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IGWT Report

Status Quo of the Inflation Trend

The end game won't be deflationary. Politically, it cannot be.

Jamie Dannhauser

- Over the past 12 months, inflation has remained stubbornly above 2% in both the US and the euro area, as we expected. Core inflation remains at a significantly higher level.
- On both sides of the Atlantic, it is primarily the service sector that is contributing to the higher inflation rates.
- The start of the interest rate cut cycle is reflected in money supply growth, which has been rising for some time.
- The inflation cards were reshuffled by the tariff conflicts triggered by the US President. Inflationary pressure is likely to increase in the US and ease in the rest of the world, at least in the short term. The sharp decline in energy prices is having a dampening effect worldwide.
- We expect inflation volatility to remain high in the coming quarters. A second wave of inflation similar to that seen in the 1970s cannot be ruled out, even if uncertainties are currently very high.
- The Incrementum Inflation Signal has recently exhibited a notably high frequency of shifts – a reflection of the considerable uncertainty currently prevailing in the financial markets. At present, it indicates a neutral inflationary environment.

Courtesy of Hedgeye

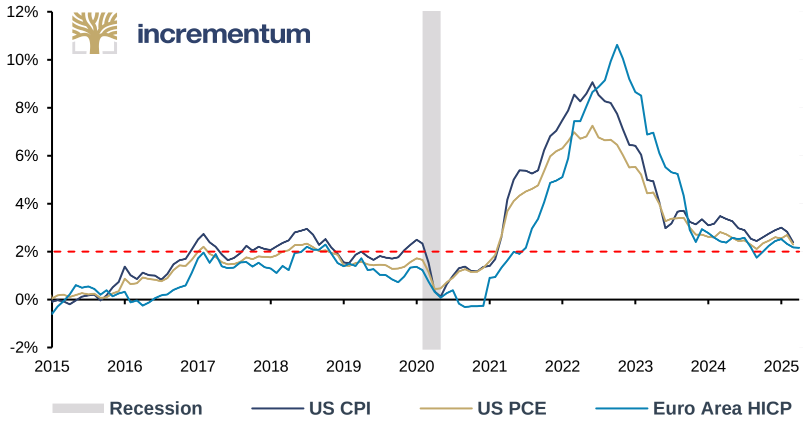
"Stubbornly at a (slightly) higher level" – this is how the inflation trend in the US and the euro area over the past 12 months can be summarized. This was also our forecast in last year's *In Gold We Trust* report, "The New Gold Playbook":

> *In our view, annual (headline) inflation will remain elevated in both the US and the euro area in 2024, i.e. above the inflation target of 2%. […] Even if the economic slowdown has a dampening effect on prices – as is desired and as can be observed as we speak in the euro area – the risk of a renewed acceleration in inflation is significantly higher than that of a permanent and significant undershooting of the inflation target.*

Food is an essential part of a balanced diet.
Frank Lebowitz

In the euro area, the HICP recorded a value below the inflation target of 2% on a monthly basis in only one month, in September 2024. In the US, neither the CPI nor the PCE fell below the 2% mark on a single occasion. **The last time both inflation measures were below the 2% target was in February 2021, more than 4 years ago.** The flash estimate for April for the euro area expects inflation to be at 2,2%, still above the ECB's inflation target.

Various Headline Inflation Rates, yoy, 01/2015–03/2025



Source: LSEG, Incrementum AG

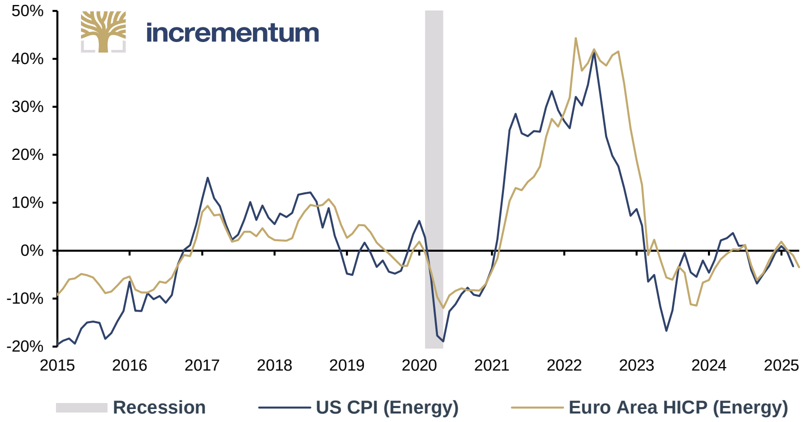
The rules of the game for investors are changing, and portfolios anchored to a belief in transitory inflation are dangerously exposed.
Jamie Dannhauser

For the calendar year 2024, overall inflation of 2.9% (CPI) and 2.6% (PCE) in the US and 2.4% in the euro area was recorded. However, there was still no reason to celebrate in 2024. Despite the continuation of the disinflationary trend, both the Federal Reserve and the ECB continued to fall well short of their inflation targets in 2024. At the same time, the overall inflation rate on both sides of the Atlantic has been significantly eased by falling energy prices since the start of 2023. Energy expenditure accounts for approximately 6.2% of the US CPI and 9.4% of the HICP for the euro area.

The expiry of government relief measures from 2021 and 2022 is having an inflationary effect, especially in the euro area. In the US, the coldest winter in 10 years left its mark on energy prices. At the end of February, US natural gas futures had risen by 140% year-on-year to almost USD 5 per MMBtu. However, the significant decline in energy prices, particularly oil, in response to the global tariff conflict triggered by Donald Trump at the beginning of April, now has a strong dampening effect on energy prices and, consequently, on the overall inflation rate.

The flash estimate for the euro area for April expects energy prices to have fallen 3,5% yoy.

Inflation Component: Energy, yoy, 01/2015–03/2025

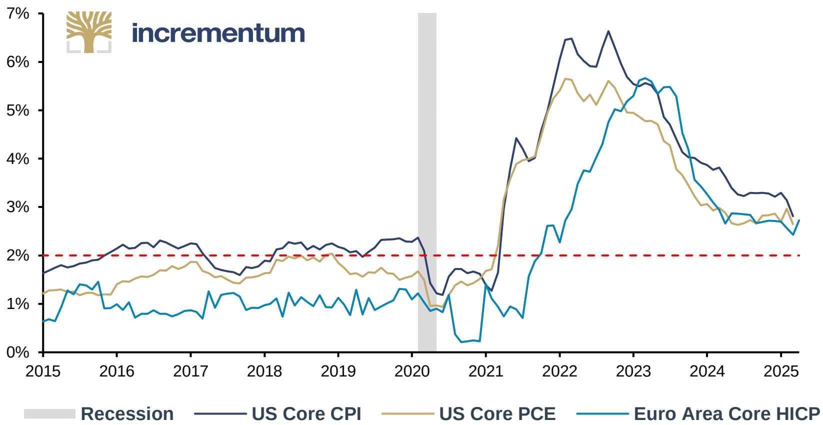


Source: LSEG, Incrementum AG

People must understand that you cannot have a little inflation, because a little inflation always leads to more inflation, and higher inflation inevitably leads to even higher inflation.
Friedrich Hayek

As a result, the core inflation rate consistently exceeds the overall inflation rate. In 2024, core inflation amounted to 3.2% (CPI), 2.8% (PCE), and 2.7% (HICP). In the US, core CPI inflation has thus been above 2% since April 2021 and core PCE (the Federal Reserve's preferred inflation measure) has been above 2% since March 2021, that is, for over 4 years. In the euro area, the 2% mark has been exceeded since November 2021, thus for around 3½ years.

Various Core Inflation Rates, yoy, 01/2015–04/2025

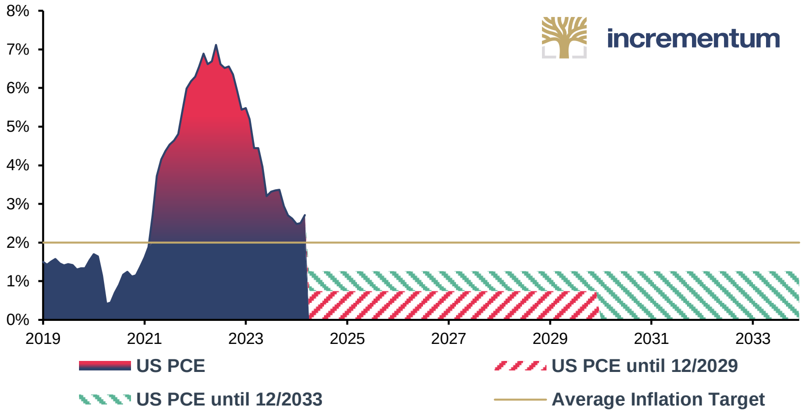


Source: LSEG, Incrementum AG

There are lies, damned lies, and statistics.
Mark Twain

A noteworthy detail in passing: No one is interested in the fact that the Federal Reserve has been aiming to achieve its inflation target *on average* since August 2020. As mentioned in the *In Gold We Trust* report 2024, "The New Gold Playbook", this is nothing more than a covert increase in the US inflation target. After years of inflation above 2%, US monetary policy would have to aim for an inflation rate of significantly below 2% for several years to achieve the inflation target of 2% on average.

US PCE Required to Reach Average Inflation Target, yoy, 01/2019–12/2032



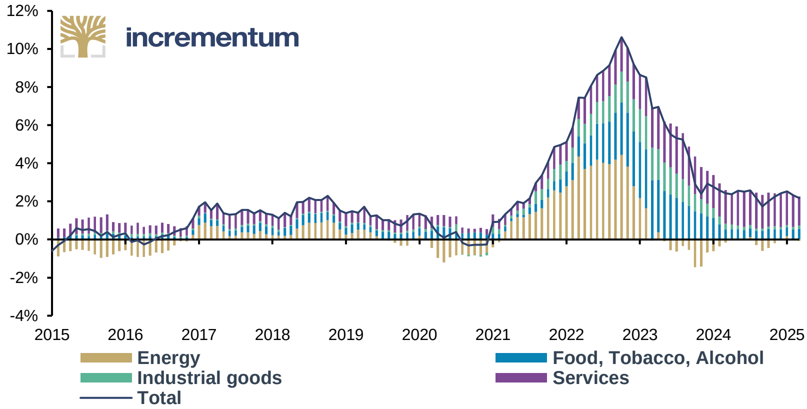
Source: LSEG, Incrementum AG

The service sector is currently driving inflation

Stagflation is like a hangover after a long party of easy money.
Jim Rickards

On both sides of the Atlantic, prices are being driven by services. Although tourism is booming, revenue growth is rising less strongly than the number of overnight stays, as travelers are cutting back on spending. At the same time, the (delayed) increase in wages in the services sector is leading to a price-wage spiral. This is exacerbated by insolvencies and business closures, which reduce supply and thus trigger additional price surges. However, weak real per capita purchasing power is somewhat dampening inflation. In addition, the weakening industrial base in the euro area is curbing general price increases.

Euro Area HICP, Contributions of the Components and Total, 01/2015–03/2025



Source: IHS, Incrementum AG

Election day was payday

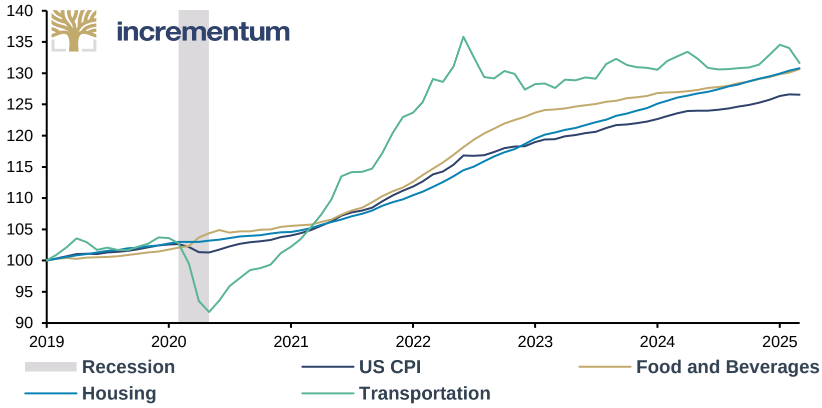
The problem with political jokes is they get elected.
Louis C.K.

2024 was the year of elections. Almost half the world's population was called to the polls for parliamentary or presidential elections. The election results in Germany were in line with the general trend of the long, super-election year 2024: the governing parties lost votes significantly, while the opposition gained votes.

Courtesy of Hedgeye

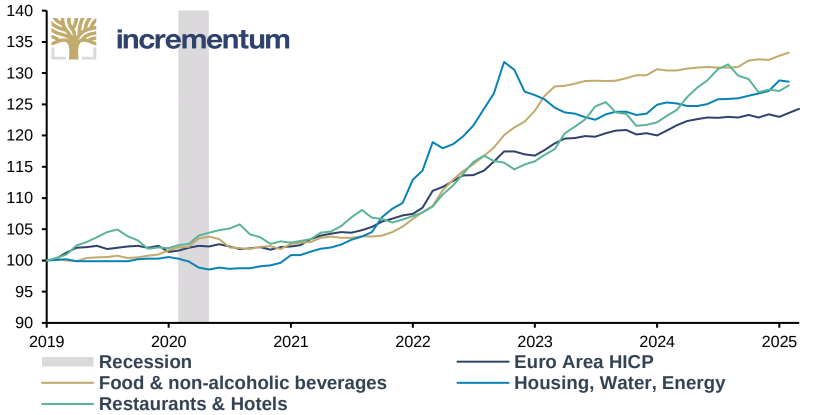
At first glance, it may seem surprising that inflation could have a decisive influence on the outcome of elections, even in countries where inflation rates had already fallen significantly. However, on the one hand, inflation rates were still high in almost all countries with elections. Secondly, the sharp rise in price levels compared to pre-inflationary times had a significant impact on the perception of lost purchasing power. Consumers are regularly reminded of how much the price level has risen, especially when buying everyday goods. The fact that incomes have also risen, albeit with a delay, cannot compensate for the higher prices. The following two charts for the US and the euro area show the extent to which prices have risen for individual product groups.

US CPI and Various US CPI Subkategories, 100 = 01/2019, 01/2019–03/2025



Source: BLS, Incrementum AG

Euro Area HICP and Various Euro Area HICP Subkategories, 100 = 01/2019, 01/2019–03/2025



Source: IHS, Incrementum AG

The inflationary surge of recent years has thus taken its toll, on consumers in the form of reduced purchasing power and on those in power in the form of substantial losses of votes in elections, which has often led to a change of government.

The wage-price spiral is the manifestation of inflation, not its cause.
Milton Friedman

The charts also indicate that the dreaded price-wage spiral has been set in motion. Since wage increases lagged behind the initial surge in inflation, recent quarters have seen notable gains in real wages, which are now fueling demand — particularly in the services sector. However, the savings rate of over 15% in the euro area is also well above the pre-Covid level , while in the US the rate has fallen to below 5%, which is less than the pre-Covid-19 level.

Quo Vadis, Inflation?

There is nowadays a very reprehensible, even dangerous, semantic confusion that makes it extremely difficult for the non-expert to grasp the true state of affairs. Inflation, as this term was always used everywhere and especially in [the United States], means increasing the quantity of money […]. However, people today use the term "inflation" to refer to the phenomenon that is an inevitable consequence of inflation, namely the tendency of all prices and wage rates to rise.
Ludwig von Mises

Representatives of the Austrian School of Economics attach great importance to the distinction between monetary inflation and price inflation. This fundamental distinction is just as rare in everyday language as it is among economists. A consistent linguistic distinction between the monetary underfeed – money supply inflation – and the inevitable consequence of an excessive expansion of the money supply – price inflation – would be immensely important to separate cause and effect.

With this in mind, we also want to analyze the most significant factors influencing inflation this year. We will start with the monetary inflation factors. The development of the money supply – in the narrower sense, the money supply M0 directly controlled by central banks, and in the broader sense, the money supply aggregates M1, M2, and M3 – provides the underpinning without which a structural reduction in purchasing power is inconceivable.

Monetary inflation factors

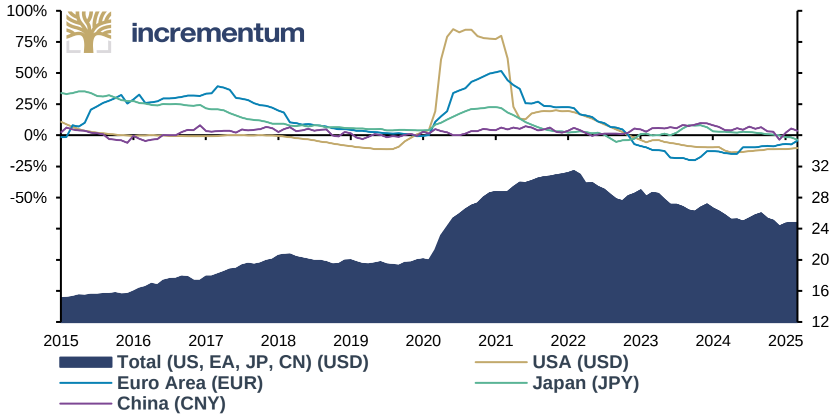
Even if price inflation can have non-monetary causes, such as an increase in indirect taxes or geopolitically caused shortages in the supply of goods due to trade restrictions or wars, these aspects are generally overemphasized today. In contrast, the development of the money supply has a somewhat ambiguous role in the analysis.

Inflation is always and everywhere a monetary phenomenon in the sense that it is and can be produced only by a more rapid increase in the quantity of money than in output.
Milton Friedman

The ECB focuses less and less on the factor it has at least partial control over, i.e., the (central bank) money supply, and instead concentrates increasingly on economic policy factors. **This could be described as a shift in responsibility.** Given the dramatic miscalculation in the core competence area of inflation development in 2021 and 2022 – remember Lagarde's mischaracterization of the inflation surge as a "hump" – such a diversionary manoeuvre is not surprising.

Let us now look at the development of central bank balance sheets. Of the four leading central banks – the Federal Reserve, the ECB, the BoJ and the PBoC – only the PBoC's balance sheet total is currently growing in local currency terms, while QT is leaving its mark in the US, Japan and the eurozone. The aggregate central bank balance sheet of these four central banks, expressed in US dollars, continues its downward trend that began in 2022. However, the aggregate balance sheet total remains at a level above that seen before Covid-19.

Various Central Bank Balance Sheets (lhs), yoy in Local Currency, and Aggregate Central Bank Balance Sheet (rhs), in USD, 01/2015–03/2025



Source: LSEG, Incrementum AG

To me, for QE to be beneficial on net, there has to be asymmetry in the effects of QE relative to QT.
Christopher J. Waller

The Federal Reserve has been engaged in QT since June 2022. Since the all-time high in April 2022, the Federal Reserve has reduced its total assets by a quarter. At USD 6.7trn at the end of Q1/2025, the level was the lowest since May 2020. This means that the Federal Reserve's total assets correspond to around 22.5% of US GDP, compared to more than 35% at their peak.

So far, the QT has been successful – surprisingly to us – with almost no major problems, apart from the three bank failures in March 2023. The *Bank Term Funding Program* (BTFP), set up to stabilize the banking sector, interrupted the QT for a few quarters and has now been completely wound up.

The decision to slow the pace of runoff does not mean that our balance sheet will ultimately shrink by less than it would otherwise, but rather allows us to project the ultimate level more gradually.
Jerome Powell

At the FOMC meeting on March 18/19, a new motto – "slower for longer" – was announced with regard to QT. As of April, the pace of reduction for US Treasuries was significantly lowered from USD 25bn to USD 5bn per month. The monthly reduction rate for MBS remains at around USD 15bn. This halves the monthly reduction in total assets, doubling the QT.

The ECB initially reduced its bond holdings from the Pandemic Emergency Purchase Program (PEPP) by EUR 7.5bn per month from July 2024; on 17 December 2024, the ECB ceased all reinvestment of expiring bonds from the PEPP. Since then, the ECB's balance sheet total has been reduced every month by the amount of the maturing bonds. The ECB still holds around EUR 1.5trn from the PEPP on its balance sheet. Until the end of 2026, the monthly reduction in the balance sheet due to maturing bonds will fluctuate between around EUR 5.8bn in December 2026 and more than EUR 26bn in April 2026.

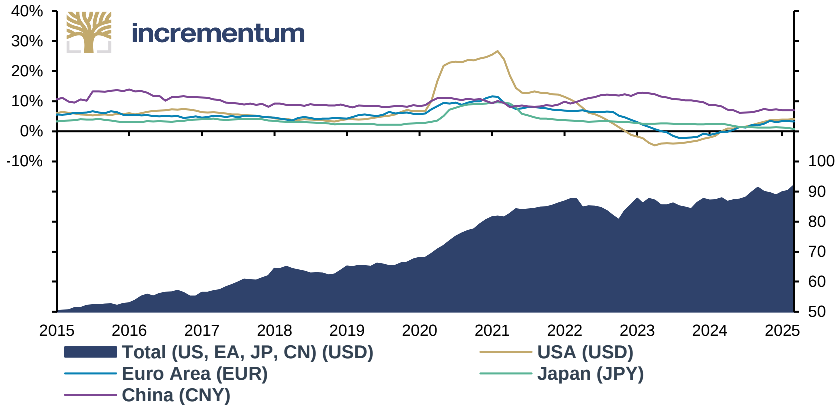
If inflation continues to soar, you're going to have to work like a dog just to live like one.
George Gobel

The BoJ announced its QT plan at the end of July 2024. This provides for a steady acceleration in the reduction of the balance sheet total until Q1/2026, which peaked at over JPY 750trn in August 2024. At the same time, the purchase of Japanese government bonds will be gradually reduced and is expected to halve by Q1 2026. Finally, the BoJ relinquished yield curve control in October 2023. At the end of March, the BoJ had reduced its total balance sheet by just under 5%.

Inflation is not a problem for this time as near as I can figure. Right now, M2 does not really have important implications. It is something we have to unlearn.
Jerome Powell

The trend in the broad money supply M2 is different. Following the contraction in the US and the euro area in 2023, M2 is now expanding again at over 3% year-on-year. In China, growth is significantly higher at around 7% due to the numerous economic support measures, while in Japan it is more subdued at just over 1%. Global liquidity growth in US dollars is currently over 3% year-on-year, with strong fluctuations due to the significant movements on the currency markets.

M2 for Various Countries (lhs), yoy in Local Currency, and Aggregate M2 Money Supply (rhs), in USD, 01/2015–03/2025



Source: LSEG, Incrementum AG

Administrative and bureaucratic inflation factors

I do not think it is an exaggeration to say history is largely a history of inflation, usually inflation is engineered by governments for the gain of governments.
Friedrich August von Hayek

The prices used to measure inflation are gross prices. Changes in indirect taxes, therefore, affect gross prices and the inflation rate. This form of inflation is, so to speak, home-grown. The strength of this effect depends on the tax incidence. Can companies pass on higher taxes and levies to their customers, or do they have to shoulder them themselves? One of the most prominent administrative and bureaucratic factors contributing to inflation at present is taxes designed to reduce CO_2 emissions.

While the US is pursuing the goal of lower energy prices by withdrawing from the Paris Climate Agreement and through the planned expansion of oil production by 3 million barrels per day, the EU remains unwavering in its commitment to achieving climate neutrality by 2050. To this end, the *Emission Trading System II* (ETS-II) will come into effect from 2027. Preparatory work has been underway since the beginning of the year. A report by the *Scientific Service of the German Bundestag* shows that various studies expect a price of up to EUR 300 for the corresponding CO_2 certificates at the time of expansion. At the end of March, the price was just under 70 euros. Together with the climate tariff, the *European Carbon Border Adjustment* (CBAM), introduced as a protective measure, will have direct and indirect inflationary effects on the energy lifeline; directly through the increase in energy prices, indirectly through the weakening of the country as a business location and the associated reduction in production.

Inflationary surge due to US Tariffs?

It can be the case that it's appropriate sometimes to look through inflation if it's going to go away quickly without action by us – if it's transitory. That can be the case with tariff inflation.
Jerome Powell

Donald Trump and his team are convinced that the introduction of tariffs will have a net positive effect on the US economy. After all, Trump believes that the higher average foreign tariffs on US goods and the current account surplus of the rest of the world vis-à-vis the US represent an exploitation of the US.

An intense debate has broken out in the US about whether the introduction of tariffs will have an impact on the US inflation rate. At one extreme, some believe that tariffs will always be borne exclusively by consumers. On the other side are those who, citing both the experience of the 19th century and the development of the CPI during Trump's first term in office, argue that the introduction of tariffs has not fueled inflation – that in fact, inflation fell during Trump's first term in office – and therefore will not fuel it now either. This is because the producers or importers would bear the tariffs, and foreign countries would be taxed by the introduction of tariffs.

Finance Minister Scott Bessent represents the third camp, which expects a one-off inflation spike – as a result of the base effect – but not a permanent increase in the inflation rate: "Nothing is more transitory than tariffs if it's a one-time price adjustment. […] I'm not worried about inflation." Jerome Powell agreed with this assessment in the press conference following the FOMC interest rate decision in mid-March. However, the US has already had very bad experiences with the word *transitory* recently.

Inflation is bringing us true democracy. For the first time in history, luxuries and necessities are selling at the same price.
Robert Orben

In the short term, Donald Trump's tariff policy is likely to have an inflationary effect in the US, due to the rise in import prices and the decline in import volumes. At the same time, in the rest of the world, it is likely to have a disinflationary effect due to oversupply due to falling exports to the US. Following the outbreak of the tariff war between the US and China, concerns were immediately expressed in the EU that China would now try to divert its flow of goods to the EU.

Courtesy of Hedgeye

The sharp depreciation of the US dollar is reinforcing this trend. The effect is likely more substantial in the rest of the world, as many countries are net energy importers and energy is still mostly priced in US dollars. This should open the window for central banks in the rest of the world to cut interest rates further, while the Federal Reserve is likely to be less able to do so. However, as of the end of April, markets are pricing in 4 (!) US interest rate cuts by the end of the year. The economic slowdown is having a global disinflationary effect.

Rearmament as a driver of inflation

Peace is deflationary, wars are inflationary.
Louis-Vincent Gave

Inflationary effects are almost unavoidable in the case of large-scale armament build-ups. After all, the demand for weaponry competes with the production of capital and consumer goods. This is all the more true if the rearmament is debt-financed. At EU level, the deficit rules have been softened for four years and, in addition, EUR 150bn is to be raised by the EU Commission as part of the *ReArm Europe/Readiness 2030* program. This should mobilize a total of EUR 800bn across the EU. In Germany, it is hoped that the incipient cutbacks in the automotive industry can be offset by building up military production capacities. **Tanks instead of cars – that seems to be the new motto.** However, demographic change will significantly reduce labor supply in the coming years and thus increase inflationary pressure. An expansion or reintroduction of compulsory military service would also reduce the labor supply, as would the recruitment of professional soldiers. If most of the desired armaments continue to be imported – which is now the case in the major European countries with the exception of France – the additional demand in the exporting countries would trigger economic and possibly inflationary effects.

We are not going to spend our way to prosperity. Prosperity comes from free markets and free people.
John Cochrane

The great importance of public finances for inflation dynamics is emphasized by the so-called *Fiscal Theory of the Price Level* (FTPL). An important representative of the FTPL is the renowned US economist John Cochrane. In contrast to monetarism, this theoretical framework does not explain increased inflation rates based on an excessive expansion of the money supply, but holds fiscal policy responsible for this. Inflation would increase whenever the view prevails that the state will no longer be able to meet its future obligations in full. In technical terms, inflation occurs when the present value of future government expenditure exceeds the present value of future government revenue. In other words: Citizens and investors no longer trust that the state will be able to offset any deficits in the present with surpluses in the future.

What history shows is that inflation is often a collective behavioral phenomenon—with all the non-linear dynamics that implies. If we think of it [… from the perspective of the FTPL] a confidence crisis like this occurs suddenly, rather than in a predictable, mechanistic manner. Think tipping points.
Henry Maxey

The practical consequence for investors is that it is not only the absolute level of government debt that is decisive for the assessment of creditworthiness, but also the confidence in the government's ability to repay future debts. This, in turn, has concrete consequences for the future inflation rate. This is because, according to the FTPL, the money supply – issued by the central banks – should be viewed as a perpetual, non-interest-bearing bond.

Because of the current multiple burdens on governments – ageing, immigration, green transformation, rearmament, higher interest rates – it seems obvious that the financing difficulties of many countries are increasing and therefore – at least according to the FTPL – so is inflation.

The 1960s are a striking example of the highly inflationary consequences of a "butter and guns" policy. Lyndon B. Johnson, successor to the assassinated John F. Kennedy, not only significantly expanded the welfare state as part of the *Great Society project*, but also entered the Vietnam War in 1964, which resulted in a significant increase in military spending. As a result, inflation in the US rose on an annual basis from just over 1% in the second half of the 1960s to well over 5% in 1969.

Real economic factors – structural and acute

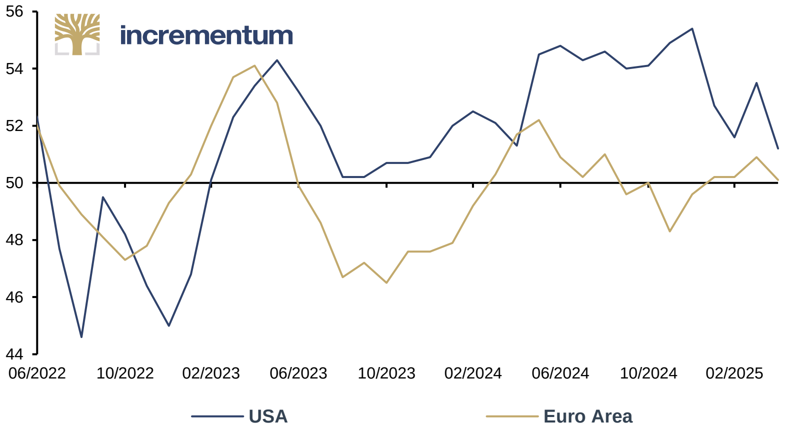
Economic development

Donald Trump and Treasury Secretary Scott Bessent have repeatedly emphasized that they are willing to accept a short-term detox

recession. There are currently many indications that at least a significant slowdown in the US economy, which has been surprisingly robust to date, is unavoidable. The Purchasing Managers' Index (PMI) is pointing clearly downward, partly due to uncertainties surrounding the trade conflict and the negative effects of tariffs, at least in the short term.

In the euro area, the PMI has been hovering around the 50-point mark for over a year, which is the dividing line between expansion (above 50) and contraction (below 50). At least in the short term, debt-financed rearmament could boost economic growth, albeit from a very modest level. However, this would only be the case if the additional defense spending were to have a significant impact on demand in the euro area. Given the lack of capacity in the defense industry, this seems rather unlikely.

Composite PMI, 06/2022–04/2025



Source: LSEG, Incrementum AG

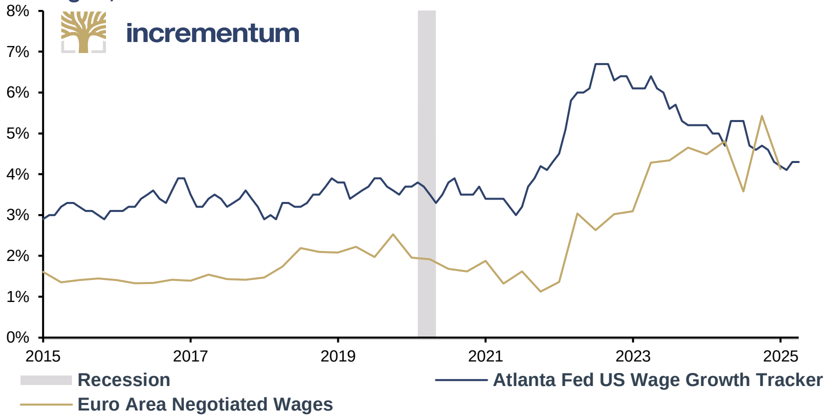
Wage development

Inflation is like a bad neighbour, once he shows up, only thing to get rid of him is for you to move.
Zack Howard

Nominal wage growth in the US and the euro area remains significantly higher than before the wave of inflation. On the one hand, this is due to the delayed adjustment of wages to the inflation rate. In the US, wage pressure in the lower-income segment is likely to increase due to tighter immigration policies and the resulting labor shortage. In Germany, in particular, wage negotiations are likely to be very difficult, as a recession is looming for the third consecutive year in 2025. In structural terms, demographic change will strengthen the bargaining power of employees[20] and thus ensure comparatively high wage settlements.

[20] See "Global Demographics Turn Inflationary", In Gold We Trust report 2021

Atlanta Fed US Wage Growth Tracker and Euro Area Negotiated Wages, 01/2015–03/2025



Source: ECB, Federal Reserve Atlanta, LSEG, Incrementum AG

AI

AI could be deflationary. This is one of the impacts of this technology that is most underappreciated and misunderstood by investors.
Sam Altman

AI certainly has the potential to gradually increase productivity in many work processes. However, as with countless other inventions, the implementation process will take time, as was the case with computers and the internet. However, a dampening effect on inflation due to rising productivity is to be expected, especially in the medium and long term. In the short term, the high energy requirements of AI systems – as exemplified by Microsoft's announcement of the reactivation of the Three Mile Island nuclear power plant – could also trigger inflationary effects, especially if a stable electricity supply cannot be guaranteed.

There is only one field where the European Union still leads the world: regulation.
Greg Ip, Wall Street Journal

The following episode is indicative of the EU's self-image: While the US, China, and other countries are developing AI and discussing the opportunities for a broad implementation of AI, the EU institutions are celebrating themselves for passing the world's first AI law.

Inflation expectations – US

I never think of the future - it comes soon enough.
Albert Einstein

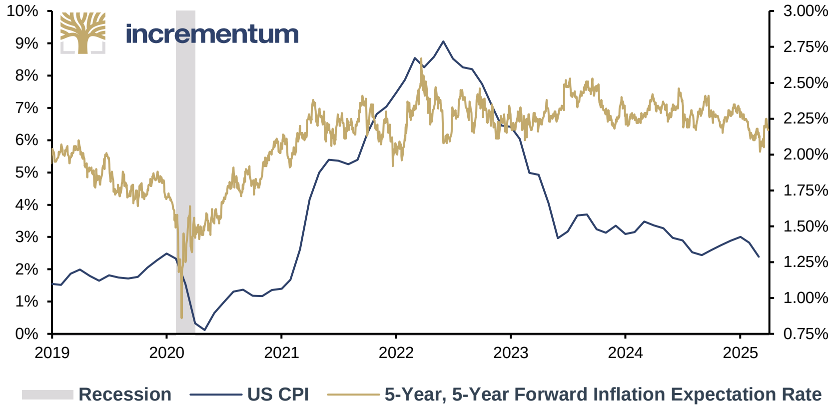
Investors now have access to a wide range of indicators that reflect short-, medium-, and long-term inflation expectations. These can be divided into market-based and survey-based inflation expectations, a division that we use below.

Market-based inflation expectations

5-year, 5-year inflation expectations

Very long-term inflation expectations have been on a downward trend since the fall of 2023 and accelerated noticeably in Q1 2025. They reached their preliminary low of just above the 2.0% mark in the days leading up to Liberation Day, when these inflation expectations plummeted by 16 basis points before shooting up sharply by 23 basis points. All in all, however, the data should be interpreted as indicating that market participants have full confidence in the Federal Reserve – and in US economic policy – to keep inflation under control.

US-CPI (lhs), and 5-Year, 5-Year Forward Inflation Expectation Rate (rhs), yoy, 01/2019–04/2025



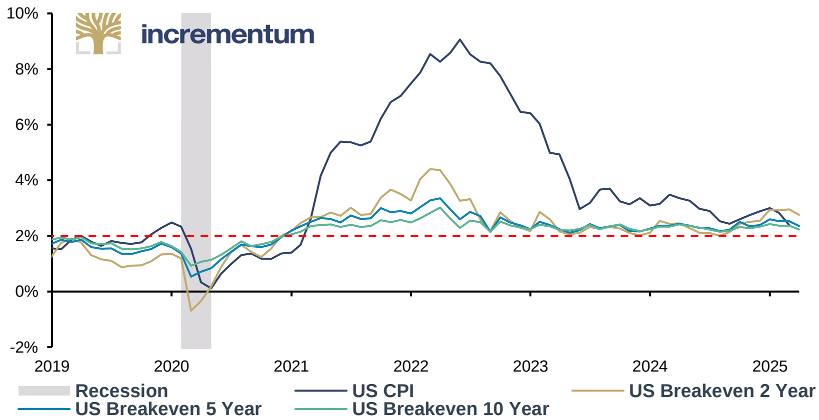
Source: LSEG, Incrementum AG

I have had to revise my formula for happiness. I used to think it was reality minus expectations. But that needs to be modified to reality minus the right expectations.
Vitaliy Katsenelson

Breakeven rate

The break-even inflation rate indicates the inflation rate required to ensure that the purchase of an inflation-linked bond yields at least the same real interest rate for the investor as the purchase of a conventional bond. The break-even rates for 5 and 10 years, measured against the Federal Reserve's inflation target of 2%, are at a slightly elevated level with a downward trend. The same now applies again to the 2-year breakeven rate, after it had risen slightly in the meantime. There is still a visible difference between the medium and long-term breakeven rates. The market therefore expects inflation to be higher in the short term than in the medium and long term. **However, the predictive power of breakeven rates is not particularly high, as evidenced by a comparison with actual inflation.**

US CPI, yoy, and Various US Breakeven Rates, 01/2019–04/2025

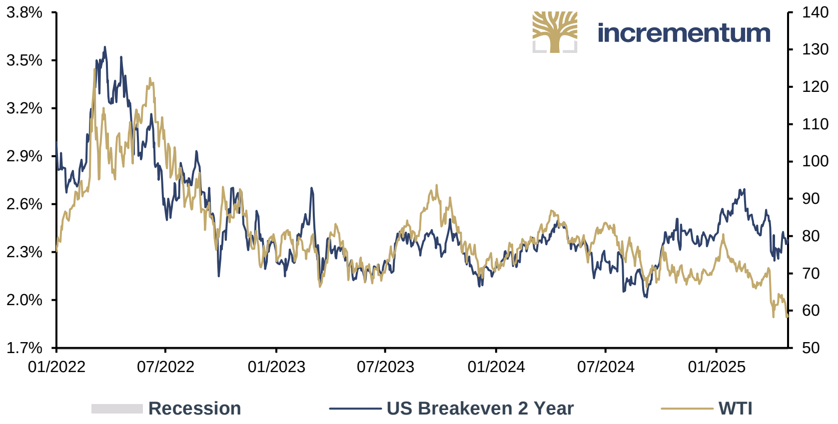


Source: LSEG, Incrementum AG

The 5-year break-even rate and the oil price

Since September 2024, there has been a clear divergence between the otherwise closely positively correlated oil price and the 2-year break-even rate. If this is used as a guide, the WTI price should be around USD 80; if the oil price is used as a benchmark, the 2-year break-even rate should be more than 50 basis points lower.

US Breakeven 2 Year (lhs), and WTI (rhs), in USD, 01/1970–04/2025



Source: LSEG, Incrementum AG

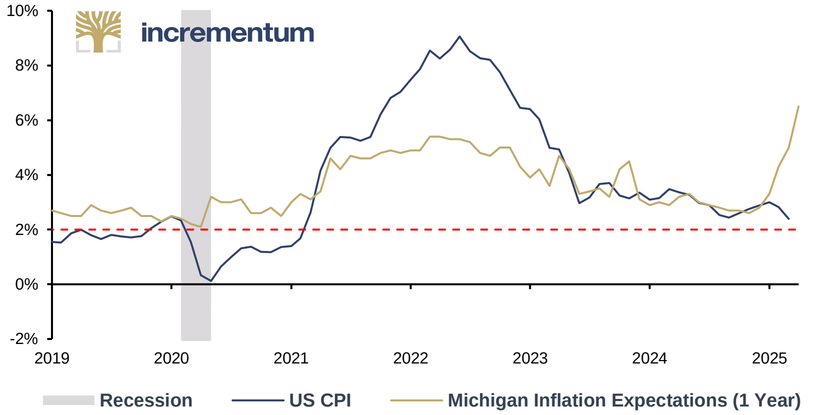
Survey-based inflation expectations

Inflation expectations, University of Michigan

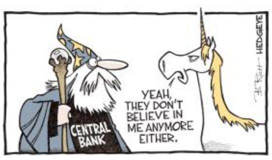
The greatest obstacle to discovery is not ignorance – it is the illusion of knowledge.
Daniel J. Boorstin

Short-term inflation expectations have risen sharply since the US elections in November 2024 and already stand at 6.5% as of April. This is a significantly above-average value for the past 45 years. A year ago, they were only half as high. Inflation expectations are comparatively rigid compared to the actual inflation trend and, even during the inflation wave, were usually well below the actual inflation figures. Long-term inflation expectations have also risen sharply year-on-year, by 1.4 percentage points or 50% to 4.4%.

US CPI and Michigan Inflation Expectations (1 Year), yoy, 01/2019–04/2025



Source: LSEG, Incrementum AG



Courtesy of Hedgeye

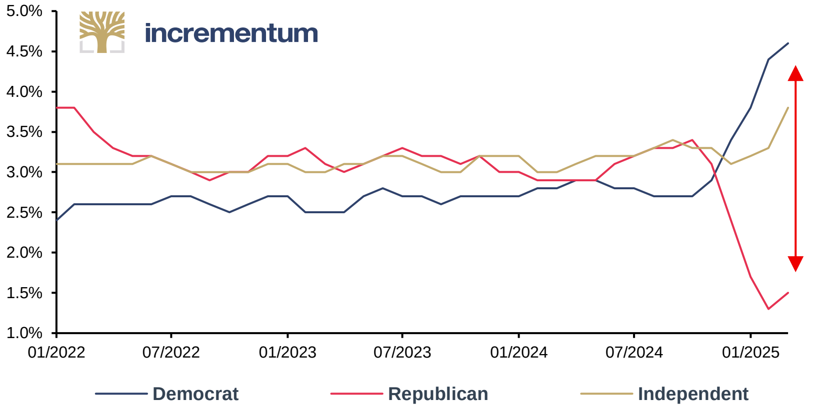
The NBER study published in February by Kuang, Weber, and Xie, entitled "Central Bank Communication with the Polarized Public", confirms the strong influence of party preferences on trust in the Federal Reserve and thus on inflation expectations. The question of whether the Federal Reserve is viewed by US citizens as an independent institution depends not only on party affiliation but also on whether the Federal Reserve is perceived as part of the *in group* or the *out group*. **Trust is higher when the Federal Reserve is perceived as part of one's**

own group. And higher trust correlates with lower inflation expectations.

Where bias lies, truth often hides.
Modern Aphorism

This has a direct impact on inflation expectations and seriously calls into question their predictive value. Supporters of the party that holds the presidency have significantly lower inflation expectations than supporters of the party that lost the presidential election, with independents in the middle. At 43% (2024), independents constitute the largest group, with 28% identifying themselves as Republicans and 28% as Democrats. If we consider the expectations of those who, as Independents, are not driven by party politics to be literally unbiased assessments, then inflation expectations shifted from disinflationary to inflationary at the turn of the year, i.e. when Donald Trump was about to take office again.

Michigan Inflation Expectations (5 Year), by Political Party, 01/2022–03/2025



Source: University of Michigan, Incrementum AG

However, these inflation expectations, which are heavily dependent on the balance of power, also show that the Federal Reserve is fundamentally perceived as an institution that is not independent of politics.

Inflation expectations – euro area

I don't mind going back to daylight saving time. With inflation, the hour will be the only thing I've saved all year.
Victor Borge

As of March, inflation expectations in the euro area remain well above the ECB's inflation target at 2.9% over the next 12 months and 2.5% over the next three years. Over both time horizons, the median value used by the ECB is well above the mean value, meaning that inflation expectations are clearly skewed to the right. The average value is 4.7% for the next 12 months and 4.5% for the next 3 years. The trend for all values is either stable or slightly upward.

The ECB Survey of Professional Forecasters is much more optimistic with regard to inflation trends. An inflation rate of around or even exactly 2.0% is expected for 2025, 2026, 2027, and long-term, i.e. 2029. Economists therefore have significantly more confidence in the ECB's monetary policy skills than consumers.

It is a capital mistake to theorize before one has data. Insensibly one begins to twist facts to suit theories, instead of theories to suit facts.
Sherlock Holmes

Finally, however, it should be noted that both market-based and survey-based inflation expectations are very often wrong. In this respect, the result of the policy brief "Financial market forecasts inflation at least as well as central bankers" is no accolade. A more appropriate title would be: "Central banks are just as wrong with their inflation forecasts as the markets (or survey-based inflation expectations)".

In financial markets, it is probably the herd instinct that encourages misjudgments. It is easy to rationalize being wrong with the crowd, but being wrong alone destroys your career. Believing you are right alone can make you lonely. *The Big Short* impressively demonstrates these psychological and social constants.

In the case of central bankers, there is also the fact that the current monetary policy is seen as appropriate, indeed must be seen as appropriate. Otherwise, a different, more appropriate monetary policy would have to be implemented, or the effectiveness of monetary policy would be fundamentally called into question. Representatives of the institutional status quo naturally do not do this.

Inflation Trends in the Rest of the World

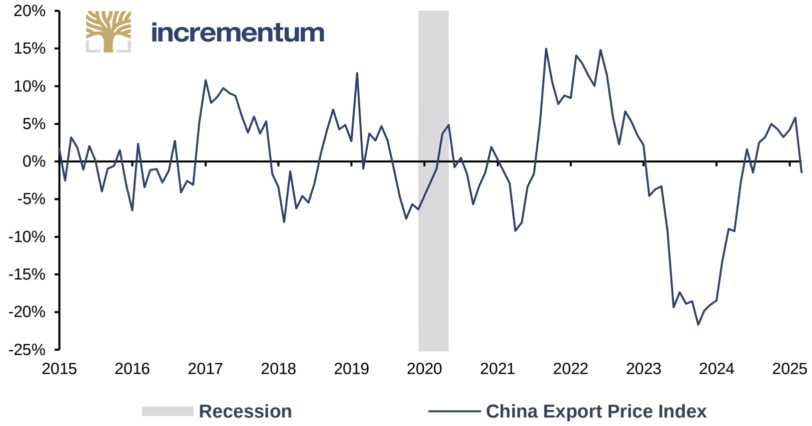
China

China faces dual economic challenges: externally, the strain of Donald Trump's tariff policies persists, while domestically, deep structural imbalances in the real estate sector continue to weigh on growth. In response, the Chinese government and the People's Bank of China (PBoC) have rolled out multiple large-scale support measures and signaled further interventions to stabilize the market.

When one tugs at a single thing in nature, he finds it attached to the rest of the world.
John Muir

However, following the wave of inflation in the wake of the energy price rally, producer prices have been in deflationary territory again since mid-2024. China is therefore exporting deflation. One reason for the pressure on producer prices could be the Trump administration's expansion of tariffs, insofar as producers and exporters are lowering their prices in order to remain competitive on the US market.

China Export Price Index, yoy, 01/2015–03/2025



Source: LSEG, Incrementum AG

No man is an island, entire of itself; every man is a piece of the continent, a part of the main.
John Donne

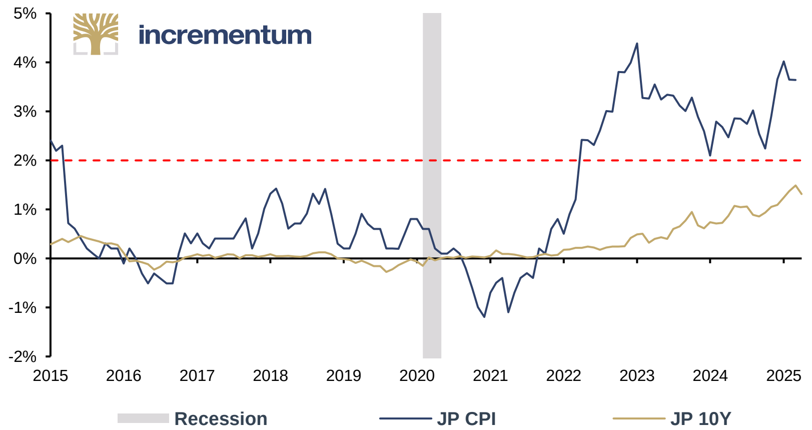
Overall, China's price dynamics, driven by persistent structural imbalances and a weak renminbi, are likely to exert disinflationary, if not deflationary, pressure on global markets. The US may prove an exception due to its tariff regime, though the ultimate burden of those tariffs remains uncertain: Will they fall on Chinese producers, exporters, US importers, or consumers? Despite China's remarkable technological advancements, the massive stimulus measures deployed by its government and central bank have yet to resolve these underlying structural challenges.

Japan

Inflation is like toothpaste: once out of the tube, it is impossible to return them.
Otto Pöhl

Not since the early 1990s has inflation in Japan remained so stubbornly above the 2% mark. There have now been almost three years with a sometimes significantly higher inflation rate. Although the BoJ officially ended yield curve control in March 2024, real yields are still in clearly negative territory.

JP CPI, yoy, and JP 10Y, 01/2015–04/2025



Source: LSEG, Incrementum AG

I've never really wanted to go to Japan. Simply because I don't like eating fish. And I know that's very popular out there in Africa.
Britney Spears

Unsurprisingly, bonds are not very attractive to Japanese investors. Gold is all the more attractive. Since August 2018, gold has gained 230% in Japanese yen terms. In euros, the gold price rose by 167% in the same period. **Gold in yen has recorded consistent gains for 7 years.**

Gold, in JPY, 01/2015–04/2025

Source: LSEG, Incrementum AG

Conclusion

In our *In Gold We Trust* report 2021, "Monetary Climate Change", the first and most important sign of monetary climate change was the arrival of *budgetary nonchalance*. With the double whammy in Germany, i.e. the adoption of the EUR 500bn special fund for infrastructure and the financing of the green transformation, as well as the easing of the debt brake for armaments, which is expected to amount to at least EUR 900bn, Germany has shed its previous fiscal virtue and moved into the camp of budgetary nonchalance.

The second sign, the merging of monetary and fiscal policy, is also becoming increasingly obvious, especially in the euro area: In the green transformation of the economy and the mobilization of private savings for investment in the EU (war) economy, EU Commission President Ursula von der Leyen and ECB President Christine Lagarde are going hand in hand. The ECB no longer even has the appearance of independence. **The third sign we identified in 2021 was that the ECB constantly expands its remit.**

On the other side of the Atlantic, Jerome Powell has now definitively rejected the Federal Reserve's stronger focus on climate policy. In mid-January, just a few days before Donald Trump took office, Powell announced the Federal Reserve's withdrawal from the *Network of Central Banks and Supervisors for Greening the Financial System*, whose work, according to Powell, "has increasingly broadened in scope, covering a wider range of issues that are outside of the Board's statutory mandate".

We write to propose, or perhaps to repropose, that the central bank is a codependent part of the government, the interest rate-manipulating and bond-buying branch of the Treasury. It's no more independent than the Forest Service.
Jim Grant

The close links between politics and central banks can also be seen in personnel decisions. Former Federal Reserve Chair Janet Yellen became Secretary of the Treasury under Joe Biden, while Jerome Powell briefly held the position of Undersecretary of State under President George H. W. Bush in 1992. Mario Draghi was a top official in the Italian Ministry of Finance, the ECB President, the Italian Prime Minister, and then the author of the Draghi Report for the EU Commission. The current ECB President, Christine Lagarde, held three different ministerial posts in the French government from 2005 to 2011.

High inflation volatility persists

The first four years of the 2020s were characterized by historically unprecedented inflation volatility in the euro area, which came into existence in 1999 only, while inflation in all other countries was at least significantly more volatile than in the past three decades.

The blatant miscalculations by leading central bankers when the wave of inflation took off in the course of 2021 also contributed to the substantial inflation volatility.[21] This policy of appeasement had dramatic consequences, but it was also a result of the underexposure of monetary factors as the underpinning of – time-delayed – waves of inflation. It was only a matter of time before the years of low interest rates took their toll.[22]

The study "The Myth of Fed Political Independence", by Thomas J. Webster, offers an explanation for this asymmetry. Webster analyzed the more than 10-year period of low interest rates from the global financial crisis through the Covid-19 pandemic to the start of the rate-hike cycle in mid-March 2022. He found that the Federal Reserve was actively involved in financing Washington's budget deficits through the printing press. He therefore concludes that the Federal Reserve is not a bastion of sound monetary policy but just another agency instrumentalized by politics, because an agency that is unable to withstand political pressure must ultimately be considered part of the government. **In short, the independence of the Federal Reserve is a myth.** With his public criticism of Jerome Powell, Donald Trump is merely making clear what otherwise remains largely hidden. However, it is always high-ranking politicians who appoint central bank presidents, which ensures that the central bank remains politically aligned with the broader political agenda.

I'll demand that interest rates drop immediately. And likewise, they should be dropping all over the world. Interest rates should follow us all over.
Donald Trump

Thomas Drechsel's paper "Estimating the Effects of Political Pressure on the Fed: A Narrative Approach with New Data" comes to the conclusion that the exertion of political pressure on the central bank does indeed promote inflation. For his study, Drechsel analyzed the personal interactions between the respective US president and representatives of the Federal Reserve between 1933 and 2016. A shock in the form of higher political pressure on the Federal Reserve not only increased inflation significantly but also led to higher inflation expectations, in contrast to a politically uncalled-for easing of monetary policy. A truly independent central bank, i.e. a central bank that is

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21 See "The Status Quo of Debt Dynamics," In Gold We Trust report 2022; "Mining Stocks and Real Interest Rates: An Unsurprising Relationship," In Gold We Trust report 2021
22 See Stöferle, Ronald, Taghizadegan, Rahim and Hochreiter, Gregor: The Zero Interest Trap, 2019

able to resist political pressure to loosen monetary policy, would therefore be a genuine institutional inflation hedge.

It seems that, in the world of politics and central banking, admitting mistakes has fallen out of favor, with a prevailing tendency to double down on existing strategies.
Fabian Wintersberger

The political wrangling over the appointment of a new Federal Reserve Chairman in May 2026 and ECB President in November 2027 – unlike Christine Lagarde, Jerome Powell could be reappointed for a third term – will once again show that the responsible political bodies will make the appointments in line with their own economic and monetary policy ideas. During the election campaign, the names mentioned as possible successors were current US Treasury Secretary Scott Bessent, Kevin Warsh, David Malpass, and Judy Shelton.

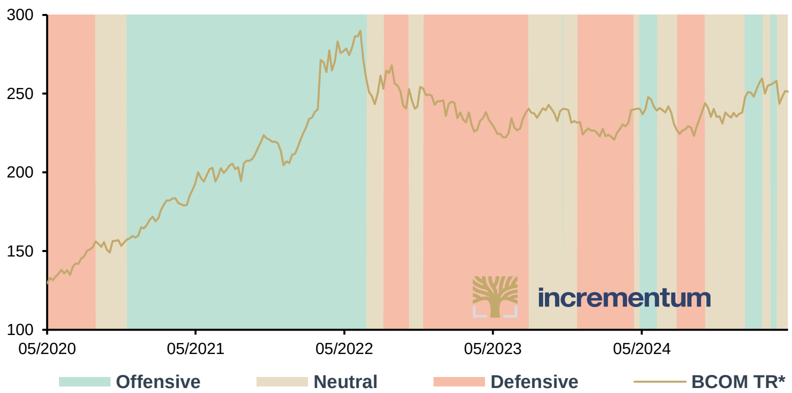
The Incrementum Inflation Signal

Invest in inflation. It's the only thing going up.
Will Rogers

Since the last publication of the report, the *Incrementum Inflation Signal* has shown a significantly increased frequency of signal changes. Between September 2024 and the political turning point surrounding the Trump shock, the signal predominantly indicated a positive inflationary environment. However, this shifted due to escalating trade tensions and the threat of a tariff conflict, resulting in a return to a neutral signal. Given the current political and economic climate, marked by considerable uncertainty, an end to this volatile phase is not yet in sight. **Should a sustained inflationary cycle emerge, we expect the signal – much like in 2020 – to once again be able to anticipate an upcoming wave of inflation at an early stage.**

Particularly noteworthy is the pronounced divergence within commodity markets over the past twelve months. While gold experienced a significant upward trend, energy commodities came under continued downward pressure. These opposing movements are also reflected in the overall stable, yet sluggish development of the Bloomberg Commodity Index.

BCOM TR*, and Incrementum Inflation Signal, 05/2020–04/2025



Source: LSEG, Incrementum AG
*Bloomberg Commodity Total Return Index

In summary, the various inflation dynamics can be broadly categorized as follows:

<u>Short-term disinflationary dynamics</u>

- Economic slowdown due to trade wars
- Quantitative tightening
- Interruption of the interest rate reduction cycle

– Possible easing of geopolitical tensions in Ukraine and the Middle East
– Energy prices
– In the rest of the world: US dollar weakness

Medium and long-term disinflationary dynamics
– Technology and innovation, AI

Short-term inflationary dynamics
– Discontinuation of (last) government price reduction measures due to the energy crisis
– US dollar weakness (in the US)
– Nominal wage development

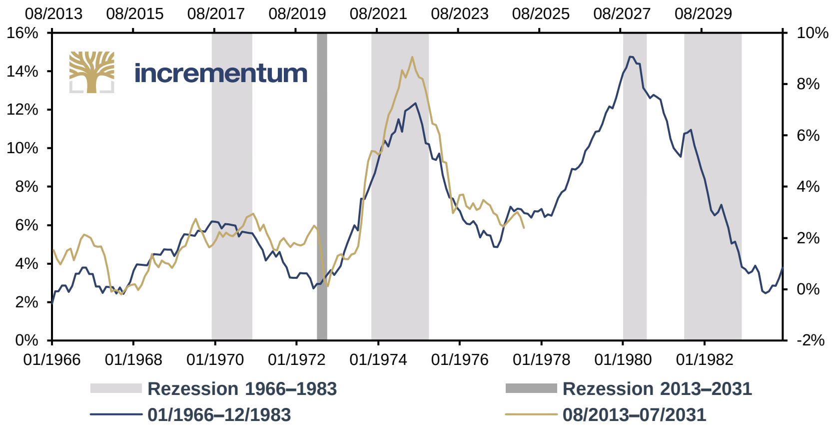
Medium-term inflationary dynamics
– Customs duties and de-globalization
– Uncertainty in international trade due to the US tariff policy
– Structural government debt
– Guns and butter policy
– Rearmament
– CO_2 pricing, in particular through the introduction of the ETS II emissions trading system from 2027 in the EU
– CO_2 duties in the EU (CBAM)
– Green transformation policy
– Implicit easing of the inflation target of 2%

Long-term structural inflationary dynamics
– Demographic change and the associated shortage of skilled workers and general labor shortage
– Geopolitical bloc formation
– Increase in energy prices due to the expansion of wind and solar energy
– Increasingly expansive fiscal policy

Having a little inflation is like being a little pregnant.
Leon Henderson

The parallelism of the inflation trend in 1966–1983 and since 2013 is still striking, albeit with only ¾ of the intensity and starting from a 2 percentage point lower base. **If this analogy continues, inflation in the US should move sideways until the end of the year and rise sharply in 2026 to around 11% in late summer 2028.** In other words, we would now be in the calm before the second, stronger inflationary storm.

US CPI, yoy, 01/1966–12/1983 (lhs), and 08/2013–07/2031 (rhs)



Source: Andreas Steno, LSEG, Incrementum AG

When all you have is a hammer, everything looks like a nail.
Abraham Maslow

In summary, it can be said that the current inflation outlook is very mixed now that the major wave of inflation has subsided. The sharp fall in energy prices will pull inflation rates down significantly in the coming months, while the tariffs imposed, and the increased uncertainty are driving up inflation. The widespread nonchalance of leading central bankers towards the persistently high level of inflation is having the effect of a tacit increase in the inflation target.

For 2025, we assume that, notwithstanding the significant short-term disinflationary effect of the fall in energy prices, inflation has not yet been tamed. This will be particularly evident in core inflation. It can also be assumed that the central banks will react as they always do in the event of significant turbulence on the financial and possibly currency markets: by opening the monetary floodgates. **The basic stance of those responsible for (monetary) policy is and remains inflationary.**

About Us

Ronald-Peter Stöferle, CMT

Ronnie is managing partner of Incrementum AG and responsible for Research and Portfolio Management.

He studied business administration and finance in the USA and at the Vienna University of Economics and Business Administration, and also gained work experience at the trading desk of a bank during his studies. Upon graduation, he joined the research department of Erste Group, where in 2007 he published his first *In Gold We Trust* report. Over the years, the *In Gold We Trust* report has become one of the benchmark publications on gold, money, and inflation.

In 2014, Ronnie co-authored the international bestseller *Austrian School for Investors*, and in 2019 *The Zero Interest Trap*. He is a member of the board of directors at Tudor Gold Corp. (TUD), and Goldstorm Metals Corp. (GSTM). Moreover, he is an advisor to *Von Greyerz AG*, a global leader in wealth preservation in the form of physical gold stored outside the banking system. He is also a Member of the Advisory Board at *Monetary Metals*.

Mark J. Valek, CAIA

Mark is a partner of Incrementum AG and is responsible for Portfolio Management and Research.

While working full-time, Mark studied business administration at the Vienna University of Business Administration and has continuously worked in financial markets and asset management since 1999. Prior to the establishment of Incrementum AG, he was with Raiffeisen Capital Management for ten years, most recently as fund manager in the area of inflation protection and alternative investments. He gained entrepreneurial experience as co-founder of philoro Edelmetalle GmbH. Since 2024, he has been a Member of the Advisory Board at *Monetary Metals*. In 2014, he co-authored the book *Austrian School for Investors*.

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We would like to thank the following people for their outstanding support in creating the *In Gold We Trust* report 2025:

Gregor Hochreiter, Richard Knirschnig, Jeannine Grassinger, Lois Hasenauer-Ebner, Stefan Thume, Theresa Kammel, Rudi Bednarek, Daniel Gomes Luis, David Waugh, Handre van Heerden, Katrin Hatzl-Dürnberger, Ted Butler, Thomas Vesely, Katharina Vesely, Niko Jilch, Florian Grummes, Elizabeth und Charley Sweet, Anton Kiener, Matthias Flödl, Kazuko Osawa, Bruce (Yuichi) Ikemizu, Max Urbitsch, Trey Reik, Tavi Costa, Velina Tchakarova, Dietmar Knoll, Louis-Vincent Gave, Luke Gromen, Grant Williams, Markus Hofstädter, Seasonax, Jochen Staiger, Ilse Bauer, Heinz Peter Putz, Paul Wong, Fabian Wintersberger, Leopold Quell, Match-Maker Ventures, Harald Steinbichler, Richard Schodde, Silver Institute, dem World Gold Council, Mining Visuals, the whole wonderful team at Incrementum and of course our families!

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