

Russell Napier: “We Are Headed Towards a System of National Capitalism”

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Russell Napier is author of the Solid Ground Investment Report and co-founder of the investment research portal ERIC. He has written macroeconomic strategy papers for institutional investors since 1995. Russell is founder and director of the Practical History of Financial Markets course at Edinburgh Business School and keeper of the Library of Mistakes, a library of financial markets history in Edinburgh.

1) Globally, total debt to GDP today is close to 200%. We've never seen that before. France is at 311%, the US at 255%, Japan at 400%. We are talking about at least a decade and a half to get this under control. For Japan and France it will take even longer.

2) There are only five ways out of a debt problem: Austerity, default, high real growth, hyperinflation or financial repression. The best one for all of us would be high real growth. To have that, you need a productivity revolution, we'd need to lift real growth to 3 or 4% per annum. Will AI deliver that? I doubt it. Look at the internet revolution: It has transformed the entire world, but it didn't boost productivity much.

There's an interesting book by my friend Alasdair Nairn, titled «Engines that Move Markets». He goes back to the railway boom in the 19th century, and he shows a very consistent pattern: When a new technology appears, it attracts huge amounts of capital. There is physical investment on a massive scale.

This inevitably leads to overinvestment, creating bad returns, and then the whole thing collapses. It's usually in the ruins of the first investment bubble where you can identify the truly productive uses of the new technology. Think of Amazon: Today, it's a clear winner of the internet age. But from 2000 to 2003, its share price fell by 90%. Will AI be different? I'm not smart enough to work that out. But I doubt it.

3) The most important part is the idea that national savings shall be used for national purposes. There will be a big push to repatriate capital, back to Europe and back to Japan, for example. The other part is that we need to understand how much of the current world financial system is based on China and its decision in 1994 to manage its currency against the dollar. After the 1997-98 Asian Financial Crisis, most Asian countries started to do the same thing. The result was an exponential growth in dollar reserves. These were all non-price-sensitive buyers of Treasuries and other US assets. This huge flow of capital has pushed interest rates down and equity prices up.

Today, 58.5 trillion dollars worth of American assets are owned by foreigners. Arguably, this system started falling apart in 2014, when global forex reserves peaked. It's now coming to an end, because it's not working for China anymore. China has reached the end of the rope,

both in terms of its total debt to GDP and also in terms of the rest of the world not willing to absorb China's overproduction anymore. Historically, every thirty or forty years monetary systems collapse. The current one, the one we have lived with since 1994, is collapsing in front of our eyes.

4a) China will separate from the rest. They will want to adopt a truly independent monetary policy, a policy that will need to be much looser in order for them to address their domestic economic problems and to inflate away their domestic debt. They would simply say the exchange rate is no longer a target. As a consequence of that, I forecast that their currency will fall.

4b) What about the financial system for the rest of the world?

It has to be a system that permits everybody to inflate away their debt. It has to be a system that allows inflation and a suppression of domestic interest rates through the use of national savings. Which means there will have to be forms of capital controls. In today's world, where most financial assets are held by institutions, capital controls can take the form of regulation. Think of your government regulator mandating all pension funds to buy a certain amount of government debt or other domestic financial assets. That's what national capitalism will look like.

5) As an investor, where should one invest now?

You shouldn't own any fixed interest securities. None. Inflating away debt means destroying the purchasing power of fixed income securities. There may be rallies, but fixed income is in a long bear market. Bond bull and bear markets move in about 40 year periods, and now we are into year 3 of the current bear market. You can lose a fortune in real terms over the long term. Therefore: No bonds. Period.

6) Gold is up 30% this year already, and I'd still want to own gold. It's the standout asset. I am talking about nothing less than a breakdown of the global monetary system as we've known it since 1994. When the Bretton Woods system broke down in 1971, gold went from \$30 to \$850 an ounce. All you know is when you get a structural breakdown in the global monetary system, gold will go up.

7) If we move into a world where every developed world savings institution has to repatriate assets to buy bonds of their own government, they will need to liquidate the one asset they have all crammed into in the past years: the S&P 500. Over the past years, all the world's institutional investors have crowded into large-cap US equities. If they are mandated to own domestic assets, they would be forced to sell US assets. So you would not want to own the S&P 500.

Because that's the asset that will be liquidated?

Yes. And it starts at a historically high valuation. The S&P 500 is excessively overvalued and over owned by foreigners who may be forced sellers.

What should you own then?

Equities that won't be liquidated, because they are not overly represented in the portfolios of institutional investors. The unloved, underowned assets: mid and small caps, as well as value stocks. Also, I'd look out for equities that benefit from the global capex boom. Japan offers many of them.

8) Let's assume we were in the year 2029 now. What would make you say that, in hindsight, you were completely wrong with your views?

If something happens to significantly elevate the real rate of growth. We have talked about AI, and I have shared my doubts. It could also be something that convinces us that we'll have super low energy prices forever. Who knows, maybe we can get there with these small nuclear reactors.

In a world where energy is effectively free, we could have a boost in real growth. It just seems unlikely, because the world is filling up with old people like me, and we are less productive. Read «The Great Demographic Reversal» by Charles Goodhart and Manoj Pradhan. It's the best book on the subject.