REAL VISION™

Transcript: Financialization of the Economy

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Synopsis: Does cheap capital and its misallocation lead to a financialization of the economy, in a process that is detrimental to consumers? In this second installment of their Exchange series, Grant Williams, Simon Mikhailovich and Dan Oliver tackle some increasingly thorny issues such as the inevitability of cycles and their distorting effect on capital and ask if the central banks are now the last stop in the march of excess credit. Filmed on May 8, 2018 in New York.

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Simon Mikhailovich: After the crash of the 1930s, for the next 30, 40 years, banking was a very boring business. The market needs to stay high for the 5% of the people who pay 60% of the taxes to continue to generate those capital gains, and to fund essentially the treasury.

Dan Oliver: And they are simply not going to let this thing collapse if they can help it, which is why I'm pretty convinced that when the next big crunch comes, I don't know how far the market has to go down. But at some point, they will run out and guarantee the whole thing, because they have to.

SM: Essentially, we are at the last instance of credit.

Grant Williams: I'm Grant Williams, and welcome to "The Exchange." Last time we spoke a little bit about history and the anatomy of financial bubbles. And this time, we're going to sit and talk about the financialization of the economy and what that means, how it works, and the inevitable consequences of that cycle. So with me again, are Dan Oliver of Myrmikan Capital and Simon Mikhailovich of Tocqueville Bullion Reserve. Gentlemen, welcome again. Let's get into this. Simon, particularly I want to start with you, the financialization of the economy. It's what Ben Hunt would call a $10 word, but let's talk about what it means and how the process evolves over time.

Simon Mikhailovich: Financialization of money in banking. When money stops being real, it comes to be in unlimited supply, perverts the incentives in the banking industry, and now we're talking about how that flows into the real industry and into the real economy.

So after the crash of the 1930s, for the next 30, 40 years, banking was a very boring business, because commercial banks were separated from investment banks. They have to husband their capital.

They had limited capital, and so they lent their capital to industry. And they lent their capital for mortgages against real estate, and then they sat there and they collected the income. And they made a sort of a smaller—

GW: So banking then.

SM: Banking. Yeah, it used to be called banking. Right. Well, as the money became soft, and as the ability of banks, or as the focus of banks has focused– has shifted– into transactional mode from the relationship mode and long-term mode. And as the capital constraints on the banks' lends started getting looser and looser, banks started coming– not started, banks start, always, coming up with better, faster ways to make money.

So what happens in financialization, with excess of money, all of a sudden, the prices of assets started going up, because it's a supply demand. As more money chases a limited amount of assets, asset prices go up. It becomes more attractive, instead of lending and waiting, to repackage things. So how does a bank, for example, use the same capital base to generate transaction fees over and over and over and over again on the same capital?

How do you turn the same money 20, 30 times? Well, you securitize it. So what you do is what used to be banking and lending now becomes origination and packaging, right? So they go out, they find a bunch of companies, they find a bunch of deals, they find a bunch of mortgages, whatever it is. They put it in a complicated legal structure.

All of a sudden, you have highly rated securities or securities that appear to be much safer for which there is a demand from a completely different set of investors, pension funds. So in other words, investors– fiduciaries– that are supposedly very conservative and whose job it is to invest the money very wisely, very prudently, and conservatively, all of a sudden, their money starts being channeled into the activities.

Now, so what does that mean? So a lot of crappy housing starts getting built, because we have all these mortgages, that people can buy houses with no money down. So all of a sudden, this tract housing just starts going up like weeds. All of a sudden, you start having all these private equity firms going up and gobbling up companies. I mean, when they start accelerating this process, how does a normal person who is a business owner, who has toiled for maybe a generation, maybe it's a second generation, they have to come to work, they have to deal with the workers, you have to do all that stuff.

The next thing you know, somebody comes along and offers you essentially 50 years' worth of your profits upfront, or something like that. So why are you going to work so hard, right? So the next thing, not only is the company gets financialized, essentially, because the owner gets replaced with a management team, and the management team's job is to get this thing prepped for float on the stock exchange, which is how they're going to make money. And once that's floated, the management's now objective is to juice up the stock price, because they get compensated, whereas the main objective of an owner of a company is to survive and prosper by being there. You know?

Like Woody Allen said, 80% of success in life is showing up. So an entrepreneur's job, a business owner's job and main objective is to keep showing up, not to be separated from his asset. The manager's job and the manager's incentive is completely different.

GW: Right.

SM: He doesn't have three generations invested into this factory. He needs to make his stock options work over the next three to five years. The ownership of business becomes financialized because wealth in this country used to be held, and that's why a lot of wealth survived the '30s– a lot of the larger wealth survived the '30s. They actually owned– and you made that point in our conversation a little while ago, is that they actually held real assets.

They held bonds, and they held companies, and they held businesses, as opposed to just shares in companies they have no control over. So what you end up with? You end up with a company that's run by people who are interested in the next 24 months, right? And you end up with the former owner who used to have something that was robust and potentially multi-generational into a speculator, who just simply owns bits and pieces of companies whose business he doesn't know.

Dan Oliver: Right. Let me add to that, because when you have an asset-backed banking system, the more assets you have, the lower your credit terms are. And this is all in the Federal Reserve data, so the bigger you are, the cheaper your cost of capital is. And what that means is that as companies grow, they become more competitive. And they can either price out the competition and run their business, or for the pesky ones that won't go away, they buy them out. Because, again, if your cost of capital is cheaper, it's very easy to raise capital on the markets and buy out your competitors.

And this is one reason why even companies that don't have debt, like Facebook and people, they buy out immediately any threats to their business, which is why they're so monolithic. But as a result, you have this natural tendency towards industry concentration, because the bigger you get, the more competitive you become. Not because you have a better mousetrap, because consumers prefer your product. Only because the financial sector showers you with really, really low cost of capital.

If you consider what stock market indices are, like the S&P 500, they're all capitalization weighted. So the bigger a company is, the more weight it's going to have in the index. And so people say, oh, gee, I want to have a passive investment. I'll buy the S&P 500. No, that's not passive at all. It's very active. You are actively chasing the largest companies, and that is a sensible thing to do in a system in which large companies do the best.

And this is why when they do survey– a recent survey I saw showed that only 17% of active money managers beat their index. Why? Because the index has the best energy. When you have all this capital concentrating in these ever-growing more powerful silos– and you can see this in the concentration. I mean, the airline industry, before deregulation, was 56% controlled by the top four airlines.

Now it's 80%. And every industry you look at, this has been the trend towards more scale. And people, you know, when I read economists and other financial writers, there is this assumption that efficiency is always better. If you become more efficient, it's always a good thing, because you have more throughput and things get cheaper.

And there is certainly nothing wrong with efficiency. But the problem is that efficiency comes at the expense of flexibility. And if you look at every industry, you have this trend towards efficiency, which results in homogenization. I mean, when you fly into—

SM: Yeah, the retail.

DO: When you fly into cities, what do you see? You see housing developments that all look precisely the same from the air. And when you live in a housing development, your kids go to government-sponsored daycare. You work in the office park, right? And one place looks exactly like the other place.

And this is why, because these big, giant companies, they get their funding from the banking system and become very efficient and very inflexible, build these assets. Build these consumer products. And so it all becomes very homogeneous, which is a characteristic that is usually associated with communist countries, right?

Think of the Soviet Union. There were commercial swimwear and nightwear and—

SM: That's right, it's all the same thing.

DO: And that's what our economy has turned into with this system. It's very unnatural. It depends on credit. And when you borrow debt as a company, you have interest payments to make right away. And so you can't use debt financing to innovate, to think of new [INAUDIBLE]. You have to use it to increase efficiency. And Adam Smith taught that the way you increase throughput efficiency is through division of labor.

GW: Division of labor, right.

DO: You make every task simpler, right? And what Marx pointed out, and I think Marx was actually correct about this, which is that as each task becomes simpler, its value becomes less.

SM: Sure.

DO: It's the wages attached to that activity become less. So it's not just that the economy becomes very concentrated economic power to just a few people. And that the products become very homogeneous, but jobs become very boring and homogeneous and don't have any meaning or require any skill. And therefore, you get a huge divergence of wealth disparity.

This story played out in the 1920s. It played out in the greenback period of the 1860s and '70s. And the second that credit mechanism gets turned off, people realize, you know, they don't want the same hamburger. They don't want to buy all the same stuff. And these companies are wholly inflexible, because they've automated themselves to such a great degree. And without that finance in the market, they all collapse, which is a good thing. I mean, it's a bad thing if you own the shares. And the market is a bad thing if you're a manager playing this option game.

It's a bad thing. At first if you're an employee, because you lose your job, right? But very quickly, the market works, and the market will become a more natural system that prizes flexibility and the skills of workers to do creative things, and not just to become, you know, like communist countries, all doing the same thing for all the same people.

GW: Let's talk about the other side of this equation. Excuse me. The consumers. Consumers and investors, because there is a certain alignment here. The consumers want, to your point, homogenized product. They want the prices to come down. They want to go into a mall and be familiar that every mall is the same. Investors want the CEOs to choose the share price.

So there's a certain alignment of incentives here. What is it that turns the credit spigots off? What should we be watching for? And throughout history, how have those terms tended to come about?

SM: I think it's interest expense. I mean, most high-yield defaults– of course, some high-yield defaults occur because there's a maturity, and the company cannot refinance or cannot repay the debt. But I think the vast majority of high-yield defaults occur because they can't pay the coupon. So I think the game stops because of the interest.

And we touched on that in the beginning. There's a balance sheet, and there's an income statement. And you know, the politicians in Washington understand the income statement.

GW: But they have no idea about the balance sheet, right?

SM: And so when my wife a lot of time says, well, you say all these things, but look outside. I mean, the restaurants are full of people. Everything looks normal.

People seem to be doing well. The companies seem to be doing well. The answer to which is yes, all income statement. In the meantime, it's like living off of a credit card for 30 years, say, 20%, 30% above you means. Now, the reason I think people feel– or many people feel like this game is going on and it will continue to go on indefinitely is because it's been going on for 35 years.

And as we have discussed, for 35 years or 40 years, the interest rates have been coming down, right? And the asset prices have been going up. The rates stopped going down five, six years ago and stabilized at a very low rate. I would suggest that we have actually passed the low point in this game, probably in 2011.

And the reason I say that is because in 2011, when I looked at the federal government interest expense, I realized that in 2011, the federal government paid exactly the same amount in interest expense as it did in 1998, except it had three times as much debt.

All right, so now if we fast-forward to fiscal 2017, federal government paid the most interest expense it has ever paid, $460-some billion at the lowest-ever interest rate it has ever paid on average across all of its debt, which was like 2.2—

GW: 2.2– yeah.

SM: 2.24%. Correct.

GW: But OK, so let me play devil's advocate, because you talk about we've gone past the bottom in 2011. That's seven years ago now.

SM: Yes.

GW: So if we passed the bottom for seven years, I mean, you can understand why people think, well, it's been seven years. I mean, why can't it be another 10? That's always the pushback you get—

SM: No, no, sure.

GW: Why can't it go on for another x years, always?

SM: If you owe $100, and you keep borrowing more money, and all of a sudden, interest rates are near zero, your borrowing capacity is almost infinite.

GW: Right.

SM: Right? Because every additional dollar of debt is generating minuscule amount of additional interest. It's an irrelevant amount. What the steady period of interest rate has allowed people to do is to continue to increase the debt, which means that their liability for interest, for every marginal, additional basis point of interest, has been increasing dramatically.

So whereas if you stop borrowing and you just hold steady, in theory this can go on forever. But we didn't keep steady. We doubled the national debt.

GW: Right.

SM: Right? We doubled the corporate debt. So now, for every percent or every basis point increase in interest rates, it's a double whammy, not the single whammy, for the impact, right? So the reason it can't go on is because if the interest rates continue to be at zero level, then we have a demographic problem and a pension fund problem. In the United States, we have 10,000 baby boomers turning 65 every day.

GW: Yeah.

SM: Right? And essentially, what they're about to do is to stage a run on the bank. They're about to start taking out benefits at 67 and 1/2, or whatever age, right? And so the Social Security trust fund, which is full of US treasuries, is going to go cash flow negative, I think is projected in the next year or so. So now, all of a sudden, the Social Security system is going to start running the cash deficit. The government is already running a cash deficit.

The interest rates are on the way up. The tax collections have become completely tied to the stock market. That happened in the '92. I mentioned it before because of the deductability. So now, all of a sudden, the top 5% of the taxpayers are paying 60% of income taxes. And the interest expense, even at these tiny, minuscule rates, is already almost a third of the tax collections.

So put these things together. The market needs to stay high for the 5% of the people who pay 60% of the taxes to continue to generate those capital gains and to fund, essentially, the treasury, right? But there's no room. I mean, it's like there's no room. Either the rates go up, in which case the financial assets go down, and we have a sort of a reset of some sort.

The rates don't go up, we have a financial crisis with the pension system going down and these huge social obligations, which are in the trillions of dollars, essentially, that's what a run on the bank. OK, it's a walk on the bank.

DO: I don't think consumers do like this system, and I think about even– I'm not an old guy. But when I was little in France, in Europe, it was nice. Every little village had a boulangerie and a charcuterie and everything. And now you go there to, say, adopt the Anglo-Saxon banking model. What happens? All that's gone. You get in your car and you drive out to the Carrefour.

And you sit in line at the stoplight. You know, that's a huge– it's like Walmart. A huge parking lot. And you go in there. It's all sterile. You've never met the butcher before, so he doesn't know who you are or what you like. And it's all homogenized project. So it's cheaper, but the reason it's cheaper is partially because it's more efficient, yes, with less choice. And again, that's not necessarily a good thing you want to pay for. But also because the system that these Carrefours, these Walmarts, these Amazons get the benefit of the bank system, which gives them a cost of capital of much cheaper than what little merchants can do.

Once you have these big companies that set up shop, they get concessions on the labor laws and all the little city ordinances–

SM: And property taxes.

DO: All the property taxes. So their economic size then feeds into their political influence. And so then they run around, and they change the rules to benefit themselves and harm the little guy. So you have economics and politics then driving towards these businesses, which again, I don't think consumers prefer.

GW: But the people– because of everything Simon has laid out, it seems to me that the god of everything is cheaper.

DO: Yeah.

GW: So for the consumer, I don't necessarily think there's that much discretionary choice in what they want to purchase. They're looking for something that's cheaper, because in this—

DO: In this world we live in now.

GW: Yeah, there is pressure. That pressure is building, and the story around that pressure, to me, seems wholly misrepresentative of what the facts are on the ground. You know, we read about the booming economy. We read about how great everything is going and how the labor force, the unemployment is at record lows. But it doesn't feel that way.

And the sensitivity– and you told me a story about sensitivity to stock market performances, which was interesting.

SM: I know somebody, an older person, I know them very well. This is a retired person who is living off of the savings. And it's literally that sensitive. I mean, this person got their financial statement for February, when the market was down. And their behavior is already changed overnight, because now, all of a sudden, well, geez, one month down. It was all up and up and up.

Now, I'm not going to buy.

DO: It's not just the level, it's the level of increase. You assume it's going to keep going up at 10% a year, 25% a year. And then it just flattens, and you think, oh my God, I got to retrench. And to your point, in a country where the tax system is very progressive based on income and capital gains, it's not that prices and stock market has to collapse to defund the government. If it just stays the same.

SM: There's almost 100% correlation between market capitalization and tax receipts. And we've been hearing news in the last couple years. Oh, tax receipts at record high. Tax receipts are at a record high. So everybody thinks it's because the economy is at record high. No, it's because the stock market is at a record high. That's why the tax receipts are at a record high.

GW: But you know, we're talking about the financialization of the economy. And what's that's done is it has moved the stock market from over here to the center of everything.

SM: Yes.

GW: And now the stock market has become the barometer for the health of the economy. People look at the stock market, and because the stock market's high, they assume the economy's doing well. It's become the place where you make money through speculation. And yet ownership of shares is still in vastly the minority amongst people.

SM: True.

GW: So how–

SM: But it also became the weathervane for how the managers manage their companies.

GW: No, absolutely right. Absolutely right. The stock option, the incentives, exactly right. So how does that change that movement in the stock market from sidebar to the center of everything? How does that ripple through the economy and society?

DO: They are simply not going to let this thing collapse if they can help it, which is why I'm pretty convinced that when the next big crunch comes, I don't know how far the market has to go down. But at some point, they will run out and guarantee the whole thing, because they have to, because they have no choice, because the entire system depends upon rising nominal prices. And it's as simple as that.

But again, what this system does is it further concentrates economic power. It further degrades the value of the average worker who's caught in the system. It further lowers their purchasing power, so they have no choice but to go buy these crappy products from China. A friend of mine who is a partner at Brown Brothers, which is the last private bank in America, and they were waiting for Goldman to roll over, because it just couldn't be saved.

The AIG was going down, and Goldman's dependent upon it. And Hank Paulson, at the end of the day, simply couldn't imagine a world without Goldman Sachs. He just simply couldn't do it. And the reason that comment stuck in my head is because when you read the history of Weimar Germany, Hammerstein, the head of the–

SM: Yeah, yeah.

DO: –kept printing money to bail out these big conglomerates. The same reason. He just couldn't imagine Germany not surviving without these giant conglomerates that are taking over the entire economy. So again, the structure builds its own momentum until the whole thing collapses, usually in a very chaotic fashion.

GW: But the pushback to that is always going to be look, if these guys don't want this to happen, if they will do anything to stop it happening, they will stop it happening. Right? And–

DO: No, no, no, no.

GW: This is the pushback. Obviously, we've talked about history. We know that it always happens. But in the moment, you know, when you're sitting here now, the people that don't read economic history, don't understand financial history, they will say, well, you've just said that the guys out there that have all the power will not let this happen. They will stop the collapse. They'll do anything.

So why, potentially, the next time– because of this financialization of the economy, why is– I hate to say the next time is different, but—

DO: It's not different. It's the same reason why when I was growing up in the Cold War, the idea was the Soviets would never allow the economy to collapse. They just wouldn't, right? I mean, if it collapsed, they'd roll the tanks, and they just wouldn't do it. And it got to a point where they just couldn't do it. And they just let it go, and it collapsed.

GW: Are we there? Are we at that point now? Or are there more levers to pull? Are there more–
SM: The fallacy of thinking is it is correct to say that powers that be would do everything to prevent a collapse.

DO: The liquidation.

SM: The fallacy is they can do everything in their power to prevent a collapse. So the assumption that everything is in their power is where the fallacy lies. Not everything is in their power. Confidence is not in their power.

GW: Exactly, confidence.

SM: Political processes are not entirely in their power, and we just witnessed that in 2016. So their geopolitical processes are not always controllable. The fact that this economy has been gutted– and this economy, I mean the United States– has been gutted, because it was more efficient and cheaper for the companies to outsource their production abroad. I mean, this is a consumption-based economy. So you've gutted your customers, right? Your consumers.

So how long are you going to continue to sell goods and services to consumers who have less and less money?

DO: If you look back at the '20s, the Fed actually did three rounds of QE in the '20s to keep commodity prices high, because they wanted to prevent the mal investment from liquidating the overcapacity. And they got to a moment in 1929 where things were so out of whack and the market was so crazy, the Fed said, you know, we just can't keep doing this.

And even when the market started collapsing, because of the gold standard, they really simply couldn't push it any further. And so here we are in a scenario where we don't have a gold standard, and the Fed has– '87, right? The S&L crisis. The long-term capital management crisis. The Asian crisis. The internet crisis. The housing crisis.

They keep doing this. And so that's a valid question. How many more cycles do we have to go?

GW: Right.

DO: The reason I think this could be the last cycle is because this time the bubble is really in the government bond market. Right? And those are the assets that sit directly on the Fed's balance sheet. The other assets that blew up were in other private players, and the Fed ran and rescued them through guarantees and so on. This is the actual– the core assets that fund the government and that keep the Federal Reserve and all the other central banks functioning.

And so when that asset blows up, they really will have very little authority or power do anything. And the way the market will liquidate the Federal Reserve, which I talked about last time, is it will send the gold price up to a level that backs Fed liabilities. And the day that prices around, it depends on how you calculate it, but $8,000 to sort of $16,000 an ounce.

If the Federal Reserve prints money to forestall the liquidation, the way John Law tried a few times, and the way we tried before in the '20s, that number could get materially higher. But right now, I do think that sovereign bond markets are leaking. And when they go, that's it. Lights out for this whole supercycle.

SM: Liquidity. Liquidity. It's about liquidity. Liquidity is draining out of these markets. The structure of these markets, the passive investors, the index funds. We saw what happened in February with these ETFs that were doing VIX. I mean, they went basically from $100-some to zero, essentially after hours.

GW: After hours, yeah.

SM: After hours, because when the liquidity dried up, there was just no there, there.

DO: And there was no way for the brokers at a margin call when it happens.

SM: Right.

DO: Right. You're done. And they're done, because obviously, there's a hole in the balance sheet.

SM: This isn't credit. This is called jump to default. So essentially, there is no slow phase transition where it goes from here to there. It's a step function. 1998, Wall Street bailed out a hedge funds, right? Long-term capital management. And in 2008, 10 years later, the government bailed out Wall Street. The next time, it's the government that's going to have to be bailed out.

Essentially, we are at the last instance of credit.

GW: Well, you know, what that means, and what we'll talk about next time, when you get these step changes, it unleashes volatility. It unleashes chaos, not just in markets, but in society amongst the political class. That ripples through everything. And in the next segment, we'll talk about that. We'll talk about the changes in society and politics and law and geopolitics, because there's a whole other side to this that stems from finance but doesn't directly –

SM: And stems from the real economy, really. I mean, because real economy is where people live.

DO: That's right.

GW: Well, that's for next time. But again, gentlemen, thanks for joining me.

Dan Oliver and Simon Mikhailovich: Thank you.