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Blame Léon Walras

"Most economists, it seems, believe strongly in their own superior intelligence and take themselves far too seriously. In his open letter of 22 July 2001 to Joseph Stiglitz, Kenneth Rogoff identified this problem. "One of my favourite stories from that era is a lunch with you and our former colleague, Carl Shapiro, at which the two of you started discussing whether Paul Volcker merited your vote for a tenured appointment at Princeton. At one point, you turned to me and said, "*Ken, you used to work for Volcker at the Fed. Tell me, is he really smart ?*" I responded something to the effect of, "*Well, he was arguably the greatest Federal Reserve Chairman of the twentieth century*." To which you replied, "*But is he smart like us ?"*

- Satyajit Das on Naked Capitalism.

Satyajit Das in this highly entertaining review of credit crunch literature also quotes US humorist PJ O'Rourke, who described economics as an entire scientific discipline of not knowing what you're talking about. "One can only quibble with the word 'scientific'." Just how did the practice of economics end up in such a dead end ?

One plausible answer arises out of Eric Beinhocker's outstanding 'The Origin of Wealth' (Random House, 2007), which sets out to ask the questions: What is wealth ? How is it created ? How can we create more of it ? In short, blame Léon Walras. In what must surely be the obligatory preparation for becoming an economist, Walras started out by being rejected, twice, from the prestigious Ecole Polytechnique ***due to poor mathematical skills***. He then failed as an engineer, then failed as a novelist. He then spent several years struggling as a newspaper writer and a bank employee. The fact that he was French may not have been an altogether promising attribute either.

"One evening in 1858, a depressed Walras took a walk with his father, a teacher and writer, discussing what he should do with his life. [An objective and dispassionate investor from the early 21st century would have responded: end it.] The elder Walras, a great admirer of science, said that there were two great challenges remaining in the nineteenth century: the creation of a complete theory of history, and the creation of a scientific theory of economics.. Prior to Walras.. economics was not a mathematical field.. Walras and his compatriots were convinced that if the equations of differential calculus could capture the motions of planets and atoms in the universe, these same mathematical techniques could also capture the motion of human minds in the economy."

There was, as Captain Blackadder points out to Baldrick when explaining why the Grand Plan to prevent war in Europe ultimately failed, one tiny flaw in Walras' supposition about transposing the theories of physics onto what amounts to behavioural (i.e. psychological) finance. It was b*****ks.

One of the world's greatest ever scientists, Sir Isaac Newton, who lost his shirt in the investment mania of the South Sea Bubble, addressed precisely the same problem:

"I can calculate the motions of the heavenly bodies, but not the madness of people."

Warren Buffett once said that any rational, red-blooded capitalist, given the choice, would go back in time to Kitty Hawk and assassinate the Wright Brothers, on the grounds that from that day to this, in the entire history of aviation, no net money has actually ever been created. Individual airlines may from time to time have meandered accidentally into profit, but the industry as a whole has been a vast, ghastly, profitless swamp for shareholders. One might legitimately say exactly the same thing about poor Léon Walras. If economics had never become a discipline suffering from physics envy, in which erroneous and inappropriate models were applied to the micro and macro economy, we might never have had developments like subprime mortgages, CDOs, quantitative trading, credit ratings agencies, economists, economic forecasting, and the mother of all credit bubbles. But we are where we are, and we just have to make the best of it.

Where we are might not be a particularly happy place. In an interview with Fortune, strategist David Rosenberg suggests that we remain in a secular bear market, wherein rallies "are to be rented and not owned" and in which the prevailing market characteristic is "wrenching volatility". For proof of the latter, if it were needed, look no further than the performance of the hedge fund industry during May, where it looks as if no single strategy generated a positive return. Odey European is believed to have lost 11% during the month, and there are numerous other high profile casualties. That said, it also looks increasingly as if the hedge fund community and its marketers have managed to infantilize investors into believing that high returns are compatible with no losing months. The reality is surely that the financial world, beset not least by random political posturing and interference, and the longer term impact of an ongoing banking and fiscal crisis, is experiencing such profound stresses that the objective of meaningful positive long-run investment returns is simply unachievable without a measure of short-term negative volatility, and to believe otherwise would be dangerously naive.

David Rosenberg is asked whether, given that the Federal Reserve's balance sheet has risen from $850 billion in 2007 to $2.3 trillion today, runaway inflation is the inevitable outcome. The deflation / inflation debate remains the most pressing one in finance. Rosenberg's view:

"Ordinarily [the expansion of the Federal Reserve's balance sheet and the US monetary base] would be inflationary, but because banks are not relending that money, it has not been. In fact, overall credit is declining. If and when we embark on the next credit creation cycle – which is probably many years away – this monetary inflation will probably result in real inflation. But not until money moves off of bank balance sheets and into the real economy."

Rosenberg's asset allocation conclusion is extraordinarily defensive: 30% equities, 50% bonds, and 20% cash. But notwithstanding his views on inflation or the apparent lack thereof, Rosenberg also maintains a $3000 target for gold. This forecast is itself trumped by that of strategist Harry Schultz, who maintains a $6000 price target. Speaking to Peter Brimelow of MarketWatch, Schultz, addressing the deflation / inflation debate, suggests that

"We (collectively) are poised at a heart-stopping moment in economic times. On the one extreme side, the world is on the edge of massive deflation and depression. At the other extreme.. hyperinflation. My view is: both these extremes are possible. Certainly deflation is, on balance, in play today and gaining ground as money supply is actually declining ! Hyperinflation seems impossible when there is not much inflation in most economies. But.. hyperinflation is a monetary event, not an economic one, and will happen on an overnight basis, not via a general uptrend in inflation data."

Given the peculiarly bi-polar nature of the investment outlook, investors need, effectively, protection against both deflationary and (hyper-)inflationary forces. The extraordinary uncertainty warrants some form of portfolio compromise, as a hedge against what BP CEO Tony Hayward has referred to as "low probability, high impact" outcomes. The highest quality bonds cater to the former requirement, and gold caters to the latter. Beyond that, all is supposition. Economists may claim to have more precise answers but – in our view – since their discipline with its presumptions is partly the cause of the problem, it is unlikely that they will bring the solution.

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