Accidents Will Happen But They Are Not Randomly Distributed? (29/04/19)

This edition of the newsletter is a bit later than usual as your analyst has been travelling, teaching the Practical History of Financial Markets course in Toronto, with a side trip to speak at The Grant’s Spring Conference in NYC and also a week’s holiday in Italy. Before progressing on to the mundane, more dismal data from China - being the key thing analysts continue to choose to ignore - some reflections on those two trips.

After a few hectic days in Toronto and NYC I treated myself to a taxi to the airport rather than the usual trip on the UP. My driver was Mike who provided me, for the first time, with some hard data that explains the difference between the behaviour of principals and the behaviour of agents. Mike runs syndicates for insurance companies: he attracts drivers he believes are good risks and he also makes sure that the body shops are not tempted to inflate payments when repairs have to be done.

The insurance companies like Mike. Mike only recruits owner-drivers to his syndicates. He does this because while an owner-driver can expect a one-in-twelve chance of being in an ‘accident’ in any given year, a third of drivers with no ownership interest in their cars can expect to be in ‘accidents’. This suggests that the standard definition of an accident may need to be amended from ‘an unfortunate incident that happens unexpectedly and unintentionally, typically resulting in damage or injury’. While neither the principal nor the agent may be intentionally seeking to damage the car, the consequences of their actions in driving cars are entirely different. Accidents, it seems, will happen but they are not equally distributed between principals and agents.

A similar theme was evident at a recent Library of Mistakes lecture by Richard Brooks on his new book on problems in the accountancy profession (Bean Counters: The Triumph of the Accountants and How They Broke Capitalism). It was pointed out that auditing in particular was working reasonably well for government entities and also for private entities. The same profession, that provides basically good outcomes in these areas, has been providing dire outcomes in another. The area where the dire results are accumulating is in the area where the agents’ interests are not aligned with those of the principals - listed companies.

Given that lack of alignment, there is ample scope for accountants to be persuaded by the agents in charge of corporate capital that some creative accounting is warranted. In the private and public sector there is little upside to anybody for such ‘creativity’, but of course in the listed-sector there can be significant financial gains for such legerdemain. There are many problems with the so-called global capitalist system, but a key remedy is to get incentives aligned or invest in companies with aligned incentives. A premium valuation is perhaps warranted if, like professional drivers in Toronto, those with aligned interests are likely to have an accident rate only one quarter the level of the unaligned agents.

Meanwhile in Italy, based upon your analyst’s week in the sun, the country continues to struggle with a grossly over-valued exchange rate. Of course, to the holder of GBP just about everywhere seems expensive these days! However, your analyst has noted for some years now the abundance of Italian tourists in numerous cities around the world, a disproportionate number relative to tourists from other developed-world nations. This abundance of travellers is not necessarily what we would expect in a country with a dire and prolonged period of GDP stagnation. Italy’s GDP per capita in real terms in 2018 was just below its 2000 level!

Italy’s current account surplus may have much more to do with depressing domestic consumption than it has to do with competitiveness in export markets. The markets certainly seem to believe
that the exchange rate will continue to contain growth and, after Japan, the lowest five and ten-year inflation break-evens in the global indexed-linked market are still in Italy. According to indexed-linked markets Italy will have lower inflation over both five and ten years than Germany. One wonders how the local politicians view such ‘success’ in containing inflation and how long this economic stagnation is the acceptable face of Italy?

The de-gearing of Italy into this sluggish growth continues. Total non-financial debt-to-GDP in Italy has now declined to just 253% from a peak of 281% of GDP in 2015. While the world frets about the rise in debt associated with Italian government fiscal policy, private sector de-gearing has more than offset marginal misses by the government in its fiscal policy. Meanwhile in France the non-financial debt-to-GDP ratio, at 314% of GDP, remains just below its all-time high set in 2017. For all its problems this analyst is left wondering why markets are so concerned about Italy, a country successfully de-gearing despite sluggish growth, and France, a country with near record high debt-to-GDP levels and sluggish growth!

At the core of Europe are two countries - France and Germany - with non-financial debt-to-GDP ratios of 314% and 174% respectively! One country’s gearing, France, is very near its record high and the other has got a gearing level well below the lowest level recorded since full records began in 1998. Germany has been de-gearing steadily since 2009. France now has a higher debt-to-GDP ratio than Ireland! So much for the successful economic integration of the Eurozone.

Meanwhile global growth continues to slow. The CPB (Netherlands Bureau for Economic Policy Analysis) World Trade Monitor shows the volume of world trade in February 2019 was back to levels first recorded in October 2017. In volume terms world trade has now declined by 3.5% from its peak level in October 2018. Year-on-year we are witnessing the biggest contraction in world trade volumes since 2009! The slowdown is particularly evident in emerging markets with EM import volumes down 8.0% from their October 2018 highs and export volumes down 6.4% over the same period. Given the declines in EM exchange rates through 2018, one might have expected that EM exports would be a beneficiary but, if anything, export volumes have deteriorated despite the exchange rate adjustment. The CPB data also tracks the prices of world trade in USD and shows prices falling by almost 3.0% from their peak in April 2018.

The slowdown in global trade and the rise of the USD - the DXY appears to have broken out of the top end of its range - are causing further problems for emerging markets. While the market is perturbed over the continued slow motion train wreck that is Turkey, a train wreck that this analyst has long maintained will lead to mass defaults on Turkey’s foreign currency denominated debt, the real story for emerging markets is in Argentina. Argentina is benefiting from the largest IMF bailout plan in history and yet the Peso is hitting new lows relative to the USD, and inflation has risen above 50%. Investors fear that the opposition will be elected to power in October and will renege on the IMF deal.

The direct contamination of other emerging markets from the crisis in Argentina may be limited. However, the indirect impact will be large. For a generation of investors the IMF has acted to clean up the mess in emerging markets and to put countries back onto an economic path beneficial to the owners of the country’s assets. A failure by the IMF in Argentina would be a practical example of how politics is shifting in emerging markets. The ability of the IMF to act as a safety net for foreign investors is significantly undermined by this shift. Similarly, the unwillingness of President Erdogan to contemplate any IMF involvement in the stabilisation of Turkey will make it very clear to investors in EM that the change in the global political dynamic, call it populism if you must, has particularly negative consequences for investors in emerging markets.

Meanwhile in China quantitative tightening accelerates while the markets laud easier monetary policy! The total assets of the PBOC declined again in March and have thus declined by 6.4% in 1Q 2019. That, of course, is an annualised rate of contraction of almost 26%! The scale of that
contraction clearly suggests some noise in the data concerning possibly the dates for Chinese New Year. Such a contraction in the Fed’s balance sheet we label as quantitative tightening but such a contraction in the PBOC balance sheet we choose to ignore. Perhaps it is ignored because it’s a contraction that is entirely at odds with the narrative that the PBOC is acting to successfully reflate the Chinese economy. Whatever the monthly noise in the data, the longer-term trend is clearly worrying.

PBOC total assets are virtually unchanged on their early 2017 level and are just above their 2014 level. The Solid Ground has long argued that the lack of growth in Chinese foreign exchange reserves means that the PBOC will be unable to create easier monetary policy in China. While there is many a trick that a central bank can pull to create credit and money without simply increasing the size of its balance sheet, the stagnation in the PBOC balance sheet shows the fundamental constraint that this central bank is under. To the extent that other tools can be used to boost growth, they lead to an external account deterioration which, given the managed exchange rate policy, constrains the ability of the central bank to further ease liquidity and boost growth. While quantitative tightening in the US is about to end, China’s quantitative tightening continues.

China desperately needs a major improvement in its capital account to offset the deterioration in its current account, and to boost foreign exchange reserves growth and PBOC balance sheet growth. Despite accelerating inflows of portfolio capital, there remains no evidence of such an improvement. This can, admittedly, change quickly but at this stage investors need to ask what else is deteriorating in the capital account if accelerated portfolio inflows are not resulting in a material increase in foreign exchange reserves? Your analyst continues to be concerned that quantitative tightening is a somewhat dangerous policy for a country that has entirely failed to degear despite its protestations to the contrary.

The most recent data from the BIS shows China’s non-financial credit-to-GDP ratio reached 252.7% in 3Q 2018 - a successful de-gearing from the 253.4% peak level reached in 1Q 2018! Given the surge in non-bank credit released in recent months, against a background of still sluggish broad money growth and nominal GDP growth, there is every prospect that China is reaching new all-time highs in debt-to-GDP and is involved in quantitative tightening simultaneously. None of this, of course, is what you read about in the newspapers when it comes to China, but foreigners have come to believe that ‘China is different’ and for some reason reflation with no external surplus in a managed exchange-rate regime is indeed possible. The data, however, continues strongly to suggest that it is not.

The data shows a scale of contraction in world trade volumes not seen since 2009 and a year-on-year contraction in the PBOC balance sheet only previously surpassed in the 2015-2016 commodity crisis. Despite these signs of another major growth slowdown and a growing crisis in key emerging markets, US equities, but not other global equity markets, have reached new all-time highs. The markets are betting strongly that the US will be a beneficiary of lower global inflationary pressure while US growth remains robust. Strong earnings/dividends growth rates combined with low risk-free rates, due to a moderation of inflation, are as good as it gets for equity valuations.

Your analyst, however, sees another period of slow growth being the precursor to a credit crisis, with little by way of monetary ammunition to wage war against it. The MSCI World ex US Capital Index is below levels reached in 2018, 2017, 2015, 2014, 2008, 2007 and 2006. This is increasingly a US equity bull market based upon the failure of others, resulting in low global inflation and thus low US interest rates. Of course, accidents will happen and it is just a matter of time until one of these growth slowdowns that have cropped up post-GFC becomes something much more serious. We will see then whether the US equity markets can continue to benefit from the problems of others. Meanwhile, bad data is good news apparently but the so-called global capitalist system continues to be controlled primarily by agents, acting primarily for the benefit of agents, and accidents will happen - more often than they should.
It's the damage that we do and we never know
It's the words that we don't say that scare me so…
Your mouth is made up but your mind is undone
Accidents will happen
They're only hit and run
You used to be a victim now you're not the only one

Accidents Will Happen, Elvis Costello, 1979
Important Legal and Regulatory Disclosures & Disclaimers

This research is for the use of named recipients only. If you are not the intended recipient, please notify us immediately; please do not copy or disclose its contents to any person or body as this will be unlawful.

Information and opinions contained herein have been compiled or arrived at from sources believed to be reliable, but Orlock Advisors Limited does not accept liability for any loss arising from the use hereof or make any representation as to its accuracy or completeness. Any information to which no source has been attributed should be taken as an estimate by Orlock Advisors Limited. This document is not to be relied upon as such or used in substitution for the exercise of independent judgement.

At Orlock Advisors Limited we are committed to protecting your privacy. Our Privacy Policy explains when and why we collect personal information about people who receive Russell Napier’s written research or contact us; how we use it, the conditions under which we may disclose it to others and how we keep it secure. It also contains information how to make a Subject Access Request.

If you wish to receive a copy of this policy or have any questions regarding it, please send an email to dataprotection@orlockadvisors.co.uk

© 2019 Orlock Advisors Limited

Postal Address: Newbattle House, Newbattle Road, Newbattle, EH22 3LH
Scotland

Registered Address: 6 Logie Mills, Beaverbank Business Park Edinburgh, Lothian EH7 4HG, Scotland

Company Number: SC36220