European Savers Beware: The Knitting is on the Wall (24/09/19)

There has been a bit of a delay in the appearance of this newsletter as your analyst has been busy writing the new quarterly report - *When Debt Matters: Where to Expect Credit Crises in The Next Recession 3Q 2019*. Utilising the early warning indicator (EWI) data provided by the Bank of International Settlements (BIS), the report looks at those countries where there is a roughly 50/50 chance of a systemic banking crisis within the next three years. As the countries on the warning list comprise 46% of global GDP, it’s a worrying structural problem for the world to face in the next recession. More interesting is which countries do not face such a crisis, most notably the USA and Germany, and the implications this will have for exchange rates and monetary policy. Too much debt rarely matters until it really does and, with growth slowing across the world, the time when it matters is now very close according to those BIS EWIs.

Based upon your analyst’s inbox this week, there are many investors who believe that the squeeze in short-term US dollar liquidity last week augurs the beginning of a new credit crunch. Even as an analyst who expects the worst, given the combination of record high debt-to-GDP ratios and near record low global broad money growth, your author is more sanguine. Subscribers will know from the last quarterly report (*Bonded: The New Normal - How The Fed Funds Up to Half the US Fiscal Deficit 2Q 2019*) that a tightening of the supply and demand conditions for US dollar reserves was expected almost exactly around this period. It would thus be a major coincidence if the sudden surge in the price of short-term money was due to a distressed and forced borrower rather than the expected tightness in reserves.

Of course, coincidences do happen but if the surge in rates is due to such distress why don’t we see that reflected in the commercial paper market? With the Fed providing new reserves on demand, investors are not likely to find indicators of distress necessarily in the market for reserves. If you want to see signs of distress, keep an eye on the market where real people allocate real savings and assess real credit risk. As yet your analyst sees no such distress in the commercial paper market and thus believes that the spike in the price of short-term money relates to the expected tightness in the supply of reserves - a problem which the Fed will fix.

While, in theory, the US banking system is flush with excess reserves, it has been clear for some time that banks will choose to hold more than their legally required level of reserves in the post-GFC world. Until last week it was just unclear what level those chosen reserves would be, but now we know. The Fed has entered the market to provide reserves on a temporary basis but based upon the analysis in *Bonded: The New Normal* this will soon turn into a balance-sheet expansion of a magnitude which, based upon last week’s market reaction and commentary, will still come as a surprise.

The conclusion in *Bonded: The New Normal*, published in June, was that the impact from the tightening in the supply/demand conditions for US dollar bank reserves would be very bullish for Treasury securities. The spike in the price of short-term liquidity last week now sets the scene for another major rally in the price of Treasuries as *Bonded: The New Normal* suggested. A new low for ten-year Treasury yields is now not far away.

The other focus over the period since the last newsletter has been the flagging in the performance of momentum stocks and the upward movement in cycicals. There is much speculation over the cause of such a sudden reversal in trend. *The Solid Ground* believes it is a result of Christine Lagarde’s hearing before the European Parliament’s Economic and Monetary Affairs Committee on September 4th. Lagarde’s submission to the hearing and her answers to questions was one of the most amazing statements your analyst has heard from any central banker since probably even before the retirement of Arthur Burns.

For those who missed it, and it seems many did, Lagarde promised to use her institution’s balance sheet to save the European project and also, by buying government green bonds and not buying non-green bonds, to save the planet! That any mere central banker, charged with a target of price stability, can seek to also achieve these key political aims is remarkable. This was a statement worthy of the
European Commission or Council, both political bodies, but not of an ‘independent’ central banker. By opening the door to funding new green bonds created by European governments or what Lagarde referred to as a ‘common treasury’, her words are a straightforward invitation for European governments to join her in launching helicopter money.

Whatever constitutional limits there may be to such a policy, the new head of the ECB clearly believes them to be surmountable based upon her words to the European Parliament. Openly declaring political goals for the ECB and seeking to fuse the ECB balance sheet with government balance sheets is a revolution in the Eurozone that will indeed, in due course, provide a fillip for cyclical stocks.

Long-term investors will of course have some concerns about the ultimate destination of this deeply politicised experiment in what monetary policy can achieve. A central banker with explicit political targets, to complete the European project and save the planet, is a new virulent strain of the interventionism that has spread through central banking in the past ten years. That it received so little comment is perhaps witness to the fact that the frog of finance has been basking in the increasingly warming ocean of central bank liquidity and is thus even happier to see that temperature rise; boiling surely must be even better?

Your analyst can think of no example in history where such major political goals were achieved by a central bank while also achieving the more mundane target of price stability. Indeed, I can think of no central bank that has embarked upon such overtly political objectives outside of supporting warfare or enacting those imposed upon it by a communist regime. As analysed in the new quarterly report When Debt Matters: Where to Expect Credit Crises in The Next Recession 3Q 2019 dramatic monetary action will also be necessary to save France from its crippling debt burden so cometh the hour, cometh the ex-Finance Minister of France to the ECB.

Helicopter money is now nearer and the markets reacted accordingly with a sell-off in European government debt and a major rebound in the price of European bank stocks. Your analyst believes that the excitement is too early. Whoever takes over at the ECB has little option but to move to helicopter money. The European project is always threatened by recessions that unveil massive debt divergences within the currency zone and, of course, as the adept politician Rahm Emanuel has reminded us, a political operator must ‘never let a good crisis go to waste’.

Lagarde’s submission makes it very clear that this next crisis will be used to bind the European states closer together through ECB direct funding of their green bonds or, much more preferably, binding them through the issuing of bonds by a ‘common treasury’. The unelected central bank will be used to centrally fuse power in the EU as it is increasingly difficult to see the elected governments being able to drag their peoples into such a fusion via the ballot box. Few investors will worry about such an abuse of power, citizens might, but the key question is whether this fusion can happen before a crisis, or only with the ‘good crisis’ that Emanuel believes is so wonderful for policy makers.

There is perhaps one scenario in which a proactive move to the fusion of the ECB with the political bodies of Europe, both local and federal, can happen without an economic crisis. The governments of Europe by themselves or acting through EU bodies could simply declare there to be a crisis - a climate crisis. Under the guise of a climate crisis such ‘emergency’ government spending, funded by the ECB, is likely to be excluded from any fiscal deficit targets. Under the guise of a climate crisis a ‘common treasury’ should be funded to provide Lagarde’s ECB with paper to buy and in return that centralised body would be responsible for allocating those funds across the supplicant states of Europe. In other words a ‘climate emergency’ could be just the ticket for those desperate to glue the states of Europe together and the glue would be the ECB’s balance sheet.

In the old days one had to wait for a good crisis to come along. Now one can declare a crisis. Investors need to be open to seeing a move to helicopter money before we have an economic crisis because we have a declared climate crisis. While seeing such a move as possible, your analyst does not believe it to be probable. Unless there is more evidence of such a European wide move to launch an ECB-funded
green bond initiative, investors should wait for the economic crisis, with its dire impact for European equity prices, before concluding that the helicopter is about to be launched.

In all the excitement of the past few weeks with cyclicals rising, government bond prices falling, and a liquidity squeeze in the US, the euro exchange rate with the US dollar remains almost unchanged. Perhaps investors have realised that whatever a Lagarde Presidency of the ECB means for saving France, saving the European Project and saving the planet, it is not good for the exchange rate. The first major central bank to move to helicopter money may see an initial pop in its exchange rate as short-term capital moves in to participate in a rally in risk assets. However, long-term capital will move in the other direction as savers recognize that their savings need to be destroyed in pursuit of these grand political goals.

Put another way, helicopter money triggers a major acceleration of financial repression in which inflation is boosted while, through administrative measures, interest rates are kept low. No investor need hang around for such theft of their savings as long as the capital account stays open. An acceleration of already large capital outflow from the Eurozone has to be expected as the helicopter takes off and the massive exercise to relieve the Eurozone’s debtors, at the expense of its savers, gets under way.

Christine Lagarde is no stranger to writing large cheques. As head of the IMF she has written a cheque for US$57bn to Argentina which the country is unlikely to repay in full. The reasoning behind the largesse to Argentina is important in assessing what Lagarde’s tenure at the ECB will mean for investors:

“I look at Argentina when it came knocking on the door and it was in a tough place, and we were the only game in town,”

Christine Lagarde, 19th September 2019

To this analyst it seems a peculiar rationale to defend a US$57bn transfer from one set of peoples to another set of peoples because ‘we were the only game in town’. There are many distressed borrowers who would welcome such an approach to credit scoring! Mario Draghi is most famous for proclaiming that he would do ‘whatever it takes’ to save the euro and with it the European Project. Madame Lagarde will be more forthcoming still, recognising that when governments come knocking and are in a ‘tough place’ she will once again be ‘the only game in town’.

These are not the words of a central banker, but soon the Eurozone will have no central bank - just a body fused with government in pursuit of entirely political goals. When that happens, there will be opportunities for investors in cyclical stocks in the Eurozone, but it will be very much picking up pennies in front of the steam roller of financial repression that is set to save Europe’s debtors at the expense of Europe’s savers.

It is savers who will suffer retribution in the monetary revolution declared by Christine Lagarde in her recent appearance before the European Parliament. Dicken’s Madame Defarge famously inscribed the names of those to face retribution in her ‘register.’ Your analyst does not know whether Madame Lagarde knits, but her comments before the European Parliament make it clear that in her register, knitted or otherwise, there is only one name - ‘savers’.

But when it is ready, it takes place, and grinds to pieces everything before it. In the meantime, it is always preparing, though it is not seen or heard.”

Madame Defarge, A Tale of Two Cities, Charles Dickens
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