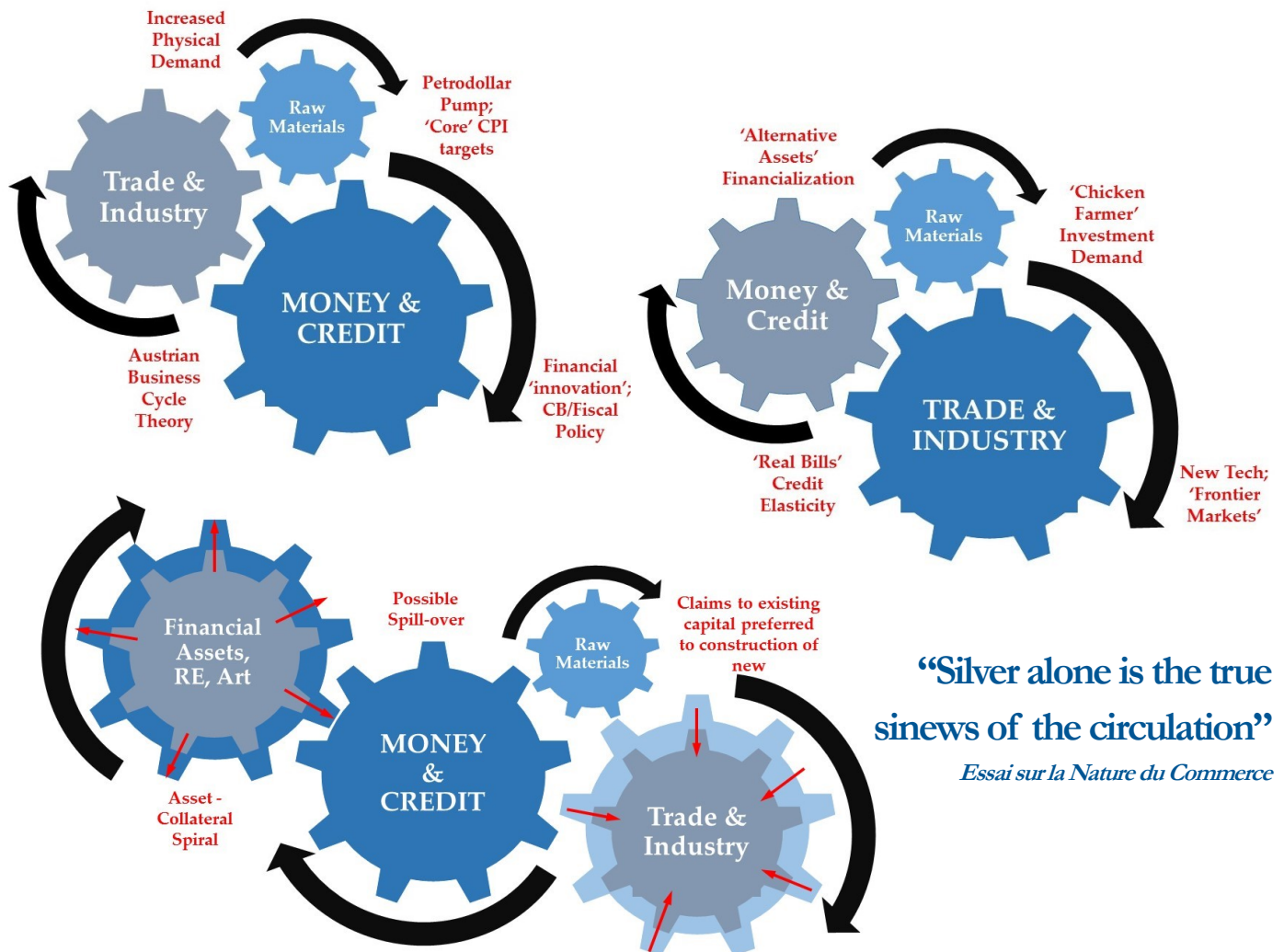


Cantillon Consulting



Easy Money, Hard Times

How the pernicious effect of holding interest rates too low has been hindering recovery today and undermining prosperity tomorrow.

Summary

Though the connexion is not always explicitly drawn, one obvious corollary of the perceived current shortfall in corporate investment spending is to be found in the lacklustre nature of the gains being recorded in something called 'productivity'.

This latter deficiency is often said to have 'puzzled' the Good and Great who presume to be able to influence such matters for the better, but one can readily identify factors which implicate the policies of those same would-be helmsmen of the economy, in the discouragement they offer for capital formation and by the incentives they afford for less than ideal practices among businesses, consumers, and governments, alike.

AS A MATTER OF INTEREST

Here we will explicitly leave aside the very real, but nevertheless unquantifiable, matter of 'regime uncertainty' – that is to say, of the degree to which executives have been disquieted by the raft of wrenching changes in the political, legal, and regulatory environment which have proliferated in the wake of the last great crisis. Instead, we will point the finger firmly at the malign effect of the negative real (and, in the extreme, negative nominal) term rates which it has been the authorities' principal response to maintain, long after the emergency which gave rise to their initial introduction has passed into the history books.

The first such influence is perhaps something of a conceptual one, but is nonetheless one whose import has profound practical implications.

Here we must pay attention to the simple fact that a combination of human psychology (perhaps even physiology) and our mortality means that we generally value available goods more highly than those whose enjoyment is only prospective. Jam today almost always tastes better in the mind's eye - and often in the mouth itself - than jam tomorrow.

The economic term for this is 'time preference' and most of us Austrians consider this to be the fundamental reason why the phenomenon of interest - effectively, the price of waiting - even exists.

From this, we also argue that goods which cannot yet furnish us with a satisfaction of our wants, but which can be transformed and processed into exactly such goods as time elapses, will be priced lower in total than will these latter, their future, anticipated embodiment. The thing produced is worth more than the thing producing. The caterpillar is prized less highly than the pupa and it than the butterfly which will be the pair's resplendently graceful culmination.

Hence, working backwards, a positive discount factor (which just a reverse-motion way of saying a positive interest rate) is the norm. From this we derive the expectation of earning a positive return on invested capital, even absent that extra reward for the successful practice of insightful, entrepreneurial initial arbitrage which is the proper defini-

tion of 'profit'.

Note, in passing, that in the widest, most consistent sense of the word, pass-through inputs of raw materials and components - of 'work-in-progress' - are also forms of 'capital', a word we should not limit to the repeat-use, durable lumps of metal we call 'machinery' or the static conglomerations of steel, brick, timber, and copper which house and connect them, which we call 'plant'. If the value of any of these is supposed to decay over time, we will seek to employ only those coming to fruition after the shortest, least avoidable period of such erosion. It will be hay-fields, not hardwood forests – battery hens not carefully-bred beef-cattle - which will then cover the commercial and industrial landscape.

DEAR MAYNARD, YOU'VE LEFT US NO LONG-RUN

With all that in mind, now consider the paradoxical nonsense of negative interest rates. The thing in embryo is, by inference, now deemed worth more than the fully-formed creature: the just-fallen acorn has more value than the mighty oak which it will take centuries to build. The 12-year old Scotch will be cheaper to buy than the 15-year old.

Thus, a major baleful influence of negative rates consists of the signal these send that the value of the forward schedule of what it is one undertakes capex (or any other time-consuming productive combination) to generate will be lower in inflation-adjusted (and even in plain, ol' dollar) terms than the sum of one's initial outlays.

Hence, such combinations seem doomed to be value destructive, not accretive, and so low rates, far from stimulating extra long-term investment, offer absolutely no incentive to do more than the bare minimum consistent with ensuring the mere continuance of one's business and hence of the maximization of one's consumable income in the here and now.

Eat drink and be merry for tomorrow we book a loss!

The second drawback is, that by deliberately keeping rates below the rate of societal time preference -with the fatuous aim of 'bringing forward' spending - exhaustive consump-

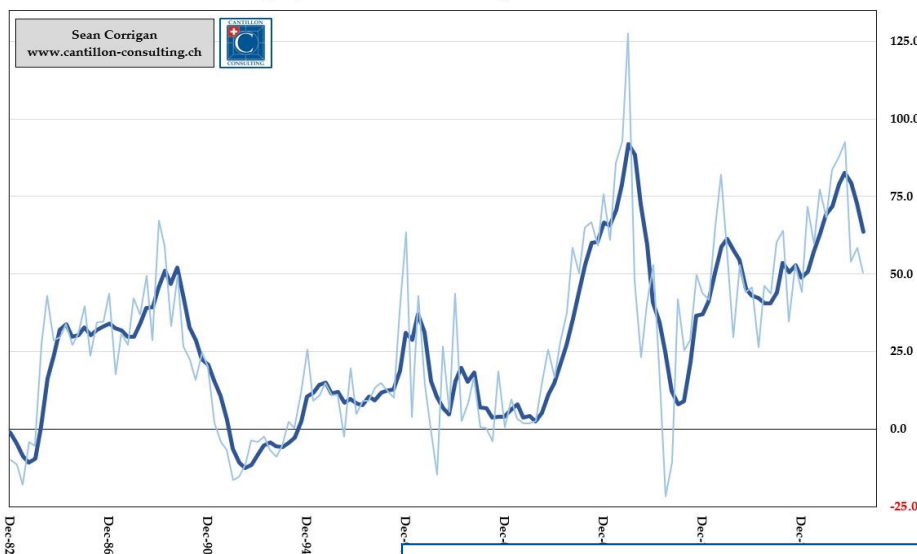
For those who care to look, there are also tantalizing signs that corporate decision-makers are slowly beginning to opt for a higher quantum of capital expenditures and that, simultaneously, at least some of the fervour has gone out of buying back equity as a way to flatter both earnings per share and return on equity (as opposed to the much less-frequently cited return on invested capital).

Taking the US as an example, so-called ‘core’ capital goods shipments (i.e., those which exclude both defence spending and the lumpy fluctuations of civilian aircraft orders) have shaken off their recent funk to rise at a healthy 6.6% 3mmaYOY which is the briskest clip in five years. Coincident to this, the pace of equity retirement registered in the Flow of Funds accounts in June (a useful proxy for actual buybacks), declined to the lowest level in ten quarters after a YOY decline which was the largest in close to five years. This represented an outlay roughly half of the sum of capital goods shipped – another 10 quarter low and mercifully far below September 2016’s post-Crisis high (indeed, third highest ever) tally of over 92%.

One can only hope that this marks a welcome return to moderation: that workshop engineering might rise a little higher on the to-do list than the financial kind. If this is indeed the case, it might not even have such an unequivocally negative impact on stock prices as might be imagined since the obvious fall off in leveraged buying of shares by companies themselves might be mitigated by the fact that, as a matter of aggregate arithmetic, higher, below-the-line capital expenditures means a greater proportion of recorded revenues do not generate a fully-expensed offset in the same accounting period.

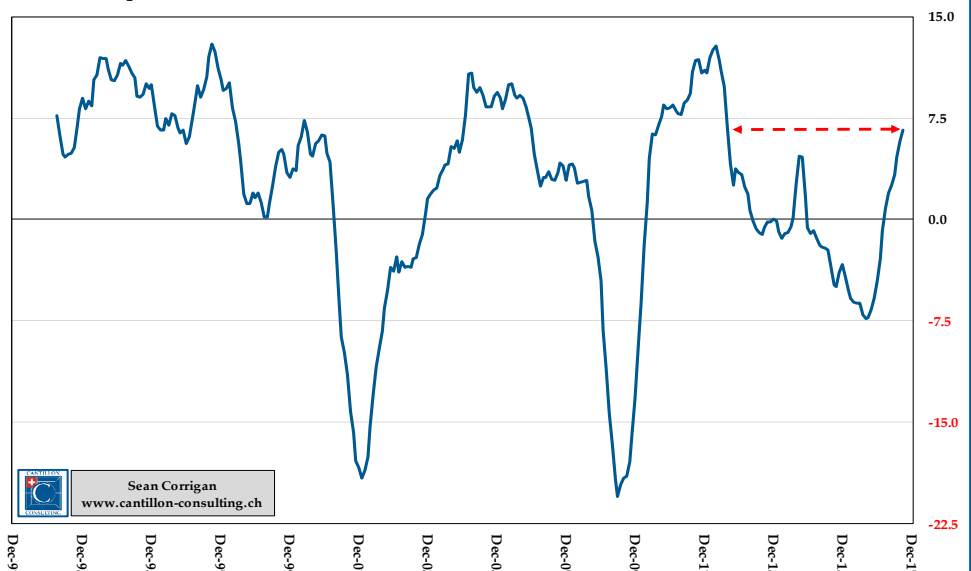
If, therefore, both revenues and overall profits are on the rise, a good deal of the rationale to boost EPS the Wall St. way might evaporate and set in train a more virtuous circle, long before the physical benefits of such investments filter down into realised gains in productivity and – one might subsequently hope – real wages.

US 4Q & 1Q Non-Financial Equity Flows as % of Core Capital Goods Sales: Source - Census, FRB



Less equity retirement through buybacks, buy-outs, and M&A versus signs of a welcome rebound in investment in physical capital. Not quite a complete Renaissance, but promising, nonetheless

US Core Capital Goods Sales, 3mma YOY: Source - Census



tion is enhanced and saving suppressed. From this, one is led - as Bernard Connolly is frequently heard to insist - to the inescapable conclusion that when Tomorrow finally comes and the piper demands his hefty payment, consumption will necessarily be lower in that bleak future than would have been the case had one's savings been encapsulated in productive capital and so had matured into spendable funds instead.

Thus, on both counts, a rational entrepreneur would concentrate hard on selling readily-consumable goods today and would devote far less money and effort to projects which could only begin to throw off such goods and then slowly to amortize their cost over a more extended horizon. Instead, whatever surplus funds the first activity threw off would be preferentially disbursed to shareholders and creditors and not incorporated into the material substance of the business.

Our man would also seek to spend both his and his financiers' money trying to gain control over more of today's spending, rather than planning to earn more of tomorrow's and so would divert funds into buying up present combinations (as embodied in other firms) rather than being used to laboriously construct his own.

Now add in the fact that end-consumers can also make that same spend-today-starve-tomorrow shift by borrowing at artificially suppressed rates of interest in a manner denied to the previous generations on the basis of whose more restricted behaviour classic Austrian Business Cycle Theory - a tale told largely of producer borrowing, remember - was originally formulated. Thus, we also have to allow for a backdrop of chronic, 'simple' (horizontal or more immediate) inflation to overlay the archetypal 'credit' (more vertical or 'roundabout') inflation elaborated by Mises, Strigl, Hayek, *et al.*

What this again implies is that goods saleable today will find a market for as long as new sources of consumer credit can be tapped with which to buy them, but that those wares which will only arrive in the shops after some considerable delay might well then encounter a customer who has exhausted all such possibilities and who may even accord a far higher priority to paying down some of his burdensome past obligations than to indulging any other material fancies

Not much of a motive for aggressive capital expansion, is it?

PULLING UP THE FLOWERS, WATERING THE WEEDS

Another complicating factor is the loosening of fiscal restraint which follows when that most inveterate consumer of all, the State, pays little (or, under QE, effectively zero) interest as the price of its incontinence.

Whether or not the overall CPI basket of goods costs more as a result, this oldest, least transparent, and least democratic of taxes - the inflation tax - is still very much at work. Nor has its heavy footprint been much disguised: its imprint can be directly identified when one recognises that the things going up most rapidly and most persistently in price today are precisely those things which the state, not the global market, either provides, mandates, regulates, or - conversely - subsidizes most heavily.

Since these are also areas which tend to be labour-intensive and where competition from across the borders is of little significance, herein lies yet another reason why nationwide measures of per capita output are so low. As for those versions of the data which confine themselves to gauging only the performance of the private sector, the effective 'outsourcing' of much low output government work - that otiose pen-pushing entailed by the need to run vast bureaux of welfare, compliance, and reporting staff alongside the engineers, the factory hands, and the sales team - is a further major depressant on the result.

Furthermore, the extra expense involved in consuming such public 'products' - not all of whose use is entirely voluntary, of course! - serves to drain purchasing power away from genuine, market-provided goods. Thus, even within our already impaired framework wherein consumption is only being maintained through the incurrence of extra debt, a disproportionate share of what the consumer shells out is not destined to end up in the pockets of those most likely to work to improve the efficiency by which they come to stock it, but in the coffers of the exchequer and in the wage packets of all the state's vast legions of competition-shielded supernumeraries.

A further perverse consequence of this stretch is that encourages industrial gigantism and - through that perverted symbiosis of the regulator and the regulated which Bruce Yandle evocatively termed, 'Bootleggers and Baptists' - to crony capitalism or, to employ a rather more sinister Italian rendering, '*corporativismo*'. The Big State, when a good portion of its costs are hidden from the electors, can only grow ever bigger. The resulting burden of loss falls disproportionately on the small, on the start-up, on the true enterpriser for whom every dollar must give rise to more than a

dollar in return and whose greatest scarcity is often that of time, not of money itself.

By contrast, the great lumbering dinosaurs of industry, for whom a few extra administrative staff here, a few extra man-hours spent filling forms there, can be much more readily absorbed in the budget. And, if not, well, some of these firms now actually get paid by their hapless creditors to borrow the funds they need to make up any shortfall – a twisted privilege, of course, denied to the brighter, faster, more innovative wannabes snapping annoyingly at their heels.

If you think this is exaggerated, we suggest you take a glance at the widespread decline in new business formation, in dwindling job turnover, or in the shrinking count of the listed corporations which comprise our soaring stock indices. Not all of this is a direct result of holding interest rates too low, for too long, but the preferential access to cheap finance which the larger, more established firms naturally enjoy is only sharpened when they are. Hence the vital, prosperity-giving Darwinism of the marketplace is further suppressed.

Sadly, for all the current pious head-shaking about the bane of rising 'inequality', what few critics seem to recognise is that perhaps most pernicious of all is the inequality fostered by easy money between the Haves and Have-Nots of the business – not of the individual - world.

Of course, no talk of such a drag would be complete without mention of the swollen population of sub-marginal, 'zombie' firms effectively either being run for cash or living hand-to-mouth off continued infusions of cheap credit. These are undertakings which, even from the commercial ICT ward which they inhabit, are still taking up scarce resources in order to pump out market-glutting end-product and so are depressing the profit-generating difference in value between the two to the detriment of others, despite these Undead businesses' own inherent lack of viability.

As such, they themselves have neither the means nor the motive to do much to increase capital formation. On the contrary, their controlling creditors will often simply be content to make the best of a bad job and suck out the firms' depreciation allowances in the hope of recovering as much of their stranded principal as possible before the liquidator finally calls.

Without low interest rates and hence without the increased forbearance of traditional lenders which these induce; absent the avidity with which the yield-starved will buy their securities issues or bundles of their re-packaged loans, much of this economic dead wood would long since have

been swept away, clearing light and space in the forest for vigorous new seedlings to emerge and grow skyward as it was.

A NEGATIVE VERDICT

Take all of the above – and add in the effect on supply of having borders largely open to those seeking work in countries less politically- and socially-benighted or economically-afflicted than their own – and here we have a system which tends to low wages, low labour productivity, high employment and - restarting the cycle once more – to correspondingly low levels of investment.

It further implies those same workers – in their guise as consumers – are treating themselves to a quantity of material comfort easily beyond their ability to afford it out of current income. Inevitably, this leads them, in turn, to endure a disproportionate increase in their own debt-burden.

On the wider financial plane, it means companies issuing ludicrously cheap debt to make equity ever more expensive by retiring their own shares and just as eagerly paying expanding multiples of book value for those of their rivals; the second in order to fend off competition, to strive for the often-elusive 'synergies' of amalgamation, to secure extensions of current market share – or even simply to satisfy executive vanity.

All of these are, of course, further examples of a debilitating loose-money Gigantism in action. Few such activities do much in the way of effecting that improvement to the count of benefits coming out per quantum of effort and resources put in which is the only path to general material betterment.

Does any of this sound wearily familiar? If so, we would suggest you address your comments principally to your hyperactive, local reserve bank, not forgetting to include a well-deserved mention to whichever opportunistic finance ministry and soft-budget, empire-building bureaucracy it is which that bank's execrable policies underwrite and which is therefore better placed to encompass an inexorable, ever more intimate intrusion into your natural right to the daily pursuit of both your livelihood and your liberty.

Sean Corrigan

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