Modern Monetary Bessies, Financial Repression & The Peril in The Third Knot (12/11/19)

‘Every age has its peculiar folly; some scheme, project, or phantasy into which it plunges, spurred on either by love of gain, the necessity of excitement, or the mere force of imitation.’

*Extraordinary Popular Delusions And the Madness of Crowds: Charles Mackay (1841) (Harriman edition with an introduction by Russell Napier)*

On the theme of ‘popular delusions’ I am delighted to welcome my friend Dylan Grice to ERIC. As most of you will remember Dylan was the top-ranked investment strategist before crossing to the dark side of investment management! Dylan will continue managing money via his new venture, Calderwood Capital, which is expected to launch its first fund early next year. Calderwood will also be making some of its research available to subscribers, via the re-launched and revamped “Popular Delusions”, and we are delighted that they have chosen to partner with ERIC in this endeavour. Dylan always combines high quality analysis with strong opinions and ERIC users can see that for themselves in the first piece of his new strategy product now available to sample on ERIC.

As the oligopoly on the provision of investment research tightens, ERIC continues to offer a home to those seeking to produce truly independent research. We are only 145 research providers in number but Fidel Castro sailed for Cuba with just 82 fighters and only 20 of them survived for long after the landing at Playa Las Coloradas! As Che Guevara later remarked-

‘We reached solid ground, lost, stumbling along like so many shadows or ghosts marching in response to some obscure psychic impulse’.


Che, I am reliably informed, is not alone in searching out Solid Ground ‘in response to some obscure psychic impulse’. And so it is to the main business of The Solid Ground that we now turn, one that Dylan also turns to in his *Popular Delusions* - the prospect of Modern Monetary Theory (MMT); MMT, for those not in the know, being that fair monetary wind, available at the press of a button, that will achieve what ten years of extraordinary monetary policy failed to achieve - a high level broad reflation.

The proponents of MMT are, of course, not the first to seek to conjure up favourable winds, monetary or otherwise. High on Binkie’s Brae, lurking above the town of Stromness on Orkney, Bessie Miller was once in the same business. Sailors, usually whalers or polar explorers on their way north, would call in to see Bessie and buy a ‘fair wind’ for their passage. In Bessie’s case creating such winds involved boiling a kettle and saying some charms and a ‘fair wind’ was called forth.

Today our modern monetary Bessies will credit the governments with newly created money that will then be dispensed to the electorate in the expectation that it will be spent, thus generating higher nominal GDP growth. Such a wind will lead to a reduction in debt to GDP ratios from their current record highs. As this ‘modern’ money comes in the form of an electronic credit to government accounts, it may well cost less than the sixpence Bessie charged Sir Walter Scott for his ‘fair wind’ on his visit to Binkie’s Brae in 1814.

It is presumably this ease of creation that accounts for why something so old can be called ‘modern’. Henry VIII needed tons of copper to pursue his modern monetary theory and even Havenstein, Germany’s central banker during the Weimar Republic, had not just paper and ink to pay for but printers constantly pursuing higher salaries - they seemed to have a better understanding of the consequences
of the task in hand than their boss. MMT, modern in its delivery, requires little labour but great faith that it can be controlled - all its previous exponents have had such faith.

The financial markets seem to be sniffing that the fair wind of monetary largesse, in the form of MMT, is now at their backs. Your analyst begs to differ. It is, I believe, fairly clear that one day the MMT wind will indeed blow. However, we have not yet reached the crisis that will bring political legitimacy to a policy that has historically unleashed not just a monetary but a socio-political hurricane. Of course, we are capable of repeating such peculiar folly but this is likely only after a crisis that will both depress equity prices and trigger a political reaction favouring reflation at all costs. While a smooth transition to folly may well be possible, it is not probable. The purpose of this Solid Ground, however, is not to seek to bring precision to when our modern monetary Bessies decide it is time to boil their modern kettle. The purpose of this piece is to explain how the whistle of this monetary kettle signals the start of an aggressive financial repression that changes the very nature of financial markets. Equities are not the winner, at least in the long-term, that many think they will be when the MMT wind blows.

Lord Adair Turner was probably the first serious policy maker to recommend that policy makers launch Friedman’s helicopter money to boost nominal demand.

“As Friedman illustrated, deficient nominal demand is one economic problem to which there is an obvious and always possible solution- money creation by government fiat. We have tools, moreover, that can ensure that the demand stimulus is appropriately modest rather than dangerously inflationary. And if money finance is excluded, escaping the debt overhang will be far more difficult and economic growth un-necessarily depressed.”

Between Debt And The Devil: Money, Credit, And Fixing Global Finance, Princeton, 2015

I was fortunate enough to join Lord Turner for dinner not long after the launch of his book. I suggested to him that the book did not consider how savers might react to the launch of the monetary helicopter and thus how financial markets might react. In particular, I suggested that long-term interest rates could rise by an amount that might more than offset the reflationary impact of the positive monetary wind. Lord Turner acknowledged that this could be a problem and that something might have to be done about it!

I argued that doing something about it, presumably corralling savers into fixed interest securities, at prospective real yields they considered unattractive, would lead to capital flight in search of better real yields elsewhere. That was also acknowledged as a problem and it was conceded something might also have to be done about that! My conclusion from the evening was that the proponents of helicopter money had either not fully considered the market implications of their policy or, more cynically, were fully aware that manipulating savings, via administrative fiat, to keep long-term interest rates low was something they were very well aware would be necessary, but were keen not to discuss. Subscription will know the huge scale of the administrative operation that will be necessary to keep interest rates ‘quiescent’, to use a word favoured by Alan Greenspan, in an age of monetary drops and higher inflation (see Capital Management in An Age of Financial Repression: A Handbook 3Q 2016).

To be clear - that first monetary drop, as The Solid Ground argued in September, most likely in the Eurozone, will push equity prices sharply higher. Indeed, the price of European banks could well double as the prospect of insolvency recedes. Soon, however, the scale of the administered repression necessary to keep interest rates at punitive low real rates will be apparent and the negative implications for efficient capital allocation, the price of equities and real returns, will be clear. There has not yet been a successful repressory policy without capital controls, though as I have argued before, these new capital controls could be more de facto than de jure. It is difficult to think of a policy more injurious to portfolio construction and total returns than the return of capital controls.

With such an aggressive policy in place to inflate away debt burdens, most of what investors think they know about investment will become redundant. A prolonged period of rising inflation, combined with ever-increasing regulation to push savings to where governments believe they are required, is a
dangerous new normal. With credit politicised for a generation and unavailable for the politically incorrect project, such as gearing up assets and buying back shares, we should face a prolonged period of re-equitisation for listed corporations and their owners, particularly highly geared owners. The replacement of cheap debt, as measured in real terms, alongside ever more expensive equity, is not a good combination for positive long-term returns for equities. Those corporations well prepared for this storm, having issued low coupon debt of long maturity, will weather the gale of financial repression with greater ease.

In the past few weeks bond prices have fallen and equity prices have risen. This little outperformance still leaves bonds very much the long-term winner against all but US equities. From March 2000 the Barclays Bloomberg Treasury Total Return Index has risen by 140% while the MSCI World ex US Total Return Index has risen just 90%. It is thus tempting to believe, when financial repression spells clear doom for long-term real returns from bonds, that the time has come for equities. In relative terms that may well be correct, but particularly in gold terms it is likely to be very incorrect. The Solid Ground continues to believe that equity investors will have to face a deflationary crisis before they hear the whirr of the monetary rotors and receive relief from deflation. Thereafter, however, it is the slow grind down in equity valuations associated with financial repression that is likely to produce poor real returns for equities.

When Bessie Smith died, not long after Sir Walter Scott’s visit, there was a gap in the market. This was seemingly filled by a Mammie Scott. Mammie brought significant technological progress to the wind-selling business and would sell sailors a string with three knots - no doubt an advance seen at the time as ‘modern’. When wind was required a knot was to be untied bringing a degree of precision that the old technology, in the form of Bessie’s boiling kettle, could not offer. One captain used Mammie’s string, untying two knots, to freshen the wind that took him successfully to his first port of call. Out of curiosity he untied the third knot and that unleashed such a hurricane, blowing in the wrong direction, that it carried him back to the port of Stromness!

The past failure of our monetary Bessies is not likely to deter new buyers, especially now that they are confident of their modernity and thus their precision. Whether they know about the necessity for aggressive financial repression that their policies necessitate is open for debate; I think many do not. However, even if they did, it is not something that will stop them as their policy is aimed at reallocating wealth from savers to borrowers and thus repressory policies are grist to this mill, whether necessitated by design or accident.

So, what if MMT also involves corralling savers into the killing pens of fixed interest securities as a part of the process? Savers, after all, have had it too good for too long and who will weep over the ‘euthanasia of the rentier’. Your analyst, however, remains deeply sceptical that destroying savings - what the modern monetary Bessies will prefer to call the destruction of debt - is ultimately beneficial, though the scale of the consequences will unfold over many years. And what man, or woman, with such a seemingly fair wind at their back will ultimately resist the temptation to untie the third knot.

_Idiot wind, blowing through the buttons of our coats_
_Blown through the letters that we wrote_
_Idiot wind, blowing through the dust upon our shelves_
_We’re idiots, babe_
_It’s a wonder we can even feed ourselves_

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