The Unbearable Impoliteness of Seeing - Structural Fracture in Europe (03/09/19)

Your analyst keeps an adder stone on his desk just in case of emergencies. The adder stone is a stone with a naturally occurring hole in it which legend tells can be used to foresee the future. Seemingly it is an old Danish proverb which warns that ‘It is always difficult to prophesy, particularly about the future’. Presumably the great Yogi Berra got his own version - 'It's tough to make predictions particularly about the future' - from his deep understanding of Danish folklore. Who knew?

As the founder of ERIC your analyst prophesied that in the post MIFID II world investment managers would buy individually-priced research from platforms. That has so far proved to be a bad forecast. Recognising that this has not happened, primarily because most fund managers have relied upon the purchase of research subscriptions from key large industry players, ERIC has changed.

ERIC is no longer just a demand-pull platform for the sale of research by its 141 research providers. ERIC now has a sales team who can help you find the research you are looking for and in doing so thus support the sales efforts of independent research providers. ERIC has further bolstered its offering with the launch of Analyst’s Pad, a turnkey solution offering all the services an analyst needs to set up as an independent. So if you are an analyst thinking about an independent future, please feel free to email myself or ERIC’s CEO Daren Riley (daren@eric.com) for further details about Analyst’s Pad and ERIC’s active sales.

There are important reasons why investors should support a high quality and vibrant independent research sector. We all know that the Herfindahl Index, a measure of the concentration of power within any specific industry, is reaching all-time highs in many global industries. (For more analysis see the excellent new book The Myth of Capitalism by Tepper and Hearn, Wiley.) Few people believe that such concentration can ultimately be for the benefit of the consumer or ultimately society. Indeed Adam Smith, the father of economics, equated capitalism with competition, as Jesse Norman explains in his compelling Adam Smith: What He Thought and Why It Matters (Allen Lane & Penguin).

The effect of competition in free markets is thus to keep profits at a minimum. High profits over any sustained period are a sign for Smith of poorly functioning markets, shortage of capital or labour, or the operation of some special (sometimes necessary) privilege. They are associated with poorer, not richer, societies, and with failure not success: ‘The rate of profit does not, like rent and wages, rise with the prosperity, and fall with the declension of society. On the contrary, it is naturally low in rich, and high in poor countries, and it is always highest in the countries which are going fastest to ruin…..’

Lobbying, rent-extraction, very high pay, growing inequality… the pattern seems clear. Yet although it is especially evident in the banking sector, one should not ignore the wider picture. For this is just one extreme example of a much more general phenomenon: crony capitalism.

Those words on crony capitalism come not from Smith but from Jesse Norman, author but also MP and Financial Secretary to the UK Treasury! Few would probably label Mr Norman a friend of Jeremy, Corbyn that is, yet even those on the right of politics and at the seat of financial power realise that crony capitalism has usurped capitalism. In any free society such concentration of power is unlikely to be sustained, though how quickly it will recede is one of those difficult prophesies about the future. As a consumer of investment research, competition in the industry should be to your long-term benefit. If you know any analysts looking to become independent, do let them know that ERIC is here to help.

Meanwhile back at the coal face of forecasting financial markets The Solid Ground continues to see a decline in long-term interest rates, the rise of the price of gold, the financial collapse of Turkey (not yet completed), the decline of commodity prices, the decline of the RMB, the rise of the USD and a bear market in equities. To continue to hold such views, after such major price movements in one’s favour,
seems aggressive to some but it represents a continued belief by your author that we are not living through a cyclical adjustment but a major structural shift.

While one need be ever watchful for a change in direction in a period of cyclical adjustment things are different during structural changes. Yes, of course prices can reverse, usually due to an intervention by the monetary or fiscal authorities, but the structural forces ultimately overpower cyclical forces and also overpower the remedies delivered by the authorities. While many of The Solid Ground’s forecasts have been correct recently, the equity market, or more accurately the US equity market, has held up well despite the decline in those other prices, indicating that we are entering a deflationary storm. It is, however, worthwhile stating that outside the US there is no bull market in equities, either measured over the short-term or over the long-term. Indeed outside the US the dreadful long-term returns from equities tend to confirm that we are living through a structural shift which is not good for equity investors.

Investors often refer to the ‘current bull market in global equities’. That statement does not coincide with the facts for non-US equities. The MSCI World ex US price index is 15% below its 2018 high and is below levels recorded in 2014 and 2007. It is just 7.5% above its 2000 high. The MSCI Europe price index is below its 2015 level, its 2007 level and its 2000 level - not exactly something that will go down in history as a bull market whether you are a short-term or long-term investor. Poor long-term returns are not just evident in Europe. The MSCI Emerging Market price index is 23% below its 2018 high and below levels recorded in 2011 and 2007. The MSCI Japan index is down almost 20% from its 2018 high and is below levels recorded in 2015, 2007 and 1987.

Meanwhile in China the MSCI price index is 26% below its 2018 high and below levels recorded in 2015, 2007 and 1993! Given the growth in nominal GDP, real GDP, corporate profits and central bank balance sheets over these periods, one really does need to ask if there is something structurally depressing returns to investors in non-US equities? If it is structural in nature, what has changed in the structural situation that will result in a rise in the price of non-US equities? If nothing has changed, will these dreadful returns continue? And can the remarkable out-performance of US equities continue?

The Solid Ground sees more than one structural issue facing investors, and subscribers will be aware of those. In this report the focus will be on the structural problem at the heart of Europe. In Europe, the biggest portion of the MSCI ex US index, much of that long-term sub-par performance can of course be attributed to the poor performance of bank stocks. The Euro Stoxx Banks price index, measured in Euro terms, is now just above its 32 year low reached in July 2012. It would be convenient to attribute these shocking returns for bank shareholders to the credit crisis of 2008. However, if that is the cause, why has the S&P500 Banks Index risen more than 200% over the same period, when the US was the epicentre of that credit crisis?

At some stage the markets will have to deal with the inconvenient truth that the destruction of value for investors in Europe, particularly for the owners of financial institutions, is due to the creation of the Euro. Investors who are prepared to accept that analysis, seen by many as plain impoliteness, realise that not only is the current collapse in European bank shares, down almost 30% from their late 2018 peak, not reflective of a cyclical slowdown but is the final structural crushing of a financial sector by a monetary system which has failed a generation of savers - but more importantly a generation of citizens. If this is structural, and perhaps 30 years of zero capital returns suggest it is something more than cyclical, then the structurally enforced pain will continue unless there is some sudden reform to that failing monetary system.

The crushing of a financial system in an economy as big as Europe has implications far beyond a decline in the price of bank equity. It augurs an economic collapse in Europe, a major decline in global growth and a socio-political earthquake in Europe. Most investors are not even prepared to discuss the possibility that European equity prices are being crushed by the failed monetary experiment to create a single currency. Treating the current decline as merely a cyclical phenomenon avoids difficult conversations with one’s fellow Europeans about the failure of a grand European experiment for integration and the dire socio-political implications of its failure.
Any European would flinch from such conversations but ignoring the possibility, your analyst thinks the probability, of such outcomes is doing no one any good, especially not your clients. We are all human and all subject to the desire to put politeness before truth - we do it every day. Investors who choose the hope of European integration and ignore the growing evidence of European financial collapse will pay a heavy price for such politeness.

With every large corporation in the world backing the European project, after all big companies like dealing with big government, do not expect any players in our over-concentrated business world to raise the prospect of structural failure. As Charlie Munger famously said, ‘show me incentives and I’ll show you outcomes’. We have an over-concentrated corporate system whether in business, finance or accountancy which is very clearly incentivised not to discuss the destructive failure at the very heart of Europe. The high level of the Herfindahl Index not only destroys economic opportunity, it ultimately destroys dissent.

Of course, this rather ‘impolite’ forecast by your analyst regarding the crushing of the European financial system due to flaws in the construction of the Euro may be wrong. Indeed, why should anyone invest based on such a forecast when almost everyone will fail conventionally, in line with consensus, should it prove to be correct. After all, failing conventionally is not a particularly dangerous pastime, whereas failing unconventionally can get one fired - or worse. Politeness is, at its heart, very often just a form of consensual thinking and there is often, but not always, safety in the herd. So, what indicators should one watch to indicate that it is time to leave the herd?

For those who prefer to see the world merely as composed of cycles there will still be key warning signals that something more than a cyclical contraction is under way in Europe and it is time to leave the herd. One of those key indicators is the performance of the Euro Stoxx Banks index. The index declined to 77.5 in August 2019, the same level it reached in August 2016 and just above its previous lows of 73.1 in July 2012 and 76.1 in November 1987. Your analyst has never relied upon technical analysis to make any forecast, but is still mindful of what financial security prices may be telling us about the future. Should the Euro Stoxx Banks index decline below the 73.1 level of July 2012, then it would be worth asking whether a 32-year low for European bank stock prices does suggest that we are facing something more than a cyclical slowdown in Europe?

Regular readers will know that your analyst thinks the negative nominal interest rates in Europe, the consequences of an ill-conceived attempt to create a single currency, are leading to the destruction of the European financial system [see German Bund Yields & The Cost of Solvency: What Fresh Hell is This? February 2019; The BRRD and the Fate of Deacon William Brodie, August 2019; and subscribers can consult When Monetary Systems Fail: A Guide For The Cautious, 2Q 2018]. Based on the feedback on that previous analysis, there is general incredulity that such dreadful outcomes await.

Simply put, the belief in policy stimulation as the answer to this structural dilemma is very pervasive, even at a time where monetary policy is clearly very constrained. Time will tell whether your analyst is right or wrong, but if the Euro Stoxx Banks index falls just 9.5% from its current level, to a 32-year low, then it will be more than just your analyst asking whether the monetary policy enforced by the single currency project is indeed destroying the European financial system. There is a reflexive nature in such things and any headlines that draw attention to such important new prices can impact the willingness of both depositors and investors to extend credit to the banking system. A new low on the Euro Stoxx Banks index can thus trigger a reflexive movement in the fundamentals that further undermines financial stability in Europe. That’s a vicious circle that may not be that far away should European bank share prices decline not far below current levels. If such a decline in bank share prices occurs, it may be worth thinking unconventionally - and quickly. Politeness can be in short supply in the queue at the teller’s window.

Another indicator that what is happening in Europe is more than cyclical is the continued decline of the Euro exchange rate. How does a currency of an economy with such a large current account surplus keep declining? The decline is all the more peculiar when one considers that, at 2.8% of GDP, the Eurozone current account surplus is very close to the peak level reached since the creation of the single
currency. With a current account surplus near an all-time high, how can the exchange rate, relative to the USD, be approaching a 16-year low!

One rational explanation is that the monetary system is creating a deflationary force that promotes lower imports and higher exports which, while positive for the current account, is so deflationary that it destroys the fabric of the financial system. Such a mechanism results in a large current account surplus but, at the same time, a capital exodus in search of better returns and financial stability outside the Eurozone. If this explains the large current account surplus, deflationary expectations in Eurozone TIPS markets, a declining Euro exchange rate and the collapse of bank share prices, then it’s a capital flight which is clearly very destructive for equity investors in Europe. Those prepared to believe that Europe faces merely cyclical problems might want to reconsider should the decline of the Euro continue.

There is almost no relief in European financial markets for investors seeking reflationary outcomes. Some relief for investors seemed possible in Italy last week, as Conte looked likely to create a new pro-EU government, but the level of one year deflation implied by the Italian index-linked market got to near a new record of -3.652% - well below its 2009 recessionary lows. Inflation expectations in the French index-linked market are now just below expectations for Germany and also well below 2009 levels. This analyst continues to believe that such low levels of inflation, in the grossly over-gearied French economy, are not compatible with economic, financial or political stability in The Fifth Republic. That belief will be tested in a deflationary recession.

In recent history the levels of inflation and deflation indicated by the European indexed-linked market have occurred during periods when investors have feared for the stability of the financial system. The steady decline in the Euro since 2014, with a brief rally in 2017, is showing that capital flight is driving the decline in the exchange rate as other investors also question the stability of the European financial system. If this is the cause of the accelerating decline in the Euro exchange rate, this is very serious because capital flight can lead to rapid deteriorations in financial stability.

If The Solid Ground is correct in its analysis of the destructive impact on the financial system from negative nominal interest rates, then removing your capital from Europe, even from the so-called risk-free assets of government debt and deposits, will be a symptom of collapse. In a monetary system with no risk-free assets perhaps investors choose to have their risk-free allocations elsewhere. The accelerating decline of the Euro exchange rate towards the end of last week may have marked the acceleration of those capital outflows.

The holders of Euro deposits and government bonds now accept material capital risk for no yield and there are no risk-free assets. There are much better risk-reward opportunities in other financial systems, most noticeably the US, for investors seeking something much closer to risk-free returns. That, to many, is another impolite forecast as few are fans of the current US President and allow that opinion to cloud their views on the risk-free nature of both US Treasury securities and US bank deposits.

Gold is clearly another major beneficiary of the search for risk-free assets in a world where the yellow metal’s lack of yield is no longer seen as a unique liability. What happens when the investors in the world’s largest monetary system, the Eurozone, conclude that there are no risk-free assets available in that monetary system? Given the consequences for the scale of movement in capital outflow from the Eurozone, that is also considered to be an impolite question. The lowest interest rates in history suggest that something extreme is happening. Yet few, if any, are forecasting extreme events.

As with the Euro Stoxx Banks index, investors should be watching to see whether the Euro can fall below its 16-year low to the USD of 1.039. That’s just 5.4% from its current levels. If that happens, the focus will be on the structural forces depressing the level of the Euro and particularly on what is driving capital flight from the Eurozone. In the 2011-2012 crisis capital fled the so-called PIIGS for the German banking system and was easily recycled by the ECB/Eurosystem back to the distressed banking systems. Today we face a very different problem with a massive increase in the risk in what were once ‘risk-free’ assets, and even German bank deposits are now not safe enough for many investors. When that happens capital can leave the Eurozone in vast amounts and the exchange rate can move very
quickly. A continued rapid decline in the Euro exchange rate will thus be another key sign that the Eurozone if facing a structural collapse and not just a cyclical downturn.

The adder stone on your analyst’s desk, complete with hole through which to see the future, was picked up from the beach at Chanonry Point on the Black Isle in the Scottish Highlands. It was picked up just a few hundred yards from the monument to the Brahan Seer. The Brahan Seer, probably born Kenneth MacKenzie, made many prophesies which turned out to be true in the way that vague prophesies often are. However, his very precise and very impolite prophesy that Lady Seaforth’s husband was enjoying the affections of another woman in Paris proved to be his undoing. For that forecast the Brahan Seer was burned to death in a vat of tar at the end of Chanonry Point.

Sometime later, also in Paris, a similar fate befell Marie Antoinette, but for very different reasons. Stepping onto the execution place she trod upon the foot of the executioner and remarked, “Pardonnez-moi, monsieur. Je ne l'ai pas fait exprès” (“Pardon me sir, I did not do it on purpose.”). This apology is perhaps a fitting epitaph for a currency forged in the hope of integration but also forged in economic ignorance and now destroying the very economic and political integration it was designed to establish. Henri Sanson, the executioner that day in Paris, replied to the Queen’s apology, “No madam, please excuse me!” — and thus the politeness continued until the blade fell.
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