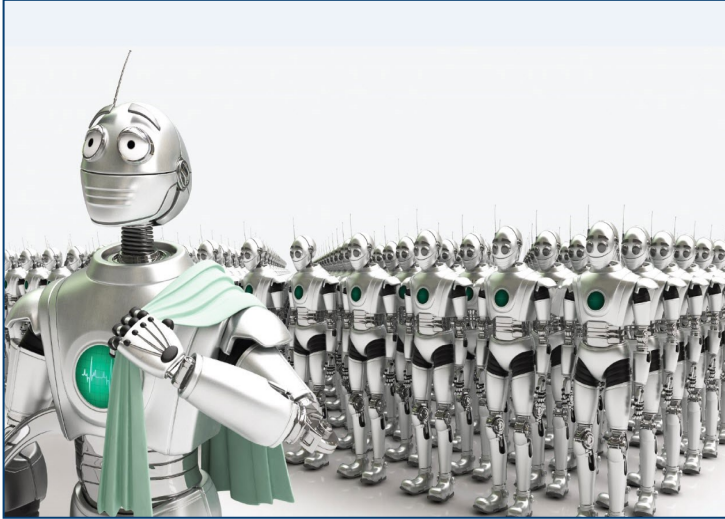




## The Humours of Change Alley



I was recently flattered to be asked how I envisaged the dreaded 'helicopter money' working if it were not to simply add further to commercial banks' already crippling mass of deadweight liabilities and assets, given that not only would printing it up in physical form be tortuous but that cash itself is only one conveniently heinous crime away from being proscribed altogether.

The first possibility is that the central bank issues requisition vouchers – i.e., it credits the Treasury in a dedicated internal account and the happy recipients of Leviathan's outlays get direct access there, too, to funds which are also, of course, legal tender for the whole bestiary of its taxes, licences, levies, and fines.

Effectively, the CB would set up some kind of separate giro bank in parallel with commercial bank system so that which 'droppeth as the gentle rain from heaven' would all be 'outside' money, i.e., M0, just as is today's wickedly untraceable cash. In fact, this latter, allegedly criminal medium could - in the Bitcoin-Rogoff dystopia into which it seems we peons must soon be driven – easily be merged into it, then quietly abolished by not being re-issued in physical form, once paid in.

Patently, banks themselves would be in need of a 'different business model' or else these perpetual embarrassments to the New Order - these 'dinosaurs', as the Bu-

ba's Andreas Dombret recently mocked them - might be made entirely redundant and simply allowed to perish.

Rather than sounding outlandish, that is something which might already have a familiar ring to it, since it has recently become the topic of that insidious, carefully concerted seeding of ideas which the elite has learned to practice in order that its most devilish innovations are introduced, not so much with a fanfare, as with blasé acceptance on the part of the carefully habituated.

Additionally, it would be a trivial matter to insist that all monies held captive in this Orwellian clearing house would not be able to be invested in financial assets but only spent on (approved) goods and services, as well as the exactions by which the state nefariously reduces the *pro quo* which its *quid* would otherwise command. Combine all this with that other well-prepared novelty, the universal income, and the apparatus of control becomes almost complete.

As an adjunct, note that those exactions can now be taken automatically, with the subject of such depredations having only the option to lodge a guilty-until-proven-innocent appeal in which the defendant will judge the merits of its own case. Nor is this some wild fantasy: Gordon Brown's late, unlamented government in the UK was said to be actively looking into the feasibility of a scheme whereby one's employer did not just withhold taxes from one's salary, but pay the whole shebang over to the Revenue so it could decide, *ex ante*, how much wool to leave on the shivering sheep's backs.

Having sealed the money in sufficiently tightly, those subversively insistent upon what remained of their freedom could now circumvent the rules only by resort to some kind of complicated and increasingly risky subterfuge, or by the narrow frustrations of barter. Gesell charges – negative interest rates, if you will - could readily be applied to make sure the title-holders kept the claims rapidly circulating. Further digital niceties could be employed to make the penalties of disuse vary according to the social profile of the holder as well as to vary that same money's purchasing power, depending on how [CONTD]

favourably the Panopticon in charge of the accounts looked upon the object and timing of his expenditure.

Once *that* babbling tributary of the Rubicon had been crossed, other, more insidious forms of social discipline could be effected here, too. One could easily imagine that there would be no pay or access for, say, supporters of 'outsiders' like Trump, Le Pen, Petry, or Farage, for climate 'deniers', or ultimately for anyone else not in complete harmony with the Davos Dominicans and the social-justice Jacobins who are their foot-soldiers in the war to re-engineer humanity.

The state could also limit your access to alcohol, or tobacco, or sugar, or meat - the first three as part of a Thaler-Shiller tyranny aimed at preventing those regarded as ignorant from harming themselves; the fourth an NGO-approved imposition to prevent them from harming that all-encompassing abstraction, The Planet. Along those lines, it could be made extremely difficult for anyone either to produce or consume proper, hydrocarbon energy rather than having to scrape by on the desultory and highly-costly output of some Carney- or Grantham-approved mediaevalism.

Big Brother might monitor your online presence to award points or deduct penalties for what it divines are your attitudes and inclinations. Mixed in with the ubiquity of smartphone and Bluetooth, WiFi and cellular networks, the Internet of Things could be used to score your performance all the livelong day. Londoners will know what I mean when I say that all aspects of life could thus be tracked and charged by means of a universal Oyster card, though others might draw the analogy rather with that of some endless, quest-based RPG which one is positively compelled always to play.

What a Brave New World that would be!

Even before we got to such dark Sci-Fi extremes of intimate, personalized stick-and-carrot 'behavioural economics', the mercantilists who, like the proverbial poor, are always with us would be swift to ensure the new money was not negotiable abroad unless some sort of CB swap mechanism was specifically authorised to that end. That way, the state could become instantly and completely protectionist in its buying - much to the detriment of the people's welfare as it takes its shears to the enriching web of the inter-

national division of labour.

At a stroke, the customs department's toll-gates could be made foolproof, on the part of both buyer AND seller- a possibility one could imagine as warming the heart of the PBoC, for example, by relieving it of its whack-a-mole attempts to limit its subjects' widespread and constantly shifting efforts at cross-border financial and legal arbitrage.

Be under no illusions, however: for the rest of us, the heat so generated would be nothing short of a bonfire of our remaining liberties.

Sean Corrigan

## DRAWING AN OMIKUJI: The Outlook from Japan

In a striking testimony to just how much we have all been spoiled by the past eight years of increasingly desperate and ever more impatient central bank intervention, the latest Wheeze from the Bank of Japan – something it grandly calls ‘QQE with Yield Curve Control’ – was greeted – if not exactly with a yawn - then certainly with a loud grumble of dissatisfaction.

By forgoing any immediate push further into negative territory for short-term rates and by simultaneously pledging to peg long-term yields at around zero, the Bank seemed instead to be paying attention to the plight of its banks and insurers who have complained that they are being starved of a way of to make ends meet.

At first blush, then, this shift seemed to signal an end to the fireworks which have been routinely set off by one of the world’s most devilishly ingenious monetary authorities these past few years.

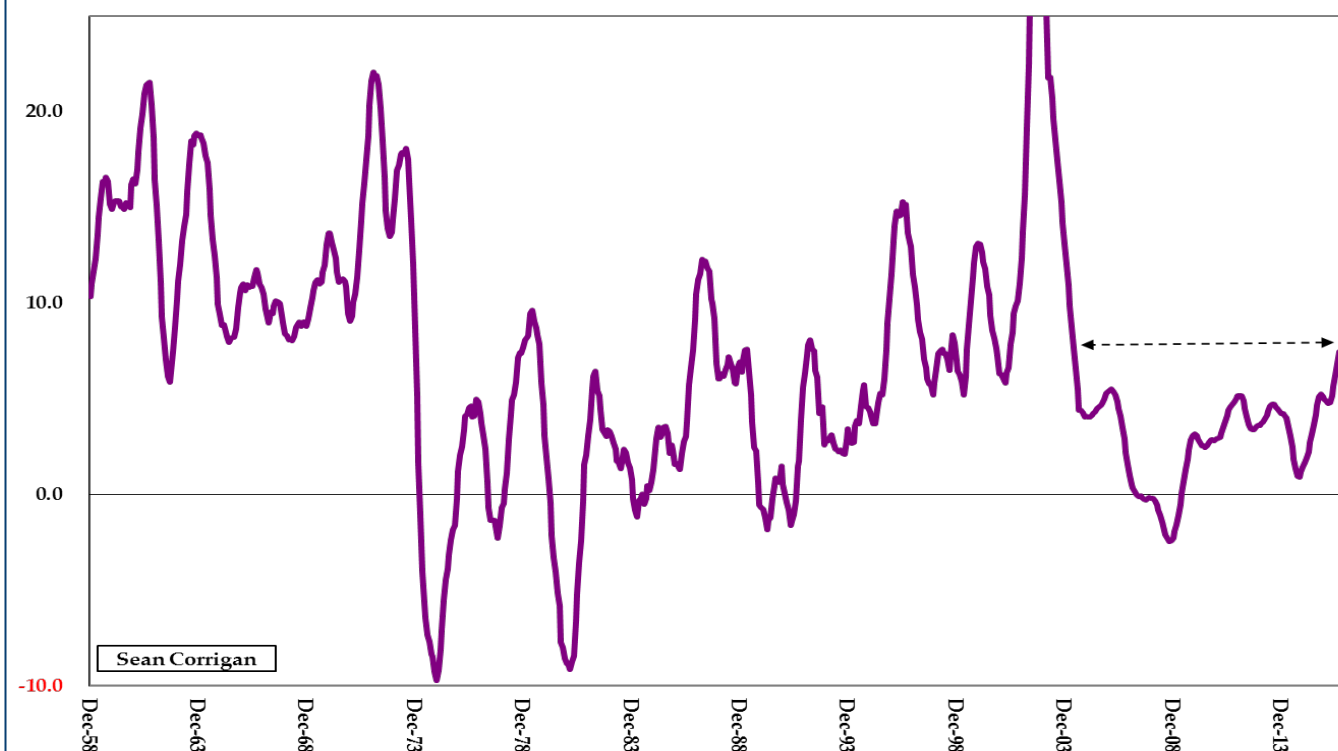
**But that rush to judgement may be a little too precipitate: for the action – and especially the accompanying rhetoric – also bear the construction that what this nest of unshakeable monetary cranks has done here is to light what is possibly a slow-burning fuse, but which is nonetheless one which leads directly to a very densely packed powder -keg.**

The Bank, you see, by setting fixed-price reverse auctions, has effectively pledged unlimited sums of freshly printed money to keep yields from ever going appreciably above zero - even, in exceptional cases, for maturities out as long as 20 years. In order to afford itself even more room for manoeuvre, it has also rescinded its own average maturity guidelines for the bonds it allows itself to buy, as well as now standing ready to provide, upon demand, fixed term finance for *ten* years at a stretch, rather than for just the prior one.

Like a petulant schoolmarm, the Bank went on to bemoan the ‘*entrenched*’ and ‘*backward-looking*’ attitude of the uncomprehending dunces in its charge – each of them stubbornly trusting to their own experience and resisting the adoption of the ‘*expectations*’ which the BOJ wishes them to have about the bright new world which awaits them if only they will finally come to believe -and rejoice! - that prices are henceforth to rise, not fall.

Not content with merely castigating them for their recalcitrance, the Bank decided to whip them into line by means of its new ‘*inflation overshooting commitment*’. Under this head, every failure to cause prices to rise by the desideratum of 2% p.a. *now* will be punished by a spell of indeterminate length on the naughty step of greater than 2% in-

Real Japan M1 yoy: Source - BOJ



creases in future, this to last until such time as the BOJ feels its will has been done, even if in a highly retrospective - and hence largely symbolic - manner.

Not that this abomination is something unique to the BOJ. Indeed, Draghi himself mused about such an approach back at his post-meeting press conference in March, telling his interlocutor then:-

*'...our mandate is defined as reaching an inflation rate which is close to 2% but below 2% in the medium term. Which means that we'll have to define the medium term in a way that, if the inflation rate was for a long time below 2%, it will be above 2% for some time.'*

As ever, the wildest ideas of the clique of monetary madmen who hover, whispering, at the elbows of today's Sanhedrin of central bankers are initially treated by the more politically-constrained among them as no more than guilty, lubricious temptations – though ones to which they are all too happy to give longing voice in public, by way of an *ex cathedra* endorsement of what they would do if only circumstances permitted.

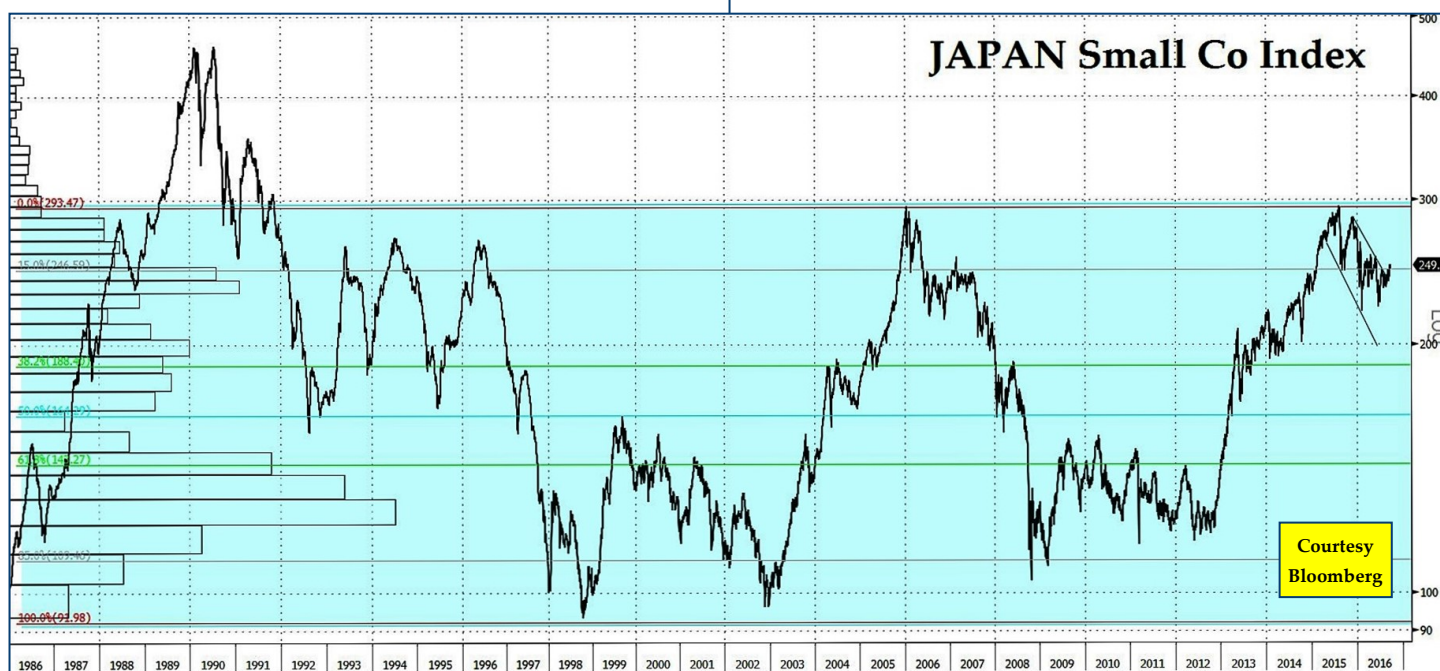
It most often falls next to the eager experimenters at the BOJ to throw such affronts to both common sense and established practice into actual operation, safe in the knowledge that their ultimate boss, Shinzo Abe, will only approve of their boldness as a diversion from his own failure to craft, much less fire, his vaunted 'third arrow' of economic reinvigoration

Henceforward, now that they have a working precedent to which to point, the others, too, can indulge their fantasies and so redouble their ongoing attempt to bludgeon the masses into conformity with the esoteric calculus of their economic 'models'.

It is all too easy to mock Haruhiko Kuroda for his descent into Peter Pan whimsy when trying to explain why it is so crucial to the MIT Macromancers that 'expectations' be hammered into the required shape. But consider, too, that such twisted, cart-before-horse ratiocinations prevail in the inner sanctum of the ECB, too.

By way of an example, as the culmination of an exposition on this very theme which its Chief Magus – sorry, *Economist* – Peter Praet was delivering, back in April, he offered up this classic exercise in reversed causation, wishful thinking, special pleading, and utterly unsubstantiated, historical speculation as a justification for the bent of the Bank's current policy:

*'Indeed, Eggertsson and Pugsley show that, in a fragile post-crisis situation where monetary policy is sustaining the recovery, any perception that the central bank is adopting a greater tolerance towards a future regime of lower inflation can have very negative effects. Looking at the Great Depression period, they argue that the return of the US economy to recession in 1937 resulted from a perception that the Fed had abandoned its commitment to reflation, creating pessimistic expectations of future growth and inflation that fed into both expected and actual deflation.'*







*'The economy then became caught in an equilibrium of "contractionary beliefs [emphasis added].'*

Now it is true that this is an episode about which, almost 80 years on, controversy still rages with regard to whether it was a mistake of the Federal Reserve, committed as it was seeking to quell an incipient inflationary episode with a modest monetary tightening; whether it was an inadvertently large adjustment to fiscal policy carried out by an uncomprehending Roosevelt administration; or whether – as your author has argued at some length in *'The Ghost of '37'* [available on the *True Sinews* website] – it was as much about the mounting of an ideologically-motivated, two-pronged assault on owners of capital and judicial independence which led to a somewhat Randian 'strike' on the part of the productive classes.

No matter which of these various contentions the reader might find more convincing – and, as with all such cases, no verdict can be definitive since no single cause can ever be isolated from amid the complex interplay of real-life events and irrecoverable contemporary attitudes - what he will *not* find among them is any trace of Praet's and Kuroda's almost quantum mechanical mysticality whereby an entire society becomes *so* convinced that bad things *might* be about to happen that they act in precisely the manner best judged to give their phantasms immediate, concrete form.

Nor can one escape the bitter irony that the very people whose 'forward expectations' have become 'de-anchored' - and so slipped into a spiral of self-defeating morbidity which is based on their 'adaptive' reaction to events of the past several years - are the central bankers themselves – what, with their 'savings gluts', their lowered 'real equilibrium interest rates', their rehashed phobias of 'secular starvation', and all the rest of their intellectual baggage!

That, alas, is where we do find ourselves today, however.

### *Dragon head, snake tail*

As a result, the BOJ now wants to reinforce its determination to reach 2% p.a. in CPI increases by bruited abroad its willingness to exceed that target over some not inconsiderable horizon.

Given that the very lack of success it has encountered in achieving the first objective has necessitated its adoption of the second, ostensibly more challenging one, this has met with a certain degree of derision from the commentariat. We, however, for all our scorn of the pretensions of central bankers would not be quite so quick to dismiss its import.

Firstly, it might not be the ordinary man and woman whose 'expectations' and calculations it is that the BOJ is really aiming to reformulate, but the managers of financial assets and the wielders of trading leverage instead.

Consider now their conundrum. The Bank wants to keep a minimum *positive* spread between the overnight rate and

the bonds they own and will tailor its bond buying to achieve this. It will try, it avers, to keep 10-year JGBs hovering around the zero percent mark while also maintaining the overnight rate at -10bps for the time being.

The fact that its ability to fix the slope of the yield curve might be compromised by its more pressing wish to buy around ¥80 trillion a year of these instruments, at a time when the government is only scheduled to issue around ¥20 trillion of them gross, is a conflict regarding which we all await further clarification.

Ostensibly, then, the change is intended to lessen the plight of those banks and insurers who have been denuded of earning assets – and, in particular, of those deemed ‘safe’ by their regulators. This the BOJ hopes to do by preserving for them at least some residual reward for undertaking the pivotal process of ‘maturity transformation’.

Pending the success of this latest adjustment, NIRP had been threatening to place banks in the somewhat paradoxical situation wherein they would henceforth be expected to earn their vital net interest margin (the bedrock of their business model, no less) by charging their depositors more

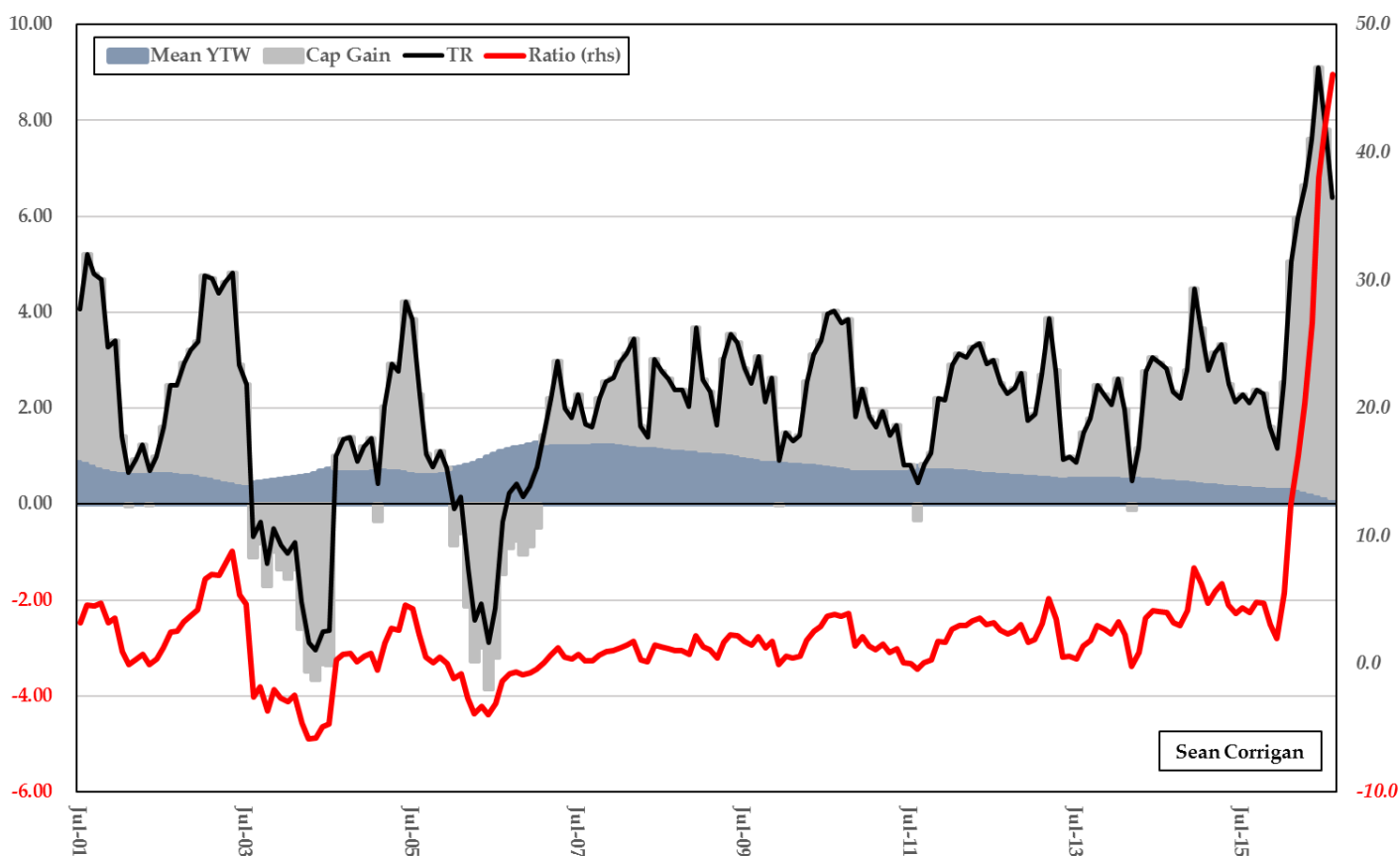
to look after their cash than they, the banks, would then have to *pay* their own borrowers to relieve them of it!

In Japan’s case, any such alleviation would be more than welcome, given that the sheer ferocity of the BOJ’s interventions caused a spectacular collapse in bond yields in the first half of the year, flipping the 10-year JGB from +30bps to -30. Even more spectacularly, the heat generated by all this led to the almost complete evaporation of the 150/60bps which the supra-longs had been commanding just before Christmas.

**The combination of their already long duration and the Gadarene rush down to the scanty few basis points of YTM which was left to them at the start of July produced some stunning increases in their quotations in what was arguably one of the greatest bond bubbles of the modern era.**

For example, the No.8 40-year rallied no less than 57% (sic) in just seven months. For a dollar-based buyer, the yen’s concurrent strength would have pushed that already breath-taking gain to just over 90%, while a sterling holder would – thanks to *his* currency’s post-Brexit slump – have

Barclay's JGB Index TR v Coupon return: Source - BBG





racked up a startling 125% profit in that same interval!

No wonder the MOF rushed to impose a capital gains tax on the instruments.

Since then, something of a classic, post-mania reaction has set in, it is true. Prices have fallen by up to a sixth and so have wiped out almost half of the prior capital appreciation. Make no mistake, however, this breaking of the fever still leaves the returns achievable on the bonds preternaturally reliant on a renewed slide in the greatly-depressed yields of 55bps which now prevail on the longest of them all.

Therein perhaps, lies the crux of a policy which has otherwise perplexed the legions of teenage scribblers who have commented upon it; to a man unable to fathom how the BOJ can hope to make its new 'symmetrical' CPI target stick when the 20%-plus fall in import prices has temporarily reduced the measure to the negative column once more.

If yields *are* to be confined to a few basis points either side of zero, not only will there be no income to accrue, but no scope for further capital gains either – at least, on the assumption that the BOJ can (much less will) act to prevent another rush into the assets. That should be enough, the Bank may well imagine, to encourage a greater appetite for, say, USD assets, which – even with the hurdle of a 70bp adverse basis swap to overcome for those who insist on hedging their forex risk - still offer a sizable premium

over the homegrown variety.

Now it may be asking too much of Mrs Watanabe to suddenly fear that the purchasing power of her *hesokuri* nest egg will begin to erode as rapidly as Kuroda-san might wish her to do though it may not matter overmuch since she invests barely 1% of her savings *directly* in JGBs, in any case.

But the manager of her salaryman husband's life assurance might not be so sanguine and *he* is the man whose opinion counts, alongside that of his banker, his credit co-operative representative, and the fellow at Japan Post, since these four between them dispose of around 85% of the domestically-owned bonds not already in possession of the BOJ and so hold an amount approximately Y85 trillion larger than does that last august institution itself.

*This* man is one who, in his professional capacity at least, might be more amenable to taking Kuroda's threats in earnest. *He* might therefore begin to reckon up the potential effect on future real returns of the Bank's new idea of balancing today's sub-par price rises with a slew of supra-normal ones tomorrow. This would, after all, be a neat way of allowing the same long-term price *level* to be reached, if by way of a less even trajectory than would be followed if the 2% target had already been attained.

Even without this apprehension, now that the passing of the frenzy in the bond market has again allowed our trusty



steward of his clients' capital means the time for reflection, he might become mindful once more of the awful fiscal arithmetic which confronts him as he tries to discharge his fiduciary duty.

### *Dust piled up becomes a mountain*

For the sobering truth is that Japan has for too long been a country where the citizens would rather not finance what their government pays out to them in benefits and boondoggles by way of taxes taken from them, but would instead prefer to bridge the chronic shortfall caused by this reluctance by *lending* it back the money it has first showed upon them.

The problem with such a system is twofold. Firstly, it predisposes them to cling to the dangerous illusion that such already expended resources still remain as 'savings' upon which they can draw down. Secondly, it entangles the mediators of such 'savings' in a web of legal obligation which cannot be honestly discharged.

That Japan is not alone in such fostering such confusion in its social accounting is true, but Japan *is* (for now) fairly unique in how viciously this interacts with its rapidly greying population. If you listen closely, you can hear the evil spirit of Keynes cackling at the consequences of people failing to think clearly about what happens when, 'in the long-run', we are all dying out.

As Professor Keiichiro Kobayashi of Keio University outlined in a recent paper for the Canon Institute, the government itself effectively admitted it is doomed in the reference material compiled for the Public Finance System Subcommittee of the Fiscal System Council, back in April 2014, as part of a presentation entitled, '*A Long Term Estimate of Japan's Finances*'.

This depressing document showed that, should matters continue to stand as they now do, by the end of this decade, the national debt would begin a catastrophic divergence from its present, already parlous course, going on to reach a putative - though, of course, practically insupportable - 500% of GDP by mid-century.

In order to stave off the disaster entailed by entering even into the early stages of such a process, the Committee's experts calculated that a fiscal adjustment of no less than 14%

of GDP would be required if the debt were to be instead reduced – and then over a forty-year horizon, no less – to a mere 100% of GDP.

*That*, Professor Kobayashi was quick to point out, would require some combination of slashing outlays and raising taxes to the tune of some Y70 trillion – such as could be achieved, for example, by raising the consumption tax to as high as 30%. Given the fall-out occasioned by 2014's piffling 2% rise in that levy to its present, hardly-swingeing 5%, it is all too apparent that this is politically, if not economically, a non-starter.

Conversely, primary budget expenses – i.e. those not involving debt service – currently stand at a not wholly incomparable Y73 trillion a year, so the problematical nature of enacting economies of the requisite Y70 trillion along *that* particular axis should need no further elaboration either.

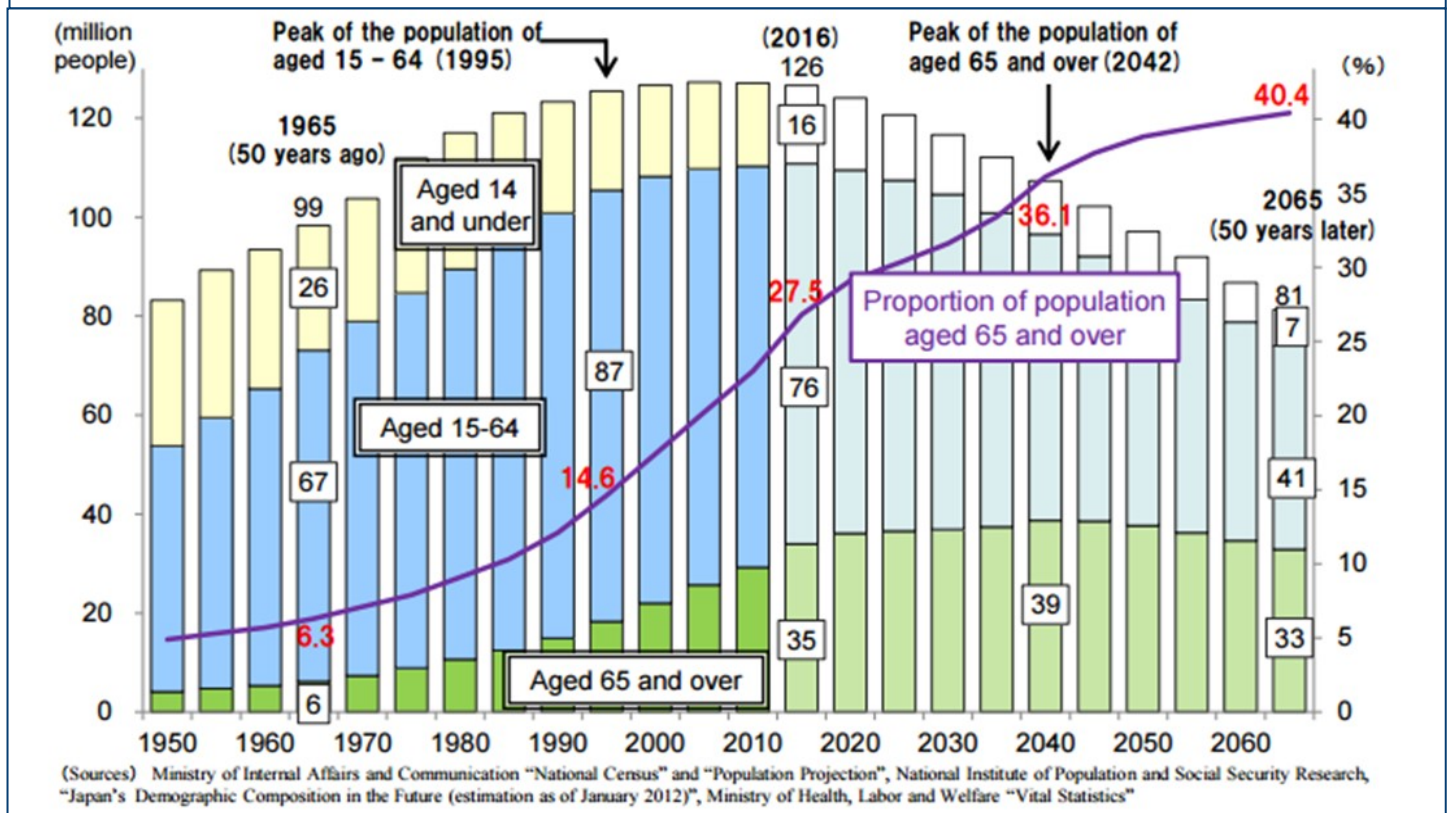
Here, those of a suspicious bent might notice that the monstrous sums currently being conjured up out of thin air by the BOJ are conveniently something of a match for this projected shortfall, comprising Y80 trillion per annum, as they do. Moreover, given contemporary debt service costs of Y23 trillion (in principal and interest payments), the least contentious quarter of the existing budget has already been paid for by means of the BOJ's seignorage. This means it has effected one-third of the prescribed reduction by stealth. Nor should one overlook the fact that NIRP itself is nothing more than the imposition of yet another unconstitutional tax with which to further fill the hole.

Though there is, of course, a distinct measure of chicken and egg in the mix, the experience in the eight years since the GFC shows JGBs in issuance rose Y292 trillion as part of a Y364 trillion increase in total government debt.

To show for all that gargantuan outlay, Japan now generates Y28 trillion in extra GD; an adverse marginal debt/income ratio of 13:1. Fortunately (or otherwise), the BOJ's helicopters absorbed Y326 trillion, or 90%, of that debt directly and chipped in an additional Y18 trillion contribution to the coffers of its potential buyers via its other interventions. That left only Y20 trillion of what amounted to a 60-point surge in the ratio of debt:GDP for everyone else to cover out of pre-existing or privately-created monies.

Adding to the concerns, primary (non-debt related) ex-





penditures outside of social security were essentially unchanged over this period, meaning that the entirety of the roughly ¥10 trillion in extra outlays which did eventuate arose as part of a near 50% rise in their social security component.

Needless to say, that particular line item is not likely to decline anytime soon. Indeed, the demographics suggest there will be around 10% more (and older, more expensive to maintain) retirees by the time their absolute number (though not their highest proportion) peaks a quarter century from now, by which time there may also be 25% fewer people of working age around both to support them and to pay off the bills they ran up in the years of their prime.

Faced with the knowledge of this looming inter-generational catastrophe and now seemingly deprived of the sweetener of rapid capital gains on what are essentially non-performing loans-in-waiting, might our life assurance manager not soon find himself itching to hit the BOJ's bid, especially since he knows that same bid will not now move against him under the weight of his own sales?

Parenthetically, the new directive also means that the bulk of the last several months' windfall capital gains will now be cemented into place by the BOJ's prevention of any further price falls; such 'profits' to be variously apportioned

between the state, the shareholders, and the owners' capital accounts – thereby allowing the former two to carry on spending and the banks among the latter to expand their loan books further, as and when the spirit moves them.

**Once such a way of thinking becomes common – and especially if the redistribution of the sellers' monies starts to move other asset classes higher and/or the yen lower – it would not be hard to envisage a self-fuelling, even a self-accelerating process being set in train.**

### *Oni ni kanabou: Giving the monster a stone*

Outside of the financial markets themselves, this might just be enough to start edging prices higher again – particularly if the foreign exchange impact were to magnify what the other central banks' gross monetary irresponsibility might be on the verge of doing for commodity prices, once more.

Here is where that averaging-out of the CPI rate might come into its Mephistophelean own, especially since Kuroda is currently 18 months into a spell wherein he has missed his target by around 2% on average and so has stored up plenty of ammunition with which to defend a prolonged period of inflationary unconcern, should the chance arise.

Given his stance, if CPI *did* begin to pick up again, the plain, good folk of Japan - assuming they had not already been swept up in whatever speculative enthusiasm for other assets had meanwhile been excited - might realize that not only was the purchasing power of their deposits beginning to erode once more, not least because the BOJ was preventing them from earning any compensatory return on them, but that the Bank had declared that it would look kindly upon an acceleration of that loss well beyond its nominal 'target' rate.

The converse would, of course, be true of anyone predisposed to borrow in order to buy assets, rather than consumables. The real value of their obligations would decline, leaving them with notionally more net collateral against which to borrow and buy again. Of those borrowing specifically in order to finance consumption, let us not forget that the foremost among them, the state, would retain all of its eagerness to do so, especially as the burden of its vast social security commitments is almost guaranteed to rise with, if not faster than, the general increase in prices and so render any increase in its tax receipts less likely to transform its fortunes.

Nor would even the *nominal* rate at which they all could do this rise very much: the BOJ's efforts to hold benchmark rates near zero, combined with an avid competition among lenders for an earning asset, would surely see to that.

As this convective vortex wound tighter and began to spin faster - and assuming some future Bank of Japan governor did not entirely abnegate the policies of his predecessor (or, if it came to pass quickly enough, Kuroda his own) - liquidators, borrowers, and lenders would all find a fixed bid for their paper in whatever size it took to absorb the effort to sell. Thus, their repeated attempts to escape would simply enable the BOJ to boost the money supply further and so potentially push CPI on faster and faster until - well - KA-BOOM!

So far, all of this is in the realm of supposition where we must hope, but should not presume, it will long remain.

For all that this represents no obvious advance on the prior situation and that therefore no-one is exactly sure of how it might succeed where the old strategy failed - and for all *we* lampoon the Macromancers' fervent invocation of

'expectations' as if they were Victorian parlour spiritualists fraudulently conjuring up the ectoplasm of the dearly departed - what the BOJ *has* undeniably done here is string out a tripwire across the path of its people which it has wired to a very large IED - in this case, an *inflationary* explosive device.

Thus, in the short term, the doubters may be proven correct in their weary assertion that nothing fundamentally has changed. What they miss, however, is the *optionality* of the new framework: that if something starts to move in the BOJ's direction - however much that might be a stroke of fortune, rather than an act of will - the mechanism will magnify its impact, even, conceivably to the point where an unstoppable chain reaction could occur.

Given the Bank's implicit intent to monetize just about everything it can in Japan - whether for its professed, thaumaturgical belief in the healing powers of mild inflation or because of an insidious plot to use its balance sheet to erode the state's unpayable mountain of debt - and given, too, that the other major central banks are not exactly ready to isolate their own citizens from whatever virus may be unleashed by the mad scientists of the Nihon Ginkō laboratories - one should certainly be prepared for the worst.

In welcoming delegates to the conference being hosted by the impenetrably named European Systemic Risk Board, ECB head Mario Draghi was at his contemptuous best, effectively denying all responsibility for the current parlous state of European banks and telling them imperiously that they needed to 'change their business model.'

Citing a 2014 report of that same body, he reminded his listeners that:-

*'...over the preceding two decades, the banking sector had out-grown capital markets. In the late 1990s, the ratio of total bank assets to equity and private bond market capitalisation in Europe was below two. By 2008, this ratio had risen to four.'*

This, he correctly argued showed how horribly 'pro-cyclical' bank lending was - though he did not acknowledge that the €13 trillion doubling in the tally of loans and securities purchased included almost €5 trillion of pig-on-pork interbank lending or that equity capitalization is itself something of a moveable feast.

Nor did he stop to reflect upon just who had aided and abetted this damaging pro-cyclical behaviour, despite having the experience of his own, long years in office upon which to draw.

Did he not realise this at some point during his ten years at the Italian Treasury, even though he it was who was charged with the reform of corporate and financial governance; or during the five years that he was *Banca d'Italia* governor, or the five since then, following his apotheosis as a latter-day Pope Gregory the Great? All this while, after all, the canker in the bud was growing, ready to metastasize in to the possibly intractable disease we are wrestling with today.

Instead of his interest-rate policies, it was the 'overcapacity' in the banking sector which was 'clearly exacerbating the squeeze on margins,' he went on to tell a Frankfurt audience, effectively expressing his desire for there to be fewer lenders operating in the Eurozone.

While this is all very well and true, it *is* a bit rich coming from a man who has spent his time in office taking ever bolder steps to prevent either those same banks – or the tottering state treasuries with whom their fate is so closely bound up – from facing the invigorating discipline of the free market.

Let us not go back all the way to when his colleague, Lorenzo Bini-Smaghi vaunted in the wake of Lehman's collapse that *all* EU financial institutions were 'strategic; and thus would be kept alive, no matter what. We only have to listen to Draghi, himself, quietly supporting PM Renzi's demand to be allowed to inject public capital into the weakest of the weak; or recall the €150 billion '*precautionary liquidity support programme*' recently authorised by the EC for their further succour, presumably with Draghi's endorsement and perhaps even his active encouragement.

We have frequently shown that, in the private sector (outside of Greece), the scale in the fall of net indebtedness to and the rise of net credit balances at the bank has been truly remarkable these past few years. This has long since reached the point where it is clear that what the ECB really now is doing is not so much financing private 'demand' or making any significant difference to firms' need for either working or fixed capital (not that it necessarily helps this cause when it vows to drive input costs up beyond what would otherwise be their market-clearing level).

Take the case of Spain. Back in 2003, before the ECB-condoned mania first took hold, Spanish non-financial companies owed their bankers €230 billion more than they held with them in deposits while households contributed €35 billion towards the shortfall.

Bit by bit, both groups abandoned all pretence at thrift as the easy-money, zero-exchange risk era eroded their financial discipline, as new houses sprang up across the land, and the current account yawned to previously unimaginable levels.

At its most extreme, householders ended up *owing* a balance of €235 billion and then several months later, corporates foray into the red peaked at over €750 billion – that combination comprising a near-fivefold increase in net bank debt.

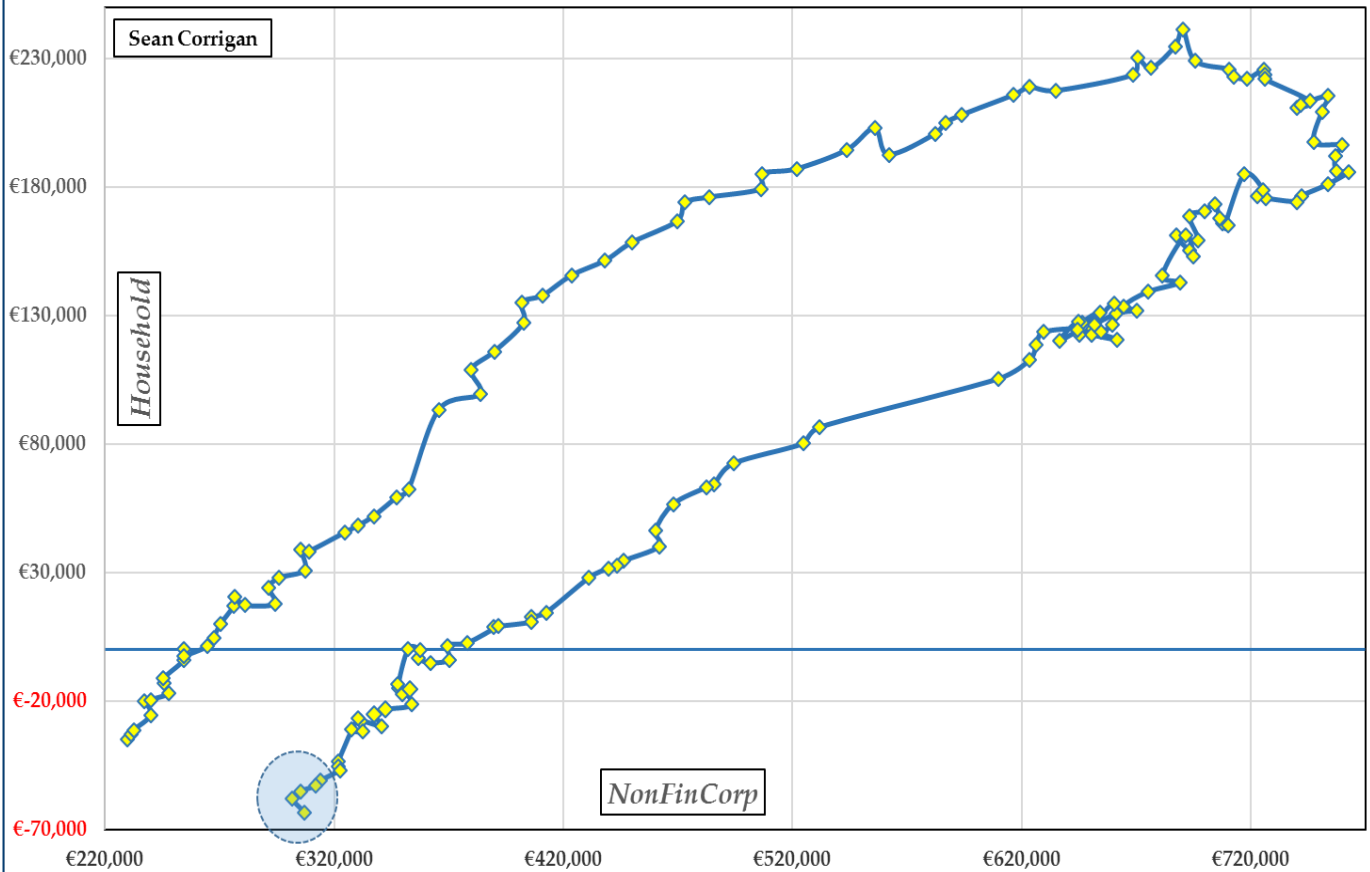
Then the grim, sober morning dawned, grey and stormy and the painful process of paying down, renegotiating, and defaulting on that debt began in earnest.

The upshot is that individuals are now €63 billion net creditors (a shift towards solvency of €300 billion) and corporates owe a far more modest €305 billion, their best showing in a decade and a net €450 billion improvement.

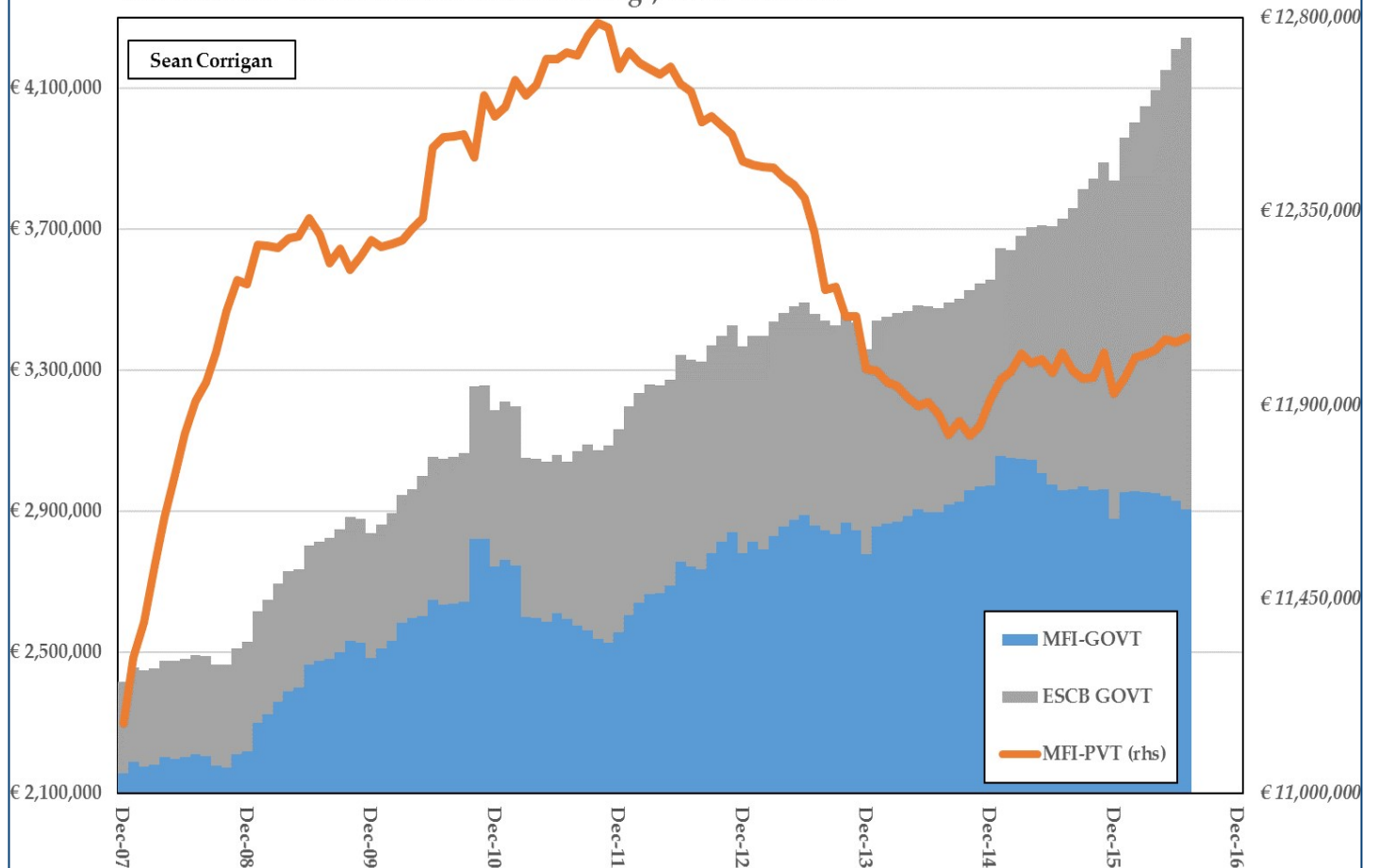


## 2003-2015 Spanish Non-Fin Corporate & Household Bank Loans - Deposits, mlns

Source - ECB



## MFI & ESCB EZ Loans & Securites Holdings, mlns: Source - ECB



Using the same methodology, we can calculate that from their (slightly displaced) respective peaks, the private sectors of both the PIIGS *and* a combination of seven of the remaining established nations have bettered their standing at the bank by over €1 trillion (the Finns we clump in with their two Scandinavian neighbours outside the Zone who are, between them, the debt champions of the new Europe).

So where is the money all going? Two places: to the state and abroad.

Since the Hurricane Cassandra of Lehman first swept ashore, trailing devastation in its wake, the ECB tells us that its favoured – if blankly ignored – measure of ‘broad money’, M3, has risen by €1,956 billion.

Over that same period, on the other side of bank balance sheets where we must look for a countervailing entry, credit to the private, non-monetary sector actually underwent a minor decline of some €119 billion.

No such reticence has informed the affairs of the state however. This, the least productive – indeed, the all too often

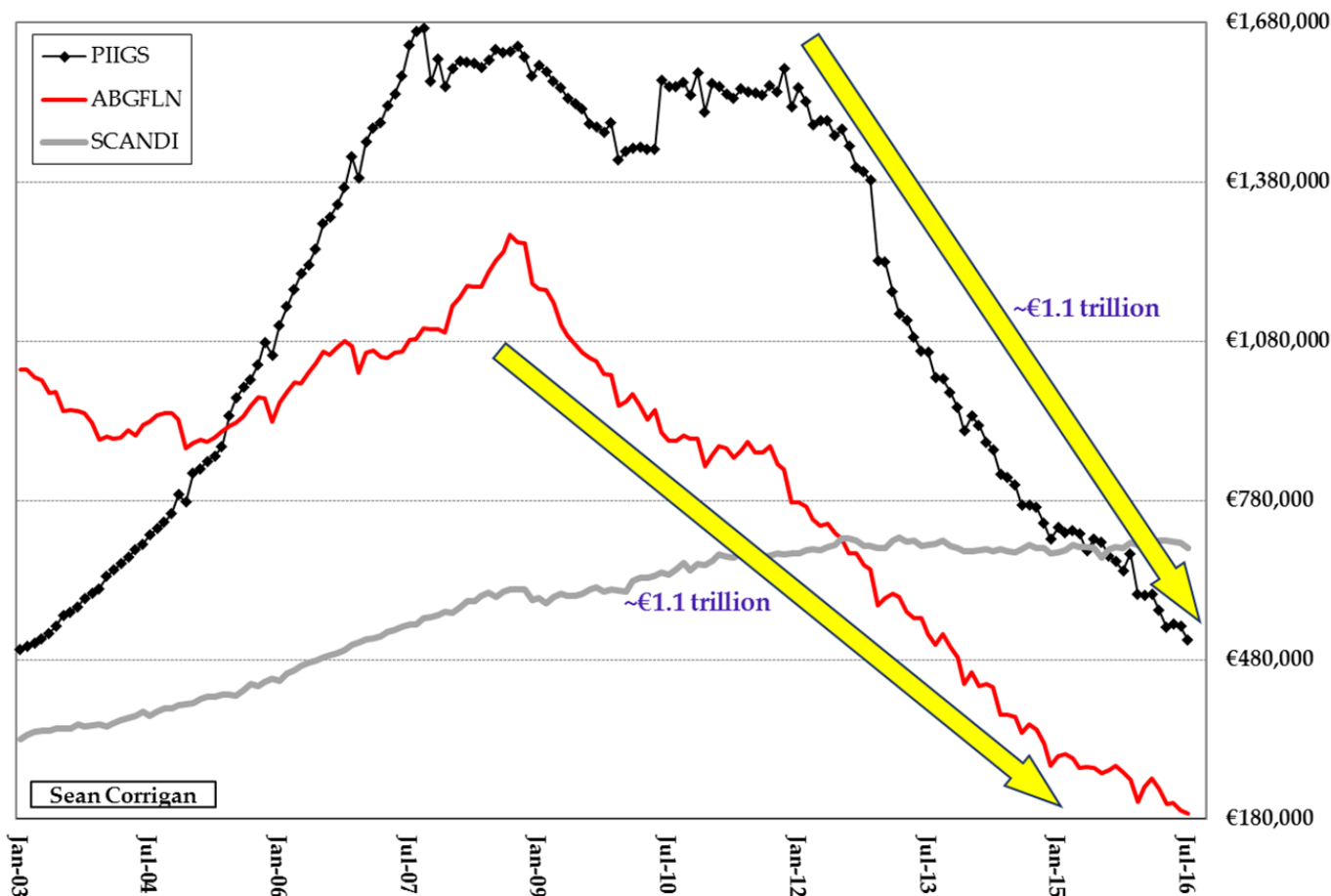
most counter-productive – of sectors has been allowed to monopolise the outlets for both the commercial banks’ desire for income and the central bank’s hunger to earn the glory of the saviour. The former have made loans to and purchased bonds from Leviathan to the value of €715 billion, while the ECB and its local offshoots have poured €1,060 billion into its coffers – almost half of that just since the start of this year – between them accounting for nine-tenths of the rise in M3, 55%, or almost €1 trillion, of that coming from the PIIS quartet alone.

And we are supposed to view ‘helicopter money’ – the central bank’s assumption of responsibility for the state’s spending – as something daring and unheard of? Or believe we are breaking the ‘doom loop’? Or that we are not engaging in any kind of fiscal transfer?

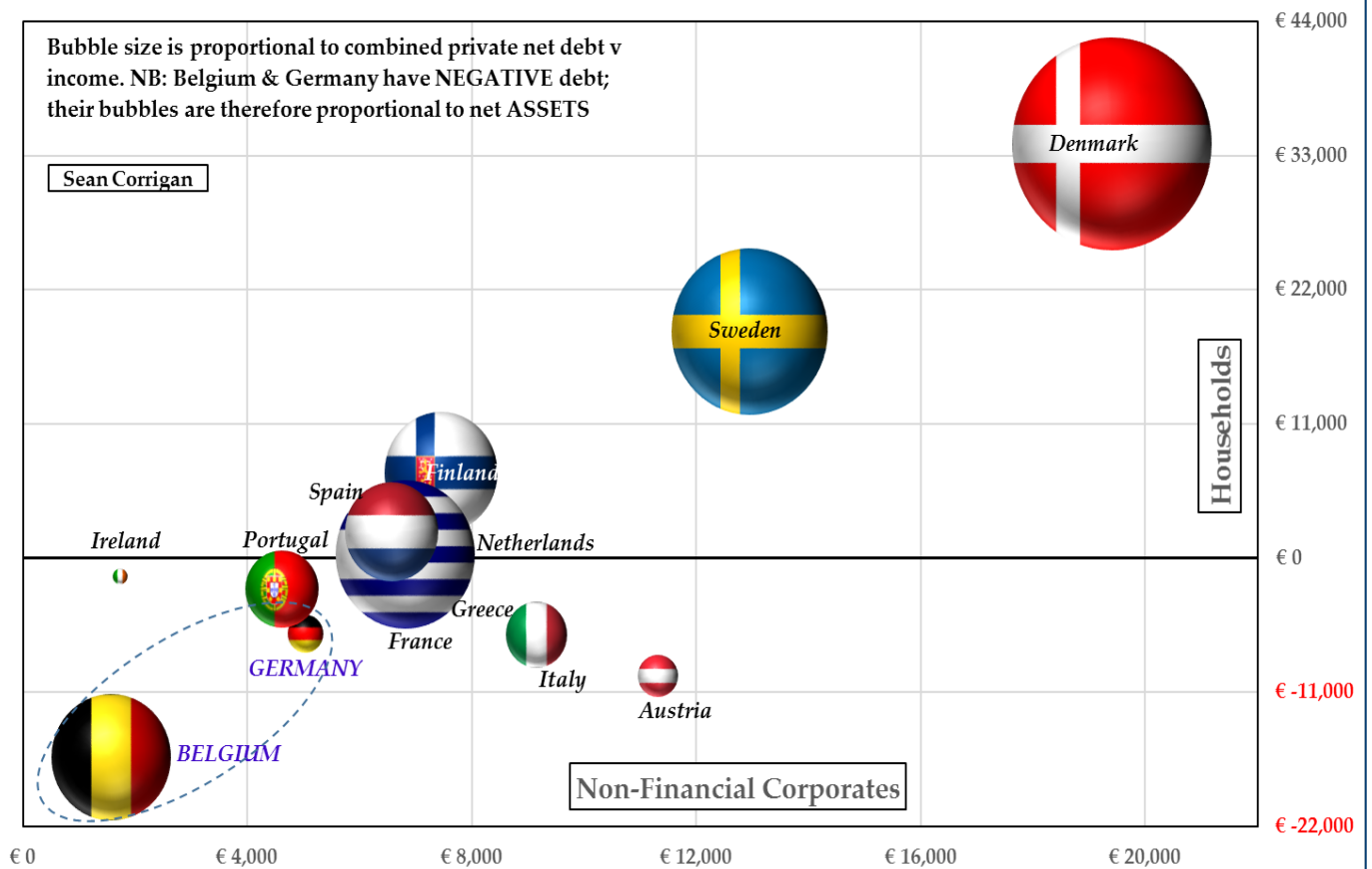
Rudolf Havenstein would be truly proud of the twisted logic and dubious practices of his successors in office.

The connection with the Rest of the World is a little more subtle, but nonetheless informative.

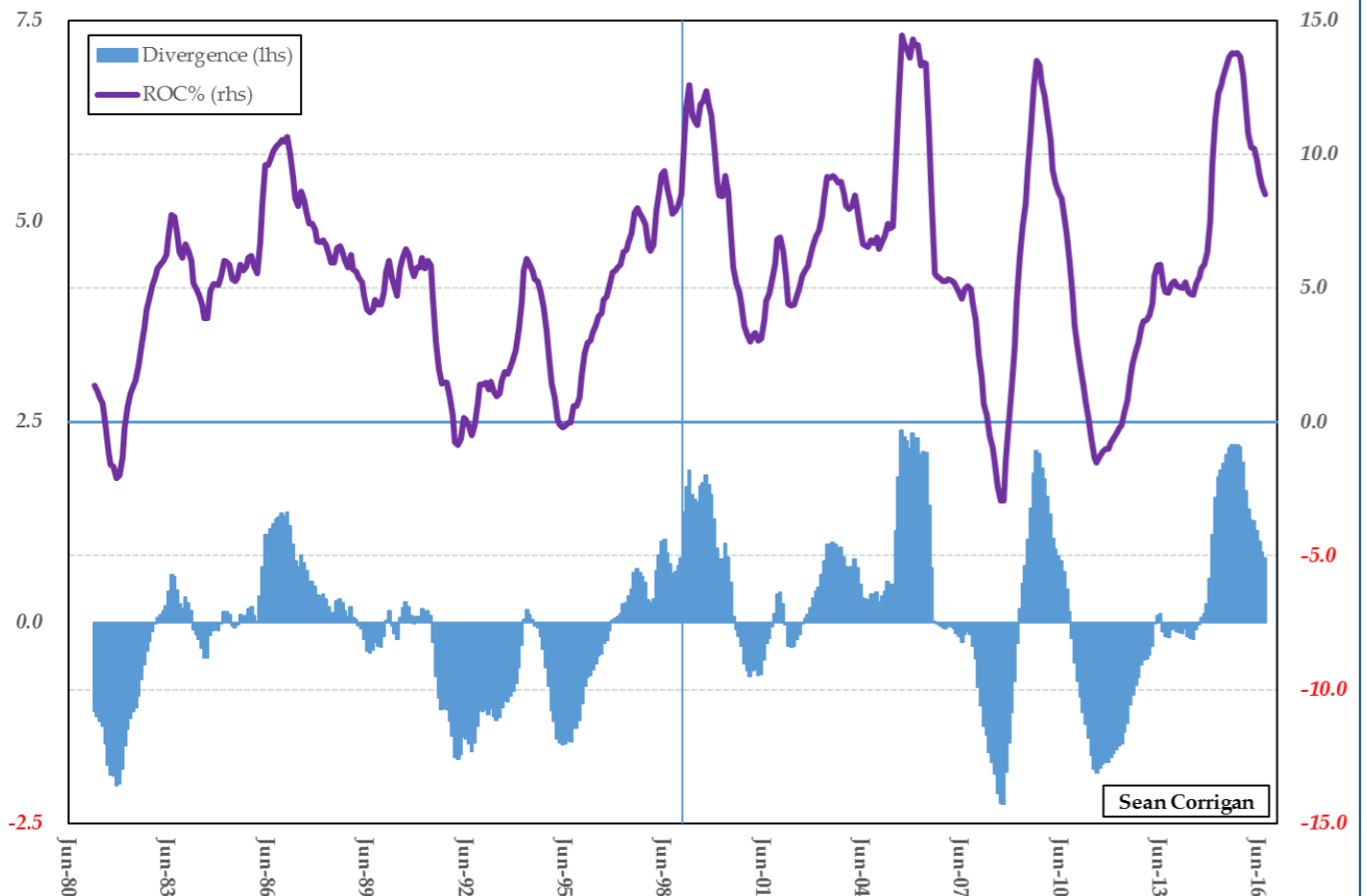
EZ & Scandi NFC & Household Net Bank Debt [Loans - Depos], mlns: Source - ECB



# Net Bank Debt per capita as % of 2014 median household income: Source - ECB



## Eurozone Real M1 6mos ROC% annualized: Source - ECB





Year to date in 2016, the Eurozone as a whole has run a current account surplus of €183 billion with those beyond its borders (half of that with the UK alone, Brexit battlers, please note). Yet the non-banking sectors of the group have simultaneously managed to 'export' €472 billion net in combined direct investment and portfolio flows.

What this means is that the Zone has needed to raise €289 billion via 'other' investments – by which are meant banking type transactions.

Non-banks undertook €53bln of that themselves, leaving the rest up to their local bankers, these latter taking in a whisker shy of €1/2 trillion from foreign lenders and depositors before placing a little more than half of it back with others of their ilk.

Out of the various entries which make up the financial account, that for portfolio debt is the most striking, showing that Non-MFIs reduced their external liabilities by €100bln and increased external securities holdings by €264 billion.

Half of the former number can be attributed to government bonds and so can be ascribed to foreigners hitting the ECB bid: the latter comes about through the actions of domestics desperately trying to find an earning asset – FX hedged

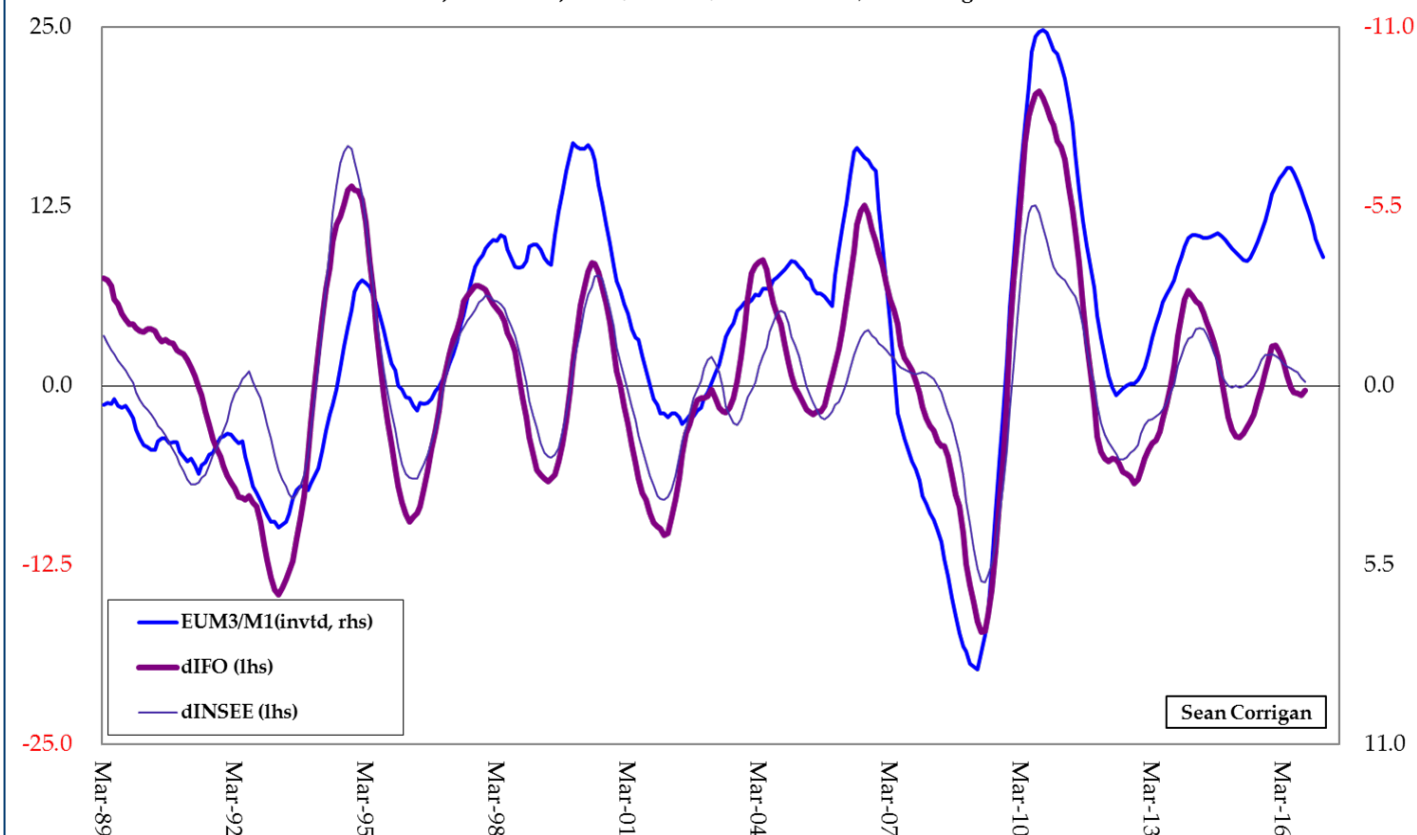
though the MFI build-up suggests it might be – in order to replace the ones they, too, have lost to their central bank's insatiable appetite. On top of this, figures for the first two quarters of the year show a near perfect geographical match between MFIs' incurrence of extra-EU short term liabilities and their acquisition of securities.

You ain't got a thing, if you ain't got that NIM, of course, so lend long and borrow short is all that remains to those in search of Draghi's 'new business model'. It's just a shame that most of the beneficiaries of his interference appear not to live within his fief.

In this way then, is the ECB helping flatten yield curves and lower long-term interest rates far beyond its frontiers, not just at home, and so – in the all-too pertinent observation of Board member, Benoît Cœuré, is helping 'tear up the social fabric' all around the world.

Grazie mille, Mario!

EUM3/M1 inverted v dIFO, dINSEE, t+6 (YOY%): Source - ECB, Bloomberg



## WHERE THE MONEY GROWS: Wall St & West

At last week's FOMC, as well as chickening out once more over raising rates, Janet Yellen gave another rambling, often self-contradictory press conference in which she sought to explain her Committee's latest display of pusillanimity.

For example, Yellen talked of how the Fed was still 'data dependent' – i.e. that it would await the first patter of raindrops before searching in the cupboard for an umbrella – but then boasted of how it was 'forward-looking' and of how it did not favour a 'whites of the eyes approach' to economic overheating!

Then, too, the case for a rate hike was similarly said to have 'strengthened', but clearly had not strengthened anywhere near enough to warrant an actual response on her part. Moreover, there was some macroeconomic mumbo-jumbo about how the US had much lower growth potential than heretofore but that this meant our esteemed Madame Chairwoman felt it had 'more room to run'.

Fully prey to the productivity fallacy of interest rate determination (a hoary old tautology of no greater respectability than the real bills arguments which used to carry so much weight at the Fed), she also kept insisting that the funds rate was so close to the unobservable chimera of the 'neutral rate' – itself an econometric circularity in the hands of the mainstream – that settings were only 'modestly accommodative', but then went on to talk about how, around the world, they were 'highly' so. If she thinks the first can occur amid the second, she must believe in the sort of impermeable barriers at the border of which one of the current presidential candidates can only dream!

Even more confusedly, she argued that, this high degree of 'accommodation' seemed '*to be necessary for countries to be able to achieve their inflation and employment objectives*'. But if such rates as we have *are* those needed to bring things to that happy pass, they are either then themselves the elusive, pixie-dust neutral rates (since that is their definition) – and hence are not at all 'accommodative' – *or* the central banks of the 'advanced' nations are wilfully pursuing 'objectives' well beyond the sustainable limit by dosing activity with a good deal of sub-neutral stimulus.

Ah, well.

But it was in here strangulated treatment of asset markets that Dr. Yellen reached the acme of her expository skill.

Witness the following assertion:-

*Yellen: Of course, we are worried that bubbles could form in the economy, and we routinely monitor asset evaluations. While nobody can know for sure what type of valuation represents a bubble – that's only something one can tell in hindsight – we are monitoring these measures of valuation, and commercial real estate valuations are high.*

We shall deal with the utterly irrational 'rational expectations' school canard of bubble undetectability in a moment, but note that what she has said here is that she can't know if there IS a bubble until AFTER there has been one but, nevertheless, there isn't one at present!

Ain't that just Dandy! Groucho Marx would be proud of that display of absurdity.

Then she offered up this giant hostage to fortune, if only in the spirit of she-would-say-that-wouldn't-she:

*'Overall, I would say that the threats to financial stability I would characterize, at this point, as moderate. In general, I would not say that asset valuations are out of line with historical norms.'*

Patently, if she has somehow arrived at the determination that there is no indeterminably constituted asset bubble in operation, then it figures that non-bubble asset prices cannot be out of line with their norms. Chalk one up to answering one's own question in the affirmative.

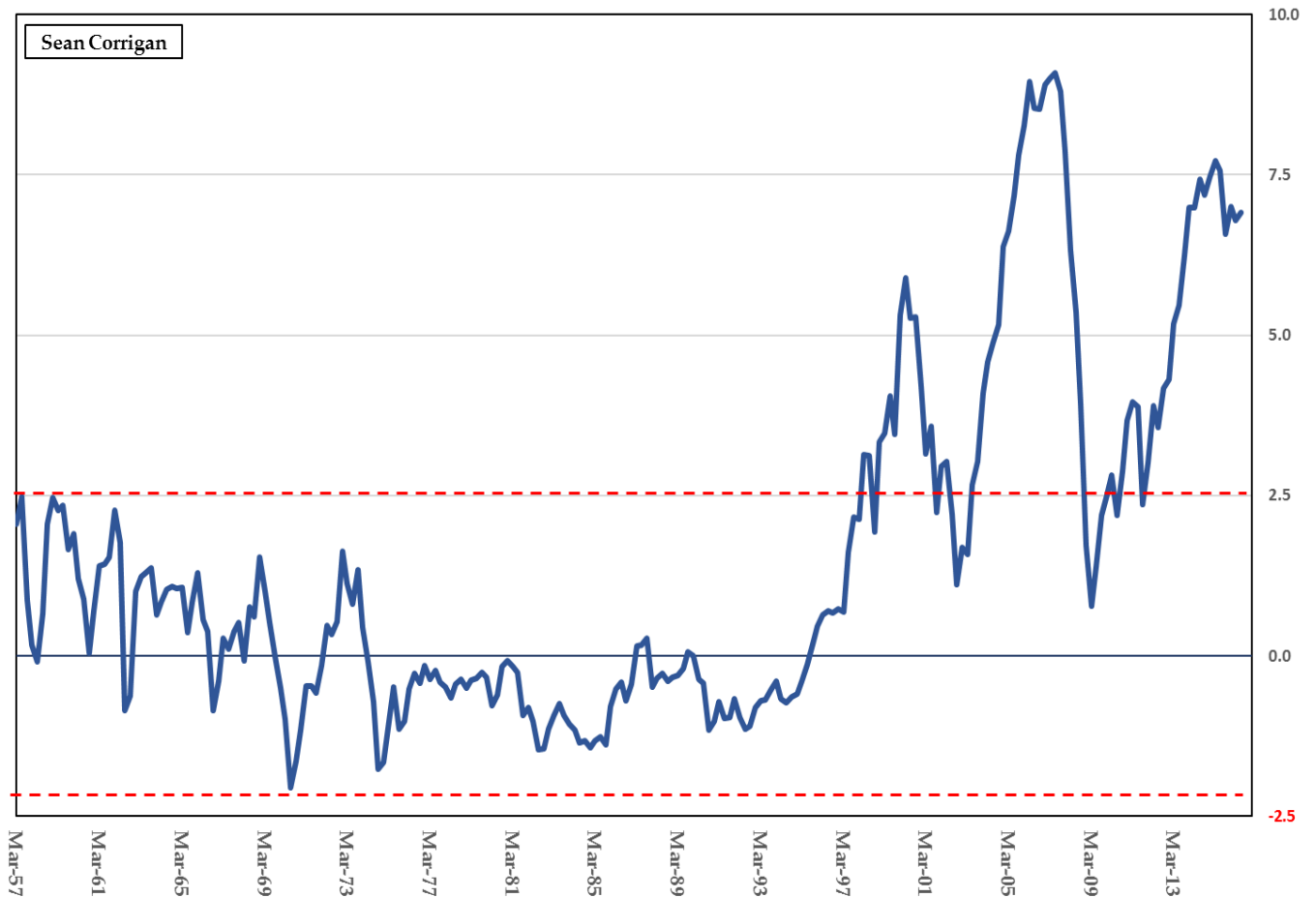
But how much truth is there in this claim? It hardly needs us to expound the proposition that bonds are way out in the far reaches of the distribution – from BAA to AAA, Moody's indices have not been here since the end of the last great episode of yield suppression, from the latter years of the Great Depression, through the war socialism of WWII and past the Korean conflict and for a few, brief years after the end of the Treasury Accord.

As for bonds elsewhere around the world – well, enough said.

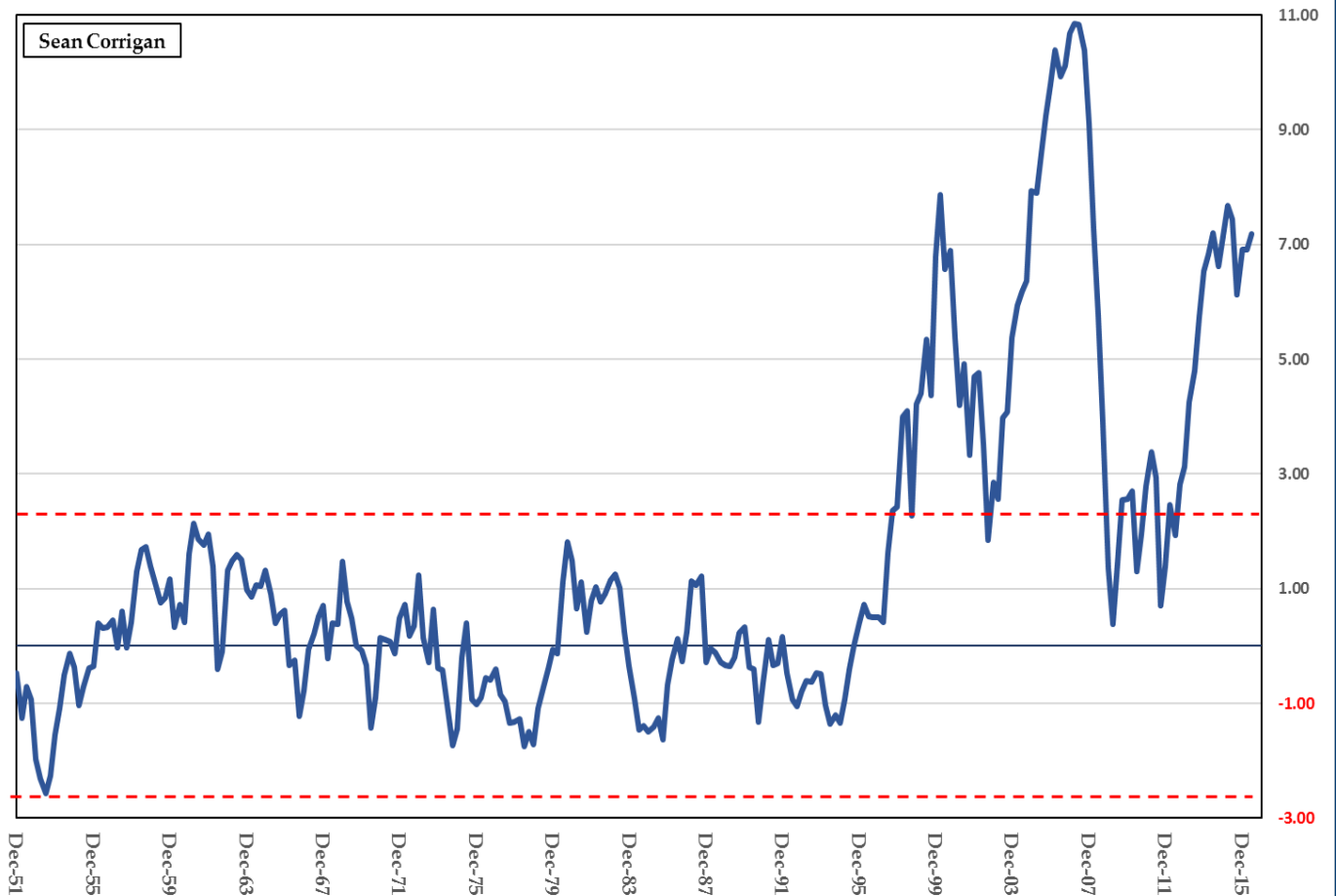
In the end, it all comes down to equities and real estate and even the Fed admits there may be problems with some elements of the latter!

As for stocks, the comparison with nugatory bond yields is the Max Factor on a particularly ugly porker, but whether

US Real Notional Net Wealth v Accumulated Saving, 1957-97 sigmas: *Source - FoF*



US Notional Net Wealth v GDP, sigmas from 1951-97 mean: *Source - FoF*





we look at price to book, earnings or cash-flow; whether we examine the relationship between what is paid out and what is taken or what remains in after other disbursement; whether we consider levels of indebtedness, or returns to capital or equity - things are either deteriorating, already parlous, or at their worst with the exception of the metrics seen at the peak of the late Tech Bubble.

Hopefully, the charts appended here will demonstrate this beyond all hope of reutation.

As for 'wealth' in general, a certain Mr. Buffett once used to sneer at those who thought they were oiling up riches not through the sweat of the brow or the keenness of their wit, but by ringing up their broker between rounds of golf.

Well, for the third time in under twenty years, 'we' have been doing much the same, thanks to Mme. Yellen and Messrs. Carney, Kuroda, Zhou, and Draghi.

No wonder the 1% are reinforcing the bars to their gated communities and the sans culottes are abandoning the political clubs of those who seem to have abandoned them as all this has taken place.

No, Madame Chair. There is little in the way of modest about the divergence of your interest rate settings from

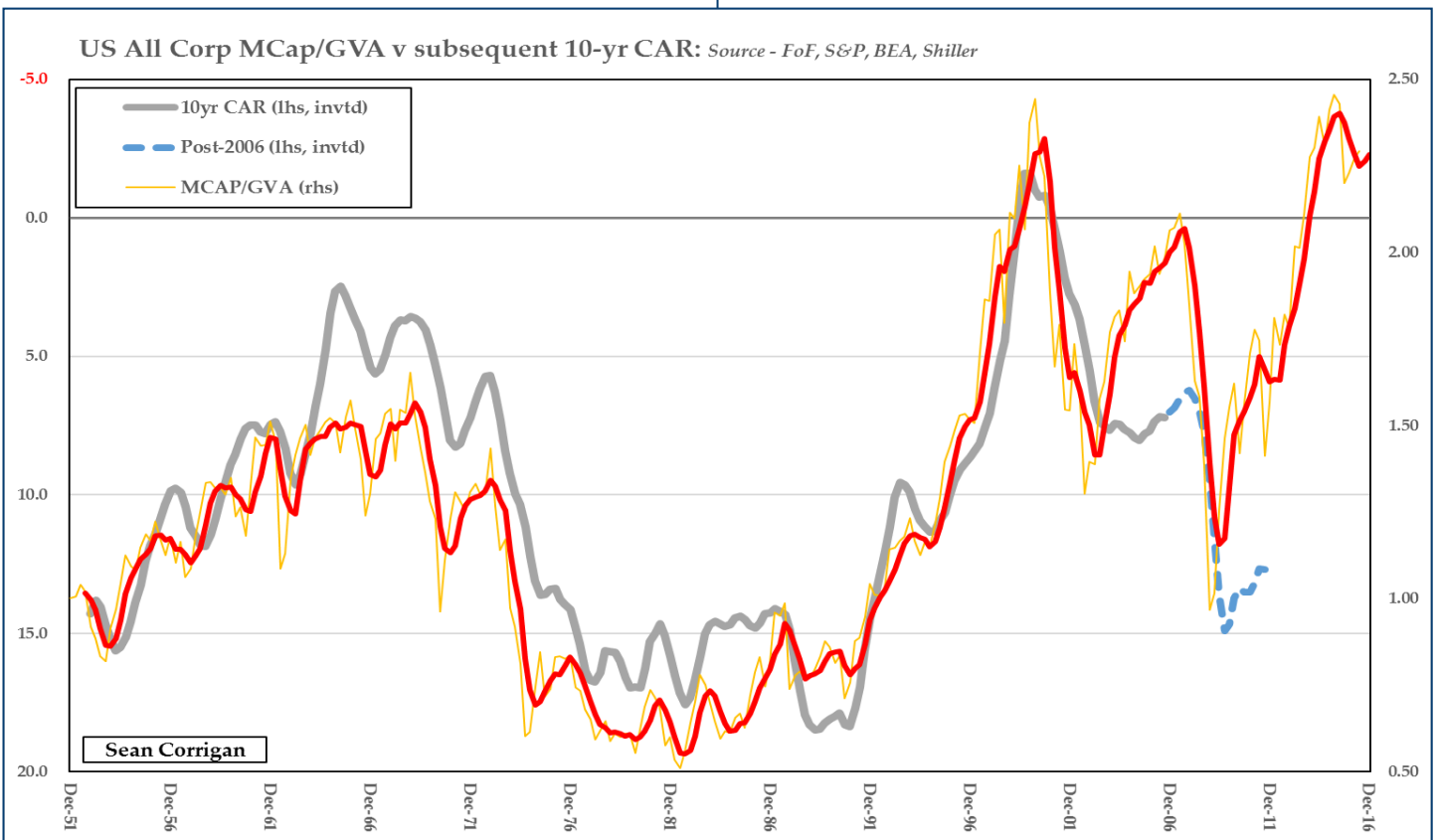
levels they should have attained, nor much in the way of historical precedent for where that has propelled asset valuations.

Those who can borrow – i.e., those who can credibly pledge the delivery of money tomorrow for the use of money today – have never had it so good.

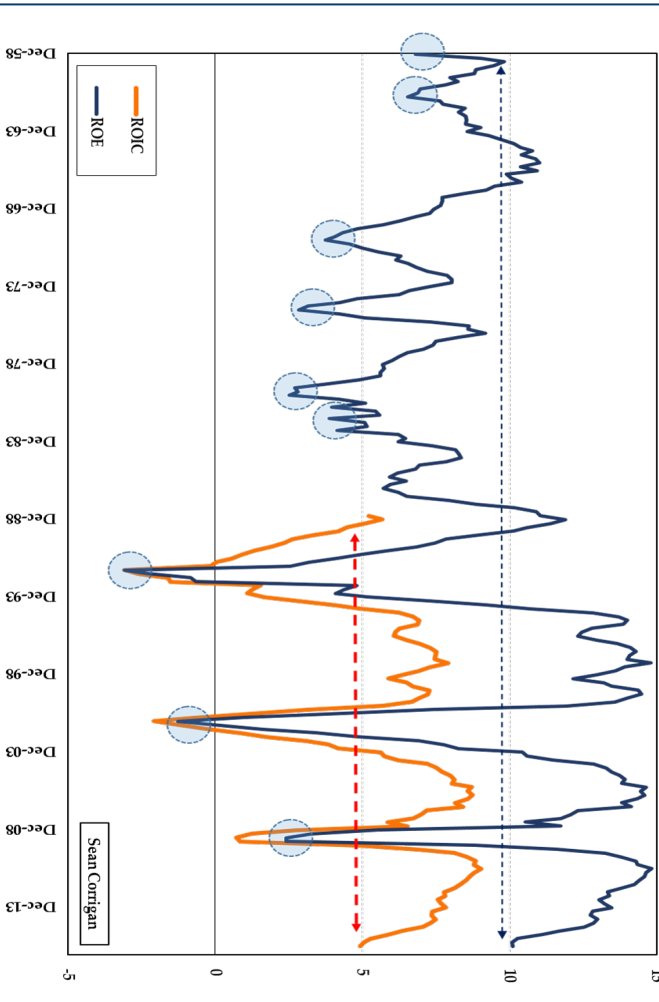
Those who cannot or will not are being forced to endure the noise of their richer neighbours partying upstairs on the higher levels of the apartment block.

Those who would instead prudentially provide for a less well remunerated tomorrow by lending are being priced out of the market by a monetary flood of biblical proportions. Worse, they are also seeing the greatest gains go not to those financing tomorrow's income-generating combinations of productive means and entrepreneurial skill at personal hazard but rather those being showered with often no-recourse table stakes by the MIT Macromancers so that they may make carefree gambles that their awareness of the Cantillon effects of selective inflation is sharper than that of the suckers sitting beside them.

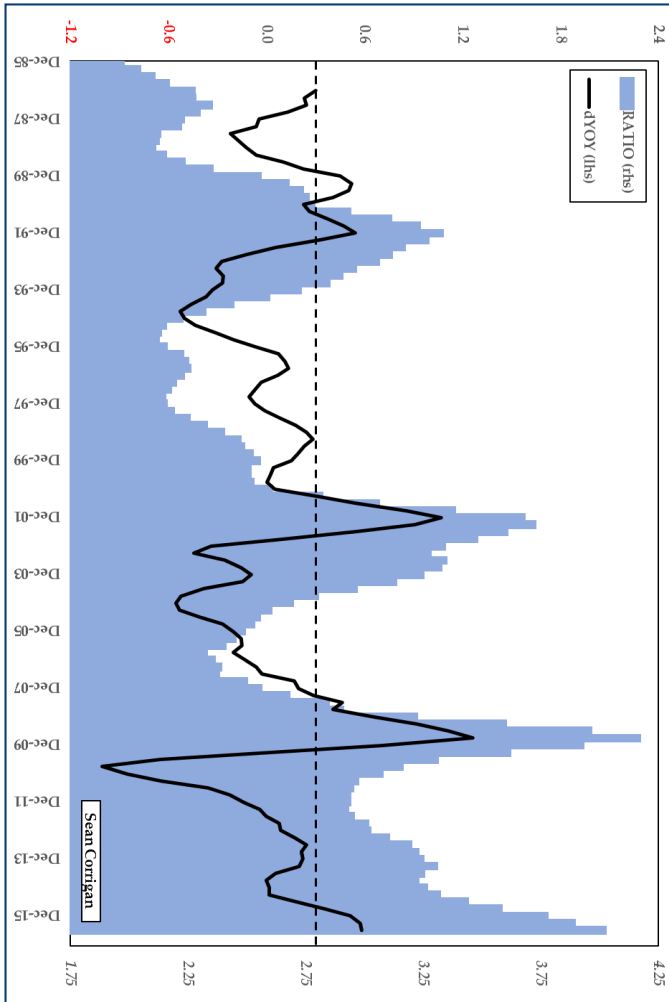
Yes, M. Coeuré, that is indeed a combination almost guaranteed to 'tear the social fabric', and to tear it, moreover, in a manner not readily to be reknitted.



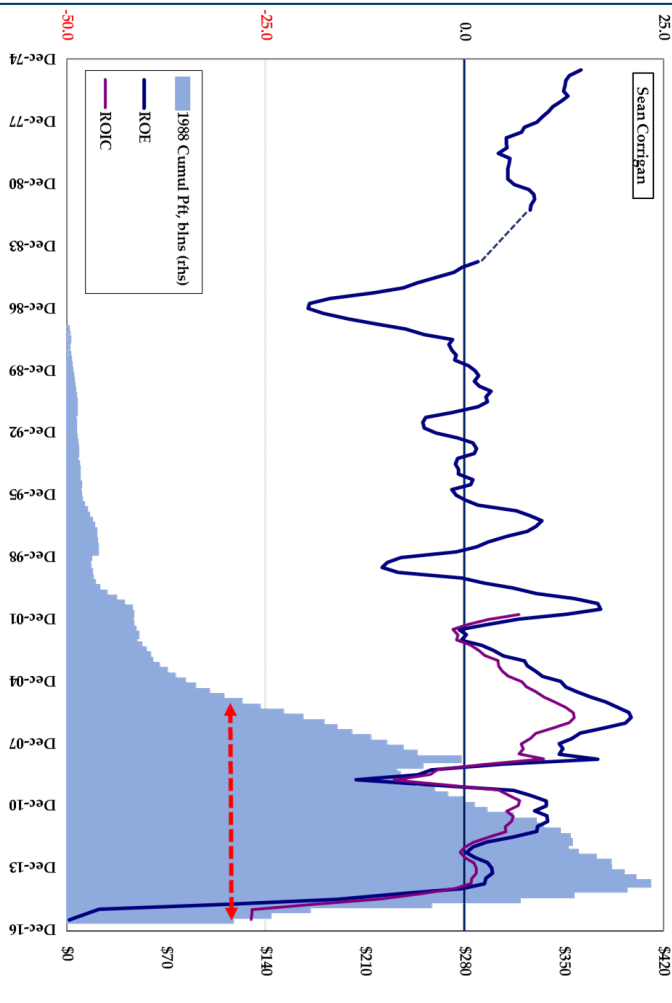
US MFG Real After-Tax ROE/IC, 4qma: Source - Census, BLS



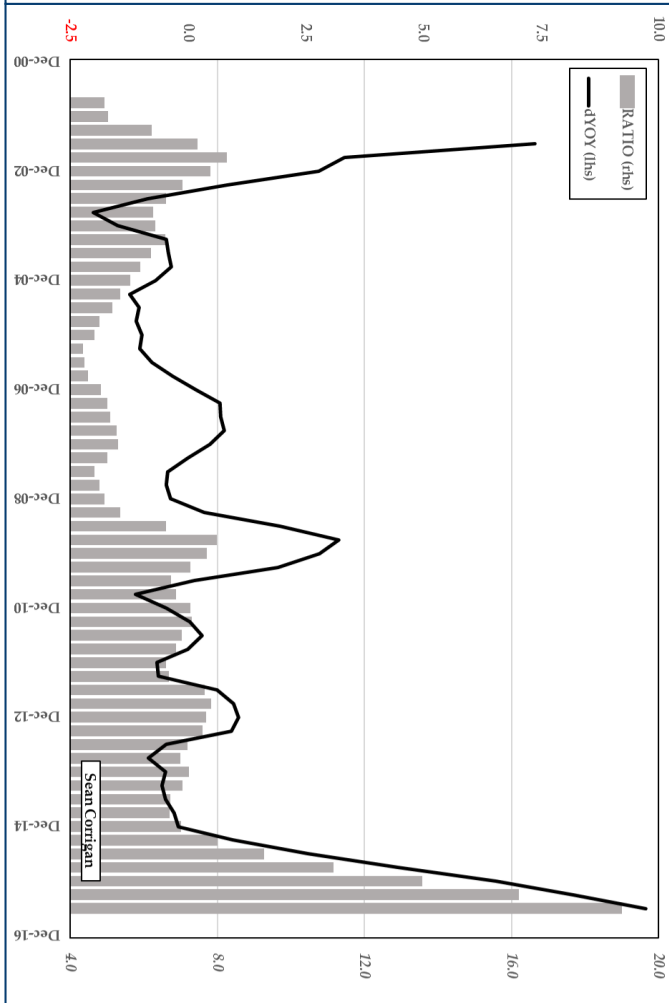
US Manufacturing Corps, Debt/EBITDA & YOY: Source - Census



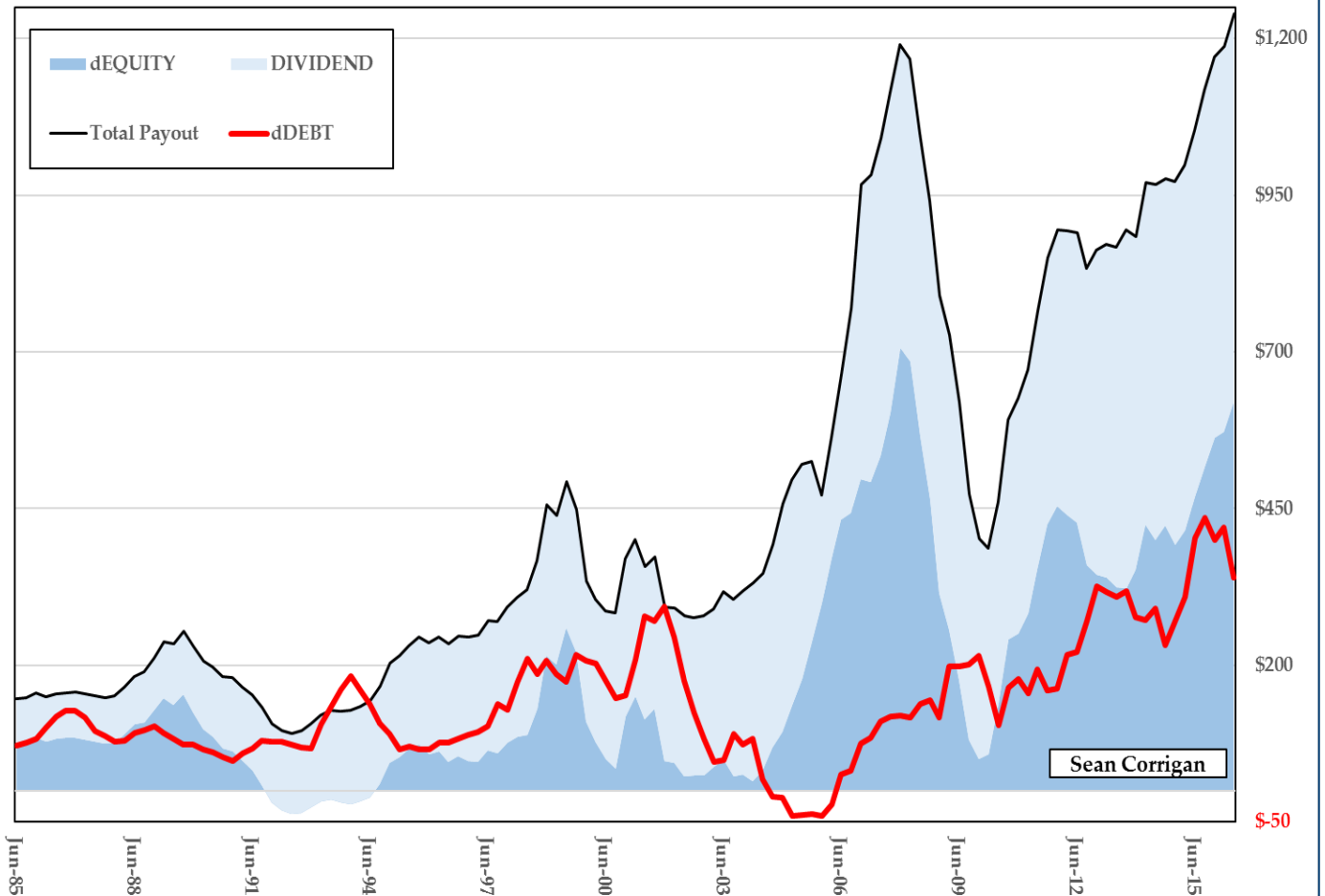
US Extractive Profits, Real ROE/IC, 4qMA: Source - Census, BLS



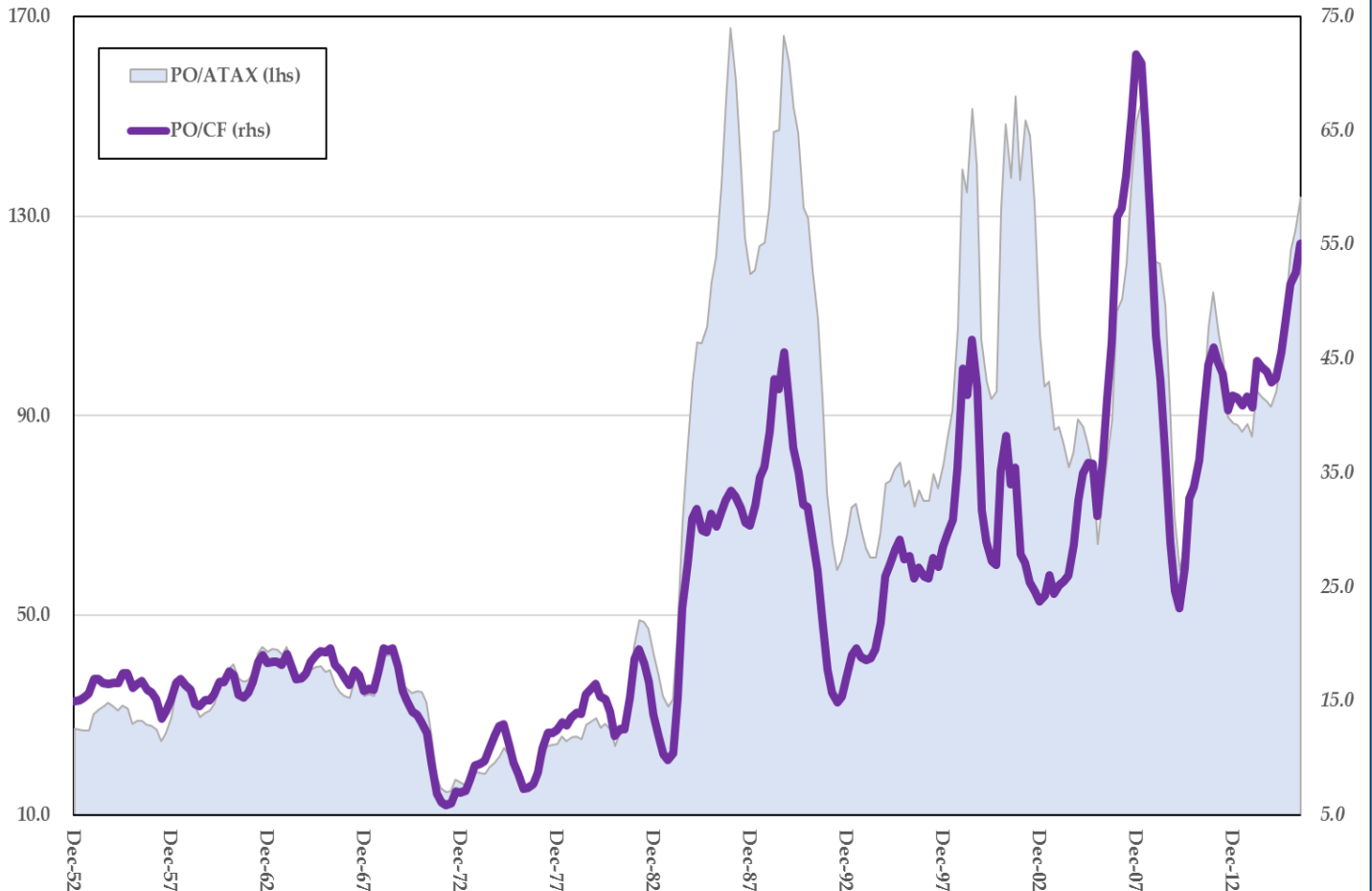
US Extractive Corps, Debt/EBITDA & YOY: Source - Census



US Non-FIN Corporates rolling 4Q Pay-out & Capital change: Source - FoF

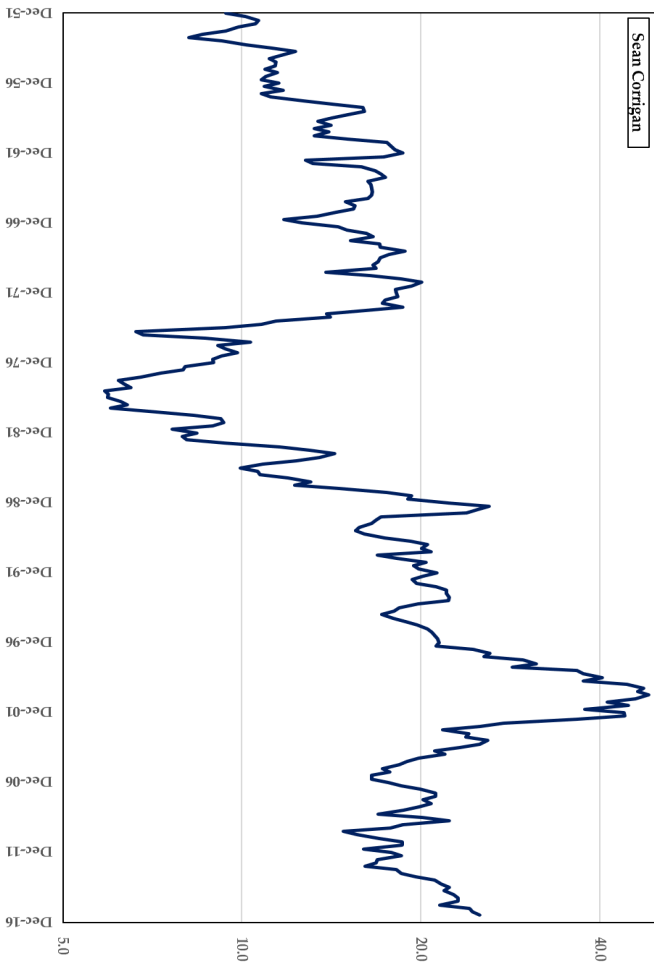


US NFC Pay-Out % of Cash Flow, Profits: Source - FoF



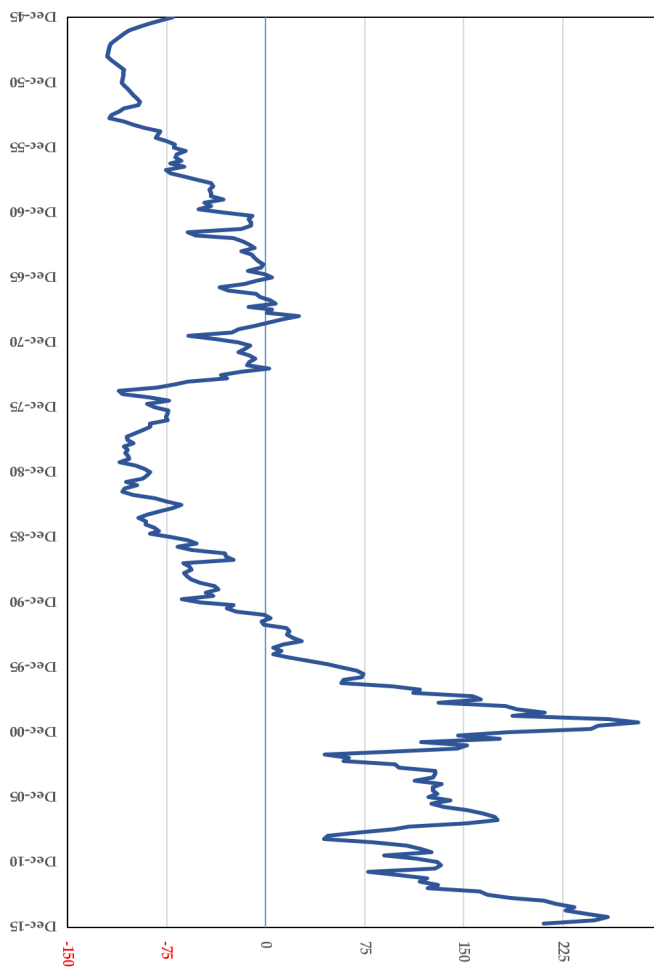
US Corporate P/E, In scale: *Source - FOF, BEA*

Sean Corrigan



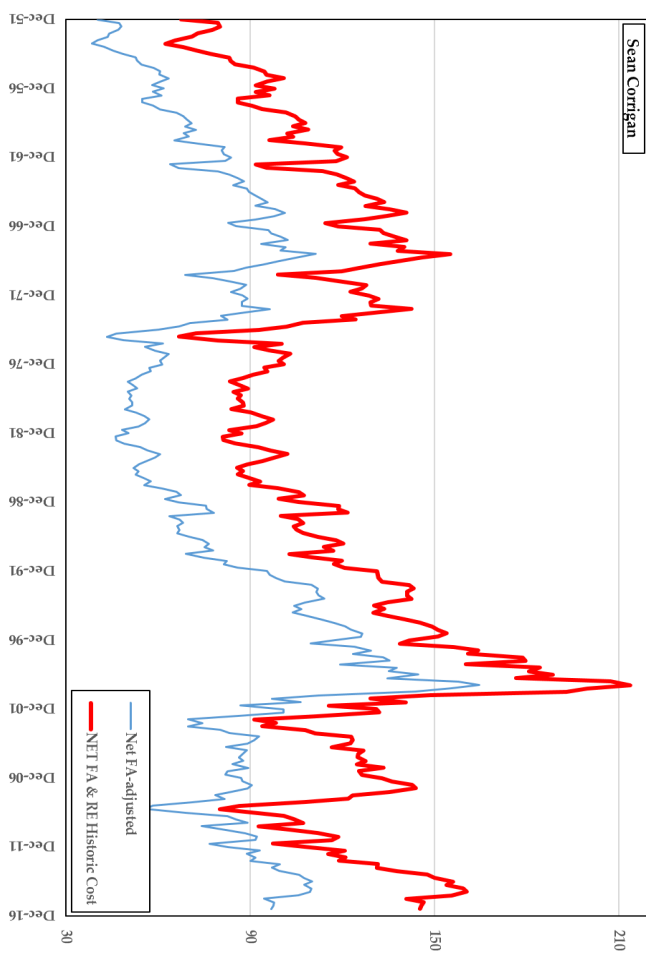
US Non-Fin Corporate Price to Sales: *Source - Fof, Census*

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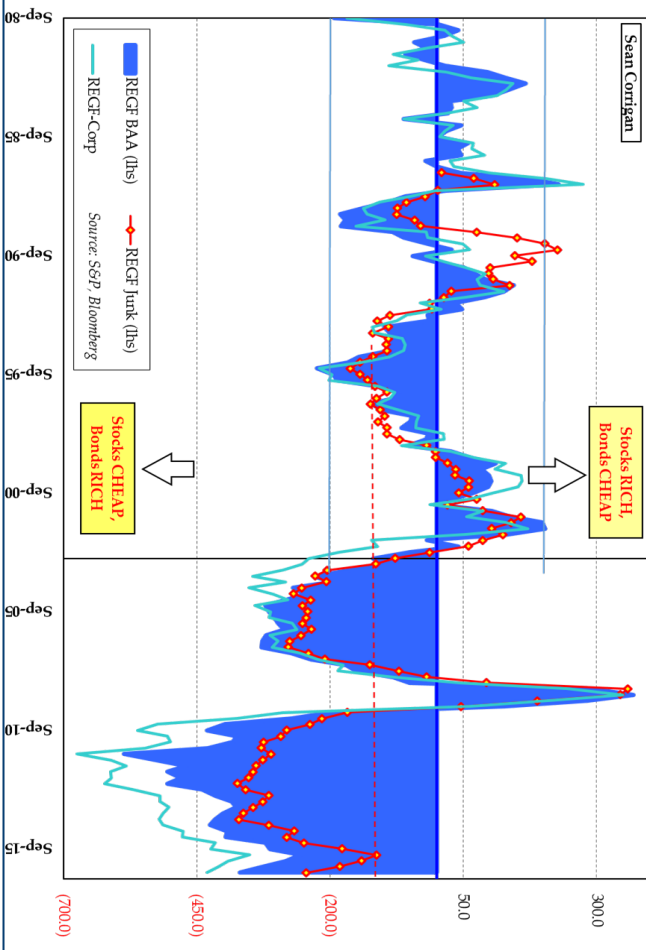
US Non-Financial Corporate Q-Ratio: *Source - Fof*

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US S&P500 Real Earnings Growth Factor via BAA, Corporate & Junk Yields,  
100 sigmas of 1980-2003 Range

Sean Corrigan





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