"If you can keep your head when all about you are losing theirs ... 
   If you can wait and not be tired by waiting ... 
   If you can think – and not make thoughts your aim ... 
   If you can trust yourself when all men doubt you ... 
   Yours is the Earth and everything that’s in it.”
   —Rudyard Kipling

The creation of money is one of mankind’s great yet underappreciated achievements. Without money, many of today’s ‘essential’ items would not be possible: a house, a book, a computer, clothes, cars, or a meal at a restaurant. As an individual is not capable of producing these items alone, money provides the means to acquire these items, because an individual can specialize in doing a specific task, whether building furniture, raising cattle, or repairing cars. The individual earns money by specializing to buy products or services from others. Before money, individuals within a society were forced to barter, indirectly exchanging their goods in return for another’s item - a cumbersome and inexact system. Fortunately, across different societies there were certain items that everyone wanted. These items served as the earliest forms of money: salt, tobacco, grain, seashells, or animal furs. Over time societies embraced the ease of some form of metal, such as gold and silver, as their preferred form of currency.

Societies valued these precious metals not only for their cosmetic appearances, but also their tangible benefits. Metals are hard to destroy, but they are also lightweight, uniform, and divisible—any two ounces of pure gold are the same. They are scarce and difficult to obtain; one cannot simply print new gold or silver. The mass utilization of uniform currency allowed human civilization to thrive, because one could buy goods without having to make them. The individual could be a farmer, a tanner, or a sailor. This specialization allowed people to produce more complex and useful items; thereby, improving the quality of everyone’s life. Money also made it easier to save for the future. By saving some of the money one earned, people could purchase larger and more complex items. With more savings, people needed new ways to protect their money. This led to banks, where one could deposit coins in exchange for paper receipts that one could redeem for coins when convenient. The paper banknotes themselves became a form of money, since an individual could exchange them with others who could in turn go to the bank and claim the gold promised by the receipt.

Once societies began using paper, it was easy for governments to print new money, even if the government had not collected enough gold or silver to redeem the paper banknotes in circulation. Throughout history, this has been a popular way for governments to generate new money; as printing paper promissory notes is easier than reducing spending or collecting taxes. Perhaps easier for politicians, but society suffers when its money loses value—as this is the definition of inflation. The United States has gradually succumbed to the will of politicians’ desire for inflation. For most of the United States history one could exchange dollars for gold. In 1913, the United States created a central bank, the Federal Reserve, which began creating new dollars without new gold. Twenty years later, the U.S. declared it illegal to own gold. In 1971, the U.S. stopped exchanging dollars for gold with other countries. Today, the U.S. dollar floats freely against all other global currencies, backed by the faith in U.S. government and the largest military in the world.

Austrian economist Ludwig von Mises wrote The Theory of Money and Credit in 1912, one year before the inception of the U.S. Federal Reserve. Despite Mises seminal dissertation on the value of money, the
Federal Reserve still struggles to define inflation. The Federal Reserve Bank of Cleveland operates the Center for Inflation Research (CFIR) to better understand inflation and the factors that influence its behavior. The research center poses a rhetorical question and answer: *Have you ever been shopping and noticed that the prices of things you buy have gone up? If the same things in your shopping basket cost $100 last year and now they cost $105, at a very basic level, that’s “inflation.”*

To most economists employed by central banks, the word “inflation” means the increase in prices of consumer goods or services, as measured by the Consumer Price Index (CPI: [https://www.bls.gov/cpi/](https://www.bls.gov/cpi/)). Using this definition, if the government imposes minimum wage laws or tariffs, if OPEC cuts oil production, or if toilet paper shortages occur due to panic, the resulting price increases constitute “inflation.” Those familiar with Austrian economics acknowledge this syntax of “inflation,” but the Austrian economist also understands the history and significance of using the term “inflation” to denote the increase in supply of money and credit. Contrast this to the Federal Reserve’s notion of a “price level” defined by central planners: Statistical agencies start by collecting the prices of a very large number of goods and services. In the case of households, they create a “basket” of goods and services that reflects the items consumed by households. The basket does not contain every good or service…

Once they select a basket of goods, they determine: the current value of the basket by calculating how much the basket would cost at today’s prices (multiplying each item’s quantity by its price today and summing up). Next, they determine the value of the basket by calculating how much the basket would cost in a base period (multiplying each item’s quantity by its base period price). The central planners further refine their basket of goods with “relative weights”: In the case of a price index for consumers, statistical agencies derive the relative weights from consumers’ expenditure patterns using information from consumer surveys and business surveys. Between each period of comparison, the central planners adjust the items, their quantities, and the relative weight of importance. This statistically-created basket of goods provides the U.S. Federal Reserve with the “data” they use to justify their policies. Very few investors question the potential harm to society should their data be incorrect, or even worse, that they employ flawed methodologies.

The U.S. government claims that the economy is rebounding from minimal damage caused by the Covid-19 closures of businesses. We are skeptical. The government justifies this claim with a statistic known as the Gross Domestic Product (GDP), which represents the total of spending in the economy. Intuitively, one understands that we grow wealthier only by saving some of our income and investing it wisely for the future. By contrast, most economists adhere to a concept called “The Paradox of Thrift”, the belief that the economy suffers from reductions in spending caused by an increase in savings. Economists argue that individual savers may be better off, but collectively the economy suffers. For example, the new car purchase that we defer denies the automakers and all who work for the company the money they need to continue production.

The reality is we invest the money that we do not spend on a new car into other endeavors that will yield greater wealth longer term. We may produce fewer automobiles today, but later we will have access to products and services that would not have existed without our previous investment. Our savings continues to compound, providing a more comfortable existence later in life. By contrast, government economists claim that frugality denies employment for our fellow citizens, which creates concerns about the GDP statistic. First, GDP focuses on retail sales but fails to adequately incorporate spending on longer term production. Also, GDP measures price increases, not increases in the production of real goods or services. Assume the price of one gallon of whole milk increases from $3.00

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to $3.75 in the past month, a twenty-five percent increase in price. Since milk consumption changes little in the short run, selling the same volume of milk at a higher price increases GDP. Government statistics indicate that the increase in GDP concludes we are better off, which seems dubious.

The best measure of price inflation is not measuring retail prices in the short run, but rather measuring the increase in the money supply. A money supply increase will eventually work its way into the price structure. The two statistics that measure the money supply are the "Monetary Base" and "M2". The monetary base consists of all cash, wherever held, plus bank reserves held at the Federal Reserve Bank (which may be converted into cash on demand by the banks). It is called the monetary base because banks create money through loans backed by their reserves. Before the 2008 housing crisis, the monetary base was $847 billion. Since the U.S. Federal Reserve Bank has dramatically increased the monetary base; in January 2020, just prior to the Covid-19 lockdowns, it stood at $3.4 trillion, a 300% increase. Following the Covid-19 lockdowns, the Federal Reserve once again increased the monetary base to $5.2 trillion, 52% higher than the January 2020 level.

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M2 is the broadest measure of the money supply that can be accessed by the public on demand. M2 was $7.2 trillion in 2008 but increased to $15.4 trillion by January 2020. M2 now stands at $19.4 trillion, a 169% increase. This monetary increase tracks well with independent measures of price inflation of ten percent compounded annually according to research by ShadowStats as well as the Chapwood Index. Updated and released twice a year, the Chapwood Index reports the unadjusted actual cost and price fluctuation of the top five hundred items on which Americans spend their after-tax dollars in the fifty-largest cities in the country. Some of the items tracked by the index include Starbucks coffee, Advil, insurance, gasoline, sales taxes, tolls, fast food restaurants, toothpaste, oil changes, car washes, pizza, cable TV and Internet service, cellphone service, dry cleaning, movie tickets, cosmetics, gym memberships, home repairs, piano lessons, laundry detergent, light bulbs, school supplies, pet food, underwear, and People magazine. The index helps explain why American workers and retirees cannot maintain their standard of living—their income cannot keep pace with expenses. Salary and benefit increases follow the CPI, which should reflect the fluctuation in prices for a typical “basket of goods,” but which has not done so for over thirty years.

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Even as production of goods and services declined due to the reaction to Covid-19, the U.S. government has been issuing unprecedented amounts of money. Many find this action justifiable, but this common misconception confuses money with wealth. One typically considers people with a lot of money as wealthy. While wealth and money may sound synonymous, they are very different. Wealth is more tangible and therefore easier to understand than money. Useful goods and services are wealth. A loaf of bread is wealth, as are the farms, factories, and human labor and ingenuity that are needed to grow and process the crops necessary to produce the loaf of bread.\(^5\)

Money, by contrast, transforms wealth from one form into another. Skills and the ability to perform work are a form of wealth, as is the food one eats. The money one receives in wages passes to the grocery store for the simple but crucial task of transforming one’s labor into food. Therefore, logically, the amount of wealth in an economy is much greater than the amount of money—wealth turns into money only for a brief period before being turned back into another form of wealth. A small business owner sells his business and retires. He likely keeps the sale proceeds in the bank for a period before investing in other assets and businesses to generate income for retirement.

Beginning in the late 1990s, something changed—the quantity of money in the economy has been growing faster than either wealth or economic output. With Covid-19, money growth has accelerated, even as economic lockdowns decreased economic output. Despite this increase in money and a decrease in economic output, the government’s CPI statistics continues to show negligible levels of consumer price inflation. One begins to wonder if there is no limit to how much money governments can create to finance politically desirable objectives. However, this line of thought mistakes money for wealth. Creating trillions of dollars of new money will not create the skilled labor or the other productive resources needed to achieve society’s economic goals. Instead, this new money redirects wealth and productive resources away from those most able to employ them wisely and into the hands of those most likely to speculate. If a large quantity of new money enters the economy during the time in which the businessman sells his business, the price of alternative forms of wealth will also rise. The soaring stock market, despite the economic destruction brought by the pandemic and associated lockdowns, illustrates the impact of money creation on asset prices. The retired businessman generated his money from the sale of real wealth, but unfortunately his money must now compete with newly created money (with no associated wealth) to purchase income-generating assets. His business wealth will not purchase as much wealth in other forms and therefore his living standard decreases.

Over time, wealth reallocated away from those who create and produce towards those who are well-connected with access to unlimited sums of newly created money, undermines the foundation of our capitalist society. It is troubling that once productive industrialized economies continue to reallocate their wealth to the control of entities who better understand how to access newly created money rather than build and nurture the skill sets and capital investments necessary to generate enduring wealth. Rather than using this money to invest in innovation and growth to create additional wealth, these new owners chose instead to increase the debt on their company balance sheets to buy their own shares on the stock market. Earnings per share and executive bonuses increase, but companies grow indebted and fragile to economic shocks. Productive wealth built up over decades withers, and in the process income and wealth inequality explode. The result of this growing misallocation of capital, according to analyst Stephanie Pomboy of MacroMavens.com, is the most overvalued stock market in history.

After twelve years of nonstop Federal Reserve-abetted asset inflation, memories fade and fewer remember that markets are cyclical. When everyone realizes these perversions have created a bubble, there will be a rush for the exit. As Ben Hunt of Epsilon Theory said, “It’s not what the crowd believes. It’s what the crowd believes that the crowd believes.”

Market participants have lost sight of the fact that financial markets exist to efficiently allocate capital. Destroy that function and one harms a functioning economy. Interest rates are no longer set in the marketplace but manipulated by central bankers. Active investment managers seeking value have been replaced by index funds which only look at price, never value. Investors and speculators have become divorced from their key role as price discovery agents. As a result, price and value no longer matter.

The stock market masquerades as an investment opportunity but is increasingly treated like a gambling parlor. The Robinhood phenomenon, the cult of Elon Musk and Tesla, the GameStop fiasco, Bitcoin zealotry, the frenzy chasing SPAC IPOs or the hero-worshipping of Cathie Wood’s Ark beta-leveraged ETFs…all signs of speculative excess. This excess is by no means limited to the retail investor. Some of the world’s most sophisticated institutions placed wagers on Chinese entrepreneur Jack Ma’s financial-technology startup, Ant Group. They speculated on outsized profits over a short period of time, but they were wrong—their bet may never payoff.

In 2018, an exclusive group of private equity firms including Silver Lake, Warburg Pincus, and Carlyle Group took part in a coveted fundraising by Ant Group that raised $14 billion and created the world’s
most valuable startup. The firms purchased shares in an offshore shell company set up by Ant Group to raise funds in U.S. dollars to secure a payment license to operate Alipay, Ant’s popular mobile application; however, the company had to remain domiciled in mainland China. Greed allowed Ant Group to dictate the investment terms, including no guarantee of liquidity, no representation on the board of directors, nor any voting rights. To access the ‘hot deal,’ the private equity firms willingly ignored the regulatory unpredictability when investing in Chinese companies. If Ant completed its initial public offering, the private equity firms would convert their two-year investment into an 80% profit. Instead, Ant’s controlling shareholder Jack Ma made a controversial speech that annoyed Chinese regulators and government officials who in turn cancelled the IPO. The deal’s cancellation closed the exit, showing that easy money causes even some of the most sophisticated institutional investors to misallocate capital.

There is too much air and fragility underneath the market, a caution nobody wants to hear. We see disconnects everywhere between price and value. The total debt-to-GDP ratio across the entire U.S. economy stands at a record 365%. In just three quarters, the U.S. added as much debt to the country’s balance sheet as in the prior two decades combined - $77.4 trillion ($620,000 per household). At the 2000 technology bubble peak, the liability was $260,000 per household and at the peak of the 2007 housing bubble the ratio was $475,000. Perhaps this massive debt overhang explains the deflationary pressures that persist and why interest rates remain so low? We do not have the answer, but we know that these low rates can support elevated asset prices for a while. Eventually, the underpinnings of low interest rates will wane when it becomes obvious that corporate profits can disappoint.

The day will eventually arrive when profitless companies will no longer outperform those with solid business fundamentals. A credible plan to generate returns on invested capital and build future residual cash flow streams will be necessary, as markets can ignore fundamentals for only so long. The key is to manage risk by continuously focusing on the quality of one’s investment and the price one pays. Timing market tops and bottoms are impossible, but one can assume that we are closer to a top than a bottom. We believe that valuations are so extreme that their starting point today represents limited future expected returns. As Jim Grant once warned, “The only permanent truth in finance is that people get bullish at the top and bearish at the bottom.” Therefore, if an investor can keep their head when all others are losing theirs, if one can wait and not be tired by waiting, if one can trust oneself when all men doubt them, yours is the Earth and everything that is in it.

With kind regards,

ST. JAMES INVESTMENT COMPANY

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We founded the St. James Investment Company in 1999, managing wealth from our family and friends in the hamlet of St. James. We are privileged that our neighbors and friends have trusted us for twenty years to invest alongside our own capital.

The St. James Investment Company is an independent, fee-only, SEC-Registered Investment Advisory firm, providing customized portfolio management to individuals, retirement plans and private companies.

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