GORDON T LONG

Advanced Technical Analysis

Gordon T Long
Global Macro Research | Macro-Technical Analysis

Technical Analysis
Market Road Maps | HPTZ Methodology

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NOTE

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FINANCIAL REPRESSION

November 23rd, 2022

AGENDA

FINANCIAL REPRESSION

WHAT IS FINANCIAL REPRESSION?
- Definition - How Government Debt is Actually Extinguished
- A Monetary Macroprudential Strategy - Not a Conspiracy
- History - Post WWII - Cap Controls & Regulatory

NEGATIVE REAL RATES
- Current Situational Analysis
- Fed Repositioning – Financial Repression III

THE ECONOMIC GROWTH CHALLENGE
- 4% Growth in a Beta Drought Decade
- Era of Stagflation & Stagnation - DJI: Gold Ratio

THE EVOLVING SOLUTION
- Government Not Central Bank
- Fiscal & Regulatory not Credit

CONCLUSION
- The Unholy Trinity & Return to Sound Money

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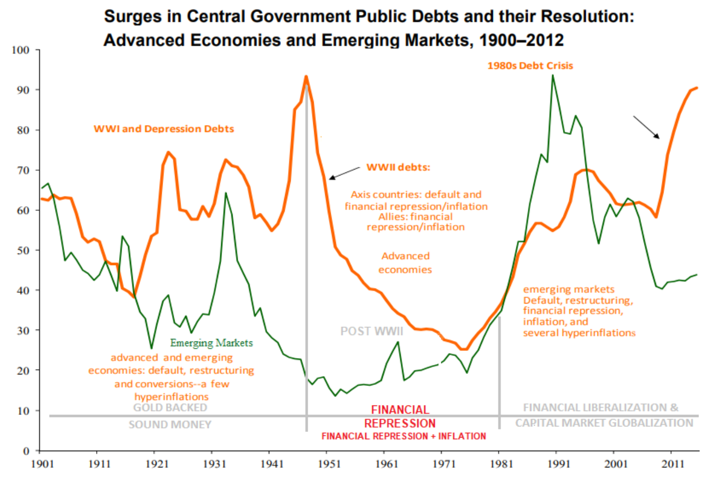


Sources: Reinhart and Rogoff (2009 and updates), sources cited therein and the authors.

WHAT IS FINANCIAL REPRESSION

Throughout history, debt/GDP ratios have been reduced by:

1. Economic growth,
2. Substantive fiscal adjustment/austerity plans,
3. Explicit default or restructuring of private and/or public debt,
4. A surprise burst in inflation,
5. A steady dosage of financial repression accompanied by an equally steady dosage of inflation.

NOTE:

- Options 4 and 5 are viable only for domestic—currency debts.
- Since these debt-reduction channels are not mutually exclusive, historical episodes of debt—reduction have owed to a combination of more than one of these channels.

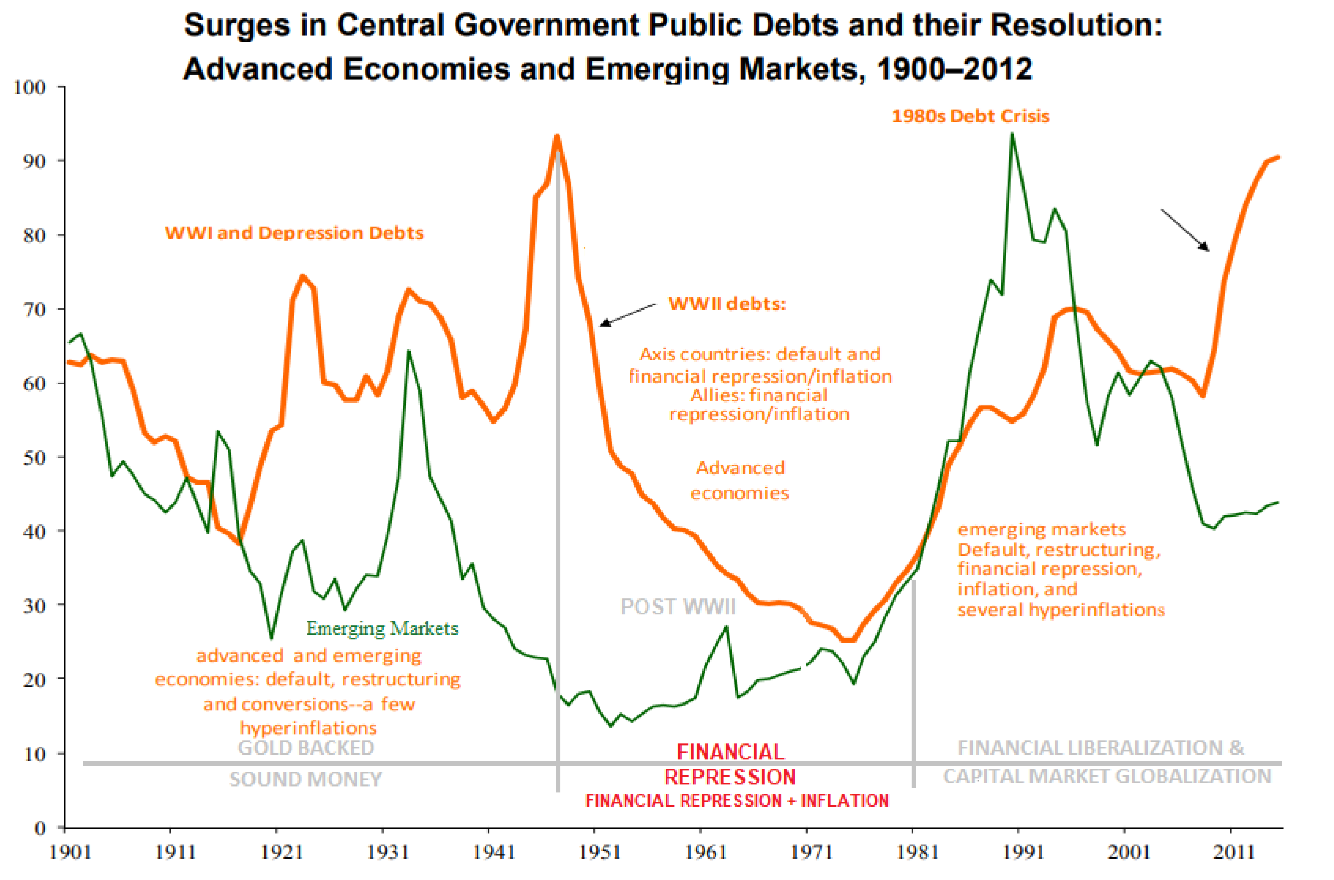
There is considerable country specific variation in the extent of implementation of financial repression. Two elements however are consistent:

THE LIQUIDATION EFFECT

- When controlled nominal interest rates coupled with inflation produce **negative real interest rates**, it liquidates (reduces) the stock of outstanding debt.
- This is referred to as *the Liquidation Effect*.

FINANCIAL REPRESSION TAX

- Even in years when **real interest rates are positive**, to the extent that these are kept lower than they otherwise would be via interest rate ceilings, large scale official intervention, or other regulations and policies, there is a saving in interest expense to the government.
- These savings are sometimes referred to as the *Financial Repression Tax*.



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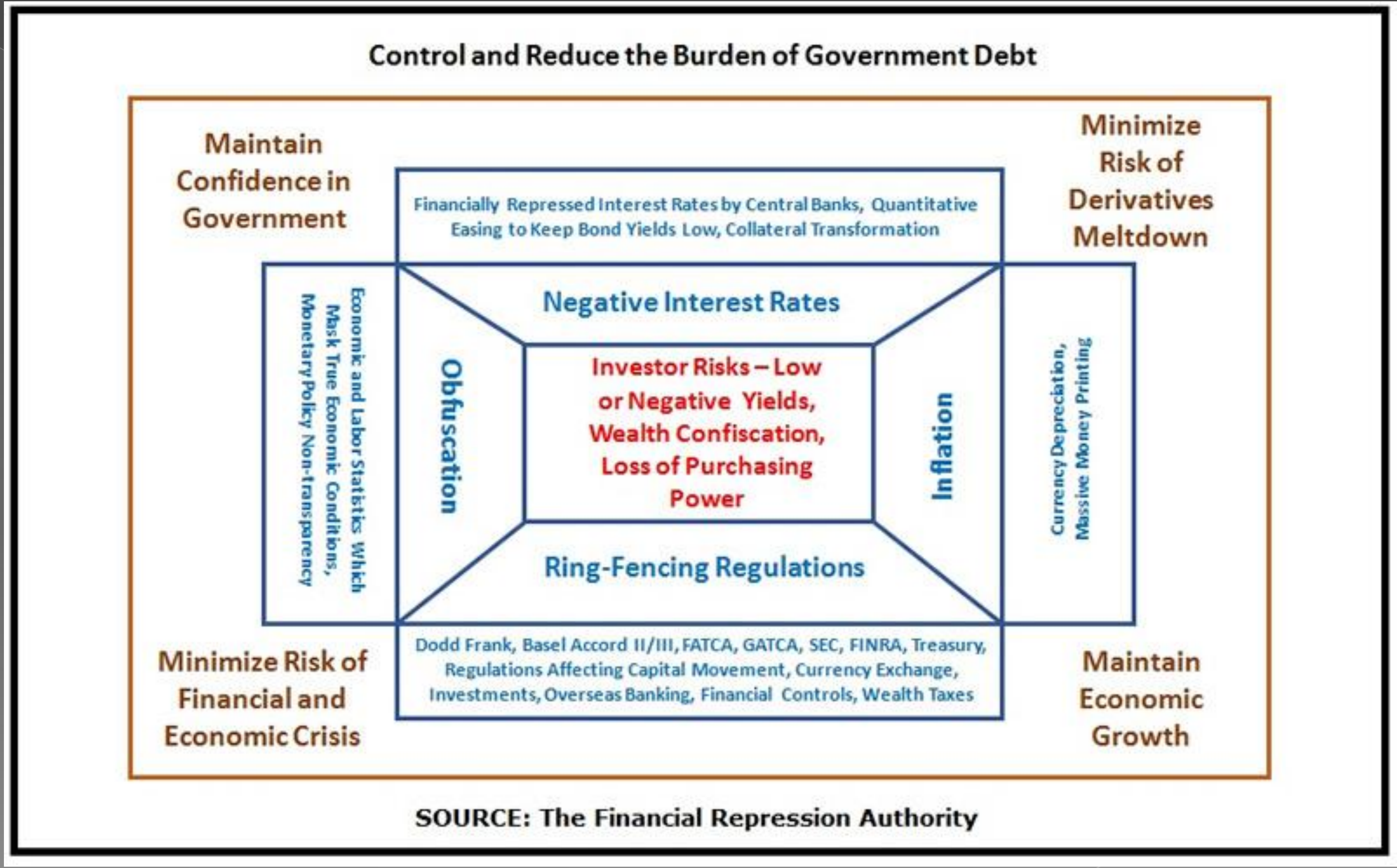
PRE-FINANCIAL 2008 CRISIS: "Austerity Centric"

- Prior to the 2007 crisis, it was deemed unlikely that advanced economies could ever experience financial meltdowns as severe as those of the Pre-World War II era,
- The prospect of a sovereign default in wealthy economies was similarly unthinkable.
- Repeating that pattern, the ongoing discussion on debt reduction had focused almost exclusively on the role played by **fiscal austerity or adjustment.**
- It apparently had been collectively forgotten that the widespread system of financial repression that prevailed worldwide from 1945 to the early 1980s played an instrumental role in reducing or liquidating the massive stocks of debt accumulated during World War II in many of the advanced countries, United States inclusive.


Control and Reduce the Burden of Government Debt
Maintain Confidence in Government
Minimize Risk of Derivatives Meltdown
Financially Repressed Interest Rates by Central Banks, Quantitative Easing to Keep Bond Yields Low, Collateral Transformation
Negative Interest Rates
Economic and Labor Statistics Which Mask True Economic Conditions, Monetary Policy Non-transparency
Obfuscation
Investor Risks – Low or Negative Yields, Wealth Confiscation, Loss of Purchasing Power
Inflation
Currency Depreciation, Massive Money Printing
Ring-Fencing Regulations
Dodd Frank, Basel Accord II/III, FATCA, GATCA, SEC, FINRA, Treasury, Regulations Affecting Capital Movement, Currency Exchange, Investments, Overseas Banking, Financial Controls, Wealth Taxes
Minimize Risk of Financial and Economic Crisis
Maintain Economic Growth
SOURCE: The Financial Repression Authority

POST FINANCIAL 2008 CRISIS – Financial Repression II

In the post 2008 crisis debt-laden environment financial repression once again resurfaced in its many forms among the advanced economies:

Through a variety of techniques. Here are just a few examples:

1-GLOBALLY

• **Explicit or indirect caps or ceilings on interest rates**, particularly (but not exclusively) those on government debt. These interest rate ceilings could be effected through various means including:

(a) Explicit government regulation (for instance, Regulation Q in the United States prohibited banks from paying interest on demand deposits and capped interest rates on saving deposits

(b) Explicit government regulation , which were a direct subsidy to the government in cases where it borrowed directly from the banks (via loans rather than securitized debt)
(c) Interest rate cap in the context of fixed coupon rate nonmarketable debt or
(d) Maintained through central bank interest rate targets (often at the directive of the Treasury or Ministry of Finance when central bank independence was limited or nonexistent).

• **Creation and maintenance of a captive domestic audience that facilitated directed credit to the government.**

This was achieved through multiple layers of regulations from very blunt to more subtle measures.

(a) **Capital Account Restrictions** and exchange controls orchestrated a "forced home bias" in the portfolio of financial institutions and individuals under the Bretton Woods arrangements.
(b) **High Reserve Requirements** (usually non-remunerated) as a tax levy on banks comparison). … Among more subtle measures,
(c) **"Prudential" Regulatory Measures** requiring that institutions (almost exclusively domestic ones) hold government debt in their portfolios (pension funds have historically been a primary target).
(d) **Transaction Taxes on Equities**
(e) **Act to direct investors toward government (and other) types of debt instruments**. And
(f) **Prohibitions on gold transactions**.

Other common measures associated with financial repression

(a) Direct ownership (e.g., in China or India) of banks or extensive management of banks and other financial institutions (e.g., in Japan) and
(b) Restricting entry into the financial industry and directing credit to certain industries

2- UNITED STATES - Selected Financial Regulations, 1930s–1980s

- **Government Securities Price Support:** During World War II there was an agreement between the Federal Reserve and the Treasury to support the price of government securities in the market. The Treasury had set a structure of returns for securities of different maturities: 3/8 Percent on 90-day T-Bills, 7/8 Percent on 12-month certificates, and higher rates on longterm issues up to a maximum of 2.5 Percent on the longest term taxable bond.

- The Fed announced that it would buy and sell securities in the market in order to maintain the prices of bonds at par. As a result, long term securities were liquid and investors were protected from capital losses.
- With the war over, the policy of low interest rates was continued. As the Treasury's debt-management program had three principal objectives:
  - To reduce the amount of the debt,
  - To maintain government credit and keep debt costs low, and
  - To widen the distribution of Federal securities. Keeping interest rates low was particularly important to the Treasury, in order to prevent debt servicing expenses from increasing even more. At the end of the 1940s, some members of the Fed started to push to eliminate the price support and to allow interest rates to rise. After several negotiations, the Fed and the Treasury reached an "accord" in March of 1951

Exchange of Marketable for Nonmarketable Debt

Interest Rate Ceilings

Margin Requirements: Regulation T

Gold restrictions-capital controls

Moral Suasion

Persistent Positive Inflation ***(continuously short of 2% target)*****,**

Regulatory changes,

Directed Credit

Capital Controls

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FISHER'S EQUATION

NOMINAL – INFLATION = REAL RATE

RECENT - Post GFC

ZERO Bound

0.0% - 1.2% = - 1.2%

EMERGING ENVIRONMENT

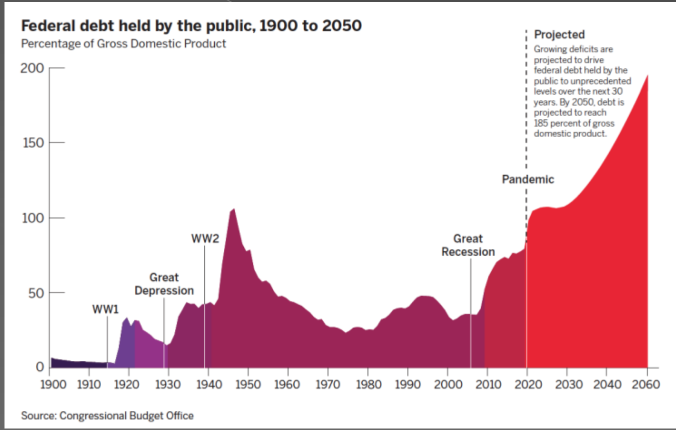
TEMPORARY 4.0% - 8.0% = - 4.0%

3.0% - 4.2% = - 1.2%

WAS - Post WW II

FLUCTUATIONS 6.0% - 7.2% = - 1.2%

EMERGING ENVIRONMENT



3.0% - 4.2% = - 1.2%

10 Years = 12.7%
15 Years = 19.6%
30 Years = 43.0%

Negative Real Interest Rates

Since 2010, the U.S. Treasury has been obtaining negative real interest rates on government debt, meaning the inflation rate is greater than the interest rate paid on the debt. Such low rates, outpaced by the inflation rate, occur when the market believes that there are no alternatives with sufficiently low risk, or when popular institutional investments such as insurance companies, pensions, or bond, money market, and balanced mutual funds are required or choose to invest sufficiently large sums in Treasury securities to hedge against risk. Economist Lawrence Summers states that at such low interest rates, government borrowing actually saves taxpayer money and improves creditworthiness.

In the late 1940s through the early 1970s, the U.S. and UK both reduced their debt burden by about 30% to 40% of GDP per decade by taking advantage of negative real interest rates, but there is no guarantee that government debt rates will continue to stay this low. Between 1946 and 1974, the U.S. debt-to-GDP ratio fell from 121% to 32% even though there were surpluses in only eight of those years which were much smaller than the deficits.[48]

"FLY IN THE OINTMENT!"

Achievement of 3% Growth With Inflation at 4.2%??

- Looming Era of Stagflation
- 3% Finance Rates Killing Housing – Adjustment Period
- Zombie Corporations
- US Debt – Interest Payments

A 7.5% YIELD

	1995	2005	2016	NOW
Bonds	100%	50%	15%	85%
Equities	0%	40%	60%	15%
Alternatives	0%	10%	25%	

"Just a year ago, the U.S. 2-year treasury notes were yielding 25 basis points. And today, they're earning 4%, corporate bonds are over 5% and high yield is above 9%. So let me give you a little helpful context. If we go back in 1995, to get a 7.5% yield, which is what many institutions were looking for, a portfolio could be in 100% bonds. If you fast forward 10 years, in 2005, it had to be 50% bonds, 40% equities, and 10% alternatives. Then move another 10 years. And in 2016, you needed only 15% bonds, 60% equities and 25% alternatives. This describes the growth of several markets. Now today, to get that same 7.5% yield, a portfolio could be in 85% bonds and then 15% equities and alternatives."

Larry Fink
Chairman & CEO
Q3 2022 Earnings Call

BlackRock

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The US is likely entering another extended period of poor returns

Source: Gerard Minack, Downunder Daily


DJI:GOLD RATIO
Monthly
DOTCOM BUBBLE
PERIOD OF TECH BUBBLE
1995
CYCLICAL PERIOD OF STAGFLATION
PERIOD TO BE IN GOLD
CYCLICAL PERIOD OF STAGNATION
PERIOD TO BE IN GOLD
PERIOD OF QE
2011
COVID-19
TRIPLE TEST
POTENTIAL 18-24 Months
PERIOD TO BE IN EQUITIES
CRITICAL SUPPORT LINE
PERIOD TO BE IN GOLD
THE BETA DROUGHT DECADE
THE GREAT STAGFLATION?
SECULAR PERIOD OF STAGNATION
64.00
51.50
41.50
33.50
27.50
21.50
17.50
14.50
11.50
9.50
7.50
6.00
4.50
3.70
2.90
2.40
1.90
1.55
1.25
1.00
0.82
1967
1972
1977
1982
1987
1992
1997
2002
2007
2012
2017
2022
2027
2032
2037
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- Structural In Nature,
- Free Markets versus Government Allocations,

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    - **Therefore GDP Growth Rate Must be Maintained at Higher Levels**

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    - **Government “Guarantees” Allows Governments To Create Money,**
    - **Guarantee are Off Balance Sheet “Contingent Liabilities.**

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    - **A Consequence of the Shift from Capitalism to Creditism.**

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    - A Consequence of the Shift from Capitalism to Creditism.
- **Governments Will Focus on Getting Higher Growth through Inflation**
    - **Nominal Growth = Real Growth + INFLATION**
    - **Maximum Inflation Range of 4% to 6%**

IMPLEMENTATION

- Disconnect Between Hawkish Central Banks and Dovish Governments
  - Governments Don't Ask – They Just Do it and Central Banks React!

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POLITIZATION OF CREDIT

• **Money Flows Are The New Game**

LIKELY APPPROACH:

1. **Increasing Government Use of Credit Guarantees,**
2. **Aim for a consistent high Growth Rate of Money (not to high),**
3. **Reinforcement of Regulatory Capture (the "Regulatory State"),**
4. **Engineer Nominal Growth & Inflation Rates > Interest Rates**

Moving from a mechanism where bank credit is controlled by interest rates to a Quantitative Mechanism that is Politicized.

ALREADY HAPPENING

• We are headed into a significant growth slowdown, even a recession, and bank credit is still growing,
• Commerzbank: *“Government Would Not Allow Larger Debtors to Fail!”*
• Relatively small bank loan Loss reserves again in Q3 though all banks are signaling a looming Recession?

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PUSHBACK?
• **We already have a captured investor base that just has to buy government bonds.**
• **If push comes to shove, the central bank would step in and prevent yields from rising higher, with the ultimate policy being overt or covert yield curve control (YCC as in Japan).**

THE END GAME?

STAGFLATION

Stagflation is the combination of high inflation PLUS high unemployment.

SEQUENCE NEEDED & TO BE EXPECTED

1. A boom in capital investment and high growth in nominal GDP,
2. Arrival of high inflation and high unemployment,
3. The Acceptance of a Hard Money Policy

A long Social and Political journey to a Political Economy

HOW TO AVOID THIS OUTCOME

What would have to happen to avoid this path?

1. If governments went out of interfering with the banking system,
2. Reinstated private sector credit risk and
3. Handed back control over the growth of money to central bankers.
4. A huge productivity revolution that would make real GDP grow at 4%. This would allow us to keep inflation at 2% in order to get nominal growth of 6%.

WHAT WILL THIS ALL MEAN FOR INVESTORS?

1. Avoid government bonds. Investors in government debt are the ones who will be robbed slowly.
2. Within equities, there are sectors that will do very well.
   - The great problems we have of energy, climate change, defense, inequality, our dependence on production from China – will all be solved by massive investment.
   - This CAPEX boom could last for a long time.
   - Companies that are geared to this renaissance of capital spending will do well.
3. Gold will do well once people realize that inflation won't come down to pre-2020 levels but will settle between 4 and 6%. The disappointing performance of gold this year is somewhat clouded by the strong dollar. In yen, euro or sterling, gold has done pretty well already.

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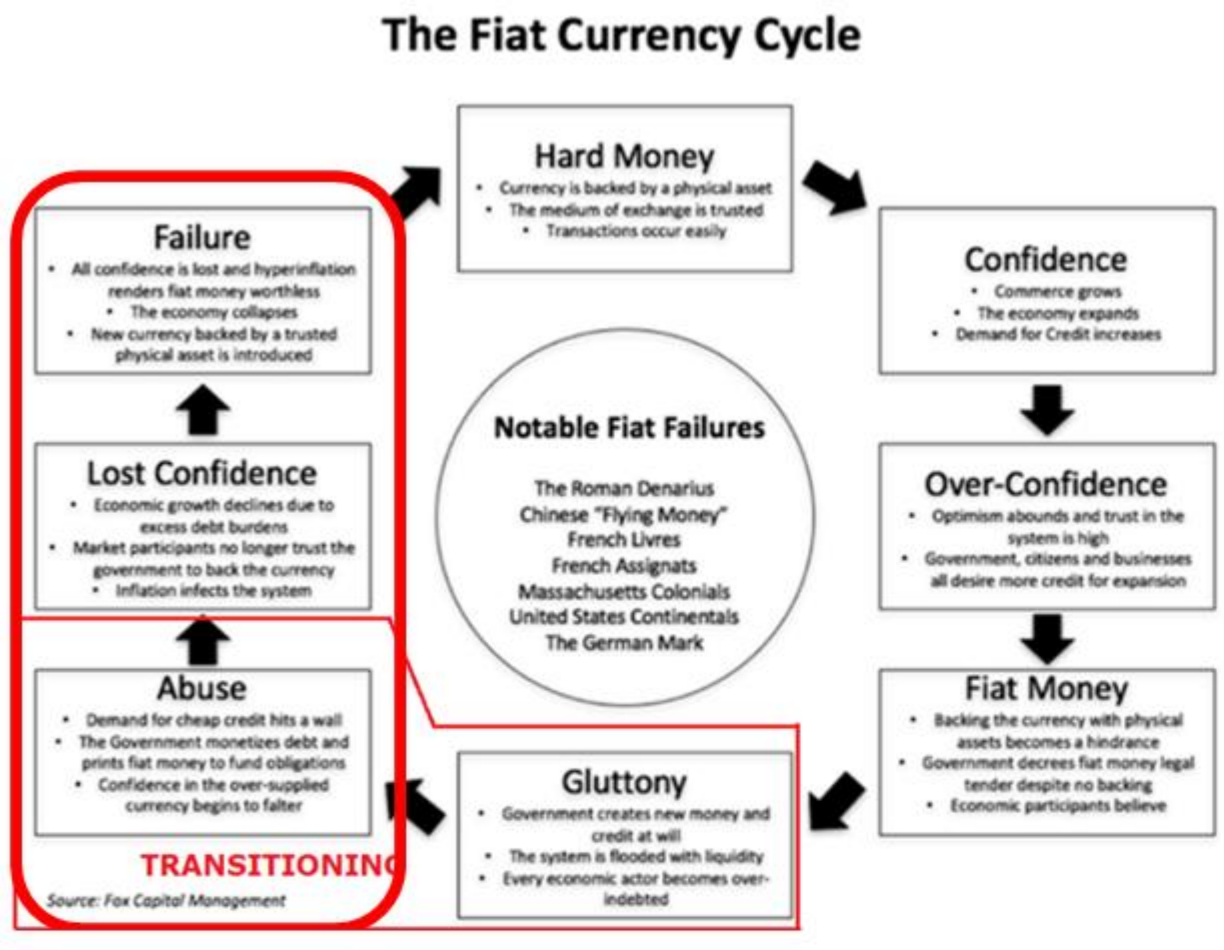
"THE UNHOLY TRINITIY"

	PEGGED EXCHANGE RATE	INDEPENDENT MONETARY POLICY	FREE CAPITAL FLOWS
US	X	X	X
JAPAN	X	X	X
UK	X	X	X
EURO	X	X	X
CHINA	X	X	X



The Fiat Currency Cycle
Hard Money
• Currency is backed by a physical asset
• The medium of exchange is trusted
• Transactions occur easily
Confidence
• Commerce grows
• The economy expands
• Demand for Credit increases
Over-Confidence
• Optimism abounds and trust in the system is high
• Government, citizens and businesses all desire more credit for expansion
Fiat Money
• Backing the currency with physical assets becomes a hindrance
• Government decrees fiat money legal tender despite no backing
• Economic participants believe
Gluttony
• Government creates new money and credit at will
• The system is flooded with liquidity
• Every economic actor becomes over-indebted
Abuse
• Demand for cheap credit hits a wall
• The Government monetizes debt and prints fiat money to fund obligations
• Confidence in the over-supplied currency begins to falter
Lost Confidence
• Economic growth declines due to excess debt burdens
• Market participants no longer trust the government to back the currency
• Inflation infects the system
Failure
• All confidence is lost and hyperinflation renders fiat money worthless
• The economy collapses
• New currency backed by a trusted physical asset is introduced
Notable Fiat Failures
The Roman Denarius
Chinese "Flying Money"
French Livres
French Assignats
Massachusetts Colonials
United States Continentals
The German Mark
TRANSITIONING
Source: Fox Capital Management

ADMINISTRATIONS CHANGE – BUT THE PRINTING NEVER DOES ….

DON'T WORRY, THEY WILL PRINT THE MONEY!

EVERYONE IS NOW IN PLACE & READY!!

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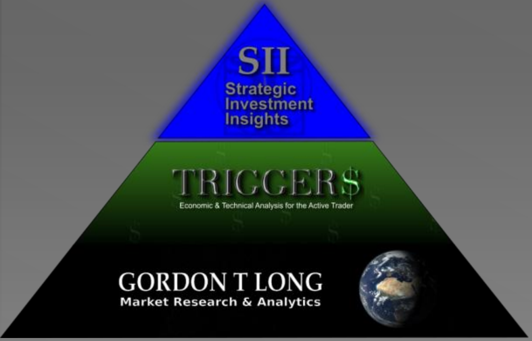

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