

Inflation is Taxation without Legislation or Representation

The Cash Crucible & the Acceleration of Financial Repression

“Cash is a Legitimate Asset Class for the First Time in Decades, Investors are piling into products that shield them from losses in a rising rate environment.”ⁱ So said a recent article in Bloomberg. Any headline-hailing investors “piling” into anything should trigger instant paranoia.

Consistent with history, our research over 12 years has demonstrated that the crowd may be comfortable, but it is rarely the right place to be. Reading that the hot spot *du jour* is cash, with nominal rates of 3.25% and a -5% real yield, is a testament to the financial repression underway.ⁱⁱ This paper builds on a 2015 study of the Financial Repression used to help liquidate government debts in the 35 years following World War II.

Summary: the nominal comforts of cash may come at a steep price for investors’ newfound risk aversion.

1. Buyers of Treasuries are betting against history, the Fed’s playbook & the interests of the US government
2. Explaining the liquidation of government debts between 1945-1980, Reinhart and Sbrancia highlighted the re-emergence of policy tools that mechanically transfer wealth from savers to the government in a “policy tax” dubbed “Financial Repression”
3. **Specifically:** *“...we document how in the post [Great Financial Crisis] debt-laden environment financial repression has once again resurfaced in its many forms among the advanced economies through a variety of regulatory changes, implicit (or explicit) nominal interest rate ceilings, and in some cases, capital controls, and “moral suasion” to induce domestic institutions to hold more government debt.”*
4. 2009 – 2020 was a period of severe financial repression that not only failed to liquidate government debts, as occurred in the post-WWII period, but actually left us more indebted than any time in history
5. **History, recent policy, and the unsustainable current trajectory of US deficits suggest Treasuries will become a “comfortable” method of transferring your savings to the US government**

KCR has been writing about these risks since June 2020 when we penned [60/40: Buying a Ticket on the Titanic](#). The recent return of nominal bond yields and the correction in equities has improved the optics of 60/40 strategies. **Unfortunately, history suggests the risks could be accelerating rather than abating.**

As usual, we will not be making forecasts here. Merely explaining where we are through the lens of financial history. Take a look at the quote below.

*“...deficit reduction usually involves highly unpopular expenditure reductions and (or) tax increases ... the relatively ‘stealthier’ financial repression tax may be a more politically palatable alternative to authorities faced with the need to reduce outstanding debts.”*ⁱⁱⁱ

That is from a paper published by the IMF. Do you think the world’s developed economies, lumbering under the weight of wholly unpayable debts, is worried about your purchasing power? We think not.

We encourage our readers to keep in mind that the policy initiatives explained over the next few pages are openly being endorsed as a means of reducing debt. There’s nothing subtle about this. The federal government’s incentives are diametrically opposed to investors. **Act accordingly.**

The Inflation Tax Refers to the Annihilation of Savings to the Benefit of the Government

The timing is uncertain. But eventually, savers in cash and Treasuries should expect to see their wealth transferred from their pockets to the government.

Sometimes quickly, through the cancellation of debts....

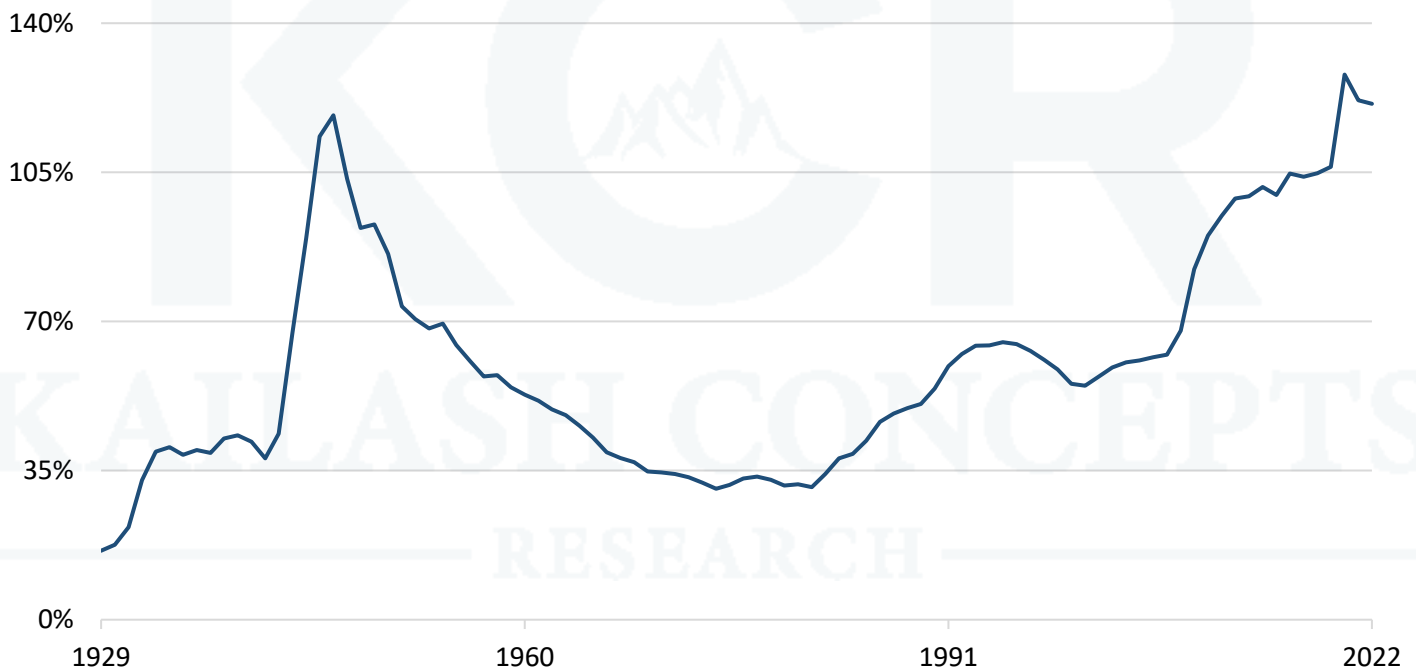
“...the high debts of World War I and the subsequent debts associated with the Depression of the 1930s were resolved primarily through default and restructuring.”

Sometimes slowly, through financial repression...

“... It apparently has been collectively forgotten that the widespread system of financial repression that prevailed worldwide from 1945 to the early 1980s played an instrumental role in reducing or liquidating the massive stocks of debt accumulated during World War II...”^{iv}

With debt to GDP at these levels, money creation and maintaining higher inflation than nominal rates are the least politically offensive method of increasing the nation’s tax rates.

Total U.S. Debt to GDP



Source: Kailash Capital, LLC, BEA; Data from 12/31/1929 - 4/1/2022

Milton Friedman’s quip, which titles this paper, invokes numerous other methods of transferring wealth to the government while foregoing higher explicit tax provisions. The Federal Reserve will likely succumb to the crushing pressure to increase money in the economy to keep inflation rates above nominal yields. This will create a surge in nominal income taxes.

Tax rates are not indexed for inflation. This creates the virtuous (for the government) cycle by which nominal gains in income create naturally higher taxes via bracket creep. While valid, these issues are outside the scope of this paper. As we show, simple financial repression policies pay the taxes without legislating fiscal austerity.

Inflation is a Tax

“Financial repression in combination with inflation played a quantitatively important role in limiting interest payments and reducing debts ... The most significant savings materialize in the decade after WWII when debt levels are highest and in the 1970s when inflation accelerated.”^v

Reinhart & Sbrancia have two solid pages explaining the methods of financial repression in the 1945-1980 period. We have truncated the verbiage and emphasize five items in the list below.^{vi}

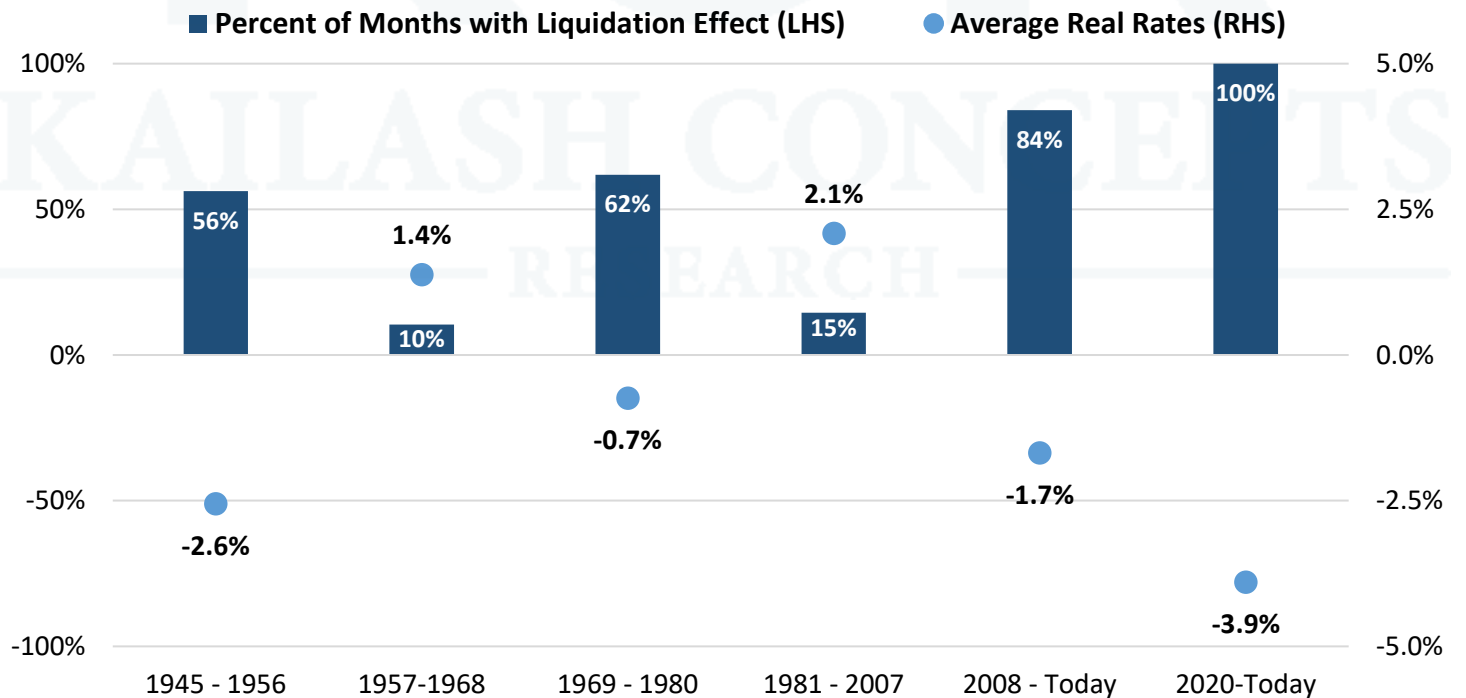
1. Caps or ceilings on interest rates
2. “Prudential” regulatory measures requiring institutions to hold government debt in their portfolios - pension funds were historically the primary target
3. Government securities price support that allowed interest rates to be controlled under the premise that it kept bonds liquid and protected investors from nominal capital losses
4. Extensive regulation and high reserve requirements on banks requiring the purchase of large amounts of government securities
5. Transaction taxes on equities to direct savers toward buying government debt

These policies are brutal in scope and prevalence today. **Unlike the post-WWII period, our debts have grown despite printing money, steep negative real yields, and recently high inflation.**

The chart below builds off R&S’ work and breaks up the last 78 years into 6 specific periods. Each bar represents the percentage of time when real rates were negative in that period. The dots show the **average real rate**.

Financial repression can be intermittent and still brutal. Look at the 1945 – 1956 period (left most bar). Despite real rates being negative “only” 56% of the time, treasury holders^{vii} still saw their wealth decline by -2.6% a year. That’s nearly a 30% collapse in purchasing power.

Liquidation Effect vs. Average Real Rates



Source: Kailash Capital, LLC, St. Louis Fed; Data from 1/1/1945 - 9/30/2022

Compare 1969 – 1980 to 2008 – Today. How many people would have guessed that recent financial repression has been worse post the GFC than in the 1970s?

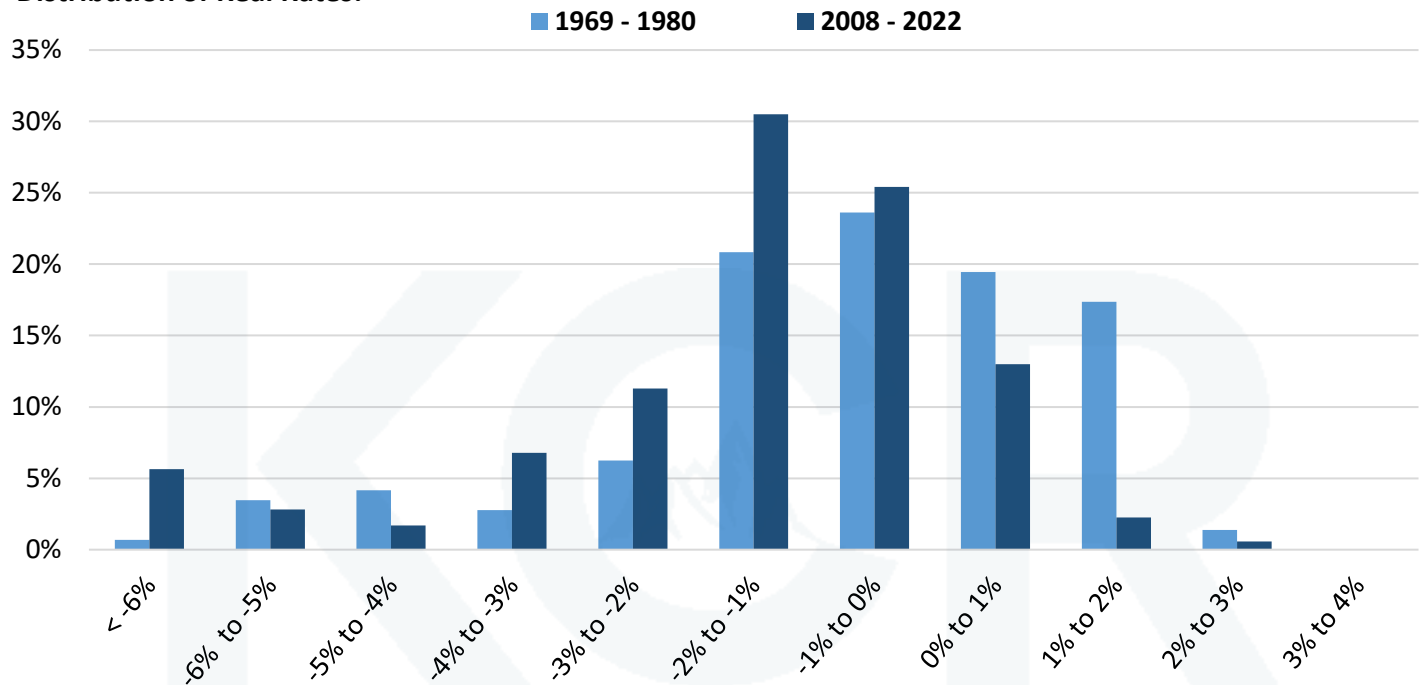
In our minds, this is a testament to the stunning success of the financial repression enacted in the post-GFC era.

- The chart below shows the distribution of real rates in the 1970s vs. the post-GFC period.
- The **light blue bars** show the distribution of real yields between 1969 – 1980
- The **navy blue bars** show the distribution of real yields between 2008 – 2022

Consider the debate over: we are already deep into the 1970s precedent.

Recent Financial Repression Approximate the 1970s

Distribution of Real Rates:



Source: Kailash Capital, LLC; Data from 1/1/1945 - 9/30/2022

Holders of cash have been systematically mugged for over a decade. The tolerance for this financial repression post the GFC was likely due to the ability to “evade” the consequences. How? By capital appreciation in speculative equities and long-duration bonds.

These behaviors were and are co-dependent in the worst possible ways.

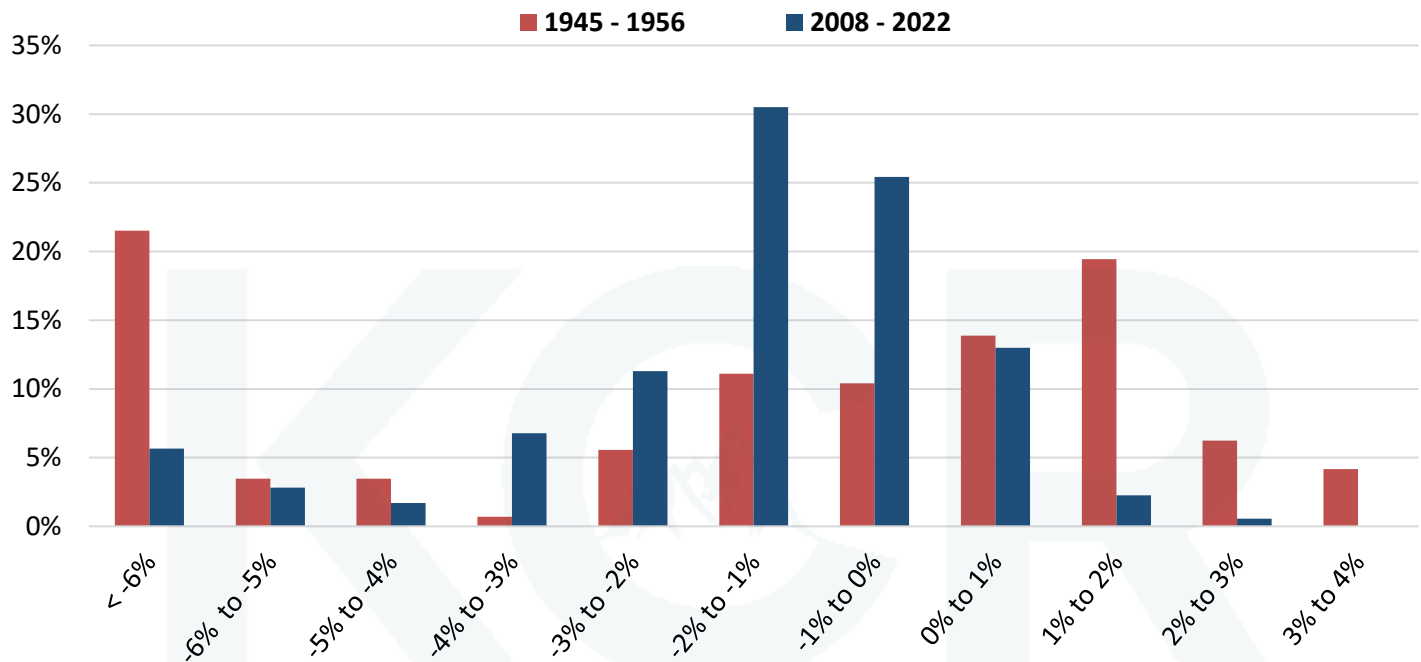
One of the many manifestations of the yield famine in cash was rank speculation and catastrophic capital misallocation. These are topics we have covered in detail for years now. **Investors are learning a painful lesson: speculation is a high-risk method of trying to evade financial repression.**

The chart below is identical to the one above, except now the **red bars** show the frequency and magnitude of the financial repression from 1945 – 1956. Here are the key points:

- Unlike the 1970s, which we have effectively just re-lived per the above, the financial repression after WWII had a very **mean streak** (left most **red bar**)
- In the 22% of those periods, real yields were negative -6% or more, a brutal and rapid transfer of wealth
- We'd like you to note how that **navy blue bar** on the left is starting to rise

We are Rapidly Catching Up to the Brutal Post-WWII Precedent

Distribution of Real Rates:



Source: Kailash Capital, LLC; Data from 1/1/1945 - 9/30/2022

Investors in US Treasuries may experience volatile real returns with a significant risk of indirect confiscation. We would like to make three key points and then offer a concluding thought on this exhibit:

- KCR does not relish making that statement.
- We further acknowledge that we do not “know” and the developed world could plunge into a deflationary spiral making bonds a terrific investment
- Even for those in the deflation camp (whom we have deep respect for), we hope this paper serves to create some balance in the risk-reward for those making this wager

Quite simply: The last time the US faced debt/GDP this high, the government’s incentives to abscond with savers’ wealth were realized via policy taxes expressed as negative real yields. Buying government bonds is a wager against historical precedent.

A Long-Term Solution to the Inflation Tax?

KCR continues to believe that broad equity indexes are overvalued and bloated with low-quality companies. We have made short work of the Small Cap and Large Cap indexes. In each of those simple papers, we demonstrated how the introduction of a **single factor** offered vastly superior outcomes for long-term investors.

We have also explained how markets today offer the index-agnostic a growing basket of remarkable pricing errors. From fantastic companies trading at reasonable valuations to cyclical businesses built for, and pricing in, a brutal macro shock, the opportunities are abundant. **Time and patience** are key to realizing the long-term benefits of investing in equities like these.

Much of the investing world seems fixated on how to trade around various and sundry Fed actions. The impulse is as understandable as it is unhealthy in our view. Trying to outguess a group of government rate-setters is fraught with difficulty.

KCR understands how persistent inflation, deflationary shocks, and financial repression can shatter margins, multiples, and economic growth. Index funds and bonds play an important role in a balanced portfolio.

Yet we continue to believe the greatest opportunities for patient capital are in low-cost, evidence-based equity strategies.

While our firm expects a robust, if lumpy, program of financial repression, our investment methodologies do not require it. In 2011, the US bought \$100s of billions of securities. Financial observers were aghast.

The public fretted about inflation and deflation simultaneously. In his 2011 letter to shareholders, Warren Buffett wrote the following endorsing the ownership of high-quality equities:

“Terror over economic collapse drives individuals to currency-based assets, most particularly U.S. obligations, and fear of currency collapse [inflation] fosters movement to sterile assets such as gold.”

Considering the magnitude of recent government intervention, we are not surprised to see the same fears manifesting themselves today.

“Whether the currency a century from now is based on gold, seashells, shark teeth, or a piece of paper (as today), people will be willing to exchange a couple of minutes of their daily labor for a Coca-Cola or some See’s peanut brittle. In the future the U.S. population will move more goods, consume more food, and require more living space than it does now.”

Our team agrees strongly. To each their own.

Low Volatility Stocks with Yields => Fed Funds

The soaring dollar, collapsing Yen, imploding Gilts market, and the prospect of deflation, inflation, and other items have created fear. The table below compares a group of stocks with **half** the beta of the market^{1,2} that had total yields > the cash rate³ and were in the top quintile of our Large Cap ranking model.

The evidence here is simple: pay less and get a whole lot more with less risk.⁴ In our view, these stocks offer interesting alternatives to staples for investors looking to stay invested, harvest yield and reduce systematic exposure.

	EV/Sales	P/E	Fwd P/E	P/B	ROE	Total Yield	Net Debt/Price	3 Yr Sales Grth	36m Beta
Low Vol w/ Yield	1.2x	13.2x	10.7x	3.3x	59.0%	10.6%	33.1%	38.9%	0.51
Russell 1000	2.5x	18.8x	15.8x	3.4x	38.6%	4.6%	15.7%	47.5%	1.04

Source: Kailash Capital, LLC; Data from 9/30/2022

KCR Agg Rank	Ticker	Company Name	Market Cap (\$m)	36m Beta	Total Yield
8	PM	PHILIP MORRIS INTERNATIONAL	128,678	0.51	6.8%
11	ACI	ALBERTSONS COS INC	13,216	0.54	2.9%
19	GILD	GILEAD SCIENCES INC	77,359	-0.01	5.3%
23	BAH	BOOZ ALLEN HAMILTON HLDG CP	12,229	0.60	4.5%
29	BMJ	BRISTOL-MYERS SQUIBB CO	151,777	0.35	8.4%
31	LMT	LOCKHEED MARTIN CORP	101,981	0.50	7.8%
32	ABBV	ABBVIE INC	237,287	0.69	4.6%
45	MRK	MERCK & CO	218,160	0.33	3.3%
61	PKG	PACKAGING CORP OF AMERICA	10,520	0.65	5.5%
63	KR	KROGER CO	31,325	0.41	7.3%
68	VMW	VMWARE INC -CLA	44,992	0.59	26.9%
81	TRV	TRAVELERS COS INC	36,354	0.55	8.4%
92	CTRA	COTERRA ENERGY INC	20,785	0.11	10.8%
97	LOPE	GRAND CANYON EDUCATION INC	2,629	0.54	44.3%
109	HRB	BLOCK H & R INC	6,803	0.65	10.9%
115	CAH	CARDINAL HEALTH INC	18,204	0.49	8.7%
116	AMGN	AMGEN INC	120,566	0.56	10.8%
142	DBX	DROPBOX INC	7,465	0.59	14.0%
147	VIRT	VIRTU FINANCIAL INC	2,158	0.36	29.8%
153	ACGL	ARCH CAPITAL GROUP LTD	16,820	0.67	10.8%
156	POST	POST HOLDINGS INC	4,895	0.59	8.4%
164	RE	EVEREST RE GROUP LTD	10,345	0.66	4.6%
173	CB	CHUBB LTD	76,112	0.67	7.5%

Source: Kailash Capital, LLC; Data from 9/30/2022

¹ Longtime readers know our fierce objections to beta as a measure of risk, but in an environment like this we believe utilizing a common, easily understood, and widely accepted metric might be appropriate. We are open to other sorts, screens and ranking methods for those who, like us, frown on daily price movements as a measure of an underlying asset's intrinsic value. Please know we'd love to hear from you!

² In selecting stocks for this screen, we used a 0.7 beta threshold which yielded a reasonably consistent 0.5 beta on average. Historically, portfolios of these type of stocks outperformed during the dot.com crash, the GFC crash and have done well since the market's peak in 2021.

³ 1m T-Bill

⁴ Statistically, based on the beta we just knocked above!

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ⁱ Cash is a Legitimate Asset Class for the First Time in Decades, Investors are piling into products that shield them from losses in a rising rate environment. Bloomberg News, 09/30/2022, quoting the head of fixed income from a prominent money manager

ⁱⁱ Fed Funds of 3.25% minus CPI YoY of 8.30%

ⁱⁱⁱ *The Liquidation of Government Debt*, Carmen M. Reinhart and M. Belen Sbrancia, IMF, Working Paper, January 2015, page 14 and page 15

^{iv} *The Liquidation of Government Debt*, Carmen M. Reinhart and M. Belen Sbrancia, IMF, Working Paper, January 2015, page 14 and page 5

^v *The Liquidation of Government Debt*, Carmen M. Reinhart and M. Belen Sbrancia, IMF, Working Paper, January 2015, page 14 and page 7

^{vi} *The Liquidation of Government Debt*, Carmen M. Reinhart and M. Belen Sbrancia, IMF, Working Paper, January 2015, sub-section “*The Pillars of Financial Repression*” pages 9-11

^{vii} Consistent with the work of Reinhart and Sbrancia, Fig. 4 we use treasury bills