More money is coming your way

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Key takeaways:

1. Accelerating the supply of money is the path of least resistance for central banks to stimulate the economy and to fund government deficits.
2. Holders of "paper assets" such as bonds might not keep up as purchasing power is eroded by accelerating money supply.
3. Gold offers portfolio protection against unconventional monetary policies and accelerating money supply.

Canadian savers generally have had it good. A whole generation has grown up in a period of economic stability and prosperity. Most consumers can afford many of the things their parents' generation could only dream about: second homes, cars, renovations, organic food and regular vacations to faraway places. The Canadian middle class has reason to feel comfortable with their lifestyle.

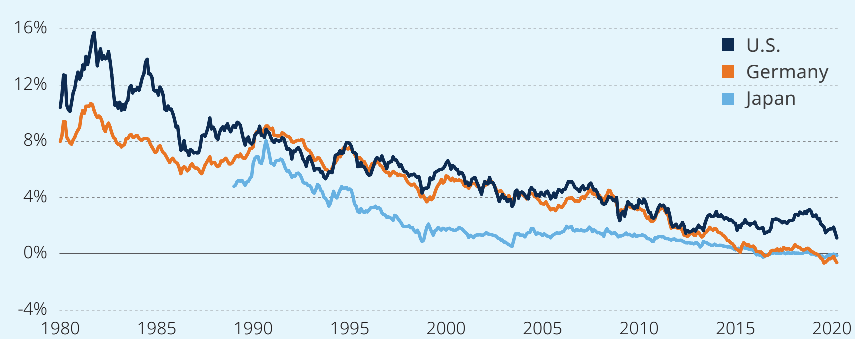
There is never just a single cause for anything, and one could argue that political calm, trade liberalization and tremendous technological development have all contributed to the current state of prosperity. While this is all true, money also got cheaper. It's been an incredible, 40-year run of lower and lower interest rates—thanks to accommodative monetary policy.

The challenge going forward is that interest rates cannot go much lower. We are "zero-bound," as the saying goes. The gift that gave so much has been spent, and we believe this represents an important juncture. While ever-cheaper money boosted investment returns for 40 years, the next 40 years will likely be different.

People may forget, but by the end of the 1970s debt was a really bad thing. Back then, inflation raged higher and interest rates, as a response, raged higher as well. At the peak, the Federal Funds rate in the U.S. – the world's primary benchmark for the "cost of money" – was a staggering 22%. This had the effect of crushing economic activity and choking real incomes. Bankruptcies soared, as did unemployment. With interest rates hitting all-time highs, becoming debt-free was something to celebrate and mortgage-burning parties were a real thing.

From there, things got better. The cost of credit came down and its availability expanded. In 1981, the Fed Funds rate averaged 16%. Four years later it was 8%. The economy soared and the Dow Jones Industrial Average almost doubled. This trend continued for another 35 years. Crises such as the "Dot-Com Crash" of the late 1990s are now a blip in retrospect. The powerful, unprecedented four-decade decline in interest rates made good of anything that got in its way.

After falling for 40 years, yields are about as low as they can go



Source: OECD; Federal Reserve Bank of St. Louis. Yield on 10-year government bonds.

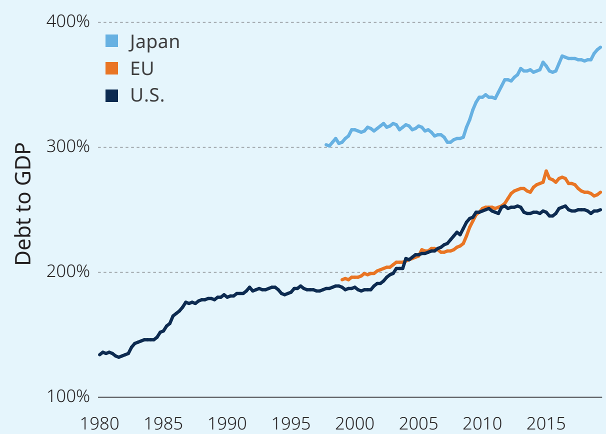
During that period, the average Canadian saver enjoyed solid fixed income returns, growth in equity earnings and expanding multiples from equity markets. Lower interest rates boosted the value of most assets. This is easiest to see in the bond market where there is typically an inverse relationship between yield and price—when one goes down, the other goes up. But the same principle applies to equities: as the cost of borrowing declines, investors are willing to pay more for the same stream of future profits ("multiple expansion"). This phenomenon is most apparent in the housing market where carrying costs, because of the long amortization periods, are strongly geared to interest rates. As rates go down, people can afford to borrow more for the same house, and house values go up. Today, mortgages with below-zero rates in Denmark are the latest phenomenon: banks pay select homeowners to have a mortgage.

These dynamics reinforce the sense of prosperity. Lower interest rates make borrowing more attractive and raise the value of assets. Rising asset values also expand the capacity to borrow. The net result is an increase in borrowing. Some of this flows through the economy in the form of rising household spending, rising business revenues and rising government tax receipts.

As of today, the borrowing continues as governments, corporations and consumers spend tomorrow's money to fund more immediate spending today. Benchmark interest rates have been forced down by ample money supply, with rates now hovering near zero. There is also a great hesitation to raise rates. With such a massive debt load, the economic impact of higher rates could stifle the economy and/or make it impossible to repay lenders. Once interest rates reach the "zero-bound" level, conventional policies—the policies that brought such prosperity—lose their effectiveness.

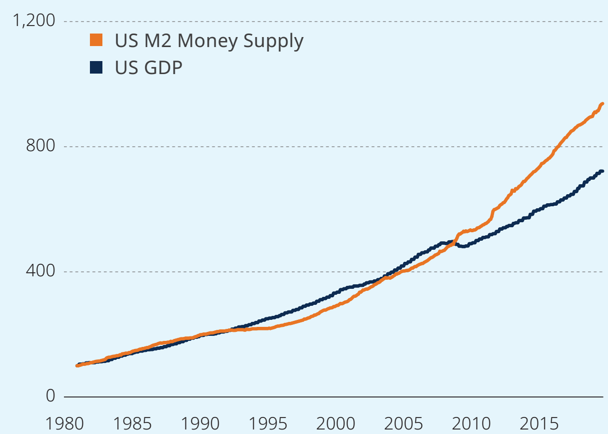
But that doesn't change people's aspirations. While debt continues to climb, populist forces push governments to spend: people want more income equality, good education, improved infrastructure, better healthcare and a healthier environment. To fund deficits, "more money" is needed. If interest rates can't rise or fall, what could central banks and governments do to maintain the liquidity that society has become so accustomed to? We classify the concept of "more money" through three types of actions by governments or central banks. Those are: lower short-term interest rates, Quantitative Easing (QE) and unconventional monetary policies (e.g., MMT).

Debt growth is outpacing economic growth



Note: Total Credit to Non-Financial Sector as a Percentage of GDP.
Source: Bank of International Settlements; Federal Reserve Bank of St. Louis

Asset prices are rising as the supply of money outstrips the economy



Source: U.S. Bureau of Economic Analysis; Board of Governors of the Federal Reserve System; Federal Reserve Bank of St. Louis
Note: Indexed, 1980 = 100.

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In the past, governments that engaged in outright "more money" policies to finance their budget deficits became isolated as their currencies devalued sharply. Venezuela, Zimbabwe and Argentina stand as extreme examples of this. Are people in Japan, Europe or the U.S. likely to line up with a wheelbarrow of money to buy bread anytime soon? Likely not, as two key conditions exist today: first, everyone is doing it, and second, much of the money remains "parked." If all countries are engaging in one or a combination of the three ways listed above to add liquidity to their economies, the relative value of their currency would remain unchanged compared to other currencies. Also, after the Global Financial Crisis, many banks have been hesitant to lend while, at the same time, the U.S. Federal Reserve Board made it appealing for banks to keep their money on their balance sheet by earning interest on excess reserves, thus slowing down the circulation of money in society.

It's the unescapable move away from conventional to unconventional monetary policies that puts at risk assets that have been historically perceived as prudent, such as bonds. Savers should take notice: financial assets that cannot adjust to changes in the quantity of money may be at risk.

"Paper assets" such as bonds have enjoyed the fruits of a four- decade decline in interest rates. As rates declined, future coupon payments from existing bonds were immediately repriced higher. But with interest rates in many developed markets steadily approaching zero, the window for incremental price appreciation from lower rates is gradually closing. Worse, one could imagine a world where the amount of money doubles, yet interest rates remain unchanged as a result of aggressive monetary policy. Upon maturity, a bondholder would contractually receive $1,000 for every $1,000 of principal. But the purchasing power of this same $1,000 would have been cut in half relative to "defensive" assets.

Equity holders of quality companies are likely to keep up with money supply. Quality companies could keep up by passing the full impact of rising costs to their customers (i.e., price-setters of unique or scarce products), or by growing faster than the supply of money. Conversely, firms with limited pricing power could see their margins squeezed as input costs would rise faster than their revenues.

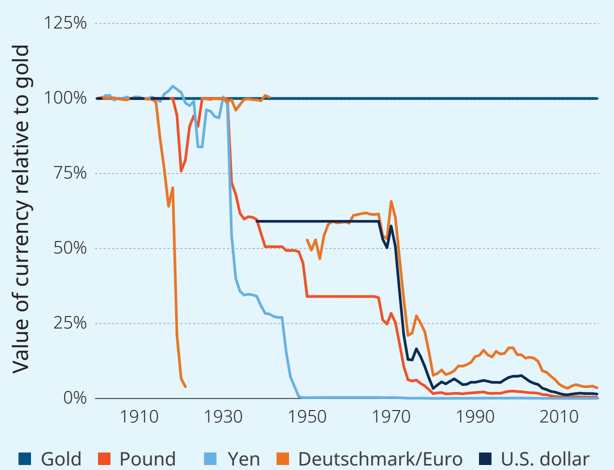
Asset classes that tend to gain favour in time of "too much money" are assets in limited supply (which includes quality companies). These might otherwise be characterized as defensive assets and include such things as real estate, agriculture and even art. The idea is to own things that maintain their purchasing power.

Roosevelt vs. bondholders

An example of the loss in purchasing power that bondholders can suffer from a monetary devaluation dates back to 1933. To battle the global depression and competitive currency devaluations around the world, the U.S. government devalued the U.S. dollar by 41% relative to the then-prevailing gold standard. A Supreme Court case followed, in which bondholders were demanding to be repaid $1,690 "new dollars" for each $1,000 of face value on federal bonds that were issued prior to the devaluation. The bondholders lost in a split Supreme Court decision that (as it turned out later) would have been overruled anyway, by proclamation from President Franklin D. Roosevelt, if the decision had not been in favour of the government.

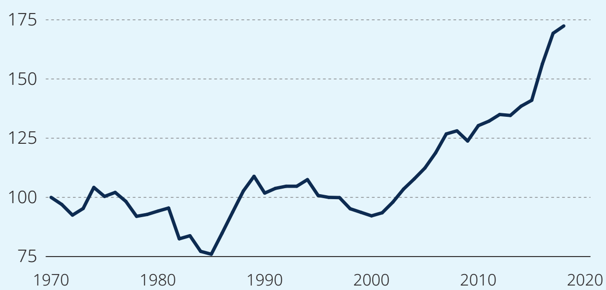
Bondholders were thus repaid $1,000 of "new dollars" for each $1,000 of face value upon maturity. However, the purchasing power of each "new dollar" was 41% less than at the time of issuance: for each "new dollar," the bondholder could theoretically acquire 15.2 grams of gold, whereas previously, the bondholder could have acquired 25.8 grams of gold for each dollar, as highlighted in the chart below. While the gold standard has long since been abolished, this remains a well-documented example of the loss in purchasing power for bondholders from monetary devaluation.

Currency devaluations can crush purchasing power



Source: World Gold Council

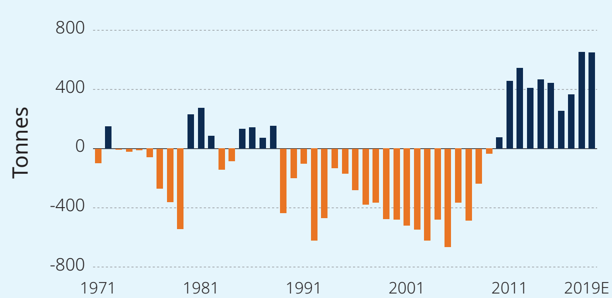
Canadian house prices reflect the availability of money



Note: OECD. Canadian house price to income ratio; Indexed, 1970 = 100.

In a "more money coming your way" environment, the pure-play strategy to protect your purchasing power is gold. The above-ground gold stocks are finite, while below-ground supply is limited by the earth's geology. Apart from scarcity, the metal also benefits from liquidity. Average daily turnover is about US$40 billion and there is always a size bid for any seller in any currency. And, unlike real estate or fine art, gold is fungible, which is to say that two halves are worth precisely the same as a whole, something that can't be said for diamonds or apartment buildings. For these and other qualities, gold has a centuries-long history of being immediately repriced higher when the supply of money increases. Central banks themselves recognize these increasingly important qualities of gold, especially in emerging markets that are prone to currency attacks—or worse, that are under sanctions. They have been buying at a pace not seen since the abolition of the Gold Standard.

Central bank gold demand – Highest since President Nixon abandoned the Gold Standard



Source: Scotiabank; GFMS; Metals Focus; World Gold Council

We believe that individual investors would be equally well served to diversify part of their portfolios into gold to be prepared for the imminent acceleration of money supply by central banks that have exhausted their traditional methods of stimulating the economy. With the real value of bonds under threat from accelerating money supply, and the average Canadian investor growing older and less tolerant of risk, adding more equities to a portfolio may be a challenge. But by holding 5% to 10% gold instead, Canadian investors will have the potential to lower their overall risk, improve returns and better protect their purchasing power.

Conclusion

The prosperity that the world has enjoyed over the past 40 years was significantly supported by a continuous decline in interest rates. However, this tailwind for investors has largely run its course as interest rates in most major economies have approached (or even dipped below) zero. Central banks and governments will therefore have to find novel ways to continue to address income disparity, the environment, healthcare and education. We believe that accelerating deficits and ample money supply will be the path of least resistance.

The "more money" threat has been around for a while. So why act now? We think that interest rates won't go much lower. We also suspect that society's appetite for less income disparity, a better environment, better healthcare and stronger education isn't likely to disappear anytime soon. The path of least resistance for governments will be to expand deficits, funded by old and novel ways to add money to the system. The impact will be felt unevenly throughout traditional portfolios. "Paper assets" such as bonds, which make up a large part of traditional portfolios, could be at risk of not keeping up.

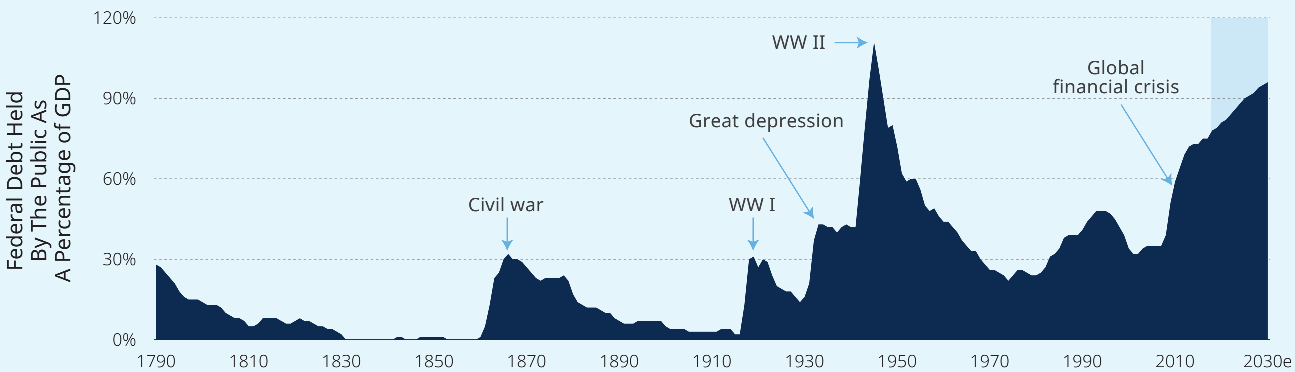
New and unproven tools to distribute money will likely be proposed and deployed. For investors with the capacity to accept more volatility than a balanced fund, quality companies may be a decent alternative to "paper assets." For those who want to minimize risk and volatility, gold is the pure play.

Three "more money" policies

To fund deficits, "more money is needed." We classify the concept of "more money" through three types of actions by governments or central banks

1. **Artificially low interest rates drive more money.** Historically, rising government deficits and growing debt burdens pushed interest rates higher—but today they stand very low thanks to accommodative central banks that pursue stimulus. Japan is a longstanding example of this. But recently, even the U.S. Federal Reserve provided "more money" to banks that were the buyers of last resort of U.S. government treasuries. Since the treasuries had not found enough buyers, the Fed had to intervene by buying this debt to prevent rates from rising. Government bonds have long been a mainstay investment, but the lack of traditional buyers may reflect concerns about a recent sharp acceleration in U.S. federal debt. Normally, a debt increase would have only taken place during periods of war or recession.

Federal debt rapidly expanding with no war or depression in sight



Source: Congressional Budget Office

2. **"Quantitative Easing" drives more money,** which has central banks buying government debt from financial institutions (pushing interest rates lower than they would otherwise), with the hope of enticing businesses and consumers to borrow and spend more. Quantitative Easing has been the status quo policy tool in Japan, has recently returned to Europe and is making a creeping return in the U.S.

3. **Allowing governments to access money as they require drives more money,** ideally at a low rate, thereby eliminating the role of an independent central bank. Although this is a radical proposal that has not yet been implemented, it is rapidly entering mainstream politics and has been proposed by several leading U.S. Democratic presidential candidates. Some argue that this technique would diminish current wealth disparity, as one of the consequences of lower rates for the past four decades is that it financially benefited asset-rich owners versus asset-poor owners. In other words, rising asset prices have benefited primarily the wealthy. Allowing the government to directly inject money into people's accounts wouldn't create wealth, but would merely redistribute wealth.

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Gold's diversification benefit

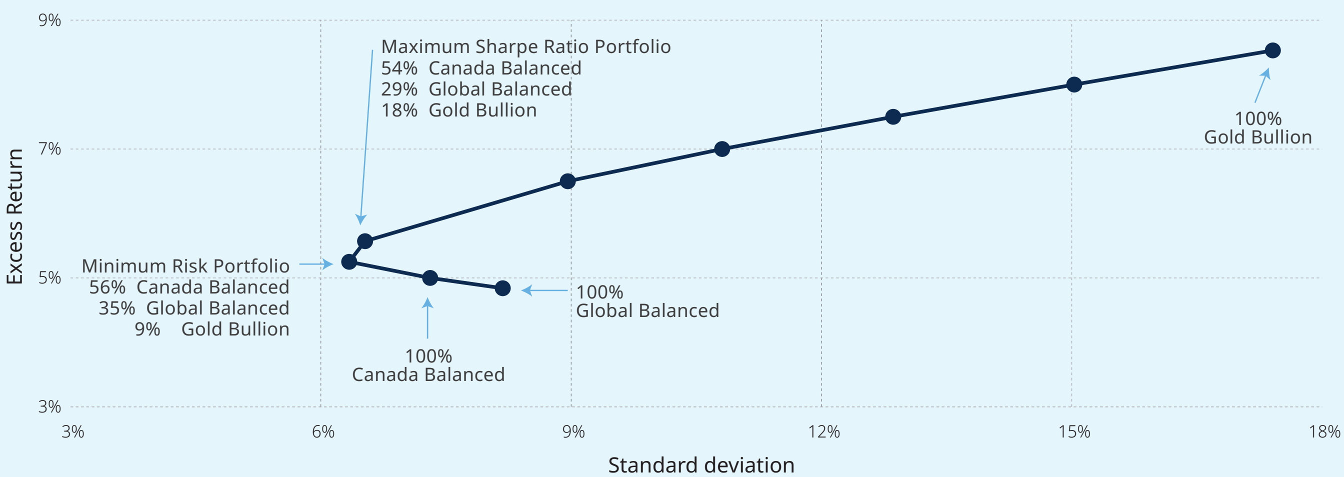
While gold as a standalone asset class is volatile, it offers a significant diversification benefit when combined with a traditional equity/fixed income portfolio for a Canadian saver. When measured over a time horizon that covers both down cycles and up cycles (e.g., 15 years), holding 9% gold bullion within a traditional portfolio of Canadian and global balanced funds would have contributed to higher returns while lowering volatility.

Gold's portfolio diversification benefit stems from a low correlation with equity markets and a negative correlation during periods of market stress. Moreover, gold exhibits an inverse correlation to the U.S. dollar (except during periods of market stress, when it can be positively correlated with the U.S. dollar), which is especially relevant for Canadian savers. The statistically most significant contributor to gold's positive returns during the past decade of positive market performance have been low and even negative real interest rates, as nominal rates were pushed down by ample money supply and Quantitative Easing.

A Canadian investor could make an investment in gold via gold bullion or via precious metal equities. Gold bullion has historically exhibited the benefit of comparatively lower volatility, whereas precious metal equities have historically exhibited a beta of approximately 2x relative to gold and, therefore, did outperform gold bullion during periods of positive price performance.

Efficient frontier from a Canadian investor perspective

Adding gold to a portfolio can reduce risk and increase returns – 15 years, Dec 2004 to Nov 2019



Notes: Global Neutral Balanced = 50% MSCI World Equity Index; 50% BofAML Global Broad Market Bond Index. Canadian Neutral Balanced = 50% FTSE Canadian Universal Bond Index; 40% S&P/TSX Composite Index; 10% MSCI World Index. Excess returns over the risk-free rate (FTSE Canada 91 Day T-Bill).
Source: Factset; Mackenzie estimates

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