



FRANCIS  
Investment Counsel LLC

# KING OF THE HILL

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## Capital Markets, Inflation and an Investment Outlook

Presented By:  
Edward McIlveen, CFA  
Principal, Chief Investment Officer

# **I. Always Start with the Fed**

## **II. The Fed's Influence on Asset Prices Waking-up the 'Inflation Monster'**

## **III. Your Action Steps**

# The Fed – Today it's “Inflation Targeting”

## The Matter at Hand in 2020

**“For many years, inflation in the United States has run below the Federal Reserve’s 2 percent goal.”**

“If inflation expectations fall, interest rates would decline too. In turn, there would be less room to cut interest rates to boost employment during an economic downturn. Evidence from around the world suggests that once this problem sets in, it can be very difficult to overcome. *To address this challenge, following periods when inflation has been running persistently below 2 percent, appropriate monetary policy will likely aim to achieve inflation modestly above 2 percent for some time.* By seeking inflation that averages 2 percent over time, the FOMC will help to ensure longer-run inflation expectations remain well anchored at 2 percent.”

Source: [https://www.federalreserve.gov/faqs/economy\\_14400.htm](https://www.federalreserve.gov/faqs/economy_14400.htm)

# The Fed in 1979 – Back then, “Anti-Inflation”

## The Matter at Hand in October 1979

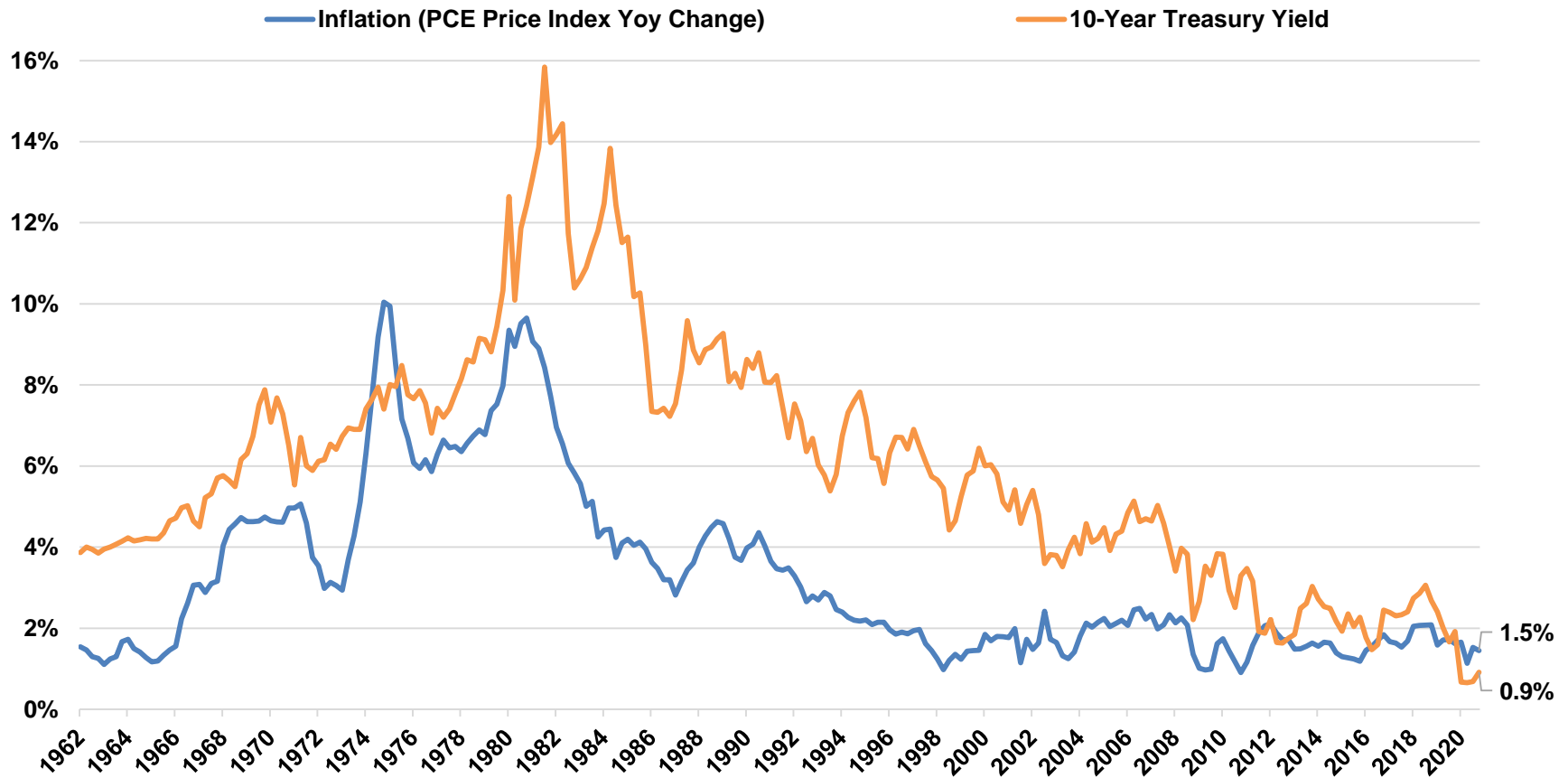
### “Volcker’s Announcement of *Anti-Inflation Measures*.”

“...Volcker, who had just started his tenure as chairman, reinforced this message, saying he would be focused on **restraining the growth of the money supply**, with the ultimate goal of promoting sustainable growth for the US economy.”

Source: <https://www.federalreservehistory.org/essays/anti-inflation-measures>

# Inflation and Interest Rates Track Together

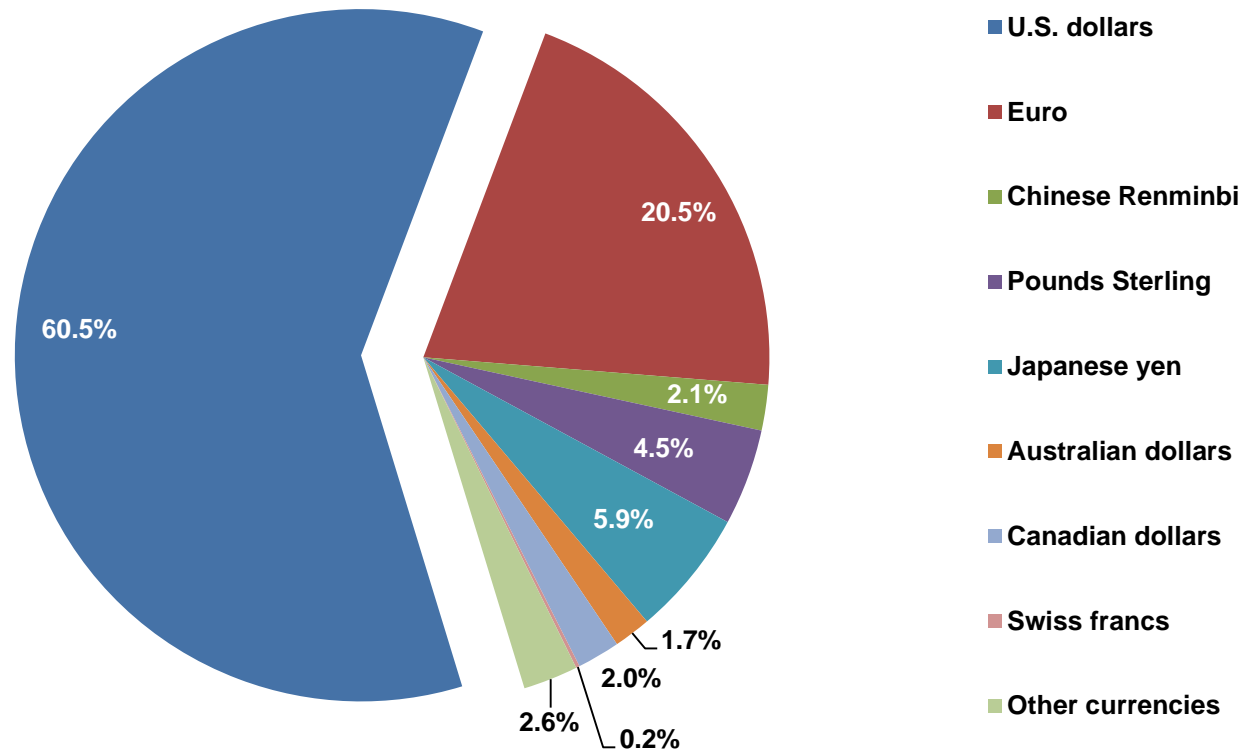
## Historical Inflation & Interest Rates



Source: Bloomberg

# The Fed's "Exorbitant Privilege"

## Foreign Exchange Reserves by Currency



As of 9/30/20

Source: International Monetary Fund, data as of 3Q 2020

... And hence why the U.S. dollar is 'King of the Hill'

# Dollar to Lose its Status as World's Reserve Currency in the Near Future?

Traditional Global Economic Analysis	
<b>Balance Sheet Focused</b>	<ul style="list-style-type: none"><li>• Terms of Trade, Deficits, Surpluses etc.</li><li>• Maybe some observations about politics</li></ul>
<b>Other Currencies Compete Away Advantages of U.S. Dollar</b>	<ul style="list-style-type: none"><li>• Rising economic growth is higher overseas</li><li>• Better real rates of growth means people will need less dollars</li></ul>
<b>U.S. is debasing the dollar, so this must all mean...</b>	<ul style="list-style-type: none"><li>• The dollar loses its dominance as countries rebel and embrace another currency or a basket of currencies</li></ul>

# Dollar to Lose its Status as World's Reserve Currency in the Near Future?

# Goldman Sachs Says U.S. Dollar Could Lose Its Status of World's Reserve Currency, Bullish on Gold

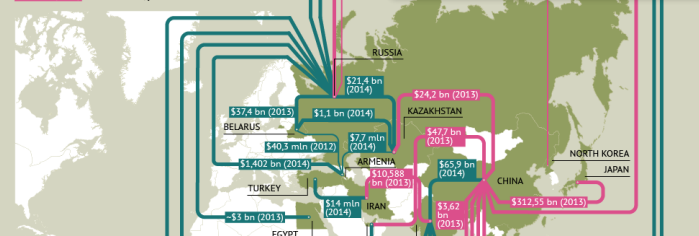
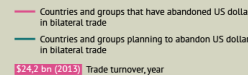
Jul 29 2020 · 11:15 UTC by Bhushan Akolkar · 3 min read

## The U.S. Dollar May Be Nearing Its 'End Game'

## Still the world's reserve currency?



Countries and international groups that have switched from US



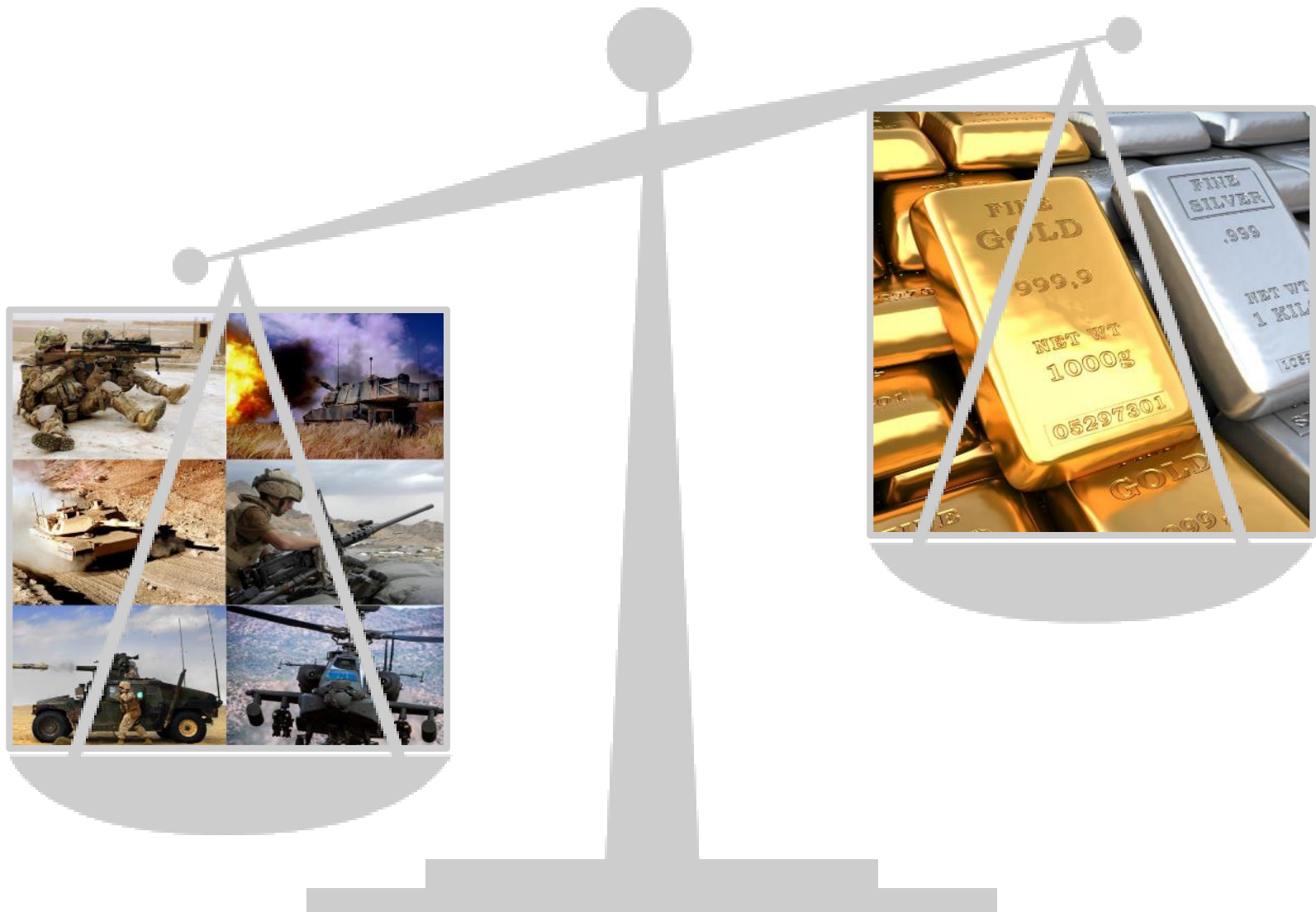
The US dollar's sharp decline this year has raised questions about it losing its status as the pre-eminent reserve currency and dominant force in the global payments.



# Not a Chance.



# Not a Chance.



# Some questions on your mind...

**How much longer can the U.S. print and spend money like this?**

**Will the U.S. experience the same fate as the Weimar German Republic in the 1920s?**

(i.e. hyperinflation, paying for a loaf of bread with a wheelbarrow of near worthless cash)



# Some questions on your mind...

**How much longer can the U.S. print and spend money like this?**

***At least a decade***

**Will the U.S. experience the same fate as the Weimar German Republic in the 1920s?**

***Not now; 'exorbitant privilege' prevails for years to come***



# Key Points So Far

<b>Always Start with the Fed</b>	<ul style="list-style-type: none"><li>• Creating, controlling, and distributing money is the most commanding lever government enacts on its citizens</li><li>• Modifications in the domestic money supply undeniably define the purchasing power of notes in domestic and global trade</li></ul>
<b>Money Supply Matters</b>	<ul style="list-style-type: none"><li>• Direction of money supply growth is central to changes in economic growth</li><li>• As growth goes, the trends in inflation and interest rates are close behind</li></ul>
<b>The Military Matters</b>	<ul style="list-style-type: none"><li>• U.S. Military is #1 in the world – best backing for currency, at all times</li><li>• It's technological dominance plus its aircraft carriers afford the U.S. virtually an unlimited reach</li></ul>

## Implication

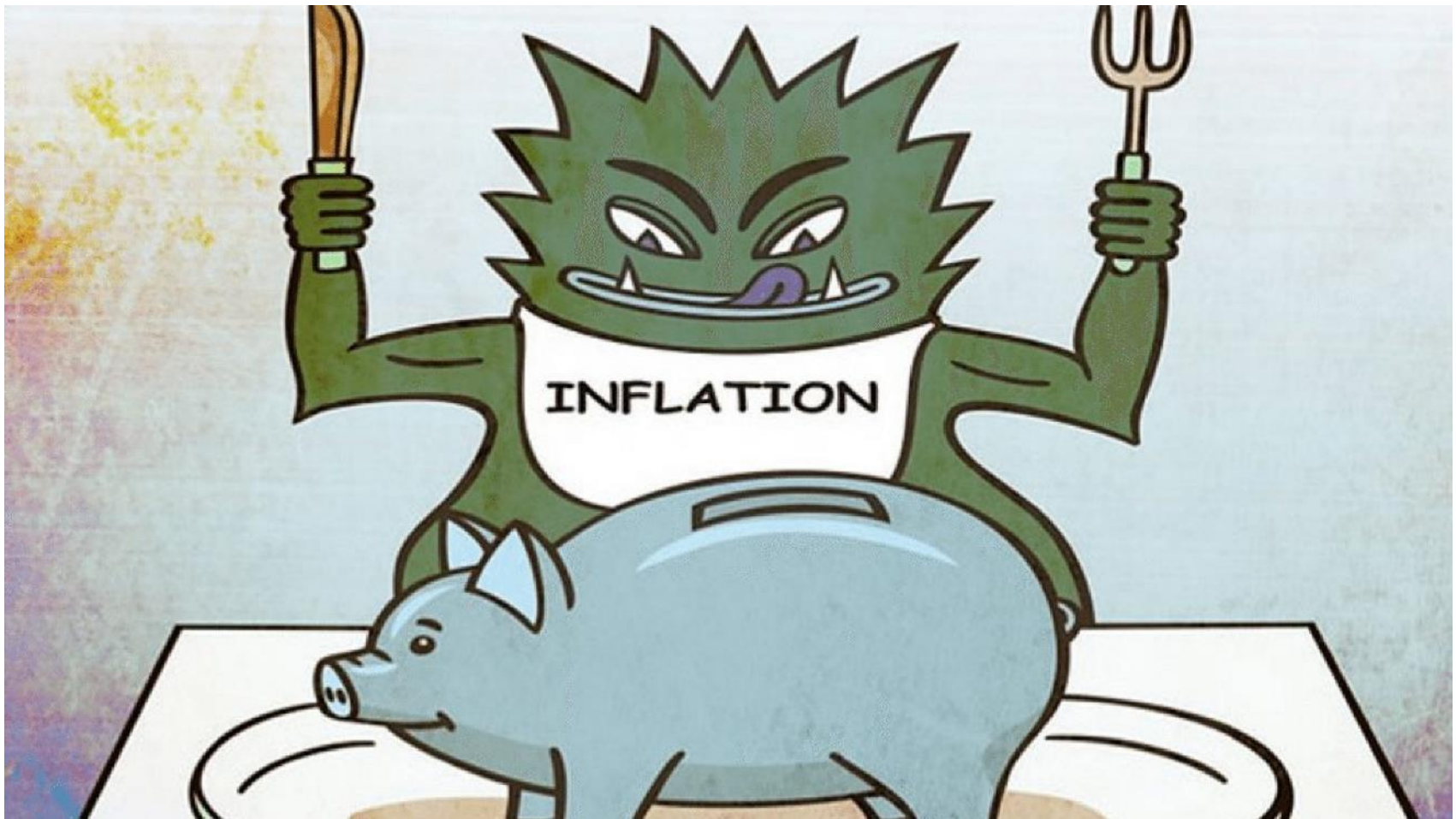
**The U.S. dollar holds top spot as reserve currency AND trillions of it can be printed and spent**

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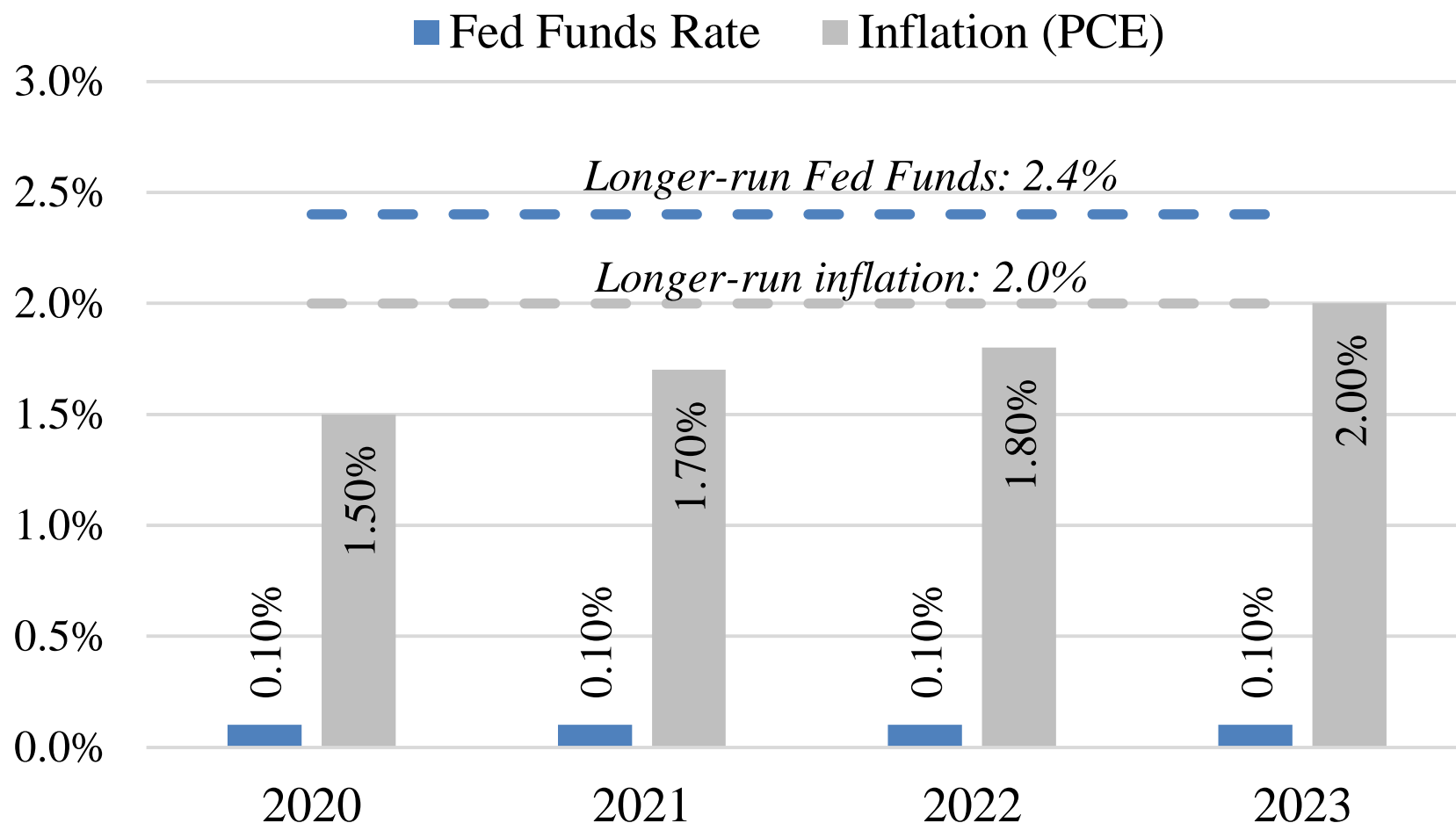


The **inflation monster** is a term utilized by George Cooper in “The Origin of Financial Crises: Central Banks, Credit Bubbles, and the Efficient Market Fallacy.” Highly recommended reading.

Source (photo): [swisslife.com](http://swisslife.com)

# Back to the Fed - Lower for Considerably Longer

## Federal Reserve FOMC Sept. '20 Projections



Source: Board of Governors of the Federal Reserve System



# Cranking the Money Supply

## U.S. Money Supply (M2) Growth

*M2 measures savings deposits, time deposits, and retail money market assets*

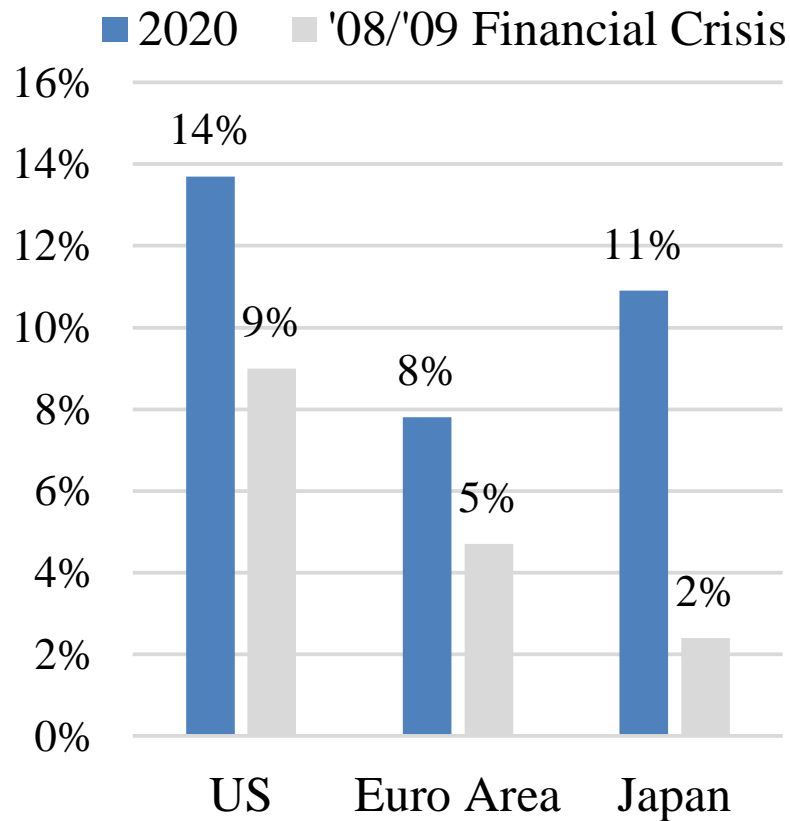


Source: Federal Reserve

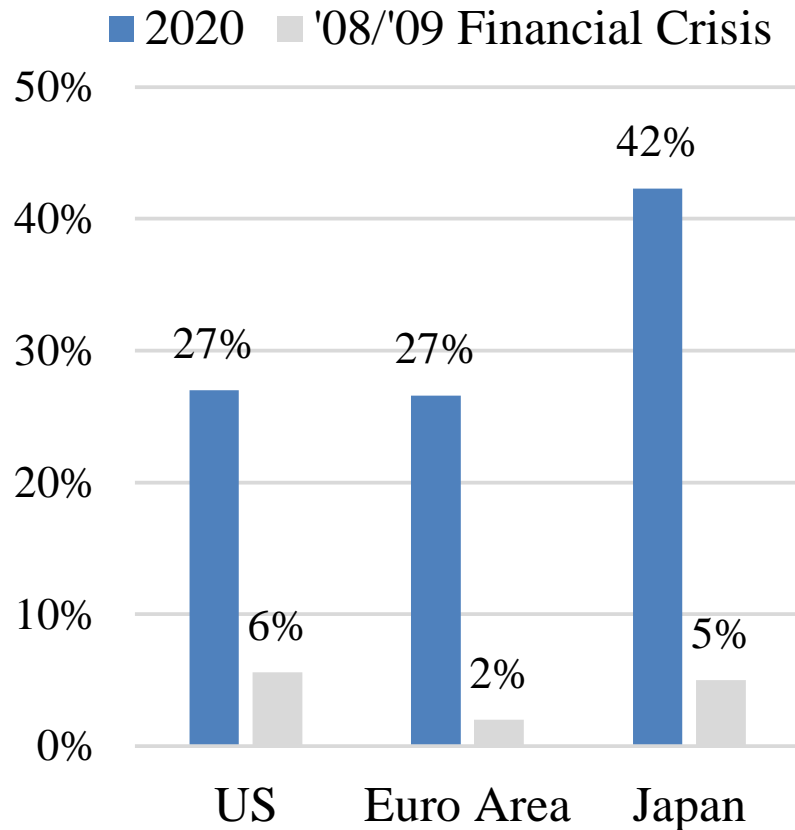
# Stimulus: Not Just Big, but Enormous

## Unconventional Policy Measures (% of GDP)

### Monetary Policy



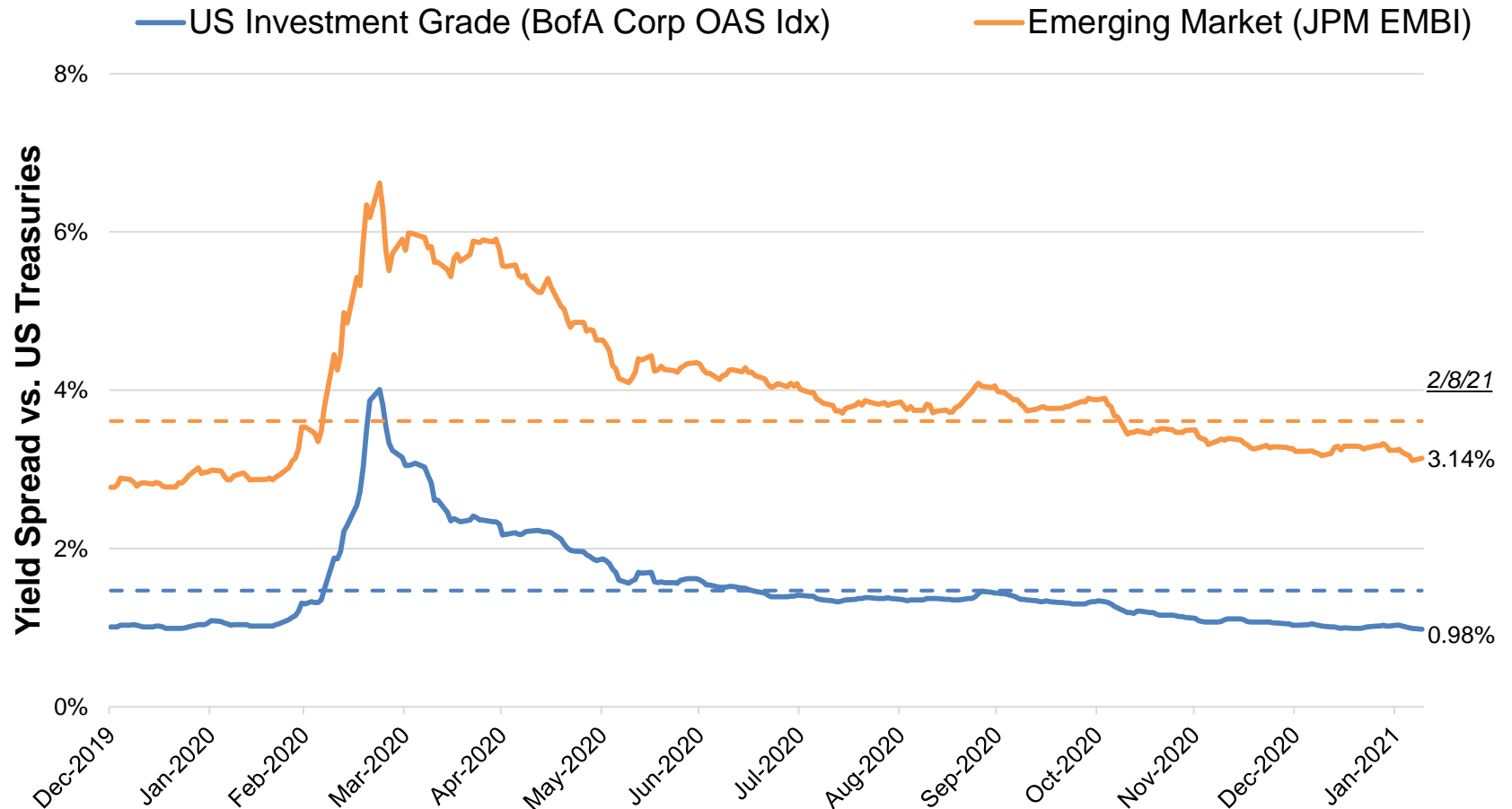
### Fiscal Policy



Source: Goldman Sachs

# Cost of Capital Cheap – Worldwide

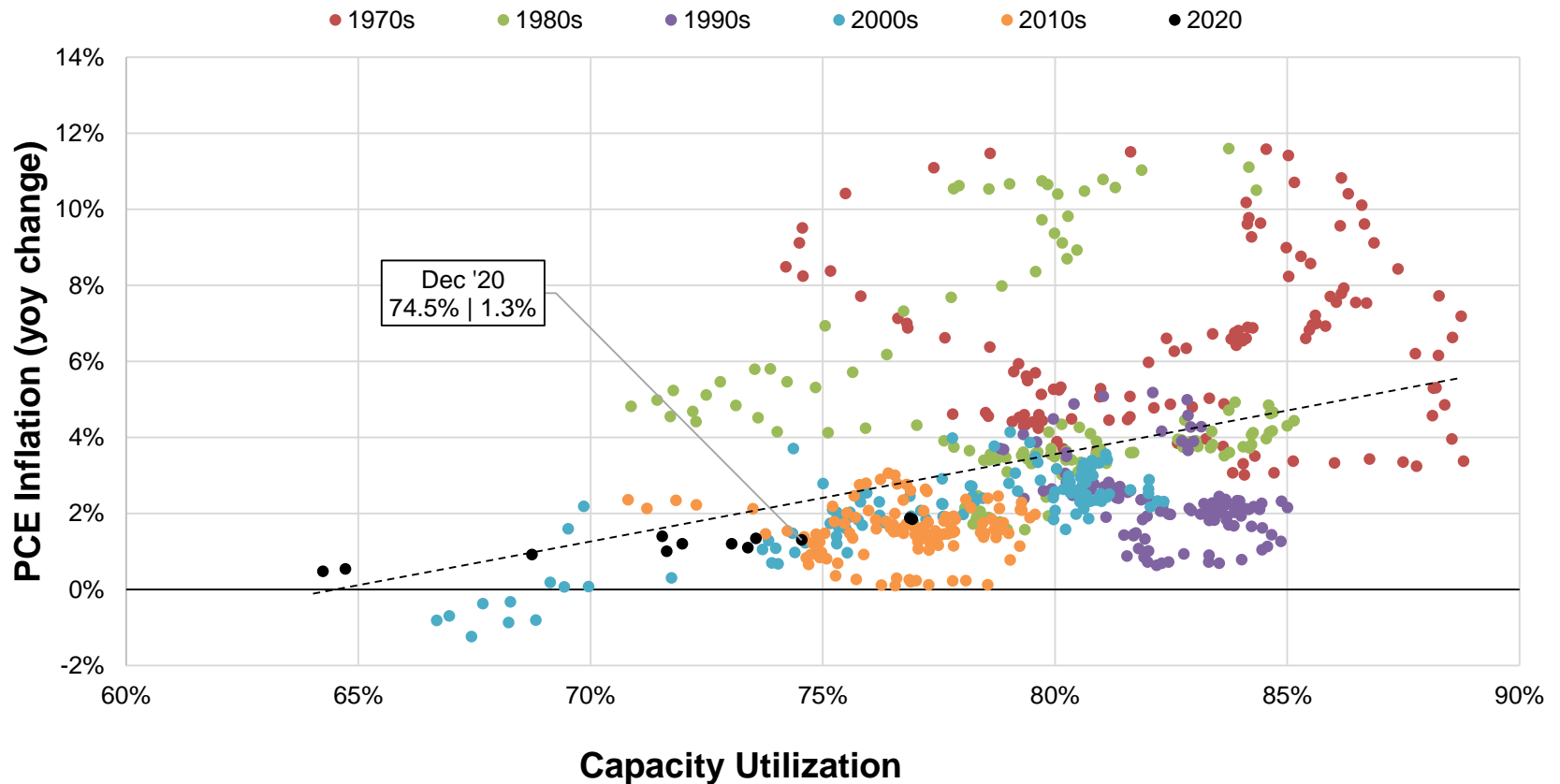
## Bond Market Credit Spreads



Source: Federal Reserve Economic Data, JP Morgan

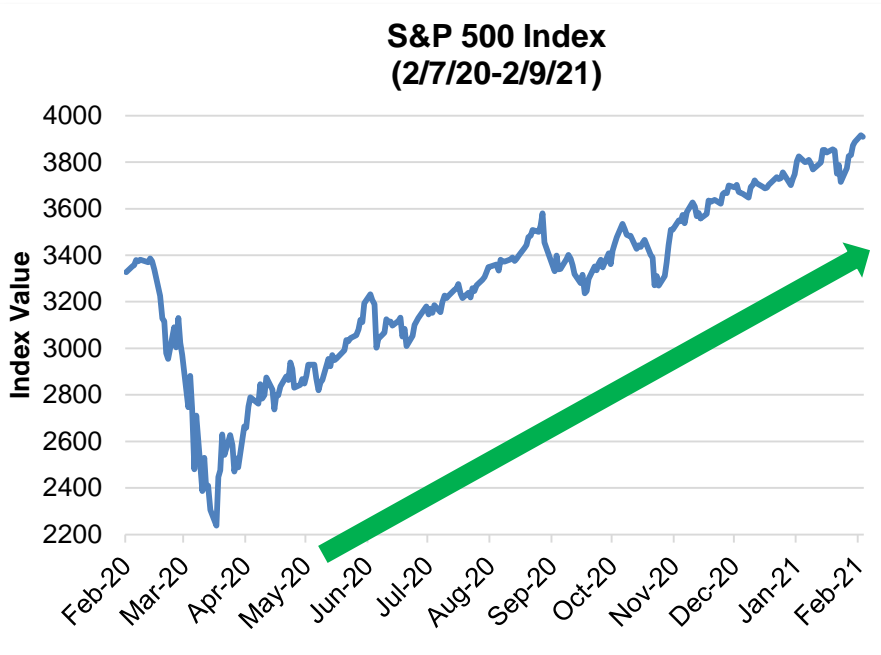
# Low Capacity Utilization Leads to Lower Inflation

## U.S. Capacity Utilization & Inflation (Monthly data, since 1970)



Source: Federal Reserve Economic Data

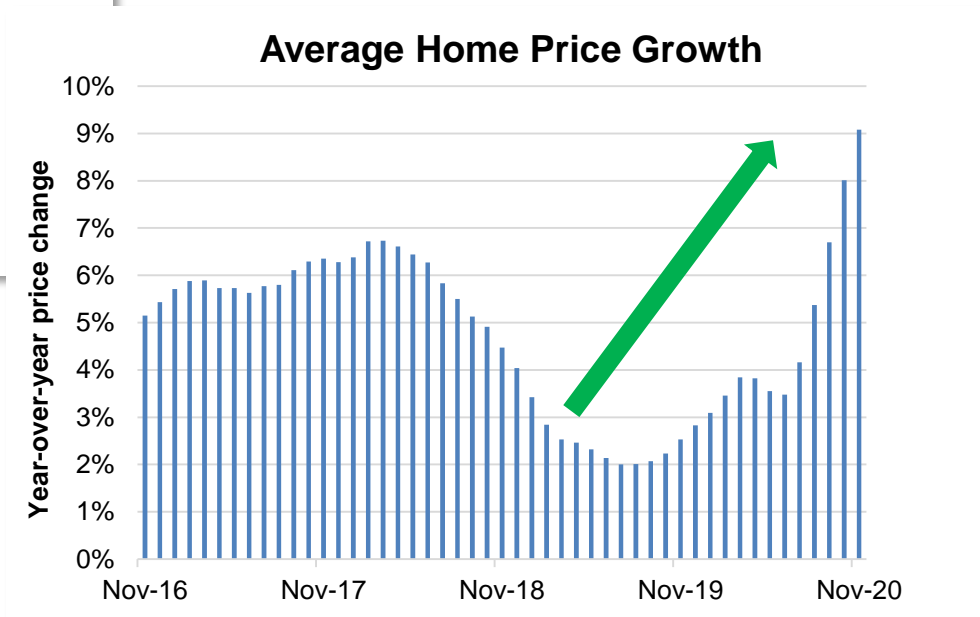
# The Wealth Effect



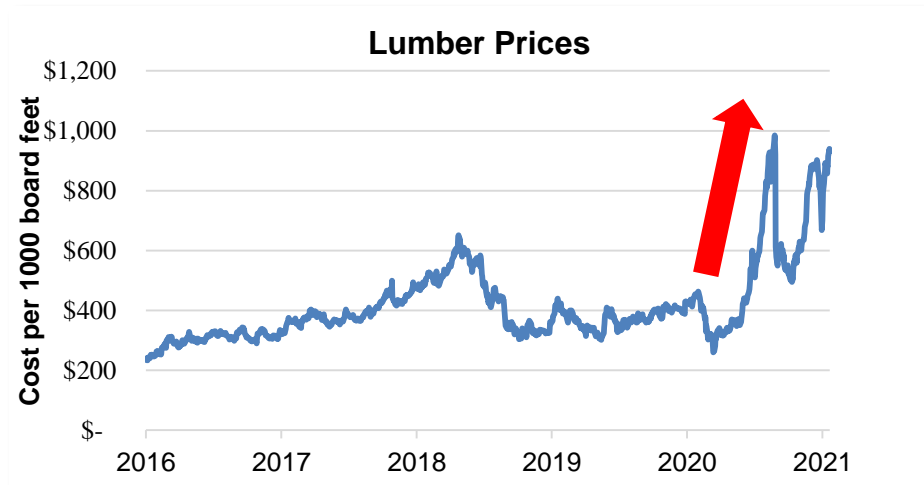
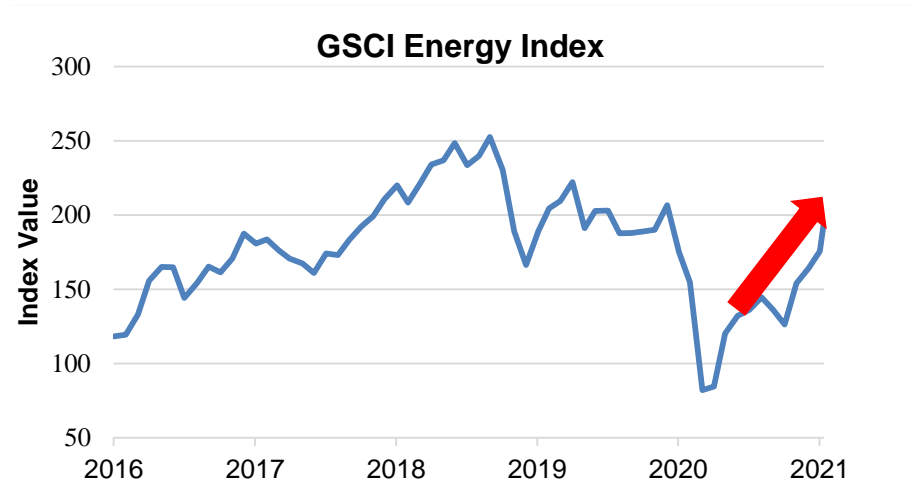
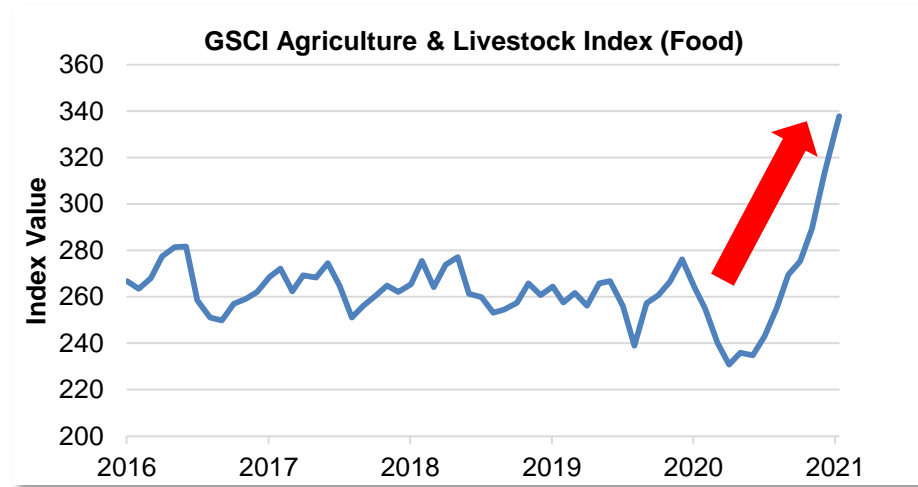
**S&P 500 Index +77%**

(since March 23, 2020 to February 9, 2021)

**It feels like:  
“We are getting  
ahead.”**



# But Food, Energy, Lumber all Going Higher



Source: Bloomberg. All data as of 2/9/21.

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# Your Action Steps

## For the Company

### Accelerate Corporate Expansion Plans

- Cost of capital is cheap at the moment
- Favor fixed rate over floating rate structures
- Lock in current prices to the extent possible

## For the Retirement Plan

### Inflation Sensitive Assets are a Must

- Treasury Inflation-Protected Securities
- Emerging Market Debt
- Emerging Market Equity
- Commodities

## For the Individual Investor

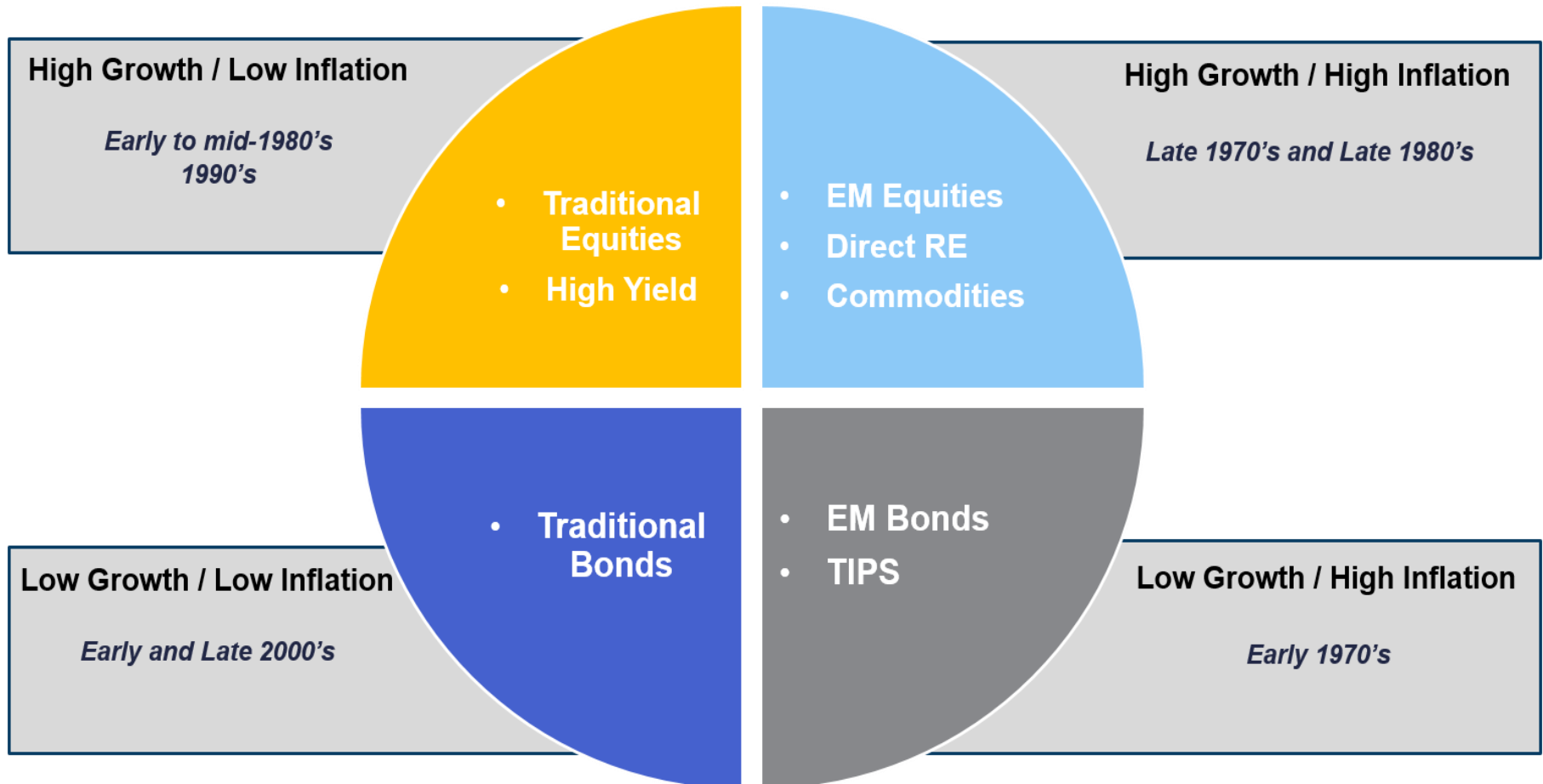
### Equities, Equities, Equities

- In order of preference
  1. Emerging Market Equities
  2. U.S. Small-Cap Equities
  3. Developed International
  4. U.S. Large-Cap Equities
- Stock ideas: [Gurufocus.com](https://www.gurufocus.com)



# Equipped for Any Economic Environment

## Best Performing Asset Classes in Each Economic Environment



# Recap: King of the Hill

- The Federal Reserve's monetary policy initiatives stand as the top reason why stock market returns soared to new highs in 2020.
- Muted inflation in the near-term will likely prevail until capacity utilization improves coincident with declines in unemployment (closing the output gap).
- Investors should overweight equities in this environment and look increasingly to commodities and real estate as hedges to unexpected inflation shocks in the future.

# Investor's Outlook

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

## **King of the Hill**

The dollar remains the world's reserve currency affording the United States the near-term ability to print and spend money at a torrid pace.

## **Research Review**

“How great does inflation have to be before a government can no longer control it?” A book review of Adam Fergusson's *When Money Dies (1975)* explores this question by focusing on the German hyperinflation in the 1920's.

## **Idea Generation for the Future**

How do you find 'smart money' moves? Take a look at [Gurufocus.com](https://gurufocus.com).



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# Questions

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