Cavelti

Cavelti & Associates Ltd.
188 Eglinton Avenue East, Suite 706
Toronto, Ontario, Canada M4P 2X7
Phone 416 - 486 1900
Website: www.cavelti.com

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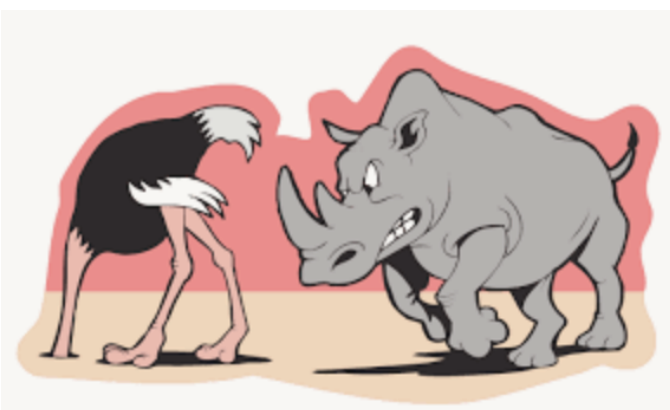
Gray Rhinos

How refreshing: a growing number of Wall Street operatives are getting cautious. A few of them use metaphors to describe impending threats—Black Swans, Gray Rhinos, the Elephant in the Room. From a purely aesthetic viewpoint, I've always preferred the image of black swans circling the pond. There is a certain serenity and elegance to it. But when considering available definitions, I have to say that the rhino fits the bill most perfectly.

In nature, as I learned during my years in Africa, the rhinoceros will appear docile, even peaceful, when left alone. When you approach the animal, there are indications that it's unhappy—the odd twitch or snort, unmistakably directed at you. And if you don't back off, there is a steep price to pay. Michele Wucker, the author of the highly recommended *The Gray Rhino: How To Recognize And Act On The Obvious Dangers We Ignore* (St.Martin's Press, 2016), provides context to her book's title. She defines a Gray Rhino as a highly probable, high-impact threat that is clearly visible but nevertheless neglected.



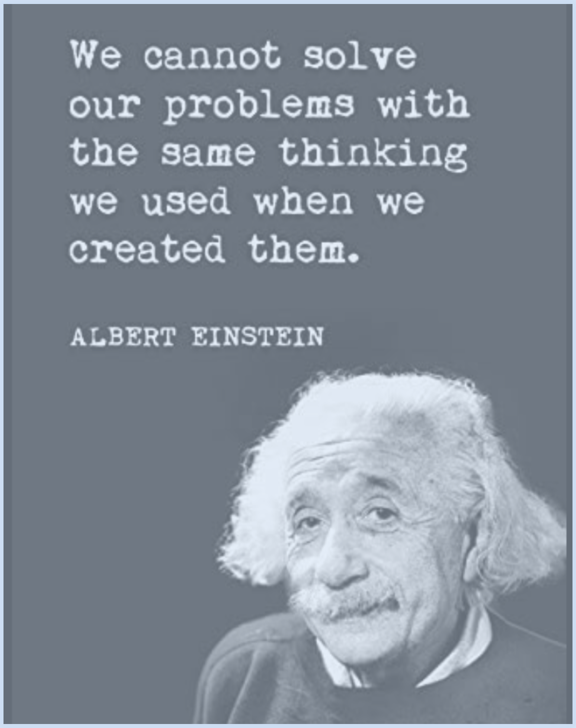
In his piece of a few weeks ago, Goldman Sachs strategist Chris Hussey named Gray Rhinos we've chosen to ignore: the run-up in commodity prices, rising inflation and elevated equity valuations. He's right, of course. All three are issues that could be addressed but are being ignored.

Still, I'd like to take the Gray Rhino motif a few steps further. First, I think we should acknowledge that Mr. Hussey's three present risks are all in the category of effects; an examination of the causes is called for. And second, it's important to recognize that there are vastly more Gray rhinos than the ones that are mentioned—in fact, the rhino population has been allowed to proliferate over a period of many decades. Moreover, the beasts, wherever situated—in the financial industry, in agriculture, in the health or educational areas or in the realm of geopolitics—have learned to talk to each other. Upset one Gray Rhino and the bunch of them will come at you.

The bottom line: we've ignored far too many utterly unsustainable systems for far too long, in some cases by disregarding them altogether, in other cases by applying shoddy, short-term fixtures and kicking the proverbial can ever further down the road. Is anyone surprised that there is talk of the need for a Great Reset?

The Reset Illusion

Several of my friends enjoy the deliberations of Great Reset advocates at some of America's think-tanks or Switzerland's World Economic Forum (the Davos Conference). The only problem with these organizations: the people offering solutions are operatives of the same enterprises that got us into the mess we're in.



Why would we trust them? I think I know what my friends would answer: we can only remedy today's ills by championing an open and intelligent discussion. That is true, but when I study these organizations' communications and programs , they're designed to prevent just that. The speakers, invariably, represent the same members of the corporate, political and central banking construct that has allowed, and often encouraged, the gradual shrinkage of the middle class to their demonstrable benefit. "New solutions" are served up, but they rarely differ in substance from what's currently in place. Instead, they're mostly ideas that perpetuate the status quo, often based on an approach that promises radical improvement, but overwhelmingly favours its architects.

Let's go back to two of the root causes of our many ills. Some take us back to the early seventies, when the largest consumption boom in history was unleashed—a boom that was reignited with greater leverage each time it stalled. The consistent theme: consume today at the expense of tomorrow. Or look at the late eighties, when Alan Greenspan started interfering with much-needed market declines, a policy which was aggressively and exponentially expanded by his successors Bernanke, Yellen and Powell—and, with enormous enthusiasm, adopted by other key central banks. These mega-trends could easily be recognized as Gray Rhinos early on. Both were clear threats to stability, but a choice was made to tolerate them, and in time to ignore or even deny them.

If you want a more complete summary of what has been going wrong during the past five decades and how missteps could have been avoided, take a look at our compilation on the next page. It traces the mismanagement of past decades and shows how different solutions could have made our economic, social and political environment more sustainable.

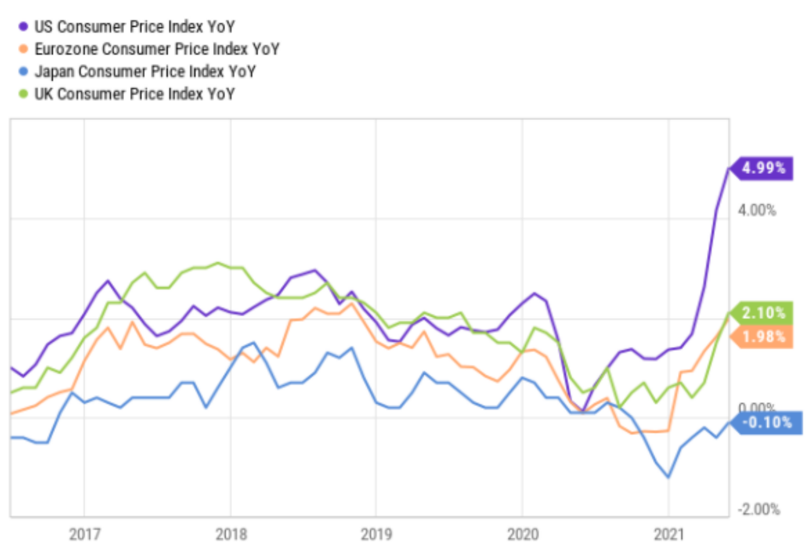
It's important to understand that the United States was in most cases the driver of policy direction. What has consistently surprised me during the past 50 years is the enthusiasm with which the other developed nations have followed the American example. Although there are clear differences in the balance between social and military spending, entrenched manifestations of U.S. life like corporatist sociopathy, the collapse of the social contract, gross fiscal imprudence, monetary recklessness, aggressive lending practices and out-of-control consumerism, are equally the norm in today's Japan, Canada, Australia and much of Europe. I learned some time ago that the only national construct I have to follow is the U.S.—whatever happens there is bound to adopted soon after in the rest of what I long ago came to see as America's vassal states. These countries' latest condemnations of everything Chinese or Russian convinces me that, in the geopolitical realm as well, original thinking is largely absent in what we loosely refer to as the West.

The 50-Year Failure of Leadership and its Consequences

1970s, 1980s, 1990s: MISMANAGED DECADES	
Policy platforms become increasingly unsustainable	
Examples:	
Consumers encouraged to overspend	
Monetary excesses undermine integrity of money	
Corporatist culture stresses growth at any cost	
Military spending crowds out social agenda	
Basic education standards start deteriorating	
Health care becomes pharma-enrichment model	
Yield boosting, GMO take over agriculture	
Environmental degradation accelerated	
1989 - 1991: COLLAPSE OF SOVIET UNION	
U.S. misses huge chance to cut back on defense	
Instead, turns to imperialism and forever war	
1999-2019: BUNGLED RESPONSES	WHAT SHOULD HAVE BEEN DONE
Massive central banks and government bail-outs	Allowing creative destruction of inefficient enterprises
Market valuations increasingly distorted	Rewarding productivity and financial prudence
Economy only grows with central bank support	Allowing interest rates to find market levels
Companies stop capital spending, buy back shares	Cutting back military spending by 50%
Social contract abandoned	Re-deploying capital to infrastructural overhaul
Wealth and income disparities explode	Re-deploying capital to social programs
Economic crash and social upheaval inevitable	Cavelti

Onto Covid

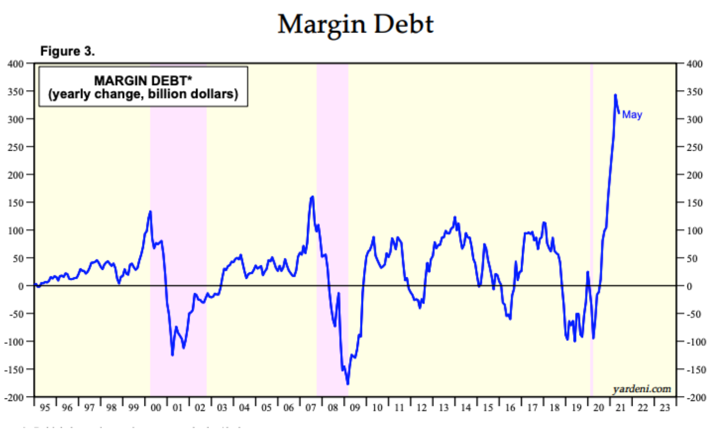
Where do we go from here? The Covid pandemic, in many ways has provided the ideal catalyst for a reset. Yet, the response by many governments has created a series of dangerous feedback loops. To begin with, lockdowns and business closures have caused economic hardship and anxiety for armies of previously employed citizens. Social tensions were the inevitable result. The authorities in many countries have since countered hardship by initiating unsustainable fiscal support programs; phasing them out without creating more upheaval is an immense challenge.



Meanwhile, lockdown policies are also causing widespread shortages of materials, which is aggravating inflation rates. The way in which central bankers dismiss rising producer and consumer prices as strictly temporary is fascinating. While disappointing economic growth may eventually dampen inflationary pressures, I'd place my bets on continuous shortages of labour, supplies and goods. Central banks are in an inescapable bind. Pumping more liquidity will only add to red-hot, pent-up demand and cannot improve supply chain problems. On the other hand, restraining liquidity by letting interest rates find their own level is likely to pressure financial markets and, in turn, place the consumer economy under renewed pressure.

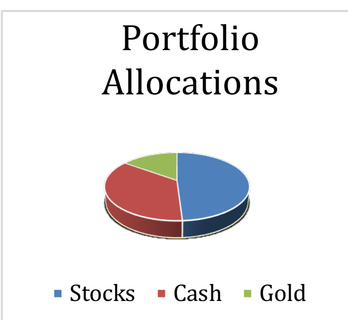
Investing Prudently

Given the high level of instability, how can we invest prudently? When looking at the broad market place, stocks and real estate have been the most discernible winners. As long as money is being debased and liquidity is plentiful, investors seem to think, why not stay exposed to markets that could go even higher? While such thinking is entirely logical and market tops are notoriously difficult to identify, it's probably still a good idea to pay attention to things like sky-high valuations and alarmingly high margin debt.



What could change the narrative? Looking at consensus views, I see that market action is driven by three main assumptions: that central banks will stay highly accommodative, that the inflation spike is a temporary phenomenon, and that robust and sustainable economic growth will be with us for some time. To me that kind of Goldilocks scenario assumes a lot of things. Yes, *if* monetary policy stay loose, the economy may stay strong. If not, it will obviously be the opposite. The truly wild card, for reasons I've already explained, is inflation. In my opinion, prices of key materials are headed higher for considerable time to come, which will place the central banks in an even more precarious position.

The bottom line: we continue to feel comfortable with a defensive portfolio balance. Stocks make up a modest 50% of our model portfolio, which caused us to underperform the popular indices during the past quarter. In terms of investment criteria, balance sheet strength remains a key consideration for us. When it comes to sector allocation, we remain well diversified, but recommend an overweight in producers of industrial metals, energy and food commodities.



What about bonds? While the fixed income sector regained some of its lost ground in the second quarter, we view it as an unrewarding and potentially treacherous place. Yields are at extreme lows and many issuers' ability to repay is more questionable than it has been for decades.

As we have for considerable time, we hold 15% in physical gold, for which we continue to have high expectations. Apart from being a solid portfolio stabilizer, the yellow metal has compelling fundamentals and an intriguing technical profile.

Finally, our cash reserve remains at a nearly unprecedented 35% level. A tiny part of it is held in crypto-currencies Bitcoin and Ethereum (1% each). We view both as speculative investments, but worth following and learning about.

Best wishes!

Peter Cavelti