PFP
Wealth Management

3 Windsor Court
Clarence Drive
Harrogate, HG1 2PE
01423 523311

Lion House
72-75 Red Lion Street
London, WC1R 4FP
020 7400 1860

www.pfpg.co.uk

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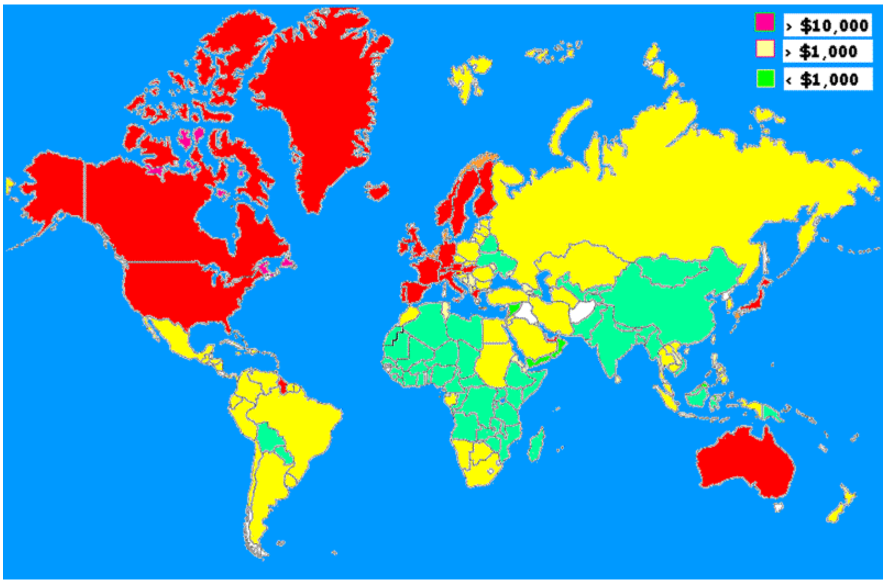
Fight the power

"Our constitutions purport to be established by 'the people' and, in theory, 'all the people' consent to such government as the constitutions authorize. But this consent of 'the people' exists only in theory. It has no existence in fact. Government is in reality established by the few; and these few assume the consent of all the rest, without any such consent being actually given."

- Lysander Spooner; hat-tip to Clive Hale.

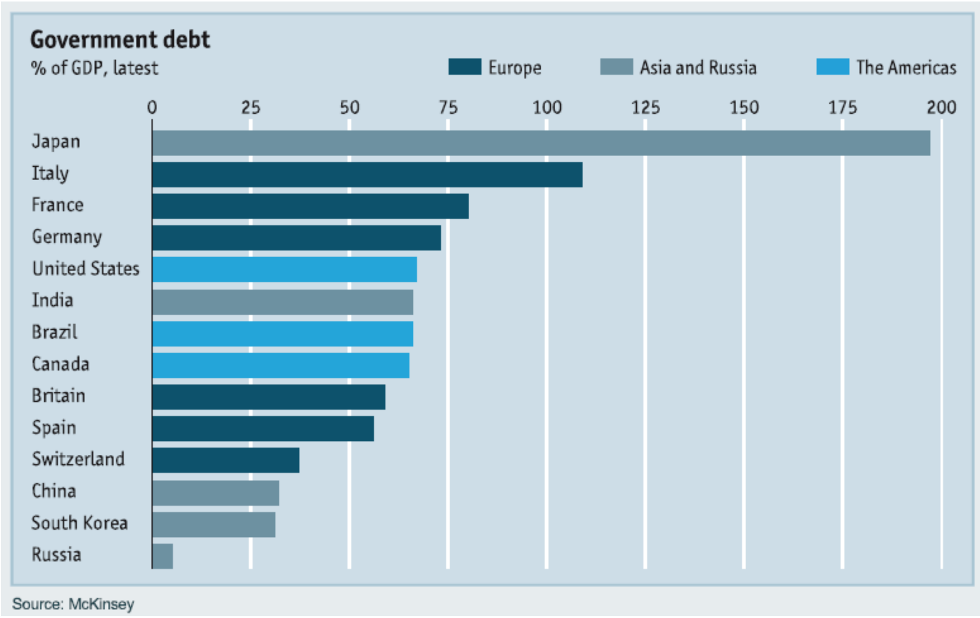
Like so many things, it comes down to context, perspective and interpretation (which degree might be more useful in the pursuit of rational investment management: Economics, or English ?). From a narrowly financial perspective, government debt is an asset class, albeit an asset class now offering vast potential for capital losses for the unwary. From a broader social perspective, government debt is taxation deferred, a burdensome claim on all our individual futures, a reflection of wealth to come being diverted from the private sector to the state and its putative political leaders. A simple 'heat map' of the world, in this case showing public debt per capita, reveals the fault lines quite explicitly:

Sovereign debt per capita, globally

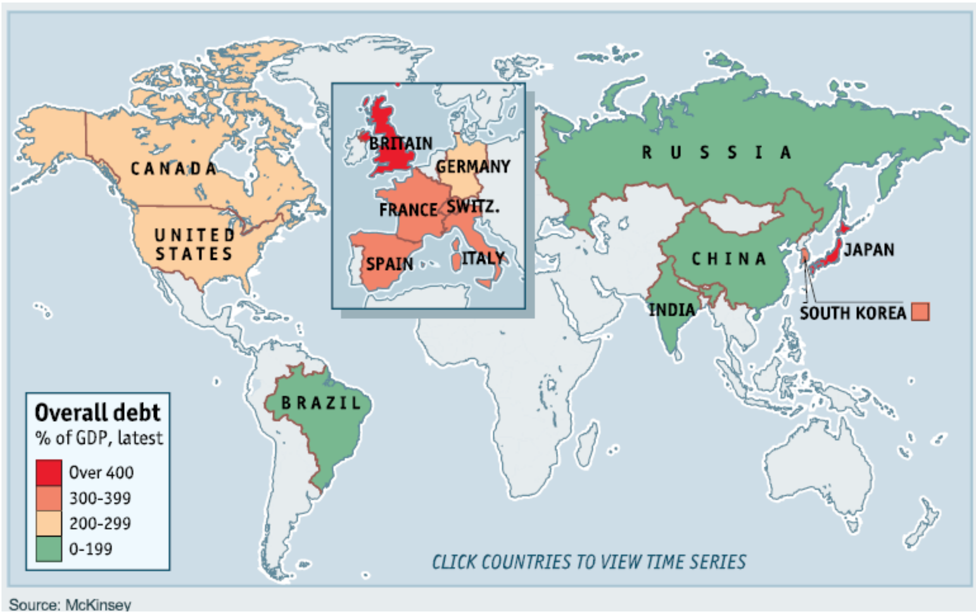


Source: Market Oracle

Not to put too fine a point on it, since the map clearly articulates the problem, the west is bust, or fast approaching it. The G7 nations (France, Germany, Italy, Japan, the UK, the US and Canada) are being crushed under a mountain of debt. Asia (notably *ex*-Japan) is, by comparison, in terrific shape. Express the problem in slightly different ways, and the culprits shift around a little, but the situation doesn't fundamentally change. Expressed solely in terms of government debt, via [The Economist](), and the picture looks like this:



Or express it in terms of overall debt (including consumer and corporate) and the culprits shift again, but the outlook remains largely the same:



However you slice the data, the G7 is a grossly indebted mess, and there are some standout sovereign debtors, including Japan and the UK. What makes the current situation so extraordinary is that there are simultaneously so many perilous sovereign entities wobbling on the edge of solvency, and yet financial markets – ***even in those same debt markets*** – seem to be in utter denial. Take North America. Even as its politicians squabbled last week over raising a debt ceiling of some $14.3 *trillion*, 10 year US Treasury yields fell below 3%. No sensible person believes the

US government's official inflation statistics, but even taking the consumer price index at face value (+3.2% year-on-year), investors are locking in negative real returns, before any consideration of the inherent credit risk.

Or take Japan. Japanese government debt stands at around the equivalent of $12 trillion, roughly 200% of GDP. Its demographics (for which not least read: the fundamental health of the future taxpayer base) are appalling; since the Japanese are a largely xenophobic people, there is little immigration; the country loses one million people a year. And yet 10 year Japanese government bonds yield just 1.1%. No need to worry, says the FT's Martin Wolf (who presumably doesn't own any), "The [Japanese] government's debt is a way for the Japanese to owe money to themselves.. The idea that the government confronts an imminent fiscal crisis strikes me as quite bizarre." Only if you play fast and loose with private property as opposed to state unaccountability.

But Europe is surely the most surreal debt circus in a world of debt circuses. It certainly has the most vocal clowns. In a recent interview with Der Spiegel, Jean-Claude Juncker, prime minister of Luxembourg and president of the Euro group, defended the fact that he lied about a secret meeting of EU finance ministers to discuss the Greek debt crisis with the following words:

"In light of the nervousness of the financial markets, it is difficult for us to keep the public adequately and correctly informed all the time."

But then Juncker also claimed that

"Greece is not broke. That is what the experienced experts[1] with the International Monetary Fund and the European Central Bank tell us.. The United States and Japan also have high debt levels, and yet no one would claim that those countries are bankrupt."

This is, of course, another lie. There is no shortage of financial commentators, this one included, willing to state quite explicitly that the US and Japan are already bankrupt, and what matters for investors is quite how this 'beyond the tipping point insolvency' will become manifest, over time, through the financial markets.

Just in the context of Greece, The Economist has nicely summarised the insoluble trap the country is in, in no small part courtesy of an intransigent European Central Bank:

Scylla, Charybdis and others

Options to solve Greece's debt crisis

Options	What it means	Pros	Cons
Fiscal transfers	Euro-area members give Greece money	Brings down Greece's debt burden. The ECB will not oppose it.	Impossible to sell openly to voters. May encourage profligacy.
Bail-out loans	Euro-zone members and IMF lend Greece more money	Buys Greece more time. The ECB will not oppose it.	Does not address solvency issue. New loan conditions may throttle growth. Official creditors gradually replace private creditors. Hard to sell to voters.
"Vienna initiative"	Banks "volunteer" to roll over holdings of Greek debts	Buys Greece time; does not leave taxpayers to pick up the bill; less likely to trigger ratings downgrade	Does not address solvency issue. Difficult to co-ordinate.
"Soft" restructuring or reprofiling	Creditors "volunteer" to extend maturities of existing debt	Buys Greece time; does not leave taxpayers to pick up the bill; may not be a credit event for CDSs	Does not fix solvency issue. Probably still means a ratings downgrade. The ECB doesn't like it.
"Hard" restructuring	Serious haircut on the the value of Greek debt	Brings down Greece's debt burden. Imposes immediate losses on private creditors.	Hurts Greek banks and risks wider contagion. Reduces reform pressure on Greeks. The ECB absolutely hates it.

Source: *The Economist*

[1]Of course, experts at the IMF may have experience in other areas than high finance.

The interviewer for Der Spiegel responded to Juncker's comments about the US and Japan by pointing out that those countries at least have control of their own currencies, which they can devalue. And of course that is exactly the path that the US has elected to follow.

Over the last two weeks, BBC 2 has been showing the latest documentary by Adam Curtis, 'All Watched Over By Machines Of Loving Grace'. The third and final episode is broadcast tonight. You can see each episode, for a limited period, on iPlayer. The latest series has much in common with a previous, award-winning, Curtis documentary – The Power of Nightmares (hat-tip to Arnaud G.), which compares the rise of neoconservatism in the US with the rise of radical Islamism, and suggests that the former massively overstated the threat of the latter for political purposes. In the current series, Curtis suggests that we have, by and large, welcomed digital technologies and social networks into our lives because they give us a (spurious) sense of enfranchisement from traditional politics and power relationships. He uses the example of Loren Carpenter.

In 1991, Carpenter, a Californian computer engineer, assembled hundreds of people in a giant building. They were each given an electronic paddle, but otherwise told nothing. Soon, a giant game of Ping Pong was projected onto a huge screen in front of them. Each invitee suddenly realised that, with their paddle, they could partially control the ball on the screen. Spontaneously, the crowd started playing a collective game of Pong.

"It was like a switch went in my head," says Curtis.

"Carpenter saw it as a world of freedom with order. But I suddenly saw it as the opposite – like old film of workers toiling in a factory. They weren't free – they looked like disempowered slaves locked to a giant machine screen. It was a video game, which made it fun, but it still made me wonder whether power had really gone away in these self-organising systems, or if it was just a rebranding. So we became happy components in systems – and our job is to make those systems stable."

The attempt to impose order on what would otherwise be a chaotic system is, realistically, the story of the financial crisis to date. Bankers and politicians maintained a naive faith in an easily manipulable financial order. Economists poured fuel on the fire by importing flawed and fundamentally inappropriate models from the world of the true sciences. In the second episode of 'All Watched Over..' Curtis highlights the flawed belief in a state of equilibrium in the natural world, which gave rise to all sorts of environmental wrongheadedness but still that same sense of man's hubristic triumph over the forces of nature.

In the years after the terrorist attacks of September 2001, Federal Reserve chairman Alan Greenspan took on some terrible risks, not least of inflation and economic instability, by cutting US interest rates to the bone. But those risks did not immediately materialise, and as Greenspan himself admitted, the absence of apparent inflation was curious. Everything seemed stable. In the words of Adam Curtis,

"It seemed that the system could manage itself, without direct political control. But it was an illusion. The reason for the extraordinary boom was the very opposite. It happened because of the vast exercise of political power, by an elite, thousands of miles away on the other side of the world. The Asian countries, led by China, had decided that never again would they put themselves at the mercy of America and her financial elites, as had happened two years before [in the Asian crisis that preceded the fall of Long Term Capital]. So the Chinese Politbureau created a system to manage America. They deliberately held their currency's exchange rate at a low level – this meant that their exports were cheap. And Chinese goods flooded into America. And to pay for them, American dollars flooded into China. But instead of spending the money on their population, the Chinese leaders immediately lent the money back to America, by buying government bonds. It was a perfect system, of cheap goods and cheap money flooding into America – all controlled by the Chinese Politbureau. And it was this that created the stability."

But as we now know to our cost, that stability was also illusory. The dramatic and quite possibly terminal explosion in western government debt levels was triggered by the decision to bail out rotten banks. As Curtis also points out, the price of the bailouts was paid by ordinary people, not by the financial elites who were largely responsible. Despite the illusion of a flat, ordered, non-hierarchical culture, power remains concentrated in a tiny subsection of the populace. "The power of politicians has been taken by others, by financial institutions, corporations. After the crash, the elite used politicised power to rescue themselves."

When the problem is too much debt, there can only be three solutions. One is austerity, and as the UK (and Greece, and Ireland..) is finding to its cost, it is difficult to cut your way back to growth. One is outright default, which is politically unpalatable (though may still be inevitable) given the extent of debt in today's world. The third option is inflation – default by stealth, in other words. Even now, given the deflationary headwinds, it is by no means clear whether the west resolves its debt mountain by Options 1, 2 or 3. Perhaps we get all three. What is clear is that in protecting the interests of a narrow financial elite, our politicians are lying to us about the reality. The best protection against the Scylla of debt deflation and the Charybdis of potentially serious inflation or hyper-inflation ? Probably no single approach. Our suggested resolution is a pragmatic mixture of high quality sovereign debt; systematic – and by definition non-discretionary – trend-following funds; gold; and an absolutely conservative allocation to equities. A sequence of debt market dominoes seems primed to topple. Aim not to be underneath them.

Tim Price
Director of Investment
PFP Wealth Management
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Email: tim.price@pfpg.co.uk Weblog: http://thepriceofeverything.typepad.com

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