Europe

Credit

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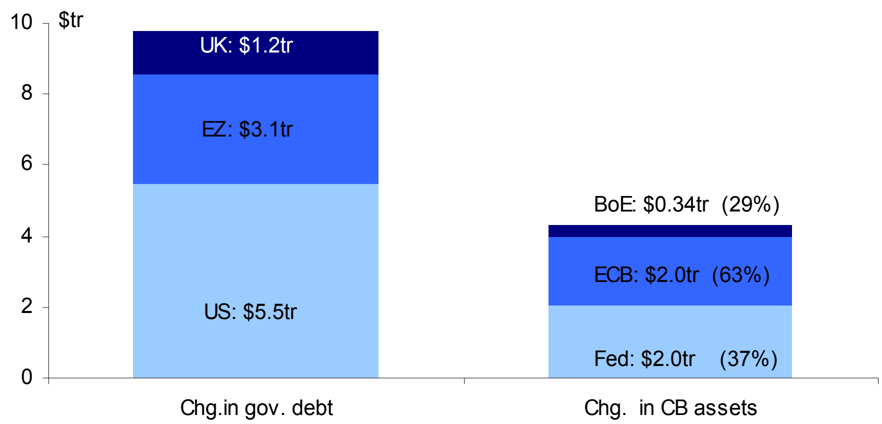
Heading for the Great Repression?

Investing in a world of government-suppressed real yields

- Every credit investor should consider the following: Why are real yields in so many countries near historical lows despite historically poor fundamentals?
- One key reason is that burgeoning government debt burdens are leading to ever more measures to influence market pricing.
- Financial repression takes many forms, but the primary aim is to keep real yields below market clearing levels. Some policies are already in place, many more will likely follow.
- Central bank balance sheet expansion alone corresponds to almost half the increase in general government debt in the US, the UK and the Eurozone since 2008 (Figure 1).
- To begin with, repression seems likely to drive more money into risky assets like credit.
- Longer term, however, history suggests the distortions and even bigger imbalances need to correct with a very negative impact on credit spreads.
- Even during the benign period, volatility and uncertainty are likely to be far higher than investors have grown used to, thanks to abrupt and far-reaching changes in policy.

Hans Lorenzen
+44-20-7986-3568
hans.lorenzen@citi.com

Figure 1. 2008-11 change in government debt vs change in total central bank assets*



Source: CIRA, Haver Analytics, Bloomberg * Chg. in central bank balance sheet measured from 2008 to Feb 2012.

Heading for the Great Repression

Over the last couple of decades we have come to take the free movement and allocation of capital for granted. Yet a quick glance back in history shows that state intervention in financial markets, and the banking sector in particular, tends to move in cycles. And most of the time it has been much heavier than it is today.

As governments struggle to restore fiscal balance, negative real yields are playing an important part in reducing the burden of the debt load. And many of the well-known tools of financial repression are making a re-appearance.

Banks and financial institutions in general are central to the implementation of that low interest-rate policy. In an upcoming piece ("Heading for the Great Repression (ii): Why banks will be the captive buyers of sovereign debt") we will explore the implications for the sector in more detail. However, in this piece we focus on the broader consequences of financial repression and the impact on risky assets, credit in particular.

We make the case that, in its early stages, financial repression is not necessarily negative for credit spreads. Quite the opposite, in fact. Low interest rates and unconventional monetary policy have provided a huge boost to risk assets since 2009. In Europe, state intervention in the banking sector has largely been positively perceived in markets – being deemed necessary to contain systemic risks.

However, the strong equity returns and the low credit spreads of the financially repressed 1950s and 1960s are probably a poor guide to the current situation. To the extent that financial repression in a low-growth environment over time facilitates even bigger imbalances that have to be corrected, we expect the long-term impact will be negative for risk assets.

The famously tight credit spreads in Japan should offer scant comfort – their debt problem has really yet to be dealt with. To the extent the ultimate solvency question is addressed through a combination of more sovereign debt restructurings and inflation, credit is unlikely to escape the impact.

Introduction

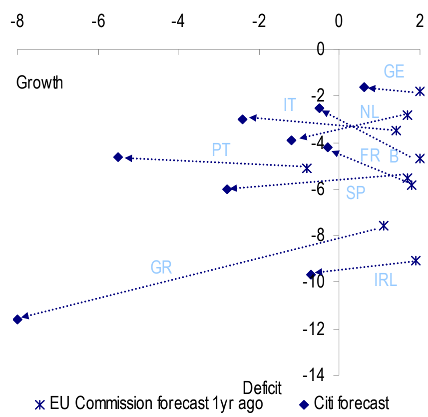
For 25 years, growth in the developed world benefited from a virtuous circle of falling inflation, falling nominal interest rates, benign demographics, globalisation and financial liberalisation. The process was augmented by rising asset prices, which created lots of wealth despite very high consumption rates and associated low savings rates. Most governments were only too happy to run their policies on the assumption that this was 'normal' – permanent, not transitory or unstable.

When the virtuous circle finally broke in 2007-08, the structural fiscal position of most countries turned out to be far worse than had been assumed. Automatic fiscal stabilisers kicked in (slumping tax revenues, rising social expenditures). Boosted in some cases by discretionary stimulus, many sovereigns have been left with gaping holes in their budgets. To make matters worse, assumptions about underlying growth rates without credit enhancement are so far proving too optimistic, forcing a big reassessment of how quickly economies will be able to expand their way out of debt burdens.

The process of correcting the structural imbalances seems to be proving far more painful than policymakers would acknowledge even a year ago – especially in the countries that have to make the biggest adjustments.

Take a look at the Eurozone for example (Figure 2). The contrast between what Citi's economists expect for growth and deficits in 2012 stands in stark contrast to what the EU Commission was expecting for 2012 just over a year ago. The growth looks set to be sharply lower across the board, with little improvement in expected deficits – indeed, in some countries deficit expectations have increased. Greece is a dramatic illustration of what happens when the burden of adjustment is simply too great.

Figure 2. Growth vs Fiscal Deficit - Citi 2012 Forecast vs. EC forecast, August 2010, %



Source: Citi Investment Research and Analysis, EU Commission

Small wonder then that markets demanded higher risk premia for holding the ever growing volumes of sovereign debt outstanding in some countries last year. When the attempt to persuade markets that solvency is beyond question and that austerity will fix the issues failed, only liquidity interventions from 'friendly neighbours' have prevented more defaults.

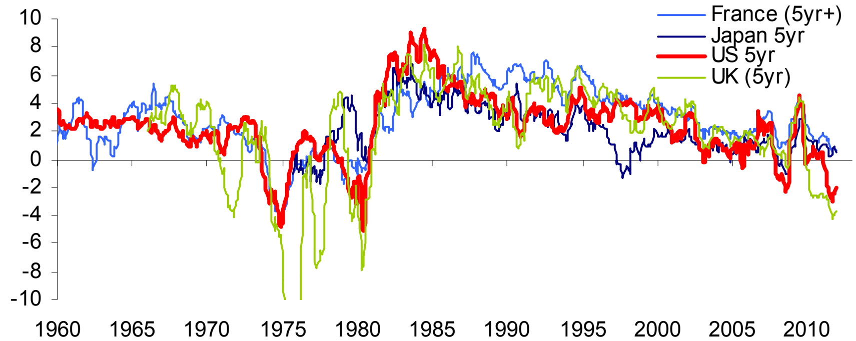
To us, the bigger question is why real yields in a number of developed economies are at 30-year lows (Figure 3), when sovereign fundamentals are deteriorating rapidly.

The answer is partly that these sovereigns still enjoy credibility in the market and investors are finding few risk assets where they see much better investment opportunities.

But we have little doubt that very expansive central bank policies are playing an equally important role. Beyond the very low policy rates, the Fed, the ECB and the Bank of England have expanded their balance sheets to the tune of almost half the increase in government debt over the last four years (Figure 1).

Not all that balance sheet expansion has been used to finance sovereign debt; it has, in our view, contributed to creating the scarcity of investable assets that is fuelling both equities and credit at the moment, seemingly without putting yields under much pressure.

Figure 3. Real yields from 1960-2012, %



Source: CIRA, Haver Analytics, IMF IFS.

But, more controversially, there is a distinct leaning in recent policy towards gradually creating a captive buyer base that can hold more of sovereign debt through voluntary or coercive means.

Below, we will discuss some of the key forms of financial repression, we will look at the impact repression has had on financial markets in the past and at how some recent initiatives are likely to impact market liquidity and transaction costs. However, our overriding message is that what we have seen to date is only the beginning. The impact on the credit market is likely to be profound.

What is financial repression?

Financial repression occurs when the market-determined demand and pricing for sovereign debt or currency is distorted by policy (regulatory, administrative, through direct control or coercion). So, any policy that induces financial actors to hold a higher share of sovereign debt than they would otherwise hold at prevailing yields is a form of financial repression. As are actions that circumvent bondholders' and shareholders' individual rights and interests.

Figure 4. Forms of financial repression in brief

Bail-ins of bank bondholders

Purpose: Recapitalising banks without public money or depositor losses (haircuts usually); *Guise:* "making bondholders take their fair share of losses – they'd lose anyway if the bank collapsed"; *Impact:* Positives: Reduces systemic risks, allows recapitalisation without tax payer money; Negatives: violates bondholders' rights, raises the cost of unsecured debt; *Problem:* Contagion to comparable banks

Bans on 'undesirable' trading practices, like naked short-selling

Purpose: Reducing selling pressure of politically sensitive assets; *Guise:* "Preventing speculative attacks on solvent institutions"; *Impact:* Positives: Politically popular; Negatives: Distorting price discovery, likely to reduce liquidity, curtailing hedging possibilities; *Problem:* Finding an effective, water-tight definition of "naked short-selling", avoidance.

Capital controls

Purpose: limiting speculative flows, controlling FX movements, preventing bank runs, creating a captive buyer base; *Guise:* "Preventing speculative attacks or regulating speculative capital flows"; *Impact:* Positives: May limit FX and interest rate volatility, may facilitate internal adjustments; Negatives: Distortions likely to build up over time; may limit return on capital. *Problem:* Avoidance, conflicts with the Internal Market in Europe.

Coercive exchanges

Purpose: Reduce the debt burden; *Guise:* "not an event of default – it's voluntary"; *Impact:* Positives: May restore the debt burden to a sustainable level, that may in turn help restore confidence; Negatives: damage to credibility, need to recapitalise banks; *Problem:* International acceptance, technicalities like "domestic" vs. "international" law debt

Deposit / interest rate controls

Purpose: Negative real interest rates, enticing savers to buy government bonds; *Guise:* "Avoiding deposit wars"; *Impact:* Positives: Bank profitability, encourages spending; Negatives: fewer savings for retirement, banks more dependent on capital market funding, encourages off-shore markets

Ex-post subordination of bondholders (in banks and sovereigns)

Purpose: Lowers political cost of bailouts; *Guise:* "It's just a gentlemen's agreement"; *Impact:* Positives: Higher official sector recovery rates through collateral (CB lending) or seniority (sovereign lending). Negatives: Lower private sector recovery rates raise the cost of unsecured debt, increases risk of losing market access.

Financial transactions taxes

Purpose: Revenue, lowering volatility in financial markets; *Guise:* "Limiting speculative casino trading"; *Impact:* Positives: Politically popular, Negatives: Bank profitability, market liquidity; *Problem:* Avoidance (unless global).

Nationalisation

Purpose: Avoid collapse of insolvent banks, control the flow of lending; *Guise:* Systemic risk; *Impact:* Positives: Preventing financial contagion, more direct control over financial sector, Negatives: Costly, likely to lead to distortions in allocation of lending; *Problem:* Taking bank balance sheet on the sovereign balance sheet.

Regulatory incentives to buy government bonds

Purpose: Create captive demand for government bonds through lower risk weights or liquidity requirements *Guise:* "Financial institutions need to hold more safe, liquid assets", *Impact:* Positives: Lower sovereign funding costs; Negatives: Crowding out of private borrowing, may prolong an unsustainable fiscal deficit, raises domestic loss in default.

Source: Citi Investment Research and Analysis

Are zero rates and QE forms of financial repression?

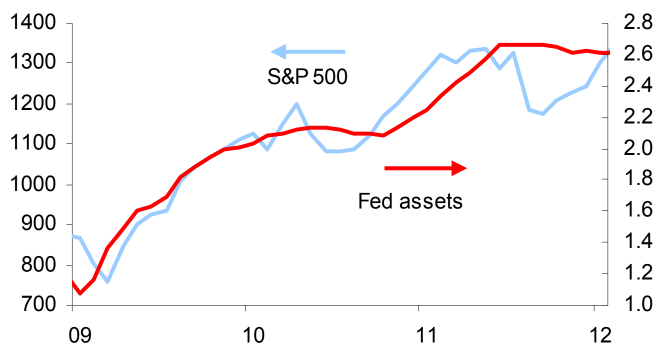
The extraordinary monetary policies central banks have pursued in recent years can also be regarded as a form of financial repression.

Granted, expansive monetary policy is normally aimed at stimulating the general economy. Yet when a central bank actively seeks to keep yields below inflation in order to generate negative real interest rates, by implication it is imposing negative real returns on investors. In so doing, it is ensuring that the sovereign can borrow cheaply.

It also pushes investors out of risk-free assets into riskier assets. We last saw that in 2009 and 2010 with the massive flows out of money-market mutual funds into credit funds in particular.[1]

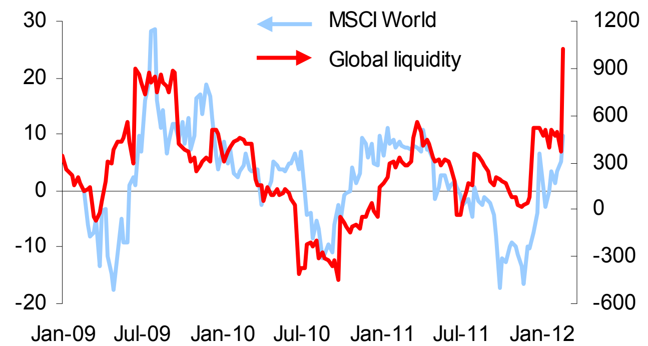
Similarly, the principal purpose of quantitative easing is to distort the supply-demand balance in the government bond market, again forcing investors to accept lower yields or find returns in riskier assets. As illustrated in Figure 5, the effect of the Fed's QE US on credit spreads and equities over the last three years is much stronger than is commonly perceived[2]. Even at the global level, market returns have been eerily well correlated with global central bank liquidity injections (Figure 6).

Figure 5. Fed holdings of securities($bn) vs. S&P 500 since 2009



Source: CIRA, Haver

Figure 6. Global liquidity* ($bn) vs. MSCI World (% chg.), 13-wk change



Source: CIRA, Haver. * Global liquidity defined as the sum of Eurozone, Japan, UK, & US central bank security / bond holdings (LTROs included for the ECB).

Coming to a sovereign near you

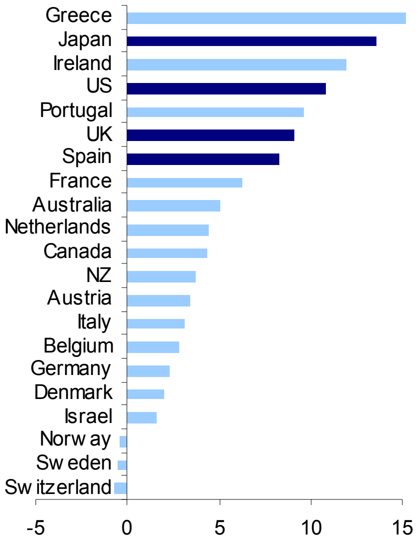
Most of us tend to regard financial repression as predominantly an Emerging Market phenomenon.

But with rising public debt levels across the developed world, keeping real interest rates low is becoming paramount. Figure 7 is probably as a good an illustration of the problem as any. It shows the amount of fiscal tightening the IMF estimates is required between 2020 to reach what it regards as sustainable levels by 2030 *before* the spending impact of demographics. Sovereigns like the US, the UK and Spain all need an adjustment similar to Portugal and only somewhat smaller than Ireland and Japan.

[1] See *Where did all the money come from?*, M. King, 19 April 2011.

[2] We have made this point more formally in 'Do Rate Hikes Matter for Credit?', H. Lorenzen, 23 March 2011

Figure 7. Fiscal adjustment required by 2020 for long-term debt sustainability



Source: CIRA, IMF Global Fiscal Monitor Sep. 11

Financial repression has been tried and tested as a means of facilitating such an adjustment many times before.

Take the 1950s and 1960s for instance. Tight regulation of financial markets helped maintain low nominal interest rates, which with moderate inflation in turn significantly eased the debt reduction left necessary by WWII. Reinhart and Sbrancia[3] find that real interest rates in the US and the UK were negative almost half the time between 1945 and 1980, and significantly lower than in the periods before and after.

They estimate that the average liquidation of debt was worth 3-4% of GDP per year in years with negative real interest rates. That's equivalent to 30-40% of the required adjustment in the above mentioned countries or in political terms: equivalent to a very painful amount of fiscal austerity.

Even a real interest rate of -2% would have a very meaningful impact on the debt burden over longer periods of time, everything else equal.

Financial repression – the US and the rest

Without capital controls, most sovereigns can only repress domestic actors – foreign investors just head for the exits. But thanks to its global reserve currency status, the US is in a unique position.

US public debt is now above $15.5tr – excluding the $7.5tr obligations of Fannie and Freddie. The debt/GDP burden has passed 100%, considerably higher than Spain. More than one in three dollars spent by the Federal government currently is borrowed. The deficit is projected by Citi economists to be 7.3% of GDP this year – again higher than Spain. Yet the US nominal yields are at the lowest level in at least 60 years.

One reason is obviously monetary independence, but the captive demand from foreign central banks is also playing an important role. An EM sovereign wanting to stimulate export-driven growth by locking the exchange rate at a competitive level against the "dollar bloc" will almost invariably end up accumulating US assets.

Expansive monetary policy in the US can accelerate the process, as low interest rates push money towards higher-yielding, faster growing EM economies. However, having learned lessons of the Asian crisis, most EM governments are still countering the exchange-rate impact of the speculative inflows. Stepping up intervention compels them to buy yet more US assets, including Treasuries, which pushes US yields even lower.

In the short term, the US benefits from even lower interest rates and a continued inflow of cheap foreign goods. But, evidently, the underlying imbalance also grows.

Oddly, perhaps part of the solution may be more financial repression, not less – albeit of a different kind. Our Head of EM Economics, David Lubin, has suggested that, if developed economies agreed to capital controls to stem the speculative money, then EM governments would likely be more willing to allow the appreciation in their currencies necessary for long-term global rebalancing[4]. For investors in risky assets, though, the inability to seek out the most attractive investments would be a big step in the wrong direction.

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3 Reinhart, Carmen & M. Belen Sbrancia, "The Liquidation of Government Debt", NBER WP 16893, March 2011.

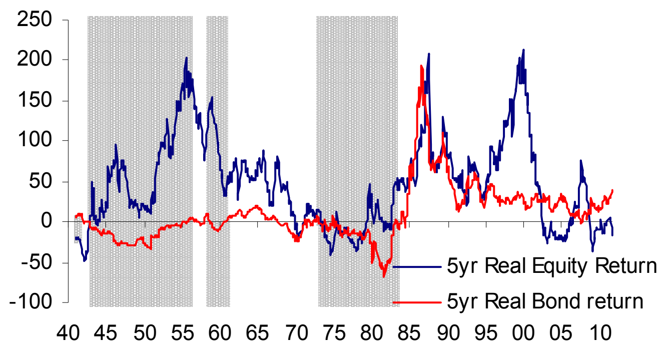
4 "Towards Financial Repression? A view from EM", David Lubin, 23 November 2011

What does repression mean for risky assets?

Looking at history, perhaps the most surprising observation is that financial repression need not be negative for risk assets. In the 1950s and the 1960s not only was monetary policy repressive (as illustrated by Reinhart and Sbrancia), but capital controls and bank regulation were also much tighter than today.

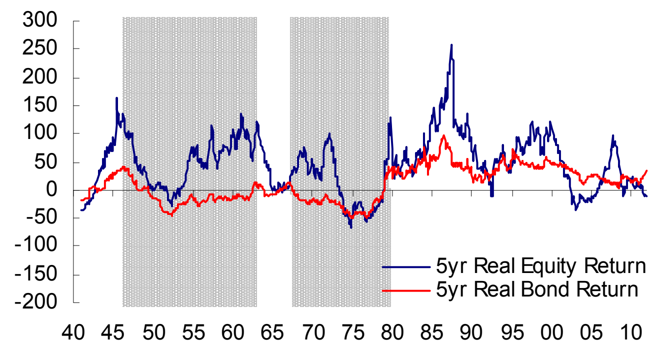
Yet none of that prevented equity markets from performing in many cases, including the US and the UK (Figure 8 and Figure 9). In fact, between 1950 and 1969 the S&P 500 rose from 15 to 108 – a seven-fold increase.

Figure 8. US 5yr real equity and bond return, %



Source: CIRA, Haver

Figure 9. UK 5yr real equity and bond return, %



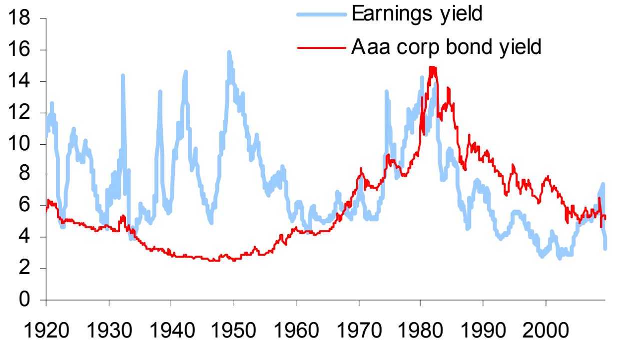
Source: CIRA, Haver

Our equity strategists have dubbed this period the "The birth of the cult of equity"[5], arguing that the negative return from bonds precipitated an asset allocation shift towards equities. This prompted a re-rating of equities. So, despite sharp earnings growth, the earnings yield fell to the lowest level seen in the last hundred years apart from at the height of the equity cult in the late 1990s.

In credit markets too, it is hard to see any negative impact of financial repression on spreads in the 1950s and 1960s – these two decades saw the lowest risk premia of the last century (Figure 10 and Figure 11).

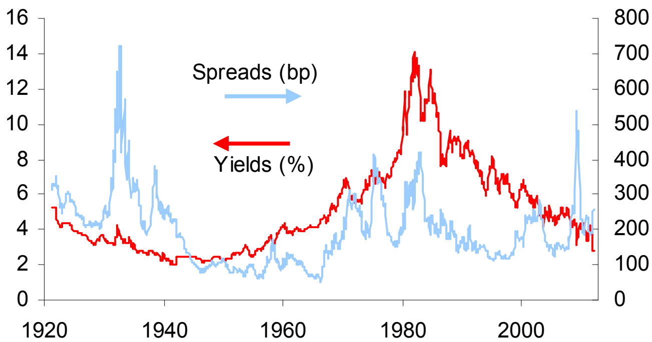
Bring on financial repression, then?

Figure 10. US equity earnings yield and AAA corporate bond yield, %



Source: CIRA, Haver

Figure 11. US Baa-Aaa IG credit spread (bp) vs. US 10yr yield, %



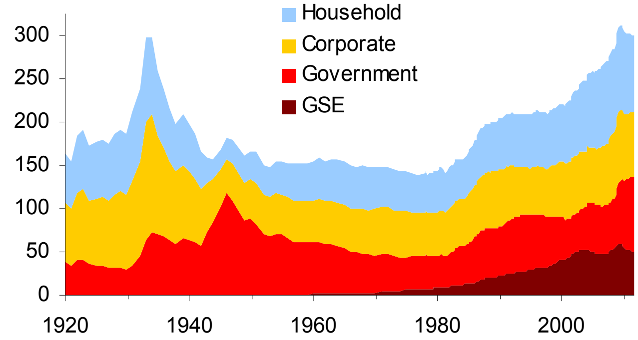
Source: CIRA, Haver

[5] "Pan-Europe – Financial Repression and Equities", CIRA euro strategists, 24 November 2011

Sadly, it is not that easy. There are simply too many differences between the 1950s and the 1960s and the current backdrop.

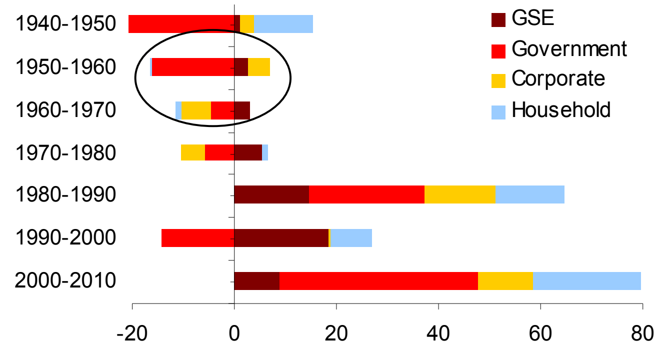
Firstly, the growth environment then was much stronger due to the post-war rebuild and very favourable demographics compared to now. Rapid economic growth eroded the relative burden of public debt much faster than it will now.

Figure 12. US debt by sector, % of GDP



Source: CIRA, Haver, US Flow of Funds

Figure 13. Change in US debt/GDP ratio by sector, Pct. points



Source: CIRA, Haver, US Flow of Funds

Moreover, when the public sector needed to delever, private sector debt levels were comparatively low, allowing private credit to expand broadly in line with GDP (Figure 12). In contrast, the last decade has seen an aggressive expansion in not just public debt to GDP but also in private debt to GDP. As a result, private sector debt as a proportion of GDP is higher than ever, with bank balance sheets encumbered by the impact of the contracting housing market.

The fact that we now face twin deleveraging makes it much less likely that financial repression will coincide with strong growth and sustainable asset price returns this time.

Secondly, the stability of the 1950s and 1960s didn't last. Financial repression contributed to an extension of the imbalances of the Bretton Woods system. When the system broke down, the sharp depreciation in the dollar and lax monetary policies led to a spike in inflation in the 1970s.

The surge in nominal yields that resulted proved very negative both for earnings yields in the equity market and for credit spreads (Figure 10 and Figure 11). The volatility of credit spreads from 1970-84 was four times higher than between 1950-69.

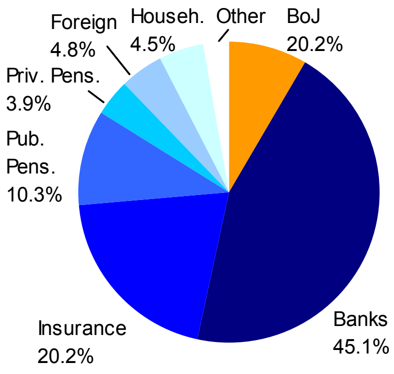
Without restrictions on capital flows and deposit caps like Regulation Q[6], yields in the 1950s and 1960s probably wouldn't have been as low, and most likely imbalances would have had to be corrected much earlier on. Quite conceivably, that would have been less painful than the adjustment in the 1970s and early 1980s.

So, while financial repression may have facilitated strong returns in risk assets for an extended period, unwinding the distortions was a painful and volatile process.

[6] Regulation Q, introduced with the Banking Acts of 1933 and 1935, set interest rate ceilings on deposits imposed by the Fed. It was phased out only in 1986 after the savings & loans crisis.

Japan a better comparison?

Figure 14. Ownership of JGBs by sector



Source: CIRA, Japanese Ministry of Finance

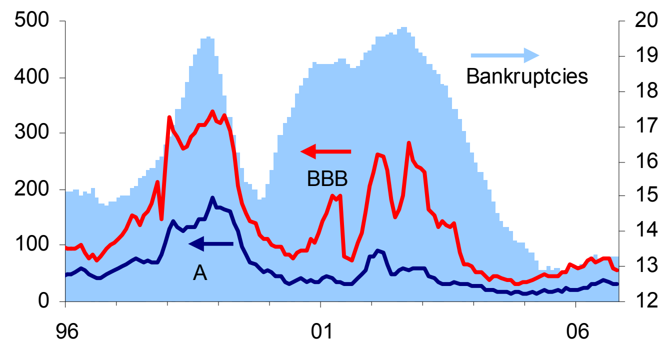
Japan provides an altogether different experience – 20 years of no growth, no inflation, corporate deleveraging, but public sector releveraging. Faced with a lack of corporate loan demand as corporate savings rates have been abnormally high, banks have had little alternative but to hold growing amounts of JGBs.

As Figure 14 illustrates, domestic banks, insurance companies, and pension funds hold almost 70% of outstanding JGBs. Could these institutions not, at least ex ante, have expected higher returns abroad?

Regulation played a crucial part in sustaining domestic demand by not requiring banks to hold capital against government bond holdings and by excluding even currency-hedged foreign bond exposures from required liquidity holdings.

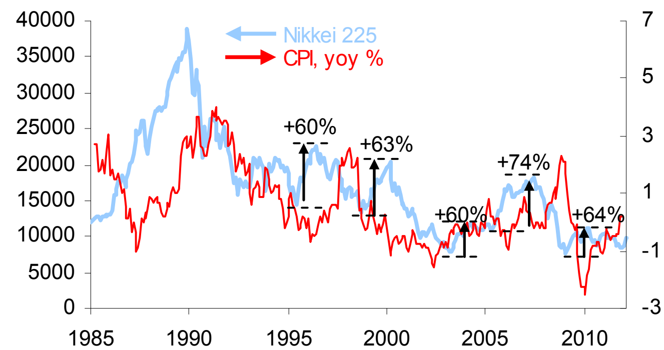
But what was the impact on performance of risk assets? In a word, it is mixed. Japan is famous for its very tight credit spreads. Yet it is often forgotten that Japanese credit went through two nasty phases of corporate defaults (Figure 15), where spreads widened substantially. These defaults seem to have had a much stronger impact on spreads than did real yields, suggesting that the impact of financial repression was less responsible than it is often argued.

Figure 15. Japanese corporate spreads (bp) vs # of bankruptcies



Source: CIRA, Haver

Figure 16. Nikkei 225 with largest rallies vs. CPI inflation



Source: CIRA, Bloomberg

Equally well known is the drop in the Nikkei from its peak of 39,000 down to the 2008 low of 7,000 (Figure 16). Yet it is often forgotten that, within this 20-year bear market there were five instances where the Nikkei rallied by more than 50% from trough to peak. Four of these five periods correctly anticipated a rise in inflation, while the direct link to both nominal and real yields was less apparent. That suggests equities were more driven by the reflation story than by asset allocation shifts associated with financial repression.

It is easy to exaggerate the similarities with Japan. Corporate leverage in the US and Europe is generally much lower – the private sector deleveraging than needs to take place is largely on the household side. That's a credit positive. Valuations are also less extreme than they were going into the crisis in Japan. Moreover, financial repression has arguably occurred at an earlier stage of the crisis – expansive monetary policy has already left real yields in the US and the UK (among others) more negative than in Japan for most of the lost decade (Figure 3). The positive impact on asset prices has been apparent across the board.

But we can't help but feel that the Japanese scenario of low growth, low inflation, weak domestic demand, constrained bank balance sheets and surging government debt levels is considerably closer to the current situation than is the US in the 1950s and 1960s. As such, we fear that either financial repression will have be so strong that it ends up being inflationary much sooner than it did in the 1950s and 1960s, or that the stimulus from low real yields and QE will ultimately prove temporary.

It's not just about asset prices…

It is striking how many of the traditional tools of financial repression listed in Figure 4 are already in use or are on the table for discussion right now. Above we focused on asset prices, but the impact of financial repression goes far beyond that to liquidity, hedging, and to the cost and even ability move capital around.

On several fronts, including short-selling bans and transactions taxes, implementation is already at an advanced stage. Could capital controls be next?

Bans on 'undesirable' trading practices, like naked short-selling

Short-selling bans received a huge amount of media and political attention in 2011. The argument in support was that 'speculative' market forces were (ab-)using illiquid markets, such as the CDS market, to drive prices on certain assets well below their 'true' fair value.

Yet there is scant evidence that such bans on equities and debt in countries including Belgium, France, Italy and Spain have really worked for more than a very short period of time. A recent article in the *Financial Times*[7] notes that share prices on several large financial institutions did drop immediately after the short selling bans were lifted.

However, while the bans were in force, they failed to prevent financial institutions from underperforming the market either at the individual or at the sectoral level.

Similarly, in a piece from 2010[8] we argue that that sovereign CDS market is too small to drive government bond markets. Indeed, a report from the EU Commission found that "*CDS spreads for the more troubled countries seem to be low relative to corresponding bond yield spreads, which implies that CDS spreads can hardly be considered to cause the high bond yields for these countries*."

Regardless, the EU Parliament and the Council of Ministers agreed on introducing a general ban on naked short selling of sovereign debt in October 2011, albeit with scope for member states to lift the ban to the extent it jeopardises market liquidity. The EU directive that will implement the legislation, however, is still being drafted and isn't expected until towards the end of this year.

We worry that a strict implementation of a shorting ban could have very tangible consequences for the liquidity of the CDS market. This is a concern to banks, in particular, as it may impede their ability to hedge other sovereign exposures. Yet this could potentially backfire on the sovereigns, with banks either insisting upon the payment of collateral against their sovereign swap exposures, or else simply becoming less willing to lend to the sovereigns in the first place.

7 'Claim of short-selling ban victory in Europe', Financial Times, 27 February 2012

8 'You can't blame the mirror for your ugly face', Michael Hampden-Turner et al., CIRA, 1 March 2010

Financial transactions taxes (FTT)

FTTs are probably the least of our concerns from a credit perspective. They might reduce liquidity, but we think the impact is likely to be less severe than from a short-selling ban, as we reckon they would remain only a modest proportion of overall transaction costs. The effect is more likely to be discernible in very liquid markets with minimal transaction costs.

Initiatives are currently in various stages of implementation in differing jurisdictions. From January 2012, France has unilaterally put a 0.1% tax on share purchases and CDS transactions, but not bonds. This was done in anticipation that an EU FTT proposed by the European Commission will follow. The proposal, which also includes bonds, would introduce a world-wide FTT on companies based in the EU from 2014. Opposition exists from some non-Eurozone countries (including the UK and Sweden); some member states have proposed an FTT only for Eurozone countries.

An FTT has also been proposed at the G20, winning support in the US from Nancy Pelosi among others. However, Treasury Secretary Tim Geithner and Paul Volcker have spoken out against FTTs in the past, suggesting there still isn't a political consensus on a global initiative.

Capital controls – could we see them in Europe again?

Economists often view capital controls in the context of the so-called 'Impossible Trinity' of having free capital movements, fixed exchange rates and independent monetary policy. Simplistically, the argument is that without restrictions on the flows of capital then it is impossible to keep fixed exchange rates unless monetary policy is used to balance between demand and supply for a currency.

Capital controls were key to the Bretton Woods system, but today they are mostly associated with EM countries seeking to limit FX appreciation. In both cases, capital controls allow(ed) fixed exchange rates and independent monetary policy.

The EU has addressed the 'Impossible Trinity' in a different way. It sought to have free movement of capital (with the Single Market Act) and a fixed exchange rate (or rather a common currency) by having a common monetary policy under EMU.

Ten years on the experiment is clearly undergoing severe strains, as periphery countries suffer with the consequences of having let competitiveness diverge too much from the core. Perhaps the 'Impossible Trinity' will be re-cast as the 'Hopeless Quaternity' by the time the adjustment in the European periphery is over...

As markets grapple with the prospect that some sovereigns may eventually feel compelled to withdraw from Monetary Union, it is important to emphasise that there is an alternative, or at least an interim, step – reintroducing capital controls[9].

While the European Treaty prohibits restrictions on payments in the EU, it also allows a member state to take "requisite measures" to ensure "prudential supervision of financial institutions" or "to take measures which are justified on grounds of public policy or public security"[10].

So in the scenario where a sovereign experiences sudden, sharp deposit outflows from its banks, for example, it is feasible that restrictions on withdrawals and cross-border capital transfers could form part of the policy response. To us, that is an additional risk which needs to be considered when buying corporate bonds in the weaker periphery countries.

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[9] Various forms of capital controls would almost certainly be introduced as part of an EMU exit.

[10] Article 65 of TFEU

More to come…?

These are just a few examples or how greater intervention in financial markets is or could have profound implications for investors. In "*Heading for the Great Repression? (ii): Why banks will be the captive buyers of sovereign debt*" will explore some of the regulatory initiatives that are more specifically directed at banks and other financial institutions.

But the key point to us is how much of the recent legislation is being introduced on a "when needed" basis – the short selling bans, the special resolution regimes in Europe, the collective action clauses in Greece.

The simple inference we draw is that investing in an era of financial repression should be based on the assumption that in any given scenario, policy will seek to tilt the rules to suit the interests of the powers that be to a much greater degree than we are used to.

For bondholders, this implies a very different level of analysis to what they are used to. Rather than focusing on whether fundamentals are good or bad and whether technicals are favourable or not, going forward a key element in the investment decision needs to be whether the investment serves a useful policy purpose or not. For many investors, that will not be a comfortable basis on which to allocate their resources, but it will be a necessary one.

Conclusion

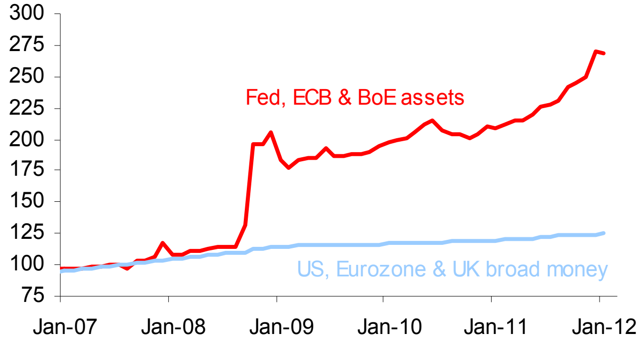
Financial repression has a multi-pronged impact on financial markets. Some elements are positive, at least in the short term. Others are very negative.

Right now, credit and equity are enjoying the spoils of an aggressive expansion of base money. We are in the unusual situation where equities and corporate bonds can rally on the expansionary effect without yields rising on inflationary fears (Figure 17), because it is not leading to a rapid rise in broad credit.

We expect the prospect of an extended period of negative real yields will lead to asset reallocation from safe-haven assets, like government bonds and money markets, into riskier assets like IG and HY credit and equities.

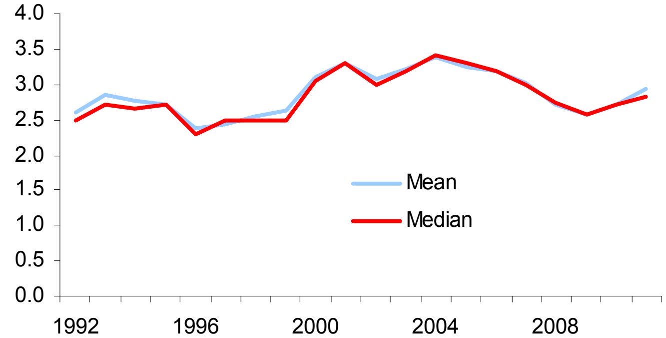
At least, low risk-free rates are likely to drive down the earnings yield required in the equity market. Similarly in credit, insurance companies and pension funds with specific return targets will likely have to take more risk to have any chance of achieving those targets – we have already been approached by insurance companies looking to be much more active in the HY space going forward.

Figure 17. Central bank balance sheet vs broad money (Jan-07 = 100)



Source: CIRA, Haver

Figure 18. Average US growth expected over the next 10 years



Source: CIRA, Philly Fed Survey of Professional Forecasters

However, increased financial repression today comes in response to a poor growth and fiscal outlook, which bears more resemblance to the experience from Japan than it does to the 1950s and 1960s.

We don't think the market is fully discounting the shift in trend growth that has actually occurred – Figure 18 shows that trend growth expected for the next 10 years is still higher than it was for much of the 1990s. Although we don't think the turning point is imminent, that leaves us sceptical about the long-term durability of the rally we have seen in recent months.

That said, credit is probably better equipped to handle this kind of environment than some other asset classes. Both in the US and in Japan financial repression did not prevent tight, or rather very tight, credit spreads for an extended period.

In Japan, the inevitable spike in default rates as overleveraged companies were unable to adjust to a radically different growth outlook led to a spike in defaults which weighed on credit spreads early on in the crisis. Europe probably has to go through a similar process, though on a smaller scale. "Amending and pretending" to preserve a capital position won't work for banks indefinitely, especially with the Eurozone in recession again. That will have a cyclical impact on spreads.

Ultimately though, the biggest danger comes from the possibility that the coming decades may combine the negatives from the US and Japanese experiences – low growth and unsustainable fiscal deficits taking financial repression to the point where it becomes inflationary. The mountain of un- or underfunded pension plans, public and private, will only make that latter outcome more appealing. Where inflation is not an option, sovereign restructuring seems the likely solution.

From a policyholder's perspective a large part of the attraction of financial repression is exactly that it buys you time to fix unsustainable trends – by lowering your cost of funding and by creating captive buyers. However, in so doing, financial repression can also to some extent mask the true scale of the problem by suspending the disciplinary effect of the market. Why implement painful reforms if no one is forcing you to today? The inability of Congress to agree on a comprehensive deficit reduction plan is a good example.

As we saw in the early 1970s the pain is likely to be all the greater when the regime finally breaks down.

Notes

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Appendix A-1

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