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Welcome back to the 1970ies

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In 1976, the author Astrid Lindgren of Pippi Longstockings fame incurred a 102% marginal tax rate by the Swedish Government, she countered by writing a satirical fairytale, "Pomperipossa in Monismania" - I think the title explains itself. She not only raised a fierce debate but also imparted a major loss on the Social Democratic government in elections later that year, as they lost power for the first time in 44 years.

I bring you the story because Astrid Lindgren's main argument with the government was the overreaching power of government to not only tax her, but to decide everything. Pomperissa in the book exclaims: "102%, that's not even possible". Well I think the lesson over the last two months is that everything – literally everything – is possible.

Over the last couple of months we have seen austerity abandoned, central banks losing independence, fiscal rules in the EU out the window, infinite QE all around the world, an explosion of the Fed's balance sheet to bail-out Wall Street and high risk corporate debt, billions extended a bit less efficiently to bail-out Main Street, an introduction through the back door of Universal-Basic-Income (grants), Modern Monetary Theory (Monetizing debt of government through central bank's balance sheet expansion). The most aggressive actor in all of this, the US Federal Reserve under Chairman Powell has ripped open swap lines to global central banks and in some of its more creative moves has violated the Federal Reserve Act by using SPV's, yes that old chestnut, to "make everyone whole".

The make everyone whole argument is a descent into terrible moral hazard, as we now not only abandon price discovery, but also the market based economy. This bailout helps airlines executives who left no cash on their balance sheet, and who allotted themselves 100 of millions of stocks in options through depleting the same balance sheet with massive stock buy-back programs. Or take IBM, which has spent $157 billion worth of stock last ten years but has a current market cap of $102 billion. Maybe we need to call on another Scandinavian author – the Danish H.C Andersen and his fairy tale of "The Emperor's new clothes" – to fully understand what is going on.

The infinite support in all shapes and forms means we now have paradigms and business models which should not be possible: Negative Interest Rates, being paid to borrow money, and even this week, negative oil prices, or being paid to consume fossil fuel. I could try to explain why everything is as it is, but the task is simply too tall, because it just doesn't make any sense. Sure, I can come up with a "talking head" explanation, but this market environment is simply too nonsensical to understand.

What is clear though is that both negative yields and negative oil prices are a function of 'Pomperissa in Monismania' - government and central bank policy overreach. Government has replaced markets in determining prices and therefore supply and demand. Oil got too cheap – and briefly negative because of the "free ride" enjoyed by oil producers in subsidies and mal-investment inducing low interest rates. This "support" kept marginal operators pumping oil despite never having realized a positive cash flow, even when oil prices were much higher. Simply put, oil prices have now also reached the zero bound as well and more importantly, as my friend Mark Voller told me this week, we now have 'liquid, but insolvent companies' operating in all sectors but in particular in the ones with big jobs, big investments and of strategic importance. Welcome to Monismania!

The 1970s started with big government and a strong USD and saw the USD weaken all decade and then high inflation and high unemployment after Nixon de-pegged the USD from gold in 1971. Marring the decade were supply constraints and terrorism. Geopolitics saw the enlargement of the EU, the opening up of China. Environmental policy crept up on the radar for the first time.

And now? We have in my opinion gone full circle over the last 50 years and learned absolutely nothing. The first Earth Day was exactly 50 years ago today, and the environment is an even bigger issue today with our ever more anthropocentric world view, China is at risk of being "cut off", the USD is very strong and is still the world's reserve standard – a standard the world desperately needs to de-peg from as the US Fed and government have decided to pay anyone holding US debt with IOU's based on printing money. EU membership has peaked will most likely be reduced again (Who will be first? Hungary? Italy?).

Inflation is still lacking despite the desperate policy attempt to "achieve 2%". But the bottlenecks and real capital destruction this crisis has created, together with infinite spending and grants to make everyone whole will see inflation returning again with a vengeance, sometime in the next two years. Unemployment is hitting 20% or worse in the US, and it will eventually fall, but 100-million plus American families have been impacted for this "inconvenience" here and now, and the UBI-type programs will act a bit like old trade unions did by requiring companies to bid up labor costs to get people to work any job. In short, welcome back to the 1970s.

What however concerns me more than the resonance with the setup in the 1970's is that other aspects of our current situation remind me of the Post World War One time-frame. This was the last time we saw truly massive sovereign debt failures. This time around, Ecuador has already declared bankruptcy, African nations have received an eight month moratorium and Argentina has declared its own moratorium and told creditors to get lost. In the Middle East Oman and Bahrain are effectively shut out of the bond market and are seeing their CDS prices (default insurance) rise and rise.

To understand the true impact of debt and potentially failed debt, read **this article** on how the UK only a few years ago repaid the last debt from that era, with Germany doing so in 2010 and the US still "making everyone whole" (Though I am sure Fed is ready to print some more money to help out.)

The two tables below are from **Sovereign-debt relief and its aftermath: The 1930s, the 1990s, the future?** by Carmen Reinhart, Christoph Trebesch, 21 October 2014.

Table 1. Unpaid allied wartime and postwar debt owed to the US and the UK: The 1934 summer defaults

	Owed to US	*Owed to UK*	*Total to US and UK*	*Debt relief to GDP (in %)*	
	Debt outstanding in US$ (w/ arrears)	Debt outstanding in US$ (w/ arrears)	Debt outstanding in US$ (w/ arrears)	Face value (upper bound)	Present value (lower bound)
United Kingdom	4,714,345,235	.	4,714,345,235	24.5	19.5
France	3,980,735,112	3,361,387,861	7,342,122,972	52.2	25.1
Italy	2,009,555,036	1,123,494,772	3,133,049,808	36.4	11.5
Belgium	413,430,000	64,631,010	478,061,010	4.1	2.7
Poland	226,248,308	17,107,860	243,356,167	.	.
Czechoslovakia	165,409,455	0	165,409,455	.	.
Yugoslavia	61,625,000	146,572,822	208,197,822	.	.
Romania	63,883,007	140,836,167	204,719,173	.	.
Greece	32,789,344	99,384,805	132,174,148	43.4	21.4
Austria	23,822,492	0	23,822,492	1.7	1.6
Estonia	18,079,383	1,432,045	19,511,429	.	.
Finland (fully repaid)	8,711,996	0	8,711,996	0.2	0.2
Latvia	7,435,784	6,222,619	13,658,403	.	.
Lithuania	6,650,080	0	6,650,080	.	.
Hungary	2,086,096	0	2,086,096	.	.
Australia	0	337,777,250	337,777,250	6.2	.
New Zealand	0	110,966,579	110,966,579	10.5	.
Portugal	0	99,459,373	99,459,373	10.3	.
Memorandum items:					
	Total owed the US:	US GDP		Owed/GDP (US)	
	11,734,806,327	66,800,000,000		17.6	
	Total owed the UK:	UK GDP		Owed/GDP (UK)	
	5,509,273,162	19,264,825,087		28.6	

Sources: Debt amounts owed to the US are from the *Annual Report of the Secretary of the Treasury on the State of the Finances – For Fiscal Year Ended June 30, 1934*, pp. 391. Debt figures are given for Nov 15, 1934. We add to this the amount of arrears, i.e. overdue payments under the debt restructuring agreements of the 1920s. Debt amounts owed to the UK are from the *Moody's Manual of Investments and Securities Rating Service: Foreign and American Government Securities*, 1935, p.1927. Debt figures are given for March 31, 1934, plus arrears. To compute present values (last column) we use the terms shown in the original loan documents, as shown in Moulton and Pasvolsky (1932). We follow their approach and use a 5% annual rate to discount future war debt payments. The amounts of debt outstanding under the broad category of WWI debt includes, especially for Eastern Europe, debts taken on after the war in connection with reconstruction. The breakdown is given for each debtor country in Reinhart and Rogoff (2014).
Exchange rates are from *Historical Statistics of the United States and United Nation* (1948). The sources for nominal GDP for 1934 are as follows: US and UK from Measuring Worth; France, Historical National Accounts Database (HNAD), 1815-1938 ; Italy, Francese and Pace (2008) 1861-2006; Belgium, 1835-2005, BNB, Center d'études économiques de la KUL; Greece, Kostelenos (2003), 1830-1939; Austria, 1924-1937. Global Financial Data; Finland GDP, Historical National Accounts Database (HNAD), 1860-2001; Portugal: Estadisticas Historicas Do Portugal, 1851-1952; New Zealand: Statistics New Zealand, 1900-1947; Australia: GFD, Haig (2001) 1852-1948;
Note: For a full set of references see Reinhart and Trebesch (2014).

Look at the debt forgiveness needed in 1930s: France at 52% debt relief relative to GDP, the UK at almost 25%, Italy at 36% and Greece at 43%.

And here is an "instructional chart" on debt crisis:

Box 1. Selected features of international debt overhang episodes

	1920/1930s Defaults	1980s/1990s Debt Crisis	2007 Subprime and its Aftermath
Characterisation	Legacy of WWI; "Lost Generation" and economic dislocation	"Lost Decade" in Developing Countries	Recurring parallels of Latin America's and Japan's lost decades. Emerging theme of 'Secular Stagnation'
Scope of debt overhang	By the 1930s, following a wave of banking crises, encompassing both advanced and emerging economies	Largely confined to emerging markets and developing countries. Most hard-hitting for Africa and Latin America	Advanced economy crisis most acutely felt in periphery Europe, where the contraction extends 5-6 years
Type of debt overhang Advanced Economies:	*1920s:* Largely government-to-government war and reconstruction loans (external foreign currency debt) *1930s:* Build-up of additional domestic public debt associated with economic depression.		Pre-crisis surge in private domestic and external borrowing, largely driven by household and financial sector debts. Post-crisis surge in public and publicly-guaranteed debt.
Emerging Markets:	Public and private external debts predominantly to private creditors	Public and private borrowers, largely private creditors (predominantly banks). Crisis follows 1970s commodity boom and capital flows bonanza	
Early policy measures	1923-1930, war debt settlements with US and UK: maturity extensions of up to 60 years (no debt write-offs)	1982-1985 repeated debt rollovers and bridge loans, 1986-1989 Baker Plan: maturity extensions of up to 30 years (no debt write-offs)	Large-scale socialization of private debts (bank bailouts). Public debt write-offs confined to Greece. Emergence of significant official lending. Limited private-sector write-offs (except US)
Late policy measures (crisis resolution)	Hoover Moratorium /w US 1931 Lausanne Agreement /w UK 1932 Generalized default 1934 (unilateral debt write-offs follow)	Brady debt relief initiative 1990-1997 (negotiated debt reduction)	Rescheduling of official debts: maturity extensions of up to 40 years. Overhang yet to be resolved

My point?

France President Macron raised a critical question on Friday in the F.T - Is Europe a political union or a mercantile club? The answer needs to be answered this Thursday at the EU Council meeting, but I think we all know the answer. If so, there will be countries leaving the EU and soon, and on that note, the ultimate risk of sovereign defaults is on the line.

We monitor Italian BTP's (sovereign debt) as the proxy for the belief that the EU holds together. The BTP market is sending stress signals despite the fact that most Italian debt is in domestic hands, but we may soon have a situation where being part of a mercantile EU club no longer makes sense, when there are no goods to trade and the legacy of past debt is denominated in a currency Italy can't directly control. Also if the Covid19 crisis is not the time for Europe to step up and act in total solidarity, when is the time?

Most important though, the real reason for a break-down of sovereign debt is not the collapsing international cooperation but the fact that governments and central banks have gone too far this time in bailout Mon-ismania.

Remember that the integrity of government financing is based on one thing only: the infinite ability for gov-ernment to tax its companies and citizens. What we will see over the next ten years will be similar to what we saw in the 1970s, bigger and bigger government ownership of companies, dictating business and boardroom decisions, less and less return on invested capital, but also much higher taxes on first technology companies, but also other corporates and financial income. The VAT will rise, as will inheritance taxes and real estate taxes. Deficits will keep growing, but will be more affordable this time around because of the brave new world of Yield Curve Control, which will keep funding for governments artificially cheap and devalue past debts as inflation vastly exceeds policy rates. This is the very definition of financial repression and will lead to a massive bull market in tangible assets. It's not new, either – the Fed was tasked with yield curve control after WWII to devalue the stock of US treasury debt used to pay for the war effort.

Prepare yourselves, as the world is fast accelerating to a place of no price discovery, one guarantor of all risk good and bad, higher taxes, and big society changes. This will require that we recalibrate the "good life" we have gotten used to.

Astrid Lindgren forced a government change, I am absolutely sure the over-reach and 1970s style government will do the same, but first this policy response needs to fail. Only through failing will we learn. That's the com-bined lesson of 1920 and 1930s, the 1970s and now 2007/2020.

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About Saxo Bank
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