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175 Strafford Avenue, Suite One
Wayne, PA 19087

www.wslfamilyoffice.com

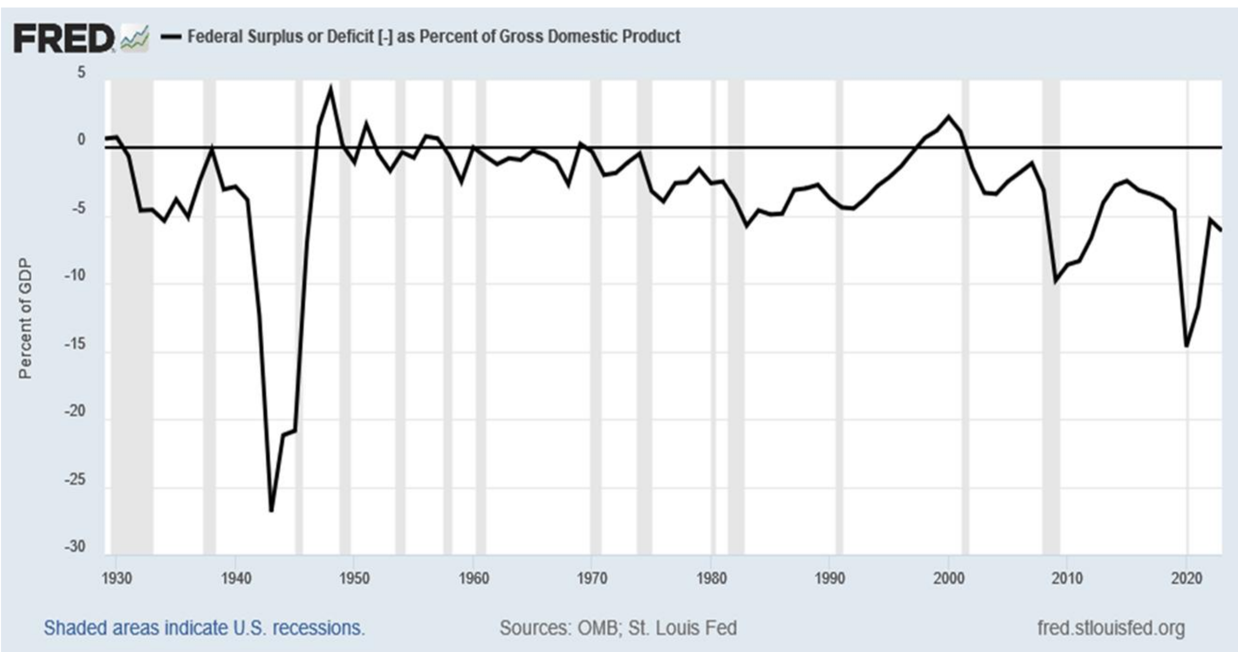
Views From the Stream

April 30, 2025

The Return of the Bond Market Vigilantes, Part III: The Rise of Gold, The Decline of the Dollar, & The Coming Financial Crisis

For those of us who remember the 1970s, they were a messy period. The Vietnam War and its funding dominated the first half of the decade along with the Arab Oil Embargo. Inflation accelerated throughout the decade, with the price of Oil quadrupling in the early 1970s, then rising further when Iran's oil was pulled off the market in 1979. In addition, the U.S. ran a Guns and Butter policy that led to further Inflation during the decade. Reflecting these trends the price of old rose from just $35 in August 1971, when President Nixon took the U.S. off the Gold Standard, to over $800 in January, 1980. Of course, all of these factors culminated in Paul Volcker creating a deep, double dip recession to break the back of Inflation from 1980 to 1982.

Fast forward to 2009. Since then, the U.S. Government ran wartime budget deficits:



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This Guns and Butter Policy came in three stages. First, the Obama Administration enacted spending without raising taxes to pay for it. Second, the Trump Administration enacted a large tax cut, while maintaining spending levels. Thus, the deficit increased further in a structural manner. With the Pandemic, the U.S. Government enacted short term, non-structural policies to mitigate the economic downside created when the FDA shut down most of the economy. This included numerous spending programs, such as “Helicopter Money”, that temporarily blew out the budget deficit. Third, the Biden Administration enacted large spending programs without raising taxes, across multiple areas of the economy with strong economic multiplier impacts, accelerating economic growth.

To fund the Government, the Powell Federal Reserve played the traditional role of providing emergency liquidity for the economy, something the Fed did in prior Recessions. However, it then embraced Modern Monetary Theory that said deficits could continue and the Central Bank should fund these deficits by creating money. In the vernacular, this meant the Federal Reserve should monetize the US Government debt by printing money. The following chart illustrates the Federal Reserve’s actions and how they vastly exceeded its prior actions in providing emergency liquidity to the economy during a Recession:

To no one’s surprise, Inflation accelerated as the money supply grew well in excess of the goods supplied to the economy:

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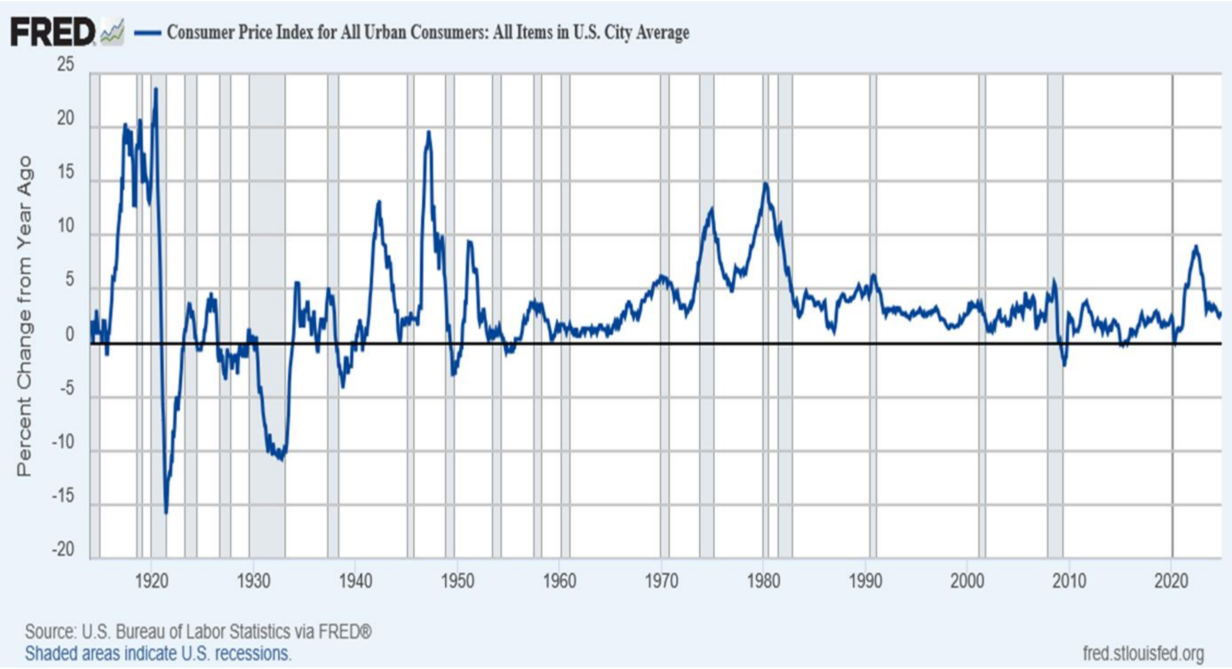

This acceleration in Inflation stands similar to what occurred in the late 1960s/ early 1970s when Inflation last accelerated. Even before Inflation accelerated, Gold Prices, which had been quiescent, started to move upward under the first Trump Administration. This reflected the increase in the U.S. Government's structural budget deficit and the financial market's skepticism around the government's willingness to raise taxes to pay for it. Historically, when governments don't raise taxes, they print money to plug the gap, which devalues the currency's real value. The Federal Reserve's embrace of Modern Monetary Theory stands just another example of this.

Gold prices then paused their rise, as the financial markets waited to see the economic policies to be enacted under the Biden Administration. Once they became clear, Gold resumed its rise. First, as noted above, the Federal Reserve monetized the debt of the US Government. Gold's rise from ~$1500 in 2019 to ~$2000 by the end of 2020 reflected this belief that the monetary presses would run. Second, the Biden Administration in May 2023, along with other G7 Governments, froze $300 billion in US Dollar Reserves of Russia. This represented almost half the Foreign Currency and Gold Reserves of Russia. This seizure set off alarm bells in foreign Central Banks as the US Dollar stands a central portion of their reserves. And they reasoned that these reserves stood subject to seizure as well. With these two factors at play, Central Bank purchases of Gold exploded upward in 2022 as foreign Central Banks sought to diversify away from the US Dollar and so did the Gold Price, rising from to almost $2,800 per ounce.

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With the election of Donald Trump, it became clear that the United States would not address its structural budget deficit. In fact, the tax cuts proposed by the Administration would increase the structural Budget Deficit at a time of positive economic growth. With the structural Budget Deficit at 6.4% of GDP in Fiscal 2024 and projected to exceed 6% of GDP over the long term, financial markets began to worry about the inevitable running of the government printing press by the Federal Reserve. And the price of Gold, which rose ~40% under the Biden Administration, due to the wartime Budget Deficits in a time of peace, took off again, as it became clear the United States would not address its structural Budget Deficit:

With the price of Gold exploding upward and the Trump Administration moving to put tariffs in place to address structural trade imbalances, numerous Countries, such as France and Germany, made negative comments on the role of the US Dollar and US Treasuries in the Global Economy. This stems from these countries' goal to reduce the role of the US in the Global Financial System and increase the role of the European countries on an international basis. And, while this is understandable as countries attempt to put forth their own interests, none of this rhetoric stands reflected in the financial markets. Despite the US Dollar making a slight pullback in value over the short term, on a long term basis, the US Dollar stands right where it stood in relative value terms over the past 50 years when compared to the major Developed Economies' currencies, as the following chart demonstrates:

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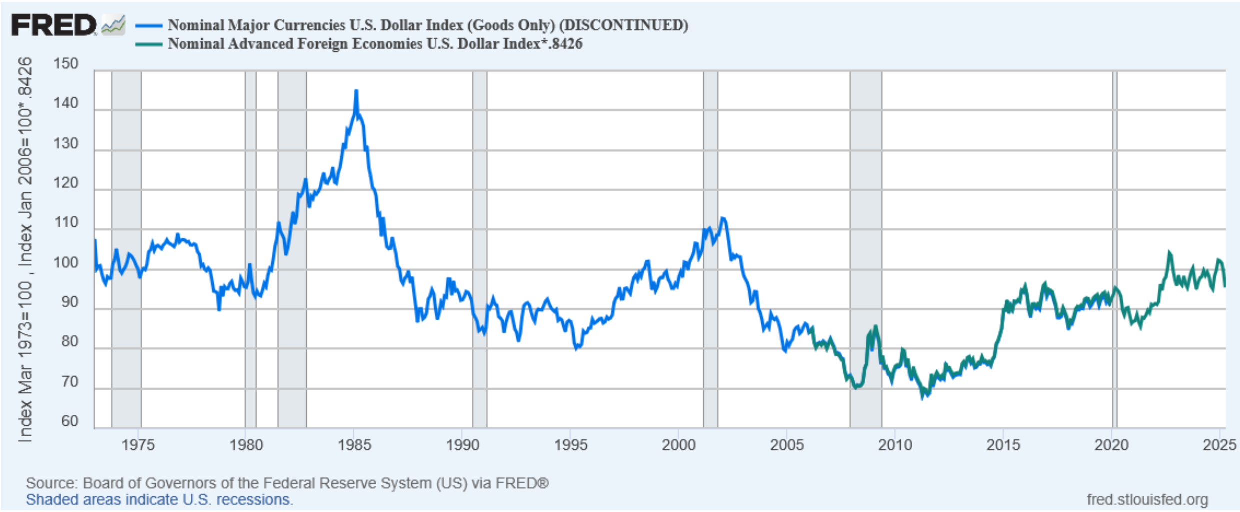
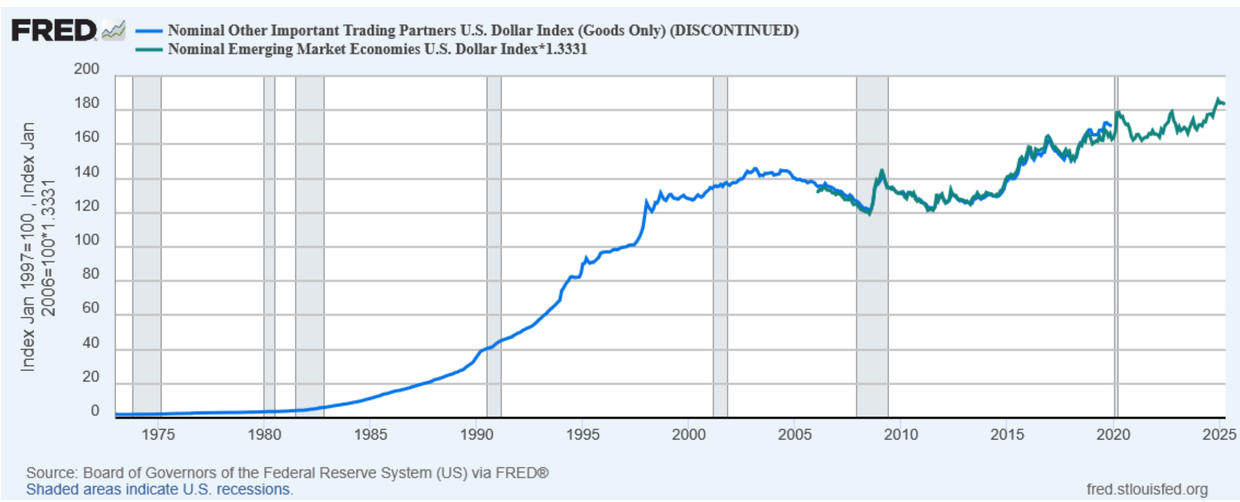


In addition, it stands at record highs relative to the Emerging Market economy currencies, as they continue to depreciate their currencies to gain competitive advantage for their economies:



So, despite the noise, the financial markets have spoken for now.

However, there does exist a true long term risk for the United States's role in the Global Financial System. China and other Emerging Market Economies desire to transact business in their own currencies for trade and investment between themselves. They formalized this goal at the latest BRIC Annual Meeting. Countries such as China and India have begun to trade with each other utilizing their own

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currencies. And China began to press other Emerging Market Countries to trade with it utilizing the Chinese Renminbi for the transactions. This stems from its goal of increasing the role of China globally in the financial system and diminishing, for geopolitical reasons, the role of the United States. While the US Dollar still reigns supreme in international trade, China continues to gain share of Global Financial Flows, as it represents the largest manufacturer in the world and the world's largest exporter. While not a near term threat to the US Dollar's role as the Global Reserve Currency, this move to conduct trade and investment in local currencies coupled with the move to diversify away from the US Dollar in their Foreign Exchange Reserves represents a long term threat to the US Dollar. (For more information, please see: *Internationalization of the Chinese Renminbi: Progress and Outlook*, August 30, 2024, Federal Reserve Board which can be found at the following link: https://www.federalreserve.gov/econres/notes/feds-notes/internationalization-of-the-chinese-renminbi-progress-and-outlook-20240830.html .)

With the role of the United States Dollar as the Global Reserve Currency under pressure, due to the forces noted above, foreign governments looked for actions by the United States Government to demonstrate financial prudence and a focus on ensuring the US Dollar's role for the future. However, instead of providing assurance to the international financial markets that the U.S. would stand behind the value of the U.S. Dollar and the U.S. Credit Rating, the United States Government continues to ignore the massive amounts of debt the country continues to generate. And it continues to ignore the ensuing sustainability issue risk if Debt to GDP continues to grow and, at the same time, investors demand a growing risk premium to protect themselves against the inevitable devaluation of the currency, thus driving interest rates significantly higher.

This stands similar to the actions of the Congress during the War of 1812. In 1812, the United States declared war on Great Britain. To fund the war, Congress borrowed $11 million in 1812, in the form of a note, and raised some Custom Duties. The Year 1812 turned out fortuitous from a tax standpoint, allowing the US Government to avoid borrowing even more money. In 1810, Congress passed a bill to embargo goods from Great Britain. However, as hundreds of ships already left for the UK prior to the bill passing, the U.S. Government waited until the ships returned to impose a full embargo. These ships returned in 1811 and 1812, providing a small boost to revenue in 1811 and a large $5 million boost to revenues for 1812. Such good fortune did not recur in 1813. For 1813, Secretary of the Treasury Gallatin estimated expenditures of $36 million for the Government but revenue of only $17 million. The Congress refused to raise taxes. Instead, it authorized additional loans of $16 million and $5 million in Treasury Notes. Due to the costs of the War, President Madison asked Congress for an additional $7.5 million in funding. Congress approved and additional loan for that amount. It also conceded slightly on taxes, putting in place some taxes expected to generate $5.5 million in 1814. Despite this, with the costs of the War spiraling upward, the new Treasury Secretary projected a shortfall of ~$30 million in 1814. Congress refused to raise taxes, instead approving a $25 million loan and another $10 million in Treasury Notes. This occurred despite the difficulties the Government faced in raising funds in 1813. In fact, only because

Stephen Girard, David Parish, and John Jacob Astor came to the Government's rescue, funding the majority of the $16 million loan the Government needed, could the US borrow the money. In addition to the deficit in 1814, the U.S. Government needed to raise funds to repay the Treasury Notes and to fund debt payments in hard money. Compounding the debt issue, revenue did not meet projections, due to the war and the disruptions to trade from the embargo. Soldiers' pay fell six to twelve months in arrears. The Springfield Armory, which supplied weapons to the army, closed. With revenue shortfalls and an inability to borrow, the U.S. Government defaulted on the Treasury Notes due in 1814 and its hard money debt servicing payments. Effectively, the U.S. Government stood bankrupt by November 1814. Congress faced no choice but to raise taxes in 1815. It took the United States until 1837 to pay off the debt it incurred during the war.

While the financial lessons of the War of 1812 stand lost in the nether regions of U.S. history, they provide a tale relevant to today. The U.S. Congress refuses to raise taxes despite massive deficits. It continues to spend money without regard to paying for the spending. It plans to lower taxes even further, creating more debt for the country. And it continues to ignore the warning signs from the financial markets, such as the massive rise in the price of Gold, that indicate concerns over the willingness of the United States to repay its debt except in vastly depreciated currency. Effectively, the U.S. Congress continues to ignore the Coming Financial Crisis for the country, playing the fiddle while Rome burns. Should Congress continue down this path, the economic consequences for the country stand clear.

With the Rise in Gold, the slow Decline of the Dollar, and the Coming Financial Crisis, it only stands a matter of time until the Bond Market Vigilantes come riding into town. These Vigilantes stand ready to reimpose order on the finances of the United States by imposing their wrath, raising interest rates and creating disorder in the financial markets, much as occurred in the 1990s. With the lessons of the War of 1812 in mind, this time may stand sooner than most denizens of Washington, D.C. expect. And when it comes, it will seem like a lightning bolt out of thin air. Yet, the reality originates in years of Deficit Spending without regard to the financial position of the country. With this future racing towards the present, all should brace for the shocks ahead that come when Vigilante Justice comes to rule the land.

In Re Memoriam: My Dad

For those of you wondering about the past few months with no publication, my Dad passed away in late February. And I and my brother were totally focused on family prior to his passing and afterward. While he may no longer be with us, he still lives inside all those he touched, in his own unique way. My Dad was born during the Great Depression and lived until 90. He served the country during the Korean War and spent his career as a corporate lawyer. He traveled the world with my Mom, visiting every Continent on the globe. Over the past few years, when he could not travel, I had the privilege of spending a

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significant amount of time with him and my Mom. He always had insightful comments, despite his age, and stood ready to listen to differing points of view. He was an avid reader. And I assume my love of reading stems from his always having a book around that he was consuming. As those who have lost their parents understand, I miss him. Life is short. And we must remember to make time for those who are most important to us. And I appreciate every minute that I had the privilege to spend with him over the past few years and before. He will be sorely missed. And I will cherish his memory for the rest of my life.

Recent & Upcoming Travel

The first part of the year became dominated by my parents health and my father's passing. While spending much time in New York, this did not represent any time spent on a business basis with those I know there. However, with my father's estate now moving ahead, I will resume travel in June. In June, I will attend a conference in Boston. It will provide me the first opportunity to hear from people from across the country and the issues on which they are focused. In July, I will be up in Newport, Rhode Island for another conference, providing more insights.

As noted before, fishing went on hiatus till the spring due to low water levels and winter weather. However, I did manage to spend a day in late April at Spruce Creek. Its fabled banks, lived up to expectations. I landed numerous trout, including several over 20 inches and one close to 26 inches. It truly was a fabulous experience. I hope to get on a stream again sometime in June. This time, summer fishing will dominate and start late afternoon and run until it is too dark to see the line on the water.

With that, we will report back next time on our future travels and fishing tales, providing color on the happenings in the U.S. and around the globe.

Yours Truly,

Paul

Paul L. Sloate
Chief Executive Officer