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Waking up in a cold debt

"UK Probe Summaries May Damage Banker Reputations"

- Bloomberg headline.

It is difficult to see how bankers' reputations could possibly become more damaged. That would be like Hiroshima in August 1945 becoming more destroyed, or Nick Clegg in 2011 becoming more unpopular; it may not simply be possible. Perhaps the British Bankers Association should consider a merger with the English Collective of Prostitutes: that might make them look a little classier. Nevertheless, the world's most overpaid wealth destroyers are doing their damnedest to continue to court unpopularity, if the latest instalment of JP Morgan's bonuses is any guide. Meanwhile, Matt Taibbi, he of the infamous Goldman Sachs 'vampire squid' coinage, has returned to the fray with 'The Real Housewives of Wall Street' (caution: parental advisory). According to Taibbi, Christy Mack (wife of Morgan Stanley's John Mack) and Susan Karches (widow of Peter Karches, a Morgan Stanley president) made an upfront investment of $15 million that quickly earned them $220 million in cash from the US Federal Reserve, most of which would be used to purchase student loans and commercial mortgages. These loans were apparently established so that Christy and Susan would keep 100% of any gains, while the US taxpayer would eat 90% of the losses. So far, so bankerly. But the more Taibbi reveals about recent Fed purchases, the more surreal the picture becomes. We know the US administration stepped in to support the US domestic auto industry. But why buy securities of foreign carmakers, including BMW, Volkswagen, Honda, Mitsubishi and Nissan ? Or extend nearly $5 billion in cheap credit to Toyota and Mitsubishi ? Or extend billions in loans to the Central Bank of Mexico, the Korea Development Bank, and $35 billion in loans to the Arab Banking Corporation of Bahrain, whose major stakeholder is the Central Bank of Libya ? Colonel Gaddafi, per Taibbi, received more than 70 loans from the Fed. Has this mad institution suddenly become the ***Global*** Federal Reserve ?

If it were just the Fed determinedly stuffing magical money[1] down any and all supplicants' gullets, that would be bad enough. But there is an opposite, if not quite equal, mad money sink in operation, and it is the global banking sector. In its latest Global Financial Stability Report, the IMF suggests that some $3.6 trillion in maturing bank debt comes due over the next two years. Will indebted governments crowd out the banks ? Will indebted banks muscle their way to the front of the money queue ? Suffice to say, the stars are not so slowly moving into alignment for a global debt catastrophe of biblical proportions. Witness #1 for the prosecution: $3.6 trillion in bank debt cited above. That's chicken-feed for the likes of the Fed, but represents real money to the rest of us. There is going to be an unseemly scrum of debt rollovers competing for investor capital over the coming months. Not all will make it through the emergency exits intact.

[1]well, dollars.

Witness #2 for the prosecution: Pimco's Bill Gross. We knew that the bond tsar had liquidated every US Treasury holding in the $237 billion Total Return Fund. Now it transpires, according to Zero Hedge, that Gross is actually net ***short*** the Treasury market, with a -3% weighting. In his April investment outlook he wrote that

"[PIMCO has] been selling Treasuries because they have little value within the context of a $75 trillion total debt burden. Unless entitlements are substantially reformed, I am confident that this country will default on its debt; [but] not in conventional ways.."

No, you did not read that wrong: he really did say $75 trillion. As a public service to readers we offer up the next numerical values for US national indebtedness. (Much of the G7 is in the same boat, mind you.)

How do I measure thee ? Let me count the ways – future units of account for the US national debt

What used to be a big number	How the US national debt / Wall Street bonuses either have been or will shortly need to be measured, in dollars
$1 million	10^{6}
$1 billion	10^{9}
$1 trillion	10^{12}
$1 quadrillion	10^{15}
$1 nonillion	10^{30}
$1 novemdecillion	10^{60}
$1 centillion	10^{303}
$1 'goldmon'	10^{Googol}

Source: PFP Wealth Management, Wikipedia

It's a peculiarly riskless 'AAA' borrower that represents a default risk. But of course, when will the ratings agencies acknowledge the fact ? Or as Juvenal put it: quis custodiet ipsos custodes ? Which roughly translates as: when will the ratings agencies grow some guts ? As the US President himself acknowledged,

"If our creditors start worrying that we may be unable to pay back our debts, it could drive up interest rates for everyone who borrows money.."

Witness #3 for the prosecution: anticipated changes in global interest rates or, if you prefer, a dramatic shift to come in the secular interest rate cycle. The European Central Bank has already

rung the tiniest of alarm bells in a largely theoretical fight against inflation, with a small but significant quarter point rise as a hugely symbolic statement of intent. As a growing variety of goods, food and energy prices march higher, the Bank of the England and the Federal Reserve sit resolutely on the sidelines, attempting to talk down inflation but with zero real conviction of following through. Perhaps they should just abandon the pretence and adopt Long or Short Capital's CPI-F measure, or inflation ex-inflation. Policy rates may remain on hold given central bank venality and generalised incompetence. Bond market vigilantes may not be so patient.

So what's an investor with an enthusiasm for true capital preservation to do ?

Strategy #1: reduce exposure to bonds, and be very selective about which bonds you do decide to hold. For our money, in an insane world, the most creditworthy sovereign bonds are the only sane choice. And if you can earn 6%+ from a diversified portfolio of high quality sovereign bonds, and in a hard currency too like Swiss Francs or Singapore Dollars, so much the better.

Strategy #2: moderate exposure to equities, and be very selective about which equities you do decide to hold. Our favourite investible themes include Big Pharma, Big Oil, oil services / energy infrastructure, and consumer defensives with emerging market exposure.

Strategy #3: maintain exposure to genuine 'absolute return' funds – not an asset class, admittedly, but certainly a judgment call on the better asset managers with unconstrained investment mandates. Our favourite investments here: diversified systematic trend-following funds.

Strategy #4: real assets, notably gold and silver. But you probably knew that anyway.

And finally.. Readers who staggered backwards in amazement at some of the extraordinary things suggested by economists also staggered backwards in amazement at:

Why not print more money and lend it to the Government ?

Bertie Ahern shares his economic wisdom with Nigerians

Stop the financial markets ! They have become a facsimile of a particularly disconcerting Hieronymus Bosch painting, and some of us want to get off.

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