Chimes At Midnight: Cap Day Cometh (02/09/20)

Falstaff: We have heard the chimes at midnight, Master Shallow.

Robert Shallow: That we have, that we have, that we have; in faith, John, we have. Our watchword was 'Hem, boys!' Come, let's to dinner; come, let's to dinner. Jesus, the days that we have Come, come.

Henry IV Part 2, Act III, Scene II

Before we embark on the subject of early reflations, Cap Day, financial repression and the advice of Sir John Falstaff - an invitation! From October 1st to 3rd The Practical History of Financial Markets course will run in London. We have a full complement of teachers and you can find out more about the course at www.didaskoeducation.org. Numbers will be restricted to meet COVID-19 safety protocols and if you would like to book directly please e-mail me at russell@sifeco.org. You may not be someone who believes that the future is replete with inflation and financial repression, but they are perhaps phenomena you might want to understand, along with much more, just in case. Now back to the play.

Since early June The Solid Ground has been arguing that we are in an early stage reflation and that this reflation will push OECD inflation to 4% or above sometime in 2021. Early stage reflation is good for the price of equities and bad for the price of bonds. It is good for the price of gold, though it can begin with some selling of gold as investors shift into equities. Gold remains the major beneficiary of this reflation, though, because the reflation leads surely to Cap Day. When Cap Day cometh gold will likely outperform equities for decades rather than just years.

It is rare for your analyst to speak with any institutional investor who does not believe that Cap Day cometh. On Cap Day action will be taken by the authorities to prevent the rise in market-determined interest rates. On that day there will be a capital exodus from that particular monetary jurisdiction, assuming of course that capital remains free to move. The prospect of prolonged negative real interest rates, possibly of large magnitude and duration, will send savings looking for monetary regimes where there is no such repression.

Cap Day marks the end of the benefits of early stage reflation and it heralds a profound regime change that will last, at the very least, for a few decades. The crucial thing for investors to understand is that Cap Day cannot be implemented by central bankers. That is why Cap Day marks a tipping point for financial assets and the initial beneficiary of early stage inflation, equities in aggregate if not all of them, then cease to preserve the real wealth of savers. Gold is the major beneficiary from the arrival of Cap Day - there are few other beneficiaries.

Many readers would argue that we have long lived in a world without market-determined interest rates, so what’s new about Cap Day? Central bank purchases of government debt have been so huge that clearly there is more than market forces determining the price of government bonds. That is correct, but it has been correct because central bankers have chosen to expand their balance sheets to ward off deflation. In that environment the extensive commercial bank reserves they create in the process of buying government debt are deemed to be in line with their policy objective of creating inflation. In Japan this has allowed the central bank to amass a pile of assets that now represents 124% of GDP. Such an expansion was aimed at creating inflation and it’s an expansion that will continue as long
as there is no sign of the craved for inflation. However, one day there will be inflation in Japan and perhaps the recent jump in broad money growth from 2% year-on-year to 6.5% year-on-year, the fastest growth in thirty years, is the trigger for that inflation. What then for central bank balance sheet expansion? Can it continue?

That central banks have constantly and patently failed to create their targeted level of inflation through balance sheet expansions is something that they have now chosen to ignore for over ten years. For more than a decade their policy has created little in the way of broad money growth or inflation, but has spurred a boom in the growth of non-bank debt and thus a rise in debt-to-GDP ratios. That’s a combination that your analyst long argued was much more likely to lead to deflation than inflation. Today, though, their money creation powers have been purloined by government and broad money growth, across the developed world, has reached a thirty-year high.

If, as The Solid Ground expects, this government-led creation of money now leads to rising inflation, what actions will the central banks take to stop it? Well, based on conversations with institutional investors, the consensus view is that they will buy even more government debt, theoretically without limit, to prevent the yields on these instruments from rising! That is the very last thing they will do. That is not the sort of Cap Day you should prepare for.

When inflation expectations rise, the central banks would normally seek to raise interest rates and shrink their balance sheets. If they are to use their balance sheets to enforce Cap Day, then they will be doing the complete opposite of this. It is common these days to say that there is nothing that central banks are not prepared to do in pursuit of their goals. That is wrong. No developed world central bank will allow the size of their balance sheet to adjust without control, in pledging unlimited buying of government debt at a pre-set yield, when the outlook is for sharply rising inflation. If investors believe that inflation is rising above artificially depressed bond yields, there is no limit to the value of bonds that they will put to the central bank.

Well, there is one practical limit to the value of government bonds that savers and investors can put to the central banks, and that limit is the entire stock of government debt - plus the large and continuing new issuance! Such are the consequences for a central bank attempting to enforce Cap Day using its own balance sheet and thus offering the biggest put in history to investors keen to sell government debt offering negative real yields. Monetization of the stock, and also the new issuance of government debt in a period of rising inflation, is the well-trodden road to hyper-inflation and it is a road that developed-world authorities will not take. When the time comes another mechanism will have to be found to enforce the Cap Day that we all know must come. That is where you come in.

That financial repression is coming is hardly a secret amongst most investors. It has been implemented before and The Solid Ground subscribers can read about the policies of our last financial repression as a guide to this financial repression in Capital Management in an Age of Repression - 3Q 2016 Strategy Report (available to subscribers on request). Your analyst first presented on this subject in late 2010 at a conference in Edinburgh where the Shadow Minister for Work and Pensions, Theresa May, also spoke. In any financial repression the first act of any saver is to remove their savings from the country and I suggested in my conclusion that this is exactly what savers should do, and would do, when financial repression comes. The first question from the floor, after the speeches, was for Mrs May and when asked if she would like to comment on those observations she replied ‘No’. When it comes to the implementation of the policy of financial repression, the less said the better; frightened horses bolt.
Currently governments and central bankers are perusing the stable to estimate which horse will pull the government debt burden through the long financial repression and keep those interest rates low as inflation rises. That is you they are inspecting. When the time comes to enforce Cap Day, you will be told to pull that burden. As the representative of a regulated savings institution, you control the savings that can buy government debt and free the central bank from the destructive task of expanding its balance sheet into an era of rising inflation.

Forcing you to buy government debt at yields below inflation creates no additional money to add to the inflationary fire. With you financing the government, this leaves the government more free to generate the flow of credit through the banking system to those who will likely vote for the government. That credit and money creation policy, combined with measures to restrict the growth in non-bank debt, creates what some call a ‘beautiful deleveraging’ and others refer to as theft. It is of course beautiful for some - debtors - but your analyst would be amazed if it was beautiful for savers.

That savers pay ultimately in any reduction in debt-to-GDP, through the use of inflation, is hardly a surprising statement. The job of the fiduciary is to work out how they will pay and how savers might be protected from such ‘national service’. That ‘national service’ will come is highly likely. That it will be enforced by government and not primarily by central bankers is also certain. With governments now creating money and running the financial repression, it begs the question - ‘What will central bankers find to do all day?’ Could the trip to Jackson Hole become a bi-annual event or perhaps permanent? For central bankers a pair of waders and a copy of Vincent Marinaro’s In the Ring of the Rise could become just as essential as a spreadsheet, some priors, a handful of equations and a well-thumbed Samuelson.

The Solid Ground has argued that central bankers are already impotent, for what is a monetary authority that has lost control of the supply of money? That such impotency occurs just as most investors believe in their supreme power is of course ironic, but it also creates incredible investment opportunities. The impotency of central bankers will only become clearer as whatever remaining tools they have to tackle inflation will be tethered by political pressure and remain unused as governments seek to inflate away their debts. That 2% inflation is insufficient for the job of destroying the current huge debt burdens is obvious. Even if we choose a 2% average through the cycle, there is similarly virtually no impact on debt-to-GDP ratios.

That something more decisive and speedy is called for is hardly a surprise. Central bankers who do not endorse that imperative for higher inflation will find their powers stripped from them. In losing their control over broad money growth, though governments move to control the speed of bank credit expansion, one can argue that they already have lost it. When governments also determine the appropriate level of once market-determined interest rates, through manipulation of the balance sheets of savings institutions, then another crucial power has passed over to the other side. The ghost of Arthur Burns might then stomp the corridors of the Marriner S. Eccles buildings on Constitution Avenue with warnings from the past, present and future much as the ghost of Jacob Marley once stomped into Scrooge’s bedchamber. For Scrooge, though, it proved not to be too late.

When Cap Day cometh savings institutions will have to sell something. Unlike central banks their balance sheets cannot expand at will. Such institutions have a wide range of assets that they could sell. It seems very likely that they would not choose to sell their foreign assets - well, as long as those foreign assets were not themselves being subjected to a financial repression. They will most likely choose to sell local assets to fund the purchase of government debt that has now been forced upon them. In the opinion of this analyst that must mean the sale of equities, as the largest liquid asset available to raise the necessary funds to meet the forced demand to buy government debt. Those sales will not be a one-off
but a long, slow enforced liquidation as savings institutions’ balance sheets fill up with low yielding government debt in a high inflation era.

That prolonged liquidation could come as many corporations seek more equity capital, if part of the financial repression means ensuring that non-bank debt is less available, particularly for what has become the national corporate pastime of financial engineering. An increase in the supply of equity at a time of forced selling of equity by repressed financial institutions is unlikely to be conducive to higher equity prices. Equities, at least in aggregate, cannot preserve the purchasing power of savings in the forthcoming financial repression. When Cap Day cometh the positives from the early stage inflation for equity investors are over.

There are two difficult assessments for any investor given the inevitability of Cap Day. For how long can we continue to enjoy the early reflation that is positive for equities, and who gets to Cap Day first? It is highly unlikely that the governments of the world will co-ordinate their move to Cap Day. It is highly unlikely because inflation and inflationary expectations will change at different places in different jurisdictions. With debt-to-GDP levels at very different levels across the world some governments will be prepared to live with higher costs of government funding and thus private sector funding than others. Perhaps even more importantly, some politicians of a particular hue will be keener to pursue such a theft on savers than others.

We also have to consider to what extent such policies will be challenged through the legal system, and how long it might take to enforce them - perhaps a re-run of the long legal battles that impacted during FDR’s administration. The next Solid Ground quarterly report for subscribers will seek to answer these questions and assess at what level of interest rates Cap Day will likely come, and also who is likely to get to Cap Day first. In particular it will focus on bank equity and just how one might assess its attractiveness as an investment given the early stage inflation, but also the matter of banks’ increasing structural redundancy as private profit-seeking institutions. In assessing which equities can continue to preserve real savings post Cap Day, another key focus will be whether the time has finally come for value stocks - that asset class that these days dare not speak its name. Whoever wins this particular race to reach Cap Day first will face a major decline in their exchange rate as the horses bolt. In the quarterly report I will also assess to which particular green fields they might bolt.

In the opinion of this analyst we remain in the early stages of the reflation and there are many investors who believe that we have not even reached that stage. For those who are undecided and registered with ERIC (www.eric.com), there is an opportunity to hear a recording of myself and Gerard Minack debating that issue last week. I believe that inflation and interest rates can rise quickly, but even so they are low and can rise significantly before Cap Day cometh, meaning early stage reflation is still a positive for equity prices.

There is no set of rules that mandates the relationship between government and savers. There are just the current acts of convenience enshrined in legislation - and then changed when convenient. When the time comes that convenience changes, then so do the rules. That is not a fact that one can garner from a business school education, but it is something that is very clear to any financial historian or indeed reader of Shakespeare. As Cap Day approaches, prepare to see that savers become not willing allies of the prince, but its captive servant. And as ‘the chimes at midnight’ come nearer, the words of Falstaff ring clearer:

The better part of valour is discretion; in the which better part I have saved my life.

Henry IV, Part One, Act V, Scene IV
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