What Risks Lie Ahead in 2024?

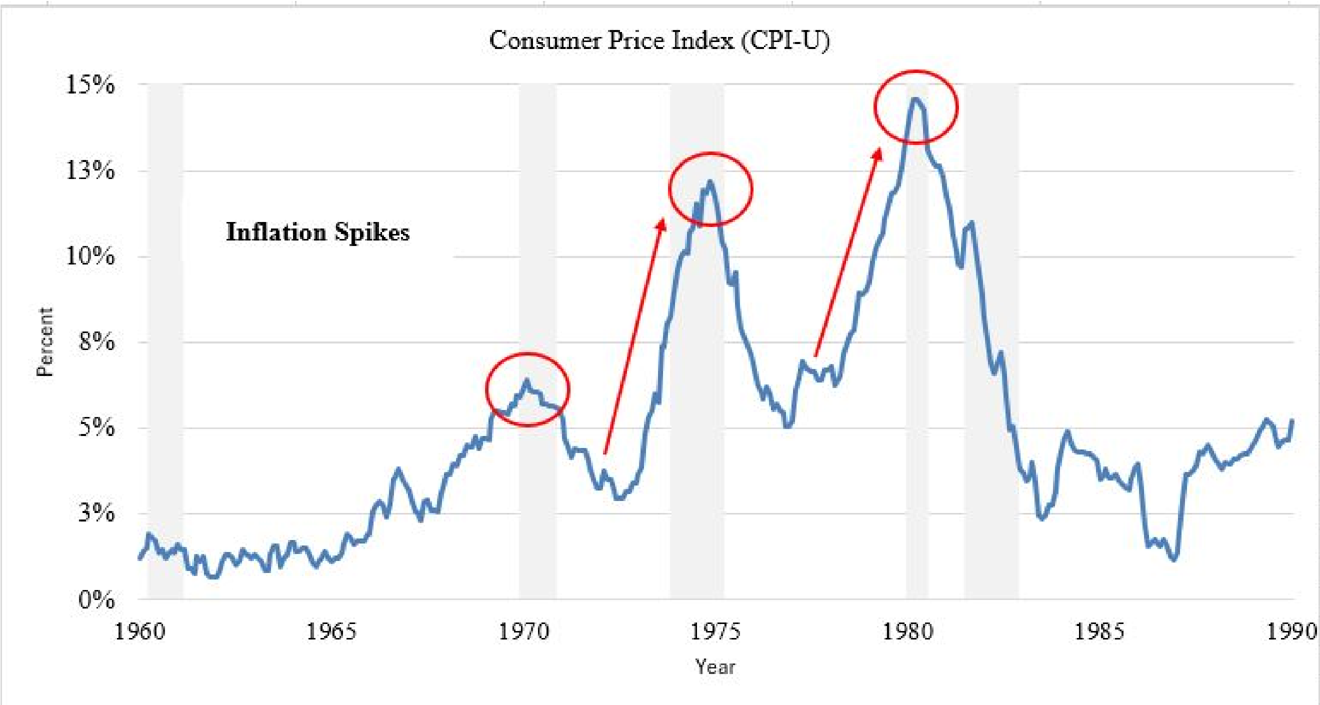
Inflation Fears: Shades of 1974?

Echoes of 1974

Each year brings investors a fresh list of hopes and fears. Often, mainstream financial firms provide guidance that extrapolates linear thinking into the future. We prefer to take a more cyclical view of the world to glean knowledge from patterns in past cycles that rhyme with today. With that in mind, we set our sights back 50 years ago to 1974, just long enough for most investors to have forgotten those events, and the lessons associated with them. There are five key lessons from that period that we believe are relevant to investors today.

Lesson 1: Inflation & Interest Rates – Volatile But Trending Upward
After experiencing renewed inflation in the early 1970's, 1974 was an inflection point that marked a relative high in annual inflation of 11.1% and interest rates 10.5% (short-term T-bills) and 7.6% (10-year Treasuries). A significant recession hit in 1974 and inflation and interest rates fell. Like today, the consensus was that rising inflation and rising rates were a "blip on the radar" with the worst likely behind us.

However, inflation and interest rates aggressively reasserted themselves several years later in a second major upcycle in the late 1970s. Inflation soared to 13.5% at its 1980 peak, pushing interest rates to 16.4% (short-term T-bills) and 13.9% (10-year Treasuries) by 1981.



1

Despite the inflation at the time, a Big Mac at McDonalds was only 65 cents, and it was actually called "Big" for a reason!

Menu Items - 1974	Price
Quarter Pounder w/ Cheese	0.70
Quarter Pounder	0.60
Big Mac	0.65
File-O-Fish	0.48
Cheeseburger	0.33
Hamburger	0.28
Large Fry	0.46
Regular Fry	0.26
Hot Apple Pie	0.26
Milk	0.20
Coffee	0.15

2

The Lesson Today:
While inflation fell leading into 2024 and 10-year Treasuries remain around 4%, inflation is not dead. It is wise to prepare for a second, bigger wave of rising inflation and interest rates in the coming decade. That said, 2024 may bring a continued temporary lull in inflation and interest rates if global economies weaken. The big caveat for this “lull scenario” is the massive Federal debt levels relative to 1974. The official national debt has surpassed $34 trillion and added a whopping $1 trillion in the last 30 days alone! The question is not who will buy the debt, as there will always be takers at the right price. The question is what interest rate will be demanded by investors.

Lesson 2: Extreme Stock Valuation Led to Pain
Today’s Magnificent 7 tech stocks have led the S&P500 with extremely narrow stock market leadership.[3] Their valuations continue to rival periods such as the 2000 Tech Bubble and the Nifty Fifty from 1974 (a basket of 50 stocks that people believed would lead to outsized returns with a single buy-and-hold proposition). These stocks were the leaders of that era until their ultimate crash into the recession of 1974 when most lost 50% to 80% of their value.

Stock	% Change	Stock	% Change
American Home Prodcuts	-78.1%	Johnson & Johnson	-57.6%
American Hospital Supply	-60.4%	Louisana Land & Exploration	-25.8%
Avon Products	-85.5%	Lubrizol	-45.2%
Baxter International	-54.1%	3M	-67.1%
Black & Decker	-80.7%	McDonald's	-46.4%
Bristol-Myers	-55.3%	Merck & Co	-88.0%
Burroughs Corporation	-72.1%	MGIC Investment	-65.1%
Chesebrough-Ponds	-69.6%	PepsiCo	-49.9%
The Coca-Cola Company	-69.1%	Pfizer	-71.5%
Amery Air Freight	-51.4%	Phillip Morris	-86.7%
Gillette	-65.4%	Polaroid	-39.2%
Halliburton	-30.6%	Procter & Gamble	-43.7%
Heublein	-97.0%	Schlumberger	-43.7%
IBM	-62.3%	Sears, Roebuck	-55.4%
International Flavors & Fragrances	-75.5%	Simplicity Pattern	-88.0%
International Telephone & Telegraph	-40.2%	Squibb	-79.2%

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The Lesson Today:
When investors fall in love with a narrow group of expensive stocks that have pushed up the stock indices, markets are at risk to greatly disappoint (or crash). Today, the S&P500 has been mainly driven by just seven stocks or approximately 1.4% of total stocks in the index. This suggests the near-term prospects for equities are challenged barring any surprise return to money printing. Although money printing will return, it will take significant pain in the stock markets first for the Fed to justify it.

Lesson 3: Political Instability Rising
President Nixon was the first president to “voluntarily” resign in 1974 amidst the Watergate scandal. This led to an era of distrust and loss of confidence in the government and economy for nearly a decade. Today, the political environment is rife with instability as we enter an election year with a divided country, polarized views, and questions at every level of government.

The Lesson Today:
Politics is a key factor in the confidence of a healthy,

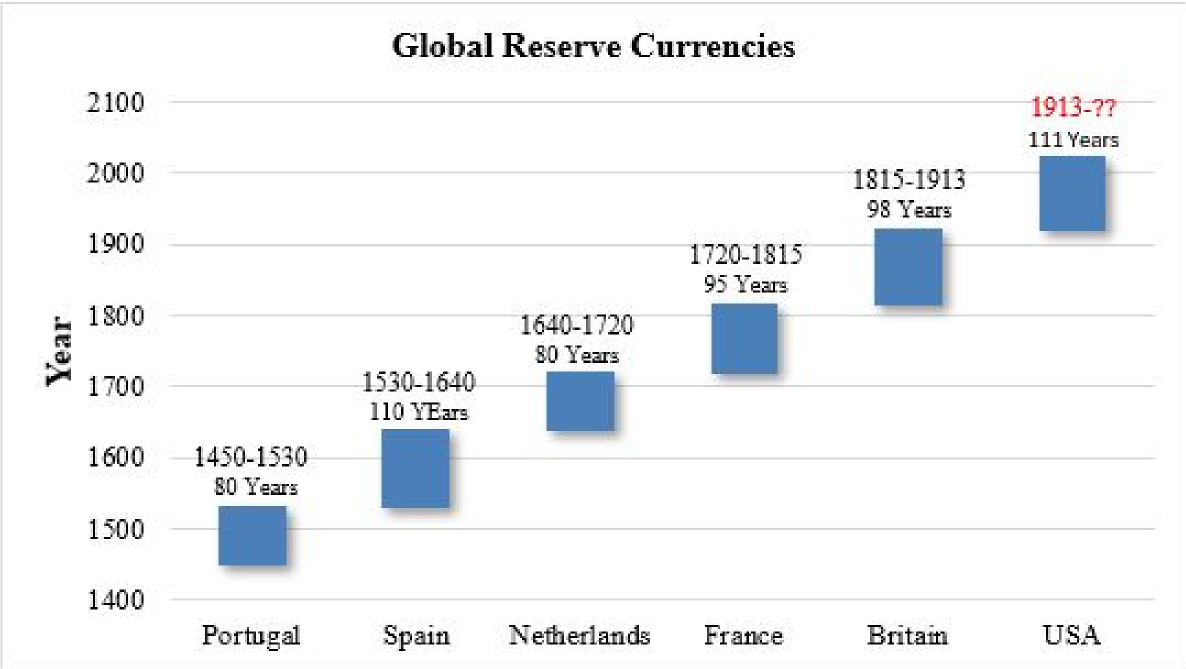
functioning capitalistic system. When markets feel at risk and do not trust the institutions or the rules, faith can be lost and not easily recovered.

Lesson 4: War, Energy & the Middle East
The Yom Kippur War between Israel and several Arab nations in the fall of 1973 led to an oil embargo and spike in energy prices. Eerily, another conflict in the Middle East began last year one day removed from the 50th anniversary of this war, sparking many unknown, long-term consequences.

The Lesson Today:
War in the Middle East has many geopolitical implications. It risks dividing countries and causing an unknown future impact on energy markets. Global war, if this were to expand, often goes hand in hand with difficult economic times in history. War has always been a great excuse to tear things up and rebuild them, but not always to benefit of the average citizen.

Lesson 5: Changing of the Guard in Currencies Every 100 Years
The early 1970s was a critical time for the U.S. dollar. What had been a pre-World War II system of currencies disciplined by the backing of physical gold or silver morphed into a dollar system under the Bretton Woods Agreement. However, holders of dollars became increasingly nervous in the early 1970s as U.S. spending was seemingly out of control (imagine if they could see things today!) due to social programs and the Vietnam War. The Bretton Woods system promised the dollar could be converted to gold – until it couldn't. France led the charge to redeem dollars for gold. This resulted in President Nixon's famous 1971 speech in which he was "temporarily suspending the convertibility of the dollar to gold". Of course, like most things from the government, temporary programs never go away. From that point forward, the dollar was simply printed out of thin air without constraints.

Today, we are nearing another critical event in the life of the dollar – a rise in nations circumventing the dollar system as seen in the growing alliance of BRICS countries expanding non-dollar denominated trade.[5]



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The Lesson Today:

No reserve currency has lasted more than approximately 100 years. Given this, the dollar is late in its life cycle as measured from the 1913 inception of the Federal Reserve system. While the dollar is not on its immediate way out, we envision world trade and capital markets becoming more multi-polar as reliance on the dollar fades. Eventually, the reality must be faced that the U.S. national debt cannot be serviced without creating a death spiral of more money printed just to service debt. Other world currencies face a similar predicament with no likely predecessor. Thus, the world will likely start a gradual, and then sudden path back to sound money (likely precious metals and perhaps cryptocurrencies) – not by choice, but by necessity.

Endnotes:

1. Board of Governors of the Federal Reserve System (US).

“10-Year Treasury Constant Maturity Rate.” FRED, Federal Reserve Bank of St. Louis, 2 Jan. 1962, fred.stlouisfed.org/series/DGS10/.
2. “Vintage McDonald’s Menu from the 70s Reveals How Much Has Changed over the Last 40 Years.” Throwbacks, 31 Aug. 2023, throwbacks.com/vintage-mcdonalds-menu-from-the-70s-reveals-how-much-has-changed-over-thelast-40-years/.
3. Magnificent 7 stocks: Alphabet, Amazon, Apple, Meta, Microsoft, Nvidia, Tesla
4. “Revisiting the Nifty Fifty.” Stray Reflections – Revisiting the Nifty Fifty, strayreflections.com/article/252/Revisiting_the_Nifty_Fifty.
5. BRICS: Brazil, Russia, India, China, and South Africa
6. “World Reserve Currencies: What Happened during Previous Periods of Transition? Economic Reason.” www.economicreason.com/usdollarcollapse/world-reserve-currencies-what-happened-during-previous-periods-oftransition/.

Fractional Reserve Airline Seats

This article was originally published by The Ludwig von Mises Institute of Canada on April 18, 2017

Every year, airlines deny thousands of passengers seats on flights due to overbooking. Airlines use sophisticated modeling to manage overbooking to maximize profits given the reality of passenger no- shows. Legally permissible under their “contract of carriage” with passengers, fewer than one-tenth of one percent of all passengers lose seats due to overbooking. 1 But when Dr. David Dao was violently removed from a United Airlines flight in Chicago, it did far more than generate a public relations nightmare; it exposed the absurdity of fractional reserve banking.

If an airline had 100 seats and overbooked by 10, then 91% of their seats are “reserved”. U.S. banks need only retain an effective 10% of demand deposits on hand for withdrawals while Canadian banks have no reserve requirement. Baring general capital requirements, the remainder can and is typically lent to borrowers. If an airline used 10% fractional reserve seating, the number of stranded passengers would approach 900 for a 100-seat airplane. The refugee-like look of an airline gate under such a situation would be no different than the typical bank run during the Great Depression.

Unfortunately, just as passengers lack legal recourse when denied seats, demand depositors cannot seek redress when their withdrawals are refused. As Murray Rothbard detailed in **The Case Against the Fed** and his other books on the history of banking, it was unfortunate 19th-century case law ceased recognizing a deposit as a bailment (the custody of another’s possessions). As Rothbard opined, the legal cover given fractional reserve banking cannot mask the fraudulent nature of lending against demand deposits. And no “contract” between a depositor and a bank can legitimize fractional reserve banking, just as naming something a “square circle” cannot create such a shape.

Even people versed in Austrian economics fail to understand the nature of fractional reserve banking. In an August 17, 2014 Forbes article entitled *The Closing of the Austrian School’s Economic Mind*, columnist John Tamny wrote:

“This alleged “multiplication” of money all sounds so frightening at first glance, but for those who think there might be some truth to the “money multiplier,” DO try it at home among friends. Hand the first friend $1,000, and let him

lend $900 to the person next to him, followed by an $810 loan to the next tablemate. What those who try it will find is that far from creating $2,710 worth of access to the economy's resources, there will still be only $1,000; the original holder of $1,000 with $100 in his possession, $90 in the second person's hands, followed by $810 in the third."[2]

And yet this illustration proves the opposite of Tamny's conclusion, for the money supply is not just the physical dollars on the table. If the arrangements between the participants allow for withdrawals *on demand*, then each person would assume their cash balances equaled their cash on hand *as well as* their "demand deposit" with the next person. The money supply would absolutely equal $2,710 with only $1,000 in physical currency.

Although few understand fractional reserve banking, even fewer appreciate its repercussion. So while Dr. Dao could passively resist fractional reserve airline seats, none of us can escape the business cycles and price inflation caused by fractional reserve banking.

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Endnotes:

[1]Ben-Achour, Sabri. "Why in the world do airlines overbook tickets?" *Marketplace*. 27 April 2015. https://www.marketplace.org/2015/04/27/business/ive- always-wondered/why-world-do-airlines-overbook-tickets.

[2] Tamny, Joh. "The Closing of the Austrian School's Economic Mind" *Forbes*. 17 August 2014. https://www.forbes.com/sites/johntamny/2014/08/17/the-closing-of-the-austrian-schools-economic- mind/#36b63f455147

Velocity Lacks Veracity

Velocity is not a substitute for demand, but rather of volume. Lots of goods and services may transact at low prices just as they may trade at high prices.

Bitcoin or Gold?

This article was originally published by The Human Events Group on July 3, 2014

We have proposed a system for electronic transactions without relying on trust. – Satoshi Nakamoto, 2009[1]

With this fairly mundane comment, the person or persons known as Satoshi Nakamoto (the jury is still be out) introduced bitcoin to the world. Since then, bitcoin has attracted widespread attention and interest – as well as numerous critics. Ironically, some of its most vocal detractors, such as Austrian economist Frank Shostak and financial commentator Peter Schiff, are champions of gold. As fiat currencies (money which exists solely due to the force of law, i.e., by fiat) further decline in value, will investors increasingly embrace a cryptocurrency such as bitcoin, or will they revert to the historically tried-and-true precious metals? Will it be bitcoin or gold?

As the values of bitcoin and gold are primarily contingent on their future acceptance as money, answering the question “bitcoin or gold” requires an examination of a more basic inquiry: what is money? Money is a medium of exchange and, as such, presupposes the ability to act as a store of value. Over two thousand years ago, Aristotle noted the primary qualities exhibited by money:

- Portability
- Durability
- Homogeneity, and
- Divisibility.

Money should also, at least before becoming accepted as money, possess “alternative value.” This term is unfortunately sometimes referred to as “intrinsic” value (as nothing possesses value without demand, nothing is intrinsically valuable).[2] Gold, (and to a lesser extent silver) possesses these qualities and was therefore used as money until quite recently (1971). Bitcoin critics who are proponents of gold cite its lack of alternative value as a fatal flaw.

But is it? True, unlike gold or silver, bitcoin cannot be used for a non-monetary purpose. Perhaps this is not a weakness, but rather a strength. As bitcoin lacks physical form, it lacks alternative value, but herein lies its unique attribute relative to gold – there is nothing to physically transmit. In the characteristic of portability, it easily exceeds gold’s virtues.

Does this mean that bitcoin is no different than any fiat money which can be transferred with a computer keystroke? No, as its usage derives from general acceptance, not mandate.

And unlike the experience of all fiat currencies throughout time, bitcoin is limited in quantity (it is designed so only 21 million bitcoins can ever be “mined” into existence). Nakamoto remarked that in creating bitcoin he had removed trust. But more accurately, he removed faith and fortified trust, for just as gold and silver use nature (their elemental physical characteristics) as an objective standard, so bitcoin utilizes math (cryptography).

The question of what ultimately may be the future of money may be "bitcoin or gold?", but perhaps the answer should be bitcoin *and* gold. For millennia, gold and silver coexisted as money, so why not bitcoin as well? Bitcoin is so unique in the history of money, and so complementary to gold, that one day in the future, it – or some other cryptocurrency (assuming they survive government regulation and financial repression) – may become more than today's speculative investment.

Endnotes:

1 Nakamoto, Satoshi. Bitcoin: *A Peer-to-Peer Electronic Cash System*. 24 May 2009 <http://bitcoin.org/bitcoin.pdf>.

2 For a real life example of the importance of "alternative value" as a quality of money, see "Only Criminals Use Honest Money" by Christopher Casey as published by the Mises Institute. <https://mises.org/library/only-criminals-use-honest-money>.

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Deflating the Deflation Myth

The fear of deflation serves as the theoretical justification of every inflationary action taken by the Federal Reserve and central banks around the world.

There is No Tradeoff Between

Inflation and Unemployment

Anyone reading the regular Federal Open Market Committee press releases can easily envision Chairman Yellen and the Federal Reserve team at the economic controls, carefully adjusting the economy’s price level and employment numbers.

Why the Wealth Effect Doesn’t Work

Across all financial media, between both political parties, and among most mainstream economists, the “wealth effect” is noted, promoted, and touted.

Scenarios for Owning Gold

Gold serves a unique role in investment portfolios, not only as insurance against extreme events, but as a timeless store of value in a world of multiplying paper currency.