



July 27, 2021

Dear Investors:

Not Your Mother's Inflation

Investors are always looking to history for guidance by attempting to find the most economically comparable period to the present. Two timeframes are the most conspicuous, the 1940s and the 1970s. Some macro investors today are citing the 1940s to validate the Fed's hypothesis that the recent rise in consumer prices will prove to be transitory. Ironically, if the past is prologue, this period supports the idea of inflation getting much worse before it gets better today. The 1970s period, meanwhile, substantiates the risks of an even longer lasting and more gradually rising inflationary trend that could last more than a decade. **In our analysis, today's macro imbalances and policy response point to even more extreme inflationary pressures than both analogs.**

In resemblance to today, the economy of the 1940s had high government debt and large fiscal deficits relative to GDP along with repressive Fed interest rate policies. It was a decade that included two sharp waves of increasing inflation in the Consumer Price Index, the first during World War II and the second right after it. Monthly CPI rose to a short-term peak of 13.2% on a year-over-year basis in 1942, and while it fell back down to 0% in 1944, it then spiked again to a higher peak of 19.7% in 1947, the highest year-over-year CPI increase of the last century. Note that during each of those inflationary spikes, CPI stayed above a 5% YoY rate every month for over two years. To our friends, "the deflationistas", if this is an accurate roadmap to follow, buckle up, the rise in consumer prices is just getting started.

Unlike the 1940s, when the US dollar was still pegged to gold, in the 1970s we had the abandonment of the gold standard which marked the onset of five decades of limited financial and monetary discipline ever escalating to the historic macro imbalances we have today. Such a shift in the monetary system was just as significant as today's unlimited QE policies. The consequence of the macro setup during that era was that inflation rose in three waves from the late 1960s through the 1970s to reach a peak of 14.7% in 1980. Those waves were steadier and more persistent than the inflationary waves of the 1940s, we think due to the long-term, trending dynamic of the wage-price spiral that was at work.

Interestingly, both of those regimes, along with today's, share one thing in common: negative real interest rates. The 1940s was the most financially repressive environment yet in that respect. The Fed at least allowed interest rates to rise in the 1970s while inflation rose faster. From a market perspective, there was one important lesson from both periods: **At times when investable assets yield less than inflation, owning tangible assets becomes imperative. Commodities were far-and-away the best performing asset class in both of those decades.**

The Fed today is favoring the 1940s' style of financial repression. It is "not even thinking about thinking about" raising interest rates anytime soon. The definition of financial repression is deliberate government and Fed policies that result in savers earning returns below the rate of inflation. The purpose of it is to inflate away excessive debt burdens, especially at the government level. **As a result, we are experiencing the loosest monetary policy of all time today.** Meanwhile, the valuation of the stock market, which is highly dependent on the suppression of the cost of capital, far exceeds the periods of the 1940s and 1970s. **Using Robert Shiller's**

cyclically adjusted price to earnings ratio as a gauge, we are at 38.3 times today. That is more than double what we saw during the most overvalued levels reached during those two decades. Even more significantly, the market cap of US stocks relative to nominal GDP is by far greater than any other time in history. The levels of overall debt are also materially higher. **Total debt, including private and public, as a percentage of GDP is almost double the size of the 1940s and 1970s.**

Now, let us get back to the 1940s case study. While the Fed was able to keep short and long-term interest rates subdued at that time, US households played a major role in accomplishing that. As a form of patriotism, Americans purchased large amounts of US government bonds to finance military operations and production. To put this into perspective, World War II cost the US close to \$300 billion. Households funded almost \$185 billion of that amount. This level of participation by US investors to fund large government deficits is completely absent today. **While we continue to see record levels of Treasury issuances in the market, the increasing dependence on the Fed and banks to continue funding extreme deficits has never been greater.**

Even from an individual income tax perspective, today's policies are far more excessive. Let's use the decade of the 1940s again for comparison. The tax rate for the lowest bracket increased from 4% in 1939 to 23% at its most extreme in 1945, which is more than twice where it is set today. Additionally, the tax rate for the highest bracket was 82% at its lowest level for the 1940s decade. It reached as high as 94% in 1944, which compares to 37% today.

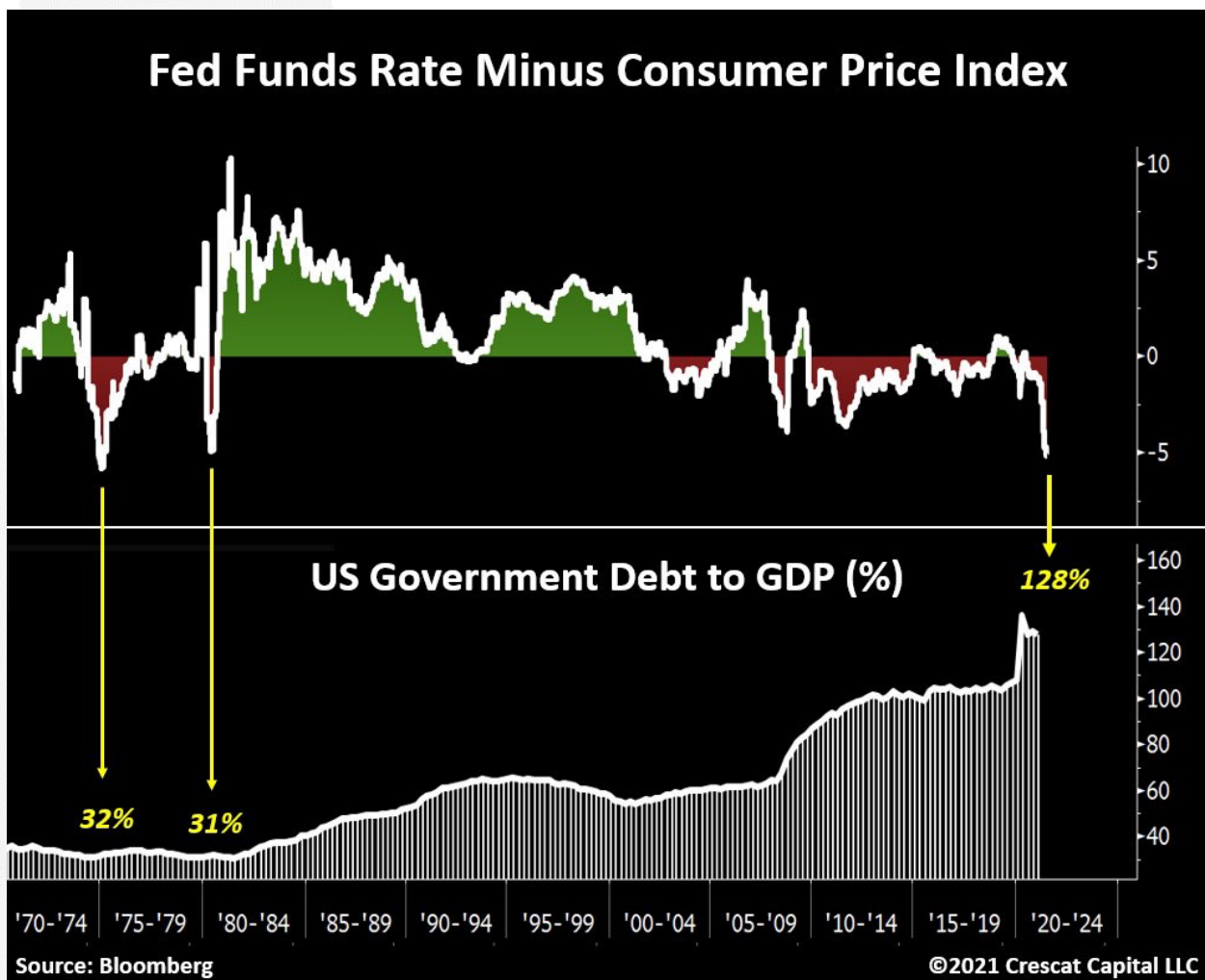
Yes, today's tax policies may not be sustainable. Throughout history, tax revenues relative to GDP have tended to follow government debt levels. Today is the first time we are seeing such a large divergence between the two. However, given the need for fundamental growth to justify today's historic valuations in risky assets, one would wonder how meaningfully the government could really reverse these tax policies.

Here is another perspective to prove our point. In 1973, when CPI was on an upward trend and reached 5%, the Fed also called it "transitory" but still raised interest rates from 7% to 13%. Note that back then, the government debt to GDP levels were only 32% versus 128% today. **If inflation ever becomes a more persistent problem, what could the Fed even do? Shock the world and raise rates by 2%? It cannot even do that at the current levels of debt or at these insane valuations for risky assets.** The world believes high asset prices are dependent on low interest rates. Our analysis shows they are even more dependent on low inflation, and that is the Fed's predicament.

Entirely different from today, the government and institutions of the 1970s were fully cognizant of the risk of inflation becoming an uncontrollable problem. Here is what Richard Nixon wrote two years after announcing the end of the gold standard:

"...everything that the government gives out with one hand it must take back with the other, in higher taxes or more inflation or both. Spending proposals must be looked at in this way, by asking whether they are worth either of these costs. Much government spending fails this test."

Today, in contrast, the most common refrain we hear from policy makers is that they have not done enough. Therefore, we shall proceed with at least \$120 billion/month of QE, 0% interest rates, and 12% government deficits relative to GDP. The macro imbalances today are extreme, and the ultimate inflationary consequences of years of reliance on ever greater monetary and fiscal stimulus as the primary policy tools to solve economic problems are inescapable.

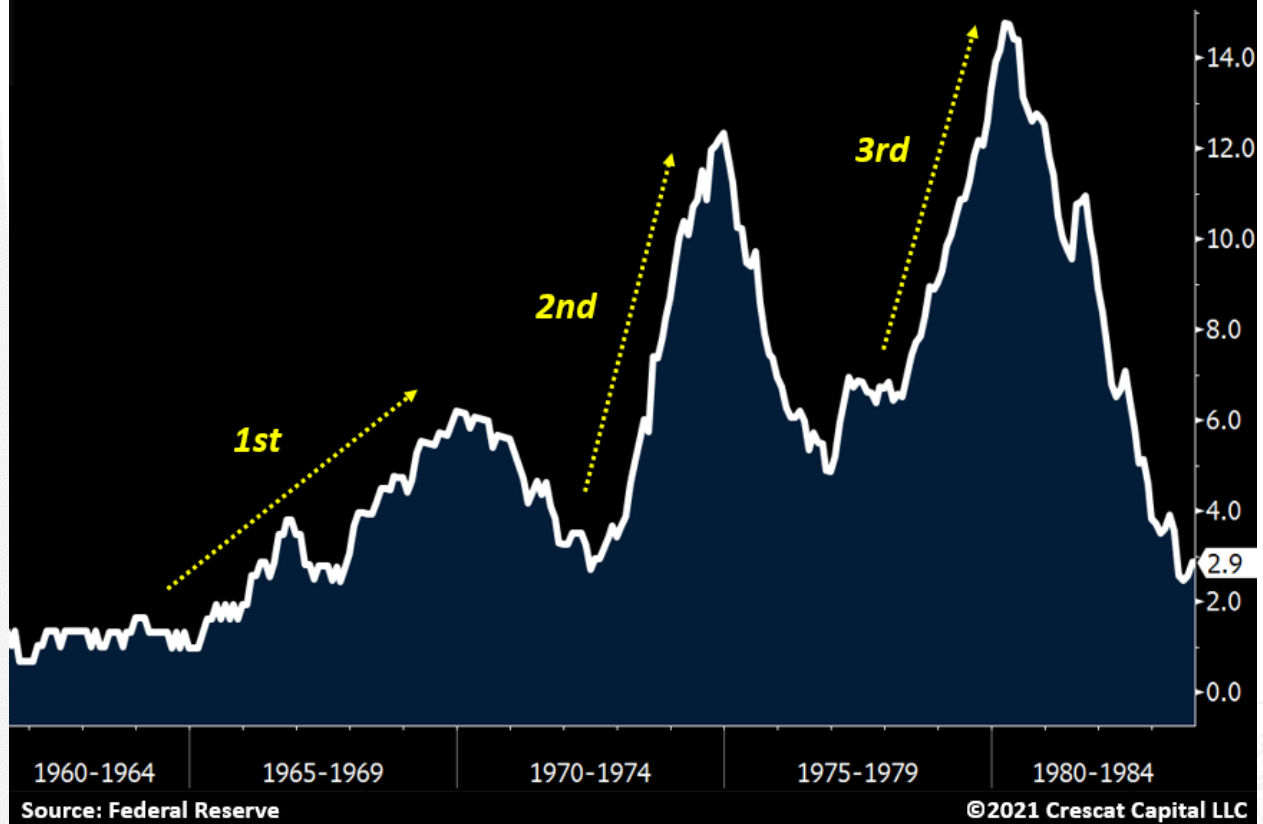


The Three Waves of Inflation

While some people like to say that the inflation rate will accelerate in steady fashion, we believe this line of thinking is utterly wrong. Macro forces are cyclical. As inflation gradually becomes the prevailing narrative, households and businesses act accordingly creating a vicious cycle that can result in surprising surges in the cost of living that ebb and flow. Let's return to the 1970s case study.

From 1965 to 1980, the US economy experienced three inflationary waves that built on themselves becoming progressively larger as time went on. Note how CPI made "higher highs" and "higher lows" marking a persistent 15-year trend of a rising annualized inflation rate. This historic fact is exactly the opposite of what is implied by the popular "inflation-is-transitory" narrative today. That idea implicitly promotes a concept that inflationary cycles are short-term and mean reverting rather than long-term and trending. **Those years were marked by fierce counter shifts in monetary and fiscal policies that repeatedly changed focus from fostering economic growth to strongly fighting inflation. As a result, financial markets experienced one of the most volatile boom-and-bust periods of history.** At that time, the Fed was fortunate to be able to raise rates without triggering a debt crisis. This is a very different setup today.

The Three Inflationary Waves of the 70s



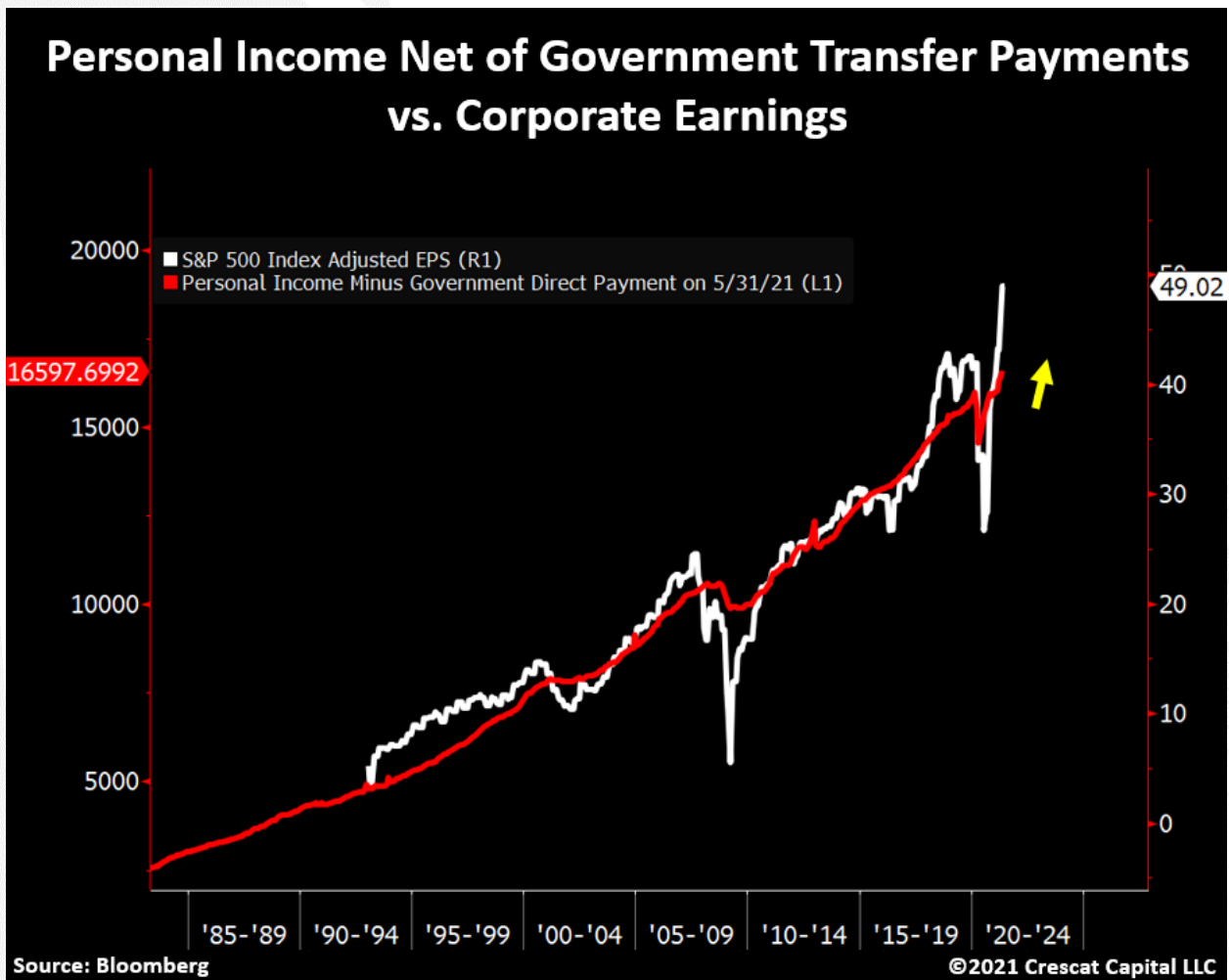
A Structural Shift Is Upon Us

The chart below could not illustrate more meaningfully our current conviction in the inflationary thesis. Through monetary and fiscal policies, the historic amounts of liquidity recently added to the economy have translated into one of the hottest economic environments we have ever seen. Consequently, corporate profits surged by 47% on a year over year basis and are now significantly higher than any other prior peak. As illustrated below, personal income less government transfer payments tend to follow the bottom-line fundamentals of companies incredibly close. To us, it suggests that personal income is about to drastically increase in the next quarters. We think it is going to be driven by a large increase in labor cost.

After experiencing a secular decline in wage and salary growth for the last 30 years, we believe there is a structural shift upon us that will critically feed into the inflationary thesis. Using our prior analytical work on the 1919 Spanish Flu period as a roadmap, when the cost of living becomes significantly more expensive, workers began to demand materially higher wages. To recall, in the wake of that pandemic, one out of five people in the US work force was engaged in a labor related strike. We believe a similar pattern is developing today. The economy is likely at the early stages of an upsurge in labor-management conflict. In fact, we have not seen an increase in the federal minimum wage since July 2009.

When the first numbers on personal income were reported, economists warned that a significant amount of it was related to the stimulus checks and other fiscal programs. They were not wrong. To be exact, today government transfer payments represent over 20% of personal income and reached 33% at their peak in March 2021.

As we have said before, US households just experienced their largest wealth increase in history, including the bottom 50%. This was already accompanied by a significant amount of inflation, even if CPI is understated due to government-sponsored fudging. But in our view, if rising personal income is further driven by a new secular rise in wage and salary growth, it would considerably add to the inflationary thesis through a demand-pull dynamic, one that ultimately feeds the classic wage-price spiral.

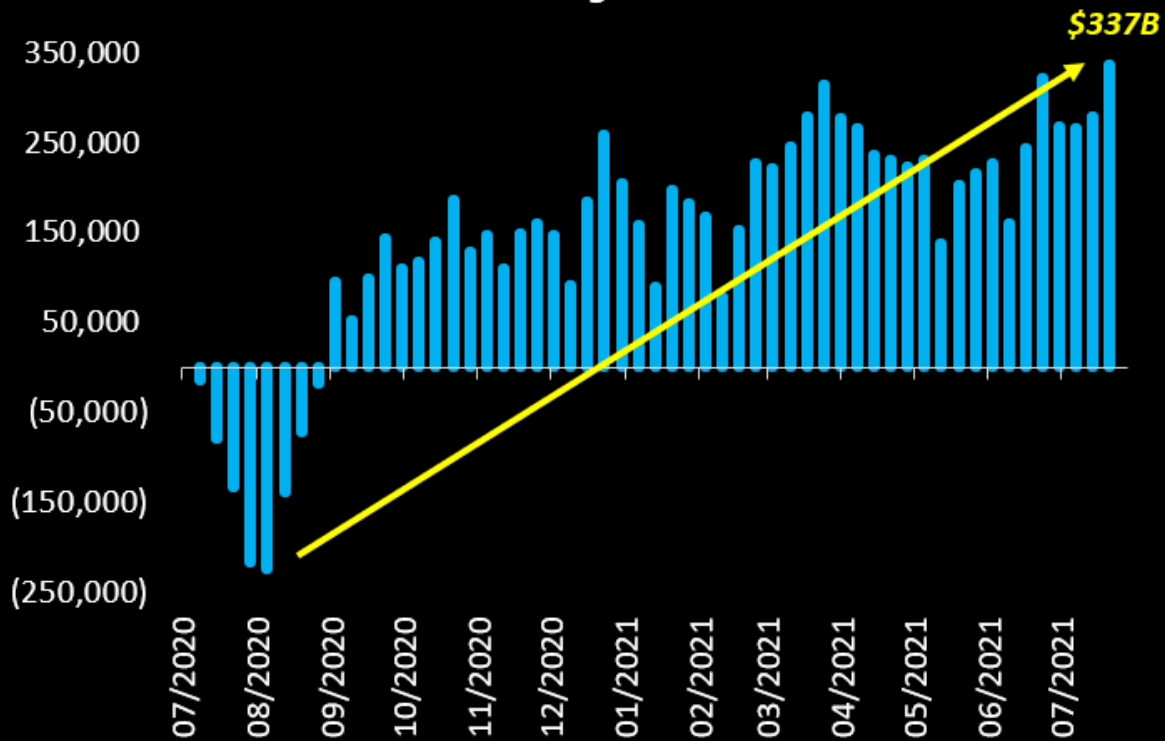


Dependent on Monetary Policy

The craziest part of all of this is that monetary policy is gradually expanding. Contrary to the taper talk, in the last two months alone, the Fed's balance sheet increased by \$337 billion, the largest amount in over a year.

Fed Balance Sheet Assets

2-Month Change in Millions USD



Source: Federal Reserve

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The Rise of the Tangible-to-Financial Assets Ratio

So, with today's environment being far more extreme than the 1940s and 1970s, does it mean that we are on the cusp to triggering hyperinflation? That is not our view.

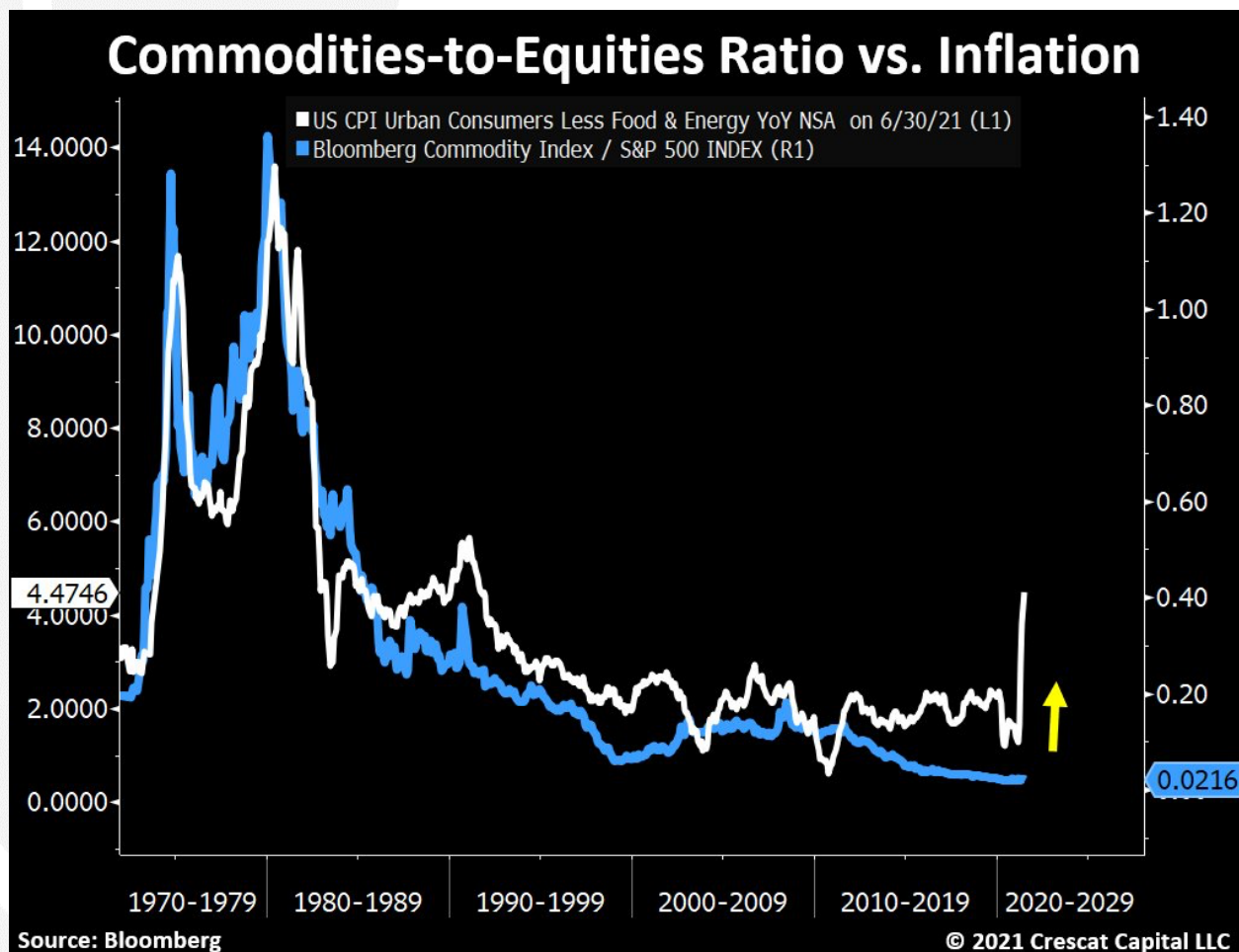
Those are extreme scenarios that start to develop when an economy experiences severe capital outflows, particularly from large businesses and institutions, which leads to a sequence of events.

First, the capital flight creates downward pressure on the local currency, increasing the likelihood of an inflationary problem. Also, as large corporations exit those countries, the labor market suffers, economic growth turns negative, and the instability of the currency is aggravated. The combination of an economic and currency crisis is what leads to social unrest, major political shifts guided by populist agenda, and a major move in opposition to capitalism. The good news is that these issues take time to evolve, sometimes decades. Aside from the obvious case being Venezuela, we think Argentina could unfortunately be going towards this path. On the other hand, we are clearly not seeing these signs in the US yet. Almost all major corporations in the world continue to be based here and do business with the US economy. **Therefore, a hyperinflationary scenario is not in our minds as of now. We think that the inflation rate will continue to rise and be more persistent for longer, the exact opposite of the concept that the Fed is promoting today by characterizing inflation as "transitory".**

We think, like the 1970s, we will see progressively larger inflationary waves that will build on themselves and set off important changes in market leadership and asset allocation. In this macro backdrop, we believe natural resource industries and their underlying commodity prices will become one of the main beneficiaries. The scarcity of investable assets that yield above inflation expectations is slowly forcing capital allocators out of risky overvalued financial assets and into cheap hard assets.

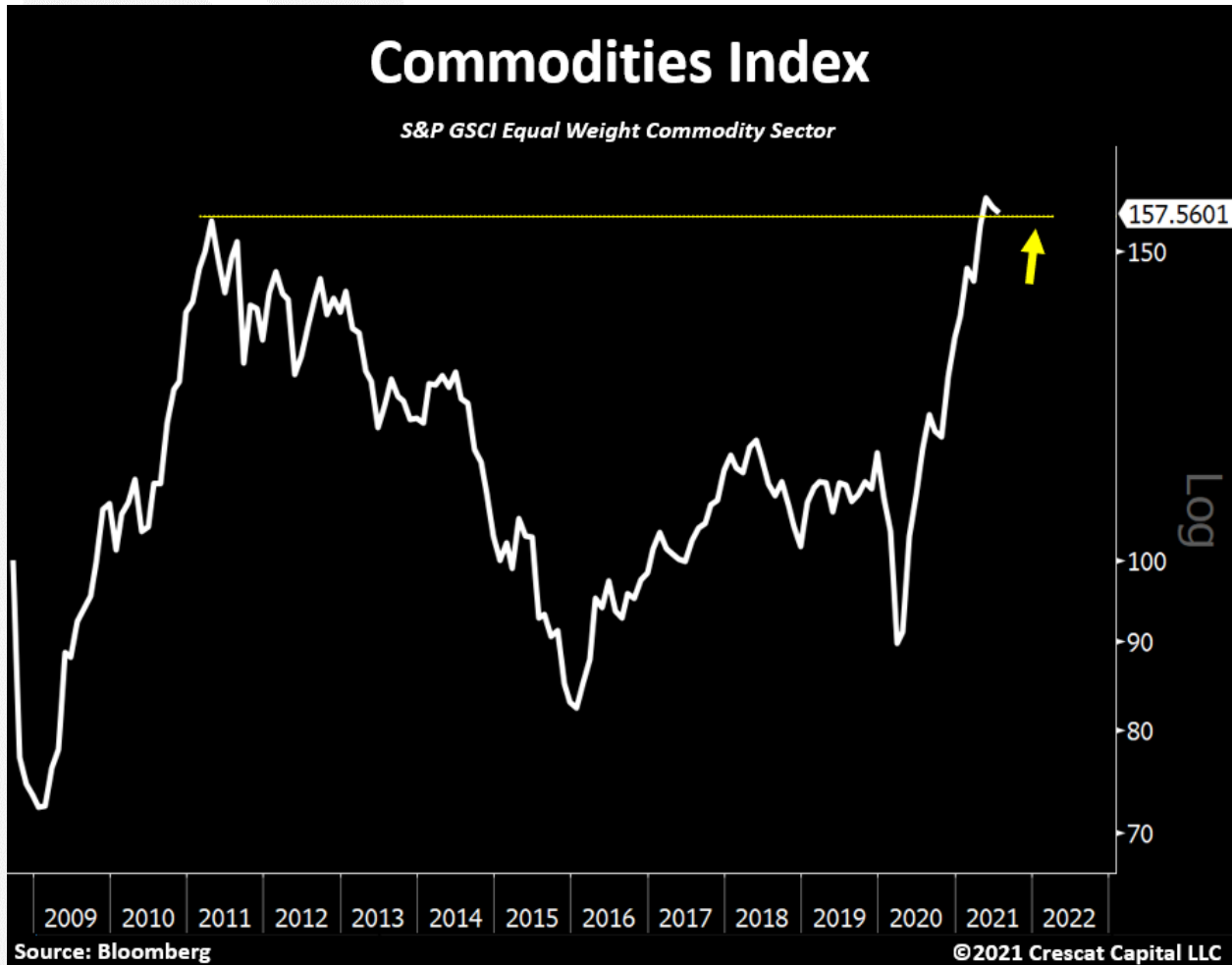
Meanwhile, there is a clear lack of appreciation by policy makers of the amount of time, capital, skilled labor, and effort that it takes to extract and produce commodities. The green agenda, and the move toward electrification, is grossly miscalculating the need for critical commodities to make this transition possible. Massive infrastructure developments through fiscal programs are unimaginable without high demand on natural resources in scarce supply.

Note how the commodities-to-equities ratio, or what we may call the “tangible-to-financial assets ratio”, tends to follow inflation incredibly close throughout history. **Given our strong views about the likely longer-lasting inflationary consequences in the economy, we believe this is the time for investors to be long tangible assets and short hyper-overvalued stocks while also avoiding bonds.** Keep in mind, commodities remain under-allocated by institutions while stocks now have negative real earnings yield just like bonds.



Lumber Prices Are Not Representative of Overall Commodity Markets

The 61% decline in lumber prices is often used as a reason to justify how inflation is in fact transitory. In our opinion, this view is largely misguided. While the crash in lumber prices is significant, that is one case versus multiple other commodities. The equal-weighted commodities index just broke out above its 2010 highs and is merely retesting that key support level. We believe these assets are headed significantly higher from here.

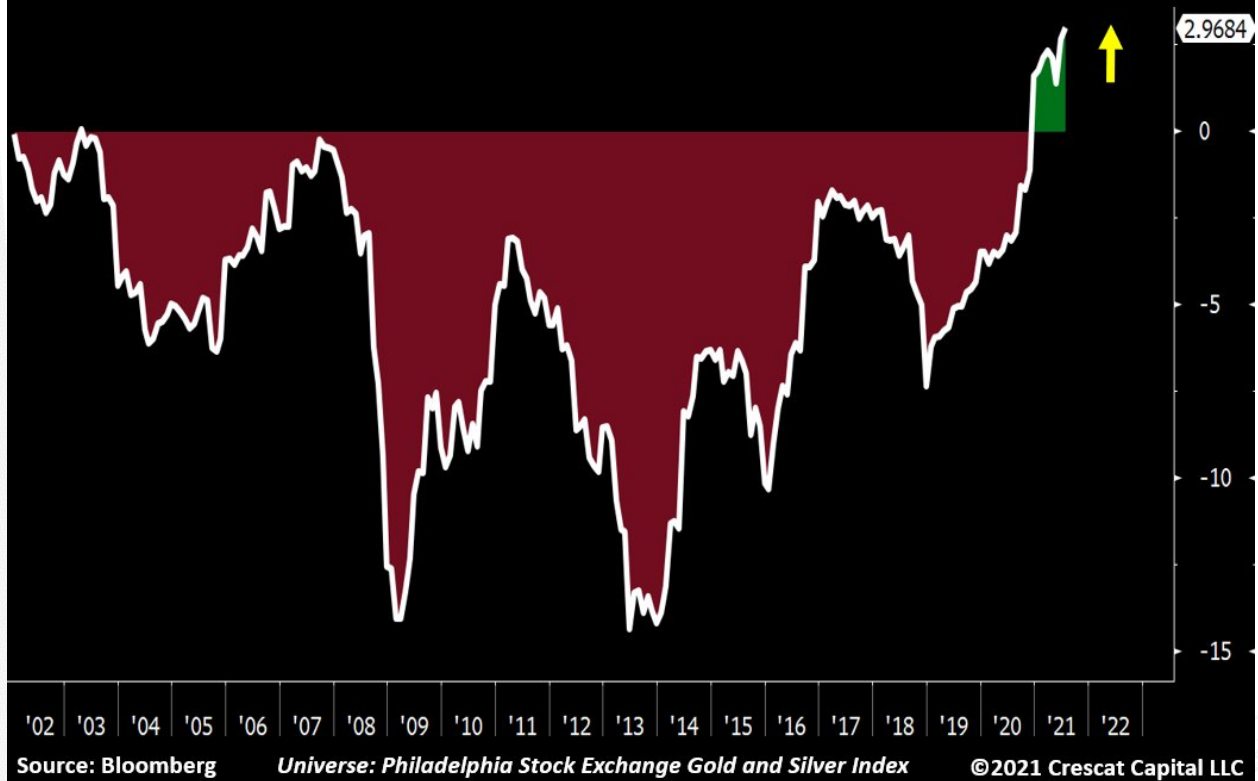


A Uniquely Bullish Setup for Miners

In our view, it seems largely inconsistent for fiscal and monetary policies to be pedaled to the metal at a time when economic activity is at one of its strongest levels in history. In a way, however, some of the current policies are unavoidable. With overall debt at historic levels and stocks and bonds at excessive valuations, stimulative policies must be targeted towards suppressing the cost of capital. We think this macro environment is what makes commodities, especially monetary metals, to be at a uniquely optimistic setup. **Gold and silver miners have never looked this cheap relative to the S&P 500. Their free-cash-flow yield is almost twice the overall market. The value and growth proposition embedded in miners today is unmatched by any other time in history.**

Precious Metals Miners vs. S&P 500

Free Cash Flow Yield Spread (%)

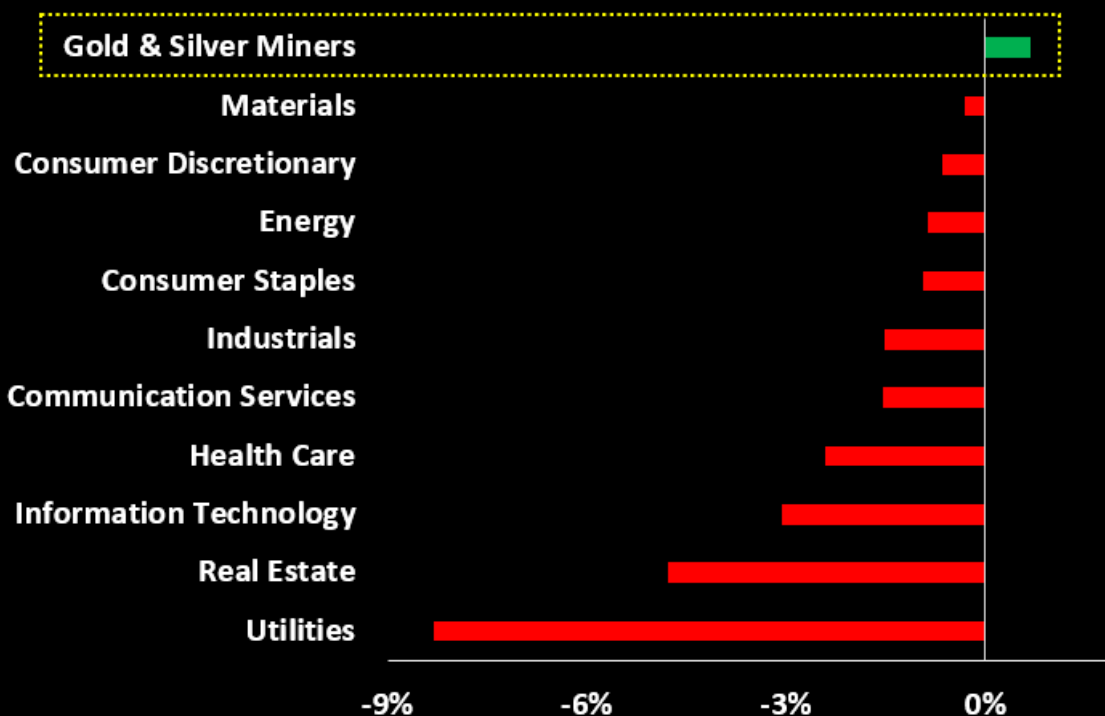


Robust Fundamentals for Miners

To follow up on this idea, if gold and silver miners were considered a sector, it would be the only part of the economy today that generates higher free-cash-flow yield than inflation.

Real Free-Cash-Flow Yield by Sector

Aggregate Free-Cash-Flow Yield Net of Consumer Prices Index YoY Change



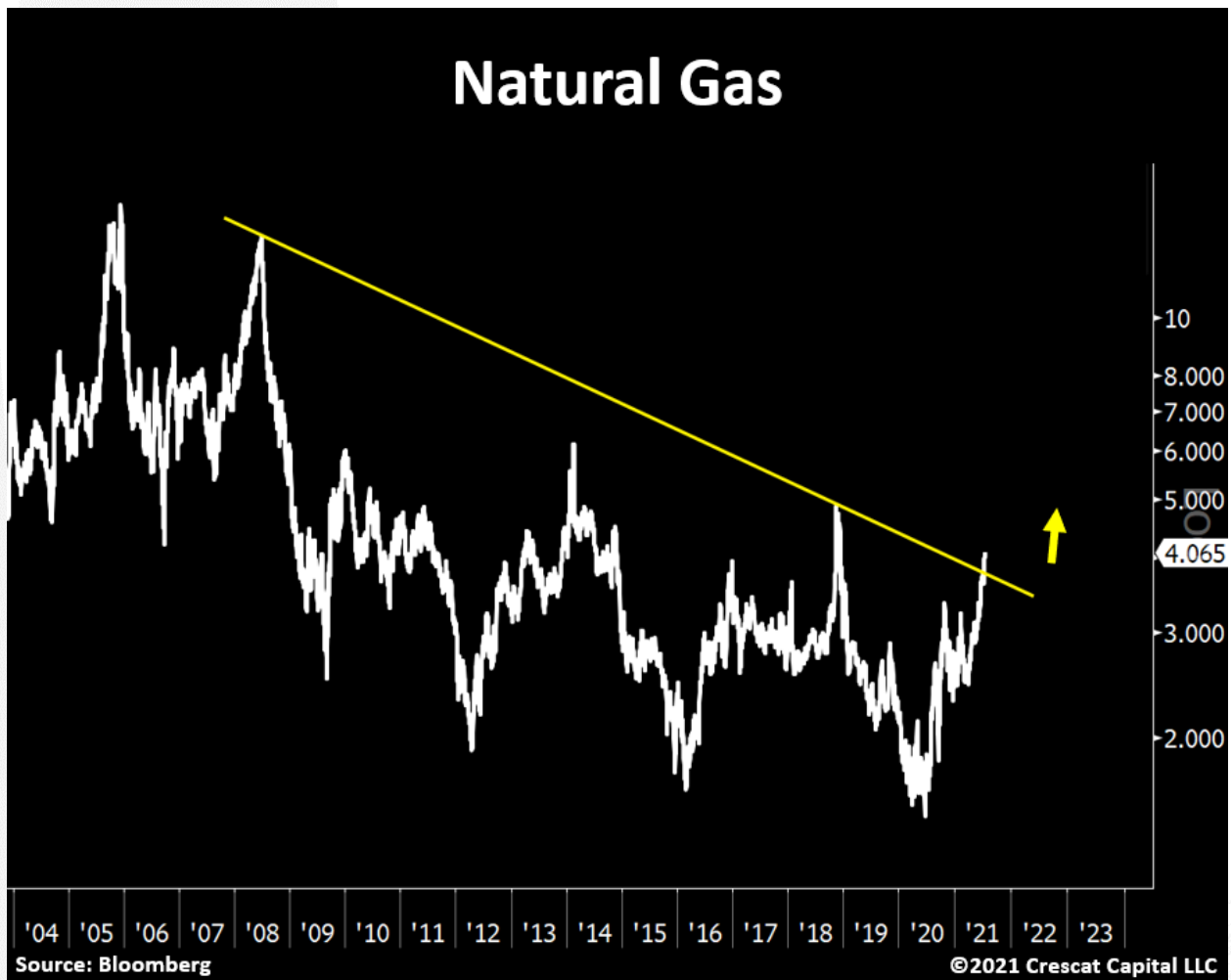
Source: Bloomberg Universe: S&P 500 Sectors Excluding Financials ©2021 Crescat Capital LLC

Crescat's Activist Precious Metals Strategy

Crescat is working with world-renowned exploration geologist, Quinton Hennigh, PhD, its Geologic and Technical Advisor to identify a portfolio of companies with the most prospective gold and silver deposits on the planet that will feed the next generation of mines. **We are leading the charge to fund exploration and discovery of the new, large, high grade deposits to fill the supply void left by the major mining companies after a decade of underinvestment in exploration and development.** The majors have not been replacing their reserves and are facing a production cliff beginning in just four years. Permitting new mines takes years. The industry leaders will need to start allocating capital soon to the best projects out there in the hands of the junior mining segment if they want to continue their growth. We believe a new M&A cycle will be ramping up soon as the larger producers are now gushing free cash flow that must be deployed to capture growth in the burgeoning new secular bull market for precious metals.

A Meaningful Breakout

While we are all focusing on oil, natural gas is now at a critical juncture after breaking out from a multi-year resistance. A sustainable move higher from here would only add to our thesis that inflation is not transitory.

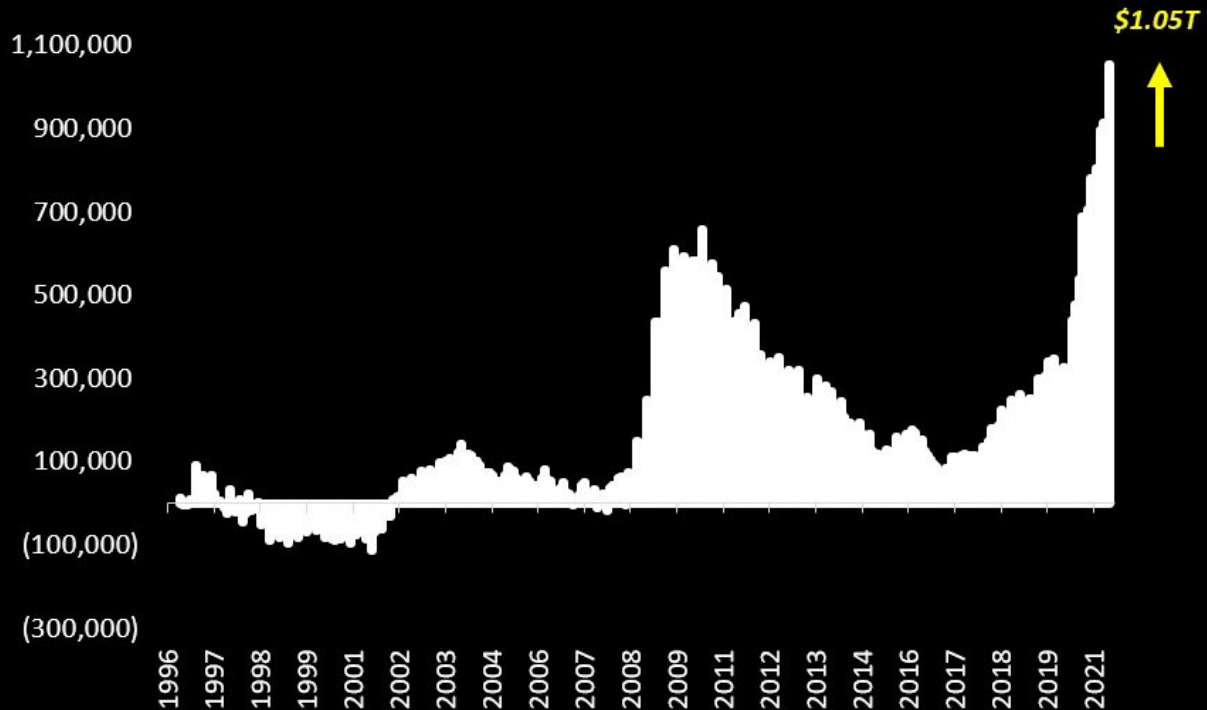


Largest Issuance of Treasury Notes and Bonds in History

As inflation surprised to the upside recently and the commodities market strengthened, the Fed was forced to shift to a more hawkish jawboning. However, how can the Fed even consider tapering its QE policies when the government is issuing Treasuries such an aggressive pace? They just issued over \$1 trillion worth of bonds and notes just in the last four months. That was the largest amount for such a window of time ever recorded in history.

US Treasury Notes & Bonds Issuance

4-Month Change in Millions USD



Source: Federal Reserve

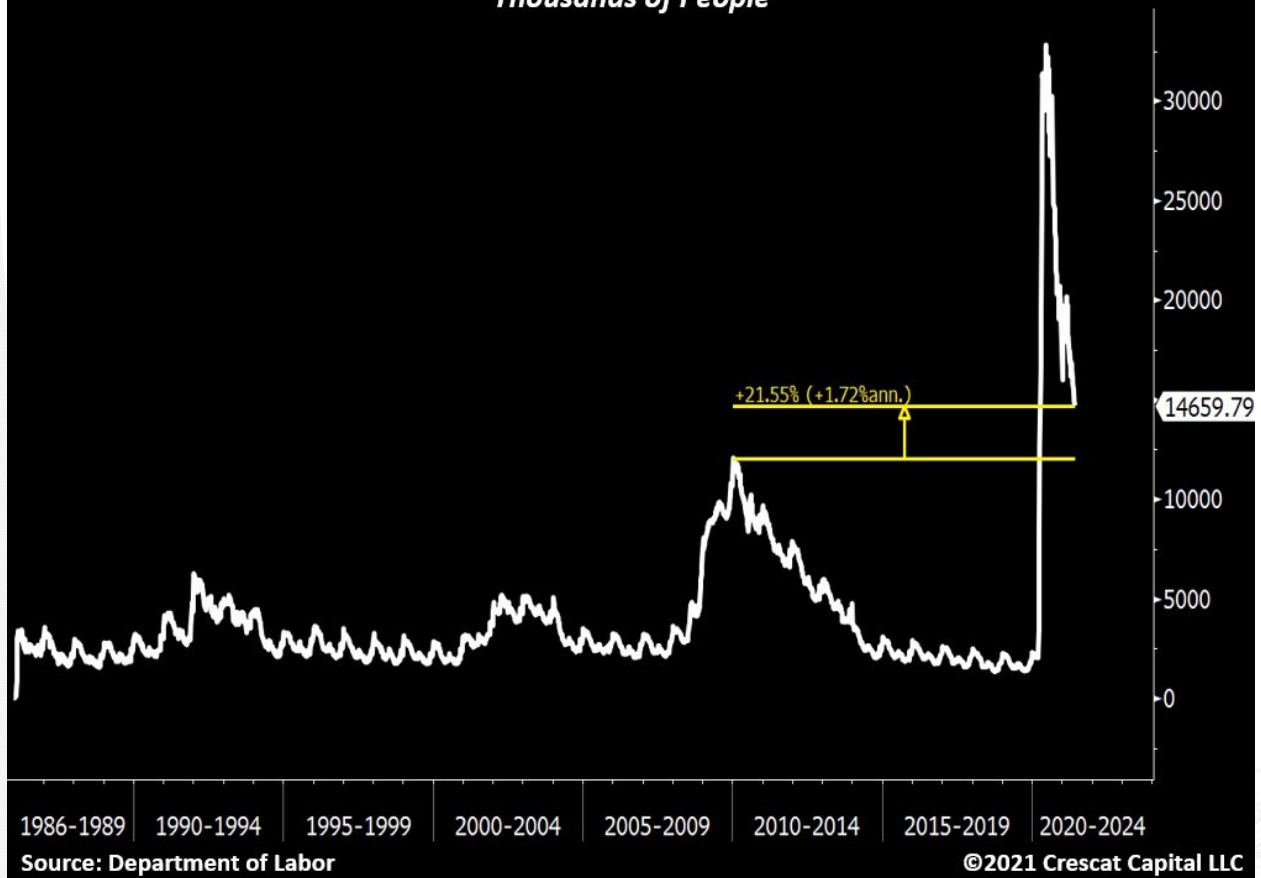
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Shortage of Workers Set to Fuel Higher Labor Cost

Here is another important point that adds to the inflationary story. There are over 14.6 million people still claiming unemployment benefits while job openings are surging. Labor shortage issues will likely lead to higher wages and salaries. Do you recall the last 30 years of declining growth in labor cost? A trend reversal looks to be upon us. This could mark a structural shift creating long-lasting inflationary implications.

Persons Claiming Unemployment Insurance Benefits

Thousands of People

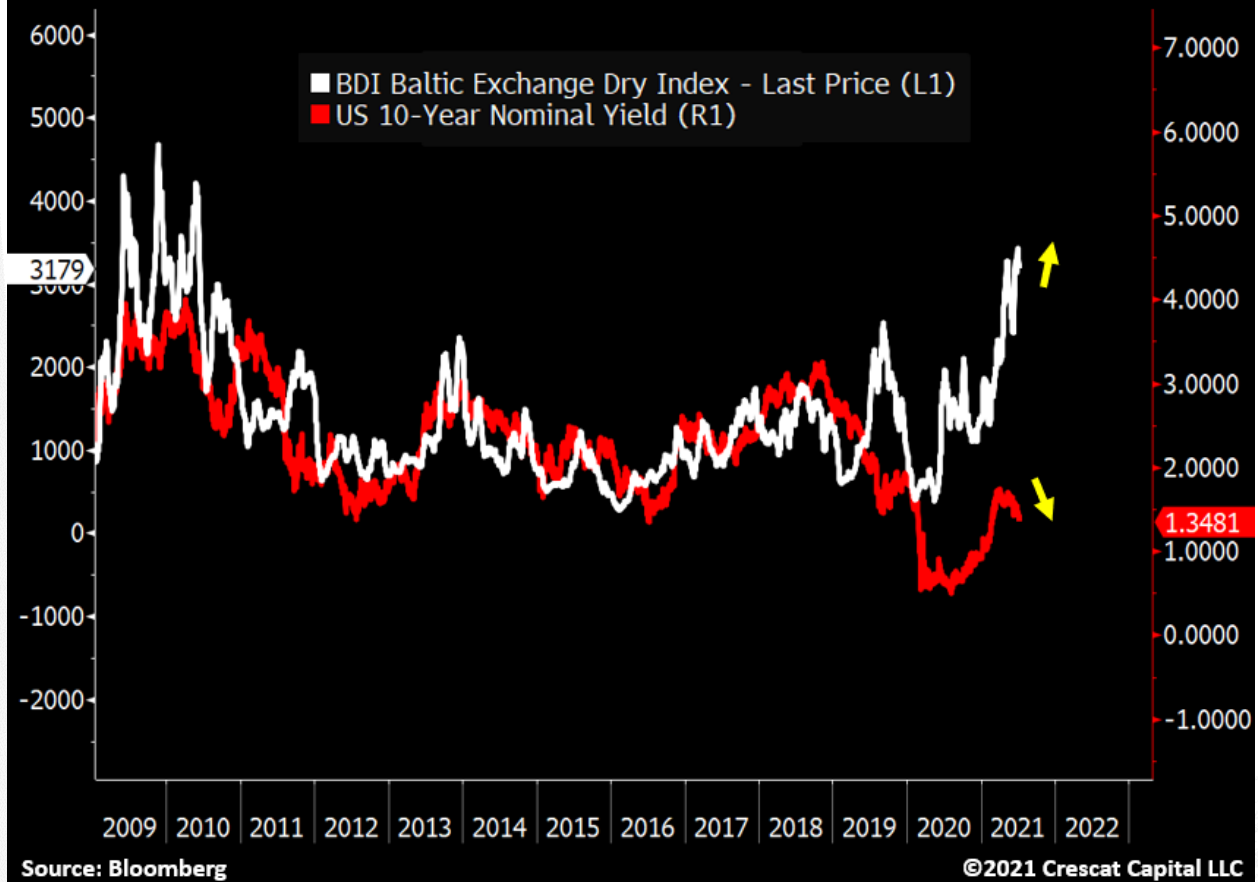


A Stagflationary Divergency

Our proprietary multi-factor macro models that measure current economic activity and inflation have never been stronger for a series of consecutive months now on both fronts. The issue is that, historically, higher inflationary periods tend to be stickier than high real growth periods. It is growth, not inflation that is more mean reverting. We believe a slowdown in the economy is likely ahead of us. Keep an eye on the macro data that will be coming out in the next several months. For instance, non-seasonally initial jobless claims increased 3 weeks in a row. The last time we saw that was in April 2020. Additionally, the Bloomberg Economic Surprise index has been moving lower, particularly since April. Also, average work hours are starting to roll over. **We think there is a high probability we could be entering a stagflationary environment in the coming months and quarters.**

See on the chart below that the Baltic Dry index just reached decade highs while 10-year yields fall. These are two opposing bellwether indicators.

Stagflationary Divergence



The Great Rotation

With inflationary pressures rising in the US, we believe investors will be rotating out of over-valued long duration financial assets and into undervalued commodity cyclicals and inflation hedge assets, including scarce natural resource stocks. First and foremost, we see a coming renaissance in precious metals exploration stocks after a decade long bear market for this segment of the industry that only ended in March of last year.

China is the Black Swan

We are seeing clear signs that the Chinese economy is under pressure. China has built a highly leveraged \$50 trillion-in-assets banking system on top of an inflated \$16.5 trillion economy. That's an unprecedented amount of leverage in a banking system for a developing economy, a whopping 303% GDP. The Industrial and Commercial Bank of China is the largest bank in the world with \$5.24 trillion in assets. Its stock price has been in a freefall since March. Every other major Chinese bank looks just as dismal. China's overall stock market has been in a steady decline since February that also more recently has morphed into collapse including Chinese ADRs that trade in the US and big tech and education stocks owned by US investors. The latter, for profit-education companies, was just banned by the Chinese government and appear headed to zero. **It is hard to believe a systemic crisis is not in the process of unfolding now in China.** China's credit impulse also recently

dipped lower to -4%. We see an extraordinary risk of capital flight and currency devaluation if not outright currency crisis in China.



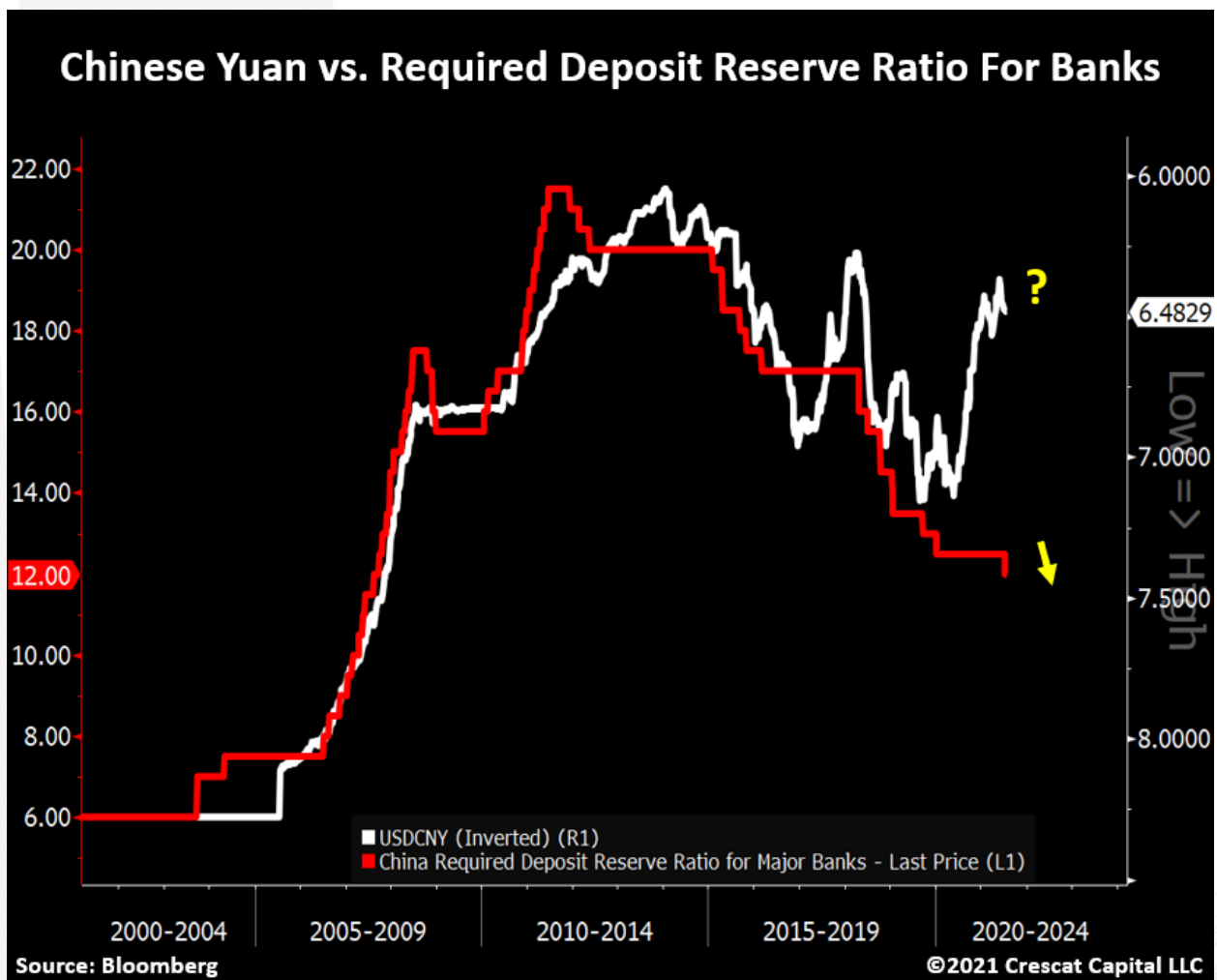
Chinese Yuan Ripe for Devaluation

With the Chinese stock market in a cascade, we must point out that a serious downturn in the Chinese economy and its stock market is the one major countervailing disinflationary forces out there that we see in the world to compete with our inflationary scenario laid out in most of this letter. We believe the ultimate Chinese money printing and currency devaluation to deal with this crisis will be extremely bullish for gold, especially in yuan terms. To most of the investing world, a Chinese financial crisis might appear as Black Swan event, but our longtime Crescat research letter readers and investors will know that it is something we have been incorporating into our macro view and preparing for since 2014. **In our global macro fund, we profited from Chinese currency short positions in 2015-16 and again in 2018-19. We are determined to do it again based on the beautiful macro setup for this trade now.** Notice in the chart below how recent yuan devaluations have followed Chinese equity market meltdowns. As the Chinese stock market downturn has recently morphed into a more serious decline, we have just significantly increased our yuan put option exposure in the Crescat Global Macro Fund. We maintain puts on the Hong Kong dollar as well for the possibility of a de-peg.



Cuts in Bank Reserve Requirement Ratio Suggests Weaker Chinese Yuan Ahead

China's steady decrease in its banks' reserve requirement ratio is another long-building macro divergence and indicator for an impending currency devaluation.



The Optionality for Gold

While Chinese deflationary forces should not be shrugged off today, we should point out that it is the type of deflation that can deliver a flight-to-safety bid for gold. **Gold is the one commodity as well as currency that we are most exposed to on the long side at Crescat today.** We are further hedged versus China contagion risks in our global macro fund and long/short funds with select highly overvalued US equity short positions as identified by our equity model. Note the divergence between Chinese equities and US equities in the chart below. Similar divergences played to Crescat's advantage in our hedge funds in late 2018 and early 2020 as the US markets followed the Chinese one down.



A Short-Term Deflationary Risk

In the longer run, we believe a Chinese currency devaluation has global inflationary implications as it should lead to even more monetary easing worldwide including in the US. At the same time, we believe that the West is in the process of disengaging with China. **The deglobalization trend currently underway is an inflationary force and a key factor portending a currency crisis. China's entire economic model has been highly reliant on Western capital inflows.**

China notwithstanding, we are most compelled to acknowledge and position for the risk of serious ongoing inflationary period ahead in the US for all the reasons we have outlined above and in our recent letters. We see average rates of inflation over the next five years substantially higher than in the last five. Today, across all the firm's strategies, we are now positioned in high absolute return opportunities in scarce resource assets with the goal of outperforming future inflation and delivering strong real returns. This positioning is the most focused in our Precious Metals and Large Cap strategies. In our Global Macro and Long/Short strategies, in addition to similar long exposures, we are also positioned in a myriad of short opportunities presented by today's macro climate which includes a historically overvalued US stock market. In our Global Macro Fund, we are further attuned to the risks and opportunities of a highly-levered and faltering Chinese economy with its impossibly over-valued Chinese banking system and currency.

June Performance

Crescat Strategies Net Returns through June 30th, 2021

CRESCAT STRATEGIES VS. BENCHMARK (Inception Date)	JUNE	YTD	ANNUALIZED TRAILING			CUMULATIVE SINCE INCEPTION
			1-YEAR	3-YEAR	SINCE INCEPTION	
Global Macro Hedge Fund (Jan.1, 2006)	-6.1%	8.7%	45.1%	20.3%	13.3%	593.8%
Benchmark: HFRX Global Hedge Fund Index	0.4%	3.7%	12.0%	4.2%	1.3%	22.6%
Long/Short Hedge Fund (May 1, 2000)	-5.7%	9.2%	55.0%	21.3%	8.8%	497.5%
Benchmark: HFRX Equity Hedge Index	1.2%	7.9%	20.4%	4.1%	2.7%	74.5%
Precious Metals Hedge Fund (August 1, 2020)	-3.3%	26.8%	-	-	-	239.5%
Benchmark: Philadelphia Gold and Silver Index	-13.8%	-1.3%	-	-	-	-7.5%
Large Cap SMA (Jan. 1, 1999)	-6.2%	7.2%	7.5%	10.3%	10.6%	861.4%
Benchmark: S&P 500 Index	2.3%	15.3%	40.8%	18.7%	7.7%	435.5%
Precious Metals SMA (June 1, 2019)	-5.8%	29.0%	74.8%	-	85.1%	260.7%
Benchmark: Philadelphia Gold and Silver Index	-13.8%	-1.3%	10.6%	-	41.4%	105.9%

A Great Time to Invest if Not Yet Positioned

For those who are not already positioned with Crescat, we believe it is an incredible time to put money to work now, after the recent pullback in precious metals, which we believe is unsustainable for the reasons we have laid out above. The gold and silver selloff has continued into July month to date as the Chinese equity market has been melting down, but our precious metals positions have improved for us in four of the last six trading days. Precious metals mining is one of the very few areas of the market that offer both deep value and strong growth. We are encouraged that the worst of the precious metals pullback could be behind us already and view this as a great time to be picking up bargains. Meanwhile, we are positioned to capitalize on the short side of the market in Global Macro and Long/Short with exposure to extremely overvalued assets ripe for correction. Our team is approaching this market in a highly constructive manner through a comprehensive macro and fundamental investment process. We are very excited about the opportunities ahead for our portfolios.

Sincerely,

Kevin C. Smith, CFA
Member & Chief Investment Officer

Tavi Costa
Member & Portfolio Manager

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