Escape from the Central Bank Trap
How to Escape From the $20 Trillion Monetary Expansion Unharmed

Daniel Lacalle

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For more information or to schedule an interview you can contact Daniel Lacalle directly via Twitter on @dlacalle (Spanish account), @dlacalle_IA (English account), or email on info@dlacalle.com
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Daniel Lacalle
Dedicated to my love, my wife Patricia and my three children, Jaime, Pablo, and Daniel. You are my life and my inspiration to be better every day. Also to our pet family, Kilda, Blinky, and Ravioli.
Abstract

The financial crisis was much more than the result of an excess of risk. It is essential to understand that the same policies that created each subsequent bust are the same ones that have been implemented in the past years, through Quantitative Easing (QE) to allegedly “solve” this crisis.

In this book, I explain how, through lower interest rates and the artificial creation of money, central banks have created a massive liquidity trap, perpetuating bubbles, incentivizing high debt, and increasing financial risk.

The objective of this book is to present solutions in fiscal and monetary policy that can be implemented today, while at the same time debunking magical solutions offered by some authors, particularly the so-called Modern Monetary Theory. I also explore the impact of monetary expansion on commodities and Emerging Markets, Trump’s economic policies, Japan’s fight against stagnation, Russia’s central bank unique strategy, and the European Union model.

Escape from the Central Bank Trap is about realistic solutions for the threat of zero-interest rates and excessive liquidity. Overcapacity, high debt and perverse incentives to assault taxpayers and consumers are not ingredients of welfare, but of secular stagnation.

The United States needs to take the first step, defending sound money and a balanced budget, recovering the middle-class by focusing on increasing disposable income, and supporting productivity growth. The rest of the OECD will follow. Because supply-side policies work.

Our future does not need to be low growth and high debt. We cannot expect humanity to progress if we enslave future generations with unsustainable debt levels just to perpetuate the imbalances of an inefficient economic model.

Cheap money becomes very expensive in the long run. There is an escape from the Central Bank Trap.

Keywords

Austrian school, debt, economics, financial crisis, inequality, Keynesian-ism, modern monetary policy, monetary policy, QE, supply side, taxation, Trump, welfare
(Manuscript Copy for Journalists)

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PART I

Creating Money from Nowhere
CHAPTER 1

How Did We Get Here?

“And you may ask yourself—Well … how did I get here?”
(Talking Heads, Once In A Lifetime. Remain In Light)

“Unconventional monetary policy.” You might have heard it many times, but it’s a misleading term.

What mainstream media and consensus call “unconventional” is and has been the most conventional policy of the past 600 years: to try to solve structural imbalances and macroeconomic problems through inflationary measures; creating money out of thin air.

Printing money, of course, is not exactly what the major central banks have been doing. What they have been doing in the past eight years is more complex. The idea of using the apparently endless balance sheet of a nation’s central bank to absorb government bonds and similar instruments to free up banks’ capacity and allow them to lend more to Small and Medium Enterprises (SMEs) and families has a logic—but only when it is a temporary measure to provide liquidity, reduce unwarranted risk perception, and return to normal. The idea seemed good at the time. Until the “temporary” and “extraordinary” measures became the norm.

And therein lies the problem. Monetary policy is nothing more than a short-term tool, but it does not solve structural imbalances. At best, as Mr. Mario Draghi, president of the European Central Bank (ECB), reminds every time he speaks, it is a measure that buys time and allows governments and other economic agents to sort out problems, mostly derived from excess debt and poor capital allocation.

But even the most carefully planned program creates significant perverse incentives. The most obvious one is to make the same mistakes repeatedly.

By the end of 2015, more than 25 central banks in the world were following the same path: “Easing,” or, lowering interest rates and increasing money supply.
After eight years, more than $24 trillion of fiscal and monetary expansion, and over 650 rate cuts, the balance is certainly disappointing. It was very easy to get in the liquidity trap of endless cheap money, and in this book, we will explore how to escape from it unharmed.

Let us look at the results achieved from years of stimulus and hundreds of rate cuts:

At 3.1 percent, the year 2016 saw the poorest global GDP growth since the crisis.
The U.S. growth is the poorest of any recovery and half of its potential, with labor participation at 1978 levels.¹
World trade has fallen to 2010 levels.²
Global debt has ballooned to an all-time high of $152 trillion, or 225 percent of world GDP.³

Rise in government debt as a percentage of GDP from 2007 to 2015:

- United States, from 64 percent in 2007 to 105 percent in 2015
- China, from 35 to 45 percent
- Eurozone, from 65 to 97 percent
- Japan, from 183 to 230 percent⁴

Meanwhile, the largest bubble in bonds ever seen was created, with $11 trillion of negative-yielding bonds issued and high yield at the lowest rate in 30 years.⁵
Yet the media calls this a success.
Are these the results anyone would have expected from a massive monetary stimulus? Clearly not.

¹ Labor force participation 62.7% in 2016, growth expectations were halved by the Federal Reserve from January to December 2016.
² World Trade Organization (WTO), December 2016.
³ International Monetary Fund (IMF) Global Outlook.
⁴ World Bank, 2015.
⁵ Bloomberg, November 2016.
While media and consensus economists were calling for devaluation policies to increase exports, these have stalled, and the boost to global growth ended at the weakest level in decades.

**But … How Did We Get Here?**

Through the same measures that we have used to “tackle the crisis.”

We got here doing exactly what the media is offering as “the solution”—a massive expansion of credit and money supply. If we ask any economist in the world about the origins of the financial crisis, they will immediately answer pointing out to “excess leverage” and “too much risk” as the causes. However, this is partially true, because those were effects, not causes.

The origin of this crisis, like every other financial crisis in history, was the massive increase in risk generated by manipulating the amount or price of money; in this case, it was lowering interest rates artificially.

Crises are not generated in assets that the public or economic agents perceive as risky, but in those where the consensus is that the risk is very low. In 2008 it was housing; in 2016 it is bonds.

In the origin of all financial crises, we see the stubborn determination of governments and central banks of ignoring economic cycles as if monetary policy will change them—the magical idea that imbalances will be solved by perpetuating and increasing those same imbalances. Excess debt and misallocation of capital are not problems that will be solved by lower interest rates and more liquidity; in fact, those measures simply prolong the same course of action by economic agents.

Low interest rates and high liquidity fuel the fire; they don’t extinguish it. At best, the measure should be aimed at helping deleverage and cutting the chain of risk taking while the economy recovers, but that does not happen. The incentive for misallocation of capital is too large.

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6 Global exports growth 2010–2016 flat, according to WTO.

Creating money, lowering interest rates, forcing credit growth at any cost, and increasing money supply are the same measures, just with different tools. In the years 2001 to 2008 the excessive risk taking was promoted by central banks and governments’ lowering interest rates dramatically, the conduit for debt-fueled growth was the private sector, with the financial system as the facilitator. See Figure 1.1. Money was too cheap to ignore.

After September 11, 2001, the U.S. Federal Reserve began to inflate credit supply to try to prevent an economic crisis. Low interest rates, which reached around 1 percent in 2003, made commercial banks and other financial agents have excess cash to lend even to individuals with poor solvency ratios (what we called “subprime”).

The largest originators of these loans were two public-sector entities, Freddie Mac and Fannie Mae. See Figure 1.2. Were the banks reckless and taking unwarranted risk? No. The public and expert opinions were that housing was a safe bet. The safest bet, actually. It was a low-risk and very liquid asset that could be sold at a higher price quickly if the borrower could not meet payments.

8 Since 2008 we have seen more than 650 cuts to interest rates (Alex Dryden at JP Morgan Asset Management).
How Did We Get Here?

3.0
2.5
2.0
1.5
1.0
0.5
0.0
-0.5
-1.0
-1.5
-2.0
-2.5
-3.0

Private-label
Fannie Mae and
Freddie Mac
Ginnie Mae

Figure 1.2 Value of mortgage-backed security issuances in trillions, 1990 to 2009

The process by which this credit was generated violated the traditional principles of bank management. Or did it? Banks invested in long-term assets (mortgages) the funds they received in the form of short-term debt (public deposits), hoping to meet these short-term obligations by repaying in the interbank money markets. The reason to do this was the widespread perception that the asset was liquid and very profitable because the underlying (real estate) demand was virtually inelastic and prices would not drop, and, if they did, it would be by a very small amount.

The result of it was a brutal credit expansion fuelled by the relentless message that houses were a secure and ever-rising asset. Like all bubbles, this one lasted longer than any sceptic could have imagined, making even the most doubtful of analysts question their position. Rising demand for credit meant higher housing prices, which in turn led to more risky mortgages and the prospect of higher returns. Liquidity was such that economic and financial agents would absorb any asset, no matter how speculative it was, because the risk seemed inexistent and prices kept rising. It seemed there was never enough supply of home and risky assets.

Household debt went from 100 percent of disposable income to 160 percent, and suitably, house prices doubled.9

9 Bank of International Settlements (BIS).
By 2004 many borrowers began to experience difficulties in repaying their loans, but demand remained healthy and house prices were slowing down, but not falling. The bubble was bursting, but the consensus was that it was no real issue. Credit for housing exceeded 20 percent of all outstanding credit. However, by early 2007 reality started to kick in and the chain of nonperforming loans started to explode, as household debt exceeded disposable income by more than 60 percent and thus began a series of massive defaults.

These defaults sank the market value of all the related mortgage loans. Given that banks had to pay for their short-term debts while a substantial part of their income disappeared, a liquidity crisis was generated. As the market value of subprime loans fell further, the liquidity crisis deepened, so much that banks themselves did not want to lend to each other.

The risk of a run on the banks increased, as customers and the general public feared for their deposits.

Central banks decided to come help contain the fire they had created with a massive liquidity injection.

Central banks behaved, again, as the “Pyromaniac Fireman,” as I always say.

I remember when Christine Lagarde, then head of the IMF said, “Central banks have been the heroes of this crisis.” She completely ignored the role of the same central banks in fuelling the housing bubble by slashing interest rates.

The Federal Reserve launched QE1 and the mirage of growth and stability through monetary policy emerged. But evidence shows that monetary stimulus simply does not work.

In a report titled “A report card for unconventional monetary policy,” Deutsche Bank analyzed in 2016 the impact of “unconventional” monetary policies, quantitative easing (QE), and negative interest rates on the economy.

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10 “In many ways, the central banks have been the heroes of the worldwide financial crisis,” Lagarde Jackson Hole, Wyoming, 2013.
11 Quantitative Easing: using the Central Bank balance sheet to purchase government bonds and mortgage-backed securities to free space in banks’ balance sheets to improve lending to the real economy.
Studying the impact on manufacturing indexes of these measures from the launch until the end of each unconventional policy, the bank found the following results:

- In eight of the twelve cases analyzed, the impact on the economy was negative.
- In three cases, it was completely neutral.
- The measures only worked in the case of the so-called QE1 in the United States, and fundamentally because the starting base was very low and the United States became a major oil and gas producer.

How do you evaluate if QE and negative interest rates are working? When I discuss this with clients, I sometimes get the response that QE and negative interest rates are working well because the payment systems are running and the financial system still functions. But the issue is not if computers can deal with negative interest rates. The issue is if QE and negative rates have been supporting the economy. The conclusion is that U.S. QE1 had an impact but in all other cases the impact of QE and negative interest rates has been insignificant. And in 8 out of 12 cases, the economic impact has been negative. Once again, there is too big of a burden on monetary policy and it is time for fiscal and structural policy to step up and begin to support GDP growth.  

The fact that in eight out of twelve cases the impact was negative speaks for itself.

Would it have been worse if these measures had not been implemented? The debate is open, but I will make my own analysis. Kenneth Rogoff states, “QE was worth taking the added risk entailed by having more short-term debt. But as the recession abates, the calculus of risk and benefit changes.”

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My view is somewhat different. I use risk compared to reward and I get to the conclusion that it would not have made much difference compared to a short-term liquidity injection measure targeted exclusively to the banks. The Troubled Asset Relief Program (TARP), which created incentives to restructure banks while at the same time generating profits for the government, would have been more than enough, and the other negatives would have been avoided.

At the end of the day, when we measure the success or failure of a particular policy we must have a clear analysis of the negative and positive effects achieved with it. Assuming that household income and employment would have worsened if such measures had not been implemented is more than questionable. In fact, looking at the examples of both the European Union (EU) and the United States immediately prior to QE and QE1, we can see that the economy had already bottomed out and started to bounce.

Other important factors that help us know if things would have “really” worsened had it not been for monetary stimulus are money velocity, investment (capex or capital expenditure), and debt. While none of them have improved since the implementation of nonconventional measures, we simply cannot assume that they would have deteriorated much more than they have in the past years.

What about inflation? The same. Combating deflation in itself is no evident requirement. But if monetary stimulus of the size and period as the ones implemented does not even do it, the “it would have been worse” argument does not stack up.

**Four Trillion for Nothing**

“Money for nothing and chicks for free” (Dire Straits, Money For Nothing, Brothers In Arms).

We mentioned before the negatives generated by monetary stimulus. Which negatives?

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14 TARP was a program to purchase toxic assets from financial institutions to strengthen the U.S. financial sector. It generated a profit for the government of almost 20 billion US$ from the $426.4 billion invested.

15 U.S. employment and GDP growth, same with EU.
For more information or to schedule an interview you can contact Daniel Lacalle directly via Twitter on @dlacalle (Spanish account), @dlacalle_IA (English account), or email on info@dlacalle.com
I have had numerous meetings with investors where the main message is something like this:

The investor feels stocks and bonds are very expensive, that private equity is too risky, and that low rates and devaluation put at risk their savings. What can they do?

The first—and most important—step is to really understand your profile as an investor.

**How Risk Averse I Am**

One of the things that financial repression has done to the average investor is to completely obliterate tolerance for volatility.

I remember once being called to appear on TV to talk about the “stock market crash.” I asked myself what the hell had happened because I didn’t notice. It turned out that the market had fallen 2 percent. Two percent. “A crash.”

Media and mainstream consensus fell so comfortably under the central bank trap that perception of risk disappeared and, with it, the idea that stocks and bonds do become too expensive and the marginal buyer loses confidence.

Look in the mirror and ask yourself which type of investor you really are.
I heard once from a client: “I am very conservative; I am OK with 5 to 6 percent.” This in an era where the lowest risk assets were yielding negative returns. Obviously, he did not analyze risk appetite adequately.

The central bank trap can be a good source of returns, but we also must understand that, by 2016, there are two consecutive generations of traders that have seen nothing but expansionary policies.

Therefore, we must understand our risk appetite and at the same time find good managers that are able to discern value and opportunities without repeating that “long term everything goes up.”

**Bonds**

When we hear, correctly, that there is a large bubble in bonds, might be too simplistic.

Not all bonds are the same.

Let us understand first why we see the bubble in bonds. Low-risk sovereign bonds yield negative or virtually zero returns and inflation expectations are rising. Therefore, bondholders that have some of these assets in their portfolio are likely to see three things:

- Negative nominal and real returns, that is, losses, on the portfolio
- Outflows of capital from ultralow yield bonds, which make them even less liquid
- A global perception that there is more value in equities, creating higher volatility

So, the first thing that the central bank trap shows us is the disproportionate risk-reward ratio in the allegedly safest assets. They become very expensive and very illiquid quickly.

The second area of risk is in High Yield. Many investors might perceive that, when inflation rises and the U.S. 10-year bond sees a better yield, it does not make sense to buy bonds of companies with very high risk and challenged fundamentals because the risk-reward is, again, disproportionate.

But there are plenty of other options.
As the Escape from the Central Bank Trap should dictate, investors must seek to cover their portfolio from the risk of stagflation and recession at the same time … and inflation-linked bonds from Investment Grade\(^1\) companies and sovereigns.

Inflation-linked bonds (ILBs) are designed to help protect investors from the negative impact of inflation by contractually linking the bonds’ principal and interest payments to a nationally recognized inflation measure such as the Retail Price Index (RPI) in the UK, the European Harmonized Index of Consumer Prices (HICP) ex-tobacco in Europe, and the Consumer Price Index (CPI) in the United States.\(^2\)

Together with inflation accrual and coupon payments, the third driver of ILBs’ total return comes from the price fluctuation due to changes in real yields. If the bond is held to maturity, the price change component becomes irrelevant; however, prior to expiration, the market value of the bond moves higher or lower than its par amount.

Just like nominal bonds, whose prices move in response to nominal interest-rate changes, ILB prices will increase as real yields decline and decrease as real yields rise. Should an economy undergo a period of deflation—a sustained decline in price levels during the life of an ILB, the inflation-adjusted principal could decline below its par value. Subsequently, coupon payments would be based on this deflation-adjusted amount. See Figure 12.1. However, many ILB-issuing countries, such as the United States, Australia, France, and Germany, offer deflation floors at maturity: if deflation drives the principal amount below par, an investor would still receive the full par amount at maturity. So, while coupon payments are paid on a principal adjusted for inflation or deflation, an investor receives the greater of the inflation-adjusted principal or the initial par amount at maturity.

This instrument is flexible enough to provide the type of security that some investors demand and a certain kicker if inflation grows. But they are not zero-risk instruments, the investor must assess the ability of the issuer to pay the maturities and coupon, as well as the risk of suffering in

\(^1\) Those companies whose credit fundamentals are highest rated. \(^2\) Source: PIMCO education.
Figure 12.1 Inflation-linked bonds have become very popular

Source: Barclays; PIMCO.

the price of the bond if inflation happens and the issuing country or the currency of the issuer is significantly devalued.

Bonds are not a zero-risk asset; there is no such thing as an asset with no risk.

Other popular bonds in this environment as we escape the central bank trap are those of emerging market companies whose revenues are in dollars because they are well diversified and their debt is in local currency or fully linked to the currency of their revenues. Especially if these companies have costs in local currency, these instruments have proven to be a good hedge against aggressive devaluations, sudden stop, and fluctuations in commodities.

Equities

Equities have been a tricky asset in the period of financial repression. Returns vary between sectors and the overall good performance of indexes has also been clouded by a diminishing inflow of capital.

Calls for a “great rotation” from bonds into equities did not happen in the years of the central bank trap because the entire focus of governments, central bankers, and companies was on the fixed-income market. This made investors prefer an asset class that everyone is adamant to
protect over equities, where volatility and yield appeared attractive but not enough to make the switch. The prospects of profit warnings, capital increases, and weak returns in a secular stagnation did just that.

However, as we escape the central bank trap, we see that the global earnings recession that we entered in 2008 could be close to an end thanks to a pickup in inflation and improved fundamentals in countries that look to boost growth through tax cuts and supply-side measures, such as the United States.

Escaping the central bank trap involves enormous volatility, and the investor must acknowledge this risk. This is no time to talk macro and make grand statements about stocks in general.

The investor will have to focus on picking stocks where fundamentals remain attractive despite the asset inflation of the past years.

In order to do that, investors will have to analyze trends and multiples. For me, the most important combination is that of strong Free Cash Flow Yield, a Return on Capital Employed that stands a few points higher than Weighted Average Cost of Capital (WACC) (as we explained in previous chapters), and a strong balance sheet. What is most important is that the company’s management interests are aligned with those of minority investors, by having a sizeable part of their remuneration in shares and solid targets that can be monitored on a quarterly basis as the company publishes earnings.

Diversification is key, but so is recognizing the strength of the equities portfolio that investors create. Such strength will only happen if we have one sentence in mind:

Cycles are becoming shorter and more abrupt, and portfolios should be protected by being active at selling once decent returns have been achieved and churning the portfolio to adapt to new opportunities that come from the change of cycle. See Table 12.1.

Keith McCullough explains how cycles matter:

The run-up is supported by cold-hard economic data. U.S. growth and inflation are finally accelerating and the investing implications are actually quite simple. You sell bonds. You buy stocks.

Here’s why.

Unlike casual macro “tourists,” I’m not wedded to opinions or how something “feels.” The only thing that truly matters is the
<table>
<thead>
<tr>
<th>Economic cycle stage</th>
<th>Characteristics</th>
<th>Business cycle industries that do well in this stage</th>
<th>Examples</th>
</tr>
</thead>
</table>
| **Expansion: Early Stage** | Low, increasing inflation Low, increasing interest rates High unused capacity Low inventory | **Cyclicals**  
**Consumer credit:** Firms that are tied to the housing industry  
**Energy:** Companies that produce energy-related products  
**Consumer cyclicals:** Manufactures of consumer products that respond to the changes in disposable income | Savings and loans, regional banks  
Oil, coal  
Advertising, apparel, auto manufacturers, retailers |
| **Expansion: Middle Stage** | Moderate inflation  
Moderate interest rates  
Moderate unused capacity  
Moderate inventory | **Basic materials:** Companies manufacturing materials (not machinery) to produce finished goods  
**Technology:** Companies manufacturing high-tech products for consumers and businesses | Chemicals, plastics, paper, wood, metals  
Semiconductors, computer hardware, software and services, communications equipment |
| **Expansion: Late State** | High inflation  
High interest rates  
Low unused capacity  
High inventory | **Capital goods:** Companies manufacturing machinery used to produce finished goods  
**Financials:** Firms tied to loans that are in demand due to economic expansion  
**Transportation:** Companies that transport goods and passengers | Equipment and machinery manufactures  
Corporate and institutional bankers  
Airlines, trucking railroad |
| **Recession** | Decreasing inflation  
Decreasing interest rates  
Increasing unused capacity  
Decreasing inventory | **Defensive**  
**Consumer staples:** Manufactures of basic consumer products that are purchased at largely the same level through all economic cycles  
**Utilities:** Regulated companies providing products and services such as electricity | Food, drugs, cosmetics, tobacco, liquor  
Electric gas, water |
| **Independent of Economic Cycles** | Varied economic circumstances | **Growth**  
**Industries and companies in the early stage of a life cycle:** Expanding quickly and not subject to economic cycles | Biotechnology |
data. On that front, U.S. economic data has been decidedly bull-ish for two straight months:

Industrial Production: U.S. Industrial Production registered its first positive reading in 15 months this week, or +0.5 percent year-over-year growth. That snapped the longest streak of negative growth ever outside of protracted U.S. recessions.

Consumer Price Index: Headline Inflation accelerated for a 5th consecutive month, taking consumer price growth to its highest level in 32 months (since May 2014) at +2.1 percent in December. This effectively ended 30 straight months of inflation readings that were stubbornly below the Fed’s 2 percent target.

Add this to the long list of economic indicators now realizing positive year-over-year growth:

- Wage Growth
- ISM (Institute for Supply Management) Manufacturing
- Durable Goods (ex-Defense and Aircraft)
- Auto Sales
- Retail Sales
- Disposable Personal Income Growth

These are extremely important factors to understand opportunities. Growth accelerating versus growth slowing. It might surprise some that these trends change in six months, but that is because we are sold by cen-tral planners to believe that cycles are five years long or more. They are not.

That is why it is so important to follow the advice of real-time investors that have no agenda to prove and who simply follow the hard data, providing recommendations that include indicators of cycle turns, over-sold and overbought, and differentiated views from consensus.

Consensus leads only to mediocrity, as I stated in my book *Life In The Financial Markets*, and it is very important to understand the macro and micro elements of investing while at the same time following a unique approach.

---

3 Buy Stocks, Sell Bonds! The Economy Is Accelerating.
Stocks are complicated, but only if you follow the same approach as everyone else and trust investment bank recommendations. However, once one understands that the macro elements do not have to be awesome or terrible, just accelerating or decelerating, and that real multiples of cash flow and returns growth matter, the challenges of equity investment are greatly reduced.

The Escape from Central Bank Trap trade follows the simple, and at the same time complex, rule of analyzing the short-term trends and how they affect earnings to pick stocks that will give us a winning portfolio by recognizing cycles.

Some of the trends that seem to be clearer in this race to win against the central bank trap are:

Rise in Inflation comes mainly from commodities, so cycle must be analyzed to see whether the supply-demand picture of those commodities is delivered or becomes another trap.

Most economists are expecting a big increase in inflation. While there is obviously an important base effect from 2016 levels due to the stabilization of commodities, the underlying factors that drive inflation expectations remain weak. Not only is China’s growth likely to disappoint, and with it its imports and purchasing power, but the compounded effect of technology, aging population in the OECD, and overcapacity count as stronger forces against inflation expectations than the rise in oil and food prices.

The biggest risk to this prediction is that the rise of protectionism affects world trade in a more severe way than expected and price rises due to lower trade are added to weak growth to cause stagflation. Core inflation, which is what matters to the economy, is likely to remain subdued, whatever happens with commodities. Oil is likely to lose momentum as supply cuts are proven ineffective, demand—especially from China—disappoints, and U.S. and Canada supplies surge.

The EU could emerge stronger from Brexit and local elections.

It is tempting to think that the EU will collapse and the euro will break up because of political turmoil. However, with each new local crisis, the underlying factors that strengthen the euro as a currency, technical and practical, overtake the evident threatening elements. This does not mean that Europe is going to grow above estimates to 2020, but the
elections and banking crises continue to make the euro project more resistant, whether we like it or not.

China will not collapse, but will likely continue weakening further. China’s imbalances were not reduced in 2016. The accumulation of debt and the massive real estate bubble, added to capital outflows, show that China is unable to tackle overcapacity and strengthen its growth model. However, growth of middle class, young population, and the fact that most imbalances are well known and denominated in local currency prevent a 2008-type collapse.

Emerging markets are likely to face sudden stop adequately and avoid collapse from strong dollar and capital outflows. Foreign exchange reserves in emerging markets have remained strong and recession and capital outflows have been tackled in the right way by most central banks. Although they are likely to face tough years, emerging economies are better prepared in 2017 for a difficult environment.

**Gold and Bitcoin**

A Nigerian citizen tweeted a very interesting case in 2016. He feared that his country’s central bank would break parity with the U.S. dollar. Worried about losing all his savings and faced with a huge devaluation, he decided to move his deposits to a platform that makes transactions in gold backed 100 percent by physical gold. The currency fell almost 50 percent against the dollar overnight. His small savings appreciated.

This case is paradigmatic of a trend that is happening all over the world among citizens who are looking for an alternative that protects them from financial repression, allowing them to store value, and at the same time is compatible with traditional means of payment.

Those who have accumulated a portion of their savings, even their wages, in platforms fully backed by physical gold have not only seen their money grow, but platforms allow making transactions in different currencies without suffering fluctuations and volatility.

At the same time, the central banks of emerging markets have increased their reserves of dollars and gold.

Gold multiplied in value in the period into financial repression driven by the fear of many that the economies would suffer hyperinflation. Many
investors were wrong because, as we explained, QE is disinflationary as it perpetuates debt and overcapacity while money velocity falls.

This “mistake” made gold lose its speculative appeal and gold-linked financial positions (ETFs) fell from almost 3,000 metric tons to less than 1,500, according to Goldman Sachs.

However, the risk of financial repression did not end, and many investors, from China to India, saw the risk of large devaluations and the demonetization of currencies, which could put their savings at risk. Risk perception of a global currency war increased.

Fear of the confiscation of savings through monetary policy also sky-rocketed, particularly in China, as capital flights increased.

And that is why those looking for a store of value, an inflation hedge and a risk hedge, a certain element of security in the face of an uncertain environment—or a very true fear—find gold attractive.

Despite the increasing Chinese, Russian, and Asian demand, Gold has been oversupplied since 2009 and reached its peak (almost 20 million ounces of overcapacity) in 2010. That trend has reversed over the past two years, and by 2016, supply is tight.

The problem for the Escape from the Central Bank Trap trade was that, for many, the purchase of gold as a reserve of value or investment was mainly via financial derivatives that are as risky as other financial products in a crisis, and are not backed by the physical precious metal. The difference with physical gold platforms that are growing all over the world is that they democratize the access to the physical trade by selling small parts of a bar of gold, but always clearly stating that it is 100 percent backed by such ingot.

Even those who, like me, think that the risk of a crisis like 2008 is moderately contained and that what we are facing is more a period of low growth and poor inflation due to saturation of stimuli, the continuous policy of attacking the saver and devaluing supports holding a portion of savings in gold.

It is not surprising that families and companies seek to mitigate the impact of financial repression via gold with guaranteed physical platforms.

Bitcoin is a completely different proposition. A digital currency that cannot be manipulated by central banks. The digital currency, whose supply cannot be increased by political decisions, has seen record inflows
from Chinese and Indian citizens on expectations of huge devaluations of their local currencies.

The resurgence of the shelters against the destruction of currencies by governments was not a novelty of 2016, but was accelerated with the generalization of financial-repression policies.

The search for ways to preserve wealth in a society which owns most of it in deposits makes citizens seek any way to avoid the assault on their savings from the massive printing of money through increase of money supply.

For this reason, the search for a currency whose control is not in the hands of States has been a constant in preserving capital for many years now.

Whenever government’s imbalances soar, the “solution” almost inevi-tably comes from “dissolving” the wealth of citizens and appropriating it via inflation—the tax of the poor—and devaluation.

The difference between bitcoin and gold in recent years is basically that, while one has been rising fast as a possible currency and as a store of value, gold was seeing a more stable increase in value.

“Bitcoin is the beginning of something great: a currency without a govern-ment, something necessary and imperative.” Nassim Taleb

Bitcoin is not yet a reality as a free currency for global use; its evolu-tion depends on the ability to implement it globally and clarify doubts about its security against hackers and its value as a refuge.

Bitcoin is a currency start-up. A means of payment where States can-not interfere in the amount and cost of money available, where it is not possible to create fake money not backed by savings, and where one can “escape” and take refuge from the assault of central banks on the saver. Doubts come because the “shelter” is virtual and therefore always subject to computer attacks.

Bitcoin is proving to be a powerful exchange network and its revalua-tion shows that those who trust in that network maintain their positions in the medium term. As the increase in supply is limited, it is revalued in the face of increased demand.

A financial asset where its scarcity, future demand, and quality are valued against the possibility of exchanging it for other currencies, goods, or services in the future.
The fact that you can liquidate that asset and pay debts and taxes with the profits generated is positive. But it is not a currency until it can be used as a generally accepted means of payment for goods, services, taxes, and debts.

What bitcoin and the revaluation of the gold in 2016 showed us is that a growing part of the population continues to look for ways to shelter their savings against devaluations.

**The Central Bank Trap and the Risk Hedge**

At the end of this book, what I try to show is that even if the reader is a casual investor or a professional, we need to be used to the idea that:

- Believing that central banks will be there to shelter savers from risk does not work.
- Monetary policy may have succeeded in hiding the perception of risk, but accumulation is happening and volatility will rise.
- By definition, it does not make sense to find shelter from systemic risk by investing in the same assets that are accumulating such systemic risk.

Financial crises always happen due to the accumulation of exposure in assets that consensus and mainstream believe have little or no risk.

Economic cycles are not changed by macro policies, the effects of trying to cover imbalances with monetary laughing gas come back again with much more aggressiveness when credibility is lost.

Our Escape portfolio does not try to provide a one-stop solution for investors—that depends on their risk profile. There are no bad asset classes, just bad risk decisions when we deny cycles and decide to hold on for too long to winning bets.

That is one of the clearest mistakes that happen when we ignore that cycles are shorter, failing to take profits on good ideas.

Escape from the central bank trap can only be achieved by avoiding consensus bets and diversifying exposure so that our savings can be protected from the voracious appetite of inflationists.

A solid combination of sound fundamental bonds linked to inflation, rock-solid earnings and return-generating equities with maximum
alignment of interests between shareholder and manager, and gold and alternative currencies, well diversified and managed actively, is, in my opinion, the best way to secure wealth and capital appreciation in this end of central-planned faith in alchemy.

**Conclusion**

The reader may have seen that this book is critical, but it is also hopeful and offers ideas based on pragmatism.

Central banks will continue to exist, and what I have tried to present here are ideas that some may share and others may not, but that can be implemented to cement credibility and avoid the enormous risk that is building up all over the world by denying the existence of bubbles and placing no interest in the rising tide of anger against mainstream monetary and economic policies.

The fact that there are risks should not preclude us from deciding to put our money to work, because if we do not, there is one certainty. Our savings will be worth less and less.

There is a tremendous opportunity for the world to show that financial operators, governments, and central banks can reorient their incentives to put their enormous power to reignite the growth of the middle class.

This growth of the middle class and improvement of the economy will come from a much more prudent approach to monetary policy: Make increasing disposable income the highest priority and let the private sector decide when and how investments should be made, allowing productive debt to overtake gratuitous deficit spending.

The central bank trap was not created in bad faith, and we must acknowledge that there have been some positives as we tried to note from the messages and policies of some of the governors. But the key message here is that we are dangerously close to crossing a line where uncertainty is taken over by panic and where citizens may simply lose any small element of trust in the system.

If panic was to arrive, it would catch central banks with no tools at all to mitigate the risk. Moving to negative rates after multiplying central bank balance sheets would not solve anything. Another QE after all that
has been done would cause a total loss of faith in the system and blaming the wrong guys for the mistakes of policymakers.

It is time for supply-side policies and lower taxes and to allow companies to invest if they see opportunity, letting them seek those opportunities without constant bureaucracy burdens. Let families save, if they so desire, and consume the money they have earned working hard every day.

This will, in turn, lead to a more sustainable growth, where taxation is a means for improvement in public services, not a burden for growth and a perverse incentive to increase imbalances.

There are two sides to every story. The Keynesian reader may think that central banks have been the heroes of the crisis and that all the negatives happened due to reckless private companies. If that is the case, the Keynesian reader should also be alarmed at the insanely low bond yields and the amount of money created to generate such poor growth.

Whatever you want to believe, even if you still believe in “it would have been worse,” “this time it’s different,” and “we have to repeat,” there is one certainty.

The indiscriminate creation of money not supported by savings is always behind the greatest crises.

The escape from the Central Bank Trap is urgent.

It can be done in a way in which growth is stronger, citizens are better off, and perverse incentives are, at least, controlled.

Inflation is not an objective, it’s an outcome.

Real productive investment is not decided by a committee that suffers no consequence if it fails.

Central Banks Don’t Print Growth.

Let’s rebuild the middle class.

London, January 2017
Endorsements

“Diocletian tried to combat inflation by fixing prices through laws. In reality, inflation was the product of the fiscal and monetary profligacy of the Roman emperors during the third century A. D. Dr. Daniel Lacalle’s book exhibits how in the years after the global financial crisis, Governments and Central Banks have performed similar measures to those of the Roman emperors. This book shows the consequences of repeating past mistakes, and what can be done to limit such dire consequences.”

—Ignacio de la Torre, Professor and Academic Director at IE Business School.

“There is a Management model that I tried to explain to my students nationally and internationally. This model is based on the principles of subsidiarity, reciprocity and solidarity among people, business and policy makers. Lacalle’s book “Escape from the Central Bank” explains in detail the consequences of massive intervention in the markets through monetary expansive measures, and why it is not the right way to proceed. This book is an absolutely must for those of us who believe in free markets and free society.”

—Prof. Francisco J. Lara, Busch School of Business, CUA Washington D.C.

“Researchers have written extensively on the topic of how money and monetary policy affect society and the international economy. Nevertheless, although the theory has been thoroughly examined, few best practices and recommendations have been put forward.

Each analyst has his or her individual point of view regarding the context that surrounds us. In his book Escape from the Central Bank Trap, the eminent economist and insightful thinker Dr. Daniel Lacalle reflects upon the most relevant internationally significant economic events of recent times. Lacalle conducts an original and visionary analysis that
provides rich insights for evaluating future business decision made under high uncertainty. The value of this book is unquestionable; congratulations, Dr. Lacalle. Scholars, students, consultants, business managers, policy makers, and many others will find useful recommendations on the key issues dealt with in this book.”

—Domingo Ribeiro-Soriano,
Professor of Business Administration, Universitat de València-Spain.

“In this book, Daniel Lacalle unveils, in a precise and clear way, proper uses (and misuses) of monetary policy and money creation, as perils associated to monetary gluts and what he coins as the “monetary laughing gas,” when the healing power of monetary policies turns to be simply a placebo effect on the real economy. This challenging approach is particularly when potential imbalances fed by inconsistent policies hit a macroeconomic environment subject to hysteresis, reducing the room for maneuver in the future. In a transgressive way, he states that categories “conventional” or “unconventional” for monetary policy should be replaced by consistent (or not) policies, making monetary policy effectiveness depend mainly on its credibility and transparency.”

—Juan Sapena,
Dean at Faculty of Economics, Catholic University of Valencia.

“To escape the trap of money printing, one has to understand why the trap didn’t work to begin with. Lacalle is one of the leading next generation economists who can simplify the complex. He’s neither a mainstream academic nor a flailing economic pundit. His teachings come from a market practitioner’s perspective. This book is about the economic truth.”

—Keith R. McCullough,
Chief Executive Officer, Hedgeye Risk Management.

“Escape from the Central Bank Trap provides a penetrating framework for understanding the co-dependencies among today’s monetary policy, the economy and the financial markets. Lacalle’s book draws out how these co-dependencies developed, the risks that have since evolved, and outlines the necessary tough medicine needed to return to a more
sustainable condition. By distilling today’s complex economic and monetary challenges succinctly, Lacalle provides us with a road map that an economist, market practitioner, or anyone who cares about long term economic health can grab hold of.”

—Michael Purves,

Chief Global Strategist, WEEDEN & CO.

“Professor Daniel Lacalle has done a wonderful job by providing a new interpretation of how central banks have contributed to worsening the financial crisis that we have all suffered during these recent years. Furthermore, the clarity of his explanations has provided a deeper understanding for practitioners and all those interested in monetary policy and its complex impact in the financial markets and the real economy. Ultimately, I do consider that this book will become essential reading material.”

—Alvaro Martínez-Echevarría,

Dean and Director of the IEB Business School.
(Manuscript Copy for Journalists)

For more information or to schedule an interview you can contact Daniel Lacalle directly via Twitter on @dlacalle (Spanish account), @dlacalle_IA (English account), or email on info@dlacalle.com
Bibliography

Apart from the scholar papers cited in the references.


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