MONETARY SCENARIOS

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Global Monetary Viewpoint

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EXECUTIVE SUMMARY:
"Stimulus policies" of the central banks this year mean even greater repression of interest rates on government bonds, especially in Europe and Japan.

The consequence has been an increase in demand for assets whose returns are not directly subject to such repression – especially equities.

In a fundamental sense though, there is no escape possible in general from monetary repression.

A high premium price on the alternative assets (to government bonds) eventually goes along with a lowered rate of return.

The same principles apply here as for the usual illusionary escape from taxation offered by tax havens.

A speculative run in haven assets, though, can create an illusion of escape for a lengthy period of time.

Monetary Repression creates a "Monte Carlo Premium": sky-high and vulnerable

The flight of capital out of Europe is most likely entering a new episode, marked by heightened momentum.

German recession, threat of trade war with the US, political tumult in Berlin likely to feature a "Green earthquake" (bringing about a Green-CDU government most likely without the CSU), Asia (once, the epicentre of boom) in the forefront of global pessimism, a populist tide sweeping aside one-time political elite in Rome and a UK exit from the EU amidst total failure of the Franco-German axis to have steered a harmonious path – these are all factors driving capital outflow from Europe.

More important than anything on that list is the plight of the euro, now to be put under a French politico (found guilty of negligence by judges in Paris - when holding the position of Finance Minister - as turning a blind eye to a 400m euro "arbitration award" to a friend of then President Sarkozy), already headed into the wildest and most radical experimentation of the fiat money era.

Sustained and ever starker negative interest rates in Europe, have been fuelling (in combination with monetary inflation elsewhere and most importantly the US) a highly distorted pattern of prices in global asset markets.

That is the main subject of today's Viewpoint, and as an introduction the reader is invited to consider the topic of "the Monaco premium".

What is the Monaco premium?

A 100 metre-square apartment in the principality of Monaco sells for several times the price of the same type of real estate in the neighbouring French city of Nice.

Why? Because individuals who gain residence in Monaco pay no tax on their worldwide income, whereas in Nice they are likely to be subject to the full taxation load of the French state or of whatever state to which they report.

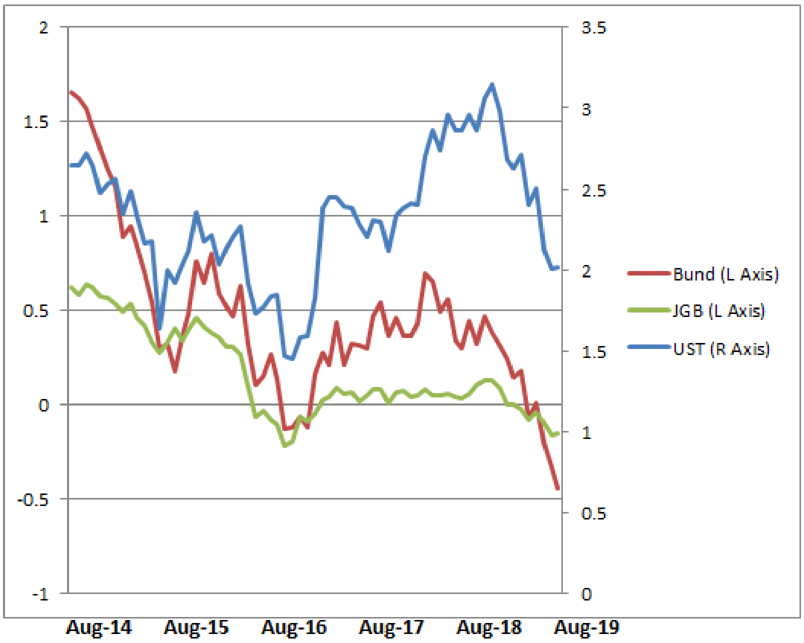
In effect, any individual weighing up the benefits of the tax haven has to offset the huge premium which he or she pays for real estate there.

Sometimes, luck will be on the seeker of the haven's side. The premium may get even bigger over a given holding period, meaning that the tax refugee makes handsome capital gain which more than offsets the implicit premium rent.

This could occur, for example, if the global search for a haven gets even more desperate, perhaps because tax rates are increasing or perhaps because overall wealth is rising fast.

Alternatively, real estate in the haven may become subject to one of those waves of speculation driven by global monetary inflation (and the speculative narrative here would be increasingly oppressive taxation).

Government bond yields



Data Source: Bloomberg

Monaco premium is a cost not a gain - normally

It would be irrational however to count on such luck continuing.

Almost by definition, efficient markets over the long run would do a decent job of discounting future wealth gains for example, and those should not be a source of ever rising premiums on haven real estate (in this example).

Furthermore, a precipitous decline in the price of haven real estate can occur, inflicting big loss on present holders; such would be the case for example if there were a world slump causing wealth to plummet.

On balance, the resident of the tax haven should assume that the implicit annual rental cost of his or her dwelling there, compared to equivalent quality elsewhere taking account of all factors relevant for comparison, will be very expensive.

Even for those for whom it makes sense, all things considered, to reside in the haven, cannot say that in any ultimate sense they have escaped oppressive tax burdens; these have become metamorphized into rental equivalent obligations.

This analysis has direct bearing to the situation of global investors trying to escape the present high rates of monetary repression tax (MRT) on government bonds, most of all in Europe and Japan (as evidenced in stark form by negative interest rate regimes).

The analysis applies also, to a lesser extent, in the US (where long-term rates in real terms are extraordinarily low by any historical yardstick).

Monaco premium on alternative assets to government bonds

True, in assembling a portfolio without such government bonds, the investor is not subject directly to the tax.

But the premium on the alternative assets – whether real estate or equity or risky credit paper – which reflects this haven quality means that current income rates of returns are depressed accordingly.

Of course, these alternative assets are not as close substitutes for government bonds as a Nice apartment is for a Monaco appointment. In buying these haven assets, the investor takes on an array of risks.

Even so, the principles of what determines the haven premium are broadly the same.

A significant potential difference relates to supply conditions.

Land supply in the tax haven is limited to some extent by natural factors – albeit that these can be overcome to a considerably degree by building higher, re-zoning land, and of course growth of alternative and new tax havens.

In the case of alternative assets to highly taxed government bonds, we can think of an inflated price for equity and for credit bringing about an increase in the supply of such paper – even having a counterpart for some time in increased capital spending.

There may be a limit to that process though, as seen through increasing monopoly power, currently evidenced so poignantly in the present cycle.

Monopolists do not increase spending in the same way as competitive firms in response to lowered cost of capital. As readers of this publication know, monetary inflation has, in important ways, caused monopoly power to flourish in the present cycle - in particular, by stimulating speculative narratives about present and future monopoly power devoid of the normal cynicism, and in this case, potential obstacles to such power.

In some respects, credit paper is the closest substitute for government bonds. The yield on such paper consists of a riskless component plus a credit risk premium.

Under present circumstances, the real riskless rate is zero or negative (zero for US, negative in Germany and Japan); the buyer of the credit paper as haven against the monetary repression tax does not escape this in its entirety but buys alongside a non-taxed component, the credit risk premium. As we all know, this becomes very thin (reflecting a haven premium) under monetary inflation.

As is the case for Monaco real estate, it may be that over an extensive period of time, speculative runs in those haven asset markets (credit, equity, real estate) mean that the implicit running premium and its amortization over time is swamped in the opposite direction by capital gain.

When luck runs out in the escape from taxed assets

These gains may have their source in economic luck (a long stretch of unexpected general prosperity) or from growing desperation (so-called “Tina” -There Is No Alternative) made worse perhaps by a new dose of monetary inflation. But the rational investor should not count on that being so over the long run.

The passive investor who smugly assumes that persistent high returns of the past on haven assets (when the premium was emerging) are a constant fact of the random walk along Wall Street, would be in (for some) sour disappointment – but, who knows when?

(We can make the same comment about a growth premium based on an apparently ever rising share of earnings and profits in national income – with no regard for long-run regression towards the mean. In fact present earnings are likely to be well above the long-run average over many years to come taking account of recessions ahead and regression).

An additional cost of the assets, which command a premium price for their “freedom” from “monetary repression tax” (MRT), is a sudden change in monetary regime. This could mean that the premium suddenly descends towards zero. (The equivalent consideration for the tax haven is that the given political jurisdiction might suddenly be stripped of that advantage – whether by tax treaty or whatever).

For example, monetary repression might come to an end – whether due to the end of present radical monetary experimentation (perhaps in response to political revulsion or perhaps to economic miracle) or more immediately from a surge in measured goods and services inflation, which means that for a sustained period, open inflation tax replaces monetary repression tax (and its incidence is quite different across asset classes).

Hazards in the rush for exit from negative rate bonds

Before proceeding along this line of argument, note first how misleading is much of the chatter in the financial media about the rush for the exit from 15 trillion of negative interest bearing European and Japanese government debt.

There is no sure escape and collectively, the debt (or the monetary liabilities which match it) is held by investors; only their composition may change.

Indeed, for most of those investors who have exited government bonds, there is no escape at all over the long run.

The prices of assets (especially equity and real estate) not subject to the monetary repression tax already reflect their haven quality in this respect.

So, we should assume that the likely expected rate of return on these over the long run (barring luck as described) taking account of the premium paid up front (and its likely amortization over time) is already abnormally low.

Perhaps, highly leveraged home purchasers taking advantage of interest costs on their mortgages which are depressed in line with government bond yields might see advantage from buying real estate, even recognizing that there is a haven premium already in the price. That premium might be set for the average home buyer rather than the highly leveraged one.

There is no free lunch here.

High leverage (way beyond what the homeowner would arrange under sound money conditions) means high risk.

Yes, this can be offset by building up a portfolio of government bonds – but that means giving back the advantage of abnormally low borrowing costs on a net basis.

This pessimism noted here, on consistently escaping the ravages of monetary repression tax, by buying "haven assets", runs counter to a recent stream of high returns on such assets.

That run, however, has been in part due to the emergence of the premium – and in part to a range of factors which are hardly likely to persist (emergence of super-monopoly profits across a broad span of the US economy and a flourishing of various types of speculative narratives typical of asset inflation which never persist into the long-run).

Negative rates on 15 trillion of government bonds should scare all investors, whether in these or not: for most likely the price of all assets have shifted to such high levels, as to mean expected returns over the long run are in line with those negative yields.

It could well be that returns on all assets will be negative over the next decade, from present high levels.

But let us step back at this point.

Defining the concept of monetary repression tax

What do we mean by "monetary repression tax" (MRT) and how does this relate to the probably better-known concept of "inflation tax"?

The monetary repression tax is levied by the central bank steering policy in a way which means that interest rates are significantly below the level which they would average, under a sound money regime, both in nominal terms and more importantly in real terms.

(Note that in the private sector of the economy there is also the paying and receiving of MRT, as importantly in the mortgage market. Individual homeowners, when they borrow in effect become recipients of a MRT, paid by the eventual owner of the loan. The premium price on the home property, reflecting the benefit of mortgage borrowing cheapened by the MRT, may mean that there is no net benefit for the mortgaged homeowner overall – see more below).

The MRT does not depend on there being a high current rate of observed inflation in goods and services markets. In fact, quite the opposite.

During the last decade, powerful downward influences on prices from digitalization and globalization have meant that central banks (led by the Federal Reserve), in the pursuance of their 2 per cent inflation targets (rather than allowing prices to fall gently as would occur under a sound money regime), have been manipulating short and long-term rates far below the neutral level, which would have prevailed under a sound money regime.

The consequence of this, as readers of this publication know only too well, is rampant asset inflation, but monetary inflation remains camouflaged in goods and services markets.

Under a sound money regime, interest rates would have been substantially higher in real terms, and to some extent (smaller) also in nominal terms.

We should distinguish the MRT (as it is levied during periods when the central bank is either seeking to drive up the rate of inflation or stimulate the economy) and see how it applies during steady state periods when inflation is at target, and the economy is in an apparently well-established business cycle expansion.

Under the latter conditions, bond yields will have risen from their low points; but the fact that there is so much asset inflation already out there, and so many individuals are aware of the end game of asset deflation at some point, that business investment in general lacks vigour - meaning that interest rates (and estimates of the neutral rate or so-called “r star”) remain low by historical comparison.

During the end-stage of asset deflation and recession, it makes little sense to still talk of a MRT.

Prospective rates of return on most risk-alternatives to government bonds have fallen, speculative narratives have faded, and the search for or identification of safe havens against the low (negative) interest rates may seem like a sick joke.

Gold may be the only asset in such cases that appears as a haven against a famine of yields, though even here it may turn out that some demand for the yellow metal (especially jewellery) is a function of economic prosperity.

Gold and the metamorphosis of MRT into inflation tax

Gold also stands to gain from the transformation at some eventual point of MRT into open inflation tax.

This could occur when the downward forces on prices from digitalization and globalization (or other possible factors such as sudden abundance of commodities or spurt of productivity growth) suddenly weaken. Then the same background momentum of monetary inflation would translate into apparent rises in goods and services prices.

Plausibly, the central bank would not meet this new situation by tightening monetary policy, but instead justify non-action by referring to past under-shoots of the inflation target which now are being compensated by over-shoots.

Under these circumstances, the real yield on government bonds could fall even further below zero. But equity and real estate are subject to the full ferocity of the inflation tax (like government bonds), unlike the case for MRT.

Consider the case of the firm which has no debt, only equity in its capital structure.

As inflation rises, the capital gains tax expressed as a proportion of real gains increases even more steeply. Typically, depreciation deductions against profits for tax purposes are calculated with reference to the historic cost of purchase, and not the new cost of replacement. Subsequently, most types of real estate become subject to taxes such as capital gains or inheritance tax which have no adjustment for inflation.

True equity of highly leveraged firms could count, in their earnings, a growing write-off of debt in real terms under conditions of rapidly rising consumer prices. This is not something, however, which should lead to a premium on leveraged equity – so long as the conditions of the well-known Modigliani-Miller theorem apply. (The theorem states that total value of the firm is invariant to leverage, as shareholders can always create leverage in their own portfolio when they buy a pure equity firm, and achieve the same overall result as no personal leverage when buying a leveraged equity).

Summer 2019: a laboratory experiment for testing MRT theory

Since early this year, the widespread perception in markets is that the Federal Reserve has resolved to "breathe inflation into the economy" (responding to the growth cycle slowdown and "concerns" that inflation could fall below target); alongside the European Central Bank has promised new radical monetary policy steps in anticipation of which yields on government bonds - taking German as a reference point – have become spectacularly negative.

The Bank of Japan has been somewhat less explicit, but there are widespread expectations that as the Japanese economy feels the weight of the sales tax increase this Autumn, coupled with other down drafts, there will be new policy "easing".

Bottom line: the monetary repression tax on government bonds seems to have increased. In the US, we could estimate this as now equal to 1-2 per cent of net Treasuries outstanding, say 1.5 per cent of US GDP. In effect, a true accounting of US public finances would show a deficit without taking into account the MRT and charging a normal interest rate on the debt of around 6.5 per cent of GDP. But this is partially closed by the revenues from MRT.

For Germany, MRT could be as high as 3 per cent (of face value of government debt), bringing in revenue to as much as 2 per cent of GDP. For Japan, estimates of MRT could be as high as 4 per cent of GDP.

No problem in seeing why a "Monaco premium" of large amount has emerged over the past decade in risk assets related to income not subject to MRT, and why this has got larger through the first 8 months of this year.

Also, no problem in seeing why this premium is highly vulnerable to accumulating recession and related end-stage asset inflation risks.

A key challenge for investors, in this late summer, is to determine whether this is another mid-cycle downturn with a new upturn on the short-term horizon (this is the central scenario of Fed Chief Powell as outlined in his recent press conference) or whether in fact we are at end cycle stage with a recession looming.

Here the central scenario is the latter. Why?

Most importantly outside the US, and especially in Asia (the epicentre in many respects of this asset inflation), the economic slowdown has been persistent and worsening for a year or more; the credit cycle globally has not re-ignited despite a compression of high-yield credit spreads this Spring in the context of leading central banks "easing".

For example, the US corporate leverage boom with its accompaniment of jumbo equity buy-back operations has been in a prolonged pause now; whilst in the emerging market space, US dollar lending growth has continued to slow according to latest BIS data – and this is consistent with a noted deterioration in credit quality here, with moves of particular well-known sovereign borrowers into junk bond territory).