Sitka Pacific
Capital Management, LLC

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Dear Investor,

At this point in a typical economic cycle, when the economy has likely moved past the lowest point of a contraction in output, the conversation among economists inevitably turns toward recovery and growth. This is a natural progression, and if this recession had been typically cyclical, and been accompanied by a conventional fiscal and monetary policy response, investors and market strategists could probably take their cues from that conversation while assessing the outlook for the markets. Yet with the U.S. equity market trading at such an overextended valuation, with bond yields just off the lowest rates in history, and with fiscal and unconventional monetary policy actively devaluing the dollar, the investment merit of U.S. stocks and bonds is the conversation which should be at the forefront of every investor's mind.

Today's valuations represent exceptional risks, but they also are part of an investment landscape with exceptional opportunities in markets which have languished as the bubble in the U.S. has inflated. For those who are value oriented, the latter half of the 2010s was a difficult period to navigate, as overvalued markets continued to rise ever higher, while undervalued global markets and real asset classes continued their relative and absolute trends lower. A dynamic similar to this defined the lead up to the tech bubble peak in 2000. Recently, however, the value present in assets outside U.S. stocks and bonds has begun to attract more attention, and this turn has been a favorable structural shift in the market landscape for those who seek investments with absolute value, as we do.

One of the most vigorous debates this year has been centered around the long-term outlook for inflation in light of the recovery and the Federal Reserve's new monetary policy framework. During the first quarter, bond yields shot higher as inflation expectations continued to rise, and higher yields eventually spawned a rebound in the dollar in February and March. However, this rebound proved short-lived, and as most of the dollar's gains were subsequently lost in April, the inflation debate heated up again. There remains widespread skepticism that the Fed's goal of higher inflation will prove any more obtainable than it did in the decade after the financial crisis, but in the pages below we will highlight two demographic trends which may aid the Fed's efforts in the years ahead. We'll then provide an update on the ongoing consolidation in gold and silver, which has unfolded in the wake of last year's gains.

In this month's letter:

- Two Demographic Drags on Inflation Are Pivoting
- An Update on Gold and Silver's Consolidation

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Two Demographic Drags on Inflation Are Pivoting

> *Our findings suggest that the deflationary effect that the age structure has had on inflation for the past four decades will reverse over the coming decades and become inflationary…*
>
> *Over the past 50 years, the increasing share of working age population has lowered average inflationary pressures by around 3 percentage points. Currently, the shrinking number of young cohorts largely offsets the increasing number of old ones – which holds inflationary pressure at historically low levels. Over the next half century, the growing share of the old will dominate and increase inflationary pressure by approximately 3 percentage points on average. Although country-specific estimates vary, the reversal of past disinflationary pressure into inflationary pressure is present in all individual country estimates.*
>
> - *The Enduring Link Between Demography and Inflation*, Bank for International Settlements, May 2018

Over the past number of years, we have taken up a lot of space in these letters discussing issues surrounding debt, deleveraging and monetary policy. The primary reason for our continued focus on these issues is that the financial crisis in 2008 represented the end of the familiar post-war era of traditional, cyclical monetary policy, and ushered in a new era in which monetary policy is primarily focused on inflating the economy out of over-indebtedness. This policy pivot has had widespread consequences throughout the financial markets over the past twelve years. It is perhaps most visibly evidenced by the cumulative 23% loss in the real, inflation-adjusted value of cash since the Fed first lowered short-term interest rates to zero in 2008. This loss of value is a consequence of short-term interest rates being held below the rate of inflation over time, and negative real interest rates represent a telltale sign of monetary policy being focused primarily on fostering inflation, not restraining it.

In pursuing an inflationary policy of negative real interest rates and quantitative easing in the decade after the financial crisis, the Federal Reserve continually expected inflation to begin trending higher as the economy continued to recover. However, inflation instead remained persistently below expectations – despite policies which were deliberately encouraging prices to rise. There was, in fact, dramatic inflation of some economic prices, particularly in financial assets, but the lack of acceleration in prices throughout the broader economy remained a mystery to the Fed, and a source of frustration. With prices throughout the broader economy relatively stagnant, it severely limited the Federal Reserve's room to maneuver.

What is well known among economists, but less well known among investors and the general public, is that the observed inflation rate of prices throughout an economy is a function of many different factors, only some of which are monetary in nature. Over time, with all other factors being equal, a large increase in the supply of money relative to the total output of an economy will eventually result in a large increase in prices. This has repeatedly been demonstrated throughout economic history, though the latter point – the amount of money *relative to output* – is usually overlooked. Importantly, however, all other factors beyond the relative supply of money are never equal in the real world, and over shorter periods of time the supply of money – even a rapidly expanding supply of money – may not be the dominant factor influencing prices throughout an economy. Sometimes, other economic forces are applying an even stronger pressure on prices than a rapidly growing supply of money is exerting.

Among the most potent non-monetary influences on the trajectory of prices are changes in population and demographics (i.e., the age structure of a population). Changes in population and demographics are factors which can have a substantial impact on the often-overlooked *output* side of the inflationary dynamic, and they often represent the "missing links" in many long-standing inflation "mysteries." In a closed economy, for instance, a growing population will have an entirely different inflation dynamic than a shrinking population, and a population with relatively large working-age cohorts relative to older, retirement-age citizens will have a different inflation dynamic than a population with a relatively large number of retirees. In addition, changes in population and demographics not only affect an economy's total output, but they also influence levels of spending, saving and many other factors which influence the overall trend in prices throughout an economy.

Although we have discussed some of the monetary factors which led to the inflationary spiral of the 1960s and 1970s, there were also significant demographic factors which contributed to that era of rising prices. The expanding base money supply in the late 1960s provided the raw fuel for rising inflation rates, but raw monetary fuel alone does not ignite inflation – the money has to be spent to begin having an impact on prices. The deficits of the federal government during that era provided some of that inflationary spending, but the entrance of the baby boom generation into the workforce also delivered a powerful inflationary impulse.

The two charts below highlight this demographic influence on inflation. On the left, it shows the close correlation of monetary velocity and long-term Treasury bond yields between 1960 and today, which have risen and fallen with inflation rates. And the chart on the right shows the close correction monetary velocity has had with the growth rate of the prime working-age population in the U.S. since 1920: the faster the workforce has grown, the faster the money supply as circulated in the economy.

Fig 4: US money velocity of MZM money stock vs. US 10 year bond yield (%)

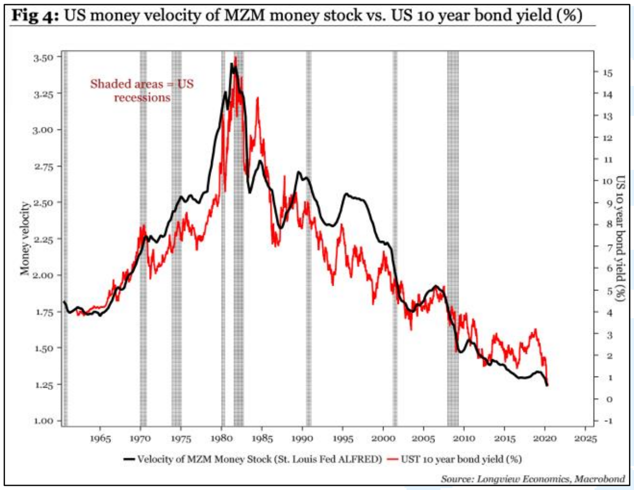
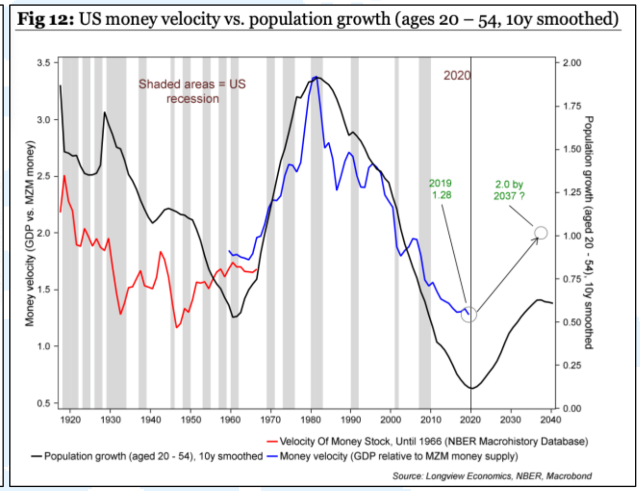


Fig 12: US money velocity vs. population growth (ages 20 – 54, 10y smoothed)



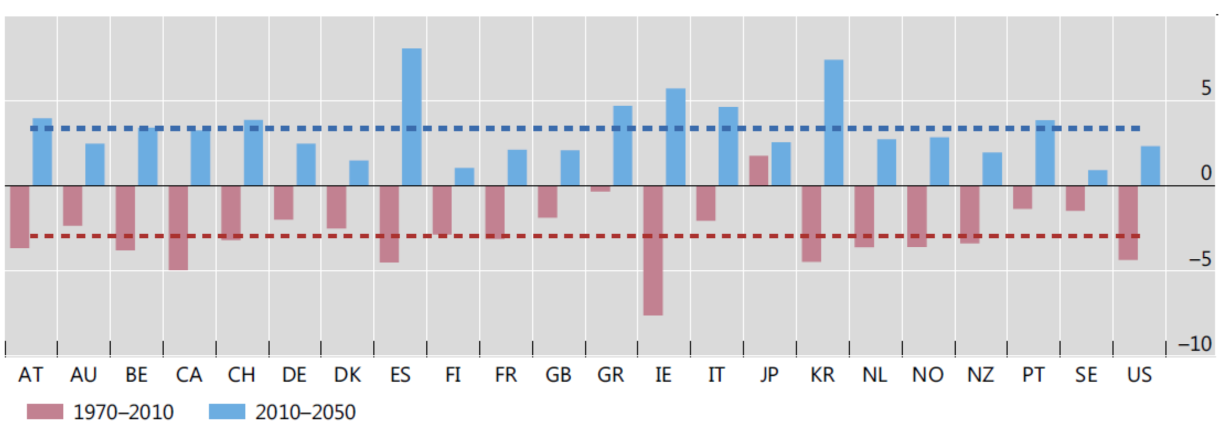
It has been forty years since Paul Volker broke the back of the Great Inflation, and he did so in part by ending the era of negative real interest rates, which slowed the growth of the money supply. However, the early 1980s also saw the peak rate of growth in the labor force, which you can see in the black line in the chart on the right, and the long decline in the labor force growth rate since then has accompanied a steady decline in the velocity of money – and a steady decline in inflation.

When the velocity of the rapidly expanding money supply rose dramatically in the 1970s, so did prices, and as the velocity of the more modestly expanding money supply continued to fall after 1980, so did the rate of inflation. While the Fed has controlled the supply of money, demographics have exerted a strong influence on the velocity the money supply has circulated. These two factors were large factors behind the Great Inflation and its disinflationary aftermath.

The entrance of the baby boom generation into the workforce in the 1970s resulted in a soaring labor force growth rate and rising monetary velocity, and the beginning of the baby boom retirement wave has had the opposite effect on the labor force: over the past decade, the labor force has seen the lowest growth rates of the past century. Along with household deleveraging since the financial crisis, the low rates of growth in the workforce over the past decade has had a depressive impact on monetary velocity, even as the Federal Reserve increased the money supply dramatically. This low monetary velocity due to the slow growth of the labor force is one direct cause of the low inflation rates of the past decade, but the long decline in the labor force growth rate is at an end. Over the next twenty years, the labor force is set to grow at steadily increasing rates, due to the coming of age of the large millennial generation, and this will likely result in steadily increasing monetary velocity.

The turn toward increasing growth rates of the U.S. working-age population over the next twenty years represents a demographic pivot toward higher monetary velocity after forty years of disinflationary pressure, and it will not be the only population/demographic pivot toward higher inflationary pressure. As the U.S. working-age population is set to increase at higher rates in the years ahead, the *global* retirement-age population is set to grow at much faster rates than ever before. According to studies by the Bank for International Settlements, this rapid growth in the retirement-age population over the next thirty years will exert a strong inflationary pressure on prices, and it represents another inflationary demographic pivot relative to the past few decades. The graphic below from the BIS summarizes the “flip” in inflationary pressure from this global retirement wave.

Age structure effect: a turn from disinflationary to inflationary pressure — Graph 5



AT = Austria; AU = Australia; BE = Belgium; CA = Canada; CH = Switzerland; DE = Germany; DK = Denmark; ES = Spain; FI = Finland; FR = France; GB = United Kingdom; GR = Greece; IE = Ireland; IT = Italy; JP = Japan; KR = Korea; NL = Netherlands; NO = Norway; NZ = New Zealand; PT = Portugal; SE = Sweden; US = United States.

The dashed lines show averages of the above economies.

When we look at the low inflation in the decade after the financial crisis, we find that it occurred just when two significant demographic forces – the ultra-low absolute growth rate of the U.S. working-age population, and the still-slowly increasing growth rate of the global retirement age population – were exerting a strong disinflationary drag on prices. These are two of the "missing links" that help explain the low rate of inflation while the Federal Reserve and other major central banks expanded their balance sheets between 2008 and 2020.

Yet these same demographic trends are now in the process of flipping into a force for higher rates of inflation in the decades ahead. The net effect of the increasing growth rates of the U.S. labor force will likely be to increase the velocity of money, the supply of which has vastly expanded over the past decade. In addition, the net effect of the growth of the global retirement-age population on saving, spending and output is inflationary as well. These demographic pivots may help the Federal Reserve achieve its goal of higher inflation rates in the years ahead, and it is one more reason why investors should not count on the strongly disinflationary market environment of the last decade to repeat itself in the decades ahead.

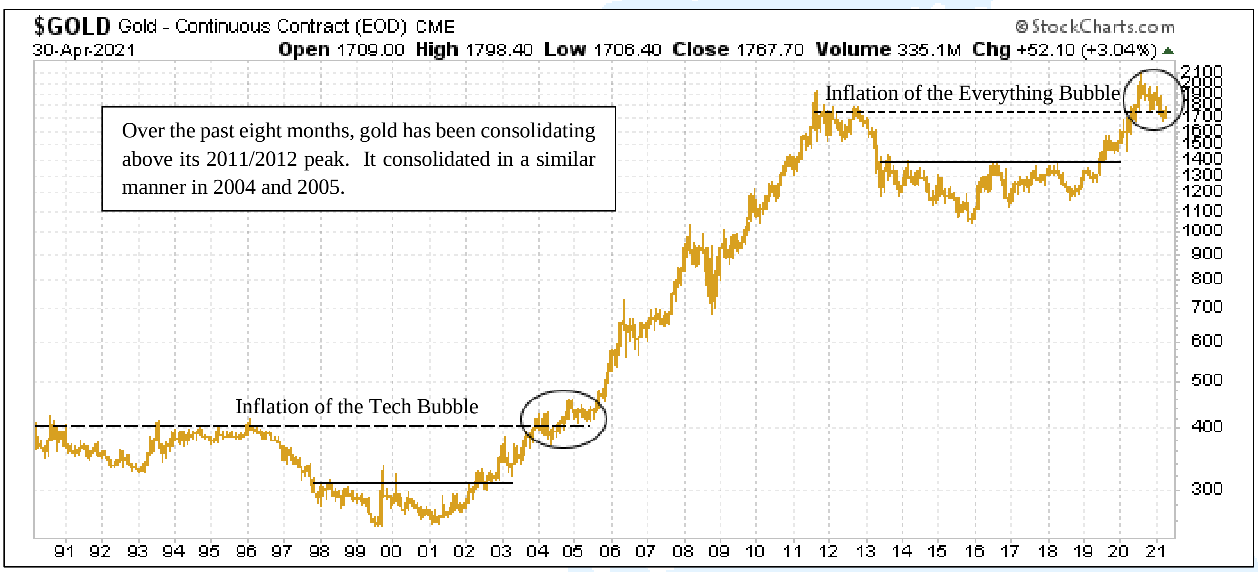
An Update on Gold and Silver's Consolidation

> *Readings on inflation have increased and are likely to rise somewhat further before moderating. In the near term, 12-month measures of PCE inflation are expected to move above 2 percent as the very low readings from early in the pandemic fall out of the calculation and past increases in oil prices pass through to consumer energy prices. Beyond these effects, we are also likely to see upward pressure on prices from the rebound in spending as the economy continues to reopen, particularly if supply bottlenecks limit how quickly production can respond in the near term. However, these one-time increases in prices are likely to have only transitory effects on inflation...*
>
> *As the Committee reiterated in today's policy statement, with inflation running persistently below 2 percent, we will aim to achieve inflation moderately above 2 percent for some time so that inflation averages 2 percent over time and longer-term inflation expectations remain well anchored at 2 percent. We expect to maintain an accommodative stance of monetary policy until these employment and inflation outcomes are achieved… I would note that a transitory rise in inflation above 2 percent this year would not meet this standard.*
>
> \- Jerome Powell's Press Conference Opening Statement, April 28, 2021

It is interesting to look at circumstances today and find so many similarities to the early years of the Great Inflation. There are key differences, of course, as there always are when comparing two periods in history. There was no demographic retirement wave looming in 1965, as there is today, and policy makers today are not struggling to maintain the Bretton Woods system of fixed exchange rates, as they were back then. These key differences are part of what will make the years ahead its own unique market environment for investors, but the similarities between today and that earlier era likely carry lessons which will prove important in navigating the markets in the years ahead.

As former Treasury Secretary Larry Summers recently pointed out, the Federal Reserve officials who talked most about "transitory factors" affecting inflation were those in the 1970s, when structural inflation was increasing rapidly. In fact, mistaking the inflation due to the increasing money supply for price increases from transitory factors was one of the fundamental errors in the Federal Reserve's *Second Great Mistake*. While there is no doubt that the recovery of the economy in the wake of the current pandemic will result in some economic adjustments which will prove temporary, the inflation debate today seems to be too narrowly focused on the pandemic and its immediate aftermath. While issues directly related to the pandemic will undoubtably prove temporary, the lasting impact of this recession on monetary and fiscal policy has only just begun to be felt.

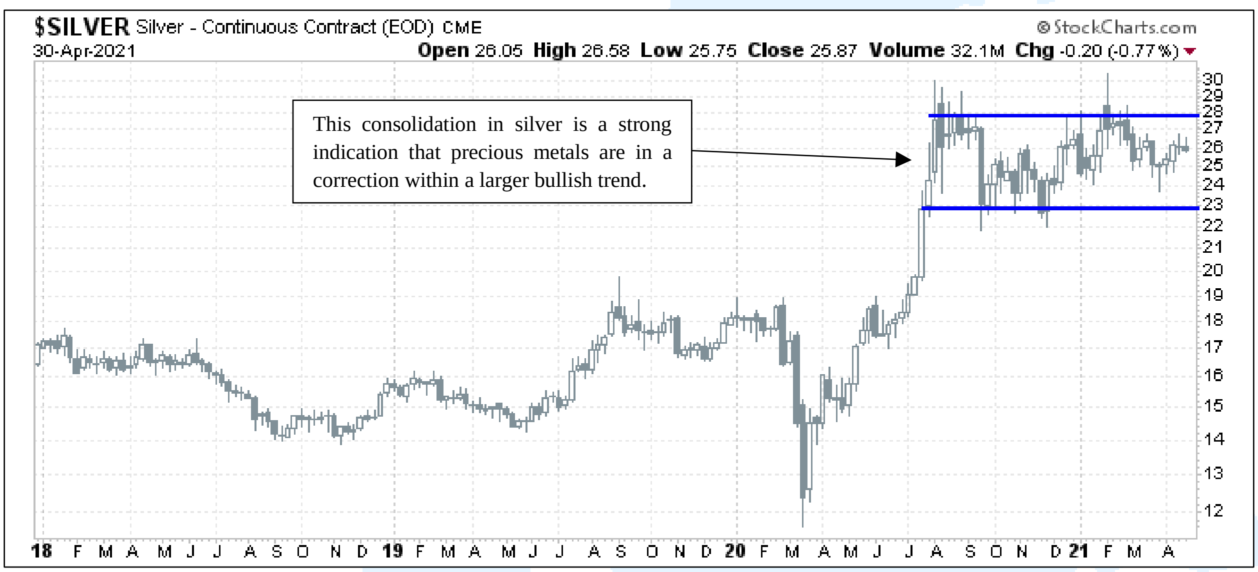
Among many of the impacts likely to last far beyond the reopening of the economy, this recession moved Modern Monetary Theory from the fringes of the economic debate to established practice, almost overnight. This shift toward managing economic growth directly with deficit spending comes as the total Federal debt will likely cross over $30 Trillion later this year, with trillion-dollar deficits likely to continue in the years ahead. This carries enormous long-term consequences for monetary policy. While there has been frustration within the Federal Reserve over being hemmed in by the low inflation in the years leading up to this recession, the Fed may find that monetary policy will be trapped in an even tighter corner in the years ahead – one that is defined by uncomfortable trade-offs between growth and inflation, similar to what the Fed faced in the late 1960s and 1970s. It is within this broader context that we view the market action in precious metals over the past year.



The price of gold rose to its high last year as real interest rates fell from their heights at the end of the Fed's campaign to raise interest rates in 2018, and since last summer gold and the rest of the precious metals sector has been consolidating those gains. Real, inflation-adjusted interest rates have the strongest influence on the long-term trend in precious metals, and the precipitous decline in real interest rates between 2018 and 2020 was a powerful cyclical force behind gold's advance during that two-year stretch. However, as you can see in the chart above, which includes the bull market in gold in the decade following the tech bubble, cyclical declines in real interest rates alone do not drive longer-term advances in gold, and it is for these non-cyclical reasons that we remain invested.

Since last summer's highs, the entire precious metals sector has consolidated the gains it made over the prior two years, and this consolidation has borne signs of being a healthy correction within a nascent bull market. For gold, the consolidation over the past eight months carries parallels with the market action nearly twenty years ago, when it was working its way through long-term resistance from the early 1990s. Back then, gold had briefly broken above $400, a level which had proven to be a ceiling for over a decade, and then fell modestly back below that level in early 2004. At the time, the decline back below $400 appeared to be a significant technical setback, as the stock market and the economy were beginning to recover from the tech bust, and investors by and large thought safe-haven assets like gold were no longer attractive. Yet gold continued to consolidate near $400 into the following year, and during that time signs emerged that precious metals had begun to trade on factors which were beyond those associated with its role as cyclical safehaven.

Over the past eight months, gold has consolidated above and slightly below long-term resistance from the peak in 2011 and 2012, just as it did in 2004 and 2005 as it worked through prior resistance, and during this consolidation the traditionally more speculative areas of the precious metals sector have maintained the strongest relative strength. This type of behavior is what is usually seen during a correction within a larger precious metals bull market, and an example of this is shown below in silver. While gold has trended steadily lower over the past eight months, the price of silver has barely budged from its high last summer.



The relative strength of the more speculative areas of this sector has also been seen in the shares of mining companies, and for those of us who closely monitored this sector in the early 2000s, this behavior is all too familiar. The precious metals sector is the most sensitive sector to long-term changes in monetary policy and the outlook for inflation, and the macro context today is perhaps more favorable for precious metals than it was at the peak of the tech bubble twenty years ago. Although precious metals have risen in value in the wake of every stock market bubble in history, a process which remains ahead of us for the current bubble, today we have the Federal Reserve firmly intent on using monetary policy to deliberately increase long-term inflation rates. In addition, there are now underlying fiscal and demographic trends which will likely facilitate a long-term rise in inflation in the years ahead – perhaps more than the Federal Reserve expects.

Beyond the narrow focus on inflation readings that accompany the economy as it recovers from this recession, these long-term trends are what drive bull markets in gold, and the correction since last summer appears to reflect that long-term outlook. Over the past eight months the precious metals sector has gone from overbought to modestly oversold, and the overall technical position today appears similar to where the sector was in 2018. If this continued strength in the midst of the recent rise in bond yields and the dollar is any indication, there is a long road ahead for precious metals.

As a final note, Japan's ongoing struggle with mild deflation has long been held up as an example of the inherent lack of risk associated with an extended era of zero percent interest rates, and a rapidly expanding base money supply. The Bank of Japan's balance sheet, and the Japanese government's enormous debt burden, have long been cited as reasons why the U.S. Federal Government and the Federal Reserve could pursue similar policies without fear of inflation.

These arguments generally do not consider the global disinflationary environment over the past twenty years, nor do they take into account the fact that Japan is one of the few advanced economies with a shrinking population; Japan's population has declined by two and a half million people over the past decade, which is in sharp contrast to the increase of twenty million citizens in the U.S. in that time. As was stated earlier, a shrinking population will have an entirely different inflationary dynamic than a growing one, and in the end there may be few parallels which can be applied from Japan's experience to countries with growing populations, like the U.S. The full cycle of Japan's story has yet to be written, and the U.S. experience throughout its coming demographic changes will likely prove to be quite different than Japan's.

We appreciate you taking the time to read this letter. As always, if you would like to discuss investments in your account, or topics discussed in this letter, feel free to contact us — we would be happy to talk with you.

Sincerely,

Brian McAuley
Founder and Portfolio Manager
Sitka Pacific Capital Management, LLC