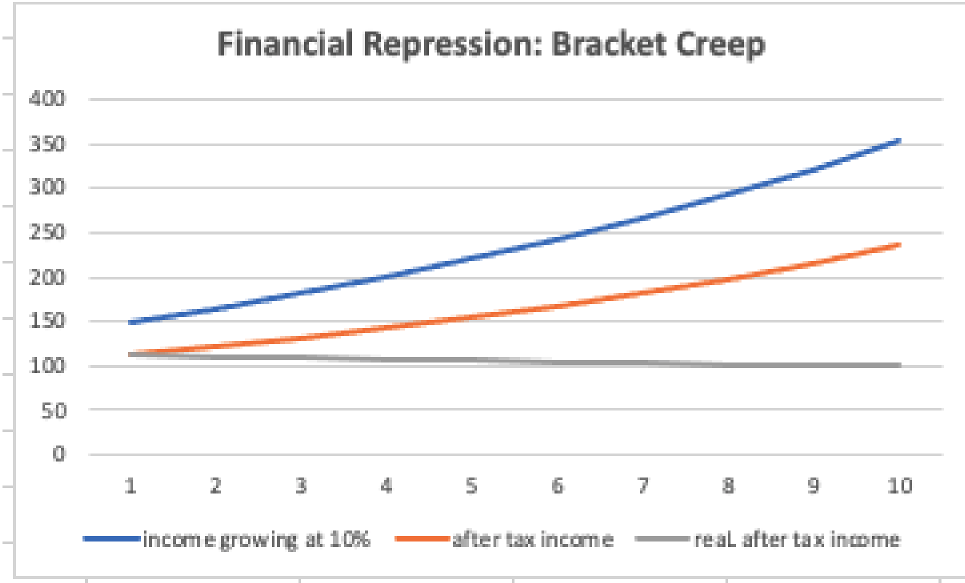
The red line is the average income for this cohort. What I like about this analysis is that it quantifies something that virtually everyone already knows: that the middle class is, at best, already swimming harder to keep up with the opposing current. Back in 1985, a middle-class family could afford the basics of food, housing, healthcare, transportation, and education and still had a little money left over, meaning saving was possible if you wanted to save. That started to change in the mid-1990s, and the gap between expenses and income kept widening.

Cost of thriving index

The actual index is calculated by dividing the middle-class lifestyle's cost by the middle class's average weekly earnings. The result is the number of weeks in a year it takes to earn that lifestyle. Here in California, where I speak today, that number is 73 weeks. That is the country's second highest cost of thriving, the highest being West Virginia at 79 weeks. I don't have to remind you that there are 52 weeks in a year. Put another way, the average middle-class family in California would have to earn 40% more income each year to purchase this basic lifestyle. This gives you a big clue as to why so thousands of middle-class Californians are migrating to Florida and Texas.

The problem will not go away and will likely worsen under increased financial repression. You may have to increase your savings rate, "save a little harder," and work a little harder, to accumulate cash for investment.

I could give many more examples of financial conditions under financial repression, but I will offer just one more. Recall that a critical feature of repression is that government takes more in taxes by inflating nominal GDP, giving them more nominal income dollars to tax. But the higher taxes don't just take away a higher number of inflated dollars. Income taxes take more real wealth from you through a phenomenon called "bracket creep," which I now want to illustrate. I worked up an example.



Let's imagine a household earning $150,000 per year and assume a progressive tax schedule similar to what exists but simplified a bit to simplify the calculations. The concept is that as you earn more, you have to give up more of your incremental earnings in taxes. So, assume the first 50k of household earnings is taxed at 15%, the next 50k is taxed at 25%, the third 50k is taxed at 35%, and any income above 150k is taxed at 40%. That's a progressive tax schedule reasonably close to today's true tax schedule.

Next, let's add inflation to the mix and assume household income grows at 10% per year for ten years, and along with that, the cost of goods and services also grows at 10%. So if there were no taxes, we assume a rosy scenario in which your top-line income, your gross income, would keep up with the increasing cost of living. But as we'll see, bracket creep allows the Treasury to take more of your real wealth in taxes.

In this hypothetical example, your gross income (blue line) grows from 150k in year one to 354k in year 10, giving you an illusion of prosperity. But because of tax bracket creep – meaning that as you earn more dollars, more dollars are taxed at higher rates – your rising nominal income is pushed into a higher tax bracket. Over ten years, the total tax you pay as a percentage of your gross income goes from 25% to 33%. Put another way, your take-home pay as a percentage of gross income goes from 75% to 66%. That's why after-tax income (orange line) rises slower than gross income (blue line).

Finally, and most importantly, your real income – your take-home pay adjusted for annual price inflation (grey line) –declines from 113k in year one to about 100k (inflation-adjusted dollars) in year ten.

This is the treadmill of financial repression. You work harder, as the government takes more of your time and talent to pay for its open-ended obligations. Please note, this is *exactly how it is supposed to work* from financial repression's point of view.

There may be other tax increases in the form of fees. Estate taxes may go up. And don't expect government services to get any better. You may have to learn to circumvent government agencies to live well. For example, government healthcare is getting more expensive, and options within government programs are pretty narrow. In the USA, we'll soon have 100 million people on Medicaid. As your costs grow and choices for medical services narrow, you will need to be nimble in seeking your own supplementary private healthcare program to stay healthy. That's another example of financial repression in stealth form.

I hope you see, through these examples, how this combination of inflation and low interest rates transfers the wealth you produce into higher tax revenue to allow the government to pay its debts with depreciated money. And the low interest rates will enable the government to give back less interest to savers and investors. You will be paying down government debt with your time and talent.

You cannot entirely avoid this predicament, but with hard work, diligence, and perseverance, you can maintain your independence and standard of living despite the government's unrelenting attempts to relieve you of your wealth." But you have to recognize this new landscape before you can fight back.

What will be some other features of the financial repression landscape? There are several related social and economic elements I want to mention. One is that you'll likely see political unrest resulting from the strain on government handouts.

These mass protests in France in January were a reaction to the proposal that France would raise its retirement age from 62 to 64. [One result is political unrest]

You will likely see continuing and possibly growing political division, protest, and unrest. This is what we saw in the 70s and early 80s. Crime may be a growing problem that you'll have to deal with personally. You may also see populist third-party candidates become more common.

Additionally, you should expect a gradually declining use of the dollar in international trade. This will affect everyone, though indirectly. Over the years, US sanctions are growing as an alternative to physical conflict, based on the assumption that the dollar will always be king, and without appreciating what made the dollar strong in the first place. This shift from the dollar might be imperceptible to most people, as it may move slowly. It will not be an abandonment of the dollar but a gradual shift toward alternative reserve currencies.

I want to illustrate this trend by pointing out the financial repression's effect on our trading partners. We run up our debt, pay it with cheap dollars, and repress interest rates. If you are an oil exporter, like Saudi Arabia or Russia, you run export-surpluses, that is, you sell oil to the rest of the world for dollars, then build up a surplus of dollars which you store by investing in US Treasurys. Your Treasury bonds earn three or four percent in an inflationary world while the price of oil rises at, say 8%. How long will you allow your savings to decline like this? You would be better off leaving your oil in the ground, wouldn't you, because you are pretty sure its price will gradually rise. So this is an example of what low real interest rates do to energy exporters, like Russia and Saudi Arabia, who have held their trade surpluses in US Treasuries. Their choice is to leave their oil in the ground or invest their trading profits in something besides dollars.

This is in addition to the fact that the USA just froze many Russian bank accounts, preventing them from cashing in their reserve holdings of US Treasuries to the tune of $650 billion. So you can see why there will be a tendency for our trading partners to diversify away from dollar-denominated investments, which means moving away from Treasuries, which means fewer buyers for Treasurys, which puts more upward pressure on interest rates.

So with changing or reduced international trade, we will see re-shoring of some industries, less globalization, less availability of cheap imported consumer goods, and more upward pressure on consumer prices as the money supply continues to grow. Your overseas investment options may be restricted due to capital controls and fiduciary requirements. For example, it is already almost impossible to invest in Russian assets if you are an American.

So to summarize the main features of the financial repression landscape: moderate to high price inflation; low real interest rates; slow or negative growth in wages when adjusted for the rising cost of living; a greater portion of your real wealth taxed away; social unrest associated with the government's inability to keep its promises fully; a tendency toward de-globalization of trade, and re-shoring of some industries; more reliance on regional international trading blocs as trading partners shift; and continued global tensions and incremental moves away from the dollar. These are some of the changing features in the investment landscape that I anticipate will come.

[pause for questions and comments]

INVESTING UNDER FINANCIAL REPRESSION: NARROWING THE FIELD

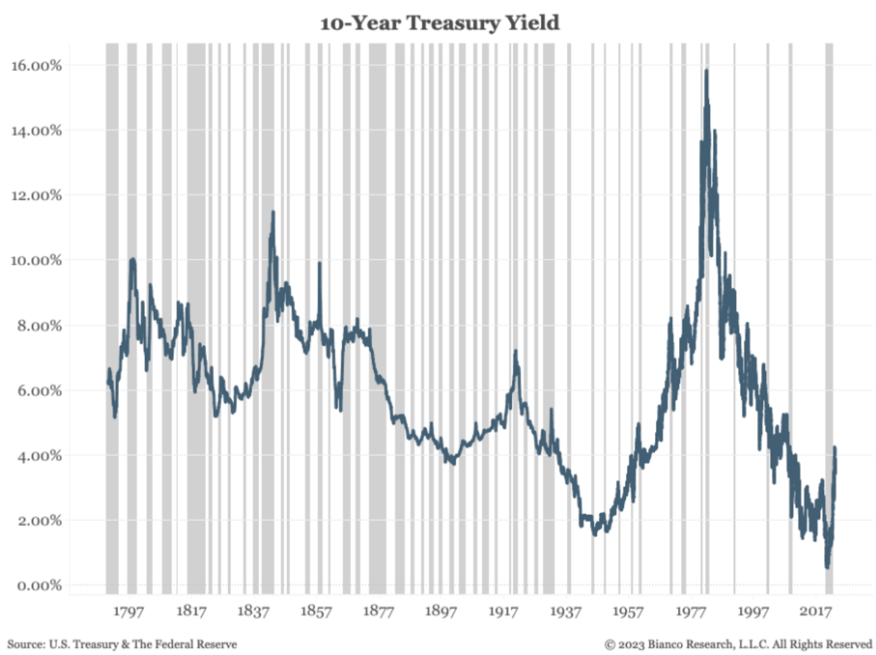
So now, having described the landscape, how can we narrow the field, that is, what investment options can we identify as not great places to look for a return? You don't want fish in muddy waters, so where are the muddy waters we should avoid? To save time and trouble, let's think of where we do NOT want to spend much time searching for good places to put our savings.

First, if possible, avoid areas where you lack knowledge or interest. Instead, concentrate on areas you know or are interested in. Unless you want to become an expert, avoid areas that are not in your lane of expertise or interest. For example, don't get into options trading unless you are committed to researching and understanding what you are doing. On the other hand – as an example – if you have a genuine interest in luxury real estate, work to understand that market and look for investment opportunities there. If you work in the defense industry, you might be in good shape to understand related opportunities.

It is always an advantage to start from a premise of actual knowledge. I'll use one of my children as an example. My oldest son (who is still very young) is a construction engineer, currently building data centers under contract for a big tech firm. He's in a position to know that this tech firm is committed long-term to building centers in that particular area. He knows what they plan to build and how long they will be there. He also knows from experience that rents in these areas are very high relative to the sales prices of the homes; there is a low housing supply and high rental demand. So he is investing in that local area by buying a house he plans to rent to construction workers who move in and out. I suspect this will work out pretty well for him for the foreseeable future. It is not sexy, but it is smart, in my view. And he is taking control of his financial future despite financial repression.

So that's an illustration of point one: Avoid areas where you don't have the knowledge, and instead look for opportunities in your backyard, so to speak.

Second, avoid long-term bonds.
Given the nature of the bond market and the nature of financial repression, you should avoid long-term bonds unless you are an expert in the bond market.



Here is an excellent chart from Bianco Research showing the yield on the 10-year US treasury, or its equivalent, back to 1787. (The vertical shaded lines indicate recessions.) The first thing you notice is that yields move up and down in long multi-decade waves. Why they do that is a puzzle, but the fact that interest rates do move in long trends is historically unmistakable. The latest wave, a big downward move, was 40 years long. I believe the direction changed from downward to upward in March 2020 when we reached the lowest yields in 5000 years of recorded history. Remember, as yields declined, existing bond prices went way up, making a fortune for those who had bought bonds when yields were higher. Several generations of investors grew up in this environment and likely have this bias built into their investment habits.

But I believe those days of falling interest rates are past; the trend of yields will now be upward, and that is one good reason to avoid long-term bonds, in my view.

Whether I am right about that or not, there are other, perhaps better reasons, to avoid long bonds. The main one is that in an era of financial repression, interest rates may rise but will not be allowed to rise above the annual rate of price increases. So even if you hold for the long term, rates won't be high enough to beat price inflation.

You should also consider avoiding other investments that mimic, or depend on, the return on long-term government bonds. For example, you should avoid equity investments in life insurance companies. That's because life companies estimate their future payouts based on current interest rates and buy long-term bonds to match assets with expected payouts. As rates rise, their liabilities also rise, but the value of their long-term investment declines, and they can quickly become insolvent. (Note, I'm suggesting avoiding life insurance companies, not necessarily property and casualty insurers, which are quite a different animal and which may do just fine under financial repression).

No doubt, some people will make positive returns investing in long-term bonds, but these will be expert bond traders. Is that you? So, go for it if you want to become an expert in trading bonds, but it will likely have to be a full-time occupation!

Third, avoid passive investing in the stock market

Another area I would avoid is the passive kind of broad index investing that has become so popular over the past 20 years. Some of you likely have a 401K invested in a fund that mimics the return on the S&P500 index. This has been an excellent investment for many years, and hard to beat the indexes by active investing.

So let's discuss why it has been so easy to invest in a broad stock market index for so many years and why that is likely to change,

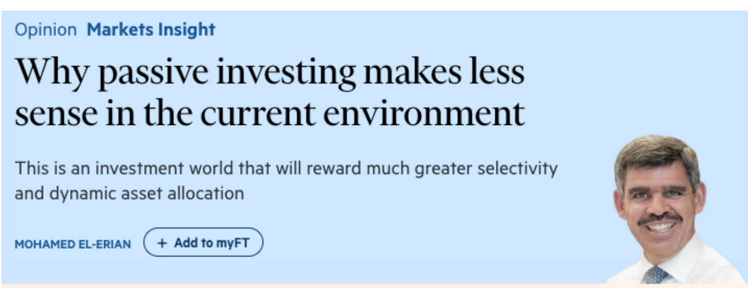
For the last 25 years, one of the best options for your savings has been to buy a fund that mimics a broad index of stocks, like the S&P500, and just keep adding to it. Despite frightening setbacks like the dot-com crash of 2002, the great financial crisis of 2008, and the lockdown panic of 2020, it always paid to stay invested in the index and keep adding your savings and keep refinancing your house because at every downturn, central banks responded with more liquidity and lower interest rates. Investors learned that assets only go up in the long run. Companies that would have normally failed were kept alive by easy credit. We have talked about these zombie companies. The extreme difference between sound companies and zombie companies was no longer reflected in their market valuations. Easy credit conditions and declining interest rates undermined the normal creative destruction of capitalism. As investors flocked to index funds, stock prices became more correlated with each other, meaning they tended to move up and down together more than they had in the past. Easy money undermined the normal reward and punishment system of the stock market. Traditional value investing – which says you should purchase historically cheap companies, or companies with a conservative balance sheet that can weather an economic downturn – became unpopular.

Other factors added to this tendency toward homogeneous valuation. Some central banks, like the Japanese Central Bank and the Swiss National Bank, actively purchased large pools of stocks or stock funds (with newly created money, by the way), adding to the upward pressure on the broad indexes. In addition, low interest rates pushed traditional savers into index funds. (I wrote about this in 2015 in *The Objective Standard* as well as LinkedIn).

Index investing worked for a long time. Under these conditions, passive investing became a no-brainer, an effective and popular one-way ticket to becoming rich. Slogans like "TINA" (there is no alternative) to stocks became popular. Get in the market, stay in the market, buy stocks for the long run, buy the dip – these are all concrete expressions of an older investment landscape that is now changing.

Geological landscapes change slowly, and so do investment landscapes. I suggest we are starting to see a shift away from the automatic pilot mode of index investing. It will not go away entirely, but we are entering an era where passive index investing may not be the world-beater it was in the past.

A recent Financial Times article by a wise and influential investor, Mohammed El-Erian, sums this up succinctly. I will quote in part.



Investing differently under financial repression

> "Passive investing is particularly attractive in a world where investment outcomes are heavily influenced by a common global factor. This was the case for more than a decade as the combination of artificially floored interest rates and massive injections of central bank liquidity boosted all assets. Even zombie companies and fragile sovereigns [debt of insolvent governments] could refinance without much difficulty…..

El Erian explains that the common global factors of low CPI inflation and low interest rates are now shaken, requiring central banks to raise interest rates and restrict money creation. In addition, globalization is declining due to rising political tensions. And with this comes shifts in how and where goods are manufactured and transported, raising costs. These changing conditions create new investment opportunities while closing off old ones. And I agree with this assessment wholeheartedly.

> “In short, this is an investment world in which greater selectivity, smart structuring, and dynamic asset allocation [“dynamic” means changing course in anticipation of new information] trump more often the lower fees on passive vehicles. It’s a world that warrants a partial return to a’ la carte selection after many years of fixed menus.”

Total returns with dividends reinvested, January 1966 to July 1982 - U.S. assets		
		Real Return
Consumer Price Index	196%	-196%
Small company stocks	619%	423%
Large company stocks	126%	-70%
Large cap growth stocks	139%	-57%
Large cap value stocks	250%	54%
Mid-cap growth stocks	118%	-78%
Mid-cap value stocks	352%	156%
Long-term corporate bonds	67%	-129%
Long-term government bonds	61%	-135%
source: Ibbotson and Russell Napier, *Solid Ground* Aug 2 2022		

To illustrate that index returns are not always the key to wealth accumulation, here are some data from a 16-year inflationary period that may prove similar to the era we are entering. The chart shows the real return on various classes of stock market investment along with corporate and government bonds. Small company stocks, mid-cap value, and large-cap value stocks were the clear winners. Bonds were a disaster, barely beating cash, which lost nearly 200% of its real value. Returns under the current financial repression will be different from this because history rarely repeats; it just rhymes. I offer this data to illustrate that buying and holding an index, as many people have done successfully in their 401K plans, may not work as well as in the recent past.

How to spot opportunities by identifying trends

Value investing is generally bottom-up investing that looks mainly at the company’s fundamentals and financial performance as a good (but not only) indicator of what it will do in the future. Value investing pays less attention to momentum or speculative factors and asks what a company is reasonably worth in terms of pricing its cash flows to the investor and attempting to buy that cash flow at a discount to its fair value. One way to think of a value stock is: If you were buying a company, one company, to feed your family after you are gone, what would that company be? And there are many such companies.

I consider myself a value investor and like to say I manage risk from the top down, but I invest from the bottom up. For example, looking from the top down, I will avoid investing in Chinese companies because geopolitical conditions make them risky even though they may look cheap from the bottom up. On the other hand, I will look hard at companies that fit a positive, top-down trend, like income-producing real estate benefiting from the migration from dense coastal urban areas to the suburbs and the country. From a bottom-up perspective, maybe I assess that the companies in that category are priced too high right now, so I will wait till they reach a fair price before investing.

Investors Pressure European Banks To Stop Financing New Fossil Fuel Projects

BY TYLER DURDEN

MONDAY, FEB 13, 2023 - 12:00 AM

Authored by Amy Gamm via The Epoch Times,

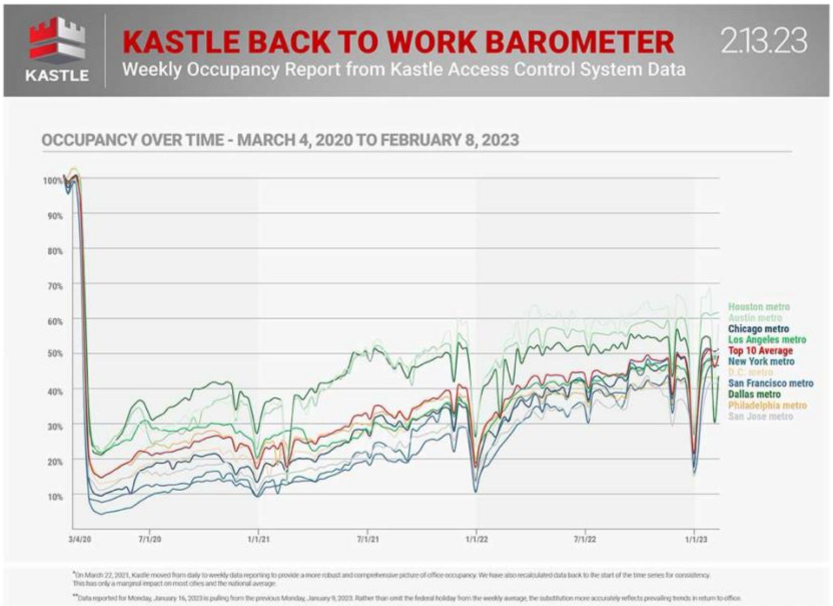
A group of investors representing over $1.5 trillion in assets under management sent demand letters on Feb. 7 to five of Europe's biggest banks, calling on them to stop financing fossil fuel firms by the end of 2023.

I want to give you a few examples of looking for important investment trends. This story in ZeroHedge highlights the pressure on European banks to stop lending to fossil fuel companies, a trend I've been aware of for some time. What does this trend tell me? That funding for fossil fuel companies is lagging, and the ideological bias against fossil fuels is one reason there is such under-investment in oil and gas. If these ESG-oriented asset managers have their way, new money creation will not go from European banks to fossil fuel companies.

Think of the implications of that policy and ask where it leads. To me, it does **not** lead to investing in carbon capture, windmills, solar panels or anything related to these forms of energy which I know are mostly uneconomic and unreliable. The true economic demand for these energy sources is limited, inflated by subsidies, and hyped by politics and global warming hysteria. The big return from investing in so-called renewables has come and gone and is, ironically, "not sustainable" anymore.

On the other hand, I know fossil fuels and nuclear technology must grow because they will absolutely be necessary to propel civilization as far as my eyes can see. And I know investment in these sources has been well below average for almost a decade, even longer in the case of nukes. So this prompts me to ask: What does that mean for the trend of prices in oil and gas? Where will the investment in oil and gas come from? What has to happen to unleash investment in nuclear power? Who benefits from this anti-fossil fuel bias, and who loses?

In my case, seeing this trend unfold has led me to invest in oil, gas, and coal-related stocks, which were depressed for years and which also fit all my bottom-up value investing criteria. So I offer this as an example of what you should do, but of how a trend can spawn an investment idea.



Here's another example of a negative trend that could generate investment ideas. What's the future of office real estate in metropolitan areas? The creator of this chart, Kastle Systems, is a maker of office security products. They monitor keycard swipes among their customers so they know the usage and occupancy of office buildings. This data is publicly available to anyone. The chart assumes an index of 100% occupancy at the beginning of the Pandemic. Three years later, we are only back to less than 50% occupancy of city office space. Everyone left the office and is working from home. Philadelphia and San Francisco are at 40% occupancy, and the best areas (Houston and Austin) are only back to 60% occupancy. Are we ever going back to 100%? I would say not in any reasonable investment horizon. This was a gradual trend already underway before the pandemic, and the pandemic accelerated it.

This trend tells you that even if office-space-related investments looked very cheap, based on historical returns, you should be very careful before jumping in. On the other hand, maybe someone can buy an office out of bankruptcy and convert it into a badly-needed living space. That might work. In any case, be careful.

Here's another trend that might produce an opportunity: Reshoring. We will be relying less on China in the future to make our consumer goods. So there will have to be an investment in bringing industries “home”or at least moving them to places more reliable or friendlier than

China, like India or Viet Nam. And if I am right about banks getting nudged by the government in a specific direction, these industries might get some cheap credit as the reshoring progresses.

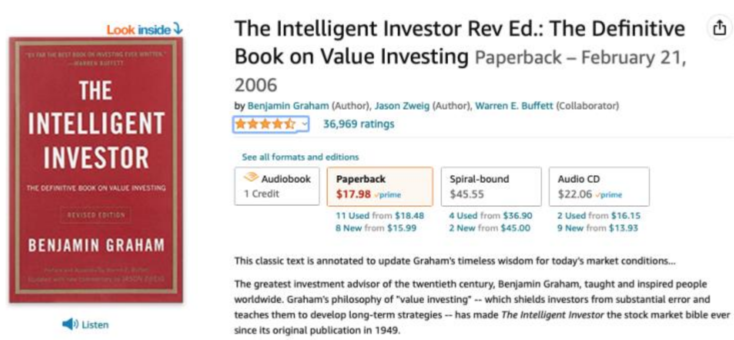
So I am looking for increased investment in tangible assets in the USA. For years since about 2000, there was not much investment in tangible assets because that industrial capacity was built in China (and other markets but mainly China), so we didn't have to invest here at home because China invested cheaper than we could and sold its products to us cheaply. But if we are now going to buy less from the Chinese, we'll have to invest in mines, intermediate assembly plants, chemical refineries, etc. So there will be these "reshoring" opportunities in the USA. And related opportunities, like real estate in the right places. What benefits from the new flow of cheap credit? I am on the lookout for such developments. Maybe some unused office space will provide a home for a new factory and employment.

How about another trend? The global population is aging, so on average, this means slower growth of consumer goods. However, countries like India, Bangladesh, Pakistan, and Ethiopia have very youthful demographics, so the demand for goods in these countries will grow. These countries represent the best investment opportunities from a demographic point of view, but they also come with issues that must be tackled first, such as infrastructure. Opportunities are coming there if you can root them out.

These are just a few examples designed not so much to tell you where to look for ideas but how to look. You narrow the field by using your knowledge or imagination to think of how some trend will uncover an investment opportunity.

Other ideas on what might work under financial repression

Note that the asset classes that gave you a return ahead of consumer price inflation were small-cap stocks, mid-cap value stocks, and large-cap value. Traditional savers who generally use bonds or savings funds based on bonds, got poorer. But value investing strategies worked then and I think they will work under today's financial repression. I believe active investing is back, and value investing is an excellent active strategy.



For investments in the stock market, I have always used the investment practices laid out by the great Benjamin Graham and made famous by Warren Buffett.

Stocks are not for everyone. There are good ways to save and invest without the stock market. But if you are going to get actively involved in the stock market to educate yourself, I would start with Graham's book *The Intelligent Investor*, then read Warren Buffett's annual letters to Berkshire Hathaway shareholders, which are readily available for free in e-book form. And if you don't find these or similar books and writings interesting, I would steer clear of the stock market. If you are not interested, don't force yourself into stocks for fear of missing out, it's not for you.

"Nobody knows what anything is worth," Greenlight Capital founder and President David Einhorn says during an interview with @SonaliBasak at the Robin Hood Investors Conference trib.al/pQDaUdj

5:17 AM · Oct 12, 2022

Value investing, or old-fashioned stock picking based on company fundamentals, has been so out-of-favor recently that one of its most outstanding practitioners, David Einhorn of Greenlight Capital, recently said in an interview that fundamental stock picking might be dead for good.

Einhorn, whom I respect, was only partly right about this. To paraphrase Mark Twain, the death of value investing has been greatly exaggerated. Value investing never really died; it just hibernated for a decade or two.

I'll probably have more to say about value investing in future chats because I believe this old-fashioned, basic approach never goes out of style and will work well in the future.

I am not offering what I would call investment advice here, but if I could offer one little aphorism to sum up my whole attitude toward investing in stocks it would be this:

"In the stock market, the opportunity of a lifetime comes along about every three months."

This means patience, buying businesses and not "stocks," hard work, study and not speculation, resisting FOMO, and shutting out tons of noise.

To wrap up today's chat, let's continue with Mohammed El Erian's theme that you should pick from an *a la carte* menu of investing ideas rather than the fixed price menu. Continuing that theme, I'd like to offer you now a partial menu of types of investments that should do OK under financial repression. This will not be a comprehensive by any means, but a list of the types of dishes you can choose from.

The analogy is more like this: I recommend you eat more beef and less corn, but I will not tell you where to buy your beef or how to cook it. I will offer four general recommendations.

Recommendation 1. Make your cash work as hard as you can
If you have extra money sitting in a bank deposit or a brokerage account, you are probably getting less than one percent annual interest on that money. You haven't had to care about this for years because consumer price inflation was less than 2%. But today it's at least 6%. So don't settle for 1% bank deposit yields. Brokered 3-month CDs are now paying 4.5%. the 6-month Treasury note is the same. Both are virtually risk-free and can be quickly sold even before their short maturity period.

You won't beat inflation with this strategy, but you'll limit its damage. So make your cash sweat.

Recommendation 2. Own your own home
Owning a home is often the best long-term investment most people ever make. In the USA, there are tax advantages, like the deductibility of mortgage interest that make it attractive. Be careful, don't just run out and buy something. Shop for the best areas, be patient, and use time as your diversifier. Be concerned with fair prices more that mortgage rates. You can't control mortgage rates. If they go up after you buy, you got a good deal, but if they go down you can always refinance to your advantage. The trend of people moving from the cities to the country or the suburbs works in your favor. Many people Take advantage of the chronic shortage of housing. Many people buy homes as rental real estate and do very well over the years. This requires work but if you like doing it, it can be very rewarding.

One important advantage of home ownership in the USA is that your home is a secure property right. in Property rights are under assault today, but the family home is such an American icon and such a strong traditional value that I suspect it will be the last place government will come to pillage your wealth. Many states have special laws that allow you to keep your home in the event of bankruptcy.

Recommendation 3. If you invest in stocks, buy good businesses for the long run.
Value investing as I see it is getting a growing cash flow and growing yield for a good price. Stocks with growing dividends can outperform inflation. "Dividends don't lie" is a common value expression.

Here's an example of a lifetime opportunity: Walmart stock. I offer this as just one great example. There were, and are, many others.

The stock price was 3.8 cents per share in 1972 (adjusted for stock splits and stock dividends). Fifty years later, it's worth 145/share. $1000 invested fifty years ago is worth 3.8 million today. This does not even include the dividends, which can be reinvested.

You buy a good company and practically forget about it. Some companies like WMT have dividend reinvestment plans called DRIPs that allow the company to hold your shares and reinvest the dividends for you. It's also an excellent way to save for college for your kids.

I was not wealthy in 1972, but I did have $1000 to invest. I did not buy and hold Walmart. I don't harbor regrets about it, but the point is that you will be presented with many opportunities like this in your investing lifetime. The question is, will you be able to see them?

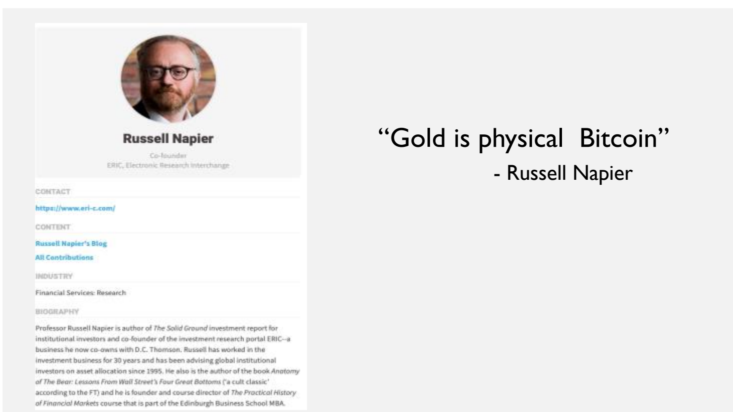
There are many other considerations for investing in companies under inflation and financial repression. I wanted to talk about things like the dangers of heavy cyclical companies; how to spot a company with pricing power that can keep up with inflation; how to spot a company that can scale up quickly; what are the hallmarks of a very long-term investment and so forth; how to buy closed-end investment funds at a discount, etc. These details will have to wait, but the good thing is we will always have a lot to talk about in this forum.

Recommendation 4. Consider traditional inflation beaters

Farmland: Fertile farmland usually keeps its value during inflation because its value depends on the value and price of the crops it produces. Farmland is not very liquid; it may be hard to sell, but if you are patient, its value generally does well, and it may provide standing ground in an era of increasing government intrusion. The same may be true of timberland.

A working farm is, of course, very expensive, and most people don't want to do farm work, so you can invest directly in farmland through private partnerships or publicly traded REITS, but in the latter case, watch out for fees and don't pay significant premiums over the net asset value of the fund.

Precious metals: To me, gold is the savings asset of choice in financial repression. There are at least two reasons. First, real interest rates are negative but gold doesn't pay a coupon so it never goes negative, but tends to perform with inflation, which is by definition better than the negative performance of long-term bonds that pay interest less than the inflation rate. Second, it is difficult for government to interfere with property rights of owning gold. Many central banks are buying gold in size. Pensions are buying it. State governments are passing legal tender laws and building gold depositories. Gold is not a security, so it will not be regulated by the SEC. Gold is the only financial asset that is not someone else's liability. There are obvious risks with gold, but there is no counterparty risk. New supplies of gold increase by only 1 to 2% per year, so it can't be severely inflated – unlike fiat money.



Some people like bitcoin as a digital alternative to fiat currency, but I like this expression from the Scottish monetary economist Russell Napier: Gold is "physical bitcoin," a play on the expression, "Bitcoin is digital gold."

You can also buy gold miners and gold royalty companies, which I'll have more to say about in future podcasts.

Recommendation 5. Find reliable advisors who make sense, not outlandish claims.

You'll have to pay for honesty and objectivity, but you won't have to pay a lot of money.
I will recommend some of these in the future.

We are out of time, so let's draw a line there. Questions or comments?