# Magic Money Tree

*Russell Napier has a clear idea of the potential impacts of the unprecedented measures taken by monetary and fiscal authorities worldwide to combat the economic effects of the coronavirus. Let's say it's not an overly rosy outlook.*

**INVESTOR INSIGHT**

**Russell Napier**
Orlock Advisors

"I tell my clients that financial repression is not the end of the world, it's just going to make your world a lot more difficult."

***Editor's Note:*** *Apart from some political grandstanding around the U.S. election, government monetary and fiscal responses worldwide to the pandemic have largely had a "shoot first, ask questions later" element to them. This is not without justification, of course, as the magnitude of the economic problems created by the virus and the consequences of doing nothing have seemed unfathomably high. The result has been a series of steps taken without precedent, and without much discussion of the long-term impacts.*

*While equity investors have thus far benefitted considerably from governmental initiatives to respond to Covid, they should at least be contemplating the long-term consequences. For help in that regard, we turn to Russell Napier, a longtime macroeconomic historian, analyst and consultant who among his many occupations provides global macro strategy research to institutional investors through his Edinburgh-based firm, Orlock Advisors. He also serves on multiple investment-firm advisory committees, teaches a course on the "Practical History of Financial Markets" at the Edinburgh Business School, and curates The Library of Mistakes, a business and financial history library in his hometown for, as he puts it, "anyone wishing to learn the lessons of the past as a guide to our financial future."*

**As a student of money, credit and financial history, how are you processing the responses by governments to ward off economic calamity during the pandemic?**

**Russell Napier:** I have a very clear idea of the massive thing that has just changed and is likely to impact the economy and financial markets for the next 20 to 30 years, and that's the extent to which governments are offering credit guarantees to commercial banks. It sounds tedious, boring and uninteresting, but I think it's transformational.

Why is it transformational? The quantitative easing period after the financial crisis was an attempt by central bankers to use the old model – by buying assets from financial institutions you create a lot of commercial bank reserves, which then incentvizes the commercial bank flush with reserves to expand its balance sheet through lending, which then expands economic activity. In reality, though, that didn't happen. In the U.S. there was only moderate bank credit growth. In Europe it actually contracted. The bottom line was that the central banks failed to get the commercial banks to extend credit.

The reason that's important is that that's how you create money. Since the 17th century, money has been created by commercial banks, not central banks. Think of central bankers as coachmen or coachwomen steering with a set of reins their six horses. The reins running to the horses are interest rates, the provision of reserves – driven by the size of central banks' balance sheets – and usually capital-adequacy rules. Central bankers try to steer the horses where they want the coach of money creation to go.

Central banks are still doing plenty of quantitative easing, but in March of this year they woke up to find someone else sitting on the horses. Governments are now driving the horses in the direction they want them to go. Through a variety of programs – the Paycheck Protection Program in the U.S., the Bounce Back Loan Scheme in the U.K. – governments are telling banks, here's who you're lending money to, here's the rate you're lending it at, here's the term you're lending it for. This is a fundamental shift we haven't seen outside of wartime in America. It means governments control the supply of money and central banks don't.

**Isn't one hope that they'll just dismount the horses when the crisis is over?**

**RN:** That's what people tell me who argue this isn't a fundamental shift, but I see a lot of evidence already that governments have no intention of dismounting.

Guaranteeing credit is a very powerful tool of policy, particularly with the economy closing down as a result of the pandemic. You have to get money into the nooks and crannies of the economy, right down to the guy who runs the taco stand. Global quantitative easing probably isn't going to do that. But everyone has a bank account and if you take control of the banking system you can get money wherever you want it to go.

Our U.K. Bounce Back loans are six-year loans, which is one heck of an emergency loan. The money lent and created will be in the system for quite some time. In early October the government launched a new 25-year, fixed-interest, 95%-loan-to-value mortgage program to incentivize first-time homebuyers. That as a commercial prospect doesn't exist in the United Kingdom, simply because it's not commercially feasible. The government is using exactly the same mechanism as for the coronavirus Bounce Bank loans – we guarantee the principal to the bank – but no one can say this is an emergency or recovery loan related to the pandemic. The government frames it in terms of social justice.

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Here's another example. If I live in Italy I can get my friend to come around and price out energy-saving investments in my home, maybe solar panels, maybe insulation. We can take that to the bank and the bank under a government program will lend us 110% of the price my friend made up. Governments are discovering what a fantastic and wonderful policy tool this is to hand money out to people who admittedly need it. But next time around, it's for recovery loans. Then there will be the green loans. I expect there will be more social justice loans. In the U.S. you're already overwhelmed with education loans.

All this means a diminution of commercial banks as commercial operations and they increasingly become wards of the state and arms of policy. There's a long and not altogether happy history of that in Europe and we're back into it. My forecast is that this is the magic money tree for governments and they're not coming out of it any time soon. That changes what the financial system is going to be and the crucial thing about all of this is that it's not fiscal spending, it's money creation.

**Is that showing up yet in the numbers?**

**RN:** The numbers jump off the page. The first place to start is to look at how much more money there is in the world. The OECD produces a total global money supply number, which includes almost everyone but China, and the data series goes back to 1981. The annual rate of growth in that number was running at 5-6% year-on-year prior to Covid, but as of the latest month it's over 18%. There have only been four quarters in the past 40 years when the supply of money has grown more quickly than that.

And yet we have the lowest interest rates in history. At the same time we have almost the lowest inflation expectations we've ever had. When I argue money growth will create inflation I get the usual response, "Oh well, money supply has never had an effect on inflation," which you can maybe say if you've only been around for 20 years, but you certainly can't say that if you've been around for 100 years. If not that response, then people say not to worry, governments will just pull back from money creation through guaranteed bank credit programs and all this will end. Again, I don't believe that.

**So you're worried all this leads to inflation.**

**RN:** Milton Friedman said inflation is everywhere and at all times a monetary phenomenon. The market has come not to believe that in recent years because broad money growth has been so low it's been hard to link it to anything, let alone inflation. At low levels of broad money growth there's little relationship to inflation.

> **ON THE IMPACT ON BANKS:**
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> **There's a long, unhappy history of commercial banks increasingly becoming wards of the state and arms of policy.**

But broad money growth is 18% globally. In the U.S. it's 24%. These are big moves. One pushback is that the velocity of money moving through the system has collapsed – you can pour money into the system, but if people don't spend it then it's not going to result in inflation. That's true, but there's actually quite a lot of evidence that people are starting to spend it, even in the middle of a pandemic. The savings rate in the U.S. spiked up but is now coming down rapidly. People are remodeling their homes. They're buying new homes. Boat sales are through the roof. Classic cars are in a bull market. My argument is that money is already circulating faster than economists think it is, and when we get a vaccine or very rapid testing, pent up spending on a lot of other things comes back with a roar. That's when you start to have to worry about inflation.

People say we'll have massive unemployment next year and if you have that prices will stay down. I think massive unemployment is highly unlikely given the pent-up demand in the system. The marginal propensity to consume is proving to be very high and I don't believe you get high unemployment when that's the case. Of course this depends on how long it takes for us to get to a vaccine – I'm assuming that's months, not much longer. These excess savings are going to explode into the system.

There are other factors at work. I believe the Biden administration will be at least as aggressive against China on trade, which could mean the cheap supply out of China that has helped depress inflation over the past 30 years is unlikely to be as important a factor going forward. Also, we hear from a lot of business people that inventories today across the board are low. If spending velocity picks up in the first quarter of next year and that's combined with low inventory levels, that puts upward pressure on prices.

**Have you gone out on a limb with an inflation forecast?**

**RN:** I've been foolish enough to put both a magnitude and timeframe on a forecast: I believe the U.S. inflation rate will be at or above 4% sometime next year. That's quite a big number – since 1995 we've only been at that level a few times before coming off it. I'm waiting before commenting specifically on where it can go after that, but it could conceivably go much higher.

I should point out that I haven't been propagating this notion that inflation is on the way for long. My biggest investment holding coming into this year was 30-year Treasury bonds. I watch money, and money-supply growth has gone through the roof. The second thing is who's creating the money. With governments in charge, it's going to be difficult for them to stop.

**What are implications you see of all this for investors?**

**RN:** Let me speak briefly first about some of the economic impact, which I refer to as financial repression.

Governments becoming more involved in the allocation of credit as their debt-to-GDP ratios go sharply up and to the right

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changes the very nature of the system. Governments are also having to hold interest rates down even as inflation increases – I can't stress enough how distortionary all that is. If history is any guide, you get much more of a command economy, dictating who qualifies for credit and who doesn't. Governments force institutions to own government bonds when they don't want to. Capital controls become more stringent. You might need consumer price controls. All of this distorts the efficient allocation of credit and capital, which can't help but repress real economic growth.

The investment implications? First, you don't own government bonds if the government controls the supply of money. If one ultimate government aim of all of this is to inflate away debts, you don't want to own those debts. If I look back at the last time something like this happened, in Britain following World War II, a British investor owning government bonds from 1945 to 1981 would have lost 82% of his or her purchasing power.

There are two arguments for precious metals in the environment I'm describing. Gold has historically done extremely well in periods of negative real interest rates, which I believe may be with us for some time. I'd also argue gold becomes more attractive as governments take a bigger role in capital allocation. If the state is going to increasingly weigh in on what financial institutions do and the assets they own, it's a good thing that gold is an asset class outside that regime. You own it and it's less susceptible to government interference.

The nice thing about equities is that there's such a huge range of options that as an active manager you should be able to find companies that benefit from an inflationary environment. Your readers will know more about that than I do. But I would say generally that the environment I'm describing – relatively at least – could be a positive one for value investors.

I'm from Ireland and any time anyone asks for directions they say, well, that will depend where you start. So it's worth pointing out where we start with respect to equities. After 40 years of disinflation, companies broadly speaking that have pricing power tend to attract higher valuations. Inflation has been no help for a long time, so the guy with the competitive moat and pricing power is a more attractive investment. That's not the only factor, but it contributes to the great disparity in equity valuations we're seeing today.

But what happens when you wake up and there's inflation? Everyone has pricing power. The guys with these low valuations because they can't raise prices look awfully cheap when they can. If people are no longer incrementally paying up for pricing power because everyone has it, what do they pay up for? In an inflationary period maybe you're more apt to pay up for cost control. If one has a large capital-asset base that doesn't require huge reinvestment, if you funded that with fixed, long-term debt that should give you structural cost control that might become more highly valued. Compare that with your asset-light, higher-moat corporate brethren. The biggest part of their costs may be wages, the growth of which has been quiescent in disinflationary times, but maybe that isn't the case anymore with inflation rising. They might find it harder to control costs, which could be a strike against them in the eyes of the market.

**ON FINANCIAL REPRESSION:**

**In the early stages, all of this feels pretty nice. It may take a long time, but it tends to end up in a very bad place.**

**Are you a Bitcoin advocate?**

**RN:** I tend to think of virtual currencies a bit like baseball cards. There are smart people who make really good money on baseball cards. It's an asset class, with bull markets and bear markets. But baseball cards at least haven't yet become a currency and I believe the same will prove to be true about Bitcoin. We're discussing how governments are taking even further control of the supply of money – would they really allow a competitor?

Again, that's not to say you can't make money trading Bitcoin. It might become a store of value like gold, but I've got no historical data giving me any clue whatsoever that it can become that. Smart people are speculating on that, but it remains speculation given the history of the asset class. Gold as a store of value isn't a speculation.

**Do you have any good news to report?**

**RN:** While I'm a relatively new convert to being worried about inflation, I've been talking about financial repression for four years and my institutional-investor clients often say, whoa, this is the end of the world. My reply is that it's not the end of the world, it's just going to make your world a lot more difficult. Financial repression essentially results in moving money from savers to debtors. Debtors are probably going to love this, and there are a lot of them out there.

In the early stages, all of this feels pretty nice. Wages grow faster. Your mortgage is almost free. Maybe your student loan is forgiven. All of that isn't bad for economic activity. But to the extent it results in inflation and the misallocation of credit and capital, that's likely not good at all long term for savers – or for governments.

Look at Robert Shiller's database and what happened to corporate earnings from 1966 to 1982. In nominal terms, earnings went up threefold over that period. But the stock market came down 40%. As savers you lost money in bonds and you lost money in equities. In the U.K. I mentioned how we ran this policy after WWII. Well, in 1976 we went bankrupt and had to go to the IMF for a bailout. It may take a long time, but it ends up in a very bad place. If you get very inefficient allocation of capital for a long period of time, you don't create jobs and the real economy stagnates.

**Here's hoping your wrong.**

**RN:** If the governments jump off the horses, then I'm wrong. I'm with you – I hope that's what they do. VII

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