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13th October 2014

Ten problems, or just one ?

“Sir, The next financial apocalypse is imminent. I know this to be true because the House & Home section in FT Weekend is now assuming the epic proportions last seen before the great crash. Twenty-four pages chock full of adverts for mansions and wicker tea-trays for $1,000. You’re all mad.

Sell everything and run for your lives.”

- Letter to the FT from Matt Long, Seilh, France, 3rd October 2014.

“Investors unfortunately face enormous pressure—both real pressure from their anxious clients and their consultants and imagined pressure emanating from their own adrenaline, ego and fear—to deliver strong near-term results. Even though this pressure greatly distracts investors from a long-term orientation and may, in fact, be anathema to good long-term performance, there is no easy way to reduce it. Human nature involves the extremes of investor emotion—both greed and fear—in the moment; it is hard for most people to overcome and act in opposition to their emotions. Also, most investors tend to project near-term trends—both favourable and adverse—indefinitely into the future. Ironically, it is this very short-term pressure to produce—this gun to the head of everyone—that encourages excessive risk taking which manifests itself in several ways: a fully invested posture at all times; for many, the use of significant and even extreme leverage; and a market-centric orientation that makes it difficult to stand apart from the crowd and take a long-term perspective.”

- Seth Klarman, Presentation to MIT, October 2007.

“At first, the pendulum was swinging towards infinite interest, threatening the dollar with hyperinflation. Right now the pendulum is swinging to the other extreme, to zero interest, spelling hyper-deflation. This is just as damaging to producers as the swing towards infinite interest was in the early 1980's. It is impossible to predict whether one or the other extreme in the swinging of the wrecking ball will bring about the world economy's collapse. Hyperinflation and hyper-deflation are just two different forms of the same phenomenon: credit collapse. Arguing which of the two forms will dominate is futile: it blurs the focus of inquiry and frustrates efforts to avoid disaster.”

- Professor Antal Fekete, 'Monetary Economics 101: The real bills doctrine of Adam Smith. Lecture 10: The Revolt of Quality'.

"Low interest rate policy has the following grave consequences:

- Normally conservative investors are increasingly under **duress** and due to the outlook for interest rates remaining low for a long time, are taking on excessive risk. This leads to capital misallocation and the formation of bubbles.
- The sweet poison of low interest rates and easy money therefore leads to massive **asset price inflation (stocks, art, real estate).**
- Through carry trades, interest rates that are structurally too low in the industrialized nations lead to asset bubbles and contagion effects in emerging markets.
- A **structural weakening of financial markets**, as reckless behaviour of market participants is fostered (moral hazard).
- A change in **human behaviour patterns**, due to continually declining purchasing power. While thrift is slowly but surely transmogrified into a relic of the past, taking on debt becomes rational.
- The **acquisition of personal wealth** becomes gradually more difficult.
- The importance of money **as a medium of exchange and a unit of account** increases in importance relative to its role as a **store of value**.
- Incentives for fiscal probity decline. Central banks have bought time for governments. Large deficits appear less problematic, there is no incentive to implement reform, resp. consolidate public finances in a sustainable manner.
- The emergence of **zombie-banks and zombie-companies**. Very low interest rates prevent the healthy process of creative destruction. Zero interest rate policy makes it possible for companies with low profitability to survive, similar to Japan in the 1990s. Banks are enabled to nigh endlessly roll over potentially delinquent loans and consequently lower their write-offs.
- **Unjust redistribution (Cantillon effect):** the effect describes the fact that newly created money is neither uniformly nor simultaneously distributed in the population. Monetary expansion is therefore never neutral. There is a permanent transfer of wealth from later to earlier receivers of new money."

- Ronald-Peter Stöferle, from 'In Gold We Trust 2014 – Extended Version', Incrementum AG.

The commentary will have its next outing on Monday 27th October.

"When sorrows come," wrote Shakespeare, "they come not single spies, but in battalions." Jeremy Warner for the Daily Telegraph identifies ten of them. His 'ten biggest threats to the global economy' comprise:

1) Geopolitical risk;

2) The threat of oil and gas price spikes;

3) A hard landing in China;

4) Normalisation of monetary policy in the Anglo-Saxon economies;

5) Euro zone deflation;

6) 'Secular stagnation';

7) The size of the debt overhang;

8) Complacent markets;

9) House price bubbles;

10) Ageing populations.

Other than making the fair observation that stock markets (for example) are not entirely correlated to economic performance – an observation for which euro zone equity investors must surely be hugely grateful – we offer the following response.

- Geopolitical risk, like the poor, will always be with us.

- Yes, the prices for oil and natural gas could spike, but as things stand WTI crude futures have fallen by over 15% from their June highs, in spite of the clear geopolitical problems. And the US fracking revolution, in combination with fast-improving fundamentals for solar power, may turn out to be a secular (and disinflationary) game-changer for energy prices.

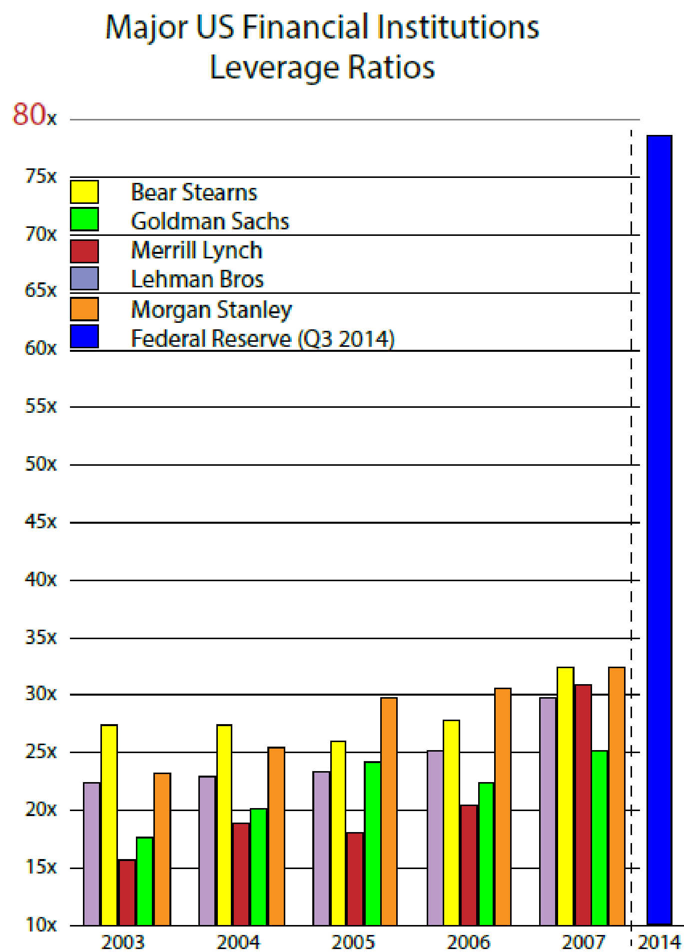
- China, however, is tougher to dismiss. If we had any meaningful exposure to Chinese equity or debt we would be more concerned. But we don't, so we aren't.

- Five of Jeremy Warner's 'threats' are inextricably linked. The pending normalisation of monetary policy in the UK and US clearly threatens the integrity of the credit markets. It's worth asking whether either central bank could possibly afford to let interest rates rise. This begets a follow-on question: could the markets afford to let the central banks off the hook ? Could we, in other words, finally see the return of the long absent and much desired bond market vigilantes ? That monetary policy rates are so low is a function of the growing prospect of euro zone deflation (less of a threat to solvent consumers, but deadly for heavily indebted governments). Absent a capitulation by the Bundesbank to Draghi's hopes or intentions for full-blown QE, it's difficult to see how the policy log-jam gets resolved. But since all German government paper out to three years now offers a negative yield, it's difficult to see why any euro zone debt is worth buying today for risk-conscious investors. Cash is probably preferable and gives optionality into the bargain. 'Secular stagnation' is now a fair definition of the euro zone's economic prospects. But all things lead back to Warner's point 7: **the size of the debt overhang**. Since this was never addressed in the immediate aftermath of the Global Financial Crisis, it's hardly a surprise to see its poison continue to drip onto all things financial. And since the policy response has been to slash rates and keep them at multi-century lows, it's hardly a surprise to see property prices in the ascendant.

- Complacent markets ? Check. But stocks have lost a lot of their nerve over the last week. Not before time.

- Ageing populations ? Yes, but this problem has been widely discussed in the investment community over the past two decades – it simply isn't new news.

We saw one particularly eye-catching chart last week, via Grant Williams, comparing the leverage ratios of major US financial institutions over recent years (shown below).



Source: Grant Williams, 'Things that make you go Hmmm…'

The Fed's leverage ratio (total assets to capital) now stands at just under 80x. That compares with Lehman Brothers' leverage ratio, just before it went bankrupt, of just under 30x. Sometimes a picture really does paint a thousand words. And this, again, brings us back to the defining problem of our time, as we see it: **too much debt in the system**, and simply not enough ideas about how to bring it down – other than through inflationism, and even that doesn't seem to be working quite yet.

In a recent interview with Jim Grant, Sprott Global questioned the famed interest rate observer about the likely outlook for bonds:

"What would a bear market in bonds look like? Would it be accompanied by a bear market in the stocks?

"Well, we have a pretty good historical record of what a bear market in bonds would look like. We had one in modern history, from 1946 to 1981. We had 25 years' worth of persistently – if not steadily – rising interest rates, and falling bond prices. It began with only around a quarter of a percent on long-dates US Treasuries, and ended with about 15% on long-dated US Treasuries. That's one historical beacon. I think that the difference today might be that the movement up in yield, and down in price, might be more violent than it was during the first ten years of the bear market beginning in about 1946. Then, it took about ten years for yields to advance even 100 basis points, if I remember correctly. One difference today is the nature of the bond market. It is increasingly illiquid and it is a market in which investors – many investors – have the right to enter a sales ticket, and to expect their money within a day. So I'm not sure what a bear market would look like, but I think that it would be characterized at first by a lot of people rushing through a very narrow gate. I think problems with illiquidity would surface in the corporate debt markets. One of the unintended consequences of the financial reforms that followed the sorrows of 2007 to 2009 is that dealers who used to hold a lot of corporate debt in inventories no longer do so. If interest rates began to rise and people wanted out, I think that the corporate debt market would encounter a lot of 'air pockets' and a lot of very discontinuous action to the downside."

We like that phrase "a lot of very discontinuous action to the downside". Grant was also asked if it was possible for the Fed to lose control of the bond market:

"Absolutely, it could. The Fed does not control events for the most part. Events certainly will end up controlling the Fed. To answer your question – yeah. I think the Fed can and will lose control of the bond market."

As we have written on innumerable prior occasions, we wholeheartedly agree. Geopolitics, energy prices, demographics – all interesting 'what if' parlour games. But what will drive pretty much all asset markets over the near, medium and longer term is almost entirely down to how credit markets behave. The fundamentals, clearly, are utterly shocking. The implications for investors are, in our view, clear. And as a wise investor once observed, if you're going to panic, panic early.

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13th October 2014.

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