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○ ISSUE 5 | ○ VOLUME 15 | ○ NOVEMBER 2026

Cadence *clips*

FOCUSED ON WHAT MATTERS MOST.

The Inflation Racket

By Casey Clarke

If you've found yourself confused when trying to make sense of inflation, deflation, their causes, and the conflicting narratives around them, you're not alone. That which is not easily understood doesn't mean you're lacking in intellectual firepower. Rather, it's usually a tell-tale sign that something is being obscured or kept from the conversation. If you also find yourself getting frustrated by the relentless rise in the cost of living, this fact should serve as a reminder of why it's so important that the true causes of inflation be kept from public consciousness and the official narrative shrouded in mystery and bewilderment. Our goal with this month's piece isn't to place blame or stoke emotions around the issue, but rather to inform, educate, and allow you to prepare with a clearer picture of how the world around us actually functions. The mission, always and with everything, is to see things clearly and objectively so that we can take productive action on that which we have control over. So, inflation...

Different things can go up or down in price for different reasons, but the simplest way to think about and define inflation is the growth of money floating around the

financial system. That's it. Done. If there's more money in the economy or financial system (banks and financial institutions) than there was before, we have inflation – less money, we have deflation. This is what we and many have found to be the best working definition of inflation. The next question should be how that money growth within the system occurs. The answer would be, the banks. The vast majority of new money simply gets lent into existence. This is the nature of a “fractional reserve” banking system that is only required to hold a small percentage of deposits relative to the outstanding loans that its banks have made. Given the old 10% reserve requirement, a bank could make \$9 in loans for every \$1 of customer deposits it holds. That requirement has since been dropped and many monetary experts argue that the fractional reserve concept is easily overcome, resulting in limitless money creation. Some estimate that for every \$100 in the financial system currently, \$3 represents tangible wealth and the other \$97, more ephemeral, magic-money, if you will. Keep in mind, that newly created money that was lent into existence – that didn't exist before – has an interest rate attached to it. The borrower needs to make

interest payments to the bank that never had the money to begin with, and to come up with that interest, needs to find somebody else inside the system who has taken a similar loan to extract “wealth” from. If we play this out across all the participants within the economic system, we quickly begin to realize that the only way this thing works is if money continually gets created to service those interest payments. Does this make it a little bit easier to understand why Ben Bernanke and the Federal Reserve in 2007-2009 were so deathly afraid of deflation and a recurrence of the conditions present in the Great Depression of the 1930’s? Once that money supply begins to shrink, things around us start to disappear.

We’ll spare the discussion around whether this system is good or bad, or could be replaced by another that is backed by physical wealth or “specie”, and for now just accept that it’s the one that exists in the Western world. For anyone interested in how it got its start, I would encourage you to research how the goldsmiths of 17th century London, who were tasked with the safe keeping of people’s gold, discovered that they could begin to lend via the issuance of paper receipts against the gold they had on deposit. The goldsmith’s realized that if the owners weren’t coming back to claim their gold, they could increase the amount of paper receipts (modern day bank notes) on which they could charge interest. Interest on money lent that never physically existed – a pretty good racket indeed. Our system today is the modern equivalent of this.

Where It Goes, Inflation Most Shows

The tendency within a system that is constantly creating new money/inflating via new credit creation is for everything within the system to go up in price. Some goods can buck that trend because of technological efficiencies or breakthroughs that drive down costs faster than the rate at which money is being created, but most things rise with the monetary updraft. This next piece is very important in understanding why the wealth gap between the “haves and have nots” tends to get really wide toward the end of big monetary expansion periods throughout history. Asset prices tend to rise first and fastest, then the prices of goods and services, then wages. This phenomenon was first pointed out by the 18th century Irish-French economist Richard Cantillon. In short, Cantillon’s theory was that those closest to the central banking money spigot – the wealthy – got the money first and invested it, while everyone else eventually received the downstream benefits/effects of that. In a system where money-creation is monitored and facilitated by a less community-oriented and more “central” bank, it stands to reason that insiders, cronies, and those with connections would benefit from that magic money the most. This being true, it also stands to reason why that system would be defended very heavily, and extremely difficult to change. The main point here, however, is that financial asset prices tend to go up the most in the expansionary part of this cycle.

The Back Side of The Cycle

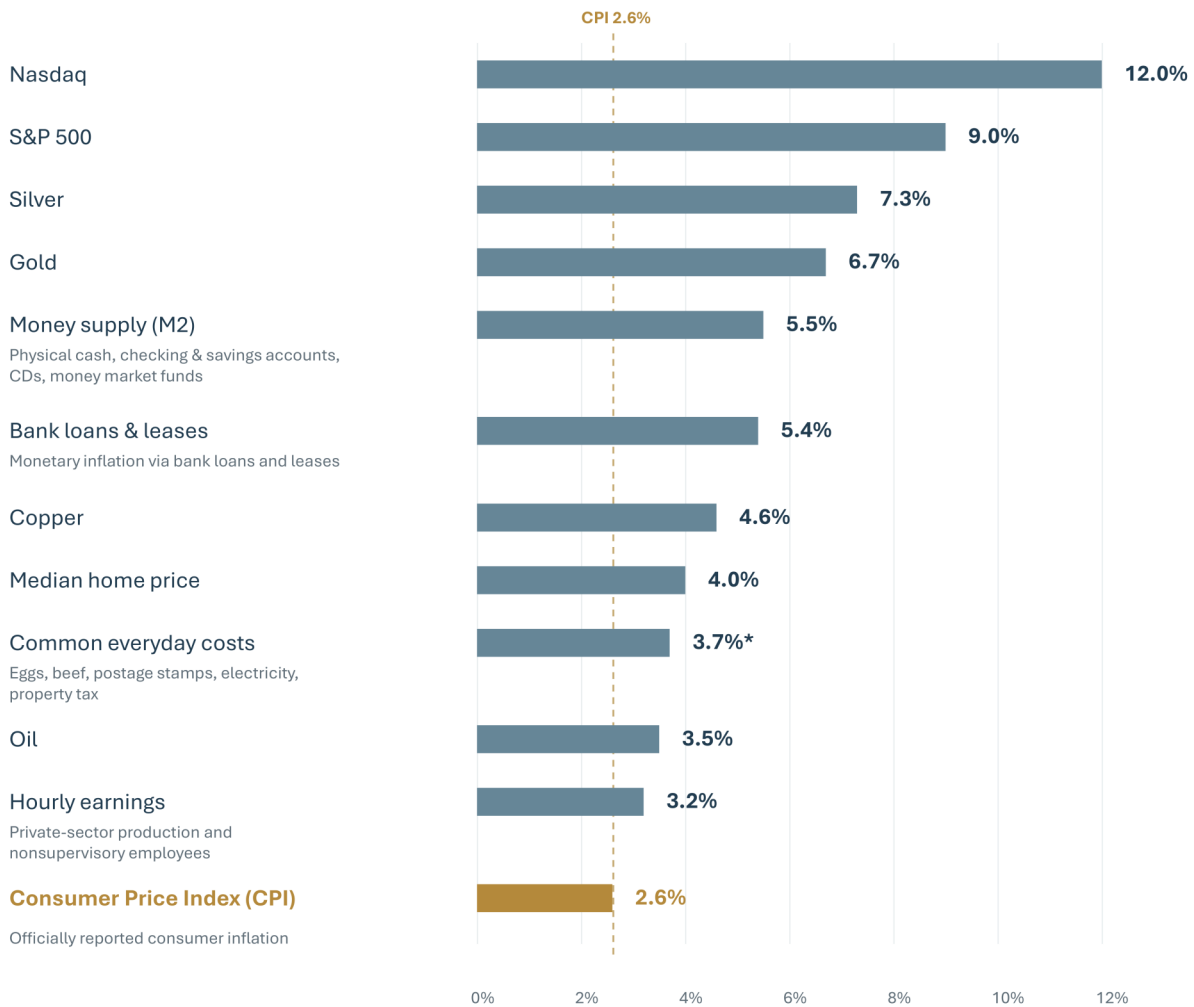
Richard Cantillon talked about the ripple effect from these asset purchases being an eventual inflation in the cost of goods and services. We have been witnessing this for the last few years and are seeing a meaningful acceleration in consumer prices now. All the new wealth creation from asset price increases is now chasing the same amount of goods and services as before that wealth creation. In addition, we’ve talked about how when the big capital investors are focused more heavily on chasing financial market returns than investing in the production of real assets/commodities, we eventually run into a shortage of those commodities at precisely the time all the new financial asset wealth is chasing them. This phenomenon tends to behave like a whip. There’s a bit of a delay before the tail end of the whip moves, but once it does, the acceleration can be dramatic. We are likely on the back side of this expansionary monetary cycle where the consumer inflation and commodity price portion at the tail of the whip will be moving with increasing ferocity. This of course makes it harder for bankers and central planners to keep the money creation machine running when the cost of living is becoming increasingly more difficult to keep up with for the average person.

Some Quick Stats

Given everything discussed, let's look at how inflation has affected various prices across the American economy since 1990.

Beyond CPI: A Broader Look at Inflation Since 1990

Annual increase in prices, wages, money supply, and markets



Source: Figures gathered from various sources and compiled by the Cadence Investment Team. Rates are rounded for presentation.

*Everyday cost growth is estimated using comparable historical prices.



Key Observations:

- 1) True monetary inflation has run at ~5.5%, and most of that money has gone into financial markets, driving up asset prices most.
- 2) Consumer inflation has lagged, averaging just under 4%, but is catching up.

- 3) The average worker's wages have not kept pace with either assets or the cost of living.
- 4) The inflation numbers the government reports are fiction. They do not reflect true inflation.

Where From Here?

If we operate from the simple model that, over time, the price changes of everything in the economy should roughly reflect the growth in money supply (inflation), then we'd surmise that stocks come down in price, commodities are more in line with inflation on average, and consumer prices and wages need to come up. This assessment fits well with our view of valuations and cycles. Of course, the starting point of 1990 matters here, since it leaves out a very difficult prior decade for commodities and a great one for stocks. Had we started our measuring period in 1980, we would see that silver averaged ~2% per year versus 7.3%, M2 ~5.8%, and the Nasdaq ~10.8%. This suggests that silver has more catching up to do in order to keep pace with the true rate of inflation within the system.

Much of where we go from here comes down to how monetary and fiscal authorities manage the dirty side of this cycle - the one where asset prices come back down to earth while commodities catch up. If we maintain the current system of fiat (magic) money that is lent into existence, then we'd argue that the stock market has to deflate more than many would care to think about in order to be more in line with true inflation, and so that the upward pressure on the cost of goods and services is released. We wouldn't expect this to relieve commodities from their upward trajectory quite so quickly due to the genuine shortages that exist because of lack of investment in new production. This is the tail of the whip and will take time. To us, this is the most likely scenario - everything sort of makes its way toward that 5.5% monetary run rate from where it is currently. Obviously, whatever's been trailing is where we feel investors would be best protected and most rewarded as this plays out.

What makes our current situation a little more problematic than it otherwise might be is the fact that we are so very close to what appears to be the end of the line for the Western fiat monetary system. The ability to simply make more loans and extend more credit in order to whip up new money with which to drive the system forward, seems limited. If individuals, corporations, and governments can't make their loans payments, then how effective can that be? This brings us to the idea of system resets, which isn't an unfamiliar concept amongst the ruling elite. If banks find it hard to lend productively and governments can't simply print currency due to inflation already being a problem, then plan C historically has been either foreign plunder, war, or both. We are seeing this today, everywhere. The conflict around the world seems to be very much about securing routes and resources, with the added benefit (tongue in cheek) of the destruction of a tremendous amount of infrastructure that will undoubtedly need to be rebuilt. Rebuilding tends to be profitable. Disgusting, but true. The fact that nobody would benefit from the money supply getting cut in half due to the cascading effect of loans going bad, or even being paid off and not replaced, means the Western world will try to avoid that, which is likely why its scouring foreign lands looking for monsters. This is a wealth and profit-seeking endeavor - war always has been. Regardless of where all this conflict ends up, none of it changes the underlying reality that we are swimming in financial assets and short on real ones. If anything, it confirms that assessment.

Conclusion

Money is at the center and always has been, and the West is desperate to keep the fiat system afloat. There is little true wealth underpinning it, and hard assets - not paper - define true wealth. Paper is abundant and easily combustible. Hard/real assets are scarce and required for survival. We are at that point in the fiat money creation cycle where the former will become famous for wealth destruction and the latter for true wealth creation. It won't be the first time, and certainly not the last.

A Word on Market Volatility

By Casey Clarke

As of a few minutes prior to publishing this letter, most investment asset classes are down on the day – stocks led by technology, most bonds, and most commodities. It's one of those broad selloff days. The source of today's volatility seems to be big technology company earnings disappointments after the close yesterday along with one of the biggest Bitcoin hacking incidents since its creation. It wouldn't surprise me at all if everything else is down out of sympathy – throwing the baby out with the bathwater; selling what you can, not what you want to; etc. Pick your metaphor. We fully expect these kinds of days, weeks, and even months as reality finally catches up with big tech valuations and the broad stock market. Here's what's important to keep in mind: First, everything we discussed above. Volatile days don't change any of that. Second, volatility is a tool that is frequently used to remove shares from weaker retail hands and place them in larger, stronger, and more confident institutional hands. If there's good, sound logic behind our investment process, we don't have to be one of those skittish, unsure investors who give the big guys a better entry price. Instead, let's be the ones taking advantage of that opportunity. Days like these are when we hold our noses, stick to our process, and buy more if we have the capacity within the strategy to do so. When looked at and executed that way, suddenly days like today don't seem so bad. They can actually be a gift.

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