Deflation & Financial Repression - The Financial Market Impacts of COVID-19 (03/03/20)

No investor can accurately forecast the impact of COVID-19 on the health of the world’s population or the global economy. It is clearly a shock to global economic activity, but how big a shock? Unable to answer that question, The Solid Ground can provide some other important answers about the impact of the COVID-19 shock on global financial markets. This shock is very deflationary, due to near record high debt levels, and even more importantly this shock will lead to a major rise in financial repression. It is through the latter impact that this particular shock will come to influence financial market returns for many decades.

This shock is deflationary. It is deflationary not just because it reduces the economic growth rate, but because world debt-to-GDP is at 242%, just below a record high, and well above the 211% reached in 2007 at the peak of the last business cycle. The then record high debt-to-GDP level in 2007 was a major reason why what started as a recession almost tipped into a depression. Today’s debt levels mean that when cash flows decline, as they do in any economic shock, debt defaults will quickly become an issue.

In Anatomy of The Bear: Lessons from Wall Street’s Four Great Bottoms (Harriman House 2016) (To be discussed live on Bloomberg on the afternoon (UK time) of March 3rd with John Authers) your analyst shows how equity valuations have always declined particularly rapidly in periods of deflation.

The modern investor has been subject to two deflationary shocks this millennium. In the first of those shocks, from 2000 to 2002, the S&P500 index fell by 49%. In the second shock, from 2007 to 2009, the S&P500 index fell by 57%. Such is the powerful and rapid negative impact of deflation, a macro force that produces the dangerous micro impact of declining cash flows and declining asset prices, that it questions the very survival of equity itself. This COVID-19 induced deflationary shock comes at a time, unlike 2000-2002 and 2007-2009, when interest rates are at, or are just above, zero. As Ben Bernanke long ago reminded us, there are huge risks when a deflation shock strikes when interest rates are at, or below, the zero bound:

‘Deflation great enough to bring the nominal interest rate close to zero poses special problems for the economy and for policy. First, when the nominal interest rate has been reduced to zero, the real interest rate paid by borrowers equals the expected rate of deflation, however large that may be. To take what might seem like an extreme example (though in fact it occurred in the United States in the early 1930s), suppose that deflation is proceeding at a clip of 10 percent per year. Then someone who borrows for a year at a nominal interest rate of zero actually faces a 10 percent real cost of funds, as the loan must be repaid in dollars whose purchasing power is 10 percent greater than that of the dollars borrowed originally. In a period of sufficiently severe deflation, the real cost of borrowing becomes prohibitive. Capital investment, purchases of new homes, and other types of spending decline accordingly, worsening the economic downturn.’


Clearly the risks of just such a rise in real interest rates are now very high indeed. There is, of course, some good news for US investors in that US interest rates are no longer at the zero bound. In the US there is thus a prospect that policy rates can fall more quickly than inflation.

There is no such good news for investors in Europe or Japan. With inflation at just 1.4% in the Eurozone and 0.7% in Japan, further declines in those inflation rates cannot be offset with lower policy interest rates. The policy buffer, used to prevent rising real rates in 2000-2002 and 2007-2009, is no longer available in Japan and the Eurozone with interest rates at the zero bound. The likelihood that the US can now follow very different policies from the Eurozone and Japan has crucial short and long-run impacts for exchange rates and the very structure of economies and savings markets.
Initially the COVID-19 induced fiscal measures, such as those announced in Italy to support corporations where revenues decline by 25% or more, can only act to reduce the economic pain, and they are not reflationary. However, the COVID-19 shock will change attitudes towards fiscal spending over the medium and long term, particularly in Europe. Such a change on fiscal policy will make Christine Lagarde’s push for so-called “helicopter money” much more likely to succeed. A move to “helicopter money” is the crossing of the Rubicon and would mean that things will change in the Eurozone for a generation and would be the longest impact from the COVID-19 shock. Subscribers can read much more about how the likely differences in real interest rates and, crucially, the differing ability of central banks to create money now shape policy responses, and how key changes mean a whole new approach to investing is necessary. (See The Solid Ground 1Q 2020 Helicopter Money: Where It Comes And Where It Goes - to be published March 12th.)

This brings us to the second question that we can answer in terms of the impact of COVID-19. The response will involve direct government intervention in the commercial credit system that, while applied in this emergency, is likely to become accepted as the new normal. In China and now also in Italy governments are asking banks for forbearance when the inevitable failure to meet interest payments by their customers occurs. While such forbearance is a wise policy to prevent otherwise healthy businesses from failing, the ability of politicians to mandate who should and who should not pay interest expense to commercial banks is a policy that politicians may come to like just a bit too much. Subscribers will know that The Solid Ground has focused on the aggressive financial repression that will follow our next deflationary shock and thus COVID-19 may go down in the history books, at least the history books that record the fate of savers, as the trigger that legitimized a much more aggressive move to financial repression.

The Solid Ground has long argued that the global financial system is fragile. Debt is being created much more quickly than money, and thus a deflationary shock is much more likely than an inflationary shock. That deflationary shock is now upon us and the MSCI World ex United States Index is already 2% below its 2011 high. This index of equity prices is well below its 2007 high and is just 6.5% above its high in the year 2000. While things have been very different for the US stock market for equity investors, investing outside the US it has been a dire two decades with almost no capital gains.

These dire returns are associated with low inflation and deflation shocks and not any surprise rise in inflation over those two decades. While there are many causes of these strong deflationary trends, investors must not forget the role played by the attempt to create a single currency in Europe. This attempt to create a single currency, where once there were nineteen continues and is unlikely to be abandoned. It has pushed interest rates to record low levels, inflation to very low levels and debt-to-GDP levels in key European countries to record highs. The Solid Ground continues to warn that it is thus the Eurozone that continues to represent the greatest risk of a new debt crisis with implications for not just economic but socio-political stability. Ultimately the free movement of capital within and also from the Eurozone is likely to be restricted in an attempt to bend market prices into the corset of the single currency. No distortionary means will be too great to meet the end of keeping the single currency together and hoping that one day it can deliver opportunity and prosperity rather than another two decades of decline.

Thus, despite the poor returns from non-US equities, there is more bad news to come. For those unlucky enough to have bought non-US equities at their peak in March 2000 there has been just the annual dividend yield of 1.4% and the growth rate of dividends to reward them for their patience. The growth in dividends has pushed the yield on the index to 3.4% today, despite almost no capital gains. The joys of compounding are of course wonderful and the index total return, with these growing dividends reinvested, has been 75% over these near twenty years. That 75% total return over the past 20 years has been significantly eroded by inflation with US inflation rising 47% over the same period. Investors who avoided non-US equities and instead invested in US Treasuries in March 2000 saw the Barclays Bloomberg US Treasury index deliver a total return of 220%!
Established 1995

It has been two decades when the race run outside the US has not been to the swift, in the form of equity capital, but to the strong, in the form of government fixed-interest securities. The good news for those considering investing in non-US equities today is that the poor capital return over the period, while earnings have grown, has reduced the current year PE of the MSCI World ex United States index from 31X in March 2000 to currently 14X. While lower valuations are good news for the long-term investor, history shows that a deflationary shock can reduce equity valuations very quickly indeed. History also shows that the scale of deflationary shocks possible within the euro, such as those already inflicted on investors in Portugal, Ireland and Greece are of a particularly dangerous scale for equity investors.

Things have of course been much better for investors in US equities, however not quite as good as they look. Solid Ground readers who also receive the work of Albert Edwards and Andy Lapthorne of Soc. Gen. will know that the performance of US equities, outside of the five largest stocks in the index, has been to put it mildly lackluster:

‘… if we removed the top ten stocks over the past ten years, the S&P 500 would be 7% lower than where it is today, with a large proportion of that divergence coming in the past couple of years.’

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For all but those few investors smart enough to see the potential in those five US meg-caps, US treasury securities have provided higher capital gains than even US equities over the past ten years. However, once again this poor capital performance, at a time of rising earnings, has a silver lining in the fact that the PE of the MSCI USA Index has declined from 28X in March 2000 to 17X earnings today. Those of us who prefer to judge the value of equities utilising the cyclically adjusted PE (CAPE) will note that the US market has declined from an all time high CAPE of 43X in March 2000 to today a still very high 32X CAPE.

The much higher level of over-valuation for US equities indicated by the CAPE suggests that to value equities on today’s earnings is probably to value them on something near peak earnings. The rationale behind the effectiveness of CAPE as an indicator of future returns is ultimately that corporate profits as a percentage of GDP will mean revert - as they have done throughout US history. However, such mean reversion has been largely absent this millennium as the corporation has continued to prosper compared to labour, creditors, the tax man and an increasingly important interest group with a claim on corporate cash flows - the defined benefit pensioner.

In a deflationary shock, as we saw from 2007-2009, corporate profits do fall as a share of GDP and of course GDP also falls. However, coming out of that 2008-2009 recession the US corporates’ ability to secure a higher and higher share of GDP was not successfully challenged by other interest groups in society. It is highly unlikely that such a victory for corporate interests will be secured in our next business cycle.

Where central bank interventionism has assisted the corporate secure a higher share of GDP, we are now entering a period when greater government intervention will be explicitly aimed at reducing the corporations’ share of GDP. The Solid Ground believes that the need for extreme government action to prevent debt defaults, as the result of the economic damage caused by COVID-19, will provide the trigger for such government interventionism and thus a prolonged decline in corporate profits relative to GDP. It is just such a mean reversion that would signify that the current very high US CAPE does indeed signal very poor returns for equity investors in the long-term.

While all the current focus of investors is on the impact of the COVID-19 shock, something else is happening which will probably have an even more profound impact on the story of this century: President Erdogan of Turkey is encouraging refugees to cross the Turkish border into the EU. In The Solid Ground of 4Q 2017, which looked at the likely mass debt defaults within Turkey, the risk of higher political instability in the EU from a change of refugee policy by Erdogan was flagged up.
‘With the President describing German politicians as ‘Nazis’ on more than one occasion, it is not clear how long the deal to retain Syrian refugees in Turkey will continue – particularly if Turkey’s own financial situation continues to deteriorate. As the repercussions from the influx of refugees into Europe in 2015 continue to be felt, particularly in Germany, Austria and the self-proclaimed Visegrad Four, political stability in the EU would be further undermined from an increase in Syrian immigration from Turkey to the EU. Should President Erdogan, perhaps supported by his new friends in Russia, wish to destabilise Europe, then breaking off the March 2016 deal on immigration would be another dangerous result of a default upon old friends. Forecasting the continued socio-political reaction to such a development in the EU is far from easy, but so far it has seemed to prompt a rise in the political power for anti-immigration parties that are usually also opposed to the further transfer of sovereign powers to Brussels.’

Solid Ground 4Q 2017 - New Debt Crisis and What It Means

Well, Erdogan’s ‘new-found friend’ turned out to be just a very old Turkish enemy but the impact of Turkey’s involvement in Syria has been the same - Erdogan has sought to weaponise the movement of people for political ends. The end is to get EU military support for Turkey’s involvement in Idlib, or the refugees will continue to come. Investors are not well placed to judge just how far Erdogan will go with this policy, but should refugees from Syria and beyond once again cross the EU border en masse the COVID-19 shock will coincide with a huge political shock.

In the opinion of your author, both these shocks are likely to be to the political benefit of those political forces that oppose the centralisation of power in the EU that is essential if the Euro is to be, one day far in the future, anything but a dysfunctional currency zone. The political struggle between the sovereigntists and the federalists in the EU is thus set to reach an even more intense level.

As of the end of last week, investors who thought their capital safe, because invested in gold, had quite a shock. The decline in the gold price probably signified a fear that real interest rates will now rise rapidly as inflation declines, and key interest rates, already at the zero bound, cannot. Since the gold price has floated, after the end of the Bretton-Woods agreement, it has tended to rise when real rates of interest have declined, and fallen when real rates of interest have risen.

As The Solid Ground believes that inflation will fall sharply and thus that real rates will rise sharply, isn’t it time to sell gold? The short answer is no.

Whatever the negative impact on the price of gold from rising real interest rates, there will be a major offsetting positive in the form of rising geo-political uncertainty and ultimately a move to financial repression. That geo-political uncertainty is evident in relations between China and the US, but also in internal relations within an EU entering a debt deflation and seeking an answer to escaping that trap that is politically acceptable to its twenty-seven members. Given such high political uncertainty and the likelihood of “helicopter money”, coupled with financial repression, gold remains very much a buy.

It was never possible to know from where the next deflationary shock would come, though your author wasted much ink on the speculation. Now it is here - at a time when central bankers have failed to boost broad money growth from very low levels, when interest rates are at record lows in Japan and Europe and debt-to-GDP levels are very close to record highs. After a decade of extreme monetary policy we are now in a worse position to deal with a deflationary shock, at least through monetary policy levers, than we have been since the abandonment of the gold standard.

All this means continued pain for equity investors, in particular, but ultimately a resort to government intervention that will seem, at least initially, to provide some form of relief. It is the form and nature of that relief that will set the scene or a whole new way of investing and your author, yet again, recommends that it is time to re-read Capital Management in An Age of Repression (Solid Ground 3Q 2016 - available to subscribers on request).
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