

## The Blinking Game

Remember as kids we used to play the blinking game where you stare at a person at close quarters and the first one to blink loses?

Central banks are playing this game with inflation? Who will blink first?

Will inflation mean revert and blink or will inflation persist and force the central banks to blink and raise rates aggressively?

**Financial repression** comprises "policies that result in savers earning returns below the rate of inflation" in order to allow banks to "provide cheap loans to companies and governments, reducing the burden of repayments".<sup>[1]</sup> It can be particularly effective at liquidating government debt denominated in domestic currency.<sup>[2]</sup> It can also lead to a large expansion in debt "to levels evoking comparisons with the excesses that generated Japan's lost decade and the 1997 Asian financial crisis".<sup>[1]</sup>

The term was introduced in 1973 by Stanford economists Edward S. Shaw and Ronald I. McKinnon<sup>[3][4]</sup> in order to "disparage growth-inhibiting policies in emerging markets".<sup>1</sup>

(Financial repression - Wikipedia, 2021)

In a nutshell this is what happening...

Central banks are procrastinating raising rates, in the hope that inflation is temporary and will mean revert sometime next year.

I cannot count the number of traders I have seen blow themselves up, hoping their positions on assets which follow a power law i.e. accelerating momentum, will mean revert.

Most of the time, the risk manager steps in and they are forced to liquidate their positions realising huge losses.

Who will guard the guards themselves? Who is the risk manager for the central banks?

The bond market vigilantes used to be, but today I am not sure because the central banks control that market as well.

If the trader and the risk manager were the same person in an investment bank alarm bells would be ringing. E.g. Nick Leeson.

Inflation isn't generally mean reverting because it represents a change in the simple equation ...

Prices = Paper stuff/real stuff (with some velocity of money circulation thrown in)

Real stuff is in shortage and looks set to be persistent.

Paper stuff is being created at an astronomical rate.

<sup>1</sup> [https://en.wikipedia.org/wiki/Financial\\_repression](https://en.wikipedia.org/wiki/Financial_repression)

So I imagine the critical juncture will come when the central banks blink.

I don't know how much inflation has to be, but I feel confident they will blink.

In the meantime while they vacillate, inflation will continue to accelerate. Investors clamber for any asset which will hopefully protect them against the decline in real value via financial repression, driving asset prices to unheard of valuations.

It will continue until it stops...

My best guess is that currencies will be the final risk manager who steps in and causes the blink.

It is the one thing that central banks historically cannot control in the medium and long term.

Once a currency starts to depreciate, the end is nigh. Import prices start to sky rocket adding to the inflation woes.

Then the blink comes.

Interest rates will be aggressively raised. Asset markets, discounted by near zero interest rates, will now have to discount at much higher rates leaving them extremely vulnerable to downward valuations. Property markets awash with investors who cannot even afford a 2% rise in their variable rate mortgage, will all come to the market as sellers at the same time.

It is a little understood fact that asset values follow inflation, EXCEPT when interest rates are rising at a faster rate than the respective inflation. In this instance they revalue downwards.

I suppose there is a chance they won't blink and will instead continue financial repression on steroids.

In that case they heap the misery of significant, if not hyperinflation, on their societies which tears very quickly at the social fabric as the phenomenon of inflation is so unfair favouring some people (normally speculators) and damning the rest.

It's a developing world tin pot dictator's playbook and I sincerely hope that the developed world's central banks will eventually do the right thing and blink once they have exhausted every other possibility.

## **Disclosure**

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