The Discretionary Global Macro program returned 3.4% in August 2020, leaving performance at 43.6% YTD.[1]

A new era for policy

It's worth spending some time thinking about the Fed's recent virtual summit in Jackson Hole, Wyoming, and the policy statements that they announced at the conference. Having failed to achieve its 2% annual inflation target in the years since the Great Financial Crisis of 2008, the Fed first decided to change its inflation target to one that is 'symmetric' in 2012 – thereby cementing the notion that it would be willing to tolerate inflation above 2% at times before raising interest rates, in order to make up for the time that inflation spent below 2%. Despite the modification to its language, inflation has continued to undershoot the central bank's target in the last 8 years, and the Fed made two monumental changes at its recent Economic Policy Symposium.

First, the central bank shifted to an average inflation targeting regime – fancy language that simply states that if inflation is running below the Fed's target for multiple years in a row, they will allow inflation to remain above their target at say 3% or 3.5% for *years*, until the inflation undershoot is completely made up for by the ensuing overshoot. How many years of overshoot will they allow? They didn't say, leading some astute Fed observers to note that if inflation remains below 2% for decades, the Fed will be aiming for above 2% inflation for the following decades, which ultimately makes its 2% target completely meaningless in any rational sense. Also, the Fed's policy is now closer to a price level target than an inflation target, which is more than just semantics, as it will influence how much base money they print in the future in order to achieve their objectives.

Second, the Fed inserted new language about mitigating the *shortfalls* of employment from their assessment of its maximum level. In the past, they had used the language "deviations of employment", and in our minds this new wording is an indirect acknowledgment that the Fed views the inability of large swaths of the public to find consistent, meaningful employment as something that it will address under its purview. One of the core tenets that we were taught in economics classes in college was the Phillips curve, which claims that a tight labor market (little slack) leads, with a lag, to inflation. The Fed has decided it no longer cares about this little chart that has had a big impact on its official policy stance over the past fifty years. We can all but guarantee that the massive service sector layoffs due to the coronavirus recession (and perhaps even the ensuing social unrest during this summer) forced the Fed's hands into putting into place language and new policy goals that might have taken another 5-10 years to come into force under different circumstances.

We don't get worked up emotionally about whether we think what the Fed is doing is morally right or wrong. Our job is to stay neutral and place the right bets based on our reading of multiple data points; that's all. Is the Fed overstepping its bounds? Probably not. When the Fed was created in 1913 its mandate was simply to act as a lender of last resort in order to prevent the

[1] Returns are net of management fees and incentive fees. Returns may vary for each individual client's separate account, due to the rounding of positions traded, as well as differences in subscriptions and redemptions.

fairly regular panics that had occurred in the recent past from becoming runs on banks and the financial system. Fast forward a handful of decades and suddenly inflation targeting and maximum employment are part of its mandates (formalized in 1977). Fast forward another handful of decades to today and it's clear that modifying inflation expectations enough to permanently move away from the deflationary/disinflationary era of the last few decades, along with making sure that employment is prioritized over all of its other mandates seems to be the new ethos.

The Fed is a living creature, created and owned by private banking entities, and empowered by Congress. If we had to stick a non-judgmental, non-moralizing purpose statement behind the Fed in our own words, it would be thus: use monetary policy to lubricate the financial and societal functioning of our economy so as to prevent abrupt phase changes such as the French revolution from taking place. We live in a complex world where the elites cannot simply hand out grain during tough times the way that a ruler in ancient Mesopotamia or Rome might have. Instead, the central bank morphs over time, making sure that policy is adjusted to allow the system to adjust and act as a release valve. Fiscal policy will change and plays a release valve role as well, but that's a discussion for a different letter.

Why does this matter? It doesn't matter much today or tomorrow, but it matters quite a bit over the next decade. It means that we are not turning Japanese – during its deflationary decades, the Bank of Japan never got to a point where it started targeting the woes of its labor market. Our central bank is determined to change inflation expectations going forward and we think they will succeed. It cements our long-term bullish views on precious metals. And it means that the bigger trade – the macro trade of a lifetime – will be short bonds starting 2-10 years from now (we're very fuzzy on the start date; very secure in the thesis). And it means that as labor finally gets its share of the pie and the corporate profit margins that the equity market has taken for granted over the past 15-20 years dissolve, the stock market may become a stagnant asset class. Hyperinflation (very unlikely) may be good for stocks, but 3-5% annual inflation with lower margins is probably not good for our tech-heavy, long duration stock market. We are excited, as the Fed just told us that our core long-term macro views are not only intact, but that policy will be actively working to make them come alive.

Current portfolio

Our portfolio is currently the opposite of what the above commentary would suggest, mainly for short-term technical reasons. We are short gold, as bullish sentiment and a short-term bottom in real interest rates means the trend in gold should be on the downside. We are also short the euro, as large speculator positioning is extremely stretched and too many have embraced the dollar bear market thesis too quickly; a wash out is needed before shorting the dollar again. And even though we are bullish almost all commodities long-term, we are short crude oil, as near-term technical action looks toppy, confirmed by sagging US gasoline and global demand. The only position we have that lines up with our very long-term views is short the 30-year Treasury bond – we're not looking for the start of the great bond bear market, we're just playing a continued rebound in economic growth and are fading the view that bond yields must stay glued to zero across the curve over concerns that the corona-recession is a depression in the making.

Sincerely,
AG Capital Management Partners, L.P.