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The Solid Ground
Established 1995

The Age of Emergencies Is the Age of Control: The Financial Press Gang Comes to Europe (28/02/2022)

For those still wishing to attend The Practical History of Financial Markets course in London from March 10th to 12th it is not too late to book a place. You can find more information at www.didaskoeducation.org. If you would like further details please email me directly at russsell@sifeco.org. If you cannot make it to London to attend the course in person, don't forget a new fully online video of the course is also available through the same website.

> *"Restricting Russia's access to the SWIFT international banking payment system would virtually mean a declaration of war" Prime Minister Dmitry Medvedev has warned.*
>
> *Speaking to reporters on Thursday, Medvedev recalled the West once seriously considered the option, and Moscow is aware of it.*
>
> *"This would in fact be a declaration of war, but nevertheless it was discussed." the Russian prime minister said, adding "This is one of the reasons why the government is looking into ways to protect the Russian part of the internet."*
>
> RT December 5th 2019

Your analyst it not qualified to opine on the military consequences of the invasion of Ukraine. The financial consequences of war though are fairly predictable. War whether hot or cold most likely leads to an age of control over returns on savings. This is likely to begin soon with yield curve controls impacting interest income and will be followed by price controls impacting dividend income. War means that interest rates are even less likely to be considered the appropriate tool to control inflation and also that China will accelerate its preparations for the form of siege we know as a Cold War. It means nominal GDP growth will continue to run very hot and all sorts of failed policies of the past to control inflation will once again be legitimised.

The number of emergencies that require 'emergency measures' just keep mounting. Thus, expect emergency measures to arrive even more quickly. Emergency measures imposed by government usually last well beyond the lifetime of the emergency - let's call that, for now, Napier's Law but I'd be amazed if naming rights on that had not been claimed a very long time ago.

The first casualty of war is said to be the truth, and it probably perishes even before the first shot is fired. The second casualty of war is sound money. Our money is not backed and to some it is by definition already unsound. Whatever soundness it might have had during the so-called 'great moderation', however, has ended with the invasion of Ukraine. Sound money melts under the heat of political necessity, whether that comes in the form of medical emergency, green emergency, inequality emergency or national security emergency. That all these issues are now considered to be emergencies will ensure that the pain of materially higher interest rates will not be inflicted upon a people living in our age of emergencies. We have enough emergencies already without adding a solvency emergency. With levels of debt-to-GDP at all-time highs, which policymaker will risk driving interest rates to a level to slow growth and reduce inflation?

The Solid Ground believes that investors continue to ignore the reality that market determined prices, particularly the price of money, are no longer compatible with political goals in the age of emergency. Investors' fixation with just how high nominal interest rates can rise is dangerous. What should it profit any investor in gaining the right answer to the wrong question? The right question is 'what other means, other than higher interest rates acting to slow economic activity, are now legitimised by another emergency in the age of emergencies?'

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History strongly suggests that the suspension of market pricing is the 'other means' for inflation control that we must increasingly expect. Preserving the purchasing power of wealth in a system that drifts, sometimes speeds, from the market economy end of the continuum to the command economy end of the continuum requires radical thinking. *The Solid Ground* continues to assert that the assets likely to provide such preservation of purchasing power are value stocks, old economy stocks benefiting from the ostracization of China from the global trading regime, Japanese equities, emerging market equities, especially Asian equities, and gold.

Even at this early stage in the new European conflict there have been two major events that will change the world of investment and finance for at least a generation. The SWIFT system has been weaponised, not just by the US, and Germany has announced a major boost to its military budget.

The new EUR100bn military spending fund just created by Germany is exactly the sort of legitimate spending that ends the so-called Black Zero fiscal policy for good. The German government's aspiration to a balanced budget will likely be seen again but perhaps not by this current generation of investors. It's possible that other German government spending programmes are cut to allow the country to meet its just proclaimed re-commitment of meeting a military spending target equivalent to 2% of GDP but it's also very unlikely that this happens. While a large proportion of the new spending will not be spent in Germany, it will largely be spent in the Eurozone, somewhat boosting reflation. It would be politically impossible for Germany now to block the choice of any EU government to also move to finally meeting their targets of spending 2% of GDP on defence.

Germany's re-commitment to the 2% target may only be the equivalent, at this stage, of an extra 0.5% of German GDP in spending but it's an important 0.5%. It's a recognition by Germany that the time when fiscal rectitude is to be praised has ended. For Germany the invasion of Ukraine is the emergency that justifies this structural change and a recognition that some forms of fiscal deficit can be essential. Long ago other countries in the Eurozone - considering that their own emergencies, of sluggish growth, low investment and growing inequality - justified the running of permanent fiscal deficits. The Germans tended not to agree and blamed these problems on the lack of structural reforms in other EU economies.

That debate has now ended. The Germans have their own emergencies and the Italians have theirs. The answer to the emergencies is not to run balanced budgets and the Eurozone can now get on with that without fear of much dispute between north and south. While your analyst looks for inflationary outcomes ultimately in the rate of the growth of money, the end of Germany's attempt to impose fiscal rectitude across the EU does further enhance the case for higher inflation. But who will fund the greater government spending and at what price? Which is another question more worth the asking than 'how high will nominal interest rates go?'

War in Europe also means it is even more likely that the ECB will be conscripted to fight the emergency. Regular readers will know that *The Solid Ground* has long expected the ECB to be the central bank most quiescent in the face of inflation. The discrepancy in the levels of non-financial debt-to-GDP within the Eurozone means that the euro project would once again be in extreme jeopardy should the ECB use interest rates to attack inflation. The rate needed to combat inflation in some economies, such as Germany, would be a rate that would bring economic collapse to France. The former French Finance Minister who now heads the ECB was never likely to force France to pay such a high price to defend the savers of the Eurozone.

Marching under the banner of the green emergency, it was clear that Christine Lagarde was already legitimising the disuse of monetary policy to contain inflation. Containing inflation could never be more important than bringing the European project to its full fruition. Now that we have war in Europe there is an even bigger and more imminent emergency that necessitates easing the flow of finance to governments through negative real yields - a national security emergency.

The Eurozone has more than its fair share of emergencies, given its physical proximity to President Putin and what has turned out to be the constant emergency of trying to forge one state out of twenty-seven sovereign states. More government bonds issued by the Eurozone, rather than its constituent states, to fund defence, will be a more acceptable feature of the financial architecture of the Eurozone. More government bonds issued to ensure that none of the member states gets left behind economically in the post pandemic recovery threatening the European project will also now be more acceptable. It was another age and another attempted federation, but the sentiment expressed by Benjamin Franklin always gains new pertinence in a national security emergency – '*We must, indeed, all hang together or, most*

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assuredly, we shall all hang separately.' Hanging together legitimises more fiscal spending across the Eurozone, lower interest rates, lower inflation and, as a result, a lower exchange rate. The move from the market economy end of the continuum towards the command economy end of the continuum just accelerated. The impact of all these changes is to repel rather than attract private capital.

In a market system the imposition of negative real interest rates would result in the evaporation of the funding necessary to combat such emergencies. Savers would refuse to fund borrowers, whether private sector or public sector, at such punitive real rates. In past conflicts war bond drives and calls to patriotism could get individuals to make such sacrifices, but savings institutions were always much more easily pressed into supporting the national defence. Financial regulation has progressed to such a level where it will be straightforward to force financial institutions to buy government bonds to fund the national defence and the other pressing emergencies in the age of emergencies. Expect the press gangs, formally and formerly called The Impress Service, to be roaming the financial markets of Europe in the not too distant future. Bond yields have probably already reached the level at which the pressing will begin.

In 3Q 2020 *The Solid Ground* attempted to calculate a level of nominal interest rates that would force the ECB to consider moving to yield curve control. We have in the past few months reached such a level of interest rates. There is as yet no sign that this higher level of nominal interest rates is bringing the negative economic reaction that *The Solid Ground* foresaw in 3Q 2020. Perhaps, early in the economic recovery, the boom in private sector cash flows has been sufficient to offset some of the rising cost of interest and reduce the pain from rising interest rates. However, war in Europe will bring even higher levels of inflation and market forces will respond by demanding even higher compensation to lend; and long-term interest rates will rise.

Now, more than ever, the regulatory authorities are backed by a political necessity to do something to keep bond yields low and make sure that the defence of the nation can be funded. While yield curve control is likely across the developed world *The Solid Ground* believes that war in Europe has made it even more imminent in the Eurozone. Government deficits will be much larger than expected and inflation much higher. Only extreme action will be able to hold down bond yields in such an environment; investors must now expect such extreme action.

Will the extreme action to depress bond yields in the Eurozone entail using the ECB balance sheet to buy bonds or in forcing the private sector to buy bonds? As we have seen now for many years, using the central bank balance sheet to buy bonds and flush savings institutions full of liquidity has forced those institutions to buy other assets. Those other assets have mainly been equities and owners of equities have been the prime beneficiaries of ever-expanding central bank balance sheets.

However, utilising the central bank balance sheet to buy bonds in a period of high and rising inflation pours the petrol of more reserve creation onto the inflationary fire. It's a policy that can be neutralised by driving up commercial banks' reserve requirements to try to prevent this form of money creation leading to higher bank credit growth and deposit creation. However, in a time of war, pandemic or climate emergency banks are no longer the cause of problems, they are the solution to problems. The expansion of their balance sheets will be creating plenty of money and inflation, and there will be little appetite to rein that in given the need for bank finance as well as government bond finance to fight the growing emergencies. So, how to control bond yields in such a world if not via the creation of bank reserves through continued QE?

It is very likely that the savings system will be conscripted for the purpose. Particularly in times of warfare it is not considered inappropriate to make savers contribute their fair share to the national struggle. Your analyst has no idea how long this particular military struggle will last but will still predict with confidence that once a policy of forcing savers to fund governments at artificially low nominal interest rates is pressed it will not be quickly unpressed. Even should this national security emergency end soon, the threat from Russia and China has grown to a level that permits the imposition of emergency finance for the foreseeable future. The invasion of Ukraine, even if peacefully resolved, will cast a very long shadow that will justify a move to emergency financing for a very long time. Even should somehow this geo-political shift become less of an emergency there is a 'climate emergency' to be fought. Savers will be expected to pay their 'fair share' in the age of emergencies.

In an age of emergencies investors most stop believing that market-determined prices are acceptable. Anyone who graduated with a degree in Finance will explain the costs, in terms of the inefficient allocation of capital from imposing the wrong prices. Any student of history will point out that such knowledge has never stopped politicians from the imposition of the wrong prices in an emergency

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situation. The consequence from capping the yield curve in the Eurozone will be to encourage capital outflow, as those still free to move capital at their own volitation seek to flee financial repression. While initially the price of equities might rise as some investors, still able to exercise such freedoms of asset allocation, flee bonds, the ultimate impact from the forced purchase of government bonds is the forced selling of equities.

The capital exodus from the Eurozone will push the US dollar higher as a conscription of private sector savings is further away in a US where the political necessity of a move to financial repression has still not come. The US may have a non-financial debt-to-GDP ratio which is the same as the EU, but it has a much lower ratio than France and also a much lower private sector debt service ratio than the Netherlands and Belgium - all euro members. There is a level of bond yields that will enfranchise an aggressive financial repression in the US but we are not there yet. War in Europe probably means that we have already reached such a level in the Eurozone.

On February 10th the Bank of Japan announced that it would once again be moving to control the yield curve. This announcement was triggered by a move in ten-year JGB yields from a low of -0.29% in August 2019 to 0.23% in February 2022. On the face of it that does not seem a necessarily dangerous level of interest rates but, in great contrast to the rest of the developed world, Japan has not witnessed a surge of inflation since 2020. Expanding the central bank balance sheet in a period of low inflation is not a particularly risky strategy as we saw across the developed world from 2009 to 2019.

Although no doubt inflation will rise in Japan, if only because of the rise in global energy prices, Japanese policymakers can get away with this easier form of yield curve control for some time to come. There is every reason to believe that it will have the powerful impact on equity prices that such central bank balance sheet expansion has had since its launch in 2009. Japan is also increasingly at an important geo-political fulcrum. It is very clearly on the side of the US and the rest of the developed world in its alliance against both China and Russia. It produces the stuff on which increasingly powerful military industrial complexes rely. It happens to have, on most measures, some of the cheaper equity valuations in the world. One day inflation will even return to Japan and when that happens there will be a more concerted shift into equities by local and foreign investors. No doubt the need to force savings institutions to buy JGBs and sell equities will also come to Japan. The announcement of BOJ yield curve control suggests that that 'one day' is probably not coming anytime soon. Before we reach that juncture, Japanese equities should continue to outperform global equities.

The weaponisation of the SWIFT system is something that those on the wrong side of the US have long feared. The important development in the past few days is that SWIFT has now been weaponised with the consent of ALL of the developed world. The obvious reluctance of some players, most notably Germany, to weaponise SWIFT has been overcome. Preparations have been made for such an eventuality. The Russians have built the SPFS system, the Chinese have built the CIPS system and the Iranians have built SEPAM as their access to SWIFT is already suspended. To be clear, these systems do not yet provide any material insulation for those who find their access to SWIFT suspended. Siege preparations need to accelerate and the invasion of Ukraine and the weaponization of the SWIFT system is the trigger for just such an acceleration.

In China the move by the developed world to suspend Russian institutions' access to the SWIFT system will lead to an acceleration of preparations for the siege known in western policy circles as the China containment policy. There are many facets to such preparations and the sale of US Treasury securities is often assumed to be part of those preparations. The problem of course is which other foreign asset can be added to reserve positions where sanctuary can be found from the long arm of a developed world now prepared to use SWIFT as part of defence policy?

It is very difficult to tell just how many Treasuries the PBOC now hold. Where once foreign central bank holdings were through the New York Federal Reserve, the PBOC has likely been diversifying its holdings of Treasuries, probably through the Cayman Islands, possibly through Ireland, for many years now. There is, however, nowhere to turn to now that it is the developed world, not just the US, that has shown itself willing to weaponise payments systems, capital flows and foreign reserve assets. One option is to accelerate the purchase of gold but there is just not enough of the yellow stuff around to allow any meaningful diversification.

Gold can be shipped and held in China and it is likely to remain a means of transaction, for very large ticket items, that will be acceptable across the world. For the Chinese and Russian it can thus form an increasingly valuable form of reserves beyond the reach of the long arm of western policymakers. That this is not true of any crypto currency holdings they might accumulate is hardly news to anyone. Gold's

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value to those preparing for siege cannot be underestimated. It can pay for things, in secret if necessary, that no other means of transaction, beyond pallet loads of bank notes, can pay for. Let us see whether Russia will be paying for its imports with crypto currency now that the SWIFT system is closed to it! In the short-term Russia might have to liquidate some of its gold reserves to make payments but in the long-term sovereign nations that believe they may be in conflict with the developed world will accumulate more gold and fewer developed world assets.

China's preparations for the siege to come must focus on other areas rather than realigning their reserves, given the limitations to such realignment. In particular they will make it increasingly difficult for capital, whether owned by its own citizens or foreigners, to leave the country. *The Solid Ground* cannot stress too strongly, and not for the first time, that investors who insist on investing in China are increasingly likely to lose all their capital - whether invested in bonds, equities or in direct investment. Should the time come when the west weaponises SWIFT to contain China, then it is at best wishful thinking to believe that the Chinese authorities will permit foreign investors to liquidate Chinese investments and sell RMB. The move by the Russians to prevent foreign investors from selling their positions in Russian equities is exactly what one should have expected when capital is on the frontline of the Cold War. Those investors with a risk profile to accept the risk of investing in Russia last week, like BP and Norges Bank, are forced liquidators of their investments this week if they are allowed to liquidate.

The need for investors to liquidate their investments in China can come just as quickly depending upon how quickly the new Bamboo Curtain descends between China and the west. If the Europeans were reluctant to join the US in drawing that curtain, their reliance upon NATO/US defence will be focusing minds on the need for united policies on these key geopolitical issues. As we have just witnessed in Ukraine, nobody can really ever know when a ratcheting up of a Cold War triggers something altogether more deadly. Any investor who continues to invest in China expecting a return of capital, never mind a return on capital, is simply ignoring all the signals of geopolitics, blinded presumably by all the signals of their discounted cash flow calculations. That there is more in heaven and earth than is dreamt of in the financial discount philosophy is surely the lesson of events in Ukraine.

The Solid Ground has made the case for gold as a store of value in a financial repression and new Cold War for many years. For a brief few hours last week gold outperformed bitcoin by almost fifteen percent. That did not last. However, it is a sign of how crypto currency might not be a preserve of the purchasing power of wealth when the financial discount philosophy clashes with the real politik of the twenty first century. What the war in Europe and the move on SWIFT shows is that capital is on the very frontline of this growing geopolitical divide. That makes some forms of capital more attractive than others and it makes gold particularly attractive. Investors in gold will benefit from this growing realisation that capital can be weaponised, by a growing domestic financial repression and also by a rising rate of inflation. The so-called 'barbarous relic' is sadly the asset of choice as we enter more barbarous times.

The age of emergencies is the age of control. You need to prepare for that. For those who think avoiding the financial press gang is a simple affair in an age of rapidly moving capital flow, the weaponisation of SWIFT and the ban on outflows of foreign portfolio investors capital by Russia should come as a salutary warning. Capital and its movement are on the front line and will be there for many years. Market analysts may always think there is a way to beat impositions placed on the free movement of capital. This ability is often called arbitrage, but politicians have a different name for it. For those who naively think that they can simply avoid the press gang it is worth remembering the fate of Hobson and Atkinson:

> *As soon as the warrant officer, Captain Shortland, set up his rendezvous, a crowd of a thousand men and women attacked it, broke down the doors and ran the gang out of town. Men and women played an equal part, two ringleaders, Hannah Hobson and William Atkinson, were tried at York assizes in March under the riot act: Hobson was transported and Atkinson hanged.*
>
> *In These Times: Living In Britain Through Napoleon's Wars 1793-1815,* Jenny Uglow

For those still convinced that they can live out a career as volunteers and avoid the fate of the conscript, you need the perspective of a Russian, called Vladimir, as to how whole systems can change more quickly than even your spreadsheet or algorithm can possibly imagine.

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"There are decades where nothing happens; and there are weeks where decades happen."

Vladimir Ilyich Ylyanov (aka Lenin)

It is possible on a daily basis to pretend that we live in a world where interest rates will be used to combat inflation, that price controls are a thing of the past and that capital will always be allowed to move freely. The pretence that financial repression is not coming must soon start to end - perhaps quickly. Those charged with the stewardship of capital need to recognise the scale of the evolving structural change in the financial system underway and accept that adjusting to that now is the best policy when 'there are weeks where decades happen'.

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Darkness on the Edge of Town: Germany Declares War on China, China Arms Serbia & NATO Announces Its Move East (12/04/2022)

> *'Democratic politics has been divorced from monetary decision-making for some time and in Germany's case even longer. Indeed, as a result of the Eurozone crisis, the relationship between the monetary sphere and political authority via elections became directly opposite to the usual requirements of democratic politics: only governments tolerable to the ECB could plausibly govern. After all the political disruption that followed from it, the monetary-economic distinction entrenched in the Maastricht Treaty, where the monetary realm is supranational and technocratic and the rest of economic policy is national and democratic, has nearly entirely broken down.'*
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> Helen Thompson - *Disorder: Hard Times in the 21st Century* (OUP 2022)
>
> *'Is a dream a lie if it don't come true or is it something worse?'*
>
> Bruce Springsteen - *The River* (1979)

On March 29th 2022, while financial analysts focused on the likely course of US interest rates, Germany, though a speech by Finance Minister Christian Lindner declared war on China. Of course this was not declaration of a hot war but a declaration of a cold war just as surely as the US had declared such a war against China in October 2018. On April 7th NATO announced that 'for the first time' it will be reacting to China's "coercive policies" in conjunction with "Asia-Pacific partners". Early in the morning of April 11th China military transport aircraft delivered ground to air missiles to Serbia.

In this newsletter *The Solid Ground* looks at the momentous consequences from this rapid acceleration to cold war with China which include: an increased chance that foreigners' RMB investments become worthless, that the RMB is allowed to float on the international exchanges, that the euro continues to decline and the US dollar rise and that the only way to hold the euro together is through either a massive expansion of the ECB balance sheet, forcing local savings institutions to buy their nations' government bonds or exchange controls between eurozone members. Such is the import of Lindner's speech on March 29th, a speech that changed the world but was largely ignored by it. That it was followed by the arrival of Chinese armaments to a Russian ally and a move by NATO to aid the defence of Asia only further illustrates how quickly the world is changing.

Once upon a time it was, according to most investors, just an extreme wing of the Republican party, represented by Vice-President Mike Pence, who saw themselves in an ideological and great power struggle with China. Investors dismissed his infamous speech at the Hudson Institute in October 2018 as a sort of rant and preferred to ignore it. Then Mike Pence was gone and it was the turn of the Democratic Party to shape US policy towards China. That policy was spelled out as recently as March 1st 2022 by the Office of the US Trade Representative.

> *"We are clear-eyed about China's doubling down on its harmful trade and economic abuses. We are also considering all existing tools – and will potentially seek new ones as needed – to combat the harms of China's state-led, non-market practices."*

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China is 'doubling down' on trade policy post Trump and the Democratic administration is prepared for greater trade 'combat'. Where the Republicans moved against trade with China, the Democrats now promise to push further and have also widened the front to attack capital. In June 2021 Joe Biden, utilising legislation enacted under the Trump Presidency, added eleven Chinese companies to the list of those banned from receiving US investment. There are now 59 Chinese companies on this list. The Biden administration has potentially widened the scope of the ban by changing the wording of the law to encompass "Chinese Military-Industrial Complex Companies", and not the "Communist Chinese Military Companies" of the original executive order. There is no need to prove any direct link with the Chinese Communist Party (CCP) before adding further Chinese companies to this list. The phrasing 'military-industrial' also potentially casts the net much wider than just 'military'. The name of the Biden amended executive order makes clear the 'threat' that this legislation has been passed to deal with - "Addressing the Threat from Securities Investments that Finance Certain Companies of the People's Republic of China". MSCI and other index providers have already had to react by dropping listed stocks added to this list from their indices. Which other stocks might have to be dropped from China equity indices as the US looks more widely for Chinese companies fulfilling a role within the 'Chinese Military-Industrial Complex'? Whatever Pence may have started, Biden seems keen to both continue and take to a higher level.

The Holding Foreign Companies Accountable Act, an executive order of President Trump, is also being implemented by the Democratic Administration. Five Chinese companies were threatened with de-listing from US exchanges on March 30th 2022 unless they met the US mandated levels of disclosure. Head of the SEC, Gary Gensler, added that a further 250 Chinese companies could be forced to de-list unless they meet the disclosure requirements. The denial of access to US capital by Chinese companies can thus spread well beyond those the Biden administration can identify as being part of the 'Chinese Military-Industrial Complex'. Similar restrictions can come through tougher ESG considerations, pressure to invest only in companies sharing western 'values', pressure on the key equity benchmark owners to drop Chinese stocks or changing laws to force the divestment of Chinese assets. The Biden administration is enforcing a capital containment on China that Vice President Mike Pence only got to dream about.

Perhaps Mike Pence would have gone even further had the Republicans won the election. Well perhaps, but the key point is that Pence's firebrand speech of October 2018 was a declaration of intent, but it is a Democrat President that is following through on that intent. The 'containment' of China is one of those rare things in DC, a bipartisan policy. Your analyst was often told that relations with China could only improve when President Trump left office. *The Solid Ground* made the case that they would worsen. This was not just because the Biden administration would be similarly opposed to the CCP but that this administration could build anti-Chinese alliances with the countries that President Trump could not. There was already ample evidence that such alliances were being built, most notably in the increased military co-operation amongst the so-called "Quad" (The United States, Japan, Australia and India). There was also progress in building alliances in Europe. Those alliances are now cemented by Russia's invasion of Ukraine as Christian Lindner has recently made crystal clear in what may prove to be one of the most important speeches of this century:

> *"My concern is that … we have a strong economic inter-connectedness with China…. We need to diversify international relations, including when it comes to our exports… Perhaps the time has come when we should preferentially do business with those who are not only trading partners, but also want to be partners in values."*
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> German Finance Minister Christian Lindner, Interview with *Die Zeit* weekly, April 6th 2022

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> *"We have to recognize that we have an enormous risk. China doesn't respect our social model, our understanding of liberality, our recognition of international law…. Our trade relationship with China is almost a concentration risk for our economy. It may be a trading partner, but it's also systemic rival."*
>
> German Finance Minister Christian Lindner- Speech on March 29th 2022

These words of the German Finance Minister are very nearly the same words used in the 'rant' by Vice President Mike Pence in October 2018. While Pence focused on the move by China to drive the US from the Asia-Pacific, Lindner sees the CCP as a "systemic rival" well beyond that region. Germany is now clearly aligned with the policy to contain China. In an Ifo survey published in late March it was revealed that 46 percent of German manufacturers source "key inputs" from China and half of those intend to reduce their imports from China going forward. The need for German manufacturers to diversify away from China has just accelerated and is part of German government policy.

Germany is not acting in isolation in reducing its dependence upon China. President Macron, in a speech on March 17th, made it clear that the French government will launch a new industrial policy to boost French 'independence', a policy clearly aimed at further disengagement with China. *The Solid Ground* has long argued that investors need to assess how the CCP will react to what is in effect a growing siege of China. More of that later but first what are the consequences for Europe from this accelerated shift to China 'containment'?

There are few facts in the public domain regarding the various forms of support that China might have given Russia in relation to its campaign in Ukraine, but plenty of rumours and likely disinformation. There may have been no support but the timing of the meeting between Xi Jinping and Vladimir Putin on February 4th 2022 strongly suggests that China was at least pre-warned of the invasion. If so the words of the two leaders that day that there are "no limits" and "no forbidden areas of cooperation" strongly suggest that both were aware that their countries would have to become more closely aligned after Russian tanks rolled into Ukraine on February 24th. The increase in anti-China rhetoric by Lindner and others, since February 24th, does suggest that they have intelligence that implicates China in some active support for Russia's invasion of Ukraine. Whatever, China's support to date for Putin's war has been enough to accelerate Europe's move to cold war status with China. We are only one bad headline away from a very rapid escalation in the cold war. As we will discuss later such a heading, such as China buys stake in Gazprom, is probable and likely imminent. It may even come before that and relate to arms shipments to Europe.

In the early hours of April 10th 2022 six Chinese Air-Force Y20 transport planes arrived at Belgrade airport. The Serbian government is expected to confirm in the next few days that these planes brought the Chinese HQ22 surface-to-air missile system to Russia's ally in the Balkans. If China is coming west, NATO, in response to the Chinese threat, is spreading east. Speaking just before the HQ22 missiles arrived in Belgrade, NATO leader Jens Stoltenberg made it clear that NATO's interests, given China's relationship with Russia, now spread to the Asia-Pacific region:

> *"We see that China has been unwilling to condemn Russia's aggression and has joined Moscow in questioning the right of nations to choose their own path. At a time when authoritarian powers are pushing back on the rules based international order it is even more important for democracies to stand together and protect our values. NATO and our Asia-Pacific partners have now agreed to step up our practical and political co-operation in several areas including cyber, new technology and countering disinformation…. Ministers agreed that NATO's next strategic concept must deliver a response on how we relate to Russia in the future. And for the first time it must also take account of China's growing influence and coercive policies affect our security."*
>
> Jens Stoltenberg speaking on April 7th 2022

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That portfolio managers believe this rapid shift in the geo-political balance can occur while they continue to be permitted to dance in and out of RMB denominated securities mystifies your analyst. The fact that these securities are 'in the index' simply creates a massive opportunity to outperform that index by not owning them - particularly if you are an emerging market investor. The implications from this rapid escalation in tensions for investment in Europe are also profound.

That Germany should be shorn of its Russian source of energy and potentially also see a decline in trade with China, its biggest source of imports and third largest export market, is enough to bring a seismic change to Germany and hence the EU. Along with the return of the war in Europe and the need for greater defence spending, the EU is still adjusting to the move by the US to energy independence and what that means for US military commitments in the Middle East. Germany relied on Russian energy, free trade with China and US military power in Europe and in the Middle East for much, but not all, of its economic might and stability. Germany is the biggest loser in the shift to the new world order and of course has, at the same time, to cope with the consequences of the eradication of the Bundesbank-like characteristics of the ECB given that organisation's role in driving political integration in Europe while also inflating away the eurozone's debts. The loss of its energy supplies, one of its largest trading partners, its defence provision at home, the security protection for its increasing energy needs from the Middle East and also its hard currency status is quite a combination of losses. All this within just a few months of also losing Mutti! It is hard to think of as rapid a transformation in the outlook for any major country except for those that have been subject to military attack by the enemy.

That some governments in the EU and even the eurozone may have different opinions on relations with authoritarian regimes brings even further risks. If the pandemic was supposed to bring a 'Hamiltonian moment' for European federation war and an energy crisis are supposed, in the minds of some, to cement the deal. Christian Lindner has opinions on that as well:

> *"We support Ukraine. There is also a joint European effort to continue to support Ukraine. But that is independent of a debate on financing instruments. Joint liability in Europe through the issuance of joint bonds is not on the agenda at the moment."*
>
> German Finance Minister Christian Lindner at a joint press conference with Dutch Finance Minister Sigrid Kaag, March 8th 2022

The problem with pushing for this to be the 'Hamiltonian moment', when the key supra-national body, the European Commission, issues debt with a view to inexorably taking power to raise taxes and assume fiscal authority, is that these powers may not accrue to those 'the project' was aimed at delivering them to. It is not clear that the President of France will be keen to assume joint liability, even if not joint and several liability, for debt issued by the EU Commission to bolster spending by the Polish Prime Minister, a man he calls a "far-right anti-semite". On April 5th, just following Viktor Orban's election victory, the EU triggered a conditionality mechanism aimed at withholding EU funds from Hungary. The debt raised at the supra-national level in the name of all may not be available to all - a strange federal system indeed. And of course there is always a risk that a sovereigntist might be elected in France. Would the EU Commission be raising money to fund a government of Marine Le Pen whose policy of favouring French citizens' rights over the rights of other EU countries' citizens and making French law supreme over EU law is clearly a direct attack on the federalist ideal? Is this really the time when politicians in Germany and in the so-called 'frugal four' (Austria, Denmark, Netherlands and Sweden) finally decide that the EU Commission should take a starring role in EU-wide fiscal policy? Their newly created federal ship of state may not have the captain they wished it to have. The prospect of a very different type of 'great helmsman' for Europe will have many questioning whether the drive to create such great centralised power is wise. For some this particular ship was only being built to allow their captain to sail

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to their chosen shore. Other possible captains are now emerging with different destinations in view.

If Marine Le Pen is not the first sovereigntist to run a major European nation in a generation it will, by June 2023 at the latest, be the head of the far-right alliance now commanding 46% of the vote in Italy. The party now leading in the Italian polls for the first time, The Brothers of Italy, want to give Italian law primacy over EU law, a move as incompatible with EU membership as the policy of Marine Le Pen. So far Jean Monnet has been correct in forecasting that 'Europe', by which he meant a federation of European states, would be 'forged in crises'. This form of 'Europe' has faced existential crises during the Great Financial Crisis and also the European Sovereign Debt crisis. Those were economic crises which it survived, though only by wielding the un-elected power of the ECB to effectively destroy democratically elected governments in both Greece and Italy. This was the 'kicking the can down the road' mantra which so many investors believe can last forever while ignoring the political costs of such a policy. The wielding of extra-sovereign power from Brussels and Frankfurt to 'kick the can down the road' and drive integration is resented by electorates and this is now having real consequences at the ballot box. This war may be the greatest crisis the 'project' has yet faced but it is the first crisis when the sovereigntists are likely to be in power in a major EU country. Disciplining Italy or France or perhaps even both is simply not as politically easy as whipping Greece into line or disciplining Hungary. Russia's invasion of Ukraine thus probably marks the high-water mark for the federalisation of the EU. That, along with its forced change of policy in China, is why the impacts of this war will ring down the ages.

Struggling to fight against this political sea change in the EU has long stood a once central bank. The institution known as the ECB long ago gave up any pretence that it was confined by its constitution and has created its own powers to do 'whatever it takes' to cement the political union of Europe. On Friday April 8th the ECB leaked a story to Bloomberg that it is readying a new tool kit to make sure that sovereign bond yields, amongst the nineteen eurozone members, do not blow out. Assuming that power is of course also *ultra vires* but as the ECB has been set upon defining its own powers since at least July 2012 investors do not even consider that such power could be finally curtailed. *The Solid Ground* will venture that this time is different. A political break on the power of this unelected body will finally be imposed by the democratically elected governments of northern Europe. The rise of the sovereigntists, particularly in France and Italy, will make them increasingly worried at the composition of the balance sheet of the central bank they may inherit. Lindner's resistance to further debt issuance at the supra-national level is a recognition that the 'project' has reached the political limits of its centralisation. There are other ways, other than using the ECB balance sheet, to cap bond yields through the introduction of capital controls and/or forcing savings institutions to buy government debt. The unelected power of the ECB will be curtailed.

Perhaps some further ECB bond buying support will be available for the government of Mario Draghi. Will it be available for an Italian government that could, by June 2023, be run by Giorgia Meloni? No doubt the threat of the withdrawal of ECB support for Italian government debt will be a key tool in the push to discipline the electorate of Italy. This cudgel might even have to be deployed to discipline the voters of France ahead of the second round of the Presidential election. Should the Italian sovereigntists accede to power and see ECB support withdrawn for their government bond market, they will most likely force their domestic savings institutions to step into the funding gap. Exchange controls, de jure or de facto, are a necessary part of such a policy. That is a drama for 2023 but between now and then just how much support will Christian Lindner and his ilk permit the ECB to provide the dying administration of Mario Draghi? For the ECB is it in for a penny in for a pound or should that be in for a euro in for a lira? If it isn't then the ECB's political power, assumed at the expense of the abandonment of its power as a monetary authority, is also on the wane.

The inability of the ECB to fight inflation has, in the past few weeks, been acknowledged by the calls by Fabio Panetta (ECB Executive Board Member) and Ignazio Visco (ECB Member Governing Council) for price controls and for direct actions by the sovereign states to control

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inflation. That's as close to raising a white flag on inflation as any monetary authority is likely to get in its public pronouncements. *The Solid Ground* doubts whether the northern EU states will allow this organisation, that recognises its impotency in the battle against inflation, to use its balance sheet to instead pursue a failing political dream of federalisation. The cost of further enfranchising the ECB's political power is the accumulation of assets that are of increasingly dubious value. Whether the value of eurozone sovereign bonds is undermined by inflation or the imposition of capital controls that create de facto separate currencies, the risk of financial loss to some sovereign states through the actions of their once central bank is getting too great. The massive money creation needed to even further expand the ECB balance sheet to prevent a blow out in sovereign bond yields, in an age of high and rising inflation, is entirely incompatible with price stability if bank lending growth, under government influence, is powering ahead. How many Italian bonds might the ECB have to buy should the prospects of a sovereigntist running Italy increase in the run up to June 2023? The next time the ECB tries to assume the power to do 'whatever it takes' there will be resistance from northern Europe. This time resistance will come from those who count - the elected politicians of key sovereign states and not just the lawyers of Karlsruhe.

A retreat from federalisation is incredibly messy for investors. It means a growing monetary and fiscal free-for-all that can ultimately only be disciplined by restricting the free flow of capital within the eurozone. The flight of capital within a single currency in the face of such a divergence of policy, economic growth, inflation and state interference with the private sector will be immense. Such capital flight will not be allowed to persist for long as in its movement it places policy shackles on the sovereign state similar to those previously imposed from Brussels and Frankfurt. There can be no greater threat to international investors than to have their capital restrained or even trapped within a currency that is increasingly non-fungible with that investors' base currency. That threat is a live threat to investors in European equities.

It is not just the sovereigntists who threaten the stability of Europe. President Macron's drive for 'independence' and his launch of an industrial policy are clearly contrary to EU law and further federalisation. This is a pledge for decentralisation from an avowed federalist and other federalist governments will be forced to follow a similar path. *The Solid Ground* has, for two years, argued that the ability of each sovereign state to control its local commercial banking system has already devolved money creation powers from Frankfurt to the sovereign state. Once again, these powers have been assumed by the federalist Macron so this splintering of monetary authority need not await the election of a sovereigntist to power to see its expression. The first sovereigntist to run a major European state, whether it be France or Italy, will just accelerate the process of fiscal and monetary devolution. The capital controls that must follow will be launched as 'temporary', but they permit an inflationary adjustment in each member state that means it is highly unlikely that they can ever be dismantled within a single currency. It may have taken over a quarter of a century to somewhat grind prices into line with productivity across nineteen nations but it is work quickly undone when central monetary and fiscal discipline break down. The gap in relative competitiveness following differing levels of inflation amongst the nation states will prevent any return to a single currency. International investors will be collateral damage as the free movement of capital ends across the eurozone.

The power of the wrong monetary policy to destroy the so-called 'fundamentals' was covered in my last book *The Asian Financial Crisis 1995-98: Birth of The Age of Debt*. Investors in the Thai equity market lost ninety percent of their investment in dollar terms as the managed exchange rate regime went from delivering too loose a monetary policy to delivering too tight a monetary policy. That the wrong monetary policy can override all other investment considerations is evident to investors in Greece, where the stock market remains more than 80% below its 2007 high and is back to levels first recorded in the 1980s. The Eurostoxx 50 Price index may still be more than 30% below its March 2000 high but it can now head even lower. In the very long run equity valuations have to be related to the so-called 'fundamentals'. However both valuations and fundamentals can be grossly distorted even over long periods by the wrong monetary policy. There has probably never been a monetary policy more wrong than the attempt to create a single European currency by forcing one monetary policy upon nineteen

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very disparate European sovereign states. The new cold war may deliver the coup de grâce to this monetary experiment but in its death throws there is huge economic, financial, social and political damage to come. Such a combination of turmoil is very unlikely to be positive for the overall level of the European stock markets. For those trapped within the eurozone there will be selected equities to buy that benefit from the need to rebuild the continent's industrial capacity that will now return from China. However, for the equity indices there is still plenty of downside, particularly when savings institutions are forced to buy government bonds and sell equities.

China is now more besieged than it has been in a generation. These words of Lindner change everything - "*Perhaps the time has come when we should preferentially do business with those who are not only trading partners, but also want to be partners in values.*" Such a policy from China's sixth largest trading partner is important. It is also important because Duisburg in Germany is an important rail and river port hub for the Belt and Road Initiative. The German port of Mukran, on the Baltic coast, is supposed to be the new outlet to a wider world for Chinese goods flowing by train from the east. If Germany's declaration that it can restrict trade with countries that do not share its values is important, how much more important would a similar declaration be from Australia? Few could contemplate such an announcement given Australia's reliance upon commodity exports to China. But can China bet on Australia not following the lead of the USA and Germany in declaring China a 'systemic risk'? Whatever the truth of Imran Khan's assertion that the CIA have removed him from power in Pakistan, another overland import and export route - the Chinese owned Gwadar Port on the Arabian Sea - may not always be available to China. Can a besieged Xi Jinping afford not to take stakes in Russian energy/commodity producers and/or arrange long-term supply contracts with such producers? It is almost inevitable that the "no limits" and "no forbidden areas of cooperation" wording of Putin and Xi on February 4th will take them to agreeing such relationships. China is not really being left with any other options. The 'bad' headlines that will see China and Russia much more closely aligned are high likely and probably imminent. Just how aggressively the rest of the world responds to those 'bad' headlines is difficult to forecast but they will surely react and NATO is already reacting. To continue to invest clients' savings in China in an age of such 'systemic risk' is, in the opinion of this analyst, a breach of fiduciary duty. No doubt, one day, a civil court somewhere will pronounce on that opinion and the best lawyers' money can buy will argue it out. The initial hit to AUM from the diminution in the value of Chinese assets will be bad enough for investment managers' revenues but they will probably be ultimately accompanied by rather large legal fees. 'But it was in the index' will be an interesting but still surprisingly expensive defence when 'my learned friends' are paid to recite it.

Given the siege of China, investors cannot expect China to continue to manage its exchange rate with reference to the currencies of those who consider it to be a 'systemic risk'. The squeeze is on China's current account and its capital account and now from Europe just as much as from the United States. The more powerful the squeeze, the tighter the monetary policy forced upon China but only if it insists on targeting the external value of its exchange rate. Toughing it out on exchange rate policy is much more difficult following Lindner's speech and the rapid escalation in the containment policy. Toughing it out, if China was running a large external surplus, might not be too painful. However in 2022 China has seen a rapid decline in its foreign exchange reserves, indicating that its balance of payments are likely in deficit and balanced only by PBOC support for the RMB. The external accounts, even before the next round of containment has been imposed, are already aligned to produce a constrained rather than an expansionary monetary policy. The impact of the external 'containment' thus forces a monetary constraint on China just as residential property prices are slumping and key commercial enterprises are facing a surge in the cost of debt capital. By sticking with its exchange rate policy China chooses to allow those to whom it represents a 'systemic risk' to inflict a deflationary adjustment upon it. A few 'bad' headlines and the deterioration in the country's external accounts will further accelerate China's debt deflation. It is unrealistic to expect China to choose to hand the power of monetary constraint to those now committed to contain it. A move to a flexible RMB is increasingly imminent.

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The Solid Ground's belief is that Japanese equities, value stocks, old economy stocks and gold are the best investments for our new age of 'disorder'. For foreign investors the terminal value of their RMB denominated assets will be effectively zero. The US dollar will continue to rise relative to other currencies and the flood of capital to the US will likely cap US bond yields at levels not far above current levels. This is a combination that buoys US equity prices though once again *The Solid Ground* prefers value stocks and old economy stocks within the US equity universe. On March 29th 2022 Christian Lindner changed the history of the twenty- first century. Some dreams may indeed be dashed by the new geo-political reality but for those tasked with the fiduciary duty of managing others' money it is important to focus not on the path of short-term interest rates but on the fact that 'there's a darkness on the edge of town'.

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The Attempt to be 'Roughly Right': Higher Interest Rates, Higher Bank Lending and Higher Equity Prices (02/08/2022)

Your author spends two weeks away from his desk, chasing fish with flies amongst other things, and a new bull market in equities begins? Well, 'maybes aye, maybes naw', as they say in Scotland, but a 12.6% rise in the S&P500 from its recent low is at least indicative that the record levels of bearishness, evident in recent sentiment surveys, is creating its usual opportunities. For those focused on the cyclical forces that drive the price of equities there is indeed much to be positive about. In this newsletter the focus will be on those cyclical positives while of course flagging up the structural challenges against which all cyclical factors must be balanced.

Let us start with the long term and work backwards. *The Solid Ground* sees a period - of 10 to 15 years - in which there will be great volatility in stock market indices marked by a continued growth in corporate earnings, in nominal terms, and a prolonged downshift in equity valuations. This structural de-rating of equity valuations, the cause of the poor real returns for equity investors, will be caused by financial repression and a move to a bi-polar world with the ostracization of China from the global trading regime and also from global capital markets. The result of these two key structural changes is that those who invest in the equity index in a buy-and-hold strategy will see the purchasing power of their savings decline - even with dividends re-invested. That is what your author would define as a real bear market; it being such a prolonged decline in the purchasing power of savings that it could take possibly a generation before investors today see positive real returns if they buy the equity index. Those looking for a parallel might consider the period from 1966-1986 when real returns from US large cap. equities, with dividends re-invested, were close to zero. Yet, despite a potentially similar dreadful long-term prognosis, your author continues to have a high weighting in equities. This is because it is the right company, with the right management in the right industry that is best placed to produce positive real earnings growth and, where equity valuations are currently reasonable, assure that their shareholders attain positive real returns given the structural shifts ahead. For those sceptical of such differentiation of performance during a long equity bear market the following table is hopefully at least cause for thought:

Total Returns with Dividends Reinvested January 1966 to July 1982 – US Asset Classes

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%

******Total returns measured from start 1967 to end 1982*
Source: Ibbotson

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Through the long equity bear market from 1966-1982 investors in large capitalisation stocks saw a rise in the value of their investment, with dividends re-invested, of just 126% while the general price level rose by 196%. Over that period S&P500 earnings per share rose by 162%. Real returns from bonds and cash were also dreadful. However, investors in value stocks and small capitalisation stocks, pursuing a buy-and-hold strategy, secured material positive real returns through this prolonged equity bear market. This is not the same thing as saying that it must be these sectors that can produce such returns going forward but it is to say that, in this form of equity bear market, there are sectors of the equity market that are likely to provide positive real returns for investors. An equity index product will thus be a dangerous investment, but selected equities will be one of the few ways to preserve and grow the purchasing power of savings in a financial repression. It will be the job of *The Solid Ground* to point you in the direction of those portions of the equity universe that can provide such returns and, at this stage, the advice continues to be to invest in Japanese equities, value equities and old economy equities if you are seeking to win the investment war to secure positive real returns from savings over the long term. Gold will also continue to provide such positive real returns as it continues to do, if currently primarily to investors whose base currency is not the US dollar. Now from the war back to the battle.

While *The Solid Ground* prefers to focus on the long-term nature of investment returns, it would be churlish to avoid the opportunities presented to add to equities when a powerful positive cyclical force can, for some quarters or perhaps even a few years, outweigh the major structural negatives likely to depress equity valuations over the long term. This was very much the pattern of returns in the 1966-1982 period. The battle to produce positive real returns for savers will be extremely difficult so more tactical opportunities to secure positive real returns on savings have to be considered, even if they come with higher risks given the long-term bear market in equities now underway. Is the current rally in equities one of those trading opportunities to bank some positive real gains, winning a battle, in the long war for investment survival ahead?

Your author believes that investors are now fundamentally mistaken about the relationship between the economic cycle and the returns from equities associated with that cycle. Ask any investor what a recession means for the price of equities and their replies will necessarily be partly conditioned by their personal experiences. There are few investors still in markets who remember back even to the recession of 1990-1991. Thus most investors will call upon their recollections of the 2001, 2007-2009 and 2020-2021 recessions in assessing what a downturn in the business cycle means for corporate earnings. In these recessions S&P500 nominal earnings per share showed the following respective contractions: -54%, -92% and -33%. Investors who have lived through all three recessions since 1991 thus 'know' that an economic recession brings with it a collapse in corporate earnings. It was not always thus. Having entered the investment business in the late 1980s I know that few people saw the scale of damage to corporate earnings that these three, especially the first two recessions, would wreak on corporate earnings. There were three key reasons for surprise which, in the opinion of *The Solid Ground*, will not be repeated in the recessions that we must all endure over the next 15 years or so.

A key reason for the scale of decline in corporate earnings has been the modern accountancy practice of swinging balance sheet items through the P&L like a giant fiscal pendulum with a dagger attached. The earnings that corporations report for tax purposes do not suffer, to the same extent, from such 'advances' in accountancy and they have not been as volatile as a result. The days when reported corporate earnings would be only about as volatile as the corporate earnings in the National Income Product Accounts are days long gone. Few investors saw just how much earnings volatility would result from these accountancy 'advances' and of course we now come to expect them to be part of

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the 'normal' earnings cycle associated with the business cycle. Your analyst is not unwise enough to forecast a damascene conversion by the accountancy profession that allows the P&L account to be uncontaminated by short-term alterations to the valuation of balance sheet items. However he is unwise enough, I'd prefer brave enough, to forecast that the scale of such adjustments will be minimal in our forthcoming recessions. The high level of inflation that pertains through these recessions and the stability of the financial system throughout will ensure that the bean counters need be less frenetic with their abaci going forward. The price of replacing most corporate assets has risen sharply and is very likely to continue to rise through any downswing in the business cycle. The price of long-term debt liabilities will likely be in decline though not by as much as the rate of inflation should warrant. Writing down the value of corporate assets in a recession is likely to be resisted by accountants even though management, always mindful of their ability to renegotiate the strike price of options when share prices fall, might continue to push for such financial legerdemain. If this is the case, the corporate earnings volatility associated with the recessions of this millennium will be significantly dampened compared to recent recessions. The reasons for the need for fewer balance sheet adjustments in our recessions relates to the other two key factors that change the nature of our future recessions and their impact on financial assets - inflation and banking stability.

Apart from the institutionalised ADHD of the accountancy profession, not surprisingly coming hot on the heels of the move to rewarding management with stock options, the recessions of this millennium have been non-typical recessions in two key other ways. They have been recessions that brought with them deflation or the risk of deflation and with that the prospect of liquidity or solvency issues for the financial system. This later issue was more prevalent in the 2007-2009 and 2020-2021 recessions, but availability bias assures that these are the two recessions that dominate what investors believe recessions look like. We have now, due to institutional changes that *The Solid Ground* has previously dwelt upon, left the era when deflation suddenly appeared on investors' radar screens again for the first time since 1955. The risk of deflations re-emergence changed the relationship between corporate earnings and the business cycle and also led to a greater risk of the debt deflation that Irving Fisher diagnosed in his famous paper of 1933. As even those with a passing knowledge of financial history know, the damage to the purchasing power of savings in equities, associated with the US debt deflation of the 1930s, is reason enough to be ditching equities and pushing prices and valuations lower. In a modern era where high levels of debt permeate the government, the household and the corporate sector, there was even greater reason to fear the ogre under the bridge called deflation. It was not just corporate earnings that were at risk if we witnessed the return of recessions with deflation but there was a much higher risk to the survivability of that fine sliver of hope between assets and liabilities we know as equity. If the future holds high inflation and low interest rates, the risks to the survivability of equity change and fewer short, sharp shocks when its survivability are questioned are likely.

When your analyst entered this business deflation was considered a historic relic and systemic banking crises were supposed to be something that afflicted what were then known as Lesser Developed Countries before their successful rebranding as Emerging Markets. In 2002 I ran a conference, for investment managers who had decades of investment experience and also key finance/monetary academics, aimed at discussing long-term returns from equities and importantly the key factors that determine the mean reversion of equity valuations. Based upon those presentations and subsequent discussions in break out groups I formulated the syllabus for what became The Practical History of Financial Markets course (running in London this October but rapidly selling out) and available always in its online version (for more information on both see www.didaskoeducation.org). In announcing the topics to be covered to the participants I mentioned that we would likely teach a unit focused on asset price behaviour during periods of inflation, disinflation and deflation. The leading academics also assembled

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objected to this as an issue worth teaching as they explained that it was 'virtually impossible' to have deflation in a fiat currency world. I mention this not just to draw attention to the fact that academics, who have somehow wrestled the control of monetary policy from practical people, have long misunderstood inflation but to point out just what a shock it was that deflation was back.

By November 2002 Ben Bernanke, an academic with a focus on financial history, had to make his famous 'helicopter speech' recognising that deflation was indeed possible, if very unlikely, and explaining what the Fed would do about it. Arguably investors had been adjusting to the risk even before this and your analyst wrote about deflation in December 1997 (*Dealing with the "D" Word*, Solid Ground 4Q 1997) and the S&P500 had almost halved by November 2002 from its 2000 high. There were bigger shocks to come as the risk of deflation became, in 2009, actual deflation and it reappeared again, albeit briefly, in 2015. Many thought it was coming again in 2020 when US two-year inflation breakevens reached almost minus 1% though *The Solid Ground* argued strongly at that time that much higher inflation was coming. These three economic downturns in the business cycle each brought forth a demon that most investors had heretofore considered to be something experienced only in a world of myth and legend - basically any period of history they have not lived through. That central bankers treated this ogre under the bridge as the most fearful thing that prowled the earth determined much of what was to happen to financial asset prices for a generation. Well, they have now, with the assistance of direct government interference in the banking system, slain that ogre and in doing so have changed the nature of interaction between the business cycle and the stock market back to something that was, until this millennium, considered normal.

It is the contention of *The Solid Ground* that future recessions will be very different from those we have experienced so far in this millennium. Corporate earnings, measured in nominal terms, will not see the spectacular collapses that investors have been conditioned to believe are the normal consequences of recession. They will not be accompanied by major alterations in the valuations of balance sheet items being forced through the P&L with both negative and then positive effect. The financial repression, which regular readers will now be very familiar with, that is impacting markets results in a slow grinding decline in corporate margins against a background of high nominal sales growth. That is a recipe for growing profits but poorer profitability - at least for the aggregate, but with exciting opportunities in individual equities for greater profits and higher profitability. The impact of this and the direct repression which eventually forces savings institutions to sell equities to buy government bonds does produce poor returns for equities over the long term. This is particularly true for equities widely held by institutional investors. These are key structural forces but while these grind on we have recessions which are very different from those of recent decades and for those seeking trading opportunities in equities. Reading the markets in these conditions is a very different art from that involved when recessions brought risk of deflation and solvency issues for the financial system.

In the 1969-1970 recession S&P500 earnings declined by just 13% in nominal terms and in the 1973-1975 recession S&P500 earnings increased in nominal terms. But before you get too excited about the power of equities to weather inflation the general price level increased by almost 17% through the 1973-1975 recession and the S&P500 index almost halved. The surge in the effective US Fed Funds rates from 3% in 1972 to 14% in 1974 did create a recession and did produce a bear market in equities but over that tightening cycle S&P500 earnings per share rose 57%. Once again the accountancy profession played a role in the distortion to corporate earnings as imaginary profits were generated by companies selling products at inflating prices while the cost of replacing those inventories was not properly accounted for.

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Similar illusory profits will re-appear in our new age of higher inflation. There is no reason to believe that inflation accounting is likely to suddenly appear to ensure that similar phantom profits do not play a role in buoying corporate earnings growth in periods of high inflation, even should interest rates be rising and real GDP contracting. For investors concerned that it will be the rising discount rate, much as it was from 1972-1974, that will cause the material damage to equity prices Jay Powell has good news. While Arthur Burns drove the effective Fed Funds rate to 14% to combat the soaring inflation of 12%, Jay Powell has just announced that the current level of interest rates is close to the 'neutral' rate given inflation at 9%!!!!! If he is this reluctant to raise interest rates and the corporate earnings recession proves as illusory as *The Solid Ground* expects then, based solely on cyclical factors, the price of US equities is now much more likely to rise than decline. We now face at most a moderate earnings contraction, high inflation, high wage growth and low interest rates. This is not a combination that will lead to a further sharp decline in US equity prices.

Those still worried that the current economic slowdown can still bring a sharp decline in equity prices need to consider the scale of the failure of monetary policy. If Powell's monetary policy is working, it will slow the growth of bank credit and money creation. A quick reminder, from the Bank of England, on the need to contain bank credit growth in staunching money growth and inflation is perhaps necessary:

Therefore, if you borrow £100 from the bank, and it credits your account with the amount, 'new money' has been created. It didn't exist until it was credited to your account.

This also means as you pay off the loan, the electronic money your bank created is 'deleted' – it no longer exists. You haven't got richer or poorer. You might have less money in your bank account but your debts have gone down too. So essentially, banks create money, not wealth.

Banks create around 80% of money in the economy as electronic deposits in this way. In comparison, banknotes and coins only make up 3%. Finally, most banks have accounts with us at the Bank of England, allowing them to transfer money back and forth. This is called electronic central bank money, or reserves.

How Is Money Created, Bank of England, 1st October 2019

Powell's focus on the neutrality of the current level of interest rates comes against a background of continued strong growth in bank credit. Since the invasion of Ukraine US bank credit has grown at an annualised rate of 8.5%. The pace of growth is not materially flagging despite the economic slowdown over the period. In June loans and leases grew at 16.3% year-on-year with the Commercial & Industrial subset of such loans growing at 30.2% year-on-year. Bank credit to the household sector also continues to expand. Loans for residential real estate are growing at 10.3% year-on-year and consumer loans by 13.3%. The growth rate of bank credit remains at very elevated levels even since the invasion of Ukraine and the spike in energy prices thereafter.

Annualised Growth in Bank Credit Since February 23rd 2022

Total Bank Credit Growth	8.5%
Loans & Leases in Bank Credit	12.5%
Commercial & Industrial Loans	20.4%
Commercial Real Estate Loans	10.7%
Residential Real Estate Loans	10.7%
Consumer Loans	12.9%

Source: BIS

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The annualised growth rate of bank credit, since the invasion of Ukraine, is the highest level of annual growth recorded, apart from the forced lending associated with emergency measures in 2020, in 14 years. Powell's failure to contain the growth in bank credit will eventually produce the rise in the growth of the money supply which will confirm his failure also to contain inflation. Until that time the focus is on the apparent end of the growth of M2 in 2022 and the likely disinflationary impact. However, the normal lag between the creation of money and a rise in the CPI is at least 18 months so there is plenty of monetary fuel to keep the rate of inflation more elevated than the recent rate of M2 growth would suggest. The 2022 hiatus in board money growth can have disinflationary impacts sometime in 2023 but by then, given the continued surge in bank credit growth, it is likely that investors will be focused on the institutional failure to control bank credit and thus the supply of money.

As in 2020, there is something very different about this recession in that it is accompanied by strong growth in bank credit. *The Solid Ground* argued from May 2020 that this seeming aberration would result in much higher levels of inflation down the road than most analysts expect. It is time to ask again – how can higher interest rates act to contain the rate of growth of money and inflation if they have no apparent impact on the rate of bank credit growth? This strong growth in bank credit is across numerous categories and cannot be dismissed as just a drive by corporates to pile up precautionary cash on their balance sheets. Even in the crisis of 2008-2009 this rush by corporations to pull down credit lines from their bankers, to boost cash balances, lasted just a few months. With 5 months now passed since the invasion of Ukraine, growth in bank credit remains strong in both the household sector and the corporate sector. Something is different this time, as it was in 2020, and the consequences will be the same. Interest rates are far too low and the incentives to borrow at these interest rates, even in an economic downswing, remain compelling. It is difficult to think of conditions that are more different from those we faced in the 2008-2009 economic slowdown. The outcome for corporate earnings will thus be very different.

That banks continue to expand their balance sheets into an economic slowdown strongly suggests that they are confident about both credit quality and also the strength of their balance sheets. This analyst finds it particularly interesting that JPMorgan, a bank that has so far shown less appetite than its competitors to grow its loan book, has announced that it will be moving to what is effectively the reintermediation of credit in an important portion of its loan book:

JPMorgan Chase's investment bank has set up a unit to compete with growing competition from direct lenders, committing a "significant chunk of capital" to hold leveraged loans on its balance sheet. JPMorgan is funding the loans and intends to hold them to maturity rather than underwriting the debt for syndication, a practice where the bank is already a dominant player. "We were always catching this fish, it was just that we were throwing it back — now we want to hold on to it," Kevin Foley, JPMorgan's head of global debt capital markets, told the Financial Times in an interview. He said JPMorgan had committed "a significant chunk of capital" to the effort, without providing further details. The bank began making the loans in 2021 and has completed around 20 deals, with the size ranging from $50mn to around $500mn, Foley said. "This is modern-day relationship lending. We have to adjust," Foley added. "We have a team of six dedicated to direct lending across banking, markets and commercial banking." The move by JPMorgan, the largest US bank by assets, is an early signal of how banks might realign their leveraged lending operations to win favour with clients and claw back market share lost to direct lenders such as Apollo, Ares and Golub Capital.

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The long structural disintermediation of credit, which accelerated from the 1980s, permitted credit to grow much more rapidly than money and, as a result, debt-to-GDP ratios rose. If JPMorgan lends using its own balance sheet money is created while if it originates debt securities, that are almost all held by non-banks, it does not create money. If Jamie Dimon can now see the profits in direct lending, rather than originating debt securities, there is a potential structural shift in which more of the credit creation in an economy involves the creation of money. This higher rate of bank credit growth and money growth will result in a higher rate of inflation and a need to restrict the rise in interest rates along the yield curve. This is a very different form of growth than has pertained for now over thirty years and investors need to understand its very different implications. The consequence will be to reverse the era of lots of debt that came with low growth in broad money and low inflation - a combination that was very positive for asset price.

It was Walter Bagehot who said that John Bull 'can stand a great deal but he cannot stand two percent'. Bagehot observed that people would not lend money at interest rates below 2% given the credit risks associated with such lending. What if US bankers now consider, with yields on corporate credit well in excess of 2%, that it is time to follow Jamie and issue and hold loans to maturity rather than originate and sell debt securities? If bank credit growth was hampered by low interest rates, in the same way it hampered John Bull in allocating capital in the 19th century, are higher interest rates driving the boom in bank credit? If these rates of interest are still attractive to borrowers, as they are well below the rate of inflation, won't this boom in bank credit continue? Will higher interest rates, though still below the rate of inflation, ensure that the boom in bank credit growth continues with inevitable consequences, in due course, for broad money growth and inflation? Higher interest rates are normally the route to slower bank credit growth, but will they have that particular impact when we are coming from the abnormally low rates that deterred bankers from accepting greater credit risk? The bond investor can see little inflation protection in current yields but the banker can see a very positive net interest margin. We now have a combination of interest rates and inflation that will encourage the growth in bank credit at the expense of credit sourced through the issue of securities. The more institutional investors are forced to hold government bonds, at the expense of corporate bonds or equities, the greater the opportunities for bankers to fill the credit void. *The Solid Ground* believes that ultimately government diktat will control the growth in the total quantity of credit but the shift towards the reintermediation of credit means that we will get more rapid growth in broad money even if the growth in total credit is moderated. This growing structural shift leads to very different equity market performance than heretofore and also a very different type of recession.

The key structural forces that threaten the ability of equities to preserve the purchasing power of savings have not gone away. Financial repression comes with a myriad of problems for equity investors but, as *The Solid Ground* has focused on in the past few months, a key star within the firmament, perhaps black hole is a better analogy, will be the inability to sustain the single currency of Europe. The Cold War with China continues to heat up and it becomes more nonsensical for Xi to fetter the PBOC's monetary powers through the operation of a managed exchange rate regime. The problem for investors seeking to benefit from the cyclical opportunities that present themselves today in the US stock market in particular is that slow burning structural issues, largely at the edge of the radar screen, can rapidly appear at its centre. The visit of the Pelosi delegation to Taiwan is a prime example of how quickly such structural issues can accelerate in their importance. That visit can escalate the move to a bi-polar world, with major negatives for equity markets, but it will not fundamentally alter the new form of US business cycle. In fact in some ways it will exacerbate the change in the nature of the business cycle to assure much higher levels of bank lending, necessary to fund investment, that creates much higher

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levels of broad money growth and adds to the inflationary forces when exports from China end.

Few doubt that investors are living through a period of structural change. At such times the easiest thing to do is to continue to ask the old questions and marvel at our ability to get fairly right answers. New questions need to be asked in a period of structural change. Have the recessions of this millennium been typical or atypical? What does the return to a more normal recession mean for equity prices? What does the boom in bank credit growth since the invasion of Ukraine mean for the Fed's success or failure to contain inflation? How might corporate profits behave differently in an economic downturn associated with strong bank credit growth and, with a lag, accelerating broad money growth? What will the reintermediation of credit mean for the nature of growth and the shape of the business cycle?

Getting the right answers to these questions is still difficult but it is, as JM Keynes reminded us a long time ago, 'better to be roughly right than precisely wrong'. Some years ago your analyst brewed a beer called 'Roughly Right'. The label was comprised of a photograph of Keynes and also its alcoholic content - to 6 decimal places! Regular readers of *The Solid Ground* will realise that such precise answers are not forthcoming from the pen of your analyst. However the beauty of investment, which consists in assessing and valuing the discounted cash flows of the future, is that we do not need to get such precise answers. All we need to get are better answers that the consensus. This is 'simple but not easy', to quote Warren Buffet but of course it is all pointless unless we begin by seeking to answer the right questions. In posing and answering what your analyst believes to be the right questions he sees that cyclical conditions now favour equities. The negative structural issues, that will determine the scale of long-term real returns, are currently still hovering on the edge of the radar screen but moving inexorably, currently slowly, towards its centre.

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