The Capital Cycle In An Age Of Financial Repression

A New Monetary System & The Return of Value

Conclusions- The Return of Value

- The supply of financial capital is restrained and is re-directed by governments away from financial engineering and less socially useful investment
- Returns on corporate capital depressed by Chinese competition rise dramatically as China is ostracized from the global trading regime
- Equity indices decline as less debt finance forces a re-equitization just as savings institutions are forced sellers of equities to finance forced bond purchases
- Value stocks see higher returns on corporate capital, access to cheap debt and limited liquidation by financial institutions as they are under-owned
- Investors wtiness the biggest rotation from growth to value since the 1930s became the 1940s

Keynes & The Capital Cycle

- *“The daily revelations of the Stock Exchange, though primarily made to facilitate transfers of old investments between one individual and another, inevitably exert a decisive influence on the rate of current investment. For there is no sense in building up a new enterprise at a cost greater than that at which a similar existing enterprise can be purchased; whilst there is an inducement to spend on a new project what may seem an extravagant sum, if it can be floated off on the Stock Exchange at an immediate profit.”*
- *The General Theory of Employment, Interest and Money.* John Maynard Keynes (1936)

Tobin & The Capital Cycle

- *"An increase in the market valuation of houses relative to current cost of building will encourage residential construction. The incentive is the gain to be made by the excess of market price over replacement cost…This profit is not wiped out immediately because construction takes time, and rapid construction is especially expensive, both for the individual builder and for the economy as a whole. In the longer run, however, the increase in the stock will bring market value in line with replacement cost, lowering the former and possibly raising the latter."*
- *Money, Credit and Capital.* James Tobin with Stephen S. Golub

Financial Capital & Corporate Capital

The Solid Ground

- The supply of financial capital changes depending upon the monetary system in place- it has been super-charged

- Returns on key forms of corporate capital can be distorted by business systems that do not focus on return on capital- the North Asian system, in particular China, depressed returns

- The post 1994 world saw a massive distortion to both the supply of financial capital and returns on key forms of corporate capital

- That system is now being replaced by a very different system

The Old ‘Hybrid’ Monetary System

The Solid Ground

“Any need for controls, for official intervention in currency markets, even for stockpiles of national reserves would be greatly reduced, and even eliminated. In fact, the “system” (or as many would label it “non-system”) could proceed effectively even without enforcing a common approach to floating. In fact, the occasional efforts to achieve cooperation in managing exchange rates – strikingly in the well-publicized agreements at the Plaza and the Louvre in the 1980s - were in response to national initiatives, with the IMF essentially a bystander. By now I think we can agree that the absence of an official, rules-based cooperatively managed, monetary system has not been a great success. In fact, international financial crises seem at least as frequent and more destructive in impeding economic stability and growth.”

- *Remarks by Paul Volcker at the Annual Meeting of The Bretton Woods Committee.* May 2014

The Communal System Decides

- The ‘hybrid’ system involved Asian central bank intervention post 1994

- The 1998 arrival of the IMF convinced the system to defend itself with higher reserves

- Developed world politicians accepted the poisitives from Asian choices- low inflation, low interest rates, more debt, higher asset prices

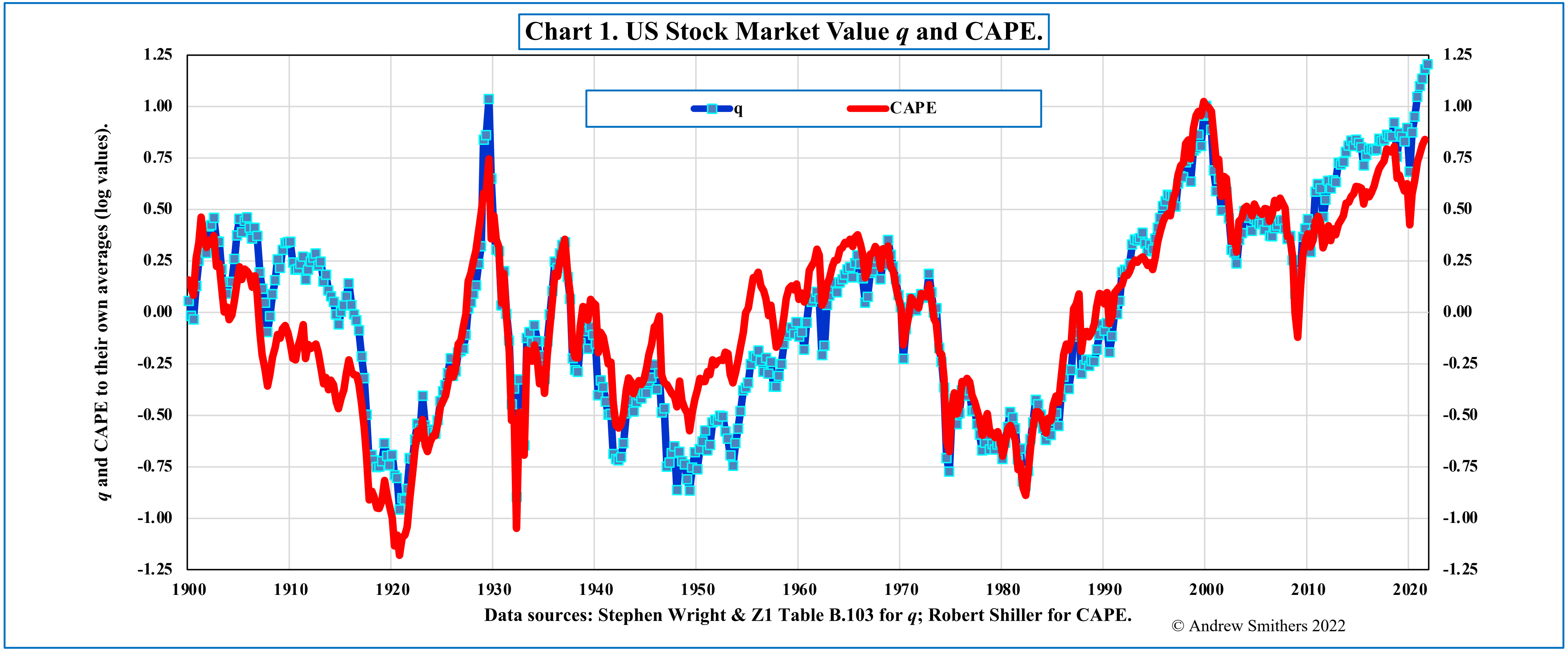
- Consequences- record high debt-to-GDP and high inequality

Communal Capitalism Explained

The Solid Ground

- *"For some time, I have been asserting that the business practices of Mitsubishi Heavy Industries put more stress on employment than on profits. We pay absolutely no heed to such concepts as ROE, because they play no part in setting management targets. The main part of managing a manufacturing business is to use facilities and labour in a stable manner and at maximum capacity, and management tends therefore to focus first on the volume of orders it can pull in. If we look likely to make more money than we were originally expecting, we take on orders at lower prices in order to adjust the figure. It is absolutely essential that our business practices take social effects into consideration and due controls are maintained."*
- Kentaro Aikawa, Chairman of Mitsubishi Heavy Industry (The Financial Times, 14 January 1998)

The Capital Cycle- CAPE and q



What happened to q post 1995?

The Solid Ground

- 1994 fall of the RMB and the birth of Volcker's 'hybrid' monetary system boosted by 97 Asian crisis and 2001 China WTO entry

- Consequences
  - massive central bank purchases of treasuries
  - imported deflation and low interest rates
  - risk of deflation forces central bank extremism
  - debt-to-GDP ratios explode
  - an investment boom in China destroys returns on some key forms of financial capital
  - More debt and less equity

World Foreign Exchange Reserves 1950-2021

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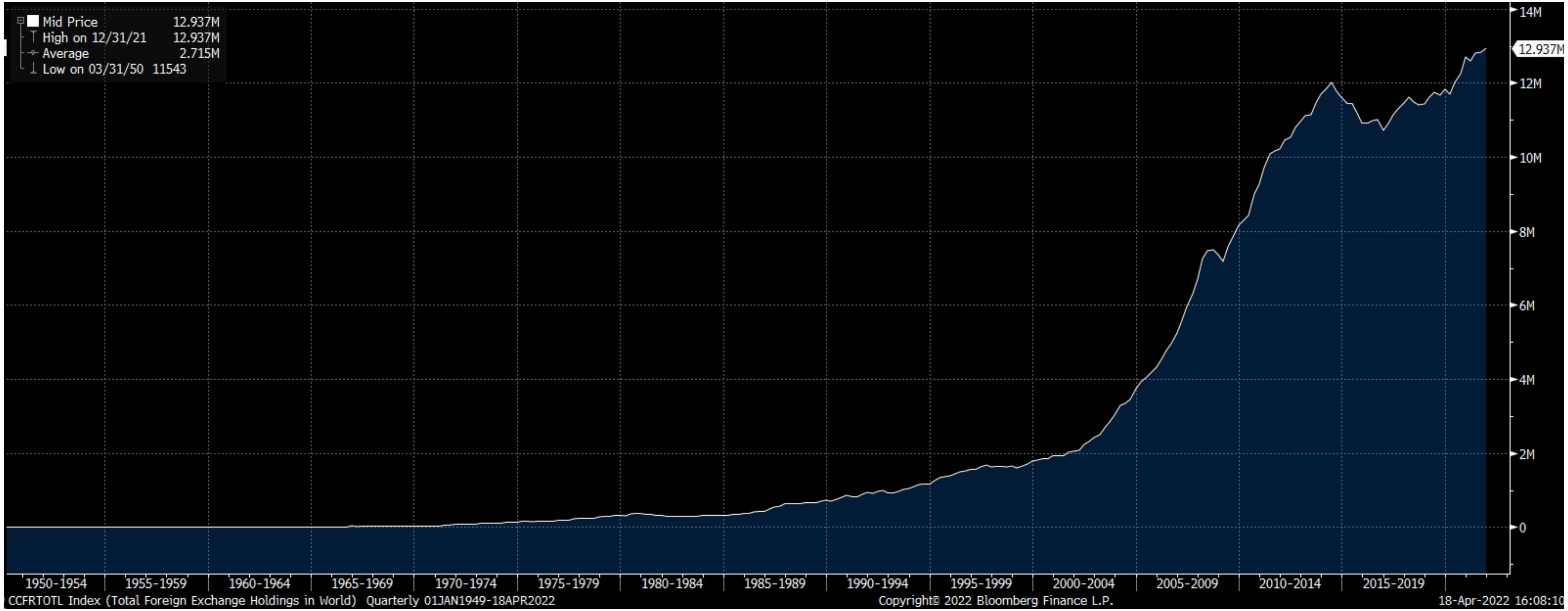

1-Consequences for The Capital Cycle

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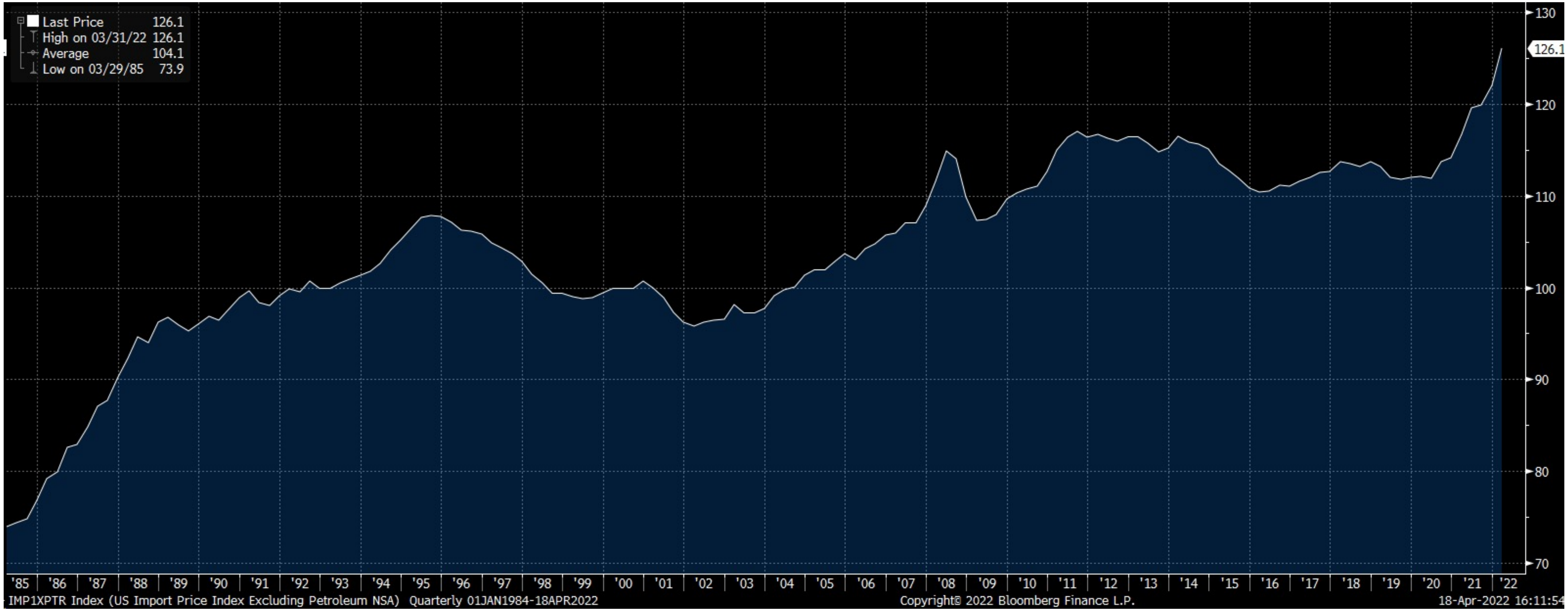
- Non price sensitive buying of world's key reserve currency keeping it overvalued and key businesses uncompetitive
- Depression of the yield curve
- Freeing up domestic savers to finance other projects
- An abundance of financial capital at low interest rates

US Import Price ex Petroleum

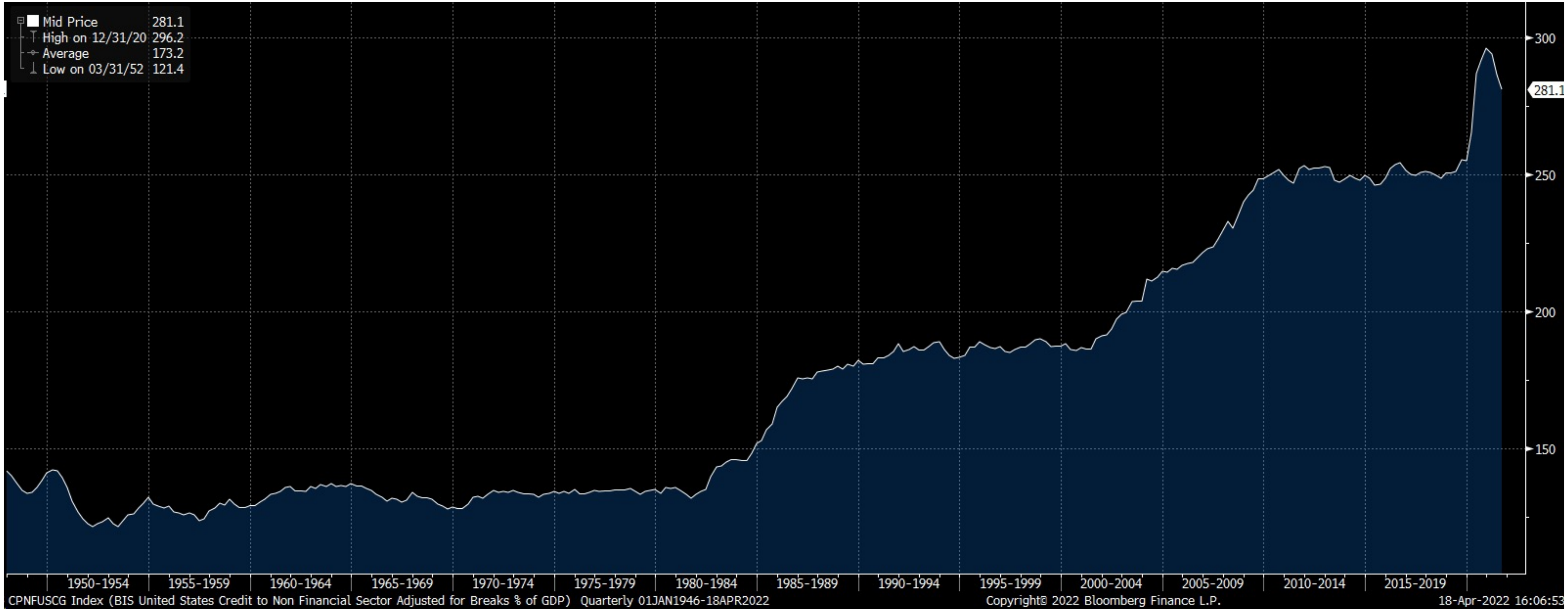


2-Consequences for The Capital Cycle

- Imported deflation keeps domestic inflation in abeyance
- Interest rates depressed by low rate of inflation
- Central banks panic when domestic slowdown threatens to turn low inflation into deflation
- Imported deflation crushes businesses competing with imports

US Total Debt to GDP 1947-2021

The Solid Ground



3-Consequences for The Capital Cycle

- Availability of financial capital soars creating arbitrage opportunities with corporate capital
- Financial engineering- gearing up existing income streams- becomes attractive relative to building new corporate capital
- With return on corporate capital depressed by foreign competition financial capital focuses on other opportunities
- Financial engineering powers the buyback and the shrinkage of shares outstanding on the stock markets

Consequences for The Capital Cycle

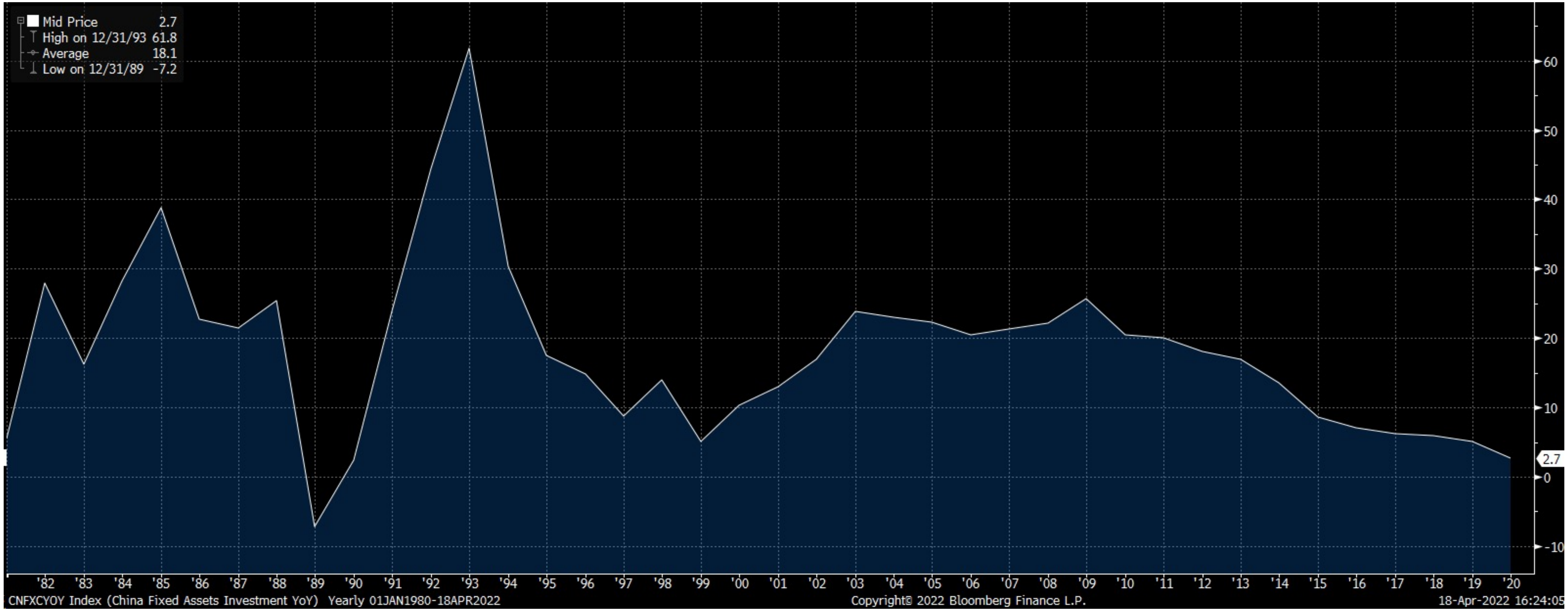
The Solid Ground

- Crucially non-bank credit grew much more quickly than bank credit

- Freed from funding the government disintermediation of banks accelerated

- As banks create money and non-banks don’t this was a form of financing that was inherently non-inflationary

China Fixed Asset Investment (% change yoy)



4- Consequences for The Capital Cycle

- Forex intervention creates massive domestic liquidity creation in the form of commercial bank reserves

- The state-owned banking system channels liquidity into increasing production rather than increasing consumption

- Cheap domestic finance finances production at uneconomic rates

- Returns for all global competitors are destroyed by this repression and as a consequence they are starved of capital

Financial Repression- The Shock Of The Old

The Solid Ground

- Austerity- usually post war but now we have social spending, where will the private sector growth come from?
- Default- BOE estimate a 7% decline in GDP: painful for Greece
- Real Growth- needs to be well above historical productivity growth
- Hyperinflation- 1944-50 France public debt to GDP 180% to 50%
- Repression- push inflation/nominal GDP growth above interest rates and force savers into government debt and deposits, UK government debt-to-GDP 238%-50% 1945-1980

Financial Repression- A Beginners Guide

The Solid Ground

- Interest rates have to be kept below inflation
- Involves administrative measures to force an allocation of savings at the wrong price and a forced selling of something else
- To reduce debt-to-GDP the flow of debt has to be restricted by administrative measures- the politicization of debt
- A re-equitization of the corporate sector is forced
- Other assets have to be made less attractive than government debt- transaction taxes, rent controls, dividend controls

Financial Repression versus The Hybrid System

- Financial Capital-
  - less buying of government debt by foreign central banks
  - savings institutions forced to sell other assets to buy government bonds
  - Inflation rises as bank lending needs to expand and everyone has ‘a moat’
  - Bank credit becomes the key source of finance
  - Interest rates higher than under hybrid system
  - Credit directed by government to fund required investment rather than financial engineering

Financial Repression versus The Hybrid System

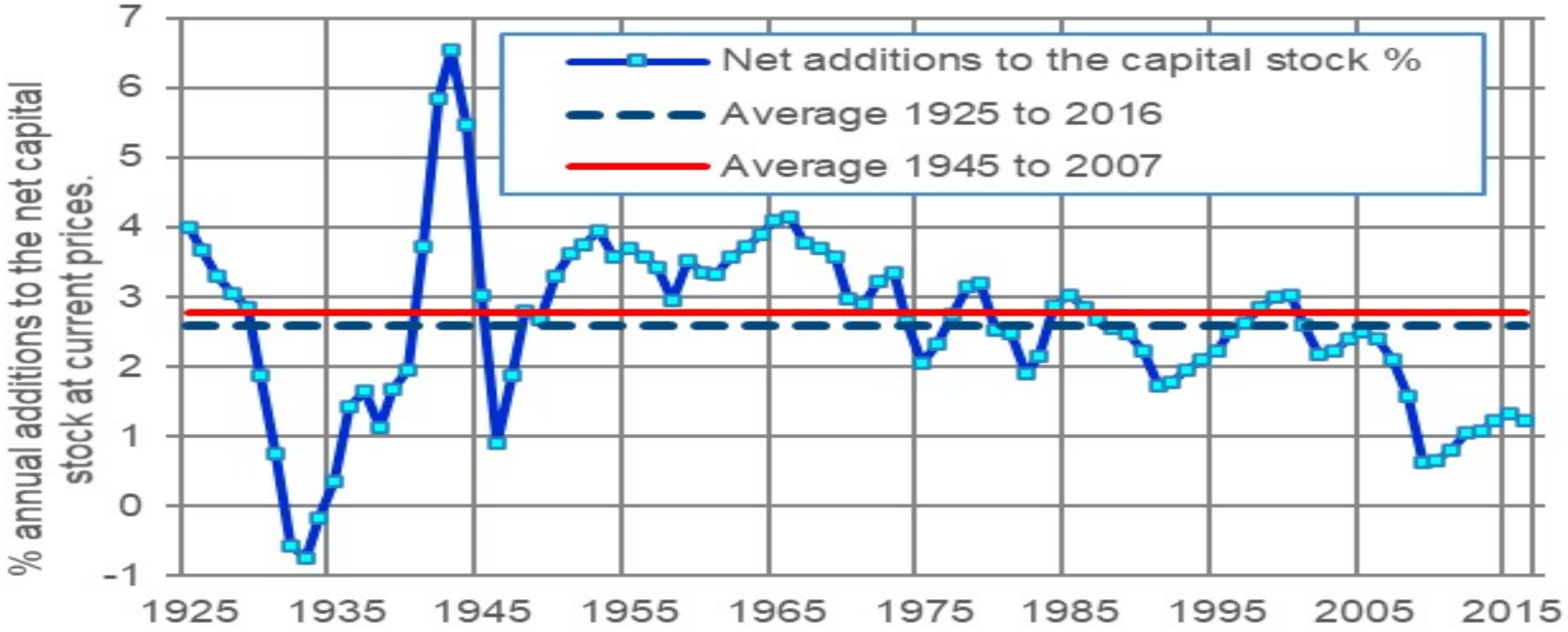
- Corporate Capital
  - Less competition from China produces higher returns
  - The quality of capital allocation by the survivors is revealed
  - A generation of under-investment and prolonged high returns
  - The cost of capital remains low for these strategic state supported corporations
  - No re-equitization as cheap debt available from banks
  - No prolonged liquidation from savings institutions forced to buy government bonds as these assets are under-owned

The Great Capex Boom

- Capex to fund the national security emergency
- Capex to fund an energy diversification emergency
- Capex to fund a response to the climate emergency
- Capex to fund a response to the inequality emergency
- Capex to fund the high wage emergency
- Capex to fund the diversification from China emergency

- Emergency Finance Is Back!

US Annual Additions to the Net Capital Stock



Total Returns with Dividends Reinvested January 1966 to July 1982

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Consumer Price Index	+196%
Small Company Stocks	+619%
Large Company Stocks*	+126%
Large Cap Growth Stocks*	+139%
Large Cap Value Stocks*	+250%
Mid-Cap Growth Stocks*	+118%
Mid-Cap Value Stocks	+352%
Long-Term Corporate Bond	+67%
Long-Term Government Bonds	+61%

From ‘Hybrid’ to Repression

- The q ratio declines as financial capital redirected to build corporate capital
- Returns on corporate capital depressed by China competition soars
- A developed world capital expenditure boom
- Japan and Korea maintain the communal system but their returns also rise as Chinese competition abates
- Cheap, under-owned, old economy stocks provide one of the few ways to sustain the purchasing power of savings
- The Capital Cycle is less distorted and value investing returns

Important Legal and Regulatory Disclosures & Disclaimers

The Solid Ground

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