The Jolt of The Needle - Record Low Bond Yields & The Earthquake That Follows. (19/06/19)

"Of all the recording devices that can reveal to an historian the fundamental movements of an economy, monetary phenomena are without doubt the most sensitive. But to recognize their importance merely as symptoms would do them less than full justice. They have been and are, in their turn, causes. They are something like a seismograph, which not only measures the movements of the earth but sometimes provokes them."

Marc Bloch: “Le Probleme de l’or au Moyen Age”; Annales d’Histoire Economique et Sociale; 1953

Across the world many key government bond yields have fallen below both their 2009 and 2016 lows. In 2009 the market thought the world financial system was collapsing and a deflationary depression was imminent. Unless of course one had read Anatomy of The Bear: Lessons From Wall Street’s Four Great Bottoms! In 2016 the market thought that China was about to devalue its exchange rate and key, large commodity producing companies were on the verge of bankruptcy. These were both dark times but not so dark as to push key global bond yields to current levels.

Key Global Bond Yields 2009, 2016 and Current

<table>
<thead>
<tr>
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<th>2009</th>
<th>2016</th>
<th>Current</th>
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<tbody>
<tr>
<td>US</td>
<td>2.05%</td>
<td>1.36%</td>
<td>2.06%</td>
</tr>
<tr>
<td>Germany</td>
<td>2.89%</td>
<td>-0.19%</td>
<td>-0.26%</td>
</tr>
<tr>
<td>Australia</td>
<td>3.85%</td>
<td>1.82%</td>
<td>1.37%</td>
</tr>
<tr>
<td>New Zealand</td>
<td>4.23%</td>
<td>2.14%</td>
<td>1.66%</td>
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<tr>
<td>Denmark</td>
<td>3.45%</td>
<td>-0.03%</td>
<td>-0.23%</td>
</tr>
<tr>
<td>Netherlands</td>
<td>3.35%</td>
<td>-0.03%</td>
<td>-0.09%</td>
</tr>
<tr>
<td>Sweden</td>
<td>2.41%</td>
<td>0.05%</td>
<td>0.03%</td>
</tr>
<tr>
<td>Ireland</td>
<td>4.24%</td>
<td>0.33%</td>
<td>0.28%</td>
</tr>
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As a financial analyst one is often asked, “Where do you see financial bubbles today?” When risk-free rates are this low it is easy to see them everywhere, but of course the biggest bubble must be in those so-called ‘risk free rates’ themselves. Remember these are the ‘risk-free’ assets many financial institutions are forced to hold to reduce their balance sheet risk! In the remainder of this newsletter we will look at what such low rates are telling us, why commodity prices will now move sharply lower, why Australia is heading for big trouble, and why US Treasuries are a buy. (Subscribers can learn more about US Treasuries in the just published Solid Ground Q2 2019 Strategy Report Bonded: The New Normal – How the Fed Funds Up to Half the US Fiscal Deficit).

Your analyst, a known, perhaps too well known, deflationist finds himself in a rather peculiar situation in meetings with clients these days. That peculiar situation is having to argue that it is possible to create inflation at all! In just these past few months many smart, well-informed investors have argued that it is ‘impossible’ to create inflation. This new seemingly structural bearishness on inflation stems primarily from the obvious deflationary impacts from technological breakthroughs. Who can argue that such breakthroughs are deflationary? Having recently read Capitalism In America: A History¹, which in the opinion of this analyst should have been subtitled ‘in praise of deflation’, it would be very difficult to argue against the power of new technologies to produce lower prices. However, that is what I now propose to do.

During a lecture at the University of Oxford last year, I argued that technological breakthrough does not lead per se to lower prices. A professor of physics in attendance took umbrage in the Q&A that followed, pointing out just how much the price of his digital watch had fallen since he first bought one. He was of course correct about the price of his digital watch. The first digital watch, launched in 1972, sold for US$2,100, which was more than the price of a new Ford Pinto. Today Amazon offers such watches for sale at less than US$15. So clearly that’s gross deflation for digital watches, but the only problem is that the general price level has risen 600% since 1972.

Whatever technology wrought in terms of lower prices, men, in particular those who work for central banks, have unwrought through the creation of money. The irony of Alan Greenspan’s celebration of the wonders of deflation from a man who spent a career creating inflation adds a certain je ne sais quoi, as they say in Scotland, to the reading of this otherwise fascinating book. So even as a deflationist I fully recognise the possibility, and actually the probability, that what science proposes – deflation - central bankers can dispose of, inflation. So with that in mind, what does the decline of many government bond yields to zero in the Eurozone and elsewhere tell us about the current success or failure of central banking and the implication for asset prices?

Inflation is fundamentally about the price of commodities. The story above about the decline in price of the digital watch is the long-term story of the price of consumer durables - in direction if not necessarily in magnitude. Readers of David Hackett Fischer’s excellent The Great Wave: Price Revolutions and the Rhythm of History, OUP, 1996 will know that for most of history the price of consumer durables has fallen relative to the price of other commodities.

A case in point was the cost of armour. This, the leading “consumer durable” in medieval Europe, was mainly designed to make a more durable consumer. Iron skullcaps called coifs were worn not merely by soldiers but also by travelling merchants who lived in a world where consumer complaints were forcefully expressed. The price of iron coifs and body armour in the thirteenth century behaved very much like that of washing machines and refrigerators in the twentieth century. It rose in nominal terms, but fell in relation to other commodities for which supply was less elastic.

So even in periods when consumer durable prices have risen in nominal terms, they have declined relative to other prices particularly the price of commodities. So if our central bankers are to succeed in generating higher inflation, in an era of technological marvels and the resultant deflation in the price of consumer durables, they will have to make some impact on driving up the price of commodities. In this they have failed, with the CRB All Commodities Index below its level of 2008, 2011, 2014 and 2018.

In the opinion of this analyst the reason for this failure is not hard to find as central bankers have failed to boost the growth in money. With OECD total M3 growth currently at the lowest level ever recorded, excluding three quarters associated with the GFC, it should perhaps not be surprising that natural deflationary tendencies have not been offset by monetary largesse. History shows that inflation can always be created by the impact on prices, particularly of commodities, of money creation, more than offsetting the deflationary forces of technological progress. There is no evidence that central bankers are currently succeeding in creating a sufficient monetary stimulus to offset technologically driven deflation. The collapse in key bond yields to record lows suggests that their failure continues and, indeed, is intensifying.

It is now ten years exactly since the US, and hence the world, economic contraction ended in June 2009. Since then central bankers have performed acts of balance sheet expansion previously only witnessed in Banana Republics, private equity vehicles, and commercial banks run by risk junkies. The point of such apparent monetary abandon has been to create more money, more inflation, more growth and ultimately to reduce dangerously high debt-to-GDP levels. The world’s bond markets are screaming that they have failed.

While government bond yields in the US are only back to their lows of 2009, when it seemed like the global financial system was collapsing, in the Eurozone and in the Antipodes bond yields have fallen
well below 2009 levels. Perhaps most interestingly, bond yields in Australia and New Zealand have also fallen below their lows of 2016 when commodity prices collapsed and there seemed to be a real threat of a Chinese devaluation and/or a credit crisis. Today, fourteen months into an avowed Chinese ‘reflation’, bond yields in Australia and New Zealand reach new all-time lows on almost a daily basis. It is not just that these yields are reaching new lows, it is the pace at which they are declining. The yield on Australian ten-year bonds has fallen from 2.33% to 1.37% in 2019! This slump in Australian bond yields occurs as the CRB All Commodities Index is marginally above where it began in 2019.

Investors tend to believe that low yields in Australia may have more to do, at this stage, with the consequences from falling residential real estate prices on financial stability, than on the prospect of falling commodity prices. Whatever the reason, new all-time lows on Australian government bond yields do not suggest that global central bankers have succeeded in pushing up global growth and inflation expectations after ten years of exceptional monetary policy. If their success was to be evident anywhere, it would be in commodity prices and hence the outlook for inflation in Australia. The yield on Australian index-linked bonds indicates that investors expect Australian inflation to average just 1.23% over the next five years - also a new low. If such expectations are met, inflation would be much lower than during and after the GFC. Such a rate of inflation in Australia would be a remarkable change in the global inflation outlook given the country’s record of inflation. Since 1964 there have only been nine quarters when Australia’s inflation was below 1.2% and five of those occurred during the Asian economic crisis. There has been no five-year period post-WW2 when inflation in Australia averaged 1.2% or less. If market expectations are correct, inflation in Australia over the next five years will be at levels not seen since the 1930s.

Can such near price stability in Australia really be compatible with stable-to-rising commodity prices and rising global growth and inflation? This should raise concerns for investors about the outlook for global growth, commodity prices, and the failure of central bankers. The monetary seismograph in Australia is suggestive of an earthquake and not a tremor; a decline in commodity prices is the most likely cause of such an earthquake. Investors do not have to look far for the epicentre of that earthquake.

Since last October The Solid Ground has been warning investors that we have entered a Cold War that initially involves China and the US, but which will drag in the rest of the world. The primary impact of such a Cold War is deflationary. This deflation would initially be most powerful for commodities and thus dangerous for Australia, and compatible with current expectations for record low inflation. Indeed, inflation expectations could move even lower. Australia would find itself linked politically to the US and increasingly economically ostracised from China in any Cold War between the US and China.

Already Australia is co-operating with the US to upgrade facilities at the Lombrum Naval Base in Papua New Guinea, and just a few days ago it announced further expansion of influence in the Pacific to offset the role of China. There can be no doubt that Australia sees its political future as an ally of the USA and not of China. This is somewhat economically challenging, given the country’s reliance upon Chinese demand for its products. A continued drift to a Cold War, a China containment policy by another name, must eventually lead to a restriction of commodity exports to China. That one act of China containment would see a gross over-supply of key commodities in the global marketplace and, across the board, price collapses. The economic impact from those price falls would not just be devastating for the Australian economy and credit system, but for central bankers’ ability to generate any inflation at a time of almost record low broad money growth.

As the table above shows it is in Europe, both the Eurozone and in those countries shadowing the Euro, where interest rates have reached particularly alarming new lows. For those who like lending money to governments you can chose the government of Ireland and receive a yield of 0.28% per annum over the next ten years or the government of the US and receive 2.06% per annum for the next ten years. Your analyst would be the first to concede that Ireland, held in the vice-like grip of someone else’s monetary policy and a fiscal policy imposed upon it by the Franco-German power block, could well see lower inflation than the US over the next ten years. However, one has to wonder about the social cohesion of Europe if there is to be, as many bond yields suggest, almost no rise in prices over the next ten years? While some countries have reduced their crushing debt burdens over the past ten years,
many have not, and neither price stability nor deflation is kind to debtors. If bond markets are correct, there is a political and social earthquake coming in Europe.

The implications from record low interest rates in Europe are particularly dire because the Euro is still not a fully formed currency. Most investors choose to ignore that the total non-financial debt-to-GDP ratio of France has risen to 311% from its levels of 223% at the peak of the last business cycle in December 2007. Much more fun to focus on the ‘populist’ Italians with a debt-to-GDP ratio of 253% and falling quickly from its peak of 281% of GDP reached in 1Q 2015. The focus on government debt-to-GDP ratios is key for politicians, but in terms of producing financial stability investors have much greater things to worry about in the excessive and rising private sector debt-to-GDP ratio of France.

While many still assert that the economies of the Eurozone are being ground together, after twenty years of the Euro, this analyst questions why France with a rising debt-to-GDP ratio of 311% is becoming more like Germany with a rapidly falling debt-to-GDP ratio of 176%? If government bond yields are correct, and there will be no inflation for the next ten years, there are very, very different consequences for France and Germany. Those very differing consequences are not likely to lead to greater political cohesion between those two states, or more generally within the EU.

Investors need to ask whether the bond yields of Europe now just reflect our current situation. Or can they indeed provoke, as Bloch warned, the broader future of the continent? The Solid Ground has covered at length the destructive nature of low interest rates on financial stability in Europe (subscribers see Q2 2018 Strategy Report When Monetary Systems Fail – A Guide for the Cautious). The situation is getting worse. You can lend to the French government for ten years at a yield of just 0.08%, presumably on the basis that their high debt burden, plus sound central banking at the ECB, will keep growth and inflation firmly in check in France. The index-linked bond markets also expect that Italian inflation will average just 0.29% over the next five years, just above the expected 0.23% for Japan! Each investor will have to make the very subjective call as to whether civil society would survive another five to ten years of such low growth and such low inflation across the continent. In this analyst’s opinion there are many countries in which it would crumble under such a monetary earthquake. Let us all hope that these bond yields are just wrong, or we are looking at much more than the risk of economic stagnation in Europe.

The quote at the beginning of this report from the famous medieval historian Marc Bloch explains how our monetary condition ‘not only measures the movements of the earth but sometimes provokes them’. It is now urgent for investors to consider what the failure of reflation in Europe, now evident from the record low yields on government bonds, means for the great economic, social and political experiment that is the ‘European project’. Bloch’s ‘monetary phenomena’ are predicting the greatest test yet for a currency, the Euro, still in the early years of its creation. While all credit systems are tested by low growth and possible deflation, this monetary experiment is to be struck by such phenomena at a period of growing political schism with the rise of the far right and the far left.

There is a very high probability that the movement of the earth in Europe is being provoked by monetary phenomenon, unless bond markets are entirely wrong. European equities will be the major losers from this earthquake and US Treasury securities the major winner. Marc Bloch, content largely to dwell in the medieval period, experienced first-hand the personal consequences of that monetary phenomenon known as the Great Depression, in the darkest form of the ensuing political consequences across Europe. Bloch was executed in 1944 for his role in the French Resistance.

“Similarly, when it is not the past that we are studying, but some set of phenomena relating to a principle still active, we expect to be told whenever a new piece of evidence may emerge, in the light of which it is quite possible that the whole elaborate structure of our conclusions will have to be changed.

Marc Bloch, Strange Defeat; written 1940, published posthumously 1946
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